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30 September 2013

This consultation is open to all

Dear colleague

## **Consultation on contractual provisions to implement options for the capacity charge in CP5**

### **Purpose**

1. The purpose of this letter is to consult you on the contractual drafting for a number of options that have been put forward in relation to the capacity charge as part of the 2013 periodic review (PR13). These options are additional to the contractual wording for the capacity charge on which we consulted in our 12 July 2013 implementation consultation. These options apply to freight operators, open access passenger operators and charter operators.
2. As we have yet to conclude on the policy for the capacity charge, we are consulting on more than one option. This consultation relates to the contractual wording, however, and not to the policy.
3. This consultation and policy and contractual documents relating to this consultation can be found on our website at:

<http://www.rail-reg.gov.uk/pr13/consultations/capacity-charge-implementation.php>

### **Background to the consultation**

4. In our draft determination<sup>1</sup> we said that we would either: implement a form of the capacity charge put forward by the rail freight operators' association (RFOA) (possibly applying it also to open access passenger operators and / or franchise passenger operators); or approve capacity charge rates that have been calculated using the CP4 methodology, updated for inflation.
5. Since our draft determination, there have been a number of developments in thinking with respect to the capacity charge for passenger traffic. We published a letter, for consultation, on 19 July 2013, in which we set out options for applying the

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<sup>1</sup> Periodic review 2013: Draft determination of Network Rail's outputs and funding for 2014-19, <http://www.rail-reg.gov.uk/pr13/consultations/draft-determination.php>

RFOA approach to passenger traffic. At the same time, the Rail Delivery Group (RDG) worked to develop the RFOA proposal into a proposal which also covered passenger services, and we received the proposal formally in a letter from RDG dated 28 August 2013. We responded to this proposal by letter on 24 September, explaining that we had taken Leading Counsel's advice and, given the advice we had received, we were not prepared to implement the RDG proposal for passenger services. Instead we set out a refined proposal.

6. On 13 September 2013 we received a proposal from the RDG freight group proposing a revised form of the capacity charge for freight operators, based on the original RFOA proposal.
7. Given that we have yet to conclude on how the capacity charge will be levied in CP5, we are consulting on the contractual wording of several options. We have already consulted on the contractual wording for the option consulted on in our draft determination of retaining the CP4 capacity charge rates in our 12 July 2013 consultation on implementing PR13<sup>2</sup>. We are now consulting on contractual wording for: the option outlined in our 24 September letter for existing open access operators, three options for freight based around the RFOA wash-up concept, and a wash-up for charter operators.
8. We outline these options in Annex A to this letter. Annex A also explains the contractual changes we are proposing to implement the different options.
9. The specific contractual provisions showing our proposed changes to Schedules 7 are set out on our website at: <http://www.rail-reg.gov.uk/pr13/consultations/capacity-charge-implementation.php> .
10. This address also provides links to all the relevant documents mentioned in this consultation.

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<sup>2</sup> Available at: <http://www.rail-reg.gov.uk/pr13/PDF/pr13-implementation-consultation.pdf>

## Responding to this consultation

11. We welcome responses on any aspect of the proposed drafting. This is a four week consultation. Please send your responses in electronic format (or if not possible, in hard-copy format) by **28 October 2013** to:

**Alexandra Bobocica**

Office of Rail Regulation

1 Kemble Street

London

WC2B 4AN

Email: [alexandra.bobocica@orr.gsi.gov.uk](mailto:alexandra.bobocica@orr.gsi.gov.uk)

12. Our aim is that all documents on our website adhere to certain standards of accessibility. For this reason, we would prefer to receive your correspondence in an editable format such as Microsoft Word. If you do send a PDF document or similar, we would be grateful if you could create it from an electronic file rather than an image scan, and ensure that 'no security' is set in the document properties.

13. If you send a written response, you should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise, we would expect to make it available on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information, which can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

14. We will take into account all comments we receive responding to this consultation and, where relevant, our wider consultation on contractual wording for passenger and freight contracts, in the changes that we make to contracts as part of PR13.

Yours faithfully

A handwritten signature in black ink that reads "Emily Bulman". The signature is written in a cursive style.

**Emily Bulman**

## **Annex A: Overview of proposed changes to track access contracts**

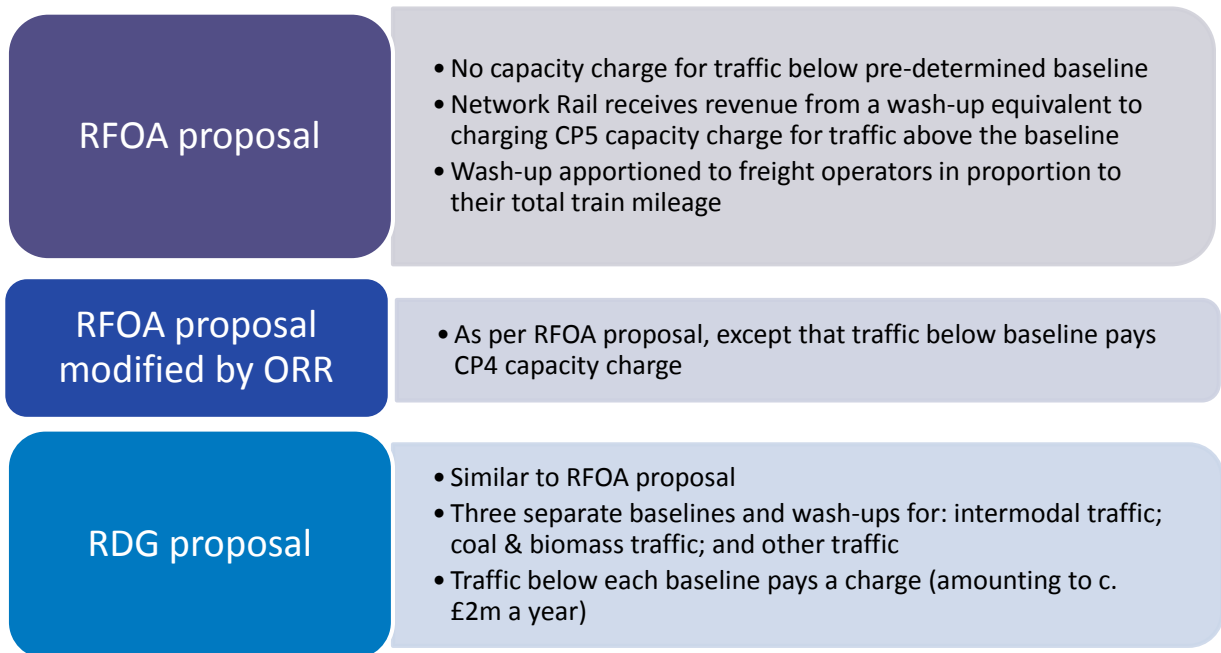
### **Introduction**

1. We are consulting on contractual wording as follows:
  - a. freight: the RFOA proposal of 24 April 2013;
  - b. freight: the RFOA proposal with an ORR modification so that traffic below the baseline is charged at CP4 rates;
  - c. freight: the RDG proposal of 13 September 2013 (with the wash-up disaggregated into three groups of commodities);
  - d. open access passenger: the proposal we set out in our 24 September letter; and
  - e. charter: a single wash-up analogous to the freight proposal.
2. We are not proposing specific changes to the franchise contract with respect to the capacity charge over and above those that we proposed in our implementation consultation.
3. We explain each option in this annex.
4. The proposed capacity charge wording is shown as tracked changes against the proposed Schedule 7 wording we have already consulted on. As such, this annex should be read with our proposed changes to the contractual wording to the franchised passenger, open access and freight model contracts. These can all be found at:  
<http://www.rail-reg.gov.uk/pr13/consultations/capacity-charge-implementation.php>
5. The relevant policy proposals can also be found at this same link.

### **Freight operators' contracts**

6. As we have yet to conclude on our policy for the capacity charge for freight operators, we are consulting on three options in relation to the capacity charge for freight operators. Please note that this consultation is restricted to the contractual wording and definitions of parameters, and is not about policy options. The options are:
  - a. the proposal set out in RFOA's letter of 24 April 2013;
  - b. RFOA's proposal with a change so that traffic below the baseline is charged at CP4 rates (we set out this option in our letter of 19 July 2013); and

- c. The proposal set out in RDG’s letter of 13 September 2013.
7. Our summary description of these policy options for freight operators is set out in the figure below.



### *RFOA proposal*

- Under the RFOA proposal, there would be no capacity charge for traffic below a pre-determined baseline, measured in aggregate freight train miles.
- For traffic above the baseline, Network Rail would receive revenue equivalent to levying the CP5 capacity charge. This would be charged to operators via a capacity charge wash-up. The wash-up would be levied on all freight operators, and each freight operator’s proportion of the wash-up would be equal to the miles it runs as a proportion of total miles run by all freight operators.
- In order to implement this option, we have defined a new term, the “capacity charge wash-up rate” (FCCW). This would apply to traffic above the baseline. It would be the CP5 rate calculated by Arup and would be published in a price list.
- Although the existing freight capacity charge has a weekend discount, the RFOA proposal did not adjust for this discount. For simplicity, we have similarly not

adjusted for the weekend discount in this option. We do, however, make such an adjustment for the other freight options that form part of this consultation.

12. The total wash-up across all freight operators would be calculated, at year-end, as a product of the following:

a. The difference between:

- i. the aggregate train miles in respect of all freight services operated during the relevant year, and
- ii. the baseline aggregate train miles for all freight operators as set out in ORR's Determination of Capacity Charge Baselines (RFOA proposed that the baseline be set to be that used for the Schedule 8 benchmarks);

b. the FCCW rate, i.e. the freight capacity charge for CP5 calculated by Arup.

13. The wash-up would be allocated to individual freight operators in proportion to their train mileage for the year in question (i.e. the total train miles operated by the operator, divided by the aggregate train miles in respect of all freight services operated during the relevant year).

14. Network Rail would charge any positive wash-up to freight operators. If the wash-up were zero or negative (i.e. traffic was below the baseline), it would not be refunded to freight operators.

#### *RFOA proposal with ORR modification*

15. This option is based on the RFOA proposal, with the following modifications:

- a. train miles below the baseline are charged at the CP4 capacity charge rates; and
- b. there is an adjustment for the weekend discount.

16. To implement this we are proposing that Network Rail charges a capacity charge, set at the CP4 rates, on all freight traffic. (The revenue for traffic above the baseline would be netted off in the wash-up to avoid double counting).

17. As with the RFOA option, we have defined a capacity charge wash-up rate (FCCW), and again it would be the CP5 rate calculated by Arup. This, together with the CP4 capacity charge rates, would be published in a price list.

18. In its proposal, the RFOA did not specify differentiation between the weekday and weekend capacity charge rate. In practice the weekend rate is a 25% reduction on the weekday rate. We think that an adjustment should be made for the weekend

discount, and we want to implement this adjustment in a way that is pragmatic and not administratively burdensome. We are proposing a particular adjustment, which is industry-wide rather than operator-specific. But we welcome alternative proposals.

19. We propose to apply a blended average rate which is the full rate adjusted by a weighting – the “WE” term - that reflects the weekend discount (25%) and the proportion of trains that operate at weekends.
20. Note that the WE term is intuitively correct in that it equals 1 in a hypothetical case when all freight services run on weekdays, and equals 0.75 (i.e. the weekend discount) when all freight services run at the weekend.
21. We propose that the weighting is derived from total actual weekend and weekday freight miles. We are seeking views on whether these are suitable definitions, and whether they are practical to measure, or whether other definitions should be used.
22. The total wash-up across all freight operators would be calculated as a product of the following:
  - a. The difference between:
    - i. the aggregate train miles in respect of all freight services operated during the relevant year, and
    - ii. the baseline total train miles for all freight operators as set out in the ORR’s Determination of Capacity Charge Baselines (RFOA proposed that the baseline be set to be that used for the Schedule 8 benchmarks);
  - b. the difference between:
    - i. the FCCW rate, i.e. the freight capacity charge for CP5 calculated by Arup, and
    - ii. the CP4 capacity charge rate; and
  - c. the adjustment to take account of the weekend discount.
23. As with the RFOA proposal, the wash-up would be allocated to individual freight operators in proportion to their train mileage for the year in question (i.e. the total train miles operated by the operator, divided by the aggregate train miles in respect of all freight services operated during the relevant year).
24. Network Rail would charge any positive wash-up to freight operators. If the wash-up were zero or negative, it would not be refunded to freight operators.

*RDG freight proposal*

25. This proposal incorporated a wash-up for traffic above a baseline which would be applied to three groups of commodities separately:
- a. coal and biomass traffic;
  - b. intermodal traffic; and
  - c. all other freight traffic.
26. We propose that each freight train be allocated to one of these three categories. In the case where the train carries commodities from more than one group, it is classified according to the commodity group to which the majority (by number) of its vehicles belong.
27. This proposal differs from the modified RFOA proposal in that it has:
- a. three separate baselines, one for each of the groups of commodities;
  - b. three separate wash-ups, one for each of the groups of commodities; and
  - c. capacity charge rates that are lowered and / or baselines increased so that if the traffic were at baseline revenues, Network Rail would receive around £2 million a year (i.e. rather than the zero payment under the RFOA proposal, or the CP4 rates under the modified RFOA proposal we put forward).
28. We have drafted this option slightly differently from the other options where the wash-up is levied by value rather than train mileage. (An alternative would be to adjust for the weekend discount, as shown with respect to the modified RFOA option.) We would be interested in consultees' views on whether they prefer a wash-up by value or train mileage.
29. Network Rail is required to calculate the aggregate revenue it would receive if the capacity charge were billed at the CP5 rates (the wash-up rates) and if it were billed at the lower rates (i.e. the rates at which services are already being billed). The contractual wording requires Network Rail to make a reasonable estimate of these amounts, but does not specify how these reasonable estimates are derived. We anticipate that this might be implemented through a top-down estimation of the proportion of services that operate at the weekend.
30. We would specify and publish the baseline value (B) for each of the three groups of commodities so that the wash-up equals zero in the case where the corresponding traffic is at its baseline. In particular, the baseline value for each of the three groups of commodities would equal the difference between:



- a. Network Rail's reasonable estimate of the aggregate revenue it would have been entitled to receive if the CP5 capacity charge rates were applied to the baseline traffic, and
- b. Network Rail's reasonable estimate of the aggregate revenue it would have been entitled to receive if the (lower) capacity charge rates were applied to the baseline traffic.

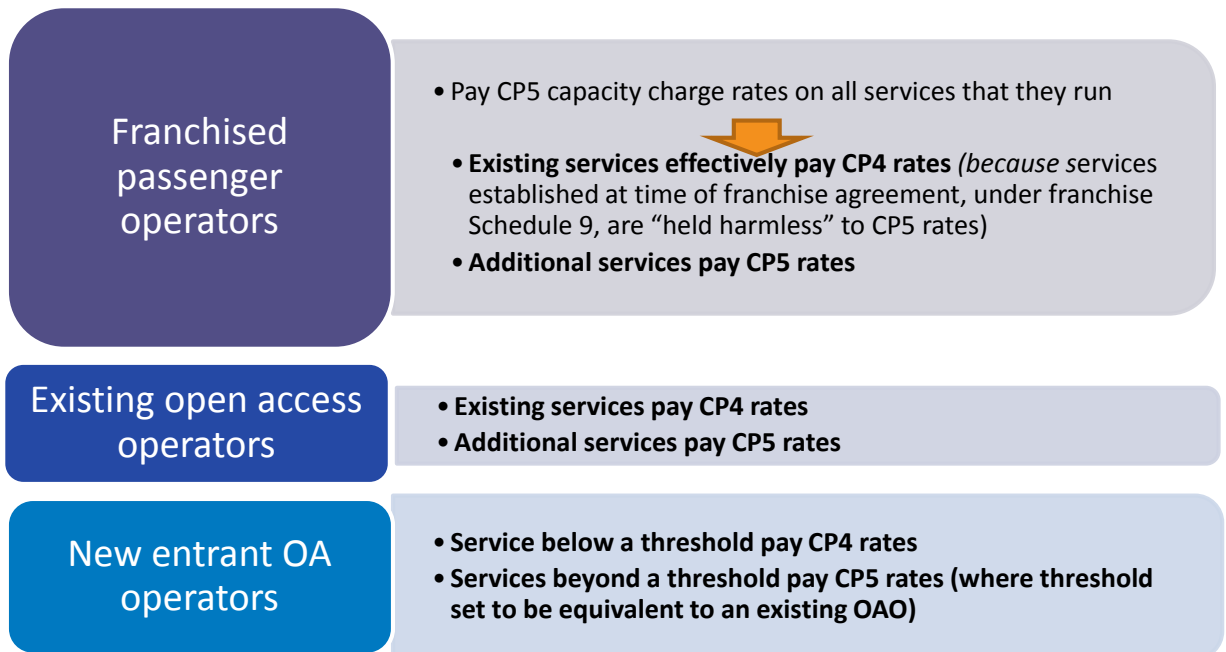
31. Network Rail would charge any positive wash-up to freight operators. If the wash-up were zero or negative, it would not be refunded to freight operators.

### **Open access operators' contracts**

32. This option is as set out in our letter to RDG of 24 September. In the proposal, franchise passenger operators are charged at the CP5 capacity charge rates. Open access operators (OAO) are charged as follows:

- a. For existing OAO, all their existing services, in existing service codes, would pay CP4 rates; any additional train mileage in those service codes, or train mileage in new service codes, would pay CP5 rates;
- b. For new OAO, services below a threshold would pay CP4 rates; any train mileage above the threshold would pay CP5 rates; we would define the threshold as part of PR13 to be equivalent to that of existing services for the smaller of the two main existing OAO, which at the time of writing is Hull Trains.

33. Our description of the option is set out in the figure below.



34. Although in principle the contract could be implemented through the price list, without using a wash-up, our understanding is that this is not compatible with Network Rail’s billing system, which requires a single charge for a service code. For pragmatic reasons, therefore, we are proposing to implement this option through a wash-up.

35. Our proposed amendments to Schedule 7 are similar to those in the freight operators’ contracts in that a wash-up is calculated. Key differences are that:
- the wash-up is applied at the level of an individual operator, rather than all operators, and therefore it is allocated to the operator in full (with no apportionment necessary); the application of the wash-up means that the sum charged to the operator is equivalent to charging the CP5 rate for traffic above the relevant baseline; and
  - the wash-up is calculated as a value rather than the product of train miles and a rate. This allows for the operator to be charged a number of different capacity charge rates for different services.

36. In the contract, we introduce the definition of ‘existing service codes’. The CP5 charge is levied on all services that are outside these named codes, i.e. any new services. In addition, the CP5 rates are effectively applied to any expansion in output of the existing services through the wash-up mechanism.

37. In order to implement this option, the contract contains provisions for Network Rail to calculate a yearly capacity charge wash-up. The wash-up is charged with respect to Existing Service Codes. It is additional to any capacity charge income received from services in Existing Service Codes (which pay the CP4 rates). The wash-up is defined so that it is zero in the case where there is no increase in traffic associated with these service codes.
38. So that the wash-up is levied by value rather than train mileage, Network Rail is required to calculate the aggregate revenue it would receive if the capacity charge were billed at the CP5 rates and if it were billed at the CP4 rates. The contractual wording requires Network Rail to make a reasonable estimate of these amounts, but does not specify how these reasonable estimates are derived. We anticipate that this might be implemented through a calculation based on the timetable of services rather than actual services run.
39. We would specify and publish the baseline value (B) for each service code so that it equals zero in the case where traffic for each service code is at the baseline of that service code. In particular, the baseline value for each of the existing service codes would equal the difference between:
- a. Network Rail's reasonable estimate of the aggregate revenue it would have been entitled to receive if the CP5 capacity charge rates were applied to the baseline traffic, and
  - b. Network Rail's reasonable estimate of the aggregate revenue it would have been entitled to receive if the CP4 capacity charge rates were applied to the baseline traffic.
40. The baseline traffic would be that scheduled for services that have access rights for the relevant year, and have been granted these rights on or before the start of CP5. If the access rights start at some point during the relevant year, the baseline calculation would take this into account by applying a weight to the value, for example by the proportion of the year that the service is operational.
41. Network Rail would charge any positive wash-up to operators. If the wash-up were negative (i.e. traffic was below the baseline), it would not be refunded to operators.

### **Charter operators' contracts**

42. In our consultation on implementing PR13 for charter operators, we proposed contractual wording for a capacity charge for charter operators. We are now consulting on an alternative proposal to charge the capacity charge using a wash-up. The option is explained the figure below.

## Charter wash-up option

- Traffic below baseline pays a capacity charge at the CP4 rate
- Network Rail receives revenue from a wash-up equivalent to charging CP5 capacity charge for traffic above the baseline
- Wash-up apportioned to charter operators in proportion to their total train mileage

43. The contractual wording for charter set out here is analogous to the contractual wording for the ORR modification to the RFOA rate.

44. We would determine a baseline, measured as total train miles across all charter operators. For traffic above the baseline, Network Rail would receive revenue equivalent to levying the CP5 capacity charge. This would be charged to operators via a capacity charge wash-up. The wash-up would be levied on all charter operators, and each charter operator's proportion of the wash-up would be equal to the miles it runs relative to total miles across all charter operators.

45. For traffic below a baseline charter operators would pay the capacity charge at the CP4 rate. To implement this we are proposing that Network Rail charges a capacity charge on all charter traffic, above and below the baseline. (The revenue for traffic above the baseline would be netted off in the wash-up to avoid double counting).

46. As with the freight options, we have defined a capacity charge wash-up rate (FCCW), and again it would be the CP5 rate calculated by Arup. This, together with the lower rate, for traffic below the baseline, would be published in the price list.

47. In practice there are two capacity charge rates for charter traffic, with the weekend rate 25% below the weekday rate. We have proposed that an adjustment is made to the wash-up to account for this effect. This adjustment is equivalent to that proposed under the relevant freight options.

48. We propose to apply a blended average rate which is the full rate adjusted by a weighting – the “WE” term - that reflects the weekend discount (25%) and the proportion of trains that operate at weekends.
49. Note that the WE term is intuitively correct in that it equals 1 in a hypothetical case when all freight services run on weekdays, and equals 0.75 (i.e. the weekend discount) when all freight services run at the weekend.
50. We propose that the weighting is derived from total actual weekend and weekday charter miles. We are seeking views on whether these are suitable definitions, and whether they are practical to measure, or whether other definitions should be used.
51. The total wash-up across all charter operators would be calculated as a product of the following:
  - a. The difference between:
    - i. the aggregate train miles in respect of all charter services operated during the relevant year, and
    - ii. the baseline total train miles for all charter operators as set out in the ORR’s Determination of Capacity Charge Baselines;
  - b. the difference between:
    - i. the FCCW rate, i.e. the charter capacity charge for CP5, and
    - ii. the CP4 capacity charge rate; and
  - c. the adjustment to take account of the weekend discount.
52. The wash-up would be allocated to individual charter operators in proportion to their train mileage for the year in question (i.e. the total train miles operated by the operator, divided by the aggregate train miles in respect of all charter services operated during the relevant year).
53. Network Rail would charge any positive wash-up to charter operators. If the wash-up were zero or negative, it would not be refunded to charter operators.