



## **Schedule 8 recalibration – Benchmarks in the passenger regime**

March 2017 – Re-calibration  
Working Group

# Purpose of this item

- Today we will discuss the Network Rail and passenger operator benchmarks in the passenger operator regime
- These slides set out some criteria for assessing options and some possible options.
- We would like to discuss these criteria and options as well as how the assessment could be taken forward.

# Benchmarks and December 2016 proposals

- ORR has not concluded on the December 2016 consultation – so why are we discussing this now?
  - We recognise that policy options will depend on the detail of the conclusions from the December consultation
  - However we want to start discussion on process to arrive at a new methodology for setting benchmarks as early as possible
  - Agreement on the process should be possible prior to any policy decisions

# The structure of the slides


- These slides discuss the following:
  - The reasons for changing how the benchmarks are set
  - Criteria for assessing changes to benchmarks
  - The options for changing the approach to setting benchmarks
  - Assessment of options

# Why are we talking about this?

- In our December 2016 charges and incentives consultation we proposed changing:
  - the approach to setting the Schedule 8 benchmarks for passenger train operators; and
  - the passenger operator measure of performance in Schedule 8.
- Furthermore, changes to punctuality outputs for Network Rail may mean that we need to review the way Network Rail benchmarks are set.
- As a result, we need to consider how the benchmarks in the passenger Schedule 8 regime should be set.
  - We have developed several criteria for comparing different options to setting benchmarks.
  - We would like to hear your views on these criteria, whether any additional criteria need to be considered and our assessment of the current approach to setting benchmarks.

# Suggested initial criteria for assessing options to setting benchmarks

- Suggested initial criteria (note there are some trade-offs between these):
  1. Minimise industry cash flows
  2. Similarity of contractual entitlements
  3. Low cost and complexity of re-calibration
  4. Maintaining performance incentives
  5. Preserve neutrality for Network Rail as central counterparty
- We will also consider the financial impact of changes to benchmarks on operators
- We will discuss the alignment of benchmarks with other industry performance targets and measures



**We will discuss each of these in the following slides**

# Criteria 1: Minimise industry cash flows

- Benchmarks set on the basis of performance projections will minimise expected industry cash flows in Schedule 8.
- Without benchmarks Network Rail and operators would have to make payments for every delay that they cause.
- **How well do current benchmarks minimise industry cash flows?**

## **Network Rail benchmarks**

- Network Rail has incurred significant Schedule 8 costs during CP5, possible explanations of this are:
  1. If benchmarks were set in line with performance targets but these targets were out of line with reasonable performance projections; or
  2. If Network Rail has been underperforming; or
  3. If the projections of Network Rail's performance were unrealistic.

## **Passenger operator benchmarks**

- To the extent that the current passenger operator benchmarks are set on the basis of each operator's expected level of performance industry cash flows should be minimised. The effects of the benchmarks will vary between operators.

# Criteria 2: Similarity of contractual entitlements

- Network Rail benchmarks set the level of performance to which operators are contractually entitled (i.e. held neutral from changes associated with it).
- The passenger operator benchmarks set the amount of delay that operators are contractually entitled to cause (without incurring payments or receiving bonuses).
- Given the similarities in the charges operators pay (and especially in light of the proposals on fixed cost charges for CP6) there may be grounds for similar contractual entitlements between operators.
- **How similar are contractual entitlements under the current benchmarks?**

## **Network Rail benchmarks**

- Setting Network Rail benchmarks at the service group level has meant that operators have very different contractual entitlements to performance from Network Rail.

## **Passenger operator benchmarks**

- Setting operator benchmarks at the service group level on the basis of historic performance has meant that operators have different contractual entitlements for the amount of delay they are contractually entitled to cause before having to pay.



# Criteria 3: Low cost and complexity of re-calibration

- Benchmarks are recalibrated at the start of each control period and during control periods (e.g. when service groups are remapped).
- The approach used to set the benchmarks determines how costly and complex it is to recalibrate the benchmarks.
- A complex process makes it more prone to errors.
- **How costly and complex is the current approach to setting benchmarks?**

## Network Rail and passenger operator benchmarks

- It is currently a costly and complex process to set the Network Rail and passenger operator benchmarks. This is because:
  - Benchmarks vary between service groups; and
  - They have to be recalibrated using different data for each service group.

# Criteria 4: Maintaining performance incentives

- Schedule 8 is designed to incentivise both Network Rail and operators to minimise the delay they cause to other parties.
- Although benchmarks are not intended to be targets for Network Rail and operators the approach used to set them can affect their performance incentives.
- **How well do the current benchmarks maintain performance incentives?**

## Network Rail benchmarks

- Network Rail is incentivised to improve its performance as its benchmarks are set to reflect the output targets (i.e. that ORR set for CP5)

## Passenger operator benchmarks

- Setting on the basis of past performance reduces operators' incentives to improve their performance (because better performance in the current CP results in more challenging benchmarks in the next CP). **We have already proposed to address this issue in the December 2016 charges and incentives consultation**

# Criteria 5: Preserve neutrality for Network Rail as central counterparty

- As the central counterparty for Schedule 8 Network Rail should be held financially neutral for making payments to operators for delays caused by other operators.

Financial year	Network Rail net financial position for TOC-on-TOC delay
2014/15	c. - £9m
2015/16	c.- £16m

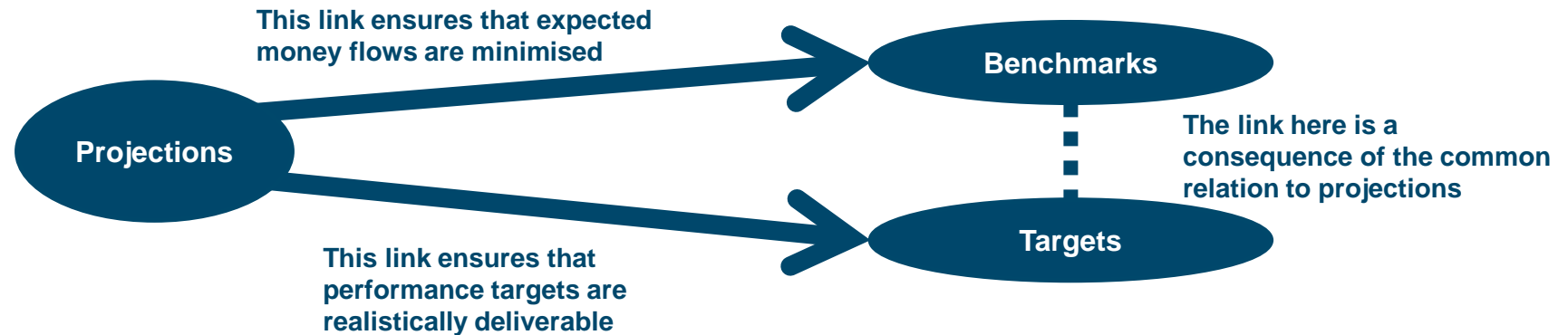
- This is approximately 8% and 15% of Network Rail's net Schedule 8 payments in 2014/15 and 2015/16, respectively.

# Financial impact of change to benchmarks on operators

- Any changes to the benchmarks should consider the financial impact on passenger operators.
- Franchised operators are held financially neutral to any changes in their benchmarks, open access operators are not.
- Note that changes to benchmarks are also likely to be considered in the assessment of the fixed cost charge mark-ups.

# For discussion: Alignment across industry

## ■ How are benchmarks related to targets?



- Changes to the way outputs are set (e.g. scorecards) may affect grounds for setting benchmarks on the basis of *targets*.
- We do not see benchmarks as targets in themselves.
- However, with respect to across industry alignment there is a wider point about the alignment of the Schedule 8 measure of performance and Network Rail's measure of performance
  - PPM vs AML
  - However this is not an issue with the *benchmarks*
  - It should be picked up by work on outputs etc.



**Options to be  
considered**

# Developing options for setting benchmarks

- There are two dimensions for any approach to setting benchmarks:

## 1. Level of aggregation

The benchmarks could be set at different levels of aggregation, such as:

- Service group level
- Operator level
- Market segment level
- National level

### Indicative options only

The detail of these options will depend on the TOC-on-TOC proposal.

## 2. Basis the benchmarks are set on

The benchmarks could be set on the basis something such as:

- Past performance
- Performance targets

# Level of aggregation

## What level of aggregation could the benchmarks to be set at?

- **Service group level:** current level of aggregation
- **Operator level:** individual benchmarks for each operator
- **Market segment level:** individual benchmarks for different market segments such as LSE, regional and intercity services
- **National level:** common benchmarks across all operators

### Benefits

Contractual entitlements more similar between operators →

Less costly and complex to recalibrate →

### Costs

Performs worse with respect to minimising industry cash flows →

Service group level

Operator level

Market segment level  
(e.g. LSE/ Regional)

National level

Higher level of aggregation →



# Basis the benchmarks are set on

- Network Rail's benchmarks could be set on the basis of:
  - Past performance
  - 'Regulated outputs' (depends on what decisions are taken for CP6)
  - Franchise targets
  - PR18 projections
  
- Passenger operators' benchmarks could be set on the basis of:
  - Past performance
  - 'Arbitrary' level – There are no other targets for passenger operators so it could be set on some basis that would need to be determined.
  
- Costs and benefits will depend on each approach

# Options – Network Rail benchmarks

		Level of disaggregation			
		Service level group	Operator level	Market segment	National level
Basis for setting benchmarks	Past performance	Consultation document proposes not to pursue these options			
	'Regulated' outputs	'Do nothing' (Current approach)	Single Network Rail benchmark for each operator based on regulated outputs	Single Network Rail benchmark for each operator based on regulated outputs	Single Network Rail benchmark for each market segment based on regulated outputs
	Franchise targets	Single Network Rail benchmark for each SG based on franchise targets	Single Network Rail benchmark for each operator based on franchise targets	Single Network Rail benchmark for each market segment based on franchise targets	Single Network Rail benchmark across all operators based on franchise targets
	PR18 projections	Single Network Rail benchmark for each SG based on PR18 projections	Single Network Rail benchmark for each operator based on PR18 projections	Single Network Rail benchmark for each market segment based on PR18 projections	Single Network Rail benchmark across all operators based on PR18 projections

# Options – Passenger operator benchmarks

		Level of disaggregation			
		Service level group	Operator level	Market segment	National level
Basis for setting benchmarks	Past performance	'Do nothing' (Current approach)	Consultation document proposes not to pursue this option	Each market segment would have its own benchmark and it would be based on the average historic performance of all services in that market segment	There would be a single benchmark for all passenger operators based on the average historic performance of all passenger operators. <b>This is the approach in the freight Schedule 8 regime.</b>
	'Arbitrary' level	Separate benchmark for each service group set on an 'arbitrary' basis still to be determined.	Separate benchmark for each operator set on an 'arbitrary' basis still to be determined.	Each market segment would have its own benchmark set on an 'arbitrary' basis still to be determined.	The same benchmark for all passenger operators set on an 'arbitrary' basis still to be determined.

# Assessment of options

- Assessing options is particularly difficult for the following criteria:
  - Preserve neutrality for Network Rail as central counterparty
  - Minimise industry cash flows
  - Financial impact of change to benchmarks on operators
  
- This is because the assessment of these options requires a special capability to model Schedule 8
  
- Taking into account the above, we would like to seek the Working Group's views on **the best way to progress the assessment of these options**