Charges and contractual incentives

Stakeholder event

February 2017

OFFICE OF RAIL AND ROAD

Introduction

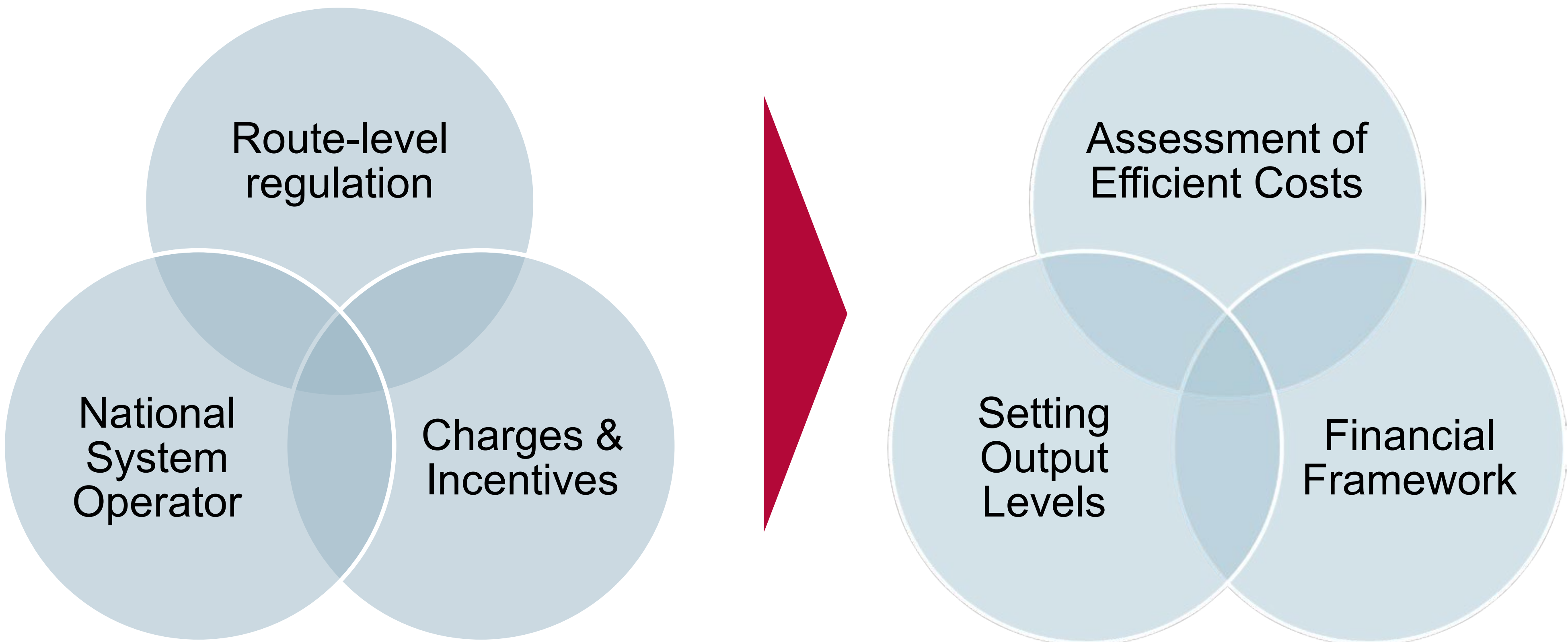
John Larkinson,

Director, Railway Markets and Economics

Our review of Network Rail is progressing

Key reforms to PR18 approach

Key aspects of final determination



We have set out our objectives for the review. These have informed our key priorities for reform: in particular the focus on route-level regulation and reforming our approach to regulating the National System Operator (NSO).

Looking ahead, we are increasingly focusing on the scrutiny of Network Rail's route and NSO business plans. This will determine what the company will be expected to deliver, the funding needed to do so, and the mechanisms for managing risk.

Throughout, we are looking to prioritise, take decisions as early as possible, and provide clear sight of when we will provide further clarity.

High level PR18 outcomes

A network that is…

More efficient	Better used	Expanded effectively
Taking cost-effective decisions on operating, maintaining and renewing the network.	Finding ways of improving performance and accommodating more services on the current network.	Informing decisions on enhancements, and delivering agreed projects in a safe, timely and cost-effective way.
Safer	**Available**	**Reliable**
Maintaining, and finding ways to improve, safety standards on the current network and as it is enhanced.	Taking effective decisions around possessions, mitigating the overall impact of these on end users.	Taking effective decisions to limit delays and cancellations, and their impact on users.

How we will structure this event

Time	Topic
14.00	Introduction to the event
14.05	Overview of the charges review
14.15	Short-run variable charges and station charges
14.30	Fixed charges, the capacity charge and financial incentives
15.30	Break
15.50	Schedule 8 and Schedule 4
17.00	Close

Overview of the charges review

Chris Hemsley,

Deputy Director, Railway Markets & Economics

What we have tried to achieve with the review

- PR18 reforms focussed on national system operator and route regulation
- Changes to charges and incentives are targeted at areas with:
  - Strong case for reform
  - Opportunities for simplification
- Key proposals:
  - Deprioritise for PR18 significant changes to short-run variable charges
  - Improve fixed costs transparency (through Network Rail's cost allocation work)
  - Apply fixed cost mark-ups to all operators (including open access)
  - Targeted improvements to the existing incentives on delays, punctuality and engineering access
  - Respond to changes in the legislative framework by removing caps on charges

How proposed changes will alter charging structure

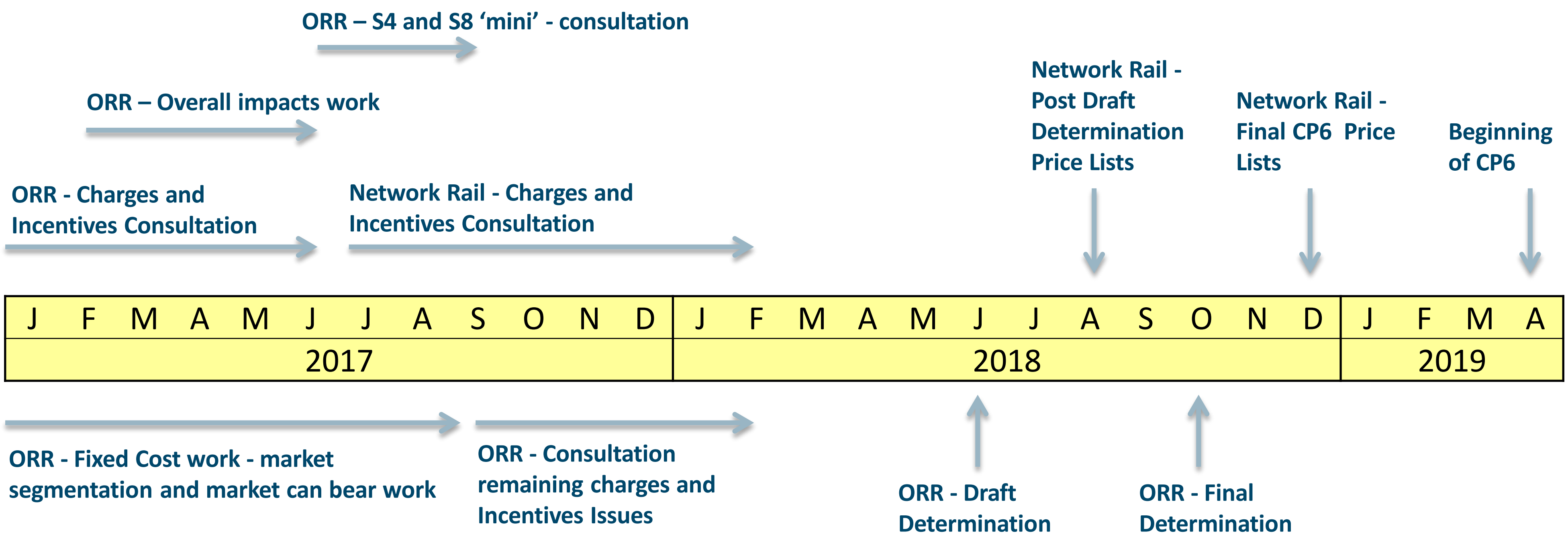
Operator	Current Charging Structure	Proposed Charging Structure
TOC — Recover Fixed Costs:	Mark-ups; Station LTC	Mark-ups; Station LTC
TOC — Recover Variable Costs:	VUC; EAUC; EC4T; CC	VUC; EAUC; EC4T; CC (TBC)
OAO — Recover Fixed Costs:	Station LTC	Mark-ups; Station LTC
OAO — Recover Variable Costs:	VUC; EAUC; EC4T; Capped CC	VUC; EAUC; EC4T; CC (TBC)
FOC — Recover Fixed Costs:	Mark- ups: Capped FOL; Capped FSC	Mark-ups
FOC — Recover Variable Costs:	Capped VUC; EAUC; EC4T; Capped CC; CSC	VUC; EAUC; EC4T; CC (TBC)

- Charter: The structure of charges and performance regime for charter operators is consistent with that for other operators

Assessing overall impact of proposed changes

- It is important to understand the financial impacts of our proposals
  - Today we present the proposed policy changes as individual options
  - But understanding how our individual proposals will financially impact operators is clearly important
- To achieve this we intend to assess the overall financial impact of the options we outline today on different types of services (e.g. passenger and freight)
- We aim to complete our analysis by June 2017 and to involve stakeholders in our study.
  - February/March 2017: Scope the analysis and develop our financial impact assessment methodology
  - April/May 2017: Ongoing discussions with stakeholders to address any modeling issues and seek further inputs
  - June 2017: Share our initial findings with stakeholders
- We will use this analysis to inform our decisions on the policy proposals outlined today.

Next steps (indicative dates)



Short-run variable charges and station charges

Paul Cornick,
Senior Economist

VUC, CSC and EAUC

No fundamental reform of charges – just simplification and recalibration … however, VUC cap will be removed

- Variable Usage Charge (VUC)
  - No fundamental reform of the VUC for PR18.
  - Cap on charge for freight traffic will be removed
  - As part of recalibration, we have asked for suggestions for minor changes to improve the accuracy of charge
  - We will work with stakeholders going forward to develop understanding of areas ahead of PR23:
    - Disaggregation of the national VUC
    - Differences between bottom-up (VTISM) and top-down methodologies
- Coal Spillage Charge
  - Coal freight volumes have fallen and are expected to continue to fall
  - Concerns over the incentive qualities of the charge
  - We propose to abolish the charge
- Electrification Asset usage Charge (EAUC)
  - Recalibration

Traction electricity charge (EC4T)

Keeping the loss incentive mechanism

- Objectives of the loss incentive mechanism:
  - Provides financial incentives to Network Rail to minimise transmission losses
  - Shares the risk of forecasting errors between Network Rail and those train operators with modelled (i.e. non-metered) consumption.
- Has it achieved its PR13 objectives?
  - Not convinced that the charge has a meaningful incentive impact on transmission losses.
  - The mechanism has been at least partially successful in achieving its goal of sharing risk between train operators with modelled consumption and Network Rail.
  - It also provides an incentive on parties to improve forecasting of losses.
- Our proposal
  - We propose to keep the loss incentive mechanism – while reviewing the methodology

Station charges

Improve the LTC methodology at managed stations and increase QX transparency

- LTC at managed stations – methodology improvement
  - The current methodology does not factor in work delivered in previous control periods.
  - Network Rail is working to understand the scale of this issue and develop a new methodology to address it.
  - Network Rail will provide more detail on a new methodology and the impact it will have on the LTC in their summer consultation.
- Increase the transparency of stations QX charges
  - Publishing total QX charges at each station would make it easier to establish if QX charges reflect efficiently incurred costs and encourage improved cost efficiency at stations.
  - Network Rail is in the process of publishing QX charges at managed stations and we plan to work with stakeholders to replicate this for franchised stations.
  - We also support Network Rail's plan to align the timings for the calculation and approval of the QX management fee at managed stations with the periodic review process.

Fixed charges, the capacity charge and financial incentives

Alex Bobocica,
Senior Economist

Fixed cost charges

Key messages

- We are proposing to improve transparency around fixed network costs and apply fixed cost charges to all operators
- We will undertake a market can bear test for passenger operators, and we will also update our analysis underpinning the market can bear test for freight operators
- We also propose to simplify freight mark-ups into a single charge

- We have identified areas for improvement in relation to fixed costs charges:

A — Understanding / transparency

There is currently a low degree of understanding and transparency around the drivers of fixed network costs

B — Cost reflectivity of fixed cost charges

The way fixed cost charges are currently allocated and levied from operators lacks cost reflectivity

C — On-rail competition

Reforms to charges could – along with a public service obligation levy – encourage greater on-rail competition

Network Rail cost allocation analysis

Cost allocation pilot study

- In 2015/2016 Network Rail commissioned a pilot cost-allocation study on the Wales route
- Purpose: develop an objective and transparent allocation of fixed costs between all operators, reflecting long run patterns of cost causation

Results of pilot study

- Results of the pilot study have been presented to industry (report published on Network Rail's website in June 2016)
- Emerging themes from the analysis:
- A large proportion of track costs are driven by the existence of a basic network (i.e. 'connectivity') rather than additional capability to accommodate heavier / faster trains
- Non-track costs are not significantly affected by the type of train (e.g. heavy / fast)

Network-wide roll-out

- Network Rail is rolling out the cost-allocation pilot at a network-wide level. The roll-out will build on the initial methodology by:
- Looking at whether frequency-related avoidable costs can be identified
- Considering a small number of additional traffic characteristics (not considered in the Wales pilot) and refining the analysis of fast and heavy characteristics
- Draft final results expected in April 2017

Fixed network costs: options considered

Information / transparency option	Charging options (all can be built on Option 1, and assume it has been implemented, but are mutually exclusive)		
Option 1	**Option 2**	**Option 3**	**Option 4**
Revise the existing allocation of FTAC to franchised passenger operators based on Network Rail's work	**Revise FTAC methodology and extend fixed cost charges to all operators based on a market can bear test**	**Link fixed cost recovery to a measure/definition of capacity utilisation**	**Link fixed cost recovery to the holding of 'long term' access rights**
Amount of costs allocated to freight and open access services would be made transparent	Transparency as per Option1	Requires accurate measure of capacity utilisation which does not currently exist	Requires extensive reforms to access rights framework
Do minimum option	**Our proposal**	**Deferred / longer term options**	

Fixed network costs: our proposed option

- In developing our proposed option further (and implementing it), there are a number of issues we need to consider:

Freight market can bear test

- Update PR13 market can bear test in light of new information
- Test to continue being based on commodities carried. Consider if there are important geographic effects.

Passenger market can bear test

- Define relevant markets and assess ability to pay (taking legislation requirements as minimum)
- Revisit NPA: determine whether it would still be appropriate (and how it would apply) if some OAO services were contributing to fixed costs

Cross-cutting issues

- Consistent principles underpinning both the freight and passenger market can bear tests (to be tested with industry)
- Level of mark-up will take into account the level of charges recovering costs directly incurred (including changes resulting from our other decisions)
- Implementation issues to consider (e.g. unit to levy charge on, variable or lump sum charges, interaction with Network Grant)

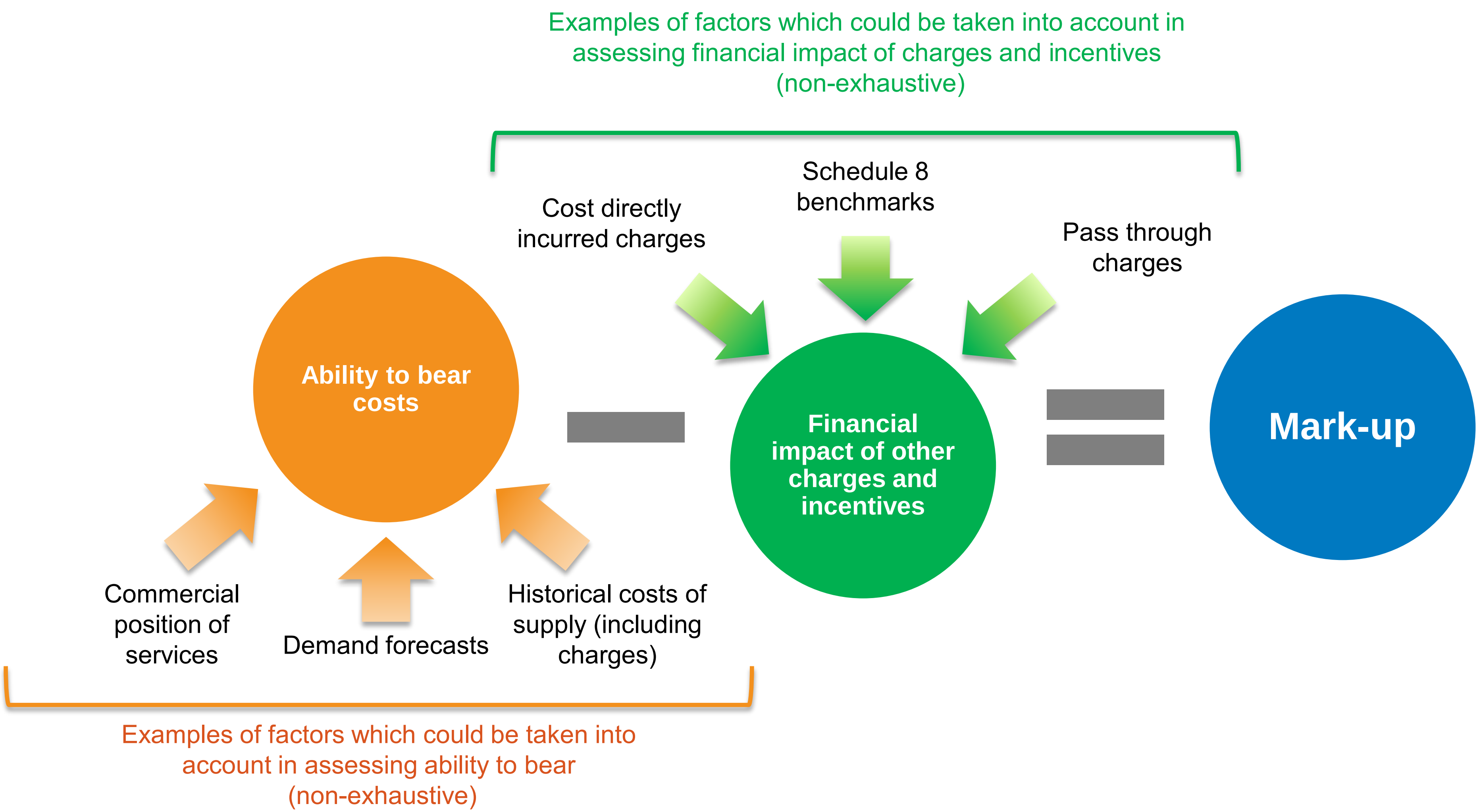
Market can bear test: proposed approach

- A key element of our proposed option is application of the market can bear test, which is likely to be a complex process, requiring on-going engagement with stakeholders
- The steps we propose to undertake in order to apply this test are:

February / March 2017	**High level principles for market can bear test: discussions with industry**	• Discussions to inform the scoping of a consultancy study to undertake the market can bear test (i.e. determining what the relevant market segments are for each type of operator and assessing their respective ability to bear costs)
Spring / Summer 2017	**Market can bear test analysis**	• ITT to be shared with stakeholders before publication • Technical and quantitative analysis to be undertaken by consultants • Regular updates to industry
Autumn / Late 2017	**ORR consults on proposals for market segmentation and market can bear caps**	• This consultation will set out the conclusions of the market can bear analysis and how we propose to implement those findings into a charging approach (i.e. what the different markets for both freight and passenger operators will be, and the approach to levying the charge etc.)

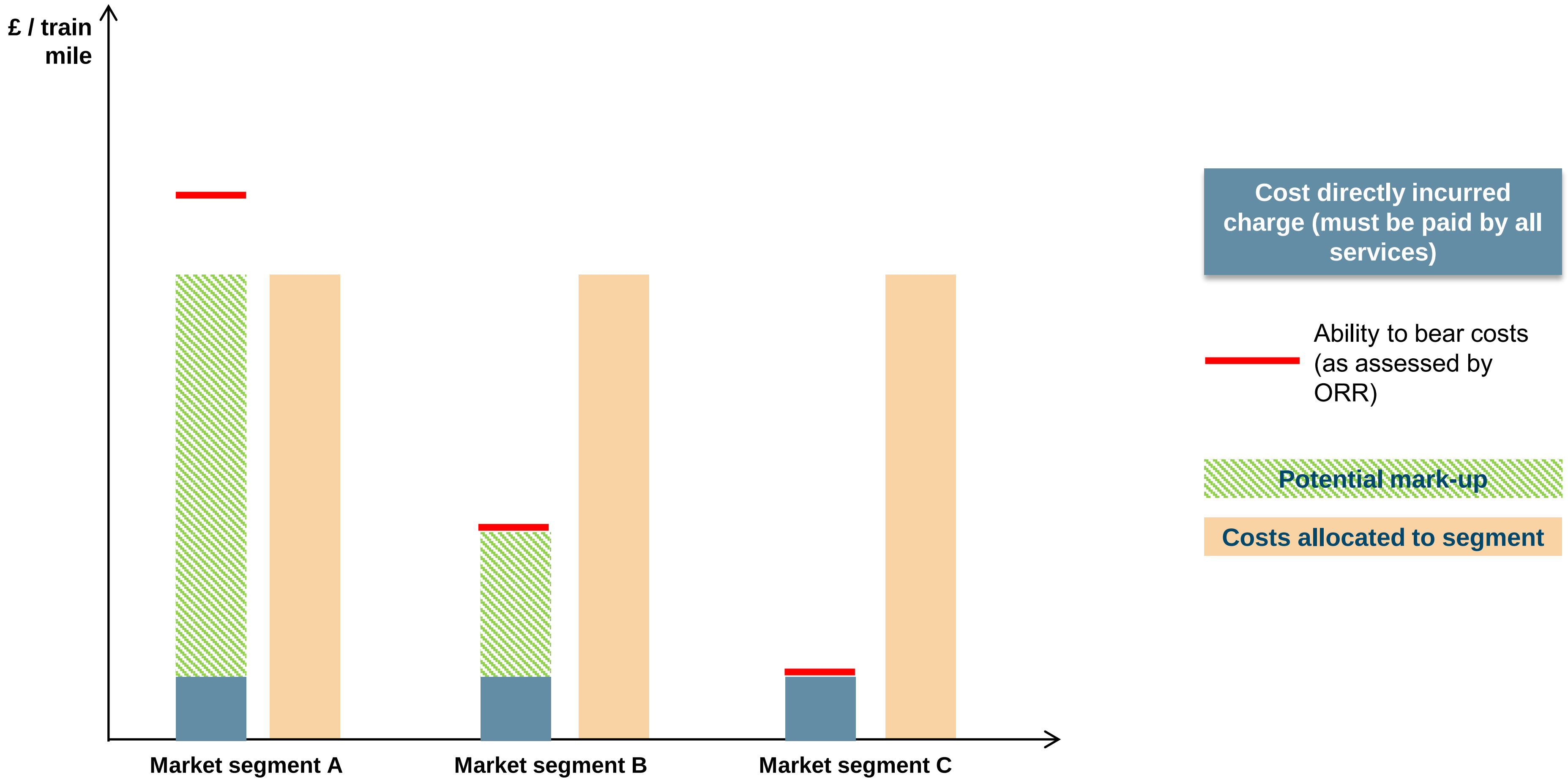
Illustration: approach to calculating mark-ups

- Below is an illustration of how the mark-ups would be calculated – this is for information only. The factors included are examples, and non-exhaustive



Illustrative scenarios: potential mark-ups for different market segments

- For illustrative purposes only – does not show all possible scenarios



Capacity charge

Key messages

- We think there are good arguments for changing the capacity charge
- We do not favour replacing it with adjustments to Schedule 8. We are interested in your views on the remaining two options below

■ We identified a number of areas for improvement in relation to the capacity charge:

A **Cost / complexity**

Charge (and wash-up arrangements) is complex and its purpose is poorly understood

B **Incentives to make best use of the network**

Some concerns that the CC rates may not reflect the impacts of use of the network particularly well

C **Incentives for Network Rail to grow traffic**

Network Rail has argued it does not face appropriate incentives to grow traffic

■ Options considered for the capacity charge:

Option 1

Retain the existing charge but remove caps for open access, charter and freight

Considering further

Option 2

Replace the charge with adjustments to Schedule 8 benchmarks

Not taking forward

Option 3

Remove the charge and recover lost revenue through higher fixed cost charges

Considering further

Option 1: retain the capacity charge, remove caps

High level description of the option

- Retain the capacity charge in its current form but remove caps (applied through the wash-up mechanism) for freight, open access and charter operators

Detailed description

PR13: having had regard to our statutory duties, due to the significant increase in the capacity charge, we capped the charge for freight, open access and charger operators

Directive 2012/34/EU Implementing Regulation: provides limited opportunity to phase in changes to direct costs

In the absence of a change to the methodology for calculating the CC (which is not proposed), **we do not consider that the existing CP5 caps on the CC (referred to as the "wash-up" arrangements) can continue to apply for CP6**.

+ Reduce cost and complexity of the CC by removing the "wash-up" mechanism. May facilitate more effective competition between franchise and open-access operators

− Charges to freight, charter and open access operators would increase, with potential impacts on the viability of their services

Option 3: remove the capacity charge

High level description of the option

- We have considered the overall impacts of removing the CC, particularly in light of the separate proposals for reform to fixed cost charges for PR18

Detailed description

- Costs recovered by the CC are currently recovered as direct costs
- The legislation requires that costs arising from the minimum access package must be charged on a ‘costs directly incurred’ basis
- As the costs recovered by the CC do not fall within scope of the minimum access package, we consider that there is some discretion regarding how these costs are recovered in CP6

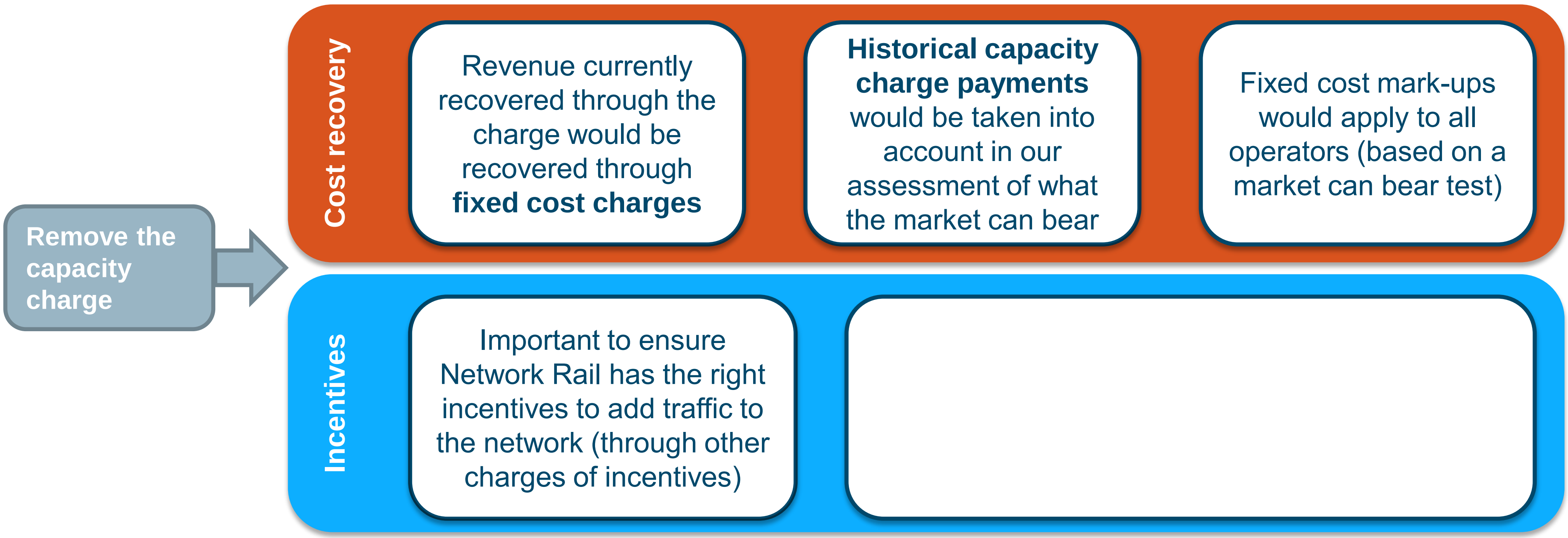
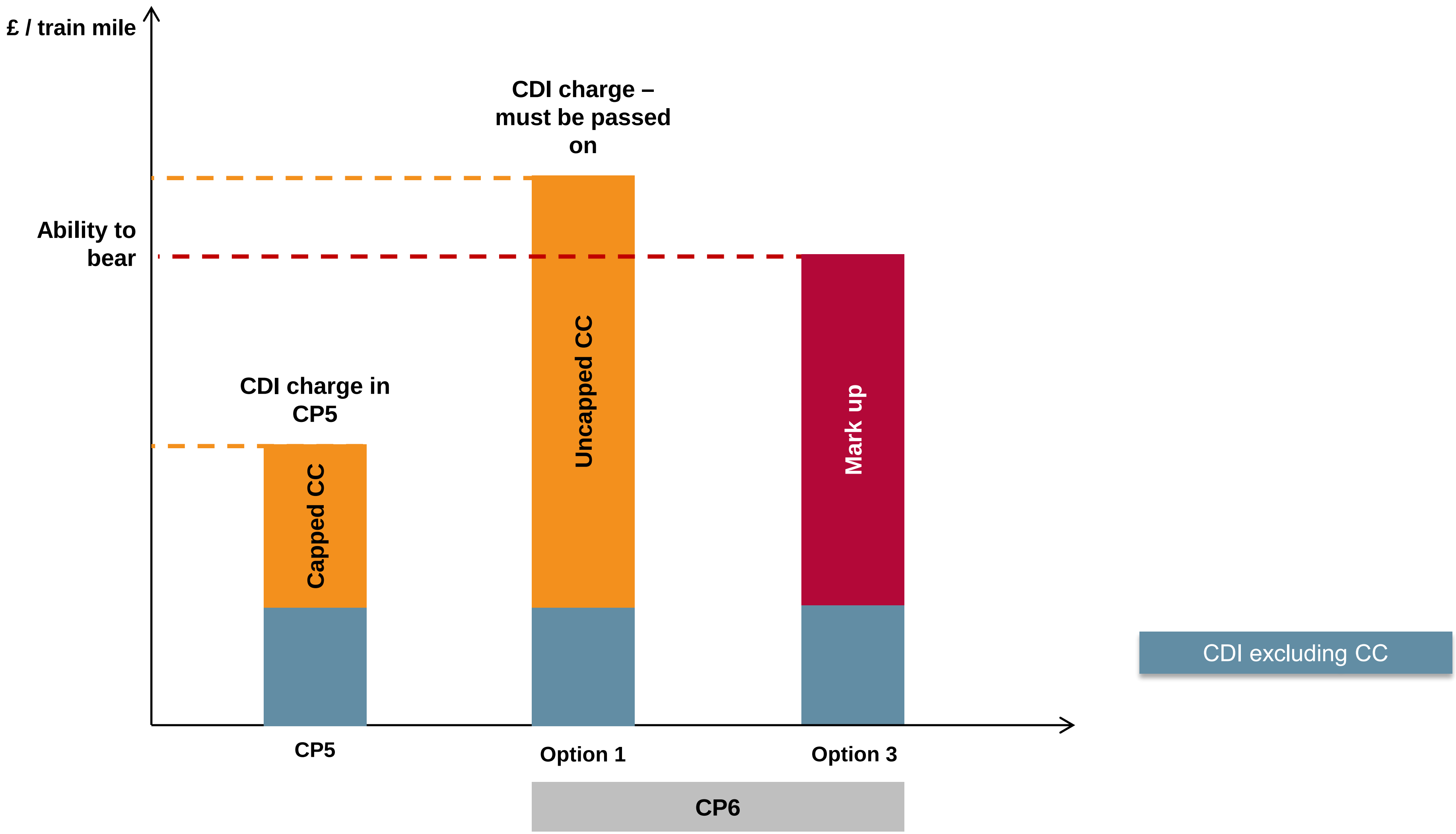


Illustration: proposed capacity charge options

- For illustrative purposes only – does not show all possible scenarios



Financial incentives

- As part of PR18 we are committed to continuing to ensure that the appropriate incentives are placed on operators to help Network Rail to reduce its network costs.
- Our December consultation mentioned several options for the future of REBS including its removal, redesign or replacement.
- If REBS were to continue then aspects of its redesign which may need to be revisited include:
  - **Baselines** – setting these and their level;
  - **Scope of costs** – what should and shouldn't be included in the calculation;
  - **Sharing percentages** – including whether there should continue to be both an upside and downside; and
  - **Optionality** – whether the opt-out mechanism should remain.
- While we will lead policy development we will continue to work closely with Network Rail and funders to develop REBS or an alternative.
- We would propose to publish our plans for REBS as part of our consultation on remaining charging issues in September 2017.
- This September consultation will be used also to set out our proposals on the future of the Volume Incentive which is intended to encourage Network Rail to accommodate extra demand for use of the network.

Schedule 8

Deren Olgun,
Senior Economist

Schedule 8 proposals

We are proposing incremental improvements to four key areas, informed by stakeholder views on what we should do with Schedule 8 in CP6.

- To re-cap, Schedule 8 does three things today:
  - Incentives on Network Rail to reduce the delay it causes;
  - Incentives on operators to reduce the delay they cause;
  - Reduces risk for operators (arising from the financial impact of delay).
- We identified four key areas for improvement:
  1. Whether passenger compensation should be reflected in Schedule 8;
  2. The approach to setting benchmarks;
  3. The measurement of TOC performance;
  4. The Sustained Poor Performance provisions.
- The following slides discuss our proposals in each of these areas.
- These proposals are in addition to the wider re-calibration of the regime (e.g. updates to payment rates).

Schedule 8 and passenger compensation

- We reviewed the alignment of passenger compensation with Schedule 8, in light of comments from stakeholders and wider public interest in the two regimes. We considered three options:

This option has been **ruled out** due to cost and difficulty of implementation in PR18

Formulaic recovery option	Add an extra payment into Schedule 8 to reflect modelled passenger compensation payments.

<u>We are interested in your views on these options</u>

"Actual costs" recovery option	TOCs able to claim compensation costs from NR for delays caused by NR.
Transparency option	Publish information on the amounts of passenger compensation operators and NR have caused.

Approach to setting benchmarks

- We are proposing the following approach to setting benchmarks for the different regimes:

<u>We are interested in your views on these proposals</u>

- TOC regime:
  - NR Benchmark: To be broadly aligned with Network Rail's target punctuality levels. The specifics of the methodology will, however, need to be discussed with TOCs, in light of changes in other areas.
  - TOC Benchmark: **NOT** to set this on the basis of past performance. **We will agree a new methodology with TOCs through the stakeholder workshops on re-calibration.**
- FOC regime:
  - NR Benchmark: **NOT** to set this on the basis of past performance. **We will agree a new methodology with FOCs through the stakeholder workshops on re-calibration.**
  - FOC Benchmark: This will continue to be set on broadly the same principles.
- Charter regime:
  - NR Benchmark and Charter benchmark: We are minded to set these on the same basis as the freight benchmarks, wherever possible. The specifics of the methodology will, however, discussed with charter operators.

The measurement of TOC performance

- The current measure of TOC performance for Schedule 8 is based on the amount of delay a TOC causes themselves.
  - The average financial impact of a TOC-on-self minute are then used as a proxy for the impact on other operators (by modelling the resulting level of TOC on TOC delay and the associated financial impact of that), and are the basis for setting the payment rate.
- We are proposing that the measurement of TOC performance be in terms of the minutes of delay caused to other operators – as it is in the FOC regime.

Basis of TOC performance measure

CP5

TOC-on-self delay minutes

PR18

CP6 proposal

TOC-on-TOC delay minutes

We are interested in your views on this proposal

Sustained Poor Performance provisions

- It was generally agreed that the Sustained Poor Performance (SPP) provisions of Schedule 8 are costly, time-consuming and hard to resolve.
- Since most of the cost and dispute is around claims for revenue compensation, and revenue compensation is already reflected in the liquidated damages scheme: **we are proposing to restrict SPP claims to costs only.**
- We will also look to introduce, where reasonable, guidance on claims and other measures to simplify the process.

CP5		CP6 proposal
SPP claims are for net revenue and cost impacts	PR18 →	SPP claims are for costs only

We are interested in your views on this proposal

Re-calibration

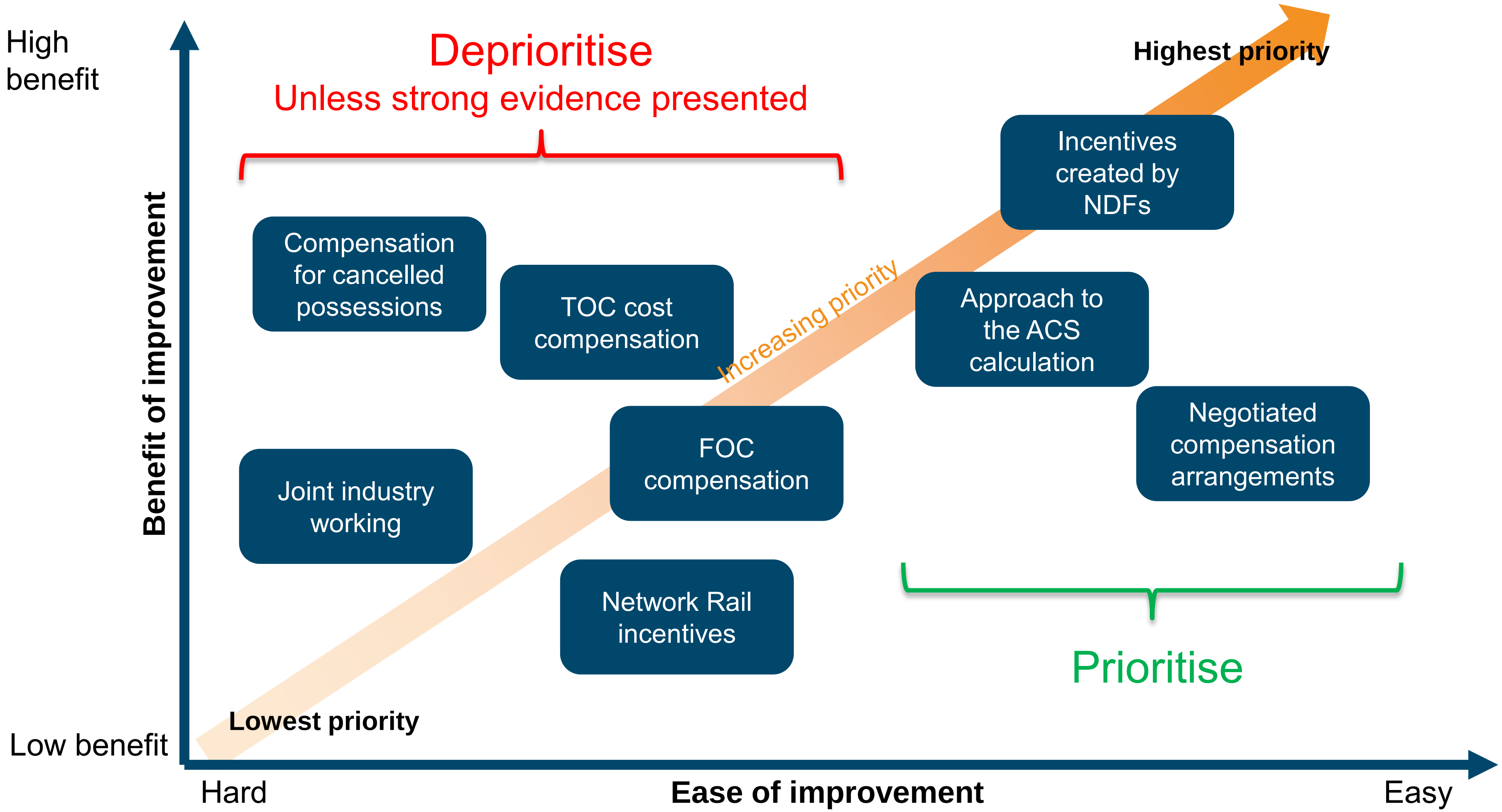
- In addition to the above changes, we will also be progressing more moderate, technical improvements and updates to the regime (including updating payment rates and agreeing a new methodology for calculating benchmarks), as part of our work to re-calibrate the regimes.
- We will be engaging with industry regularly on each of the areas that need re-calibration – the first meeting is scheduled for 15th February.
- We expect industry to take the lead in developing evidence for the re-calibration, and oversight of the process.

Schedule 4

Sheona Mackenzie,
Senior Economist

Schedule 4 proposals

Key message
We are proposing to focus our efforts where we think the most value can be delivered and therefore prioritise work on three aspects of schedule 4



Schedule 4 proposals

	Incentives created by NDFs	Approach to ACS calculation	Negotiated compensation arrangements
Issue	NDFs were last reviewed in PR08 may no longer be accurate and therefore may not incentivise good possession planning	ACS is calculated using forecast maintenance and renewals activity (in the SBP) but actual levels are likely to differ from forecast	Process difficult to follow and SPD thresholds may be too high. Known issue with the contractual wording
Proposed approach/ options being considered	• Review notification discount factors to ensure they reflect passenger awareness (we have commissioned research into this); and • Review notification thresholds to ensure they reflect the impact on passengers	• Base ACS calculation on the delivery plan (still a snapshot but should be more up to date than the SBP); or • More frequent recalculation (possibly annually or on an ex post basis); or • High level adjustment to ACS (for example to reflect historic under/over recovery)	• Amend the wording to make things internally consistent; and • Review the SPD thresholds to determine if they accurately reflect the revenue/cost implications to operators; and • Review the contractual wording and process (with a view to simplifying it if appropriate)
Next Steps	• We welcome views on the issues and options being considered • We will consult on detailed proposals this summer.		

Key dates and contacts

- Key stakeholder dates:
  - 9 March 2017: Charges and Incentives consultation response deadline
  - June 2017: Charges and Incentives conclusions publication
  - Autumn 2017: Consultation on remaining charges policy areas

Charge	Main contact
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