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Emailed to ORR's structure of charges mailing list

Dear stakeholders,

### **An update on ORR's review of charges**

1. On 10 December 2015 we published a consultation looking at the way in which Network Rail charges train operators for use of its network<sup>1</sup>. This was the first consultation as part of a comprehensive review of Network Rail's structure of charges for control period 6 (CP6), which is likely to run from 2019 to 2024 and beyond. The purpose of this letter is to provide an update on how we plan to progress this review, in light of the consultation responses received and the input provided at the two industry workshops.
2. In the consultation, we proposed prioritising development of a better understanding of the drivers of the fixed costs of using the network and how this improved understanding might be reflected in charges. We also proposed continuing work on improving Network Rail's current short-run variable charges.
3. This consultation closed on 4 March 2016 and we received 22 responses. Respondents included train operators, Network Rail, funders, academics as well as industry group representatives. We have published all the non-confidential responses received [here](#). We were also grateful for the attendance at two industry workshops in February 2016. The slides for these workshops are published [here](#).
4. I would like to thank those that were involved in the consultation. The feedback received was useful and has informed our thinking.
5. This letter sets out the high-level conclusions on the proposals we considered and our response to some common themes raised in the responses. Finally, this letter sets out our next steps, with a high-level timetable provided in Annex A.

### **High-level conclusions**

6. Our consultation identified three high-level options for changes to the existing charging structure. We referred to these as 'packages', as each would involve options for new or modified charges, which would then need to be developed in detail. Our conclusions on each of these packages are consistent with what we proposed, and are set out below.

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<sup>1</sup> The consultation document is available [here](#)

7. We will **continue to develop the infrastructure cost package**. Nearly all respondents were supportive of our proposal to gain a better understanding of the drivers of the network's fixed costs (all costs that are not short-run variable costs), noting that improved transparency could have many benefits in terms of better decision-making.
8. Following feedback at an industry workshop in July 2015, and reflecting the findings from the Rail Delivery Group's (RDG) review of charges<sup>2</sup>, we consulted on the distinction between increasing understanding of costs and passing this improved information into charges. Although consultation responses strongly supported a better understanding of Network Rail's fixed costs, views on passing this information through to charges were mixed. For example, some noted that operators cannot influence enough of Network Rail's costs for it to be reasonable to reflect them in charges, whilst others noted the incentive impact will be significantly weakened unless these costs are passed through to charges.
9. In addition to the work on improved transparency, we will explore options for the recovery of fixed infrastructure costs, and develop an understanding of the impacts of these options before considering whether to pass these costs through to charges. This will involve considering the linkages between changes to the way Governments channel their funding of the railways, and Governments' views on the potential for increased exposure of (future) franchised TOCs to these costs.
10. We will **not undertake any more work to develop specific options to implement value-based charges for CP6**. The majority of respondents either supported or were content with our proposal not to develop specific value-based charging options in CP6. As we highlighted in our consultation, we support the view that it is important to obtain a better understanding of the value of different services but measuring 'value' would be very complex and capacity is currently allocated administratively so the benefits of charging in this way would be limited.
11. We remain of the view that it may be important to consider carefully the overall effects of any cost-based charging options to ensure that they send sensible signals about use of capacity and do not, for example, lead to a reduction in charges where demand for capacity is high. Should this be an issue, we might need to make adjustments to cost-based charges so as to send appropriate signals about use. However, we are not planning any further work to develop any charges for CP6 which directly reflect the value of different train services.
12. We will **continue work on options within the package of improvements to Network Rail's short-run variable charges**. Although there was some diversity of views about the options that stakeholders wanted us to prioritise, the vast majority of stakeholders wanted us to continue to develop this package.
13. We published an initial list of potential options for consideration in this package as part of the February 2016 workshop material. Some stakeholders responded to this list, and provided helpful points for us to consider.

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<sup>2</sup> RDG's review of charges is published [here](#).

14. We will shortly be starting a process of shortlisting options, using the comments we have received so far, RDG's assessments and our own analysis. We will share the draft results of the shortlisting, and plan to seek further input from industry stakeholders, including through RDG. More details on this will be provided soon.

### **General themes**

15. As well as responding to our proposed priorities, stakeholders made a number of other comments. We will incorporate these into our policy development over the coming months. However there were some views that came up a number of times and, in order to provide as much early clarity as possible, we would like to respond to those here.

#### *Feedback on particular charges and incentives*

16. On the package of improvements to our current short-run variable charges we received feedback on nearly all charges and incentives that were in scope of the consultation. The capacity charge, route-level efficiency benefit sharing mechanism (REBS) and the volume incentive received most attention.
17. Reflecting the concerns raised by stakeholders, and recognising the emphasis placed on it by RDG, we will be carrying out a thorough review of the capacity charge, aligned with our review of Schedule 8. We are also planning an evaluation of REBS and, separately, to review the role of the volume incentive as part of our system operation work. We will continue to work with Network Rail and the rest of industry to identify and assess potential options to address known weaknesses with the other charges and incentives.

#### *Clarity of purpose and assessing the impacts of change*

18. We received a number of requests to ensure all impacts are included when we assess options; to ensure that the benefits to changing the structure significantly exceed all the costs of change. We understand that changing the structure of charges can result in significant costs to industry, over and above those resulting directly from making charges more cost-reflective. For example, changes might be required to Network Rail's billing system or have transitional impacts on users. Any options we propose will include a draft impact assessment to provide transparency around the costs we have considered, allowing stakeholders to identify any missed impacts.
19. We have been requested by RDG and others to ensure the purpose of charges is clear and to be mindful of the cumulative impact of changes. We think that our commitment to using impact assessments will support these objectives.

#### *Impacts on freight*

20. All responses received from the freight industry expressed concerns about the impacts of changing the structure and level of charges. Specific questions were raised about what we meant by the possibility of using the network grant to hold operators harmless to big changes in levels, only exposing them to updated marginal

incentives. Some respondents also raised concerns about relying on government funding due to the uncertainty that could bring to their businesses.

21. Although decisions on funding are matters for Governments, we are working closely with the Freight Investability and Sustainability Group (FISG) and Rail Freight Strategy Advisory Group (FSAG) set up by DfT to help it consider the future arrangements for freight. We are mindful of the need to recognise the wider contribution of freight and the impacts that the current (absence of) road pricing has on intermodal freight. However, we see the potential for wider changes in funding arrangements to recognise these benefits – with funding linked more directly to the wider benefits of rail freight. Developing this thinking in parallel could allow charges for use of the railway more closely to reflect cost, without impacting the commercial viability of rail freight and supporting efforts to improve efficiency in rail.
22. More generally, we remain mindful of our duty to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance. In addition, Directive 2012/34/EU<sup>3</sup> contains provisions setting out how fixed costs can be recovered from operators, such as the mark-up provision in Article 32, which requires an assessment of what the market can bear.

#### *Complexity and managing change*

23. Our consultation proposed two options for reducing the complexity of our current regime – a charges calculator and introducing complexity as a test into our assessment criteria for each option. Responses on these proposed options were mixed. However, the majority of stakeholders agreed that complexity impacts on the effectiveness of charges. We will therefore assess these two options and others such as merging (or possibly removing) charges where the resultant reductions in complexity look to have benefits.
24. We will be updating the potential states of the world (originally developed by RDG in its review of charges) that we will use to assess how changing circumstances affect each option. Similarly we will be considering the outcomes of the Shaw Review in detail to understand how they impact on potential charging options.

#### *On-rail competition*

25. The Competition and Markets Authority (CMA) published its final report on on-rail competition on 8 March 2016<sup>4</sup> where it outlined how greater competition could benefit rail passengers, particularly on Great Britain's major intercity routes. We will be reviewing CMA's final report and continuing to work closely with it and the DfT in the coming months to progress the work further.

#### **Next steps**

26. We welcome the outputs from RDG's own review of charges and were very pleased to see this positive example of the industry working together to improve incentives and value for money. We will continue to incorporate RDG's work into our review of

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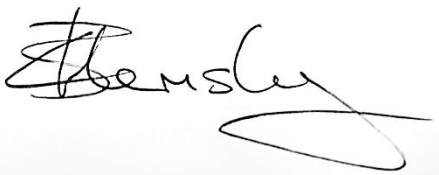
<sup>3</sup> This Directive can be found [here](#).

<sup>4</sup> The report is published [here](#).

charges. In particular, the RDG work identifying impacts of specific charging options will be useful to inform our detailed assessments – and our impact assessments in particular – as our review progresses and we narrow our focus on a smaller set of options.

27. We hope this letter has been helpful in clarifying the decisions we have taken so far and the process we plan to take to complete this review of charges and incentives.
28. We are still finalising the exact details of our industry engagement plan but we expect this to take the form of regular presentations to industry working groups. We will be in touch again shortly to agree further details of how these working groups will be organised.
29. Our timeline, set out in Annex A, shows that we will be consulting on charges and Schedules 4 and 8 together in Winter 2016. Ahead of this we will be publishing a document in late spring 2016 on the purpose and priorities for Schedules 4 and 8 and engaging with industry on this and shortlisted charges options.
30. This letter is also being published on our website. If you wish to get in touch to discuss this letter please email our structure of charges inbox ([orr.structureofcharges@orr.gsi.gov.uk](mailto:orr.structureofcharges@orr.gsi.gov.uk)).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Chris Hemsley', with a large, sweeping flourish underneath.

**Chris Hemsley**

## Annex A – Next steps, indicative dates

