Rail Delivery Group

CONTRACTUAL AND REGULATORY REFORM WORKSTREAM

RDG vision for the charges and incentives regime in the long run

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What is the Rail Delivery Group?

- The **Rail Delivery Group** (RDG) seeks to improve services for rail users and deliver better value for money for taxpayers
- It was set up in 2011 to bring together the owners of Britain's passenger train operating companies, freight operators and Network Rail to provide leadership to Britain's rail industry
- RDG's mission is to promote greater co-operation between train operators and Network Rail through leadership in the industry and by working together with governments, the supply chain and stakeholders
- We are committed to the long-term health of the railway but also recognise the need to see improvements in the shorter term
- RDG's current work programme spans 13 different areas, one of which is contractual and regulatory reform
- RDG's Review of Charges is one element of RDG's contractual and regulatory reform workstream – the focus of this slide pack is RDG's Review of Charges

Purpose of these slides

- The purpose of these slides is to explain:
  - The background to RDG's Review of Charges
  - The context of Phase 1 of RDG's Review of Charges
  - The output of Phase 1 of RDG's Review of Charges – the vision
  - How we will use the vision

For further information in relation to RDG's Review of Charges, please contact:

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Background to the RDG Review of Charges

Background: What is the RDG Review of Charges

- RDG's Contractual and Regulatory Reform workstream is carrying out a review of the charges and incentives regime for the use of Network Rail's infrastructure
- This project began in spring 2014 and is expected to be completed by the end of 2015
- RDG's 'Review of Charges' considers how the charges and incentives regime should operate under several alternative 'states of the world' (or scenarios) for the industry
- Once completed, our review should allow the industry to constructively inform the Office of Rail Regulation's (ORR's) next periodic review process (the 2018 periodic review (PR18)), and future reviews, by presenting the industry's own conclusions on the charges and incentives regime
- The aim is to provide clarity on areas where the industry has shared views and where there are legitimate differences – this will provide an opportunity for the periodic review to focus on the areas where there are genuine differences of opinion
- ORR is supportive of RDG's work and considers it to be a positive example of the industry working together to improve incentives and value for money

Background: Why are we doing the review?

- In the past, work on determining the appropriate structure of Network Rail's charges and incentives has been squeezed during periodic review processes, due to the volume of work that is required to deliver a price control, and the limited time available
- For CP6, the industry is taking an early opportunity to work together to clearly set out its own views on the appropriate structure of charges and incentives. This is being done in advance of the start of ORR's formal periodic review process for PR18 – RDG is facilitating this work
- By setting out our views before the start of PR18, RDG can provide ORR with information that can help inform ORR's decisions, and allow it to prioritise work in certain areas
- ORR is also carrying out work in this area, along similar timescales to RDG's review
- ORR considers that it is essential for its review to incorporate industry views, including the outputs of RDG's Review of Charges, and where possible work together with RDG

Background: How are we doing the review?

- The analysis and conclusions that are produced as part of this review should reflect the views of RDG members
- Therefore, the Review of Charges draws on expertise from across RDG's membership, which is made up of passenger operator owner groups, freight operators and Network Rail
- As part of the review, we have, and will continue to, undertake a number of workshops and one-to-one meetings with representatives from across RDG to gather the information we require to develop our conclusions
- The Review of Charges has up to four phases:

1 **Vision**
(What?)

Vision of what the charges and incentives regime 'should' deliver

2 **Reality**
(Where are we now and what could change?)

a) Describe the current and potential alternative states of the world
b) How well does the current charges regime deliver the RDG vision?

3 **Options**
(How to get to the vision?)

Develop options for the new / updated charges and incentives regime

4 **Conclusions**
(Which approaches?)

Conclusions to ORR and funders on the changes to the charges and incentives regime under different states of the world

RDG vision for the charges and incentives regime in the long run

We have now completed Phase 1 – the vision

- The majority of the work for Phase 1 was completed between April and September 2014 and was the product a number of workshops that brought together views from a wide range of industry stakeholders

The RDG vision articulates what the charges and incentives regime should deliver in the long run and provides the framework against which various options can be assessed later in the review

- RDG's vision should remain valid, even if external factors change the environment in which the charges and incentives regime would operate
- Therefore, we tested the vision against a number of different 'states of the world' (or scenarios), in which the regime may operate in, in the future
    - For example, alternative states of the world could reflect: different degrees of risk allocation between Network Rail, funders, and operators (passenger and freight); different degrees of flexibility in franchise specifications; and different degrees of on-rail competition
- One of the key achievements of Phase 1 was that it brought together different industry groups in a way that was able to deliver a vision that all RDG members bought into
- The following slides provide a summary of the RDG vision

What is the RDG vision?

- The RDG vision for the charges and incentives regime presents the shared view of the RDG members of what the regime should achieve in the long run:
  - The pre-requisites the regime should abide to **(axioms)**
  - The objectives that the regime should pursue **(objectives)**
  - The fundamental criteria that should be followed when selecting charges and incentive mechanisms **(judgement criteria)**
- Axioms, objectives and judgement criteria are the building blocks of an ideal regime. They will hold true in any **environment in which the industry operates** in the future (or 'state of the world')
- A regime that meets the axioms, objectives, and judgement criteria of the vision will result in different charges and incentive mechanisms, according to the state of the world
  - As the characteristics of the current state of the world change, e.g. degrees of risk sharing, franchise flexibility and competition amongst operator, priorities among objectives also change
  - As a result, the way the charges and incentives regime will need to be designed to meet the objectives will be different

By '**long run**' we mean the end of CP7 (or 2029)

Summary of the RDG vision

Here, '**efficient**' means that the greatest net benefits for the whole system are delivered

Axioms

- System safety
- Consistency with law
- Funding of Network Rail efficient costs
- Allowance for market conditions
- A single approach for the network as a whole

Objectives

- Service costs recovery
- Efficient whole-system whole -life industry net costs (balance of benefits and costs)
- Efficient long run investment decisions
- Efficient performance management
- Efficient use of network capacity

Judgement criteria

- Predictability
- Simplicity
- Transparency
- Low transaction costs

Outputs

The **optimal charges and incentives mechanism will depend on the state of the world**, but will result in:

- Network Rail accountability
- Non-arbitrary allocation of costs
- Optimal traffic growth
- Aligning industry incentives
- Value for money for funders, taxpayers and users

Each element of the vision is explained in further detail in the following slides

Axioms | The charges and incentives regime should be based on the following pre-requisites**:**

- **System safety**: charges must fund, and should not create incentives to compromise, the safety of the railway system
- **Consistency with law**: the charges and incentives regime should comply with the relevant regulations and laws. This includes consistency with the non-discrimination principle
- **Funding of Network Rail efficient costs**: total revenues (access charges plus government support) should allow Network Rail to recover the total efficient costs of providing and improving all services
- **Allowance for market conditions**: where the charges for a service exceed the costs directly incurred for the provision of that service, any mark-up[1] should recognise pressures from competitive external markets and may only be applied if the market segment concerned can bear the cost
- **A single approach for the network as a whole**: the charges and incentives approach and methodology should apply to the whole network, but may be different for different customers with different characteristics. Different methodological decisions regarding the calculations of charges should not be allowed: methodology and policy decisions should be the same for the whole network. This does not mean that actual charges will be the same

[1] We note that the reference to ‘mark-up’ reflects an application of fixed common costs into charges. ‘Mark-ups’ are charges that exceed the short-run marginal costs: the fixed track access charge (FTAC) is currently an example of this

Objectives | The objectives of the charges and incentives regime should be:

- **Service cost recovery:** charges for any service provided by Network Rail should recover at least the efficient costs directly incurred to provide that service. The level at which services are defined will need to be considered
- **Efficient whole system whole life industry net costs:** the charges and incentives regime should incentivise or enable changes in the pattern of service (including in respect of journey times) where the resulting benefits exceed the change in efficient costs directly incurred
- **Efficient long run investment decisions:** the charges and incentives regime should incentivise or enable Network Rail to invest where the long run benefits of the investment exceed its efficient costs
- **Efficient performance management:** the charges and incentives regime should incentivise or enable the efficient management of both planned and unplanned disruptive work
- **Efficient use of network capacity:** the charges and incentives regime should not result in distortionary incentives for the allocation, and should encourage the best use of, available network capacity

'**Efficient**' means that the greatest net benefits for the whole system are delivered

Judgement criteria | Alternative implementation mechanisms for the achievement of the objectives should be judged according to the following criteria:

- **Predictability:** the regime should avoid undue volatility in the structure and level of charges across multiple control periods, so that operators can predict the future level of charges for a given pattern of operations with a reasonable degree of confidence
- **Simplicity:** all charges to all operators should be easily understood
- **Transparency:** all charges to all operators should be derived from a clear set of principles. Any deviations from these principles should be clearly identified, and their impact clearly shown
- **Low transaction costs:** the charges and incentives regime should impose low transaction costs

Outputs | A charges and incentives regime based on the specified axioms, objectives and judgement criteria would have different outputs in terms of charges and incentives design in different states of the world, but it would result in:

- **Network Rail accountability:** a transparent regime will result in Network Rail being accountable to its customers, funders and users in relation to charges and incentives. However, full accountability depends on non-charging structure issues such as institutional and contractual mechanisms, which cannot be reflected in a set of objectives that relates to the structure of charges
- **Non-arbitrary allocation of costs:** if a clear distinction can be made between the base services bought by operators, and the incremental enhancements to those services bought by the DfT, Transport Scotland and other funders, then a charges regime which recovers at least the efficient costs directly incurred to provide any service can generate a non-arbitrary charge for those incremental enhancements. This can result in a non-arbitrary allocation of costs between operators and funders
- **Optimal traffic growth:** a regime that provides efficient industry costs, efficient long run investment decisions and efficient use of network capacity will incentivise the growth of traffic volumes where the net benefits of doing so are positive. It will also provide value for money for funders, taxpayers and users
- **Aligning industry incentives:** improved efficiency from and greater co-operation (e.g. through alliances) between Network Rail, train operating companies and freight operating companies

How will we use the vision?

- RDG's vision for the charges and incentives regime provides the basis for the rest of the Review of Charges work programme
- We will use the vision in:
  - Phase 2, when we compare the vision to the current charges and incentives regime to understand the gaps in the current regime
  - Phase 3 and 4, when we develop options for the regime to ensure that those options meet the axioms and objectives of the vision and deliver the required outcomes
- The crucial aspect to the project is that it brings together RDG members' views in one place
- ORR considers that it is essential for its own review to incorporate industry views, including the outputs of RDG's Review of Charges, and where possible work together with RDG

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Annex: Definition of ‘benefits’ and ‘service’

Definition of 'benefits' (1)

- The term **'benefits'** appears in two objectives, efficient whole system whole life industry net costs and efficient long run investment decisions
- There are two definitions of benefits, with the second the most suitable:
    - **Narrow definition**: benefits are financial benefits to operators. They exclude externalities. The role of incentives would be to incentivise customers to change their behaviour where the financial benefit to them exceeds the financial cost to the supplier of accommodating that change

      Typically, this is achieved by setting price signals for variations in service patterns which are based on some measure of directly incurred cost, and letting the customers' natural self-interest take care of the rest
    - **Wider definition**: benefits are financial benefits to operators and wider benefits to society, to the extent they are considered a priority by funders. They include externalities. The role of incentives would be to influence customer behaviour to take account not only of the financial benefit to them, but of broader benefits to society

      Price signals would be modified in order to take account of these broader benefits and to still allow the customers' natural self-interest to work

Definition of 'benefits' (2)

- The **wider definition of benefits** requires a number of important questions to be addressed in due course:
  - Who decides what these broader benefits and dis-benefits are, and how they should be accounted for in a structure of charges regime?
  - Is Network Rail to be left exposed to the impact of these adjustments? If so, how do we avoid distorting its behaviour, because it may, for example, make an incremental loss on each mile served to a particular kind of traffic?
  - If Network Rail is protected, this means somebody else, most likely the governments, will have to pick up any costs resulting from these losses. Are they prepared to do so?

Definition of ‘service’

- The vision does not currently provide a **definition of service**. Service can be specified at different levels, according to the level of aggregation and other characteristics:
  - For example, a service could be a route, or a line, but it could also be a train service on that line at a particular time of day
  - Service cost reflectivity requires access charges to be based on underlying costs. The law, however, allows for mark-ups to recover common costs, when the market can bear them, and to pricing for capacity, which could lead to a definition of service also based on demand characteristics
  - For charging purposes, the definition of service has to be consistent with the non-discrimination axiom
  - The wording of the Rail Directive indicates that the basis for charging does relate to individual services, although it is permissible to aggregate them (charges may be averaged over a reasonable spread of train services and times) as long as this does not disturb the underlying service cost recovery principle
  - Note, that if routes with different route characteristics (and therefore different cost structures) are considered to be different services, then “accounting for route differences” follows immediately from this: it becomes an outcome

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