



Kings Place, 90 York Way
London, N1 9AG
T: 020 3356 9325

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Dear colleague,

Cancellation of possessions – proposal for a liquidated sums approach to compensation payment

Introduction

In November 2012, ORR consulted on the Schedules 4 and 8 possessions and performance regimes¹ as part of the periodic review (PR13). In its consultation, it proposed allowing operators to claim for **actual** costs incurred when Network Rail cancels a Type 1 possession (i.e. a Restriction of Use of less than 60 hours). Network Rail supports the principle of compensation for cancelled possessions (including Type 1) where costs are incurred, but believes that this should be achieved through an efficient process which avoids significant transaction costs.

In its response to the consultation², Network Rail suggested an alternative to ORR's proposed compensation arrangements (ORR's proposal was based on actual losses), whereby operators would be compensated for cancelled possessions on a 'liquidated sums' basis.

Our detailed proposal is set out in full, below. We received very helpful comments from ATOC and other colleagues, which have influenced the proposal set out in this letter.

Background

Under the current Schedule 4 regime, when Network Rail cancels a Type 1 possession and an operator reinstates a service that otherwise would not have run, operators are not eligible to claim costs that have been incurred or committed. This is in contrast to Type 2 and Type 3 possessions, where operators are entitled to claim **actual** costs (on a claims basis) from Network Rail under paragraph 2.9 of the Track Access Contract.

Train operators consider that there is currently no incentive on Network Rail to consider the financial impact on operators of cancelling or changing possessions at short notice. In its November 2012 consultation, and following suggestion from ATOC, ORR proposed extending the scope of the protection provided by paragraph 2.9 of the Track Access Contract to enable the recovery of direct costs related to amended or cancelled Type 1 possessions. This is

¹ ORR – consultation on Schedules 4 and 8 possessions and performance regimes, 27 November 2012. Available at:

<http://www.rail-reg.gov.uk/pr13/consultations/possessions-and-performance-regimes.php>

² Network Rail – response to Schedules 4 & 8 consultation, 28 January 2013. Available at:

<http://www.networkrail.co.uk/publications/delivery-plans/control-period-5/periodic-review-2013/orr-publications-on-PR13/>

consistent with the way in which operators can already claim for possession costs associated with Type 2 and Type 3 possessions.

ORR considers that this proposal is aligned to the general principle of the Schedule 4 regime that franchised passenger operators should be compensated for costs incurred due to possessions. It believes that this will enable operators to better challenge Network Rail's management of possessions, and therefore reduce industry costs. It considers that this will also strengthen the incentive on Network Rail to better plan possessions, reducing the need for late changes to possessions plans.

Network Rail agrees with the principle that operators should be compensated in these circumstances, and agrees that this would be consistent with the overall objectives of the Schedule 4 regime.

However, we consider that a claims based regime could entail significant transaction costs to train operators, Network Rail and ORR. Type 1 possessions are far more numerous than Type 2 and Type 3 possessions, accounting for approximately 95% of the total. It is therefore likely that widening the scope of paragraph 2.9 of the Track Access Contract, so that operators could claim **actual** costs, could result in a significant increase in claims that would need to be administered by the industry.

Proposal

We propose that Network Rail makes a fixed cash payment to operators when it cancels a possession and train services are subsequently reinstated i.e. a '**liquidated sums**' approach.

Network Rail's proposal

Our proposal is as follows:

1. Define a payment rate for each **market sector** to be applied *per affected train* (the definition of an affected train and determination of the payment rate are discussed below). This would be defined in the Track Access Contract. Call this π_k for market sector k.
2. The operator would claim for a cancelled possession by informing Network Rail of the number of trains (along with their head codes) in each sector affected by the cancelled possession. Call this N_{ik} for TOC i and sector k (further detail regarding the definition of N_{ik} is set out, below).
 - i. The operator would claim by filling out a template form.
 - ii. Network Rail would then verify N_{ik} .
 - iii. The claim would be included in the Day 42 statement.
3. Network Rail would then pay the operator:

$$\sum_k N_{ik} * \pi_k$$

Worked example (using illustrative payment rates)

Suppose the payment rate for the Regional market sector is £100 per affected train, and the payment rate for the London and South East market sector is £200 per affected train.

Suppose Network Rail cancels a possession which would have affected trains for TOC A in both the Regional, and London and South East market sectors. Assume this would have affected 10 Regional trains and 5 London and South East trains.

The claim amounts would be as follows:

10 * £100 = £1,000 for Regional services
5 * £200 = £1,000 for London and South East services

This gives an overall payment to TOC A of £2,000.

TOC A would inform Network Rail of the number and head codes of trains affected by this cancellation. This would be verified by Network Rail and set out in the Day 42 statement.

This compensation mechanism would be funded through an Access Charge Supplement (ACS), consistent with Type 2 and Type 3 possessions. This is discussed in more detail, below.

Defining N_{ik}

We recognise that trains run at different frequencies during the day and across the week, and believe that operators should be compensated reasonably accurately for costs incurred whilst maintaining simplicity in the Schedule 4 regime. Therefore, we consider that it is appropriate to compensate operators per affected train as this will allow for a more reflective estimation of the actual costs involved.

It would be necessary to define the criteria for an affected train upfront, with the number of affected trains being identified following the cancellation of the possession. We set out our proposed definitions, below.

Cancelled Type 1 Restriction of Use: A Type 1 Restriction of Use which is changed 6 weeks or less prior to the Restriction of Use Day, such that no Restriction of Use occurs.

Affected train: A train which is reinstated in light of a Cancelled Type 1 Restriction of Use, which would have been subject to rail replacement bus cost compensation under Schedule 4 had the Type 1 Restriction of Use not been cancelled.

N_{ik} : If the Cancelled Type 1 Restriction of Use is instigated by Network Rail (i.e. a Network Rail Restriction of Use), N_{ik} shall be the number of affected trains in sector k , for TOC i . If the Cancelled Type 1 Restriction of Use is the result of a request from the train operator (TOC i), N_{ik} shall be zero in respect of that TOC and N_{jk} shall be the number of trains affected for the other TOCs (TOC $j \neq i$) in sector k .

Note that these definitions imply the following:

- If a cancellation is made by Network Rail in the Possessions Planning System, and subsequently rebooked for administrative purposes, no compensation would be paid;
- Possessions cancelled more than **6 weeks in advance** would not be subject to compensation; and
- If the cancellation of the possession was made **at the request of an operator**, that operator would not receive compensation (although other operators would).

Moreover, for payment to be made, the affected train would have had to be subject to rail replacement bus cost compensation had the possession not been cancelled. We note that these are provisional definitions, and may need to be refined.

We recognise that some TOCs requested that possessions cancelled with less than 12 weeks notice should warrant a compensation payment. However, we consider that providing compensation for cancellations made 6 weeks in advance will ease the administrative burden by reducing the number of claims, while more closely reflecting the costs that TOCs will incur as a result of reinstating their services. Furthermore, we note that any increased number of compensation payments will result in an increased ACS for TOCs.

Consultation question 1

What is your view on the proposed definitions by which a train qualifies as being affected by a cancelled possession?

Defining π_k

We propose that the payment rate will be set for each market sector, and will apply per affected train in the qualifying possession.

We recognise that operators' costs will vary depending on the number of passengers transported and the nature of the journey (i.e. whether or not a replacement bus service is required, or if the train can be re-routed). We consider that the proposal to apply a different payment rate per market sector will be the best measure to capture these differences, and the proposal to compensate for each affected train will allow for a more reflective estimation of the actual costs incurred by operators.

Consultation question 2

Do you agree that the payment rate should be defined by market sector, and applied per affected train in the qualifying possession?

In determining the payment rate per affected train (π_k), we propose that the following costs are taken into account:

- The typical cost of replacement services, which could include the following:
 - The cost of cancelling buses;
 - The cost of taxi hire for customers; or
 - In the case of a possession where traction electricity will be turned off, the cost of cancelling hired diesel trains.
- Typical publicity costs (e.g. posters advertising the disruption to customers);
- The typical cost of train planning (the train operator is often required to plan alternative routes for its services); and
- The typical cost of additional train crew.

In determining this payment rate, we would ask operators to provide estimates of the above cost categories per train. If Network Rail and operators cannot agree on a payment rate, it will be for ORR to determine an appropriate payment rate to be applied per affected train.

We would expect π_k to be set for the Control Period, and be uplifted each year for RPI.

Consultation question 3

Do you agree with the cost categories which we propose to cover in the formulaic compensation payment? Do you consider that any other cost categories should be included?

We would request that TOCs provide evidence of the magnitudes of these proposed cost categories in response to this consultation.

Claims process

We propose that the claim should be initiated by the Train Operator by means of a simple template form, which would be the basis upon which to apply the formulaic compensation payment. The form would require information such as the number of affected trains, the head code of these trains for verification purposes, and to which market sector they belong. We propose that this is administered through the Day 42 statement. The process of incorporating the claim into the Day 42 statement should be relatively straightforward, although it would require a strengthening of the current process.

We recognise Train Operators' concerns that a potential drawback of incorporating the claim into the Day 42 statement would be that the Train Operator could potentially have just one week from the date of the possession in which to make this claim, i.e. by Day 35. If the operator missed this deadline, there is a ten day dispute period during which it would have the opportunity to suggest amendments to the Day 42 statement. Nevertheless, we believe that this situation will be quite infrequent, as many possessions would be cancelled earlier in the Day 42 timescales. Additionally, the claim would be made in the Day 42 statement which follows the date for which the possession was originally booked. This would mean that Train Operators could prepare to make a claim many weeks in advance. We therefore consider that this process should allow Train Operators sufficient time in which to gather the evidence required, and submit a claim to Network Rail.

Consultation question 4

Do you agree with the process by which a claim could be made?

Funding implications

It will be important that Network Rail is funded for an efficient level of cancellations in order to cover the increased expected liability. It may be appropriate for Network Rail to cancel a possession due to safety considerations or to reflect operational reality and the needs of passengers and freight customers. Examples of situations where the cancellation of a possession and the subsequent reinstatement of the service is appropriate include, but is not limited to:

Very low temperatures meaning that High-Output Trains cannot run, whilst passenger and/or freight trains may be able to operate; and

Work being delivered more efficiently during an earlier possession, so that subsequent possessions are no longer necessary.

There is a general regulatory principle that agents should be compensated for taking on risk. We therefore propose that Network Rail should be funded for an efficient number of cancelled possessions, and that this should be accounted for by means of the Schedule 4 Access Charge Supplement (ACS). As the payment rate varies for each Train Operator, the additional element in the ACS will also vary by each Train Operator. In determining the ACS, it will be

necessary to estimate the level of future cancellations and therefore the level of the payment to operators to be recovered.

We consider that the 'liquidated sums' proposal will allow ORR to provide greater accuracy in the funding arrangements than if the compensation was paid on an 'actual costs' claims basis. This is because, under a regime where actual costs can be claimed, assessing the appropriate level of funding will be difficult, not least because robust historical data on Train Operators' costs is unlikely to be readily available.

Consultation question 5

Do you agree that an efficient level of compensation payments should be funded through the Schedule 4 ACS?

Conclusion

We consider that the approach described above provides a suitable mechanism for compensating TOCs in instances when Network Rail cancels a possession and the TOC subsequently reinstates its services. We believe that:

- The approach strikes the correct balance between cost reflectivity and simplicity. It avoids unnecessary transaction costs while providing operators with broadly appropriate compensation payments;
- It will suitably incentivise Network Rail to plan possessions more effectively and take account of the impact on TOCs of cancelling a possession; and
- We expect the process of incorporating the claim into the Day 42 statements to be straightforward.

Alternatives to a 'liquidated sums' compensation mechanism

Following industry discussions at the Schedules 4 and 8 passenger regimes industry group³ in April 2013, several Train Operators noted their concern at the proposal outlined above. Concerns centred on the difficulty in establishing a payment rate per affected train in each market sector. Train Operators considered that the amount of work required to calculate the rates may be disproportionate to the financial impact that cancelled possessions are likely to have during CP5.

Several Train Operators expressed support of an alternative approach to providing compensation for cancelled possessions, whereby Train Operators would be eligible to make a claim if their **cumulative costs** (rather than costs for a given incident) exceeded a predefined threshold.

Whilst this approach may be more aligned to the expected financial value of cancelled possessions in CP5 in terms of industry time and resources, we consider that it may also have a number of weaknesses. These will need to be considered in more depth before proceeding further with this approach. We consider that the principal areas of concern are as follows:

- **Varying costs across Train Operators.** The costs associated with planning for a possession which is then cancelled will vary significantly across Train Operators. Those who transport larger numbers of passengers are likely to incur higher costs, and will, therefore, be more likely to exceed the set threshold. However, 'smaller'

³ This is an industry group which meets every 6 weeks and draws together stakeholders from the passenger operators, charter operators, ORR, Network Rail and other interested parties.

Train Operators are unlikely to breach the threshold, but the effect on their businesses could still be significant. It may therefore be more appropriate to set a threshold per Train Operator, or per market sector. In determining this, it will be necessary to ensure consistency across Train Operators, or market sectors. The work associated with this would be similar to that required under the 'liquidated sums' approach.

- **Defining the threshold.** Due to the reasons outlined, above, there may be difficulties in defining the threshold to be applied. It is likely that each Train Operator will have a different view on what constitutes an 'appropriate' figure. Therefore, setting this threshold may require similar levels of industry time and resources as for determining the payment rates in Network Rail's proposal, detailed above.

We further note that, regardless of which mechanism is pursued, it would be appropriate for Network Rail to be funded for the increased liability via an increase in the Schedule 4 ACS. This is consistent with funding arrangements for Type 2 and Type 3 possessions.

Consultation question 6

Do you consider that the alternative approach, whereby compensation would be paid if cumulative costs exceeded a predefined threshold, is preferable? We would be interested to hear your views on how the threshold should be set under this approach.

Next steps

We would welcome stakeholders' views on the consultation questions, or on any other matter relating to the issue of compensation for cancelled possessions in the Schedule 4 regime. The closing date for this consultation is **8 July 2013**. Please send responses to: Caitlin.Scarlett@networkrail.co.uk.

If you have any questions, please contact me using the details above. We intend to publish responses to this letter on our website and, therefore, kindly request that you make clear if any part of your response is confidential.

Yours faithfully,

Caitlin Scarlett

Planning and Regulation Assistant