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Dear Stakeholders,

Charges and contractual incentives – PR18 update

A key aspect of our 2018 periodic review (PR18) has been reviewing how access charges and contractual incentives can be developed to improve decisions made by Network Rail, train operators and funders to produce better outcomes for passengers, freight customers and taxpayers.

In June 2017, we concluded that this review would focus on a number of targeted reforms which will simplify the charges and incentives regime; improve transparency around fixed network costs; and work towards implementing a charging framework which recovers these fixed costs from all services (subject to a market-can-bear test) to support competition on the network.

This letter provides a progress update on our charges work – in particular, we outline that:

- the draft determination (to be published in June 2018) will include a proposal to cap / phase in the Variable Usage Charge (VUC) for freight and charter services over a time limited period
- we are considering whether such a proposal is appropriate for open access passenger operators; and
- we have asked Network Rail to cancel publication of its 'draft CP6 price list', consistent with its Strategic Business Plan (SBP), scheduled for April 2018. A price list reflecting our proposed approach to capping / phasing-in will be published by Network Rail following publication of the draft determination

We also provide an update on the ongoing development of our Infrastructure Cost Charging (ICC) approach, including two decisions we have taken in relation to proposals to be included for consultation as part of the draft determination.

Variable Usage Charge

Throughout PR18 we have proactively engaged with stakeholders. A key theme emerging from this work is that stakeholders are concerned the VUC could increase significantly in CP6, reflecting changes to Network Rail maintenance and renewal costs. We have been working with Network Rail to explore how recalibrating the charge will impact on rates paid by operators.

We have listened to stakeholder concerns regarding this issue and have considered the context in which the freight market operates. We are aware of the implications such an increase would have for operators who are exposed to changes in rates.

As previously stated, while legislation requires ORR to set the VUC in a way that will reflect costs directly incurred, we are satisfied that we have the flexibility to allow for such changes to the level of the VUC to be brought in over a limited period of time (i.e. the charge can be capped / phased in).

We have now further considered this issue and, reflecting the balance of our statutory duties, have decided that it would be appropriate for the draft determination to include proposals to cap / phase-in the VUC for freight and charter services on a time-limited basis. We are finalising the detail of what such approaches could look like, this work will take into account the financial impact of other changes to charges and incentives in PR18.

The decision to include such proposals is consistent with the views of Department for Transport and Transport Scotland who have expressed concerns as funders about possible large increases in freight and charter VUC rates. These letters are published on our website.

Open access passenger operators are also exposed to changes in charging rates. We are working to model the overall impact of our charging decisions (including removing the capacity charge) for these operators and will consider whether it is appropriate for the draft determination to contain a VUC capping / phasing-in proposal for these services.

Reflecting the above, and in order to provide clarity to stakeholders (including freight customers and investors), we have asked Network Rail to cancel publication of the 'draft CP6 price list', consistent with its SBP, scheduled for April 2018. A price list reflecting our proposed approach to capping / phasing-in will be published by Network Rail following publication of the draft determination. Such an approach will also allow the quality assurance of the charge calculations to be progressed.

Infrastructure Cost Charges

Since publishing our June 2017 conclusions letter, we have been working to develop the approach in relation to charges which recover fixed network costs, i.e. ICCs.[1] We commissioned consultants to undertake technical analysis to inform the market-can-bear test over the summer of 2017, and we continued to work with Network Rail and industry to develop proposals in relation to ICCs for passenger and freight services.

In September 2017, we consulted on some areas of the infrastructure cost charging approach, including the market segmentation for freight services, a potential approach for defining market segments for passenger services, and the design of ICCs for passenger services. We also consulted on the technical analysis undertaken by our consultants, CEPA and Systra.[2] In September 2017, Network Rail also consulted on the new methodology it has been developing for allocating fixed network costs to all services running on the network. This new cost allocation could inform ICCs in CP6.

[1] These charges are recovered as mark-ups under the European (Directive 2012/34/EU) and domestic (The Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016) legislation. The legislation places certain requirements in order to levy these charges, including assessing whether services are able to bear them (the market-can-bear test).
[2] The CEPA and Systra passenger analysis is available here, and the CEPA freight analysis is available here.

We are working to finalise proposals in all areas of the ICC policy. This has included commissioning additional analysis from MDST Transmodal in relation to biomass services, following feedback received to our September 2017 consultation. We will set out final proposals, for consultation, as part of our June draft determination publication, which will cover:

a) How costs are allocated to services in CP6;
b) Which services (i.e. market segments) are potentially subject to an ICC (taking account of the market can bear test);
c) The structure / design of that charge; and
d) The level of the charge for each market segment.

We outlined in our September 2017 consultation that, should we conclude to levy ICCs on all types of operators, including open access operators, in CP6, we will need to revisit our access policy (including the not-primarily abstractive (NPA) test), to determine what changes might be needed.

The passenger market-can-bear analysis supporting our September 2017 consultation produced estimates that would inform the level of ICCs that different passenger market segments could bear. However, there is a high degree of averaging in the analysis (due to the available data and tools). As such, our consultants produced conservative estimates of ability to bear, which would support conservative charges for any market segment deemed to be able to bear ICCs.

In addition, the DfT has now published the response to its consultation on the passenger rail public service obligation (PSO) levy. We are continuing to work with DfT on this issue; however, it appears unlikely that a levy will be introduced in the short-term.

In light of the issues highlighted around the likely scale of ICCs, and the lack of a PSO levy, it would appear at this stage that our charging reforms will only support very limited changes to our access policy (and only limited amendments to the NPA test). We will consult on any such changes in due course. Our emerging thinking indicates that a possible approach would be to include revenue generated through ICCs in the calculation of the NPA ratio (i.e. as part of the revenue generated).

We are committed to transparency and want to provide stakeholders with early sight of our decisions, where we are able to do so. This will also enable Network Rail to begin work on the implementation of some of these proposals.

In two areas we have taken high-level decisions, in principle, around proposals we will consult on as part of the draft determination:

a) Based on feedback to Network Rail's consultation, and our assessment of the methodology, we will propose in the draft determination to use the new Network Rail cost allocation methodology to set ICCs in CP6 (also subject to a market-can-bear test). In response to feedback from stakeholders, we will propose that Network Rail only allocates fixed costs to train services which are avoidable in the long-run at lower levels of traffic (i.e. what Network Rail refers to as 'traffic related' avoidable costs), and not those costs which would not be avoided in the long-run even at minimal traffic levels (i.e. non-avoidable costs);

b) Based on feedback to our September 2017 consultation, we will propose in our draft determination that any ICCs levied on open access services in CP6 are levied as a rate per train mile. We will also propose that Fixed Track Access Charges (FTACs) for franchised passenger operators vary in CP6 with changes in timetabled traffic. We will continue working with stakeholders, and Network Rail, on the detailed implementation of this proposal, including establishing the best data source for measuring changes in timetabled traffic. Acknowledging concerns raised in response to our September 2017 proposals, as part of the draft determination, we will consult on options for limiting Network Rail's financial exposure in relation to FTACs in CP6.

In all other areas of our ICC policy, we will set out proposals, for consultation, as part of the draft determination.

Our ongoing engagement and next steps

I would like to thank all of you for your continued engagement in PR18. I look forward to further discussions on these issues in the coming months including at industry groups – particularly, following publication of our detailed proposals as part of the draft determination.

Yours faithfully,

John Larkinson