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29 June 2017

Dear stakeholders,

Charges and contractual incentives – consultation conclusions

As part of 2018 periodic review (PR18) we are reviewing how access charges and contractual incentives can be developed. This work aims to improve decisions that Network Rail, train operators and funders make and will play an important role in producing better outcomes for passengers, freight customers and taxpayers.

As with our PR18 work more generally, our review of charges and incentives has benefited from extensive stakeholder engagement. In December 2016 we consulted on a series of proposals to improve the charges and incentives regime. We are grateful to the 37 stakeholders who responded to this consultation including train operators, Network Rail, funders and transport groups. We have published all the non-confidential responses received [here](#).

Following analysis of these responses we have decided to make a number of targeted reforms which will simplify the charges and incentives regime, improve fixed cost transparency and continue work towards an improved cost allocation to support competition on the network. In particular, our key decisions are that:

- the capacity charge will no longer apply, with the income from this charge to be collected through other charges;
- we will continue to work to extend fixed cost recovery to all operators, subject to a market-can-bear test; and
- as previously announced, the overall approach to variable charges will remain as it is now. However, following further analysis, we now consider that these charges can be set below the level of costs directly incurred, in certain circumstances and for a time-limited period – i.e. the capping of variable charges is possible.

In addition, while there are potential benefits from improving the measurement of the delays caused by passenger operators under the Schedule 8 performance regime, we have decided to retain the current method for CP6. This will allow reforms to the regulation of system operation to be implemented fully and provide time to review the effectiveness of the delay attribution processes.

Annex A to this letter sets out these conclusions in more detail. We have also finalised our impact assessments based on our analysis of stakeholder responses. These have been published on [our website](#) alongside this letter.

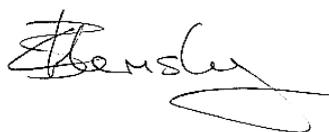
In addition to comments in response to our proposals, stakeholders discussed a number of cross-cutting themes: not least the impact of our decisions on operators' businesses. We continue to focus on these impacts as part of our decision-making process, including through ongoing engagement with stakeholders, our own analysis of financial impacts and the work that is underway to understand the impact of the mark-ups that recover fixed network costs.

As previously outlined, we are planning to consult in the autumn on a number of further areas of charging and incentives policy, including on aspects of the implementation of the decisions we have set out today. In particular, in September 2017 we will consult on our approach to implementing the market-can-bear test and any potential changes to Schedule 4, following the completion of our passenger research and any outstanding areas relating to Schedule 8. A further consultation on how to improve the alignment of incentives between operators and Network Rail (e.g. a 'Route-level efficiency benefit sharing' style mechanism) and the volume incentive will follow in November 2017, reflecting their dependency on the decisions we have now taken. Annex B to this letter sets out a timetable of our next steps.

Finally, we will continue to consider the overall impact of our decisions and how they deliver against our objectives for PR18. This will be supported by our analysis of the likely financial impacts on the industry and ongoing engagement with stakeholders. This is particularly important as we move towards implementation and more information becomes available about Network Rail's likely costs and expenditure.

If you wish to get in touch to discuss this letter, please email the PR18 inbox PR18@orr.gsi.gov.uk.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Chris Hemsley', with a long horizontal flourish extending to the right.

Chris Hemsley

Annex A: Charges and contractual incentives conclusions

1. This annex sets out the conclusions to our December 2016 charges and incentives consultation. It is structured in five main sections, considering: fixed costs; variable costs; passenger compensation; Schedules 4 & 8; and aligning incentives.
2. The decisions set out below are supported by final impact assessments, which are published on [our website](#) alongside this letter. Our approach to these impact assessments is consistent with the [Assessment Framework](#) we published in December 2016 to accompany the consultation document.

Fixed Costs

Decision

3. We will continue to work towards levying charges to recover fixed network costs on **all** operators, subject to a market-can-bear test and potentially based on an updated cost allocation methodology Network Rail is developing¹.
4. The implementation of this proposal in CP6 will depend on the outcome of the work currently underway to extend the market-can-bear test to passenger operators. It will also depend on the results of Network Rail's cost allocation work, including responses to the consultation that Network Rail is going to hold on this methodology later in 2017.
5. We are also confirming our proposal to merge the two existing freight mark-ups – the freight specific charge (FSC) and freight only line (FOL) charge – into one charge.

Background to this decision

6. At present, train operators contribute towards the fixed costs of running the rail network as follows:
 - (a) franchised passenger operators pay a lump-sum fixed track access charge (FTAC). The allocation of the FTAC between operators takes place prior to the start of the control period. The cost allocation methodology is simplistic: the net revenue

¹ The market-can-bear test is required under *The Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016* in order to levy mark-ups. This is intended to ensure that the level of charges does not “exclude the use of infrastructure by market segments which can pay at least the cost that is directly incurred”. The legislation seeks to ensure that mark-ups imposed do not unduly discourage services from using the network which can pay the direct cost, but cannot pay their full share of total costs.

requirement for each route² is allocated to franchised operators based on the forecast of their usage of the network (i.e. using simple traffic metrics such as train miles);

- (b) open access passenger operators (OAOs) do not contribute towards the fixed costs of running the network, but pay short-run variable charges, such as the variable usage charge (on the same basis as franchised passenger and freight operators). We assess access rights to OAOs by considering a number of factors, including the financial and performance impacts on existing services; and
- (c) freight operators contribute towards fixed network costs, paying the FOL and FSC. Both charges are levied as mark-ups (on top of charges for costs directly incurred, in line with European legislation), on trains carrying electricity supply industry (ESI) coal, iron ore and spent nuclear fuel (the market segments determined to be able to bear mark-ups for CP5). The level of these charges is informed by an assessment of freight avoidable costs (i.e. those costs that would no longer be incurred by Network Rail if freight trains stopped using the network), having regard to the forecast freight traffic volumes. They are levied as a rate per thousand gross tonne miles.

7. In December 2016, we made three key proposals in relation to charges which recover fixed network costs:

- (a) simplify the FOL and FSC into a single charge;
- (b) improve transparency around fixed network costs using Network Rail's new cost allocation methodology; and
- (c) apply charges to recover fixed costs to all operators, including OAOs, based on the new allocation methodology and a market-can-bear test.

8. There was support from stakeholders for proposal (a), in light of the benefits from simplifying these charges.

9. Overall, there was a mixed response from stakeholder on proposals (b) and (c). Having reviewed these responses, we continue to see potential benefits to proposals (b) and (c). These are discussed in more detail in the following two sections, alongside a discussion of some of the concerns raised in consultation responses.

Transparency of network costs

10. On the proposal to improve transparency, Network Rail has been developing a revised – and much more detailed – method of allocating its costs to operators. Key features of this methodology compared with the existing FTAC allocation methodology are:

² This is the revenue each route needs, after taking account of the revenue received from other charges, network grant and any other sources of income.

- (a) Network Rail's cost base is disaggregated to route sections (rather than at a route level, as per the existing FTAC methodology)³. This will improve the accuracy of the cost allocation, provide transparency around the relative costs on different parts of the network, and improve the information available about the costs of those parts of the network;
- (b) costs are allocated to all operators using a particular route, rather than just franchised passenger operators (the impacts of this change are discussed in more detail below); and
- (c) it identifies the costs associated with having a basic network (i.e. low traffic, low speed, but serving the range of destinations that it does at present) and the additional costs incurred in order to accommodate different types of traffic ('traffic-type avoidable costs').

11. Overall, this looks to have the potential to align the allocation of costs more closely with the drivers of costs; linking the allocation to the network assets, their cost and whether different types of operators require these assets to be in place. This approach has the potential to provide improved information and understanding on what drives network costs, which would inform decision-making by funders, franchise authorities and other parties.

12. Two main objections were raised in the responses to our consultation. First, there were concerns that Network Rail had not engaged sufficiently with stakeholders in developing its methodology. Network Rail has engaged with industry throughout its cost attribution work (including through the RDG working group⁴), discussing its proposed methodology and presenting emerging results. It is also consulting formally on the methodology later this year. This consultation will feed into our final decision whether to base fixed cost charges in CP6 on the new methodology.

13. Second, freight operators argued that the methodology should focus on avoidable costs (the costs avoided should a type of operator cease using the network) rather than seeking to allocate all Network Rail costs to all operators. Information about avoidable costs is valuable, and is typically relevant to decisions about whether to discontinue use of part of the network. However, we also see benefits in reporting the full allocation of costs (including 'sunk' costs) to all operators on a consistent basis, and to link this allocation to the costs that each type of operator could be said to have 'caused' to be incurred.

14. Reflecting this, we have asked Network Rail to identify separately the avoidable and fully-allocated cost levels. In addition, it is important to consider the costs notionally allocated

³ The network is made up of approximately 6,800 constant traffic sections.

⁴ Specifically, RDG's PR18 working group on route-level regulation, charges and incentives, and outputs.

to freight services (both in terms of avoidable and fully allocated costs) in the context of the social and environmental benefits of rail freight.

15. Having considered the potential benefits of improved transparency, we remain of the view that there could be benefits in implementing the Network Rail cost allocation methodology. However, before implementing this methodology, we will consider the responses to the consultation Network Rail is issuing later this year. We will also consider the potential impacts on customers of using this methodology as part of the calculation of fixed cost charges, alongside the development of the market-can-bear tests.

16. A related point was raised in a few responses: namely that respondents support improved transparency based on the Network Rail cost allocation methodology, but that they do not see a clear rationale for using the methodology as part of the calculation of charges to recover fixed costs from operators. We consider that there are additional benefits from passing this improved information into charges, in terms of incentives to Network Rail and operators, examples of which we set out in our [fixed costs impact assessment](#). Therefore, if the methodology is robust and implementing it does not give rise to unintended effects⁵, we continue to see benefits from passing the improved information into charges.

Revising the methodology and extending fixed charges to all operators

17. In our December 2016 consultation we recommended adopting a new approach to recovering fixed network costs, which would mean that OAOs would contribute an appropriate amount towards the fixed costs of providing the network. In addition, this approach would involve using Network Rail's new cost allocation methodology to set the maximum level of mark-ups to recover fixed costs, with ORR applying a market-can-bear test to establish the level of mark-ups to be paid by each market segment (reflecting the segmentation requirement of the relevant legislation).

18. Our proposed changes to charges recovering fixed costs have the potential to improve competition between passenger operators over the longer-term. If OAOs contribute an appropriate amount towards fixed costs this will mean that governments can choose between service provision by franchised operators and OAOs based on which is most appropriate. This could improve upon the current situation, where this decision is also influenced by the fact that OAOs do not face these costs. Consequently, governments typically expect to receive lower revenues if they facilitate growth in open access (rather than franchise services).

19. Overall, there was a mixed response from respondents, with most concerns focusing on how the proposal would work in practice. In particular, operators wanted to understand

⁵ For example, volatility of charges over time or significant changes which are difficult to explain, such as inconsistent geographic results.

how the mark-ups would be applied and how the market-can-bear analysis would be undertaken. They were keen to be involved in both areas. We discuss below the concerns raised in relation to these two areas.

A. Stakeholder feedback in relation to the application of the market-can-bear test

20. The points raised by stakeholders in this area reflect, in part, the stage we are at in developing the detailed design of the infrastructure cost charges and the market-can-bear analysis. We are committed to involving stakeholders in this work as it develops. We shared the draft tender for this analysis with stakeholders through the RDG working group, and incorporated their comments before issuing the final invitation to tender. The tender made clear that our consultants would need to engage with stakeholders throughout the analysis.

21. This will be the first time we have undertaken a market-can-bear test for passenger services. The analysis will be innovative and complex, and inevitably require ORR to balance a number of considerations (such as the trade-off between complexity and accuracy) when implementing the results into a charging policy. We have appointed consultants CEPA and SYSTRA to undertake this analysis, which will support a proposal later this year on which passenger market segments should be subject to mark-up charges (as part of a consultation in September 2017).

22. However, if it becomes apparent that the market-can-bear analysis for passenger services will not be sufficiently robust to support our proposed changes in CP6, we will review our current position and consider whether it would be more appropriate to continue with the existing FTAC for franchised passenger operators in CP6. This FTAC approach might be based on the new Network Rail cost allocation methodology, if that is determined to be sufficiently robust. For freight, the two existing mark-up charges (merged into one charge) could continue, if the market-can-bear analysis supports their retention.

B. Stakeholder feedback in relation to the implementation of mark-ups

23. A particular area of interest in the consultation responses and in subsequent conversations with stakeholders has been the form of the fixed cost charge being developed, and particularly how it would apply to franchised passenger operators and how it would differ from the existing FTAC. We have been thinking about this issue and some options in this area are emerging. We set out one possible approach below. We will continue to work with stakeholders and Network Rail to ensure that any proposals we put forward can be implemented consistently⁶.

⁶ The approach to levying mark-ups on OAOs also needs to be considered. It would most likely be similar to the approach used for freight services, where operators pay the charge on the basis of a traffic metric (e.g. as a rate per train miles).

24. The option we discuss below for levying the fixed cost charges on franchised passenger operators essentially involves an annual recalculation of FTAC to reflect changes in timetabled traffic. For clarity, in the rest of this document we will refer to such charges as ‘infrastructure cost charges’. This is to differentiate them from charges recovering fixed costs as a lump sum (which are fixed for the control period), such as the existing FTAC. We therefore distinguish between the following:

- (a) Fixed Track Access Charges (FTAC): The current approach to levying charges to recover fixed costs. Such lump sum charges, once calculated, do not vary in response to the level of services run by operators during the control period; and
- (b) Infrastructure Cost Charges: An alternative approach to levying charges to recover fixed costs, which for franchised passenger operators would replace the current FTAC lump-sum approach. Such charges could be levied either based on a metric that measures actual traffic (e.g. train miles), or linked to changes in timetabled traffic (i.e. which would reflect the expected level of traffic, rather than output).

25. There were also concerns from respondents about how the infrastructure cost charges would be implemented in a way that would not discourage loss-making but socially and economically important services from operating, while also sending appropriate signals about using scarce and costly network capacity. We acknowledge this concern, as we do not want charges to have this unintended effect.

26. This risk is, however, mitigated by the way that the market-can-bear test works: where train operators might significantly vary their current services in response to an increase in charges (i.e. high elasticity of demand) this would tend to result in the market-can-bear analysis showing a low ability to bear charges above short-run variable charges. In addition, franchise authorities typically require franchised operators to operate a certain number of train services. This limits the ability of those train operators to reduce the services they operate, and holds them harmless to changes in charges by virtue of their franchise agreements.

27. More generally, we are considering ways to reform these charges so that additional services face similar incremental charges, whether operated under a franchise agreement or by an OAO. This would support our objective of encouraging competition between train operators and avoiding the situation where the charging framework unduly distorts decisions between franchised operators and OAOs.

28. In the remainder of this section we set out a more detailed discussion around the possible issues associated with the implementation of infrastructure cost charges. Policy in this area is still under development, but we have set out an update on our current thinking to support further engagement with stakeholders.

29. One issue is how the approach to implementing infrastructure cost charges for passenger services affects the incentives faced by Network Rail and operators. For

example, if all operators (franchised and open access) paid infrastructure cost charges when adding new services this would strengthen Network Rail's incentives to find ways of accommodating additional services on the network. If these charges were higher where costs are high, this would encourage operators to make best use of the scarce capacity and provide a better incentive on Network Rail to find ways to accommodate this traffic.

30. These incentive effects are particularly important given our decision to remove the capacity charge (discussed below). Removing the capacity charge will remove one part of the financial incentives operators currently face when adding services. It also reduces the extra revenue generated for Network Rail from these services (recognising that there is currently a weak correlation between the capacity charge rates and the level of utilisation of the infrastructure).

31. The strength of the incentives that infrastructure cost charges can send will depend on the results of Network Rail's cost allocation analysis and ORR's market-can-bear analysis. The Network Rail cost allocation analysis currently suggests higher costs are associated with busy urban areas, and at busy times (peak)⁷. Therefore, infrastructure cost charges based on this cost allocation, if levied on all services, could send sensible signals about use of these parts of the network (to operators and Network Rail). We will be better able to understand these effects in practice once the results of the cost allocation analysis and the market-can-bear work are available.

32. The market-can-bear test may lessen these effects, as it would cap infrastructure cost charges based on ability to pay. However, we would generally expect ability to pay to be higher in busy areas, which would tend to retain this link between the level of use of the infrastructure and the charges paid.

33. In this respect, we are mindful of the need to maintain sensible financial incentives on Network Rail to accommodate new traffic, and to avoid circumstances where higher traffic growth reduces the company's profitability. The reforms to fixed charges could provide an opportunity for its revenue to increase as it accommodates additional services. However, the application of the market-can-bear test might reduce income from new traffic (compared with the level of infrastructure costs allocated to that service). If appropriate, we could address this through other mechanisms; most obviously by adjusting the current volume incentive so that it provides a 'top-up' to meet any difference between infrastructure cost charges and the full allocation of costs to these services.

⁷ It should be noted that the impact of the analysis to establish the costs that are avoidable at different levels of usage showed a relatively small impact at an operator level (although it could be more significant when considering individual market segments, i.e. types of services). Additionally, the impact of higher costs in urban areas might not result in higher charges per train movement, because these costs would be spread over a higher volume of traffic.

34. Network Rail has raised some concerns about this approach, as the CP5 volume incentive only increases the company's income in subsequent control periods (i.e. there is a delay in receipt of the cash). We will consider this issue as we work towards developing this charging approach, and we will take into account other potential changes to the company's funding in CP6 as a result of Network Rail having become a public sector body.

35. Another concern Network Rail has raised in relation to this approach relates to the impact of these changes on the variability of its income. We recognise that this new approach could increase the variability of Network Rail's income (for example if some services stopped running – and were no longer timetabled – they would stop paying infrastructure cost charges which cover Network Rail's fixed costs). However, as services run by franchised passenger operators are specified in their franchise agreements, we do not see this variability as substantially higher than it is at present. However, at the margin and in particular in relation to unexpected (i.e. not forecast) demand, Network Rail would be incentivised to add services, as it would be receiving income above short-run marginal costs (through infrastructure cost charges).

36. We note that this potential change of approach needs to be considered in more detail to ensure the incentives to Network Rail and operators are sensible, and that Network Rail can recover its revenue requirement with a reasonable degree of predictability, including taking account of impacts through Schedule 8. We will work through the technical details of these implementation issues with stakeholders over the coming months, as we continue to develop our policy and as the results of the Network Rail cost allocation work and the market-can-bear test become available.

Next steps

37. It is important that there is clarity for stakeholders on how we propose to take this work forward over the coming months, and how they can be involved. As such we set out below the next steps on fixed costs:

- (a) September 2017 – ORR will consult on which freight and passenger market segments appear to have high ability to bear charges above cost directly incurred, and should therefore be considered for application of infrastructure cost charges in CP6. We will also publish the technical analysis developed by our consultants alongside this consultation, in order to provide stakeholders with an opportunity to comment on it; and
- (b) draft determination (June 2018) – ORR will consult on final proposals on which market segments can bear infrastructure cost charges, and the level of those charges. The latter will be informed by: the consultants' analysis; feedback from stakeholders on that analysis received in response to our September 2017 consultation; and emerging information about the level of cost directly incurred charges in CP6 (based on Network Rail's draft price lists). We will also set out a final

proposal on whether or not to implement the Network Rail cost allocation methodology in the calculation of charges to recover fixed network costs.

Stations Charges

Decision

38. In respect of stations charges, we continue to support:
- (a) improving the methodology used to forecast maintenance, repair and renewal costs for the Long Term Charge (LTC) at managed stations to address limitations with the current methodology, in particular to ensure work completed in previous control periods is not excluded from calculations. Network Rail will provide more detail on the proposed new methodology in its summer/early autumn 2017 consultation; and
 - (b) making station Qualifying Expenditure (QX) charges more transparent at both managed and franchised stations.

Background to this decision

39. Respondents generally supported our proposal to adjust the methodology to account for work undertaken in previous control periods. The main concern raised was about the size of a possible increase in the LTC at managed stations. The scale of any changes in the level of the LTC is still unclear and we will consider the impact on operators when more information is available.

40. There was broad support from stakeholders for more transparency on QX charges at both managed and franchised stations. A number of suggestions were provided on how the information should be presented to facilitate useful comparisons.

41. Network Rail is continuing to work on publishing total QX charges at managed stations. For franchised stations we are not best placed to lead on this work since QX is not a regulated charge. We are keen for industry to lead this work and are willing to engage with stakeholders to discuss how this work should be taken forward.

42. One stakeholder also wanted to understand ORR's role in relation to stations with alternative ownership and management models, in particular stations on 99 year full repairing and insuring (FRI) leases. When the FRI lease model was first proposed we decided that these stations would no longer be included in a periodic review.

Short-Run Variable Charges

Variable Usage Charge

Decision

43. We will not undertake a fundamental review of the Variable Usage Charge (VUC) – in particular, we will not geographically disaggregate the charge, nor will we replace the role that the VTISM model has in setting the charge. We continue to support Network Rail to

consider minor methodology changes to improve cost reflectivity, subject to its consultation on any proposals it might bring forward.

44. Since our consultation document, following further analysis, we now consider that the VUC can be set below the level of costs directly incurred, in certain circumstances and for a time-limited period – i.e. the capping of variable charges is possible.

Background to this decision

45. There has been significant stakeholder comment on whether there should be a fundamental review of variable charges. In our consultation we stated that, in light of changes proposed elsewhere, the case for substantial reform of the VUC in PR18 is less strong and so we proposed that there would be no fundamental review of the charge. This proposal received broad support from stakeholders, albeit that a limited number of responses also offered support for more cost reflective variable charges.

46. Our consultation raised the prospect of some proportionate improvements to the VUC methodology. We intended these changes to be minor: i.e. they would not require significant resource to develop or implement. Nor would they have a significant impact on operators' VUC costs. We invited stakeholders to suggest areas of recalibration they would like to see implemented. A number of suggestions were submitted and these have been passed to Network Rail for consideration – selected options will be included in Network Rail's summer/early autumn consultation.

47. A number of wider points were raised in relation to the VUC. For example, some stakeholders raised concerns that the VUC could rise to reflect an increase in Network Rail's operating, maintenance and renewal unit costs. Stakeholders emphasised the potential impact this could have on operators.

48. While the scope of the consultation meant we did not comment directly on this issue, we are acutely aware of the potential for changes to charges and incentives to have significant impacts on operators. We will continue to work with Network Rail on this issue, and together will discuss potential options for mitigation of any increase with stakeholders. In this context, we note that a number of responses highlighted the importance of the assumptions made about future efficiency savings and how these are included in the VUC methodology.

49. It is also important to emphasise that we will continue to focus on these impacts as part of our decision-making process, including through ongoing engagement with stakeholders and our own analysis of financial impacts. Indeed, it is important to consider charges 'in the round'; something that we will do as part of our work on the market-can-bear test.

50. Our consultation document outlined our position that, simply stated, new legislation limited our ability to 'cap' or 'phase-in' direct costs. A number of stakeholders raised concerns regarding the removal of caps and some questioned our interpretation of the

legislation. Since the consultation was published we have received further detailed legal arguments from stakeholders and have undertaken our own further legal analysis in response to these arguments. This material helpfully set out a number of additional arguments about how the relevant legislation should be interpreted.

51. Having considered this material, we have changed our interpretation of how the legislation can be applied in practice. We now consider that there are circumstances where we would be able to cap or phase-in changes to the level of the VUC. The relevant legislation still requires ORR to set the VUC in a way that will reflect costs directly incurred, but we are satisfied that it provides some flexibility for such changes to the level of the VUC to be brought in over a limited period of time. Such a decision will need to reflect evidence available and be considered in light of our statutory objectives⁸.

52. Reflecting this, we will consider whether caps or phasing-in of changes are appropriate (and, if so, how it should be implemented) at a later date, once more information is available about the likely level of the VUC and the impact of other charges and incentives. As is consistent with our wider approach to PR18, we will engage closely with stakeholders on this issue.

Electrification Asset Usage Charge (EAUC)

Decision

53. We will not alter the EAUC methodology.

Background to this decision

54. We initially considered whether we could simplify charges by combining the EAUC and VUC. In our consultation, we proposed not to take this option forward as the change is likely to be administratively burdensome, reduce transparency and bring very few benefits. We proposed not to alter this charge beyond recalibration in PR18. There was wide support for this proposal.

Traction Electricity Charge (EC4T)

Decision

55. We will keep the loss incentive mechanism.

Background to this decision

56. Responses to our consultation were mixed, with a majority of respondents supporting our proposal to keep it. In their responses, Network Rail and RDG agreed with our view that this mechanism had not achieved its main objective of incentivising Network Rail to reduce

⁸ As per our Railways Act 1993 section 4 duties and principles of EU law.

transmission losses. This is mainly because the interventions aimed at doing so are very expensive and in many cases the benefits are long-term and do not generate a positive business case in any given control period. While Network Rail has initiated studies in CP5 with the aim of identifying initiatives to reduce transmission losses, this does not appear to be linked to the financial incentives introduced by the loss incentive mechanism.

57. On balance, we have decided to keep the mechanism, as it provides an incentive for on-train metering (under the mechanism, Network Rail bears risk of error in losses estimates, thereby allowing metered operators to have certainty in their billing for transmission losses), while also retaining some incentive on Network Rail and the industry to continue working to reduce transmission losses.

Coal Spillage Charge

Decision

58. We will abolish the Coal Spillage Charge (CSC).

Background to this decision

59. Stakeholder responses were broadly in favour of our proposal to abolish the CSC. As we noted in the consultation, removing the charge would have benefits in terms of simplification, while the decline of coal and weak incentive properties of the charge means that there are very limited adverse impacts of such a change.

60. The consultation also noted that Network Rail would like to see a clause added to freight operators' track access contracts allowing commodity spillage costs to be recovered from the operators responsible. In response to this consultation, Network Rail confirmed it would like to explore this (though it is mindful any provision should be proportionate and avoid undue transaction costs). We note that freight stakeholders argued that the model freight contract already deals with environmental damage, and that this was sufficient protection. While we think there is merit in a mechanism to recover spillage costs (using either new or existing provisions), it is ultimately for Network Rail to consider these issues as it takes forward its proposals in this area.

Capacity Charge

Decision

61. The capacity charge will no longer apply (from CP6).

62. The revenue that would otherwise have been collected from this charge will instead be recovered through higher charges to recover fixed costs (i.e. infrastructure cost charges, in line with the proposals set out above).

Background to this decision

63. In December 2016, we invited views on two options for the capacity charge:

- (a) retaining the existing capacity charge (but removing the caps on open access, freight and charter operators); and
- (b) removing the existing capacity charge and recovering lost revenue through fixed cost charges.

64. We also invited suggestions for alternative options. Network Rail and RDG jointly suggested three.

65. We had previously ruled out the 'do nothing' option of retaining the caps on the current capacity charge owing partly to our view on the legality of doing so. In light of our changed view of the relevant legislation and the effect of this on our powers to permit capping directly incurred charges, we also reconsidered the possibility of retaining the charge in its current form (alongside the options of retaining the charge in an amended form).

66. When reaching a decision on the capacity charge we first considered whether the incentive effects of this type of charge were sufficient to justify it continuing, in terms of the contribution it is likely to make to improving outcomes.

67. On this, the available evidence suggests that the incentive effects of the current capacity charge are relatively weak. In particular, it is calculated in a way that does not provide a strong link between the level of the charge and either congestion or the impact on end users (passengers or freight customers). Furthermore, the complexity of the charge looks to be a significant barrier to stakeholders responding to it in practice.

68. Consequently, the benefits of retaining the capacity charge – in its current form or modified in some way – do not look to be large, while the cost of calibrating and administering the charge are significant. Furthermore, all of the options proposed by Network Rail and RDG are based on the same calculation as the current capacity charge (thereby having the same incentive effects) but would all increase the complexity of administration. As such, we do not see significant advantages from adopting them. For these reasons, we favour simplifying the charging regime by removing the charge.

69. We recognise the concerns of some respondents about the potential consequences for Network Rail's incentives to add traffic. We will be reviewing the incentive effects of the new infrastructure costs charges as they are developed and the role of the volume incentive as part of PR18. Both of these workstreams will take the decision to remove the capacity charge into consideration. In principle, the new infrastructure cost charges (applied as mark-ups) could send some clearer and more effective signals about use on the busiest parts of the network while also providing additional income to Network Rail where it accommodates additional growth on the network.

Passenger compensation

70. We identified the linkages between Schedule 8 and passenger compensation as an area for further work in our response to the Which? super-complaint. Reflecting this, we set out for discussion a proposal that would allow passenger operators to recover the actual costs of compensating passengers for delays from Network Rail, to the extent that Network Rail caused those delays.

71. We noted that this option could strengthen the financial incentives on Network Rail, but would have a number of other impacts. These include administrative costs (including impacts on the costs of delay attribution) and complexity for Network Rail and operators.

72. Passenger operators generally supported the proposal but Network Rail stressed that it would need funding to cover the costs of compensation and of administering claims.

73. We remain of the view that Schedule 8 and passenger compensation perform different functions. Schedule 8 helps operators to manage risks they cannot control, while also providing a range of incentives to improve performance. Any payments received under Schedule 8 are not meant for the purpose of funding passenger compensation or linked to the likely cost of this compensation. Instead, passenger compensation levels are set by governments and franchise authorities, consistent with legislative requirements; with passenger operators meeting the cost of compensating passengers.

74. Reflecting the different purposes of Schedule 8 and passenger compensation arrangements, the above option would be implemented by providing additional funding to Network Rail to meet the cost of passenger compensation that it is expected to pay. To do this effectively, we would need to consider how these arrangements would work within the overall funding framework for Network Rail and the appropriate incentives on the company to manage the funding appropriately. Furthermore, when understanding the case for this approach, it is important to recognise that it is ultimately about how best to use taxpayer funds. Consequently, we consider this to be an issue where funders are best placed to decide about the balance between taxpayer and passenger interests, and where close working between funders and the ORR would be needed to make it work effectively.

Schedule 8

Approach to setting benchmarks

Decision

75. We have decided to retain the link between passenger operator benchmarks and operators' past performance.

76. We will be pursuing our proposal that the Network Rail benchmarks for freight operators should not be set on the basis of Network Rail's past performance (this was proposed for PR13 but, in the end, not adopted).

77. The approaches to setting the freight operator benchmarks and the Network Rail benchmarks in the passenger regime will, as proposed, continue to be based on the same principles as they are today.

Background to this decision

78. We originally proposed to change the approach to setting passenger operator benchmarks so that they would no longer be based on operators' past performance.

79. Responses to the consultation stressed that passenger operators have commercial and contractual incentives to perform well, so that any perverse incentives created by setting benchmarks on the basis of past performance was low. They also noted that the administrative savings of a more standardised regime would be low and outweighed by the impacts of the proposal on cash flows within the regime.

80. We agree with these arguments and have revised our assessment of the proposal. Reflecting this, we are recommending, contrary to our previous proposal, that passenger operator benchmarks continue to be based on operators' past performance.

Improving the measure of passenger operator performance

Decision

81. While there are benefits from improving the measurement of the delays caused by passenger operators, we have decided to retain the current method for CP6. This is in order to allow reforms to the regulation of system operation to be implemented fully and to provide time to reform delay attribution processes.

Background to this decision

82. One of the functions of the Schedule 8 regime is to incentivise operators to limit the delay they cause to other operators. It does this by measuring delay relative to a benchmark and applying a payment rate that turns this into a financial payment.

83. Freight operator performance is directly measured on the basis of how much delay they cause to other operators, and the amount they pay is based on that measure. However, in the passenger operator regime, due to historical data limitations, the delay that passenger operators caused to themselves had to be used as a proxy for the delay they caused to other operators (with the payment rate reflecting this calculation). As a result, the Schedule 8 regime does not provide passenger operators with any incentive to reduce the delay they cause to other operators above the incentive it provides them not to delay themselves.

84. Reflecting this, and Network Rail's view that it is now technically feasible to directly measure TOC performance in terms of 'TOC-on-TOC' delay, we proposed moving the measurement of TOC performance from 'TOC-on-self' (the proxy measure) to 'TOC-on-TOC'.

85. This proposal met with considerable opposition from passenger operators. In particular, operators argued that there would be unintended consequences of moving to 'TOC-on-TOC', albeit that the National Task Force (NTF) report into this proposal provided no evidence to illustrate what these consequences might be.⁹ DfT and Network Rail supported ORR's proposal.

86. Following further engagement with stakeholders, we identified two particular arguments relevant to the proposed change:

- (a) that the proposal would increase the cost of delay attribution, to the extent that it may even frustrate the realisation of the benefits; and
- (b) operators might seek to exert undue influence over how the system is operated, raising concerns that it would be operated to benefit the larger operators in each route.

87. On the first of these, stakeholders argued that when Network Rail manages reactionary delay on operator-caused incidents poorly, the resulting additional delay is not reliably attributed to Network Rail. Under TOC-on-TOC measurement, the existing approach to delay attribution could then lead either to operators paying for delay that was a consequence of Network Rail's mismanagement or to a significant increase in the cost of disputing such delay – neither of which reflect the intent of this proposal.

88. On the second point, we were not convinced that this was a likely outcome, and consider that there are controls already in place that put obligations on Network Rail not to discriminate in this way (not least, through its network licence). However, we acknowledge that the reforms to how Network Rail organises its system operator functions and how we regulate these functions introduces a degree of uncertainty.

89. Stakeholders also challenged whether the TOC-on-TOC proposal reflected the purpose of the passenger operator regime in Schedule 8 and whether operators needed additional incentives in respect of reactionary delay. We consulted on the purpose of Schedule 8 in 2016 and clearly set out the purpose of the regime; we have been clear for some time that part of the purpose of the regime is to incentivise operators to limit the delay they cause to other operators.

90. Furthermore, we remain of the view that there is a gap in the incentives on passenger operators in respect of the reactionary delay they cause; as the existing commercial and contractual incentives (notably the franchise agreements) only relate to the performance of

⁹ The NTF report also put forward an alternative proposal. This would expose (through the franchise agreements) passenger operators affected by reactionary delay to a proportion of the cost of this delay. This is not an alternative to the proposal to move to TOC-on-TOC measurement, as it would expose the operator affected by reactionary delay rather than the operator causing the delay.

the operator's own services. Where there is a conflict between what is best for the network as a whole and what is best for the individual operator's services, the latter will inevitably dominate their decision-making. Reflecting this, we remain of the view that TOC-on-TOC measurement has the potential to improve outcomes and to align operator incentives with the interests of users across the network, complementing the suite of commercial and contractual incentives on operators to manage the delay that affects their own passengers. This would also establish a common approach across passenger and freight operators.

91. However, on balance, we see risks in making such a change at this time, and, having revised our assessment of the proposal, we no longer plan to implement it in PR18. This decision, in large part, reflects underlying concerns about the effectiveness of the existing delay attribution system and our desire to maximise the effectiveness of reforms to system operation. As indicated, we are still of the view that the current approach uses the wrong measure given the purpose of Schedule 8, and we will be looking to ensure that the necessary reforms are delivered over CP6 to introduce this approach in PR23.

92. We recognise that the issues above already affect freight operators, but we do not think these considerations are strong enough to warrant changing their regime to one that we take to be less accurate. However, this strengthens the case for a timely review of the delay attribution system.

93. Addressing the flaws in delay attribution on the network should be a priority for industry; as well as inhibiting accurate incentives, the existing system is both too costly and inaccurate. For that reason we will be adding a programme of work to our forward plan to ensure that the system for delay attribution is improved and that reforms can start as soon as PR18 decisions are taken.

94. In particular, we will be looking to ensure that delay is more reliably attributed to the party that causes it, whether that be through causing a delay incident or through mismanagement of the resulting delay. This provides one way to address concerns that freight operators are exposed to higher costs where Network Rail does not manage reactionary delay effectively.

95. We also want to ensure that the classification of delay allows for better comparability across Network Rail and operator-caused incidents. Good quality information about delay is critical to understanding and addressing its root causes and to improving outcomes for end users. A more accurate regime will ensure greater scope for accountability, including the possibility of the publication of data on the causes of reactionary delay and challenge from stakeholders.

Sustained Poor Performance (SPP) provisions

Decision

96. We proposed to restrict claims for SPP to costs only. In light of responses from operators, we will not be implementing this proposal.

Background to this decision

97. The SPP provisions exist principally to ensure that operators are appropriately compensated for periods of sustained poor performance. We proposed this option in light of concerns raised by industry that SPP claims are costly to make, time-consuming and hard to resolve and that most of those issues resulted from disputes over revenue claims.

98. We made the proposals with a view to improving the overall effectiveness of the provisions. We noted that while the individual amounts payable would be lower, the timeliness and frequency of payment would likely increase. However, many operators objected to this change and stressed the importance of retaining the possibility of revenue compensation.

99. Since the SPP provisions exist for the benefit of operators, in light of their concerns about our proposal we have revised our assessment of it and we will not be pursuing any changes to SPP provisions. There remains a limited opportunity for further proposals in this area. However, we are not proposing to undertake any further work in this area, and so for any alternatives to be considered they would need to be developed by industry and supported by both operators and Network Rail.

Schedule 4

100. We will consult on detailed proposals for Notification Discount Factors (NDFs) in our September 2017 consultation. In addition to NDFs, we are giving further thought to the way the Access Charge Supplement (ACS) is calculated and the arrangements for bespoke compensation. The September consultation will set out our position on whether changes are appropriate for these two areas (if we feel changes are appropriate, we will include detailed proposals for consultation).

101. We note the concerns raised by some respondents about the Schedule 4 freight regime. Many of the detailed points raised have been discussed by the recalibration working group, to help decide whether the recalibration should consider them.

102. Although some respondents suggested other areas that should be considered as part of the review we did not receive strong enough evidence to support reprioritisation of our further work.

Notification Discount Factors thresholds

103. There was very strong support from respondents for our proposal to review the notification discount factors. We have now almost completed the research we commissioned to support this. We will engage with industry (via the RDG working groups) ahead of our September consultation.

Access Charge Supplement

104. There were mixed views from respondents about the appropriateness of changing the way ACS is calculated. Many TOCs were supportive of changes that would mean ACS more accurately reflects operations, maintenance and renewals (OMR) possessions. However, Network Rail expressed concern about losing the link between ACS and the strategic business plan that underpins the final determination. We are considering this issue further and will confirm our position (and any specific proposals) in our September consultation.

Bespoke compensation arrangements

105. There was mixed support from respondents regarding the bespoke compensation arrangements which are for large scale planned disruption. We encourage Network Rail and industry to work together to make improvements to the claims process where possible. We are considering this issue further and will confirm our position (and any specific proposals) in our November consultation.

Aligning Incentives

106. We will consult in the autumn on proposals to better align incentives between operators and Network Rail.

107. Our consultation gathered views on how financial incentives could be improved to encourage collaboration and what cost categories could be the basis of any potential mechanism.

108. We received a number of responses to these questions. These views, as well as those expressed in a recent RDG working group session, will inform our thinking ahead of our November consultation when we will outline detailed proposals in this area.

Annex B: Charges and contractual incentives next steps

Activity	Date
ORR's market segmentation and market-can-bear test – analysis for freight and passenger	Spring/summer 2017 Engage with industry throughout.
ORR explanatory note introducing the model developed to assess the financial impact of PR18 changes in charges and incentives	July 2017
Network Rail's charges consultation covering the detailed recalibration of charges for CP6	Publication: Summer/early Autumn 2017 Responses deadline: Autumn 2017 Conclusions (incl. draft CP6 price lists): February 2018
ORR consultation: Fixed Costs, Schedule 4, and, if required, Schedule 8	Publication: September 2017 Responses deadline: November 2017 Conclusions: February 2018
ORR consultation: Aligning incentives (e.g. REBS) and Volume Incentive	November 2017
ORR's draft determination	June 2018
Network Rail's post draft determination price lists	August 2018
ORR's final determination	October 2018
Network Rail's final CP6 price lists	December 2018
Beginning of CP6	April 2019