

25 November 2009

Dear consultee

Review of arrangements for establishing access charges for CP4

Background and context

1. The responsibility for developing and setting access charges for control period 4 (CP4), which runs from 1 April 2009 to 31 March 2014, was split between Network Rail and us. Network Rail had responsibility for developing charge proposals in line with our charging objectives and guidance, and we were responsible for the development of the charging guidance, the development of new charge proposals and the audit and approval of the final charges. This was a change in the arrangements, giving Network Rail greater responsibility for the development of its charges.
2. When we gave Network Rail greater responsibility, we said that we would review the approach once the 2008 periodic review (PR08) had finished. This letter describes the allocation of responsibility for developing charge proposals for CP4 and highlights Network Rail's successes and areas where there are lessons to be learnt. We would welcome your views on how well you thought the new arrangements worked and your suggestions for any further changes to the responsibilities for establishing the charges for control period 5 (CP5), which we expect to run from 1 April 2014 to 31 March 2019. We will use the responses we receive to this letter to inform our preparation for the 2013 periodic review (PR13).
3. We are undertaking a review of the arrangements at this time because work on access charges can take some time to undertake. It is important that major decisions on the structure of charges are taken as early as possible to allow operators and funders to implement the proposals. In addition, following completion of PR08, our Board commissioned an independent evaluation of the periodic review. This evaluation did not specifically review the structure of charges. We published our 'looking ahead to PR13'¹ letter on 29 October 2009, which contained our response to the independent evaluation and outlined our initial thinking on the process and timeline for PR13.

¹ Our 'looking ahead to PR13' letter can be accessed at: <http://www.rail-reg.gov.uk/upload/pdf/pr13-orr-letter-291009.pdf>

4. We intend to hold an industry workshop in March 2010, to provide an opportunity to discuss key policy issues and options for the structure of charges for CP5. We plan to formally begin PR13 in October 2010 with an open consultation on the objectives for the review, and on any issues that require early public debate and resolution, which could potentially include changes to the structure of charges.

5. The annex to this letter provides more detail on the arrangements for establishing charges for CP4.

Our initial view on the charging arrangements for CP5

6. When we announced our intention in 2006 to give Network Rail greater responsibility there was some concern expressed by the industry that the company would not dedicate sufficient attention to this issue, we agreed that we would review the allocation of responsibility following PR08.

7. We are broadly satisfied that the new arrangements worked well, and that Network Rail generally consulted well with the industry and has engaged positively with us. However, we recognise that there have been some specific instances where the company did not provide us with the information we required in a timely way, and that in some cases the management of consultations on charges proposals with the industry were less than ideal.

8. On balance, we see no reason to change the current arrangements, and Network Rail should therefore retain its current responsibility for developing proposals for existing charges and general technical implementation of charges. We consider that it is important for us to lead the work on new charges as part of the development of the overall regulatory framework. We intend to work more closely with Network Rail in the development of any new charges. We will expect Network Rail to improve its engagement with the industry as it undertakes its work and consults on its proposals.

Consultation responses

9. We would welcome your views on the charging arrangements for CP4 and the proposed arrangements for CP5.

10. Please can you send your views on the issues we have raised in electronic format (or if not possible, in hard-copy format) by **28 January 2010** to:

Ekta Sareen
Economist
Office of Rail Regulation

1 Kemble Street
London
WC2B 4AN
Tel: 020 7282 2164
Email: ekta.sareen@orr.gsi.gov.uk

11. We also welcome the opportunity to discuss the issues raised in this letter. In the first instance, please contact Ekta Sareen or Tim Griffiths (principal economist, email: tim.griffiths@orr.gsi.gov.uk, tel: 020 7282 2163).

12. 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 in our library and 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 that 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.

13. Copies of this letter can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely



Paul McMahon

Annex – Arrangements for establishing access charges for CP4

14. This annex describes:

- The purpose of access charges and our role
- the CP4 arrangements for the development of charges;
- specific ORR requirements and guidance; and
- a review of the CP4 arrangements.

Purpose of access charges

15. Access charges are an essential part of the economic architecture of the railway. They are fundamental where there is separation between rail infrastructure and train operations, where commercial disciplines apply and where there is a range of public sector bodies making decisions about train services.

16. Access charges serve four purposes, providing:

- a mechanism for Network Rail to recover the efficient costs it incurs in providing track and station infrastructure used by train operators;
- a well-designed and cost-reflective structure of charges allows costs to be allocated to, and recovered from, those that cause them to be incurred;
- signals to train operators, their suppliers and funders for the efficient use and development of the infrastructure, subject to other policy objectives and constraints; and
- incentives to Network Rail to outperform the regulatory settlement (through the form of price cap regulation employed).

Background to CP4 arrangements

17. Decisions about access charges are a matter for us as we either approve or direct into, track and station access contracts and ultimately are responsible for determining access charges (under Schedule 4A of the Railways Act 1993). In our 'structure of track

access and station long term charges' document published in June 2006², we set out our intentions for Network Rail to take greater responsibility in developing charging methodologies and in calculating the charges than had previously been the case. The process for setting charges is shown in figure 1 and was as follows:

- we would publish our charging objectives and guidance for Network Rail for setting charges;
- Network Rail would develop charge proposals in accordance with these objectives and guidance;
- we would audit the charge proposals; and
- Network Rail would publish the final price list.

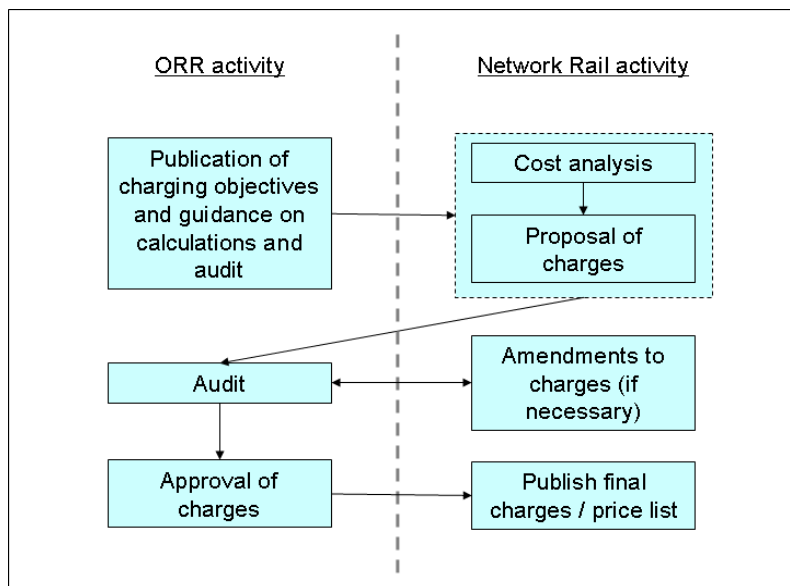
18. The transfer of responsibilities to Network Rail only applied to charges within the current structure of charges and we retained responsibility for developing new charge proposals for CP4.

19. We considered that giving Network Rail more responsibility would provide the following benefits:

- a more efficient and effective process of setting charges, through a more appropriate split of responsibilities, where we set the charging objectives and audit the company's technical work and proposals rather than undertaking much of the technical development work ourselves;
- additional impetus to Network Rail in its process of improving the understanding of its costs;
- a more commercially mature relationship between Network Rail and its customers; and being potentially more consistent with the EU Directive 2001/14/EC and the envisaged role for infrastructure managers in charging matters.

² The structure of track access and station long term charges document can be accessed at: <http://www.rail-reg.gov.uk/upload/pdf/291.pdf>

Figure 1: Charge setting activities



Specific ORR requirements and guidance

20. Network Rail was required to develop charge proposals that took account of our guidance, and adhered to our charging objectives, which are to:

- promote the objectives of our duties under section 4 of the Railways Act 1993 and be consistent with the wider objectives of funders;
- incentivise Network Rail, train operators, train manufacturers, rolling stock companies and funders to ensure the efficient utilisation and development of the network and the optimisation of whole industry costs;
- not discriminate between users of the network;
- be practical, cost effective, comprehensible and objective in operation;
- be consistent with relevant legislation, including the EU Directive 2001/14/EC;
- reflect the efficient costs caused by use of the infrastructure (to Network Rail or otherwise); and

- ensure that Network Rail recovers its allowed revenue requirement.

21. We required the company to provide submissions, which set out in detail how it had calculated its charges and considered the issues in our guidance. Key issues included in the guidance were for Network Rail to:

- consider whether it retains the current approach to calculating the variable usage charge or develops an alternative approach;
- consider the way in which variable costs change with location on the network to determine the appropriate disaggregation of the variable usage charge by route/geography;
- take explicit account of rolling contact fatigue/rail wear in the calculation of the variable usage charge; and
- take forward work from the 2005 structure of costs and charges review on developing an avoidable cost based approach to determining the fixed charge.

22. In developing its charges proposal, Network Rail were expected to fully engage with stakeholders, to give them visibility of the company's work and to allow input to the proposals in a timely and effective manner.

Review of charging arrangements in CP4

23. The change in responsibilities was intended to encourage Network Rail to have a greater degree of 'ownership' of access charges and build on improving its cost knowledge following its work to develop its infrastructure cost model (ICM).

24. As part of its strategic business plan (SBP)³, Network Rail set out its proposed indicative track and station access charges, including price lists for the variable usage charge and part of the price list for the traction electricity charge. In addition, Network Rail carried out an industry consultation on its indicative charges⁴ and held an industry workshop on 29 November 2007. Following our review, summarised in our 'update on the

³ Network Rail's strategic business plan and supporting documents can be accessed at:
<http://www.networkrail.co.uk/aspx/4355.aspx>

⁴ Network Rail's consultation documents can be accessed at:
<http://www.networkrail.co.uk/browseDirectory.aspx?dir=\Regulatory%20Documents\Access%20Charges%20Reviews\Consultations%20on%20Future%20Charging\SBP%20Update%20April%202008&pageid=2893&root=>

framework for setting outputs and access charges and SBP assessment' in February 2008⁵, Network Rail provided a revised set of proposals in its SBP update⁶. We published our view on the revised charge proposals in our draft determinations, with Network Rail undertaking further consultations in August and September 2008, with the overall level of access charges set in the final determinations⁷ and the final price lists published in December 2008⁸.

25. There were a number of areas that went well with the new arrangements. Network Rail undertook a large amount of work to develop the charge proposals. Network Rail successfully managed a number of consultations, including an industry workshop, which provided the industry with an opportunity to discuss their concerns at a working level. The development of the ICM was a notable step forward for Network Rail. Network Rail used the ICM to develop estimates of variable costs, which increased the robustness and cost reflectivity of charge proposals. Network Rail worked with consultants TTCl to develop the rail surface damage term, which successfully met objectives to reflect rolling contact fatigue and rail wear damage in the variable charges for CP4. In their review of the structure of charges, the Institute of Transport Studies (ITS) found that overall charges package represented a step forward in providing incentives to industry parties.⁹

26. With regard to the keys point of our guidance, Network Rail proposed the following:

- Network Rail's charge proposals were based on the existing arrangement for variable track access charges but variable costs were calculated using the ICM which was felt to provide a more bottom-up assessment of costs which was more reflective of the wear and tear caused by traffic.
- Network Rail successfully developed a new variable charges model with TTCl which included a rail surface damage term which was a positive response to our

⁵ The update on the framework for setting outputs and access charges and SBP assessment document can be accessed at: <http://www.rail-reg.gov.uk/upload/pdf/351.pdf>

⁶ Network Rail's strategic business plan update and supporting documents can be accessed at: <http://www.networkrail.co.uk/asp/5160.aspx>

⁷ The determination of Network Rail's outputs and funding for 2009-14 document can be accessed at: <http://www.rail-reg.gov.uk/upload/pdf/383.pdf>

⁸ These price lists can be accessed at: <http://www.rail-reg.gov.uk/server/show/nav.1917>

⁹ This study can be accessed at: http://www.rail-reg.gov.uk/upload/pdf/cnsIt-ITS_rev-NR_charg-props.pdf

requirements to consider rolling contact fatigue and rail wear within the charge calculation.

- Network Rail developed estimates of route based charges based on route type and track curvature although these were not produced until the SBP update. We subsequently decided not to introduce route based charges due in part to concerns over the robustness of Network Rail estimates of cost variation with curvature.
- In its proposals, Network Rail moved some way towards adopting the avoidable cost approach to establishing the fixed charge as per our guidance. The company significantly improved the approach by increasing the disaggregation of the fixed maintenance and renewals costs, for example in the case of renewals, costs are now allocated to 307 strategic route sections rather than 26 routes.

27. There were however some areas of Network Rail's work that went less well. Our assessment of the indicative charges was hampered by some data not being provided at the time of publication of the SBP, as we had required, and in some cases being provided months later. There were still outstanding issues that remained to be addressed by Network Rail between draft and final determinations, these were:

- variable usage charge suspension band discounts;
- coal spillage charge rebate;
- traction electricity charge (consumption model and rates);
- capacity charge rates; and
- station long term charges (rebalancing of charges between portfolios).

28. We wrote to Network Rail on 29 August 2008¹⁰ highlighting our concerns. Our letter also highlighted that due to the delays, late consultations were limiting the time for consultees to respond to Network Rail's proposals and for us to review the company's proposals/submissions.

¹⁰ This letter can be accessed at: http://www.rail-reg.gov.uk/upload/pdf/pr08-cons_SOCC_2PP_010908.pdf