Pedro Abrantes
Head of Analysis and Rail Economics

25 October 2018

Caitlin Scarlett
Schedule 8 Recalibration Lead
Rail Delivery Group

Dear Caitlin,

Schedule 8 Recalibration: Approval of Network Rail payment rates

1. In your letter of 12 June 2018, RDG requested approval of the Network Rail payment rates for all service groups, except Govia Thameslink Railway (GTR) and London South Eastern Railway (LSER) service groups. In the remainder of this letter we refer to the recalibration of the Network Rail payment rates submitted as part of this letter as the 'national recalibration'.

2. Some operators and/or Network Rail routes proposed alternative Network Rail payment rates to the ones calculated as part of the national recalibration. We discuss these below.

3. In addition, on 19 October 2018 we received a submission from you requesting approval of revised Network Rail payment rates for Crossrail service groups. The rates for Crossrail service groups were revised to reflect the unexpected delay to the implementation of the December 2018 timetable. The revised Network Rail payment rates for the Crossrail service groups used the national recalibration methodology but used new revenue figures to reflect the delayed implementation of the timetable.

4. We received another submission on 19 October 2018 from the Schedule 8 recalibration lead for GTR and LSER requesting approval of the Network Rail payment rates for GTR and LSER service groups. Although the Network Rail payment rates for GTR and LSER were recalibrated separately, the methodology used was broadly similar to the methodology used in the national recalibration.

5. We note that, through the passenger operator Recalibration Working Group, operators and Network Rail have had the opportunity to review and challenge the recalibration of the Network Rail payment rates. In particular, we note that, with the exception of cases where an operator and/or Network Rail has proposed an alternative Network Rail payment rate to the one calculated as part of the national

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk

recalibration, no party has objected to the Network Rail payment rates recalibrated as part of the national or GTR and LSER recalibrations.

6. Moreover, we note that the national and GTR and LSER recalibrations have been independently audited by Vivacity and that they have confirmed that they have no concerns that need to be addressed.

7. Thus, in light of the above and having reviewed both the methodology and audit reports, we approve the Network Rail payment rates recalibrated as part of the national recalibrations (subject to what we say in relation to those three operators set out below). We also approve the GTR and LSER recalibrations and the revised Network Rail payment rates for Crossrail.

8. Below we set out our decisions on the alternative payment rates proposed by operators and/or Network Rail routes.

Chiltern Railways

9. Chiltern Railways and the Network Rail London North Western (LNW) route proposed alternative Network Rail payment rates for service groups HO02 and HO04. As requested, we informed you of our decisions in relation to these rates by email on 27 July 2018. This letter re-iterates these decisions.

10. An alternative Network Rail payment rate was proposed for HO04 to reflect changes in demand during CP5 between Chiltern Railway and Great Western Railway. We approve the alternative Network Rail payment rate proposed for service group HO04 for use in CP6.

11. However, for service group HO02 we cannot approve the alternative Network Rail payment rate proposed by Chiltern Railway and the Network Rail route. This means the Network Rail payment rate in CP6 for this service group should be the Network Rail payment rate calculated as part of the national recalibration. Our rationale for this HO02 decision is set out in Annex 1.

Virgin Trains West Coast

12. Virgin Trains West Coast and the Network Rail LNW route proposed an alternative Network Rail payment rate for service group HF06 to reflect the revenue impact that the closure of the Lamington Viaduct in 2016 had on this service group. As requested, we informed you of this decision by email on 13 July 2018. This letter re-iterates this decision.

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk

13. We approve the alternative Network Rail payment rate proposed for HF06 for use in CP6.

c2c

14. The Network Rail LNW route and c2c disagreed on the Network Rail payment rates to use for c2c's service groups in CP6. The Network Rail LNW route approved the Network Rail payment rates recalibrated for c2c service groups as part of the national recalibration. However, c2c did not approve them and proposed alternative rates for its service groups.

15. As requested, we informed you of our decision in relation to this disagreement by email on 10 July 2018. This letter re-iterates this decision.

16. For the reasons set out in Annex 2, on the basis of the submissions from c2c and the Network Rail LNW route, we cannot support c2c's proposal. As a result, the Network Rail payment rates calculated as part of the national recalibration should be used for c2c's service groups in CP6.

Next Steps

17. This letter states our final decisions on the Network Rail payment rates in the passenger Schedule 8 regime for CP6, including our decisions on any alternative Network Rail payment rates proposed by operators and Network Rail routes. This letter approves these rates, as described above, for use in CP6.

Yours sincerely,

Pedro Abrantes

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk

Annex 1: Network Rail payment rate for Chiltern Railway service group HO02

18. In your letter of 12 June 2018, you requested our approval of Network Rail payment rates for Chiltern Railway service group HO02, both peak and off-peak, as proposed by Chiltern Railway and the Network Rail LNW route.

19. In addition to that letter, we had conversations with both parties about the proposal and received further supplementary information on 13 July 2018.

20. On the basis of the evidence and arguments submitted, we have decided that we cannot approve the Network Rail payment rates for service group HO02, proposed by Chiltern Railway and the Network Rail LNW route.

21. We informed you of this decision by email on 27 July 2018, having reviewed the proposal and the supplementary information. This annex provides further information on our rationale for this decision.

Proposal

22. Chiltern Railway and Network Rail proposed to uplift the CP5 Network Rail payment rates for service group HO02 by the percentage change in peak and off-peak revenues during CP5.

Rationale for this proposal

23. Chiltern Railway and the Network Rail route did not consider that the payment rates calculated for this service group as part of the national recalibration accurately reflected the long-term revenue impact of unplanned disruption.

24. Specifically, both parties considered the payment rates calculated using the methodology in the national recalibration to be too high because the service group is high performing.

25. The supplementary information we received on 13 July 2018 compared the Schedule 4 revenue compensation Chiltern Railway would have received under the different Schedule 8 Network Rail payment rates, against Chiltern Railway's own forecasts of its revenue losses. This showed that the Schedule 4 compensation Chiltern Railway would have received under the Network Rail payment rate proposed by Chiltern Railway and Network Rail would have been closer to Chiltern Railway's forecasts of its losses, compared to if the Network Rail payment rate calculated as part of the national recalibration had been used.

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk

ORR view

26. The evidence provided did not persuade us that, given HO02 is a high performing service group, the national recalibration methodology results in inaccurate Network Rail payment rates for this service group. Firstly, similar concerns have not been raised regarding other high performing service groups that used the national recalibration methodology. Secondly, the Oxera study ('The impact of unplanned disruption on train operator revenue', 2017) did not find a statistically significant relationship between base lateness and the relationship between lateness and demand.

27. In terms of the supplementary information we received on 13 July 2018, whilst we recognise that changing the Schedule 8 payment rates will have an impact on Schedule 4 revenue compensation we do not consider this as evidence that the Network Rail payment rates calculated using the national recalibration methodology are inaccurate. In addition, it was not clear how Chiltern Railway's forecasts of its losses were arrived at.

28. Overall, the evidence submitted to us did not demonstrate that the Network Rail payment rates proposed by Chiltern Railway and the Network Rail route are a more accurate reflection of long-run revenue losses than the rates calculated in the national recalibration. For this reason, we cannot approve Chiltern Railway and the Network Rail LNW route's proposal, and the Network Rail payment rates for HO02, peak and off-peak, in CP6 should be the rates calculated as part of the national recalibration.

29. We note that we did approve the use of a similar, non-standard methodology for this service group for CP5. At the time, we noted our concerns with the justification for doing so. Noting the above remarks, we still have concerns about the weak justification for this approach, and the body of evidence informing the rates proposed by Chiltern Railway and the Network Rail route is now much older.

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk

Annex 2: Network Rail payment rate for c2c service groups

30. In your letter of 12 June 2018 you noted that Network Rail and c2c had not been able to reach agreement on how the Network Rail payment rates for c2c service groups should be recalibrated for CP6 and you requested that we determine this.

31. In addition to that letter, we had conversations with both parties about the proposals and received further supplementary information from c2c on 4 July 2018.

32. We have decided that, based on the evidence and arguments submitted, we cannot support c2c's proposal. As a result, the Network Rail payment rates calculated as part of the national recalibration should be used for c2c's service groups in CP6.

33. We informed you of this decision by email on 10 July 2018, having reviewed the proposal and the supplementary information. This annex provides further information on our rationale for this decision.

Summary of the dispute and our decision

34. c2c and the Network Rail Anglia route did not agree on the Network Rail payment rates that should be used for c2c service groups in CP6. The Network Rail Anglia route proposed to use the Network Rail payment rates calculated as part of the national recalibration. c2c proposed two alternative approaches; use a c2c revenue-weighted average Generalised Journey Time (GJT) and the GJT elasticity and lateness multiplier from PDFH v5.1; or use an average of the semi-elasticity values for London Travelcard area and London to/from south east calculated as part of the Oxera study.

35. We have reviewed c2c and Network Rail's proposals, and, on the balance of the arguments put to us, we have determined that the Network Rail payment rates calculated as part of the national recalibration should be used for c2c service groups in CP6.

c2c's arguments

36. c2c did not consider that the Network Rail payment rates calculated using the national recalibration methodology accurately reflected the revenue impact of unplanned disruption for its service groups.

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk

37. Specifically, c2c considered that the ways in which its services are different from other LSE services makes the marginal revenue effect calculated using the methodology in the Oxera study inappropriate for its services.

38. c2c claimed its services are different from other LSE services because:

a. it faces greater competition from other modes of transport;

b. the composition of its ticket revenue is significantly different;

c. it has a low base level of AML and that low level of base AML means it has higher demand response to changes in AML; and

d. it has a low base GJT and that means it has a higher demand response to changes in AML.

ORR view

39. We have reviewed the ways in which c2c considers it is different to other LSE services.

40. On (a) and (b), c2c's submission did not provide evidence that c2c faces greater competition with other modes of transport than other LSE services or that its composition of ticket revenue is markedly different. In addition, the Oxera study considered both of these factors and they were consequently factored into their estimation of the elasticities.

41. For (c), the Oxera study did test the relationship between base level of AML and revenue. The Oxera analysis did not support c2c's claim that base level AML affects the impact on revenue of changes in AML.

42. Finally, for (d) we note that the Oxera study did not control for the relationship between GJT and AML. We therefore agree that c2c's low base GJT may affect the accuracy of the results of the Oxera study for its service groups, however, there is no evidence on the extent to which it does.

43. Overall, while there may be weaknesses in the Oxera study's applicability to the c2c service groups, the evidence submitted to us did not demonstrate that c2c's proposed alternatives would improve on the accuracy of the national recalibration for c2c service groups. For that reason we are not able to approve either of c2c's proposals, and the Network Rail payment rates calculated as part of the national recalibration should be used for c2c service groups in CP6.

Head Office: One Kemble Street, London WC2B 4AN T: 020 7282 2000 F: 020 7282 2040 www.orr.gov.uk