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11 October 2018

Dear Freight and Charter Recalibration Working Group,

**Final decision on the approach to recalibrating the freight and charter operator benchmarks for CP6**

1. You asked us,<sup>1</sup> to determine how the freight and charter operator benchmarks for CP6 should be recalibrated, on the basis that you could not reach agreement.
2. In response to your 11<sup>th</sup> May submissions on the freight operator benchmark, we wrote to you on 16<sup>th</sup> May noting that the submissions we received did not contain enough detail to allow us to make a decision, and in that email we set out our provisional position. In light of the impact of the freight operator benchmarks on the wider Schedule 8 recalibration, and the consequent need to arrive at a decision quickly, we wrote to you on 18<sup>th</sup> May asking for final submissions by Friday, 25<sup>th</sup> May. In that email we noted that the provisional position described in our 16<sup>th</sup> May email would be the *de facto* approach, i.e. the approach that should be used in the absence of a better-evidenced alternative. We received submissions from both Network Rail and freight operators by that date. We set out our decision on the freight operator benchmark, and our rationale for it, in correspondence with you on Friday, 1<sup>st</sup> June.
3. You also noted on 6<sup>th</sup> June that agreement could not be reached on the level of expected performance for charter operators. In light of the fact that the charter operator benchmarks ought to be based on expected performance for charter operators, in our reply of 6<sup>th</sup> June we noted that this would mean that your lack of agreement meant that we would need to determine this issue. We set out our decision on the charter operator benchmark, and our rationale for it, in correspondence with you on Thursday, 7<sup>th</sup> June.
4. This letter re-iterates the decisions on the freight and charter operator benchmarks and the rationale for them, as communicated in our earlier correspondence with you.

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<sup>1</sup> In your submissions to us on 11<sup>th</sup> May 2018 and in subsequent correspondence.

## **Freight operator benchmarks**

### ***Background***

5. The freight operator benchmarks set the level of performance at which freight operators will neither pay nor receive Schedule 8 payments in relation to delay that they cause. For CP6, the policy with respect to the benchmarks for both Network Rail and operators is that they should be set on the basis of expected performance; this ensures that money flows in the Schedule 8 regime are, on expectation, zero.

### ***Summary of proposals***

6. In what follows, when we refer to 'FOC performance' we mean the measure of performance for freight operators used in Schedule 8.
7. The proposals set out in Network Rail and freight operator submissions can be organised on the basis of their responses to the following questions:
  - a. Average FOC performance over which years best reflects expected performance in CP6, absent the impact of traffic growth?
  - b. How should traffic growth be measured?
  - c. What is the relationship between traffic growth and FOC performance?
  - d. Are any other adjustments necessary to reflect expected FOC performance in CP6?
8. The proposals can be categorised according to their responses to these issues (as set out in Table 1).
9. We discuss each issue in turn.

Issue	Network Rail Proposal	Freight Operator Proposal
(a)	2-year recalibration period: 2015/16 – 2016/17	5-year recalibration period: 2012/13 – 2016/17
(b)	Traffic growth = Expected average mileage in CP6 – average CP5 mileage	Traffic growth = Expected average mileage in CP6 – average mileage over the 5-year recalibration period
(c)	Use adjusted FOC benchmark calculation as described in the CP5 track access contracts.	Use adjusted FOC benchmark calculation as described in the CP5 track access contracts.
(d)	Apply FOC performance improvement trajectory for CP6.	No further adjustment.

**Table 1:** Proposals on approaches to recalibrating the freight operator benchmark

**Issue (a): What years best reflect expected performance in CP6, absent the impact of traffic growth?**

*Network Rail view:*

10. Network Rail argued that average FOC performance over 2015/16 and 2016/17 is more representative of what FOC performance will be in CP6, absent the impact of traffic growth, than the 5-year recalibration period proposed by FOCs. The main argument for this claim is that these years are more recent than the 5-year recalibration period proposed by FOCs.
11. Network Rail argued that recent years are more likely to reflect CP6 performance for the following reasons: (a) the traffic mix over those years more closely reflects CP6 traffic mix (and performance varies with different types of traffic); and (b) FOC performance has improved significantly over CP5, so earlier years are less representative of how FOCs will perform in CP6.

*Freight operator view:*

12. Freight operators argued that average FOC performance over the 5-year recalibration period they propose is more representative of what FOC performance will be in CP6, absent the impact of traffic growth, than the 2-year recalibration period proposed by Network Rail. The main argument for this claim is that FOC performance over these two years was unsustainably good, so it cannot be expected throughout CP6.

13. Freight operators argued that the good performance in 2015/16 and 2016/17 was the result of the sudden decline in coal services. They argued that this decline left them with underutilised assets (including locomotives, drivers and ground staff) that they then used as contingency assets for performance management. They argued that this was why FOC performance was so good over this two year period. They support this claim by noting that as underutilised assets have been wound down FOC performance has worsened. They further argued that it would be unsustainable to maintain such asset contingency given the losses arising from the lowered levels of utilisation, and that without it they would not deliver these levels of performance.
14. Freight operators thus argued that they could not sustainably deliver the level of performance seen over these two years (absent traffic growth), on average, over CP6. Instead, freight operators suggest that the good performance seen over these two years should be 'smoothed out' by taking the average over a 5-year period that includes the two years proposed by Network Rail, but also years in which freight operators lacked the asset contingency and performed worse.

*Our view:*

15. We note Network Rail's arguments about the more recent years being more reflective of CP6 traffic mix and about them being more reflective of what freight operators have done to improve their own performance. We recognise that these are reasons in favour of using the two-year recalibration period rather than the 5-year recalibration period proposed by freight operators.
16. However, we also recognise the freight operators' arguments that these two years were exceptional. Network Rail has not submitted any arguments against freight operator claims that the good performance in those years was the result of freight operators having significant asset contingency, nor has it argued against the claim that this level of contingency is unsustainable for freight operators. Indeed, we understand from discussions in previous Working Group meetings that these claims were originally accepted by Network Rail. In the absence of arguments to the contrary, the available evidence suggests that the freight operators' claims are accurate.
17. We also note that the information that more recent years' performance contain on traffic mix, in particular, is likely obscured by the effect of this asset contingency, since, as freight operators indicate, all else being equal the change in traffic mix (i.e. the decline of high performing coal services) should have led to a worsening

of performance. That is, when we would have expected to see a decline in performance as a result of the change in traffic mix, we actually saw an improvement, owing to the asset contingency. This undermines the usefulness of more recent years as a signal of the expected impact of changes in traffic mix on performance.

18. On balance we consider that the arguments submitted by freight operators against the two-year period outweigh Network Rail's arguments in favour of it. It would not be appropriate to base expectations of CP6 performance solely on years in which freight operators had considerable and unsustainable asset contingency to devote to performance management, particularly because this asset contingency cannot be expected to persist throughout CP6.
19. We are satisfied that the inclusion of these years as part of a larger 5-year recalibration period recognises that there might be exceptional years of performance in CP6 without expecting freight operators to perform at exceptional levels throughout CP6.
20. Our decision on issue (a): Use the 5-year recalibration period proposed by freight operators.

***Issue (b): How should traffic growth be measured?***

*Network Rail view:*

21. Network Rail suggested that traffic growth should be measured as the difference between average mileage over CP5 and expected average mileage over CP6. It argued that 'we should seek to use the most recent data as this more closely reflects CP6 traffic and, therefore, the adjustment for traffic growth should be smaller and more certain.'

*Freight operator view:*

22. The freight operators proposed that traffic growth should be measured as the difference between average mileage over the 5-year recalibration period and expected average mileage over CP6. The FOCs argued that they 'would expect the recalibration period for the FOC benchmark and the baseline for growth to be the same.'

*ORR view:*

23. With respect to Network Rail's argument that its proposal would lead to a smaller and more certain adjustment: firstly, the fact that the traffic growth adjustment

would be smaller if Network Rail's proposal were followed is not a reason to use it. Secondly, it is not clear why it would be more certain, given that the same forecast numbers are being used for both estimates.

24. More generally, it is worth noting that the rationale for incorporating a traffic growth adjustment is that FOC performance is a function of mileage on the network – an increase in traffic results in worse FOC performance, all else being equal. Whatever recalibration period one chooses, it follows that FOC performance over that recalibration period is a function of the mileage over that same period.
25. To understand the impact of traffic growth on performance in the recalibration period compared to CP6, then, one needs to understand the change in mileage from the recalibration period to CP6. It would not make sense to use mileage over a different period, because performance over the recalibration period is not a function of some other period's mileage.
26. For these reasons we are of the view that traffic growth should be measured as the difference between the average mileage over the chosen recalibration period and expected average mileage over CP6. Given that, above, we have indicated that the recalibration period ought to be the 5-year period proposed by FOCs, the baseline mileage for the traffic growth calculation should be taken as the mileage over this period also.
27. Our decision on issue (b): Traffic growth should be calculated as the difference in mileage between the average mileage over the 5-year recalibration period and expected average mileage over CP6.

***Issue (c): What is the relationship between traffic growth and FOC performance?***

28. It appears that Network Rail and freight operators are in agreement on this point. Both parties agree that there is a relationship between traffic and FOC performance and that the best available way of modelling this is to use the adjusted FOC benchmark calculation set out in CP5 track access contracts. We note the concerns of both parties that this methodology may be inaccurate (e.g. given that the congestion factor has not been updated), but in the absence of any alternative options, this is how you have suggested that the impact of traffic growth be determined.
29. Decision on issue (c): We are content for you to proceed on the agreed basis.

***Issue (d): Are any other adjustments necessary to reflect expected FOC performance in CP6?***

*Network Rail view:*

30. Network Rail suggested that the freight operator benchmark should include the same performance improvement assumptions as Network Rail's SBP FDM forecast.
31. Network Rail argued that 'only adjusting the Freight Operator Benchmark for traffic growth and ignoring all the other assumptions in Network Rail's forecast would result in a Freight Operator Benchmark that is not consistent with the assumptions that underpin Network Rail's FDM forecast.'
32. Network Rail argues further that freight operators have made performance improvements in the last three years, so can be expected to do so in future.
33. Finally, Network Rail argues that setting a freight operator benchmark that includes a performance improvement trajectory would incentivise freight operators to improve their performance.

*Freight operator view:*

34. The freight operators do not support the principle of adding a performance improvement trajectory, on the basis that FOC performance expectations for CP6 should not include performance improvement.

*Our view:*

35. With respect to Network Rail's first point: We see no inconsistency in recognising the impact that traffic growth will have on FOC performance in CP6 without assuming that FOC performance will improve over CP6. Network Rail is funded by government to deliver performance improvements. That is, in part, why performance improvements are expected and, consequently, why they are factored into the Network Rail benchmarks for both passenger and freight operators. Freight operators have no such funding. If they did then we should factor that into the benchmarks, but they do not.
36. There is therefore no exogenous reason to expect performance improvements from freight operators (unlike for Network Rail); that is, any performance improvements that are likely would be funded by freight operators themselves, and in that respect, discretionary. If we were to use freight operator plans to improve their own performance as a basis for forming our expectations of their performance



in the next control period this would provide them with a perverse incentive not to make any plans to improve their performance (because any Schedule 8 gains from doing so would be deducted ex ante in the setting of the benchmark). This would not be desirable.

37. With respect to Network Rail's argument that freight operators have improved their performance in the last three years (and therefore should be expected to continue to do so in CP6), we note that two of these three years include the period in which freight operators had considerable asset contingency, and for the reasons stated above it is probably not reasonable to take these as the basis for talking about trends in FOC performance. More generally, the fact that freight operators have improved their performance in the past is no basis for assuming that they will continue to do so in the future.
38. As to the incentive claim: setting more challenging benchmarks does not provide any greater incentive for freight operators to perform well, because the marginal incentive on good performance (i.e. the payment rate) remains unchanged. All that setting more challenging benchmarks achieves is the deduction of a fixed sum from freight operators, irrespective of their outturn performance, which could have no incentive effect. In any case, the policy position on the benchmarks is that they should be set on the basis of performance expectations.
39. Moreover, no reason has been given as to why we should expect the percentage improvement for FOC performance over CP6 to be the same as Network Rail's performance improvement. Indeed, it would be pure coincidence if they followed the same trajectory, so Network Rail's SBP FDM forecast would seem to be an arbitrary basis for adjusting the freight operator benchmarks.
40. Finally, Network Rail's suggestion contained no clear proposal for how to turn the trajectory into a single benchmark for CP6. In the absence of that there is no concrete proposal for us to approve, even if we were minded to.
41. For these reasons, given the PR18 policy position that benchmarks should reflect expected performance, we do not consider that it would be appropriate to include a performance improvement trajectory for freight operator benchmarks.
42. Our decision on issue (d): No adjustment for FOC performance improvement should be applied.



### ***Conclusion on freight operator benchmarks***

43. We were asked to decide between two proposals. We divided them into four discrete issues and the remarks above set out our decisions on each. These decisions amount to supporting the freight operator proposal set out in Table 1.
44. It is worth noting the following point, because of the repeated stress Network Rail has put on it: Network Rail claims, as an argument in favour of its proposal, that 'it would result in a Schedule 8 regime that is financially neutral on expectation'. This argument is contingent on Network Rail's proposal being the best reflection of FOC performance on CP6. In making it Network Rail thus assumes precisely the point that is in contention.
45. In relation to this, Network Rail notes that the freight operator proposal 'would result in passenger operators, open access operators and DfT paying around £22.5m to freight operators in CP6 as a result of an 'easier' and unrealistic Benchmark. Should ORR wish to progress this option, we would strongly encourage ORR to consult with franchised train operators, funders, and most importantly open access operators who would necessarily bear this cost (Network Rail would be financially neutral to this, through the star model). It is important that franchised train operators, funders and open access operators are aware of the money they would be expected to pay to freight operators in CP6.'
46. This is a claim that Network Rail has made much of, so we should be absolutely clear on this point: if we expected the freight operator proposal to result in these sums of money being paid to freight operators by passenger operators, we would not be supporting it. We support the freight operator proposal precisely because, on the basis of the arguments submitted to us, we are of the view that it is more likely to result in a Schedule 8 regime that is financially neutral on expectation than Network Rail's proposal. And this is precisely because, on the basis of the arguments put to us, and contrary to Network Rail's view, we are of the view that the freight operator proposal is better aligned with expected CP6 performance, and therefore more 'realistic' than Network Rail's proposal.

### **Charter operator benchmarks**

#### ***Background***

47. The charter operator benchmarks set the level of performance at which charter operators will neither pay nor receive Schedule 8 payments in relation to delay that they cause.

48. For CP6, the policy with respect to the benchmarks for both Network Rail and operators is that they should be set on the basis of expected performance; this ensures that money flows in the Schedule 8 regime are, on expectation, zero.

### ***Summary of proposals***

49. In the working group meeting of Wednesday, 6<sup>th</sup> June, the working group agreed on the use of the 5-year recalibration period proposed by freight operators for the recalibration of the charter operator benchmark. However, the working group was not in agreement on whether or not the traffic adjustment needs to be applied to the 5-year average in order to get the best estimate of expected charter performance. Given that the charter operator benchmark ought to be based on expected performance, we agreed to treat this as a dispute about how the charter operator benchmarks should be set.<sup>2</sup>
50. Given the areas of agreement, we consider that we were asked only to determine whether or not the traffic adjustment should be applied.
51. Neither Network Rail nor charter operators elected to provide any further arguments, beyond those set out in previous submissions in relation to the freight operator proposal, as to why a traffic adjustment is or isn't warranted in this case.

### ***ORR response***

52. Before setting our decision, we should first note the following: the submissions contain very little discussion as to the appropriateness or not of the five-year recalibration period as a reflection of expected charter performance. Given that Network Rail accepted that traffic growth has an impact on charter performance, we could assume that Network Rail believed that the 5-year period reflects expected performance including the effects of traffic growth. In contrast, charter operators do not think that it does. We have no understanding as to why there is a disagreement there.
53. Furthermore, it is not actually clear whether Network Rail is challenging the principle of applying a traffic growth adjustment in general (i.e. whether Network Rail just disagrees with the principle of reflecting traffic changes in benchmarks),

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<sup>2</sup> Network Rail were willing to support the charter operator proposal on the basis that 'it is consistent with the FOC regime' although it wished to maintain that it was not the best forecast of expected performance. In line with the agreed process for the recalibration, we elected to treat this as a dispute, since we could not support a proposal to recalibrate the benchmarks if the parties proposing it did not agree that it reflected expected performance.

or whether, as suggested above, Network Rail considers that the average of the 5-year recalibration period already includes the effect of traffic growth.

54. These are significant concerns, and given more time we would have expected far clearer, and better evidenced submissions from both Network Rail and charter operators.
55. However, despite the lack of evidence on charter operator performance in the submissions, owing to the urgency of a need for a decision on this issue, and the limited impact of weaknesses in the methodology on the wider regime, we nonetheless took a decision on this issue.
56. We decided that the charter benchmark should be set using the same recalibration period and methodology as freight operators, and this letter confirms that decision.
57. We took this decision because, in the absence of arguments to the contrary, we understood that:
  - i. the 5-year recalibration period is the best reflection of expected charter performance in CP6 excluding the effects of traffic growth;
  - ii. it is reasonable to factor in the effect of traffic growth; and
  - iii. the best available methodology is the adjusted benchmark calculation set out in track access contracts.

### **Next steps**

58. This letter states our final decision on how the freight and charter operator benchmarks should be recalibrated.
59. This decision is restricted only to the basic principle of how these benchmarks should be recalibrated for CP6. You should note that the review and approval of the benchmarks themselves is separate to this decision (as per the general approach to the recalibration that we have previously discussed).

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Deren Olgun', is written over a light blue horizontal line.

Deren Olgun