



Schedule 8 recalibration – Benchmarks in the freight regime

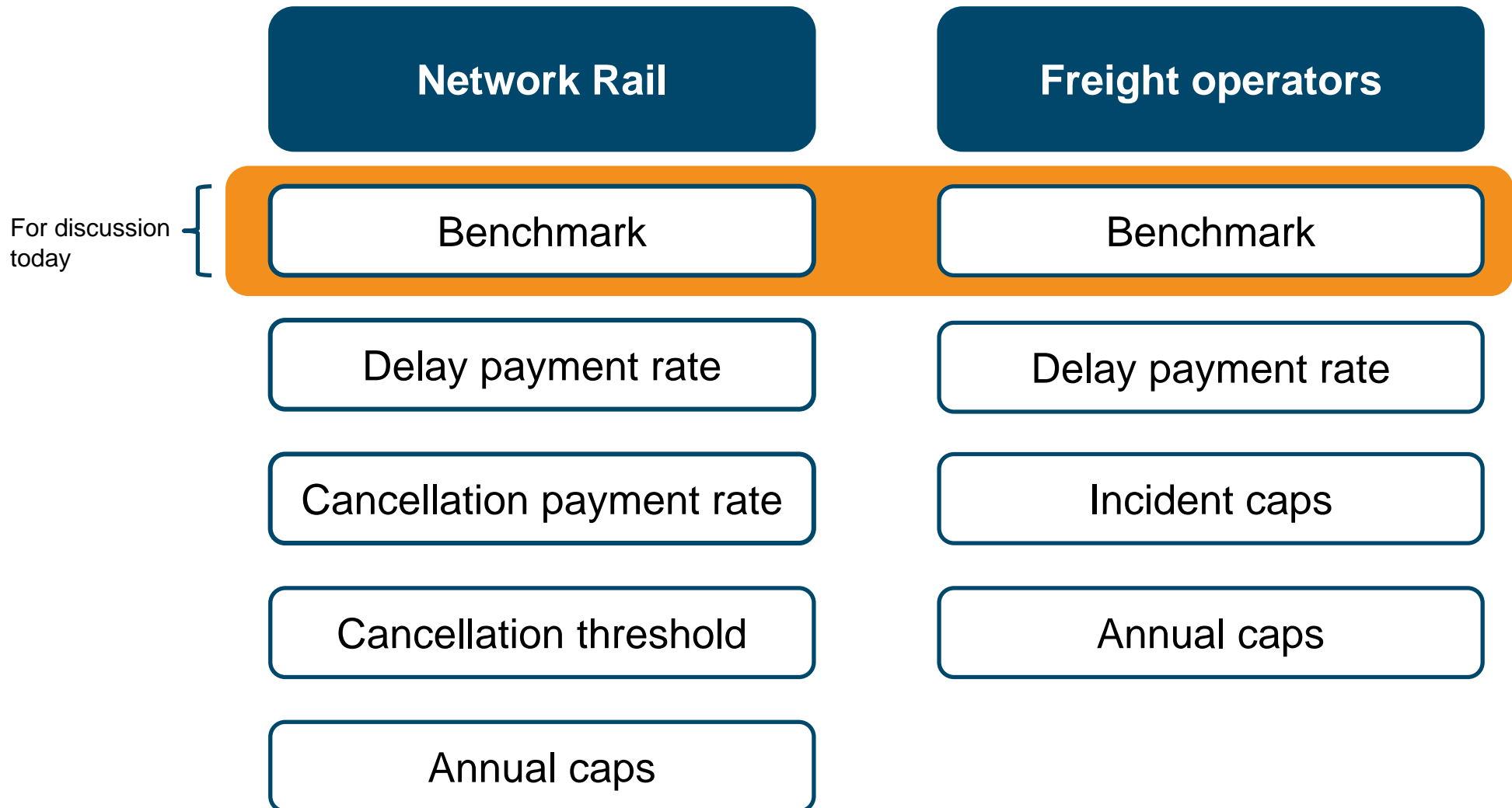
April 2017 – Re-calibration
Working Group

Purpose of today's discussion

- To discuss the approach to re-calibrating the following aspects of the freight Schedule 8 regime:
 - Freight operator benchmark
 - Network Rail benchmark

Freight Schedule 8 regime

- The different aspects of the freight Schedule 8 regime



The structure of the slides

- These slides cover the following:
 - **Current approach to setting benchmarks**
 - **Benchmarks and December 2016 proposals**
 - **Network Rail benchmark**
 - Why change the current approach?
 - What do we need to consider when changing the approach?
 - Options
 - **Freight operator benchmark**
 - Current approach to setting the benchmark
 - What are we proposing?

Current approach to setting benchmarks

■ Network Rail benchmark

- Network Rail's benchmark is set on the basis of its own past performance in relation to freight services (note we have proposed to change this approach, we will discuss this in detail later).

■ Freight operator benchmark

- The freight operator benchmark is set on the basis of average past performance across all freight operators.
- In addition, the freight operator benchmark is adjusted each year to reflect actual traffic growth or reduction.

Benchmarks and December 2016 proposals

- In the December 2016 charges and incentives consultation we proposed:
 - **Network Rail benchmark**
 - Remove the link between Network Rail's past performance and its benchmark.
 - **Freight operator benchmark**
 - Continue to set the freight operator benchmark on the basis of average industry performance.
- ORR has not concluded on the December 2016 consultation – so why are we discussing this now?
 - There are areas that we are not consulting on that we can discuss now.
 - And ,for those areas that we are consulting on, we want to start discussion on agreeing the process for arriving at the revised approach – and that should be possible prior to any policy decisions.



Network Rail benchmark

Why change the current approach?

■ Current approach

- Network Rail's benchmark is set on the basis of its own past performance in relation to freight services.

■ Issue

- This approach reduces Network Rail's incentive to improve their performance as doing so could result in a more challenging benchmark in the next control period.
- We consulted on this in our December 2016 charges and incentives consultation document.

What do we need to consider when changing the approach?

- Suggested initial criteria to consider when looking at alternative approaches for setting the Network Rail benchmark:
 1. Minimise expected industry cash flows
 2. Similarity of contractual entitlements
 3. Low cost and complexity of re-calibration
 4. Avoid perverse incentives
 5. Preserve neutrality of Network Rail as central counterparty

- We will also consider the financial impact of changes to benchmarks on operators

Options

- Initial suggestions on possible options for setting NR's benchmark:
 - 'Regulated outputs' such as the Freight Delivery Metric (FDM)
 - PR18 projections
- **'Regulated outputs':**
 - If targets are based on Network Rail's expected level of performance, then setting the Network Rail benchmark on the basis of their regulated output for freight would help minimise industry cash flows,.
 - However, changes to the way outputs are set (e.g. proposals on scorecards) may affect the appropriateness of using regulated outputs as benchmark.
- ❖ We intend to keep a common/single Network Rail benchmark for the freight Schedule 8 regime.



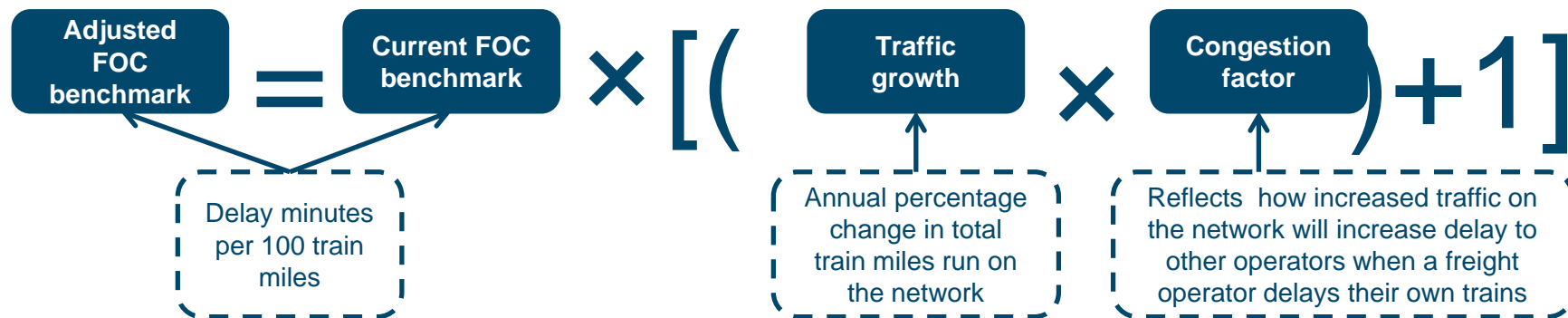
Freight operator benchmark

What are we proposing?

1. Continue to set a single freight operator benchmark on the basis of average FOC performance.
 - This approach gives all freight operators an incentive to improve their performance.
2. Industry to update congestion factor

Current approach to setting the benchmark

- The freight operator benchmark is set on the basis of average past performance across all freight operators.
- The benchmark is then adjusted each year to reflect actual traffic growth or reduction.
- Formula used to adjust the freight operator benchmark:



- Illustrative example for year 2 of CP5 (based on actual traffic levels in the previous year)

$$2.37 \text{ delay minutes per 100 FOC miles} \times \left[\left(0.63\% \times 1.044 \right) + 1 \right] = 2.39 \text{ delay minutes per 100 FOC miles}$$

Updating the congestion factor

- Expect Network Rail and freight operators to take this forward
 1. Network Rail is exposed to financial risk as result of congestion factor
 2. ORR will need to review implications of any substantial change to the congestion factor