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To: Network Rail, track access contacts, trade associations, and other stakeholders

6 February 2019

Dear all

Model connection contracts – switching to CPI

This is a consultation about changing the adjustment factor in our model connection contract. We propose that the inflation measure used in the annual adjustment factor is changed from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI). I would be grateful for your views by 6 March 2019.

Current model contract

Connection contracts are formal agreements between two parties with connecting networks. Connection contracts set out the rights and obligations of connected parties in respect of the on-going maintenance, repair and renewal of connections between two networks.

The Office of Rail and Road (ORR) has published a model connection contract that may be used between Network Rail and connecting parties[1]. The model contract increases consistency across the sector and allows parties to use ORR's General Approval[2] in preference to individual submission to ORR. It is used for most new Network Rail connections, or at least they are all based on it. Under the Railways Act 1993, ORR approval is needed for Network Rail's connection contracts to be valid.

The adjustment formula

The current model contract, at Schedule 3, has a standardised annual indexation formula. This calculates how charges should be adjusted annually for general inflation and to include efficiency targets for Network Rail, reflecting ORR's regular Periodic Reviews.

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[1] ORR's model contract and forms are at http://orr.gov.uk/rail/access-to-the-network/track-access/forms-model-contracts-and-general-approvals There is a separate model for Scottish contracts but the adjustment factor and relevant clauses are the same.
[2] http://orr.gov.uk/__data/assets/pdf_file/0007/11599/connection-contract-general-approval.pdf

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The current formula is[3]:

$$\text{Adjustment factor} = 1 + \frac{((RPI_{(t-1)} - RPI_{(t-2)}) - X)}{RPI_{(t-2)}}$$

When we published the current model connection contract in 2014 we said that the efficiency factor ("X") used in the model contracts should reflect the efficiency targets we set Network Rail as part of our Periodic Reviews. We set that X was 3.53% for each year of CP5. This was based on Network Rail's total CP5 maintenance cost efficiency factor of 16.45%. The rate of inflation is taken as being the RPI rate published by the Office of National Statistics under code 'CHAW: RPI All Items Index. The CP6 efficiency factor has been calculated as 2.4%.

Inflation measure

In our CP5 Final Determination we used RPI as the measure of inflation[4]. Following consultation for CP6 (2019-24) we decided that CPI should be used instead. This change will impact on the measure of inflation used to calculate charges in track access contracts, amongst other things. The change reflects recent trends by other regulators to move away from RPI, given that CPI is regarded as a more accurate and robust measure of calculating inflation. It also reflects changes to Network Rail's ability to borrow RPI index linked debt.

Connection contracts are outside of the formal Periodic Review process. They are not automatically changed as a consequence of the Final Determination. However, there is an established the link between connection contracts charges and the efficiencies expected from Network Rail, through the adjustment factor. For the same reasons as set out in our Final Determination for CP6, we consider that CPI is a better measure of inflation, in this context.

ORR considers therefore that it is appropriate to amend the adjustment factor in the model connection contract accordingly so that CPI is used rather than RPI.

ORR's proposal

Our proposal is that the published model contract is changed from RPI to CPI. All new contracts would be completed on the basis that the formula for the adjustment factor would be[5]:

$$\text{Adjustment factor} = 1 + \frac{((CPI_{(t-1)} - CPI_{(t-2)}) - X)}{CPI_{(t-2)}}$$

Connection contracts with parties other than Network Rail, that do not have this formula, would not be affected by any of these changes.

We also propose to add a clause to the effect that rounding should be to three places [rounded upwards]. This will mirror the process with track access contracts and reduce the potential for disputes on small sums. The proposed wording, to be

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[3] See the model contract, Schedule 3, for the full terms and definitions.
[4] http://orr.gov.uk/__data/assets/pdf_file/0019/39304/pr18-final-determination-overview-and-decisions.pdf
[5] All other terms and definitions would remain as they are now.

added to the schedule, or potentially clause 15.1.1, is "and the amount rounded to three decimal places".

Transition

The change would be to the model connection contract. The change in formula would therefore apply to all new connection contracts using that model, from date the change is made.

There is no mechanism for ORR to propose amendments to existing connection contracts. However, it is possible for the parties to agree to amend their existing contracts on their own account. They will also be able to review the clauses at the five-yearly reviews, or when they are due for renewal or assignment. Parties will be able to use ORR's General Approval[6] for this change, where the contract was originally entered into using a general approval. In other cases they may need to apply to ORR for specific approval but we will endeavour to keep that process straightforward.

Minimising distortions and differences

As part of the Periodic Review ORR found that switch from RPI to CPI will have limited direct effect on Network Rail's finances. The switch will apply across the board to all Network Rail's track access charges. That will not be the case with connection contracts. We will inevitably have classes of contracts using either CPI or RPI, probably for some years. We noted in our consideration of the issues that RPI inflation is forecast to exceed CPI inflation by 1% over CP6[7].

We therefore propose publishing a separate efficiency factor for contracts using CPI in addition to the one we will publish for RPI, for CP6. In effect this would minimise any differences between the outcome according to whether the contract uses RPI or CPI. A worked example is at Annex A.

We expect that many connection contracts will have transitioned to the new formula before the start of CP7. As matters stand, we do not envisage repeating calculating separate efficiency factors to reflect both CPI and RPI for CP7 and make no guarantee that we will. The efficiency factor from CP7 onwards would be calculated only on the basis of CPI being used.

The rate of inflation to be used is calculated using different measurement periods for passenger train and freight connection contracts. It may mean that the impact of the adjustment factor does not impact at the exactly the same these groups. However it is well established, reflects the different accounting periods already in place for these groups. We do not propose making any changes to that arrangement.

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[6] http://orr.gov.uk/__data/assets/pdf_file/0007/11599/connection-contract-general-approval.pdf - using clause 6(b) where this is relevant.

[7] 2018 periodic review final determination Supplementary document – the Variable Usage Charge in control period 6: conclusions. October 2018. Para 26

Implementation

We propose changing the model contract on 1 April 2019, the start of CP6, or soon after.

Impact assessment

Network Rail is a party many different connection contracts. For CP6, the difference between price changes, for contracts with CPI and those still with RPI, will be minimal because of the way that ORR will calculate the efficiency factor.

ORR does not intend to differentiate after CP6. So there may then be limited divergence after that. Where this is a concern, the parties can agree to amend the contract in the way set out above.

Where parties make changes to their contracts this will require resources and time. But all operators should already be ensuring that their connection contracts are up to date and fit for purpose. Making this change should be relatively straightforward as part of that maintenance, especially if it involves simply switching adjustment factors.

If you do consider that this change would incur administration costs for your organisation, or if the switch itself would raise any costs or risks for you, please could you detail these for us.

Conclusion

ORR's view is that the use of CPI is more appropriate than RPI in the adjustment factor. Your views on how we should make that change and the proposals in this letter are welcomed.

If the change is made, we expect it to be with effect from 1 April 2019, or soon after. Therefore we would appreciate your views by **6 March 2019**. Please send your replies to me at this address: **Track.access@orr.gov.uk**.

I would welcome feedback from any industry parties, especially those with, or considering, connection contracts with Network Rail. I am sending this letter to our standard list of track access consultees and trade associations. I have also placed a copy of this letter on our website.

We may publish the responses to this consultation on our website. This may include personal data such as your name and job title. For more information on this or how to request that replies are made in confidence, please see the details on our consultation webpage[8].

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[8] http://orr.gov.uk/rail/consultations/open-consultations/model-connection-contract-transitioning-to-cpi

Annex A: worked example

This is a simplified example for illustrative purposes and using hypothetical figures

Case 1: Adjustment factor with RPI

2019/2020 price = £100

RPI adjustment factor = £100 + RPI-X

2020/2021 price = £100 + £3 - £2.40 = £100.60

Case 2: CPI Adjustment factor with CPI

2019/2020 price = £100

RPI adjustment factor = £100 + CPI-X

2020/2021 price = £100 + £2 - £1.40 = £100.60

Summary table

	£	A	B	A+B	£
Adjustment factor	2019/20	Inflation	Efficiency	Total adjustment	2020/21
RPI Inflation	£100	3%	-2.4%	-0.6	£100.60
CPI Inflation	£100	2%	-1.4%	-0.6	£100.60