

Deren Olgun  
Principal Economist

12 October 2018

Caitlin Scarlett  
Schedule 8 recalibration lead  
Rail Delivery Group

Dear Caitlin,

**Final decision: Approach to recalibrating the SPP thresholds in the franchised passenger Schedule 8 regime**

1. In your letter of 14 March 2018 you asked us to determine what the level of the SPP threshold should be.
2. We have reviewed all the submissions we have received and our final decision is that the SPP threshold should be set at 20% for CP6. That is, in CP6 a passenger operator will be eligible to make an SPP claim only when the average Schedule 8 payment Network Rail makes over 13 periods exceeds the amount that would be paid if performance were 20% worse than benchmark for all of that operator's service groups. We confirmed this decision at the Schedule 4 and 8 Re-calibration Working Group meeting on 24 September 2018.
3. The rest of this email sets out the process we have followed and our rationale for this decision.

**Background**

4. To recap, Network Rail and passenger operators disagreed on what level the SPP threshold should be set at for CP6. We were asked to determine the level of the threshold. In March 2018 we received a number of submissions from operators and Network Rail.
5. Network Rail proposed to increase the SPP threshold from the current level of 10% to 30%, while passenger operators suggested that the SPP threshold should be maintained at 10%.

**Provisional Position**

6. After reviewing the submissions we received, we presented our provisional position, for discussion, at the Schedule 4 and 8 Re-calibration Working Group

meeting on 2 July 2018. Our provisional position was to increase the SPP threshold to 25%.

7. This position was based on our review of the current SPP threshold, which indicated that an SPP threshold of 10% could be expected to be exceeded even by 'normal' variations in performance. Given that Network Rail has limited ability to prevent such 'normal' variations in performance, setting the SPP threshold at this level is likely to constrain the potential incentive benefits of the regime.
8. We suggested that setting the threshold at a level where approximately 5% of service groups would be expected to exceed the threshold would put it outside the range of normal performance variation, and that this would give Network Rail a more effective incentive to reduce sustained poor performance specifically.
9. Our analysis of performance suggested that, over CP5, there has been, approximately, a 5% probability in each period of a service group having been, on average, more than 25% from their mean CP5 performance for the previous thirteen periods. On the basis of this, our provisional position was to set the SPP threshold at 25%.

#### **Responses to our provisional position**

10. Operators and Network Rail were given the opportunity to reflect on our position, and we received several responses to it.
11. In particular, several operators raised concerns about the analysis that underpinned our provisional position. They noted that:
  - a) the implied operator-level probability of being in SPP with a threshold of 25% would likely be lower than 5% (SPP applies at the operator level, and operators are typically made up of several service groups);
  - b) applying an annual trend to mean performance would have the effect of lowering the threshold; and
  - c) the 25% threshold was an approximation anyway, having been rounded up from 23.85%.
12. In response to these concerns, ORR invited the Recalibration Working Group to consider whether they could reach an agreed position. The Working Group consequently formed the "SPP subgroup", for that purpose. Following a meeting of this subgroup, Network Rail and a number of operators jointly agreed that an

SPP threshold of 20% would be acceptable to them, and submitted this proposal to us on 14 August 2018.

13. On 14 August 2018, Stagecoach Group also sent us a further submission disagreeing with our provisional position; it maintained that the SPP threshold should remain at 10%.

### ***Response to the Stagecoach Group submission***

14. Stagecoach Group's response to our provisional proposal, and to the alternative proposal put by some operators and Network Rail, stressed the following issues:
  - the difficulty and cost of pursuing SPP claims;
  - the approach to setting the benchmarks; and
  - the increasing costs to operators of poor performance.
15. Stagecoach Group also raised a technical point about the analysis that informed our provisional position and put forward several proposals on how to improve the SPP mechanism.
16. We set out our response to each of Stagecoach Group's concerns, below.

### ***The difficulty and cost of pursuing SPP claims***

17. Stagecoach Group noted that the process for making and resolving SPP claims is costly and time-consuming, particularly in relation to revenue claims.

### ***Our response***

18. We recognise this concern; it was for this reason that, in our December 2016 consultation on charges and incentives, we proposed a simplification of the regime that would make it easier to settle claims. This proposal was not supported by operators. We also left open the possibility that operators and Network Rail could propose an alternative simplification of the SPP process. To our knowledge, no operator agreed to take this work forward. It is now too late to make any changes to simplify the process for making SPP claims for CP6.
19. Stagecoach Group was particularly concerned that Network Rail has made it difficult for operators to prove revenue claims under SPP. With respect to this concern, we would note that the track access contract (clause 13) provides for disputes to be raised through the ADRR process; we consider that disputes concerning an SPP claim are capable of being raised in this manner.

### ***The approach to setting the benchmarks***

20. Stagecoach Group expressed concern that Network Rail's benchmarks would be set at a low level, and that this would create an incentive for Network Rail to perform badly.

#### *Our response*

21. We do not consider either that the Network Rail benchmarks will be set at a low level for CP6, or that, even if they were, this would have any significant incentive effect on Network Rail.
22. With respect to how the Network Rail benchmarks will be set: they will be based on Network Rail's expected performance for CP6, which we will determine in our PR18 final determination, having given due consideration to Network Rail's funding and expected efficiency improvements. This process has provided an opportunity for all operators to share their views and evidence on the expected performance level for CP6.
23. With respect to the incentive effects of setting low benchmarks: Network Rail's incentives under Schedule 8 are determined by the payment rates, and the payments rates in Schedule 8 are not affected by the level of the benchmark. That is, the gain to Network Rail of improved performance is the same, irrespective of the level of the benchmark. We consequently do not consider that the level of the benchmark has a significant incentive effect.

### ***The increasing costs to operators of poor performance***

24. Stagecoach Group suggested that recent changes to passenger compensation have increased the costs of delay to operators.

#### *Our response*

25. In arriving at our provisional position, we noted that, due to a lack of reliable evidence, it is not possible to set the threshold on the basis of the financial impact of sustained poor performance. Instead, we proposed to set the SPP threshold at a level that would put it outside of the range of normal variations in performance. We considered that setting it at a level such that approximately 5% of service groups could be expected to be in breach of the SPP threshold would improve the incentives the SPP provision provides to Network Rail to improve performance.

### ***Technical point on our analysis***

26. In paragraph 2 of the note we sent to the Re-calibration Working Group setting out our provisional position we stated that:

“Currently, a passenger operator can make an SPP claim when the average Schedule 8 payment made by Network Rail over 13 periods exceeds the amount that would be paid if performance were 10% worse than benchmark for all of that operator’s service groups.”

27. Stagecoach Group suggested that ‘if the above is to be taken literally, there is a possible discrepancy to the Track Access contract template which states that the trigger is for each of the Service Groups rather than the aggregate of all service groups of that train operator.’

### ***Our response***

28. Stagecoach group is correct that the SPP trigger applies to each service group, meaning that sufficiently poor sustained poor performance for just one service group can trigger an SPP claim for an operator.

29. However, nothing in the statement above contradicts that claim; this wording is consistent with the wording in the model track access contract and with the calculation of the SPP thresholds. By way of clarification: the statement that the threshold is what ‘would be paid if performance were 10% worse than benchmark for all of that operator’s service groups,’ should not be read as implying that all service groups need to be 10% worse than benchmark for SPP to be triggered (e.g. SPP could be triggered by just one service group for which performance was significantly more than 10% worse than benchmark).

### ***Stagecoach Group’s SPP proposals***

30. Stagecoach Group suggested a number of areas for improvement of the SPP process. As noted above, as part of our [December 2016 charges and incentive consultation](#) we consulted on a proposal to simplify the SPP claims process, and Network Rail also offered to develop a proposal for the Re-calibration Working Group. In both cases there was limited support from operators, and, as a result, no reforms were taken forward.

31. While it is too late in the PR18 process to implement any of Stagecoach’s proposals, we encourage Stagecoach to use them to inform work on the 2023 Periodic Review, as it progresses.

## Decision

32. On the basis of the submissions we received, we have decided that the SPP threshold should be set at 20% for CP6.

## Next steps

33. This letter states our final decision on how the SPP threshold should be recalibrated for CP6, which you asked us to determine. This decision is restricted only to the percentage deviation from the benchmark to be included in the calculation. You should note that we will still need to review and approve the detail of how the Average Periodic Liabilities (into which the SPP threshold is an input) have been calculated once they have been calculated (as per the general approach to the recalibration that we have previously discussed).

Yours sincerely,

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

Deren Olgun