



Caitlin Scarlett
Network Rail
Kings Place
London
N1 9AG

Alex Bobocica
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

CC: RDG's CRRWG open access members

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Dear Alex,

Network Rail's response to ORR consultation on the implementation of the CP5 Capacity Charge for new open access operators

Network Rail welcomes the opportunity to respond to ORR's consultation on the implementation of the CP5 Capacity Charge for new Open Access Operators (OAOs).

Executive summary

We are strongly of the view that the arrangements for OAO's Capacity Charge in CP5 should be judged against the criteria that:

All traffic of a similar nature operating on the same part of the network should be subject to the same treatment.

ORR's proposal falls short of this, and appears to lead to undue discrimination in all scenarios.

In autumn 2013, the industry, through the Rail Delivery Group (RDG), proposed an alternative Capacity Charge arrangement to ORR¹. This proposal allowed for particular arrangements on the East Coast Mainline (ECML), where the increase in the Capacity Charge for OAOs was the most significant. The rationale for the particular arrangements proposed for the ECML was in recognition that it is a separate area of the network. The RDG proposal, therefore, fares well when judged against the above criteria.

Prior to the publication of the Final Determination, ORR stated that it was not prepared to implement the RDG proposal. **We would encourage ORR to reconsider this decision, as we consider that the RDG proposal, or a development thereof, has considerable merit compared with the ORR proposal.** We also note that the principles underpinning the RDG proposal continue to have significant industry support.

¹ RDG's proposal was developed by its Contractual and Regulatory Reform Working Group (CRRWG) and later, fully endorsed by RDG members.

However, if ORR continues to pursue its proposal, we consider that there are several important issues which should be addressed prior to implementation:

1. ORR's proposal appears discriminatory – in all feasible circumstances there appears to be a risk of undue discrimination against either passenger operators seeking to introduce additional services, or new OAOs.
2. ORR states that *“We did not receive any objections to our proposal that the threshold is equivalent to that of existing services of the smaller of the two main existing OAOs, Hull Trains.”*. ORR first raised this in a consultation which closed after the publication of the Final Determination (in which ORR committed to this approach). This meant that there were limited opportunities for objections to be raised. Furthermore, we consider that the use of Hull Trains' mileage to calculate the baseline is:
 - Arbitrary;
 - Would often be unrepresentative of actual operations on much of the network;
 - Would lead to undue discrimination; and
 - Would create perverse incentives.
3. The allocation of the threshold mileage to new service codes which are introduced at the same time could create perverse incentives and be contrary to the key purpose of the Capacity Charge as a cost recovery mechanism.
4. The use of CP4 rates will result in charges which will be around 20 years out of date by the end of CP5. Furthermore, the calculation of 'new' CP4 rates will always be of limited 'meaning'.
5. The way in which a new OAO is defined should minimise undue discrimination by aiming to treat all new OAOs the same, regardless of their owning group structure. We do not consider that the ORR proposal achieves this.

The remainder of this document discusses these issues in more detail.

Network Rail response

RDG proposal for the implementation of the Capacity Charge

As part of the periodic review process (PR13), ORR asked Network Rail to recalibrate the Capacity Charge for CP5. In autumn 2012, Network Rail commissioned consultants, Arup, to undertake this work². Prior to the recalibration, the Capacity Charge had not been updated since its inception more than 10 years previously. The recalibration therefore took account of the increased use of capacity on the network since this time, and the increase in the Schedule 8 payment rates for CP5 (which were updated as part of the PR13 Schedule 8 recalibration).

The result of this was a significant increase in Capacity Charge rates for most operators. This increase was especially significant for OAOs operating on the ECML reflecting significant changes in the use of that part of the network over recent years

² Arup's final report is available at:

<http://www.networkrail.co.uk/WorkArea/DownloadAsset.aspx?id=30064786027>

(for some OA service codes, the increase in the Capacity Charge was approximately 700%).

These significant increases prompted the industry to consider alternative arrangements for the implementation of the higher Capacity Charge rates, in order to avoid it becoming unaffordable for OAOs (which are fully exposed to increases in the rates).

In autumn 2013, the industry, through the RDG, worked collaboratively to develop an industry proposal for the Capacity Charge for CP5³. In summary, the proposal was as follows:

- The industry identified the ECML as a geographically isolated 'market'. This meant that any special arrangements for this 'market', with regards to the Capacity Charge, would not create undue discrimination as competing operators would be subject to equal treatment.
 - For the ECML, all passenger operators (both OA and franchised) should pay a weighted average of the CP5 payment rates on passenger mileage above baseline only (no charge applies to below baseline mileage).
 - The baseline should be equivalent to the passenger mileage run on the ECML in 2012/13 (the latest available data at the time of implementation).
 - At the end of the financial year, baseline mileage should be compared with actual passenger mileage on the ECML. The total Capacity Charge payment for the ECML should then be calculated, and hence a £ per train mile rate established, according to the following formula:
$$\frac{\text{Above baseline passenger mileage} * \text{weighted average CP5 rate}}{\text{Total ECML passenger mileage}}$$
- For all other parts of the network, CP5 Capacity Charge rates apply to all traffic.

In a letter to RDG⁴, ORR stated that it was not prepared to implement the RDG proposal.

However, we consider that the RDG proposal has a number of important advantages over the ORR proposal set out in its consultation letter.

- **It does not give rise to undue discrimination.** Under the RDG proposal, all competing operators are subject to the same treatment in relation to charges on the same part of the network.

³ The industry proposal is available at: http://orr.gov.uk/_data/assets/pdf_file/0017/1826/rdg-proposal-schedule-8-280813.pdf

⁴ Available at: http://orr.gov.uk/_data/assets/pdf_file/0013/1741/capacity-charge-for-franchise.pdf

- It is an **industry agreed position**, which still has considerable support. The industry worked collaboratively to develop this proposal, and all parties agreed that this was the appropriate way forward for CP5.
- It avoids many of the issues which occur with ORR's proposal. These are discussed in more detail in the remainder of this letter.

We would, therefore, encourage ORR to reconsider its position in relation to the RDG proposal.

Discrimination in the ORR proposal

The ORR proposal for new OAOs appears to be highly discriminatory. In all feasible circumstances, it appears that there would be undue discrimination against at least one type of operator.

- In network locations where there is not currently an OAO (e.g. Wales), any OAO with services at a different network location would be classed as an existing OAO for this location. It would therefore be at a disadvantage compared to an OAO which was completely new to the network. The new OAO would have a Capacity Charge baseline equivalent to Hull Trains, below which CP4 rates apply, whereas the existing OAO would pay CP5 rates on all of its traffic at this location. In addition to this, franchised passenger operators would pay CP5 rates on all traffic.
- In network locations where there is currently an OAO (e.g. ECML), the disadvantaged operator(s) would depend on the level of the incumbent OAO's threshold mileage (and hence Capacity Charge baseline).
 - If the incumbent OAO's threshold mileage is below the threshold mileage of Hull Trains, the incumbent OAO would be at a disadvantage compared to any new OAO (it would have to pay CP5 Capacity Charge rates from a lower level of traffic than the new OAO).
 - Conversely, if the incumbent OAO's threshold mileage is above that of Hull Trains, any new OAO would be disadvantaged.
 - In any circumstance, franchised passenger operators would pay the CP5 rates on all traffic (as noted above), and would be discriminated against compared with some OAOs (e.g. either existing or new).

In each of these circumstances, competing operators are being treated differently in the way that they are charged for use of the same part of the network. The principal reasons for this discrimination are the use of Hull Trains mileage as the threshold, and the definition of a new OAO. These two factors are discussed in more detail, below.

The threshold at which Capacity Charge wash-up rates are payable instead of CP4 equivalent Capacity Charge rates

In ORR's consultation letter, paragraph 8 states that "*we did not receive any objections to our proposal that the threshold is equivalent to that of existing services of the smaller of the two main existing OAOs, Hull Trains.*". However, ORR first raised this issue in a consultation letter which closed after the publication of the Final

Determination, in which it committed to this approach without allowing the industry sufficient opportunity to comment.

We consider that the use of Hull Trains' mileage to calculate baselines for new OAOs is flawed for the following reasons:

- The selection of Hull Trains, for setting the baseline, is completely arbitrary.
- For much of the network, the Capacity Charge baseline for new OAOs would be unrepresentative of actual services.
 - For example, for a new OAO operating an infrequent, short service (in terms of mileage), it is unlikely that the threshold mileage would ever be reached. In contrast, a new OAO operating a frequent long distance service would reach the threshold relatively easily.
 - OAOs planning to operate significantly fewer miles than Hull Trains would essentially be subject to the CP4 Capacity Charge regime. The level of this charge would be around 20 years out of date by the end of CP5, hence undermining the cost recovery purpose of the Capacity Charge.
- As noted in the section above, we consider that ORR's proposal is likely to lead to undue discrimination. This is because OAOs operating very similar services could be subject to very different Capacity Charge baselines for the same part of the network, hence affecting their competitive positions.
- We believe that this proposal sends incorrect price signals to OAOs, and this could create perverse incentives.
 - For example, under ORR's proposal, it would appear reasonable for OAOs to plan mileage only up to the threshold level, potentially by concentrating mileage on the most profitable sections of the network. The most profitable sections of the network are likely to be the most congested, and therefore this proposal could discourage OAOs from making best use of capacity.

These issues are likely to be a feature of any proposal which involves the selection of a universal threshold to apply to all new OAOs. **We therefore believe that ORR should consider adopting RDG's proposal, since this avoids the issues highlighted above.**

However, if ORR does continue to pursue its alternative approach, given that ORR has already committed to creating a baseline consistent with that of Hull Trains, we consider that using train diagram mileage would be the most appropriate option.

The allocation of threshold mileage to service codes

ORR proposes that, for new OAOs with more than one service code, the threshold mileage should be allocated to service codes on a 'first come first served' basis. For service codes which are introduced to the network at the same time, ORR proposes that threshold mileage should first be allocated to service codes with the greatest monetary difference between CP4 and CP5 (wash-up) weekday rates.

We consider that this contradicts the main objective of the Capacity Charge, to allow Network Rail to recover additional Schedule 8 costs as a result of accommodating traffic above the Schedule 8 baseline. As a result of this objective, the Capacity Charge should avoid disincentivising Network Rail to accommodate above-baseline traffic.

In allocating threshold mileage, prioritising service codes with the greatest discrepancy between CP4 and CP5 (wash-up) weekday rates would mean that Network Rail under-recovers its additional Schedule 8 liability by the greatest amount. This could create perverse incentives, since Network Rail would no longer be financially neutral for accommodating additional traffic on the network. Furthermore, the areas of the network where the discrepancy in rates is the greatest would presumably be those that have seen the largest increase in demand for capacity (and hence have experienced a significant increase in Capacity Charge rates). These areas are likely to be the most desirable for OAOs, creating conflicts of interest between OAOs and Network Rail - OAOs would want to operate new services, but Network Rail would not be held neutral for them to do so.

In addition, ORR's proposal only allocates threshold mileage up to the OAO's planned mileage for that service code. This means that, if the OAO plans to operate fewer miles than the Hull Trains threshold, there would be some 'leftover' threshold mileage which is not allocated to any service code. The implication is that, for any new OAO planning to operate fewer miles than Hull Trains, its baseline would not be equivalent to that of Hull Trains. It would instead be equivalent to the mileage that it plans to operate.

Table 1, below, demonstrates our understanding of how ORR proposes to allocate threshold mileage to service codes which are introduced simultaneously. For this illustrative example, we have assumed the following:

- There is one new OAO with 3 service codes (introduced simultaneously).
- Service code 1 has the largest discrepancy between CP4 and CP5 weekday rates, followed by service codes 2 and then 3.
- The Hull Trains threshold mileage is 800,000 for weekday services and 200,000 for weekend services.

Table 1 - ORR's proposal for threshold allocation

OAO 1 Service code	Weekday		Weekend	
	Planned mileage	Threshold allocation (max. 800,000)	Planned mileage	Threshold allocation (max. 200,000)
1	250,000	250,000	80,000	80,000
2	300,000	300,000	100,000	100,000
3	150,000	150,000	70,000	20,000
Total	700,000	700,000	250,000	200,000

In this example, planned weekday mileage is less than threshold weekday mileage (700,000 planned miles vs. 800,000 threshold miles). Under ORR's proposal, all service codes would receive a threshold allocation exactly equal to its planned mileage. This would result in 100,000 threshold miles which are unallocated (i.e. 'leftover' threshold mileage).

Conversely, planned weekend mileage is more than threshold weekend mileage (250,000 planned miles vs. 200,000 threshold miles). Under ORR's proposal, service code 1 would be prioritised (as it has the largest discrepancy between CP4 and CP5 weekday rates) and so would receive a threshold equal to its planned mileage. The same is true for service code 2, since there would be sufficient threshold mileage to cover all planned mileage for this service code. However, for service code 3, only 20,000 threshold miles remain (compared to planned mileage of 70,000). Therefore, service code 3 would have a threshold much lower than its planned mileage.

We suggest instead that ORR allocates threshold mileage to new OAOs' service codes on the basis of their proportional contribution towards total planned mileage. This approach is demonstrated in the worked example in Table 2, below. The same assumptions apply as in the example of ORR's proposed threshold mileage allocation.

Table 2 - Network Rail's proposal for threshold allocation

Service code	Weekday			Weekend		
	Planned mileage	% of total OAO mileage	Threshold allocation	Planned mileage	% of total OAO mileage	Threshold allocation
1	250,000	36%	$36\% * 800,000 = 285,714$	80,000	32%	$32\% * 200,000 = 64,000$
2	300,000	43%	$43\% * 800,000 = 342,857$	100,000	40%	$40\% * 200,000 = 80,000$
3	150,000	21%	$21\% * 800,000 = 171,429$	70,000	28%	$28\% * 200,000 = 56,000$
Total	700,000	100%	800,000	250,000	100%	200,000

Since planned weekday mileage is less than threshold weekday mileage, the weekday threshold mileage allocation for each service code would be higher than its planned mileage (by a total of 100,000 miles across all service codes). Conversely, since planned weekend mileage is more than threshold weekend mileage, each service code would receive a weekend threshold mileage allocation which would be less than planned mileage (by a total of 50,000 miles across all service codes).

We consider that this proposal addresses the issue of cost-recovery in a fairer and more transparent way than ORR's proposal. It also ensures that the full amount of the Hull Trains threshold mileage is allocated to the new OAO, conforming to ORR's commitment to ensure the Capacity Charge baseline is equivalent to that of Hull Trains. In so doing, it allows OAOs which are planning to operate fewer miles than Hull Trains, considerable flexibility against their initial planned mileage.

How the threshold would be converted into a monetary baseline to go into the formula in Schedule 7

The conversion of the threshold mileage into a monetary baseline should be consistent with the approach adopted to calculate the monetary baselines for existing OAOs. We see no reason for this approach to differ, as this would result in the baselines having different interpretations for new and existing OAOs.

The approach that should be followed when calculating CP4 equivalent Capacity Charge rates for a new entrant OAO

We note that the CP4 Capacity Charge rates have not been updated for changes in traffic since the Capacity Charge was first introduced. By the end of CP5, these rates

will be around 20 years out of date, sending incorrect price signals to OAOs regarding the use of network capacity. The RDG proposal sought to minimise the use of the CP4 rates across the network. In so doing, it eliminated the need to calculate a Capacity Charge rate equivalent to CP4 levels for new OAOs, avoiding this issue completely.

ORR's proposed Capacity Charge arrangements require all OAOs (both new and existing) to pay CP4 rates on traffic below a baseline and CP5 rates on all traffic above this baseline. This means that, for new OAOs, Capacity Charge rates equivalent to CP4 rates would need to be calculated. The calculation of these rates is likely to involve a considerable degree of arbitrariness, because we would be calculating 'new' CP4 rates based on network operations of nearly 20 years ago, by the end of CP5. As detailed above, this would not be necessary in the RDG approach.

However, if ORR does decide to pursue this alternative approach, we consider that the way in which CP4 rates are calculated for new OAOs should be consistent across the network, and follow the same approach as was used to update the CP4 rates for Hull Trains and Grand Central. This approach is set out below:

- Calculate the CP5 average tariff for East Coast Trains, weighted by train miles (East Coast was selected as the 'anchor' for updating the Hull Trains and Grand Central CP4 rates);
- Calculate the CP4 average tariff for East Coast Trains, weighted by train miles;
- Calculate the percentage 'discount' to be applied to the CP5 average tariff, in order to arrive at the CP4 average tariff; and
- Multiply the CP5 tariffs for Grand Central and Hull Trains by the 'discount', to arrive at a CP4 rate equivalent to East Coast Trains CP4 rates.

The issue then becomes how to define the 'anchor' for new OAOs. There appear to be two options for this: to select a 'representative' operator or service code(s) to act as the anchor, or; to apply a standard discount (based on East Coast Trains rates) to the CP5 rate(s) for any new OAO.

We consider that the latter approach is favourable, as it:

- is simple and understandable, and would provide certainty to OAOs with regards to their charges;
- is consistent, not only with the calculation of Hull Trains and Grand Central CP4 rates, but it would also ensure consistent treatment for all new OAOs, regardless of network location; and
- avoids the need to select a 'representative' operator or service code(s).
 - If the representative operator approach were to be pursued, it would undoubtedly require a set of 'decision' principles to be defined upfront. The application of these principles would introduce a great deal of complexity, and may not always apply perfectly to any one operator or

service code in practice. Furthermore, the variability in CP4 rates for similar service codes (e.g. on the ECML) could place a great deal of weight on the selection of the 'correct' representative operator, as the impact on the CP4 rates for the new OAO could be significant.

An alternative to this approach would be to calculate a network-wide discount using the national weighted CP4 and CP5 rates. This would ensure that the overall impact of the change to the Capacity Charge is taken into account. However, we do not consider that this is consistent with the approach taken to update the Hull Trains and Grand Central rate, as only the East Coast Trains discount was used for this.

We consider that the CP4-equivalent Capacity Charge rates should be calculated using the 'East Coast discount' approach, discussed above.

How to define a new entrant OAO

The way in which ORR proposes defining a new OAO appears to be discriminatory. As identified previously in this response, it appears that in all feasible circumstances, one type of operator would always be unduly discriminated against, be that new OAOs, existing OAOs or franchised passenger operators.

This definition should, instead, seek to minimise undue discrimination by aiming to treat all new OAOs in the same way, regardless of owning group structure.

If ORR were to revert to the RDG proposal (or a development thereof), there would be no need to have a definition for a new OAO, since all OAOs would be subject to the same treatment in their geographic market. This would avoid the issue of undue discrimination.

However, if ORR does decide to pursue its proposed approach, we consider that the following set of definitions for a new OAO would minimise the risk of undue discrimination:

1. *"a new Open Access operation is one which is not an existing Open Access operation"*
2. *"an existing Open Access operation is one which is defined in Network Rail's list of Capacity Charge baselines for CP5, approved or directed by ORR and published on or before 10 February 2014, and one whose services are consistent with the geographical extent of services set out in the consolidated Track Access Contract at 1 April 2014"*

This would mean that an existing OAO can still be defined as a new OAO if it wishes to extend its existing services geographically, or if it operates in a completely new part of the network. However, any increase in the frequency of its current services would be classed as an existing operation.

This set of definitions would minimise the extent of undue discrimination, as it would mean that existing OAOs are treated consistently with new OAOs, in new, geographical areas. It does not, however, avoid the issue completely. This is because, under ORR's proposed approach, franchised passenger operators seeking to introduce new services would always be subject to CP5 rates on all traffic. Also, at network locations with a current OAO (e.g. ECML), it is likely that the new OAO

would be subject to a different Capacity Charge baseline, as discussed previously. **We do not believe that undue discrimination can be avoided under the ORR proposed approach.**

Conclusions

In conclusion, we are strongly of the view that the arrangements for OAO's Capacity Charge in CP5 should be judged against the criteria that:

All traffic of a similar nature operating on the same part of the network should be subject to the same treatment.

The RDG proposal passes this test, whereas ORR's proposal appears to fall short of this criteria.

We have significant concerns regarding ORR's proposal for Capacity Charge arrangements for OAOs, which appears to lead to undue discrimination in all instances. However, in the event that ORR does continue to pursue its approach, we stress the importance of addressing these issues:

1. The use of the Hull Trains mileage threshold appears arbitrary and would often be unrepresentative;
2. The allocation of threshold mileage to service codes is contrary to the purpose of the Capacity Charge;
3. There would always be some level of arbitrariness in the calculation of CP4-equivalent Capacity Charge rates for new OAOs; and
4. The definition of new OAOs does not minimise undue discrimination.

The RDG proposal, set out in detail above, avoids these issues. We would therefore strongly encourage ORR to reconsider its position on the RDG proposal for the Capacity Charge for CP5.

Regardless of ORR's final decision, any arrangements put in place for OAOs in relation to the Capacity Charge should be restricted to CP5. RDG is currently undertaking an industry review of charges for CP6 and beyond. We consider that the Capacity Charge for OAOs, in particular, is an area which should be addressed by means of this review.

If you would like to discuss any part of this response, please contact me directly. We are content for this response to be published on your website.

Yours sincerely,

Caitlin Scarlett
Regulatory Economist