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OFFICE of
RAIL REGULATION

16th December 2005

Dear Consultee,

PROPOSALS FOR A REBATE MECHANISM FOR INVESTORS IN LARGE-SCALE NETWORK ENHANCEMENTS

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). This includes ensuring that there is an effective mechanism that enables third party funders to recover a fair proportion of the costs incurred in funding a project where other parties benefit from the use of the enhancement concerned.

2. 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 reduces the promoters’ incentives to invest and ultimately may mean that a beneficial investment does not go ahead.

3. The need for such a mechanism was highlighted during the consultation process on the Investment Framework[1]; with a number of freight industry consultees in particular indicating that investment projects were being stalled as a result of the free rider problem[2]. The issue has also been raised in relation to specific large-scale freight enhancement projects.

4. We have already put in place a rebate mechanism (through the freight model clauses) to allow investors to recover some costs from beneficiaries whereby, effectively, operators benefiting from the enhancement pay a charge

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1 Our Investment Framework, the final policy conclusions on which were published in October 2005, is intended to provide a framework to facilitate efficient investment. The final conclusions document is available at http://www.rail-reg.gov.uk/upload/pdf/255.pdf.

2 Consultation responses can be found at http://www.rail-reg.gov.uk/server/show/ConWebDoc.7125

to the investor via Network Rail. However, this rebate mechanism currently only applies to schemes with a value below £250,000.

5. We recognise the importance of putting in place a rebate mechanism for investors in large-scale network enhancements. The attached paper proposes such a mechanism, with the principal objectives being:

a) To ensure that an entity choosing to invest in a network enhancement 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.

6. We have considered a range of options for establishing the level of the rebate. We believe that the methodology put forward balances the objectives set out above, whilst being transparent, conceptually relatively straightforward and practicable.

7. The proposals have been tested against a number of scenarios. While it is believed that the principles behind the proposals are robust, it is recognised that there will be specific circumstances where the proposals will need to be tailored to fit. It is impossible to anticipate in advance every possible scenario that may arise. Consequently, it is important to emphasise that the proposals should be regarded as forming a set of guiding principles rather than a firmly defined methodology.

8. It is important to note that the proposed approach would require mid-control period changes to access charges. In order to affect this, an amendment to the Network Code is also proposed.

9. The proposals have been developed primarily in relation to third party investors. However, in principle, the proposals could be extended to government funders. Once the mechanism is in place, we will be examining the implications of extending it, in line with the principle that the ‘user pays’, as part of the review of the structure of charges for the 2008 periodic review.

Responses to this document

10. We would welcome views on any of the issues raised in the accompanying consultation paper.

11. As part of the consultation process, ORR would welcome the opportunity to meet stakeholders and intends to arrange a meeting with stakeholder representatives and groupings in the new year.

12. Responses to this consultation letter should be sent in both electronic and hard copy by 28 February 2006 to:

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13. Responses will be made available in our library, published on our website and may be quoted from. Respondents should indicate clearly if they wish all or part of their responses to remain confidential to ORR. Where a response is made in confidence, a statement summarising the submission but excluding the confidential information should accompany it, which can be treated as above. We may also publish the names of respondents in future documents or on our website unless a respondent indicates that they wish their name to be withheld.

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

Hannah Nixon

Head of Regulatory Economics

Proposals for a rebate mechanism for investors in large-scale network enhancements

Issue

1. In certain circumstances, entities (train or non-train operators) choose to invest in enhancements to the rail network. These enhancements may range from the construction of a new spur to the upgrading of an existing line.

2. Typically, the investor pays Network Rail to undertake the enhancement, including raising the finance for it (though other models are possible). The ownership of the enhancement resides, not with the investor, but with Network Rail, which then has responsibility for its subsequent operation and maintenance. The commercial risks of the investment, however, lie with the investor[3].

3. Any train operator can then apply for access to the enhancement and, if granted, an access charge is payable to Network Rail. Investors have no ability to charge operators directly for access to enhancements for which they have paid[4]. In the absence of intervention, this means that operators are able to free ride on the investments of others. The implication of this is that an investing entity could find itself at a competitive disadvantage, reducing the incentive to undertake such enhancement in the first place and so resulting in a sub-optimal level of enhancement to the network, (i.e. there will be market failure).

4. There is already in place a rebate mechanism (through the freight model clauses) whereby investors can recover some costs from beneficiaries where, effectively, operators using the enhancement pay a charge to the investor via Network Rail. However, this rebate mechanism currently only applies to schemes with a value below £250,000[5].

5. Industry consultation on the Investment Framework and specific proposals for network enhancements have highlighted the need for a

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[3] I.e. the risk that the investment is ill founded. In the event that the enhancement is not utilised, Network Rail would be entitled to implement network change (part G of Network Code) to amend its requirement to maintain the enhancement.

[4] Secondary trading in slots is illegal under EU law (Article 13 of Directive 2001/14/EC).

[5] Rights to the rebate are set out in the access contract or access option, the duration of which would be subject to ORR's policy on long-term track access contracts.

mechanism that enables third-party funders of enhancements to recover a fair proportion of their investment costs from other parties that benefit from the enhancement. Without such a mechanism, the freight industry in particular felt that efficient investment was being stalled.

6. This consultation paper sets out our proposals for a rebate mechanism for investors in large-scale (i.e. above £250,000) network enhancements. The proposals are likely to be of most relevance to freight investors but could equally well apply to investments for passenger services.

7. The proposals presented here have been developed primarily in relation to third party investors. However, in principle, and in line with the concept that the 'user pays', the proposals could be extended to government funders. In the limit, where the costs of all enhancements are treated in this way rather than being spread across network users as a whole[6], the implications for the distribution of costs could be significant.

8. We will be examining the implications of extending the proposed mechanism as part of the review of the structure of charges for the 2008 periodic review.

9. The test of the proposed arrangements will, of course, be whether they result in more schemes being taken forward. We would keep the mechanism under review, and look to make changes in the light of experience if further improvements are needed.

Objectives and principles

10. The primary objectives of the proposed rebate mechanism are threefold:

    a) To ensure that an entity choosing to invest in a network enhancement 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[7]; and

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6 Via the addition of enhancement expenditure to the regulatory asset base (RAB)

7 Other aspects of network change are dealt with in Part G of the Network Code.

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.

The proposed approach

11. We have considered a range of options for establishing the level of the rebate. We believe that the methodology put forward balances the objectives set out above, whilst being transparent, conceptually straightforward and implementable.

12. The proposals have been tested against a number of scenarios. While it is believed that the principles behind the proposals are robust, it is recognised that there will be specific circumstances where the proposals will need to be tailored to fit. It is impossible to anticipate in advance every possible scenario that may arise. Consequently, it is important to emphasise that the proposals should be regarded as forming a set of principles rather than a firmly defined approach. Scenarios under which we anticipate that some tailoring of the proposals will be required are discussed (see 'specific scenarios arising' section below).

13. It is proposed that:

    a) For each enhancement funded by an investor, a flat (index linked) tariff is set per train service benefiting from the particular enhancement;

    b) The rebate is payable to Network Rail (or other applicable network operator) as a premium to the access charge. Network Rail then has responsibility for distributing the rebate to the appropriate investing parties, the rights to which are set out in the access contract or access option;

    c) Any operator accessing and benefiting[8] from the enhancement is liable for the rebate. To the extent that an operator has funded the enhancement, it will 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);

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[8] It is clearly possible for an operator to access an enhancement without benefiting from it, e.g. a passenger operator may access part of the network that has been gauge enhanced without benefiting from that gauge enhancement.

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, it should be ensured that the mechanism for paying rebates to the investor survives.

Issues arising

Eligibility

14. An entity funding a network enhancement should only be eligible to receive a rebate to the extent that their investment is not otherwise remunerated. Not all network enhancements funded by third parties will be eligible for the rebate:

a) ***Co-funding by Network Rail***: If Network Rail co-funds an enhancement, it should not be eligible to receive a rebate to the extent that its investment is funded through its regulatory determination.

b) ***Third party funder***: Where a non-train operator (part-) funds a network enhancement, a rebate should only be received by the investor if the train operator accessing the enhancement is doing so without the intention of accessing the investor's facility for which the investment was made. If the train operator is accessing the investor's facility then no rebate should be due; such usage is therefore considered equivalent to the investor's own usage.

For example, if the investor is a port operator and the enhancement is a dead-end branch to access a port, then a rebate should only apply where the train operator accessing the branch is not doing so to get to the port. Where the train operator is accessing the port, it is reasonable to expect the port fees to take into account the cost of accessing the branch.

Establishing average cost

15. The average cost of an individual enhancement is calculated as:

$$Average\cos t = \left(\frac{Total\ investment\ \cos t}{capacity\ measure}\right)$$

where the total investment cost can be calculated as:

$$Total\ investment\ cost = depreciation\ charge + (NBV\ of\ investment \times cost\ of\ capital)$$

16. Calculating the average cost therefore requires four pieces of information, as set out below. The proposed approach for establishing each is as follows:

    a) ***The investment cost***: The total cost to the investor of the enhancement (excluding financing costs) as paid to Network Rail should be used.[9]

    b) ***Depreciation charge***: For the purposes of calculating the rebate, the enhancement should be depreciated 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 rights for the investing entity.

    c) ***The cost of capital***: The actual cost of capital will be project and (arguably) time specific. However, in the interests of simplicity and reducing the regulatory burden, it is proposed that a default cost of capital is set, which would be used in the absence of any compelling reason for a different rate being presented by the investor to ORR.

       This default rate could either be Network Rail's allowed rate of return or an estimate of the industry cost of capital. On the basis that, in the majority of instances, Network Rail is likely to provide the financing for such network enhancements, with the investor paying Network Rail in instalments, it is proposed that Network Rail's allowed rate of return as applicable in the year in which the enhancement is financed is used as the default cost of capital.

    d) ***Capacity measure***: To arrive at average cost, the total cost of the investment needs to be divided by some measure of the capacity of the enhancement. There are clearly several options here[10].

       It is recommended that the capacity measure used is the ex ante expected usage by the investor (as set out in the access rights /

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[9] If the enhancement is paid for by the investor in instalments to Network Rail then the net present value (NPV) of these instalments should be used.

[10] Including, total capacity, capacity used, capacity booked, ex ante expected usage and a fixed percentage of total capacity.

option) plus 50% of the residual capacity available. Such an approach means that the investor may under- or over-recover his investment depending on actual usage. This is not necessarily undesirable as long as the risks are not inappropriately skewed. The use of 50% of the residual capacity to determine the capacity measure means that the risks are likely to be slightly skewed in favour of under-recovery and so the possibility of the rebate foreclosing access is reduced.

It is recognised that it may be difficult to quantify the actual level of capacity available. For instance, where the enhancement is a gauge enhancement, users may either replace existing users or be additional, requiring some level of judgement in determining the total capacity of the enhancement.

Multi-party funding

17. Where an enhancement is funded by more than one entity, the following principles should apply:

    a) The eligibility of each funder for a rebate should be considered separately, against the principles set out in the section 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 operators accessing 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.

Specific scenarios arising

18. Two scenarios have been identified where the specifics of the case will need to be considered carefully and the rebate mechanism tailored appropriately. We are particularly interested to obtain views on how such scenarios should be dealt with under the proposed mechanism.

    a) ***Capacity enhancement***: Where the enhancement concerned is an increase in the capacity of a route and the use of that additional capacity cannot be ring fenced, the issue arises as to who should be required to pay the rebate. There are two main options here, (i) marginal users of the route, and (ii) all users of the route.

In general, the second of these is likely to be most appropriate, especially where the additional capacity significantly eases capacity constraints and congestion and therefore reduces related charges, as all users of the route will benefit. However, there may be instances where charging only marginal users is more appropriate.

b) ***New link creating an alternative route***: Where a network enhancement is a new link that creates an alternative route, situations may arise where Network Rail effectively forces an operator to use that route rather than the operator's usual or preferred route. The question then arises as to who should be liable to pay the rebate. It is proposed that treatment differs between two situations:

- <u>Where the route alteration is one-off</u>: In this case the sole beneficiary is considered to be Network Rail, as the operator's avoidable costs are likely to be minimal and to be offset by disruption costs. Network Rail should therefore be liable for paying the applicable rebate to the investor.

- <u>Where the route alteration is long term</u>: Again Network Rail will likely be the prime beneficiary. However, to the extent that the operator avoids certain costs, e.g. capacity charges, there may be a rationale for the train operator bearing some of the cost of the rebate[11]. This would need to be considered on a case-by-case basis.

Resetting the level of the rebate

19. It is envisaged that the real level of the rebate will be set upfront at the ex ante average cost (as set out in the section on 'establishing average cost' 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, it is proposed that the level of the rebate is not reassessed on a regular basis.

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[11] It is assumed that the avoidable costs of using the alternative route are less than the level of the rebate, otherwise the operator would choose to use the alternative route.

20. However, it is recognised that there may be circumstances where the level of the rebate does need to be reassessed. Where the investor or an operator provides evidence to ORR that:

    a) actual usage differs significantly from the anticipated level, or

    b) access is being inefficiently foreclosed,

    the appropriate level of the rebate will be reassessed.

Implementing charges

21. As stated below, the rebate will be paid by the operator benefiting from the enhancement to the investor in that enhancement via a premium to the user's track access charge. Any change in the access charge payable requires a change in the operator's track access contract.

22. 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. Generally, these circumstances are:

    a) Where there has been a review of access charges as described in Schedule 4A of the Railways Act 1993; or

    b) Where ORR issues directions under section 22A of the Railways Act 1993.

23. In other circumstances, 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.

24. Where an operator's use of a network enhancement that is subject to a premium requires a change in its access contract, implementing the higher access charge is straightforward. For example, some 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. ORR could therefore require a change in the access charge as part of the amendment process.

25. However, in other instances, a user's existing access rights may enable it to benefit from an enhancement for which another investor has paid without paying a premium to cover the rebate to the investor.

26. One option would be simply to amend the access charges as part of the Periodic Review process. However, this would imply a delay in implementing the rebate of up to five years. In our view, such a delay is unacceptable.

27. An alternative option would be to include in Part G (Network Change) of the Network Code a mechanism to activate the rebate mechanism described in this consultation letter. Such a Network Code provision would have the benefit of applying to the track access contracts of all regulated users of Network Rail's network and would allow the modification of their contracts, when necessary, to impose the type of surcharges envisaged.

28. We believe that this would be an effective and efficient way of implementing the revised access charges to cover the rebate.

29. In order to make such an addition to the Network Code, access beneficiaries would need to agree to the change. We would therefore particularly welcome views on the acceptability of such a provision.

Responses to this document

30. We would welcome views on any issue raised in this paper. In particular, responses are sought in relation to:

    a) The practicalities of implementing the proposed rebate mechanism;

    b) How the mechanism should operate under the specific scenarios identified in above;

    c) The suggested amendment to the Network Code; and

    d) A possible extension of the mechanism to government funders.

31. As part of the consultation process, ORR would welcome the opportunity to meet stakeholders and intends to arrange a meeting with stakeholder representatives and groupings in the new year.

32. Responses should be sent in both electronic and hard copy by 28 February 2006 to:

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