



# Schedule 4&8 Re-calibration Working Group

November 2017

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## Background

1. As part of the re-calibration of Schedules 4 and 8 we set up the Schedule 4 and 8 Re-calibration Working Group (hereafter: the Working Group).
2. Between February and June 2017 we organised and hosted a series of meetings for this Working Group, holding separate meetings for passenger, freight and charter operators.
3. This note summarises the points of clarification and agreement from those meetings and confirms the next steps for the re-calibration of each aspect of the regimes.
4. More information on what the Working Group discussed in each meeting and any slides presented are available on our website [here](#).

## Responsibilities

5. Industry will lead the re-calibration of Schedule 4 and 8 in PR18, with the exception of the Notification Discount Factors in the passenger operator Schedule 4 regime.
6. We have set out set out the following split of responsibilities for the re-calibration of each aspect of the regimes (see Figure 1).

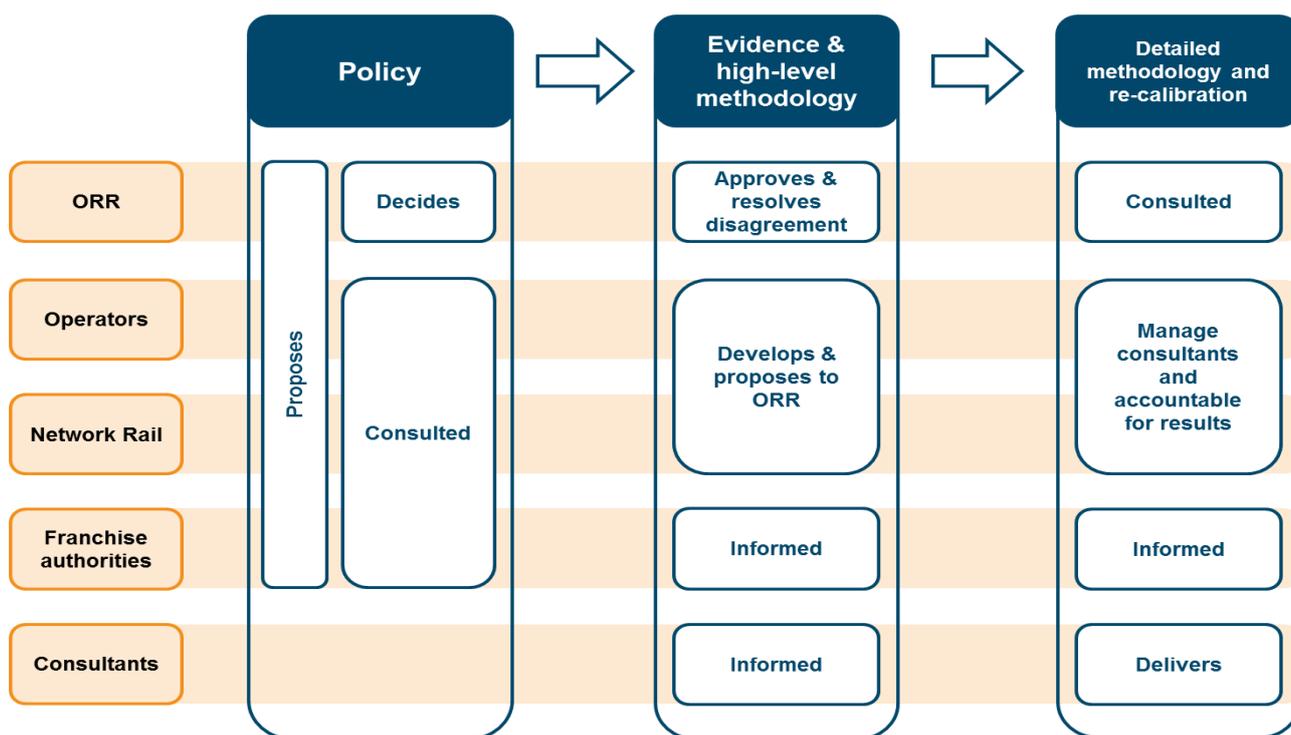


Figure 1

## Passenger operator regimes

### Schedule 8

7. The Rail Delivery Group (RDG) will lead the passenger operator Schedule 8 re-calibration.
8. Some operators require a bespoke Schedule 8 re-calibration. This work will follow a separate project plan, led by the Network Rail routes and the train operators affected.
9. The passenger operator Working Group discussed the following areas of the passenger operator Schedule 8 regime:
  - Payment rates;
  - Benchmarks;
  - Monitoring Point Weightings;
  - Cancellation minutes; and
  - Sustained Poor Performance (SPP).

### Payment Rates

10. The Network Rail payment rate for a given service group ought to reflect the impact of unplanned disruptions on the long-run revenue of that service group.

11. The passenger operator payment rate for a given service group ought to reflect the long-run revenue impact on other operators of delays caused by that service group. The CP6 passenger operator payment rates should be estimated using the CP6 Network Rail payment rates for other operators.
12. It is vital for the effective functioning of the Schedule 8 regime that the re-calibrated Network Rail and passenger operator payment rates accurately reflect the long-run revenue impacts of the delays caused. To do this the re-calibrated rates must be based on the best available evidence and be calculated using an appropriate methodology – it is the role of industry to ensure that this is done.
13. The final rates will come to us for approval and, in order to approve them, we will need to be convinced that the evidence used is robust and that the methodology used gives effect to the intent of the policy. To be clear, we can only approve the re-calibrated payment rates if it is clear that they are consistent with the principles of the policy and calculated on the basis of the best available evidence.

## **Benchmarks**

14. The main purpose of benchmarks in Schedule 8 is to minimise the money flows within the regime. To ensure that they achieve this aim, the benchmarks should be set on the basis of the expected level of performance for CP6 for both Network Rail and passenger operators.
15. In PR13, Network Rail's benchmarks for the passenger operator Schedule 8 regime were set on basis of Network Rail's regulated outputs in relation to passenger operators, since the regulated outputs were also supposed to reflect Network Rail's expected performance. To the extent that Network Rail's regulated performance outputs in CP6 are also set on the basis of expected performance, the benchmarks ought to align with them. If, and to the extent that, the regulated outputs are not set on the basis of expected performance, then the benchmarks will need to diverge from the regulated outputs.
16. Passenger operator benchmarks should continue to be based on past performance of each service group. The period of past performance used to calculate the new passenger operator benchmarks, the 're-calibration period', should be chosen on the basis that it provides a good estimate of expected level of performance in the next control period.
17. Industry is responsible for re-calibrating the Network Rail and passenger operator benchmarks. ORR will confirm what the Network Rail benchmark ought to be based on once the approach to setting regulated performance outputs is confirmed. To re-calibrate the passenger operator benchmarks Network Rail and passenger operators will have to agree on the re-calibration period.

18. When considering whether to approve the re-calibrated benchmarks or not we will assess whether they reflect the expected performance of Network Rail and passenger operators in CP6. The rationale behind the choice of re-calibration period should therefore be clearly explained when industry submits the benchmarks to ORR for approval.

### **Monitoring Point Weightings**

19. Performance in the passenger operator Schedule 8 regime is recorded at a set of stations for each service group, known as monitoring points. Weightings are given to monitoring points to reflect the proportion of passengers that complete their journey at each monitoring point (and the stations preceding them that are not monitoring points).
20. There are two elements to the re-calibration of monitoring point weightings: (i) the location of the monitoring points; and (ii) the calculation of the monitoring point weightings.
21. The Working Group agreed that passenger operators, with engagement from Network Rail routes, are best placed to select the locations of monitoring points for their services. Industry will then lead on the calculation of the new monitoring point weightings.
22. We will check the methodology used to calculate the new weightings and then approve or reject the re-calibrated results based on whether or not they are consistent with the stated purpose of the monitoring point weightings.

### **Cancellation minutes**

23. In the passenger operator Schedule 8 regime cancellations are converted into a specific number of minutes of lateness, known as cancellation minutes. Cancellation minutes are included when comparing Network Rail's performance against its benchmarks.
24. Cancellation minutes for each service group are calculated by multiplying the service interval for the service group by a fixed number, the 'service interval multiplier'. The service interval multiplier for all service groups is currently 1.5.
25. The passenger operator Working Group agreed that cancellation minutes should continue to be the product of the service interval and the service interval multiplier.
26. The service interval multiplier will continue to be 1.5 unless operators can demonstrate that it does not accurately represent the financial impact they experience when one of their services is cancelled. A change to the service interval multiplier must be agreed with Network Rail, or referred to ORR for a decision if agreement cannot be reached in a timely manner.

## **Sustained Poor Performance (SPP)**

27. The SPP provisions under Schedule 8 protects passenger operators against Network Rail's performance falling to such a level that the payments they receive through the liquidated damages element of the regime are substantially lower than the actual financial impact they experience.
28. Under the SPP provisions passenger operators can claim for 'all relevant losses' when Network Rail's performance is on average 10% worse than benchmark for 13 consecutive periods.
29. In our [conclusions to the December 2016 charges and incentives consultation](#) we confirmed that we will not pursue any further changes to the structure of the SPP regime. However, we are still willing to consider new proposals put forward by industry, provided that they enjoy significant cross-industry support.
30. The SPP threshold should be set at the point at which the financial losses incurred by passenger operators due to Network Rail's poor performance significantly outstrip the liquidated damages payments.
31. It is the role of industry to review the evidence for the current threshold. If it is determined that the threshold should be revised new evidence will need to be developed and a new threshold proposed. We will then assess any proposals to check that the evidence is robust and delivers a more accurate SPP threshold.

## **Schedule 4**

32. The Rail Delivery Group (RDG) will lead the passenger operator recalibration for Schedule 4. As agreed at the Working Group this will focus on two areas:
  - Bus replacement costs; and
  - Train mileage costs.

### **Bus replacement costs**

33. Passenger train operators in receipt of formulaic Schedule 4 receive cost compensation for supplying replacement bus services during possessions. Payments are based on Estimated Bus Miles (EBMs) which are a payment rate per mile of bus services operated. There are two payment rates; one for London and the South East, and one for the rest of the country. EBM rates were established at PR08 based on surveys of TOCs' costs associated with replacement buses. EBMs were adjusted at PR13 to bring compensation payments into line with actual costs.
34. Operators have raised a concern that the current levels of compensation do not cover actual bus costs. However, it was also noted that it is in the nature of a liquidated damages regime that compensation would not necessarily cover full costs

in all cases but rather average costs. It was agreed at the Working Group that, as part of the Schedule 4 recalibration, operators would consider whether:

- a. there is evidence to support updating the EBM payment rates; and
  - b. two payment rates are sufficient to reflect bus costs across the country.
35. It was agreed that it was for the industry to supply the necessary evidence to support any recalibration of EBM rates and/or additional rates. Such evidence needs to show that costs were systematically and materially greater than the payment rates to justify recalibration.

### **Train mileage costs**

36. Schedule 4 cost compensation rates take into account Train Mileage Costs (TMCs). TMCs adjust the level of compensation paid to TOCs for the impact on costs of running longer, diverted services during possessions. However, compensation is offset where TOCs' costs are reduced as a result of possessions, e.g. from fuel savings where services are cancelled.
37. TMC payment rates are based on variable track access charges, diesel fuel and electricity costs. During PR13, TMC rates were mainly adjusted for inflation rather than being re-calibrated for changes in underlying costs e.g. fuel prices.
38. The Working Group agreed there would be merit in the industry reviewing underlying costs including whether or not other variable costs should be included in the TMC rate calculation.

### **Contractual wording**

39. Passenger operators raised some concerns about the clarity of some of the contractual wording within Schedule 4. ORR has collated the issues raised and will consider these further over the coming months.

## **Freight operator regimes**

### **Schedule 8**

40. Freight operators and Network Rail will undertake the re-calibration of the freight operator Schedule 8 regime jointly.
41. The freight operator Working Group discussed the following areas of the freight operator Schedule 8 regime:
- Payment rates;
  - Benchmarks;

- 'Balance' in the freight operator regime;
- Annual caps; and
- Incident caps.

## **Payment rates**

42. The Network Rail delay and cancellation payment rates are intended to reflect the average financial impact on of delay on freight operators.
43. The Network Rail delay and cancellation payment rates in PR08 were based on survey evidence from freight operators. Since PR08 these rates have only been uplifted for inflation (i.e. they have not been re-calibrated on the basis of new evidence).
44. Freight operators raised concerns that the current Network Rail payment rates do not accurately reflect the financial impacts they experience when one of their services is delayed or cancelled.
45. If the Network Rail payment rates for CP6 are to be re-calibrated (beyond uplifting for inflation) then freight operators and Network Rail will need to develop new evidence and an appropriately revised methodology.
46. We will approve new Network Rail payment rates if it is clear that the identified cost and revenue impacts of delay are unavoidable for freight operators and that the evidence and methodology the rates are based are robust and consistent with the intent of the policy.
47. The purpose of the freight operator payment rate is to reflect the impact of delay that freight operators cause to operators they interact with.
48. The freight operator payment rate should continue to be based on the Network Rail payment rates for other operators.
49. Freight operators expressed a concern with the lack of transparency on the methodology for calculating the Network Rail payment rates in the passenger operator regime. In particular, there is no freight representative involved in the revisions to the Passenger Demand Forecasting Handbook (PDFH), the main source of evidence for the payment rates. We will continue to consider ways to improve freight operators' understanding of the methodology used to calculate Network Rail payment rates in the passenger operator regime.

## **Benchmarks**

50. The purpose of the benchmarks in the freight Schedule 8 regime is to minimise money flows in the freight regime as a whole. To ensure that they do this, the benchmarks should be set in line with their average expected performance in CP6.

51. To the extent that Network Rail's regulated performance outputs for freight operators in CP6 are set on the basis of expected performance, the benchmarks ought to align with them. If, and to the extent that, the regulated outputs are not set on the basis of expected performance, then the benchmarks will diverge from the regulated outputs.
52. As with the passenger regime, ORR will confirm what the Network Rail benchmark ought to be based on once the approach to setting regulated performance outputs has been confirmed.
53. The freight operator benchmark will continue to be set on the basis of average freight industry performance over a re-calibration period. The re-calibration period should be selected on the basis that it best reflects expected average performance of freight operators in the next control period.
54. Industry's role is to develop and propose a methodology for setting the Network Rail and freight operator benchmarks. When considering whether to approve the re-calibrated benchmarks we will assess whether or not they reflect the expected performance of Network Rail and freight operators in CP6. The rationale behind the choice of re-calibration period should therefore be explained carefully when industry submits the benchmarks to ORR for approval.
55. The freight operator benchmark includes an annual adjustment to account for changes in the level of traffic on the network. The calculation for this adjustment includes a 'congestion factor', which is calculated using the capacity charge model. We have now confirmed that we are removing the capacity charge, so we will be revisiting the implications that this decision has for the annual adjustment. We will confirm our decision with industry shortly.

### **'Balance' in the freight operator regime**

56. Freight operators raised concerns that the regime is not 'balanced'. Our understanding of the concern is that the Schedule 8 payments between freight operators and Network Rail are not equal when both deviate from their benchmark by the same amount. And that, in particular, freight operators explained that when both parties cause no delay, freight operators nonetheless make a net payment to Network Rail.
57. We recognise that the net payment between Network Rail and freight operators would not be zero if both parties were to cause no delay. However, we consider that this is just a consequence of the payment rates and benchmarks being different, which, itself, is a direct consequence of the design of the regime.
58. The Network Rail and freight operator payment rates are not intended to reflect the same impacts, so we should not expect similar deviations from benchmark performance to result in similarly sized payments.

59. However the concern raised may indicate other issues with the freight Schedule 8 regime. One possibility is that the Network Rail benchmark is below Network Rail's expected level of performance for freight operators, increasing payments from freight operators to Network Rail. Alternatively, the payment rates may not reflect the impacts they are intended to; if they were accurate freight operators should be indifferent to the level of performance they receive from Network Rail. These issues should be picked up by both freight operators and Network Rail in their re-calibration of the regime.

### **Annual caps**

60. Annual caps provide Network Rail and freight operators with certainty about the maximum annual liability they could face under Schedule 8.
61. The appropriate cap between Network Rail and a freight operator depends on the size of the operator's operations, so, there should continue to be a default cap for 'small' freight operators and a specific cap for all other freight operators. Any re-calibration of the caps ought to be agreed between Network Rail and freight operators.
62. Our role will be to check the caps to ensure they are at a level which has a low likelihood of being reached, due to the dampening effect of the cap on incentives.

### **Incident caps**

63. Incident caps provide insurance for freight operators against the risk of facing significant Schedule 8 costs for a single incident that they cause. Freight operators pay an access charge supplement (ACS) to Network Rail for this insurance and can choose the level of their cap.
64. We expect Network Rail to update the ACSs for each level of cap to reflect the risk it is exposed to.
65. Although we expect the current incident cap regime to remain broadly similar we are willing to consider proposals from industry to improve the regime, such as how the ACSs are calculated.

## **Schedule 4**

66. The working group concluded (albeit not unanimously) that re-calibration should be limited to adjustments to take into account inflation.

### **Payment rates**

67. Freight operators receive formulaic compensation based on the level of notice about upcoming service disruption due to possessions and the amount of disruption

caused. Freight Schedule 4 is unfunded in the sense that freight operators do not pay an ACS (although they have the option to do so in return for higher payment rates). Payments are met from a fixed budget within Network Rail's revenue requirement.

68. In working group discussions, FOCs told us that current payment rates do not incentivise Network Rail to plan possessions efficiently. ORR explained that the level of freight Schedule 4 funding should be discussed between funders, operators, and Network Rail.
69. ORR confirmed that any discussion about the 'size of the pot' needed to be had with funders.

### **Contractual wording**

70. Freight operators raised some concerns about the clarity of some of the contractual wording within Schedule 4. ORR has collated the issues raised and will consider these further over the coming months.

## **Charter operator regimes**

### **Schedule 8**

71. The charter operator Schedule 8 regime is closely linked to the freight operator regime. This is because charter services are a relatively small share of the rail industry traffic and it would be disproportionate to have bespoke arrangements for every aspect of Schedule 8 regime for charter operators. The Working Group agreed to continue the current approach of basing the charter regime on the freight regime, and stressed that charter operators should be involved in the re-calibration of the freight operator regime.
72. The charter operator Working Group discussed the following areas of the charter operator Schedule 8 regime:
  - Payment rates;
  - Benchmarks;
  - Annual caps; and
  - Incident caps.

### **Payment rates**

73. The purpose of the Network Rail payment rate is to reflect the impacts of Network Rail caused delay on charter operators' costs and revenues.
74. The purpose of the charter operator payment rate is to reflect the impact of delay that charter operators cause to the operators they interact with.

75. The working group agreed to:

- Set the Network Rail payment rate equal to the Network Rail payment rate in the freight regime.
- Set the charter operator payment rate on the basis of the Network Rail payment rates for other operators weighted by the amount of third party charter operator delay affects those operators.

76. Charter operators also raised the concern about a lack of transparency on the methodology for calculating the Network Rail payment rates in the passenger operator regime. We will continue to consider ways to improve charter operators' understanding of the methodology used to calculate Network Rail payment rates in the passenger operator regime.

## **Benchmarks**

77. As in the freight operator regime the purpose of the benchmarks in the charter operator regime is to minimise money flows in the regime as a whole, so that they do this the Network Rail and charter operator benchmarks should be set on the basis of their expected performance in the next control period.

78. The Working Group agreed to:

- Set the Network Rail benchmark based on its own past performance to charter operators.
- Set the charter operator benchmark based on average charter operator performance over the re-calibration period.

79. The charter operator benchmark includes the same annual adjustment for traffic growth as the freight operator benchmark. This means our decision on this adjustment will also affect charter operators. We will communicate our proposal to industry shortly.

## **Annual caps**

80. The Working Group agreed to continue to use the default annual cap used for 'small' freight operators for all charter operators.

81. As part of the re-calibration of the annual caps in the freight operator regime we will check the level of the 'small' freight operator annual cap to ensure that there is a low likelihood of it being reached.

## **Incident caps**

82. For incident caps we expect Network Rail to update the ACSs for each level of cap to reflect the risk Network Rail is exposed to.
83. As in the freight regime we are willing to consider proposals from industry to improve the regime.



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