

Annex C – States of the world

- This annex sets out the work that has been carried out by the Rail Delivery Group (RDG) with ORR's support to develop a set of alternative states of the world (or scenarios) to consider charging and incentives framework under¹. RDG defines a state of the world as the environment within which the charges and incentives regime operates. It represents elements of the rail industry that are not part of the regime, e.g. the degree of franchise protection or the extent of regional decision making.
- 2. Following the implementation of the charging framework for PR18, we expect that the broad structure would continue to apply beyond CP6. If it is to maintain this stability over time it will need to be robust to changes in external factors and the environment in which the new regime would operate. It is important, therefore, that we assess our proposed set of broad options under different states of the world.
- 3. We think that it would be optimal for our review of charges to be based on the same or similar set of states of the world as the RDG review. We see no reason why they should differ, so long as they are based on what realistically might happen in the future, have an impact of the optimal structure of charges, and are not defined by the set of outcomes that RDG members regard as being desirable. We were, therefore, actively involved in supporting RDG's work to develop the set of alternative states of the world.

RDG's view of the current state of the world

4. The starting point for RDG to develop alternative states of the world was to establish key characteristics of the current state of the world. This was informed by workshops run by RDG to articulate the features, purpose and outcomes of the current state of the world (these are summed up in Figure 1 below).

¹ States of the World were developed by RDG as part of their own review of charges, available <u>here.</u>



Figure 1: RDG's summary of the current state of the world

	Main features		Purpose of the features	Outcomes
1 Infrastructure	Monopoly provider Mixed usage network Product not fungible Range of capabilities and technology across the network High fixed costs, which are not easily allocated to users Long planning horizons and long asset lives Common charging methodology		 Deliver a safe and reliable network Protect users – retain non- commercial services and allow political input to setting fares 	Improvements in safety and passenger approval ratings Sustained growth in demand for passenger and freight services Effective competition for the passenger services market but limited competition in the market High level of competition amongst freight
2 Train operations	 Highly specified franchises for provision of passenger services with some open access services Open access provision of freight services Limited exposure to changes in passenger access charges but exposure for freight Conflicting user priorities 	k	 Protect / retain franchise value and provide financial benefit to funders Provide environment for freight services to operate commercially Deliver societal benefits Allow governments to have input into decision-making within the industry Protect assets, e.g. from closing routes / changing services / underinvestment Avoid undue discrimination Developed based on forecast decline in rail usage 	 operators Provides both commercial services and those with societal benefits Highly contractualised industry Limited alignment of incentives between Network Rail and train operators Network Rail can't choose its customers and its customers can't choose Network Rail Significant government involvement and for direct build in the provide the provident and the provident and
3 Funders, governments and regulation	 Two main funders: DfT and Transport Scotland Regional / third party funders have some involvement DfT/TS regulates franchises and ORR regulates safety and infrastructure Governments take majority of financial risk EU legislation influences characteristics of the structure of charges 			funding but limited transparency of what is being paid for • Significant investment across network • Network capacity issues in certain parts of network often making it difficult to accommodate additional services • Focus on government / regulatory requirements • National pricing for use of infrastructure

Source: RDG's Review of Charges

5. Elements of Figure 1 above were used to consider the range of factors that could drive changes to the current state of the world over the next 15 years. These were broadly categorised as political, economic, social, technological, legal/regulatory, and environmental. The list of factors was whittled down based on the likelihood and potential impact of each change on the structure of charges, and complementary changes were then grouped to form a set of alternative states of the world.

Key features of RDG's states of the world

- 6. In selecting alternative states of the world, RDG followed these principles:
 - more than one state of the world can co-exist on the network;
 - avoid 'cluttering' the alternative states of the world so that they are not overly specific; and
 - incorporate changes that are complementary, for example more regional decision making is likely to require a different approach to infrastructure funding.
- 7. Figure 2 below sets out the summary of RDG's alternative states of the world. The first three are focused on different approaches to passenger service delivery, in particular the different degrees of on-rail competition, franchise protection and



franchise specification. The remaining ones focus on specific changes to other parts of the GB rail industry which can be considered separately or in conjunction with other states of the world.

Feature					Alternati	ve states of	the world		
	Summary of current state	How will the current feature change?	1. A more dynamic railway	2. On-rail comp. via flexible franchising	3. More highly specified franchises	4. Freight protection / subsidy	5. Beneficiary pays for capability	6. Change in approach to capacity allocation	7. More regional decision making
On-rail competition	Limited competition in the market for passenger rail services	Increase in on-rail competition	~	~					
Franchise protection	Significant protection from changes to access charges	More / less protection	√ (less)		√ (more)				
Franchise flexibility	Limited flexibility due to highly specified franchise requirements	More / less flexibility	✓ (more)	✓ (more)	√ (less)				
Freight protection	Limited protection from changes in access charges but indirect subsidies	More protection and / or direct subsidy				1			
Availability of network capacity	Some capacity issues across network but surplus capacity elsewhere	Increase in network capacity (HS2 or technology driven)						[~]	
Approach to infrastructure funding	Funded by track access charges, 'lump sum' grants from governments and Network Rail's commercial income	Beneficiary pays for new network capability	~				~		~
Approach to allocating network capacity	Administrative approach, reflecting historic rights, rather than overall benefits of use	More analytical approach to allocation, e.g. responsive to changes in demand	1					4	
Regional decision-making	Two main funders / specifiers (DfT and Transport Scotland), one infrastructure and safety regulator (ORR)	Greater regional decision making							~

Figure 2: RDG's alternative states of the world

Please note: the symbol [1] reflects that we will consider Alternative State of the World 6 with, and without, increased network capacity

Source: RDG's Review of Charges

- 8. Below we set out the key features of RDG's alternative states of the world.
- 9. State of the world 1 A more dynamic railway:
 - More on-rail competition between passenger operators.
 - **Low franchise protection** from changes in access charges.
 - Increased franchise flexibility as a result of less highly specified franchise agreements.
 - 'Beneficiary pays' approach to fixed costs. For example, governments no longer provide funding of infrastructure via the lump sum Network Grant and instead direct funding to specific projects.
 - Decisions on allocation of network capacity are no longer based largely around the rights reflected in the existing capacity and instead reflect other factors, such as the overall benefit of use.
- 10. State of the world 2 On-rail competition via more flexible franchising:



- More on-rail competition between franchised passenger operators or from more open access as a result of fewer services being franchised on certain parts of the network.
- Increased franchised flexibility as a result of less highly specified franchise agreements.
- 11. State of the world 3 More highly specified franchises:
 - **Greater franchise protection** from changes in charges.
 - Reduced franchised flexibility as a result of more highly specified franchise agreements.
- 12. State of the world 4 *Freight protection/subsidy*.
 - More financial protection from changes in charges or a direct subsidy for freight operators from governments to reflect the positive externalities/societal benefits of freight.
- 13. State of the world 5 Beneficiary pays for network capability:
 - Governments no longer provide funding of infrastructure via the lump sum Network Grant and instead direct funding to specific projects or to Network Rail but for specific elements of existing capacity.
- 14. State of the world 6 Change in approach to allocation of network capacity:
 - Decisions on allocation of network capacity are no longer based largely around the rights reflected in the existing capacity and instead reflect other factors, such as the overall benefit of use.
 - This state of the world should be considered under two scenarios a) current network capacity/capability remains; and b) a significant increase in capacity resulting from a major enhancements project such as HS2.
- 15. State of the world 7 Regional decision making:
 - More responsibility for decision making (funding, policy, operational) at a regional level.
 - 'Beneficiary pays' approach to fixed costs. For example, governments no longer provide funding of infrastructure via the lump sum Network Grant and instead direct funding to specific projects.



Our view on RDG's states of the world

- 16. We consider the approach RDG has taken in developing the alternative states of the world to be a sensible one. Although RDG does not represent the whole of rail industry, we view RDG's states of the world as a realistic reflection of the types of factors external to the charges framework that might change in the future.²
- 17. We have used these states of the world when carrying out our gap analysis (see <u>Annex B Gap analysis</u>) and also referred to them in our assessment criteria used to carry out impact assessment of our proposed charging options. RDG's states of the world do not define the extent that each of their features change, e.g. the extent of franchise protection decrease is not specified. This gives us the flexibility to vary these features as we feel appropriate for our analysis.
- 18. When using alternative states of the world for our analysis, we adopted a few deviations from RDG's work:
 - Current state of the world we think that the outcomes column of the current state of the world is too subjective and is not necessary in order to assess our options within the current state of the world (see Figure 1 above). We therefore do not intend to use it in our assessment of the options.
 - Alternative states of the world under regional decision making, we also consider greater route level decision making within Network Rail. We also make a distinction between freight protection and freight subsidy because they could both have very different impacts on the appropriate structure of charges.

² We have noted the comments made by the industry stakeholders during our July industry workshop about how the Shaw Review into the structure and funding of Network Rail may require a separate 'state of the world'. At this stage of developing packages, we do not think this requires a separate assessment but we will consider further as we develop and assess specific options.