

**Paul Plummer**

**Chair, RDG Contractual and Regulatory Reform Working Group**

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Joanna Whittington  
Director, Railway Markets and Economics  
Office of Rail Regulation  
One Kemble Street  
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Cc: RDG Contractual and Regulatory Reform Working Group members

Dear Joanna,

## **ORR's structure of charges review**

Thank you for your letter of 5 December, which explained ORR's proposed approach to reviewing Network Rail's structure of charges, including how you envisage interacting with RDG's own work in this area. Your letter also proposed a set of aims and objectives for the charging framework.

You wrote to me in my capacity as Chair of RDG's Contractual and Regulatory Reform Working Group (CRRWG). Whilst that letter was not a formal consultation, you welcomed comments on the content.

The rest of this letter provides RDG's comments on ORR's proposed work programme and aims and objectives for the charges and incentives regime. I hope you find these comments useful.

### ***Industry engagement***

It is helpful that your letter sets out your thoughts on how ORR will engage with the industry, particularly as we are at an early stage in the periodic review process. We welcome the recognition of RDG's recent work on the charges and incentives regime, and that you intend to incorporate the output of RDG's work in your review. It is pleasing that ORR recognises the value that RDG can add with an appropriately focused work programme.

The aim of RDG's work is to get much greater industry engagement for ORR's review than there has been in the past. To deliver this aim, we are keen to maintain the current degree of collaboration between RDG and ORR. However, to allow industry colleagues to plan ahead, we would like to understand more about how ORR intends to involve the industry in each stage of its review.

We are mindful that by providing ORR with the 'richness' of debate from our members (reflecting the views of franchised and open access passenger operators, freight operators, and Network Rail), we would be more likely to influence ORR's PR18 deliberations. This consideration is reflected in how we have designed our charges and incentives work programme, which aims to capture both areas of agreement and areas where there are legitimate differences in views amongst members.

To support on-going collaboration with RDG, we suggest adding a standing agenda item to future CRRWG meetings to provide ORR with an opportunity to update RDG members on the progress of its review. This should help ORR and RDG to minimise unintended duplication of work and also highlight any areas for further collaboration at a senior industry level.

## ***Proposed ORR work programme***

The high-level timetable for ORR's structure of charges, set out in your letter, provides us with information that we can use to plan future phases of the RDG work programme. However, the focus of that plan was, understandably, the structure of charges.

In order to support wider industry planning, we consider that there would be benefits in setting out how ORR's structure of charges review interacts with any other PR18 preparatory work that ORR plans to undertake over the next 12 to 18 months. In particular, we would like to understand the way in which the output of the consultancy studies that ORR is currently undertaking will be incorporated into ORR's structure of charges review, and into the wider PR18 process.

RDG's current plan is to complete our work on the charges and incentives regime by the end of 2015. Given this is similar to the timescales for ORR's review, we will, where possible, expedite our work to provide ORR with the greatest opportunity to consider the output of RDG's work programme in its review.

To support RDG in planning its future work, we would value visibility of key ORR milestones and decision points so that we can work towards the key dates in your review. For example, it would be helpful to have visibility of proposed dates for publishing formal consultations and the dates of key ORR Board meetings.

It is important that lessons from previous periodic reviews are captured and used to improve future processes. We are aware that Penny Boys is undertaking an independent review of the PR13 process and we would like to understand when the findings of that review will be published and how it will feed into the development of ORR's work programme for PR18.

## ***Proposed aims and objectives for the charges and incentives regime***

Given the similarities between ORR's proposed aims and objectives for the charges and incentives regime, and those in RDG's vision, we are broadly content with your proposals. However, we should be careful, from the outset of the review, not to overstate the ability of the charges and incentives regime to solve industry problems. Whilst a well-structured charges regime can provide incentives to improve industry outcomes, we should have realistic expectations about what the regime can and cannot achieve.

We have set out some specific comments on elements of ORR's proposed framework below:

- a) We think that a **single approach** to the charging methodology across the network is an important feature of the regime. A single methodological approach would not rule out charges that reflect differences between the characteristics of each part of the railway. Instead, it would mean that differences in the levels of charges reflect real differences in the network or services provided, rather than an arbitrary difference in methodology. Different charging approaches across the network could create anomalies, worsening the understanding of the regime amongst users and potentially reducing the predictability and simplicity of the regime.

- b) Effective **competition** can deliver tangible benefits to customers and funders through innovation, and improvements in cost efficiency and customer service. However, we consider that competition is not an outcome that is delivered simply to comply with the law or your statutory duties. Instead, competition should be promoted where it can deliver genuine benefits to rail users and funders.
- c) Reducing costs, in a safe and sustainable way, is essential if the rail industry is to continue to improve value for money for customers and funders. However, ORR's proposed objectives do not currently refer to **safety and sustainability**. Cost savings should certainly not come at the expense of safety and should not lead to higher industry costs in the longer term.
- d) It is important that the charges and incentives regime is coherent and that it minimises instances of conflicting objectives. We consider that **coherence of the regime** should be considered as part of ORR's structure of charges review.
- e) Whilst **practicality, cost effectiveness and comprehensibility** are relevant principles, we consider that they should be presented as separate principles rather than as one. We would also like to understand the definition of the principle 'objective in operation'.
- f) Charges should provide Network Rail with an appropriate amount of funding to allow it to deliver the outputs required by the regulatory settlement. However, we consider that charges should allow Network Rail to recover its full **efficient** costs, rather than 'full costs' so that it is incentivised to deliver cost efficiencies throughout the control period.

## **Cost analysis**

We agree that the development of the future structure of charges should be supported by a thorough understanding of the underlying costs which it seeks to recover. To this end, in autumn 2014, Network Rail commissioned an independent consultant to review the current approach to cost attribution and allocation. The output of this review should be useful input for PR18 and may also inform later stages of RDG's work on charges and incentives. Network Rail had considered that, once the initial work completes in February 2015, it may commission a further study focusing possible alternative approaches to attributing Network Rail's costs.

To avoid unnecessary duplication of work, and to get best value out of both current and future studies, we would like to discuss further the scope of ORR's proposed cost analysis, prior to it starting.

## **Options analysis**

The scope and timescales of ORR's proposed options analysis are similar to RDG's own work on assessing the options for a new, or updated, charges and incentives regime (Phase 3). RDG plans to start Phase 3 in April 2015 and complete by the end of September 2015. As mentioned earlier, we will strive to make sure that our work, as far as possible, dovetails with ORR's own timescales.

We welcome ORR's commitment to assess the impact of each charging option on different market segments, such as freight and open access. We consider this to be critically important, given the variety of issues faced by different types of rail operators. In producing an assessment of each charging option, we think that it is important for ORR to reflect on best practice from other regulated sectors and consider whether any existing, or additional, regulatory approaches could inhibit the efficient working of the industry.

We agree that ORR should make explicit reference to its statutory duties when reaching decisions on the charges and incentives regime, and incorporate industry and funders' views.

However, we also think that ORR's review should consider other factors that could influence the industry, such as relevant ministerial guidance.

Whilst your letter set out the key factors that you will consider in your assessment of the options for the charges and incentives regime, we would welcome further information about how you will carry out the assessment, and in particular how you will quantify the potential impacts and what role formal regulatory impact assessments will play in the review.

## **Next steps**

In summary, we are pleased that ORR is as committed as RDG to bringing forward the charges and incentives work programme for PR18. On a more general point, we consider that it may be worth exploring the possibility of extending this acceleration of work to other aspects of PR18, building on similar approaches used by regulators in different industries, e.g. as seen in Ofwat's pre-qualification process.

I hope that the comments that we have made in this letter are useful in the development of ORR's work programme for the structure of charges review.

If you have any queries in relation to any aspect of this letter, please do not hesitate to contact me.

Yours sincerely



**Paul Plummer**

Chairman, Contractual and Regulatory Reform Working Group