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12 October 2015

Dear John

Network Rail's response to ORR's TOC payment rate error letter

This letter sets out Network Rail's response to ORR's letter "Error in CP5 Schedule 8 passenger train operator payment rates", issued on 14 September 2015.

Background

Network Rail considers that Schedule 8 plays an important role in the structure of charges and incentives. It is designed to hold operators financially neutral to the long term effects on their ticket sales associated with different levels of performance, through a formulaic, pre-determined mechanism. In so doing, it maximises value for the tax payer by maintaining franchise values (and the values of open access and freight operators' businesses). To this end, large sums of money change hands through Schedule 8 each year (in 2014/15, Network Rail made net payments of over £100m to operators through the Schedule 8 regime). Setting the regime at the wrong level could, therefore, have significant financial consequences for all industry parties.

The TOC payment rates govern how much operators pay to Network Rail for below benchmark performance. Network Rail passes this money on to other operators affected by the delay, through what is known as the star model. The TOC payment rate error outlined in ORR's letter has led to an imbalance between these two amounts, such that Network Rail is £3m worse off overall to date. This is not an insignificant figure, and highlights the need for robust quality assurance processes to be put in place for all future Schedule 8 recalibrations. It also highlights the importance of having a fully transparent recalibration process for the periodic review, and for each mid-control period recalibration.

Comments on ORR's proposal

ORR's letter sets out its proposals for addressing the TOC payment rate error, made as part of the PR13 Schedule 8 recalibration. Network Rail's comments on these proposals are set out, below.

1. The error in the TOC payment rates shows the need for **greater transparency in future Schedule 8 recalibrations**. As part of the PR13 recalibration, Network Rail was not allowed to view several of the calculations, primarily as a result of operators' concerns about sharing their revenue data with Network Rail. Given the significant financial flows that result from Schedule 8, we consider that it is vital that all parties to

the regime understand the basis of the payments. In addition, having a greater number of parties review the calculations will help to reduce the risk of errors occurring. Therefore, Network Rail will be advocating a more transparent recalibration as part of the next periodic review (PR18), which would allow all parties to the Schedule 8 regime full visibility of all calculations.

2. Network Rail **strongly welcomes ORR's proposal to impose a change to all TOC payment rates prospectively, if Network Rail and TOCs are unable to agree a way forward.** This will provide clarity, and will allow all parties to move forward constructively. The TOC payment rates are a key parameter of the Schedule 8 regime. If calibrated correctly, they hold Network Rail financially neutral for TOC-caused delays. We will be approaching all operators to seek to agree corrections to all TOC payment rates (following ORR's confirmation of its preferred approach) and would hope that operators would agree to make these changes without ORR's intervention.

3. Network Rail **will not request, or agree to, retrospective changes to the TOC payment rates** regardless of the direction of the error (i.e. whether operators have gained or lost). We consider that such retrospective changes would not be good use of industry resources, recognising that there will be instances of losses and windfall gains for individual operators which would make retrospective changes complex and burdensome. Our understanding is that the impact on operators of this error is minimal, given operators' franchise agreements. Assuming that this understanding is correct, we consider that it would be better to use the corrected rates on a prospective basis only.

4. Since the start of CP5, there have been several recalibrations of Schedule 8, largely due to changes in franchises. These have all involved an adjustment of the original CP5 Schedule 8 parameters and, as such, will be affected by the TOC payment rate error. The corrected TOC payment rates provided by CH2M Hill in ORR's letter do not take account of these later recalibrations (i.e. they are for the original CP5 Schedule 8 values only). Therefore, further work will be required in order to correct for the error. We would be grateful if ORR could clarify whether CH2M Hill would undertake this work and, if not, who would be expected to fund this additional work (which would be over and above the recalibration costs).

We note that ORR's letter makes no mention of the financial impact of this error for Network Rail. As stated, above, this amounts to a not inconsiderable £3m adverse impact. We would welcome discussions with ORR regarding this.

If you would like to discuss the content of this letter in more detail, please contact Caitlin Scarlett (Caitlin.Scarlett@networkrail.co.uk).

Yours sincerely

Peter Swattridge