OFFICE OF RAIL AND ROAD

Improving incentives on Network Rail and train operators:

A consultation on changes to charges and contractual incentives

December 2016

Contents

Summary

Access charges and incentives are important as they affect the decisions that Network Rail, train operators and funders make. They play an important role in improving outcomes for passengers, freight customers and taxpayers.

As part of our 2018 periodic review (PR18) we are reviewing how these charges and incentives can be improved. We have decided to focus our PR18 reforms around ‘route-level regulation’ and a new approach to regulating the national system operator – both of which could support a step change in how Network Rail performs. Reflecting this prioritisation, our proposals for charges and incentives are targeted at areas where there is a strong case for reform or where there are opportunities for simplification. Specifically we propose to:

- deprioritise significant changes to short-run variable charges for PR18, while making refinements and removing the coal spillage charge;
- improve fixed costs transparency (through Network Rail’s cost allocation work);
- use the improved cost allocation to apply fixed cost mark-ups to all operators (including open access), ensuring that all operators make an appropriate contribution to the cost of providing the network;
- focus on targeted improvements to the existing incentives on delays, punctuality and engineering access in those areas where there is a clear and pressing need for reform; and
- respond to changes in the legislative framework by removing caps on charges.

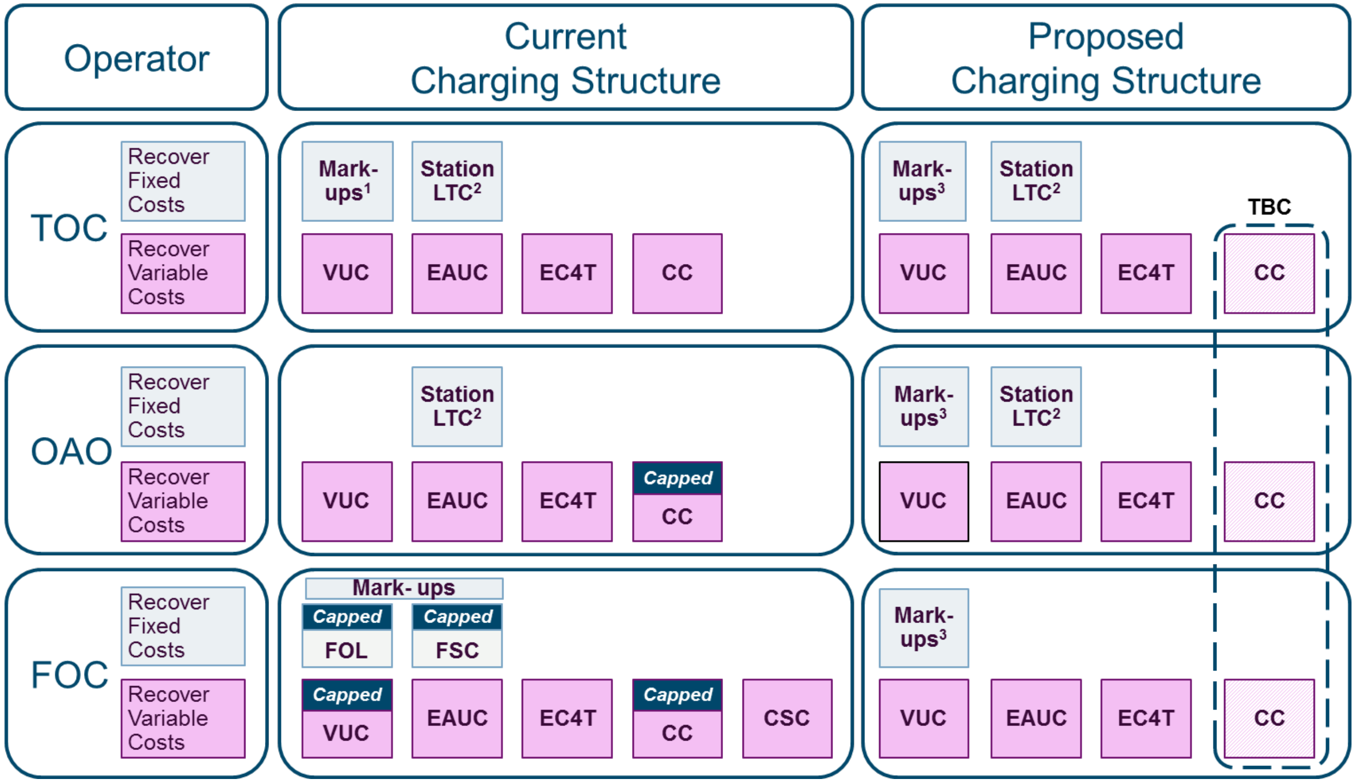
In addition, we also ask open questions exploring the capacity charge and some options for improving the incentives on operators and Network Rail to work together.

These changes represent a proportionate development of the current framework, simplifying the charging structure (see the summary figure overleaf).

This review has already benefited from significant stakeholder involvement and we are keen for this engagement to continue going forward. We welcome your views on this consultation by 9 March 2017. We will hold stakeholder events in London and Glasgow to help support the development of your response.

Looking ahead, to support our final conclusions, we will publish a working paper in early 2017 outlining our proposed methodology for understanding the overall financial impact of these changes.

Summary of proposed changes to the charging structure (Note: charges definitions can be found in Annex A)



Supporting Notes

1. Specifically FTAC.
2. Station charges: In addition to the station long term charge, there is qualifying expenditure (for which we regulate the management fee at managed stations), facility charges (which we approve) and franchised station lease income (which we do not regulate).
3. Our proposed approach for fixed cost mark-ups is to levy these where the market can bear for franchised, open-access and freight operators using the Network Rail cost allocation work.
   - TOC: FTAC may become a per unit of traffic rate (e.g. a rate per train mile / vehicle mile, or another metric).
   - OAO: The proposed structure would include fixed cost charges for open access services.
   - FOC: The proposed charging structure will combine FOL and FSC.

Further information relating to caps on charges is outlined throughout the document.

1. Introduction and context

1.1 We are currently undertaking our 2018 periodic review (PR18) of Network Rail. PR18 will determine Network Rail Infrastructure Limited's (Network Rail's) outputs and funding in control period 6 (CP6, which we expect to run from 1 April 2019 to 31 March 2024). This will feed through into the service passengers and freight customers receive and, together with taxpayers, ultimately pay for. It will also determine the wider regulatory and incentive framework to encourage Network Rail and train operators to perform well.

Charges and incentives review

1.2 As part of PR18 we are reviewing the structure of the charges levied for use of the network and the incentives in place on Network Rail and train operators[1]. This is important because charges and incentives affect the decisions that Network Rail, train operators and funders make, influencing both the cost of maintaining and renewing the network and how efficiently network capacity is used. They can therefore play an important role in improving outcomes for passengers, freight customers and taxpayers.

Charter operators

The structure of charges and performance regime for charter operators is consistent with that for other operators (albeit that it takes account of the characteristics of charter services). The conclusions to our review of charges and incentives will therefore have implications for charter operators. Given this, Network Rail will include detail on charter charges and incentives in its summer 2017 consultation.

Developing our recommendations

1.3 This review has already benefitted from extensive stakeholder engagement. Following our first charges consultation in December 2015, we confirmed we would not undertake further work on charges that are linked to value (e.g. auctions or charges linked to passengers' value of use). Instead, we said we would focus on two broad packages of work: improving fixed-cost and short-run variable charges.

1.4 Separately, in our initial consultation on PR18 in May 2016 we confirmed our intention to focus on targeted improvements to the possessions and performance regimes (Schedule 4 and Schedule 8, respectively).

[1] This includes freight operators and franchised, open-access and charter passenger operators.

1.5 Following further analysis and discussion with stakeholders, we developed a shortlist of options and have now identified a set of proposals for consultation.

Assessing our recommendations

1.6 This document outlines our recommended changes to the charges and incentives regime for PR18. It explains why we think they are important and how we intend to develop the analysis of financial impacts going forward.

1.7 In coming to these recommendations we have maintained a clear focus on understanding how changes to the charging and incentives regime will impact on stakeholders. We have produced a series of proportionate impact assessments that explain this thinking in more depth. In particular, the impact assessments provide more detail about the impacts on franchised and open-access passenger operators, freight operators and charter operators. These impact assessments are published in draft, pending any stakeholder comments we receive as part of this consultation.

1.8 For more information about our approach to impact assessment please see Annex C: Assessment Framework.

1.9 It is also important to consider the cumulative financial impact of changes on operators. The impact assessments do not typically quantify the financial impacts, not least as it is difficult to do so at this stage of policy development.

1.10 Consequently, we are planning additional analysis to quantify these financial impacts and will publish a working paper in early 2017 outlining our methodology for this work. To accompany this working paper, we will hold a workshop and provide an opportunity for stakeholders to comment.

Implementing our conclusions

1.11 In June 2017, we will publish our conclusions on the issues discussed in this consultation. We will confirm which changes we intend to implement and include finalised impact assessments.

1.12 Following our conclusions, we will work closely with stakeholders on implementation issues. Network Rail will consult on the detailed aspects for the recalibration of each of the charges and of Schedules 4 and 8 in summer 2017. In parallel, our further work will likely focus on considering what the market can bear and whether there is a case for phasing-in any direct costs as a result of the changes made as part of PR18. We will audit and approve the final charges.

1.13 We have not set out firm proposals in all areas, and so some charges and incentives (for example, the route-level efficiency benefit sharing mechanism (REBS) and the capacity charge) may require an additional consultation on proposals, likely to take place in mid to late 2017.

Consultation timetable and next steps

1.14 This consultation closes on 9 March 2017.

1.15 At the end of each chapter we include questions relating to our recommendations. We have produced a pro-forma which you may wish to use to make your response to this consultation. If you have any comments on our draft impact assessments (IAs) please include these in the relevant policy section of your response.

1.16 We will host two stakeholder events to support this consultation. These will be held in our offices in London on 9 February 2017 and Glasgow on the 14 February 2017.

1.17 Table 1.1 sets out key dates relating to PR18 charges and incentives work. These are indicative and may be subject to change as project plans are updated.

Table 1.1: Indicative key dates for PR18 charges and incentives milestones

Activity	Date
ORR's charges and incentives consultation	Publication: 15 December 2016 Responses deadline: 9 March 2017 Conclusions: June 2017
ORR's market segmentation and market can bear test – scoping work (high level principles)	Early 2017 Industry engagement February / March 2017
ORR's market segmentation and market can bear test – analysis for freight and passenger	Spring / summer 2017 Engage with industry throughout.
Network Rail's charges and incentives consultation	Publication: July 2017 Reponses deadline: October 2017 Conclusions (incl. price lists): February 2018
ORR's potential consultation on remaining charges and incentives issues	Mid / Late 2017
ORR's proposals to industry as to which market segments could be subject to mark-ups in CP6	Autumn / Late 2017
ORR's draft determination	June 2018
Network Rail's post draft determination price lists	August 2018
ORR's final determination	October 2018
Network Rail's final CP6 price lists	December 2018
Beginning of CP6	April 2019

Structure of this document and supporting documents

1.18 The remainder of this document is organised in the following sections; infrastructure (fixed) costs, short-run (variable) costs contractual incentives; and next steps.

1.19 Supporting this document is a series of annexes and draft impact assessments. These documents, which we have published on our website, are listed in Table 2.2 below.

Table 1.2: List of supporting documents

Annexes
Annex A: Summary of control period 5 charges and contractual incentives framework
Annex B: Glossary
Annex C: Assessment framework
Draft Impact Assessments
Fixed costs: Options for fixed costs
Freight mark-up charges: Merging FOL and FSC and updating underlying cost allocation methodology
Long term charge: Methodology change at managed stations
Qualifying expenditure (QX): Improving transparency
Capacity charge: Options for the capacity charge
Coal spillage charge: Abolition of the charge
Schedule 8: Passenger compensation
Schedule 8: Approach to setting benchmarks
Schedule 8: Measure of passenger operator performance
Schedule 8: Effectiveness of the sustained poor performance (SPP) regime
Initial Thinking and Proposals
Schedule 4: Proposal not to pursue a range of issues in PR18
Schedule 4: Initial thinking on incentives created by notification discount factors (NDFs)
Schedule 4: Initial thinking on the approach to calculating the access charge supplement
Schedule 4: Initial thinking on negotiated compensation arrangements for planned disruption

2. Infrastructure costs

Summary

We are proposing to improve transparency around fixed network costs and apply fixed cost charges to all operators, including open access operators, in accordance with the application of the market can bear test set out in *The Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016* (the Regulations). This is in order to promote further competition in passenger services. In order to determine the level of fixed cost mark-ups, we will undertake a market can bear test for passenger operators, and we will also update our analysis underpinning the market can bear test for freight operators, to take account of new information available (and also taking into account the level of charges recovering costs directly incurred). Furthermore, we propose to simplify freight mark-ups into a single charge. We also propose minor changes to the methodology behind station charges and to improve their transparency.

Introduction

2.1 In this chapter we consider how Network Rail recovers the fixed costs of running the rail network: i.e. those costs that do not vary with use in the short term. Currently, these costs are met through a mix of direct grant from governments, mark-ups paid by freight services carrying specific commodities, and fixed charges paid by franchised passenger operators. There are also charges which operators pay for use of stations on the network, which cover both variable and fixed costs.

2.2 We have been considering a range of different options, some of which would lead to significant changes to the way fixed charges are calculated, while others are relatively minor improvements to existing fixed cost charges. Proposals in relation to both are set out in this chapter.

2.3 The rest of this chapter is structured in three sections:

- potential changes to the overall framework for fixed cost charges;
- incremental changes to fixed cost charges for freight operators; and
- proposals for improvements to existing station charges.

Overall approach to fixed cost charges

2.4 In CP5[2], fixed network costs are recovered from operators as follows:

[2] Control period 5 runs from 1 April 2014 to 31 March 2019.

- **franchised passenger operators pay a fixed track access charge (FTAC) (annual lump-sum charge).**[3] The allocation of the FTAC for each control period is based on forecast traffic levels, so additional services (above forecast) that franchised operators run in the subsequent control period only pay short-run variable charges.[4] Franchised passenger operators currently pay FTAC based on the level determined at the time when they entered into their franchise agreement and are held neutral by the franchising authority to subsequent changes;

- **open access operators (OAOs) do not pay fixed cost charges***,* but pay short-run variable charges. We approve access rights to OAOs after considering the impacts on existing services[5]. These access rights determine the services they can run; and

- **freight operators pay the freight only line charge (FOL) and the freight specific charge (FSC).** The FOL recovers the fixed costs of freight-only lines for certain commodities. The FSC recovers freight avoidable costs, i.e. costs that Network Rail could avoid if freight services did not use its infrastructure.[6] Both charges are levied as mark-ups, and only on trains carrying electricity supply industry (ESI) coal, iron ore and spent nuclear fuel.

Areas for improvement

2.5 Two of the areas for improvement we identified in relation to fixed cost charges in our December 2015 consultation related to transparency:

- there is currently a low degree of understanding and transparency around the drivers of infrastructure costs; and

- the way fixed cost charges are currently allocated and levied from operators lacks cost reflectivity (i.e. does not accurately reflect the causes of costs in terms of different service characteristics or patterns of use).

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[3] The FTAC for each operator is calculated by allocating the net revenue requirement for each of Network Rail's operating routes (minus all other sources of income such as short-run variable charges, station charges, other single till income and Network Grant) to operators on that route using a number of traffic metrics. The route FTACs for each operator are summed across routes to determine the total FTAC bill for each operator.

[4] Franchised passenger operators run the services required as part of their core franchise specification, as well as additional services they choose to run and for which ORR approves access rights.

[5] We decide track access applications in accordance with our duties as set out in section 4 of the Railways Act 1993 ("The Act"). More information about our approach is available at http://orr.gov.uk/what-and-how-we-regulate/track-access.

[6] This is net of the costs recovered by short-run variable charges and the FOL charge.

2.6 In addition, we identified the links between charges and potential wider reforms to encourage greater on-rail competition in passenger services. These are discussed below.

Transparency of fixed costs

2.7 A wide range of decisions are underpinned by the ability to understand and forecast costs in the medium and long term. A better understanding of these costs could improve decisions taken by Network Rail, funders, franchising authorities and ORR.

2.8 In 2015, Network Rail appointed Brockley Consulting to undertake a review of cost allocation and attribution approaches in the rail industry, and explore potential alternatives. In 2016, it completed a pilot for a cost allocation methodology on the Wales route. The study sought to develop an objective and transparent allocation of fixed costs between all operators, reflecting long run patterns of cost causation[7].

2.9 The approach started with the total allocation of FTAC to each route. It then built on this by: allocating infrastructure costs to small units of the network (route sections); identifying what activities cause these costs to be incurred; and finally aggregating these costs to an operator level, based on their forecast use.

2.10 The analysis has highlighted the potential for a more sophisticated approach to cost attribution and allocation, which would represent a significant improvement in the industry's understanding of the drivers of fixed costs. For example, it provides information about the balance of costs between parts of the network that have higher levels of traffic, and the extent to which heavier and faster trains are likely to cause additional costs to be incurred[8].

2.11 We are supportive of this work[9], which has potential to provide useful information about cost drivers, could enable industry parties to consider steps to reduce costs, and is a necessary first step in order to implement our proposals on fixed cost charges described below. Network Rail is currently in the process of rolling-out the Wales pilot study at a GB-wide level, while also refining its methodology in a number of areas (for example around the extent to which different traffic levels cause costs to be incurred). It expects to complete the cost allocation analysis by spring 2017.

2.12 The outputs from the cost allocation exercise will underpin the calculation of fixed cost mark-ups for both freight and passenger operators (although the level of the

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[7] Full details of the methodology are available in the report published in June 2016. Brockley Consulting: *"Cost allocation pilot study modelling and results – A report for Network Rail"*, available here.

[8] For example, the cost allocation pilot study highlighted the higher costs associated with faster traffic (in addition to those implied by the VUC) due to the whole life costs associated with higher line speeds.

[9] In August 2016, we published a letter expressing our support for Network Rail continuing this work and rolling out the cost allocation analysis at a network-wide level. This letter is available here.

charge would depend on the results of the analysis underpinning the market can bear test[10]).

Facilitating more competition in passenger services

2.13 In early 2016, the Competition and Markets Authority (CMA) concluded a project investigating the potential for greater competition in rail passenger services.[11] The project identified a number of options for improving on-rail competition, including an option that would allow OAOs to play a larger role, complementing the franchising system.

2.14 To do this, two key changes were identified: reforming the charging structure to ensure OAOs contribute towards fixed network costs; and introducing a mechanism for addressing the impact on government funds of more on-rail competition, in the form of a levy on OAOs (a 'PSO levy'[12]).

2.15 The Department for Transport (DfT) has been considering the introduction of a PSO levy, and is considering consulting on the principles of any such levy in due course.

2.16 One of the issues that we will need to address is how charges and any PSO Levy interact, and take account of an operator's ability to pay. In principle, this could be achieved in two main ways:

- when assessing the ability of passenger services (and OAOs in particular) to bear charges above variable cost, we would take into account the PSO levy payable by those operators / services; or

- our assessment of what the market can bear would determine the overall maximum that an operator could be expected to pay (i.e. cover both the appropriate mark-up and whether the PSO levy should apply).

2.17 We will continue to work with DfT to ensure that the implications of our proposals on fixed charges and the work on the PSO levy are joined up. As part of this package of reforms, we would also revisit the 'not primarily abstractive' (NPA) test that we currently apply when granting access to OAOs.[13]

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[10] This test ensures that only those market segments/commodities that are able to bear costs additional to the costs directly incurred (recovered through short-run variable charges) pay mark-up charges.

[11] The CMA's final policy report published in March 2016 and called "Competition in passenger rail services in Great Britain" is available here.

[12] This refers to the levy having the purpose of protecting governments' ability to deliver public service obligations (PSOs) in rail.

[13] The NPA test is part of our access policy for new competing services. The test considers whether the primary impact of a proposed new service would be to abstract revenue from incumbent operators without compensating benefits (in which case we would not expect to approve the application).

Table 2.1: Fixed cost options considered

We have developed four options for changes to the overall framework for fixed cost charges	
Option	**Description**
Option 1 **Revise the FTAC methodology**	FTAC for franchised passenger operators would be calculated based on the new Network Rail cost allocation methodology. The amount of costs allocated to freight and OAOs would be made transparent through Network Rail's cost allocation work. FTAC would continue to be paid by franchised passenger operators only. Freight operators would continue to pay the fixed cost charges they currently pay, based on a market can bear test based on commodities carried (noting we are also proposing incremental improvements to those charges, discussed below, including an update of the market can bear test which could result in changes to the market segmentation and/or the level of the charges for different segments).
Option 2 **Revise cost allocation methodology and recover fixed costs from all operators**	Implement greater transparency as per Option 1. We would develop an approach to recover fixed costs from all passenger operators, including OAOs. This would be based on the application of a market can bear test to determine which passenger market segments can bear the charges (and would take account of the amount of directly incurred cost charges payable, including as a result of our other policy decisions, e.g. on the capacity charge). Freight operators would continue to pay the fixed cost charges determined based on a market can bear test based on commodities carried. We are also proposing incremental improvements to those charges, discussed below, including an update of the market can bear test which could result in changes to the market segmentation and/or the level of the charges for different market segments. In doing so, we would also take into account the level of charges recovering costs directly incurred, including changes resulting from other decisions, e.g. on the capacity charge).
Option 3 **Link fixed cost recovery to a measure/definition of capacity utilisation**	Implement greater transparency as per Option 1. Fixed cost charges would be levied on all operators based on the capacity utilisation of the areas of the network they use. This could also involve the application of a market can bear test.

We have developed four options for changes to the overall framework for fixed cost charges	
Option	**Description**
Option 4 **Link fixed cost recovery to the holding of 'long term' access rights**	Implement greater transparency as per Option 1. Fixed costs charges would be levied on operators, including freight and OAOs, based on the access rights they hold. This would involve replacing the current access rights framework[14] with one that: • would create new types of distinct 'long term' and 'short term' access rights; • would give priority in the approval of access rights to those seeking long term rights. Short term rights would only be approved once all requests for long term rights had been considered; and • Levies short-run variable charges on operators with 'short term' rights, while those holding 'long term' rights would additionally pay fixed cost charges.

2.18 We note that in its review of charges which concluded in 2015[15], RDG also considered two options relating to the recovery of fixed costs, namely an 'avoidable cost' approach and an 'ability to pay mark-up' approach. These options are broadly equivalent to our Options 1 and 2, respectively. RDG assessed both options at a high level, and in addition assessed the avoidable cost option in more detail. The assessments highlighted a number of costs and benefits associated with each option. We have taken account of relevant costs and benefits highlighted in RDG's analysis in developing our own impact assessment.

Recommendations

2.19 The costs and benefits associated with these four options have been considered in more detail in the accompanying impact assessment.[16] In practice, options 3 and 4 cannot reasonably be implemented at this time, due to the scale of the changes required to make them work. Further, while Option 1 delivers some transparency benefits, it fails to deliver a reformed approach to charging OAOs and so performs badly in terms of promoting competition and the benefits that this brings for passengers.

2.20 Based on our assessment of the options, and discussions with industry (including through working groups facilitated by RDG), **we are proposing to implement**

[14] The process Network Rail uses to make decisions on what services to include in the timetable could remain the same (i.e. timetable all firm rights approved). We would need to consider whether the existing distinction between firm and contingent rights would still remain.

[15] Documents relating to RDG's review of charges are available here.

[16] Our full draft impact assessment of these four options is published on our website here.

Option 2 for PR18. This would represent a step forward in terms of transparency and cost reflectivity, and could facilitate more competition in passenger services (consistent with the CMA's recommendations).

2.21 Options 3 and 4 could form part of our longer term direction of travel. If a measure of capacity utilisation is developed in time for the 2023 periodic review, we could revisit the feasibility and potential benefits of Option 3. Whereas Option 4 might be appropriate in a future where significantly more open access services operate.

2.22 There are a number of key considerations and areas for further work associated with our proposed option.

- **Option 2 involves applying a consistent framework for freight and passenger services** - i.e. applying a market segmentation approach and a market can bear test which has a consistent set of underlying principles. The results of the analysis will, of course, depend on the specific features of these sectors. A market can bear test is already applied in order to recover fixed cost mark-ups from freight operators, and this would be refreshed (see below).

- **We would apply fixed cost charges to all passenger operators**, including OAOs, based on a market can bear test. We will need to develop a market segmentation approach in order to undertake this assessment in line with the requirements of The Regulations. These regulations require us to consider, as a minimum, the following segments: services within the framework of a public service contract, other passenger services (which would include charter services) and freight services. As this is a minimum specification, we would expect to introduce additional market segmentation where there are significant differences in the nature of demand across markets (e.g. for intercity or peak services versus rural or off-peak services). We will also need to consider how to incorporate charter services into this analysis. A high level timetable for this work and our consultation with stakeholders is set out in Chapter 1.

- **Revisit the NPA test** to determine whether it would still be appropriate to apply it (and how) if some OAOs were contributing towards fixed network costs. Our access policy would also need to reflect the introduction of any PSO levy.

Incremental changes to freight mark-up charges

2.23 The FOL and FSC are paid by freight services carrying certain commodities, based on a market can bear test.[17] In CP5, the FOL and FSC have been levied separately.

[17] The FOL charge was introduced in PR08 for CP4 and, following a market can bear test, was levied on ESI coal and spent nuclear fuel. In PR13 we consulted on implementing the FSC and considered a range of freight market segments that would pay this mark-up charge, refreshing the market can bear test in the process. The market segmentation was based on commodities transported and, based on a report by MDST,

This is largely for transparency purposes, as the FSC was introduced in PR13 (while the FOL was introduced in PR08 and levied in CP4) and was phased in over the control period to help industry understand the new charge and adjust to it.

2.24 Both charges were capped in CP5 using the lower end of the range of avoidable costs as estimated by Network Rail's consultants LEK. The charges were phased in gradually over the duration of CP5 (0% in years 1 and 2, rising to 20% in year 3, 60% in year 4 and 100% in year 5).

Areas for improvement

2.25 Our analysis has highlighted that the charging structure for freight operators could be simplified by having a single mark-up charge rather than two separate ones.

2.26 In addition, recent developments in rail freight markets (notably the decline in coal traffic), Network Rail's cost allocation analysis and ORR's competition decision in respect of Freightliner (which highlighted that the levels of competition between rail and road freight varied by location) all suggest that there should be a recalibration of the market can bear test from PR13.

Recommendations

2.27 To address the areas for improvement noted above, we propose making the following incremental improvements to freight fixed cost charges.

Combine the FSC and FOL charge

2.28 This proposal was supported by industry in response to our December 2015 consultation and would result in a simplified charging structure for freight. The change appears straightforward as both charges are levied on the same basis.

Update the market can bear test

2.29 We are proposing in PR18 to undertake a recalibration of the market can bear tests undertaken in PR13. This will involve using new information available to assess the ability of different freight market segments to bear mark-ups.

2.30 The assessment would continue to be based on commodities, but could involve looking at how the ability to pay might vary by location for some commodities (in light of new evidence as highlighted by the ORR's competition decision in respect of Freightliner). The recalibration would provide up to date values which would be used in setting mark-ups for CP6 (taking account of the level of short-run charges payable,

this was narrowed down to coal for ESI, spent nuclear fuel, iron ore and biomass. Following a further study by NERA, we concluded that the former three market segments were able to bear the new FSC charge. The same analysis was extended to the FOL charge.

including as a result of our policy decisions on cost directly incurred charges, e.g. the capacity charge and coal spillage charge).

2.31 While this would constitute a recalibration of the previous assessment we have done, undertaking this analysis would involve a period of uncertainty around the level of charges for different freight market segments. We propose to mitigate this by setting out a clear process and milestones for this work, as well as continuing our close engagement with freight stakeholders. A high level timetable for this work is set out in Chapter 1.

Apply Network Rail's cost allocation methodology to freight

2.32 The new cost allocation methodology developed by Network Rail (described earlier in this chapter) would replace the current avoidable cost methodology developed by Network Rail's consultants LEK for PR13. This would improve transparency regarding the level of costs allocated to freight. A market can bear test would apply to determine the level of charges.

Station charges

2.33 The two main charges operators pay to use stations are:

- **the station long term charge (LTC)**. This allows Network Rail to recover its efficient maintenance, renewal and repair (MRR) costs at the managed and franchised stations[18] that it owns. The LTC is a regulated charge;
- **the qualifying expenditure (QX)** charge. This allows the station facility owner (SFO), who is responsible for the management and operation of the station, to recover day-to-day running costs of providing services and amenities. With the exception of the QX management fee[19] at managed stations, the QX charge is not regulated.

2.34 We do not regulate franchised station lease income and we are not proposing to make any changes to facility charges (where they exist).

Areas for improvement

2.35 Stations are a key part of the network, and significantly affect passengers' experience of the railway. However, we agree with RDG's review of charges which

[18] Managed stations are the stations at which Network Rail is the Station Facility Owner (SFO). Franchised stations are the stations at which at a franchised train operator is the SFO. For more information see Annex B: Glossary.

[19] The QX management fee reflects the SFO's central support costs and a percentage profit applied to the entire QX charge.

concluded that the most significant issues related to stations are not best addressed by changes to station charges. Therefore we are recommending only minor changes to station charges for PR18.

LTC at managed stations – methodology improvement

2.36 The managed station LTC is equal to the annual average of long run efficient costs over 100 years for each station[20]. The methodology uses bottom-up estimates of costs for the next control period which are then extrapolated for the subsequent 19 control periods, in accordance with Network Rail's asset management policies on MRR of station assets.

2.37 The current methodology does not factor in work delivered in previous control periods. This means that any expenditure categories with no MRR work expected in the next control period are set at zero for the 100 year period covered by the forecast. We are supporting Network Rail's work to understand and address this issue so as to improve cost reflectivity.

2.38 While this refinement to the methodology could lead to an increase in the level of the charge for passenger operators that use managed stations we do not expect it to result in a significant increase to charges overall, as any increases in the total amount recovered by the LTC at managed stations should be matched by a reduction in the total amount recovered by other charges. We will consider the scale of the impacts when the new methodology has been developed.

Increase the transparency of stations QX charges

2.39 Station QX is not a regulated charge. However there are benefits to making the charge more transparent, in particular as there is currently no information on how QX charges differ between stations. Publishing total QX charges at all individual managed and franchised stations would allow Network Rail and operators to make comparisons of QX charges across the network. This would make it easier to establish if the QX charges reflect efficiently incurred costs and encourage improved cost efficiency at stations (although it would be important to understand the key station characteristics that may drive some of the differences in the charges).

2.40 Network Rail is in the process of publishing total QX charges at managed stations on its website. We plan to engage with stakeholders to discuss how this can be replicated for franchised stations.

[20] The Station Information and Security Systems (SISS) element of each managed station's LTC is based on forecast annual average MRR expenditure over 35 years.

2.41 We also considered the option of ORR regulating the QX charge, which was also assessed in the RDG review of charges. However, in common with the RDG conclusions, we consider that greater transparency of QX charges at different stations could provide similar benefits and be significantly easier to implement.

2.42 In addition, we also support Network Rail's plan to align the timings for the calculation and approval of the management fee element of the QX charge at managed stations with the periodic review process. This will provide greater certainty for both Network Rail and operators and more transparency for industry on the calculation of the fee. Network Rail has confirmed it will consult on the methodology for the QX management fee at managed stations in summer 2017.

Recommendations

2.43 We propose to improve the methodology used to calculate the managed station LTC and to increase the transparency of the station QX charge.

Other issues considered in relation to stations

2.44 Recently there has been an increase in the different types of model of station ownership and management used across the network. This can help address issues related to stations that cannot be easily resolved through charges. For example, 99 year full repairing and insuring leases for certain franchised stations are intended to help align MRR activities at a station with the interests of the operator. We are working with stakeholders to consider what the appropriate charging arrangements should be for any future ownership and management models that are developed.

Consultation questions

Fixed cost charges:

Q1: Do you support our proposal to levy fixed cost charges on all operators, including open access operators, to the extent that they can bear them (option 2)?

Fixed cost freight charges:

Q2: Do you support our proposal to simplify the current charging regime by having a single freight mark-up charge?

Q3: Do you support the recommendation to apply Network Rail's cost allocation methodology (discussed in this chapter) to freight mark-up charges?

Stations charges:

Q4: **Long term charge:** Do you support our recommendation that the methodology for the LTC at managed stations be recalibrated?

Q5: **Qualifying expenditure:** Do you agree with our recommendation that we support the work to make total QX charges more transparent at both managed and franchised stations?

3. Short-run variable charges

Summary

We propose not to make significant changes to short-run variable charges for PR18. Specifically, our work is limited to simplifying charges to reduce the administrative burden on operators and incrementally improving charges to ensure accuracy and stakeholder confidence. An exception to this is the capacity charge where we do not yet have a clear favoured proposal.

Introduction

3.1 Short-run variable charges are important in encouraging appropriate behaviour on the network. Specifically, through recovering the short-run variable costs (or ‘costs directly incurred’) of running a train on the network, the charges should encourage operators to manage the costs they impose on the network.

3.2 The charges considered within this chapter are the:

- variable usage charge (VUC);
- capacity charge (CC);
- traction electricity charge (EC4T);
- electrification asset usage charge (EAUC); and
- coal spillage charge (CSC).

Caps on charges

3.3 Before discussing the options for each of the charges in this chapter, it is important to consider the position on caps on charges.

3.4 In PR13, having had regard to our statutory duties, we decided to cap the VUC for freight operators and the capacity charge for freight and open access operators (this is explained in more detail later in this chapter). Since PR13, new legislative provisions have come into effect[21]. These provide clarification regarding the calculation of direct costs.

[21] Specifically, *Directive 2012/34/EU establishing a single European railway area (recast)* has been implemented in Great Britain (by *The Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016*) and the *Commission Implementing Regulation (EU) 2015/909 of 12 June 2015 on the modalities for the calculation of the cost that is directly incurred as a result of operating the train service* has come into effect.

3.5 The relevant directive (2012/34/EU) requires infrastructure managers to adapt to the provisions set out in this implementing regulation within four years of the entry into force of the implementing regulation. In recognition of the need for predictability in charges, the implementing regulation provides a limited opportunity to phase in direct costs for railway undertakings who will see their charges significantly increase following a review of the existing method for calculating direct costs.

3.6 Our interpretation is that this would have the effect that any phasing in or capping of direct costs can only apply where a review of the existing method for calculating those costs has occurred and the implementation of that review has resulted in significant increases. In light of this, it is not possible to roll over into CP6 a cap which is in place for a charge which was calculated at the outset of CP5. However, should there be a substantive methodological change as part of PR18 that leads to a significant increase in charges, then new capping arrangements (set above the CP5 uncapped level of charges) could be permitted.

Variable usage charge

3.7 The VUC is a charge designed to equal the operating[22], maintenance and renewal costs that vary with traffic. The charge recovers costs that change with marginal changes in traffic. It does not reflect the costs of providing or changing the capability or capacity of the network.

3.8 The charge is important in delivering PR18 objectives of a network that is efficient and better used. It does this by (either individually or in combination with other charges) affecting the incentives for:

- operators to develop track friendly vehicles;
- operators to only operate services where the short-run marginal benefit is greater than short-run marginal cost; and
- Network Rail to accommodate additional traffic.

3.9 The VUC recovers costs relating to three broad cost elements: track, civil engineering and signalling. Track wear and tear costs make up about 85% of the VUC and are underpinned by an engineering model, VTISM[23].

[22] In practice, rail infrastructure operating costs are widely understood not to vary materially with traffic, and the charge was set in CP4 to recover variable maintenance and renewal costs only.

[23] VTISM is a model developed for the cross-industry Vehicle/Track Systems Interface Committee (V/T SIC). This 'bottom-up' model uses engineering principles to relate rolling stock and track characteristics to track damage, and thus to renewal and heavy maintenance requirements.

3.10 In PR13, we concluded that the new rates for VUC freight traffic should be implemented subject to a cap on the average VUC. This cap was relative to CP4 rates and was 10%. The capped average increase to the VUC for freight traffic was phased in over the duration of CP5 (0% in years 1 and 2, rising to 20% in year 3, 60% in year 4 and 100% in year 5). As set out in paragraphs 3.5-3.6 above, the changes to the legislation means there are limited opportunities to cap direct costs for CP6. In the absence of a change to the method of calculating the VUC (which is not proposed for CP6), we do not consider there to be an option to phase-in the VUC over CP6.

Areas for improvement

3.11 Given the nature of the VUC and the incentive properties it displays, a key consideration in relation to the charge is ensuring it accurately reflects the costs it is supposed to recover.

3.12 Various options were considered with the aim of improving cost reflectivity. These ranged from 'recalibration' of the charge to more fundamental reform (for example, to disaggregate the VUC on a geographical basis[24] or to explore whether there is a material under-recovery of costs[25]).

3.13 As noted in our summary of responses to our initial consultation on the 2018 periodic review, the majority of most stakeholders offer a clear view that fundamental reform of the VUC should not be considered a priority for PR18. Various concerns were raised including a lack of suitable evidence to underpin options, the nature and scale of behaviour change it would produce, the potential complexity of changes, the likely impact on freight operators and the capacity of industry to accommodate change (especially considering the wider PR18 work that is being undertaken).

3.14 In light of the changes we have proposed elsewhere – notably the move to route-level regulation and a new approach for the national system operator – we consider that the case for fundamental reform for the VUC in PR18 is less strong. Indeed, these two reforms should contribute to improvements in efficiency and use of the network, while also implying a significant degree of work from all stakeholders to get these changes right. Therefore, for PR18, we propose to implement only ‘recalibration’ changes to the VUC.

3.15 However, our recent work has identified a number of options that could play an important role in improving outcomes in future control periods, including after we

[24] We note that the RDG charges review considered a geographically disaggregated VUC in its ‘Initial Options Assessment Report’. The option was graded as ‘amber’ overall.

[25] This option relates to the under-recovery of wear and tear costs generally and could therefore cover the EAUC as well as the VUC.

have moved to route-level regulation (e.g. disaggregation of the national VUC), and has highlighted a number of questions about whether the current methodology could be improved with more time (e.g. explaining the differences between bottom-up and top-down cost modelling). We propose to undertake further work with stakeholders to explore these issues so that we have a better understanding ahead of PR23.

Recalibration

3.16 While we have decided not to pursue fundamental reform of the VUC for PR18, it would be a proportionate use of resources to make some – albeit minor – changes to the VUC that we do not expect to have a significant impact on operators' VUC costs and could be implemented without significant resources. For example, there is value in reviewing whether it remains appropriate for a single speed to apply to fleets, where those fleets are actually used at different speeds for different services, as well as the current vehicle characteristics assumptions.

3.17 We are keen that stakeholders are given the opportunity to suggest areas of recalibration they would like to see considered for PR18 implementation. Suggestions can be made in response to this consultation or raised directly with Ben Worley (Ben.Worley@networkrail.co.uk), Regulatory Economics Manager at Network Rail.

3.18 Following consultation, we will work with Network Rail and wider stakeholders to identify which changes are suitable for PR18 implementation. Selected options may then be discussed in more detail in Network Rail's summer 2017 consultation.

Recommendation

3.19 We consider that the VUC is not a priority area for PR18. We therefore propose not to pursue fundamental reform of the charge for CP6. In keeping with our approach elsewhere, we recommend recalibrating the charge and making proportionate improvements to the existing methodology.

Capacity charge

3.20 The capacity charge (CC) does two things:

- it provides Network Rail with additional revenue to cover the increase in Schedule 8 payments that typically results from adding traffic; and
- it provides operators with some incentives to take account of the financial impact on other operators of the change in performance[26] that typically results

[26] Here (and beyond this point), by performance we mean operational performance, i.e. delays / punctuality.

from increased use of the network, thereby sending price signals to train operators and funders to promote better use of network capacity.

3.21 The calculation of the CC is based on the Schedule 8 costs arising from the historical average increase in reactionary delay associated with extra traffic. For passenger operators it is set at a geographically disaggregated level, which reflects the impacts of individual TOCs[27], whereas for freight operators it is set as one average rate across the network[28]. In PR13, we capped the CC paid by open access, charter and freight operators on the baseline (CP4) level of traffic, while the full CP5 rate was levied on above-baseline traffic.

Areas for improvement in PR18

3.22 We have identified the following areas where there may be scope for improvement in the CC for PR18:

- **Cost and complexity**: As reflected in RDG's review of charges, the current charge is complex and the purpose of the charge poorly understood, which may dampen its incentive effects. The complexity of the "wash-up" process also makes it costly to administer.
- **Incentives on operators to make best use of the network**: The CC provides one element of the incentives on operators to consider the cost impacts of their use of the network. We have some concerns that it may not reflect these impacts particularly well for some passenger operators, since it is not well correlated with congestion on the network and, for freight operators, does not reflect the cost of adding traffic in different locations (as the freight charge is not geographically disaggregated).
- **Incentives for Network Rail to grow traffic**: Network Rail has argued that it does not face appropriate incentives to grow traffic – suggesting that the combination of the current CC, other short-run variable charges and volume incentive may not be a sufficient incentive.

Options considered

3.23 We considered the following three options for improving the CC.

[27] Geographic disaggregation is achieved by calculating the charge at a service code level, on the basis of weighted average of effects at the level of constant traffic sections.

[28] This is based on the average effect at the level of constant traffic sections (as a weighted average).

Retain the existing charge but remove caps for open access and freight

3.24 An option would be to retain the CC in its current form, but remove the caps. This would be consistent with our interpretation of the legal restrictions on the capping of direct costs, set out in paragraph 3.5-3.6 above. In the absence of a change to the methodology for calculating the CC (which is not proposed), we do not consider that the existing CP5 caps on the CC (referred to as the “wash-up” arrangements) can continue to apply for CP6.

3.25 This option would also reduce the cost and complexity of the CC by removing the “wash-up” process (through which ‘caps’ are applied), and may facilitate more effective competition between franchise and open-access operators.

3.26 However, this option would mean that charges to freight, charter and open access operators would increase, with potential impacts on the viability of their services.[29]

Replace the charge with adjustments to Schedule 8 benchmarks

3.27 This option was proposed by RDG in its review of charges and RDG has subsequently developed this. It involves adjustments to Schedule 8 benchmarks[30] of affected operators as traffic joins the network. Because this option would only recover sums on traffic above the baseline, it would require that most of the costs currently recovered by the CC would need to be recovered through fixed charges.

3.28 This option would be consistent with our interpretation of the legal restrictions on the capping of direct costs.

3.29 However, this option may weaken the incentives on operators and Network Rail to put the network to best use and would lead to costs caused by one operator being met partly by competing operators. It may also increase the cost and complexity of the regime, due to the work involved to incorporate and administer moving benchmarks.

Remove the charge and recover lost revenue through higher fixed cost charges

3.30 We have considered the overall impacts of removing the CC, particularly in light of the separate proposals for reform to fixed cost charges for PR18.

[29] The impact of this increase in direct costs would be taken into account when setting the level of any fixed cost mark-ups, in line with the methodology of the market can bear test.

[30] The Schedule 8 benchmarks for Network Rail set the level of performance that operators get for the charges they pay. Network Rail compensates the operator for performance worse than the level of the benchmark, and the operator pays Network Rail a bonus for better than benchmark performance. The payments are determined formulaically, based on evidence on the financial impact of delay on operators.

3.31 The costs recovered by the CC are currently recovered as direct costs. As set out in paragraphs 3.5-3.6 above, any costs recovered as direct costs must comply with the implementing regulation. The legislation requires that costs arising from the minimum access package must be charged on a ‘costs directly incurred’ basis. As the costs recovered by the CC do not fall within scope of the minimum access package, we consider that there is some discretion regarding how these costs are recovered in CP6 i.e. they could either continue to be recovered as direct costs (in which case they must comply with the implementing regulation) or we could discontinue the CC and the costs could be recovered by way of revised fixed cost charges.

3.32 Removing the charge would also have the advantage of reducing both the cost and complexity of the current regime.

3.33 If the existing CC were discontinued then the revenue it currently recovers on baseline traffic would be recovered through fixed cost charges. Under our proposed approach to revising fixed cost charges, set out above, these new charges would be based on an updated allocation of fixed costs to different parts of the network, apply to all operators (including freight, charter and open access operators), subject to the market can bear test, and be implemented through fixed cost mark-ups.

3.34 This approach has the potential to send signals to operators about the relative costs of using different parts of the network, potentially replicating and *possibly* improving upon the incentives under the current CC. Under this option it would also be important to ensure that Network Rail has the right incentives to add traffic to the network, which might require other changes, such as to the volume incentive.

3.35 However, the balance of these impacts depends crucially on the detailed design and implementation of the revised fixed cost charges, which will not be known for some time.

Our recommendation

3.36 We think there are good arguments for changing the CC. However, we do not favour replacing the CC with adjustments to Schedule 8 benchmarks because of the costliness and complexity of the proposal and because it has no beneficial incentive effects. We are interested in your views on the remaining two options: removing the ‘caps’ and charging the full CC, or removing the CC. Under both options we would also be considering what operators’ contributions to fixed costs could be, in line with our proposals above.

3.37 In terms of the overall impact on charges to operators, if the CC were to be removed, we would expect that our assessment of what individual operators could contribute to fixed costs would be higher than what it would be under the option of levying an uncapped CC. This is because our assessment would take into account the fact that operators would no longer be paying for the CC.

Traction electricity charge (EC4T)

3.38 The traction electricity charge (EC4T) recovers the costs of electricity supplied by Network Rail to power electric trains. All operators who run these services pay this charge, based on either a metered or non-metered (modelled) approach.

Areas for improvement

3.39 In addition to recalibrations that we will undertake to improve accuracy in formulas used to calculate this charge, we are consulting on potential improvements to the volume reconciliation.

3.40 In our PR13 determination, we introduced the loss incentive mechanism whereby a proportion of costs relating to transmission losses are allocated to Network Rail during the end of year volume reconciliation process. The intention was to provide an incentive on Network Rail to reduce transmission losses. The loss incentive mechanism also shares the risk of forecasting errors between Network Rail and those train operators with modelled (i.e. non-metered) consumption.

3.41 However, it is unclear whether the mechanism has had useful incentive effects. Taking action to reduce transmission losses would involve costly investment in new electricity assets, with cost savings that mostly span several control periods. This limits the benefits to Network Rail from responding to the mechanism.

3.42 The mechanism looks to have been at least partially successful in achieving its goal of sharing risk between train operators with modelled consumption and Network Rail. However, it has also had the unintended consequence of moving money from train operators to Network Rail, as there has consistently been a big difference between actual and forecast losses in PR13. This difference could be reduced in CP6 as we are reviewing the methodologies used to measure the losses mark-up charged to metered operators.

Our recommendation

3.43 Our overall assessment is that this mechanism’s incentive properties appear relatively weak in terms of reducing losses. However, it does provide a mechanism by which Network Rail and relevant train operators have incentives to ensure that the forecast losses are reflective of likely outturn (and for sharing of the cost of forecast errors).

3.44 On balance, we propose to keep this incentive for CP6 and invite views from stakeholders on this approach.

Electrification asset usage charge

3.45 The electrification asset usage charge (EAUC) is designed to recover maintenance and renewal costs of electrification assets that vary with traffic. We considered whether we could simplify charges by combining the EAUC and VUC. We have decided not to take this option forward as the change is likely to be administratively burdensome, reduce transparency and bring very few benefits. Therefore, we are proposing to leave this charge unchanged for CP6. In the longer term, we will explore whether the charge needs change alongside our VUC work.

Our recommendation

3.46 We consider that the EAUC should not be altered, beyond recalibration, in PR18.

Coal spillage charge

3.47 The Coal Spillage Charge (CSC) aims to reflect the cost to Network Rail of coal spilt on the network, to provide an incentive on industry to reduce spillage.

3.48 Downward trends in coal freight mean the already small amounts raised by the charge are likely to decrease further. This trend brings into question whether it is appropriate to retain the charge.

3.49 In addition, there are concerns that the charge has poor incentive qualities as the charge is linked to gross tonne km rather than the amount of coal actually spilt. Given trends in coal freight, any redesign/recalibration to improve incentive properties risks being disproportionate and is likely to have a limited impact on behaviour change.

Our recommendation

3.50 Reflecting this, we propose to abolish the CSC, which will simplify the charging structure for freight operators.

3.51 Network Rail has stated that it would like to see a mechanism in place which provides an incentive on operators to minimise spillage by freight operators of all products. This would take a contractual approach, whereby a clause is added to freight operators' track access contracts to allow Network Rail to recover spillage costs from the operators responsible, when there is evidence to indicate who is responsible. This approach warrants further consideration.[31]

[31] Our proposal to remove the CSC is independent of any such contractual provision being implemented.

Consultation questions

Variable usage charge:

Q6: Do you support our recommendation not to make fundamental changes to the VUC for PR18?

Q7: Do you have any suggestions for ‘recalibration’ style changes to the VUC you would like to see considered for PR18 implementation?

Capacity charge:

Q8: Do you support our recommendation not to replace the CC with adjustments to Schedule 8 benchmarks?

Q9: Do you think we should: (a) retain the existing CC (but remove the caps on open access, freight and charter operators); (b) remove the existing CC and recover lost revenue through fixed cost charges; or (c) do you have any alternative proposals?

Traction electricity charge:

Q10: Do you support our recommendation to keep the loss incentive mechanism?

Electricity asset usage charge:

Q11: Do you support our recommendation that the EAUC not be altered, beyond recalibration, in PR18?

Coal spillage charge:

Q12: Do you support our recommendation to abolish the CSC?

4. Contractual incentives regime

Summary

We propose to make a number of targeted improvements to the incentives associated with unplanned and planned disruption. We are also inviting views on whether some passenger compensation could be included in the performance regimes, by allowing train operators to recover certain passenger compensation costs from Network Rail, where Network Rail is responsible for the delay. We are also considering how we can encourage a greater alignment of incentives and more joint working on efficiency through incentive schemes such as REBS.

Introduction

4.1 This chapter considers the financial incentives in the track access contract, namely:

- Schedule 8 (the performance regime);
- Schedule 4 (the possessions regime); and
- the incentives to promote joint-working by operators and Network Rail on cost reduction (e.g. the current REBS scheme).

4.2 Note that given we limit our consultation to incentives which are in the track access contract, this document does not discuss the volume incentive[32]. Further work assessing the effectiveness of the volume incentive will be taken forward alongside our work on fixed costs.

Schedule 8 (the performance regime)

4.3 Network Rail and operators face a number of different incentives to improve performance on the network. For Network Rail these include the regulated outputs framework, the possibility of enforcement action, reputational incentives and Schedule 8. For operators these include: impacts on revenue, compensation (to passengers) for delay, franchise obligations, reputational incentives and Schedule 8. It is important that Schedule 8's incentive effects be considered within the context of these wider performance incentives.

4.4 The Schedule 8 regime has three main functions.

[32] The volume incentive is designed to encourage Network Rail to think about the provision of network capacity to its customers in a more commercial way. It incentivises network capacity being made available in response to unexpected demand. Only Network Rail and government funders make or receive payments as part of this mechanism.

- **Incentivising Network Rail**: The regime provides Network Rail with financial incentives to improve performance on the railway.
- **Incentivising operators**: The regime provides operators with financial incentives to limit the delay they cause to other operators.
- **Reducing risk for operators**: The regime aims to reduce operators' exposure to losses that arise from delay and cancellations caused by Network Rail or other operators, by compensating operators for some of the losses incurred as a result of delay. This reduces the risk to train operators of operating and investing in the industry, reducing the cost to taxpayers.

4.5 Schedule 8 is a 'liquidated damages' regime: the payments made are determined formulaically (instead of requiring parties to negotiate actual losses for each delay), as a function of a payment rate and how actual performance compares to a benchmark level. There are different benchmarks and payment rates for Network Rail and each operator. The payment rates provide Network Rail and operators with an incentive to improve their performance by attaching financial consequences to the delay they cause, in the following way:

- payments from (to) Network Rail to (from) operators when Network Rail causes more (less) delay than the benchmark level are intended to reduce operators' exposure to financial risk caused by Network Rail; and
- Network Rail administers payments between operators, so that when operators cause delays they compensate other operators they affect. This provides all operators with incentives to limit the delay they cause to other operators.

Areas for improvement

4.6 In November 2015, we wrote to stakeholders seeking views on the key areas of focus on Schedule 8 in PR18. The consensus was that the regime was broadly effective at driving the right incentives and behaviours, and that our focus should be on making improvements to the existing regime, rather than exploring significant overhauls of it. This view echoed the findings of RDG's review of charges.

4.7 Accordingly, we have focused our efforts on prioritising those areas where there is a clear and pressing need for reform or improvements to the current framework that can deliver the most value.

4.8 Reflecting stakeholders' views, we propose to focus our work on the following areas:

- whether passenger compensation should be reflected in Schedule 8;
- the approach to setting benchmarks;

- measuring TOC-on-TOC impact directly, rather than through a proxy measure; and
- making the sustained poor performance provisions more effective.

4.9 We outline our proposals on each issue, and our assessments of them, below.

Schedule 8 and passenger compensation

4.10 Schedule 8 payments to passenger operators and the amounts those operators pay out in compensation to passengers serve different purposes (as described in Box 4.1). However, greater alignment of the regimes could help address a perception of unfairness about the current arrangements, as well as potentially improving some of the incentive effects.

4.11 We identified the linkages between Schedule 8 and passenger compensation as an area for further work in our response to the Which? super-complaint. It was also highlighted in RDG's review of charges and in responses to our November 2015 stakeholder letter.

Box 4.1 The purpose of Schedule 8 and passenger compensation

Schedule 8 and passenger compensation perform different functions, and the amounts payable are set in different ways.

Why do operators receive Schedule 8 payments?

- If the reliability of a passenger service gets worse (i.e. if it is late more often, or to a greater extent) then, over time, passengers will use the service less (whether by changing their journey, switching to a different service or a different mode of transport). Fewer passengers means lower revenue for the operator.
- Where these delays are caused by Network Rail or other operators, Schedule 8 ensures that the affected operator is compensated for the expected long-run revenue losses – losses which they cannot plan for or control. Instead the party causing the delay meets these costs.
- Ensuring that operators are compensated in this way reduces their uncontrollable financial risk, while the competition for franchises means that the savings from risk reduction will be passed on to taxpayers.

Why are Schedule 8 payments different from passenger compensation?

- Schedule 8 helps operators to manage risks they cannot control. These payments are not meant for the purpose of funding passenger compensation; they reflect long-run revenue losses by operators.
- Passenger compensation levels are set by governments and franchise authorities, consistent with legislative requirements. They are set in a way that balances the inconvenience caused to each passenger with the cost to taxpayers. More generous passenger compensation will tend to increase the overall cost to taxpayers of funding rail services, by affecting franchise premia.
- Passenger operators are currently expected to pay the cost of compensating passengers themselves, regardless of who caused the delay, and are funded for expected payments through their franchise agreement. We have been supporting efforts to improve passengers' ability to claim compensation that they are due.

Options considered

4.12 We considered the following potential changes:

- allowing operators to recover the passenger compensation that arises from events that are the responsibility of Network Rail or (possibly) other operators from those parties. We consider two potential sub-options: formulaic recovery or actual sums recovery; and
- improving transparency around the amount of passenger compensation due to delays caused by Network Rail.

Assessment of options

4.13 Our assessment of each option, relative to the option of leaving it unchanged, is as follows.

Recovering passenger compensation costs

4.14 There are two main ways to recover passenger compensation costs.

4.15 First, a new mechanism could be introduced to reflect compensation payments in the Schedule 8 liquidated (i.e. formulaic) damages calculations. In its review of charges, RDG considered an option of this kind, and that work has informed the options we have developed and our assessment of them.

4.16 Owing to the nature of the liquidated damages scheme, including an element for the recovery of passenger compensation costs to operators would likely need to involve automatic payment (to affected operators) of a pre-determined proportion of the compensation due, regardless of whether or not it was paid out (by those operators, to passengers).

4.17 This approach would allow an operator to recover the cost of compensating passengers on services that are delayed either by Network Rail or other operators. However, it looks likely to be very difficult and costly to implement, not least as:

- passenger compensation is currently payable when a certain threshold is crossed, whereas Schedule 8 payments are determined on a per-minute basis;
- compensation and Schedule 8 are measured against different standards of performance;
- new payment rates would need to be determined that would reflect the average compensation liability for each service, which would be a significant undertaking, and would also be likely to change more over a control period than the long-run revenue effects on which the current Schedule 8 rates are based; and
- Schedule 8 payments go straight to operators at the moment, but if they also included sums for passenger compensation then provisions would need to be put in place to ensure that operators are only receiving what they need to cover the compensation they pay out (i.e. that they are receiving closer to their actual compensation liability rather than their potential liability).

4.18 Given the time available to implement this option and the costliness of doing so, we have ruled out this approach for PR18.

4.19 The alternative approach would be to allow passenger operators to recover the actual costs of compensating passengers from Network Rail directly, to the extent that these costs were caused by Network Rail. These costs would be recovered through periodic claims made by operators to Network Rail, evidenced by the actual amounts paid out. Under this option, operators would still be exposed to the cost of compensating passengers on delay caused by other operators (as they are currently).

4.20 This option has the advantage of further strengthening the financial incentives on Network Rail, as it would face the cost of compensating both operators and passengers when it is responsible for delays (this would mean an overall increase in the costs faced by Network Rail). It would also reduce operator exposure to risks they cannot directly control, and arguably might increase the willingness of operators to promote compensation arrangements. This approach may also improve the understanding of the differences in the regime, by compensating operators for passenger compensation separate from, and in addition to, Schedule 8 payments.

4.21 However, this option would involve administrative cost and complexity for Network Rail and operators, and inevitably raise questions about how to implement the arrangements in practice (e.g. the treatment of payments made to passengers on a discretionary[33] basis), and could have implications for the costs involved in delay attribution between Network Rail and operators.

4.22 The introduction of these measures would also need to involve adjustments to payments under franchise obligations to avoid operators being funded twice for passenger compensation. This would result in increased administrative costs to franchise authorities, although the incremental effect is likely to be small, given that adjustments will anyway be required by the PR18 process as a whole.

Improved transparency

4.23 An alternative approach is to publish passenger compensation levels, and the attribution of these costs between operators and Network Rail. This would increase the transparency of who is responsible for the passenger compensation operators pay out and could improve the reputational incentives on Network Rail to address the causes of delay. However, it would involve additional administration costs.

Our recommendation

4.24 There is a potential benefit from changes to the treatment of passenger compensation within Schedule 8, but the options all involve costs and could introduce perverse incentives. Reflecting this, we do not have a preferred option at this time, and encourage stakeholders to share their views.

The approach to setting benchmarks

4.25 Schedule 8 benchmarks minimise money flows within the Schedule 8 regime. They are not intended to be targets. However, to ensure appropriate flows of funds for Network Rail it is important that benchmarks for Network Rail are broadly aligned with the regulated outputs.

4.26 In the passenger operator regime, the benchmarks vary at the level of the service group (i.e. at the sub-operator level) both for Network Rail and for passenger operators. In PR13, passenger operator benchmarks were set on the basis of the

[33] That is, compensation that the operator is not legally required to pay, but pays as an act of good will or for other reasons.

past performance of each service group, while Network Rail's benchmarks were set on the basis of the performance needed to deliver the regulated outputs.

4.27 In the freight operator regime, the benchmarks are constant across all freight operators, both for Network Rail and operators. In PR13, freight operator benchmarks were set on the basis of average past performance across all freight operators, while Network Rail's benchmarks were set on the basis of its own past performance. The benchmarks in the charter operator regime for PR13 were set on a very similar basis, with the charter operator benchmark set on the basis of average performance across all charter operators, while Network Rail's benchmark was set on the basis of its own past performance in relation to charter operators.

Options considered

4.28 **On the passenger regime:** Setting passenger operator benchmarks on the basis of past performance may weaken incentives for operators to improve their own performance, since doing so could result in a more challenging benchmark in the next control period. For franchised operators, the size of these effects may, however, depend upon the operator's performance against its franchise commitments and the remaining term of the franchise.

4.29 We have considered removing the link between operator benchmarks and individual past performance for passenger operators, to improve the overall incentive effects. This would involve setting the benchmarks on the basis of some new methodology (e.g. the average across all operators (as in the freight regime), or in line with franchise obligations, etc.). We would work with industry over 2017 to develop a new methodology for setting these benchmarks.

4.30 We are proposing to keep the current principle of broadly[34] aligning Network Rail benchmarks in the passenger regime with Network Rail's punctuality targets. However, there may be a case for greater uniformity in both operator and Network Rail benchmarks (either within or across operators), which could deliver cost savings and simplicity.

4.31 **On the freight and charter regime:** We are proposing to keep the current approach of setting freight operator benchmarks on the basis of average freight industry performance. This approach gives all freight operators an incentive to improve their performance.

[34] We note that they should be "broadly" aligned to reflect the fact that (a) depending on the unit in which regulated outputs are set, it may be more or less difficult to achieve full alignment and (b) exact alignment is not necessary given that the benchmarks are not meant to be targets.

4.32 With respect to the Network Rail benchmarks in the freight regime we have considered removing the link between Network Rail's past performance and its benchmark, for example by linking the benchmarks to Network Rail's regulated performance targets for freight, similar to the proposal for passenger operator benchmarks.

4.33 In principle, the recommended options for the freight operator regime would appear to also be appropriate for the charter operator regime, and so we could take a similar approach. We would welcome views on this.

4.34 The above changes would potentially simplify the process of recalibrating of the regimes, thereby delivering cost savings to industry. But there may be some cost impacts associated with implementing the changes, as a new methodology would need to be established.

Our recommendation

4.35 We are recommending that the approach to setting both passenger operator benchmarks and Network Rail benchmarks for freight operators be changed such that they are no longer set on the basis of past performance. If we pursue this recommendation we will work with industry in 2017 to establish a new methodology for setting these benchmarks.

4.36 We are not proposing to change the basic principles on which either Network Rail benchmarks for passenger operators or freight operator benchmarks are set.

Improving the measure of passenger operator performance

4.37 The Schedule 8 regime for passenger operators is meant to make operators pay for the impact of delay they cause to other operators. However, due to limitations on the data systems (i.e. PEARS) at the time of the previous review, the measure of performance used in the regime is actually based on a proxy, linked to the delay that passenger operators cause to themselves. Empirically derived assumptions are then made about the relationship between the delays that operators cause to themselves and the amount of delay caused to other operators.

4.38 The current approach may have some perverse consequences: for instance, if an operator cancels a service before it sets off, the regime would still treat the cancellation as though it had caused a pre-determined amount of delay – thereby reducing the incentive on operators to make sensible decisions about whether to run delayed services or to cancel them.

Option considered

4.39 We considered the impacts of changing the measure of passenger operator performance to one based on delays caused to other operators, rather than delays an operator causes to its own services.

Assessment of option

4.40 This option would improve the incentives on operators to avoid causing delay and to recover from delay they cause, by directly measuring the amount of delay they cause to other operators. It would also correct the perverse incentives created by the current treatment of cancellations.

4.41 More generally, it looks likely to reduce the cost of administering the regime and the risk of errors by significantly simplifying the calculation involved. It would also reduce Network Rail's exposure as central counterparty, by making the sums that Network Rail pays on operators' behalf better match the amounts it receives from those operators.

4.42 This option has the disadvantage of reducing the incentive on Network Rail to recover from delay it does not cause, as these would be allocated to the TOC causing the original delay. It will also involve some transitional administrative costs for Network Rail, operators and franchise authorities.

Our recommendation

4.43 We recommend changing the measure of passenger operator performance to one based on delay caused to other operators.

Sustained poor performance provisions

4.44 The sustained poor performance (SPP) provisions of Schedule 8 are based on the assumption that if performance is 10% worse than the benchmark for a sustained period then losses incurred by an operator may significantly exceed those compensated for through Schedule 8 – both in terms of lost revenue and additional costs, such as paying staff to work overtime and hotels, taxis and buses for passengers.

4.45 Industry responses to our November 2015 consultation expressed the view that SPP claims are costly, time-consuming and hard to resolve; with the result that claims are rarely made.

Option considered

4.46 Industry responses suggest that disputing claims of revenue losses (over and above those compensated for by Schedule 8 liquidated damages) account for most of the difficulty in making an SPP claim. There was generally less dispute over claims for increased costs, because they are easier to demonstrate.

4.47 With that in mind, we considered the option of restricting SPP claims to costs only. In other words, operators would only be able to claim for costs incurred as a result of sustained poor performance. Revenue losses would be taken to be settled entirely by Schedule 8 payments.

Assessment of option

4.48 While the total potential value of any one SPP claim may be lower, this option could increase the likelihood that claims are settled (and settled in a timely manner). Reflecting this, in practice, we expect that restricting SPP claims to costs only would *increase* the number of claims and potentially the amounts paid. This could increase the incentives on Network Rail to reduce sustained poor performance and also reduce operator exposure to the uncontrollable risks associated with it. It would also reduce the transaction costs of the current regime.

Our recommendation

4.49 We recommend that SPP provisions be changed such that claims may be made for costs only.

4.50 Separately, as we work through the detailed implementation and recalibration, we will also revisit: (a) the current SPP threshold (which we would update if we are provided with supporting evidence); and (b) the clarity of the contractual wording around the intent of the regime and the scope for claims and the process and procedures for claiming.

Schedule 4 (the possessions regime)

4.51 Schedule 4 relates to planned disruption on the network (“possessions”), which is needed to undertake maintenance, renewals and enhancements. It has two main functions:

- reducing risk for operators: the regime reduces operators’ exposure to financial risks associated with possessions (which are outside of their direct control); and
- incentivising Network Rail: the regime provides Network Rail with financial incentives to limit the level of service disruption as a result of possessions.

4.52 For most possessions, Schedule 4 is a 'liquidated damages' regime. Therefore compensation levels are determined by a formula set in advance, with different arrangements for passenger and freight operators. However train operators can also claim bespoke compensation for severe disruption. For passenger operators, the Schedule 4 regime is designed to be financially neutral provided that Network Rail delivers its baseline plans efficiently.

4.53 Franchised passenger operators pay an access charge supplement (ACS) and in return receive compensation under the liquidated damages regime. Currently, no open access operators choose to participate in this regime.

4.54 Network Rail also pays some compensation to freight operators under Schedule 4. These arrangements are not funded by freight operators, but instead by means of Network Rail's general settlement determined by ORR at periodic reviews.

4.55 Charter operators do not have a Schedule 4 regime as possessions are typically agreed before the majority of charter services are planned.

Areas for improvement in PR18

4.56 Our November 2015 stakeholder letter revealed a strong industry consensus that Schedule 4 is broadly effective at driving the right incentives and behaviours, but highlighted certain areas where improvements could be made. This echoed the findings of RDG's review of charges. Accordingly, we have focused our efforts on those areas where there is a clear need for reform and where meaningful improvements to the regime can deliver the most value.

4.57 We are proposing to prioritise three areas for improvement:

- the incentives created by notification discount factors (NDFs);
- the way the access charge supplement (ACS) is calculated; and
- bespoke compensation arrangements.

4.58 We have published a supporting document on a number of Schedule 4 issues that we are proposing not to pursue further in PR18.[35] If in response to this consultation we receive sufficient evidence that we should change our priorities, we will consider doing so.

[35] These issues are: the scope of passenger and freight train operator cost compensation, cancelled possessions, the scope of incentives and joint timetabling.

Incentives created by notification discount factors

4.59 Network Rail is incentivised to plan possessions early as the compensation it pays to franchised passenger operators is reduced based on the notice it gives. This is meant to reflect the lower impact on operators' revenues if early notice of service disruption is given, as passengers who are aware of service disruption before travelling are less affected. The reduction is calculated using a notification discount factor (NDF), linked to the assumed level of passenger awareness of disruption prior to travelling. Further information on how NDFs work can be found in our accompanying note published alongside this consultation[36].

4.60 Both RDG's review of charges and responses to our November 2015 stakeholder letter have highlighted the strong case for reviewing NDFs. A concern is that NDFs may no longer reflect the actual impact on passengers and may consequentially produce perverse incentives for Network Rail to book possessions prematurely, undermining effective possession planning.

Options considered

4.61 As identified by RDG in its recent review of charges there are two factors that we could vary to adjust the incentives relating to NDFs: the value of the discount that is applied for advance notice; and the notice period required for it to apply. We propose to review the evidence supporting both of these parameters. We are not proposing to redesign the structure of NDFs.

Our recommendation

4.62 In order to review the NDFs, there is value in better understanding how advance notice of planned disruption mitigates impacts on passengers. We have therefore commissioned market research into this.

4.63 We will also consider how the NDF approach fits in with Network Rail's possessions planning and operators' processes, to consider the full set of issues and impacts.

4.64 Further information on our intended approach and planned research can be found in our accompanying note.

Approach to ACS calculation

4.65 The amount train operating companies pay in ACS charges is based on the forecast volumes of engineering works (maintenance and renewals) included in the strategic business plan (SBP) for each periodic review.

[36] Initial thinking on incentives created by notification discount factors (NDFs) published on our website.

4.66 If renewals are delayed or cancelled Network Rail may be able to over- recover its costs. It became clear early in both the last two control periods that renewals volumes would be significantly below those assumed in the corresponding SBP.

Options considered

4.67 There are a number of options for improving the accuracy of the ACS charge.

- Estimate the ACS on the basis of the delivery plan, produced immediately prior to the start of the control period, rather than the SBP.
- Annual recalculations to adjust ACS for business plan variations in the volume of maintenance and renewal activity during the control period (as identified by RDG in its recent charging review).
- Retain the existing methodology but subject it to a high level adjustment to the total ACS needed (for example on the basis of historical over-recovery).

4.68 Although we recognise that there are issues with the way the ACS is currently calculated, it is important that any solution is proportionate.

4.69 More frequent recalculations of ACS or changing the plan on which the calculation is based, would likely improve the accuracy of the calculation and arguably improve incentives on Network Rail. However the additional work required could be disproportionate to the scale of the problem.

4.70 A simpler approach would be to make a high level adjustment to the ACS calculation to reduce the likelihood of over recovery. The adjustment could be based, for example, on historical over-recovery in CP5 and CP4. This approach might, however, lead to systematic under-recovery in the event that Network Rail delivers a plan that reflects likely renewal volumes.

Our recommendation

4.71 We do not have a firm recommendation at this time, and invite views on whether either of the above alternatives have merit, or whether we should retain the current approach.

Bespoke compensation for major disruptions

4.72 Operators can claim bespoke compensation for severe disruption. We have received feedback from industry that the process for claiming bespoke compensation is difficult to follow and that the regime is not working effectively.

4.73 In addition, there are concerns that the current revenue thresholds for claiming sustained planned disruption (SPD) compensation are too high. The mechanism is intended to capture the most disruptive possessions (c. 1%) but initial feedback suggests this is not happening.

Our recommendation

4.74 We propose over the coming months to review the SPD compensation threshold as well as the contractual wording and process for claims. This is consistent with our intended approach for sustained poor performance in Schedule 8 (set out in paragraphs 4.44-4.50).

Recalibration of Schedules 4 and 8

4.75 We are encouraging an industry-led approach to recalibration, in particular to ensure that the calculations are quality assured effectively, consistent with approaches taken in other industries. Our recommendation is that Network Rail's established responsibility for most aspects of recalibration of charges and incentives is extended to recalibration of the passenger regime's payment rates.

4.76 Historically, consultants have undertaken the recalibration of Schedule 8 payment rates for the passenger train operator regime with substantial input from ORR and Network Rail, and some input from TOCs. Only the consultants and ORR have had full access to the calculations, however. This lack of industry scrutiny has made the complex process more prone to errors. We have seen this during CP5, where a single spreadsheet error resulted in significant administration to correct TOCs' payment rates.

4.77 For PR18 we expect the equivalent confidentiality restrictions that apply to the consultants to apply to Network Rail, notably that a named team at Network Rail has access to the required LENNON (fare revenue) dataset and is unable to use the data for other purposes. This would allow Network Rail not only to be a client in the consultants' contract (as it has, with ORR and ATOC[37] previously), but also use its industry knowledge to sense check and help quality-assure the calculations.

4.78 In addition, we want the industry to explore ways in which their expertise can be used to sense check the payment rate calculations while at the same time respect the sensitivity of other operators' revenue data.

Aligning Network Rail and operator incentives

4.79 The vast majority of Network Rail's customers (i.e. franchised passenger operators) face limited exposure to Network Rail's costs. This is because they are protected to changes in most charges by their franchise agreements. Furthermore, a significant

[37] Association of Train Operating Companies (ATOC), which has now adopted the Rail Delivery Group name.

proportion of Network Rail's income is in the form of direct government grant, while the remaining fixed cost recovery does not closely reflect the activities that caused these costs to be incurred.

4.80 As a result, franchised passenger operators have limited interest in Network Rail's costs, as a change in these costs has little or no impact either on the charges which they pay or on the quality of the service which they receive. This arguably acts as a barrier to collaboration to reduce overall costs, and limits the extent to which Network Rail's customers challenge its cost levels.

4.81 We have sought to address this lack of aligned financial incentives, and to support greater co-operation between train operators and Network Rail, through the route-level efficiency benefit sharing (REBS) mechanism. Introduced in April 2014 as part of PR13, REBS is a contractual mechanism designed to strengthen the incentives on train operators to work with Network Rail to reduce network costs.

4.82 REBS works by allowing efficiency gains or losses to be shared between Network Rail and its customers (i.e. operators) on an annual basis. A key example of how operators can help Network Rail reduce cost is by working together to facilitate engineering access.

4.83 REBS has the following key properties[38]:

- it operates at a Network Rail operating route level. REBS route baselines were set by Network Rail in its CP5 delivery plan (DP14) and agreed by ORR;
- it provides operators with both upside (25% share) and downside (10% share) exposure to Network Rail's cumulative financial performance (as measured through our annual efficiency assessment);
- it covers a large subset of Network Rail's costs but not enhancements and is subject to adjustments for non-delivery of output; and
- It provides train operators with an opt-out from the mechanism (by route) at the start of, and in certain circumstances during, the control period.

4.84 REBS, or an equivalent mechanism, is likely to be of more importance in circumstances where there is no similar financial incentive included in franchise agreements. DfT's new franchises are required to opt in to REBS or establish an alliance with Network Rail. These alliance arrangements have sometimes sought to include financial exposure over costs.

[38] For more detailed information, please see our REBS guidance note

Areas for improvement in PR18

4.85 During CP5, our assessment to date has been that Network Rail has underperformed relative to its baseline, resulting in a range of payments from those train operators participating in REBS to Network Rail.[39]

4.86 Operators have strongly criticised REBS as too unpredictable and as having a weak link between the actions of train operators and REBS payments. Potentially reflecting this, the majority of train operators opted out of the mechanism. In its work, RDG considered that REBS could be improved. However, as REBS has been operational only since the start of CP5, we have limited experience and evidence of its performance.

4.87 As part of PR18 we see value in exploring ways to provide Network Rail's customers with appropriate incentives for them to help Network Rail to reduce its costs. This is an aspiration which we share with DfT with whom we have been working to consider how this might best be achieved.

4.88 With respect to aligning industry incentives through a REBS-type mechanism, we considered the following options.

Remove the current financial incentive (REBS)

4.89 Removing REBS would reduce administrative burdens. However, it would also remove any useful incentive effects that it currently has. Unless alternative financial arrangements are put in place through franchise agreements, there would be no mechanism to allow Network Rail's customers to share in cost savings. This could discourage collaboration to reduce these costs.

Change the design of the financial incentive

4.90 Many industry stakeholders recognise the rationale for REBS but consider it to have some major areas for improvement in the design. This could lead to a replacement incentive scheme to implement changes including:

- **resetting of baselines:** resetting baselines on a more frequent basis than every control period – for example by aligning them to Network Rail's routes' business plans – could potentially make the financial incentives less risky and more predictable. However, this process of resetting baselines could add to cost and complexity;

[39] During the first year of its operation it paid out £261,761, £232,848 of which was payment from operators to Network Rail and only £28,913 of which was payment from Network Rail to operators.

- **change the scope:** the incentive scheme could be based on a narrower set of costs, with a focus on areas which operators can more directly control (for example by removing renewals). If the scheme works on this basis then in the future the scope could be widened in light of experience;
- **update the cost allocation:** the measurement of costs under the financial incentive could be improved. For example, information from the new fixed costs allocation methodology (see chapter two of this document for more detail) could be applied to a financial incentive;
- **change the sharing percentages:** current REBS sharing percentages have been criticised by the industry with a view that the upside is not significant enough to incentivise a change in behaviour while the existence of a downside acts as a deterrent to opting-into REBS. An increased upside (or asymmetric) exposure could be explored further;
- **remove optionality:** the optionality of a financial incentive may undermine its intended incentive effects (and reduces participation). If a new financial incentive scheme had lower risks than the current REBS scheme, this could allow the replacement to be made a compulsory (minimum) requirement for all operators. In principle this could be implemented through the franchise agreement or through the track access contract.

Links with other policy work

4.91 We consider that financial exposure offers the potential for TOCs and FOCs to bring pressure on Network Rail to reduce costs, improve collaboration on cost reduction and to encourage constructive challenge of route business plans. These aims are broadly shared with the DfT and Transport Scotland with whom we have been working jointly to consider alternative ways of improving incentives on Network Rail and train operators to work together to improve efficiency. These include a range of different ways to improve the alignment of incentives, including:

- changes in industry structures to encourage greater alignment of incentives;
- deep alliances[40];
- between control period exposure such as franchised operators' exposure to VUC; and

[40] Alliances are collaborative working relationships between Network Rail and operators. They can take different forms with the common factor being that Network Rail and a train operator reach agreement to work together more closely and share the benefits of doing so, within the framework of their existing individual accountabilities and responsibilities. A 'deep alliance' can be defined as one in which the management of the operation and infrastructure aspects of the network are more aligned and could include financial risk sharing.

- (as discussed above) in-control period exposure, such as REBS.

4.92 We will continue working closely with DfT and Transport Scotland to explore this policy area further and inform them in their policy making.

Our recommendation

4.93 We note the concerns raised regarding REBS. However, we also note the potential for financial incentives to encourage collaboration between Network Rail and its customers to reduce industry costs. Indeed, stakeholder engagement confirms there is some appetite for a mechanism of this type.

4.94 We will continue to work closely with DfT and Transport Scotland to support policy development around aligning industry incentives. As part of this, we will explore alternative financial incentives that could replace REBS.

Consultation questions

Schedule 8:

Q13: **Passenger compensation:** What are your views on the options of passenger compensation recovery and improving the transparency of compensation relating to Network Rail's actions?

Q14: **Approach to setting benchmarks:** Do you support our recommendation to only make changes to delink passenger operator benchmarks and Network Rail benchmarks for freight operators from past performance (but to leave the approach to the other benchmarks unchanged)?

Q15: **Measure of passenger operator performance:** Do you support our recommendation to change the measure of passenger operator performance to one based on the delay caused to other operators?

Q16: **Sustained poor performance provisions:** Do you support our recommendation to limit SPP to costs compensation only?

Schedule 4:

Q17: Do you support our recommended prioritisation of schedule 4 issues? If you think we should reconsider any of the areas we have de-prioritised please submit supporting evidence.

Q18 Do you wish to submit relevant evidence regarding: (a) processes associated with planning possessions; and/or (b) planning alternative arrangements to deal with planned disruption (e.g. the notification that is needed to arrange bus replacement services)?

Aligning operator and Network Rail incentives

Q19: Do you have any views on how financial incentives could be improved to encourage collaboration between Network Rail and operators to reduce industry costs?

Q20: Do you have any views on the cost categories you think could be controlled by operators and whether these costs would be suitable as the basis of a potential future mechanism?

5. Next steps

5.1 The following section outlines the next steps of our charges and incentives work that will be undertaken following publication of this document.

Stakeholder events

5.2 We will be holding two stakeholder events: London on the 9 February 2017 and Glasgow on the 14 February 2017.

5.3 The purpose of these events is for us to outline the recommendations discussed in this document and answer stakeholder questions. If you would like to attend an event please fill out this online registration form with details of the representatives from your organisation that will be attending. Further details about the events, including the agenda, will be provided at a later date.

Responding to this consultation

5.4 This consultation closes on 9 March 2017.

5.5 Please submit your responses, in electronic form, to PR18@orr.gsi.gov.uk. You may find it useful to use this pro-forma.

5.6 We plan to publish all responses to this consultation on our website. Accordingly, when sending documents to us, we would prefer that you send your correspondence to us in Microsoft Word format or Open Document Format. This allows us to apply web standards to content on our website. If you do email us a PDF document, where possible please:

- create it from an electronic word processed file rather than sending us a scanned copy of your response; and
- ensure that the PDF's security method is set to "no security" in the document properties.

5.7 Should you wish any information that you provide, including personal data, to be treated as confidential, please be aware that this may be subject to publication, or release to other parties or to disclosure, in accordance with the access to information regimes. These regimes are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). Under the FOIA, there is a statutory code of practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

5.8 In view of this, if you are seeking confidentiality for information you are providing, please explain why. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on ORR.

5.9 If you are seeking to make a response in confidence, we would also be grateful if you would annex any confidential information, or provide a non-confidential summary, so that we can publish the non-confidential aspects of your response.

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