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Dear Charles,

Sustained Poor Performance

Thank you for your letter of 30 October 2014, in which you asked ORR to confirm the policy intent behind the sustained poor performance ("SPP") compensation scheme, and explain how that compensation is to be calculated. This letter sets out the intention of the SPP regime, and how we understand SPP compensation is calculated. Given that I understand there is some debate within the industry on this, I am circulating this letter more widely.

The SPP regime is only applicable to franchised and concession passenger operators (given that no open access operators have chosen to incorporate it into their access contracts). As such, we are commenting on the intention of the text found at paragraph 18 of Schedule 8 of the model franchise passenger access agreement. The attached annex sets out an explanation of how paragraph 18 puts the SPP intention into practice, but it is not a clause-by-clause interpretation of parties' contracts, rather it is a description of how the SPP regime is intended to work in broad terms.

In brief, the SPP regime is intended to provide additional compensation to a TOC when lateness and cancellations attributable to Network Rail reach a specified threshold, beyond which it is considered the liquidated sums nature of Schedule 8 could start significantly to undercompensate the TOC. That additional compensation is measured in relation to the benchmark level of Network Rail's performance.

Network Rail is funded to achieve a certain level of performance during CP5. At an aggregate level, the CP5 Network Rail benchmarks have been calculated to be consistent with this. During PR13, we also advised Network Rail that at TOC-level, the Network Rail benchmarks should reflect the industry's view on expected CP5 performance. When Network Rail's performance in respect of a service group of a TOC is worse-than-benchmark, the TOC is entitled to revenue loss compensation in the form of liquidated sums to put it in the same position it would have been in if the average level of Network



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Rail's performance was at benchmark. When Network Rail's performance is worse-than-benchmark to such an extent that the liquidated sums compensation which it is liable to pay is above the SPP threshold set out in that TOC's access agreement, the TOC is entitled to claim additional compensation. This additional compensation is for those "Relevant Losses" (defined in the access agreement) which the TOC has suffered as a result of Network Rail not achieving the benchmark level of performance, minus those revenue losses it has already recovered by way of the liquidated sums it automatically receives under Schedule 8.

No TOC has any contractual entitlement to receive better-than-benchmark performance, and therefore has no contractual right to recover any losses it may incur in respect of Network Rail performing at levels between benchmark and 'perfect' (that is, operating a network with zero lateness and cancellations), whether or not SPP compensation has been triggered. "Relevant Losses" do not include losses incurred by the TOC in relation to that degree of Network Rail performance which was less than 'perfect' but still better than the contracted (and funded) benchmark level.

We consider that Schedule 8 of the model franchise passenger access agreement gives effect to the intentions as set out above. We cannot comment on any specific disputes which may exist between the parties to an access agreement, but would note that the contract contains an established mechanism for determining disputes through the Alternative Dispute Resolution Rules, and that these rules include the possibility of having ORR determine matters which are considered to be regulatory issues.

I trust this letter provides the guidance and confirmation you have asked for.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Larkinson', is positioned above the printed name.

John Larkinson

Annex

1. ORR introduced the SPP compensation regime in the 2005 periodic review, as a replacement for the Local Output Commitments regime (then set out in Part L of the Network Code) to streamline the compensation provisions for poor performance by placing them all in Schedule 8.
2. The stated intention of the SPP regime when it was first introduced as part of the 2005 periodic review was that it provides additional compensation to TOCs when lateness and cancellations reach a specified threshold, the level of which “would reflect the point where Schedule 8 payments start significantly to undercompensate TOCs”¹. This has remained the case in subsequent periodic reviews, while being repeatedly acknowledged that it is difficult to find evidence to determine the appropriate threshold level (though the level has been progressively lowered at each periodic review, starting at 25% worse-than-benchmark performance over at least 12 months in 2006/07 to the current level of 10% worse-than-benchmark performance). Our most recent periodic review stated:

“Under Schedule 8, additional compensation may be claimed when Network Rail’s performance in relation to a specific train operator’s services is worse than the Sustained Poor Performance (SPP) threshold, providing the train operator can show that it has not been adequately compensated through the liquidated sums element of Schedule 8. Our intention is that the SPP threshold should enable additional compensation to be claimed for sustained poor performance where compensation under the standard Schedule 8 arrangements is likely to be materially less than what is needed to reflect the actual impact of poor performance on the train operator.”²

This ‘additional compensation’ comprises those of a TOC’s losses which fall within the definition of “Relevant Losses”, minus the net sum for which Network Rail is liable to the TOC for all NRPS values across all of the TOC’s service groups³.

3. The Network Rail letter asks for guidance on the extent to which Relevant Losses within that SPP additional compensation are intended to be recoverable – we understand one question is, is it intended that all Relevant Losses incurred as a result of Network Rail not achieving its benchmark level of performance are recoverable; alternatively, once SPP has been triggered is a TOC entitled to claim

¹ Paragraph 2.19 of “Review of the Schedule 8 performance regime: final conclusions”, December 2005.

² Paragraph 20.169 of “Final determination of Network Rail’s outputs and funding for 2014-19”, October 2013.

³ See paragraph 7 below for detail of NRPS.

Relevant Losses to put it in the position it would have been in if Network Rail had delivered perfect performance (that is, as if Network Rail had operated the network with zero lateness and cancellations)?

4. ORR's intention is that Relevant Losses are measured in relation to the benchmark level of performance - we are not aware that this intention has ever been identified as an issue in industry consultations for the previous periodic reviews, even as recently as PR13; if it had been, we could have taken that opportunity to clarify the position as appropriate.
5. The starting point for understanding the performance regime is that Network Rail is funded to achieve a certain benchmark level of performance, recognising that there is a certain amount of lateness and cancellations which will be caused to train operators. This is reflected in paragraph 20.7 of the 2013 final determination: "Schedules 4 and 8 are designed to be financially neutral if possession activity and the performance of Network Rail and train operators are at expected levels during CP5". Network Rail is not funded to achieve 'perfect' performance, that is operating the network with zero lateness and cancellations.
6. Schedule 8 sets out a liquidated sums regime which, if Network Rail's performance is worse-than-benchmark, is intended to compensate affected train operators for future revenue losses that result from that fall in performance⁴. The intention is that the TOC should at the end of each year be in the same financial position it would have been in if the average level of Network Rail's performance was at benchmark. This also therefore means that if Network Rail achieves better-than-benchmark performance, then the TOC pays liquidated sums to Network Rail, again to put the TOC in the position it would have been in if the average level of Network Rail's performance was at benchmark (so that to the extent Schedule 8 considers the TOC increases its revenue as a result of better-than-benchmarked performance levels on the part of Network Rail, the TOC pays Network Rail).
7. Paragraph 18 of Schedule 8 sets out how the SPP regime operates. At the end of each of the 13 Periods during a year, the parties calculate whether and to what extent Network Rail is liable to the TOC, or *vice versa*, for the purposes of the Network Rail Performance Sum ("NRPS"). The calculation is based on a comparison between the benchmark average minutes lateness attributed to Network Rail and the actual average minutes lateness attributed to Network Rail. If that calculation yields a negative sum, then it shows that for that Period, overall Network Rail performed worse-than-benchmark (and Network Rail pays the

⁴ "Final determination of Network Rail's outputs and funding for 2014-19", October 2013, paragraph 20.15: "Schedule 8 compensation is an intra-industry arrangement designed to compensate train operators for the impact of poor performance on their long term revenue."

appropriate liquidated sum to the TOC), and if it is a positive sum then it shows Network Rail performed better-than-benchmark (and the TOC pays an appropriate liquidated sum to Network Rail).

8. At the specified Period Liability Dates (the first day of every quarter⁵), the parties work out the Average Periodic Liability for the 13 Periods preceding those Dates. That 13 Period year is the Calculation Term for the purposes of calculating whether Network Rail's performance has been so much worse-than-benchmark as to entitle the TOC to SPP additional compensation under the terms of paragraph 18 of Schedule 8.
9. This is done by deducting the sum of all the NRPS which the TOC paid to Network Rail from the sum of all the NRPS which Network Rail paid to the TOC, for that entire year which constitutes that Calculation Term. The overall result is then divided by 13, to produce the Average Periodic Liability ("APL") amount. A negative APL shows that Network Rail has on average performed worse-than-benchmark, and the value is compared to the SPP Threshold value set out in appendix 3 of the TOC's Schedule 8. If the magnitude of the APL is equal to or greater than the magnitude of the threshold figure, Network Rail is liable to indemnify the TOC in accordance with paragraph 18.2 of Schedule 8.
10. Paragraph 18.2 provides that if and to the extent that the APL shows Network Rail has exceeded the SPP Threshold, the TOC is entitled to an indemnity from Network Rail against its Relevant Losses, with the effect that the TOC recovers Relevant Losses for the Calculation Term in which it is experiencing SPP. The TOC continues to receive the Schedule 8 liquidated sums while performance levels have passed the SPP threshold, but paragraphs 18.3 and 18.4 together make it clear that all liquidated sums already paid to the TOC for worse-than-benchmark performance are netted off in order to avoid double-recovery of any element. This is also intended to ensure that where SPP is an on-going issue from one Calculation Term to another, there is no double-counting.
11. It is worth noting that SPP compensation does not automatically become payable in all subsequent Calculation Terms once it has been triggered in the past; rather each Calculation Term needs to be assessed separately to see if the indemnity is triggered. While it remains open to a TOC to choose not to bring a claim for additional SPP compensation in relation to a Calculation Term for which SPP has been triggered, the TOC must treat each Calculation Term as a whole – it cannot pick and choose which individual Periods within a whole Calculation Term it decides to include in its claim.

⁵ The 1st, 4th, 7th and 11th Periods.

12. Paragraph 18.3 provides that the Relevant Losses for the purposes of additional SPP compensation are calculated to be all the TOC's Relevant Losses arising as a result of lateness and cancellations (for which the TOC itself has not been allocated responsibility) minus the sum of the NRPS values (described in paragraph 7 above). Those NRPS figures are by definition measurements against Network Rail's performance benchmark, and a TOC has no entitlement to receive compensation in respect of service levels which are better-than-benchmark but less-than-'perfect', whether the TOC is experiencing SPP or not.