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30 October 2018

Dear Schedule 4 & 8 Working Group,

Final Decision on disputed aspects of Network Rail's Schedule 4 Access Charge Supplement calculation methodology

1. You asked us to determine on the issues set out in paragraph 6 below. These issues were raised during Schedule 4 & 8 Working Group discussions about the Access Charge Supplement (ACS) recalibration. After it became apparent that the Working Group work was not going to reach a consensus on these issues, Network Rail submitted its proposed methodology to ORR in April 2018 noting the areas of dispute. We received submissions from Working Group members explaining their views and the reasons for the disputes including a detailed counterproposal for forecasting Emergency Timetable related restrictions, submitted by GTR.
2. The rest of this letter sets out the process we have followed to decide on these disputes and our rationale for doing so.

Background

3. The passenger Schedule 4 regime is funded through an ACS paid by passenger operators in return for receiving full Schedule 4 compensation. All franchised passenger operators pay an ACS. Open access operators can pay an ACS if they choose to but currently none do. As a result, they are only eligible for compensation for very disruptive possessions.
4. Schedule 4 funding is set at the start of each Control Period based on Network Rail's forecast of the Schedule 4 payments it expects to make over that Control Period. As Schedule 4 is funded through the ACS, this forecast is the basis for the ACS payable by each operator.
5. The ACS should reflect expected Schedule 4 payments over the Control Period, to ensure that Network Rail is, on expectation, fully funded for the Schedule 4 cost of expected restrictions of use on the network.

Summary of disputed areas

6. As part of the PR18 Schedule 4 recalibration process, Network Rail has proposed a methodology for calculating the ACS payable by passenger operators. Network Rail consulted on its proposed methodology with passenger operators

through the working Group. While the Working Group was in agreement with most of Network Rail's methodology, a number of operators raised disputes relating to the following aspects of the methodology:

- a. whether possessions relating to Emergency Timetables (ET) should be included in the ACS calculation;
 - b. the level of granularity at which the ACS should be allocated between passenger operators;
 - c. whether the ACS should be set on the assumption that Network Rail notifies passenger operators about all possessions in advance of the early notification threshold in an attempt to reduce the number of late notice possessions.
7. In light of the lack of agreement on these issues, we were asked to determine what the approach should be on each. We set out our decision on each of these issues below.

Emergency Timetables (ETs)

8. As noted above, the ACS should reflect the expected Schedule 4 payments over the control period. Historically, an estimate of the number of possessions related to ETs has been included in the ACS calculation (i.e. compensation for ET-related restrictions of use is funded through the ACS); this reflects the fact that some ET-related restrictions of use are to be expected in any Control Period.
9. A number of operators object to ET-related restrictions of use being included in the methodology and therefore funded through the ACS. Currently, the ET element of the ACS is based on ET-related Schedule 4 payments over the previous Control Period. Operators noted that a consequence of forecasting ET-related Schedule 4 costs in this way is that, in each Control Period, Network Rail is effectively paid back in arrears for the amount of ET-related Schedule 4 payments made in the previous Control Period. They argued that this effectively removes the incentive on Network Rail to reduce the impact of ETs by better incident management when they occur and/or to reduce the likelihood and impact of disruptive incidents.
10. In its submission, GTR also expressed the following concerns with funding ET-related Schedule 4 payments in this way:
- a. "It distorts the correct allocation of cost between train companies and the infrastructure owner (i.e. this cost currently sits within franchise costs);

- b. It increases the funding provided to the ORR for Network Rail by the Government, over and above that explicitly stated in the 'Statement of Funds Available', when this money could be spent elsewhere within the public sector;
- c. It fails to hold NR to account and to ensure it improves its delivery in this area over time."

ORR decision

- 11. Policy issues about how the ACS is recalibrated should have been raised at the series of Schedule 4 and 8 Recalibration Working Groups completed in June 2017. Given the late stage of the Periodic Review in which received submissions on ET funding and the process involved in making changes to policy, the threshold for us to approve changes to policy, particularly those that do not enjoy support from both operators and Network Rail, is now very high and has not been met in this case.
- 12. We understand stakeholders' concerns that the way in which ET-related Schedule 4 payments are currently forecast potentially reduces the incentive on Network Rail to minimise the incidence and impact of ET-related restrictions of use.
- 13. However, we consider that the actual incentive effect of this approach may be limited because Network Rail's finances and funding are determined in Control Period-specific settlements; so the possibility for 'gaming' between Control Periods is limited.
- 14. Nonetheless, the approach to forecasting ET-related Schedule 4 payments could be reviewed as part of PR23, including the possibility of setting the ET-related component of the ACS on the basis of forecast efficient ET-related Schedule 4 costs. This also means that Network Rail should not expect to recover the sums paid out in ET-related Schedule 4 payments in CP6 through its ACS for CP7. We consider that making this principle clear now should mitigate any potential perverse incentive effects for CP6.
- 15. In addition, we will look to use on-going monitoring tools in CP6 to encourage Network Rail to minimise the incidence and impact of ET-related restrictions of use.
- 16. In response to each of the other arguments put forward by passenger operators:
 - a. We do not agree that this approach distorts the 'correct' allocation of costs between train operators and Network Rail. Including expected ET-related 4

- payments in the ACS is consistent with the principle that the ACS should reflect Network Rail's expected Schedule 4 payments.
- b. It is not accurate to suggest that this approach increases the funding to Network Rail over and above that stated in the SoFA. The funding for ET-related Schedule 4 costs via the ACS is meant to match what Network Rail is expected to pay out in Schedule 4 payments in relation to ET-related restrictions of use.
 - c. We consider that the proposals described above will strengthen the incentive on Network Rail to improve its management of ET-related restrictions of use.
17. For the reasons set out above we have decided to retain funding of ET-related Schedule 4 payments within the ACS.

The level of ACS granularity

18. Network Rail currently forecasts its Schedule 4 payments for a Control Period at Network Rail route level. It then apportions these route-level forecasts across each TOC within the route, based broadly on train miles operated during the recalibration period to determine each individual operator's ACS.
19. A number of operators argued that for CP6 the ACS should be disaggregated below route-level, e.g. to Delivery Unit level, to reflect better the actual level of forecast maintenance and renewals related possessions each passenger operator will face. This would improve the accuracy of the ACS apportioned to each passenger operator.
20. Network Rail explored the feasibility of doing this; it estimated that the work would take in excess of 8 weeks to complete and that it would be unlikely to increase significantly the accuracy of the ACS.

ORR decision

21. In calculating the ACS for a full Control Period there is a need to balance complexity with accuracy. In this case we agree with Network Rail's assessment that the amount of additional work that would be needed at this stage to increase ACS granularity is not proportionate to the potential benefit.
22. For this reason we have decided not to require that Network Rail amend its methodology for apportioning the ACS amongst passenger operators. However, improving the accuracy of the ACS calculation is important and we would expect this to be reviewed as part of the approach for PR23.

Notification assumptions in the ACS

23. Network Rail receives a discount on the amount of Schedule 4 revenue loss compensation it pays in proportion to how early it notifies operators about a possession. The level of discount is set by contractual 'notification factors' and there are currently three levels of discount applied at three different thresholds in respect of the amount of time before the possession Network Rail notifies passenger operators. One operator asked us to set the ACS funding on the assumption that Network Rail achieves 100% notification of possessions by D-26¹, the earliest threshold. It was suggested that this would strengthen the incentives on Network Rail to notify early.
24. This operator also suggested that Network Rail should be set targets to reduce the number of late notice possessions.

ORR Response

25. We agree that Network Rail should be properly incentivised to notify operators about possessions as early as possible and consider that the current notification discount process helps to achieve this.
26. Since the ACS is payable to Network Rail irrespective of the amount of notification it gives, we consider that changing the level of ACS is unlikely to have a significant effect on the incentives Network Rail has to notify operators early. These incentives are provided by the notification factors applied to the actual Schedule 4 payments Network Rail makes.
27. Moreover, we consider that the ACS should reflect Network Rail's expected performance in notifying TOCs about possessions at each threshold over a Control Period. There will always be situations where Network Rail cannot notify passenger operators before D-26, which in many cases, will not be due to inefficiency on Network Rail's part.
28. Given that we can expect some notification after D-26, setting the ACS on the basis of 100% notification by D-26 would mean that Network Rail would be underfunded for Schedule 4 over the Control Period.
29. We agree that it is desirable to reduce late notice possessions and support ways of strengthening current incentives. We think it would be useful before doing so to understand better the reasons why possessions are notified later than D-26 in the

¹ D-26 refers to twenty-six weeks before the start date of the new (winter or summer) timetable.

possessions planning process. We have asked Network Rail to collect more data on when it actually notifies operators about possessions over CP6, which could include collecting data on the reasons for late notifications. This data could inform efforts to strengthen the incentive on Network Rail to reduce late notice possessions in the next Periodic Review.

30. In summary, we do not agree that ACS funding should be set on the assumption that Network Rail would achieve 100% notification by D-26. However, we support future industry work to strengthen incentives on Network Rail to plan and notify possessions as early as possible alongside other initiatives in this area (such as an additional notification discount threshold) to be looked at over CP6 in time for inclusion as part of PR23.

Next steps

31. This letter states our final decisions on:
 - a. whether possessions relating to Emergency Timetables (ET) should be included in the ACS calculation;
 - b. the level of granularity at which the ACS should be allocated between passenger operators; and
 - c. whether the ACS should be set on the assumption that Network Rail notifies passenger operators about all possessions in advance of the early notification threshold in an attempt to reduce the number of late notices possessions
32. Our decisions are restricted only to the issues on which we have been asked to determine. We still need to review and approve the detail of how the ACS has been calculated once submitted.

Yours faithfully,

[By email]

Chris Hemsley