# The approach to the recalibration of charges and incentives for CP6

## High-level Overview

May 2018

# Introduction

- Charges and incentives send signals to operators and Network Rail about the costs and impacts of usage of the rail network. They are thus an integral part of helping deliver the PR18 outcomes of ensuring that the network is efficient, better used, reliable and available.

- As part of PR18, the levels of all of the charges and incentives need to be recalibrated to ensure that the signals they send in CP6 are accurate.

- Given their role in determining network outcomes, any errors or weaknesses in the recalibration of charges and incentives could frustrate the ability of PR18 to achieve its objectives. It is therefore important that we have in place an appropriate process to ensure that we mitigate the risk of such errors or weaknesses.

- These slides set out our expectations for that process, at a high level. A detailed description of the process, for recalibration leads, is available on our website (here).

- An earlier version of these slides was presented at the RDG PR18 Working Group on 19th February 2018.

# Recalibration leads

■ Some areas of the recalibration are being led by Network Rail, some by industry and some by ORR.

■ The principles of the recalibration process are the same, regardless of which organisation is leading the recalibration.

| Charge/Incentive | Re-calibration Lead | Contact |
|---|---|---|
| Infrastructure cost charges (cost allocation) | Network Rail | Ben Worley |
| Infrastructure cost charges (setting mark-ups) | ORR | Alexandra Bobocica |
| Variable charges (i.e. VUC, EAUC, EC4T) | Network Rail | Ben Worley |
| VUC capping policy | ORR | Nicholas Hall |
| Station charges | Network Rail | Aaren Healy |
| Passenger Schedule 4 (ACS) | Network Rail | Simon Harding |
| Passenger Schedule 4 (Notification Factors) | ORR | Sheona Mackenzie |
| Passenger Schedule 4 (excl. Notification Factors & ACS) | RDG | Chris Dellard |
| Freight Schedule 4 | Network Rail and operators | Alexis Streeter (working group secretary) |
| Passenger Schedule 8 | RDG | Caitlin Scarlett |
| Freight & Charter Schedule 8 | Network Rail and operators | Alexis Streeter (working group secretary) |

# The Risk-based Approach: Overview

- We are adopting a risk-based approach to scrutiny across PR18. The principle of this approach is that the most resources are put into the areas with the highest risk.

- In keeping with this risk-based approach, for the recalibration of charges and incentives, we expect recalibration leads to:

    - Propose a score for the inherent risk of errors or weaknesses for each source of risk for each parameter in the recalibration;

    - Propose assurance processes for the recalibration lead and for industry that are proportionate to the inherent risk; and

    - Set out clear proposals for the evidence and methodology to be used in each area of the recalibration, along with a rationale for those proposals.

- Where we are not satisfied with any of these proposals, we may require revisions. Further, where we are not or cannot be satisfied by the level of assurance provided by the recalibration lead and industry, we will seek to obtain further assurance ourselves.

- This approach is already implicit in the approach that has been followed to date for the recalibration of charges and incentives. The purpose of these slides is to make this approach explicit and to make the expectations on all parties clear.

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# Sources of risk in the recalibration

# Sources of risk

■ We have distinguished five different sources of risk across the recalibration and implementation of charges and incentives for CP6:

  – **Evidential risk:** the risk that the evidence does not reflect the target variable (as determined by the policy).

  – **Methodological risk:** the risk that, given accurate evidence, the methodology nonetheless fails to produce an accurate estimate of the target variable.

  – **Model design risk:** the risk that the model design does not reflect the methodology.

  – **Model delivery risk:** the risk that the model does not do what the design says it should do.

  – **Transposition risk**: the risk that the numbers written into contracts do not reflect the outputs of the model.

# Weaknesses and errors

- We distinguish between weaknesses and errors:

  - *Evidential* risk and *Methodological* risk are sources of potential *weaknesses* for PR18.

  - In contrast, *Model Design* and *Delivery* risk, as well as *Transposition* risk are sources of potential *errors* for PR18.

- Why make this distinction?

  - We recognise that <u>there will be weaknesses in PR18</u> (it won't be perfect – for instance, the only available evidence may not be very good); *however*, <u>we aim for PR18 to be error-free</u>.

  - We will, in general, not seek to address *weaknesses* until PR23, however we may seek to address *errors* within CP6.

- Nonetheless, we wish to mitigate the risk of *both* weaknesses and errors – both are detrimental to the delivery of PR18 objectives.

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# Scoring risk

# Scoring risk

- We are asking recalibration leads to score the impact and likelihood of each of these sources of risk – this will inform decisions about how much assurance is required in each area.

- We have developed a template for recalibration leads to fill in (see below) and an associated risk framework to help them do so. These are available on our website (here).

- We will review and, where appropriate, revise proposed risk scores

| Charge/Incentive | e.g. Schedule 8; VUC |
|---|---|
| Parameter | e.g. Monitoring point weightings; VUC rates |

| | Inherent impact score | Rationale for score |
|---|---|---|
| Inherent impact | | |

| Source of risk | Inherent likelihood score | Rationale for score |
|---|---|---|
| Evidential | | |
| Methodological | | |
| Model design | | |
| Model delivery | | |
| Transposition | | |

*Risk scoring template*

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# The assurance process

# The assurance process

- In line with the risk-based approach, the level of risk in each area determines how much assurance is required.

- There are three main sources of assurance:

  - Recalibration lead

  - Industry

  - ORR

- The subsequent slides detail what we expect from recalibration leads on each of these.

# ORR review of assurance

■ We are asking recalibration leads to set out the proposed assurance processes for the recalibration lead and industry using the following template:

| Charge/Incentive | |
|---|---|
| Parameter | |

| Source of risk | Inherent risk | Recalibration lead assurance process | Industry assurance process |
|---|---|---|---|
| Evidential | | | |
| Methodological | | | |
| Model design | | | |
| Model delivery | | | |
| Transposition | | | |

■ When reviewing the assurance for any given source of risk for any given parameter we will take a view on whether the *totality* of controls in place are proportionate. If we aren't satisfied that they are sufficient, given the level of risk, we will require more.

# Recalibration lead assurance

- Recalibration lead assurance processes are the first set of mitigations against the risk of errors or weaknesses in the recalibration.

- These include both the recalibration lead's own assurance processes and the assurance provided by independent audit that the recalibration lead procures.

- The extent of recalibration lead assurance will likely vary depending on the source of risk and the extent of industry assurance.

- As noted, when reviewing the level and nature of recalibration lead assurance we will take into account the proposed level and nature of industry assurance processes.

# Industry assurance processes

■ Scrutiny from industry is a particularly important source of assurance for all areas of the recalibration.

■ When recalibration leads set out the proposed industry assurance process for ORR, they must detail, for each area:

– Whether and how they are proposing to engage with industry; and

– The process for recognising and escalating industry disagreement.

■ Where there is disagreement within the industry about how to proceed:

– The recalibration lead should ask ORR to determine the issue

– The recalibration lead should organise for each side of the disagreement to submit a proposal, and a rationale for that proposal.

– ORR will then consider the different proposals and reach a determination.

■ Clarity about the process for resolving disagreement is particularly important where Network Rail is the recalibration lead – we must be confident that disagreements within industry will be raised with us.

# ORR assurance processes

■ In most areas of the recalibration we will seek to rely on the recalibration lead and industry assurance processes. However, where we cannot take comfort in the recalibration lead and industry assurance processes alone, we will seek to obtain further assurance ourselves.

■ Our contribution to assurance will generally depend on the source of risk:

– For *evidential* and *methodological* risk we will generally seek to obtain some assurance ourselves. To facilitate this, recalibration leads are required to set out both (a) what the proposal is and (b) the rationale for the proposal.

– For *model design* and *model delivery* risk, we will generally seek to rely on the recalibration lead and industry assurance processes. In particular: we do not plan to audit spreadsheet models for any of the charges or incentives.

– For *transposition* risk we will likewise largely be relying on the recalibration lead assurance processes, however we will do some very high-level 'sense-checking' on final numbers before implementation. We should stress that these tests will, by necessity, only be crude order-of-magnitude tests.

# Conclusion

# What recalibration leads need to do

- We require recalibration leads to do the following:

  - Send us a risk score for each recalibration parameter – we may ask them to increase the score in areas where we are not comfortable with their score.

  - Set out the recalibration lead assurance process for each source of risk. These should be proportionate to the level of risk, and we may require more assurance where appropriate.

  - Set out the industry assurance process for each source of risk. Again, this should be proportionate to the level of risk, and we may require a more thorough industry assurance process where appropriate. It is important that recalibration leads communicate the industry assurance process to industry.

  - For evidence and methodology, we will likely be doing more assurance ourselves, so recalibration leads will need to set out: (a) what they are proposing and (b) why.

- We are not insisting on a one-size-fits-all approach. It is important that recalibration leads follow these steps, but the format of what they send us can vary.

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