

12 August 2020

Dear Stakeholders and Funders,

FTAC annual adjustment ('wash-up') mechanism in Control Period 6

I am writing to you regarding the fixed track access charge (FTAC) wash-up mechanism, a charging mechanism created in our 2018 periodic review (PR18) for control period 6 (CP6)¹. ORR is now minded to suspend the mechanism for the remainder of CP6 due to the effect of the ongoing exceptional circumstances in the industry. This has significantly reduced the expected benefits of the mechanism compared to what had been expected at the time of PR18. In our 2023 periodic review (PR23), we will consider the mechanism alongside other charges and incentives.

This letter provides the background and reasoning behind this minded to decision. As outlined below, we invite views in response.

Background

A key objective of the FTAC wash-up mechanism was to create a stronger financial incentive on Network Rail to add capacity to the network during CP6. The mechanism would also provide franchised passenger operators with an incentive to consider the long-run fixed costs caused by adding new services to the network.

The mechanism works by applying a proportionate change to an operator's FTAC if its actual traffic is higher or lower than the baseline traffic² for the year (as determined by ORR).

An example shows the size of payments involved. If every franchised train operating company (TOC) exceeded its traffic baseline by 1% this would result in an annual payment to Network Rail of around £12m³. If actual train miles were *fewer* than benchmarked, Network Rail's payments to TOCs would be calculated similarly but limited to 1% (£12m) because the mechanism deliberately caps Network Rail's

¹ Control Period 6 runs from 2019-20 to 2023-24. The wash-up mechanism is another name for the 'annual adjustment' referenced in ORR's [final determination](#) (e.g. paragraphs 3.119 and 3.120).

² This is the number of timetabled train miles ORR expects the TOC to operate in each year of the control period.

³ This example is based on 2021-22 'base' Fixed Track Access Charges of £1.2bn (i.e. the sum of FTAC charges from Network Rail's price list), or an average of £60m per operator. The wash-up mechanism applies a percentage uplift to this base FTAC cost.

exposure. From the TOC perspective, the average TOC payment triggered by exceeding the baseline by 1% would be £0.6m, but would range for different TOCs from £0.04m (Caledonian Sleeper) to £2.9m (ScotRail).

Due to the May 2018 timetable problems, ORR deferred the process to set traffic baselines until after our PR18 final determination, as there were concerns that traffic baselines determined at that time might overstate expected traffic, and could lead to unintended payment flows.

We then worked with Network Rail and operators from August 2019 to March 2020 to set traffic baselines. However, it soon became clear that the effect of Covid-19 meant that passenger numbers were set to drop sharply and timetables would be significantly changed. We were concerned that the traffic baselines that we were ready to determine would prove to be substantially inaccurate forecasts.

We therefore told the industry in April 2020 that we were minded not to set baselines for 2020-21, but would revisit in summer 2020 the approach for the remainder of the control period⁴.

Minded to decision

ORR has considered how to proceed – this process included some informal engagement with funders, several TOCs and Network Rail. We are now minded to suspend the mechanism for CP6: we consider that there are compelling reasons, related to the industry's very unusual circumstances, to change this policy for this control period. The factors we considered, several of which were also put to us by Network Rail and TOCs, are:

- We have **already suspended the mechanism for two years. If we put the mechanism in place for 2021-22, there would only be three years left of the control period**, which limits the benefits of the policy⁵.
- Emergency Measures Agreements (EMAs), which transfer most financial risks and control over services to public bodies, have blunted the incentives on TOCs to respond to the wash-up mechanism⁶. It is expected that EMAs, or similar concession arrangements, will remain in place for some time. This means that **the effects of the mechanism are likely to be limited for the remainder of CP6**.

⁴ This was communicated through an email from ORR to Network Rail and train operators, sent on 3 April 2020.

⁵ And, if we suspended the mechanism for a further year, before revisiting it for 2022-23 onwards, there would only be two years left, limiting the benefits further.

⁶ We understand that FTAC costs are currently passed through by TOCs to franchise bodies and carry no incentive properties for TOCs. In addition, EMAs define the train services that TOCs are expected to operate: as such, franchise bodies rather than TOCs directly influence the number of train miles within the timetable.

- The industry's near-term **operational priorities may have changed, with a shift away from adding new services**⁷. Although passenger numbers are likely to rise from current levels, these new operational priorities can be expected to persist for some time, so the need to incentivise Network Rail to accommodate new services may be reduced.
- The effect of Covid-19 makes any **traffic forecasts very uncertain**, which increases the risk of the mechanism resulting in large and unintended financial flows between TOCs and Network Rail. Uncertainty is very significant at the moment and, although it will eventually ease, it is likely to persist for another year or two.
- The process of determining baselines requires **significant work for the industry**, at a time when the industry is still focused on mitigating the effects of Covid-19 disruption – so there would be an administrative cost to repeating the process⁸.

Track access contracts incorporate a Schedule of Baseline Timetabled Traffic, which has not yet been determined by ORR. We are minded to consider that the most appropriate way to implement the proposed approach of suspending the mechanism, is for ORR to determine that baseline train miles will be equal to actual timetabled train miles. As such the determination can be properly issued in accordance with the definition of "Schedule of Baseline Timetabled Traffic" in Schedule 7 of each operator's track access contract, and the determination results in no payments being made by any party under the mechanism. The Schedule is already incorporated by reference into the contracts, so no further amendment to any contract will be necessary.

We will revisit in PR23 all charges and incentives for control period 7 (CP7). This minded to decision does not prejudice any future policy decision on the FTAC wash-up mechanism.

We invite responses to this minded to decision by Friday 11 September 2020. Please copy in Will Holman (will.holman@orr.gov.uk) to your reply.

Yours sincerely,



Carl Hetherington

⁷ The wash-up mechanism was designed during PR18, at a time when many operators planned to launch additional services to meet growing demand. However, the effect of Covid-19 has shifted the industry's immediate priorities towards providing a reliable service for fewer passengers.

⁸ Network Rail and TOCs have stressed that setting baselines (which was attempted between August 2019 and March 2020) was a time-consuming and complex exercise.