Responses to ORR’s October 2022 consultation on outstanding matters in the Schedule 8 performance regime

OFFICE OF RAIL AND ROAD

Response to ORR's consultation on outstanding matters in the Schedule 8 performance regime

This pro-forma is available to those that wish to use it to respond to our consultation. Other forms of response (e.g. letter format) are equally welcome.

Please send your response and any queries to performance.incentives@orr.gov.uk by 9 January 2023.

About you

Full name: Steve Longmore

Job title: Head of Performance

Organisation: CrossCountry

Email*: [redacted]

**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

- On Schedule 8, we are proposing to insert new clauses into Schedule 8 for operators that will be contracted by Great British Railways. If triggered in the event of legislative change, these clauses could remove the majority of requirements for Schedule 8 payments for these operators.
    - Would not oppose the clause being inserted, however for CrossCountry we would need some comfort that a robust mechanism was in place in to recalibrate benchmarks for performance minutes and the payments rates as and when this occurred. A vast majority of passenger lateness is the responsibility of Network Rail and other

operators, we would need to understand of those operators contracted by GBR and therefore excluded from schedule 8 payments, would that mean they are excluded from the 'star model' and therefore any compensation payable. In some respects COVID is a perfect way of demonstrating this, passenger lateness decreased, however the performance benchmarks remained unchanged which led to a huge swing in payments from CrossCountry to Network Rail.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

- We are also proposing an approach to add flexibility to Schedule 8 in CP7.
    - Would welcome it, benchmarks and payments rates cannot be immovable for an entire Control Period, they need to be fluid so that schedule 8 reflects a more accurate and changing operating landscape.

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Sent via email to performance.incentives@orr.gov.uk

6 January 2023

Dear Sir/Madam

Response to ORR's consultation on outstanding matters in the Schedule 8 performance regime – East West Railway Company response

Introduction

Thank you for giving East West Railway Company (EWR) the opportunity to contribute to the consultation on issues pertaining to questions posed by ORR in its PR23 October 2022 consultation on Schedules 4 & 8.

EWR note that ORR does not pose any consultation questions relating to Schedule 4 but does set out more decisions on this regime.

About East West Rail

East West Rail is a nationally significant railway project which aims to deliver much-needed transport connections for communities between Oxford and Cambridge by:

- Upgrading an existing section of railway between Oxford and Bicester
- Bringing back a section of railway between Bicester and Bletchley
- Refurbishing existing railway between Bletchley and Bedford
- Building brand new railway infrastructure between Bedford and Cambridge

EWR, therefore, has a strong interest in how the trains that will operate on this new railway will deliver the reasonable performance expectations of passengers.

EWR recognises that performance is an important driver of passengers' satisfaction with the railway, along with the number of train journeys that can be delivered and the cost of operating the railway. Therefore, EWR considers that the railway should strive to deliver performance that is consistent with the railway's funding. We consider that partnership working between infrastructure managers and train operators is a good way to deliver such performance.

EWR recognises that Schedule 8 has historically been seen as an important tool to try and encourage delivery of appropriate levels or performance, but consider that its formulation and operation should ideally reflect the real economics of each part of the railway. Specifically, if train operators are not exposed to revenue risk from performance, Schedule 8 should reflect this so as not to produce potentially inappropriate money flows.

In extremis, exposing train operators to Schedule 8 who are not subject to revenue risk could weaken partnership working. With this in mind, we respond to each of ORR's questions posed in its consultation.

EWR response to each of the six ORR consultation questions

1. ***Do you agree with ORR's proposal to insert new sub paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR contracted operators if the required legislative change is implemented?***

EWR agrees with ORR that new text is required to be included into Schedule 8 of Track Access Contracts to deal with the potential ramifications of legislative changes relating to this mechanism. Specifically, we agree that if new legislation leads to GB-contracted operators no longer requiring a regulated performance regime, then it would seem inappropriate for ORR to retain Schedule 8 money flows in such circumstances.

However, we encourage ORR to ensure that its proposed drafting for such new text within Schedule 8 and within any framework for how ORR will act if such a legislative change occurs affords as much certainty as possible for the operation of Schedule 8. Without reasonable clarity as to how ORR will act in these circumstances, we consider, there could be unnecessary uncertainty for DfT, GBR, and train operators which could increase the risks faced by these parties.

2. ***Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?***

We recognise that the ORR's interpretation of existing railway legislation is such that it considers it is not consistent with the law to remove GBR contracted operators from the scope of Schedule 8. However, railway legislation may change to remove the requirement to have a regulated performance regime. Therefore, we consider that ORR should 'future proof' its PR23 determination to allow the possibility of the removal of Schedule 8 where contracts with train operators do not expose them to revenue risk. Absent such mechanisms, it seems to us that the ORR could end up inadvertently complicating contractual matters between a contracting body and a train operator.

Should new railway legislation include other infrastructure managers within the same exclusion currently being contemplated for GBR from the requirement to have a regulated performance regime, it would seem reasonable for ORR to consider any implications for

Theoretically it seems reasonable that Schedule 8 should be turned off where train operators are not subject to revenue risk within their contracts and should ideally only apply when a train operator is exposed to revenue risk. We recognise that non-GBR train operator contracting bodies can create contracts that remove Schedule 8 money flows through back-to-back arrangements, where Schedule 8 is incompatible with the contracts created between themselves and train operators. However, this can create unnecessary complexity and contractual contortions.

3. ***Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?***

EWR notes that Paragraph 2.14 of the ORR consultation has four bullet points identifying factors that ORR proposes would need to be satisfied before it would exempt GBR operators from Schedule 8. These are repeated, below:

- *consider whether the 2016 Regulations had indeed been amended in such a way as to allow the removal in Schedule 8 of the requirement for the majority of financial payments between GBR and its contracted operators;*

- *need to be satisfied that developments in rail reform and changes in industry structure meant there was sufficient justification to remove the operators from exposure to the majority of Schedule 8 payments;*

- *need to be satisfied that there were reasonable incentive structures in place for GBR and its contracted operators (for example through financial performance incentives set by GBR for its operators) to minimise disruption for passengers and freight customers across the whole network; and*

- *be satisfied that there was no reduction in the financial protection offered through Schedule 8 to non-GBR operators such as freight and open access ('third-party operators') that remained fully exposed to payments under Schedule 8.*

EWR encourages ORR to consider whether these criteria may be too broad and could afford ORR with too much discretion in implementing what would be revised legislation passed by parliament – especially bullet points 2 and 3.

EWR considers that it may be appropriate for opt outs from Schedule 8 to apply automatically if the railway legislation has been revised to exempt GBR commissioned operators from Schedule 8, with Schedule 8 continuing for open access, freight, and other third-party operators if their arrangements have not also been affected by changes in legislation.

ORR will have a key role overseeing GBR's future performance and would hold considerable powers to hold GBR's performance to account even if Schedule 8 no longer applied to GBR

Therefore, EWR encourages ORR to consider whether bullet points 2 and 3 are necessary. We would welcome discussing this with ORR, if it considered this helpful.

4. ***Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?***

EWR is mindful of the extreme difficulty in creating accurate forecasts of performance and payment rates for five years, especially given the uncertainties concerning both the present and future patronage – especially as the railway continues to recover and adjust to a post-COVID world.

Therefore, we agree with this proposal. However, we consider the hurdle for any such recalibration should be such that it is not unduly difficult to trigger. In addition, we consider that there should be as much transparency as possible as to when a recalibration will take place so as to afford stakeholders as much certainty as possible.

5. ***Do you think that this should be a feature of each of the passenger, freight and charter regimes?***

Yes. Absent including this feature in all Schedule 8 regimes, there seems to EWR to be a risk of inappropriate payments arising.

6. ***Do you have any views on the circumstances under which such a power should be used?***

EWR agrees that ORR should produce a guidance note on the circumstances in which a Schedule 8 reopener would ‘trigger’. Absent such a note, we consider that there could be too much uncertainty on the matter during CP7 to the detriment of parties subject to Schedule 8.

The absence of a guidance note could also lead to too much uncertainty as to how ORR could apply the reopener once it is triggered. This could lead to undue uncertainty for those subject to Schedule 8.

EWR would encourage ORR to consider setting out, ex ante, triggers that would lead to the reopener applying. For example, if outturn performance levels were to vary by more than 10% from benchmarks, the reopener could be applied. Another example of a potential trigger could be a 10% variation in annual passenger levels compared with those assumed in the PR23 recalibration. Applying the reopener in these sorts of circumstances should reduce inappropriate money flows and the associated uncertainty faced by parties subject to Schedule 8. In addition, this should mitigate the risk of distortion of incentives from Schedule 8.

EWR would welcome the opportunity of discussing our feedback with ORR. We are content for ORR to publish our response.

Yours sincerely

Richard Perrin
Contracts Executive, East West Railway Company

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Please send your response and any queries to performance.incentives@orr.gov.uk by 9 January 2023.

About you

Full name: Andy Wylie

Job title: Head of Regulation

Organisation: FirstGroup

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR’s proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to ‘switch off’ the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR’s contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

We agree with the proposal to insert the required paragraphs into Schedule 8 for DfT/GBR contracted operators only.

We support the “switch back on” ability in 12.5, should moving operators back into revenue risk requires Schedule 8 to be re-instated.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

The proposal to allow the ORR to initiate a mid-control period recalibration is welcomed, as it preserves the integrity of the star model by helping prevent a large amount of Paragraph 17 work being carried out at different times in the Control Period.

However, we wish to see the existing Paragraph 17 drafting effectively retained “as is” to enable further adjustments to take place, should individual TOC/FOC circumstances require them to take place.

We feel the proposed mid-control “enabler” should be a feature of the Schedule 8 for each type of operator, again to preserve the integrity of the star model principle.

The policy guidance on the circumstances that require a mid-control recalibration is awaited with interest but, to provide clarity to all parties, we would expect that the ORR uses its national data to both establish and publish the required thresholds.

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About you

Full name: Peter Graham

Job title: Head of Policy & Regulatory Affairs

Organisation: Freightliner Group

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR’s proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to ‘switch off’ the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR’s contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

Freightliner recognises that although any ‘switching off’ of Schedule 8 would likely only apply to GBR contracted operators, introducing such an arrangement could weaken the incentivisation properties of Schedule 8 for those operators remaining in the regime. The Schedule 8 regime plays an important role in incentivising the infrastructure to minimise unplanned disruption to freight operators. It also incentivises freight operators to make investments to improve performance and outperform their benchmarks thus supporting a high performing railway, as well as providing a mechanism to recover the costs of delays caused to other operators.

Such a performance regime will arguably become more important post Rail Reform. When most passenger operators are vertically integrated into the infrastructure manager, there is a risk that GBR will prioritise its contracted services over non-GBR contracted operators. Therefore, a balancing incentive to drive positive behaviours, like Schedule 8, becomes even more important.

We understand that the GBR-TT Commission is currently considering potential performance regimes that could be introduced post-Reform, but to date only limited information has been provided. The introduction of multiple different performance regimes could potentially make it more difficult to establish a cross-industry approach around performance targets and performance incentives. It is essential, where there are multiple different performance regimes operating, that they all point in the same direction and focus on the same outcomes. Without absolute alignment between the regimes, the incentivisation properties of Schedule 8 in the freight regime risk being dampened.

Should any 'switching off' be introduced, it should be limited to GBR contracted operators. The reform of the railways amplifies the need for a strong performance regime for operators, like freight operators, which continue to bear revenue risk for the services that they run and sit outside the GBR tent. There is a risk that the vertical integration of passenger operators into GBR could result in greater disruption to freight services, as GBR seek to minimise disruption and prioritise their own services. We would not support any 'switching off' for freight operators, as contemplation of such a scenario would send the wrong the signals about the importance of a strong performance regime post-reform.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

Freightliner recognises the motivation for incorporating greater flexibility into the Schedule 8 regime by permitting a mid-control period recalibration of parameters. The inability to change the parameters following the initial wave of the COVID-19 pandemic meant that the regime was operating outside of its calibrated parameters for much of 2020/21. In fact, the absence of a regulatory mechanism to alter the regime, meant that Schedule 8 was suspended for a few periods in early 2020. Establishing a mechanism and agreed process to re-open the calibration to address any such future exceptional situation is therefore welcome.

It is important though that any mid-control period recalibration is reserved for exceptional scenarios. There must be agreed triggers that would give rise to the possibility of a re-opener. Any re-opener should only adjust for external factors and importantly should not reward poor performance, nor penalise good performance.

To do so would create significant instability in the regime and consequently reduce the incentive properties, undermining confidence around investments.

Exceptional swings in traffic levels, far beyond those foreseen in the Network Rail business plans, could be one such trigger for a re-opener. This was of course the scenario with the COVID-19 pandemic.

Any recalibration of Schedule 8 following the re-opener must apply equally to the operator and infrastructure manager sides of the regime and therefore not affect the gearing of Schedule 8. It is also important that such a re-opener is responsive to the changing environment and does not result in a lag being created that could worsen outcomes. For example, a re-opener that is applied only based on the prior year's traffic levels would create a lag and risks a see-sawing of the regime.

Using the initial wave of COVID-19 as an example, the reduction in mileage in 2020/21 could likely have triggered an adjustment to the benchmarks and payment rates in the following year. However, in 2021/22 network mileage had largely bounced back, meaning that a further re-opener would be required in 2022/23 to adjust for the subsequent increase in mileage.

If the rationale for the introduction of a re-opener is to address exceptional events, like the COVID-19 pandemic, then it is important that the re-opener is responsive to the operating environment. Was it to incorporate a lag, it would likely risk swings in the regime and exacerbate the period of time that the regime is operating outside its calibrated parameters.

While it is important that re-opener applies equally to the infrastructure manager and operator sides of the regime, it should also retain the ability to re-open all necessary parameters and not be limited solely to the benchmarks. For instance, during the initial wave of the pandemic, the payment rates remained calibrated on a much higher assumption of passenger numbers and therefore were too high for the operating environment. Furthermore, on the assumption that the Network Rail Benchmark is aligned to its regulatory performance target, the re-opener also needs to be able to re-open the performance target itself. Without being able to re-open FDM (or equivalent performance target), the ability to recalibrate the Network Rail Benchmark will be limited, as to do so would mean that the benchmark would no longer be aligned to the regulated performance target.

Response to ORR's consultation on outstanding matters in the Schedule 8 performance regime

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About you

Full name: Daniel Matthews

Job title: Head of Performance

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

GBRf believe the schedule 8 regime to be an important tool to ensure both NR and operators take seriously their performance obligations.

GBRf do not object to the above proposals, as long as none of the benchmarks and rates for freight operators are affected.

GBRF do have concerns around removing incentives for Network Rail. Currently, with all operators in the regime, NR have a large financial penalty for poor performance, this financial penalty will be greatly reduced if the majority of operators are removed from the regime.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

Broadly speaking GBRF do not agree with the proposal for mid-control period recalibration of schedule 8.

The schedule 8 regime encourage good practice from operators and infrastructure suppliers, the importance of these should not be diluted by constant recalibration.

The current methodologies (and levels of compensation) are fully integrated into contracts that GBRf hold with many of its customers and suppliers.

Consistent, stable and predictable access to the network (Including the cost of that access) is key to freight operators being able to grow new markets in rail freight distribution, allowing the government to meet green agenda targets.

There could be an argument around “catastrophic” events (Such as COVID19) but there would need to be clear targets that would trigger a discussion on mid period recalibration to take place.

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About you

Full name: Chris Brandon

Job title: Head of Business Development & Programmes

Organisation: Grand Central Railway Company

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Do you agree with ORR’s proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to ‘switch off’ the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR’s contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

Open Access Operators and those operators who remain exposed to financial risk will continue to require schedule 8 to remain in place in order to reduce their exposure to losses that arise from cancellations and delays outside of their control, alongside incentivising them to minimise their own performance impact across the network. We would therefore agree that the sub paragraph should only apply to GBR contracted operators.

We support the ORR’s position that would only allow elements of the Schedule 8 regime to switched off if it was satisfied that other reasonable incentive mechanisms were in place. It is not clear at this stage what these incentive mechanisms would look like, however they must seek to deliver at least the same level of incentive as now in order to ensure all operators have equivalent drive to improve performance.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

Open access operators face full exposure to Schedule 8 and therefore we would support the additional flexibility to adjust parameters at a mid-control period recalibration in the event of a material change in circumstances.

The recalibration work for CP7 has now commenced and we recognise that the recalibration period chosen by ORR provides the most recent information available but also note the difficulties in finding an appropriate period which will be representative of CP7 performance and revenue levels due to the evolving nature of the railway as it continues to recover from the impacts of Covid related restrictions and ongoing strike action.

We recognise the provision under paragraph 17 of schedule 8 which allows operators and Network Rail to request updates to their schedule 8 parameters, but an option for the ORR to initiate a recalibration demonstrates recognition of the uncertainty and potentially avoids a series of operators making requests under paragraph 17 which could be challenging to manage.

Given the ORR’s proposal to limit updates to the parameters in Appendix 1 with particular focus likely on benchmarks and payment rates we would expect significant changes in circumstances to focus on service levels, demand and revenue with appropriate thresholds identified.

It is not clear from the consultation how and when a mid-control period recalibration would be triggered. For example, would the relevant factors be monitored throughout the control period, or would an annual test be undertaken to check whether relevant thresholds have been met. An annual test may provide an appropriate frequency to ensure operators are not over exposed to volatile payment flows. As mentioned in the consultation the proposal would not seek to recalibrate on the basis of short run impacts and therefore the test will need to include an element to confirm that that the change in circumstance is a long run effect.

It is also not clear how a mid-control period recalibration would be funded if it was to be undertaken to the same level as at the start of a control period. If the proposal is taken forward any guidance on what would trigger a mid-control period recalibration should include proposals on how this would be funded.

The consultation discusses a mid-control period review, however, specifically on the East Coast Mainline (ECML) we are aware of significant changes (implementation of ESG timetable and Operational Migration Overlay for East Coast Digital) which could have a significant impact on performance and will be implemented around or just prior to the start of the control period. We appreciate that the current recalibration is ongoing, however on the basis of the data currently being used we would suggest consideration needs to be given to this as early as possible following the start of CP7.

Whilst the consultation confirms ORR would not be looking to initiate a recalibration in response to a ‘shock’ that was likely to be short lived, we would like to draw the ORR’s attention to the experience of Open Access Operators during the pandemic when passenger demand was catastrophically reduced and there was a significant reduction in service levels.

When operating services during the pandemic the schedule 8 regime continued to operate as in a pre-pandemic world and saw some extremely volatile payment flows, which clearly did not reflect the circumstances at the time. Whilst we are aware a number of local arrangements were put in place with Network Rail, this was an industry wide impact. Whilst we do not anticipate such a significant shock event again, we would welcome some consideration of how this could be dealt with should such a situation arise in the future. For example, for a short run shock impact could a mechanistic approach to adjusting schedule 8 parameters be applied as a temporary intervention. Alternatively, Network Rail has worked with operators in the past on Schedule 8 overlays. Given the exposure of both Network Rail and Operators to such shocks, further support for overlays in such circumstances with a clear recognition they are a temporary measure to address the volatility of payments could provide a sensible approach.

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About you

Full name: Darren Gay

Job title: Track Access Contract Manager

Organisation: Govia Thameslink Railway Limited

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

GTR believe the future arrangement should have maximum flexibility as the position evolves particularly around revenue share. GTR would propose a new parameter in the Schedule 8 calculation, which outlines exposure to Schedule 8 from switched off for GBR-contracted operators to fully switched on for non GBR-contracted operators. Such an arrangement would allow a specified level of performance protection for any future exposure to revenue risk.

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

No, they should be industry wide. We believe that the proposal should be future proofed to allow maximum flexibility if circumstances change and this is agreed by all parties.

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

No other than the above and the need to remain agile in case the structure changes.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Yes as long as the change is material (and this could be determined against an agreed materiality test of some sort) and the scope is pragmatic and limited to just those areas most affected (I.e. performance/revenue) setting the impact against the recalibration cost, as well as industry time and effort. The CP7 recalibration should aim to take account of as much of the emerging position (at Apr'24) as it reasonably can to attempt to avoid this repeat exercise.

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

All three, but criteria for triggering could well be different. They are not independent of each other so need to consider impact of not changing all regimes together.

Do you have views on the circumstances under which such a power should be used?

When it can be shown that the regime is significantly out of balanced using some pre-defined measures.

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About you

Full name: Sam Berry

Job title: External and Government Affairs Manager

Organisation: Heathrow Airport Limited

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Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

For open access, freight and other operators that do not opt for the 'switch off' we need assurances that NR/GBR have the right incentives in place to manage performance on the network including for GBR-contracted operators. Heathrow requires to see the detail of how GBR will manage the performance of GBR-contracted operators and that fairness is still applied to non GBR contracted operators.

In short, it is not immediately apparent why these paragraphs apply only to GBR's contracted operators. Heathrow would therefore have to review the applicable legislation and the drafting of the ORR notice before concluding on its effectiveness.

Again, whilst we understand the approach, Heathrow requires assurances that GBR will still manage the performance of GBR contracted operators, and visibility of the changes in legislation and the ORR notice must be provided.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

It may be appropriate for a mid-control period recalibration during CP7 if uncertainties about the recovery from the pandemic mean that the parameters turn out to be inaccurately determined.

However, this should only be done if clear benefits to the industry can be demonstrated and clearly justified by a material change. In turn, the power should not be introduced in response to a shock likely to be short lived or that has a limited effect.

If the proposal were to be implemented, it would need to apply to all operators and their regimes. The circumstances would also need to be outside of NR/GBR and the operators' control and something unforeseen at the recalibration, prior to the start of CP7.

Sheen Mathew
Finance & Performance Manager
Merseyrail

Will Holman
Head of Incentives and Reform
Office of Rail and Road

13 January 2023

Dear Will

Schedule 8 conclusions and outstanding consultation: Merseyrail response to ORR consultation on a mid-control period recalibration

The purpose of this letter is to respond to the Office of Rail and Road's (ORR) technical consultation "PR23 - Review of Schedules 4 & 8: Conclusions and consultation on outstanding matters", issued on 20 October 2022 on behalf of Merseyrail.

Please note that this response is in respect of ORR's consultation questions on its proposal to initiate a mid-control period recalibration.

Context

ORR are currently in the process of recalibrating the Schedule 8 regime's parameters for CP7. To do this, ORR have proposed to recalibrate parameters based on a recalibration data period covering P8 2021/22 to P7 2022/23.

We recognise that the recalibration period chosen by ORR provides the most recent information available and that it is difficult to find a recalibration period that would be representative of performance in CP7. However, we also are cognisant that the chosen recalibration period may not provide an accurate predictor of CP7 performance and revenue levels due to the evolving nature of the railway as it continues to recover from the impacts of Covid related restrictions and ongoing strike action.

Therefore, Additional flexibility to adjust the regimes parameters during CP7 would provide some comfort that NR and operators would not face significant financial uncertainty as a result of initial CP7 parameters being set at a level which is not representative of actual performance and/or revenues.

Relevance to Merseyrail

Additional flexibility to adjust the regime's parameters during the control period is of particular importance to Merseyrail where the operator (or their funder) faces full exposure to Schedule 8.

To provide assurance that the regime remains fit for purpose we believe that more frequent updates to Schedule 8 parameters may be necessary, depending on circumstances within CP7.

Our view is that more frequent updates to the regime may be required both prior to and during the control period. Extensive changes prior to 1st April 2024 are likely to have an impact on Merseyrail's performance and revenues, potentially requiring a recalibration at the start of or very early on in CP7 – something which ORR should factor into its policy decisions on recalibrations.

We would not want to limit any change to a single, mid-CP recalibration. This will be too late for many operators, if significant financial flows are being generated inappropriately through Schedule 8. Our preferred approach is therefore to update the regime's parameters annually in a mechanistic way, if certain criteria are met. Criteria could include a change in revenue that is significant and/or a significant change in traffic levels above a pre-determined threshold. It is also important to be able to consider forthcoming Supportchanges that can have an impact on either revenue/traffic levels and act pro-actively. If this doesn't seem practical enough , we propose to consider the possibility of applying the changes back dated with a view to ensure parties involved do not suffer financially.

We see merit in ORR reviewing its criteria against outturn on an operator-by-operator basis, allowing mechanistic changes for the operator's where pre-determined thresholds have been met. This would ensure that the parameters are based on the latest evidence without having to undertake significant, costly work to wholescale recalibrate the regime.

Additional comments

Alongside proposals to update the regime more flexibly and frequently, we also consider it prudent for ORR to set out how it plans to deal with any external shocks that arise in CP7. Given the exposure of NR and operators to such shocks, it is important to us that they are dealt with swiftly to avoid large perverse payment flows as was seen during the Covid pandemic.

Conclusion

As outlined in this letter, we have concerns around ORR's proposal to initiate a one-off mid control period recalibration of Schedule 8 given the difficulties associated with ORR's chosen recalibration period. We would welcome additional flexibility to update the regime more frequently, if appropriate, and ask ORR to consider this proposal when concluding on this matter later in the year.

We welcome further engagement with ORR on this matter and look forward to continued conversations.

Yours Sincerely

Sheen Mathew

performance.incentives@orr.gov.uk
Office of Rail and Road
By email

James Linley
63 St Mary Axe
London
EC3A 8NH
09th January 2023

To Whom it may concern

Re: PR23 – Review of Schedule 8 Conclusions and Consultation on Outstanding Matters

Thank you for the opportunity to address the questions on the outstanding matters for Schedule 8 in CP7 posed by ORR. MTREL is pleased to provide its response to each as follows:

1) *Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?*

- Although the proposal to insert new paragraphs into Schedule 8 is preferable to the proposals of the GBRTT, MTREL does not agree with the proposal.
- Switching off payments whether partially or entirely removes or significantly impairs the incentives to ensure all parties to mitigate or address performance issues. MTREL's operating concession has a pass-through arrangement to ensure that Schedule 8 payments reaches the party which exposed to that risk whilst simultaneously maintaining incentives on all parties to deliver performance. MTREL continue to pay NR to compensate other affected operators through the star model, which provides incentivisation to minimise and mitigate performance impacts to other operators. The new proposal creates a two-tier system whereby non GBR operators will continue to pay whilst the GBR operators will no longer be required to.

2) *Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?*

- All operators should continue to be fully incentivised as outlined above.

3) *Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?*

- Given the uncertainty of the start of GBR, MTREL agrees it is sensible to undertake only limited changes to Schedule 8 for CP7. The ability to withdraw mtr Elizabeth line

or revoke these amendments is also a sensible approach to allow for further potential changes with regards to revenue risk.

Consultation questions

4) *Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?*

- Yes. The current Paragraph 17 provisions have proved wholly inadequate given that both infrastructure manager and operator must agree when in almost all foreseeable circumstances this is unlikely.

5) *Do you think that this should be a feature of each of the passenger, freight and charter regimes?*

- Yes

6) Do you have views on the circumstances under which such a power should be used?

- This power should be exercised when there are significant changes to an established train service through infrastructure, operator or rolling stock or when there is a substantial timetable recast that will likely affect reactionary delay impacts fundamentally.
- This power should also be used where there is a demonstrable and disproportionate financial effect of Schedule 8 against the value of a service group revenue which risks its viability. It is not appropriate or fair to make any party bear such risk through the remainder of a control period or until such time as another systemic change of circumstance arises to trigger a Schedule 8 recalibration.

Yours sincerely

James Linley

Head of Performance & Operations Delivery

Rachel Grashion
Senior Regulatory Economist
Network Rail

Will Holman
Head of incentives and reform
Office of Rail and Road

9 January 2023

Dear Will

Response to ORR's PR23 consultation on outstanding matters on the Schedule 4 and the Schedule 8 regimes

1. This letter sets out Network Rail's response to the Office of Rail and Road's (ORR) technical consultation "PR23 - Review of Schedules 4 & 8: Conclusions and consultation on outstanding matters", issued on 20 October 2022. This response has been endorsed by and had input from the Great British Railways Transition Team (GBRTT).
2. The main body of this letter summarises the key points of our response. Appendix 1 to this letter contains detailed responses and supporting evidence for each of ORR's outstanding consultation questions on Schedule 8. There are also two further supporting Appendices, containing an impartial, evidence-led 'feasibility assessment' of our mid-control period recalibration proposals and further information on regulatory precedent from other sectors.
3. The remainder of this letter is structured as follows:
    a) Summary
    b) ORR outstanding consultation questions: High-level response
    c) Appendix 1 – Network Rail's response to ORR's outstanding consultation questions on Schedule 8
    d) Appendix 2 – Feasibility assessment of Schedule 8 mid-control period recalibration options
    e) Appendix 3 – Regulatory precedent in other sectors: Managing uncertainty in setting financial performance mechanisms

Summary

4. ORR's 2023 periodic review (PR23) has come at a time of significant change for the rail industry. ORR must undertake PR23 in recognition of the likely changes in the event of the formation of Great British Railways (GBR) during Control Period 7 (CP7).
5. ORR's decisions on Schedules 4 and 8 have a direct impact on the ability of GBR to achieve its desired operating model and the associated benefits of an integrated railway. It is therefore crucial that the PR23 process, including the key decisions around Schedules 4 and 8, are consistent with and support the implementation of GBR.

6. We welcome ORR's recognition of industry reform and the potential desire for Schedules 4 and 8 to apply (or not) to different operator types in a reformed railway. We support ORR's proposal to switch Schedule 8 off for GBR specified TOCs once there is legislative change, as this would remove the requirement to have a regulated performance regime. We do however have reservations over how ORR's proposed clauses to turn off Schedule 8 for GBR specified TOCs will work in practice, which we discuss in more detail below and in Appendix 1 to this response.
7. We also welcome ORR's recognition of the difficulties with recent historical data which is unlikely to be representative of future performance and revenue levels as the industry recovers from the impacts of the COVID-19 pandemic.
8. We support ORR's proposal to provide for 'at least one' recalibration in CP7. This will introduce additional flexibility and resilience to the Schedule 8 regime, and we prefer this to a fixed, 5-year recalibration or the option of a single mid-control period recalibration. We would particularly welcome the flexibility for ORR to initiate multiple recalibrations (with the need for a recalibration reviewed annually) if it was deemed appropriate. We note that this is consistent with the recommendation made by Europe Economics in their paper on mid-control period updates to Schedule 8, which was commissioned by ORR[1]. Regular updates would provide increased flexibility and lead to better Schedule 8 outcomes (by reducing the risk of benchmarks being fixed incorrectly and leading to significantly inaccurate and inappropriate payments) for operators outside of GBR who will still be exposed to the regime throughout CP7. We provide information and evidence to support the need for a more flexible approach to updating Schedule 8 in CP7 in the appendices to this document.
9. We observe that the drafting in ORR's consultation could be interpreted as allowing, or at least strongly biasing towards, a single mid-control period recalibration. However, in discussions with ORR and given the reference to 'at least one' recalibration we take it that there is full flexibility to consider updates every year if justified. We would welcome clarity on this in ORR's conclusions.

ORR outstanding consultation questions: High-level response

10. ORR has asked for responses to outstanding topics that it felt unable to conclude upon in its October 2022 document, which broadly cover 2 topics:
    a) The practicalities of 'switching off' Schedule 8 for GBR specified TOCs (and the scope of application to other TOCs); and
    b) The use of a mid-control period recalibration of Schedule 8.

[1] Europe Economics Recommendations on Mid-Control Period Updates to Schedule 8 - https://www.orr.gov.uk/media/23925

Topic 1: The practicalities of 'switching off' Schedule 8 for GBR specified TOCs (and the scope of application to other TOCs)

11. ORR has proposed the insertion of new clauses in Schedule 8 of the Track Access Contracts (TACs) between Network Rail and passenger train operators which would allow Schedule 8 to be switched off (in the event of legislative change which would remove the requirement to have performance regime payments). We agree with ORR that this is a practical solution to switch off Schedule 8 payments and that the proposed clauses appear reasonable.
12. We note that GBR is unlikely to be stood up prior to the start of CP7, as previously anticipated. The Schedule 8 regime will therefore remain relevant to all operators until the point at which GBR is formed and legislative change removing the requirement to have a regulated performance regime is in force, which is likely to happen during CP7. It is therefore highly important that the CP7 regime is recalibrated appropriately, and that the option to flexibly turn-off Schedule 8 payments part way through the control period is made available, so we are supportive of the flexibility that ORR's proposal provides.
13. We also welcome the flexibility that the proposed clauses provide to turn Schedule 8 payments off and on to suit GBR specified TOCs and their revenue risk arrangements.
14. We support additional flexibility in terms of the scope of application of the proposed clauses beyond GBR specified TOCs. In particular, if it was legally possible, we would welcome the option to insert these clauses into contracts with devolved authority operators if desired by the devolved authority.
15. Whilst we acknowledge that such clauses within the TACs require approval from ORR, we have concerns that some of the considerations set out in paragraph 2.14 of ORR's consultation are framed in a way that might give ORR undue latitude to create conditions, and that this introduces uncertainty to the programme of rail reform, which would be unhelpful.
16. We would support ORR's proposition that some conditions will need to be met before they could insert the clauses into GBR TOC access contracts. The key conditions, in our view, are matters of fact, such as whether enabling legislation has come into force, whether GBR has become contracting authority, and whether there are any adverse impacts on the schedule 8 payments of other parties (which we know will not be the case if Schedule 8 is retained for non-GBR TOCs as ORR proposes – which we agree with).
17. However, we have some concerns around the wider conditions as currently phrased in the consultation. We do not think the proposed condition that ORR must be content that GBR TOC contracted performance regimes are "reasonable" for driving good performance is necessary in this context. ORR's duties and powers will already be designed to ensure GBR organises efficiently and effectively to deliver good performance to its users. In particular, ORR will be able to investigate any issues of poor performance by GBR and its contractors and has broad powers to require GBR to develop and implement improvement plans.

18. As well as being unnecessary, we also have concerns it may be unhelpful. As currently phrased, the condition could create expectation that ORR should exercise direct oversight of GBR TOC performance regimes in either National Rail Contracts (NRCs) or in the development of future GBR TOC contracts. We do not understand this to be in line with the intended operational model for ORR and would appreciate clarification on this point and the opportunity to discuss further (including GBRTT colleagues) before ORR finalise its conclusions. It also raises some implementation issues that have not been considered as part of the developing transformation programme, for instance, creating a new decision-gate where ORR has to scrutinise NRC performance arrangements before allowing Schedule 8 to be turned off in TACs, a prerequisite to being able to transfer pre-existing NRCs to GBR (due to the revenue risks associated with Schedule 8). We have similar concerns about the broad wording of condition 2 (of paragraph 2.14 of ORR's consultation document), which requires ORR to consider if there is "sufficient justification", without providing clarity as to what this might mean.
19. Given our concerns, we would welcome greater clarity on this issue to ensure that all parties understand the nature of ORR's role, and the purpose of the proposed conditions. It would be particularly helpful if ORR could confirm whether they agree that the conditions should be limited to 'matters of fact' as we suggest in paragraph 16, and if there are additional conditions which ORR expects GBR to meet beyond those that we have ascribed.

Topic 2: The use of a mid-control period recalibration of Schedule 8

20. Having read ORR's October 2022 conclusions and further consultations document, ORR's position is not entirely clear in terms of whether mid-control period recalibrations would be limited to a single recalibration, or if multiple recalibrations during the control period were acceptable if circumstances meant that this was appropriate. We note that paragraph 2.25 of ORR's document highlights the opportunity to correct parameters to better reflect industry conditions 'at least' once during the control period, tending to suggest that multiple recalibrations are possible. Further to this, paragraph B.14 discusses adding additional flexibility through 'frequent updates to parameters'. Again, this tends to suggest parameters can be adjusted regularly throughout the control period by means of multiple recalibrations. In contrast, other language used in the conclusions document tends to suggest ORR's preferred position is a single mid-control period recalibration. Paragraph 2.22 refers to adding 'limited flexibility' to Schedule 8, and 2.24 refers to 'a mid-control period recalibration', both suggesting CP7 would be restricted to a single wholescale recalibration. Given the document's ambiguity and inconsistencies, we would welcome ORR explicitly stating their preferred approach moving forward. As highlighted throughout this document, Network Rail's position is that we should move forward with the flexibility to have multiple recalibrations during the control period if justified.
21. Our preferred approach would be to update key Schedule 8 parameters up to annually (if triggers were met), adopting a mechanistic approach that would avoid the need for a wholescale recalibration. This approach would allow the regime to respond quickly to fundamental changes to the railway, for example, growth in traffic levels and passenger revenues as the industry continues to recover from the impacts of COVID-19. This should limit the financial uncertainty of the regime, minimising the potential for large, 'incorrect' payments, something which is of particular importance to Open Access and freight operators who are fully exposed to Schedule 8 and may not be able to absorb such large payments.

22. Whilst our preferred approach would be more costly to implement than fixing the Schedule 8 regime for the full control period, given the potential for significant Schedule 8 payments as a result of an 'incorrect' regime, the small additional cost of undertaking the update will be significantly less than the financial risk faced by all industry parties if the regime cannot respond quickly to changes in the nature of the railway. We also note that a one-off mid-control period recalibration could prove quite costly and time-consuming, compared to smaller scale mechanistic updates during the control period. We set out more detail on how our preferred option could work in practice in Appendix 1 to this document and provide detail of the costs and resourcing requirements of this approach and a one-off wholescale mid-control period recalibration in Appendix 2.
23. The alternative to a mechanistic approach would be to fully recalibrate the regime each time an in-control period recalibration is triggered. This would be a significantly costly and resource intensive exercise, which may not necessarily garner better results when weighted against the associated costs. We have provided additional information to evidence the potential costs and benefits of the various approaches to Schedule 8 regime updates in Appendix 2 to this document.

Next steps

24. We have significant concerns around ORR's criteria for switching off Schedule 8 payments in the event of legislative change, and would welcome clarification from ORR on the approach to in-control period recalibrations. We would like to work with ORR (and DfT, where appropriate) to understand and resolve these issues over the coming months.
25. We believe that some sensible next steps may be as follows:
    a) For Network Rail, GBRTT and DfT to continue to work closely together with ORR to understand ORR's requirements which would allow the Schedule 8 switch off clauses to be enacted;
    b) For ORR to set up an industry forum which considers the possibility for and scope of multiple in-control period Schedule 8 recalibrations in light of this response; and
    c) For ORR and Network Rail to continue to work closely with industry on the recalibration of both the Schedule 4 and Schedule 8 regimes.

* * *

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

Yours sincerely

Rachel Grashion

Appendix 1 – Network Rail’s response to ORR’s outstanding consultation questions on Schedule 8

Topic 1: The practicalities of ‘switching off’ Schedule 8 for GBR specified TOCs (and the scope of application to other TOCs)

Question 1: Do you agree with ORR’s proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to ‘switch off’ the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

1. We generally agree with the approach proposed by ORR as it seems like a pragmatic solution to enable Schedule 8 payments to be turned off in the event that they are no longer required for GBR specified TOCs. The proposed drafting appears to achieve the intended aim without compromising the requirement for Open Access and freight operators to have full protection from performance fluctuations outside of their control through Schedule 8. The clauses can also be applied flexibly to suit individual GBR specified TOC’s revenue requirements (which may evolve differently over time) and the transition of NRCs to GBR (which we now expect to happen during, rather than prior to, the control period), so we welcome the ability to be able to apply Schedule 8 in this flexible manner.
2. We accept that a prerequisite to ORR enacting the proposed clauses would be a change to the legislation, which provides ORR with assurances that it is no longer a legal requirement to have a performance regime in place for GBR specified TOCs.

Question 2: Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR’s contracted operators?

3. As stated previously, we agree that the sub-paragraphs should apply to GBR specified TOCs. However, we also consider that it would be useful for ORR to allow the clauses to be applied flexibly to other operators depending on their circumstances and agreements with GBR at the time. For example, devolved authority operators may wish to agree alternative arrangements on performance with GBR if they felt that the new arrangements would be in the best interest of both parties to drive collaboration on performance improving initiatives. This would be a legitimate position if there was no longer a requirement in legislation to have a regulated performance regime, so in this case, if both parties agreed to turn Schedule 8 off, the use of ORR’s proposed sub paragraphs would be beneficial.
4. Irrespective of the application of the proposed sub-paragraphs, we agree that all non-GBR operators should be offered Schedule 8 and its necessary protections. For example, Open Access and freight operators are likely to still require the protection that Schedule 8 provides and should be granted those protections if they wanted them (irrespective of other operator’s performance arrangements) in full.

Question 3: Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

5. We are comfortable with the proposed drafting and pragmatic approach. However, we have concerns with the requirements which ORR has stated that they would need to be satisfied with in order to enact the proposed clauses to turn off Schedule 8 payments and how this may be operated in practice. From previous ORR consultations, it was made clear that ORR would permit Schedule 8 payments to be switched off in the event of legislative change i.e. that no further requirements would need to be met.
6. This position appears to have changed with ORR now setting a higher bar for permitting the removal of Schedule 8 from the TAC for GBR specified TOCs only if ORR is satisfied with several criteria. We would like to understand this shift in policy and any burden of proof on GBR that may be required to obtain ORR consent.
7. We envisage that the following conditions would be appropriate, and would welcome ORR confirmation of these conditions along with any other conditions to be met:
    a) That legislation has been passed, removing the requirement for GBR specified TOCs to have a regulated performance regime;
    b) That GBR has become contracting authority in respect of GBR specified TOCs;
    c) That non-GBR operators are not adversely impacted by the removal of Schedule 8 for GBR TOCs; and
    d) That GBR provides relevant information to ORR on a timely basis such that ORR can report annually on GBR's performance and take enforcement action where appropriate.
8. Switching Schedule 8 off for GBR specified TOCs is a crucial prerequisite to GBR becoming the contracting authority. If ORR does not allow Schedule 8 to be switched off in the TACs, the current NRCs are highly unlikely to be able to be transferred to GBR due to the revenue risks associated with Schedule 8, and the inability for GBR to 'neutralise' Schedule 8 payments to and from the operator as the contracting authority (as this could render TACs void in extremis if implemented without the prior approval of ORR). This therefore risks a critical aspect of Rail Reform and could undermine the many benefits that Rail Reform is seeking to achieve for the rail industry. We caution ORR against taking such a strong line on the Schedule 8 switch off for this very reason.
9. To work through these issues, we would appreciate the opportunity to hold joint discussions between Network Rail and ORR, DfT and GBRTT, with the end result being written ORR confirmation of the conditions to be met in order to switch Schedule 8 off for GBR TOCs (and possibly others in the future).
10. More broadly, we would welcome further discussions with ORR on this important topic. We would like to work closely with ORR to ensure that the transition to GBR runs smoothly and that operators and GBR have appropriate incentives in place which recognise the opportunity brought about by rail reform, rather than relying on a regime that was designed to support a vastly different industry structure.

Topic 2: The use of a mid-control period recalibration of Schedule 8

Question 4: Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

11. We are supportive of ORR's proposal to initiate 'at least one' recalibration of Schedule 8 during CP7 and agree that this option is better than fixing parameters for the entirety of the control period. Our view is that a more flexible approach can be achieved through the use of multiple recalibrations throughout CP7 (providing specified triggers are met and ORR agree a recalibration is necessary), which could be carried out via simple mechanistic updates to the regime's parameters. We believe this approach will provide greater benefits to industry than the traditional method of fixing parameters for an entire control period, or an approach which would only allow a one-off mid control period recalibration. As we mention in the main body of this response, we would welcome clarity from ORR on its position on recalibrations during the control period and support Europe Economics' recommendation to introduce more flexible recalibrations during a control period with the need to recalibrate being reviewed on an annual basis.
12. Below, we have set out each option for updating the Schedule 8 regime that we believe is available to ORR for CP7 and assessed these against the 'do nothing' option of fixing Schedule 8 parameters for the entirety of CP7. We have set out separately below the options for the passenger regime and the freight and charter regimes.

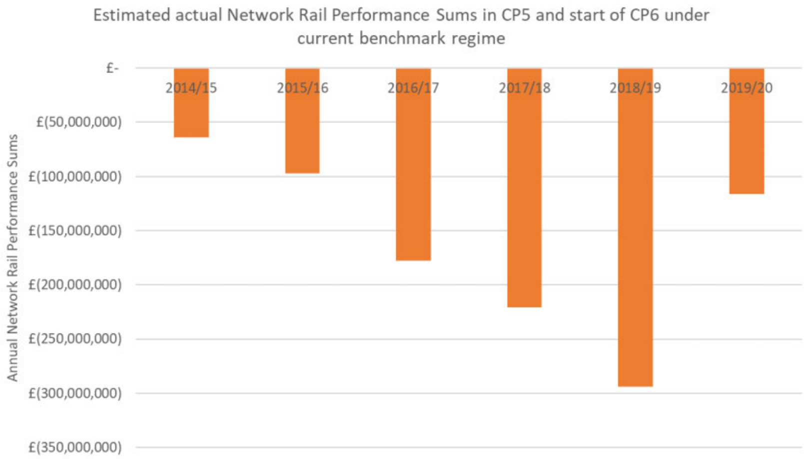
Passenger Regime:

Option 1: 'Do nothing', fixing parameters throughout CP7.

13. Option 1 assumes that no changes will be made to how the current CP6 regime operates. This means, if this option was taken forward, both benchmarks and payment rates would be fixed for the entirety of CP7, with the exception of individual recalibrations that happen during a control period through Paragraph 17 of Schedule 8, for example, due to a significant timetable change.
14. We do not favour the traditional approach of fixing parameters throughout the control period. Our main concern relates to the proposed dataset (P8 2021/22 to P7 2022/23) that is being used to recalibrate Schedule 8 for CP7. Whilst we agree with ORR that the selected dataset is arguably the most appropriate at this time (due to the impact of COVID-19 in previous years), it is still tainted by the impact of Omicron related restrictions, staffing issues and industrial action, which are likely to have an adverse impact on the calculation of Network Rail and TOC benchmarks. Therefore, if parameters are fixed, Schedule 8 for CP7 is unlikely to accurately reflect or respond to changes in future performance, as the industry continues to recover from the impacts of COVID-19. Similar arguments exist with regards to Schedule 8 payment rates, whereby revenues in the chosen base period could be wholly different to future revenue. This has the potential to leave both parties vulnerable to perverse payments and heightened financial risk.

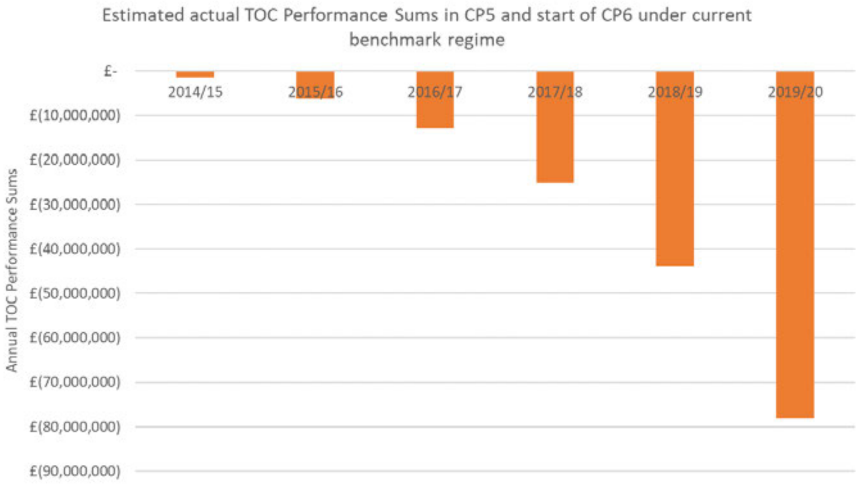
15. Further to this, we commissioned work in response to ORR's June 2021 Schedule 8 consultation which highlighted a fundamental issue with the current regime, identifying how it creates uncontrollable financial risk for both parties where parameters are fixed for an entire control period. We shared this work with ORR as part of our response to that consultation, and the findings are summarised below.
16. The work commissioned concluded that due to the difficulties in accounting for all internal and external factors when using historical data to predict future performance and revenue, the Schedule 8 regime is inherently problematic. For instance, future industrial action, timetable changes, and unexpected shocks are difficult to predict far into the future. This unpredictability will be worse for CP7, given the impacts of COVID-19 in the base data and the uncertainty of the industry's recovery from the pandemic. As we continue to progress through CP7, the net Schedule 8 payments are likely to significantly increase as performance deviates from benchmark, which in part may be as a result of inherent issues in forecasting future performance (in the case of Network Rail benchmarks) or as a result of historical data not being reflective of future performance (in the case of TOC benchmarks) rather than a shift in actual performance alone. Figures 1 and 2 illustrate this point, showing that even in relatively stable times (CP5), Schedule 8 payments tend to increase over time, suggesting that benchmarks set at the beginning of a control period are unlikely to be reflective of future performance.

Figure 1 - Estimated Network Rail Performance Sum under the current regime



Source 1 - Analysis of PEARS data, CP5 and CP6 performance benchmarks and payment rates

Figure 2 - Estimated TOC Performance Sum under the current regime



Source 1 - Analysis of PEARS data, CP5 and CP6 performance benchmarks and payment rates

17. For CP7, the chosen base data may leave operators in a more vulnerable position than ever before. The benchmarks for CP7 are likely to be vastly different from actual performance (particularly as we progress further into the control period), leading to the increased possibility of money flows to either us or TOCs due to an incorrect recalibration rather than good or poor performance, thereby increasing financial liability and risk. The liability could be so great in some cases that it may cause significant financial difficulty, especially to smaller TOCs who don't have any financial protection from Schedule 8 such as Open Access operators. This is something that was demonstrated during COVID-19 where TOCs approached Network Rail to agree overlay agreements to prevent large, inappropriate payment flows which were not offset by increased revenue, which otherwise would have had a disproportionate impact on their businesses.
18. We also argue that incentives are likely to be weaker under the 5-year approach as we expect actual performance could deviate significantly away from benchmarks as the control period progresses. If benchmarks are inadvertently set to a level that is considered unattainable (or equally, too 'easy' to achieve), there will be minimal incentive for either party to outperform, or even meet these benchmarks.

Option 2: A single, mid-control period recalibration

19. Although ORR's document suggests that there could be 'at least one' recalibration during the control period, the text is ambiguous as there are also references that suggest that a mid-control period recalibration would be limited to a wholescale 'one-off' recalibration covering all parameters (similar to the recalibration undertaken as part of each periodic review). As such, we have based our answers to this consultation question on these assumptions. If this assumption is incorrect, we would welcome ORR providing clarity on what it considers is the extent of a mid-control period recalibration, and whether this has changed, for instance in light of Europe Economics recommendations.
20. As stated previously, we agree that a single mid-control period recalibration would be a better option than fixing parameters for the entire control period due to the problems that have been identified under option 1. However, we consider that this option also has issues, which we discuss below.
21. Our view is that the recalibration should be able to be initiated at any stage within the control period, at a time that is deemed most necessary by ORR. We also believe that the 'mid-control period recalibration' should not be limited to a single recalibration throughout CP7; but instead that a number of recalibrations could be carried out. This will be contingent on ORR confirming a material change in circumstances is met at more than one stage of the control period. This approach would provide additional flexibility to the regime vs a one-off recalibration (which would not account for multiple changes in circumstances throughout the control period), benefitting both Network Rail and TOCs by reducing the financial risk and perverse incentives associated with an incorrectly calibrated regime.
22. We note Europe Economics Recommendations on Mid-Control Period Updates to Schedule 8[2], and would welcome the recommendation to allow recalibrations during the control period based on changes to traffic levels. We agree with the recommendation in the Europe Economics paper which suggests a preference towards allowing multiple recalibrations during a control period if an annual review suggests that the thresholds to warrant a recalibration have been met. This approach would ensure that benchmarks are based on more up-to-date information relating to traffic levels, thus mitigating financial risk for both Network Rail and operators as a result of the impacts of traffic on performance. As Europe Economics suggest, this approach introduces flexibility into the regime without compromising incentive properties for either the operator, or Network Rail.

[2] Europe Economics Recommendations on Mid-Control Period Updates to Schedule 8 - https://www.orr.gov.uk/media/23925

23. If ORR agrees to pursue a more flexible approach to recalibrations, we ask that ORR considers the scope of application to both Network Rail and Operator benchmarks. This is because the performance trajectories which are applied to Network Rail benchmarks do not account for the impact of traffic growth on the level of TOC caused delays to other operators. Network Rail benchmarks will need to be set at the level of expected CP7 performance. Therefore, the TOC-on-TOC delay aspect of Network Rail benchmarks should be adjusted for traffic changes to ensure that the approach is consistent with operator benchmarks (if this approach is chosen), and to ensure balance of payments between Network Rail and operators through the 'Star model'.
24. Europe Economics also recommend the option of recalibrating TOC and Network Rail payment rates alongside any mid-period recalibration of benchmarks. We agree with this approach as it will provide additional flexibility to update payment rates such that they are more reflective of actual revenue losses. Our preferred approach would be for ORR to adjust payment rates for changes in revenues as this is simplistic, whilst still providing the benefit of having a more reflective regime.
25. Europe Economics also point out that ORR should either recalibrate both Network Rail and TOC payment rates, or neither, explaining it would not be feasible to update one without the other due to the risk associated with misbalancing the Star model. We agree with this suggestion.
26. Similar to our view on benchmarks, we would also prefer that any mid-control period recalibration was not limited to a one-off update, with payment rates updated each time a pre-defined ORR trigger was met, and, in the round, it was considered justified to update the regime.

Option 3: Multiple recalibrations during the control period

27. Whilst ORR has recently published its October 2022 conclusions confirming it is not supportive of the previously suggested approach of annual updates; we have since held further discussions with ORR about an alternative approach in the form of multiple recalibrations during a control period that we consider meet many of ORR's concerns with the original annual updates proposal, and is aligned with ORR's suggestion to recalibrate Schedule 8 'at least once' if sufficient triggers are met.
28. We appreciate ORR's previous reservations with our proposed 'rolling average' methodology (which we put forward in response to ORR's initial consultation on Schedule 8 in 2021) and have since adapted our proposal; suggesting that benchmarks could be updated mechanistically (if triggers are met) in control period for the relationship between traffic and performance only, and payment rates adjusted to reflect % changes in revenues year on year. This is now our preferred approach, and we go on to explain this in more detail in the sections below.

29. Our view is that recalibrations could be completed in a purely mechanistic way through models which would allow the parameters to be easily adjusted, requiring minimal effort when updates are required. In order to do this, work could be carried out to understand the relationship between changes in traffic and performance; obtaining an index that can then be used to simply adjust benchmarks based on actual changes to network mileage, either at a network wide level, or at a more granular level, e.g. by region, route, geographic area etc. Payment rates could be ratcheted up or down based on changes to outturn revenues at a service group or TOC level.
30. We believe that there should also be an annual review to determine whether a recalibration is necessary; evaluating all 'trigger' parameters, any significant changes to the industry (i.e. a % change in passenger numbers, a % change in traffic levels, revenue changes, external shocks etc. beyond agreed thresholds), and any other factors ORR wish to consider. ORR should consider the need to recalibrate holistically, rather than based on any single trigger being met.
31. In Appendix 2, we provide an in-depth feasibility assessment of options 2 and 3 mentioned above, explaining both in further detail, and providing estimates of the costs and resources required. In Appendix 3 to this document, we discuss regulatory precedent in other sectors to highlight the application of additional flexibility in setting regulated performance regimes to account for recent uncertainty.

Mechanistic Updates to Benchmarks

32. Once the relationship between traffic levels and performance has been modelled, which could be done as part of the periodic review process, ORR could implement a formulaic process to calculate benchmarks in years where an update is deemed appropriate. The model owner would be able to input the latest traffic data (i.e. the overall increase or decrease in traffic levels for the year vs the previous year or a forecast), and adjust the benchmark based on the calculated relationship between traffic level changes and performance.
33. We consider that by adopting a mechanistic approach that considers the relationship between traffic and performance only, there will be no adverse incentive effects. This is because there is only a single adjustment being made to benchmarks; entirely based on changes in network traffic for each year. This means that any initiatives that TOCs or Network Rail have implemented that improve performance would not feature in the adjusted benchmark, and so that party would continue to benefit from that initiative. Therefore, by adopting this approach, Network Rail and TOCs will remain incentivised to invest in performance improvement schemes which will continue to enable benchmark outperformance resulting in a net Schedule 8 inflow.
34. Allowing more frequent updates supports a more sustainable path for industry recovery, as we continue to move away from some of the issues identified with the base recalibration data (such as the inclusion of Omicron restriction periods and strike days) which would otherwise be included throughout the entirety of the control period or at least up until the one-off mid-control period recalibration if that is the chosen option. By updating on this basis, the Schedule 8 regime will be able to more accurately reflect real traffic levels on the network, and appropriately update the benchmarks for the impact this will have on operator and Network Rail performance.

35. We have carried out a further cost analysis which identifies the Schedule 8 costs associated with introducing and maintaining incorrect benchmarks. The findings are shown in Tables 1 and 2 below and demonstrate that just a 1 % deviation in performance from Network Rail benchmarks, i.e. actual Average Minutes Lateness (AML) being 1 % higher or lower than benchmark AML would have led to Schedule 8 payments on the Network Rail side of the regime of £9.9m in 2019/20 and £9.3m in 2020/21, and so on. This highlights the importance of ensuring that benchmarks are set accurately, and the potential impact of getting them even slightly 'wrong' – which we believe will become increasingly likely as the control period progresses without appropriate, and regular, adjustments.

Table 1 - The Financial Impact of Incorrect Network Rail Benchmarks £2019/20 prices (negative values indicate a net payment from Network Rail to TOCs as a result of Network Rail AML being x% below benchmark AML)

1. Incorrect Benchmark Network Rail	2. Cost Implications 2019/20	3. Cost Implication 2020/21
4. Performance 1 % below benchmark	5. -£9,895,144	6. -£9,347,902
7. Performance 10 % below benchmark	8. -£98,951,439	9. -£73,479,018

Table 2 - The Financial Impact of Incorrect TOC Benchmarks £2019/20 prices (negative values indicate a net payment from TOCs to Network Rail (to fund the Star model) as a result of TOCs AML being x% below benchmark AML)

10. Incorrect Benchmark TOC	11. Cost Implications 2019/20	12. Cost Implication 2020/21
13. Performance 1 % below benchmark	14. -£800,561	15. -£594,088
16. Performance 10 % below benchmark	17. -£8,006,506	18. -£5,940,876

36. We are concerned that these values will be most problematic for Open Access and small, devolved authority TOCs, as they are liable for the full costs associated with Schedule 8.

37. This issue has become apparent in recent years where, as a result of COVID-19, benchmarks have been at the wrong level, and net payments have been volatile. In 2019/20, "On Time" performance was at 65 %, which increased to 79.8 % in 2020/21 when traffic levels declined as a result of COVID-19 impacts (train miles were c.7.8m in 2019/20 vs 6.1m in 2020/21)[3]. In this time, Schedule 8 payments were extremely volatile, with Network Rail Schedule 8 expenditure of £57m in 2019/20 and income of £347m in 2020/21, a financial 'swing' of over £400m in just one year.[4]
38. This clearly illustrates that the cost associated with carrying out recalibrations during the control period would be dwarfed even by a 1 % deviation in benchmark (we estimate that the costs associated with mechanistic updates would be approximately £50-200k upfront to estimate a 'congestion factor' with minimal additional costs during a control period if updates were fully mechanistic and completed in house by Network Rail[5]).

Mechanistic Updates to Payment Rates

39. A mechanistic approach could also be taken in updating payment rates. A direct relationship between payment rates and revenue change (and/or passenger numbers) could be considered for CP7 (i.e. a 10 % increase in revenue change, could lead to an uplift in the Network Rail payment rates by 10 %). This approach would help to ensure the Network Rail payment rates better reflect revenue losses to operators, making certain they are adequately compensated throughout CP7. The Star model could remain balanced through a straightforward update of the consultant's CP7 TOC Payment Rate models, which we understand that ORR has already asked the consultants to make updateable. Further detail on this option can be found in Appendix 2 to this document.
40. In conclusion, our preferred approach for CP7 would be in control period mechanistic recalibrations to Schedule 8 parameters. However, whilst we consider this to be the best option, a single mid-control period recalibration would still be better than fixing parameters for the entirety of the control period.

[3] Source – Network Rail National Performance Team
[4] Source – Network Rail Regulatory Financial Accounts – 2019/20 and 2020/21
[5] Source – Network Rail Feasibility Assessment (Appendix 2 to this document)

Freight and Charter regimes:

Updates to Freight and Charter Operator Benchmarks

Option 1a: No benchmark updates

41. This option is a 'do nothing' approach which would calibrate benchmarks solely on the basis of historical data from the recalibration period in the case of freight and charter benchmarks, and on the basis of the performance trajectory for the Network Rail benchmark.
42. Whilst this approach is both simple and cost-effective, there is a significant lack of flexibility within the regime; meaning parameters would be unable to be adjusted to reflect changes as they happen during the control period.
43. We have reservations with this approach. If traffic levels change significantly, Schedule 8 would be unable to respond to this change. For instance, if traffic were to have an inverse relationship with performance, this could mean that Network Rail and operator benchmarks would become increasingly difficult to meet as traffic increased on the network. Thus, if benchmarks are not adjusted for this change, we may see parties struggling to meet benchmarks, resulting in an influx of perverse payments.

Option 1b: No benchmark updates, with a mid-control period recalibration

44. This option is the same as option 1a as described above, but with the opportunity to have a one-off ORR mandated mid-control period recalibration during the control period. Our assumption is that the mid-control period recalibration would be wholescale; reviewing and updating all of the regime's parameters.
45. The mid-control period recalibration would allow for some flexibility during CP7, meaning parameters could be adjusted if necessary; avoiding perverse payments that would otherwise remain constant throughout CP7. This approach also ensures there is no additional costs to the industry until the recalibration is initiated, at which point we expect the cost to be equal to a full recalibration.

Option 2: Multiple in-control period updates to benchmarks based on the CP5 Congestion Factor

46. To account for the impact of changing traffic levels on performance, ORR could consider the use of the previous CP5 congestion factor. The congestion factor could be applied on an annual basis (where thresholds to trigger a recalibration have been met), adjusting benchmarks based on changing traffic levels.

47. As the congestion factor has already been developed, this is another simplistic and cost-effective approach that could be considered. However, we have some concerns that the analysis used to calculate the congestion factor is now almost 10-years out of date and is unlikely to represent the position of the current network due to the long-term impact of COVID-19 and the industry uncertainty that has followed. As such, this could lead to incorrect adjustments being made, potentially worsening the position of Network Rail, or operators.

Option 3: Multiple in-control period updates to benchmarks based on an updated congestion factor which has been updated in a simplistic way

48. Whilst not as robust as a full recalibration (option 4), we consider adopting a simplistic approach to updating the CP5 congestion factor as being the preferred option for updating benchmarks in the regime. We anticipate this work could be completed as part of the wider PR23 recalibration work for a small additional cost. Under this option we would not expect a detailed analysis similar to the capacity charge work, rather this option would update the congestion factor by adjusting the CP5 factor based on evidence gathered through a case study style exercise (for a small fee).
49. This approach would involve consultants evaluating recent evidence to understand the material changes between traffic levels and performance since the congestion factor was last reviewed. The work may consider a number of factors, including but not limited to: changes to traffic levels and mix; changes to the nature of reactionary delays; network capacity/capability; changes to freight/charter traffic and distribution across the network and any additional insight from NR and operator performance experts (alongside any knowledge that the consultants can provide themselves).
50. This option would be based on knowledge of changes to the network and the anticipated changes that this will have to the relationship between traffic and congestion-related reaction delay. Once this factor has been established, we will be able to update benchmarks mechanistically on an annual basis (where triggers have been met); reflecting the actual changes in network traffic year-on-year and the impact this has on performance.
51. This is our preferred option, and we consider the benefits from adopting this approach will significantly outweigh the financial costs. Further to this, upon ORRs decision on benchmark updates in early 2023, we are confident that this piece of work will be completed in time for the November 2023 final recalibration sign-off.

Option 4: Multiple in-control period updates to benchmarks based on a fully recalibrated congestion factor

52. This option would involve a comprehensive economic analysis i.e. similar to the capacity charge work in CP5, to confidently map the relationship between delay and performance to come up with a new congestion factor.
53. We do not see this being a feasible option due to the limited timeframes, high cost and levels of resource required.

54. The CP5 revision of the congestion factor took approximately 1 year to complete, and a similar amount of time would be required to complete the work for CP7. Without an ORR decision on in control period benchmark updates until early 2023, completion of this option would not happen until early 2024. This would be too late to implement in time for CP7, as the Congestion Factor to be used would need to be written into track access contracts which are signed off towards the end of 2023 Thus, we do not see this as a feasible option, and suggest that ORR dismisses it at this stage.

Application of updates to benchmarks

55. Each of options 2, 3 and 4 can be applied in one of two ways: via in-control period updates (where appropriate) to benchmarks based on actual traffic changes or by continuing to apply the CP6 methodology whereby benchmarks are adjusted up front to account for forecasted changes to traffic levels on average over the 5-year control period. This approach would still require the use of a congestion factor (to be applied to the 5-year average annual traffic forecast) which could be rolled over from CP5 (i.e. per option 2) or updated in some way (option 3 or 4).
56. The main issue with the 5-year average approach is that traffic levels in the current world will be incredibly difficult to forecast accurately, thus, the benchmark adjustments may not reflect the actual changes to traffic levels that we observe (something that an in-control period update approach could achieve with greater accuracy), potentially leading to perverse payments if the forecasts are not representative. Our view is therefore that a multiple in-control period update approach would be the preferred option as this provides a more up to date and accurate reflection of traffic levels, which although would be lagged in the benchmark by a year, would balance out overall through under and over performance as the benchmark catches up to reality.
57. Considering the options above and the benefits and drawbacks of each, we strongly believe that option 3 should be the chosen approach, applied to actual traffic level changes on an annual basis (where triggers are met). This option provides a balance between improving on and updating the CP5 Congestion Factor to better reflect the impact changes in network traffic have on performance, without there being a significant financial cost and resource requirement. Multiple in-control period updates also provide a better solution vs a 5-year average approach due to the inherent difficulties in accurately forecasting future traffic levels (as discussed above).
58. Our view is that the proposed adjustments should be applied to both Freight Operator and Network Rail benchmarks, to ensure that both parties are shielded from the impact that changing traffic levels have on performance (for the same reasons that we give in respect of passenger regime in paragraph 23 above).

Updates to Freight and Charter Operator Payment Rates

59. There could be merit in updating freight and charter operator payment rates if the passenger regime is to be updated more frequently (or once mid control period) to ensure that Network Rail is not left exposed via the Star model. However, we see less merit in updating the Network Rail Payment Rate at this stage given the additional costs and resource required when considered in parallel to the much smaller benefit (since freight and charter traffic has typically been much more stable in recent years).

Question 5: Do you think that this should be a feature of each of the passenger, freight and charter regimes?

60. We agree that multiple in-control period updates (our preferred approach) or as a minimum a single mid-control period recalibration should feature as part of the passenger regime. However, for the freight and charter regimes, our preferred option differs depending on the approach taken by ORR. This is shown in part (b) of our response below.

a) Passenger Regime

61. As alluded to in our response to question 4, we are conscious that benchmarks are likely to be set incorrectly due to Omicron and industrial action data being included in the recalibration period. This leaves both Network Rail and TOCs vulnerable; with either party being subject to large deviations from their benchmarks and associated payments, potentially worsening as we progress through CP7.
62. Whilst there is a significant number of TOCs that are now protected from revenue risk by the DfT through NRCs and would not face such a risk; we are aware that Open Access operators and devolved authorities will be required to absorb the full costs of Schedule 8, and this is a concern. Multiple in-control period updates (or as a minimum a single mid-control period recalibration) would enable benchmarks to be updated as the industry recovers from COVID-19 impacts. This will help mitigate the financial risk that is put on Open Access operators and others, which is something that we have discussed in conjunction with ORR and a number of Open Access operators recently.
63. As mentioned in response to question 4, we are strongly supportive of updating payment rates (via multiple in-control period recalibrations) in the passenger regime. We argue that if there were to be a material change in circumstances, such as a significant change in passenger operator revenues, the inability to reflect this change in the payment rate would harm Network Rail and operators from a financial perspective. This is because payment rates would no longer represent actual revenue losses. As such, we believe it is critical that recalibrations feature as part of the passenger regime.

b) Freight and Charter Regime

64. We see merit in the Freight and Charter regimes adopting an approach whereby the Network Rail and operator benchmarks are adjusted annually (where appropriate) to reflect changes in network traffic levels (as discussed in response to question 4 above). There could be merit in updating operator payment rates if the passenger regime is to be updated more frequently (or once mid control period) to ensure that Network Rail is not left exposed via the Star model.
65. We do not however see merit in a wholescale mid-control period recalibration of the freight and charter regimes as the CP7 year 1 parameters will be based on a more stable recalibration period (2015/16 to 2019/20) which is unaffected by some of the issues discussed in regard to the chosen passenger regime recalibration period. A wholescale recalibration is likely to be cost and resource intensive with a much smaller benefit vs the passenger regime. A simple approach, as we suggest in response to question 4 above, to uplift benchmarks more frequently for the impacts of traffic levels on performance and update operator payment rates to retain Star model neutrality (if the passenger regime payment rates are adjusted) ought to reduce cost and resource required, whilst still protecting parties from changes over time.

Question 6: Do you have views on the circumstances under which such a power should be used?

66. As stated previously, we believe that the circumstances in which a recalibration should be initiated should be considered by ORR by assessing industry circumstances in the round, and on an operator-by-operator level. We are conscious that if some operators are impacted significantly by changes to industry circumstances, a national recalibration approach may still be appropriate if enough operators are affected.
67. As part of our wider concerns, we would also be keen to understand how ORR plans to respond to any future exogenous shocks. It is important that there is a mechanism in place to mitigate financial risk to operators and Network Rail for circumstances outside of their control; ensuring financial stability and the continued provision of essential services across the United Kingdom. To address this, ORR could propose introducing a clause into the operators TACs that will enable ORR to temporarily suspend or adjust Schedule 8 under such circumstances.

Appendix 2 – Feasibility assessment of Schedule 8 mid-control period recalibration options

Purpose

1. This appendix supports, and should be in read in conjunction with, our overarching response to ORR's October 2022 Schedule 8 consultation.
2. In this appendix, we consider the practical feasibility and resourcing requirements of two options for in-control period adjustments to Schedule 8 parameters: (a) a single mid-control period recalibration, described in our overarching response as Option 2; and (b) multiple mid-control period recalibrations subject to an annual trigger-based assessment by the ORR, described in our overarching response as Option 3.
3. Option 2 involves a single wholescale recalibration covering all Schedule 8 parameters for all operators. It requires granular (service group level) performance data likely covering a minimum one-year period and active industry involvement. It would likely also involve a review and possible update of the calibration methodology used at the periodic review stage if the methodology was no longer deemed appropriate.
4. Option 3 involves a formula-based adjustment to benchmarks and/or payment rates. It could be based on a single parameter and readily available train-km and revenue data, with limited need for industry involvement.

Approach

5. The information contained in this appendix is based on a combination of:
   a) Desktop review of documents produced as part of the PR18 recalibration of Schedule 8[6 7 8];
   b) Experience of the PR23 recalibration process to date;
   c) Desktop review of PR13 capacity charge recalibration report[9] and Network Rail conclusions document[10];

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[6] ORR, Schedule 4 and 8 PR18 re-calibration working group Schedule 4 and 8 PR18 re-calibration working group | Office of Rail and Road (orr.gov.uk)
[7] Rail Delivery Group, Schedule 8 Recalibration: Request for approval of Phase 1 parameters RequesttoORRforapprovalofPhase1parameters.pdf (raildeliverygroup.com)
[8] Vivacity Rail Consulting, RDG Sch8 Audit Final Report November 2018 file.html (raildeliverygroup.com)
[9] Network Rail (2013), Periodic Review 2013 – Capacity Charge Conclusions and Draft Pricelists, https://www.networkrail.co.uk/wp-content/uploads/2017/02/Capacity-charge-conclusions-.pdf
[10] Arup (2013), Recalibrating the Capacity Charge for CP5 – Final Report, https://www.networkrail.co.uk/wp-content/uploads/2017/02/Arup-final-report-Recalibrating-the-Capacity-Charge-for-CP5.pdf

d) Internal consultation with relevant staff to establish data availability, the administrative process required for updating Schedule 8 parameters in track access contracts, and related resource requirements; and

e) Consultation with external experts involved in previous recalibration exercises in relation to industry and consultancy resource requirements, and recalibration methodology.

6. The practical feasibility and precise resource requirements for a given recalibration exercise depend on a wide range of factors, including the complexity of the methodology employed; the expected level of granularity, accuracy and assurance required; the degree of industry involvement and consultation; the degree of industry engagement in the process; data availability and quality; who revenue risk sits with[11]; and the state of working relationships between Network Rail and train operating companies (TOCs)[12]. We have considered these factors in estimating the potential resource requirements ranges set out in this appendix.

7. Whilst the appendix seeks to give a clear view on methodology, process and resource requirements, there is a significant degree of expert judgement involved, which has been applied to our best knowledge. The information provided in this appendix should therefore be seen as indicative of a range of possible outcomes to help inform ORR's decision. We would welcome further discussion with ORR on the feasibility of the options presented to refine our estimates further if it would aid ORR's decision making process.

Key Messages

8. Although there is limited precedent for in-control period industry-wide recalibrations of Schedule 8[13], both Options 2 and 3 appear feasible in terms of process, methodology and data availability. However, they vary in terms of their resource requirements and total cost.

9. This appendix demonstrates that Option 3 could be based on a very simple calculation method and trigger assessment which could be implemented quickly, with fewer resources and data requirements, and with lower risk of slippage or of industry disputes arising. The accompanying appendix 3 on regulatory precedent illustrates how a similar scheme operates in relation to the service quality regime for the National Air Traffic Service, Regulated by the Civil Aviation Authority (CAA).

[11] Train operators exposed to Schedule 8 are likely to engage more closely with any recalibration exercise, and hence this factor is likely to vary the amount of time input from industry.
[12] We use train operating companies, train operators, operators and TOCs interchangeably.
[13] The accompanying annex on regulatory precedent shows that there are several examples of in-period adjustments to financial incentives in other UK regulated industries.

10. Option 2, a mid-period wholescale recalibration of Schedule 8 could, in a best-case scenario, be completed in around 5.5 months. However, there is high likelihood of its duration being extended given the significant scope for disagreement to arise in relation to (a) the need for the recalibration; (b) the overarching methodology to be followed; (c) exceptions to this methodology; and (d) the implementation of the agreed methodology (with there being scope for calculation error). Experience from previous recalibrations shows that they can become contentious, and therefore consume significant industry energy and extend timescales. It therefore seems possible that a mid-period recalibration could take 12 months or longer to complete.
11. In terms of resource, it is estimated that Option 2 would require between £300k and £600k in consultancy fees, depending on methodological complexity and the degree of independent audit and/or assurance required. Industry input could amount to c. 3.2-7.0 FTEs depending on the extent of train operator interest in the process (for example, due to a policy shift in the allocation of revenue risk or the proportion of operators still exposed to Schedule 8 payments in their track access contract) and of potential disputes arising. The process for deciding whether to trigger a recalibration in the first place could itself become a point of disagreement if it is not agreed upfront. There would be considerable data requirements and some of the information could prove challenging to source and process.
12. **Option 3**, involving **multiple trigger-based mechanistic recalibrations during the control period**, would be considerably simpler to implement than a wholescale recalibration. The adjustment formulae could be based on a single parameter, defined and estimated at the start of the control period, and based on readily available traffic and revenue data. The process for triggering an adjustment could either be formulaic (Option 3A) or involve a more flexible annual assessment by the ORR (Option 3B)[14]. In either case, Option 3 would offer much less scope for dispute and challenge thereby reducing resource requirements and delivery risk. This approach also offers greater flexibility as it could be implemented for only a sub-set of operators or for a sub-set of parameters. This would allow a more targeted approach, thereby reducing industry resource requirements and upheaval.
13. Under Option 3A, ORR would automatically set off an adjustment to Schedule 8 parameters if, at a certain point each year, trigger conditions were met. This process would require some work upfront to define and consult on the triggers (assumed to come from existing PR23 resource commitment) and a negligible amount of industry resource during the control period.

[14] Options 3A and 3B represent two ends of a spectrum. ORR could, in practice, choose to adopt a combination of objective formulaic triggers and more subjective consideration of wider factors.

14. Under Option 3B, ORR would carry out a (non-formulaic) assessment of trigger conditions, issue a decision and consult with industry before proceeding with a recalibration. The process would be expected to take **c. 2 to 3 months** to complete and require between **0.4 and 2.6 FTE** of existing industry resource for each year of the control period. Resource would come from existing ORR, Network Rail and train operating company roles, and the precise quantum is highly dependent on the degree of engagement of train operating companies with the process. The lower bound assumes that ORR's decision would be uncontentious and TOCs would choose to engage with the process in only a light-touch way.
15. Where an adjustment is triggered, it is assumed that the work could be done in-house by Network Rail, with ORR having an assurance and approval role, as is the case for annual updates to access charges. It is estimated that the calculation and implementation of adjusted benchmarks could take **1-2 months** and require between **0.2 and 0.4 FTE** of existing industry resource.
16. The overall process (trigger assessment + recalibration) would take **1-3 months** and between **0.2 and 0.4 FTE** for **Option 3A**; and **3-5months** and **0.6-3.0 FTEs** for **Option 3B**.
17. Whilst it is assumed that no consultancy input would be required during the control period, there would likely be an **up-front cost of between £50k and £200k** to estimate the relationship between key underlying variables (such as train-kms) and delay. The lower bound assumes a single national parameter and the upper bound assumes a TOC/service-group specific estimation. However, ORR and industry could choose to forgo this expense by adopting a unit elasticity between traffic and delay, such that, for example, a 10% variance in train-kms would result in a 10% adjustment to the benchmark.

Structure of the appendix

18. The remainder of the appendix is structured as follows:
    a) The sections, 'Option 2: Mid-period Wholescale Recalibration' and 'Option 3: 'Multiple Trigger-Based Mechanistic Recalibrations', set out our views on the potential process, methodology and data requirements for the implementation of Options 2 and 3 respectively.
    b) Finally, 'Resource Requirements', provides estimates of resource requirements for each of the two options.

Option 2: Single Mid-Control Period Recalibration

19. Option 2 would involve a single wholescale recalibration carried out at any point during the control period, on condition it is considered appropriate by ORR. For example, during year 3 and taking effect for the last two years of the control period. It is assumed that this option would cover a recalibration of both benchmarks and payment rates. It could, in principle, cover all or a sub-set of operators. In practice, we consider that it would need to cover all operators in some way to ensure a financially balanced outcome for Network Rail[15].
20. This section sets out, at a high level, the process, recalibration methodology and data requirements that would be involved in this option. This information underpins the estimates of resource requirements that follow in the final section.

Process

21. Schedule 8 parameters would initially be set in track access contracts, as part of PR23, for the full duration of CP7 based on historical performance/traffic and forward-looking trajectories.
22. There would then need to be a provision, likely set out in the final determination and in track access contracts, for Schedule 8 parameters to be updated as the result of a mid-period recalibration, subject to ORR's agreement.
23. Europe Economics, in its supporting paper for ORR's consultation document, suggests that more than one mid-period recalibration may be possible.[16] Given the resource requirements involved in a wholescale recalibration, we have assumed that this scenario would in practice need to be closer to our Option 3, involving a more mechanistic adjustment of Schedule 8 parameters.
24. It is expected that ORR would set out in the final determination the process that it would follow and the criteria that it would consider in deciding whether to trigger a recalibration. The criteria could be mechanistic though ORR may also want to be able to consider in the round whether a recalibration is appropriate. This creates a risk that the decision of whether to trigger a recalibration would be a focal point for disputes.
25. If consideration of a recalibration is triggered, ORR would then call for evidence and make a decision on the basis of that evidence whether a recalibration should go ahead. ORR may want to consider whether to allow an appeals process in relation to its decision. In any event, ORR's decision would be open to judicial review as is normally the case.

[15] In any event, it is considered that a partial recalibration would require the same elapsed time and only slightly fewer resources than a full recalibration given economies of scale and the fact that requirements are driven mainly by the operators where there is a greater gap between out-turn performance than that assumed at the periodic review stage.

[16] Europe Economics, Recommendations on Mid-Control Period Updates to Schedule 8 – November 2022

26. In the event of a recalibration being triggered, consultancy support would then need to be procured by ORR and/or industry, and a governance process need to be set up to agree the recalibration methodology and oversee the process. Past experience shows that disputes can often arise at this stage both on points of principle in relation to the default methodology and in relation to specific exceptions that some operators may consider to be warranted in their case.
27. Consultants would then proceed with the recalibration, with the results being subject to a degree of audit and assurance to be agreed, possibly with the use of independent external reviewers.
28. We would then need to issue updated versions of Schedule 8 for each relevant operator's track access contract, which operators would be required to check, and which ORR would need to subsequently approve.

Criteria for triggering a recalibration

29. Under this option, it would be for ORR to set out in the final determination, or possibly in follow-up guidance, the criteria that it would be expected to consider in deciding whether to trigger a recalibration. Criteria could be more or less prescriptive but would likely need to allow for a degree of flexibility in order to respond to unforeseen events. Some of the criteria could include those that are described later in the appendix in relation to Option 3, such as variance between out-turn and forecast traffic growth or the scale of Schedule 8 payments. In practice, we would expect this to involve a more nuanced judgement on the part of the ORR in line with its broad set of duties, but which could also be more open to challenge and dispute.

Recalibration methodology and data requirements

30. It would be for ORR to set out in the final determination the extent to which a mid-period recalibration would be expected to follow a similar methodology as that carried out at the periodic review stage.
31. One of the advantages of a mid-period recalibration, however, is that it could offer greater flexibility to changing and unforeseen circumstances. In such cases it would be appropriate for the methodology to be re-visited. However, this more flexible approach would create greater opportunity for disputes to arise, would require greater industry involvement and could lead to a more protracted process.
32. In any event, it is expected that the recalibration methodology would follow a similar structure to that carried out during the periodic review, therefore requiring:
    a) granular (service group level) analysis of historical train performance data, broken down between Network Rail, TOC-on-TOC and TOC-on-Self;
    b) input from Network Rail regions, ORR and, potentially, train operators on performance trajectories;
    c) a method for translating performance trajectories into service group benchmark delays, if performance trajectories are updated during the control period;

d) input from Network Rail regions and train operators on exceptional events which may require excluding, or focusing on, certain periods (which could, for example, include weather, major service changes, strikes, infrastructure and rolling stock investment);

e) analysis of industry revenue data to recalibrate payment rates; and

f) review of most recent industry research on the link between delays and passenger demand.

33. In addition, consideration would need to be given to the quality assurance approach. Depending on the novelty and complexity of the methodology, and the degree of disagreement between Network Rail, operators and ORR, it may be justified to involve an independent reviewer, which would add cost and time to the process.

34. Table 3 summarises the expected minimum data requirements for a mid-period recalibration.

Table 3 - Minimum Data Requirements

	Data item	Time period	Granularity	Source	Delivery timescales
1	Train-kms	Previous year	Service group	Network Rail	Weeks
2	Delay minutes	Previous year	Service group, broken down by cause	Network Rail	Weeks
3	Cancelations	Previous year	Service group, broken down by cause	Network Rail	Weeks
4	Deemed late minutes conversion factor	New research since periodic review	n/a	Rail Delivery Group (via consultants)	Weeks
5	Revenue	Latest year	Service group	Rail Delivery Group (via consultants)	Weeks
6	Forward-looking performance trajectories	Covering the remaining of the control period	Regions / TOCs	Network Rail regions and ORR	Months
7	Exceptional events	Previous year	Service group	Network Rail and train operators	Months

35. Items 1-5 would require considerable Network Rail resource and likely some consultancy resource but could be made available within a matter of weeks.

36. Items 6 and 7 should in principle be available but could require a considerable amount of time and industry effort to gather (likely months, rather than weeks). One challenge is that this information would be more qualitative in nature, thereby making standard information requests and automation of the analysis process less feasible. Another complicating factor is that information from different sources may be of varying quality and not directly comparable, which could require considerable effort in terms of data cleaning and reconciliation.

37. We consider that there is a viable process for implementing Option 2 and that all required data can be obtained in a timely way given sufficient resource. However, there is significant risk of slippage both due to possible disputes arising and to data processing and calculation complexity. Overall resource requirements are discussed in the final section of the appendix – 'Resource Requirements'.

Option 3: Multiple Mechanistic Recalibrations

38. This section sets out, at high level, the process, recalibration methodology and data requirements that would be involved in Option 3. This information underpins the estimates of resource requirements that follow in the final section
39. It is assumed that this option would involve an annual assessment by the ORR of the need to undertake an adjustment to Schedule 8 parameters. Under **Option 3A**, ORR would automatically set off a recalibration if, at a certain point each year, trigger conditions were met (and there was no reason to suggest that a recalibration would be inappropriate). Under **Option 3B**, ORR would carry out a (non-formulaic) assessment of trigger conditions, issue a decision and consult with industry.
40. It is possible that this assessment would need to be carried out in the first year of the control period (which would mean any adjustments taking effect from year 2), as there could be some material deviation at that point from the assumptions in the periodic review given the level of uncertainty in the industry. On the other hand, it seems unlikely that the assessment would need to be carried out in the final year of the control period, as a periodic review recalibration will be under way by that point in any case. Therefore, we consider that this annual assessment would occur a maximum of four times in the control period.
41. A mechanistic adjustment could be implemented flexibly. ORR's assessment could be based on national, regional or operator-specific criteria. A national assessment would result in an adjustment to all operators' Schedule 8 parameters whereas alternative criteria could result in adjustments to all or a sub-set of operators. And although our preference would be to update both benchmarks and payment rates at the same time, there could be separate criteria applying to the two sets of parameters such that neither, either or both could be adjusted in each of the relevant years.
42. Should an adjustment be triggered by ORR, Network Rail would then be responsible for recalculating the relevant Schedule 8 parameters using a mechanistic, or formulaic, approach specified at the start of the control period. No consultancy resources, and only a minimal amount of additional industry input, would be required by this annual adjustment. However, there would need to be a small up-front investment, likely in the form of consultancy support, to specify the adjustment formulae.

Process

43. As with Option 2, under Option 3 Schedule 8 parameters would initially be set at PR23 for the full duration of CP7 based on historical performance/traffic and forward-looking trajectories. There would need to be a provision, likely set out in the final determination and in track access contracts, for Schedule 8 parameters to be updated using a pre-specified formula, subject to an annual assessment to be conducted by the ORR (Option 3B). It would be possible, in principle, to do away with this annual assessment by specifying a trigger formula in track access contracts (Option 3A). This is the approach taken in the CAA's service quality incentive regime (described in appendix 3). This would have the advantage of considerably reducing the required ORR input. However, for the purpose of estimating resource requirements later in the appendix we have assumed the more flexible approach of an ORR assessment.
44. Following publication of the final determination, Network Rail or ORR would commission consultancy support to develop the triggers and adjustment formulae to be used in the event of annual adjustments. This work would likely be concluded early in the first year of CP7 (including a short consultation period).
45. It is expected that ORR would set out in guidance the criteria that it would follow in deciding whether to trigger an annual adjustment (whether entirely formulaic or not) and the process that would be followed to implement adjustment to Schedule 8 parameters. We make some suggestions in this appendix as to the potential criteria it could use.
46. If an adjustment is triggered, ORR would communicate this decision to industry and simultaneously instruct Network Rail to implement the adjustment. ORR could choose to give industry a short period of time (for example, two weeks) to express any concerns or to challenge ORR's assessment on factual grounds. This is unlikely to be required if the criteria are entirely objective/formulaic (much as in the case of annual updates to access charges) but may need to be extended if ORR chooses to adopt a more judgement-based approach.
47. Following any consultation period deemed necessary, Network Rail would calculate new Schedule 8 parameters and issue updated versions of Schedule 8 for each relevant operator's track access contract, which operators would be required to check, and which ORR would need to subsequently approve.

Criteria for triggering an annual adjustment

48. This sub-section considers potential trigger criteria, more likely to be used in the context of a formulaic trigger assessment (Option 3A) but which could also inform a more subjective judgement-based approach.
49. Effective triggers would be outside Network Rail's control and have a direct bearing on train performance.
50. Examples of trigger variables could include the following:
    a) Out-turn train-kms from the previous year
    b) Forecast train-kms for the year ahead
    c) Out-turn passenger numbers or passenger-kms
    d) Out-turn passenger revenue
    e) Scale of Schedule 8 net payments by Network Rail

51. Both traffic and passenger demand have a direct bearing on performance, respectively through congestion effects and through increased variation in boarding times. Revenue has a direct bearing in payment rates and is the obvious choice of trigger for adjustments to that set of parameters.
52. Given the relatively low levels of traffic currently on the network (by historical standards), Network Rail could be expected to accommodate most new traffic requests. If this is the case, traffic levels are effectively beyond Network Rail's control. In addition, this variable would help protect Network Rail against the financial impact of poor performance due to traffic being above the levels assumed at the periodic review, thereby incentivising Network Rail to accommodate new traffic (in circumstances where it was to have a degree of control over whether to accept that traffic). It can be argued that passenger traffic is even less within Network Rail's control as it is driven primarily by exogenous factors (such as economic activity) and by decisions within the gift of train operators (such as in relation to fares).
53. The scale of Schedule 8 payments is suggestive that benchmarks may have become out of kilter with performance. At the same time, large payments could reflect efforts by Network Rail or operators to improve performance. In principle, it would be preferable to focus on exogenous variables though there could be a case for including this variable subject to a high threshold or in combination with other criteria.
54. On balance, we would favour out-turn train-kms and passenger revenue as trigger variables for benchmarks and payment rates, respectively. These are readily available at aggregate industry level and can also be easily obtained at train operator level.
55. In the case of each trigger variable, ORR would need to specify **reference values** and the **thresholds** (in terms of difference between out-turn and reference value) that would warrant an adjustment to take place.
56. Reference values could be based, for example, on projections published in the final determination or on historical values. The setting of thresholds could be informed by historical analysis of fluctuations in relevant variables which would show how often a given threshold had been crossed in the past. This could be combined with consideration of the financial impact on Network Rail and operators of a given threshold being crossed (for example, based on the analysis carried out by Network Rail and shared with the ORR in the Summer of 2022). In any case, there would need to be an element of judgement on the part of the ORR in setting thresholds.

Adjustment methodology

57. In the event that an adjustment is triggered by the ORR, revised Schedule 8 parameters could be calculated using simple formulae, as described below.
58. In the case of **benchmarks**, it is envisaged using a similar approach as for adjustments to the capacity charge for freight operators in CP5. In this scenario, a statistical relationship would be established between a measure of delay and a measure of network utilisation. In the context of the CP5 freight capacity charge, this was known as the 'congestion factor'. Adjusted benchmarks would then be calculated by plugging this parameter into Equation 1 below.

Equation 1 - Benchmark Adjustment Applied to Freight Operators Annually in CP5

$$\text{Adjusted Benchmark} = \text{Current Benchmark} \times \left\{ \left(\text{\% Traffic Deviation} \times \text{Congestion Factor} \right) + 1 \right\}$$

Where:

- *Benchmarks are expressed in delay minutes per 100 train miles*
- *Deviation between out-turn and reference value for traffic variable, expressed as a percentage*
- *Congestion factor is expressed as an elasticity of delay to traffic i.e., how increased traffic on the network will increase delays to other passenger operators when a passenger operator delays their own trains. Note that if the expression is logged the coefficient on train volumes (congestion factor) represents an elasticity.*

59. The relationship between delay and network utilisation can be estimated and applied at different levels of granularity, depending on the preferred trade-off between accuracy and complexity. We set out the following alternative approaches, which inform the resource requirement range estimates in the final section of the appendix:
    a) National congestion factor: single congestion factor estimated at GB level, applied equally to all operators and service groups;
    b) Regional or route congestion factor: separate congestion factors estimated for each Network Rail region or route; individual service groups would then be allocated to a given region or, in some cases, could be subject to a weighted congestion factor combining the parameters for different regions;
    c) Train operating company congestion factor: separate congestion factors estimated for each train operating company; and
    d) Service group estimation: separate congestion factors estimated for each service group.
60. For each of the sub-options, there could be a single or separate congestion factors applying across Network Rail and operator benchmarks.
61. The size of the data set required, and the complexity of the estimation process would vary across sub-options. Assuming a single congestion factor applying across Network Rail and operator benchmarks, and that data would be available for the past 10 years, this would involve 10 data points; a regional/route congestion factor would involve 50/140 data points (5 regions/14 routes); TOC-specific congestion factors would involve 240 data points; and service group-specific congestion factors would involve around 2,000 observations. Using separate congestion factors for Network Rail and operators would double the number of observations. Note also that it would be possible to estimate more aggregate congestion factors from more disaggregate datasets. For example, it would be possible to estimate a single national congestion factor from the regional/route data set.

62. It is possible that more granular estimation could lead to more accurate congestion factors. At the same time, more granular data sets are also likely to include a higher proportion of noise as there will be localised factors other than network utilisation driving the observed level of delay. It is also worth noting that delay experienced by a given operator is likely to be more closely related to overall traffic on the relevant section of the network than to the traffic it alone operates. As a result, more granular estimates may also be less statistically robust and at greater risk of resulting in spurious estimates, which could turn offer greater scope for disputes. On balance we would favour a more aggregate congestion factor.
63. Data permitting, control variables could also be added to the estimation to increase robustness. This could include exogenous impacts linked to network disruption through the use of binary/dummy variables. However, this would require further investigation in practice to determine practical feasibility (in terms of size of the data set and hence degrees of freedom available) and added explanatory power.
64. An alternative to a national congestion factor would be simply to assume a unit elasticity between traffic and delay and to forgo the statistical estimation of this parameter. It is worth noting that the freight congestion factor rounds down to unity with one decimal place.[17]
65. In the case of **payment rates**, it is envisaged that the adjustment would be equivalent to the deviation between out-turn and reference revenue. This is equivalent to taking a congestion factor equal to unity in Equation 1, and means that no up-front estimation of this parameter would be required. As with benchmarks, payment rates could use the same national adjustment factor for all operators and service groups or a more granular approach.

Data requirements

66. The following information would be required across a 10-year time horizon to allow for an estimation of the appropriate congestion factors:
    a) Annual measure of delay, such as delay minutes plus deemed late minutes broken down to the appropriate level of granularity (national, region/route, operator or service group);
    b) Annual measure of network utilisation, such as vehicle-kms or train-kms, broken down to the appropriate level of granularity;
    c) If deemed appropriate, information on other relevant explanatory (control) variables, such as number of passengers, passenger-kms or exogenous events causing disruption.

[17] Network Rail/Arup, Recalibrating the Capacity Charge for CP5 final Report, May 2013 [Recalibrating the Capacity Charge for CP5 - final report (networkrail.co.uk)]

67. Calculation of adjustments to Schedule 8 benchmarks would require out-turn or forecast data for the relevant year, at the appropriate level of granularity, for the chosen annual measure of network utilisation. Out-turn network utilisation data can be made readily available by Network Rail from its Track Access Billing System.
68. The information under points 66.1 and 66.2 can be made readily available by Network Rail. All levels of granularity above are feasible in principle from a data point of view though TOC or service group-specific calibration factors would require greater effort to estimate than national or regional factors.
69. Calculation of adjustments to Schedule 8 payment rates would require out-turn or forecast revenue data for the relevant year, at the appropriate level of granularity. Although out-turn data is readily available in the LENNON database, there are confidentiality restrictions on how this information can be handled and so practical implementation would require further investigation.

Resource Requirements

70. Whilst the previous sections set out the high-level process involved in implementing Options 2 and 3, this section provides an indication of their relative resource intensity.
71. Resources refer to overall elapsed time, industry input from ORR, Network Rail and train operating companies, as well as budget for consultancy support where appropriate.
72. These are high-level indicative estimates only, included with the intention of comparing the two options. A detailed resourcing exercise would be required should either option be pursued. This includes estimates for consultancy spend, which would be dependent on scope of work and market rates.
73. Option 2 could require between 5.5 and 12 months of elapsed time, 3.2-7.0 FTEs of industry resource and a consultancy budget in the range of c. £300k to £600k.
74. Option 3A would require negligible resources in the event that a recalibration is not triggered. If a recalibration is triggered, this would be estimated to take 1 to 2 months of elapsed time to implement and 0.2 to 0.4 FTEs of industry resource. Overall, this option would take between 1 to 3 months to implement when factoring in time to assess the need to recalibrate.
75. Under Option 3B, the initial trigger assessment phase would require between 2 to 3 months of elapsed time, and 0.4 to 2.6 FTEs of industry resource. Similar to Option 3A, it would then require between 1 to 2 months of elapsed time and 0.2 to 0.4 FTEs of industry resource if a recalibration is triggered.
76. Both Option 3A and 3B would require some consultancy support for the up-front congestion factor estimation and for the development of triggers, with a likely budget in the range of £50k to £200k, depending on the level of granularity at which the estimation was carried out.

77. The quantum of industry resource required is highly dependent on the degree of engagement with the process from train operating companies (TOCs). It is assumed that a majority of TOCs would closely engage with a mid-period wholescale recalibration, much as they would with a periodic review recalibration. However, they could choose to engage only in a light touch way with a mechanistic adjustment, especially if this was based on objective triggers (Option 3A). This possibility is reflected in our lower bound estimates.
78. In the case of Option 3, it is assumed that industry input would be resourced largely from existing ORR, NR and TOC roles. In the case of Option 2, it is possible that this would require additional resource or diverting staff from their existing duties given the greater intensity, duration and degree of detail involved in the process.
79. The rest of this section provides further explanation of our resourcing estimates for each option.

Option 2: Wholescale mid-control period recalibration

80. To implement Option 2, a mid-period recalibration during CP7, we estimate that it could require between 5.5 to 12 months of elapsed time, using 3.2-7.0 FTEs of industry resource and a consultancy budget in the range of c. £300k to £600k.
81. These estimates have been developed based on:
    a) **Information on the process and resources involved** in the PR18 recalibration and in the on-going PR23 recalibration from published documents and from colleagues involved in those processes;
    b) **Assumptions related to the resource intensity during different** parts of the process;
    c) **A consideration of which aspects of the full recalibration process would no longer be necessary** as part of a mid-period recalibration; and
    d) **Input from external experts** to estimate the resource required to undertake an initial assessment of whether a recalibration should be triggered.
82. Spend on consultancy support takes account of the known budgets for the PR18 and the PR23 recalibrations. Day rates are in today's prices and therefore do not take account of future inflation.
83. Unless otherwise stated, 1 FTE represents one full time staff employed for a year.

PR18 recalibration resource estimates

84. The PR18 recalibration can be split into four phases consisting of (i) scoping, (ii) recalibration of monitoring point weights (MPWs) and Cancellation Minutes (CMs), (iii) recalibration of remaining parameters and independent audit of phase ii and (iv) independent audit of phase iii. Based on published information, we know that these phases each lasted, respectively, c. 4[18], 4, 12 and 8 months. Based on consultation with colleagues directly involved in the process, we estimate that each phase required, respectively, c. 2.0, 2.0, 2.0 and 1.0 FTE/month. The number of FTE/month for each phase are based on bottom-up estimates based on knowledge of the number of people involved in the process at the time. For example, the 2.0 FTE/month for the scoping phase is made up of 1.6FTE/month from TOCs (0.1 per TOC x 16 TOCs), 0.2FTE/month from ORR, 0.2 FTE/month from NR and 0.4 FTE/month from consultants.

Applying PR18 resource estimates to a mid-control period recalibration

85. It is assumed that a mid-period recalibration would exclude the recalibration of MPWs and CMs (as this should be done throughout the control period anyway at the request of operators and/or NR) and hence would not require stage (ii). In addition, the resource required by phase (iii) would be slightly reduced because an independent audit of the recalibration of MPWs and CMs would no longer be required.
86. Based on this information, a mid-period recalibration would likely involve a recalibration phase taking 3 to 4 months with input from ORR, TOCs, Network Rail and external consultants.

Initial assessment resource requirements

87. A mid-period recalibration would also require an initial assessment of whether a recalibration is warranted. This would likely involve analysis (by the ORR and/or Network Rail and operators), internal governance/decision-making process, communication of decision to industry and consultation process.

[18] These 4 months included separate rounds of meetings for passenger and freight operators. Timescales could likely be compressed if this stage was to cover only the passenger regime.

88. Based on consultation with colleagues with direct experience of similar processes, such as the implementation of the fixed track access charge (FTAC) wash-up[19] and the recent Market Can Bear tests[20] we consider that an initial assessment phase for the passenger regime would likely take around 3 months. However, with a stream-lined process, with limited consultation and accelerated decision making, this phase could be brought down to 2 months. Industry resource would be required from ORR, TOCs[21] and Network Rail.

Option 2: Resource Requirements

89. Overall, the initial assessment and recalibration phases would take c. 7 months of elapsed time in our *central case scenario*, utilising c.4.0-5.0 FTE of industry resource and around 1.4 FTE of a consultant. The assumed industry resource split is 0.8 FTEs from ORR, 3.0 FTEs from TOCs and 0.6 FTEs from NR.
90. Applying an annual rate of £225,000 and £375,000 per FTE to consultant's time, this gives an estimated consultancy budget of £300k to £400k.
91. From past experience of periodic review recalibrations and in-period disputes, there is a high likelihood of the duration of the process being extended given the significant scope for disagreement to arise in relation to (a) the need for the recalibration in the first place; (b) the overarching methodology to be followed; (c) exceptions to this methodology; and (d) the implementation of the agreed methodology (with there being scope for calculation error).
92. The recalibration process can become contentious, and therefore consume significant industry energy and extend timescales. It is possible that a mid-period recalibration could take 12 months or longer to complete increasing the cost to between £500k and £600k. At the same time, the process could potentially be streamlined by speeding up procurement and decision-making processes, by reducing consultation/audit time and by reducing scope.
93. To take account of these uncertainties we have estimated:
    a) A lower bound of 5.5 months of elapsed time, 3.2 FTE of industry resource and a consultancy budget of c. £300k.
    a) An upper bound of 12 months of elapsed time, 7.0 FTE of industry resource and a consultancy budget of c. £600k.

[19] ORR, Approval of the recalibration of track access charges for CP6, November 2018 Approval of the recalibration of track access charges for CP6 - Letter to Network Rail 22 November 2018 (orr.gov.uk)
[20] ORR, PR23 access charges further consultation, April 2022 PR23 – Review of Network Rail's access charges – Technical consultation – Further proposals - 14 April 2022 (orr.gov.uk)
[21] It is not expected that all train operating companies would be equally engaged in the process. Based on previous experience, we expect around two-thirds of operators would be closely involved – this is equivalent to 16 companies. We have used this assumption in deriving overall FTE requirements.

Table 4 - Option 2 Resourcing Estimates

Phase	Estimate	Option 2 Lower Bound	Option 2 Upper Bound
Initial assessment	Total Industry Resourcing (FTE)	1.8	4.0
Recalibration	Total Industry Resourcing (FTE)	1.4	3.0
	Consultancy budget (000s £)	300	600
Initial assessment and Recalibration	**Total Industry Resourcing (FTE)**	**3.2**	**7.0**
	Consultancy budget (000s £)	**300**	**600**
	Elapsed Time (months)	**5.5**	**12**

Source 2 - Network Rail Analysis

Option 3: Mechanistic Adjustments Resource Requirements

94. This option would involve three distinct stages: the upfront estimation of a congestion factor and definition of trigger criteria; an annual assessment of whether an adjustment should be triggered; and if it is triggered, the calculation of adjusted Schedule 8 parameters.
95. Upfront work would be estimated to require a consultancy budget in the range of c. £50k - £200k. Under Option 3A, the annual trigger assessment would take a negligible amount of time and resource; under Option 3B it could take around 2 to 3 months and require 0.4-2.6 FTE of industry resource. If recalibration is triggered, the work would then take 1-2 months to implement and require 0.2-0.4 FTE of industry resource.

Estimation of congestion factor and definition of trigger criteria

96. This stage would involve specifying the work and commissioning consultants, defining the methodology, collating and cleaning relevant data, model estimation, consideration of alternative trigger criteria, reporting, independent audit and consultation with industry (which could happen both at the start and end of the process).
97. Based on experience of previous similar exercises, we would expect this stage to take c. 3 to 6 months and require input from across ORR, Network Rail, TOCs and external consultants. This is envisaged to require between 0.2 - 0.4 ORR FTE, 0.4 - 1.4 TOC FTEs and 0.2 - 0.6 Network Rail FTE. The 0.8 - 2.4 FTE of industry input would be expected to fit within existing allowances for the overall PR23 process.

98. Consultants' input would likely be considerably greater for the estimation of TOC or service-group specific congestion factors. Based on the rate per FTE quoted previously, we estimate that consultancy budget could be in the £50k-£200k range.

Annual Trigger Assessment

99. The annual trigger assessment is expected to be led by ORR and, under Option 3B, to involve a short analysis and consultation period22. We estimate that this would take c. 2 to 3 months of elapsed time and require input from ORR, Network Rail and TOCs. This is envisaged to require 0.1 - 0.4 ORR FTEs, 0.2 – 2.0 TOC FTEs and 0.1 - 0.2 Network Rail FTEs . The 0.4-2.6 FTE of industry resource would come from existing roles, and the precise quantum is highly dependent on the degree of engagement of train operating companies with the process. The lower bounds assumes that ORR's decision would be uncontentious and that TOCs would choose to engage with the process in only a light-touch way. The upper bound assumes ORR would place greater emphasis on subjective judgement and a more contentious context and decision.

Calculation of adjusted parameters

100. Network Rail would be expected to lead this stage of the process, with ORR auditing results, much as is currently the case for annual updates to track access charges. This could be completed in c. 1 to 2 months of elapsed time and require 0.1 to 0.2 FTEs from each of NR and ORR. The 0.2-0.4 FTE of industry resource would come from existing roles. The upper bound takes account of the additional work required by more granular adjustment approaches.

Option 3 resource requirements

101. The sum of estimated resource requirement ranges across each stage is set out in **Error! Reference source not found.**.

102. As mentioned previously, it should be noted that the estimated ranges below are highly dependent on the degree of TOC engagement in the process and could vary if engagement were to significantly differ from the assumption behind the estimates.

[22] Under Option 3A, it is assumed that the time and resource required would be negligible.

Table 5 - Option 3 Resourcing Estimates

Phase	Estimate	Option 3A Lower Bound - Upper Bound	Option 3B Lower Bound - Upper Bound
Upfront Estimation of Congestion Factor	Total Industry Resourcing (FTE)	0.8 – 2.4	
	Consultancy budget (000s £)	50 - 200	
Annual Trigger Assessment [23]	Total Industry Resourcing (FTE)	Negligible (< 0.1 FTE)	0.4-2.6
Annual Calculation of Adjusted Parameters (if required)	Total Industry Resourcing (FTE)	0.2 - 0.4	
Assessment and Calculation	**Total Industry Resourcing (FTE)**	**0.2 - 0.4**	**0.6 - 3.0**
	Consultancy budget (000s £)	**50 - 200**	
	Elapsed Time (months)	**1.0 - 3.0**	**3.0 - 5.0**

Source 2 - Network Rail Analysis

[23] If ORR's decision is uncontentious, the resource requirements in the annual trigger assessment under Option 3B would be closer to the lower bound.

Comparison of resource requirements across options

103. The following table sets out overall resource requirements for options 2, 3A and 3B side by side.

Table 6 - Comparison of Resourcing Estimates

		Option 2	Option 3A	Option 3B
Phase	**Estimate**	**Lower Bound - Upper Bound**	**Lower Bound - Upper Bound**	**Lower Bound - Upper Bound**
Assessment and Calculation	**Total Industry Resourcing (FTE)**	**3.2 – 7.0**	**0.2 – 0.4**	**0.6 – 3.0**
	Consultancy budget (000s £)	**300 - 600**	**50 - 200**	
	Elapsed Time (months)	**5.5 - 12**	**1.0 – 3.0**	**3.0 – 5.0**

Source 3 - Network Rail Analysis

Appendix 3 - Regulatory precedent in other sectors: Managing uncertainty in setting financial performance mechanisms

Introduction

1. Network Rail would be expected to lead this stage of the process, with ORR auditing results, much as is currently the case for annual updates to track access charges. This could be completed in c. 1 to 2 months of elapsed time and require 0.1 to 0.2 FTEs from each of NR and ORR. The 0.2-0.4 FTE of industry resource would come from existing roles. The upper bound takes account of the additional work required by more granular adjustment approaches.
2. The purpose of this appendix is to illustrate some of the instances where regulators have taken uncertainty into account in their regulatory approach and/or the mechanisms that regulators use to deal with similar types of uncertainty as those faced by the industry during the post-Covid recovery period. The focus is on financial performance incentive mechanisms, such as Schedule 8, and demand -related revenue uncertainty. This appendix is written in support of, and should be in read in conjunction with, our main response to ORR's October 2022 Schedule 8 consultation.
3. The appendix covers the following mechanisms:

<u>Performance-related uncertainty mechanisms</u>

- *CAA – National Air Traffic Service (NATS) Service quality incentive regime – modulation of delay metric (C3) targets*
- CAA – National Air Traffic Service suspension of service quality incentives during covid-19
- CAA – Outcome Based Regulation (OBR)
- Ofwat – Outcome Delivery Incentives (ODI)
- ORR – National Highways performance targets and post-pandemic travel uncertainty

<u>Demand-related uncertainty mechanisms</u>

- CAA – Heathrow H7 Traffic Risk Sharing (TRS) mechanism
- Ofwat – Revenue Forecasting Incentive (RFI)

Key Messages

4. The appendix sets out how regulators in air transport, water, roads and telecoms have all taken account of unexpected fluctuations and uncertainty in demand/traffic patterns in the application of financial or reputational performance incentive mechanisms:

a. **Mechanistic target adjustments: CAA**'s service quality incentive regime for the National Air Traffic Service includes a mechanistic adjustment of the performance targets for one of its metrics, known as a 'modulation'. A formulaic adjustment is triggered when traffic growth in a given year exceeds or falls below a given range.

b. **Annual bespoke adjustments: Ofwat** takes account of unforeseen events (such as the impact of extreme weather or peaks in demand) in the application of its Outcome Delivery Incentives framework; this is done through annual adjustments to related financial payments but has the same practical effect as changes to performance targets would have. Although adjustments are not formulaic, Ofwat's annual reviews appear to follow a well-understood, precedent-based process.

c. **Suspension of performance incentive regimes: ORR** (in relation to National Highways) and **CAA** (in relation to the National Air Traffic Service) both suspended elements of their respective performance incentive frameworks during the 2020-22 period. They continue to maintain the relevant incentive mechanisms under review given lingering uncertainty in the pattern of demand recovery post-covid.

d. **Bespoke exclusions: CAA** has a proposed a licence modification that would allow it to determine disputes between Heathrow airport and airlines about the exclusion of certain periods of disruption from performance measurement in its Outcome Based Framework (OBR).

5. Beyond performance incentive regimes, **CAA** and **Ofwat** have both adopted formulaic traffic risk sharing mechanisms which have the effect of adjusting future charges as a function of the difference between forecast and out-turn demand.

6. These examples serve to demonstrate (1) that regulators acknowledge that fluctuations in demand are partly beyond regulated entities' control; (2) that the financial impact of this uncertainty has undesirable consequences for users; and (3) that these regulators implicitly consider that a mechanistic adjustment strikes an effective balance between incentives towards growth and protection from risks beyond a regulated entity's control. At the same time, the relevance of the examples in this paper to the implementation of Schedule 8 will necessarily vary from case to case.

Performance-related uncertainty mechanisms

CAA – National Air Traffic Service (NATS) Service quality incentive regime – modulation of delay metric (C3) targets

7. NATS En Route plc (NERL) is subject to a system of financial incentives linked to flight delays, with performance targets set through periodic reviews[24]. One of the metrics used in this regime, C3, results in NERL earning a bonus/penalty when flight delay performance falls outside a given target band[25]. C3 target band thresholds are subject to what the CAA refers to as 'modulation', whereby the targets are mechanistically adjusted if traffic is more than +/- 4 % different from the level forecast for that year at the periodic review stage. Thresholds are modulated by the net change in traffic beyond the +/- 4 % threshold, multiplied by an 'elasticity factor' of 5. So, for example, if traffic growth in a given year is 6 %, then each of the target thresholds are multiplied by 1+(0.06 – 0.04)*5 = 1.10.
8. This is a very similar regime to out proposed Option 3, multiple in-control period 'mechanistic' updates.

CAA - National Air Traffic Service (NATS) suspension of service quality incentives due to covid-19

9. During covid-19, the CAA decided to suspend the service quality incentives system as 'targets for delays in 2020 onwards did not reflect the impact from a significant downturn in traffic in 2020 and 2021'[26]. NATS itself acknowledged that it would not be appropriate to seek to recover from users the bonuses to which it was entitled given that 'the achievement of the targets was materially easier while traffic remains well below anticipated levels'. NATS therefore supported disapplying the incentive and considered, equally, that it should not be subject to penalties if traffic returned much quicker than expected. The CAA is maintaining the service quality incentive system under review.

[24] CAA (2019), UK RP3 CAA Decision Document: CAP1830
https://publicapps.caa.co.uk/docs/33/CAP%201830%20CAA%20Decision%20Doc.pdf
[25] CAA (2019), UK RP3 CAA Decision Document Appendices: CAP1830a
https://publicapps.caa.co.uk/docs/33/CAP%201830a%20appendices.pdf
[26] CAA (2021), Economic regulation of NATS (En Route) Plc: decision on licence modifications to implement Exceptional measures – CAP2279
https://publicapps.caa.co.uk/docs/33/NERL%20licence%20modifications%20(CAP2279).pdf

CAA – Heathrow Airport Outcome Based Regulation (OBR)

10. In its recent Final Proposals[27], the CAA confirmed its intention to implement a performance framework to incentivise service quality improvements. The proposed framework is called Outcome Based Regulation (OBR) and it is an iteration of the previous Service Quality Rebates and Bonuses (SQRB) scheme. OBR contains a combination of financial incentives (with bonuses/penalties payable if performance is above/below target) and reputational incentives (where performance against target is monitored and reported on but no financial bonus/penalty applies).
11. The Final Proposals include a licence modification that would allow the CAA to make binding decisions on disputes between Heathrow Airport Ltd (HAL) and airlines about **exclusions** to the OBR regime during major operational disruption events. The CAA notes that it "would only expect to consider the most serious cases where the risk of consumer harm or the financial impact on HAL is significant". Exclusions are typically implemented by removing data points relating to certain periods from the data set used to measure performance against target. This has the same effect in practice of adjusting targets downwards. Whilst this provision does not imply that CAA anticipates adjusting OBR targets if circumstances turn out to be different than expected, it does create the opportunity for the airport to require the CAA to consider such changes on an ad hoc basis.
12. The CAA expects to carry out a **mid-term review** of the OBR framework that would include several aspects, amongst which, "any specific issues arising from the application of new measures and targets. This could include any definitions that are difficult to apply or measure in practice, or any targets that now appear unachievable for reasons outside of HAL's control"[26].

Ofwat – Outcome Delivery Incentives (ODI)

13. Ofwat makes annual adjustments to individual companies' original price controls (as set out in its periodic review final determination) as part of what is known as its Outcome Delivery Incentive (ODI) framework. These annual adjustments reflect companies' performance in relation to their 'performance commitments' (effectively, performance targets). Annual adjustments are described formally as 'in-period determinations'.

[27] CAA (2022), CAP2365 Economic regulation of Heathrow Airport Limited: H7 Final Proposals, https://www.caa.co.uk/commercial-industry/airports/economic-regulation/h7/consultations/final-and-initial-proposals-for-h7-price-control/

14. Whilst adjustments partly follow a formulaic approach[28], Ofwat also makes **bespoke adjustments** "to account for matters that have arisen after our PR19 determinations and publication of the reconciliation rulebook". In 2022, Ofwat made bespoke adjustments to all 17 companies it regulates, which amounted in net terms to £54m[29]. Ofwat gives the example of its 'green recovery funding'[30] decisions as the rationale for bespoke adjustments to Severn Trent Water and South Staffs Water. Green recovery funding is aimed at building back greener from the pandemic by supporting new, green investment projects.
15. It was not possible to review bespoke adjustments for each of the companies regulated by Ofwat due to time constraints. However, we have looked at the example of Northumbrian Water[31], which received a bespoke adjustment of £12m. In this case, bespoke adjustments are due to the impact of storm Arwen on water supply interruptions (one of the ODI performance commitments). Effectively, Ofwat acknowledged through this process that a proportion of the instances in which Northumbrian Water failed to meet its water supply interruption target was due to factors beyond its control.

ORR – National Highways performance targets and post-pandemic uncertainty

16. The ORR specifically called out the impact of the pandemic in its 2022 benchmarking report of National Highways regions[32]. The report is based on 2020-21 data, which ORR said was intended to form a baseline for the remaining four years of Road Investment Period 2. However, ORR notes that the data "has been affected by the impacts of the pandemic on travel behaviours and traffic levels" and that as travel demand recovers, new insights would be generated on the relationship between traffic levels and aspects of performance such as safety.

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[28] In simple terms, if a company exceeds its performance commitments, then it is allowed a higher revenue, which it can reflect in user charges in future years.
[29] Ofwat (2022), Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22, https://www.ofwat.gov.uk/wp-content/uploads/2022/10/Sector_overview_Final_determinations_of_in_period_outcome_delivery_incentives_for_2021_22.pdf
[30] https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/green-recovery/
[31] Ofwat (2022), Final determination of Northumbrian Water's in-period outcome delivery incentives for 2021-22, https://www.ofwat.gov.uk/wp-content/uploads/2022/10/Final_determination_of_Northumbrian_Waters_in_period_outcome_delivery_incentives_for_2021_22_with_cover.pdf
[32] ORR (2022), Benchmarking National Highways: 2021 Progress update, https://www.orr.gov.uk/sites/default/files/2022-02/benchmarking-national-highways-2021-progress-update_1.pdf

17. ORR recognises that "indicators that are influenced by the level of traffic on the network have been significantly affected by the impact of the pandemic on travel demand", and highlights where it considers this to be the case. ORR makes specific reference to the number of people killed and seriously injured and to average delay on the network, where the reductions observed in 2020 were both attributed primarily to lower traffic levels. ORR recognises that NH's achievement of its incident clearance target was made less challenging because of lower traffic levels and number of collisions.
18. ORR also made the decision to suspend customer satisfaction targets for 2020-21 and 2021-22 due to a combination of a change in survey methodology (with the survey moving from face-to-face interviews to on-line data collection) and journey patterns and travel purposes being impacted by lockdowns and travel restrictions. In its 2022 report, ORR also acknowledges that travel patterns are still settling post-Covid.
19. These examples demonstrate ORR's acknowledgement of the link between traffic levels and certain dimensions of performance, and its willingness to adjust its regulatory approach when traffic levels due to reasons beyond a regulated entity's control. Whilst there are operational differences between roads and railways, the relationship between traffic and performance is in the same direction.

Demand-related uncertainty mechanisms

CAA – Heathrow Airport H7 Traffic Risk Sharing (TRS) Mechanism

20. Passenger demand forecasts are a central component of airport price controls. In its recent Final Proposals for Heathrow Airport Ltd's (HAL) H7 price control[33], the CAA recognised that there is a "great deal of continuing uncertainty over how developments in the industry, the economy, the aviation market and the course of the covid-19 pandemic will affect traffic at Heathrow". This has represented a policy shift on the part of the CAA relative to previous price controls and is an indication of how covid-19 has fundamentally changed the industry.

[33] CAA (2022), CAP2365 Economic regulation of Heathrow Airport Limited: H7 Final Proposals, https://www.caa.co.uk/commercial-industry/airports/economic-regulation/h7/consultations/final-and-initial-proposals-for-h7-price-control/

21. In order to reduce the "risk of significant gains or losses for HAL arising from changes in passenger numbers (over which it has limited control" the CAA is proposing to introduce a new traffic risk sharing mechanism. The CAA notes that this mechanism is also expected to "generate benefits for consumers as a result of a stable regulatory regime, stronger efficiency and growth incentives for HAL, and a greater ability for both HAL and airlines to plan their businesses". The new Heathrow airport mechanism is a significant departure from previous CAA policy on traffic uncertainty with respect to airport regulation and is an indication of how covid-19 has fundamentally changed the industry [34]. It also highlights CAA's acknowledgement of the challenges involved in making regulatory determinations based on medium to long-term traffic projections.
22. The TRS operates in the following way, where passenger numbers refer to each calendar year:
    a. For differences of up to 10 % between forecast and out-turn passenger numbers, HAL will be able to recoup (/be required to refund) 50 % of the resulting difference in allowed revenues through higher (/lower) charges.
    b. For differences greater than 10 %, HAL will be able to recoup (/be required to refund) 105 % of the resulting difference in allowed revenues through higher (/lower) charges. The reason for this figure being greater than 100 % is that HAL generates non-regulated income that is a function of passenger traffic numbers.
23. The CAA points out that the 10 % threshold would have been passed only in two years over the previous three control periods, and only by a small amount. It also notes that the purpose of the high-risk sharing factor in the outer band is to provide HAL with a relatively high degree of protection (or to reduce windfall payments, we might add) from the impact of extreme events, while also preserving some incentive for it to take actions to facilitate traffic growth.

Ofwat – Revenue Forecasting Incentive (RFI)

24. Water companies set consumer charges in advance of the start of each year such that expected revenues align with those allowed under the price control. However, Ofwat recognises that there is forecast uncertainty in this process, partly due to reasons beyond companies' control, such as the impact of weather on demand. The RFI allows companies to revise their target revenue to collect from customers to correct for any shortfall/over-recovery up to 2 % of their revenue forecast[35]. For a gap between 2 % and 3 % of revenue forecasts, a financial penalty applies[36].

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[34] Although a similar mechanism has existed for some time with respect to National Air Traffic Service charges, its introduction was driven by European requirements and reflects the fact that air traffic control has considerably less influence over traffic levels than airports or airlines.
[35] Ofwat (2017), Delivering Water 2020: Our methodology for the 2019 price review Appendix 7: Network plus water and wastewater controls, https://www.ofwat.gov.uk/wp-content/uploads/2018/12/Appendix-7-Wholesale-revenue-incentives-FM.pdf
[36] https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/pr19-reconciliation-models/

25. Note that this mechanism operates differently to CAA's TRS (where a penalty applies to the central dead band and full revenue recovery is allowed outside this band). This is possibly because water demand is stickier and hence more predictable than air passenger demand, which can vary significantly for reasons beyond an airport's control.

Conclusions

26. The examples set out in this appendix demonstrate that there is precedent for regulators taking account of demand uncertainty by allowing changes to performance targets, charges or other financial incentives during a control period in response to fluctuations in demand. Some regulators adopt more mechanistic adjustments, others a more subjective or ad hoc approach.
27. These examples also demonstrate that:
    a. some regulators acknowledge that fluctuations in demand are partly beyond regulated entities' control;
    b. that the financial impact of the related uncertainty has undesirable consequences for users; and
    c. some regulators implicitly consider that a mechanistic adjustment strikes an effective balance between incentives towards growth and protection from risks beyond a regulated entity's control.
28. Although the rail industry and the Schedule 8 performance regime have unique features, there is regulatory precedent for allowing Schedule 8 parameters to vary as a function of rail market demand.

OFFICE OF RAIL AND ROAD

Response to ORR's consultation on outstanding matters in the Schedule 8 performance regime

This pro-forma is available to those that wish to use it to respond to our consultation. Other forms of response (e.g. letter format) are equally welcome.

Please send your response and any queries to performance.incentives@orr.gov.uk by 9 January 2023.

About you

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

NTL do not agree with the insertion of new sub-paragraphs to switch off the majority of schedule 8 payments.

Without the necessary supporting frameworks on what is proposed for performance management and incentives for operations, as well as lack of clarity on application of direct penalties to TOCS/FOCs as part of any alternative proposal, we cannot support the addition of these new paragraphs.

NTL previously stated that Schedule 8 serves an important function in protecting revenue for franchised operators. Whilst the nature of how a GBR model would operate is currently unknown, our concern with the removal of the Schedule 8 mechanism would be the potential lack of incentives to deliver performance and TOCs ability to prove the benefits of performance enhancing initiatives.

We note that the ORR set out in their plans that incentives and financial protections would be considered prior to the issuing of any notice, but these would need to be clearly stated and agreed beforehand and consideration given to how the model will work with non GBR operators.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

NTL supports a mid-period recalibration exercise and has the following comments:

- Significant changes to services structure and operations across our network and involving other operators due to major projects (TRU/HS2) and the impact of MRTF as well as the post covid recovery support this exercise being carried out.
- We would also like to see consideration of re-baselining of operational costs as part of this exercise, such as alternative transport provision costs which are all covered under Schedule 4, however this has an impact on day-to-day operations (Schedule 8).
- NTL cannot see why it would not be appropriate to have this clause included within all contracts.
- NTL cannot comment on circumstances under which a power should be used, until the policy guidance on application is available.

Other comments

Schedule 4: Proposal E (Development of schedule 4 formulaic compensation estimate tool) not being taken forward.

Given the financial constraints on both NwR and Operators – this tool would assist both parties in developing possession responses in order to deliver industry benefits, We believe that this could be of great value to both parties and therefore it is disappointing that this option I not being taken forward.

Schedule 4 Recalibration: point 1.33 EBM and TM to be raised in line with CPI.

The rail replacement bus market is requiring much higher prices, due to a combination of factors (largely inflationary, but compounded by the Ukraine war and Brexit freedom of movement restrictions, along with a net lack of coaches which is linked to drivers' shortages currently running at ~26% vacancy gap caused by DVLA/Brexit/moving to be Lorry drivers for higher wages and better conditions). Although government (TSC) have instructed road freight supply chain to fix systematic short comings before 2024, including recruiting more drivers and creating a code of conduct to improve conditions, this is unlikely to be resolved and we can anticipate that this will be a long-term issue that will extend well into and possibly beyond the next control period. This influence to supply chain policy will adjust market demands and increase procurement costs.

NTL anticipates that the situation as described will result in a lower level of rail replacement provision (to fit within the financial envelope), which will ultimately result in a "worse" service for passengers. We believe that the issue needs to be systematically addressed as part of recalibration in order to provide sufficient compensation to allow effective contracts to be in place for alternative transport that are not at the cost of the operator/taxpayer but as a clean and direct pass through from the possession.

NTL has sent a note to ORR describing these challenges in detail and we would urge ORR to consider this as part of the PR23 process.

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Please send your response and any queries to performance.incentives@orr.gov.uk by 9 January 2023.

About you

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

- Question 2:
  - We believe that all operators should have the ability to switch off the performance regime, as it represents a big risk to operators when incorrectly calibrated and not working as intended.
  - The PR should protect Train Operators and incentivise NR, but doesn't currently work, as it has not been recalibrated to reflect post Covid reduced timetables.
- Question 3:

    - We do not believe the drafting of Clause 12.3(a) works, in particular the word “amended” is too blunt an instrument. It should say something like “amended… in such a way as to prohibit the Schedule 8 performance regime”.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

- Question 4:
    - Yes, but recalibration should not be limited just to the midpoint of CP7, it is not currently working for post Covid reduced timetables.
    - Moreover, train operators should be able to initiate a recalibration.
    - We believe that there should be a reopener whenever there is a material change that invalidates previous calibrations.

OFFICE OF RAIL AND ROAD

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About you

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Organisation: Rail Partners

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This information will not be published on our website.

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

Rail Partners recognises the need for additional flexibility to account for future reform, particularly as the legislative programme to establish Great British Railways is likely to continue into the next Control Period.

The Plan for Rail White Paper outlines that in future GBR will be responsible for the specification and procurement of most passenger rail services through Passenger Service Contracts (PSCs). The Department for Transport envisages that these PSCs will include performance measures through which passenger operator performance will be assessed. Whilst we recognise that this could make requirements for further performance incentives through the Schedule 8 regime an unnecessary administrative burden given GBR will have dual responsibilities for managing infrastructure and specifying passenger services, we remain concerned that the ability to switch off the Schedule 8 regime for GBR operators in future could result in a worse performing railway if there is not a strong alternative incentive regime in place. A high performing railway is critical to attracting passengers back to rail and growing revenues following the pandemic. It will remain critical for all commercial operators – open access passenger and freight operators and other operators with revenue incentives switched on within National Rail Contracts and in the future Passenger Service Contracts – given the strong link between performance and revenue.

Private sector open access passenger and freight operators have invested significantly to both create and expand markets, yielding significant economic and environmental benefits to society. It is right that they remain exposed to payments through the Schedule 8 regime as it provides a strong incentive to make investments and refine operational practices to improve performance and exceed their benchmarks thus contributing to a high performing railway. There is a risk that should Schedule 8 be switched off for some operators, without alternative strong incentives, all parties will not face the equivalent drive to improve performance. Open access passenger and freight operators represent a small proportion of all traffic on the rail network. Should Schedule 8 be switched off for most operators and services, there is a considerable risk that the regime no longer strongly incentivises the future infrastructure manager to deliver a high performing railway. Any future regime must ensure that the signal around Schedule 8 is not weakened for those operators that remain in scope of this regime.

We note that that ORR does not intend to issue a notice that enables elements of the Schedule 8 regime to be switched off for GBR operators unless it is satisfied that there are reasonable incentive structures in place. To date, little detail has been shared by DfT on what the performance incentives within PSCs may look like. Rail Partners members would welcome further information on what future performance structures ORR may consider appropriate.

There has rightly been a strong emphasis on the need for greater collaboration between industry partners in a reformed railway, something that Rail Partners and its members strongly support. However, it will need to be considered how this ambition could be undermined should some operators be exposed to Schedule 8 and others opted out, as incentives for all operators will not be aligned. This could potentially make it more difficult to establish a cross-industry approach between all operators and the infrastructure manager. It is essential where multiple different performance regimes co-exist in a new industry structure, that they all point in the same direction and incentivise the same outcomes. Without close alignment between the regimes, it is likely that the incentive properties of Schedule 8 will be significantly diluted.

It was reassuring that the consultation on the legislation required to establish GBR outlined a continued role for a strong, independent regulator. It is vital that ORR is able to challenge GBR and its funders in a robust manner to ensure that any amendments to the performance regime work for all operators. Any assessment on changes to the performance regime proposed by GBR should be conducted transparently and should include consultation with industry.

Rail Partners supports ORR's decision to keep the delay attribution process which will continue to play a pivotal role in identifying and mitigating performance risks to deliver the high performing railway envisaged in the Plan for Rail, even if elements of Schedule 8 are turned off in future. For passenger operators that have performance incentives through fees within their National Rail Contracts or Passenger Service Contracts, retaining a clear process to determine the party responsible for impacts and incidents will be important so that cause can be apportioned fairly between operators and the infrastructure manager. This will ensure that operators are fairly assessed against the performance related criteria in their contracts.

Adding flexibility to Schedule 8 in CP7

Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?

Do you think that this should be a feature of each of the passenger, freight and charter regimes?

Do you have views on the circumstances under which such a power should be used?

Rail Partners recognises the benefits of incorporating greater flexibility into the Schedule 8 regime by permitting a mid-control period recalibration of parameters. We agree that the strongest case for including this clause exists in the passenger industry where it could be particularly valuable as the industry continues to recover from the impact of the pandemic and long-term passenger numbers, and therefore service levels, remain uncertain. In extreme circumstances it could be beneficial for freight operators too.

The need for greater flexibility must be balanced against the benefits of a stable performance regime against which private sector operators have the confidence to make investments to improve performance levels and exceed the benchmarks agreed at the beginning of the control period. It is therefore essential that any re-opener should only adjust for external factors and importantly should not reward poor performance or penalise good performance. Should ORR have the ability to trigger a mid-control period recalibration without clear parameters under which this could take place, this could reduce confidence to invest in performance improvement opportunities as operators may not have a five-year horizon against which they can make informed decisions. It could also create a perverse incentive should operators consider that continued investment would result in higher benchmarks resulting from mid-period recalibrations.

To mitigate this, it is important that ORR specifies a threshold, for example, measured as a change in traffic levels, which must be exceeded before a recalibration could be initiated. This threshold should be sufficiently high to ensure that this clause is only triggered in exceptional circumstances, enabling private sector operators to continue to have confidence to make investments. Any recalibration of Schedule 8 following the re-opener must apply equally to the operator and infrastructure manager sides of the regime and therefore not affect how the regime is geared. The threshold for commencing a recalibration should also be measured over a prolonged period of time to avoid the risk that a recalibration is not caused by a short-term shock to traffic levels.

Should a recalibration take place but further into the control period traffic levels return to a level where the initial CP7 benchmarks would be more appropriate, ORR should be able to reimpose these benchmarks and this should be kept under review. Otherwise there is a risk that the re-opener results in a regime that operates outsides of its calibrated parameters for an exacerbated period of time. For example, despite the significant impact that the pandemic had on traffic levels (which we assume would have triggered a recalibration), it is certain that the benchmarks agreed at the beginning of CP6 are more representative of traffic levels currently than any adjusted benchmarks implemented in 2020 or 2021 would be. ORR could also consider conducting a recalibration if changes are made to Network Rail’s funding within a control period where this would significantly change their renewal and maintenance plans, making the initial benchmarks unrepresentative.

The consultation notes that a recalibration would not be initiated based on poor performance that was under the control of industry parties – while this is often clear cut, in other cases it can be far more nuanced, for example industrial action can have a significant impact on performance but is not necessarily in the gift of train operators or Network Rail to resolve.

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Ref TPE Response Sch 8

6th January 2023

Email only

performance.incentives@orr.gov.uk
Office Of Rail and Road

Dear Sirs

TransPennine Express Limited Response
Schedule 4 & 8 Conclusions & Consultation – 20th October 2022

Please see the response to the questions raised in the consultation document of the 20th October 2022.

Schedule 8 Switch Off Provision.

In the event that GBR becomes operational during CP7, contracted passenger operators will be required to comply with the terms of their contracts. As it is likely that these terms would supersede current performance requirements, it seems sensible to provide a ’switch off’ clause within Schedule 8, where applicable.

Comments on the proposed paragraphs are best made by legal representatives.

Mid-control Period Recalibration

Schedule 8 re-calibration discussions have repeatedly highlighted the difficulties in determining relevant data following, amongst other issues, the pandemic. In doing so, it has also highlighted the need to reassess schedule 8 following a material change. The proposal for a mid-control period recalibration under an agreed set of circumstances is therefore supported.

It seems sensible to sensible for the provision to apply to all industry operators, as empirical evidence has shown major events affect the entire railway industry.

As indicated, it is preferable to have an agreed set of triggers for a recalibration exercise. Perhaps an industry workshop could be arranged to determine these circumstances.

Yours Faithfully,

Helen Bold
Commercial Contract Manager

TransPennine Express Ltd

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Office of Rail and Road
By email

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[redacted]

9 January 2023

To Whom it may concern

Re: PR23 – Review of Schedule 4 and 8 Conclusions and Consultation on Outstanding Matters

Thank you for the opportunity to respond to the questions raised in consultation of the Outstanding Matters for Schedule 8 in CP7 posed by ORR. TfL is pleased to provide its response in two sections below addressing each set of questions accordingly. Section A provides a response to the Scope of Application of Schedule 8 and Section B answers questions relating to Adding Flexibility to Schedule 8 in CP7.

<u>Section A: Scope of application of Schedule 8</u>

1) *Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?*

- Although the proposal to insert new paragraphs into Schedule 8 is preferable to the proposals of the GBRTT, TfL does not agree with the proposal.
- Switching off payments whether partially or entirely removes or significantly impairs the incentives to ensure all parties to mitigate or address performance issues.
- As such the new proposal sees the remaining few non-GBR operators continuing to pay as now and thereby remain directly incentivised at a locally accountable level whilst the GBR operators will be insulated from the impact of their operational performance on others with no clear incentive to mitigate and minimise delays. This inevitably will result in a drop in overall system performance.
- Both TfL's existing mainline train operating concessions have a pass-through arrangement to TfL to ensure that Schedule 8 payments made to the operator in recognition of the risk to revenue from service performance reaches the party which exposed to that risk. However, our concession operators continue to pay NR for their own caused delays to compensate other operators via the TOC-on-TOC matrix. The demonstrable benefit of this approach is that incentives on all parties to deliver better performance can be maintained.

2) *Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?*

- TfL believes all operators should continue to be fully incentivised as outlined above.

3) *Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?*

- Given the uncertainty of the start of GBR, TfL agrees it is sensible to undertake only limited changes to Schedule 8 for CP7. The ability to withdraw or revoke these amendments is also a sensible approach to allow for further potential changes with regards to revenue risk.

Section B: Adding flexibility to Schedule 8 in CP7

1) *Do you agree with our proposal to allow ORR to initiate a mid-control period recalibration of Schedule 8 in the event of a material change in circumstances?*

- Yes. The current Paragraph 17 provisions have proved wholly inadequate given that both infrastructure manager and operator must agree that a change is necessary when in almost all foreseeable circumstances given the typical financial implications, such joint agreement is unlikely.

2) *Do you think that this should be a feature of each of the passenger, freight, and charter regimes?*

- Yes. TfL agrees that this feature should apply to each of the passenger, freight, and charter regimes.

3) Do you have views on the circumstances under which such a power should be used?

- This power should be exercised when there are significant changes to an established train service through infrastructure, operator or rolling stock or when there is a substantial timetable recast that will likely affect reactionary delay impacts fundamentally.
- This power should also be used where there is a demonstrable and disproportionate financial effect of Schedule 8 against the value of a service group revenue which risks its viability. It is not appropriate or fair to make any party bear such risk through the remainder of a control period or until such time as another systemic change of circumstance arises to trigger a Schedule 8 recalibration.

Yours faithfully

Russell Parish
Network Performance and Strategy Manager, Transport for London

Response to ORR's consultation on outstanding matters in the Schedule 8 performance regime

This pro-forma is available to those that wish to use it to respond to our consultation. Other forms of response (e.g. letter format) are equally welcome.

Please send your response and any queries to performance.incentives@orr.gov.uk by 9 January 2023.

About you

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**This information will not be published on our website.*

Scope of application of Schedule 8

Do you agree with ORR's proposal to insert new sub-paragraphs into Schedule 8 which would allow ORR to 'switch off' the majority of Schedule 8 payments for GBR-contracted operators if the required legislative change is implemented?

Transport Scotland (TS) has made clear in its feedback previously that it should have Schedule 8 payments suspended for publicly owned/let operators in Scotland. This mechanism creates a "cottage industry" with teams unnecessarily in dispute over misaligned incentives. This is not best use of scarce resource Scottish Ministers believe a fully devolved Network Rail is necessary. Additionally, the payment process can create disputes which are not compatible with Scottish Ministers' objectives of a more integrated rail network (integration between track and train). TS recognises that the ORR does not set legislation, but TS does expect Scottish Ministers' devolved responsibilities to be respected. Therefore, should legislation change in the future which would also allow Scottish Ministers to access the same benefits as offered to DfT, we would like the ORR to remain open to applying changes mid control period.

Do you agree that the proposed new Schedule 8 sub-paragraphs should apply only to GBR's contracted operators?

No. TS would argue that part of the ORR's role is to ensure the safe and efficient operation of the GB rail network as a whole. If allowances are made for GBR only there will be a bias within the system especially for Scottish Minister let operators compared to those operated by GBR.

Do you have any comments on the proposed approach to this issue and the drafting of the proposed new sub-paragraphs under Schedule 8?

As drafted the proposed sub-paragraphs do not reference Scottish publicly owned/let operators and therefore are not directly relevant for the reasons set out above. However, even as drafted the ORR's proposals limit the types of Schedule 8 payments GBR will be able to opt out of. Again, as highlighted above, Scottish Ministers fully expect legislation within the Transport Bill to respect the devolved powers of Scottish Ministers (as stated originally in Williams-Shapps plan for rail) and therefore would expect similar clauses to be available for Scottish publicly owned operators as is the case for DfT operators. Therefore, with this in mind TS would propose, as we have previously, that the level of opt out be greater. TS would like the ability for any Scottish publicly owned/let operators to fully opt out of Schedule 8 payments. This would include things like resolution disputes. It makes little sense for any Scottish publicly owned/let operators to be in financial dispute with the publicly owned infrastructure manager (Network Rail) when they are each both funded by the Scottish Government albeit accountable to different Governments.