



See attached list

29 April 2005

## **Review of the Schedule 8 performance regime: emerging conclusions on the TOC-on-TOC arrangements and bonus payments to Network Rail**

### **Purpose**

1. This letter sets out ORR's emerging conclusions on two issues consulted on in its March 2005 document<sup>1</sup>. These were:
  - possible changes to the TOC-on-TOC delay arrangements within Schedule 8; and
  - the removal of bonus payments to Network Rail in the event of better than benchmark performance.
2. Annex A to this letter provides further details on these two issues. It sets out ORR's emerging conclusions and the reasons for those conclusions, drawing on the consultation responses.
3. In summary, ORR's emerging conclusions are that neither of the two proposals should be implemented. The majority of consultees opposed the changes, highlighting a number of possible adverse impacts. No strong evidence has been put forward in support of the benefits (including cost savings) that the proposals might generate.
4. ORR believes, however, that the industry should examine further the merit of capping bonus payments to Network Rail where there is clear evidence that a train operator's farebox revenue does not respond to better than benchmark performance and where this cannot be resolved through the re-calibration of payment rates. Network Rail has offered an alternative possible option to capping bonus payments which ORR also believes should be explored further. This is the possibility of offering end-of-year rebates of Schedule 8 revenue where this is linked to delivery of overall performance improvements.

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<sup>1</sup> [Review of the Schedule 8 performance regime: emerging views and further issues](#), Office of Rail Regulation, London, March 2005

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## **Next Steps**

5. ORR intends to publish the draft conclusions of the review in May 2005. This slight revision from the timetable set out in the March 2005 document is to enable further review of some remaining technical issues, in particular the appropriate threshold beyond which compensation would be payable for persistently poor performance and the proposed methodology for calculating train-operator specific performance trajectories to include in Network Rail's forward-looking benchmarks.

6. In the light of this, and a better understanding of the timescales required for the re-calibration of payment rates, it is envisaged that the final conclusions will now be published in August 2005 and not July 2005 as previously stated.

**John Thomas**

## Annex A

### Review of the Schedule 8 performance regime: ORR's emerging conclusions on proposed changes to TOC-on-TOC arrangements and the removal of bonus payments to Network Rail

#### TOC-on-TOC arrangements

##### *The issue*

1. 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 of track access agreements. DfT / SRA proposed 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).

2. 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. The approach outlined in the second bullet point in paragraph 1 (DfT's / SRA's preferred approach) 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.

4. The emerging views and further issues document on the performance regime, published by ORR in March 2005, noted that the following needed to be considered in relation to this proposal:

- whether the current financial incentives on Network Rail are sufficient in relation to TOC-on-TOC delays (which arise because Network Rail's payments to affected train operators are based on the *actual* impact on those operators while it only receives payments based on a *pre-estimated* impact of a train operator's delay on other operators);
- the impact on train operators' incentives; and
- the scale of the likely cost savings resulting from the proposal.

### *ORR's emerging conclusions*

5. ORR does not propose to implement this change as it is not clear that it would generate sufficient benefits to outweigh the potential disadvantages.

### *Reasons for ORR's emerging conclusions*

6. Although some limited support was received for removing TOC payments to Network Rail in relation to TOC-on-TOC delay (for example, Go-Ahead suggested that such an approach would provide Network Rail with an additional incentive to consider operational and fleet based initiatives) the majority of respondents opposed the proposal. The following concerns have been identified:

- 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 (as noted by Virgin in relation to the impact of other train operators on Virgin Cross Country's performance);
- complexity of calculation of any access charge supplement to be payable by train operators to Network Rail to fund the income shortfall caused by the change;
- no identified savings through any associated simplification of the attribution process;
- possible 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 they are unable fully to respond to these incentives. This will be resolved through the proposed reform to Part H of the Network Code.

7. ORR has 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 proposed reforms to Part H of the Network Code, are not sufficient.

8. ORR agrees 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 train operator-caused incidents (for which it faces financial incentives under the current regime).

9. ORR recognises 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. ORR expects that the roll-out of integrated control centres and the introduction of joint performance improvement plans (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.

## **Bonus payments**

### *The issue*

10. DfT / SRA proposed the removal of bonus payments currently paid to Network Rail by train operators when Network Rail's performance is better than the benchmark level. The possible advantages of this are:

- it would remove the funder's financial exposure in the event of Network Rail performing better than benchmark (the exposure arises because of the provisions of Clause 18.1 of the franchise agreement);
- it would be consistent with customers and funders only wanting to pay for a given level of performance; and
- it could protect those franchisees on revenue sharing arrangements from the possibility of paying out more than they receive through the farebox from improved performance.

11. Disadvantages identified in ORR's emerging views and further issues document were:

- a need for train operators to pay access charge supplements reflecting the loss of income to Network Rail which results from the benchmark being an annual average<sup>2</sup>. This would be difficult to calculate and would reduce or remove the cost savings achieved from implementing the proposal; and
- Network Rail's incentives to improve performance would be dampened as its performance levels approached its benchmark because of its awareness that it was approaching a level of performance above which Schedule 8 would provide no further financial rewards.

12. These problems could at least partly be addressed by adopting ATOC's proposal to limit rather than remove bonus payments completely.

### *ORR's emerging conclusions*

13. ORR does not support the removal of bonus payments to Network Rail but believes that the industry should consider further the possible application of a cap to limit bonus payments payable in the following cases:

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<sup>2</sup> Actual performance in any period will vary around the average level of performance reflected in that year's benchmark. At present, where the actual performance deviates around this benchmark, Network Rail's income through bonus payments enables it to bear losses in periods where performance is poorer than the benchmark.

- where the services operated do not have spare capacity to enable an increase in patronage and revenue that would normally result from better than benchmark performance; or
- where performance is so good that further incremental improvements cease to be a significant influence on passenger decision making in relation to travel options.

14. Network Rail has offered an alternative possibility to capping bonus payments that ORR also believes should be explored further. This is to offer end-of-year rebates of Schedule 8 revenue where this is linked to delivery of overall performance improvements.

*Reasons for ORR's emerging conclusions*

15. Network Rail and train operators generally opposed the removal of bonus payments. In particular, the following concerns were identified:

- it would reduce/remove the financial incentives on Network Rail to strive for better than benchmark performance;
- train operators and end customers generally want better than benchmark performance and want Network Rail to be incentivised to achieve this;
- the financial incentives provided through the bonus payments would support the non-financial JPIP targets (which will be designed to be stretching);
- the calculation of an appropriate access charge supplement adds complexity and potentially impacts on the future franchise value because it would represent a fixed payment for an uncertain output and would therefore introduce a risk element;
- the negative impact on Network Rail's incentives to invest in performance improving enhancements (GNER highlighted in its response performance improving work on the overhead line equipment on the East Coast Main Line); and
- during periods of out-performance, Network Rail could face a perverse incentive to tolerate delay.

16. ORR's view is that this proposal is unlikely to provide sufficient benefit to outweigh the negative impacts identified above and is therefore unlikely to provide value for money. Introduction of access charge supplements would mean that the financial exposure of funders under clause 18.1 of the franchise agreement would not be removed by this proposal.

17. Most train operators have signalled that they are prepared to pay bonus payments for better than benchmark performance given the likely associated positive impact on their revenue. The proposed recalibration of payment rates should help to ensure that bonus payments and additional TOC revenue from improved performance are closely aligned.

18. Additionally, the marginal financial incentives which bonus payments are meant to provide should complement the JPIP process in striving for improved performance.

19. It is possible however that the bonus payments should be limited in certain circumstances. Some operators favoured a limitation on bonus payments, particularly where there were limits to the extent that revenue could increase (for example due to capacity constraints) in the light of better than benchmark performance.

20. Therefore, ORR believes that the issue of limiting the extent of bonus payments, at a train operator by train operator level, should be examined in more detail in conjunction with the recalibration of the payment rates.

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