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One Kemble Street
London
WC2B 4AN

28 August 2013

Dear Cathryn

RDG'S PROPOSALS ON SCHEDULE 8 / VOLUME INCENTIVE / CAPACITY CHARGE FOR CP5

I am writing further to ORR's industry workshop of 21st August on Schedule 8, Capacity Charge and the Volume Incentive for CP5. I write in my capacity as the chair of the RDG working group on Contractual & Regulatory Reform.

I am grateful to ORR for organising the meeting, which I think was very useful indeed. The industry attendees have universally reported to me how helpful they found the workshop. It was helpful that ORR allowed the RDG working group's proposal to be presented. I enclose this as an attachment to this letter as a formal proposal for your consideration. As we stated at the meeting, this proposal is endorsed by all RDG members. The only points of difference being on relatively subtle tone and with regards to the Open Access (OA) and freight transition mechanism for CP5 (where there is a legitimate debate over whether base traffic should or should not be charged the Capacity Charge). Clearly, it is important that the baseline issue is resolved before ORR can conclude on the proposal.

Summary of RDG's proposal

I note that the RDG proposal regarding the Capacity Charge is very close to ORR's 'option 1'. The key point I would stress about our proposal is that we consider that OA and freight impacts from the re-calibrated Capacity Charges can be mitigated without needing to compromise other principles that the RDG considers as being important.

As we explained at the workshop, the RDG team started from 'a blank piece of paper' and then built up a set of general principles that were agreed upon. The group then agreed on some specific statements pertinent to Schedule 8 / Capacity Charge and Volume Incentive. These are set out in the attached note. Colleagues were in particular keen to emphasise that:

"There are significant charging and incentive issues within the current arrangements, but the RDG group recognise that there is simply insufficient time to attempt a structural 're-design' for CP5"[1]. This is consistent with the RDG's previously established position in which the Group agreed that "Radical change to the structure of charges and performance/compensation regimes is therefore unnecessary and potentially unhelpful [in CP5]. However, there are opportunities to simplify arrangements in some areas and to make minor changes which facilitate decisions that improve value for money".

<u>Open Access capacity Charges in CP5</u>

In addition, to the general principles and specific statements (see attached RDG note), the group also concluded that "There would be merit in 'special arrangements' for OA Capacity Charges in CP5", and proposed an Open Access wash-up on part on the LNE route. This wash-up is consistent with the RFOA proposal for freight operators.

It was very useful that members of your legal team were able to attend last week's workshop. Their insights were particularly helpful. Given the queries they posed at the meeting about the open access proposal, I thought you might find it useful if I set out the key legal principles behind the RDG proposal i.e.

- that there should be full cost reflectivity from all incremental traffic;
- that the same rate for all operators on same part of the railway should apply; and
- the transitional nature of the RDG proposal, to mitigate impact of change where there is no fixed charge, means that it would represent a 'glide path' to the 'right answer'.

I am confident that the RDG proposal is consistent with these principles, and also conforms to the two legal challenges that ORR presented at the meeting (Slide 11 of Emily's presentation).

In addition, it seems to me that the RDG proposal is more consistent with these legal principles than ORR's 'option 1'. Unless I have misunderstood some aspect of 'option 1' it appears that it would treat Open Access traffic that is introduced during CP5 less favourably than existing Open Access traffic on the same part of the railway. This is because all of the new entrant's traffic would be charged at the CP5 prevailing Capacity Charge rate whereas the existing operator would not be charged the CP5 Capacity Charge rate on their baseline traffic. This would mean that the average Capacity Charge per train mile for the new entrant would be significantly higher than that for an existing operator on the same part of the railway, which would seem to fail the *undue discrimination* test.

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1 Meeting of the Rail Delivery Group, 22 August 2011, Paper 3: Remit for the workstream on the revision of commercial agreements "A new contract between Government and the rail industry"

By contrast, the RDG proposal, by virtue of the year-end wash-up, would charge all Open Access traffic operating on similar parts of the network the same Capacity Charge rate.

Longer-term review

In addition to needing to agree a pragmatic and industry-agreed way forward for CP5, I would also like to emphasise RDG's desire to drive consideration of the longer term issues. I think that it is important that there are discussions between RDG and ORR as soon as practical about how to carry out this review. RDG is keen that this work should commence as soon as possible after the PR13 Final Determination is 'out of the way'.

Next Steps

I would like to thank ORR for its constructive engagement at the workshop. I am genuinely encouraged by how the industry, through RDG, has worked together to develop its proposal for what are quite tricky issues. I am equally keen that this approach can be extended to ORR's consideration of our proposal.

I anticipate that you will be keen to understand better the full RDG package. Conscious of the time pressure that ORR is under in formulating its Final Determination, RDG members would be pleased to assist your team with this task.

If you have any questions regarding this letter please let me know. I am copying this letter to members of the RDG Contractual & Regulatory Reform sub-group.

Yours sincerely,

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Paul Plummer

RDG Contractual and Regulatory Reform Working Group

On 6 August, the RDG Contractual and Regulatory Reform group (with extended owning group and freight attendees) met to conclude where the industry was in agreement and where more discussion will be needed on ORR's draft determination proposals regarding Schedule 8, Schedule 4, the Volume Incentive and Capacity Charge in CP5. The RDG meeting looked at proposals in the round, and did not seek to replace or supercede the more detailed feedback on each element that has been given by the involved parties through formal consultations and industry meetings. This note sets out, in summary, the conclusions and proposed industry response to ORR.

RDG is invited to endorse this note and encourage its members to use it as part of their responses to ORR's consultation on its draft determination.

Overall

The industry considers that it is important that policy decisions concerning Schedule 8, Schedule 4, the Capacity Charge and Volume Incentive are considered for their combined impact and coherency. The group felt strongly that to date, consultations have come out from ORR in a piecemeal way, dealing with issues in isolation and leaving consultees to model and discover for themselves the likely collective impacts on their business. It is an increasing regulatory burden, often requiring last minute activity. **The industry requires a much improved approach from ORR with regards to regulatory development and impact assessments**.

There are significant charging and incentive issues within the current arrangements, but the RDG group recognise that there is simply **insufficient time to attempt a structural 're-design' for CP5**. The industry agreed that, subject to explicit ORR agreement that the review of charges for CP6 will start through RDG now, to progress these important areas, they would seek to pro-actively propose solutions for CP5. The recent ORR letter regarding the Capacity Charge, whilst useful, would be best channelled through the RDG led accelerated review of charges for CP6.

This note and the industry discussions that led to its creation were informed by analysis that shows the combined impact of ORR's draft determination proposals on: Schedule 8 rates, the volume incentive and the Capacity Charge. ORR's has proposed, in summary, that for CP5:

- Schedule 8 rates should be updated based on up to date information;
- Not reflecting the updated Schedule 8 rates into the Capacity Charge rates; and
- Higher incentive rates (approximately doubled) for Network Rail's Volume Incentive, but also introducing a downside to the mechanism.

General Principles

The industry agreed that:

1. ORR should promote greater regulatory stability, giving a high regard to its duty to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance;

2. Network Rail should continue to be financially incentivised to grow traffic in all parts of the network;

3. Such incentives should be based on consistent principles, for the whole network;

4. Incentive and compensation regimes should be considered for their collective impact, as well as individually. They should reflect the best available evidence and be robust over a range of different performance scenarios;

5. There needs to be an effective and transparent transmission mechanism to incentivise Network Rail staff to balance appropriately the benefits, costs and performance consequences of additional rail traffic and show how it is securing the intended behaviours;

6. The Capacity Charge should, as far as possible, be designed to charge Network Rail's incremental costs of growth above the control period baseline; and

7. Capacity Charge rates that were set in 1999 are unlikely to be consistent with the usage of the network over CP5.

Specific Statements

1. The **Schedule 8 and Capacity Charge** regimes should **continue to be linked** so that the cost impacts for Network Rail of accommodating additional trains on the network from increased disruption are borne by the additional trains brought onto the network.

a) Network Rail should, as a matter of course, do all that it can to operate the railway to minimise disruption from accommodating more traffic;

b) The industry wants to see core issues with regards to Schedule 8 and the Capacity Charge addressed in CP6, rather than ORR attempting a series of 'quick fixes' in CP5 that may cause unintended consequences or leave all parties insufficient time for fair consideration.

c) There was little confidence from train operators and ATOC that the capacity charge itself has yet been designed correctly, is clear in what it is aiming to achieve or would drive the intended behaviours. This perspective should be factored into the RDG-led review of charges for CP6.

d) There is genuine benefit to be had from the recalibrated CP5 Capacity Charge rates (i.e. going down to sector level from service group, and updating them from 1999 when they were last determined).

2. It is **important that Freight operators' legitimate concerns** about potentially significant increases in their Capacity Charges are addressed.

a) Freight traffic is different to passenger traffic, in that it competes directly with road haulage and is not protected through any financial stabilisers through a franchise

[1]

for the Capacity Charge for FOCs.

b) An ‘RFOA-like’ Capacity Charge arrangement for FOCs should be introduced for CP5 - details to be provided separately by the RDG Freight Working Group.

3. The **Schedule 8 rates** should be recalibrated such that **they reflect, as accurately as possible, the revenue impacts of disruption for train operators**.

- If the rates are set too low or too high, risk will be introduced to the GB railway model.
- For passenger operators the Schedule 4 payment rates should continue to be set on a consistent basis with the Schedule 8 rates.

4. **Schedule 8 benchmarks** should be recalibrated so that **they reflect determined levels of performance in CP5**.

- If benchmark levels are set inappropriately, significant money flows (either way) could result.

OPEN ACCESS (OA)

It was noted that the way that OA operators gain access to the GB rail network is very different to the way that franchised operators do. Franchised operators compete for access through franchise competitions and contribute toward Network Rail’s fixed costs through FTAC charges. Because franchised operators pay an FTAC, it is possible to set their Capacity Charges such that they are, in effect, charged only on trains above an ORR determined baseline (by offsetting Capacity Charge income for baseline traffic against their FTAC).

By contrast, OA operators do not contribute toward Network Rail’s fixed costs. OA operators Capacity Charges are effective on all of their traffic (including baseline traffic) – it is not possible to offset their Capacity Charge income for baseline traffic against an FTAC.

The group concluded:

1) There should be, as far as possible, a predictable and stable charging regime for all operators. This was considered particularly important for OA operators.

2) Trains of a similar nature operating on the same parts of the network should have their various access charges set on a consistent basis.

3) OA operators entered the market and based their business cases / models on a reasonable expectation of predictable charges.

4) The Arup CP5 proposed capacity charge rate increases for OA are very significant and a sustainable pace of transition is needed if they are not to become unaffordable for existing OA operators.

[1] For example, FOCs already have a single CC rate

5) There would be merit in ‘special arrangements’ for OA Capacity Charges in CP5. A suggested solution is included in Appendix 1.

6) That any OA Capacity Charge ‘special arrangements’ should be restricted to CP5 and clearly signalled as such in anticipation of an immediate review of charges for CP6.

Meeting attendees:

Nick Ellins (ATOC – Chair)
Alec McTavish (ATOC)
Peter Swattridge (NR)
Joel Strange (NR)
Richard McClean (Arriva)
Richard Stuart (Go Ahead)
Phil Whittingham (Virgin)
Michael Holden (DOR)
Chris Kimberley (Serco)
Hugh Clancy (First)
Jan Chaudhry (Abellio)
Andrew Chivers (National Express)
Nigel Jones (DB Schenker)
Lindsay Durham (Freightliner)

RDG Contractual and Regulatory Reform Working Group

Appendix 1.

Open Access Arrangements

There could be merit in considering the following **OA CP5 Capacity Charge** approaches for CP5.

- Being clear that any OA Capacity Charge 'special arrangements' should be restricted to CP5.

- Restricting any Capacity Charge CP5 'special arrangements' for ex London Service Codes on the ECML, given it is these types of service that have significant OA traffic;

- All other parts of the GB network should have the Arup CP5 OA CC rates introduced at the start of CP5 on current basis; and

- Creation of an 'RFOA-like' scheme for **ALL** ex-London Service Codes operating on ECML.

    - ECML ex-London Service Codes: 4 for EC, 1 HT, 2 GC
    - Baseline total traffic based on 2011/12 year (c.15m train.miles)
    - Single blended Arup based Capacity Charge rate for all 7 Service Codes 325p (Note: individual operators Arup rates are: EC 325p, GC 329p, HT 328p)
    - Year-end Capacity Charge revenue wash-up based on traffic above baseline year at blended rate, but shared between all covered traffic
    - Any future ECML ex-London Service Codes also covered by same rate and wash-up (meaning no discrimination against similar future Service Codes)
    - For East Coast trains, their franchise protection arrangements would continue to apply (if covered, for example, by Schedule 18.1 provisions)

    Worked example

    The following example is based on 2011/12 traffic. However, if progressed, the proposal would be to use the latest available data. All prices are in 2012/13 terms.

    - base traffic for ex-London ECML service codes in 2011/12 is 15m train.miles
    - Year 1 outturn train.miles is 16m
    - Capacity Charge revenue payable in year 1 = 1m x 325p = £3.25m
    - All covered Service codes pay, per train.mile: £3.25m /16m = 20.3p per train mile

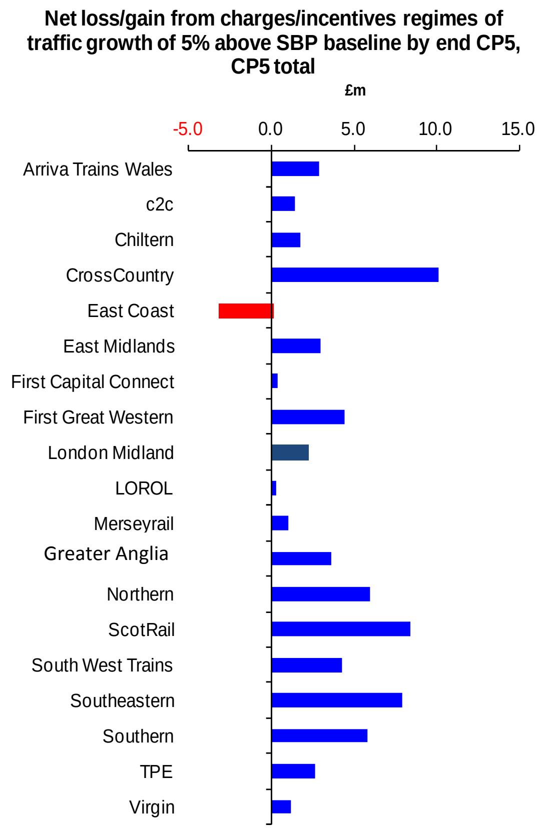
    By way of comparison, the CP4 current Capacity Charge rates are (in pence per train.mile): EC 60p, Hull Trains 26p, Grand Central (Sunderland) 58p, Grand Central (Bradford) 40p

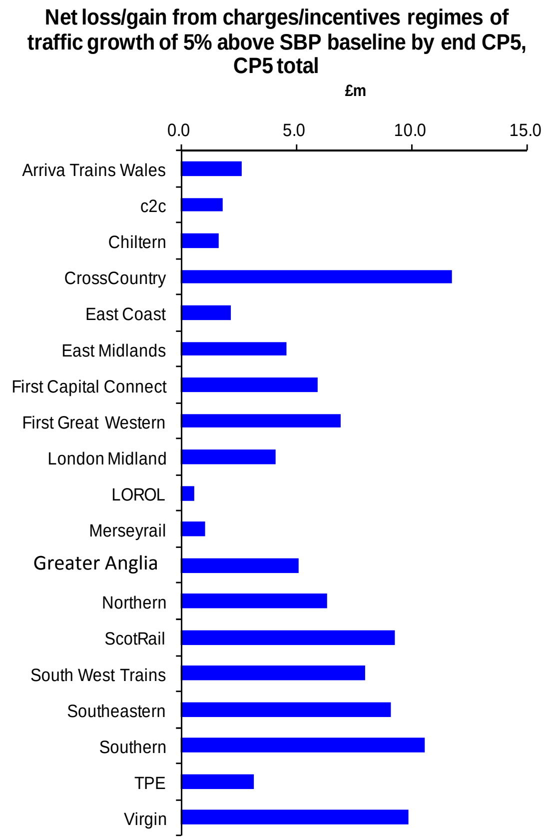
Impact of ORR's Capacity Charge proposal on Network Rail's incentives to accommodate growth

ORR Proposal

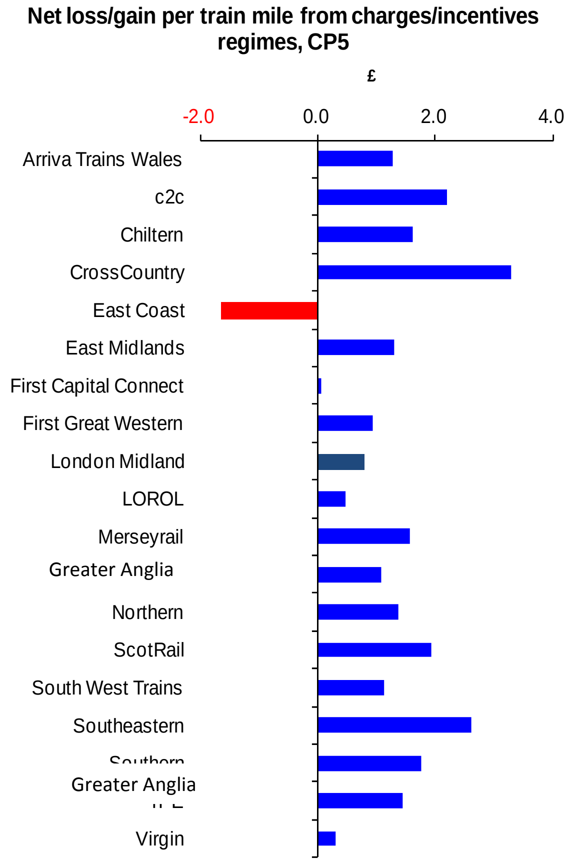
Network Rail Proposal

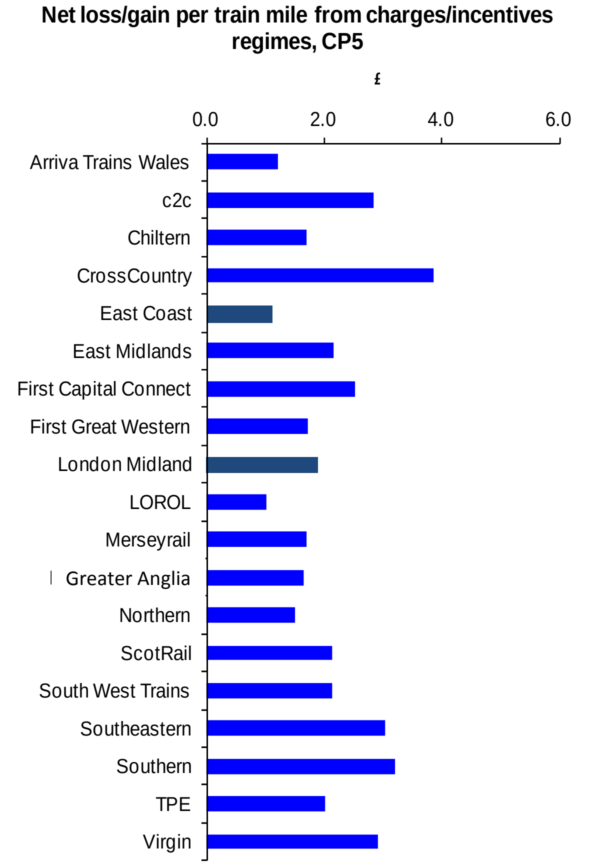
5%growth above baseline





Per additional train mile





Impact of ORR's Capacity Charge proposal on Network Rail's incentives to accommodate growth

CP4 Regime