



OFFICE *of*
RAIL REGULATION

**Review of the Schedule 8 performance
regime: final conclusions**

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Executive Summary

1. This document sets out the final conclusions to our review of the Schedule 8 performance regime in franchised passenger train operators' (TOCs) track access contracts. The accompanying review notice, which is being published at the same time, implements the review's conclusions under the provisions in Schedule 4A of the Railways Act 1993. The objective has been to review whether the objectives of Schedule 8 are still appropriate and, if so, whether the regime could be improved better to meet these objectives.
2. The marked improvements in performance achieved by the industry over the past 18 months are to be welcomed. But the industry recognises that there remains room for improvement before performance reaches acceptable levels for passengers and freight customers. In order to achieve those levels as quickly as possible and then sustain them over the longer-term, a number of performance related initiatives are being taken forward by the industry.
3. Reforms to the Network Code have been progressed to promote constructive and cooperative working relationships between Network Rail and train operators in order to achieve material and sustained improvements in performance. These include the development of joint performance improvement plans (JPIPs); more effective procedures where Network Rail and train operators will work together to restore services to normal operation after disruptive events; and streamlining the delay attribution system to avoid unnecessary and costly disputes.
4. Furthermore, integrated control centres have been introduced so that Network Rail and train operators can jointly evaluate and respond to operating problems more quickly.
5. The review of the Schedule 8 performance regime is intended to complement and reinforce these initiatives. The aims of the regime are to provide additional financial incentives to reduce delays, and to compensate train operators adequately for the revenue they lose when they are affected by poor performance caused either by Network Rail or other train operators. The proposed changes set out in these final conclusions have been made with a view to strengthening the effectiveness of the regime. These are:

- changes to payment rates to reflect more accurately the impact on train operators' revenues when performance deteriorates or improves beyond benchmark levels;
 - a commitment by us to approve, in principle, caps on bonus payments to Network Rail in specific circumstances where revenues can be shown not to respond to improvements in performance, for example as a result of capacity constraints;
 - streamlining compensation provisions by moving the compensation arrangements for sustained poor performance, from Part L of the Network Code to new provisions in Schedule 8;
 - the introduction of train operator-based performance trajectories at the start of new franchises; and
 - a commitment not to change the structure of the performance regime for the life of the underlying franchise and only to change payment rates and benchmarks either between or at periodic reviews, in certain circumstances. This should provide a greater degree of certainty to train operators at the time of bidding for franchises.
6. We recognise that a 'one size fits all' approach is not necessarily appropriate. Therefore, we do not rule out approving bespoke performance regimes to meet the specific needs of Network Rail and TOCs (and their customers and funders).
7. It is intended that revised payment rates and the provisions relating to sustained poor performance will be implemented on 1 April 2006. However, the implementation of the latter is conditional upon Part L of the Network Code ceasing to apply to the relevant TOCs. Train operator-based performance trajectories should be implemented into track access contracts to coincide with the commencement of new franchises from 1 April 2006 onwards. This should ensure that forward-looking benchmarks in the performance regime and performance obligations in the franchise agreement are aligned.

1. Introduction

Background

- 1.1 The Government's White Paper, *The Future of Rail*¹, envisaged strengthening the relationship between Network Rail and train operators so that they would work constructively and cooperatively in order to achieve material and sustained improvements in performance. Over the past 18 months, significant developments have taken place to support the White Paper proposals.
- 1.2 We have modified Network Rail's Network Licence to ensure that the company is accountable for the new responsibilities placed on it following the White Paper, including in relation to whole industry performance. This is in recognition that Network Rail, in its role as network operator, has a key part to play in mitigating the effects of, and hence facilitating the timely recovery from, performance incidents even if train operators are the initial cause of those incidents.
- 1.3 In support of these new responsibilities, the industry has been working together on a number of performance related initiatives. These include:
- reforming Part H (operational disruption) of the Network Code to include a requirement to establish a railway operational code (ROC). This sets out specific procedures under which Network Rail and train operators will work to sustain operation of trains in accordance with the timetable and to restore train services to normal after disruptive events;
 - the introduction and roll-out of integrated control centres, where Network Rail and train operators are located together, enabling quicker evaluation and responses to operating problems; and
 - replacing local output commitments (LOCs) under Part L of the Network Code with joint performance improvement plans (JPIPs). This will provide a framework within which Network Rail and TOCs will work together to develop JPIPs to improve punctuality and reliability of services.

¹ *The Future of Rail*, Department for Transport Cm 6233, London, July 2004.

- 1.4 The industry is also considering changes to Part B of the Network Code to streamline the delay attribution system to avoid unnecessary and costly disputes. This is the process whereby delays are not only attributed to either the train operator or Network Rail but more specifically to the underlying cause of the delay (e.g. signal failure, train failure). It therefore provides the essential management information required to target and tackle root-causes of delay with a view to preventing recurrence.
- 1.5 In order to complement and reinforce these initiatives, we commenced a review of Schedule 8 of franchised passenger train operators' track access contracts (the performance regime) in November 2004.
- 1.6 In particular, the purpose of the review has been to:
- assess whether the objectives of the regime (principally to incentivise both Network Rail and train operators to improve performance, and to compensate train operators for the farebox revenue lost in the event of poor performance by Network Rail or other train operators) remain appropriate and are being achieved;
 - assess whether the regime imposes unwarranted cost and bureaucracy in relation to the benefits; and
 - determine whether changes to the regime are appropriate to improve the alignment of incentives with new responsibilities, in light of the proposals in the Government's Rail Review White Paper.

Purpose of this document

- 1.7 This document sets out our final conclusions to our review of the performance regime. We largely confirm our draft policy conclusions set out in July 2005. We also conclude on the outstanding issues consulted upon in our September 2005 letter, entitled *Emerging conclusions on technical issues*². Specifically:
- the level of the sustained poor performance (SPP) threshold, beyond which TOCs can claim additional compensation;

² The consultation letter *Emerging conclusions on outstanding technical issues*, 23 September 2005 is available on our website at <http://www.rail-reg.gov.uk/upload/pdf/sch8-review-emergingconcllet-230905.pdf>.

- other properties of the SPP threshold and measurement of performance against it;
- circumstances where limitations on bonus payments, to Network Rail (where performance is better than benchmark) are appropriate; and
- the outcome of the recalibration work undertaken by the industry technical group³ taking account of changes in revenue since the previous recalibration of payment rates in the 2000 periodic review (PR2000).

Implementation

- 1.8 These conclusions will be implemented through the statutory process set out in Schedule 4A of the Railways Act 1993. They accompany the review notice⁴ being served on franchised passenger operators and Network Rail in relation to their track access contracts.
- 1.9 The review notice sets out the legal changes required to implement this review including, where applicable, specific bespoke elements relating to individual TOCs' track access contracts.
- 1.10 The implementation arrangements are set out in more detail in Chapter 4 of this document.

Structure of this document

- 1.11 The remainder of this document is structured as follows.
- Chapter 2 summarises the changes to be made to Schedule 8.
 - Chapter 3 describes in more detail each of the changes (and the reasons for them) and where applicable how the final conclusions interact with other work designed to improve overall performance, including through reform of the Network Code.
 - Chapter 4 explains the process for implementing these final conclusions.

³ Further detail on the work of this cross industry group is presented in Chapters 2 and 3.

⁴ This can be found on our website at:
<http://www.rail-reg.gov.uk/upload/pdf/sch8-review-notice-201205>.

- Annex A provides a list of respondents to the June 2005 draft conclusions document and to the 23 September 2005 consultation letter.

1.12 Copies of this document can be found on ORR's website (www.rail-reg.gov.uk) and in our library.

2. Summary of final conclusions

Introduction

- 2.1 This chapter provides a summary of the changes to be made to the Schedule 8 performance regime, to be implemented in the way described in Chapter 4. More details of these changes and the reasons for making them are provided in Chapter 3.

Structure of the regime

- 2.2 These final conclusions confirm our draft conclusions that replacing Schedule 8 with a radically different performance model would not be appropriate. Instead, changes are being made which are aimed at strengthening the effectiveness of the existing regime. This approach has received widespread industry support. Those most familiar with the workings of the regime argued that Schedule 8 in broadly its current form is the least complicated way of providing adequate compensation to train operators in the event of poor performance. If adequate compensation was not available for poor performance through Schedule 8, it is reasonable to assume that additional risk premia would be factored into franchise bids.
- 2.3 A small number of consultees (the Passenger Transport Executive Group (PTEG), the Rail Passengers Council/London Transport Users Committee (RPC/LTUC) and Transport for London (TfL)) argued for more radical changes to the regime. We do not rule out approving track access contracts containing bespoke performance regimes to meet the specific needs of Network Rail and train operators (and their customers and funders). We would however need to be satisfied that the bespoke arrangements did not work against the interests of other users, and ensure adequate protections were in place for the interests of other TOCs.

Changes to strengthen the effectiveness of the regime

- 2.4 We believe that our final conclusions will improve the effectiveness of the performance regime both as a compensation and incentive mechanism. As such, we will support those industry initiatives to improve performance described in Chapter 1.

Level of payments

- 2.5 If the regime is to be effective, it is essential that payments between Network Rail and TOCs reflect, as closely as possible, the impact of changes in the level of performance on TOC revenues. If performance deteriorates beyond the expected (benchmark) level, payments from Network Rail to TOCs should reflect the expected reduction in farebox revenues. On the other hand, if performance is better than the expected level, payments from TOCs to Network Rail should reflect the expected increase in farebox revenues.
- 2.6 An industry technical group consisting of Network Rail, train operators and ourselves, has overseen and managed a recalibration of payment rates conducted by consultants AEA Technology (AEAT). The recalibration used: the most up-to-date research on passenger responses to changes in performance; recent revenue data; and updated research on the way cancelled trains should be treated.
- 2.7 The recalibration work involved extensive consultation with TOCs, both in relation to the base data used and the recalibrated payment rates, cancellation weighting changes and consequential changes to benchmarks.
- 2.8 More detail on this process is provided in Chapter 3 and the detailed methodology used is set out in AEAT's final report⁵, which is being published at the same time as these final conclusions. The relevant changes to Appendix 1 of Schedule 8 for each track access contract is contained within the relevant copy of the review notice being sent to individual TOCs.
- 2.9 In parallel with this recalibration work, we have examined whether, in certain circumstances, payments to Network Rail in periods of better than benchmark performance should be capped. This may be appropriate if, for example, capacity constraints combined with the regulation of fares mean that farebox revenues do not increase as anticipated with improvements in performance or at particularly high levels of performance.
- 2.10 In principle, we recognise that a situation could occur where the bonus payments payable to Network Rail as a result of its performance being better than benchmark (or expected) performance are not reflected in changes in

⁵ This is available on our website at:
<http://www.rail-reg.gov.uk/upload/pdf/sch8-aeat-payment-review-dec05>.

revenue. TOCs should provide evidence that this had been the case over a period of at least 12 months.

- 2.11 We have proposed minor modifications to Schedule 8, to facilitate the implementation of such a cap where this evidence is available. These include the insertion of a mechanism in paragraph 9 of Schedule 8 (Network Rail performance sums) to allow a cap to apply to bonus payments. In addition, we intend to write to TOCs and Network Rail in January 2006 with further criteria setting out the sort of evidence that might be used to demonstrate the rationale for limiting bonus payments, building on the criteria set out in Chapter 3.
- 2.12 The changes to the level of payments under Schedule 8 also directly affect the compensation paid in relation to restrictions of use (possessions) under Schedule 4. Network Rail has provided calculations of the additional costs that it estimates it will incur. We do not propose to change the access charge supplements in Schedule 4 at this time to compensate Network Rail for the expected additional costs. Instead, we propose to review Network Rail's calculations and commit to remunerating the company at the 2008 periodic review (PR2008).

Basis of payments

- 2.13 The basis of payments, i.e. Network Rail and TOC minutes lateness, will remain unchanged. Consideration was given to changing the basis of payments to a whole-industry measure, such as the public performance measure (PPM⁶), to reflect Network Rail's responsibility for whole-industry performance. This has been rejected for the reasons set out in Chapter 3.
- 2.14 Payment rates will continue to be based on the expected full revenue impact of lateness and cancellations. An alternative approach, basing payments at a level less than the expected revenue impact of poor performance, was put forward during consultation. This would potentially have provided further financial incentives for TOCs to assist with the timely recovery of incidents caused by Network Rail or other TOCs. This is not considered appropriate however and has been rejected for the reasons set out in Chapter 3.

⁶ PPM is a measure of reliability and punctuality (including both lateness and cancellations). It is widely used by the Government and the industry. It does not include freight performance.

TOC-based performance trajectories

- 2.15 At present, Network Rail's benchmark levels of performance in respect of each TOC are ratcheted downwards each year to reflect the required network-wide improvements in performance set at the Access Charges Review 2003 (ACR2003). Forward-looking benchmarks do not therefore reflect local conditions. In future, as franchises are re-let, local trajectories will be applied to benchmarks. This will ensure that performance trajectories in the relevant track access contracts are aligned with JPIPs and obligations in franchise agreements.

Sustained poor performance (SPP)

- 2.16 Part L of the Network Code (local output commitments) currently contains provisions under which compensation may be available when performance deteriorates beyond a threshold level (currently 25%) of committed performance. In order to streamline compensation provisions in relation to very poor performance, the compensation arrangements currently provided for under Part L will be moved to new provisions in Schedule 8. (This is contingent upon TOCs moving to the new Part LA of the Network Code by 1 April 2006. Relevant losses will be the basis for compensation (as in Part L).
- 2.17 The SPP threshold for each TOC (measured in financial terms) for 2006-07 will be set at a level where Network Rail's performance is 25% worse than its expected (benchmark) performance. The corresponding figures for 2007-08 and 2008-09 will be 22.5% and 20% respectively.
- 2.18 Performance measurements against the SPP threshold will be conducted after periods 3, 6, 10 and 13 of each year. The threshold will be compared against Network Rail's actual average financial liability per period for the 13 periods that precede the measurement. Further detail on the basis of the SPP threshold as well as other aspects relating to these new provisions is provided in Chapter 3.
- 2.19 As there remains uncertainty about the appropriate level of threshold that would reflect the point where Schedule 8 payments start significantly to under-compensate TOCs, we would expect to review the level as part of the PR2008 (to identify whether it is appropriate to further decrease or indeed increase the level of the threshold). We would expect this review to consider any available

evidence from the use of these provisions and any appropriate research that has been carried out.

Delay attribution

- 2.20 A number of possible changes to Schedule 8 to reduce the costs and bureaucracy of the delay attribution process have been examined. None of these changes will be implemented at this stage since it is not apparent that they would lead to a significant reduction in disputes and resource savings. Indeed, in some cases, they would increase complexity and potentially lead to the loss of valuable information about the root causes of delay.
- 2.21 Instead, the effectiveness and efficiency of the delay attribution process will be improved through changes currently being considered by the industry following the recommendations to the Delay Attribution Board.

TOC-on-TOC arrangements

- 2.22 Our March 2005 document⁷ consulted on possible changes to the TOC-on-TOC delay arrangements within Schedule 8. Implementing the changes would have meant that TOCs responsible for delaying other TOCs⁸ would not face penalty payments under the regime. Our final conclusion is not to adopt these changes for the reasons set out in Chapter 3.

Implementation

- 2.23 It is proposed that the conclusions of this review will be implemented into all franchised passenger train operators' track access contracts from 1 April 2006. While payment rates and benchmarks may be subject to review during the life of a franchise (subject to certain criteria discussed further in Chapter 4), as well as the SPP threshold levels set out in the new Appendix 3 of Schedule 8, we do not propose to alter the structure of the regime at future periodic reviews.

⁷ *Review of the Schedule 8 performance regime: emerging views and further issues*, Office of Rail Regulation, London, March 2005.

⁸ These delays might also be to freight and other operators.

3. Details of the changes to Schedule 8 and other performance related initiatives

Introduction

3.1 This chapter provides further details on our final conclusions of the Schedule 8 performance regime review and sets out the reasons underpinning these conclusions. It covers:

- the level of payments;
- the basis of payments;
- TOC-based performance trajectories;
- sustained poor performance;
- delay attribution; and
- TOC-on-TOC arrangements.

Level of payments

3.2 As described in Chapter 2, AEAT has carried out work under the management of the industry technical group, and in consultation with TOCs, to establish the appropriate level of Schedule 8 payment rates.

3.3 There has also been a small adjustment to the Network Rail and TOC benchmarks to reflect changes in cancellation weightings.

3.4 The TOC payment rates have also been partially recalculated (see below).

Recalibration of payment rates

3.5 One of the key objectives of the performance regime is to provide appropriate compensation to TOCs for the loss of revenue resulting from lateness and any cancellation of their services. To fulfil this objective effectively, the payment rates from Network Rail to TOCs need to reflect, as accurately as possible, the effect on TOCs' revenues of changes in Network Rail performance.

- 3.6 The industry technical group identified the following issues which informed the recalibration of payment rates:
- for some groups of customers, the demand response to changes in scheduled journey time is different from that assumed when the existing payment rates were calculated;
 - changes to the cancellation weighting⁹ are required; and
 - there is a need to update ticket revenue data.
- 3.7 As part of the consultation exercise, the base data used to identify revenue on the principal flows was shared with TOCs on 2 August 2005. On 2 September 2005 the revised payment rates were made available. Since then, we have met with most TOCs and in some cases have made changes to the input data based on the TOC's own available data. A complete list of such changes has been shared with the industry technical group and details are contained in the AEAT recalibration report. The revised Appendix 1s to Schedule 8 were then made available to TOCs.
- 3.8 The AEAT recalibration report, being published simultaneously with these final conclusions, sets out in detail the work carried out and, in particular, highlights differences compared to the methodology used in the previous recalibration of Schedule 8 payment rates, as part of the PR2000.
- 3.9 The consequential changes to TOC payment rates result from:
- the recalculation of Network Rail's liability for TOC-on-TOC delays in light of the new Network Rail payment rates; and
 - adjustments to the TOC benchmarks to incorporate the new cancellation weightings.
- 3.10 The calculation does not, however, include:
- any recalculation of TOC-on-TOC interaction, as this was carried out in the ACR2003; and

⁹ Cancellation weightings enable the revenue impact of a cancellation to be taken into account.

- the passenger charter portion of TOC payment rates (except to reflect the change made to the TOC benchmark).

3.11 There is also no change to the passenger charter access charge supplement. However, consistent with the Association of Train Operating Companies' (ATOC) proposal, we have implemented legal drafting that allows a TOC to disapply paragraph 14 permanently.

3.12 Table 3.1 shows the changes to Network Rail payment rates resulting from the recalibration. Assuming Network Rail's performance continues at current levels, with an overall better-than-benchmark performance, the company's initial calculations suggest that bonus payments could increase by between £3 million and £8 million per annum.

Table 3.1: Comparison between recalibrated and existing payment rates by sector¹⁰

Sector	Change in Network Rail Schedule 8 payment rates
Long distance high speed – longer	- 3%
Long distance high speed – shorter	+34%
South East – longer	+9%
South East – shorter	+24%
Regional – longer	+20%
Regional – shorter	+17%

3.13 We confirm our draft conclusions that we will consider bespoke arrangements for smoothing payments (i.e. through the use of a moving annual average basis for calculating the payments), if Network Rail and train operators agree to such arrangements.

3.14 As a result of the recalibration, TOCs bidding for a franchise are likely to be more confident that they have adequate compensation in the event of poor

¹⁰ Further details can be found in AEAT's recalibration report.

performance. The improvement in accuracy of the level of compensation resulting from the recalibration should also promote better decision-making by Network Rail, for instance in relation to appraising and prioritising investment projects.

Capping bonus payments to Network Rail

3.15 A number of TOCs have said that in certain circumstances revenue can be unresponsive to improvements in performance. This may occur where:

- there are capacity constraints which may not be reflected in the payment rates (since these are based on historic data, coupled with constraints on increases to regulated fares); and
- performance is so good that further incremental improvements cease to be a significant influence on passenger decision-making in relation to travel options.

3.16 Where it is not possible currently to reflect these circumstances in the recalibration of payment rates, we have concluded that the ability to limit the level of bonus payments through a cap should be available in the following circumstances:

- where the TOC can demonstrate that its increase in revenue has been significantly less than the bonus payments made through Schedule 8;
- that this can be demonstrated over at least a 12 month period; and
- where it can be demonstrated that no specific TOC action is the main cause behind the lack of response of revenue growth to the improvement in Network Rail's (and others') performance.

3.17 In circumstances where Network Rail disagrees with the inclusion of a limitation on bonus payments, TOCs can use paragraph 17 of Schedule 8 of track access contracts to seek expert determination on the matter. Some TOCs suggested that the scope of paragraph 17 might be insufficient to enable such a change to be made. We have therefore made changes to paragraph 17 to enable the necessary changes to implement a possible cap on bonus payments. These changes substantially reflect those suggested by train operators, concerned that they would be unable to implement caps using the paragraph 17 process.

- 3.18 We are aware that some train operators are considering applying for a cap on bonus payments from 1 April 2006. In addition to the above changes to paragraph 17 of Schedule 8 and in order to minimise the uncertainty around such an application, we have provided the skeleton framework for the implementation of a cap. We acknowledge that there are additional issues that will need to be considered further. This includes the temporal basis of the cap and indexation arrangements. In addition, we intend to provide further information in January 2006 on approaches that might be used to demonstrate the need for such caps building on the principles set out above.
- 3.19 We recognise the possibility that by capping bonus payments, this could weaken Network Rail's financial incentives to continue to implement performance-improving initiatives. However, it is likely that the full range of incentives and obligations on Network Rail to improve performance is likely to mitigate against this. We will be reviewing the incentive framework in detail, as part of the PR2008, including the effectiveness and appropriate balance between financial and non-financial incentives, and corporate and management incentives.
- 3.20 Other than the possible limitation of bonus payments, we confirm our draft conclusion that bonus payments to Network Rail for better than benchmark performance are to be retained in Schedule 8.

Implications for Schedule 4

- 3.21 Schedule 4 compensation payments in relation to restrictions of use are automatically affected by the change in Schedule 8 payment rates (and by the change in cancellation weighting). The expected change in Network Rail's Schedule 4 costs could be reflected in a change to the access charge supplement (ACS) in Schedule 4.
- 3.22 We have however concluded that it would be inappropriate to make changes relating to the Schedule 4 ACS at this time because it was only apparent at a very late stage of the review (when the final Schedule 8 payment rates were established) that it is likely that Network Rail will incur additional Schedule 4 compensation costs. If we were to propose increasing the Schedule 4 ACS, we believe that, in order to follow due process, we would need to consult with the industry. This would mean not being able to implement the performance regime conclusions on 1 April 2006.

3.23 Furthermore, we have not been able to review Network Rail's estimates of the expected additional costs (around £20 million per annum) in the time available. We propose to review Network Rail's calculations and commit to taking into account the additional efficient costs at the PR2008.

Basis of payments

3.24 We confirm our draft conclusion that Schedule 8 payments should continue to be on the basis of Network Rail and TOC caused lateness and cancellations, and on the full expected revenue effect of poor performance. We have examined and rejected the following options:

- basing Network Rail's payments on a whole-industry performance measure such as an adjusted version of PPM (to support Network Rail's responsibility for delivering improvements in whole-industry performance); and
- basing payments to TOCs below the expected revenue impact of poor performance (to potentially further incentivise train operators to assist in the recovery of performance incidents caused by Network Rail or by other train operators).

Network Rail's responsibility for whole-Industry performance

3.25 While the need for Network Rail to be accountable for the delivery of better overall industry performance is recognised, we confirm our draft conclusion that this is better achieved through changes to the Network Code and Network Rail's Network Licence (see below) rather than through changes to the basis of payments in Schedule 8.

3.26 Network Rail's responsibilities for whole-industry performance are being supported by the following initiatives:

- a change to Condition 7 of Network Rail's Network Licence, which we have made in order to clarify the company's responsibility under its Licence for facilitating whole-industry performance;
- the development of JPIPs to replace LOCs in Part L of the Network Code. This will provide a framework within which Network Rail and train operators will work together to improve performance. The process will set out a structure of JPIPs (to support achievement of a PPM target) and

monitoring/challenge arrangements between Network Rail and each operator;

- the introduction of the ROC into Part H of the Network Code, which sets out the rules for operation of the network. The industry is currently developing the various sections of the ROC covering issues such as train regulation, emergency timetabling, clearing track blockages, control arrangements and arrangements arising from seasonal/weather conditions; and
- the introduction and roll-out of integrated control centres, enabling Network Rail and train operators' staff to work together to improve performance through quicker response to operating problems, to the benefit of passengers and freight customers. This shorter chain of communication improves the recording of incidents and attribution of causes. In turn it will lead to fewer disputes, and the improved understanding of events and better flow of information then provides the data to enable more effective planning of improvements to future performance.

3.27 Responses to the initial consultation document noted the importance of the Schedule 8 payment rate being based on factors that are directly controllable by Network Rail and train operators, and that the clarity of incentive provided by the regime would be weakened by the proposed change. It was also noted that the initiatives described above reduced the justification for such a change.

Train operator compensation

3.28 We consulted on the possibility of basing payments to train operators below the expected revenue impact of poor performance. This would arguably provide a further financial incentive on train operators to assist with the timely recovery of incidents caused by Network Rail or other train operators.

3.29 We confirm our draft conclusion that, in our view, there is no strong case for changing the level of compensation payable to train operators to less than 100% of the expected revenue effect. The importance of the regime in adequately compensating train operators for lateness and cancellations has been recognised elsewhere in this review as an important objective of the regime. Payment rates based on less than 100% of the expected revenue

effect is inconsistent with this objective. Such a change would also be likely to lead to higher risk premia being included in franchise bids.

3.30 Train operators face other strong incentives and obligations to assist in service recovery, including:

- provisions in Part H of the Network Code to deal with recovery from operational disruption;
- Network Rail's ability to attribute delay to train operators for their failure to assist in service recovery;
- performance arrangements and obligations within franchise agreements;
- poor performance impacts on resource costs; and
- the fact that train operators' performance records are taken into account by the Department for Transport (DfT) in its assessment of future franchise bids.

TOC-based performance trajectories

3.31 Network Rail's benchmark level of performance is profiled over the five years of the current control period to reflect the performance trajectory established at the ACR2003. This trajectory was set on a national basis.

3.32 In light of the work on LOCs, the development of route utilisation strategies (RUSs) and Network Rail's move to a route-based planning approach, the initial consultation document consulted on setting the trajectories at a train operator level. This reflected, where applicable, a greater scope for performance improvements at a local level.

3.33 There was general support from consultees for the introduction of TOC-based trajectories. However, we cautioned in our emerging views document in March 2005 that their implementation would only be possible where a practical approach can be developed.

3.34 We confirm our draft conclusion that the TOC-based trajectories should be applied when a new access agreement comes into effect, reflecting a new franchise being let. This will provide franchise bidders with greater certainty of the performance improvements that Network Rail is expected to deliver over

the life of the franchise and should be aligned with the targets that the franchisee is required to meet. Network Rail is developing a methodology for implementation in time for the new franchises, due to be let from April 2006.

- 3.35 Network Rail's knowledge of the local determinants that affect performance is still improving. Therefore it is expected that its ability to assess possible TOC-based trajectories will become more sophisticated over time. In the trajectories for the franchises due to be let from April 2006, Network Rail is proposing to base these on the national trajectory, modified for major local differences (including traffic growth). For later franchises, the local trajectory will be based on a more detailed assessment of local factors that impact on Network Rail's ability to drive better performance.
- 3.36 Network Rail has argued that it would need to be funded for committing to performance levels in excess of the national trajectory. It recognises that an access charge supplement for this purpose could be positive or negative dependent on the performance assumed for the particular TOC at the 2003 access charges review (ACR2003). The precise arrangements would need to be established at the time of introduction of the TOC-based trajectory into the track access contract.

Sustained poor performance (SPP)

- 3.37 We confirm our draft conclusion that compensation provisions for SPP should be streamlined by replacing the compensation arrangements currently in Part L of the Network Code. This would only apply to franchised passenger operators and so at present the current Part L arrangements would be retained for other operators.
- 3.38 The changes are drafted so that the SPP provisions will only come into effect for franchised passenger operators if they have moved to the new Part LA of the Network Code prior to 1 April 2006¹¹ as otherwise the Part L arrangements and SPP arrangements would both be available.

¹¹ In the unlikely event that this has not happened it is assumed that operators will introduce these provisions through a Section 22 supplement agreement (Railways Act 1993) at the time they agree to move to the new Part LA.

3.39 The new provisions enable relevant losses demonstrated by TOCs to be recovered (as in the current Part L) net of Schedule 8 payments received¹², where performance reaches a threshold level of SPP. The following issues associated with the SPP threshold are examined below:

- the basis of measurement of SPP;
- the level of SPP threshold; and
- the implications of volume changes in services.

Basis of measurement of SPP

3.40 The proposals set out in the consultation letter of 23 September 2005 included some differences from that proposed in the draft conclusions. Our final conclusion is that measurement of the average per period performance over the preceding year (13 periods) will be done at the end of the 3rd, 6th, 10th and 13th periods. This will enable sustained poor performance to be identified quickly without having to wait until the year-end. Alternatively it was suggested that periodic triggers could be used. However, this would place a significant burden on industry resources and we have therefore rejected this option.

3.41 We have attempted to balance the need for this provision to provide potential protection to TOCs from sustained poor performance with the need to minimise the additional burden on industry resources with respect to measurement. In addition to the change identified in paragraph 3.40 above we have also concluded the following.

- the threshold should be set at a TOC-wide level rather than at service group level (although poor performance in high value service groups will rightly be more likely to trigger the threshold) since measurement will be in financial terms;
- no amendment should be made to take account of disputed minutes preventing the SPP threshold being triggered. Disputed minutes could potentially at least delay a point where the SPP provisions are triggered

¹² Such payments include those under the passenger charter arrangements specified in paragraph 14 of Schedule 8. The drafting also makes it clear that there should be no double recovery, for example if a TOC was otherwise compensated.

but to resolve this would risk increasing the industry resource burden, (e.g. by having a revised calculation against the threshold once disputed minutes are resolved and allocated);

- no amendment should be made to take account of amended timetable provisions preventing the SPP threshold being triggered. While acknowledging that such provisions will tend to be associated with sustained poor performance, including adjustment for this (e.g. part basing the threshold on Schedule 4 payments) would make measurement of the SPP threshold more complex, i.e. through needing to identify different elements of Schedule 4 payments. This could be reviewed under the possessions review;
- it would be inappropriate for performance orders to be available in respect of the SPP regime because the regime and the wider Schedule 8 is a compensation regime, while performance orders are related to recovery from poor performance; and
- there should not be a carve out for force majeure events. While this is a departure from Part L, it:
 - would be inconsistent with Schedule 8 and its role as a compensation regime to include such a carve out;
 - would require different Schedule 8 payments to be isolated in order to measure performance against the SPP threshold;
 - would normally not be sufficient in isolation to trigger the provisions; and
 - still requires the TOC to demonstrate relevant losses even where the inclusion of force majeure events is sufficient to trigger the provisions.

3.42 In addition, while potentially preventing TOCs receiving compensation for all relevant losses, the provisions will be subject to limitation on liability provisions where these exist in a track access contract. We have carried this forward from the Part L structure as any change could have significant financial implications for Network Rail. We would expect to review this at the PR2008.

Level of SPP threshold

3.43 We recognise that the appropriate level of performance at which the SPP threshold should be set is uncertain. In particular, it is not clear at what level of performance Schedule 8 payments begin significantly to under-compensate TOCs for the revenue impact of lateness and cancellations caused by Network Rail or other train operators. Despite this uncertainty, the levels set out in Table 3.2 below are aimed at reflecting a trade off between the need to avoid:

- inefficient transaction costs from setting the threshold at a level where it may be triggered with only minimal relevant losses then being demonstrated; and
- the provisions being unable to provide additional compensation during periods of poor performance where this can be demonstrated, an aim that received general support earlier in the review.

3.44 It is important to note that a TOC still has to prove relevant losses, whatever the threshold.

Table 3.2: Level of SPP threshold

2006-07	2007-08	2008-09
25%	22.5%	20%

3.45 In 2006-07, the threshold will be triggered if average period performance is 25% worse than the benchmark at a TOC level, reflected in terms of Network Rail's Schedule 8 financial liability¹³ (as opposed to lateness minutes), in such circumstances. This declines to 20% in 2008-09. When the threshold was first established in Part L of the Network Code, we had envisaged that it would be tightened over time. As indicated above, we cannot be certain that a 20% threshold represents the point at which Schedule 8 payments will significantly under-compensate TOCs for poor Network Rail performance. However, we believe that it will provide greater incentives on Network Rail in relation to individual TOC performance.

¹³ Net of bonus payments to Network Rail.

Volume changes

3.46 To minimise the complexity associated with the new provisions, we have not included any automatic adjustment to the threshold for changes in volume of rail services (either increases or decreases). In most cases, significant changes to access rights would result in changes to Network Rail's benchmark and therefore the SPP threshold level would not need to change. Where volume changes are made through a supplemental track access agreement and benchmarks are not changed, consideration should be given to making corresponding revisions to the SPP threshold level at that time.

Delay attribution

3.47 We have consulted on possible changes to Schedule 8 to streamline delay attribution and reduce the potential for disputes, costs and bureaucracy. Three options were considered:

- increasing the delay threshold in the Schedule 8 performance regime;
- excluding certain classes of delay from the remit of attribution review and possible dispute; and
- removing the right to dispute small delays.

3.48 We confirm our draft conclusion that these changes should not be made. This is because changes to Schedule 8 would provide insufficient benefit to justify the potential loss of information about the causes of delay.

3.49 ATOC, train operators and Network Rail all opposed the possible changes to Schedule 8 because of the potential loss of management information.

Changes to the delay attribution process

3.50 We do, however, consider it important that the delay attribution process is improved so as to maximise its effectiveness and efficiency. The Delay Attribution Board has asked consultants to advise on ways of improving the process.

3.51 The Delay Attribution Board has subsequently written to us in support of taking forward the proposals made by its consultants. These proposals particularly address cultural, organisational, management and systems aspects of the current process and we are content that, taken together, they

create an opportunity to improve, significantly, delay attribution processes and efficiency. The proposals are to:

- establish a culture change programme to provide greater understanding of each party's point of view;
- analyse historic patterns in 'small delays';
- co-locate staff;
- establish a professional head of delay attribution within Network Rail;
- reduce the level of disputes through understanding the largest repetitive reasons for disputes across the industry and agreeing, at an industry level, a suitable approach;
- enable train operators to flag incidents that are awaiting reports or investigation differently from those where some information has already led the train operator to challenge the attribution;
- improve information on why particular decisions have been made;
- improve the speed of delivery of train crew reports;
- make enhancements to current systems;
- implement a national training programme for delay attribution; and
- strengthen the Delay Attribution Guide in the way that it deals with train operator related issues.

3.52 The industry is taking the work forward on these changes. It is possible that some of the above changes may impact on the appropriateness of the current benchmarks. However, benchmarks are not being altered to account for this in the review, as the changes appear unlikely to have a consistent effect on the allocation of lateness between Network Rail and train operators.

TOC-on-TOC arrangements

3.53 Our final conclusions confirm our draft conclusion in this area, which was not to make changes to TOC-on-TOC arrangements within Schedule 8.

3.54 When one train operator delays another (TOC-on-TOC delay), any compensation payable to the affected train operator is made through Network Rail under the provisions of Schedule 8. Possible changes considered were either to:

- eliminate compensation for TOC-on-TOC delay, i.e. remove the obligation to make payments from the responsible train operator to Network Rail and payments from Network Rail to the affected train operator (placing the risk for such delays with the affected train operator); or
- retain compensation for TOC-on-TOC delay but remove the payments to Network Rail from the responsible train operator (placing the risk for such delays with Network Rail).

3.55 The justification put forward for either of these changes was that they would:

- result in cost savings for train operators and funders; and
- simplify the regime.

3.56 The approach outlined in the second bullet point in paragraph 3.54 above could additionally support Network Rail's accountability for whole-industry performance by providing it with strengthened financial incentives to assist with the initial incident and recovery.

3.57 However, it is not clear that either change would generate sufficient benefits to outweigh the potential disadvantages. This is because:

- financial responsibility for incidents should be with those best placed to manage improvements at source (a large proportion of control in these cases is with the train operator rather than Network Rail). This is particularly important because TOC-on-TOC delays can impact heavily on some operators, e.g. the impact of local services on inter-city services;
- the calculation of any ACS to be payable by train operators to Network Rail, to fund the income shortfall caused by the change, is very complex;
- there were no identified savings through any associated simplification of the attribution process;
- possibly less accurate measurement of root cause of incident; and

- Network Rail is already incentivised to reduce TOC-on-TOC delays. The problem is rather that it is unable fully to respond to these incentives; and this should be achieved through the reform to Part H of the Network Code.

- 3.58 We received no evidence on the extent of any cost savings that such a change to the regime would generate. for train operators and/or funders, or any compelling reasons to suggest that current financial incentives on Network Rail, to be reinforced by the reforms to Part H of the Network Code, are not sufficient.
- 3.59 We continue to believe that it is appropriate for those best placed to manage performance improvements at source to be directly responsible for the financial implications of incidents, albeit recognising that Network Rail plays a key role in mitigating the knock-on impact of TOC-caused incidents (for which it faces financial incentives under the current regime).
- 3.60 We recognise that it is important for TOC-on-TOC delays to be controlled and reductions to be achieved in a similar way to those recently achieved in Network Rail-caused delay. We expect that the roll-out of integrated control centres and the introduction of JPIPs will complement the financial incentives in Schedule 8 and provide an opportunity for Network Rail and train operators to examine and reduce TOC-on-TOC delay further.

4. Implementation

Timing and method of implementation

4.1 The conclusions of this review have been reached following an open and transparent consultation process with the industry and other stakeholders. Network Rail and train operators have led on much of the work. This chapter sets out the timing and method of implementing these conclusions.

Performance regime review – final conclusions

4.2 In summary, the review's final conclusions, which are to be implemented are:

- changes to payment rates: these will be made for all franchised passenger train operators from 1 April 2006. They are intended to last for the life of the underlying franchise subject to changes at periodic reviews or in revisions to track access contracts in the event of:
 - further developments in research on responsiveness of passenger demand to lateness and cancellation; and/or
 - significant changes in operator revenue.
- sustained poor performance: new compensation provisions are included in Schedule 8 from 1 April 2006 if TOCs have moved to Part LA of the Network Code by this date (and subject to review at periodic reviews or in changes to track access contracts where significant volume changes occur); and
- caps on bonus payments: minor modifications to be made to Schedule 8 to allow the introduction of such a mechanism at a later date either in agreement with Network Rail or through the paragraph 17 Schedule 8 dispute procedure.

Other conclusions

4.3 TOC-based performance trajectories are to be incorporated into Network Rail's forward-looking benchmarks for each franchised passenger train operator in its track access contract as each new franchise is let from 1 April 2006 onwards. The benchmarks will be subject to review at future periodic

reviews in the event of significant changes in the level and pattern of traffic across the network but not where deviations in performance from benchmarks have been caused by factors within Network Rail's or the relevant train operator's control.

- 4.4 As described in Chapter 3, TOC-based trajectories will be implemented at the time of franchise replacement. Where franchise replacement involves franchise re-mapping, we would expect Network Rail and train operator benchmarks also to reflect the impact of these changes (and also for these to be reflected in other affected TOC' Schedule 8s).
- 4.5 We would expect to hold the rest of the structure of the Schedule 8 regime constant for the life of a franchise. The purpose of this is to provide increased certainty to franchise bidders.
- 4.6 As the review conclusions are due to be implemented on 1 April 2006, train operators and Network Rail will have the necessary time to make any necessary financial planning and systems changes prior to that date.

Future adjustments to payment rates and benchmarks

- 4.7 Widespread support was received from respondents during the review for holding the structure of the Schedule 8 regime constant over the life of a franchise. However, a number of respondents suggested that flexibility to adjust payment rates and benchmarks remains beneficial. This is because without the regime being able to adapt to changing circumstances, train operators could be exposed to greater risk. If there were a loss of accuracy in the payment rates over time for instance, the regime would not fulfil the key objective of ensuring that compensation to train operators in the event of poor performance reflects loss of revenue.
- 4.8 We feel that a commitment to fix the structure of the regime for the term of a franchise, with the exception of the possible adjustment of benchmarks and payment rates in specific circumstances (either at periodic reviews or approved changes to track access contracts), provides a reasonable degree of certainty whilst addressing concerns about the need for some flexibility.

Implementation procedures

- 4.9 The power to undertake a review in order to establish appropriate incentives for the efficient use of the network is provided for in paragraph 2.4 (c) of Part

7 of Schedule 7 of franchised passenger train operators' track access contracts. Schedule 4A of the Railways Act 1993 (as amended)¹⁴ prescribes the procedure which we must follow in implementing an access charges review. The implementation of the conclusions of this review will therefore follow the procedures, which are summarised below.

4.10 The first notice (the 'review notice'), which initiates the implementation of this review:

- incorporates these final conclusions, which explain why we have reached these conclusions;
- specifies the changes we propose to make to any access agreements for or in connection with giving effect to the conclusions; and
- states the date on which we propose that each of those changes should come into operation.

4.11 A period of not less than six weeks from the date of publication of the review notice must also be specified in the review notice, which Network Rail¹⁵ has an opportunity to object to any of the proposed changes or the date on which it is proposed that the review should come into operation. In this case in the light of the period including Christmas, this deadline is longer than the six week minimum being on 13 February 2006. If we receive such an objection, which is not withdrawn, we may issue a new review notice or make a reference to the Competition Commission. If we issue a new review notice, this stage of the process begins again.

4.12 If we receive no relevant objections, a second notice (a 'notice of agreement') must be published stating that this is the case and it must be served on franchised passenger train operators. These operators, may, if they wish, give notice of termination of their access agreement. Any such notice must be given within 28 days of receiving the notice of agreement. This period is expected to be from 14 February 2006 to 15 March 2006. If no termination notice is given (or any notices which have been made are withdrawn), a third

¹⁴ This review was initiated prior to the changes to Schedule 4A of the Act made by Schedule 4 of the Railways Act 2005 being brought into force.

¹⁵ As well as any party whom we consider ought to be given a copy of the review notice and which has an estate or interest in, or right over, the railway facility or network installation to which the access agreement relates.

notice (the 'review implementation notice') must be published (unless we were to consider that we should issue a new review notice). This notice must set out again the relevant changes to access agreements and the date on which the changes take effect.

- 4.13 As indicated above, 1 April 2006 is the proposed date of implementation of the conclusions of this review.

Policy conclusions

- 4.14 The TOC-based performance trajectory is not being implemented through the above access charges review process, as this element of the review's conclusion will be implemented in the track access contracts for new franchises only (from April 2006 onwards). The inclusion of this approach in the final conclusions does however constitute a policy statement by us in relation to the approach we would expect to use in approving track access contracts associated with the letting of a new franchise.

Changes to Schedule 8 between now and 1 April 2006

- 4.15 Train operators and Network Rail may submit to us proposed amendments to their track access contracts that include modifications to Schedule 8 between now and 1 April 2006. In such cases, the parties will need to discuss with us how to maintain the effect of the changes beyond the implementation of this review.
- 4.16 In practice, it is suggested that parties who have made any such amendments in 2005 should check with us to ensure that the intentions of such amendments will continue to be effective beyond April 2006.

Freight and open access

- 4.17 The initial consultation document set out that the conclusions of this review would only be implemented into franchised passenger train operators' track access contracts.
- 4.18 The freight performance regimes differ in structure from the franchised passenger train operators' regime and therefore some changes made in this review may not be relevant. However, we will consider and consult on any appropriate changes that could be made to freight performance regimes in the light of these conclusions as part of the PR2008.

- 4.19 At that stage, for instance, it will be appropriate to consider the effects of the change made in this review to passenger payment rates in order to ensure that Network Rail does not over- or under- recover through the star model¹⁶.
- 4.20 We will consider the application of some or all of the conclusions of this review to open access passenger operators in individual track access applications.

¹⁶ The star model is the mechanism by which payments for lateness caused by one TOC on other TOCs is paid, with Network Rail at the centre of each transaction.

Annex A: Respondents to the June 2005 document and the September 2005 letter

June 2005 document

Association of Train Operating Companies (ATOC)

English Welsh & Scottish Railway (EWS)

First Group

Go-Ahead

National Express

Network Rail

South Eastern Trains (SET)

Strathclyde Passenger Transport Executive (SPTE)

Transport for London (TfL)

September 2005 letter

Angel Trains

Association of Train Operating Companies (ATOC)

English Welsh & Scottish Railway (EWS)

First Group

First Great Western/First Great Western Link

Go-Ahead

National Express

Network Rail

Virgin Trains