



## **Freight Schedule 8 recalibration – Payment rates in the freight regime**

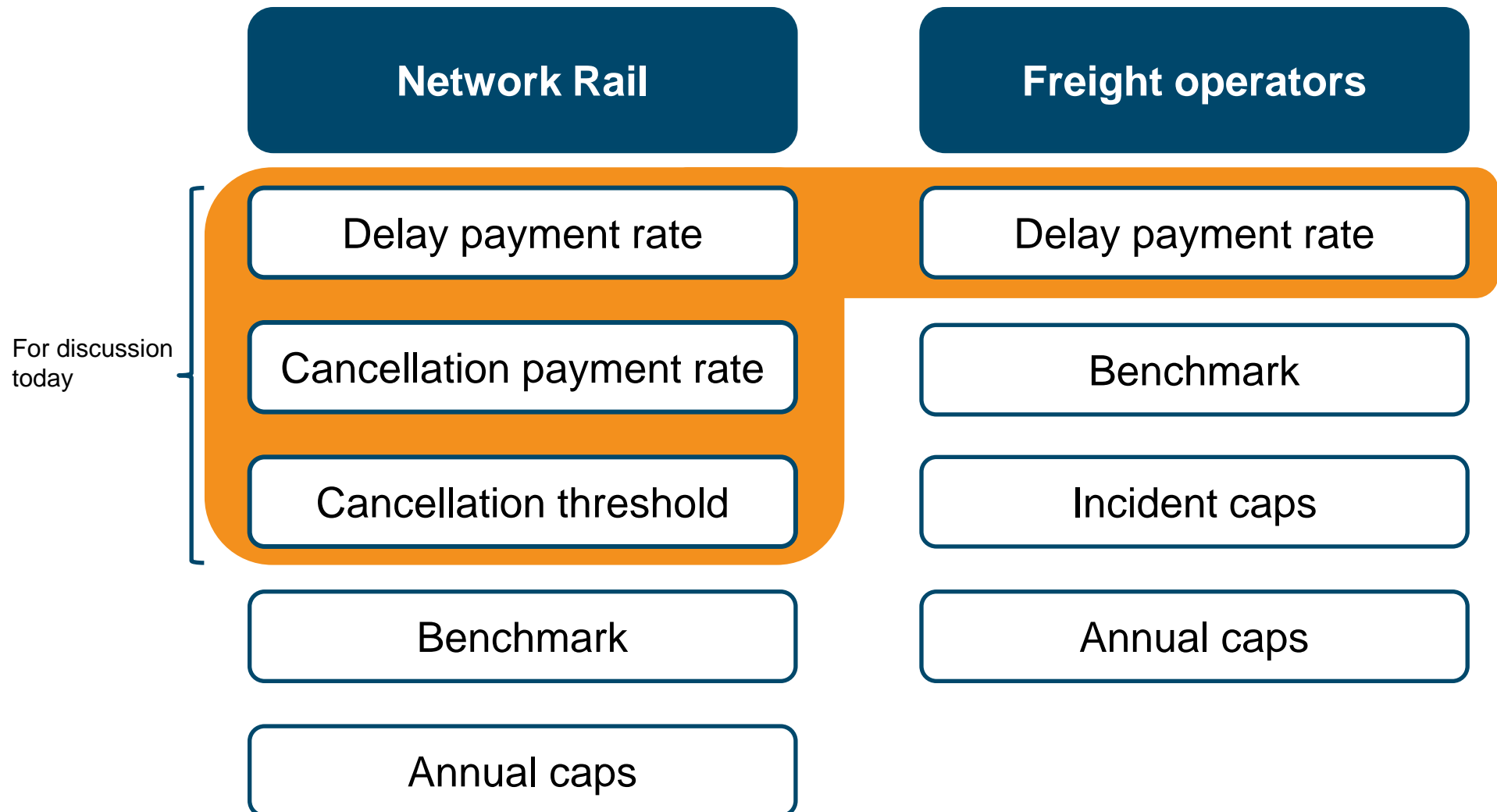
February 2017

# Purpose of today's discussion

- To discuss the approach to recalibrating the following aspects of the freight Schedule 8 regime:
  - Network Rail delay payment
  - Network Rail cancellation payment rate
  - Cancellation threshold
  - Freight operator payment rate

# Freight Schedule 8 regime

- The different aspects of the freight Schedule 8 regime



# Structure of slides

- These slides cover the following:
  - FOC concerns about ‘balance’ in the regime
  - Re-calibration of the Network Rail delay and cancellation payment rates and the cancellation threshold
  - Re-calibration of the FOC payment rates



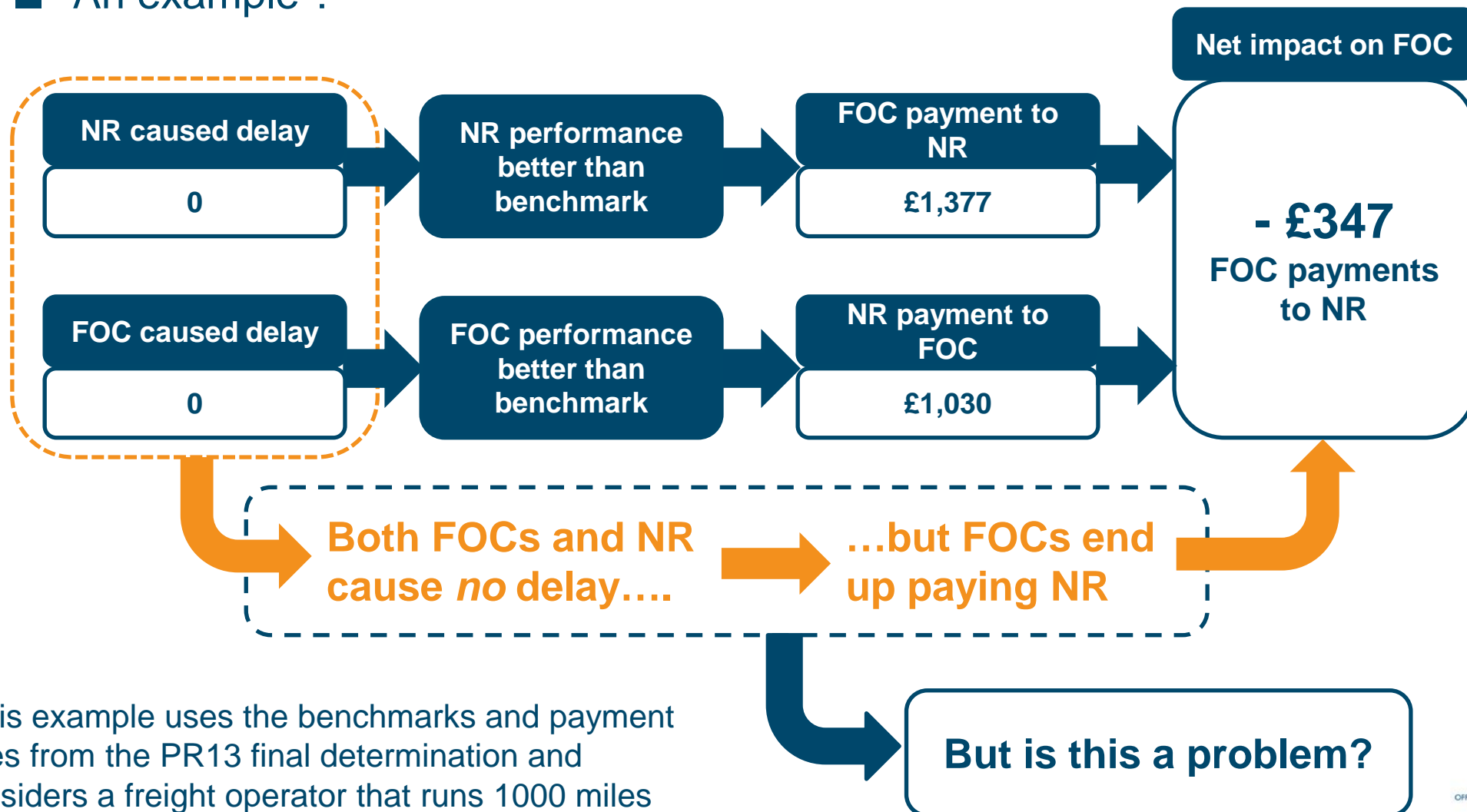
## **‘Balance’ in the FOC regime**

# Balance in the FOC regime

- In this section we will:
  - Explain our understanding freight operators' complaint that the freight Schedule 8 regime is not 'balanced'
  - Discuss whether the regime should be balanced
  - Discuss what may be driving these concerns

# FOC complaint: The regime is not balanced

- Some freight operators have raised concerns that the regime is not 'balanced'
- An example\*:



\*This example uses the benchmarks and payment rates from the PR13 final determination and considers a freight operator that runs 1000 miles

# Re-cap of the purpose of the payment rates

## ■ Network Rail delay payment rate:

- Expose Network Rail to the financial impact to a *single operator* of the delay it causes to (with a view to incentivising them to minimise delays they cause)
- Hold each freight operator appropriately neutral to the financial impacts of delay caused by Network Rail

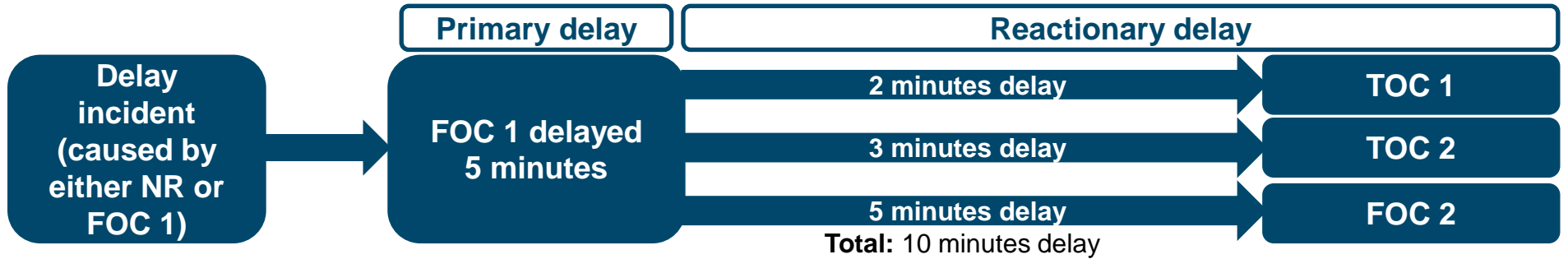
## ■ Freight operator payment rate:

- Expose freight operators to the financial impact of the delay they cause *to all other operators* (with a view to incentivising them to minimise the delay they cause)
- Hold operators appropriately neutral to financial impacts of delay caused by other operators



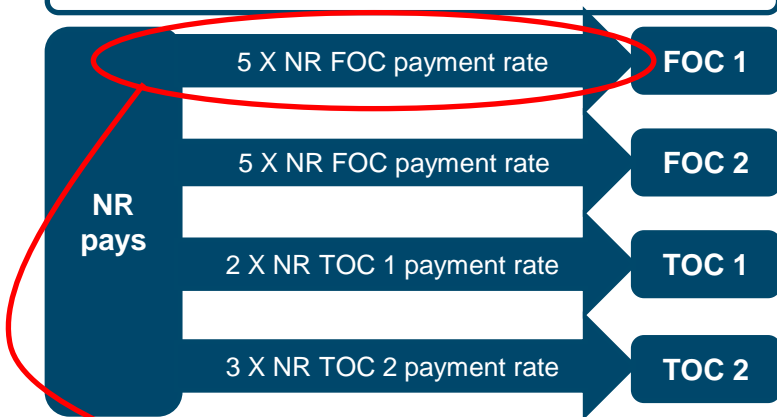
# FOC regime example

- An illustrative example of the financial flows in the FOC regime
- Consider a delay incident that causes the following primary and reactionary delay



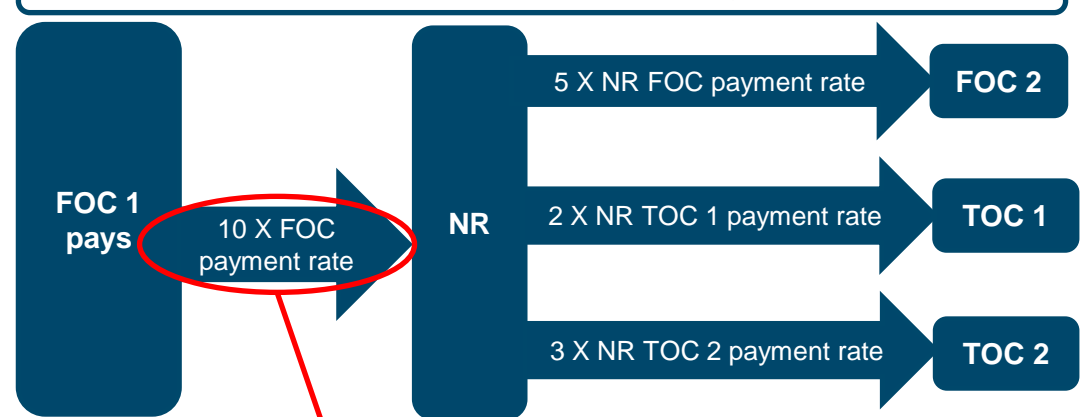
## Resulting financial flows

### If NR caused the delay...



NR Payment to FOC 1

### If FOC 1 caused the delay...



FOC payment to others

No presumption that these should 'balance' because they reflect different things

# Should the regime be ‘balanced’?

- The regime is not designed to ‘balance’ the payments that Network Rail makes to an individual operator for delay it causes to that operator *against* the payments that the operator makes for delay it causes to others.
- So in the event that NR causes no delay and a FOC causes no delay, there is no particular reason why the net payment should be zero in either direction – that is, there is no particular reason why the regime should be, in this sense, ‘balanced’.
  - This is just a consequence of the what the regime is designed to do.
- However, concerns about imbalance may indicate issues with other areas of the regime – which we can do something about.

# Possible issues relating to 'imbalance'

## ■ The concerns that freight operators have raised may reflect two things:

### A. Network Rail benchmarks may be too 'easy'

- The Network Rail benchmark may be too 'easy' for Network Rail to achieve, increasing the payments from freight operators to Network Rail
- This is a possible consequence of setting Network Rail's benchmark on the basis of past performance – which we are proposing to move away from.
- The approach to setting Network Rail's benchmark will be discussed at a future recalibration working group meeting (not today)

### B. Payment rates may be inaccurate

- If the payment rates are accurate freight operators will be indifferent to the level of performance they receive from Network Rail
- Freight operators' complaints may indicate that the rates are inaccurate
- **Today we will discuss the recalibration of the payment rates**



# Network Rail payment rates re-calibration

# Approach to re-calibrating payment rates?

- The following slides discuss the re-calibration of Network Rail delay and cancellation payment rates.
- We discuss the following topics:
  - Should we [the industry] re-calibrate the rates?
  - What is the process for doing the re-calibration?
  - What financial impacts should they recover?
  - What should be done about the cancellation threshold?

# Recalibrating the payment rates

- With any modelled rates, there is always a degree of uncertainty.
- Recalibrating the rates will be a costly process and introducing new rates will have a financial impact on freight operators.
- **However, the following arguments count in favour of recalibrating these payment rates:**
  - **The evidence used is old** – The rates have not been recalibrated since PR08
  - **There is a lack of clarity around the original evidence and methodology** – The current rates are based on survey evidence provided by freight operators. It is not clear what methodology was used to calculate the rates based on the information supplied by freight operators and is consequentially unclear how robust it was.

# Issues with recalibrating the rates

## Issues

- There is not a clear policy on what financial impacts the current Network Rail delay and cancellation rates are intended reflect.
- In the PR13 final determination it says:

### Delay payment rate

*“The payment rate should reflect the average financial impact to a freight operator of each minute of delay to a freight train attributable to Network Rail”*

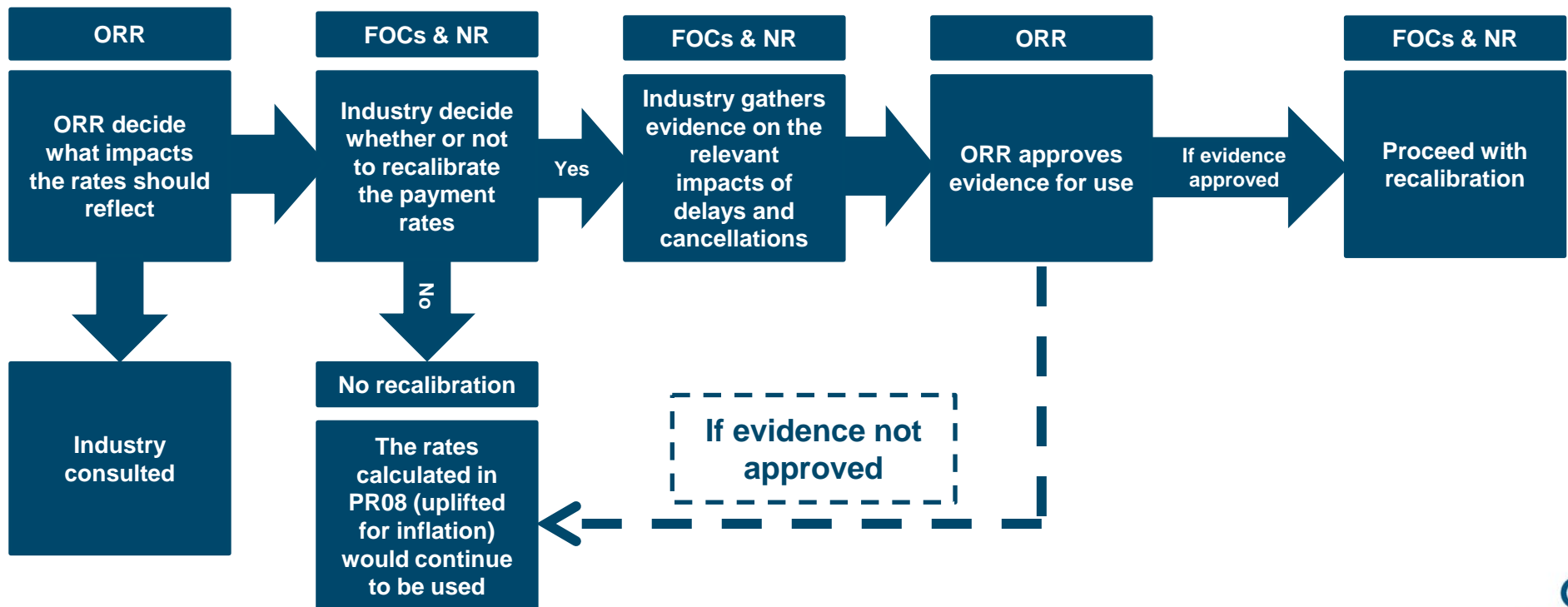
### Cancellation payment rate

*“Network Rail cancellation payments compensate freight operators for the financial impact of each freight train cancellation attributable to Network Rail”*

- However, both rates **were only based on evidence of freight operators costs** when the rates were set in PR08 – i.e. not ‘average financial impact’.
- **If the rates are to be recalibrated we should first agree what financial impacts they should cover.**

# Approach to recalibrating the rates

- ORR is not well placed to oversee or deliver the recalibration of the rates
- Industry has the necessary expertise and data to revise the rates, so if industry wants the rates to be recalibrated they will need to take this work forward
- Process and roles of each party for recalibrating the rates:





# ORR's approval

- When determining whether or not to approve the evidence developed by industry ORR will consider factors such as:
  - Is the sample data representative (e.g. unbiased)?
  - Is the methodology used robust and consistent with the principles of the policy?
- If there is agreement between operators and NR on the evidence collected ORR will take this into account and take a proportionate approach to assessing it for approval.
- Industry should keep ORR informed throughout the process in order to ensure the likelihood of approval of evidence.
  - We want to be able to approve the evidence and to do so in a timely manner, so it is in everyone's interests to ensure that we are bought into the methodology and evidence base as it is developed.
- ❖ Note: Time should also be factored to in to allow passenger operators the opportunity to comment on the work.

# Options

- As already mentioned, the policy position on what the rates should be recovering is not clear.
- We think it would be useful to give guidance on what the rates should be set on the basis of prior to any re-calibration.
- ‘Do nothing’ – Continue to use the rates from PR13 (uplifted for inflation).
- If the rates are recalibrated they could be based on:

	Short Run	Long Run	Short Run + Long Run
Costs	Option 1 Short run costs	Option 2 Long run costs	Option 3 Short and long run costs
Revenues	Option 4 Short run revenues	Option 5 Long run revenues	Option 6 Short and long run revenues
Costs + Revenues	Option 7 Short run costs and revenues	Option 8 Long run costs and revenues	Option 9 Short and long run costs and revenues

# Options assessment – FOR DISCUSSION

	Short Run	Long Run	Short Run + Long Run
Costs	<p><b>Option 1: Short run costs &amp; Option 4: Short run revenues</b></p> <p>✓ Short run impacts are simpler to estimate</p>	<p><b>All options that include long run impacts</b></p> <p>✗ Long run financial impacts are very uncertain making them difficult to accurately estimate</p> <p>✗ The freight sector is a competitive sector and operators can adapt to changes in performance over the long-term</p> <p>✗ Operators cannot be in a position of being compensated for lost profit in excess of cost of capital over the long-run</p>	
Revenues	<p>✗ Cost and revenue impacts are difficult to separate, so either of these options may inadvertently capture impacts that they are not intended to</p>		
Costs + Revenues	<p><b>Option 7: Short run costs and revenues</b></p> <p>✓ Short run impacts are simpler to estimate</p> <p>✓ Cost and revenue impacts are difficult to separate so appropriate to consider both together</p>		

 **Suggested option – for discussion**

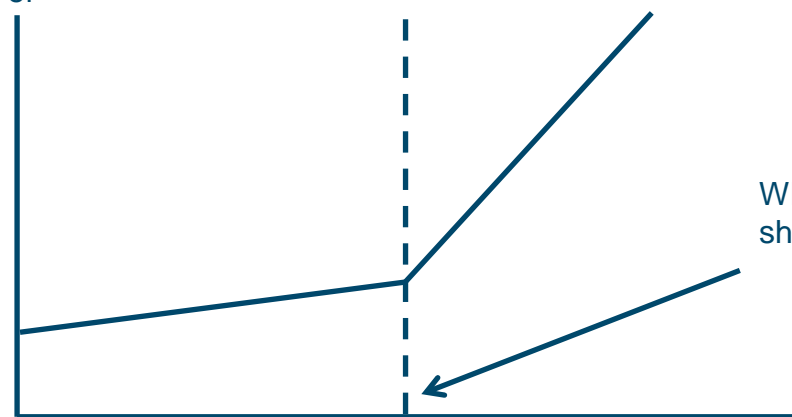
# Impacts on other aspects of Schedule 8

## ■ Cancellation threshold

- If the Network Rail cancellation payment rate is recalibrated the cancellation threshold also needs to be recalibrated
- The evidence collected to recalibrate the cancellation payment rate should also indicate what the cancellation threshold should be, or if there should be one at all
- If there is a cancellation threshold, it should represent the level of cancellations at which the cost to freight operators dramatically differs from the standard cancellation payment rate and only if such a difference is observable

Financial impact of  
cancellation

Indicative  
example



Where cancellation threshold  
should be set

% scheduled services  
cancelled



# Freight operator payment rate

# Freight operator payment rates

- The freight operator payment rate determines the amount freight operators pay when they delay other operators.
- The freight operator payment rate is calibrated to reflect the average impact of a minute of delay caused by a freight operator to other operators.
- For CP6 the rates will continue to be based on the Network Rail payment rates for freight and passenger operators weighted by freight operator caused delay affecting each service.
- Discussion points:
  1. **Concerns about the recalibration of the freight operator payment rates**
  2. **Industry involvement in the recalibration of the payment rate**
    - Work on operator payment rates has yet to start.
    - We suggest having a standing item on the agenda to update this group on the work being done to update the passenger operator payment rates – with discussions as to how and when FOCs want to get involved.