

Hannah Nixon
Head of Regulatory Economics
Telephone 020 7282 2146
Fax 020 7282 2044
E-mail hannah.nixon@orr.gsi.gov.uk



OFFICE OF **RAIL REGULATION**

21 December 2006

See attached list

Dear Consultee

Proposals for a rebate mechanism for investors in large-scale enhancements – draft conclusions

1. In December 2005 we published a letter consulting on proposals for a rebate mechanism for investors in large-scale track infrastructure enhancements^{1 2}. This proposed mechanism forms part of our policy framework for investment and should help to address one of the barriers to investment by enabling investors to recover a fair proportion of the costs incurred in funding an investment scheme where competitors benefit from the use of the enhancement.

2. We asked stakeholders for views on the following issues:

- (a) The practicalities of implementing the proposed rebate mechanism;
- (b) How the mechanism should operate under the specific scenarios identified in the consultation letter;
- (c) Implementing the mechanism through the Network Code; and
- (d) A possible extension of the mechanism to government funders.

¹ Including track, civils and signalling enhancements

² Available at <http://www.rail-reg.gov.uk/upload/pdf/rebate-letter.pdf>



3. Following an industry workshop on 20 February 2006 to discuss a number of the outstanding issues in detail, we received 12 responses to our consultation letter³. We have also held bilateral meetings with stakeholders on particular issues where appropriate. Following the consultation process, the paper attached to this letter now sets out our draft conclusions on the proposed rebate mechanism.

4. The time it has taken to reach these draft conclusions reflects the complexity of the issue. We have had to consider carefully with Network Rail the practicalities of implementing such a mechanism, as well as ensuring compliance with the legal framework and having due regard to the views of other stakeholders.

5. Our proposals have received general support amongst consultees, albeit with some concerns about the possible degree of complexity involved. We therefore intend to implement the rebate mechanism broadly in accordance with our December 2005 proposals. However, further consideration of the legal framework as well as views expressed during the consultation process, have resulted in a number of amendments and the development of thinking on the detailed application of the mechanism.

6. We recognise the importance of putting in place a mechanism that is conceptually straightforward, relatively simple to implement and operate, and transparent. Our objective is to keep the mechanism as simple as possible and adopt a pragmatic, rather than theoretically pure, approach. We have therefore simplified the methodology for calculating the level of the rebate as far as we believe is appropriate.

7. We would welcome your views on any of the issues raised in this letter and, in particular, on:

- (a) Whether you still believe there is merit in implementing the proposed mechanism, given its inherent complexity;

and, if so:

- (b) The revised scope of the mechanism;
- (c) The methodology for calculating the rebate, and in particular our proposals for simplification;

³ Respondents are listed in Annex A. Responses are available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8176>.

- (d) Our proposals for dealing with enhancements that create additional capacity or an alternative route;
- (e) Our proposal to implement the mechanism through applications under Section 22 (or Section 22A) of the Railways Act 1993, rather than the Network Code; and
- (f) Our proposal to keep the mechanism under review.

8. As part of the consultation process, we would welcome the opportunity to meet again with stakeholders. We therefore intend to arrange a further workshop early in 2007.

9. Responses should be sent in electronic format (or, if not possible, in hard-copy format) by **Friday 2 March 2007** to:

Hannah Nixon
Head of Regulatory Economics
Office of Rail Regulation
One Kemble Street
London WC2B 4AN
E-mail: Hannah.Nixon@orr.gsi.gov.uk

10. We will make your response available in our library, publish it on our website and may quote from it. If you wish all or part of your response to remain confidential to us then please indicate this clearly. We may also publish the names of respondents unless a respondent indicates that they wish their name to be withheld.

11. Copies of this document can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely

Hannah Nixon
Head of Regulatory Economics

Proposals for a Rebate Mechanism for Investors in Large-Scale Enhancements – Emerging Conclusions

Background

1. If rail services are to develop so that the needs of users are better met, it is essential that there is an effective framework for delivering infrastructure investment, including that sponsored by third parties (i.e. non-government funders).
2. In October 2005 we published our conclusions on our new policy framework for investments⁴, which aims to facilitate investment in the railway by addressing a number of barriers to the delivery of efficient investment. We have implemented the framework by establishing clear roles and responsibilities and, where appropriate, new approaches to enable these barriers to be overcome. These are set out in our investment guidelines, published in March 2006⁵.
3. One such barrier is the inability under current arrangements of third party investors to recover a fair proportion of the costs incurred in funding an investment scheme where other parties benefit from the use of the enhancement. Under current arrangements, third party funders cannot charge operators directly for access to enhanced assets, which means that operators may be able to 'free ride' on these investments. This 'free rider' problem means that the investing entity could perceive itself to be at a competitive disadvantage, reducing the promoters' incentives to invest and ultimately meaning that a beneficial investment may not go ahead.
4. The need to address this barrier was highlighted during the consultation process on the Investment Framework, with a number of freight industry consultees in particular indicating that investment projects were being stalled as a result of the free rider problem⁶. In December 2005, we therefore published a letter consulting on proposals for a rebate mechanism for investors in large-scale enhancements⁷, which is aimed at addressing this barrier to large-scale investment⁸.

⁴ Available at <http://www.rail-reg.gov.uk/upload/pdf/255.pdf>

⁵ Available at <http://www.rail-reg.gov.uk/upload/pdf/277.pdf>

⁶ Consultation responses are available at <http://www.railreg.gov.uk/server/show/ConWebDoc.7125>.

⁷ Available at <http://www.rail-reg.gov.uk/upload/pdf/rebate-letter.pdf>

⁸ There is already a mechanism (in the freight model clauses) to allow investors to recover some costs from beneficiaries. However, this mechanism applies only to schemes with a value below £250,000.

5. Our proposals for a rebate mechanism have received general support from the industry. The responses are available on our website⁹.

Objectives of the rebate mechanism

6. As set out in our December 2005 consultation letter, the objectives of the proposed mechanism are:

- (a) To ensure that an entity choosing to invest in a track infrastructure enhancement¹⁰ is not placed at a competitive disadvantage as a result of other operators being able to 'free ride' on that investment;
- (b) To ensure that parties are not disadvantaged by the investment of any other party, to the extent that the level of the rebate forecloses efficient access to the enhancement; and
- (c) To provide certainty both to investors as to the level of rebate that they can expect to receive and to operators wishing to access the enhancement as to the cost of doing so.

7. We also recognise the importance of putting in place a mechanism that is conceptually straightforward, relatively simple to implement and operate, and transparent. Although respondents to the consultation generally welcomed our proposals, several noted that there is a risk of uncertainty, prolonged disagreement and perverse outcomes if the mechanism is too complex. We understand the respondents' concerns and are aware that a mechanism that is too administratively complex may add time and costs to industry processes without providing the required certainty for investors and future users.

8. Our objective is therefore to keep the mechanism as simple as possible and adopt a pragmatic, rather than theoretically pure, approach. Indeed, we have attempted to simplify the proposed mechanism in a number of ways, as highlighted in the remainder of this paper; and we believe that we have now simplified the mechanism to the extent appropriate.

⁹ <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8176>

¹⁰ Including track, civils and signalling enhancements

Summary of proposed rebate mechanism

9. In our December 2005 consultation letter, we proposed the following:

- (a) For each enhancement funded by an investor, a flat (index linked¹¹) tariff should be set per train service benefiting from the particular enhancement;
- (b) The rebate would be payable to Network Rail (or other applicable network operator) as a premium to the access charge. Network Rail would then have responsibility for distributing the rebate to the appropriate investing party(ies), the rights to which would be set out in the access contract or access option;
- (c) Any operator accessing and benefiting from the enhancement would be liable for the rebate. To the extent that an operator has funded the enhancement, it would be exempt from the charge;
- (d) The level of the rebate payable/receivable should be calculated by Network Rail and be based on the average cost of the investment (see section on 'establishing average cost' below); and
- (e) The rebate should be applicable only for the ex ante payback period of the investment, as set out in the access rights or options of the investing entity. If the original investor loses its access rights with respect to the enhancement, the mechanism for paying rebates to the investor would survive.

10. These principles received widespread support amongst consultees.

11. We therefore intend to implement the rebate mechanism broadly in accordance with our December 2005 proposals. However, further consideration of the legal framework as well as the consultation process and subsequent bilateral discussions, have resulted in a number of amendments and the development of thinking on the detailed application of the mechanism. These are elaborated throughout, but include:

- (a) **Scope of the mechanism:** We propose to limit the scope of the mechanism to investments that could not go ahead without the rebate mechanism, to ensure consistency with the requirements of the Railway Infrastructure (Access and Management) Regulations 2005. We also propose that Government should be

¹¹ The level of the rebate would be linked to the annual change in UK RPI inflation, as published by the Office for National Statistics (ONS), calculated November-November as for passenger track access charges currently.

outside the scope of the mechanism but other public sector bodies should be eligible;

- (b) **Calculation of the rebate:** We have simplified the methodology for calculating the level of the rebate;
- (c) **Specific scenarios:** We have developed our thinking on how the level of the rebate should be calculated where the enhancement concerned either increases the capacity of a route or creates an alternative route; simplifying the methodology in the process; and
- (d) **Implementation:** We propose to implement the mechanism through applications under Section 22 (or Section 22A) of the Railways Act 1993, rather than through the Network Code.

Scope of proposed mechanism

Eligibility

12. In December 2005, we proposed that any track infrastructure enhancement funded by a third-party should be eligible for the rebate mechanism to the extent that the investment is not remunerated through other mechanisms (e.g. a franchise contract).

13. We need to be satisfied that the rebate mechanism is consistent with the charging principles set out in Schedule 3 to the Railways Infrastructure (Access and Management) Regulations 2005 (the Regulations)¹². We consider that the higher charges upon which the rebate mechanism depends are capable of falling within the exception to the general principle that charges should be set at the cost that is directly incurred for specific investment projects¹³. We have therefore developed criteria to assist in determining whether or not this exception applies. In doing so, we have sought to balance appropriately our various policy objectives, particularly with respect to encouraging efficient investment in the network on the one hand and ensuring that users are not inefficiently priced off the network on the other.

¹² Available at <http://www.opsi.gov.uk/si/si2005/20053049.htm>

¹³ Paragraph 3 of Schedule 3: "3. (1) Subject to sub-paragraph (2), for specific investment projects completed (a) since 15th March 1988; or (b) following the coming into force of these Regulations, the infrastructure manager may set or continue to set higher charges on the basis of the long-term costs of the project. (2) For sub-paragraph (1) to apply (a) the effect of the higher charges must be to increase the efficiency or cost-effectiveness of the project; and (b) the project could not otherwise have been undertaken without the prospect of such higher charges..."

14. However, at least in the initial stages, we would review each individual case in detail to ensure that the proposed charges are permissible under this exception in the Regulations. Network Rail would need to provide us with all of the relevant information provided by the investor.

15. Potential investors would need to demonstrate that without the rebate mechanism (i.e. the prospect of recovering an element of the investment from the higher charges) the investment could not go ahead. In particular, investors would only be eligible for the rebate mechanism if they can demonstrate to Network Rail (and us) that they are not being funded for the investment through other mechanisms and that they satisfy one of the following criteria:

- (a) Though there is a stand-alone business case for the investment, there is a real likelihood of free riding on the investment by competitors, which would mean that the project could not be undertaken without the prospect of such higher charges.
 - (i) Importantly, the possibility of only non-competitors benefiting from the enhancement would not satisfy this criterion (e.g. a FOC benefiting from an enhancement funded by a passenger TOC). Where non-competitors are expected to benefit, the investor has the option of agreeing joint funding up-front.
 - (ii) Enhancements due to commitments under Section 106 or similar provisions are generally unlikely to satisfy this criterion: arguably these schemes would proceed whether or not the mechanism was introduced. However, such schemes would not be automatically excluded;

OR

- (b) The funder is a public sector third-party funder (e.g. PTE, TfL) and funding constraints mean that the scheme could not proceed without the prospect of recovering higher charges via the rebate: for example, although the scheme represents value for money even in the absence of the rebate, it would not go ahead without the rebate mechanism due to a lack of available funding.
 - (i) In such cases, we expect stakeholders to have explored thoroughly the possibility of joint funding arrangements, rather than relying on the rebate mechanism.
 - (ii) Where joint funding is not possible, we would expect the funder to provide evidence of this and of the funding constraint.

- (iii) We propose that commercial entities are excluded from this category as otherwise there would be a risk of encouraging speculative investment in the network.

16. To illustrate, we have summarised the key categories of scheme according to the funder and beneficiary, applying the criteria above, in a table. This table is attached as Annex B.

17. An application for a rebate is likely to be made as part of an application for an access option. We will be consulting separately on our policy for the approval of track access options early in 2007. However, we acknowledge that an application could also be made under an existing access contract.

Other scope issues

18. We propose that Government (i.e. DfT and Transport Scotland) should be outside the scope of the mechanism but other public sector bodies (e.g. TfL and PTEs) should be eligible. This is because Government already has a number of processes available to it to fund investment schemes, which are not generally available to other public sector bodies. These include the periodic review process, whereby investments are funded through the RAB (or potentially in-year), the logging-up mechanism for investments identified between periodic reviews, and the franchise regime¹⁴.

19. Where Government wishes to obtain partial funding from beneficiaries, we recommend that it generally does so by agreeing joint funding arrangements up front.

20. We also propose that, at least initially, the use of the mechanism should be limited to track infrastructure enhancements. We will consider extending the scope to include station and depot schemes once the mechanism is up and running. If the scope is extended, suitable provisions would need to be introduced into the Station and Depots Codes in order to implement the mechanism.

Applying for a rebate

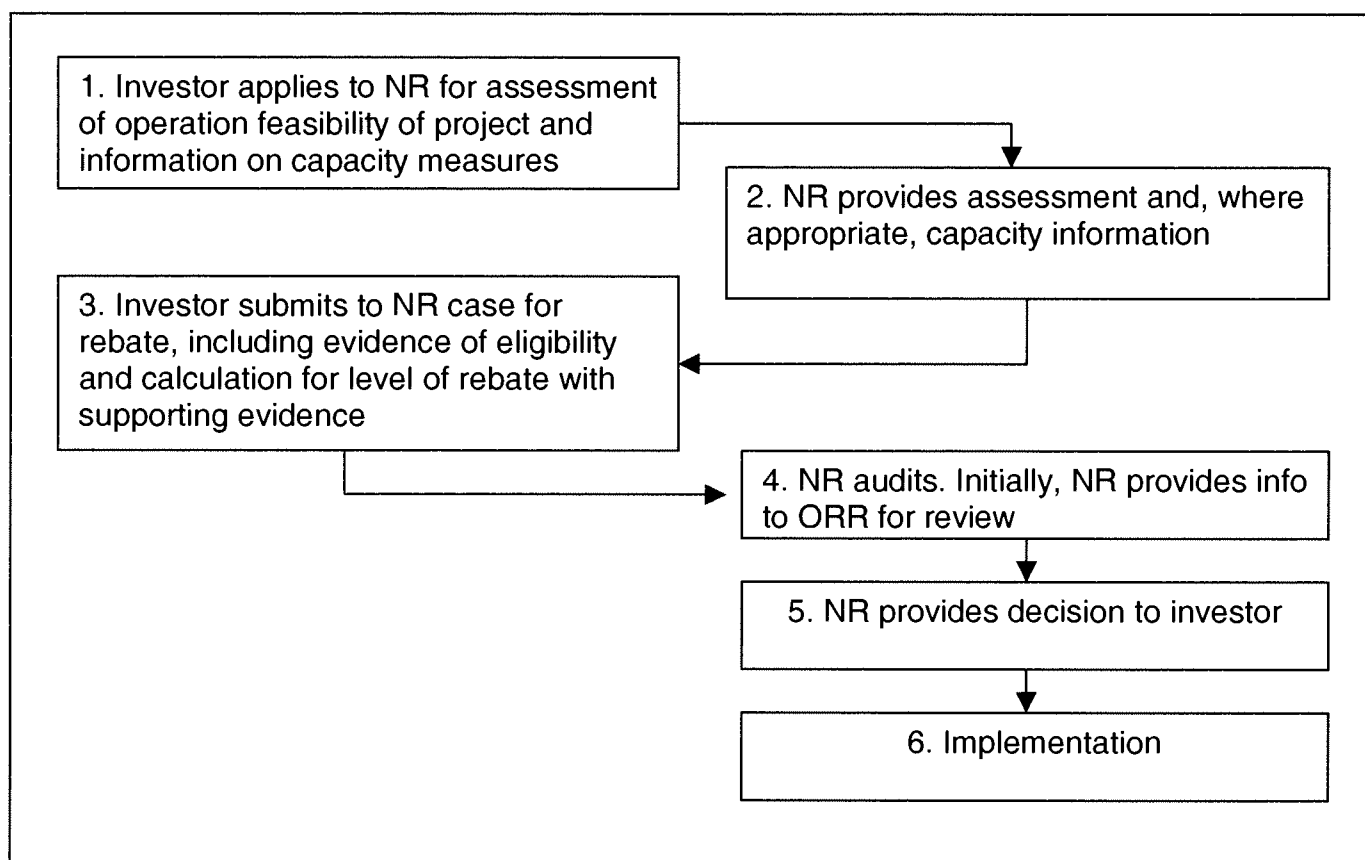
21. Potential third-party investors would be responsible for setting out and justifying to Network Rail, in the first instance, their case for higher charges and accompanying rebate, and the level of that rebate. Investors would have to demonstrate that the enhancement satisfies the eligibility criteria set out in paragraph 15 above.

¹⁴ See ORR, February 2005, *Policy Framework for Investments: An initial consultation*, paragraphs 2.5-2.13 for further details. This document is available at <http://www.rail-reg.gov.uk/upload/pdf/223.pdf>.

22. Network Rail would be responsible for assessing the eligibility of the enhancement and its consistency with the Regulations. In line with its new responsibilities for developing station and track access charges, Network Rail would also have responsibility in the first instance for verifying the level of the rebate proposed by the investor.

23. Figure 1 below sets out the steps in the process. We intend to discuss with Network Rail the exact timings for each stage in this process.

Figure 1: Steps in applying for a rebate



24. We would keep the mechanism under review. If in the light of experience amendments were needed, we would look to make changes at the end the first year of implementation, subject to the number of applications received in the period.

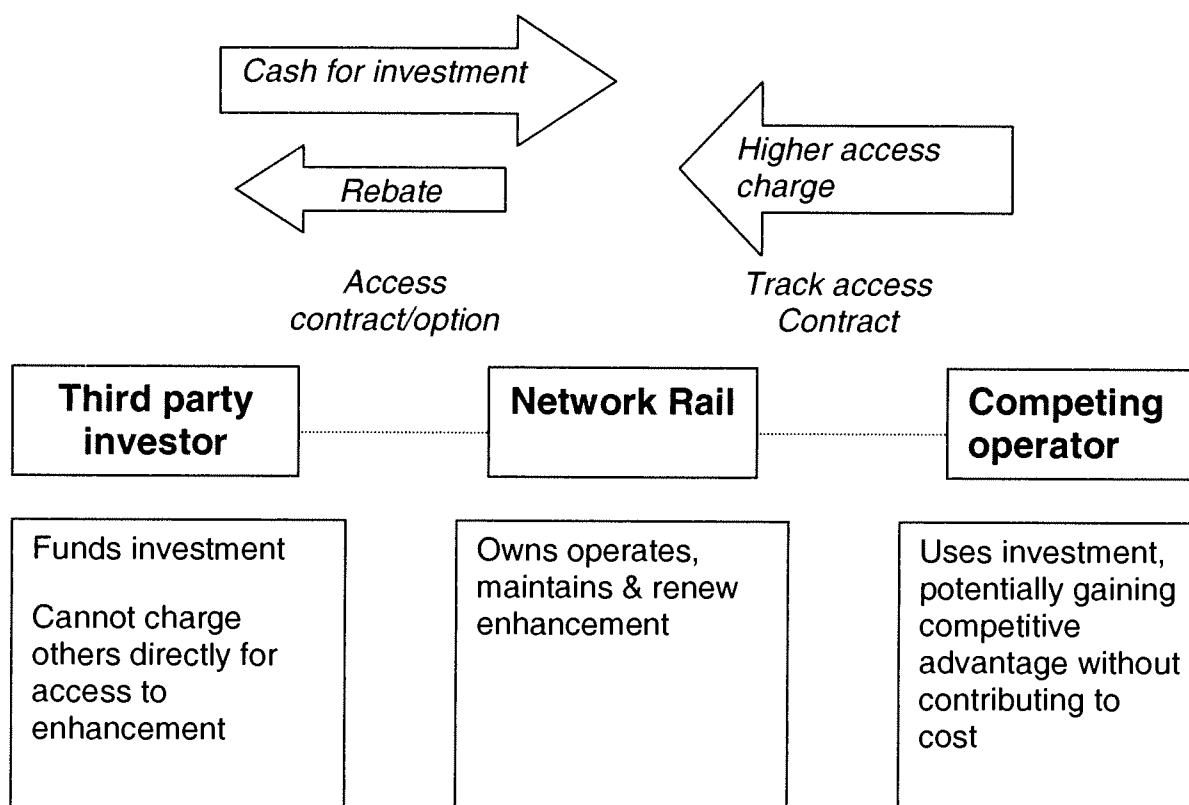
Operation of the mechanism

25. In the case of an enhancement funded by a private sector third-party, where a competitor to the investor accesses and benefits from that enhancement, the accessing party would be required to pay the higher charges. (Note that operators accessing and benefiting from a private sector enhancement that are not competitors to the investor would not be required to pay the higher charges.) In the case of an enhancement funded by a public sector third-party, any operator accessing and benefiting from the enhancement would be required to pay the higher charges.

26. As third party investors cannot charge other operators directly for access to the enhancement, operators would pay the rebate via a premium to their track access charge. Network Rail would receive the access charge incorporating the rebate element and would be responsible for transferring the rebate element to the investor.

27. Figure 2 summarises how payment flows would work in practice.

Figure 2: Paying and receiving the rebate



Calculation of the rebate and application to different scenarios

Calculation of the rebate

28. As set out in our December 2005 letter, the level of the rebate should be set equal to the average annual cost of the investment per relevant path available, calculated as:

$$\text{Average annual cost} = \left(\frac{\text{Total annual investment cost}}{\text{capacity measure}} \right)$$

where the total annual investment cost is calculated as:

$$\text{Total annual investment cost} = \text{annual depreciation charge} + (\text{NBV of investment} \times \text{annual cost of capital})$$

and:

- (a) The **investment cost** is the total cost to the investor of the enhancement (excluding financing costs). Where Network Rail undertakes the enhancement on behalf of the investor, this should be the amount paid to Network Rail¹⁵. Incremental operating, maintenance and renewals costs may also be included, consistent with our policy set out in our March 2006 investment guidelines.
- (b) The **depreciation charge** is that implied by depreciating the enhancement on a straight-line basis over the ex ante payback period of the investment (rather than the asset life), as set out in the access contract for the investing entity.
- (c) The default value for the **cost of capital** is Network Rail's prevailing allowed rate of return, in nominal terms, in the year in which the enhancement is financed. Investors may propose an alternative cost of capital but will need to provide compelling and robust evidence as to why the proposed rate is more appropriate than the default rate.
- (d) The **capacity measure** is the anticipated capacity of the enhancement available to beneficiaries. Where accessing the enhancement does not necessarily imply benefiting from it, e.g. a gauge enhancement, relevant capacity may be significantly below the total capacity of that route section. (Annex C provides an example.) This represents a change from our December consultation letter. Following discussion at the workshop, we believe that this revised approach is more straightforward and

¹⁵ If the investor pays NR for the enhancement in instalments, then the net present value (NPV) of these instalments should be used.

provides appropriate incentives on potential investors. In particular, it means that there is no scope for an investor to over-recover the cost of the investment, discouraging speculative investment in the network.

29. Box 1 provides a simple worked example of how the level of the rebate would be calculated.

Box 1: Worked example of calculation of rebate charge

Net book value (NBV) of investment	£300,000
Anticipated payback period	10 years
Real cost of capital	6.5% real (NR's allowed return for 2006-07)
Average RPI inflation	2%
Capacity measure	20 paths / day => 7,300 paths / year
Depreciation charge = $£300,000 / 10 = £30,000$	
Nominal cost of capital = $6.5\% + 2\% = 8.5\%$	
Total investment cost = $£30,000 + 8.5\% \times £300,000 = £55,500$	
Rebate = $£55,500 / 7,300 = £7.60$ / benefiting path	

Multi-party funding

30. As set out in our December 2005 letter, where an enhancement is funded by more than one entity, we would expect the following principles to apply:

- (a) The eligibility of each funder for a rebate should be considered separately, against the principles set out in paragraph 15 on 'eligibility' above; and
- (b) The rebate available to eligible funders should be the proportion of the investment funded multiplied by average cost. Consequently, if all funders are eligible for the rebate, the total rebate payable by competitors accessing and benefiting from the enhancement will be the average cost (as calculated above). Where one or more funders are not eligible to receive the rebate, the total rebate payable will be less than the average cost.

31. However, it may be that such an approach is not appropriate for all joint funding arrangements. Multi-party funded enhancements would therefore need to be looked at on a case-by-case basis.

Resetting the level of the rebate

32. It is envisaged that the real level of the rebate would be set upfront at the ex ante average cost (as set out above) for the duration of the payback period set out in the investor's access rights; and will then be indexed to inflation. In the interests of providing certainty, we propose that the level of the rebate is not reassessed on a regular basis.

33. In our initial consultation letter, we had envisaged providing for a reassessment of the level of the rebate where there was robust evidence that access to the enhancement concerned was being inefficiently foreclosed. However, in light of the narrowed scope of the proposed mechanism, we no longer believe this is appropriate.

Specific scenarios arising

34. In our initial consultation letter, we identified two specific scenarios that raise difficult issues in relation to the calculation of the level of the rebate. These were:

- (a) Capacity enhancements; and
- (b) Enhancements creating an alternative route.

35. We discussed these in detail at our February workshop and they were commented on in the consultation responses. Drawing on these discussions, consultation responses and further analysis, we have developed and refined our thinking in these areas. We would therefore welcome your views on our proposed approach here.

Capacity enhancements

36. In our initial consultation letter, we set out two options for assessing the level of the rebate to be paid where the enhancement concerned is an increase in the capacity of a route:

- (a) Charging only incremental users of the route; or
- (b) Charging all users of the enhanced route.

37. At that time, we expressed a preference for the second of these to be the default option; although we noted that this may not always be appropriate. Following feedback from consultees and further analysis, we believe that the appropriate default position is for

the rebate to be payable only by incremental users, i.e. those services that would not have been able to run in the absence of the capacity enhancement, and that fall within the scope of the rebate mechanism. This means that existing services, although potentially benefiting at the margin from lower congestion, would not pay the rebate charge; the rationale for this being that they are not free riding on the investment.

38. It also means that the capacity measure used in calculating the charge would be lower than under the alternative.

39. Further, if an existing right expires or is otherwise terminated, the associated 'exemption' from the rebate charge would be transferred to the first incremental user. We believe that this would ensure that the business risk associated with the enhancements remains with the investor, while providing transparency and fairness to operators. This approach should also be reasonably straightforward to implement through the inclusion of a mechanism in the underlying access contract that would provide for an adjustment to the higher charge in specified circumstances.

40. To illustrate, if the capacity of the existing route is 100 paths / day, of which 90 are currently used, and the enhancement increases the capacity available to 150 paths / day, then the first 10 additional services, i.e. paths 91 to 100, would not be subject to the higher charge, but all further services operated by competitors to the investor would be whether they use the 101st path available or the 150th. The appropriate capacity measure for calculating the level of the rebate would therefore be 50 (150-100).

41. Further, if the access right for an existing service expires, or the service stops running resulting in the loss of the related access right, then the 101st service would no longer be required to pay the higher charge. If the access right in relation to the original service is subsequently renewed then the new right would effectively be an incremental right, and the operator would be required to pay the higher charge. In other words, the renewed right would 'go to the back of the queue'.

42. For the purposes of calculating the rebate charge, the onus would be on the investor to justify the volume of capacity created as a result of the enhancement.

43. As stated above, we intend to keep the mechanism under review, particularly in relation to capacity enhancements. If, in the light of experience, amendments are needed, we would look to make changes at the end of the first year of implementation, subject to the number of applications received in the period.

Alternative routes

44. The question of exactly who might pay the higher charge is complex where the enhancement concerned is a link creating an alternative route.

45. Where an operator that falls within the scope of the mechanism chooses to use the alternative route, for example because it is much shorter or enables a 'better' slot to be obtained, then the operator should pay the higher charge. However, there may be instances where the operator is able under its access contract and would prefer to use the existing route but Network Rail requires it to use the new link.

46. In December we distinguished between two scenarios:

- (a) Where the route alteration is one-off or short term, e.g. due to emergency diversion from the main route; and
- (b) Where Network Rail would prefer an operator to use the alternative route on a long-term basis.

47. In the former case, all parties concerned will face costs and benefits. It is also clear that such use does not place the investor at a competitive disadvantage. We therefore suggest that, for simplicity, no rebate charge is applicable in these circumstances.

48. In the latter case, Network Rail only has the right to flex an operator's access rights to the extent set out in the underlying access contract / Network Code. However, there may be instances where Network Rail is able to re-route an operator along the alternative route on a long-term basis, even where that operator would prefer to continue to use the main route. Where Network Rail wishes to do this, it is likely to be to realise performance benefits and/or accommodate additional capacity; for which it may obtain incentive payments and which would have whole industry benefits. However, if Network Rail is required to pay the full rebate charge, it will only have the incentive to divert traffic if the benefits it obtains from relevant incentive mechanisms (e.g. volume incentive, performance regime) outweigh the additional costs incurred, potentially meaning that whole-industry benefits may be lost. Further, Network Rail's actions do not disadvantage the investor in the enhancement, as it is not competing with Network Rail.

49. We therefore propose that in such situations, the default position should be that no rebate charge is applicable.

Implementation of the mechanism

50. As explained in our December 2005 letter, any change in the access charge payable currently requires a change in the operator's track access contract. Once a track access contract is approved, changes to that contract cannot be made without the consent of the parties to the contract except in certain defined circumstances (for example, an access charges review). Amendments to track access contracts can only be made with approval from ORR under Section 22 of the Railways Act 1993 following submission of an agreed amendment by both parties or, in the absence of agreement under Section 22A, where the amendments permit more extensive use. It is, of course, also possible that a new entrant would apply for rights to benefit from the enhancement as part of an application under Section 18 or 17.

51. The investor/operator will also need have an arrangement with Network Rail that provides for the payment of any rebate to it in an access contract (either an access option or access agreement). It would be at this stage that consideration would be given to whether the application satisfied the requirements under paragraph 3 of Schedule 3 of the Regulations (see paragraph 15 above).

52. Where an operator's use of a track infrastructure enhancement that is subject to the payment of the rebate charge requires a change to its access contract, implementing the higher access charge is straightforward. For example, freight operators' contracts include specific mention of the gauging of the network that they may use for particular train slots. If the route for these slots were enhanced to a higher gauge, a change to the contract would be required before that slot could be used at the higher gauge. We could therefore require a change in the access charge as part of the amendment process.

53. We are aware that in theory a user's existing access rights may enable it to benefit from an enhancement for which another investor has paid without requiring a change in its access contract. We have concluded that where an operator's existing property rights may enable it to take the benefit of an enhancement it is not at this time appropriate for the rebate mechanism to cover this possibility. However, we will monitor these cases and review the mechanism as necessary.

54. We believe that implementation as part of an application under Section 22 (or Section 22A) of the Railways Act 1993 is the appropriate way of implementing the revised access charges to cover the rebate.

55. In our initial consultation letter, we proposed that the rebate mechanism be implemented through the Network Code. However, following further analysis and discussion, we have concluded that this is not appropriate. Though we recognise that a rebate charge might result from a network change and therefore it might be appropriate to

include a hook in Part G of the Network Code, we do not think that it is appropriate or necessary to include such a provision in respect of charging in the multilateral Network Code. We think that it is important that there is regulatory oversight of these charges at least in the initial stages. In addition, an important advantage of implementation through applications under Section 22/22A is that the drafting could be developed to fit the particular circumstances of each scheme.

56. We therefore propose to implement the mechanism by including provision for payment of an appropriate supplemental access charge (the rebate) from any applicant under Section 22 or 22A receiving ORR approval for the use of access rights created by an eligible investment scheme.

Other issues arising

Alternative approaches

57. Although respondents are supportive of the aims of the proposed mechanism, some have questioned whether other approaches may be available to encourage cooperation between investors and potential beneficiaries, e.g. through joint ventures.

58. In this respect, we note that the rebate mechanism is an alternative route for would-be investors, aimed particularly at investors placed at a competitive disadvantage as a result of the 'free riding' of the enhancement by other operators.

59. Parties will remain free to adopt the approach they believe is most appropriate in their particular circumstances. Indeed, we would expect investors to explore any other available alternatives before applying for a rebate, if they believe these are more appropriate. The rebate mechanism does not remove any of existing remedies already available through our investment framework.

Next steps

60. We would welcome your views on these revised proposals for a rebate mechanism. The consultation period will close on **2 March 2007**.

61. We expect to set out our final conclusions on the mechanism in 2007-08 Q1.

Annex A: Respondents to the December 2005 letter on the rebate mechanism

ABP Ports

ATOC

DfT

Freightliner

Hutchinson Ports

National Express

Network Rail

Rail Freight Group

Rail Industry Association

TfL

Virgin Trains

Welsh Assembly Group

Annex B: Eligibility for different scenarios (funder/beneficiary combinations)

Funder	Beneficiary	Eligible?
Franchisee 1	Franchisee 2	Yes – but existing mechanisms may also be used ¹⁶
Franchisee	Open access	Yes – if existing approaches not feasible
Open access	Franchisee	Yes– if existing approaches not feasible
TOC	FOC	No
FOC	TOC	No
FOC	FOC2	Yes
Other 3 rd party (public sector)	Operator	Yes – if funding constraints exist
Other 3 rd party (private sector)	Operator	Yes – in exceptional circumstances ¹⁷

¹⁶ Such as investment framework approaches

¹⁷ The investor would need to demonstrate a competitive disadvantage in the absence of the mechanism

Annex C: Assessing relevant capacity

This Annex provides an example of how the relevant capacity measure, for the purposes of calculating the level of the rebate, would be assessed for an enhancement where accessing it does not necessarily imply benefiting from it. An example is a gauge enhancement. It is perfectly possible, and likely, that a number of operators would access the gauge-enhanced line without benefiting from it.

The example set out in the table below considers a gauge enhancement on a part of the network that is predominantly used by passenger services: 90 of the 100 paths available per period are used by passenger services, who do not benefit from the enhancement. The remaining 10 paths are available to freight services, which may or may not benefit from the enhancement.

If the relevant capacity measure is taken to be all the paths available, i.e. 100 per period, then, as shown in column A in the table below, the investor will be implicitly paying considerably more per benefiting path than a competitor would have to pay in order to benefit from the enhancement: £242 / path versus £10 / path. The free-rider problem therefore remains largely unresolved.

If, instead, only that capacity that is able to benefit from the enhancement is considered in the relevant capacity measure – so, in the example, 10 paths / period – then there is a better match between the amount that the investor implicitly pays per path and the level of the rebate: £175 / path versus £100 / path. (Note that the investor will always pay at least as much as the level of the rebate – see paragraph 28 (d).)

	Column A	Column B
	Considering all capacity	Considering only paths potentially able to benefit
Total investment cost / period	£1,000	£1,000
Paths available / period	100	10
Capacity measure	100	10
Rebate charge / path	$£1,000 / 100 = £10$	$£1,000 / 10 = £100$

	Column A	Column B
	Considering all capacity	Considering only paths potentially able to benefit
Expected investor usage / period	4	4
Expected number of benefiting competitor paths / period	3	3
Total charge received	$3 \times £10 = £30$	$3 \times £100 = £300$
Implied cost / path to investor	$(£1000 - £30) / 4 = £242$	$(£1000 - £300) / 4 = £175$
Rebate charge as % implied cost to investor	$£10 / £242 = 4\%$	$£100 / £175 = 57\%$



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