

John Larkinson
Acting director, rail markets and economics
Telephone 020 7282 2193
E-mail john.larkinson@orr.gsi.gov.uk

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Paul Plummer
Chair of RDG working group
on contractual and regulatory reform
Rail Delivery Group
c/o Network Rail
Kings Place
London N1 9AG

Dear Paul

Capacity charge for franchise and open access passenger for CP5

Purpose

1. The purpose of this letter is to:
 - (a) to make RDG aware of the legal advice we have received with respect to RDG's proposed approach to the capacity charge; and
 - (b) update RDG and the industry on our further thinking on the capacity charge, taking account of the feedback we have received. We are giving the industry a further, final opportunity to comment on this issue, which I'm afraid needs to be received by 5pm on 30 September 2013, to meet our internal decision making deadlines.

Process so far

2. In our draft determination we said that we would either: implement a form of the proposal put forward by the rail freight operators' association (RFOA) (possibly applying it also to open access passenger operators and / or franchise passenger operators); or approve capacity charge rates that have been calculated using the CP4 methodology, updated for inflation.
3. Subsequent to the draft determination, we published a letter, for consultation, on 19 July in which we set out options for applying the RFOA approach to passenger traffic. At the same time, RDG worked to develop the RFOA proposal into a proposal which also covered passenger services. We welcomed this industry led approach. We held a capacity charge working group meeting on 26 July to discuss options. And we held a separate industry and funders meeting on 21 August at which representatives of RDG presented its proposal to us. We received the proposal formally in a letter from you dated 28 August.

4. On 13 September 2013 we also received a proposal from the RDG freight group on implementing a form of the capacity charge for freight, and we are separately meeting representatives from the freight group to discuss that. Our decision on how the capacity charge will be implemented for freight (whether retaining existing CP4 rates or based on either the RFOA proposal as we have consulted on already, or this latest RDG freight proposal) will not affect the decision to be made in relation to passenger, but the decisions will be made at the same time.

5. The remainder of this letter sets out the position for passenger. By way of reminder, we have prepared a short description of the passenger part of previous options we have discussed in Annex A and Annex B.

Legal advice on the passenger options

6. At our 21 August meeting, we identified some initial concerns about the lawfulness of the RDG proposal. We have subsequently considered it further, and have taken Leading Counsel's advice on the same. We have already agreed to share that advice with you, and therefore attach a copy. In its conclusions, the advice is as follows:

“29. [...] I consider that there is a material risk that, were the RDG proposal adopted in its current form, it would be vulnerable to challenge by new entrants on parts of the network other than ECML as contrary to the charging principles laid down in the Directive and the Regulations and to the general principle of equality of treatment.

“30. Although the circumstances in which such a challenge might be brought is impossible to predict, my current view is that such a challenge would be very likely to obtain permission from the Administrative Court and would have a significantly better than even chance of success.”

7. Given that advice, we are not prepared to implement the RDG proposal, since doing so would not be compatible with our obligation to ensure that charges comply with the relevant charging provisions of the Railways Infrastructure (Access and Management) Regulations 2005.

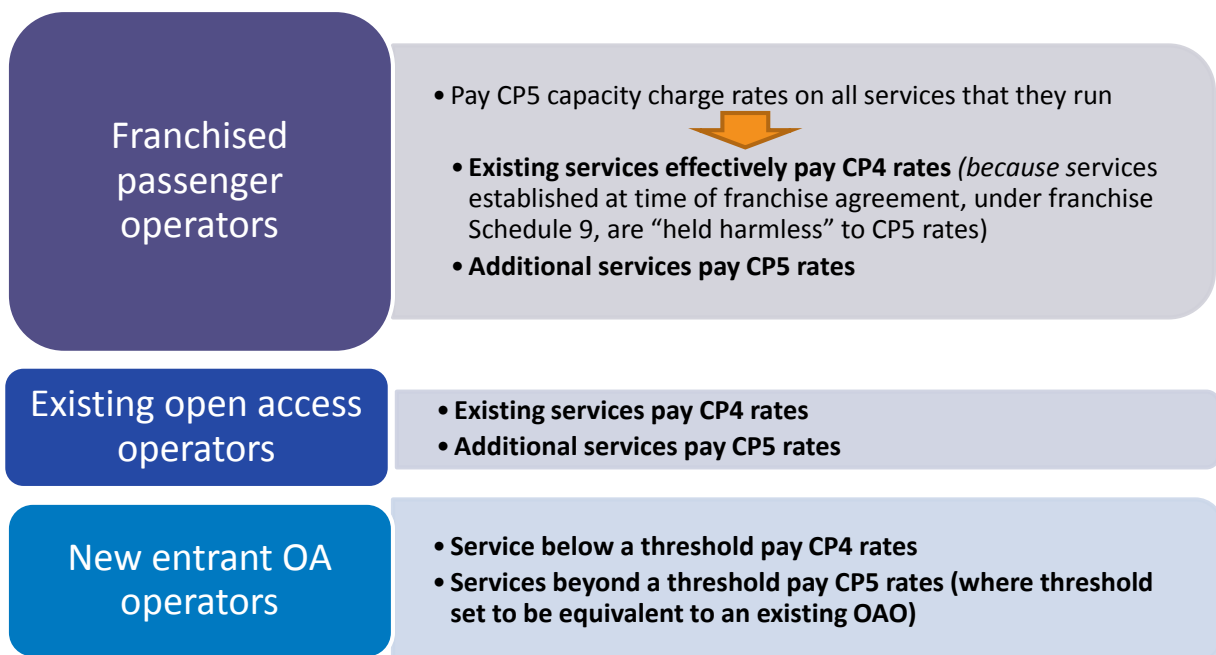
8. In your letter of 28 August 2013, which accompanied Network Rail's response to the draft determination, you set out a criticism of our 'Option 1' (from our 19 July letter, set out in Annex A), that it would treat new open access traffic which joins the network during CP5 differently from existing open access traffic. You consider that the relevant difference in treatment would amount to undue discrimination between different open access operators, potentially operating on the same part of the network.

9. We do not have an equivalent written opinion in respect of Option 1. We have discussed the option with Leading Counsel, together with your criticisms of it, and as part of those discussions we have identified the permutation which we discuss below, and which we are satisfied is more robust than our original Option 1 proposal.

Proposed way forward

10. We have considered the characteristics of the proposal RDG has developed and listened to industry feedback, including your concerns regarding our Option 1. On that basis we have developed a permutation on previous work that meets your concerns on discrimination and also serves to promote competition to a greater extent than the original Option 1 would have done.

11. This refined proposal, as it affects franchise and open access passenger traffic, is shown in the figure below¹.



¹ A similar diagram setting out how RDG’s proposal would affect passenger traffic is included in Annex B for comparison purposes, notwithstanding our decision on its legality.

12. The proposal is complex because, as the RDG working group will understand, it is difficult to mitigate the impacts of a very large increase in the capacity charge while at the same time ensuring that Network Rail is compensated for accommodating additional traffic and that the charges do not unduly discriminate between operators.

13. The new element to this refined proposal is more favourable treatment of new open access operators (OAO) relative to our previous proposals:

- (a) For existing OAO, all their existing services, in existing service codes, would pay CP4 rates; any additional train mileage in those service codes, or train mileage in new service codes, would pay CP5 rates;
- (b) For new OAO, services below a threshold would pay CP4 rates; any train mileage above the threshold would pay CP5 rates; we would define the threshold as part of PR13 to be equivalent to that of existing services for the smaller of the two main existing OAO, which at the time of writing is Hull Trains.

14.3. While we would set out the principles of how this will be applied in our final determination, some of the details would be resolved as part of the process for establishing a track access agreement with any new open access operators.

15. Our assessment of the refined proposal is shown in the table below.

Assessment	Recommended proposal
Legality	Does not discriminate between existing passenger operators; does not discriminate between existing and new OA operators
Cost-reflective incentives for Network Rail	Fully incentivised for volume
Cost-reflective incentives for operators	Fairly good. Passenger operators face full cost at the margin with the exception of open access new entrants services.
Impacts	Existing franchisees no change in expected bill (difference paid by funders) Existing OA no change in bill for current services, and new services at CP5 rates OA entry promoted, by treating new OA operators on a similar basis to existing operators
Feasibility	Principles will be set out in FD; actual implementation drafting can be determined afterwards



Seeking your views

16. We are grateful to the RDG for the work it has put in over the summer to propose how to apply a form of the RFOA proposal to passenger services. Over the same period, we have been engaging with you and others on this particular issue of the capacity charge. We now need to make a decision, but to help us to do so we would be grateful to receive any final comments from industry or funders. Please send these comments to Alex Bobocica, Alexandra.Bobocica@orr.gsi.gov.uk . We must receive any such comments by **5pm on Monday 30 September 2013.**

17. I am copying this letter to members of the contractual and regulatory reform working group, the capacity charge working group, Department for Transport and Transport Scotland. We are also publishing this letter on our website.

Yours sincerely

John Larkinson

Annex A – ORR description of the Option 1 set out in its 19 July letter

Franchised passenger operators

- Pay CP5 capacity charge rates on all services that they run
- **Existing services effectively pay CP4 rates** (*because services established at time of franchise agreement, under franchise Schedule 9, are “held harmless” to CP5 rates*)
- **Additional services pay CP5 rates**

Open access operators

- **Existing services pay CP4 rates**
- **Additional services pay CP5 rates** through a wash-up relative to a baseline for each OAO individually

Annex B – ORR description of the RDG proposal

Franchised passenger operators	<ul style="list-style-type: none">• Pay CP5 capacity charge rates on all services that they run, except for ex-London service codes on the East Coast Main Line (ECML)
Open access operators	<ul style="list-style-type: none">• Pay CP5 capacity charge rates on all services that they run, except for ex-London service codes on the East Coast Main line
Ex-London services on the ECML	<ul style="list-style-type: none">• Baseline total traffic based on 2011/12 year• Single blended Arup based Capacity Charge rate for all ex-London ECML Service Codes• Year-end Capacity Charge revenue wash-up based on traffic above baseline year at blended rate, but shared between all covered traffic• Any future ECML ex-London Service Codes also covered by same rate and washup