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Dear colleague

High level review of track access charges

1. This letter informs you that we have published the high level review of track access charges and options for CP5 (control period 5¹) report that we recently commissioned from CEPA (Cambridge Economic Policy Associates).
2. We would be keen to receive any views you have on this study and any other comments on the overall approach to track access charges², which we will take into account in our consideration of possible improvement to the structure of charges for CP5.

Background

3. Track access charges are an important part of the industry's economic architecture, they provide:
 - a mechanism for Network Rail to recover the efficient costs it incurs in providing track infrastructure used by train operators;
 - a means to allocate costs to, and be recovered from, those that cause those costs to be incurred;
 - incentives to train operators, their suppliers and funders for the efficient use and development of vehicles and the infrastructure (subject to other policy objectives and constraints); and
 - incentives to Network Rail to outperform the regulatory determination (through the form of price cap regulation employed).

¹ CP5 is expected to be the period from 1 April 2014 to 31 March 2019

² Station charges, schedule 8 performance regime and schedule 4 possessions regime are not included in this review.



INVESTOR IN PEOPLE

4. The current structure of track access charges largely dates back to the periodic review 2000³ (PR2000) for passenger train operators and the review of freight charging policy 2001⁴ for freight train operators.

5. Table 1 lists the track access charges and the income Network Rail has received in 2009-10.

£million (2009-10 prices)	Purpose of charge	Income in 2009-10
Variable usage charge Of which: - <i>passenger</i> - <i>freight</i> - <i>open access</i>	Recovers maintenance and renewal costs that vary with traffic	197 129 63 5
Traction electricity charge (passenger and freight)	Recovers the costs of providing electricity for traction purposes	195
Capacity charge (passenger and freight)	Recovers the increased costs incurred by Network Rail as a result of increased traffic on the network	167
Fixed track access charge (franchised passenger only)	Determined on basis of Network Rail's total revenue requirement	936
Other (electrification asset usage charge; coal spillage charge; freight only line charge)	Recovers associated costs	15
Network grant	Paid direct by government in lieu of fixed charges	3,560
Total		5,070

2008 periodic review (PR08)

³ Documentation from the access charges review 2000, may be accessed at: <http://www.rail-reg.gov.uk/server/show/nav.1915>

⁴ Documentation from the review of freight charging policy 2001, may be accessed at: <http://www.rail-reg.gov.uk/server/show/nav.181>

6. Working with Network Rail and the industry, we undertook a review of track access charges as part of PR08, which built on the work in our structure of costs and charges review in 2005⁵.

7. We considered, and consulted on, a range of changes to the structure of track access charges. These included the possible introduction of scarcity charges, reservation charges and environmental charges. In the June 2006 consultation on the structure of track access and station long term charges⁶ we stated that we thought that it would be inappropriate to do further work on the introduction of a scarcity charge at that time. Our rationale for this was the considerable complexity likely to be involved in implementing this charges and because it was important to allow sufficient time for the route utilisation strategies to be developed nationwide. In our policy statement on our sustainable development and environmental duties,⁷ we stated that we did not intend to implement an environmental charge at the start of CP4 (control period 4⁸) or during CP4 unless an equivalent charge is implemented for other transport modes, but we undertook extensive work on the pros and cons of implementing a reservation charge. Following our work and consultation with the industry, we said that there was insufficient evidence that a reservation charge would produce net benefits and we would therefore not introduce it in CP4, pending further consideration of alternative ways to deal with hoarding of access rights using the network code.

8. Route based variable usage charges were also considered as part of PR08; however, we did not consider that the cost information was sufficiently accurate at the time to justify introduction of this charge. Some changes were, however, made to the structure of charges, including:

- the inclusion of the cost impact of lateral forces in the allocation of variable usage charges between vehicle types;

⁵ Structure of costs and charges review 2005, documentation from this review may be accessed at: <http://www.rail-reg.gov.uk/server/show/nav.176>

⁶ Structure of track access and station long term charges, this document may be accessed at: <http://www.rail-reg.gov.uk/upload/pdf/291.pdf>

⁷ Sustainable development and environmental duties, this may be accessed at www.rail-reg.gov.uk/server/show/ConWebDoc.8651

⁸ CP4 is the period from 1 April 2009 to 31 March 2014

- a more accurate allocation of fixed costs between franchised passenger train operators; and
- the introduction of the freight only line charge.

9. The final CP4 track access charges represent a generally incremental, but nevertheless important, improvement in the overall structure of charges.

10. At the end of PR08 we said that we would consider improvements to the structure of track access charges for CP5, including looking further at scarcity charges, reservation charges and route based charges.

Objectives of track access charges

11. Our track access charging objectives have been developed since PR2000, and during the SOCC review 2005, and were consulted on as part of PR08. Our current charging objectives are:

- to promote the objectives of our duties under section 4 of the Railways Act 1993 and be consistent with the wider objectives of funders;
- to incentivise Network Rail, train operators, train manufacturers, rolling stock companies (RoSCOs) and funders to ensure the efficient utilisation and development of the network and the optimisation of whole industry costs;
- to not unduly discriminate between users of the network;
- to be practical, cost effective, comprehensible and objective in operation;
- to be consistent with relevant legislation, including the EU Directive 2001/14/EC;
- to reflect the efficient costs caused by use of the infrastructure (both to Network Rail or otherwise); and
- to ensure that track access charges enable Network Rail to recover but not to over recover, its allowed revenue requirement.

12. One of our goals in our corporate strategy is to promote efficient use of capacity on the mainline rail network, and to improve the alignment of incentives across the industry. In light of this, we consider that it is important that we consider options for potential improvement of the structure in order to improve its effectiveness, in particular to

strengthen incentives on train operators, Network Rail and others to make decisions for the better use and development of network capacity.

13. We acknowledge that for the price signals and incentive effects to work to their best effect, transparency and simplicity are important. However, simplicity should be offset against the need to allocate costs to those who cause them. We want train operators, funders and others who make decisions about the choice of rolling stock and use of the network to pay their fair share of costs, and also to face effective price signals on the basis of the costs they impose on the network. In this way, over time, the best possible economic use of the network should be achieved (subject to other non-price related decisions) and the overall costs should be minimised. (One example of this is if one operator chooses to use a heavier, faster vehicle it is reasonable, all other things being equal, to expect it to pay higher charges because of the greater wear and tear that this vehicle will cause to the network.)

14. Freight operators and non-franchised passenger operators face the impacts of changes to track access charges directly whereas franchised operators are protected from most changes to track access charges that occur during their franchises. The level of track access charges therefore plays a significant role in freight and open access operators' decision making, e.g. about the level of service to run and the type of vehicles to use.

15. We know that price signals do pass along the supply chain to train manufacturers; RoSCo's; PTE's and others.

16. We accept that there are limits to the ability of track access charges to influence franchised passenger train operators. The fairly tight specifications of franchise agreements and the 'no net loss, no net gain provisions' (the clause 18.1/schedule 9 provisions) mean that franchised operators pay the track access charges in place at the time of their original franchise bid, and so limit their ability to make decisions on services and vehicles. However, where franchised operators have commercial freedom we believe that the track access charges can promote efficient behaviour.

CEPA report

17. Earlier this year we asked the economic consultancy CEPA to undertake a high level review of track access charges. The purpose of this study was to identify the key issues and options for track access charges in CP5, so that Network Rail is more responsive to the needs of train (passenger and freight) operators, and that it, train operators and others are incentivised to make the best use of existing capacity and develop the network efficiently.

18. The CEPA report discusses the options for changing the existing structure of charges, and assesses these options against a set of criteria, including;

- optimising network use;
- cost reflectivity;
- practicality;
- simplicity; and
- promotion of competition.

19. CEPA scores the options against the existing track access charges, whilst balancing each of the, sometimes conflicting, criteria. The report identifies and focuses on six short listed options which are:

- **a regional 'long run incremental cost' (LRIC) approach**, where the variable usage charges would reflect the forward looking costs of providing capacity, including the costs of enhancements, and would be disaggregated across the network. Such an approach would typically mean higher variable usage charges (where there are capacity constraints), but with lower fixed charges;
- **an 'average cost' approach**, based on the view of simplification of charges. In this case, variable usage charges would translate to an average charge which would be equivalent for all users across the network. This type of approach could be implemented with or without (or lower) fixed charges, and may reduce or increase individual charges;
- **a regional 'short run incremental cost' (SRIC) approach**, this would be similar to the current approach, however it could mean disaggregating variable usage charges on a regional basis to reflect the differentiated costs across regions;
- **scarcity charge**, where charges reflect the opportunity cost associated with the use of a path, which prevents another operator from using that path. Such an approach would typically mean higher charges for use of more capacity constrained areas of the network;
- **a track occupancy charge**, where the focus on charging for network capacity as opposed to track damage. For example, it could be charged per minute rather than per vehicle or train km. Such an approach may result in higher charges for those services which consume capacity on the network for long periods of time; and

- **cost benefit sharing**, this type of mechanism could allow Network Rail to share a fixed proportion of train operator revenues. Such an approach could incentivise Network Rail to target investment towards projects that would result in higher operator revenue. This approach could be implemented alongside other changes to charges.

20. Of these six options, CEPA recommended that four could offer improvements for the sector, they were; LRIC based charges, regional SRIC based charges; scarcity charges; and cost benefit sharing. CEPA did not consider that the average cost or the track occupancy charge option would provide benefits or improve the current charging structure. This was largely because of the poor signals that each of these options would send to customers for optimal use and development of the network. CEPA recommends that further detailed work should be carried out to fully evaluate the benefits of any of the options.

21. We do not have a preferred view on any of these options at this stage, or indeed, whether any changes to track access charges are justified, but will give the CEPA report our full consideration, taking into account your views. We will also recognise that there may be potential changes to the franchise model that may provide greater opportunity to use the structure of charges to provide incentives for better use and development of the network.

Industry workshop

22. We held an industry workshop on 20 April 2010 to discuss the current structure of charges, and to allow CEPA to present its short listed options. This was well attended and there was a comprehensive discussion on aspects of track access charging. We are publishing the presentation slides from this workshop today.

23. We consider that it is important to ensure that track access charges continue to be fit for purpose, that they take account of improved cost knowledge and a “changing world”. Specific issues to consider are:

- Can track access charges be used to incentivise train operators, Network Rail and others to make decisions for the better use and development of capacity?
- Are track access charges too complex, and / or too uniform?
- Can track access charges be structured to promote competition better?
- Should open access passenger and freight operators be dealt with differently?

24. Some important issues were discussed at the workshop. Many participants pointed out that it was important to be clear about the purpose of track access charges and the issues that this review seeks to address. Others noted that the structure of charges is not always the only way to achieve the best use of the network or reduced costs. The group also discussed the importance of considering the societal benefits of rail when considering changes to track access charges, and comparing rail charges with equivalent road charges. Another point that was raised was the administrative burden caused by changes to track access charges, as franchised train operators generally need to be compensated for the effects of changes as a result of their clause 18.1 / schedule 9 provisions, which requires additional financial work.

Next steps

25. We are publishing the full CEPA report today, and are seeking your views. We will also continue to discuss track access charges and related issues with the industry steering group (regulatory and contractual architecture), (ISG). If we consider that any major changes to the structure of track access charges are worthwhile, we intend to consult on these in October 2010⁹. Following the outcome of this, any detailed work as part of any wider changes to track access charges will continue in 2011-12.

26. You may also recall that we wrote to you in November 2009 seeking your views on the process for developing track access charges in CP4. We would like to thank those of you that provided very useful feedback. We will take all your comments into account when we consult in October 2010.

Your views

27. While we are happy to receive comments at any time, if you have any further views or comments to make on track access charges which you would like us to take into account in our consultation letter in October, please send them in electronic (or if not possible, in hard-copy format) by 26 August 2010 to:

Ekta Sareen
Economist
Office of Rail Regulation
1 Kemble Street
London, WC2B 4AN
Tel: 020 7282 2164

⁹ In October 2010, we intend to start our 2013 periodic review with a consultation on the objectives for the review and any key issues relating to the regulatory framework for CP5.

Email: ekta.sareen@orr.gsi.gov.uk

28. If you would like to discuss any of the issues raised in this letter, in the first instance please contact Ekta Sareen.

29. If you send a written response, you should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise, we would expect to make it available on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information that can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

30. A copy of this letter can be found on the ORR website (www.rail-reg.gov.uk).

Yours faithfully,



Paul McMahon

Annex A – Distribution list

Association of Train Operating Companies
Department for Transport
FTA
Freight train operating companies
HM Treasury
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PTEG
Rail Freight Group
Rail Freight Operators Association
Railway Industry Association
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