



Update on PR18 structure of charges: infrastructure costs

RDG PR18 working group on
route level regulation

16/09/16



Purpose and background

Purpose

■ The purpose of today's session is to:

- Update you on the PR18 structure of charges work stream on **infrastructure costs** (relating to the recovery of fixed network costs)
- Present the **high level policy options** we are considering and which we intend to consult on in December 2016
- Discuss your initial thoughts on these options, including potential design features, costs and benefits

■ Structure of this slide pack:

- A. Background on our structure of charges consultation to date
- B. Rationale for developing the infrastructure costs package
- C. Potential policy options under the infrastructure costs package

Background

- We are reviewing the structure of Network Rail's access charges as part of PR18
- We consulted on the high level priorities for the structure of charges review in December 2015, based on a set of objectives (which reflected the RDG objectives) and gaps between the current structure of charges and these objectives
- The gaps we identified are:

Gaps in current charging framework	Cost-reflectivity	The existing charging framework has a limited ability to drive down costs, encourage efficient decision making and to achieve value for money
	Capacity	The existing charging structure falls short of providing specific and strong incentives for the efficient provision and use of network capacity
	Competition	The existing charging structure may not support effective competition between different types of passenger operators
	Complexity	Charges have changed at control periods in a way that has created uncertainty for users of the network

PR18 initial consultation document

- In May 2016 we published our initial PR18 consultation, where we identified six high level outcomes relating to what Network Rail delivers, and which our review could support
- An improved structure of charges could support a number of these outcomes, including: **a more efficient network, and a better used network**

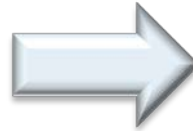
A network that is...		
More efficient	Better used	Expanded effectively
Taking cost-effective decisions on operating, maintaining and renewing the network.	Finding ways of improving performance and accommodating more services on the current network.	Informing decisions on enhancements, and delivering 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.

December 2015 charges consultation

Packages considered

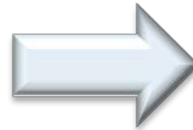
April 2016 update

Infrastructure costs package



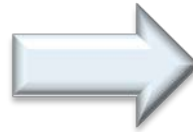
Continue developing. Respondents were generally supportive of our proposal to gain a better understanding around the drivers of fixed network costs. Although there were mixed views on whether improved information on fixed network costs should be passed through to charges.

Value-based capacity package



Do not continue to develop in PR18. We remain of the view that it is important to consider the overall effects of any cost-based charging options, ensuring they send sensible signals about use of capacity.

Improvements package



Continue developing. Some diversity of views about options for short-run variable charges.

Supporting packages

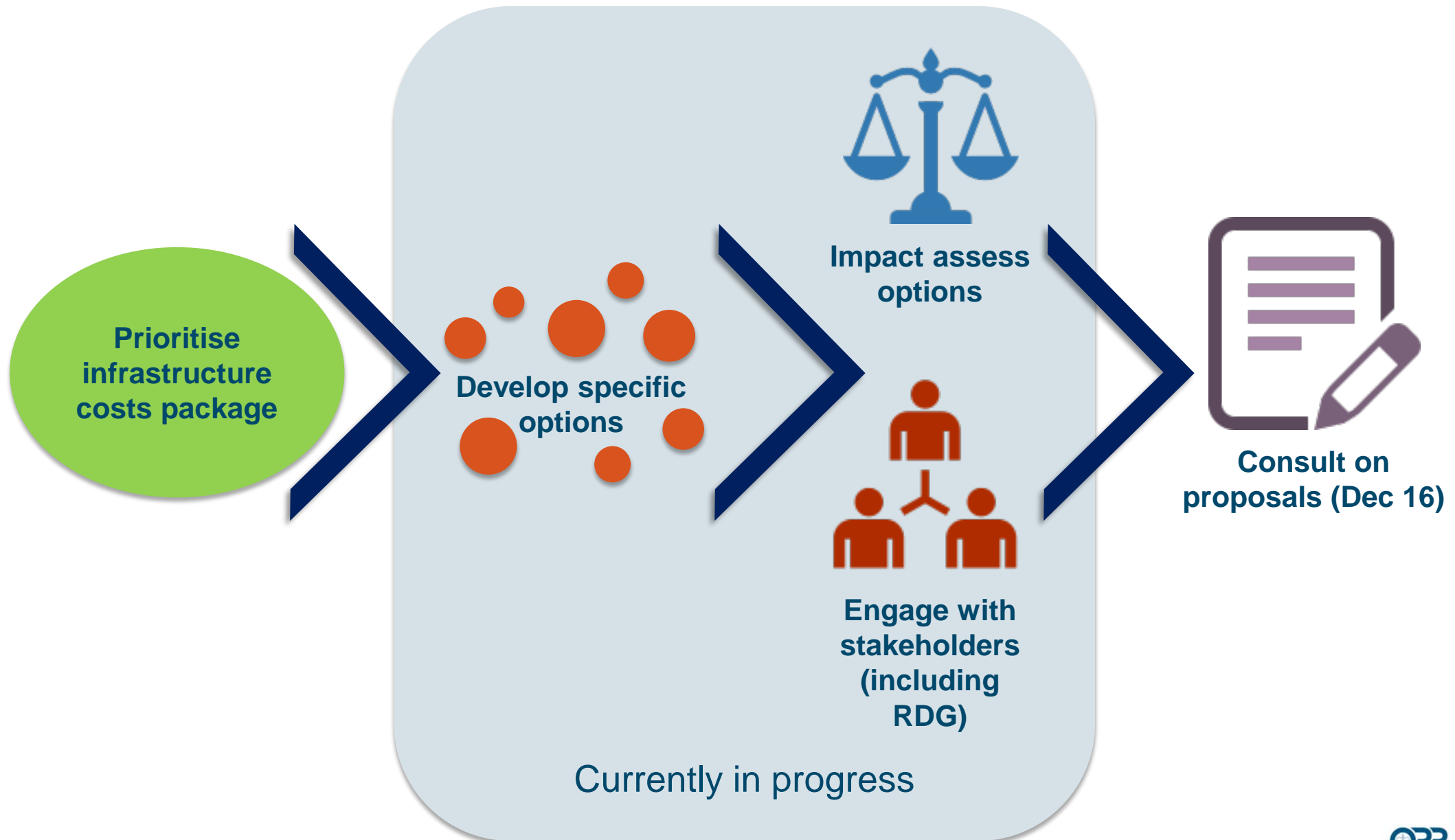
Competition options

We are considering whether some open access operators should make a greater contribution to network costs, particularly where capacity is scarce and most valuable.

Complexity options

We think that complexity could be limiting the effectiveness of existing charges and we have considered what proportionate changes might improve the ease with which charges are understood.

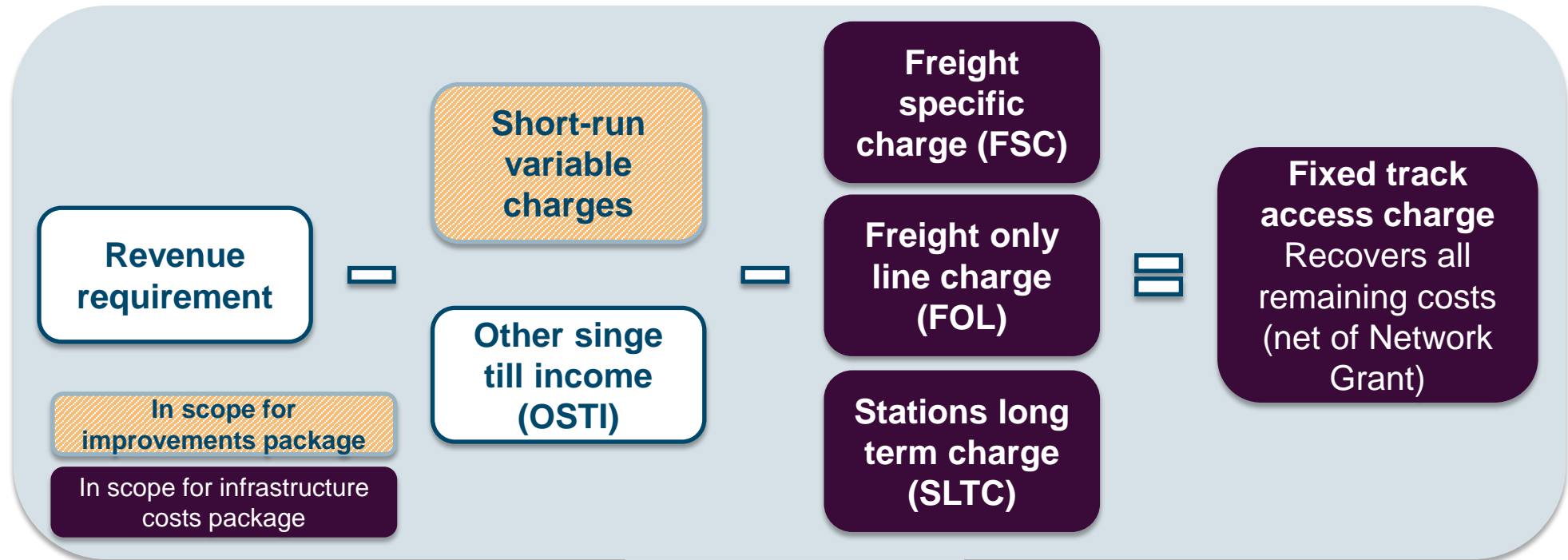
Option development and next steps





Overview of the infrastructure costs package

Scope of the infrastructure costs package



What are the issues?

1

Relatively low degree of understanding around the drivers of infrastructure costs

2

FTAC lacks cost reflectivity

3

Open-access contribution towards fixed costs

Infrastructure costs package: high-level options set out in December 2015 consultation

- The primary objective of the infrastructure costs package is to develop a charging structure in which the costs currently captured by fixed charges (i.e. the costs which are fixed or vary only in the medium to long-run) are recovered in a way that better reflects their cost drivers. In our December 2015 consultation we put forward two high level options under this package:

Sub-option 1: an improved attribution of Network Rail's infrastructure costs

This would lead to a step-change in the industry understanding of these costs and what drives them.

Sub-option 2: exposing operators to charges which reflect an improved attribution of infrastructure costs

This would lead to a step-change in the industry understanding of these costs and what drives them, together with the resulting development of a more cost-reflective charging structure on the basis of this attribution.

- Network Rail has recently concluded a pilot cost-allocation study on the Wales route – the results of this have been presented to industry. Emerging themes from the analysis include:
 - It confirms that a large proportion of track costs are driven by the existence of a basic network (i.e. 'connectivity') rather than additional capability to accept heavier/faster trains
 - Non-track costs are not significantly affected by the type of train (e.g. heavy/fast)
- We are supporting Network Rail's proposal to extend the analysis GB-wide



Developing options under the infrastructure costs package

General points on option development

- There are a number of steps (*and choices associated with each of these steps*) involved in developing a new charging approach for the recovery of fixed costs:

Analysis – the Network Rail pilot study has developed an approach for allocating costs to all operators using the rail network. If determined to be robust, this modeling approach could replace the existing approach to allocating costs between franchised passenger operators for the purpose of calculating FTAC. It could also replace the approach used to allocate costs to freight operators for the purpose of calculating the FSC and FOL charges. This would not necessarily imply changes to the amounts recovered from operators as this would be subject to a market can bear test.

→ ***This step would improve transparency around cost causation.***

Market can bear test – apply market can bear tests to determine the level of cost to recover from different market segments (e.g. freight by commodity as currently but we also need to develop an approach for passenger operators – open access and franchised).

→ ***This step could result in changes to the level of charges paid by certain market segments***

Charging options – taking as a starting point the Network Rail analysis, we are developing options for the recovery of fixed costs which reflect the particular characteristics of different types of traffic (e.g. freight versus passenger).

→ ***This step could result in different levels of cost recovery and affect incentives***

Rationale for high level options

- The options we have developed are aimed at addressing the gaps identified previously in our work, and delivering against the two key PR18 outcomes which charges can help achieve: ***more efficient and better used***
- In developing options however, we have to keep in mind a range of constraints, but also the potential links with other reforms/policy objectives:

Policy constraints

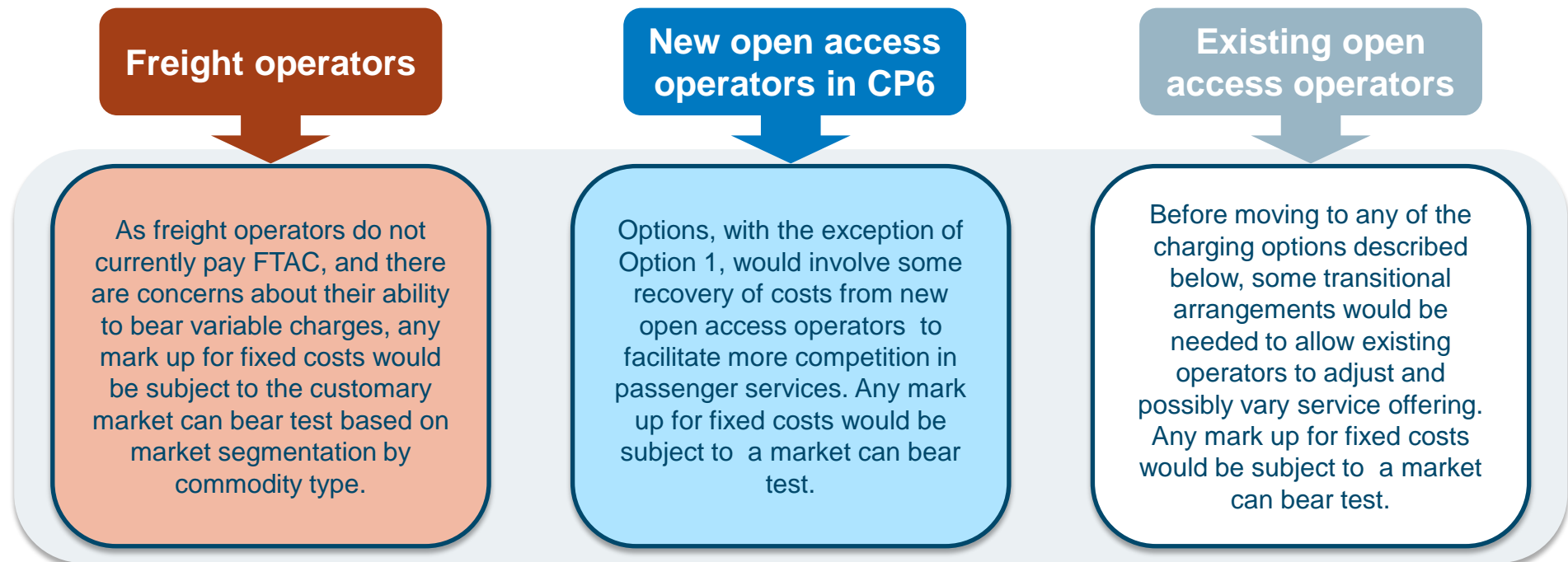
- Network Rail's ability to recover its costs with a reasonable degree of predictability
- The need to send sensible signals on network use on both busy and less-busy parts of the network
- Compliance with legal tests (mostly in European Law) – market can bear test for mark-ups and ensuring no undue discrimination
- Lack of road pricing and financial recognition of wider benefits (externalities) of rail freight and its impact on commercial viability
- Current open access operators have entered the market on the basis of the NPA test
- Billing systems and data requirements

Linkages with other policy areas

- Open-access framework: sustainable competition between open-access and franchise operators
- Use of the network: efficient use of congested infrastructure
- Freight subsidy: potential for reforms to Government support for freight
- Increased transparency: changes to the flow of funds and transparency about subsidy in the industry
- Support greater alignment of incentives between train operators and Network Rail
- Potential reforms to other charges

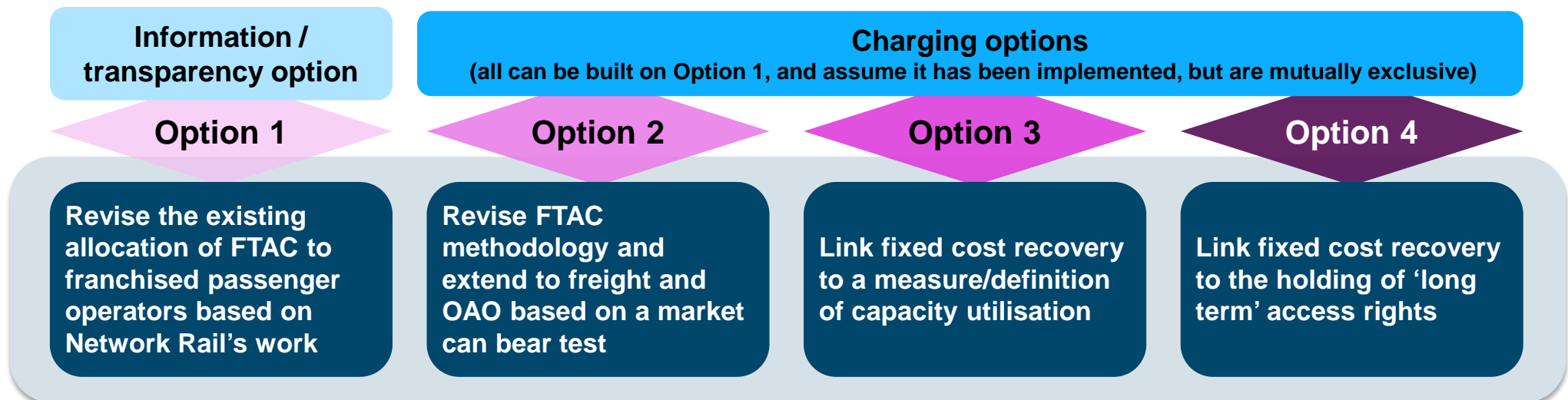
Approach to developing options

- We have developed four potential options for changes to the charging framework for recovering fixed network costs
- In principle these options could be applied to all operators, so we have considered how they could be implemented in practice for different types of operators
- We have specifically considered how different charging approaches could be applied to freight operators and new and existing open access operators



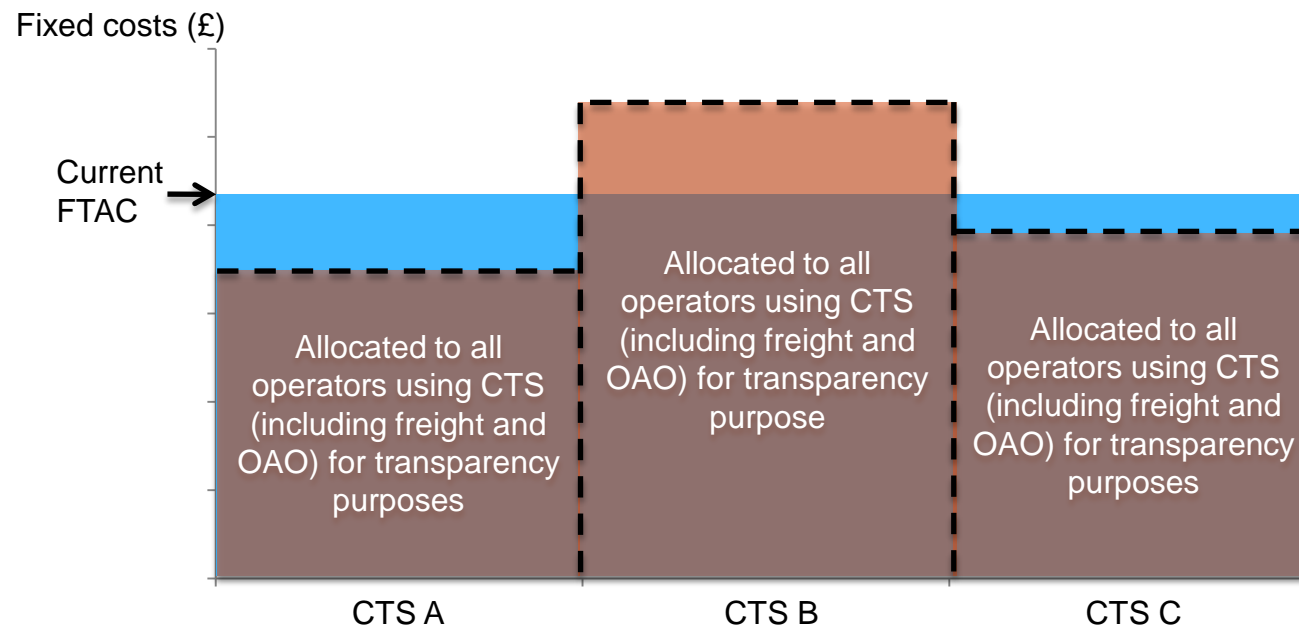
Potential options for fixed cost charging

- We have developed four ‘straw men’ options for changes to fixed charges (i.e. in addition to the do-nothing option)
- As set out on the previous slide, the approach to implementing these different options for different groups of operators would differ:
 - For **freight operators** most options would be based on the existing approach to the market can bear test
 - For **existing open access operators** there would be transitional arrangements
 - Therefore, in developing the options below we have mostly focused on how the charging framework would be different for potential new open access operators



Option 1: revise FTAC methodology

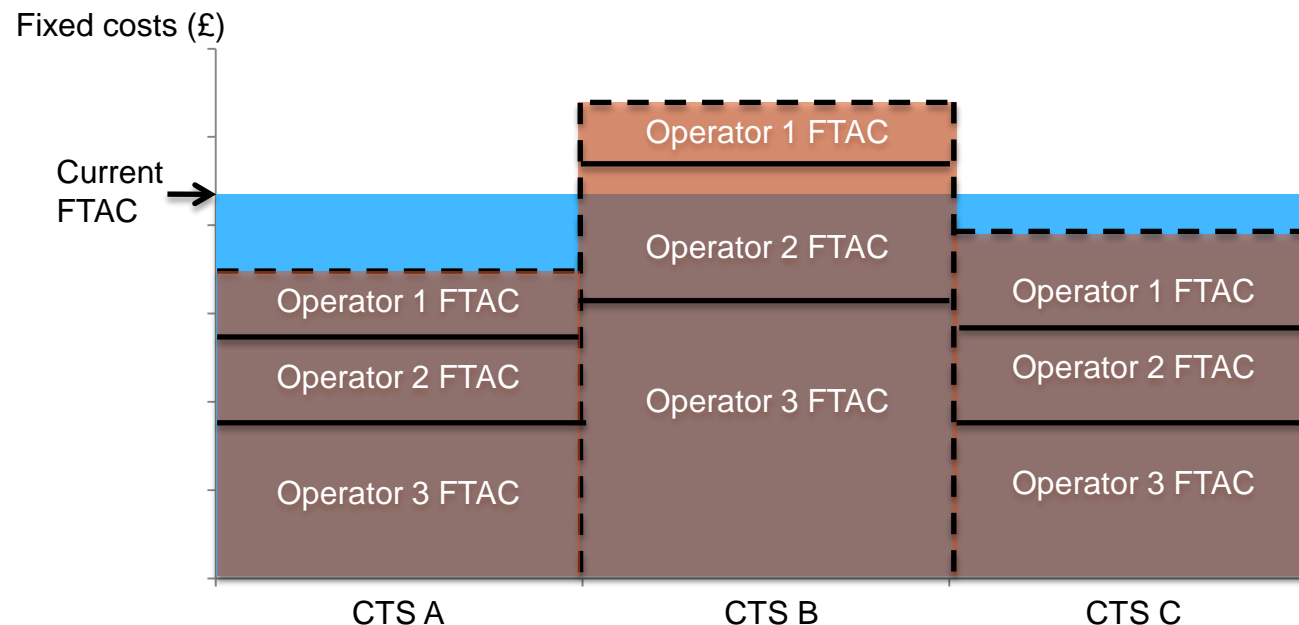
- **Option summary:** FTAC reallocated based on updated methodology, reflecting results of the cost allocation work but no additional fixed costs recovered from freight and OAOs
- Illustrative example (based on track sections being used by the same number and type of trains):
 - Based on current FTAC methodology, the same proportion of costs would be allocated to each track section and only to franchised TOCs
 - Based on revised Network Rail cost allocation methodology FTAC would be recalculated based on costs allocated at level of constant traffic section (CTS) and aggregated into charges as currently
 - Improved transparency on cost allocation to all operators



Under this option, FTAC would be reallocated based on the Network Rail methodology but no additional costs recovered from freight or OAOs

Option 2: revise FTAC methodology and extend to freight and OAO

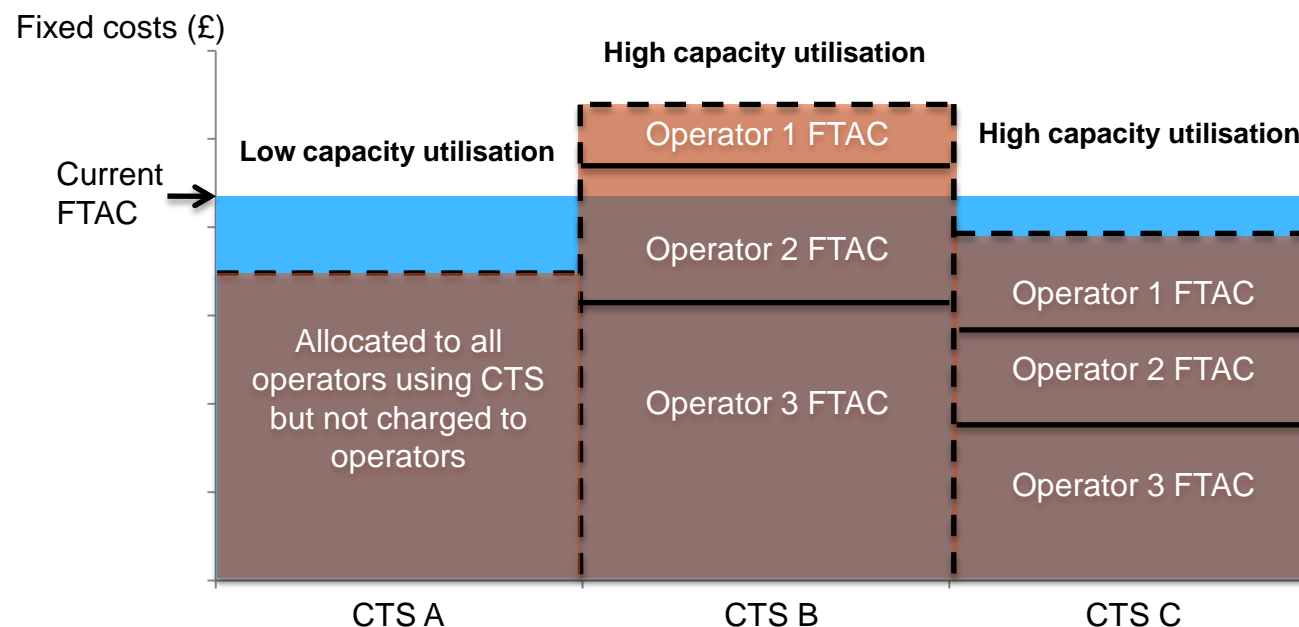
- **Option summary:** apply Option 1 and extend to OAOs and freight – importantly – a market can bear test would be applied to test the mark up different segments can afford.
 - Test likely based on current approach for freight and would need to develop an approach for OAOs
- **Illustrative example** (based on track sections being used by the same number and type of trains):
 - Based on revised Network Rail cost allocation methodology costs would be allocated at CTS level and to all operators using the track section and aggregated into charges as currently
 - This would take the form of a mark-up levied on OAO and freight operators, but only where the ‘market can bear’



Under this option, FTAC would be reallocated based on the Network Rail methodology, and costs recovered from all operators, including freight and OAOs. The level of mark-up for each type of operator (and market segment) would be assessed based on a market can bear test

Option 3: link fixed cost recovery to a measure/definition of capacity utilisation

- **Option summary:** apply Option 1, and levy charges to all operators based on the capacity utilisation of the areas of the network that they use.
- Illustrative example (based on track sections being used by the same number and type of trains):
 - Based on revised Network Rail cost allocation methodology costs would be allocated at CTS level and to all operators using the track section
 - Operators only pay fixed cost charges for using highly utilised sections of track. The amount freight and OAOs pay would also depend on a market can bear test



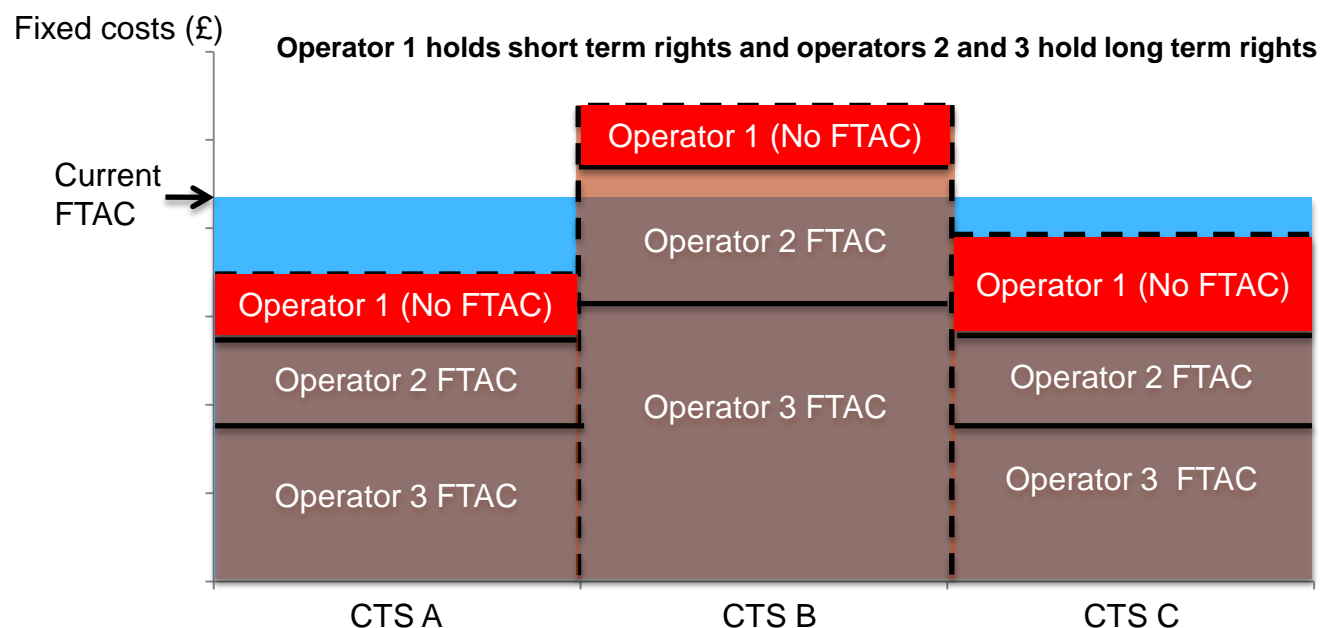
Under this option, FTAC would be reallocated based on the Network Rail methodology. FTAC would be charged to all operators, including freight and open access, that use highly utilised sections of the network (and subject to market can bear test)

Option 4: Link fixed cost recovery to the holding of 'long term' access rights (1)

- **Option summary:** apply option 1, and levy fixed costs on all operators based on the type of access rights that they hold. Fixed cost charges would only be levied on operators, including freight and OAOs, who hold 'long term' rights. Operators with 'short term' rights would only pay variable charges.
- This option would involve significant changes to the existing access rights framework. Including:
 - The creation of distinct 'long term' and 'short term' access rights
 - Priority for access rights would be given to operators who apply for long term rights, short term rights would only be approved once all long term rights had been satisfied
- The process Network Rail use to make decisions on what services to include in the timetable could remain the same (i.e. timetable all firm rights approved). We would need to consider whether the existing distinction between firm and contingent rights would still remain.
- Operators that hold long term rights would pay FTAC, operators that choose to hold short term rights would only pay variable charges. This would apply to all operators, including freight and OAOs.
- This option would encourage better use of capacity on the network as it would provide operators with an incentive to only hold long term rights on areas of the network that are highly utilised and where there are competing demands for rights.

Option 4: Link fixed cost recovery to the holding of 'long term' access rights (2)

- **Option summary:** apply option 1, and levy fixed costs on all operators based on the type of access rights that they hold. Fixed cost charges would only be levied on operators, including freight and OAOs, who hold 'long term' rights. Operators with 'short term' rights would only pay variable charges
- Illustrative example (based on track sections being used by the same number and type of trains):
 - Using the revised Network Rail cost allocation methodology costs would be allocated at CTS level and to all operators, the amount that each operator pays would depend on the access rights they hold



Under this option, FTAC would be reallocated based on the Network Rail methodology. FTAC would be charged to all operators, including freight and open access, that hold 'long term' access rights.

Emerging thinking for discussion

- Option 1: revise FTAC methodology
 - Improved transparency
 - Relatively straight-forward to implement

- Option 2: revise FTAC methodology and extend to freight and OAO
 - In addition to improved transparency it addresses issue of OAO fixed cost recovery
 - Requires significant analysis of 'market can bear' test

- Option 3: link fixed cost recovery to a measure/definition of capacity utilisation
 - Potential to send better signals on network use
 - Requires accurate measure of capacity utilisation

- Option 4: Link fixed cost recovery to the holding of 'long term' access rights
 - Potential to send better signals on network use
 - Requires extensive reforms to access rights framework which would be difficult to implement in time for CP6



Annex: overview of current approach to access rights

Background information for Option 4

■ Overview of current approach to access rights:

- Types of charges operators pay are currently determined by the kind of track access contract they hold, i.e.:
 - Franchised passenger operator
 - Open access passenger operator
 - Freight passenger operator
- These contracts also define the kinds of access rights operators hold:
 - Firm access rights:
 - Held by most operators (including freight operators)
 - If they have been approved by the Priority Date, Network Rail has to accommodate them
 - Move towards more flexible specification of firm rights (quantum only, window)
 - Contingent access rights
- Most operators have firm access rights. Franchised operator's rights are normally for the length of their franchise while OAOs and FOCs typically have ten year access contracts – therefore in effect most operators have long-term access rights
- Part J of track access rights:
 - transfer / reclaim access rights if they have not been used for 90 days