

Carl Hetherington  
Deputy Director, Railway Markets and Economics



8 March 2019

Network Rail Infrastructure Limited  
c/o Rachel Gilliland

Freightliner Limited  
c/o Peter Graham and Lindsay Durham

Dear Rachel, Lindsay and Peter

## **Schedule 8 Recalibration: Our determination on the annual caps for Freightliner Limited**

### **Introduction**

1. This letter sets out our determination on the annual caps for Network Rail Infrastructure Limited (Network Rail) and Freightliner Limited (referred to in this letter as Freightliner Intermodal (FLIM)) (together 'the parties') in respect of the Schedule 8 regime for control period 6 (CP6)<sup>1</sup>. We have made this determination after Network Rail and FLIM were unable to agree the annual caps themselves.

### **Background**

2. In the freight operator Schedule 8 regime, freight operators and Network Rail have reciprocal annual caps on the net annual liability they face under the Schedule 8 performance regime.
3. The purpose of the annual caps is to provide certainty to freight operators and Network Rail on their maximum Schedule 8 liability for any year, without removing incentives and compensation for operators on events within 'normal' bounds<sup>2</sup>.
4. To achieve this, the annual caps should be set at a level with a low likelihood of being reached, since once the annual caps are breached Schedule 8 no longer provides any compensation for freight operators or an incentive for Network Rail or freight operators to improve performance.

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<sup>1</sup> CP6 will run from 1 April 2019 to 31 March 2024.

<sup>2</sup> We consider an event to be outside 'normal' bounds if there was no way to expect it at the start of the control period, so Network Rail or freight operators could not be expected to plan for it.



5. The annual caps are the same for all small and new entrant freight operators. All other freight operators have bespoke annual caps. The recalibration process for the 2018 periodic review (PR18) provided for Network Rail and each relevant freight operator to agree the level of the annual caps that should apply for CP6. Subject to our approval, these annual caps would apply from 1 April 2019 in the relevant parties' track access contract, through the inclusion of the annual caps in our PR18 review notices, which began the implementation process for PR18.
6. However, Network Rail and FLIM were unable to agree annual caps in time for them to be included in the review notice that was issued on 20 December 2018. Because of this, we included in the new Appendix 1 to Schedule 8 that will apply to the parties' track access contract from 1 April 2019, a provision to allow us to determine these annual caps at a later date<sup>3</sup>. We also gave the parties some further time in which to agree the annual caps, but with the condition that if they could not agree, we would make a determination.

### **Developments since December 2018**

7. On 11 January 2019, the freight and charter Schedule 8 recalibration working group informed us that Network Rail and FLIM had not been able to agree on annual caps for CP6. As result, both parties submitted their proposals to us and asked us to determine what the annual caps should be for CP6.

### **Network Rail proposal**

8. Network Rail proposed annual caps with FLIM of ₤ (2017-18 prices), but said it was willing to agree to annual caps of ₤ (2017-18 prices).
9. Network Rail considered that the recalibration of the freight Schedule 8 regime for CP6 required a full recalibration of the annual caps, as opposed to an adjustment of the annual caps used in CP5 for FLIM. Network Rail explained that it considered the CP5 annual caps to no longer be appropriate as they do not reflect the CP6 Schedule 8 regime or expected CP6 performance.
10. The methodology Network Rail used to arrive at its proposal of ₤ was:
  - (a) to calculate what the annual average net Schedule 8 payments would have been between Network Rail and FLIM from 2014-15 to 2017-18, had the CP6 freight Schedule 8 parameters (i.e. payment rates and benchmarks) been in place; and

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<sup>3</sup> See paragraph 4.6(b) of Annex 2 of the aforementioned review notice.

- (b) to apply a 40% uplift to the annual average net Schedule 8 payments between Network Rail and FLIM.
11. In its submission, Network Rail explained that the purpose of the 40% uplift was to reduce the likelihood of the annual caps being easily breached in CP6.
  12. This is the methodology Network Rail used to calculate the annual caps for the other freight operators who have bespoke annual caps. Network Rail revised its proposal to  $\pounds$  in an attempt to reach an agreement with FLIM.

### **FLIM proposal**

13. FLIM did not agree that the annual caps should be lower than they currently are ( $\pounds$  for 2018-19). It considered that Network Rail's proposal of  $\pounds$  would significantly increase the likelihood of the annual caps being breached in CP6.
14. FLIM proposed two alternative approaches:
  - (a) adjust the existing FLIM caps ( $\pounds$  in 2018-19 prices) by expected CP6 traffic growth, the same methodology used to recalibrate the annual caps for small and new entrant freight operators; or
  - (b) adjust the existing FLIM caps ( $\pounds$  in 2018-19 prices) where there is more than a 2.5% change in annual mileage, based on the difference between 2018- 19 and 2017-18 mileage. This is the same methodology outlined in the model freight operator track access contract.
15. Following further discussions, FLIM informed us that the annual caps under the proposal in paragraph 14(a) would be approximately  $\pounds$ . The level of the annual caps under the proposal in paragraph 14(b) is not known because FLIM has not yet been informed whether the difference in annual mileage between 2018- 19 and 2017-18 is higher or lower than 2.5%.
16. In addition, on 4 February 2019 FLIM approached Network Rail with a third alternative proposal. FLIM proposed to uplift its CP5 annual caps by the percentage increase in the freight operator payment rate<sup>4</sup> between CP5 and CP6. Under this proposal the annual caps would be  $\pounds$ . Network Rail did not accept this proposal.

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<sup>4</sup> The freight operator payment rate is the amount freight operators pay for every minute of delay they cause to another freight or passenger train operator.

## Our decision

17. Having reviewed Network Rail's and FLIM's proposals, we set out our minded to position to the parties on 8 February 2019. Our minded to position was to adjust the existing annual caps (⌘ in 2018-19) by expected CP6 traffic growth (that is, FLIM's proposal in paragraph 14 (a)).
18. We asked the parties to inform us of any factual inaccuracies or significant errors in the rationale we provided for our minded to position.
19. The responses we received to our minded to position did not include any reasons for us to change our minded to position. As a result, our decision is that the existing CP5 annual caps should be adjusted by expected CP6 traffic growth.
20. Accordingly, through this letter we determine that in Appendix 1 of Schedule 8 of the parties' freight track access contract that will apply on and from 1 April 2019:
  - (a) the Network Rail Cap shall be ⌘ (2017-18 prices); and
  - (b) the Train Operator Cap shall be ⌘ (2017-18 prices).

## Rationale

21. We agree that some aspects of Network Rail's approach are reasonable, e.g. it has tried to approximate the liability for CP6 using available data from CP5. But, we note that Network Rail has not provided evidence that it is reasonable to assume that the level of variability in performance across CP5 will be the same in CP6.
22. However, we had concerns with some aspects of Network Rail's approach, e.g. the annual caps are based on the average potential liability over the period of time modelled instead of a view of a reasonable maximum liability.
23. In addition, although Network Rail explained it applied an uplift to the annual average net Schedule 8 payments over CP5 to account for possible changes in performance in CP6, it did not provide a rationale for why it considered 40% to be an appropriate uplift. As a result, it is difficult for us to agree the methodology underpinning Network Rail's proposal.
24. We acknowledge that Network Rail's proposed methodology was used to calculate the annual caps for the other freight operators who have bespoke annual caps, and that we approved those annual caps. However, our decisions were based on the freight operators agreeing with Network Rail's proposed annual caps. We gave due weight to the agreements reached between Network Rail and the freight

operators, and see no reason to consider these agreed bespoke annual caps are not appropriate.

25. The proposals put forward by FLIM for the CP6 annual caps adjust the CP5 annual caps. In the absence of an agreement between Network Rail and FLIM, we think this is a reasonable approach because:
  - (a) we understand the CP5 annual caps were previously agreed between Network Rail and FLIM, and we have not received any evidence to suggest that the nature of FLIM's operations is going to be significantly different in CP6; and
  - (b) in the PR18 recalibration of Schedule 8, the Freight and Charter Recalibration Working Group agreed that the CP5 annual caps for small and new entrant operators should be increased to reflect the expected increase in traffic on the network in CP6. Both FLIM and Network Rail are part of this working group. We agree that this is a reasonable way of adjusting the CP5 annual caps for the differences between CP5 and CP6.
26. We acknowledge that the annual caps calculated using this methodology may not necessarily provide the best balance between certainty to FLIM and Network Rail and incentives and compensation for FLIM on events within 'normal bounds'. However, in the absence of the parties agreeing the annual caps themselves, or an established alternative, we consider this approach to be appropriate and expect it to protect both parties from Schedule 8 costs for events outside 'normal' bounds, while maintaining the incentive effects of Schedule 8.

### **Public register**

27. In line with section 72 of the Railways Act 1993 (the Act), we will include a copy of this determination on our public register.
28. In entering any provision on the public register, we are required to have regard to the need to exclude, as far as is practicable, the matters specified in section 71(2)(a) and (b) of the Act. These sections refer to:
  - (a) any matter which relates to the affairs of an individual, where publication of that matter would or might, in the opinion of the ORR, seriously and prejudicially affect the interests of that individual; and
  - (b) any matter which relates to the affairs of a particular body of persons, whether corporate or incorporate, where publication of that matter would or might, in the opinion of the ORR, seriously and prejudicially affect the interests of that body.

29. We propose to redact all financial sums from this letter before placing it on the public register. If you consider that there are other matters in the letter that meet the threshold for exclusion, as set out in (a) and (b) above, please would you notify Joel Moffat by 22 March 2019, providing reasons why publication would seriously and prejudicially affect your interests. If we do not hear from you by 22 March 2019, we will assume that you are content with our proposed approach to this matter.

Yours sincerely,

A handwritten signature in black ink that reads 'Carl Hetherington'.

**Carl Hetherington**