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Schedule 8 compensation payment rates in CP5

13 December 2012

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Workshop purpose

Objectives of Schedule 8

The primary role of Schedule 8 is:

- To compensate train operators for the financial impact of service disruption attributable to Network Rail or other train operators. This reduces the level of risk faced by train operators and therefore helps reduce franchise costs.

By doing this, it also:

- Helps align financial incentives between Network Rail and train operators, so the impact of service disruption on revenue and/ or costs is incurred by the organisation that the disruption is attributable to, rather than the train operator who faces the disruption.

- Provides signals to Network Rail on the impact of service disruption on train operators costs and revenues to help drive their decision making, for example in relation to investment prioritisation and possessions management.

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Background

- The exercise to recalibrate Schedule 8 compensation payment rates (and benchmarks) has recently started.
- Left unchecked, this mechanical process could give rise to significantly higher payment rates for CP5 as a result of increased passenger revenue.

$$\text{Marginal Revenue Effect} = \frac{R\ D\ E}{T}$$

operator revenue (R)

delay multiplier (D)

elasticity of demand with respect to the generalised journey time (E)

generalised journey time (T)

- Typically, and assuming other parameters stay the same, the increase is likely to be of the order of 30% - 40%.

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Objectives of this workshop

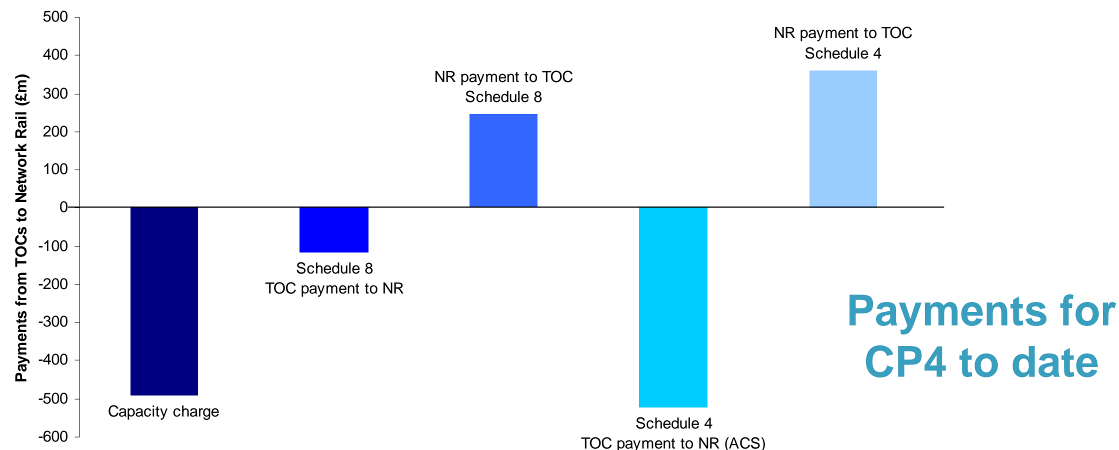
- Network Rail does not see the revenue-performance relationship directly.
- Therefore, we are seeking input from TOC colleagues around what changes in Schedule 8 payment rates are needed to ensure that payment rates are 'right' in CP5.
- We are keen to hear the views of TOC colleagues about whether a 'mechanical' uplift for revenue is appropriate.

What we're not considering at this workshop

•ORR has investigated whether Schedule 8 rates should be set at a level below 100% of full compensation for lost revenue. We support ORR's position that rates should be kept at 100% of compensation.
•However, this is not the issue we want to consider today.
•Instead, we want to consider whether an increase in Schedule 8 payment rates to reflect revenue growth will maintain compensation at 100% of the revenue impact of performance.

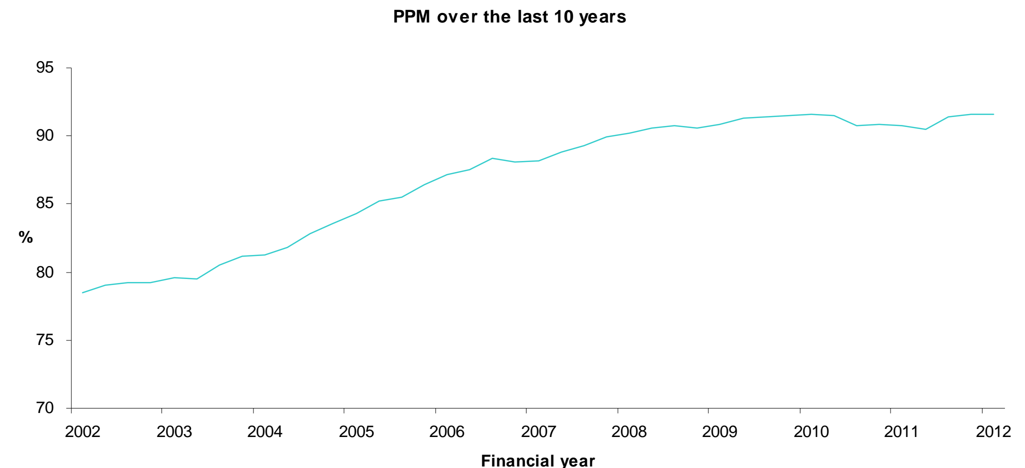
Why is this an issue?

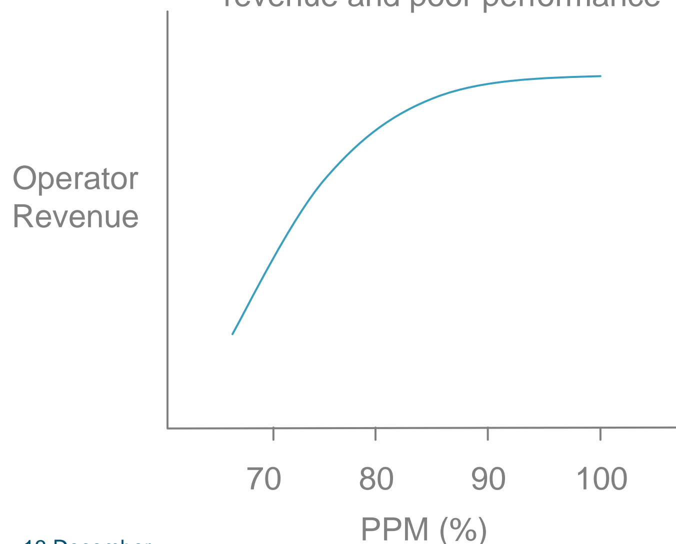
- Over £100m changed hands through Schedule 8 in the latest financial year.
- Moreover, Schedule 8 payment rates drive Schedule 4 compensation rates and Access Charge Supplements, as well as the Capacity Charge paid by train operators.
- In aggregate, and at current Schedule 8 payment rates, in excess of £500m per annum of industry financial flows are driven by Schedule 8 payment rates.
- In CP4 to date, the two largest flows, Capacity Charges and Schedule 4 ACS, have involved a transfer from TOCs to Network Rail.



*Why is this an issue **now**?*

- Over the past decade, performance has improved significantly – the railway now enjoys unprecedented levels of PPM.





- It is possible that that the relationship between performance and revenue becomes less sensitive as performance increases, as shown by the diagram opposite.

- As such, there is a question as to whether uplifting for revenue (and assuming a straight line) is appropriate.

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Update on discussion at RDG subgroup

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Update on discussion at RDG subgroup

- Network Rail sought views on whether a mechanical process of recalibration of Schedule 8 payment rates for CP5 was appropriate.
- Network Rail noted that higher payment rates could increase financial risk to train operators and Network Rail.
- TOC representatives emphasised that Schedule 8 provides an important hedging mechanism.
- RFOA emphasised that an increase in Schedule 8 payment rates could increase the risk of running some freight services to prohibitive levels.
- TOCs present believed that it would be appropriate for rates to be uplifted to reflect increased revenue.

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The importance of getting payment rates ‘right’

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The importance of getting payment rates 'right'

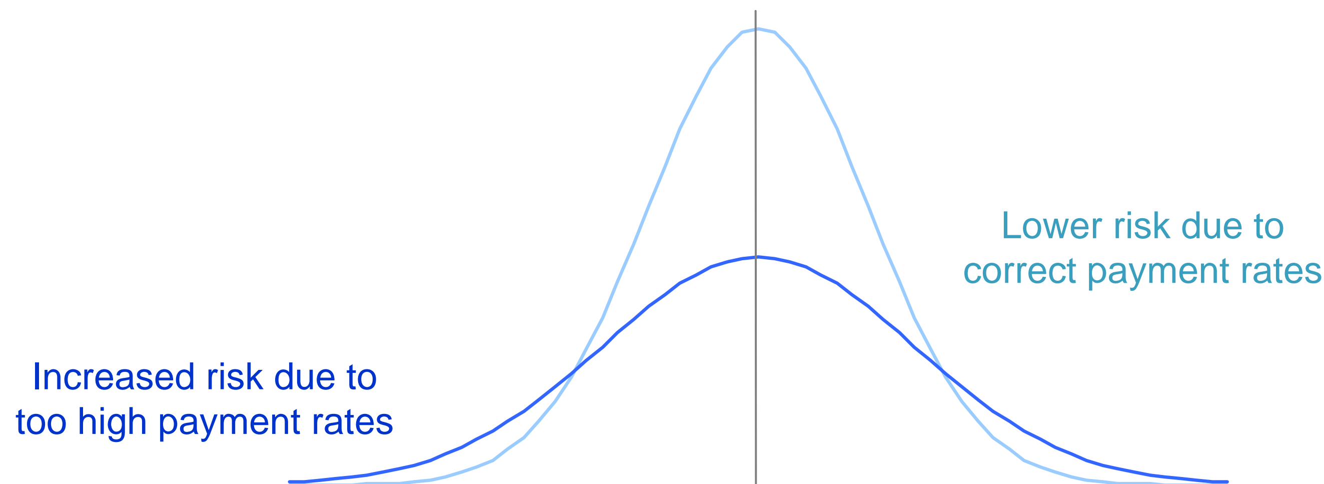
Getting payment rates right is important for a number of reasons:

- Mitigating financial risk;
- Supporting collaborative working;
- Avoiding industry reputational risk;
- Avoiding perverse incentives; and
- Avoiding adverse impacts on freight services.

We consider each of these in turn.

Financial risk

- Schedule 8 is designed to be financially neutral on average.
- If payment rates are set appropriately, it provides a “hedge” against performance risk.
- If rates are set too high (or too low) this hedging effect is undermined.
- This greater volatility will mean that both operators and Network Rail face increased risk.
- Increased risk means that greater contingencies have to be maintained by operators, reducing investment and affecting operators’ and Network Rail’s bottom line.



Financial risk – the regional component

- In CP5, we expect to meet our regulatory targets.
- Moreover, it is likely that on certain parts of the network and in certain years, Network Rail will exceed its Schedule 8 benchmarks.
- Network Rail is outperforming on some parts of the network today.
- For operators where Network Rail ‘beats’ its benchmarks, if payment rates are set too high, the increased farebox revenue may not be sufficient to cover Schedule 8 payments to Network Rail.

Financial risk – the temporal component

- The impact of performance on demand and revenue takes time to materialise – perhaps several years.
- Schedule 8 payments occur immediately however.
- In instances of Network Rail outperformance, TOCs may pay Network Rail despite fairbox gains not being realised for some time (the reverse also being true).
- This could give rise to a misalignment in cashflow that would be exacerbated in if payment rates were set at excessively high levels.

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Undermining collaborative working

- Incorrect Schedule 8 payment rates could distort incentives for the industry to work collaboratively.

- For example, if Network Rail's performance was above target, the payment **to** Network Rail **by** operators would exceed operators' increased revenue due to good performance.

- As such, operators would be 'penalised' for good Network Rail performance. Operators may, then, prefer lower PPM.

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Industry reputational risk

- The Railway industry is under ever-increasing public scrutiny, with Schedule 8 payments drawing particular attention recently.

"Train operators cash in on delays"
The Telegraph

"Franchises claim huge sums from Network Rail for delays – so where does all the cash go?"
The Independent

"Train operators are pocketing millions of pounds in compensation for late running trains at passengers' expense"
The Telegraph

"The great train robbery? How rail firms make millions from running late"
The Independent

- Further increases could be detrimental to the reputation of the industry.

- We will be publishing Schedule 8 payments by TOC in the New Year as part of our transparency drive. This will strengthen the need to get payment rates 'right' in order to guard against collective reputational risk.

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Perverse incentives

- Excessively high payment rates could incentivise excessive risk aversion for Network Rail in relation to performance.
- As performance and efficiency involve a trade-off, excessively high rates could lead to Network Rail attaching a disproportionately large weight to performance at the expense of efficiency.
- In CP4, this did not directly affect operators.
- In CP5, with operators exposed to Network Rail's efficiencies via REBS, this could have an adverse impact on operators' profits.

The impact on freight

- The impact of incorrect passenger Schedule 8 payment rates will not be confined to Network Rail and passenger operators.

- Higher passenger Schedule 8 payment rates will feed through to the freight regime.

- If rates are set ‘too high’, the increased risk could drive freight services off the network artificially.

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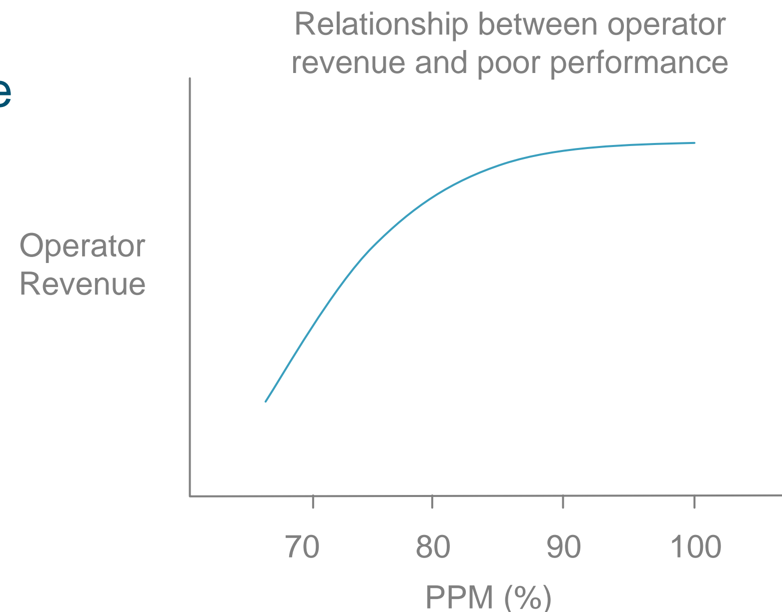
Views on the ‘right’ levels of payment rates in CP5

Questions

- Do TOCs consider that current Schedule 8 rates typically under-compensates for lost revenue over the long term?
- Do TOCs believe that increasing payment rates in line with revenue will ensure that payment rates are 'right' in CP5?
- If Network Rail outperforms its benchmarks, will higher payments to Network Rail be justified by increased farebox revenue?
- Do TOCs believe that the revenue-performance relationship stays the same as performance improves?
- Is there a delay before customer behaviour 'catches up' with PPM?
- What is the likely impact on FOCs of excessively high payment rates?



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Conclusions

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Conclusions

- The regime will always be subject to ‘swings and roundabouts’, and it is important to recognise this in the context of higher rates.
- The regime is a ‘two-way street’:
  - Increased payment rates will mean larger TOC payments to Network Rail in areas where Network Rail outperforms.
  - TOCs should be comfortable with this.
- The reputational risk to the industry should not be ignored, and we should work together to promote understanding of the regime and avoid criticism of it.
- We encourage the industry to engage closely with the recalibration to ensure that payment rates reflect local revenue effects, and benchmarks reflect expected performance in CP5.