

Periodic Review 2008:

Recommendation to ORR on changes to the regime for compensating disruptive possessions - freight

July 2008

**Published by the Schedule 4 freight group
established by the Industry Steering Group
(economic and contractual framework)**

Contents

Executive Summary	3
1. Introduction	5
Background.....	5
Method of work and industry involvement.....	6
Purpose and structure of this document.....	6
2. Summary of freight group debate and consultation issues	8
Background.....	8
Summary of consultation and responses	9
Interim recommendation to ORR and subsequent steps.....	10
3. Conclusions and recommendations on the regime for freight operators	11
Agreed principles of regime.....	11
Proposed changes.....	11
Disruption criteria.....	14
Payments.....	15
Setting the overall level of compensation.....	15
Funding the regime.....	16
Next steps and timing of implementation.....	16

Executive Summary

The efficient planning of work to maintain, renew and enhance the railway is important for all users of the network. In planning its engineering work efficiently, Network Rail takes into account the impact of disruption on passengers and freight users and, in doing so, the cost of paying compensation to train operators for the effects of disruptive possessions. The existing compensation arrangements for the effects of disruptive possessions in Schedule 4 of track access agreements and the Network Code currently provide a number of different mechanisms for doing this.

ORR asked the industry in January 2007 to consider possible improvements to the existing provisions with the aims of achieving consistency, simplicity, transparency and incentivising Network Rail. It asked the industry to make a proposal such that all compensation for possessions is made through Schedule 4 of a track access agreement (for freight as well as passenger) to the exclusion of Part G of the Network Code, with the proposal striking the appropriate balance between accuracy and efficiency of compensation mechanisms.

The Industry Steering Group for the economic and contractual framework (ISG) has carried out a programme of work to address ORR's remit. ISG now presents a recommendation to ORR on possible changes to the compensation regime for freight operators (with proposed legal drafting to effect these changes to follow) for further consideration by the parties during ORR's formal consultation on these issues during July and early August 2008.

ISG believes that this recommendation fully addresses ORR's remit. It envisages that changes to possession compensation mechanisms can be incorporated into the contractual framework such that all compensation for possessions will be made through Schedule 4 of a freight track access agreement to the exclusion of Part G of the Network Code. Proposed changes to Part G were presented by ISG to ORR in January 2008 in relation to changes to compensation for possessions for passenger operators - no further changes are proposed to Part G as a consequence of these proposals.

There will be no change to the existing provisions for disruptive possessions advised in all material respects after T-12 – this disruption will continue to be picked up by the Service Variation & Cancellation mechanism and compensated accordingly.

The new compensation mechanism will apply only to those possessions advised in all material respects before T-12. It will also be limited to those possessions that trigger specified levels of disruption to freight services and will provide different types of compensation reflecting the impact of the disruption, rather than being dependent on the type of work being carried out. These types of compensation will constitute a range of liquidated sums with actual costs being available only in exceptional circumstances.

It is intended that the new mechanism:

- would capture a similar scale of financial protection for disruptive possessions to the existing compensation provisions in Part G of the Network Code;
- would not be a comprehensive regime intending to cover all operator costs and losses;
- would capture only extremely disruptive possessions; and
- would therefore not require the payment by freight operators of an Access Charge Supplement.

This mechanism would work in a similar way to the existing Service Variation & Cancellation mechanism, in that operators would identify services which trigger the disruption criteria (subject to verification by Network Rail).

ISG has developed recommendations on which types of disruption have the most significant impact on freight services and on the form of compensation available in each case. The remainder of this paper sets out the recommendation in more detail. Whilst all parties support these principles, some of the financial values, including an estimate of the overall value of what is currently claimable by freight operators for disruptive possessions (required to inform the initial calibration of the regime) and the appropriate "de-minimis" level for making an actuals-based claim, remain to be determined. It is proposed that each party will make separate representations to ORR on these and any other, related points.

ISG believes that this recommendation incorporates a wide set of industry views and represents the right way forward for the industry.

1. Introduction

Background

1.1 ORR wrote to the Industry Steering Group on the economic and contractual framework (ISG) on 5 January 2007 stating:

“We understand from discussions with Network Rail and train operators that the current compensation mechanisms for possessions are not working as effectively as they should, in particular due to:

- (a) issues around the boundaries between Schedule 4 and Part G;
- (b) an inconsistent approach to compensating train operators for the effects of possessions;
- (c) concerns over the accuracy of compensation arrangements and the resulting economic signals;
- (d) a lack of transparency in the Part G and Schedule 4 process; and
- (e) unnecessarily high transaction costs.”

1.2 ORR also included in its letter of 5 January 2007 the following remit to the industry for a review of the current mechanisms:

- (a) all compensation for possessions should be made through Schedule 4 of a Track Access Agreement (or its freight equivalent) to the exclusion of Part G;
- (b) a consistent approach should be taken for compensation for possessions for differing purposes i.e. there should be no differentiation between a possession taken for a renewal or an enhancement. Differentiation may however be introduced to reflect the scale and impact of a possession or number of different possessions if this is considered appropriate. Differentiation may lead to different rates and/or approaches to compensation;
- (c) transaction costs should be minimised;
- (d) Network Rail should be incentivised, where possible, to manage the use of possessions efficiently and effectively;
- (e) operators should receive “fair” compensation for the restriction on contractual rights if these are affected by a possession. A balance should be struck between accuracy and the efficiency of compensation mechanisms;

- (f) a right of appeal should be retained to enable train operators and Network Rail to seek redress if compensation is disputed;
- (g) transparency of costs / benefits to be paid should be established, where possible, so that the risks and impact of disruption caused by possessions can be anticipated; and
- (h) there should be a consistent approach for paying compensation to franchised and non-franchised passenger operators and freight operators unless there is a compelling case to take a different approach.

Method of work and industry involvement

- 1.3 ISG established a Schedule 4 policy group to consider the matters set out in ORR's remit. As the work developed, it became necessary to convene a separate freight group, where the work has been carried out jointly between EWS, Freightliner, GB Railfreight, Network Rail and ORR (as observer and secretariat).
- 1.4 This freight group has considered various options and has defined and specified the work it considers necessary to support this review, which included engaging external consultants to carry out relevant supporting analysis and drawing upon legal representatives to set out how any proposed changes would be incorporated accurately into the drafting of the revised Schedule 4 of the freight track access contract.
- 1.5 The policy group published, through ISG, a formal industry consultation on 27 September 2007, to invite comments from a wider set of industry stakeholders (prompting further contributions on the freight side from EWS, First Group, Freight Transport Association and Network Rail).

Purpose and structure of this paper

- 1.6 This document constitutes a formal recommendation from ISG to ORR, based on all the work undertaken by the freight group over the last eighteen months at regular freight group meetings, often including contributions from the joint industry consultants, as well as operational planning colleagues from Network Rail, legal reviews and most importantly the industry responses to the formal consultation in the autumn of 2007. Chapter 2 of this recommendation sets out all matters which have been considered in this review.
- 1.7 Legal drafting for Schedule 4 of the freight track access contract is being developed, and a draft will follow.

- 1.8 The paper also identifies two areas on which ISG has not been able to agree unanimously, and on which it asks ORR to make a decision. These areas relate to the estimated annual value of what can currently be claimed for disruptive possessions, which is required to calibrate the regime, and to an appropriate de minimis level for triggering additional compensation claims. Where appropriate, each party will make separate submissions to ORR on these issues.
- 1.9 Copies of this recommendation, and the relevant supporting reports from consultants will be available at the Network Rail website from 4 July 2008. (www.networkrail.co.uk / Resource Library / Regulatory Documents / Access Charges Review / PR2008 / Review of Possessions Compensation Regime). ISG also agrees to this documentation being published on ORR's website.

2. Summary of freight group debate and consultation

Background

- 2.1 The consultation paper dated 27 September 2007 set out ISG's emerging views on how amendments could be made to Schedule 4 of track access agreements to achieve a single new compensation mechanism for disruptive possessions and how such changes could be implemented.
- 2.2 The consultation reflected the agreement of the freight group that the work would concentrate on designing a compensation regime that would provide costs and losses net of benefits for "extremely disruptive" possessions. There was no intention to change the existing "Service Variation & Cancellation" provisions within the existing freight Schedule 4 and Schedule 8 which would continue to compensate operators for disruption for possessions advised in all material respects after T-12.
- 2.3 The freight group considered the following two main building blocks for developing a mechanism within freight Schedule 4, in order to create a compensation mechanism which replaces the existing provisions in Part G:
- Definition of a new set of thresholds for "extremely disruptive" possessions which trigger compensation
 - Linking compensation to the non-availability of agreed key routes and diversionary routes
- 2.4 The proposal to identify and agree key routes and diversionary routes was examined in some detail. Network Rail believed that if feasible, such an approach would provide an incentive for core routes or a valid diversionary route to be available at all times and that this would therefore form the backbone of a freight compensation regime.
- 2.5 Whilst freight operators welcomed the initiative to formalise the necessary information on diversionary routes, concern was expressed at how appropriate it would be to combine this with a compensation mechanism at this stage. It was felt that the suitability of different routes would be specific to each freight operator and that incorporating this work into a compensation regime could lead to additional bureaucracy and provide more ground for disputes. Freight operators also argued that, even on an operator-specific basis, almost every route could be considered to be a "key" route for at least some of their customers and that the identification of key routes would hence be problematic.
- 2.6 The freight group therefore pursued the option that the compensation for extremely disruptive possessions advised in all material respects prior to T-12 would be based only on a new set of trigger thresholds to be examined and agreed. Where possessions caused disruption to

freight services which triggered these thresholds, freight operators would be entitled to claim actual costs and losses (net of benefits). The thresholds would be expected to apply equally to all freight operators.

- 2.7 Initial values were suggested for where the trigger thresholds might be set, to be informed by a period of shadow running (carried out by joint industry consultants appointed later). The freight group agreed that the objective was to set the thresholds such that they are only triggered in the event of “extreme disruption”.
- 2.8 Designing a regime based only on the extremely disruptive events was also consistent with the freight group’s intention that the regime should not require the payment of an Access Charge Supplement to Network Rail by freight operators.

Summary of consultation and responses

- 2.9 Whilst much debate took place within the freight group, the 27 September 2007 consultation offered the opportunity for a wider set of industry parties to contribute their views.
- 2.10 The full list of consultation questions from the September 2007 paper can be viewed in full at www.networkrail.co.uk / Resource Library / Regulatory Documents / Access Charges Review / PR2008 / Review of Possessions Compensation Regime.
- 2.11 Consultees were invited to comment on the emerging views for determining compensation for freight operators, namely whether the proposed criteria for extreme disruption due to possessions advised in all material respects prior to T-12 would cover all the situations in which losses would occur, and whether the identification of suitable diversionary routes would add value to a compensation regime. Views were also sought on the proposed next steps of shadow running and further analysis.
- 2.12 Recognising the need for ongoing work, respondents were supportive of the work done to date, and felt that the information gained from shadow running would be valuable in moving forward.
- 2.13 Whilst content to consider alternatives, operators emphasised that they would not accept a regime which left them financially worse off than current arrangements. EWS also restated in the consultation that it would certainly not be prepared to pay an Access Charge Supplement.
- 2.14 Consultation responses re-emphasised freight operators’ views that incorporating the network-wide identification of key routes and diversionary routes into a Schedule 4 compensation mechanism would not be appropriate at this stage and would add an additional level of complexity.

Interim recommendation to ORR and subsequent steps

- 2.15 As a result of industry feedback prior to and during the formal consultation process, ISG put a formal recommendation to ORR in January 2008 that the new regime would be based on the “extreme disruption” concept, using trigger thresholds to be examined and agreed. Where disruption to freight services were to trigger these thresholds, freight operators would receive compensation, either on the basis of liquidated sums or on actual costs and losses (net of benefits).
- 2.16 The freight group developed initial recommendations for defining the disruption criteria, the intention being that the thresholds should capture a similar scale of financial protection for disruptive possessions to the existing provisions under Part G of the Network Code.
- 2.17 In order to test the suitability of these suggested criteria and to refine them where appropriate, joint industry consultants (Faber Maunsell) were appointed in March 2008 to carry out two months of shadow running, in accordance with a remit drawn up by the freight group. The consultants were also asked to provide analysis to inform the freight group’s considerations on possible thresholds at which the benefits of a formulaic approach might be outweighed by the benefits of agreeing compensation on a bespoke basis.

3. Conclusions and recommendations on the regime for freight operators

3.1 This chapter sets out the recommendations made by ISG to ORR, and discusses the reasons for reaching these conclusions in light of the work carried out and the contributions from across the industry and from the joint industry consultants.

Agreed principles of regime

3.2 The recommendation reflects the following main principles that the regime should:

- capture a similar scale of financial protection for disruptive possessions to the existing compensation provisions in Part G of the Network Code;
- not be a comprehensive regime intending to cover all operator costs and losses;
- capture only extremely disruptive possessions; and
- therefore not require the payment by freight operators of an Access Charge Supplement.

3.3 Legal drafting, setting out how a revised Schedule 4 of the freight track access contract would look, will follow.

3.4 ISG intends that the current proposals for freight operators are designed to capture only exceptionally disruptive possessions to replace the existing provisions under Part G and on that basis does not propose that freight operators should pay an ACS.

Proposed changes

3.5 This recommendation intentionally avoids making any changes to the current provisions in freight Schedules 4 & 8 for compensation for disruption caused by possessions which have not been notified in all material respects after T-12 (Service Variations & Cancellations – “SV&C”). These provisions will remain in place and be unaffected by this review.

3.6 Instead, ISG recommends that the freight Schedule 4 should include new tiers of compensation for any extreme disruption caused by possessions which are notified in all material respects prior to T-12.

3.7 Stipulating triggers for compensation based on the scale and impact of disruption rather than the type of work being carried out in possessions

is consistent with ISG's approach across all aspects of the Schedule 4 review, and enables the current Part G provisions for compensating disruptive possessions to be removed.

- 3.8 It is envisaged that the additional mechanism would work in a similar way to the existing SV&C mechanism, in that operators identify services which trigger the disruption criteria and the subsequent claim is then verified by Network Rail (including, in respect of Cancellations, a test that the services concerned have run previously within a certain timeframe, as a proxy for whether the services concerned would have run in the absence of the possession).
- 3.9 After analysing the results of two months of shadow running carried out by the external consultants, ISG recommends that the criteria comprise the triggers set out in Table 1. These would be reflected in the freight model contract and, therefore, would be expected to apply equally to all freight operators.

Table 1: Triggers for different levels of compensation treatment

	Disruption	Threshold	Compensation treatment
"claimable events"	CATEGORY 1 DISRUPTION	Where, due to a possession advised in all material respects before T-12: <ul style="list-style-type: none"> the end to end journey of the service is affected by more than 10 miles; or the planned departure time of the service differs by more than 60 minutes; or the planned arrival time of the service at destination differs by more than 60 minutes; or more demanding length or weight restrictions for the affected service are imposed; or 	Flat rate sum of [£a] per service affected (payable only once per service)
	CATEGORY 2 DISRUPTION	<ul style="list-style-type: none"> the affected service is cancelled (subject to the 28-day test as currently applied within the SV&C provisions)¹; or more demanding gauge restrictions for the affected service are imposed; or the use of at least one additional locomotive on the affected service is required; or the use of a diesel locomotive as a substitute for an electric locomotive is required. 	Flat rate sum of [£b]² per service affected (payable only once per service)
"yellow flag events"	CATEGORY 3 DISRUPTION	Where, due to a possession advised in all material respects before T-12: <ul style="list-style-type: none"> the access to Origin or Destination³ is blocked (including where a suitable alternative gauge cleared route is not available for longer than 60 hours,); or any of the freight conveyed on the service has to be transported by other means; or the use of at least one additional locomotive on the affected service is required⁴; or the use of a diesel locomotive as a substitute for an electric locomotive is required⁵. 	Flat rate sums apply as set out above Possibility of top-up compensation based on actual costs/losses (net of benefits) - only where the total liquidated sums compensation undercompensates by more than [£X per service OR per possession⁶ (subject to further discussion)]
No compensation claimable for other forms of disruption			

¹ This need not necessarily be included in the contractual drafting, but could, for example, be addressed in Criteria & Procedures documentation

² Where "b" equals approximately 10 x "a" (to reflect the particularly significant impact of the four bullet points below the dotted line)

³ "Origin" and "Destination" as per the definitions in Clause 1 of the freight track access contract

⁴ EWS and Network Rail proposed that this provision should apply only where there is a need for the additional locomotive to be procured from a third part, however this is still subject to review in the legal drafting discussions

⁵ See previous footnote

⁶ This is currently envisaged to be a "one way arrangement" – this is subject to the final flat rate sums and de minimis level agreed

Disruption criteria

- 3.10 Given the agreed principle that this regime should not cover all disruption to freight services, a number of different types of exceptional disruption were identified as possible qualifying boundaries for claims. These were confirmed or refined by the shadow running, and Table 1 illustrates these.
- 3.11 ISG believes that types of disruption represent a clearer way of agreeing the qualifying boundaries for claims, rather than, for instance, the duration of a possession, which would not in all cases correlate with the amount of disruption suffered.
- 3.12 ISG proposes that compensation would be based on liquidated sums for all qualifying “events”, although it recognises that some are considered to be more serious than others. For this reason, a higher payment would be available in these cases. Table 1 illustrates which “claimable events” would be considered as Category 1 Disruption⁷ or Category 2 Disruption⁸ and would qualify for the lower or higher payment respectively
- 3.13 In all cases, the disruption would be identified by reference to a “base service”, defined in the attached contractual drafting of Schedule 4 of the freight track access contract to cover planned services or services with Level One or Level Two Rights which are not able to run owing to a possession advised in all material respects before T-12.
- 3.14 Of the originally identified criteria in the 27 September 2007 consultation, most have been included (albeit refined in some cases). The criteria relating to alternative origin or destination have been omitted from this recommendation as ISG believes that the other criteria capture this type of disruption.
- 3.15 One further criterion has been identified by the freight group as being a relevant type of disruption, namely where the mileage of the service is affected by more than ten miles. ISG has added this to the list of “claimable events” to the exclusion of the criteria concerning the provision of additional resources and the requirement of additional route knowledge. (However, costs relating to the latter two areas may be recovered if an operator experiences a Category 3 Disruption, see below.)
- 3.16 The recommendation is that, by default, all compensation should be based on liquidated sums. However, it recognises that there may be exceptional cases where freight operators should have the option to request additional compensation to recover actual costs (net of benefits). These circumstances have been described in the freight group debate as “yellow flag events”, and are illustrated in Table 1 as Category 3 Disruption⁹. In these cases, freight operators would be entitled to claim additional compensation only where their actual costs (net of benefits) exceeded a minimum amount (either per service or per possession), to be specified in the

⁷ The classification “Category 1, 2 or 3 Disruption” will be the contractual terms for the different types of disruptive events.

⁸ See above footnote

⁹ The classification “Category 1, 2 or 3 Disruption” will be the contractual terms for the different types of disruptive events.

contract. Each party will make its own representation to ORR on the proposed level of the de minimis threshold, and on whether it should be per service or per possession.

- 3.17 ISG believes that this provision should be reserved for the most significant events only. Therefore, Category 3 Disruption has been defined such that the “yellow flag” would be triggered very infrequently. Freight operators identified which sort of events were the most disruptive to their business and Table 1 illustrates the agreed list of criteria.
- 3.18 The freight group considered whether a trigger threshold based on frequency of disruption was desirable but concluded that it would be difficult to define and therefore has not included any such measure in this recommendation.

Payments

- 3.19 In the case that more than one disruptive claimable event is registered for an individual service, for example if a service runs more than 10 additional miles and is more than 60 minutes late, the freight operator may only claim once per service.
- 3.20 If a service were to suffer disruption which fell into two of the disruption Categories, the freight operator would always be entitled to the compensation provided for in the higher Category. In the cases where a “yellow flag” event is triggered, the operator would automatically receive the higher liquidated sum, and could request additional compensation under the provisions of Category 3 Disruption provided that the actual costs (net of benefits) exceeded the de minimis level.
- 3.21 The payment rates in the liquidated sums regime remain to be determined – this is largely dependent on the conclusion on the overall value of what can currently be claimed under Part G, which will be used to calibrate the regime, see discussion in section below.
- 3.22 However, in light of the external consultants’ analysis, ISG’s emerging view is that the cost impact of Category 2 Disruption is about ten times the impact of Category 1 Disruption and that the payment rates should reflect this accordingly.

Setting the overall level of compensation

- 3.23 All parties support the principle that the new regime should capture a similar scale of financial protection for disruptive possessions to that which would be captured under the existing compensation provisions in Part G of the Network Code.
- 3.24 However, the industry has not yet been able to reach a conclusion on what this value is, owing to a lack of consistent record keeping, historical fluctuations in claimable Part G activity, and inconsistency between operators in the extent to which they have historically claimed.
- 3.25 Agreement on this issue is a precursor to being able to agree what the flat rate liquidated sums should be for Category 1 and 2 Disruption.

- 3.26 ISG is therefore referring the decision to ORR, and in the interests of commercial confidentiality, each party will make a separate representation to ORR, sharing the analysis or evidence behind the number which it believes should be considered.

Funding the regime

- 3.27 Freight operators will not be required to pay an Access Charge Supplement for this regime.
- 3.28 This is because the regime is not a comprehensive regime intending to cover all operator cost and losses and would capture only extremely disruptive possessions. The regime is providing a similar level of overall protection (in terms of financial compensation) as that which is currently available for disruptive possessions through Part G.

Next steps and timing of implementation

- 3.29 Without prejudice to discussions on the timing of implementation for the proposals for passenger operators, the aim is that a new regime for freight operators could be implemented for the beginning of Control Period 4.
- 3.30 ISG notes that ORR intends to consult formally on the changes proposed to the regime in the week commencing 14 July 2008.