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OFFICE OF RAIL REGULATION

8 October 2013

Peter Maybury
Chair of RDG freight group
Rail Delivery Group
c/o Network Rail
Kings Place
London N1 9AG

Dear Peter

Capacity charge for freight operators for CP5

Purpose

1. Thank you for your letter of the 13 September 2013 in which you set out the RDG proposal for implementing the capacity charge in respect of freight operators in CP5.

2. We are pleased that the industry has worked together to develop the proposal on the capacity charge. We have built on this work following our further discussions and we are giving the industry a further, final opportunity to comment on the three options described below. We are looking for comments across the industry, whether parties have been actively involved in developing the RDG proposal or not**.**

3. I am afraid we need to receive any comments on this by 5pm on Tuesday 15 October 2013, to meet our internal decision making deadlines.

Policy development and process so far

4. The capacity charge is set to recover the costs directly incurred by Network Rail as a result of Schedule 8 performance regime payments that vary with traffic. Network Rail recalibrated the capacity charge for CP5. However, the recalibration resulted in very substantial increases in capacity charge rates for some traffic, including freight traffic (rising from around 17p to 73p per train mile for weekday traffic).

5. The rail freight operators association (RFOA) wrote to us in April 2013 setting out an alternative proposal to levying the recalibrated charge that would address this issue. Under its approach, Network Rail would not be disincentivised to accommodate additional traffic because it would charge CP5 rates on new traffic. At the same time, impacts would be mitigated by using a “wash-up”. Under the RFOA proposal, the wash-up works for each additional service an individual operator decides to run in CP5: it calculates the CP5 rates

for that additional service, and then shares the resultant amount across all freight operators (essentially, spreading the risk), rather than the individual operator responsible for the additional train paying the amount itself.

6. In our draft determination we said that we would either: implement a form of the proposal put forward by the 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.

7. Subsequent to the draft determination, we published a letter, for consultation, on 19 July 2013 in which we set out options for applying the RFOA approach to freight and passenger traffic. We held a capacity charge working group meeting on 26 July 2013 to discuss options. And we held a separate industry and funders meeting on 21 August 2013. Subsequently, the RDG freight group worked to develop a proposal that took account of the comments in our letter and the views of its members. We received the proposal formally in a letter from you dated 13 September 2013.

8. On 30 September 2013 we issued a consultation on contractual wording for the capacity charge. We set out contractual wording for three policy options for freight: the RFOA proposal, the modified proposal that we set out in our 19 July 2013 letter, and the RDG proposal of 13 September 2013 (in which we had assumed no negative wash-up, see discussion below). The contractual wording consultation closes on 28 October 2013.

9. On 2 October 2013 ORR colleagues met members of the RDG freight group to discuss the RDG proposal for freight. During the meeting it emerged that members of RDG had differing thoughts on how the proposal might be implemented, in particular whether or not it had a negative wash-up.

Our observations on the proposal set out in your letter

10. Particular features of the RDG proposal are that:

(a) the wash-up is disaggregated into three groups of commodities to “avoid potential cross-subsidies between different types of traffic”; and

(b) “a baseline [is] established to recover (at GB wide level) circa £2m per annum during CP5”. This provides “headroom for downside incentives to work…whilst ensuring a contribution to Network Rail’s funding”.

11. We deal with each of these points in turn.

Potential implications of having three separate wash-ups

12. The table below sets out Network Rail's forecast, based on the freight market study, of the three proposed groups of freight traffic, current and during CP5.

Network Rail freight traffic forecast (June 2013)

Thousand train miles	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Coal & biomass	6,935	6,007	5,846	5,389	5,315	4,971	4,675
Intermodal	8,718	8,892	9,152	9,491	9,806	10,130	10,514
Other	9,479	9,522	9,565	9,609	9,654	9,699	9,744
Total	25,131	24,421	24,564	24,489	24,775	24,800	24,933

13. This table illustrates that, if the baseline to the wash-up were set at 2012-13 traffic levels:

(a) due to forecast freight traffic growth, intermodal would be forecast to face a significant positive wash-up towards the end of CP5;

(b) due to declining traffic, coal and biomass combined would be forecast to have a substantial negative wash-up (which may or may not be charged depending on the policy); and

(c) the wash-up for the other traffic category would be broadly neutral.

14. We think that these observations are useful for understanding the potential impacts of different options, which we set out below.

Revenue recovered from the capacity charge

15. You proposed establishing a baseline to raise (at GB wide level) around £2m per annum during CP5. You set out that this would provide headroom for downside incentives to work and would also ensure a contribution, from the capacity charge, to Network Rail's funding.

16. Picking up some of the discussions at the 2 October 2013 meeting, in order for the capacity charge to fulfil its role of compensating Network Rail, the revenue that Network Rail receives from the capacity charge should vary according to traffic, and therefore by definition would not be a precise amount each year. As the freight traffic forecast for CP5 is fairly flat, however, the revenue received from the freight capacity charge could be fairly constant if the baseline and wash-up were constructed so that the revenue from an increase in some freight traffic broadly cancelled out the reduced revenue associated with a decline in other freight traffic. An option that permitted a negative wash-up, i.e. a rebate to freight operators for traffic below baseline, could work in this manner.

17. In our draft determination we acknowledged that changes to charges can significantly affect freight operators and their customers, and we explained that we had considered these impacts and taken pragmatic steps to mitigate them. By considering the cumulative effect of changes to all charges on freight operators, we made a decision to cap the overall increase to the variable usage charge and we also decided to approve a lower freight specific charge than we had previously stated. Our decision was based on estimates of Network Rail's revenue received from each charge, which for the capacity charge at current freight traffic levels amounted to around £4 million to £5 million a year (as shown in table 16.62 of the draft determination).

18. We continue to think it is important to assess the impact of the PR13 package as a whole on freight operators and customers. We have therefore modified RDG's proposal to bring the forecast revenue closer to our draft determination assumptions.

The options

19. The three options set out in this letter are summarised in the figure below. Each of these options is our development of proposals which have originated from industry, in each case with some modifications we consider necessary. The first option is that of our 19 July 2013 letter, and which we also set out in our consultation on contractual wording. The second and third options (which you have explained reduce cross subsidy between commodities) follow from the two ways of implementing the RDG proposal that emerged from the 2 October 2013 meeting.

RFOA proposal modified by ORR	• Capacity charge set at CP4 rates • Wash-up applied relative to baseline of 2012-13 traffic • Network Rail receives revenue from a wash-up equivalent to charging CP5 capacity charge for traffic above the baseline • Wash-up apportioned to freight operators in proportion to their total train mileage • Forecast to generate revenue of around £4m for each year of CP5
"RDG proposal" – no negative wash-up	• Capacity charge set at c. two thirds of CP4 rates • Three wash-ups - for coal & biomass, intermodal and other commodities – applied relative to baseline of 2012-13 traffic for the relevant commodities • Network Rail receives revenue from each wash-up equivalent to charging CP5 capacity charge rates for traffic above the relevant baseline • Each wash-up apportioned to freight operators in proportion to their train mileage for the relevant commodities • Forecast to generate revenue of £3.3m in 2014-15, rising to £4.2m in 2018-19
"RDG proposal" – positive & negative wash-up	• Capacity charge set at CP4 rates • Three wash-ups - for coal & biomass, intermodal and other commodities – applied relative to a baseline set to equal the forecast traffic for the relevant year for the relevant commodities • Network Rail receives or rebates revenue from each wash-up equivalent to charging CP5 capacity charge rates for traffic relative to baseline • Each wash-up apportioned to freight operators in proportion to their train mileage for the relevant commodities • Forecast to generate revenue of around £4m for each year of CP5

20. The remainder of this letter sets out:

(a) the detail of the three options identified in the graphic above for implementing the capacity charge for freight; and

(b) our assessment of the options, and explanation as to why we propose to implement the RDG proposal with no negative wash-up.

Our modification to the RFOA proposal

21. In our 19 July 2013 letter we set out a modification to the RFOA proposal. This was one of the options we included in our consultation on contractual wording.

22. As per the RFOA proposal:

(a) for traffic above the baseline, Network Rail would receive revenue equivalent to levying the CP5 capacity charge. This would be charged to freight operators via a capacity charge wash-up. The wash-up would be levied on all freight operators in proportion to their traffic; and

(b) the wash-up would equal zero in the case where the corresponding traffic is at its baseline. 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.

23. Our modification is that traffic below the baseline would be charged at the CP4 capacity charge rates (whereas under the RFOA proposal there would be no charge associated with this traffic). This would provide both Network Rail and operators with incentives in the case where traffic was below the baseline, and would also contribute to Network Rail's funding.

Our interpretation of the RDG proposal (no negative wash-up)

Our proposal on contractual wording

24. In our proposal on contractual wording, we set out how we thought the RDG proposal would be implemented. We repeat the information here, with the focus on policy rather than contractual wording.

25. Each freight operator would be billed the capacity charge by period. In addition, there would be a year-end wash-up.

26. Under the RDG proposal, there would be three different groups of commodities, each with its own baseline and wash-up.

27. For freight traffic above the baseline, Network Rail would receive revenue equivalent to levying the CP5 capacity charge. This would be charged to freight operators via a capacity charge wash-up. The wash-up would be levied on freight operators in proportion to their relevant traffic.

28. Each wash-up would equal zero in the case where the corresponding traffic is at its baseline. 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.

Additional details

29. Under the RDG proposal, the capacity charge rates would be lowered and / or baselines increased so that if the traffic were at baseline revenues, Network Rail would receive around £2 million a year.

30. Instead we propose:

(a) that the baselines be set to equal 2012-13 actual traffic; and

(b) as the RDG proposal disaggregates the capacity charge wash-up over different commodity groups and we anticipate that this would have the greatest impact on intermodal traffic, we think it would be appropriate to adjust the capacity charge rate for traffic below the baseline so that it is around 12-13 pence per train mile weekday rate in 2012-13 prices (compared to 17 pence currently).

31. By doing this, we estimate that the cumulative impacts of all our charging proposals, including the capacity charge, on freight traffic including intermodal, would be appropriate and reflects what we set out in the draft determination

A variation on the RDG proposal permitting positive and negative wash-ups

32. At the 2 October 2013 meeting between ORR and RDG, it emerged that different members of the group had different thoughts on how the proposal might be implemented, in particular whether it could have a negative wash-up. For completeness we set out here how we think a negative wash-up would work.

33. Each freight operator would be billed the capacity charge by period. In addition, there would be a year-end wash-up. As before, there would be three different groups of commodities, each with its own baseline and wash-up.

34. Network Rail would be compensated for traffic diverging from the baseline according to the CP5 rates. This would be charged to freight operators via a capacity charge wash-up (with the capacity charge on this traffic netted off to prevent double counting) in proportion to their relevant traffic. A negative wash-up would take the form of a rebate from Network Rail to operators. The wash-up would equal zero in the case where the corresponding traffic is at its baseline.

35. Under the RDG proposal, the capacity charge rates would be lowered and / or baselines increased so that if the traffic were at baseline revenues, Network Rail would receive around £2 million a year. As above we have adjusted this proposal to increase the forecast revenue in line with our draft determination. We would:

(a) set each baseline on the basis of a forecast rather than 2012-13 traffic levels, so to minimise the size of the wash-up and reduce the likelihood of the entire charge falling below zero. In particular, we would set each baseline consistent with the freight forecast we are using for the Network Rail volume incentive; and

(b) set the capacity charge at CP4 rates (we would not make an adjustment to the capacity charge under this option because the higher costs borne by intermodal traffic would be offset by substantially lower costs borne by coal and biomass).

Our assessment

36. Our broad brush assessment of the options we have set out in this letter is shown in the table below.

Assessment	RFOA proposal with ORR modifications	"RDG proposal" (no negative wash-up)	"RDG proposal" (positive and negative wash-up)
Legality	No major issues	No major issues	No major issues
Cost-reflective incentives for Network Rail	Incentivised for volume risk – incentives weaker if traffic is below baseline	Incentivised for volume risk - incentives weaker if traffic below baseline	Incentivised for volume risk – incentives weaker if traffic is substantially below forecast
Cost-reflective incentives for operators	Incentives from CP4 charge and share of wash-up, but the latter is spread across all traffic	Incentives from capacity charge, but this is lower than the CP4 charge, and share of relevant wash-up	Incentives from CP4 charge and share of relevant wash-up
Impacts	As traffic forecast is flat, little expected change in bill Some risk of increase in bill resulting from traffic growth. Potential uncertainty regarding size of wash-up for all traffic.	Fall in expected bill at start of control period – but expected higher bills for intermodal towards end of CP5. Some groups of traffic will not have wash-up in practice as traffic expected to be below baseline	As baselines are set at traffic forecast, little expected change in overall bill. Some upside and downside risk of increase in bill resulting from traffic diverging from forecast – likely to be different effects for different customers so may be difficult for operators to manage.
Feasibility	We have consulted on contractual wording. Some issues regarding implementation of wash-up.	We have consulted on contractual wording. Some issues regarding implementation of wash-up.	We have not consulted on contractual wording, but it would be based on the RDG wording we have consulted on, with amendments to the implementation of wash-up.

37. While the RDG proposal with no negative wash-up may appear to have weaker incentives for both Network Rail and freight operators for traffic below baseline, we do not think that this is a material issue. This is because this weaker incentive would not apply to growth in intermodal traffic, which is expected to be above baseline. It would primarily affect coal (for which the forecast is declining traffic), and potentially other commodities. And for electricity supply industry coal, the weakened incentives associated with a lower capacity charge are compensated for by the incentives associated with the freight only line charge and freight specific charge (which are levied on only a small subset of commodities including ESI coal). In any case, we think that Network Rail's incentives for declining traffic are less important than those for it to accommodate additional traffic.

38. Under the modified RFOA proposal, the incentives may not work as well however. With a single wash-up across all traffic, the incentives may be weak for Network Rail to accommodate additional intermodal traffic, for example, if its growth is more than offset by a decline in traffic in other commodities and hence overall traffic is below the baseline.

39. We are concerned about the potential impact on freight operators of the version of the RDG proposal which permits a negative wash-up. As it would mean all traffic would be affected by a wash-up (as compared with the other options where coal and biomass would be below the baseline and therefore unaffected by a wash-up), it would be more difficult to price and communicate to customers. But we would be interested in views.

40. On balance, on the basis of the reasons set out here, our preference is to implement our version of the RDG proposal with no negative wash-up for freight operators.

Seeking your views

41. We are grateful to the RDG for the work it has put in to develop the original RFOA proposal for freight services. Over the same period, we have been engaging with you and others on the capacity charge. We now need to make a decision, but to help us to do so we would be grateful to receive any final comments from industry or funders. Please send these comments to Alex Bobocica, Alexandra.Bobocica@orr.gsi.gov.uk . We must receive any such comments by **5pm on Tuesday 15 October 2013.**

42. I am copying this letter to members of the capacity charge working group, the VTAC development group, Department for Transport and Transport Scotland. We are also publishing this letter on our website at http://www.rail-reg.gov.uk/pr13/Consultations/capacity-charge-freight-opertors.php .

Yours sincerely

John Larkinson