

As part of the 2008 Periodic Review, ORR asked the Industry Steering Group (economic and contractual framework) to review the arrangements for compensating train operators for the effects of disruptive possessions, covering both Schedule 4 and Part G of the Network Code.

The following recommendations were made to us by the industry in January 2008.

## **Periodic Review 2008:**

# **Recommendation to ORR on changes to the regime for compensating disruptive possessions**

**January 2008**

**Published by the Schedule 4 policy group  
established by the Industry Steering Group  
(economic and contractual framework)**

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*Other annexes to follow:*

*Proposed legal drafting for passenger Schedule 4*

*Proposed changes to Part G of the Network Code*

## **Executive Summary**

The efficient planning of work to maintain, renew and enhance the railway is important for all users of the network. In planning its engineering work efficiently, Network Rail takes into account the impact of disruption on passengers and freight users and, in doing so, the cost of paying compensation to train operators for the effects of disruptive possessions.

Operators will incur costs and losses when disruptive possessions are taken, and it is important that the compensation regime for dealing with these does not introduce distortions. It is also important for Network Rail to be provided with clear price signals to reflect the level of disruption associated with the work. The existing compensation arrangements for the effects of disruptive possessions in Schedule 4 of track access agreements and the Network Code currently provide a number of different mechanisms for doing this. Whilst the current arrangements have strengths, over recent years the industry has identified a number of concerns about inconsistency, accuracy and the boundaries between the existing mechanisms, in particular the current differentiation between how compensation for maintenance, renewal and enhancement is treated.

ORR asked the industry in January 2007 to consider possible improvements to the existing provisions with the aims of achieving consistency, simplicity, transparency and incentivising Network Rail. It asked the industry to make a proposal such that all compensation for possessions is made through Schedule 4 of a track access agreement (or its freight equivalent) to the exclusion of Part G of the Network Code, with the proposal striking the appropriate balance between accuracy and efficiency of compensation mechanisms.

The Industry Steering Group for the economic and contractual framework (ISG) has carried out a programme of work to address ORR's remit, involving wider industry parties in this work, through debates, workshops and a formal consultation in September 2007.

ISG now presents a recommendation to ORR, which it believes addresses the original remit, reflecting that ISG fully supports, and has been guided by, ORR's own objectives of consistency, simplicity, transparency, fair compensation and incentivising Network Rail. Furthermore, ISG has endeavoured to strike the appropriate balance between accuracy and efficiency.

ISG believes that its proposed changes to possession compensation mechanisms can be incorporated into the contractual framework such that all compensation for possessions can be made through Schedule 4 of a track access agreement (or its freight equivalent) to the exclusion of Part G of the Network Code.

The assumption underpinning much of the recommendation is that the type of compensation available should be a function of the scale and impact of different levels of planned disruption, rather than being dependent on the type

of work being carried out, as has often been the case in the past because of the overlap between mechanisms in the track access contracts and Part G of the Network Code.

The recommendation therefore contains, as one of its most significant features, proposed classifications of thresholds/boundaries, which trigger different treatment of compensation:

- for franchised passenger operators, a tiered structure has been developed, which is based on formulaic compensation as far as possible (introducing a new liquidated sums regime for compensating costs, as well as continuing the existing revenue-loss regime) but which allows for the possibility for compensation to be calculated on a bespoke basis for revenue and/or costs in cases where disruption exceeds proposed thresholds of planned disruption;
- open access passenger operators would automatically be entitled to bespoke compensation in cases when planned disruption exceeds the highest threshold, with an option to participate in the more comprehensive regime subject to payment of an Access Charge Supplement (ACS), as paid by franchised passenger operators for the same protection;
- for freight operators, it is also envisaged that additional compensation provisions will exist where thresholds defined by extreme levels of planned disruption are breached (in the case of possessions advised before T-12, as it is proposed that the existing provisions after T-12 remain unchanged).

ISG consulted with the industry formally in September 2007 on its emerging views, and believes that the responses demonstrated the broad alignment of the industry in its concerns about current arrangements and proposed changes. It considers that these proposals recognise the industry's concerns and that, in addressing them, the proposals represent the right way forward for the industry.

## **1. Introduction**

### **Background**

1.1 ORR wrote to the Industry Steering Group on the economic and contractual framework (ISG) in January 2007 and stated:

“We understand from discussions with Network Rail and train operators that the current compensation mechanisms for possessions are not working as effectively as they should, in particular due to:

- (a) issues around the boundaries between Schedule 4 and Part G;
- (b) an inconsistent approach to compensating train operators for the effects of possessions;
- (c) concerns over the accuracy of compensation arrangements and the resulting economic signals;
- (d) a lack of transparency in the Part G and Schedule 4 process; and
- (e) unnecessarily high transaction costs.”

1.2 ORR included in its letter of January 2007 the following remit to the industry for a review of the current mechanisms:

- (a) all compensation for possessions should be made through Schedule 4 of a Track Access Agreement (or its freight equivalent) to the exclusion of Part G;
- (b) a consistent approach should be taken for compensation for possessions for differing purposes i.e. there should be no differentiation between a possession taken for a renewal or an enhancement. Differentiation may however be introduced to reflect the scale and impact of a possession or number of different possessions if this is considered appropriate. Differentiation may lead to different rates and/or approaches to compensation;
- (c) transaction costs should be minimised;
- (d) Network Rail should be incentivised, where possible, to manage the use of possessions efficiently and effectively;
- (e) operators should receive “fair” compensation for the restriction on contractual rights if these are affected by a possession. A balance should be struck between accuracy and the efficiency of compensation mechanisms;

- (f) a right of appeal should be retained to enable train operators and Network Rail to seek redress if compensation is disputed;
  - (g) transparency of costs / benefits to be paid should be established, where possible, so that the risks and impact of disruption caused by possessions can be anticipated; and
  - (h) there should be a consistent approach for paying compensation to franchised and non-franchised passenger operators and freight operators unless there is a compelling case to take a different approach.
- 1.3 In its covering letter to the above remit, the ORR also noted the need to take account in making changes to possessions compensation regime of any changes to risk profiles, the application of Clause 18.1/Schedule 9 provisions in the franchise agreements of franchised passenger operators and any other relevant factors. The remit stated that ORR expected ISG to consult on draft proposals by the end of September 2007, with recommendations made to ORR by the end of January 2008.

### **Method of work**

- 1.4 ISG established a Schedule 4 policy group to consider the matters set out in ORR's remit. The policy group is a cross-industry body which has met regularly since February 2007, with attendees from:
- Passenger operators
  - Freight operators
  - Network Rail
  - ATOC
  - Department for Transport
  - Transport Scotland
  - Office of Rail Regulation (as observer and secretariat)
- 1.5 This policy group has defined and specified the work it considers necessary to support this review, engaging external consultants where appropriate.
- 1.6 Broadly speaking, the policy group developed this work within three distinct workstreams to address the areas where it believed that the regime would benefit from analysis. In each case, one of the main



areas of focus was on considering possible thresholds at which the benefits of a formulaic approach might be outweighed by the benefits of negotiating compensation on a bespoke basis.

- Compensation to passenger operators for revenue loss
- Compensation to passenger operators for costs
- Compensation to freight operators

1.7 The first two workstreams were supported by consultants jointly appointed by ATOC, Network Rail and ORR, although they involved many conversations directly with passenger operators in the course of the analysis. Passenger operators and Network Rail provided data directly to the consultants in both cases.

1.8 As the work developed, it became necessary to convene a separate freight group, where the work has been carried out jointly between freight operators, Network Rail and ORR.

1.9 In the later stage of the passenger work, it also became necessary to schedule a separate legal drafting sub-group in parallel with the policy group meetings, to set out how any proposed changes would be incorporated accurately into the track access contracts and Part G of the Network Code.

### **Industry involvement**

1.10 The policy group published, through ISG, a formal industry consultation at the end of September 2007, which prompted further contributions from a wider set of industry stakeholders

**Table 1.1: Respondents to the September consultation paper**

ATOC	Network Rail (NR)
Arriva Trains Wales (ATW)	Northern Rail
DfT	ORR
EWS	South West Trains (SWT)
First Group	TfL
Freight Transport Association (FTA)	Transport Scotland (TS)
London Midland (LM)	Virgin Trains (VTL)
National Express (NEX)	

1.11 The policy group has considered all findings from the work undertaken and initiated its own internal debates, informed by contributions from all industry parties represented and by the consultation responses. Chapter 2 of this recommendation sets out how key issues identified

through consultation responses have been taken into consideration and addressed in the final proposal.

- 1.12 In order to facilitate further industry-wide involvement in the process, the policy group has also scheduled industry workshops and briefings, hosted by Network Rail.
- In the passenger revenue workstream, all passenger operators were invited to a workshop on 9 July 2007, the purpose of which was for the external consultant Steer Davies Gleave (SDG) to present its initial findings and to provide passenger operators with an opportunity to contribute by sharing their views and concerns with the revenue loss compensation element of the regime.
  - In the passenger cost workstream, all passenger operators were invited to a briefing on 30 October 2007. Faber Maunsell (FM) presented the proposed new cost compensation mechanism, offering passenger operators the opportunity to ask questions and to understand what the implications of it might be for their businesses.
- 1.13 Freight operating companies have maintained regular direct involvement through their participation in the freight policy group.

### **Purpose and structure of this paper**

- 1.14 This document constitutes a formal recommendation from ISG to ORR, based on all the work undertaken by the policy group over the last twelve months. This consists of industry workshops and briefings, discussions at the policy group meetings, issue-specific smaller meetings involving representatives from across the industry, support and advice from external consultants, extensive analysis and contributions from all industry parties including from those at the front line of delivery within Network Rail e.g. Delivery Planning and Operational Planning, legal reviews and most importantly the industry responses to the formal consultation in the autumn of 2007.
- 1.15 ISG has not been able to reach a consensus on the timing of implementation of these changes for franchised passenger operators, but instead sets out the arguments presented for two possible options, and asks ORR to consider this further. This is covered in Chapter 5.
- 1.16 On the issue of Sustained Planned Disruption (see discussion in Chapter 3), ISG has agreed the principle that there should be two types of trigger mechanism and has agreed the high level form that they should take. However, further analysis is being carried out by the policy group to inform a final recommendation on the precise level of each trigger. ISG will write to ORR separately on this matter by the end of February 2008.

- 1.17 One further issue has become more significant late in the proceedings, namely the treatment of possession overruns. The policy group is continuing to investigate this area and consider possible solutions – ISG will also address this point when writing to ORR by the end of February 2008.
- 1.18 In the case of freight, this paper makes a recommendation on the way forward subject to the results of shadow running still being undertaken (described in Chapter 4). It sets out the emerging views of the freight group and outlines the next steps, including a remit for some further consultancy support work in collecting data which will inform the final decision.
- 1.19 The remainder of this paper is structured as follows:
- Summary of the consultation paper and the issues raised in industry responses;
  - Recommendations for the passenger regime, including description of the ongoing activities to support implementation;
  - Recommendations on the freight regime, subject to the outcome of shadow running activities; and
  - Presentation of options on implementation and timing.
- 1.20 Legal drafting for Schedule 4 of the track access contract and Part G of the Network Code has also been developed. ISG will forward this to ORR in the first week of February 2008.
- 1.21 Copies of this recommendation, and the relevant supporting reports from consultants will be available at the Network Rail website from 4 February 2008. ([www.networkrail.co.uk](http://www.networkrail.co.uk) / Resource Library / Regulatory Documents / Access Charges Review / PR2008 / Review of Possessions Compensation Regime). ISG also agrees to this documentation being published on ORR's website.

## **2. Summary of consultation issues and responses**

### **Overview of consultation issues**

- 2.1 The consultation paper of September 2007 set out ISG's emerging views on how amendments could be made to Schedule 4 of track access agreements (and additionally Schedule 8 of freight access agreements) to achieve a single compensation mechanism for disruptive possessions and how such changes could be implemented.
- 2.2 The consultation paper reflected ISG's view that compensation should reflect the scale and impact of different levels of disruption. One of the features common to the proposals for both passenger and freight operators was therefore the identification of thresholds / boundaries which trigger different treatment of compensation.
- 2.3 For franchised passenger operators, the cornerstone of the proposal was the formulation of a tiered single structure of thresholds which differentiated between the scale and impact of different levels of disruption, as described above. Following analysis of the existing formulaic approach within Schedule 4 of track access agreements for revenue loss compensation and investigation of a possible new formulaic approach for cost compensation, the tiered structure was intended to provide the possibility for compensation to be calculated either on a formulaic basis or a bespoke basis for costs and/or revenue, subject to the respective thresholds of disruption.
- 2.4 Feedback at the workshop held in July 2007 indicated that the existing Schedule 4 formula for revenue loss compensation was believed to represent an appropriate structure for formulaic compensation although some changes were proposed to the data used within the formula, such as notification factors, in order to reflect new research into the impact of disruption on passengers.
- 2.5 On the cost side, the consultation proposed a further two-month feasibility study into a liquidated sums regime for rail replacement bus costs and the cost impact of changes in train mileage, which might apply in the case of possessions below an agreed disruption threshold, if not more widely. It was envisaged that where the relevant thresholds were exceeded, there would first be a transition which would permit the recovery of Direct Costs on a similar basis to the current Significant Restriction of Use (SRoU) arrangements for a long possession and second a transition which would permit compensation to be based on actual costs and revenue losses net of benefits.
- 2.6 ISG's emerging view was that such a revised Schedule 4 would allow the removal of compensation for disruptive possessions from Part G. The consultation discussed two options for the timing and implementation of this. The intention was that a revised Schedule 4 would apply to all franchised passenger operators and that Network

Rail would be funded for this through the charging regime, options for which were also set out in the September consultation.

- 2.7 This regime was also expected to be available to open access passenger operators, who would be automatically entitled to compensation above the upper threshold for disruption but could choose whether to sign up to the formulaic components of the regime, subject to the payment of an Access Charge Supplement.
- 2.8 The proposal for compensating freight operators for the effects of disruptive possessions was also based on the concept of a different type of compensation to reflect the scale and impact of different levels of disruption. There would be no change to the existing provisions for disruptive possessions advised after T-12, but where thresholds defined by extreme levels of disruption were breached by possessions advised before T-12, additional compensation provisions would exist to capture the effects. Work was still ongoing at the time of the consultation and some shadow running was proposed.

## **Summary of consultation responses**

- 2.9 The full list of consultation questions from the September 2007 paper is set out in Annex E, but a short summary of each area is offered at the relevant point below, together with the main issues raised in responses and how this has informed the policy group's thinking. The responses can be viewed in full at [www.networkrail.co.uk](http://www.networkrail.co.uk) / Resource Library / Regulatory Documents / Access Charges Review / PR2008 / Review of Possessions Compensation Regime).
- 2.10 The conclusions reached by ISG as a result of the consultation process and subsequent consideration by the policy group are set out fully in the following chapter.

### **General questions**

- 2.11 **Consultees were invited to comment on the appropriateness of the current compensation mechanisms and whether or not the high level proposals set out in the consultation paper would represent an improvement. Consultees were also invited to suggest possible alternative approaches and identify other changes for consideration.**
- 2.12 Although accepting that much of the existing arrangement works, the consultation revealed common concerns, echoing those described in chapter 2 of the consultation document. The responses reemphasised the lack of consistency between compensation treatment for different types of work, highlighting in particular the issues around the boundaries between Schedule 4 and Part G. The shift of focus towards compensation being a function of the extent of disruption rather than

the cause was therefore broadly supported. ISG believes that these points are addressed in its recommendations.

- 2.13 Concern was also expressed, for example by London Midland, about the “price” of possessions to Network Rail under existing arrangements, with the common view among operators that they were “too cheap”. The principle of a cost formula was welcomed by respondents, as they believed that a greater recognition of industry costs would send clearer price signals and allocate risk more effectively to Network Rail. Respondents emphasised the need, however, to understand the workings of the proposed cost formula in greater detail. ISG believes that the amendments to notification discount factors and the introduction of the cost formula address the concerns about the price of possessions. The ongoing work on the cost formula, including an industry briefing and two workshops with a train operator and Network Rail has enabled satisfactory development of the detail which can now be shared more widely with industry parties.
- 2.14 Operators also highlighted the concerns resulting from Clause 18.1 / Schedule 9 of franchise agreements. ISG notes that further work will be done by the Department for Transport, Transport Scotland, ATOC and ORR to identify the main concerns and develop the principles for how they will be addressed.
- 2.15 Few significant other changes to Schedule 4 or Part G were identified which were not already being considered. Emphasis was placed by National Express and Network Rail on the questions of “netting off benefits” in Part G and by Transport Scotland on the establishment of clear dispute processes. Network Rail also requested that the provisions in Schedule 4 for compensation for Competent Authority Restrictions of Use be revisited, as these tended to create uncertainty about the amount of compensation available to operators, resulting in increased tension between the parties. All these issues are addressed in the recommendation and accompanying legal drafting.
- 2.16 Whilst supporting the proposals to remove the reliance on Part G and Major Project definitions, National Express believed that a stronger “fall-back” mechanism should exist than envisaged in the consultation proposal, to protect operators from unusually disruptive possessions. This has been discussed further in the context of the Sustained Planned Disruption threshold, and ISG now considers that satisfactory arrangements are incorporated into the recommendation.
- 2.17 Network Rail also suggested that further work might consider whether a time limit should be placed on any claim under Part G to avoid retrospective wide-ranging claims with onerous historical information requirements. Network Rail has accepted that this was a broader issue than that covered by the remit of the policy group and has requested that ISG considers this separately.

## **Revenue boundaries**

- 2.18** Comments were asked to comment on the continued use of a formula as a default approach, and whether there was any systematic under- or over-compensation in Schedule 4.
- 2.19** It also sought views on the original proposed thresholds prompting different compensation treatment of possessions, in particular for how to trigger a “series”, which would then enable bespoke arrangements to be made between the parties. ISG initially consulted on an hours-based approach to measuring a series, although provided a second option based on revenue loss as estimated by the Schedule 4 algorithm itself (an “algorithmic approach”). It invited comments on both, and also asked whether this should be measured at operator level or by Service Group.
- 2.20** All respondents agreed that the continued use of a formula was necessary for practical purposes, as long as provisions were available to agree compensation on a bespoke basis in exceptional cases.
- 2.21** The existing formula was accepted as generally “balancing out” over the long term, at least across the smaller possessions, with no systematic under or overcompensation. Respondents indicated less certainty about its ability to deal with long or repeated possessions, which might generate different levels of costs and losses. Virgin Trains felt that Schedule 4 did not sufficiently reflect long-term business recovery impact. The policy group recognised these concerns and reflected them in its ongoing consideration of thresholds / boundaries for both single possessions, ongoing disruption and of notification discount factors.
- 2.22** In terms of the thresholds at which the option would be available to agree bespoke compensation for individual possessions, respondents expressed a range of views. They were generally in favour of the duration-based approach illustrated within the proposed tiered structure, although Arriva Trains Wales, First Group and Transport for London questioned whether 120 hours as the trigger for the highest tier of compensation was already too high, preferring 100 hours or lower. The policy group reviewed all suggestions, taking into account how the inclusion or exclusion of public holidays would determine the appropriate levels.
- 2.23** ATOC and First Group preferred a revenue-based approach for setting the trigger for the highest tier of compensation, such that a significant variance between actual losses and formulaic compensation in any individual case would trigger a bespoke mechanism. The policy group was concerned that, in setting a revenue-based threshold for a single possession, an element of asymmetry would be introduced, as operators had more information at their disposal than Network Rail. The policy group also noted that the character of compensation regimes was such that the accuracy ought to be judged by the aggregate effect over time rather than on the basis of individual examples.

- 2.24 Setting 60 hours as the trigger for the “medium” tier of compensation for individual possessions did also not find universal support, as some parties, including First Group and National Express, believed it would incentivise Network Rail to continue taking large numbers of 54-hour possessions. The policy group registered the concerns, although had to balance them against the fact that 60 hours represented a continuation of the existing SRoU duration mechanism and that wherever the duration threshold were to be set, there may by implication be an incentive for Network Rail to seek possessions just below the duration threshold. However, it also noted that any such issue was likely to be greatly diminished given that formulaic cost compensation would now be available for possessions below this threshold.
- 2.25 Some parties, including Northern Rail and South West Trains, raised comments about the amplified effects of disruption at certain times or locations. The policy group accepted that there might be such instances but that this was another area where the appropriateness of a compensation regime should be judged by the aggregated effect across a wider spectrum of times and locations. Furthermore, the policy group believed that the elements of time and location are recognised in the payment rates for appropriate Service Groups (also through their subdivision into Peak and Off-Peak), and that these factors would not be as clear as possession duration for the purposes of setting thresholds.
- 2.26 The proposal for how to set a trigger for a serial level of disruption also stimulated much debate. Setting a trigger at an aggregated number of hours over several periods (as per the first option in the consultation paper) would not distinguish between times of negligible disruption and material disruption. Drawing such a distinction would be complex to operate, necessitating high transaction costs. First Group and Network Rail expressed a preference for further exploration of an “algorithmic approach” (based on formulaic revenue loss as estimated by the Schedule 4 algorithm as a % of revenue). Network Rail suggested that it could be positioned as the parallel mechanism to the Sustained Poor Performance mechanism within Schedule 8.
- 2.27 In parallel with the consultation, the policy group commissioned a further piece of work from SDG to look at the question of serial disruption in more detail and to provide a model which would illustrate the effect of setting thresholds in different ways, based either on hours across a Service Group (either location-specific or otherwise) or using an “algorithmic approach”. In both cases, the illustrations provided by the model were tested against past activity on the network. Both options picked up an encouraging number of the disruptive projects, although in practical terms the hours-based approach was considered more complex to operate. The revenue-based approach suffered from the disadvantage that triggering it was likely to be identifiable only retrospectively, as argued also by a number of respondents - although it was accepted that this was true also of the hours-based approach to some extent. The policy group considered both options further in light



of the view that, however it were to be set, its objective should be to provide a “safety net” to operators and to capture the extreme disruption caused. As a guideline, it was considered that a threshold should cover 0.5% - 1% of possessions. In the policy group’s view, the revenue based approach was considered to be most appropriate on balance.

- 2.28 ATOC and First Group expressed a concern that the trigger proposals would not work reliably to capture all situations where the template compensation arrangements might otherwise be unfair to a significant degree. They proposed a trigger based on the scale of difference between template compensation and actual costs and losses net of benefits. This was considered by the policy group. In relation to revenue compensation, it was a concern that the level of variation in the revenue formula was too great in order to reliably establish such a trigger which would not disadvantage Network Rail, because of the information asymmetry regarding revenue losses. It was however acknowledged that legitimate concerns may arise with regard to costs, and that this concern should be addressed through the introduction of a separate costs trigger.

### **Long-running Restrictions of Use**

- 2.29 Consultees were invited to comment on the treatment of long-running Restrictions of Use.**
- 2.30 This issue was largely the result of the criteria under which a Corresponding Day Timetable (CDTT) could be agreed for purposes of setting the “comparator” timetable in calculating compensation. Respondents generally agreed that this issue could be addressed by adjusting the rules by which parties could agree a CDTT, allowing them the option of choosing any suitable day. The policy group agreed with this approach and ISG has reflected it in its recommendations.

### **Possessions Compensation Guide**

- 2.31 Consultees were invited to comment on the proposal to develop a Possessions Compensation Guide to facilitate estimation and calculation of revenue losses arising from possessions**
- 2.32 Respondents cautiously supported the idea of a Guide as a starting point for informing constructive negotiations of bespoke arrangements, considering that it should be non-binding and with a change control mechanism. ISG has reflected this in its recommendations.

### **Cost boundaries**

- 2.33 Consultees were asked views on a proposed formulaic approach to cost compensation, and what the appropriate thresholds (lower and upper) might be for the applicability of such a formula. They**

**were also asked views on the definitions of the costs which could be claimed.**

- 2.34 Recognising the importance of providing clearer “price signals” to Network Rail in planning its possessions, the proposed formulaic approach to cost compensation was welcomed in principle, although almost all respondents emphasised the need for more detail. South West Trains believed that all compensation should be based on actuals, reducing transaction costs. The policy group agreed with the majority that a formulaic approach was more appropriate, and that the transaction costs associated with the inevitable need for parties to review the response to every possession would be considerable.
- 2.35 Subject to practicability considerations, respondents felt strongly that cost compensation should be available for all possessions, not just for those above a certain minimum duration, particularly as the evidence suggested that the formula was more accurate for shorter possessions. The policy group agreed that this would be the preferred approach.
- 2.36 Notwithstanding earlier comments on the suitability of the proposed levels of any upper thresholds, respondents generally agreed that it was helpful for a bespoke option to be available at higher levels of disruption, although the formulaic approach should remain the default option. Furthermore, they also agreed that the definition of “Direct Costs” for the “medium” tier of disruption was appropriate, replicating the existing SRoU duration provisions, and that the “all costs” definition was equally appropriate for the highest tier of disruption.
- 2.37 Whilst in line with the tiered structure approach, Virgin Trains suggested alternative definitions which incorporated different reopener thresholds for each type of possession. The policy group considered this to contain too many variables, which would risk confusion and lack of clarity among users.

**Implementation and development of the cost formula**

- 2.38 **Consultees were asked to comment on the specifics of the proposed approach to use ‘Estimated Bus Miles’ to calculate rail replacement bus costs, particularly its practicability and proposed implementation, as well as on the parallel mechanism to calculate costs or savings resulting from changes in train mileage.**
- 2.39 A briefing was scheduled early in the consultation process for allowing all industry parties the opportunity to ask questions and to identify any issues which FM would need to address in continuing the analysis and formulating a more detailed proposal on how this might be implemented.
- 2.40 In the formal responses, parties welcomed the work carried out to date on the bus cost formula, although looked forward to finding out more detail. A number of issues were raised about the formula needing to take into account regional differences such as network topography (e.g. availability of alternative routes in remote or rural areas, raised by

Arriva Trains Wales), access to stations, size of train (raised by London Midland and National Express) or times of the day/week. The policy group considered these issues in light of the second stage of work carried out by Faber Maunsell (FM) and accepted that a differentiation between London/South East and other parts of the country would be beneficial, but that introducing a time-dependent element would be difficult to administer, particularly where a possession overlapped between two time bands, as would inevitably be a regular occurrence.

- 2.41 FM has also addressed the point of network topography and access to stations in its methodology for agreeing the reference data, also now trialled with one operator. This introduces the concept of Viable Transfer Points, which recognise the points at which it is logistically feasible to transfer passengers from train to bus and vice versa.
- 2.42 It was recognised that the size of the train would affect the number of replacement buses required. This was partly addressed by the differentiation between London/South East and other parts of the country, but also by other mitigating factors such as the access to faster and more direct roads in those parts of the country where traveller numbers were likely to be higher.
- 2.43 The proposal to incorporate a much simpler parallel mechanism to calculate the costs or savings resulting from changes in train mileage was also supported, although it was noted that, in this case, an operator-specific rate might be more appropriate, for example to reflect different vehicle types.
- 2.44 The envisaged implementation process was supported, although it was noted that this would be developed more robustly following the findings of the ongoing testing during autumn 2007.
- 2.45 In parallel with the consultation period, the policy group asked FM to carry out further work to test and refine the proposed mechanism and provide confidence to the industry. In particular it wanted FM to validate the analysis and conclusions on the EBM element, using new data from a greater sample size.
- 2.46 In conjunction with this, the policy group asked FM to investigate system issues to test the level of automation that is feasible. This would include in the short-term:
  - Development of a prototype system; and
  - Compilation of the necessary reference data for operating the system for one or more train operators, in order to assess feasibility.
- 2.47 The briefing session early in the consultation process also raised a number of issues which informed FM's work in November and December 2007, particularly in the workshops with one train operator and Network Rail to agree the reference data which would be used in the daily operation of this mechanism.

### **Process and timescales for agreeing compensation**

**2.48 Consultees were invited to comment on the proposed process and timescales by which compensation is agreed.**

2.49 With some exceptions, respondents generally envisaged that the existing process for SROUs would be equally applicable to any new arrangements, although they questioned how this might work for those possessions which fell within the “serial disruption” category (however defined), given that there might be a large number of these which were not known about until after the event.

2.50 Given the ongoing consideration of thresholds and moreover the definition of “serial disruption”, the policy group has addressed this issue in the light of those discussions, particularly as the legal drafting was being developed which highlighted the difficult areas.

### **Notification factors**

**2.51 Consultees were invited to comment on the proposals to revise notification discount factors, to reflect new research carried out by SDG into passenger awareness. They were asked views about the appropriate alignment of compensation with associated revenue loss, as well as whether the incentive effect on Network Rail would remain sufficient through the new proposal.**

**2.52 There were also asked for views on the possible introduction of an additional notification discount factor in between T-12 (Informed Traveller Working Timetable) and T-0.**

2.53 Respondents supported the idea of revising notification discount factors to align with passenger awareness, as long as this did not detract from the incentives on Network Rail. For this reason, preference was expressed for the option which retained significant differences between notification discount factors at each level, to increase the significance to Network Rail of moving from one step to the next. ISG has reflected this in its recommendation.

2.54 The introduction of an intermediate category in between T-12 and T-0 was rejected by most respondents, on the basis that it would dilute Network Rail’s incentive to meet its T-12 obligations, sending the wrong signals to Network Rail’s own planning teams. Arriva Trains Wales and Northern Rail did support this, citing the benefit of an incentive to Network Rail even where T-12 had been missed. The policy group accepted the validity of both views, but on balance, and also taking into account the practicalities of introducing a further notification discount factor, decided not to pursue this option.

### **Implementation issues for franchised passenger operators**

- 2.55 Consultees were asked to comment on issues surrounding Clause 18.1 / Schedule 9 of the franchise agreement, particularly on the “no net loss / no net gain” principle, as well as to comment on their preferred approach to the timing of implementation.**
- 2.56 A number of issues were raised on potentially difficult areas, particularly emphasising the concern that the classification of Network Change and Major Projects would remain an issue for operators and Department for Transport / Transport Scotland to regularly resolve, even if they no longer played a role in the compensation paid to operators by Network Rail.
- 2.57 This first issue informed the responses to the question on parties’ preferred timing of implementation, although not in a consistent way. Respondents were split almost equally in number in their preferences for either a phased implementation or an immediate implementation at the beginning of CP4. Relevant issues (although not necessarily resulting in identical conclusions) included the risk profiles of operators, the need for shadow running of legacy mechanisms, the avoidance of perverse incentives on Network Rail and general administrative obstacles.
- 2.58 Operators generally accepted that the “no net loss / no net gain” principle would apply, otherwise there would be an unacceptable risk allocation to operators. However, some felt that industry interests might be better served by deactivating Clause 18.1 / Schedule 9 for some changes resulting from this review, avoiding the transfer of dispute from operator and Network Rail to operator and Government department.
- 2.59 ISG was unable to reach a consensus on the timing of implementation and refers this matter to ORR, with both arguments set out fully in Chapter 5.
- 2.60 ISG also recognises the difficulties inherent in Clause 18.1 / Schedule 9 of implementing the recommendations presented in this paper, but asks ORR to note that DfT, Transport Scotland and ATOC will carry out further work to develop a way forward on these issues.

### **Compensation to open access passenger operators**

- 2.61 Consultees were invited to comment on the proposal for open access passenger operators, namely that the highest tier of compensation would be available to them automatically but that the lower tiers would be dependent on payment of an access charge supplement.**
- 2.62 Given the ongoing debate about how to classify the “serial disruption” which would trigger the highest tier of compensation, First Group emphasised the importance of the incumbent Part G provisions and reserved judgement until the details of the upper threshold were clear.

They also asked for more detail on what an access charge supplement might be.

- 2.63 Other respondents supported the approach, with National Express inferring that it may be inequitable for open access passenger operators to enjoy the same protection as those operators who were not paying for it through an access charge supplement. This also lent credence to the principle that the upper tier of disruption should be set at a level which captures only the extreme levels of disruption.
- 2.64 All views expressed informed the continuing development of the work to assess how to set a measure of serial disruption, and have been reflected in the recommendation.

### **Compensation to freight operators**

- 2.65 Consultees were invited to comment on the emerging views for determining compensation for freight operators, namely whether the proposed criteria for extreme disruption prior to T-12 would cover all the situations in which losses would occur, and whether the identification of suitable diversionary routes would add value to a compensation regime. Views were also sought on the proposed next steps of shadow running and further analysis.**
- 2.66 Recognising the need for ongoing work, respondents were supportive of the work done to date, and felt that the information gained from shadow running would be valuable in moving forward.
- 2.67 Discussion with freight operators prior to the consultation indicated that, whilst freight operators welcomed the initiative to formalise the necessary information on diversionary routes, they were uncomfortable over how appropriate it would be to combine this aspect with a compensation mechanism at this stage. It was felt that the suitability of routes would be specific to each freight operator and that incorporating this work into a compensation regime could lead to additional bureaucracy and provide more ground for disputes. Freight operators also argued that, even on an operator-specific basis, almost every route could be considered to be a “key” route for at least some of their customers and that the identification of key routes would hence be problematic.
- 2.68 The freight policy group therefore focused its attention on the “extreme disruption” concept in subsequent discussions.

### **Access Charge Supplements**

- 2.69 Consultees were invited to comment on proposed options for the future treatment of access charge supplements (ACS).**
- 2.70 Respondents expressed a general (though not unanimous) preference for a visible and transparent ACS. Historically the individual ACS payments had not always matched the actual payment received very

closely, but it was felt that there was merit in retaining a separate arrangement nevertheless, particularly if it could be accompanied by work to make individual ACS payments more cost reflective. Network Rail was encouraged to develop an improved methodology on this.

- 2.71 Network Rail argued that it was also important to be able to adjust the ACS during a control period, in order to reflect changes to Schedule 4 costs resulting from unanticipated changes in train mileage. Other respondents were also keen to restrict these changes only to those cases where there were material unforeseen changes to traffic levels (and not simply growth, which should be taken into account anyway in setting the ACS).
- 2.72 The policy group agreed with the arguments that a separate ACS is preferable and encouraged Network Rail to develop an alternative methodology to set out how this might be achieved in a more cost-reflective way. It recognised the reasoning behind Network Rail's view that the ACS should be adjustable, although also upheld the view of other respondents that adjustment should be restricted to material unforeseen changes.

### **3. Conclusions and recommendations on the regime for passenger operators**

- 3.1 This chapter sets out more fully the recommendations made by ISG to ORR, and discusses the reasons for reaching these conclusions in light of the work carried out and the contributions from across the industry.
- 3.2 ISG makes recommendations on:
- the proposed categorisation of possessions for different compensation treatment, including how to deal with serial disruption (Sustained Planned Disruption);
  - adjustments to the notification discount factors used in the calculation of compensation for revenue loss;
  - the compensation treatment of costs incurred; and
  - other structural points of Schedule 4.
- 3.3 The recommendations are supported by legal drafting, setting out how a revised Schedule 4 of the track access contract would look. This is accompanied by revised legal drafting for Part G of the Network Code. Both sets of drafting will be forwarded to ORR in the first week of February 2008.
- 3.4 ISG asks ORR to note that the revisions to Part G have been drafted in the context of changes to the possessions compensation regime for passenger operators. Given the status of the freight work, however, the freight policy group has not yet been able to consider the drafting in the context of possible changes to the possessions compensation regime for freight operators. Clearly the intention is that the same revisions would apply ultimately to all track access parties. ISG is not aware of any aspects of the revised Part G drafting which would prevent it from being equally appropriate to freight operators.
- 3.5 It is envisaged that the changes to Part G will be given effect through the Charges Review and included in Clause 18.1/Schedule 9 arrangements between DfT / Transport Scotland and franchised passenger train operators.

#### **Categorisation and thresholds – tiered structure proposal**

- 3.6 ISG concluded that a tiered structure is the correct principle to adopt, as there is general recognition across the industry that it is appropriate for there to be different types of compensation to reflect the scale and impact of different levels of disruption. The proposal in Table 3.1 takes



this into account, having incorporated some adjustments as a result of consultation responses.

**Table 3.1 Tiered structure - categorisation of possession types for single possessions**

<b>Possession Type</b>	<b>Threshold</b>	<b>Cost</b>	<b>Revenue</b>
<b>Type 3</b>	Single possession >120 hours (includes public holidays)	<p style="text-align: center;"><b>Existing Schedule 4 algorithm &amp; cost formula</b></p> <p style="text-align: center;"><b>Possibility* of costs/losses net of benefits</b> (where possible to be based on forecast actuals)</p> <p style="text-align: center;"><i>* Where either party believes that the total formulaic compensation will under or overcompensate by more than £10k</i></p>	
<b>Type 2</b>	Single possession > 60 hours <sup>1</sup> (excludes public holidays)	<p style="text-align: center;"><b>Cost formula</b></p> <p style="text-align: center;"><b>Possibility* of Direct Costs<sup>2</sup> net of benefits</b> (where possible to be based on forecast actuals)</p> <p style="text-align: center;"><i>* Where either party believes that the cost formula will under or overcompensate by more than £10k</i></p>	<b>Existing Schedule 4 algorithm</b>
<b>Type 1</b>	Any other single possession	<b>Cost formula</b>	

3.7 ISG believes that “duration of possessions” represents the clearest and most transparent way of agreeing the boundaries for individual possessions, best reflecting the actual disruptive impact on the operators and their customers. ISG has also concluded that any reference to location or time of day should not be included in the definition of Types, as this would be very operator-specific and would introduce complexity.

<sup>1</sup> (formerly SROU duration threshold)

<sup>2</sup> As defined in Schedule 4 of the track access contract

- 3.8 Table 3.1 therefore shows the recommended classification of thresholds and boundaries for different types of compensation treatment.
- 3.9 Together with Table 3.2 later in this chapter, this sets out the proposed tiered structure for the template passenger regime. This tiered structure would apply to franchised passenger operators and to those open access passenger operators who elect to participate in the full regime (the compensation for Type 3 possessions and Sustained Planned Disruption being an automatic entitlement).
- 3.10 The bottom row of Table 3.1 (Type 1 possessions) reflects the industry preference that cost compensation should be available in all cases, following a discussion over whether, for practical and pragmatic reasons, there should be a lower threshold below which cost compensation would not be given. It was feared that the introduction of a lower threshold might introduce scope for dispute and perversely increase transaction costs as both parties engage resources in “monitoring” the boundary.
- 3.11 The duration threshold for a Type 2 possession has been set at 60 hours to allow consistency and continuity with the existing duration definition of a Significant Restriction of Use. Some parties argued that the duration threshold should be set to capture the fact that Network Rail takes many 54 hour possessions. ISG believes, however, that wherever the duration threshold were to be set, there may by implication be an incentive for Network Rail to seek possessions just below the duration threshold, whilst accepting that any incentive will be diminished by the existence of formulaic cost compensation for all possessions.
- 3.12 The corresponding figure for a Type 3 possession is 120 hours. Setting it at this level is intended to ensure that Type 1 possessions over Christmas and Easter holidays do not inadvertently fall into the Type 3 category, even though they would not be Type 2s (due to the exclusion of public holidays from the Type 2 definition) and therefore, in the absence of also qualifying for what would have been a “Major Project”, would never previously have triggered the Significant Restriction of Use threshold. While this means a possession of just under a full working week would not trigger Type 3 treatment, other industry planning mechanisms are available to safeguard against increase in the use of such possessions.
- 3.13 Where changes to possession details cause the possession to occur as a different type of possession (with the timetabled services being amended as a consequence), then the legal drafting provides for compensation to be made on the basis of the latter type, with protection for any costs which have already been committed to.
- 3.14 In the case of overruns which are not reflected in any timetable, revenue loss compensation will continue to be addressed through the

Schedule 8 performance regime mechanism. As with the existing arrangements, where an amended timetable is put in place, Schedule 4 would apply. It is recognised that, as a result, in the case of unscheduled overruns, Schedule 4 may provide more compensation than Schedule 8.

- 3.15 The policy group has discussed whether any potential perverse incentive to avoid putting an amended timetable in place for an overrun, in order to avoid incurring Type 3 treatment, would be outweighed by other incentives e.g. delay minute targets. It is considering further the issue of costs associated with possession overruns, as well as other compensation issues arising from amended timetables, and ISG will write to ORR separately before the end of February 2008.

### **Sustained Planned Disruption**

- 3.16 ISG recognises that a sustained high level of planned disruption, for which single possessions do not in themselves trigger Types 2 or 3, might lead to a significant difference between actual costs/losses and formulaic compensation. For this reason the policy group considered a number of options on how to define and implement a measure of serial planned disruption, beyond which provisions exist for the agreement of bespoke compensation.
- 3.17 Having considered both options set out in the consultation document, ISG recommends that a revenue-based trigger is more appropriate than an hours-based trigger, being more effective at identifying high impact planned disruption in relation to passengers and considerably less complex to implement. The revenue-based mechanism would be triggered if, over a number of consecutive periods, the formulaic compensation relating to revenue loss as estimated by the Schedule 4 algorithm exceeded a defined percentage of Service Group / Operator revenue.
- 3.18 The policy group considered the concerns raised during and after the consultation that this approach means that the triggering of the Sustained Planned Disruption threshold is largely a retrospective activity, which may create uncertainty for train operators in planning their response to possessions, leading to inefficiency and also reduce transparency of price signals to Network Rail.
- 3.19 ISG believes that these concerns can be addressed by including a provision in the legal drafting which obliges the parties to engage in discussions about compensation where reasonably practicable, once it has been agreed or determined that Sustained Planned Disruption looks likely to occur. ISG believes that both parties have a shared incentive to work together in these cases, in the interests of securing

agreement for possessions and for mitigating costs and losses early in the planning process.

- 3.20 As noted in chapter 2 above, ISG believes that there should also be a cost trigger within the Sustained Planned Disruption mechanism, recognising the concerns which may arise with regard to costs during periods of serial disruption.
- 3.21 The trigger for the Sustained Planned Disruption threshold is expected to therefore consist of two parallel elements, see table below, and would lead to the relevant possessions being treated as if they were Type 3 possessions for compensation purposes<sup>3</sup>.

**Table 3.2 Sustained Planned Disruption threshold**

Disruption type	Threshold	Cost	Revenue
<b>Sustained Planned Disruption</b>	Revenue loss compensation > x% or y% of revenue for a Service Group / Operator <sup>4</sup> over a defined timeframe of 3 or 7 periods respectively <sup>5</sup> ;  OR  Cost compensation > £Xm or £Ym difference from actuals for the Operator over a defined timeframe of 3 or 7 periods respectively.	<b>Existing Schedule 4 algorithm &amp; cost formula</b>  <b>Possibility of costs/losses net of benefits for all possessions during defined timeframe</b> (parties will be able to agree to exclude some possessions where no adverse effect)	

3.22 ISG agrees that the aim is to capture only the most disruptive possessions (individually or cumulatively) within these thresholds, i.e. approximately 1% of all possessions. This is to try to provide for a broadly equivalent level of financial protection for disruptive possessions as that currently offered by Part G of the Network Code and the Major Project Notice element of the definition of Significant Restriction of Use in Schedule 4 of the track access contract.

<sup>3</sup> To provide clarity to those using the contract, they will not be called “Type 3” possessions. Instead, the legal drafting provides separately for the appropriate compensation treatment.

<sup>4</sup> For both the revenue and the cost trigger, the decision has yet to be made on whether this would be by Service Group or Operator.

<sup>5</sup> The intention is that there will be a 3-period **and** a 7-period threshold in both the algorithmic approach and the cost approach. The threshold would be triggered if **either** were exceeded.

Evidence will be provided to support the proposed figures, using possessions compensation data (see below).

- 3.23 Network Rail has provided initial analysis to show possible points at which the thresholds might be set for the (revenue) algorithmic trigger. The policy group expects that it will be broadly in the range of 10%-20% by Service Group, with the threshold for 3-periods higher than the threshold for 7-periods, so as not to be triggered by smaller fluctuations.
- 3.24 Further analysis produced in February will demonstrate how a number of possible thresholds would have played out in practice in 2005/06 and 2006/07. The analysis will identify which significant possessions would have been captured, as well as attempting to identify any substantial planned disruption which would not have been captured. This will inform a final decision on exactly where the triggers should be set.
- 3.25 Similarly, the policy group is carrying out additional analysis to inform a decision on the points at which the thresholds might be set for the cost trigger. This would be set at the Operator level and would also work over a 3-period and 7-period timeframe. The options being explored are:
- A single £ figure, applicable to all operators;
  - A single £ figure, applicable to all operators, unless the operator is a “small operator” (to be defined) in which case it would be a figure based on train-km or vehicle-km; or
  - A figure based on train-km or vehicle-km in all cases.
- 3.26 By setting the measure over 3 and 7 periods, the Sustained Planned Disruption mechanism will also pick up different methods of disruptive working.
- 3.27 Legal drafting sets out more fully the timescales to be followed by each party in advising the other of a triggering of the Sustained Planned Disruption mechanism, and in agreeing compensation. This is subject also to the mechanism discussed above to enable parties to engage in discussions in advance.
- 3.28 The policy group will also consider further whether a “trailing mechanism” is required, such that once breached, the Sustained Planned Disruption provisions remain in force until disruption has dropped below a lower threshold.
- 3.29 ISG will write to ORR by the end of February to confirm its recommendation on all aspects of the Sustained Planned Disruption mechanism.

## **Compensation for revenue loss**

- 3.30 Through the formal consultation, the policy group identified general industry agreement that the default approach to revenue loss compensation should be formula based, and that the formula itself is generally fit for purpose, leading neither to systematic under- nor over-compensation. No changes were suggested to the formula, other than to notification discount factors.
- 3.31 ISG therefore recommends that revenue loss compensation should generally be formula-based by default because it believes that:
- whilst the answer may over predict in some cases and under predict in others, a formulaic approach has low transaction costs and appears to give realistic results in most cases; and
  - a more predictable level of compensation incentivises Network Rail by providing the right price signals for it to plan its possessions effectively. This would be the scenario in possessions **Types 1-2**.
- 3.32 There is, however, an occasional need for a bespoke approach, recognised by the proposals above on the tiered structure and the Sustained Planned Disruption threshold. Both these mechanisms recognise that for large possessions or “serial disruption”, any under-prediction of losses may be significant and there should be the possibility for operators to claim costs and losses net of benefits.<sup>6</sup> In practical terms it is likely that these would be based on either modelling using MOIRA, or on analysis of outturn actual revenue. This is the rationale behind proposing the **Type 3** possession.

## **Notification discount factors**

- 3.33 Whilst no change is proposed to the revenue loss compensation formula, ISG recommends implementing changes to notification discount factors, in order to better reflect passenger awareness and thereby the actual revenue losses experienced by passenger operators.
- 3.34 ISG’s recommendation incorporates a slight adjustment to the figures initially proposed through the consultants’ study, so that the increments between the different levels of notification discount factors remain sufficiently well spaced to provide meaningful incentives for Network Rail to plan and notify its possessions before the next level of notification factor comes into effect.

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<sup>6</sup> Where “costs and losses net of benefits” is defined in the revised Schedule 4 of the track access contract as “costs, direct losses and expenses (including any loss of revenue) reasonably incurred or reasonably expected to be incurred by the Train Operator (including any increase in RoU Variable Cost but net of any benefit arising from the taking of a Restriction of Use including any decrease in RoU Variable Costs)

- 3.35 The recommendation is based on new evidence provided by SDG on passenger awareness, suggesting that not all passengers (and potential passengers) are aware of the possessions even if notified in time for inclusion in the First Working Timetable, and furthermore that the level of awareness among passengers at later stages of the timetabling process is actually higher than currently indicated by the Schedule 4 notification factors.
- 3.36 ISG believes that these revisions help Schedule 4 compensation to become more reflective of the actual impact of disruption, whilst still maintaining strong incentives for Network Rail to plan its possessions early and efficiently.

**Table 3.3 Proposed revision of notification discount factors**

<b>Illustration of notification discount factors</b>	<b>By FWTT</b>	<b>By ITWTT</b>	<b>By ATT</b>
Existing notification discount factors for a Service Group with delay multiplier 2.5	40% of MRE payable	60% of MRE payable	80% of MRE payable
Proposed new notification discount factors	55% of MRE payable	70% of MRE payable	85% of MRE payable
Existing notification discount factors for a Service Group with delay multiplier 5.1 / 6.5	19% / 15% of MRE payable	50% / 48% of MRE payable	80% / 80% of MRE payable
Proposed new notification discount factors for Service Groups with delay multipliers 5.1 / 6.5	45% of MRE payable	65% of MRE payable	85% of MRE payable

- 3.37 To illustrate the difference between the current situation and the future situation, the final proposals are set out in Table 3.3 below. The

notification factors differ according to the “delay multiplier”<sup>7</sup> used to calculate the Network Rail payment rate in Schedule 8, as follows:

- Delay Multiplier = 2.5: London & South East and Regional Service Groups (except those primarily serving airport markets)
- Delay Multiplier = 5.1: Long Distance Service Groups
- Delay Multiplier = 6.5: Service Groups primarily serving airport markets

3.38 To reflect the views of the wider industry, ISG is not pursuing the option described in the consultation paper to revise the notification discount structure, which would have brought in a fourth notification factor between T-12 and T-0, to incentivise Network Rail to notify operators of planned disruption before T-0 even when the impact of possession had not been reflected in the Informed Traveller Timetable.

3.39 The industry, including Network Rail, demonstrated a strong consensus against this proposal, citing a potential dilution of the incentive effect on Network Rail to comply with its T-12 obligations. As well as potentially sending a message that T-12 was of reduced importance, having an extra tier of notification discount factors would also reduce the size of the increments between them, and thereby reduce the incentive in each case for Network Rail to plan its possessions before the next level of notification discount factor were to come into effect.

## **Compensation for costs**

3.40 ISG believes that it is important for Network Rail to be provided with clearer price signals to reflect the level of disruption associated with work. Compensation for costs currently exists only for Significant Restrictions of Use (or for possessions associated with a Network Change).

3.41 ISG believes, therefore, that the introduction of a mechanism for cost compensation will incentivise Network Rail to plan its possessions more effectively by providing clearer price signals of the costs to the wider industry of the disruption caused by possessions.

3.42 By default, cost compensation would be calculated through the proposed cost formula (for rail replacement bus costs and the net effect on costs of changes in train mileage). It would apply in all cases up to the 60 hour duration threshold (excluding public holidays), consistent

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<sup>7</sup> The delay multiplier reflects the fact that passengers are more inconvenienced by an unscheduled delay than by a timetabled, advertised increase in journey time. For example, the delay multiplier for most London & South East, and Regional service groups, is 2.5.



with the duration threshold in the “Significant Restriction of Use” definition.

- 3.43 **Type 2** possessions occur when the 60 hour duration threshold is triggered, representing the point at which either party has the option to request that “RoU Direct Costs”<sup>8</sup> are calculated on a bespoke basis (subject to the formulaic cost compensation under or over compensating by more than £10k), on the basis that disruption becomes more significant above this level.
- 3.44 Putting the boundary at this level also helps to reduce any issues around Clause 18.1 / Schedule 9 of agreements between franchised passenger operators and DfT / Transport Scotland, as it is consistent with the existing duration threshold for SROUs.
- 3.45 For **Type 3** possessions, parties have the option to request that full costs and losses net of benefits are calculated on a bespoke basis.

#### **Estimated Bus Miles** (see also Annex A)

- 3.46 Bus costs are the most significant cost category. Faber Maunsell (FM) has developed a parameter of “Estimated Bus Miles”, which reflects that bus miles, and therefore TOC costs, are not just a function of affected route miles, but are also dependent on the availability of diversionary routes.
- 3.47 Estimated Bus Miles (EBMs) are felt to incorporate the busyness, or intensity of track use better than simply possession duration or other measures of disruption. The parameter takes into account the quantity of trains operating over the section of the network affected by the possession, the mileage affected, but also reflects, through a weighting, the actual impact on the service (see further detail below).

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<sup>8</sup> “RoU Direct Costs” defined in Schedule 4 of track access agreements as the aggregate amount of:

- (a) bus and taxi hire costs;
- (b) publicity costs;
- (c) train planning and diagramming costs; and
- (d) other costs directly related to the organisation and management of the Train Operator’s response to a Type 2 Restriction of Use, reasonably incurred by the Train Operator as a result of a Type 2 Restriction of Use, adjusted by
  - (i) adding any increase in RoU Variable Costs; and
  - (ii) deducting any decrease in RoU Variable Costs

where RoU Variable Costs are defined as “any Train Operator costs which vary as a result of a Restriction of Use arising directly from changes in train mileage including maintenance, fuel or electricity costs, the Variable Track Usage Charge and the Capacity Charge”.

**Table 3.4 Formula for Estimated Bus Miles**

<p><b>Estimated Bus Miles (EBMs)</b></p>	<p>=</p>	<p>Length of route where train services affected</p> <p style="padding-left: 40px;">x Number of trains</p> <p style="padding-left: 40px;">x Weighting</p>
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3.48 The weighting reflects the impact on the service by identifying the level of rail replacement services required for the section where train services are affected by the possession. This depends on the availability of an alternative diversionary route, or the presence of an alternative parallel operator such as LUL. This would fall into three categories:

**Table 3.5 Weighting for Estimated Bus Miles**

<p><b>Full provision</b> of bus services where all passengers travelling over the route affected by the possession must transfer to buses.</p>	<p>100% weighting</p>
<p><b>No provision</b> of bus services where all passengers use the train services which use a diversionary route, or transfer to a parallel operator such as LUL;</p>	<p>0% weighting</p>
<p><b>Partial provision</b> of bus services where some passengers use the train services which use a diversionary route, or transfer to a parallel operator, but where some buses are needed to serve intermediate stations.</p>	<p>50% weighting (with adjustment)</p>

3.49 In the case of a 50% weighting (partial provision of bus services), a further adjustment is made to reflect the percentage of trains stopping at intermediate stations.

3.50 The cost formula would work primarily on the basis of “Estimated Bus Miles” multiplied by a cost per Estimated Bus Mile (calculated by FM based on a sample set of data directly from operators on the costs associated with 150 disruptive possessions).

3.51 Recognising that the rate per Estimated Bus Mile is based on data from less than 1% of possessions on the network and not likely to be accurate in every case, the group believes that the primary benefit of the cost formula derives from the fact that it provides a greater incentive to minimise disruption. The rate per Estimated Bus Mile will differentiate only between London/South East operators and others, set at £12.38 and £8.32 per Estimated Bus Mile (2007-08 prices)

respectively and indexed consistently with the prices in the track access contract. ISG does not recommend introducing any distinction between times of days, given the inevitable and regular overlaps of many possessions between different time bands.

- 3.52 FM has now, through a trial session with one train operator and Network Rail, begun to develop exact rules on how the reference data for EBMs would be agreed. Those parties who participated in the trial have provided positive feedback, indicating that it would be relatively straightforward to carry out this work.
- 3.53 Using the findings from the pilot study, FM has provided a proposal for agreeing the reference data with all other affected operators, see Annex B. FM will facilitate the agreement of data between parties, developing best practice along the way in dealing with complex issues of route geography, so that they can be identified and resolved more easily in future cases – FM will document the process more fully for future users.

### **Changes to costs resulting from changes to train mileage**

- 3.54 Changes to an operator's train costs (e.g. fuel, maintenance, variable track access charges) would be picked up by a straightforward "train miles x cost/mile" calculation in parallel. ISG asks ORR to note that this could also lead to savings by the operator, which will be off-set against any cost liability. The cost/mile will be calculated on an operator-specific basis as part of the same process for agreeing reference data for the EBM formula.
- 3.55 Changes to an operator's other costs such as publicity or additional station staff would be picked up in Type 2 and Type 3 possessions in cases where the difference to the operator's overall costs and the formulaic compensation is greater than £10k, leading to bespoke agreement of those cost items.
- 3.56 ISG recommends the incorporation of a mechanism into Schedule 4 to allow either party to make adjustment to the data required for the cost formula, if it can demonstrate a material change in circumstances. The policy group envisages that all unit cost rates within the cost formula will be indexed annually by RPI.

### **Implementation of the cost formula**

- 3.57 From a practicability side, the cost formula requires development of the existing IT system S4CS (Schedule 4 Compensation System), and some training for Network Rail compensation teams, who will be required to carry out some manual input, owing to the geographical logic of the existing software which does not permit complete automation. More detailed understanding of resource and cost

implications is being worked on. The development of the software is expected to cost less than £500k, and the ongoing manual operation of the formula is likely to involve around three extra full-time Network Rail resources. A fully specified and costed proposal is being developed by Network Rail Information Management and Delivery Planning teams, which will support the implementation timescales of the cost formula.

- 3.58 The cost formula also requires development of contractual reference data, to be agreed upfront between operators and Network Rail before CP4. It is intended that this work will be sufficiently developed in time to inform ORR's Draft Conclusions in June 2008. Agreement of this data requires the investment of time and money in advance of CP4, but once this is completed, data would only need to be changed in cases of major redesign or remapping of routes.
- 3.59 Further detail on the envisaged process for implementation of the cost formula is offered in Annex B. This also includes training of users in advance of implementation.

## **Other issues**

### **Treatment of long-running Restrictions of Use**

- 3.60 In order to avoid a situation whereby very long-term disruption (of over, say, 2 years) can become "normalised" into the timetable and thereby no longer reflected in compensation calculations, ISG recommends that new legal drafting will allow parties to agree a bespoke Corresponding Day Timetable, for purposes of comparing timetables in the compensation calculation.

### **Transitional arrangements**

- 3.61 ISG recommends that transitional arrangements should be put in place, which allow the existing compensation arrangements for possessions to apply where the compensation itself, or the compensation methodology, has been agreed prior to the changes to the possessions compensation regime.

### **Long term benefits**

- 3.62 Currently, for Network Changes, any long term benefits can be netted off any compensation for disruption (along with any benefits from the disruption itself). However, given the proposed separation of long term costs/losses and disruptive costs/losses, ISG recommends that long term benefits should not be able to be netted off any non-formulaic compensation in Schedule 4.

### **Possessions Compensation Guide**

- 3.63 In order to support the bespoke agreement of compensation in the higher tiers of possession, particularly for revenue loss, ISG recommends the development of a non-contractual, non-binding Possessions Compensation Guide, which has no formal status in disputes.
- 3.64 This Guide would set out best practice in estimating revenue loss due to possessions (and may be informed by guidance issued in 2006 by DfT on the efficient management of possessions). It would not be obligatory for operators or Network Rail to follow such a Guide in estimating revenue loss for any particular possession. However, a Guide could enable most claims to be settled more quickly, and reduce transaction costs.
- 3.65 It is envisaged that a Guide might include advice on issues such as
- The use of MOIRA in estimating revenue loss due to possessions;
  - Adjustments that might commonly be made to MOIRA results, to better reflect specific issues arising as a result of possessions; and
  - Best practice in estimating revenue loss directly from analysis of historic revenue data; and
  - Isolating the most disruptive restrictions, with a view to appropriately focusing the bespoke compensation effort, and managing and controlling the re-opening of formulaic compensation to avoid inefficiency in the process.
- 3.66 It is proposed that a Guide might be compiled in the coming months with the input of industry experts, and in accordance with a remit approved by the policy group.

### **Clause 18.1 /Schedule 9 issues**

- 3.67 Franchised passenger train operators are subject to franchise agreement terms which make adjustments to take account of the impacts of charging reviews, including changes of the type being proposed here to Schedule 4 and Part G.
- 3.68 ISG asks ORR to note that further work will be done by DfT, Transport Scotland, and ATOC to develop a way forward on addressing issues which might arise from this area.
- 3.69 The work will depend partly on the timing of implementation - chapter 5 sets out two different options.

## **Access Charge Supplements (ACS)**

- 3.70 ISG recommends that the regime should continue to be funded by a distinct and visible ACS paid by each operator. This reflects the preferences of almost all industry parties.
- 3.71 Nevertheless, ISG recognises the industry's desire that each operator's ACS should be more cost-reflective than at present and provide parties with a more reliable price signal (the current arrangement being that Network Rail's network-wide Schedule 4 funding requirement is disaggregated to operators in proportion to the fixed charge).
- 3.72 Earlier analysis from the Interim Review in 2003 already demonstrated that Schedule 4 expenditure is driven more heavily by some types of asset investment than others. The policy group is therefore supporting Network Rail's exploration of a proposed new way forward which, in disaggregating the total Schedule 4 funding requirement to an operator-level, will take into account asset expenditure by strategic route section and hence by operator. This improved approach is also made possible by the new capabilities of Network Rail's Infrastructure Cost Model. The April SBP update will include a first estimate of the network-wide funding requirement for Schedule 4 and more detail on how the ACS disaggregation approach will work.
- 3.73 ISG recognises that mid-term adjustment of an ACS might be necessary for significant unanticipated changes in service patterns e.g. changes to quantum rights in Schedule 5, which may lead to either a reduction or an increase in an operator's ACS. The circumstances in which change may be required will however need to be kept to a minimum and established in a manner which both supports planning with a reasonable degree of certainty and, in the case of franchised operators, pass through of the charges under the relevant franchise agreement provisions relating to service change.
- 3.74 For open access passenger operators choosing to have the full Schedule 4 (see next section on open access passenger operators) an ACS would still be payable as a contribution to the cost of the overall compensation scheme.
- 3.75 Network Rail expects that the funding settlement for network-wide Schedule 4 expenditure will also need to incorporate the additional expenditure associated with the cost formula, so that Network Rail is held financially neutral to the change in the regime's mechanics. It does not consider that this should impact on the overall consideration of the HLOS / SOFA matching process (given 18.1 / Schedule 9 arrangements).

- 3.76 ISG intends that the current proposals for freight operators are designed to capture only exceptionally disruptive possessions to replace the existing provisions under Part G and on that basis does not propose that freight operators should pay an ACS.

## **Open access passenger operators**

- 3.77 In order to enable the correct incentivisation for Network Rail and to protect open access operators from more significant levels of disruption as well as to facilitate a more consistent approach across the network, ISG recommends that the revised compensation regime should also be available to open access passenger operators.
- 3.78 To provide open access passenger operators with a level of protection broadly equivalent to that currently provided for under Part G provisions<sup>9</sup>, ISG recommends that compensation for Type 3 possessions and for Sustained Planned Disruption would be available automatically to open access passenger operators.
- 3.79 However, in order to avoid discrimination between franchised passenger operators and open access passenger operators, compensation for Type 1 and 2 possessions would be available only to those open access passenger operators prepared to pay for the increased protection through an ACS.
- 3.80 In the case where an open access passenger operator decided not to pay an ACS, it would be necessary to set up a shadow regime within S4CS for a Type 1 and Type 2 formulaic compensation scheme, in order to facilitate the measurement of disruption for purposes of monitoring the Sustained Planned Disruption threshold.
- 3.81 Open access passenger operators would use the same templated legal drafting as the franchised passenger operators, but with an amendment to provide for the payment procedures for compensation to apply only to the types of possession for which they have elected to receive compensation protection.

## **Competent Authority Restrictions of Use**

- 3.82 ISG recommends the removal of the distinction between compensation for a Competent Authority RoU and a Network Rail RoU within the new Schedule 4. In future, operators will simply receive compensation from Network Rail commensurate with the level of disruption they have

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<sup>9</sup> The objective has been to try to provide for a broadly equivalent level of financial protection for disruptive possessions as that currently offered by Part G of the Network Code. It should be noted that the cost of this is reflected in Network Rail's revenue requirement.

experienced, in accordance with the structure of the regime. This will help Network Rail to secure operator agreement for possessions and reduce any risk of confusion regarding appropriate treatment of compensation.

- 3.83 The clearer set of rules in the track access contract will improve Network Rail's negotiation position with any external party causing disruption on the network ("the disrupting party"), because it will eliminate the need to have to first demonstrate to the disrupting party that it is actually a Competent Authority. Instead, the very fact that the disrupting party is, by definition, causing disruption on the network, resulting in a financial liability from Network Rail to an operator, will be sufficient to persuade it of its own financial obligations to Network Rail (subject, of course, to existing commercial agreements between the disrupting party and Network Rail).
- 3.84 This will also remove the doubt over the precise level of the financial obligation of the disrupting party to Network Rail. Currently, the concept of a "Competent Authority Rate" leaves open the possibility that it could theoretically be zero if the disrupting party were to refuse to pay.
- 3.85 In summary, the current provisions lead to time-consuming discussions with all parties on whether the disrupting party is a Competent Authority at all and then what its liability should be. ISG believes that the removal of the concept from Schedule 4 presents a clearer position to all concerned. Whilst an element of risk would remain, Network Rail believes that the proposal would result in a lower level of risk than at present, and is less likely to lead to significant unfunded costs to the industry (including Network Rail) than under current arrangements.



## **4. Conclusions and recommendations on the regime for freight operators**

### **Overview of freight work**

- 4.1 ISG recommends that the current provisions for compensation for disruption caused through possessions which have not been notified in all material respects by T-12 (Service Variations & Cancellations – “SV&C”) should remain in place and be unaffected by this review.
- 4.2 However, in order to enable the Part G provisions to be removed also for freight operators, the freight policy group has considered a similar concept to the one described for passenger operators, namely that there should be an additional tier of compensation within a freight Schedule 4 mechanism, which reflects the impact of higher levels of disruption. This reflects ISG’s intention that the type of compensation available should be a function of the scale and impact of disruption rather than the type of work being carried out in possessions.
- 4.3 Subject to ongoing shadow running which will inform the detail of this approach, ISG therefore recommends incorporating compensation provisions into a freight Schedule 4, which capture the effects of breaching thresholds defined by extreme levels of disruption caused by possessions advised before T-12.
- 4.4 It is envisaged that the additional mechanism would work in a similar way as the existing Service Variation mechanism, in that operators identify services which trigger the disruption criteria and this is then verified by Network Rail. (Network Rail is investigating the extent to which the requirement for manual identification could be reduced by harnessing the capability of existing train planning tools.)
- 4.5 ISG therefore recommends that the compensation for extremely disruptive possessions set prior to T-12 will be based on a new set of trigger thresholds to be examined and agreed. Where possessions exceed these thresholds, freight operators will receive compensation, either on the basis of a liquidated sums regime, or on actual costs and losses (net of benefits), (dependent on further discussions once data has been collected through shadow running, see below.)
- 4.6 The policy group developed initial recommendations for defining the disruption criteria. The intention is that the thresholds should capture a similar scale of disruption to the existing provisions under Part G of the Network Code<sup>10</sup>.

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<sup>10</sup> The objective has been to try to provide for a broadly equivalent level of financial protection for disruptive possessions as that currently offered by Part G of the Network Code. It should be noted that the cost of this is reflected in Network Rail’s revenue requirement.

- 4.7 The criteria comprise the following triggers, which would be expected to apply equally to all freight operators:
- a) the affected service is cancelled
  - b) the affected service commences its journey from an alternative origin
  - c) the affected service has to operate to an alternative destination
  - d) the planned departure time differs from that of the original service by more than 'X' minutes (60 or 120, to be determined)
  - e) the planned arrival time at destination differs from that of the original service by more than 'X' minutes (60 or 120, to be determined)
  - f) the affected service is diverted over a route [of] which the train operator has no route knowledge
  - g) the imposition of any more demanding length, weight or gauge restrictions for the affected service
  - h) the use of at least one additional locomotive on the affected
  - i) service or use of a diesel locomotive as a substitute for an electric locomotive
  - j) the operation of the affected service requires additional resources to be provided (but only where the FOC could demonstrate that the additional costs it will be exposed to will exceed £250 per train)
- 4.8 As a result of industry feedback prior to and during the formal consultation process, ISG has concluded that Network Rail's proposal to incorporate the network-wide identification of key routes and diversionary routes into a Schedule 4 compensation mechanism was not appropriate at this stage.
- 4.9 Without prejudice to discussions on the timing of implementation for the proposals for the passenger operators, discussed fully in Chapter 5, the aim is that a new regime could be implemented for the beginning of Control Period 4 for inclusion into Schedule 4 (in place of compensation for possessions through Part G).

### **Next steps - freight**

- 4.10 The freight policy group facilitated an initial period of shadow running to test the recommendations on trigger thresholds, with the intention of gauging the suitability of the initial proposals, allowing refinement where necessary.

- 4.11 This initial period of shadow running proved to be quite resource-intensive, which did not allow sufficient data to be collected. It was therefore not conclusive whether the above proposed thresholds were correctly set.
- 4.12 Therefore, ISG recommends that a further period of shadow running be undertaken, with external support to provide more extensive information. A remit for external support on the activity has been drafted and is now being considered by freight operators. It is planned that the further period of shadow running will permit the collection of more extensive data over a two-month period from the three participating freight operators.
- 4.13 During the same two months, cost data will be collected to help the freight policy group understand how the actual compensation mechanism might work.
- 4.14 In agreeing definitions of the criteria, consideration will also be given to the interaction between the changes to Schedule 4 and the proposed changes to Schedule 8 as part of PR08.
- 4.15 The next steps beyond collection of the data are, therefore, to consider whether to:
- adjust the criteria so that only the appropriate number of trains are captured by the mechanism (namely, those suffering extreme disruption, but on a similar scale to those currently captured by Part G); or
  - if the criteria are capturing too large a number of services, leave the criteria as currently proposed, but only compensate for a proportion of actual costs/losses.
- 4.16 Based on the cost data to be collected during the two month shadow running period (and its usefulness), the freight policy group will also consider whether:
- compensation should be on the basis of actual costs/losses or liquidated sums; or
  - compensation should be on the basis of actual costs/losses for cancellations, but on the basis of liquidated sums for service variation disruption.
- 4.17 Proposed legal drafting will also be provided for freight Schedule 4 – this is expected to be structurally similar to the existing provisions for Service Variation & Cancellations.
- 4.18 The introduction of freight Schedule 4 provisions, which introduce a definition of “Restriction of Use” and the associated compensation mechanisms, will also require amendments to Part G, in order to remove the incumbent provisions for compensation for disruptive possessions.

- 4.19 The legal drafting sub-group on the passenger work has already formulated what the appropriate revisions to Part G might be, although these have been drafted in the context of changes to the possessions compensation regime for passenger operators. Whilst the intention is that the same revisions would apply ultimately to all track access parties, given the status of the freight work the freight policy group has not yet been able to consider the drafting in the context of possible changes to the possessions compensation regime for freight operators. ISG is not aware of any obvious feature of the revised Part G drafting which would prevent it from being equally appropriate.
- 4.20 ISG intends that the current proposals for freight operators are designed to capture only exceptionally disruptive possessions to replace the existing provisions under Part G and on that basis does not propose that freight operators should pay an ACS.
- 4.21 The following sets out the proposed timescales for the remaining work, although these are subject to review by the freight policy group.

Confirmation of FOC funding contributions for shadow running	February 2008
Finalisation of shadow running remit and appointment of consultants	February 2008
2-month shadow running of proposed criteria and collection of cost data	Early March – early May 2008
Evaluation of shadow running results	May / June 2008
Recommendation to ORR	July 2008

## **5. Timing of implementation**

- 5.1 The DfT and Transport Scotland have confirmed that implementation of the proposal for franchised passenger operators will be subject to the application of Clause 18.1/ Schedule 9 of franchise agreements. These provisions apply a change mechanism which, in differing manners, provides protection to train operators under existing franchises for the impacts, and a pass through to the DfT / Transport Scotland of the gains or losses, consequent on the changes to Schedule 4 and Part G made as part of an access charges review.
- 5.2 ISG has taken account of the application of these arrangements and has considered two main approaches for implementation:
- implement all aspects of the proposal with effect from 1 April 2009 (the "immediate implementation proposal");
  - implement the elements of the proposals relating to revised notification factors and formulaic compensation for bus costs and adjusted train mileage with effect from 1 April 2009, but phase in changes to Part G and SROUs on a franchise by franchise basis as new franchises are awarded (the "phased implementation proposal").
- 5.3 ISG has been unable to reach consensus on this, with differing views expressed by industry consultees. Network Rail and DfT have expressed a preference for immediate implementation, with the operators divided approximately equally between the two options. Both arguments are set out more fully below and ISG asks ORR to consider these further.
- 5.4 The immediate implementation proposal would involve implementation of all aspects of the proposal with effect from 1 April 2009. Short term transitional arrangements would need to be considered in respect of Significant Restrictions of Use and Network Changes which have already been notified before that date.
- 5.5 The phased proposal would involve implementing the elements of the proposals relating to revised notification factors and formulaic compensation for bus costs and adjusted train mileage with effect from 1 April 2009. However, the balance of the changes to Part G and compensation for Significant Restrictions of Use would be phased in on a franchise by franchise basis as new franchises were awarded. In these circumstances, Clause 18.1 / Schedule 9 adjustments would be unlikely to be applicable.
- 5.6 The advantages and disadvantages of the options are set out below, although these assume that a one-off deal between operators and DfT / Transport Scotland is not possible. Costs would be reduced if a deal could be struck. Whilst this has taken time to achieve, such deals have

been struck in the past in relation to changes made to regimes at previous access charges reviews.

5.7 The advantages of the immediate implementation proposal include the following:

- The removal of the distinction, for compensation purposes, between Network Change and non-Network Change possessions as between Network Rail and train operators thereby removing any disincentive to pursue an efficient mix of renewal and enhancement work.
- Improved clarity between Network Rail and train operators in respect of when bespoke compensation can be claimed and therefore improved working relationships and reduced transaction costs between the parties.
- The provision of improved cost signals to Network Rail in respect of the costs of possessions for which it does not currently pay cost compensation.

5.8 The disadvantages of the immediate implementation proposal include the following:

- Cost compensation for Major Projects and Network Change compensation for possessions would still need to be calculated for the purposes of the operation of Clause 18.1/ Schedule 9 (requiring the ongoing categorisation of possessions in relation to Major Projects, other Significant Restriction of Use categories and Network Change) and therefore transaction costs between DfT / Transport Scotland and operators are likely to increase. It should be noted that, apart from the West Coast franchise where special provisions apply, the number of Part G claims is small, particularly where Schedule 4 is not used to calculate revenue compensation. Any further increase in transaction costs will be temporary (until franchise renewal) and will be at least partially offset by the reduction in transaction costs between franchised passenger operators and Network Rail.
- The operation of Clause 18.1/ Schedule 9 will mean that franchised passenger operators will, until franchises are replaced, still perceive the old regime. This will maintain the economic incentives on franchised passenger operators to claim Network Change or Major Project status for possessions. This means that there will still be some transaction costs that remain.
- Given that DfT / Transport Scotland will have less knowledge in this area than Network Rail, this carries the risk of increased administrative costs.

5.9 The advantages of the phased implementation proposal include the following:

- The elements of the proposals (revised notification factors and formulaic costs compensation) which are more easily processed through clause 18.1/ Schedule 9 can still be implemented immediately.
- The elements of the proposals which would otherwise give rise to the most significant clause 18.1/ Schedule 9 issues (chiefly exclusion of Major Projects from Significant Restriction of Use treatment and the changed test for full revenue and costs compensation) are aligned with franchise replacement, so that existing franchises are not required to address these changes and new franchises will be awarded on the basis of the new proposals.
- Train operators and Network Rail continue to operate the established Major Projects and Network Change categorisations until the time of franchise change, avoiding the need for any shadow process between train operators and DfT / Transport Scotland.

5.10 The disadvantages of the phased implementation proposal include the following:

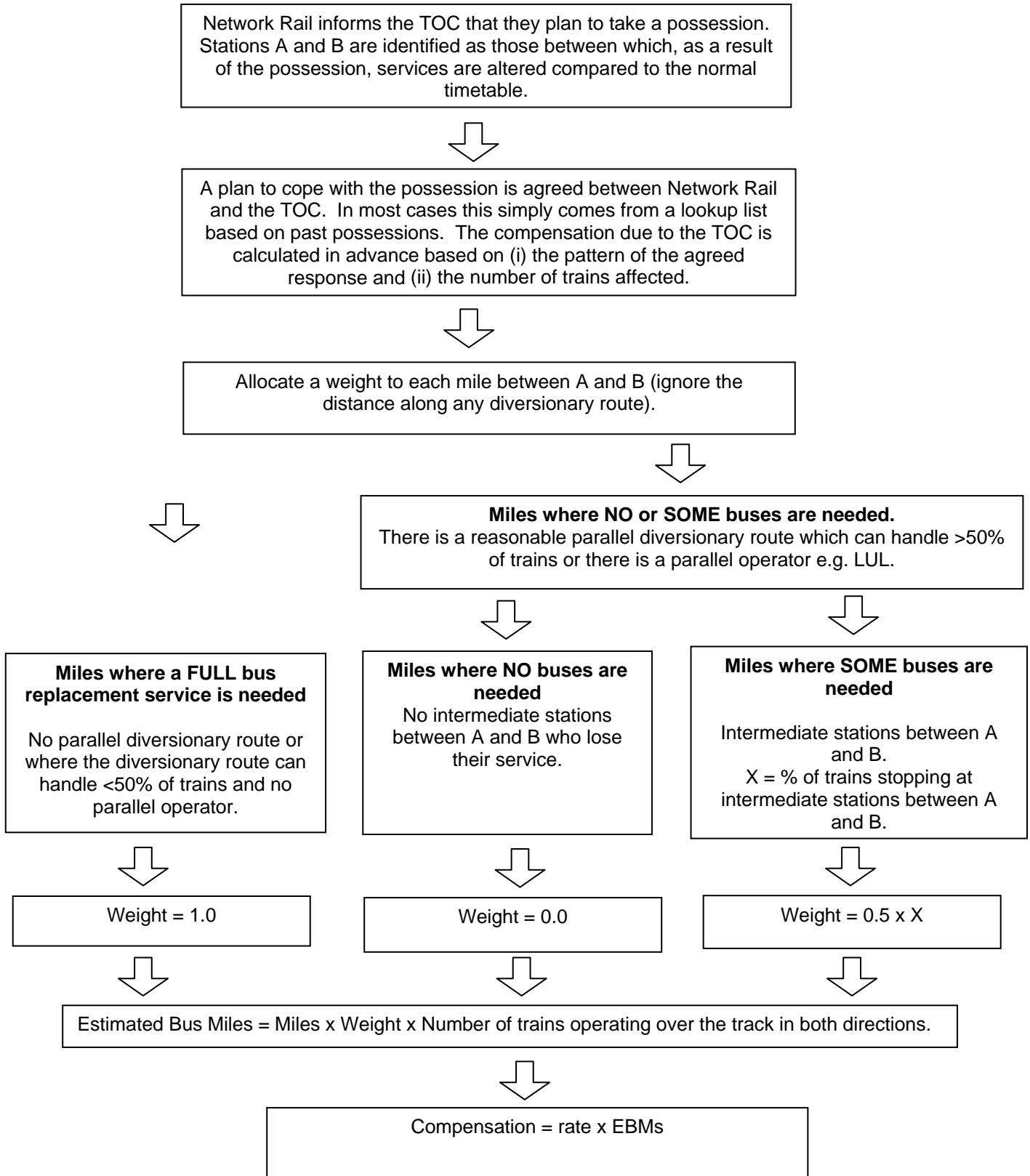
- Continuation of the existing Major Projects and Network Change categorisation leaves in place an inconsistent approach in terms of compensation between Network Rail and train operators for possessions for differing purposes (in particular, a differentiation between a possession taken for a renewal and a possession for an enhancement would remain).
- Different operators would be on different regimes which may increase transaction costs and the parties may face inconsistent incentives according to such regimes.
- The advantages of clearer compensation costs would not be achieved.
- It will take some time for the new arrangements to be fully introduced (see Annex D for a full list of franchise renewal dates).

### **Implementation issues for freight**

5.11 Without prejudice to discussions on the timing of implementation for the proposals for the passenger operators, the aim is that a new regime for freight operators could be implemented for the beginning of Control Period 4 for inclusion into Schedule 4.

## Annex A: Estimated Bus Miles

This annex is taken from the FM report dated 17 September 2007 (page 72) to demonstrate how the Estimated Bus Miles (EBM) value would be calculated in practice. Please refer to the FM report for full detailed information, available at ([www.networkrail.co.uk](http://www.networkrail.co.uk) / Resource Library / Regulatory Documents / Access Charges Review / PR2008 / Review of Possessions Compensation Regime).





## **Annex B: Implementation of the cost formula – process for data collection**

Source: Letter from Faber Maunsell 17 January 2008

In order to operate the system a process of data collection needs to be undertaken for each of the franchised Train Operators. This would involve the following tasks (done at service group level):

- Identifying and recording the relevant Viable Transfer Points (VTP) on a VTP Network Map;
- Network Rail and the Train Operator agreeing the standard response (in terms of alternative transport arrangements) to a possession between pairs of VTPs and recording this in a VTP-VTP Lookup Table; and
- Codifying each possession response to feed into the calculation of EBMs in S4CS.

We propose that external support for this data collection process is restricted to:

- Supporting Network Rail and Train Operator staff who have been tasked with the responsibility of populating the VTP Network Map and VTP-VTP Lookup Table, by explaining the methodology, chairing two workshops and writing up the conclusions;
- Ensuring consistency in the process and assumptions across the Train Operators; and
- Codifying each possession response to feed into the calculation of EBMs in S4CS, a task that it is likely that the industry does not have available resources to undertake.

We think it would be useful to budget a small allowance of time to support the development of S4CS to include the cost compensation mechanism. This might involve attending meetings with Network Rail Information Management and reviewing functional specifications.

To meet the timescales set by the Industry Steering Group (ISG), the data collection work needs to begin on 4<sup>th</sup> February 2008 and to finish by the end of May 2008. We believe that the process will be more efficient and robust if it is split into two stages. During Stage 1 (weeks 1 to 5), we will setup the process in order that it can run smoothly during Stage 2. We will:

- Prepare a 'how to' manual for industry parties;
- Brief and train our internal team to ensure consistency across the Train Operators;
- Hold a number of industry briefings;
- Complete the process with London Midland;

- Trial the process on another Train Operator; and
- Schedule dates for future workshops with Network Rail and Train Operators.

Our aim is that by the end of Stage 1 the remaining 16 Train Operators should be fully informed of the process.

To ensure speed and efficient geographical coverage, during Stage 2 (weeks 6 to 17), we propose to use four sub-teams, each of which will cover four Train Operators. This will allow much of the work to proceed in parallel.

During Stage 2, for each Train Operator, we will:

- Chair two workshops involving representatives of the Train Operator and Network Rail;
- Write up and circulate the conclusions of the workshops; and
- Codify each possession response to feed into the calculation of EBMs.

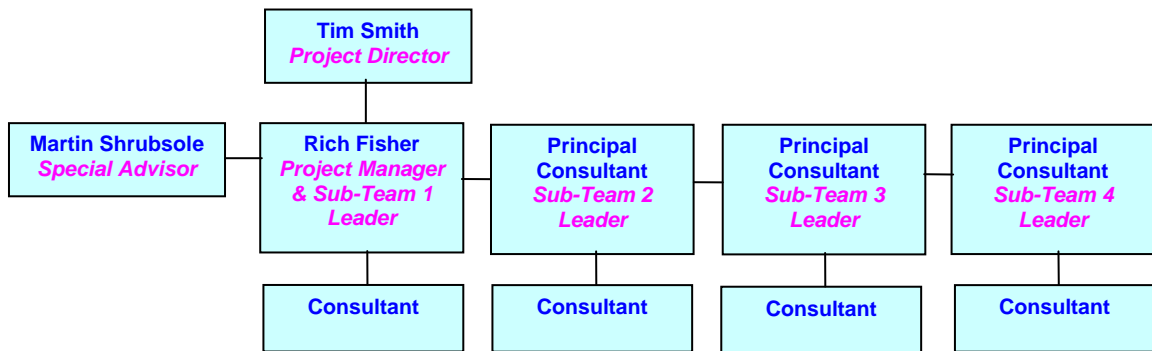
To maximise the efficiency of the workshops, we will help the Train Operator to produce an initial list of VTPs in advance of the first workshop occurring. Workshop 1 will involve a review of the VTPs proposed by the Train Operator and will aim to get agreement as to a final list. It will also begin work on populating the VTP-VTP Lookup Tables. Workshop 2 will aim to finish the population of the VTP-VTP Lookup Tables.

Our estimate assumes that two day-long workshops will be sufficient for a Train Operator and Network Rail to populate the VTP Network Map and VTP-VTP Lookup Table. We will need to discuss with the Policy Group how things should be handled if agreement cannot be reached between the two parties during this time.

To ensure that the process is applied consistently, there will need to be a process of national co-ordination, through staged review meetings. This will involve discussing any issues encountered with individual operators, and agreeing how the compensation rules should be applied to such 'difficult' cases. We also propose that some of these key review meetings should be attended by members of the Policy Group, representing Network Rail, ORR and ATOC.

Our proposed team structure is shown below in Figure 1. National co-ordination of the process will be undertaken by Tim Smith (Project Director) and Rich Fisher (Project Manager), with specialist advice being provided by Martin Shrubsole. Martin will continue to provide team with pragmatic advice as to the application of principles, as well as challenging, where necessary, the views of industry parties based on his extensive experience.

Figure 1: Proposed Team Structure.



Attached to this letter is a detailed project plan for the data collection process. The success of this plan will be dependent on our ability to arrange meetings within the required timescales. We see holding a briefing session for all Train Operators (repeated if necessary) during Stage 1 as a critical part of the strategy of ensuring industry parties engage in the process.

We have estimated the support required to complete the process for all 18 franchised Train Operators, in the attached spreadsheet. We propose working on a Time & Materials basis, with a budget of around £110,000.

Approximately, £35,000 of this will be spent by the end of Stage 1 (14<sup>th</sup> March). At this point we would review and agree with you the inputs and budget required to complete the process. We would provide weekly reports of the staff time inputs and fee expenditure to date. The agreed budget will not be exceeded without authorisation from you.

We will provide the Policy Group with a brief report at the end of the data collection process. This will record the major issues that were encountered and any decisions made about how to deal with any 'difficult' cases.

We hope that this outline provides you with the information you need as you consider how the proposals might be taken forward. We would welcome the opportunity to discuss with you further our ideas and suggestions.

## **Annex C: Shadow running of the proposed freight regime (draft remit)**

This remit is subject to finalisation by the freight policy group.

### **Invitation to Tender**

#### **1. Introduction**

1. Network Rail compensates train operators for possessions<sup>11</sup> under the provisions of Schedule 4 of operators' track access agreements; and, in some circumstances, under the Network Change provisions in Part G of the Network Code. Freight operators do not receive compensation for the vast majority of maintenance and renewal possessions and receive compensation for:

- (a) Compensation through Part G of the Network Code for the disruptive effects of Network Change RoUs.
- (b) Compensation through Schedules 4 & 8 for service variations and cancellations resulting from short-notice RoUs that have not been notified in all material respects within 12 weeks of the timetable day (This work is not intended to affect or replace the freight Schedule 4 & 8 liquidated damages regime for short-notice disruption);
  - (i) A flat rate payable per cancellation (trains that either do not operate at all or are delayed over 12 hours)
  - (ii) A flat rate payable for a service variation, see below (note that only one claim allowed per round trip, even if the service varies in several ways):
    - The planned departure or arrival time being varied by 30+ minutes
    - Mileage amended by 5+ miles
    - Restriction on load, length or gauge
    - Extra loco needed
    - Substitution of an electric locomotive for a diesel
    - Certain Network Rail omissions in the Network Code Part D process

2. The Office of Rail Regulation (ORR) has decided to review possessions compensation paid through Part G and Schedule 4 as part of the Periodic Review 2008. In particular, ORR is seeking to incorporate within Schedule 4 all compensation relating to possessions on the network, for both passenger and freight operators. ORR has therefore asked the Network Code Industry Steering Group (ISG) to review the arrangements for compensation for possessions.

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<sup>11</sup> Or, more generally for "Restrictions of Use" (RoUs), i.e. any amendment to the timetable imposed by Network Rail, whether caused by a possession or for any other reason. The term "possession" in this paper should be taken as including all Restrictions of Use, howsoever caused.

3. Further details of ORR's decision, and its remit to ISG, can be found in the letter of 5 January 2007 published on the ORR website [www.rail-reg.gov.uk/upload/pdf/pr08-toc\\_comp.pdf](http://www.rail-reg.gov.uk/upload/pdf/pr08-toc_comp.pdf).
4. The ISG has set up a Possessions Compensation Policy Group ("Policy Group") to deal with this issue. The Policy Group met for the first time in February 2007, and agreed a number of workstreams that need to be undertaken.
5. One of these workstreams is to develop a regime in Schedule 4 that provides compensation for the most disruptive possessions to freight operators. This regime would provide broadly the same level of compensation as currently received through Part G, although the compensation would be provided for all types of possessions not just those associated with Network Change. The Policy Group is seeking consultancy support for this workstream in this ITT.
6. The aim of the study is for consultants to undertake a period of shadow running of the potential regime and make recommendations for the appropriate way to define and compensate the most disruptive possessions in Schedule 4 of freight operators track access contracts.
7. Any proposals should be ready for implementation at the start of the Control Period 4 (2009-2014) – and should not involve onerous additional costs.

## **2. Structure of this ITT**

8. The remainder of this ITT is structured as follows.
  - (a) Section 3 briefly describes the work undertaken by the Policy Group;
  - (b) Section 4 gives an overview of the proposed consultancy work; how it is expected to support the workstream as a whole; deliverables and timescales. It sets out some of the work that the Policy Group anticipates may be undertaken as part of the consultancy work under this ITT, and for which Policy Group members expect to be able to provide data. However, bidders are encouraged to define whatever work programme they believe is most appropriate to support the overall aims of the Policy Group. Similarly, bidders are free to include work in addition to that set out in Section 5, if they believe that such work would help to support the overall aims of the Policy Group within the time available.

Bidders are welcome to discuss their proposed approaches with the Policy Group in advance of submitting tenders.

- (c) Section 5 sets out the information required in tenders, and the procurement process following submission.

## **3. Work of the Policy Group**

9. The Policy Group has developed initial recommendations for the definition of the most disruptive possessions. These are largely based on the existing definition of service variations, albeit with some important changes to ensure only the most disruptive possessions are included.
10. The proposed threshold is when any of the following occur:
  - (a) the affected service is cancelled
  - (b) the affected service commences its journey from an alternative origin
  - (c) the affected service has to operate to an alternative destination
  - (d) the planned departure time differs from that of the original service by more than 'X' minutes

- (e) the planned arrival time at destination differs from that of the original service by more than 'X' minutes
- (f) the affected service is diverted over a route [of] which the train operator has no route knowledge
- (g) the imposition of any more demanding length, weight or gauge restrictions for the affected service
- (h) the use of at least one additional locomotive on the affected
- (i) service or use of a diesel locomotive as a substitute for an electric locomotive
- (j) the operation of the affected service requires additional resources to be provided (but only where the FOC could demonstrate that the additional costs it will be exposed to will exceed £250 per train)

11. Both 60 and 120 minutes have been suggested as possibilities for the time threshold.

12. It is envisaged that the regime would work in a similar way as the existing service variation regime where operators would identify services that meet the criteria and this would be verified by Network Rail. Unlike service variations rather than a flat rate liquidated damages sum compensation could be paid based on actual losses, with claims submitted by operators.

13. Freight operators have undertaken some initial shadow running on the basis of the above criteria. This has identified the following:

- (a) For EWS over a 2-week period there were 27 cancellations of services that had recently run, with 39 with an amended start time (4 over 60 minutes) and 68 with an amended destination time (14 over 60 minutes).
- (b) For Freightliner Intermodal over a one-week period no cancellations of services that had recently run, with 31 services with an amended start time (none over 60 minutes) and 59 with an amended destination time (22 over 60 minutes).
- (c) For GB Railfreight (over a four week period) there was one cancellation of a service that had recently run and 7 variations 5 due to gauge restriction, 1 change of origin time greater than 60 minutes and one change of mileage of 47 miles.

14. Compared to above EWS had 10 service cancellations covered by Part G of the Network Code. We have not identify Part G possessions for Freightliner and GB Railfreight.

15. From the above analysis it appears clear that the threshold may lead to more services being captured and possibly compensation be paid under Schedule 4 than under Part G of the Network Code.

16. The Policy Group has identified four possible ways forward:

- (a) Keep the above approach with possibly tightening the criteria so that only the most disruptive possessions are captured;
- (b) Keep the above criteria but only compensate for a proportion of actual costs/losses;
- (c) Keep the above criteria but pay a liquidated damages sum, with a different rate applying to cancellations and other service disruptions. The liquidated damages sums would be set so that compensation was broadly the same as that currently available under Part G

- (d) Keep the above criteria and pay actual losses for service cancellations and a liquidated damages sum for all other disruption.

#### **4. Proposed consultancy work**

17. The key task for this consultancy work is to:

- undertake two months of shadow running of the proposed threshold.

18. The consultant should also:

- In conjunction with freight operators identify relevant, typical, costs by type of possession such as costs of cancellations, delays, route learning, change of gauge;
- in conjunction with freight operators, identify the possessions likely to come under Part G of the Network Code and the level of compensation likely to be payable over the same period; and
- provide recommendations on changes to the thresholds and Schedule 4 regime.

19. The shadow running will involve, for two months and for the three train operators: EWS, Freightliner (both Intermodal and HeavyHaul) and GB Railfreight, the identification of all train services that would fall into the above criteria. Rather than using a specific time disruption threshold the consultant should note the actual change to departure or arrival times. An example of the proposed output is included in Annex A.

20. The first step will be to examine informed traveller documents to identify freight train services likely to be affected by possessions

21. The second step will be to identify from TOPS or BIFS the impact on individual train services. BIFS contains the following information:

- Did a train run?
- If not, when did it last run and how often?
- Was its start/end times different to normal?
- Was its mileage different to normal?
- Did it have additional or different loco?
- Did it have less wagons than normal?

22. An example of BIFS output is included in Annex B.

23. It may also be necessary to use TRUST to check schedules for trains – ‘normal’ mileage and times and Y or Q paths, parallel schedules etc. Occasionally Quail Maps will be needed to check mileages on diversionary routes (which are sometimes missing from BIFS). Network Rail have agreed to provide access to each of these systems.

#### **5. Procurement process**

24. Information required in tenders

- Proposed approach and rationale
- Data requirements / assumptions
- Details of key staff involved

- Price – including breakdown between elements of work, as applicable. Expect a fixed price for defined scope of work, then day rates for further support.
- People, CVs, day rates
- Details of relevant experience

#### **6. Assessment criteria**

25. Bidders will be assessed on the following criteria:
- Compliance with the Tender Declaration
  - Confirmation with the Terms and Conditions
  - Total Costs
  - Relevant experience
  - Detailed methodology of how the work is undertaken
  - Project plan and resource plan



## **Annex D: Franchise renewal dates**

<b>Franchise</b>	<b>Earliest Renewal</b>	<b>Latest Renewal</b>
South Central	September 2009	
TPE	January 2011	January 2013
Greater Anglia	March 2011	
Scotrail	October 2011	October 2014
West Coast Main Line	March 2012	
Southeastern	First quarter 2012	First quarter 2014
Thameslink/GN	First quarter 2012	First quarter 2015
Northern	March 2013	
Great Western	March 2013	March 2016
East Coast Mainline	October 2013	March 2015
New Cross Country	October 2013	March 2016
South West Trains	February 2014	February 2017
East Midlands	October 2014	September 2015
West Midlands	September 2015	
London Rail Concession	March 2016	To be confirmed
Wales	December 2018	
Chiltern	December 2021	
Merseyrail	June 2028	

## **Annex E: Questions from the September 2007 consultation**

### **General questions**

1. Consultees are invited to comment on the appropriateness of the current compensation mechanisms (i.e. through Schedule 4 and Part G of the Network Code) and whether or not the high level proposals set out above would improve the way in which compensation is identified and paid.
2. Consultees are also invited to propose any other alternative approaches that you feel would be more appropriate along with your reasoning for supporting such proposals.
3. Consultees are asked to comment on whether there are other changes to Part G or Schedule 4 which the policy group should consider.

### **Revenue boundaries**

4. Consultees are invited to indicate whether or not they support the continued use of a formula as a default approach to identifying associated revenue loss or, if not, set out the reasons why you do not believe use of a formulaic approach is appropriate and what alternative approach you believe should be adopted.
5. It is recognised that Schedule 4 does not in all cases reflect actual revenue loss. However, the consultants found little evidence of a systematic under- or over-compensation. Consultees are invited to indicate whether or they agree with this, and if not, to provide supporting evidence for the view.
6. Consultees are invited to comment on the proposed thresholds for calculating revenue loss, particularly on the appropriateness and the impact on incentives of a Type 4 possession being defined as one which is over 120 hours or part of a “series” of possessions, based on the cumulative duration of possessions affecting a Service Group over any 3 and/or 7 consecutive periods.
  - If the “series” of thresholds is to be designed by reference to cumulative hours over a number of periods, what would consultees consider to be an appropriate threshold?
  - Do consultees agree that, except in a relatively small number of cases, a “series” of possessions should include the cumulative number of hours across a whole Service Group? Which Service Groups might need to be subdivided to reflect distinct passenger markets?
  - Alternatively, do you think that the trigger for a “Type 4” possession should be based on another measure, for example on a percentage of revenue loss as estimated by the Schedule 4 algorithm?

### **Long-running Restrictions of Use**

7. Consultees are invited to comment on the treatment of long-running Restrictions of Use.

### **Possessions Compensation Guide**

8. Consultees are invited to comment on the proposal to develop a Possessions Compensation Guide to facilitate estimation and calculation of revenue losses arising from possessions.

### **Cost boundaries**

9. Consultees are invited to indicate whether or not they support, in principle, the use of a formula as a default approach to calculating cost compensation for rail replacement bus costs and costs or savings resulting from changes in train mileage. If not, set out the reasons why you do not believe use of a formulaic approach is appropriate.

10. Consultees are invited to comment on the proposed thresholds for when it would be appropriate to claim any costs associated with the taking of a possession, particularly:

- Is it appropriate to have a lower threshold below which cost compensation could not be claimable? If so, why do you think a threshold is appropriate and at what level do you think it should be applied? Would a lower threshold be appropriate even if the calculation of cost compensation could be automated?
- Should a formula based approach apply in all cases (above a notional lower threshold) or should there be an upper threshold beyond which it becomes the default option but not mandatory?
- If thresholds are appropriate, where do you think they should be set and why?
- Should the definition of Direct Costs also apply to Type 4 possessions?

### **Development of the cost formula proposal**

11. Consultees are invited to comment on the proposed approach to use 'Estimated Bus Miles' to calculate rail replacement bus costs. Do you believe that this is a practicable way forward and would be easy to apply? What practical issues would such an approach raise?

12. Consultees are invited to comment on the appropriateness of using a formula based approach for the costs or savings resulting from changes in train mileage? Do you consider that the Faber Maunsell recommendations are appropriate? If not what alternative approaches do you recommend?

13. Consultees are asked to comment on the proposed method of implementation of this formula based approach. Please also refer to Annex C.

### **Process and timescales for agreeing compensation**

14. Consultees are invited to comment on the proposed process and timescales by which compensation is agreed.

### **Notification factors**

15. Consultees are invited to comment on the proposals to change the notification factors as indicated:

- Do you believe that the proposed approach will better align compensation paid with associated revenue loss?
- Does the “incentive regime” proposal strike the appropriate balance between being cost reflective and providing the right incentives, and if not, what other factors should be taken into consideration?

16. Consultees are invited to comment on the appropriateness of introducing a new point for notification at an interim point such as T-6 weeks. Are there practical issues that make such a notification point difficult and if so is there another point where a threshold would be more appropriate?

### **Implementation issues for franchised passenger operators**

17. Consultees are asked to indicate, if the proposed changes are adopted, whether, and if so, to what extent you anticipate difficulties in netting off the effects of the changes through Clause 18.1 / Schedule 9 of the franchise agreement and what measures could be pursued to mitigate this.

18. Consultees are asked to express a preference from the approaches set out above, and to identify any alternative approach to implementation which they may prefer.

19. DfT has indicated that it would expect to apply the arrangements in franchise agreements which ensure financial neutrality to franchised passenger operators where such changes arise from a Regulatory Review and have emphasised the importance of any proposal allowing the financial neutrality arrangements in the franchise agreements to be calculated reliably and to the satisfaction of all parties involved. Consultees are invited to comment on the implications of this in their response.

### **Compensation to open access passenger operators**

20. Consultees are invited to comment on the proposal above for open access passenger operators.

### **Compensation to freight operators**

21. Consultees are invited to comment on the proposed criteria for determining compensation for freight operators. Do you believe that this would cover all situations where losses would occur? If not, what other factors should be incorporated?

22. Consultees are asked to comment on whether or not the identification of diversionary routes would add value to a possession compensation regime for freight operators and, if so, how would you envisage that this concept could be incorporated into the regime?

23. Consultees are invited to comment on the proposals set out in Annex F concerning the way in which the regime is intended to be shadow run, including any practicalities or problems with collecting and producing the data.

### **Access Charge Supplements**

24. Consultees are invited to comment on the proposed options for the future treatment of the ACS.

- Is there advantage in retaining the current arrangement, where each franchised passenger operator pays, and has visibility of, a separate ACS for formulaic Schedule 4 compensation?
- If a separate Schedule 4 ACS is retained, how would consultees propose to make it more cost reflective to individual operators?
- If absorbed into the fixed charge, how would a Schedule 4 ACS be calculated for open access operators who opted into the formulaic components of the regime?
- In any event, do you agree that it should be subject to adjustment during the control period where traffic levels change?

### ***Annexes to follow:***

*Revised legal drafting for Schedule 4 of the track access agreement for passenger operators*

*Revised legal drafting for Part G of the Network Code*