Rail Delivery Group

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Response to:

Office of Rail and Road

Network Charges - a consultation on how charges can improve efficiency

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Rail Delivery Group response to Office of Rail and Road consultation on Network Charges

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Introduction

The Rail Delivery Group (RDG) was established in May 2011 to bring together the owning groups of passenger and freight operating companies and Network Rail. Its purpose is to enable the organisations it represents to succeed by delivering better services for their customers. This ultimately benefits taxpayers and the economy.

One of RDG's strategic aims is to make changes, or inform government and/or regulatory decision makers, to enable industry parties to collectively deliver whole-industry outcomes through a framework that focuses all parties much more clearly on end-user interests, in a way that:

- is simple, clear and understandable;
- has a clearly articulated purpose with objectives and incentives that align through all organisations;
- improves the performance of the railway for customers and taxpayers - punctuality, connectivity, frequency, capacity, value for money; and
- provides a sustainable business environment for operators and investors.

1. Overview

RDG is pleased to respond to the Office of Rail and Road (ORR) consultation 'Network Charges - a consultation on how charges can improve efficiency'.

During previous periodic reviews some work on charges and incentives was 'timed out' due to the volume of work required to be completed. Therefore, we welcome ORR starting its work on charges and incentives earlier than in previous reviews.

Our response builds on the findings of our recent work with the industry to review the charges and incentives regime – **the RDG Review of Charges**. It also reflects the key messages from recent RDG responses to industry reviews.

The content of this response is consistent with the presentations we have given on the key findings of RDG's Review of Charges to ORR's Economics team (19th January) and at ORR's network charges workshops in Glasgow (5th February) and London (12th February).

ORR will also, no doubt, receive responses from our members, which build on this response.

The key messages in this response are:

- **Network charges are important.** They are a significant source of income for Network Rail and affect some decisions made by industry parties. However, ORR should **recognise the limits of charges**, particularly given the complexity of decisions around the allocation of network capacity and the impact that current contractual arrangements have on incentives.
- ORR should give high regard to industry's views and it should build upon RDG's recent work on charges and incentives. In particular, **ORR should take careful note of the areas of the charges and incentives regime where we have identified the most significant issues**, and focus its resources in these areas.
- We ask that **ORR provides a formal response to RDG's work** on charges and incentives, setting out its views on our analysis, given the level of resource and dedication that the industry has put into it.
- At this early stage of PR18, it is important to be **clear about the purpose** of charges and incentives, before considering the detailed aspects of the regime.
- We welcome that ORR has acknowledged the **difference between improving information to support business planning decisions, and reflecting that information in charges**.
- Without significant changes to industry arrangements (or 'State of the World'), there are likely to be **limited benefits from making fundamental changes** to charges and incentives.
- ORR should consider the **reality of train operators' business models** when developing proposals for PR18, e.g. most operators compete with other transport modes and so changes in charges between control periods can have material impacts on their businesses.
- Changes to the structure of charges can result in **significant implementation costs**, e.g. from reflecting changes in franchise models and updates to billing systems. Therefore, ORR should clearly articulate the tangible benefits that will result from its 2018 periodic review (PR18) charging proposals.

- ORR should **align its work on network charges with its review of the performance and possessions** regimes as there are currently strong links between these elements of the charges and incentives regime.

RDG wishes to continue to engage constructively with ORR during the next periodic review, with the aim of improving charges and incentives. We strongly recommend that ORR regularly communicates with industry stakeholders throughout PR18 to provide transparency of its policy development and decision-making.

The rest of this response is structured as follows:

- Section 2: Overview of RDG's Review of Charges project; and
- Section 3: RDG responses to questions raised in ORR's consultation document.

2. RDG's Review of Charges

Overview

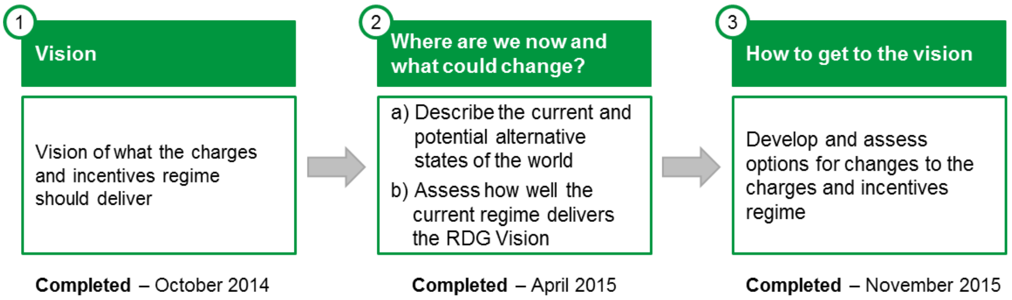
RDG's Review of Charges was a work programme, carried out over almost two years, to set out the industry's views on the charges and incentives regime for the use of Network Rail's infrastructure. The review included the possessions and performance regimes.

The aim of the project was to inform PR18 (and future reviews) so that ORR can focus its resources on the areas of the charges and incentives regime where we have identified the most significant issues.

At ORR's last periodic review, the industry waited for ORR to set out its views before responding. This time, the industry, through RDG, has taken the time to carefully set out its own views before ORR starts its review.

RDG's review was made up of three phases of work and involved around 100 stakeholders from across the GB rail industry. It started in early 2014 and concluded in November 2015.

Figure 1: High level plan for RDG Review of Charges



The findings of RDG's Review of Charges are intended to reflect the views of RDG's membership, i.e. passenger operators, freight operators and Network Rail. However, our work has also been informed by governments (Department for Transport (DfT), Transport Scotland and Welsh Government). ORR has also been involved in this project, as an observer. We have sought to provide clarity on areas where the industry has shared views and also where there are legitimate differences of views.

RDG's Review of Charges work is set out in a number of detailed reports that were published on RDG's website and shared with ORR as each phase of work concluded. However, we have produced a summary report[1] to help readers access the findings of RDG's work.

How RDG's work is relevant for ORR's consultation on Network Charges

RDG's Review of Charges set out to inform ORR's future review of the charges and incentives regime. We think that ORR should be able to build on RDG's work in this area and we welcome the references to RDG's findings in ORR's consultation documents.

We recognise that some of the outputs of our work may be more relevant in later stages of ORR's PR18 policy development process, e.g. the detailed assessments of charging options. However, we

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[1] RDG's Review of Charges summary report and all other reports from the project are available at: http://raildeliverygroup.com/what-we-do/our-work-programme/contractual-regulatory-reform/review-of-charges.html.

think that most of the project outputs can be used by ORR to inform its early thinking on charges and incentives. For example, we think that ORR should reflect on the areas of charges and incentives that RDG set out as priorities for further review during PR18. This is because it is important to close out issues as early as possible in the periodic review to help limit uncertainty within the industry.

3. Responses to ORR's consultation questions

In this section, we have set out responses to the questions that ORR asked in its consultation document. Our responses draw on the findings of RDG's Review of Charges. It also reflects the key messages from recent RDG responses to industry reviews.

Please note that when providing our responses, we have grouped some related questions together.

Chapter 1 – Introduction

Q1. How much does Network Rail's structure of charges matter today?

Charges are important because they:

- provide price signals to users and policy makers for the efficient use of infrastructure – they can affect the way that Network Rail and train operators work together to deliver the service that customers expect;
- define rail's 'pricing' compared with alternative transport sectors, i.e. for those operators that compete with other modes of transport, the prices they are charged can affect their competitive position;
- facilitate private sector investment;
- can allow the costs of the railway to be paid for over the life of assets; and
- account for over £1.6bn of Network Rail's income every year (£5.5bn including Network Grant) and allow Network Rail to recover the costs of providing rail infrastructure on a proportionate basis.

However, ORR should recognise that not all train operators are affected by changes to charges and incentives in the same way. For example, freight and open access passenger operators have full exposure to changes in the charges that they pay. Whereas most franchised agreements ensure that where franchises extend beyond one control period, franchised operators are not materially affected by significant changes to charges that take place during a periodic review, compared to the charges in place at the time the franchise was let.

In the future, charges may have greater importance for future franchised passenger operators as a result of the following developments:

- the value of industry funds flowing through charges is expected to be higher in the next control period as a result of the 2015 Summer Budget, which announced that "… the government will change the way it channels public money through the industry, directing it through the train operating companies."[2]
- DfT is looking at "… whether it would be practical and appropriate to partially expose franchised train operators to changes to the rate of charges which they have the ability to influence."[3]

[2] Summer Budget 2015 available at: https://www.gov.uk/government/publications/summer-budget-2015/summer-budget-2015.

[3] DfT sets out this work in its letter to ORR on improving incentives for better outcomes, available at: http://orr.gov.uk/__data/assets/pdf_file/0008/19853/DfTs-letter-on-improving-incentives-for-better-outcomes.pdf.

Q2. What issues could a new structure address?

Network charges play an important role in the GB rail industry. However, ORR should recognise their limits, particularly given the complexity of decisions around the allocation of network capacity, franchise specifications, and the impact that current contractual arrangements have on incentives. For example, some of the decisions about use of capacity on the rail network are so complex that charges and incentives, alone, are unlikely to be able to optimise the use of capacity. Therefore, non-charging approaches, e.g. administrative processes and procedures, are also an important part of the industry's contractual and regulatory framework.

ORR should be mindful of the State of the World[4] that the GB rail industry is likely to be in during Control Period 6 (CP6). In the current State of the World, some train operators have limited ability to respond to many of the price signals / incentives that charges seek to provide. For example, many operators have limited choices over the type of rolling stock they can use and also limited scope to change the services they provide. Whilst there may be some changes to the industry structure before, and during, CP6 there are unlikely to be significant changes that affect train operators exposure to, and ability to respond to, the charges and incentives regime.

In PR18, ORR should seek to prioritise areas where there are the most significant issues and where changes can have a demonstrable benefit to the industry and to its users. Through RDG's Review of Charges, we identified the following areas of the regime as priorities for PR18:

- developing a clearer and better understanding of the **purpose** of the regime, and each of its elements – one of the most important issues identified during our work was that the current charges and incentive s regime does not provide sufficient clarity on its purpose and so it is not well understood by industry, funders and broader stakeholders;
- resolving issues with the **Capacity Charge** - the purpose of the charge is not well understood and it is not considered to accurately reflect the financial impact of additional delay;
- developing a better **understanding of Network Rail's cost drivers**. However, there was only limited support for using such information in charges, particularly in the current State of the World;
- considering the role of **end-user compensation** within the performance regime. There was some consensus that this should be explored in PR18 as a way of improving the passenger perception of the industry; and
- reviewing the **discount structure for the possessions regime**. Our work suggested that there may be opportunities to address concerns that discounts encourage Network Rail to book possessions too early, which are then not used efficiently.

RDG's assessment of the current charges and incentives regime[5] provides further information on the issues that the industry thought could be addressed by charges. However, there was broad consensus that the structure of wear and tear charges, i.e. variable usage charge and charges for traction electricity, were reasonably well aligned with RDG's vision for charges and incentives. Therefore, these were not areas that RDG members thought should require significant review during PR18.

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[4] A State of the World refers to the environment that the charges and incentives regime operates within.

[5] RDG's assessment of the current charges and incentives regime report is available at: http://raildeliverygroup.com/files/Publications/2015-05_rdg_roc_assessment_of_current_regime.pdf.

Q3. Can you provide examples of behaviours that would change within your organisation or elsewhere in the rail industry with an improved structure of charges?

As part of RDG's Review of Charges, we carried out impact assessments on 22 options for changes to charges and incentives. As part of these assessments, we considered the way that different parts of the industry would react to changes. We recommend that ORR considers this work in detail and respond to RDG to set out its views on the analysis that we have carried out.

RDG's assessments highlighted how the impacts of changes to charges are affected by the State of the World that the regime operates within. Our analysis suggests that the greatest benefits from changes to charges and incentives are realised in alternatives States of the World. Therefore, without significant changes to industry structures, many of the options that we assessed provide limited improvements in industry outcomes.

As an indication of the potential impact of changes to charges and incentives, only four of the 22 options assessed by CEPA were expected to have an overall positive impact in the current State of the World. Additionally, three of those four options were expected to lead to a negative impact on simplicity, predictability or transaction costs.

However, there are still some changes that could affect industry behaviour in the current State of the World. For example, improved information on Network Rail's cost drivers could help funders and train operators develop more informed business cases for making changes to the services they provide. However, the benefits of this approach were considered to be predominantly informational.

Similarly, better information about the value of network capacity may encourage funders to consider whether their use of scarce capacity gives value for public funds, where they are excluding commercial operators. However, in the current State of the World, franchised operators have limited incentives to respond to value-based charges given current franchising arrangements, e.g. they are often committed to delivering a relatively fixed set of rail services.

ORR should identify the tangible benefits that would result from its PR18 charging proposals and determine whether they are likely to outweigh the significant implementation costs of the changes.

Chapter 2 - Background and approach

Q4. Are the high-level gaps (in Figure 4) a good starting point for developing solutions? Would you have expected to see any other high-level gaps and, if so, what are they?

The four gaps identified by ORR are described at a very high level. Therefore, it is not clear that these gaps are sufficiently meaningful to inform the development of a new structure of charges.

We encourage ORR to set out further detail on these gaps so that there is a clear link between them and its PR18 proposals. This could be done as part of regular engagement between ORR and industry stakeholders during PR18. Without this detail, there is a risk that the options that ORR develops during PR18 do not address the most significant issues with the regime.

RDG's assessment of the current charges and incentives regime highlighted gaps in the current regime. Our work identified that there were significant elements of the current regime that work well and RDG is keen to retain these benefits. However, it also identified opportunities for improvements.

We have highlighted, below, some of the overarching gaps that were highlighted in RDG's assessment, which do not appear within ORR's four high-level gaps:

- Purpose – one of the most important issues identified during our work was that the current charges and incentives regime does not provide sufficient clarity on its intended purpose and so it is not well understood by industry, funders and broader stakeholders.
- Customers/end-users – we considered how the charges and incentives regime can improve the end-user (passengers and freight users) experience. ORR's gaps include 'competition', which is not an end in itself. In addition, ORR does not consider the lack of alignment between charges and desired customer outcomes.
- Coherence of the regime – there was consensus in RDG's work that the current regime was not coherent. Individual charges and incentives have been introduced without sufficient consideration of the impact on, and alignment with, the rest of the regime, and wider industry frameworks.

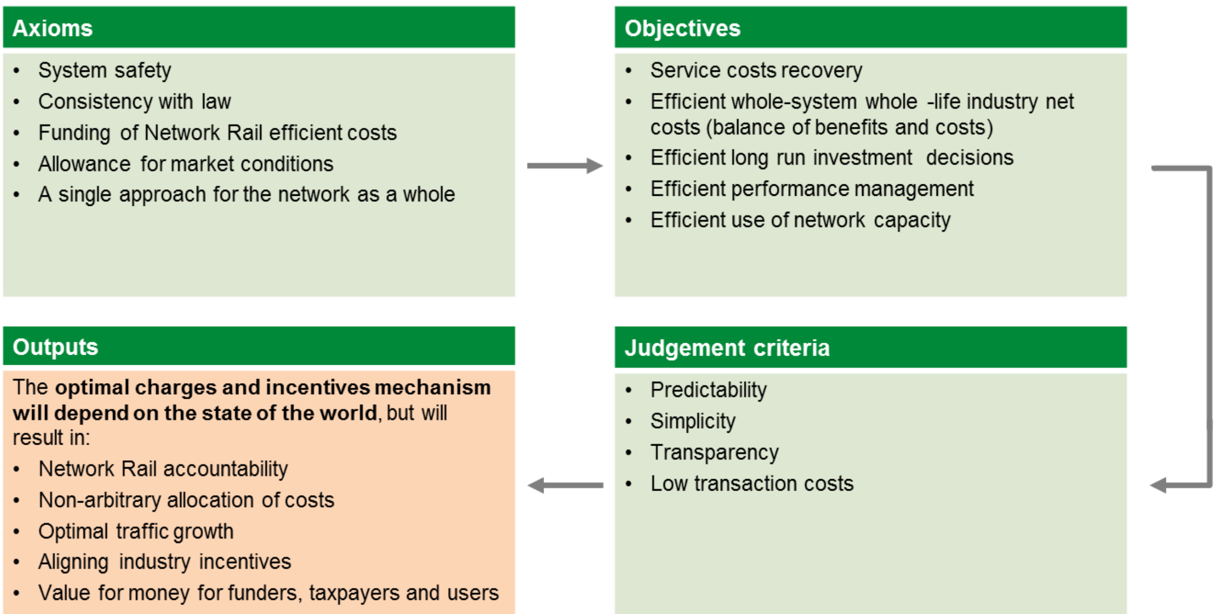
There are also a number of specific gaps that were identified in RDG's assessment, which covered: running costs; customer experience; possessions; performance; use of network capacity; and alignment of incentives and coherence of the regime. ORR should reflect on these gaps as it develops options for changes to charges and incentives during PR18. ORR should focus its efforts on areas where changes can lead to demonstrable benefits, i.e. where they can actually drive positive changes in behaviour and decision making within the industry.

It is also important to note that some of the gaps identified by ORR may be better resolved outside of the charges and incentives regime. For example, network capacity is currently contracted and allocated using a series of administrative processes and there are improvements that could be made to these existing arrangements, e.g. revise 'use it or lose it' provisions for operators, to address gaps in this area.

Q5. Do the assessment criteria accurately reflect the main factors we should consider for assessing the impact of options?

RDG's Vision formed the basis for the criteria that we used to assess the advantages and disadvantages of the current regime. It also provided a framework to assess options for change. The vision was the product of a number of workshops that brought together views from a wide range of industry stakeholders. It provided a robust and comprehensive set of criteria for use in our assessments.

Figure 1: Summary of RDG's vision for charges and incentives



Taking a similar approach to RDG's assessment, ORR's criteria draw on its charging objectives. There is a significant overlap between the RDG Vision and ORR's objectives. However, we wrote to ORR at the beginning of 2015[6] to provide feedback on ORR's proposed objectives. Whilst ORR is not consulting on its charging objectives, we have repeated our comments below as they do not appear to have been considered in the final charging objectives set out in ORR's consultation (they appear to be unchanged from the set of objectives that ORR consulted on in 2015):

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.

There are a number of overlaps across ORR's assessment criteria. For example, ORR's charging objectives include 'be legally consistent'. However, one of the five high-level assessment criteria is also 'legal impacts'. Duplication of criteria could lead to the unintentional over-weighting of certain impacts in the overall assessment. Therefore, ORR should seek to remove duplication within its criteria.

[6] RDG's response to ORR's letter, in relation to its structure of charges review, is available at: http://raildeliverygroup.com/files/Publications/2015-02_rdg_response_to_orr_charges_review_letter.pdf.

Q6. To what extent does the use of scenarios, in the form of the RDG 'states of the world', help to understand the likely effectiveness of future charging structures?

RDG worked with the industry to develop a number of alternative States of the World, in which it could test options for changes to charges and incentives. It did this so that RDG's conclusions on the charges and incentives regime remained valid, even if external factors change the environment in which the regime would operate.

In selecting the alternative states of the world, we considered the following:

- more than one State of the World can co-exist on the network, e.g. there could be more on-rail competition for intercity services but more heavily specified franchises for commuter/local services;
- we avoided 'cluttering' the alternative States of the World so that they were not overly specific;
- we considered changes that were complementary, e.g. more regional decision making is likely to require a different approach to funding; and
- we did not set out any views on which States of the World industry preferred. There are likely to be advantages and disadvantages of each of the alternatives States of the World and we did not determine whether each alternative was desirable, or otherwise, as part of our work.

We think that the robustness of RDG's assessment of charging options was improved by the use of the States of the World. It required RDG's assessments to consider not only how an option would improve outcomes within the current industry structure but also how that assessment might differ as a result of changes to the environment that charges operate within.

We welcome ORR's use of the States of the World in developing its thinking on charges for PR18. We suggest that, when developing its proposals, ORR should actively consider the impact on industry behaviours in the State of the World that the industry is likely to face in CP6.

Chapter 3 - Options and proposal

Q7: To what extent do the packages of options represent the key strategic choices available to improve the existing charging structure?

We welcome that ORR has considered broad areas of the charges and incentives regime before it begins to develop detailed proposals for change. However, given the strong links between some of these packages, it is important that these packages are not developed separately through PR18 so that those links are overlooked. Many industry colleagues are concerned that ORR has not learnt the lessons from PR13 that its work should be more holistic, i.e. that it should be clear about the overall impact of its periodic review proposals on different groups of stakeholders.

The high-level nature of ORR's proposed packages, and the potential overlaps between them, makes it difficult to envisage how the charges and incentives regime would look as a result of the implementation of each package. For example, the 'Package of improvements to short-run variable charges' could lead to a wide range of changes to the current set of charges and incentives and also has strong links to performance regime, through the Capacity Charge, which has been considered by ORR in a separate consultation.

One of the key findings from RDG's Review of Charges is that the industry should be realistic about the limits of what the regime can achieve. For example, some of the decisions about use of capacity on the network are so complex that charges and incentives, alone, are unlikely to be able to optimise the use of capacity. Therefore, non-charging approaches, e.g. administrative processes and procedures, are also an important part of the industry's contractual and regulatory framework. ORR should consider how these processes and procedures can work with charges to improve industry outcomes.

Q8. Would you expect the infrastructure costs package to deliver more (or fewer) benefits than the value-based capacity package at this stage and, if so, why?

Q9. We welcome your views on our proposal to prioritise further development of the infrastructure costs package.

The text below relates to Q8 and Q9 of ORR's consultation document.

ORR's 'infrastructure costs package' is focused on developing a better understanding of the drivers of the network's fixed costs, whereas the 'value-based capacity package' would introduce new charges linked to the relative value of using different parts of the network. The high-level nature of the two packages means that it is difficult to determine whether one package could deliver more benefits than the other.

RDG's Review of Charges has considered options for changes to charges, which are likely to fall into the scope of these two packages. The findings from RDG's analysis suggests that the greatest changes to charges in these areas are delivered in alternative States of the World, e.g. where the approach to allocating network capacity is less administrative and passenger operators have greater ability to respond to the price signals provided by charges.

However, the benefits from each package would depend on how they are implemented. For example, the value-based package could be implemented in a number of different ways – RDG considered reservation charging and scarcity charging. Whilst these options could both be considered to be value-based, they could lead to very different impacts on each industry group.

RDG welcomes ORR's proposed approach to prioritising its PR18 activities. We consider that it is important to close out issues as early as possible to help limit uncertainty within the industry, which can affect prospects for future industry investment. RDG's Review of Charges found that the priorities for charges in PR18 should include:

- developing a clearer and better understanding of the purpose of the regime, and each of its elements;
- resolving issues with the Capacity Charge; and
- developing a better understanding of Network Rail's cost drivers. However, there was only limited support for using such information in charges, particularly in the current State of the World.

However, without significant changes to industry arrangements, i.e. a move to an alternative State of the World, there are likely to be limited benefits to making fundamental changes to charges and incentives. Given that there is unlikely to be significant changes from the current State of the World, ORR need to be realistic about the impact that changes to charges and incentives can have on improving industry outcomes.

Chapter 4 - Infrastructure costs package

Q10. What costs and benefits do you see with the infrastructure costs package? Do you think our draft impact assessment is missing any significant impacts or has misrepresented any impacts?

Q11. To what extent do you think the benefits of this package can be realised through more information, rather than through the use of charges?

The text below relates to Q10 and Q11 of ORR's consultation document.

RDG's Review of Charges assessed the impact of setting charges used to recover Network Rail's net revenue requirement in a way that is more reflective of underlying costs than the existing Fixed Track Access Charges (FTACs). This option ('fixed charge based on avoidable cost') is similar to the broad proposal set out in ORR's infrastructure costs package and so we have set out some of the findings from this assessment below.

Industry participants supported RDG in selecting this option for further investigation, given its potential to send more informative price signals to train operators and their funders in the context of anticipated changes to money flows, i.e. a significant reduction in the Network Grant. It was also selected to investigate freight sector concerns about the implications of using avoidable cost information in charges.

CEPA assessment of fixed charges based on 'avoidable cost'

CEPA's assessment envisaged that the current FTACs could be replaced with a new charge based on long-run incremental cost (LRIC) principles. CEPA's assessment assumed these charges would be implemented as 'mark-ups' as defined by EU legalisation. However, further legal analysis is required to confirm this assumption as it crucial in determining the likely impact of this option.

CEPA's indicative modelling uncovered potential for large shifts in costs, and therefore charges, between operators. In particular, it might be possible to see shifts from train services operating on busy lines where economies of scale are realised to those where they are not. There was also the potential to attribute avoidable costs to freight operators, which could be substantial. As a result of the competition from road haulage, freight operators would require significant protection from such a change in fixed charges as estimated increases (before considering any potential 'mark-up' protections) easily outstrip current profits.

Overall, CEPA found that while there could be informational benefits from investigating avoidable costs, this should not be conflated with those benefits that might arise through charging. In the current State of the World, CEPA anticipated minimal benefit from putting avoidable cost information into charges, given the nature of current franchising arrangements and decision making processes.

It is not clear that there would be sufficient benefit from this option to outweigh the burden of the supporting calculations, and the effort required to calibrate the level of the mark-up to ensure the viability of open access and freight operators.

Despite the weak overall performance of this option against the RDG Vision in the current State of the World, CEPA identified potential for this option to be beneficial in alternative States of the World, where there is more flexibility for franchised operators to respond to the price signals, and where there are changes to the way that network capacity is allocated.

RDG views on fixed charges based on 'avoidable cost'

Passenger operators consider that it is important to distinguish between informational benefits and those from using avoidable cost information in charges. They saw minimal benefit from avoidable cost charging in the current State of the World, particularly given the burden of calculating the charges and ensuring that operators without public service contract income would be able to pay the charge and remain financially viable.

Where changes lead to greater transparency of Network Rail's cost drivers, industry colleagues thought that this additional information should be presented in the wider context of the benefits of the rail industry to the GB economy.

There was also recognition that there is more than one approach that could be used to allocate Network Rail's costs, i.e. there is not just one 'correct' way of approaching cost allocation (particularly for common costs). The choice of allocation approach, and the assumptions that are made in implementing it, are likely to have a material impact on the way that costs are allocated to particular groups of services, and ultimately to train operators. Therefore, ORR should carefully consider how it uses this information. For example, a revised allocation of costs could allocate significant costs to certain train services, which could cause instability in services at a local level, particularly if this information is reflected in charges.

The issue of ensuring the viability of freight operators was shared by all industry participants, with some passenger operators expressing the view that this issue must be explicitly addressed as it is an inevitable requirement. However, freight users noted that some options for supporting freight, such as providing direct grants to operators could potentially create barriers to competition / new entrants.

Currently, a large proportion of freight operators' contribution to Network Rail's fixed costs comes from charges on coal traffic. With coal traffic volumes reducing significantly over CP5, freight operators would be concerned if costs were, instead, recovered from other traffic flows that compete more directly with road haulage, i.e. intermodal services.

There was agreement that it is essential for further work to be done to close down legal uncertainties, particularly whether this option would be implemented as a 'mark-up' or as a 'cost that is directly incurred'[7], at an early stage of policy development. Passenger operators considered it important to address the impact on service sponsors and funders, particularly those associated with regional public service obligation (PSO) contract.

Open access operators expressed the view that there is a strong link between the existing charges structure and processes for capacity allocation and network access processes. Existing open access operators do not pay FTAC with one rationale being that this reflects the different markets served and the fact that they get access to the network in a different way. In particular, franchised passenger operators are able to access the whole of the relevant passenger market while the open access operator access is controlled, currently, by the Not Primarily Abstractive (NPA) test amongst other mechanisms. If Open Access operators were to face an avoidable cost charge, there would

[7] The EU Commission Implementing Regulation 2015/909 (from June 2015) sets out the 'modalities' for the calculation of the cost that is directly incurred as a result of operating train services, i.e. it sets out the types of costs that can be included when calculating this minimum track access charges for operators. Whilst the regulation is relatively new, it appears to use a very short run approach to calculating this set of cost.

need to be a parallel adjustment to the capacity allocation process. We acknowledge that potential changes to the role of open access operators are being considered as part of CMA's competition policy project on passenger rail services.

Network Rail considers that the current approach that is used to allocate Network Rail's 'fixed' costs is too simplistic; it could be improved to better reflect the actual causes of costs. It considers that the informational benefits of this could be powerful, even if it were concluded not to fully reflect this in charges.

An issue raised by freight users was that charging structures should not create anti-competitive effects e.g. where changes to the structure of charges lead to ports or quarries having different charges for the same product.

Specific comments on ORR's impact assessment of its infrastructure costs package

We have set out some specific comments in relation to ORR's impact assessment below:

- we welcome that ORR has acknowledged, in its consultation, the difference between improving information to support business planning, and putting that information into charges;
- ORR's assessment has limited discussion of the impact of this package on station charges. Stations charges are an important part of the charges and incentives regime and should be given sufficient attention during PR18;
- ORR's supporting analysis suggests that generating a 1% efficiency in Network Rail's operations, maintenance or renewals costs could lead to a significant absolute cost saving. However, this analysis does not appear to have any direct relationship with the benefits of the changes discussed in this package. It does not provide any meaningful insight into the 'size of the prize' for changes to charges. There needs to be a much clearer articulation of the likely changes in behaviour / activity that could drive such costs saving as a result of ORR's PR18 charging proposals;
- the definitions of terms such as 'avoidable cost', LRIC, attribution, and allocation that are used by ORR appear to be slightly different from those in Network Rail's work on cost allocation by Brockley Consulting, which have been shared with ORR. It would be helpful if these terms were used consistently to reduce confusion about future proposals; and
- ORR's impact assessment does not appear to take into account the likely increase in the proportion of the net revenue requirement as a result of the 2015 Summer Budget announcement to flow more funds through franchise passenger operators.

Q12. We welcome your views on our proposal not to prioritise further development of options based on the value of capacity.

RDG welcomes ORR's proposed approach of not prioritising further work on the value-based capacity package. We consider that it is important to close out issues as early as possible to help limit uncertainty within the industry. <u>This means that ORR should **not** seek to reconsider this package at a later stage of PR18.</u>

However, ORR should recognise that by not carrying out further work on options based on the value of network capacity, this may limit ORR's options in other areas of charges and incentives. For example, CEPA's analysis of a disaggregated variable usage charge suggested that it would require some form of scarcity charge to accompany it, i.e. it would require value-based charging options.

Whilst RDG's Review of Charges did not identify value-based charging as a priority for PR18, there was some consensus on developing a better understanding of the value of train paths.

Chapter 5 - Value-based package

Q13. What costs and benefits do you see with the value-based capacity package? Do you think our draft impact assessment is missing any significant impacts, or has misrepresented any impacts?

RDG's Review of Charges assessed the impact of introducing different types of value-based charges, which included the illustrative options highlighted in ORR's consultation:

- reservation charges;
- scarcity charges; and
- auctions.

The options that we assessed were not necessarily supported by all RDG members – the purpose of this phase was to set out the advantages and disadvantages of options and draw out industry views.

CEPA assessment of value-based charging options

We have summarised the main findings from CEPA's assessments of the value-based charging options, below.

CEPA's assessment of **capacity auctions** found that even on a limited basis, the overall benefits from this option, such as the improved management of congestion would be negated by the complexity of the approach and its potential negative impacts on smaller users of the network. CEPA considered that auctions would not be practicable in the current or most other States of the World.

CEPA found that **path reservation charges** could have some positive benefits in incentivising better use of existing capacity but in some forms could have a significant adverse impact on freight operators. In the current State of the World, impacts on franchised passenger operators are likely to be small given that they have limited scope to change their service levels. In States of the World where there is greater on-rail competition or where there is greater emphasis on the value of capacity, reservation charging could have a more positive impact.

CEPA's assessment of **scarcity charging** found that it could have positive benefits in incentivising better use of existing capacity. However, it considered that there would be significant difficulties in trying to develop a charge that reflected both commercial and non-commercial value. A scarcity charge based solely on commercial value would require funders to decide whether the social benefit of their funded service justified paying the premium, which may not be considered to be an appropriate way of making trade-offs between commercially beneficial and socially beneficial uses of infrastructure. For services that provide social benefits but are not procured by funders e.g. freight services, they may not be able to access funding to offset the effect of this charge. This approach was considered to have greater benefits in States of the World where there was greater on-rail competition, or where train operators played a greater role in capacity allocation.

RDG views on value-based charging options

There was no support within RDG for capacity auctions.

There was consensus in the industry that a path reservation charge would almost exclusively 'bite' upon freight operators, raising concerns that it could be impractical given the nature of the market within which they operate. Freight operators require some flexibility in their access due to variability in their customers' demand for the products they transport.

Several industry representatives suggested that socio-economic as well as commercial value should be included in any measure of scarcity value. However, using price to encourage reallocation of capacity between funded and commercial services was considered to be politically controversial.

If the scarcity charge applied to freight and open access operators, those operators thought that there would need to be a parallel adjustment to the capacity allocation process to make them freer to obtain paths.

Network Rail considered that there could be merit in carrying out more work to better understand the full economic value (i.e. societal and commercial) of each train path. They would be concerned about pricing off traffic of high social value if a purely commercial value approach were adopted.

Specific comments on ORR's impact assessment of its value-based capacity package

We have set out some specific comments in relation to ORR's impact assessment below:

- ORR suggests that it will ensure cost-based charges send sensible signals about the use of scarce capacity. Without developing a greater understanding of the value of train paths, it may be difficult to do this; and
- given the high-level description of this package, it is difficult to determine the impact of this package on stakeholders.

Q14. Would you expect a better understanding of costs to be an essential precursor to value-based charges?

Value-based charging seeks to reflect the value that users of the network place on access to particular train paths. This approach to charging generally seeks to address issues with the allocation of network capacity. Cost-based charges reflect the costs that the infrastructure manager incurs as a result of providing access to the infrastructure.

Network Rail needs to recover sufficient funds to run its business, i.e. its revenue requirement. Therefore, in a scenario where value-based charges do not recover Network Rail's revenue requirement, additional charges (or other money flows) would need to recover the gap. However, this does not mean that ORR needs, first, to develop a better understanding of Network Rail's costs before seeking to gain a better understanding of the value of network capacity.

Q15. To what extent do you think the benefits of this package can be realised through more information alone, without passing that into charges?

Some of the decisions relating to the use of network capacity are so complex that charges and incentives, alone, are unlikely to be able to optimise the use of capacity. This is particularly true in the current State of the World where administrative processes and procedures are an important part of the industry's contractual and regulatory framework.

In the current State of the World, capacity is contracted and allocated, primarily, through a series of administrative procedures. Therefore, without significant changes to industry arrangements, it is likely that there will be relatively few additional benefits from reflecting information on value in charges, compared with the benefits from simply using this information to help improve the existing decision making processes around capacity allocation. This is because in the current State of the World, most train operators are unlikely to be able to respond to any such price signals.

Chapter 6 - Package of improvements to current short-term variable charges

Q16. What options would you expect to see in a long list of improvements to Network Rail's short-run variable charges?

Q17. What options do you see as a priority for this package?

Q18. What costs and benefits do you see with this package?

The text below relates to Q16, Q17 and Q18 of ORR's consultation document.

As part of RDG's Review of Charges, we identified aspects of the current regime that the industry thought should be retained. For example, marginal wear and tear charges and charges for traction electricity were considered to be broadly aligned with RDG's Vision. There was general consensus that the structure of these charges should not be revisited for PR18. ORR should reflect the industry's view of priorities for PR18 when developing the scope of its work plan for charges and incentives.

For the avoidance of doubt, even where the structure of a charge largely remains the same, it should still be recalibrated using up-to-date information on costs for CP6. When charges are recalibrated, ORR should be mindful of the impact of changes to the overall level of CP6 charges for train operators. For example, a number of passenger operators are concerned about the rising level of traction electricity charges as a result of increasing transmission and distribution costs, and government levies. These 'add-on' costs currently account for around half of the total Electric Current for Traction charge, and are expected to rise significantly over the next decade.

ORR has included the Capacity Charge in the short-term variable charges package. Throughout RDG's Review of Charges, there was a clear desire, amongst RDG members, to explore options to reform the Capacity Charge. Its purpose is not well understood by stakeholders and it is not considered to accurately reflect the financial impact of additional delay. There are very clear links between the Capacity Charge and the performance regime. Therefore, ORR should ensure that its work on the Capacity Charge is closely aligned with its review of the performance regime.

As part of RDG's Review of Charges, we considered the possibility of updating Network Rail's Schedule 8 performance benchmarks annually to take account of changes in traffic. This option could remove the need for a Capacity Charge. This option could also help the Schedule 8 benchmark to be more reflective of the achievable level of performance and it is likely to improve industry understanding of the regime. There was general agreement, that this option should be explored further in PR18.

At its network charges workshops in Glasgow (5th February) and London (12th February), ORR presented a long list of options for this package that it will be reviewing during 2016. ORR explained that it is likely to then consult on a shorter list of options by the end of the year. Many RDG members have questioned why ORR needs to start from such a long list of options, given that RDG has already set out a significant amount of analysis on many of the options on that list. RDG members also sought clarity from ORR as to how its list had been derived, which was not clear.

RDG considers that there is a significant risk that if ORR does not set out a shortlist of options for this package until the end of 2016, then we will again be 'timed out' on the development of some of these options during PR18. ORR should seek to narrow down its PR18 proposals as soon as possible so that it can work with the industry to ensure that sufficient time is given to those options that are most likely to be implemented for CP6.

Chapter 7 - Supporting packages: competition options

Q19. We would welcome comments on how charges might apply to open access in future. In particular, we would welcome comments on:

- **a) whether open access operators should face charges implemented under the infrastructure costs package;**
- **b) what forms of adjustments to charges might be appropriate for open access operators, relative to franchised operators; and**
- **c) how current incumbent open access operators should be treated.**

ORR's consultation on network charges is taking place at the same time as CMA is undertaking a project to consider whether increasing competition in passenger rail services could lead to better value for money and improve service quality. CMA is also considering how open access operators could contribute more to Network Rail's costs and possibly to the revenue abstracted from franchised services.

When considering the impact of an avoidable cost approach to charges, open access operators expressed the view that there is a strong link between the existing charges structure and processes for capacity allocation and network access processes. Existing open access operators do not pay FTAC with one rationale being that this reflects the different markets served and the fact that they get access to the network in a different way. In particular, franchised passenger operators are able to access the whole of the relevant passenger market while open access operators' access is controlled, currently, by the Not Primarily Abstractive (NPA) test. If Open Access operators were to face an avoidable cost charge, there would need to be a parallel adjustment to the capacity allocation process.

ORR should make sure that any decisions it takes on changes to the charges paid by open access operators are aligned with CMA's project on competition in passenger rail services.

Should open access operators be allowed similar access rights to franchised passenger operators, franchised and open access passenger operators should face the same charges. Otherwise, there is likely to be a need for administrative intervention, e.g. complex wash-up arrangements to address differences. Therefore, the charges would need to be based on the value of the paths being used (which ORR has ruled out) or those operators should just face marginal cost charges, which would require DfT to pay for Network Rail's fixed costs. If charges were levied above costs directly incurred, the ability to bear test is likely to apply and so open access operators are unlikely to face the same charges as franchised operators.

In considering how open access operators could contribute to Network Rail's fixed costs, ORR should recognise that incumbent open access operators have based their current business models, and related investment decisions, on the existing arrangements for access and charging. However, we also understand that there is a need to avoid unduly discriminating against potential new entrants.

Chapter 7 - Supporting packages: complexity options

Q20. Would you like to see either of the complexity options developed further?

Q21. Are there other options you would like assessed to reduce complexity?

Q22. What costs and benefits would you expect with these complexity options?

The text below relates to Q20, Q21 and Q22 of ORR's consultation document.

RDG's Review of Charges highlighted the need for the charges and incentives regime to be straightforward, transparent, and readily understandable at the point of use by all parts of the industry and broader stakeholders. Therefore, we welcome that ORR is seeking to address the issue of complexity. In carrying out PR18, ORR should be mindful of the potential to add further complexity to the regime.

A 'charges calculator' could help to improve the understanding of the impact of changes to charges at a periodic review and should be explored as part of PR18. This could accompany an updated charges and incentives user guide[8]. However, we do not think that introducing a 'complexity test' is necessarily the best approach. ORR should actively seek to remove unnecessary complexity throughout its review, rather than just considering this in the context of a formal test.

As part of PR18, we would encourage ORR to consider opportunities to simplify the regime. For example, freight operators consider that there may be merit in applying one mark-up, over wear and tear charges, for each freight commodity, where they apply, to simplify their charges.

Whilst considering the complexity of charges is important, ORR should also consider how it can reduce the burden and complexity of the periodic review process so that stakeholders can more easily engage in developing policy with ORR. For example, increasing the transparency of ORR's decision making can help to reduce the perceived complexity of charges and incentives.

Chapter 8 – Implementation of the structure of charges

Q23. In chapter 8, we started to highlight issues associated with implementation of a new charging structure and potential actions to alleviate negative impacts. Do you have any views on options for implementing a new structure and what would be the impacts of these options?

As part of RDG's Review of Charges, we identified a number of considerations for ORR as it considers changes to the charges and incentives regime:

- there should be a relatively high hurdle for making changes, i.e. there should be a demonstrable benefit that clearly outweighs the costs involved in making changes to the regime. ORR should recognise this in its PR18 impact assessments;
- ORR should consider the realities of the GB rail industry and should not assume that changes impact all parties in the same way. For example, explicit consideration should be given to the parts of the regime that are affected by other industry arrangements (e.g. franchise agreements and the approach to capacity allocation) and this should be reflected in ORR's review;
- the regime needs to provide stability to allow for business planning and industry investments, recognising that asset lives in the rail industry are often 30 years or more;

[8] The current RDG charges and incentives user guide is available at: http://raildeliverygroup.com/files/Publications/2014-07_charges_and_incentives_user_guide.pdf.

- charges and incentives should reflect the wider benefits that the GB railway provides to the UK economy (economic and societal), e.g. making the economy more productive by up to £11.3bn[9], and be mindful that it is a mixed-use railway; and
- the charges and incentives regime should take a single approach to the network as a whole, i.e. the principles for calculating charges and incentives should be the same across the network.

Q24. We understand the structure of charges has the potential to impact different groups in different ways. In developing the options in this consultation (particularly in the draft impact assessments), have we drawn out the implications for different groups? Please explain your response.

The content of ORR's impact assessments reflects the relatively high-level nature of the charging packages, i.e. the impacts are relatively broad. There also appears to be a lack of understanding about how some operators' business models work. Therefore, there are likely to be implications for stakeholder groups that have not been considered.

As ORR develops its thinking on its charging proposals, it should revisit the impact assessments and seek to, more fully, quantify the benefits and costs of options. It should also consider the impact on different types of train operators and how their business models may differ. For example, RDG's analysis considered the impact of proposals on six different stylised operators:

- franchised commuter passenger operators;
- franchised regional passenger operators;
- franchised inter-city passenger operators;
- open access passenger operators;
- freight operators – multi customer; and
- freight operators – bulk.

In considering the impact on stakeholders, it is important for ORR to recognises that even small (or incremental) changes to charges can lead to relatively significant impacts for operators, particularly, where the rail services that they provide compete with other transport modes.

One of the industry's concerns with PR13 was that it was not possible to fully understand the impact of ORR's proposals on their businesses. During PR18, ORR should assess and present the likely, overall, impact of its charging proposals on each stakeholder group, not just the impact of individual changes.

[9] Source: Oxera, "What is the contribution of rail to the UK economy?" 2015. This is available at: http://www.raildeliverygroup.com/files/Publications/2015-09_contribution_of_rail_to_UK_economy-1.pdf.

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