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Dear Emily

1. Schedule 8 compensation payment rates in Control Period 5

In May 2013, we wrote to the industry regarding some important issues with regards to Schedule 8 payment rates for CP5, especially in relation to commuting services in London and the South East. We held a workshop on this matter on 31 May 2013, which was attended by a large number of stakeholders.

We received a number of responses to this consultation. We are grateful to those parties which responded to the consultation. We have considered these responses carefully, and a summary of these is contained in the Annex to this letter. Responses to the consultation were mixed on the particular issue of Schedule 8 payment rates for LSE commuting flows. In addition, some fundamental concerns about the increases in Schedule 8 payment rates – not just in relation to LSE commuting flows, but regarding **all flows** – were raised, especially by the Department for Transport (DfT) and Transport Scotland.

The purpose of this letter is to set out:

- Network Rail's views on setting Schedule 8 payment rates across the board; and
- Network Rail's conclusions on the particular issue of the appropriate Schedule 8 payment rates for LSE commuting flows – the specific issue covered in our May 2013 letter.

Ultimately, any decisions on Schedule 8 payment rates for CP5 are, of course, for ORR.

2. The overall picture

In its response to the consultation, DfT, whilst supporting revisiting the Schedule 8 payment rates laid down in 2005, expressed concerns about the PDFH 5.1 recommendations. In particular, it emphasised that the increases to Schedule 8 rates resulting from the PDFH changes could introduce considerable volatility into Network Rail and TOCs' financial positions, with consequential financial impacts for DfT. Transport Scotland expressed similar concerns.



DfT declared that it will be undertaking its own review of the PDFH 5.1 framework later in 2013, and Transport Scotland cited the prospect of further work in its response to the consultation.

Both DfT and Transport Scotland requested that the previous GJT elasticities and lateness multipliers be used for purposes of setting Schedule 8 payment rates in CP5, with Schedule 8 rates – in effect – only being increased to reflect higher passenger numbers and above inflation fares rises.

Network Rail's view

We welcome the industry's recent work to update the parameters of the PDFH. Of course, we also believe that the PDFH update would benefit from further scrutiny, as is being proposed by DfT. We consider that the industry should seek to actively engage in the DfT review of the revised PDFH parameters and that the DfT review will provide a useful robustness check of the parameters of the PDFH. Such a review may also benefit from not being constrained to report within the timescales of the periodic review and from the removal of CP5 financial considerations in coming to a consensus.

We recognise some of the issues emphasised by DfT and Transport Scotland. Moreover, we are deeply concerned about ORR's proposal, set out in its draft determination, to 'fracture' Schedule 8 and the Capacity Charge. We are planning to discuss the issue of Schedule 8 payment rates and the proposal to misalign Capacity Charges and Schedule 8 with operators, shortly. We will set out our views more fully following these discussions.

3. Central London commuting flows

If ORR does decide to set CP5 Schedule 8 payment rates on the basis of the PDFH 5.1 parameters, the issue remains open as to whether it is appropriate to set payment rates for LSE-commuting flows on this basis of the PDFH 5.1 parameters. As we set out in our May 2013 letter, we do not believe that the PDFH 5.1 parameters – **when taken in isolation** – provide a realistic view of the impact of poor performance on demand.

We made the following proposal:

For calculating CP5 Schedule 8 payment rates for London commuting flows, the Lateness Multipliers and GJT elasticities should not be taken from PDFH 5.1, but should remain unchanged from those used in 2005 to calculate the current rates¹.

We asked stakeholders whether they agreed with this position, and invited respondents to set out their reasons for their position. We also asked for views on alternative arrangements.

Summary of responses

Responses to the consultation were mixed. The large majority of TOCs – together with ATOC – stated that they believe that the revised parameters set out in PDFH 5.1 are appropriate, and that Schedule 8 should be set on the basis of these revised parameters for LSE commuting flows. One TOC stated that the PDFH 5.1 parameters implied Schedule 8 payment rates which seem excessive. As noted above, DfT and Transport Scotland argued that payment rates across the board – not just for LSE commuting – should only be increased for passenger growth and fare increases above RPI. GB Railfreight supported

¹ In practice, as shown in Table 1, the Lateness Multipliers for London commuting flows in PDFH 5.1 are in any event unchanged from those used in 2005.

Network Rail's proposal. A summary of all the responses is contained in the Annex to this letter.

The PDFH framework

A recurring theme among TOCs opposing our proposal was that they did not consider that it would be appropriate to deviate from the PDFH approach. Stakeholders stated that the PDFH is an industry-agreed approach and that its recommendations were evidence-based and arrived at by independent parties. TOCs considered that the latest version of the PDFH offered the appropriate source from which to draw delay multipliers and GJT elasticities.

We fully understand this position. We would stress, however, that our proposal was not based on whether the parameters in the PDFH were 'right' or 'wrong'. In fact, in our consultation letter, we stated that it was 'unlikely that this [PDFH 5.1 parameters that were 'too high'] could account for more than a modest proportion of the gap'.

Rather, we contended that the explanation for much of the 'gap' may not lie with the lateness multipliers or GJT elasticities *per se*, but in other parts of the PDFH framework, which have not been taken into account in recalibrating Schedule 8 for CP5. Indeed, the intention of our proposal is to follow the PDFH **more closely**, by seeking to 'approximate' certain aspects of PDFH which are not formally captured by Schedule 8.

In particular, in our May letter we suggested that the following factors could explain part of the 'gap':

- Re-distribution effects;
- Time lags; and
- Crowding.

We recognised that, to the extent that re-distribution effects are 'responsible' for the gap, it would not be appropriate to 'adjust' Schedule 8 payment rates. However, insofar as time-lags and crowding underpin the 'gap', we stated that it would be appropriate to make adjustments for purposes of 'discounting' future cashflows and the 'moderating' effect of crowding. **We would emphasise that the PDFH explicitly recognises the importance of these factors, but these factors are not taken into account in recalibrating Schedule 8. Our proposal is actually to follow the PDFH guidelines more closely, by seeking to recognise certain factors contained in the PDFH framework (crowding and time-lags) that are currently omitted from the Schedule 8 framework.**

Our proposal to use current – i.e. CP4 – PDFH parameters as the basis for calibrating Schedule 8 payment rates for CP5 is **a pragmatic solution intended to approximate the effect of the omission of these factors in the calibration of Schedule 8**, given that the timescales of PR13 are unlikely to allow a full analysis to evaluate the impacts of these omitted factors.

Specific issues

Stakeholders made a number of very helpful points in responding to the consultation. We consider each of these, below.

Reliance on Hatfield

Some stakeholders stated that Network Rail's position relied too heavily on its 'back-casting' analysis of performance around Hatfield and its aftermath. Some TOCs, in particular, stressed that this was a unique event, and that it would not be appropriate to infer the relationship between performance and revenue on the back of this experience. It was noted that Hatfield represented a 'large change', whilst the elasticity approach explicitly relates to 'small changes'.

We understand this concern, and we discussed it extensively at the workshop held in May. However, we do not believe that the case relies on the Hatfield incident, or any other particular 'event'. We would stress two points.

Firstly, our principal source of evidence for questioning the appropriateness of using GJT elasticities and lateness multipliers **alone**, is not the back-casting exercise but rather, the body of formal empirical research which suggests that the relationship between performance and revenue for LSE commuting is highly 'inelastic'. As we stressed in our letter, of the three studies that have directly examined the relationship between performance and demand for LSE commuting examined as part of the PDFH review:

- two² were unable to find a statistically significant effect; and
- the third³ found that the response of demand to performance was negligible (around 10 per cent of the response that would be implied by the PDFH 5.1 lateness multipliers and GJT elasticities).

Secondly, whilst our back-casting exercise used the period immediately prior to Hatfield as the 'base-year', in no way do the results apply uniquely to performance reductions and improvements following Hatfield. By way of example, by 2005-06, PPM for peak demand into Central London had recovered to its pre-Hatfield level. Between 2005-06 and 2008-09 (i.e. up to the beginning of the recession, from which time demand responses have become very difficult to predict), actual demand grew by circa 10 per cent. The PDFH 5.1 parameters – without appropriate adjustments for crowding and time lags – imply growth of at least double this amount⁴.

We note that no response provided any examples of instances where London commuting demand has responded to the degree implied by the PDFH GJT elasticities and delay multipliers **taken in isolation**.

Detailed analysis of other market segments

Some respondents suggested that further analysis was required in relation to other market segments – for example, the back-casting work only examined peak demand. We appreciate this point, and as emphasised at the workshop, agree that our back-casting work does not tell – and was not intended to tell – a complete story.

² MVA (2008), Arup / OXERA (2010)

³ SDG (2003)

⁴ This takes account of changes to Central London employment growth and fares increases.

As emphasised above, however, the chief source of evidence for our proposal was not the back-casting work, but rather the fact that **all** empirical research of which we are aware pertaining to LSE commuting elasticities suggests that the relationship between performance and demand for LSE commuting is weak, at best.

Impact of crowding

Some stakeholders suggested that Network Rail’s submission that crowding will not dampen demand is ‘flawed’. It was argued that enhancement schemes such as Thameslink and Crossrail will provide significant additional capacity which will allow demand to increase in line with the elasticities implied by PDFH 5.1.

We agree that enhancements provide ‘room to grow’ and that enhancements will dampen – and in some cases remove – the impact of crowding. This point was discussed in our consultation document. However, it should be borne in mind that even the most far-reaching enhancement schemes – notably Thameslink and Crossrail – affect a relatively modest portion of the demand base being considered. Furthermore, both Crossrail and Thameslink are not planned to commence services until close to the end of CP5, so that crowding will continue to be an important feature – even in markets that these enhancements will ultimately serve – for the bulk of the control period.

Our proposal

We have reviewed the responses of stakeholders and considered these representations carefully. Whilst a number of interesting and helpful points have been raised, we have not been persuaded by the representations against our proposal. We therefore continue to believe that the proposal we made in May 2013 is the appropriate one.

In particular, we propose that, for calculating CP5 Schedule 8 payment rates for London commuting flows, the lateness multipliers and GJT elasticities should not be taken from PDFH 5.1, but should remain unchanged from those used in 2005 to calculate the current rates⁵.

The parameters included in PDFH 5.1, together with our proposed parameters for purposes of Schedule 8 calibration for CP5 for London commuting flows, are shown in Table 1, below.

Table 1 - Proposed parameters for London commuting

	PDFH 5.1		Network Rail proposed	
	GJT elasticities	LMs	GJT elasticities	LMs
Within Greater London	-0.9	2.5	-0.8	2.5
South East to/from London	-1.25	2.5	-0.8 / -0.6 ⁶	2.5
Rest of Country to/from London	-1.35	2.5	-0.6	2.5

As we advised in our original letter, we regard this proposal as a pragmatic way of ensuring that Schedule 8 provides a more accurate picture of revenue effects of performance, without

⁵ In practice, as shown in Table 1, the Lateness Multipliers for London commuting flows in PDFH 5.1 are in any event unchanged from those used in 2005.
⁶ A figure of -0.8 was used in 2004-05 for ‘London inners’ (i.e. services operating within the M25, in general) and a figure of -0.6 for ‘London outers’ (i.e. services operating from within the ‘inner’ zone, to further outside London).

formally introducing crowding, time-lag and other effects into the Schedule 8 calibration. We have formed this view on the basis that:

- Using this approach would provide CP5 Schedule 8 payment rates that **imply a closer 'match' with the empirical evidence** (particularly the evidence set out in the independent research cited earlier); and
- We have **not received any arguments or evidence** from stakeholders that conflicts with this empirical evidence or our experience in CP4 to date.

4. Conclusion

We believe that the exercise to consult on Schedule 8 payment rates for LSE commuting has been a fruitful one, and we are grateful for all responses received.

On a general level, it is clear from the responses of funders (DfT and Transport Scotland) that some unease exists in relation to PDFH 5.1, and in particular its application to Schedule 8 payment rates for CP5.

We recognise some of the issues emphasised by DfT and Transport Scotland. Moreover, we are deeply concerned about ORR's proposal, set out in its draft determination, to 'fracture' Schedule 8 and the Capacity Charge. We are planning to discuss the issue of Schedule 8 payment rates and the proposal to misalign Capacity Charges and Schedule 8 with operators, shortly. We will set out our views more fully following these discussions.

If ORR does decide to set CP5 Schedule 8 payment rates on the basis of the PDFH 5.1 parameters generally, we continue to believe that it would be appropriate for ORR to set payment rates for London commuting flows on the basis of those used in 2005 to calculate the current rates.

We would like to take this opportunity to thank you for considering this matter. We look forward to hearing your decision on this matter over the course of the summer.

Yours sincerely

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Annex – summary of consultees' responses

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