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Principal Economist

4 May 2018

Dear Freight and Charter Recalibration Working Group,

**Final decision on the level of the risk premium in the incident cap access charge supplement**

1. You asked us<sup>1</sup> to determine what the level of the risk premium (as charged by Network Rail to operators for the provision of incident caps) should be.
2. This letter sets out our final decision on this issue, namely, that the risk premium charged by Network Rail for the provision of the incident caps should remain at 10%.
3. We informed you of this decision in the Working Group meeting of 15<sup>th</sup> February 2018, having reviewed your proposals and your responses to each other's proposals. This letter provides further information on our rationale as well as confirming this decision.

**Background**

4. As part of the freight and charter Schedule 8 regimes, operators can choose to purchase an incident cap, which limits the amount they have to pay under Schedule 8 for any single delay incident for which they are responsible.
5. The Access Charge Supplement (ACS) that operators pay Network Rail for the provision of these caps includes a risk premium. For CP5, the risk premium is 10% of the expected cost to Network Rail of providing the cap.

**Summary of the dispute and our decision**

6. Operators and Network Rail could not reach agreement on what the level of the risk premium should be for CP6. Network Rail proposed to increase the risk premium to 20%. Freight and charter operators proposed to maintain the risk premium at 10%. Each wrote to us with the arguments for their proposals.
7. We have reviewed Network Rail and operators' proposals, and, on the balance of the arguments put to us, we have determined that the risk premium for CP6 should remain at 10%.

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<sup>1</sup> In your letter of 8<sup>th</sup> November 2017, together with clarification in subsequent Recalibration Working Groups and through further correspondence.

## Reasons for the risk premium

8. We recognise that there are reasons why Network Rail should charge a risk premium for the provision of the incident caps in CP6. These include:
  - a. **Network Rail's ability to weather downside risk:** Network Rail's funding constraints for CP6 mean that it has comparatively limited ability to weather downside risk in CP6. The inclusion of a risk premium mitigates Network Rail's exposure to downside risk.
  - b. **Adverse selection:** Freight operators are likely to have better knowledge than Network Rail of their expected performance in CP6. As a result, they can be expected to select the incident cap (and the associated ACS) which represents the best value for them, which would likely result in Network Rail's being financially worse-off as consequence of providing the caps. The inclusion of a risk premium mitigates the financial impact of such adverse selection.
  - c. **Moral Hazard:** An operator that has an incident cap is more likely to breach the cap than one that does not (since the latter is exposed to the associated Schedule 8 costs, while the former is not). Thus, the provision of incident caps to operators that did not previously have them creates *moral hazard* for those operators. Such moral hazard also applies to operators who choose a lower cap than one they selected in the recalibration period. While we would expect the impact of moral hazard to be small (given that performance expectations for CP6 are based on periods in which operators had incident caps), the inclusion of a risk premium nonetheless mitigates the possible impact of moral hazard.

## Network Rail's arguments

9. Network Rail suggested that the risk premium should be increased from the CP5 level of 10% to 20% for CP6. Its reasons were as follows:
  - a. The five year re-calibration period (2012/13 to 2016/17) agreed between Network Rail and freight operators does not reflect expected freight performance for CP6 with respect to delay minutes above the cap.
  - b. The provision of incident caps has cost Network Rail over £1.5m over the first three years of CP5.

- c. Network Rail faces risk beyond what typical insurance firms would face because it does not include strict terms and conditions in the incident caps provided to freight operators.
- d. Compared to the start of CP5, Network Rail is subject to greater financial constraints, owing to its reclassification as an arms' length government body. This means that Network Rail is less able to weather downside risk in CP6 than it was at the start of CP5.

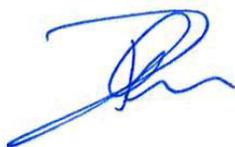
### **ORR view**

- 10. The issues raised in reasons (a) and (b) both relate to the inaccuracy of the CP5 forecast of the cost to Network Rail of providing the incident caps, which was based on freight operators' past performance.
- 11. Our view is that a more accurate approach to arriving at this forecast in CP6 is possible and would be a better way to address Network Rail's concerns than increasing the risk premium. For instance, an approach that took into account expected changes in performance, rather than basing the forecast solely on past performance, would be more likely to produce an accurate estimate of the cost of providing the incident caps.
- 12. Whatever the approach used (which remains to be determined), we would expect the underlying assumptions about performance to be consistent with those used for calculating the freight and charter operator benchmarks (this expectation is discussed further in the Annex to this letter).
- 13. With respect to reason (c), Network Rail could propose to include terms or conditions on the provision of incident caps, for discussion with operators and subject to our approval. Furthermore, even if Network Rail must face risk beyond that faced by typical insurance firms, it also should not be making a profit from the provision of the capping scheme, unlike typical insurance firms.
- 14. With respect to reason (d), whilst we recognise this as a reason for Network Rail to charge a risk premium for the provision of the incident caps, we do not think it supports a risk premium of 20% rather than 10%.
- 15. Indeed, in our view, none of the arguments provided support a risk premium of 20% rather than one of 10%. For that reason, we have determined that the risk premium charged by Network Rail for the provision of the incident caps should remain at 10%.

## Next Steps

16. This letter states our final decision on what the level of the risk premium should be, which you asked us to determine. This decision is restricted only to the basic principle of how the risk premium should be recalibrated for CP6. You should note that we will still need to review and approve the detail of how the risk premium component of the ACS has been calculated once it has been calculated (as per the general approach to the recalibration that we have previously discussed).
17. Finally, I would like to thank you all for leading the recalibration of the regime and for respecting the agreed process for resolving disputes.

Yours faithfully,

A handwritten signature in blue ink, appearing to be 'Deren Olgun', written in a cursive style.

Deren Olgun

## **Annex: The relationship between the freight and charter operator benchmarks and the incident cap ACS**

18. This annex sets out our expectations of the relationship between the freight and charter operator benchmarks and the incident cap ACS. The Recalibration Working Group should bear this in mind when considering how to set the freight and charter operator benchmarks and the ACS for CP6.

### ***Freight and charter operator benchmarks***

19. The freight and charter operator benchmarks should be based on the expected performance of freight and charter operators in CP6 (thereby ensuring that expected Schedule 8 payments are zero for both Network Rail and operators).

### ***The Access Charge Supplement***

20. The ACS for each incident cap level should reflect the expected cost to Network Rail of paying for operator-caused delay minutes above the selected incident caps, plus the risk premium.

### ***The relationship between freight and charter operator benchmarks and the ACS***

21. The level of the freight and charter operator benchmarks and the ACS both depend on the expected level of freight and charter operator caused delay in the next control period. As a result, we would expect the freight and charter operator benchmarks and the ACS to use the same evidence base.
22. For instance, if the freight and charter operator benchmarks are based solely on operators' performance in the re-calibration period we would expect the ACS to also be set on that basis. Alternatively, if the freight and charter operator benchmarks account for traffic growth in CP6 we would expect the ACS to do so as well.