



# PR18: Infrastructure cost charges – draft impact assessment on implementing infrastructure cost charges for open access operators

December 2018

This impact assessment supports our proposals in our open access infrastructure cost charge implementation [consultation](#).

Policy	Charges – infrastructure cost charges
<b>Policy area</b>	Implementing infrastructure cost charges for open access services
<b>Background</b>	<p>In our <a href="#">June 2017 conclusions letter</a> to our December 2016 charges and incentives consultation, we confirmed that we will continue to work towards levying charges to recover fixed costs from all operators, through what we call ‘infrastructure cost charges’ (ICCs).</p> <p>The high-level impacts of charging open access services to recover fixed costs was assessed in the June 2017 <a href="#">final impact assessment on options for fixed costs</a>.</p> <p>In our <a href="#">October 2018 conclusions document on ICCs</a>, we set out most of our policy decisions for how ICCs would be levied on open access operators (OAOs). We decided that the ICC would apply to new or substantially modified existing open access services in the interurban market segment. We also determined that transitional arrangements would apply, including phasing in the charge for new OAOs, and relief over CP6 for existing OAOs (unless they substantially modified their service/s).</p>

However, we did not define the ‘interurban’ market segment, or specify the potential changes to access policy that would follow (specifically to the ‘not primarily abstractive’ (NPA) test).

In our [December 2018 consultation document](#), we set out a proposed methodology for determining whether part of a service between two given stations falls within the interurban market segment. We have defined this based on station demand and station distance thresholds.

- **Station demand** (based on the sum of annual station entries and exits, as published by ORR). At least one station served has annual entries/exits above a specified threshold S1, and at least one other station has annual entries/exits above a specified threshold S2 (where S2 is less than or equal to S1). We proposed four options for S1 and S2 illustrated in table 1.

**Table 1: Proposed options for passenger number thresholds**

	<b>S1</b>	<b>S2</b>
<b>1</b>	≥15m passengers/year	≥15m passengers/year
<b>2</b>	≥15m passengers/year	≥10m passengers/year
<b>3</b>	≥10m passengers/year	≥10m passengers/year
<b>4</b>	≥10m passengers/year	≥5m passengers/year

- **Straight-line distance between stations** (calculated based on the station coordinates published by ORR). We proposed that distances could be 40 miles, 50 miles and 60 miles.

In the consultation we also set out proposed options for how we could amend the NPA test to take into account the additional income generated by an ICC.

In this document, we assess the impact of a relatively wide definition (S1=10m, S2=5m, distance ≥40 miles) and a relatively narrow interurban definition (S1=S2=15m passengers, distance ≥60 miles), against the status quo (the ‘do-nothing’ option outlined in the next section), alongside two potential options for changes to the NPA test.

	Following this, we assess the effect of a more discretionary approach to defining the interurban market segment.
<b>PR18 outcomes and objectives to assess each option against</b>	➤ <b>Outcome:</b> The network is efficient <i>(The network is being operated, maintained and renewed at the lowest cost, given the level of use and performance)</i>
	➤ <b>Outcome:</b> The network is better used <i>(Network Rail and operators find ways to improve network use and accommodate new services)</i>
<b>General objectives</b>	<ul style="list-style-type: none"> <li>➤ <b>Promote competition on the railway</b></li> <li>➤ <b>Promote positive impacts on customers and funders</b></li> <li>➤ <b>Limit transitional impacts</b></li> <li>➤ <b>Limit transaction costs</b></li> </ul>

## Outline of impact assessment

In this section we explore the impact relative to the status quo of a number of scenarios involving different combinations of options for the interurban market segment definition and adjusting the NPA test ratio calculation. Set out below are the options for the interurban market segment definition and amending the NPA test on which we are consulting.

### *Interurban market segment*

#### **Option 0: 'do nothing'**

The 'do nothing' option is to exclude all services from the interurban market segment. All services would then fall into the 'other' market segment and no open access services would pay the ICC in CP6.

#### **Option A: Wider definition – potentially larger effect on passenger rail markets**

This option defines a portion of a service serving a given pair of stations as interurban if one station has average annual entries/exits equal to or greater than ten million passengers, at least one other has average annual entries/exits equal to or greater than five million passengers, and the two stations are at least 40 miles apart. These requirements result in a relatively wide definition of the interurban market segment. From the 90 stations with passenger traffic over five million and the 37 stations with traffic over ten million passenger, there are 1,379 station pairs that would fall inside this segment. See the [accompanying spreadsheet](#) for the station pairs.

#### **Option B: Narrower definition – potentially smaller effect on passenger rail markets**

This option defines a portion of a service serving a given pair of stations as interurban if one station has average annual entries/exits equal to or greater than 15 million passengers, at least one other also has average annual entries/exits equal to or greater than 15 million passengers, and the two stations are at least 60 miles apart. These requirements result in a relatively narrow definition of the interurban market segment. From the 28 stations that have passenger traffic over 15 million, there are 163 station pairs in this segment. See the [accompanying spreadsheet](#) for the station pairs.

### *Amending the NPA test*

#### **Option 0: 'do nothing'**

The 'do nothing' option is to make no adjustment to the NPA test ratio calculation.

#### **Option 1: Add the ICC payment to revenue generated**

$$\frac{\text{revenue generated} + \text{ICC}}{\text{revenue abstracted}} > 0.3$$

Income generated from the ICC is added to 'revenue generated' in the NPA test. Our high level analysis of option 1 suggests that it is more likely to result in an application passing the test than option 2 (albeit only for marginal cases).

### **Option 2: Subtract the ICC payment from revenue abstracted in the NPA test**

$$\frac{\text{revenue generated}}{\text{revenue abstracted} - \text{ICC}} > 0.3$$

Income generated from the ICC is subtracted from 'revenue abstracted' (i.e. abstracted from existing operators). The ICC represents a payment to government, funded by the farebox revenue (i.e. revenue from passenger fares) generated by the new service. Therefore, in this option, it is subtracted from revenue abstracted as it lessens the long-term loss to taxpayers. Our high level analysis suggests option 2 is less likely to result in an application passing the test than option 1.

### ***Combined scenarios***

We have combined these options in the following scenarios:

- Scenario 0: exclude all services from the interurban market segment / no change to the NPA test;
- Scenario A1: wider interurban market definition / ICC payments added to forecast level of generation in the NPA ratio;
- Scenario A2: wider interurban market definition / ICC payments subtracted from forecast level of abstraction in the NPA ratio;
- Scenario B1: narrower interurban market definition / ICC payments added to forecast level of generation in the NPA ratio; and
- Scenario B2: narrower interurban market definition / ICC payments subtracted from forecast level of abstraction in the NPA ratio.

Scenario 0 is the 'do nothing' scenario.

Scenario A1 includes the widest interurban definition and the change to the NPA test that is most likely to enable open access applications to be granted access rights. It is the scenario that will likely have the biggest impact relative to the status quo.

Conversely, scenario B2 uses a narrower interurban definition and a change to the NPA test that is less likely than option 1 to enable open access applications to be granted access rights. This scenario will likely have a smaller impact than scenarios A1, A2 and B1.

Our assessment of the impact of these different scenarios is set out below.

## Assessment against PR18 outcomes

**Outcome:** The network is efficient

In scenario 0, OAOs would continue to not contribute towards fixed infrastructure costs and therefore continue to have no financial incentive to take into account the longer-term costs of using the railway.

Therefore, compared with scenario 0 (for both the interurban market segment definition and changes to the NPA test), all scenarios would contribute to Network Rail being able to recover a greater share of its total costs from access charges.

Of the combined scenarios, A1 is likely to result in Network Rail recovering the largest proportion of its total costs from charges, with the magnitude of the impact lessening in each of A2, B1 and B2.

**Outcome:** The network is better used

Compared with scenario 0, all scenarios would mean Network Rail recovers some part of its fixed costs from open access services, resulting in higher revenue from charges. In addition, because the charge would be levied on OAOs on a variable basis (per train mile), Network Rail's decision to add traffic to the network would be based on the revenue associated with these additional services. As a larger proportion of services would fall within the interurban market definition and pay an ICC under scenarios A1 and A2, Network Rail would likely have an increased incentive compared with B1 and B2, to consider open access and add traffic to the network under these scenarios.

In all scenarios, OAOs running interurban services would take into account some of the longer-term costs when using the network, contributing to a better-used network.

## Assessment against general objectives

### ***Promote competition - impact on operators and funders***

#### **Open access operators**

OAOs proposing to operate in the interurban market segment would be charged an ICC that would be taken into account when granting access rights. There is a negative effect on operator profitability due to the additional cost, and a positive effect on the increased likelihood of being granted access rights due to the fact that this income will be taken into account in the NPA test.

The transitional arrangement for both new and existing operators (outlined above) will likely lessen potentially negative impacts of higher charges on OAO profitability in the short term.

Regarding the interurban definition (options A and B), it is difficult to determine the overall impact on operators from the breadth of the definition. However, if the definition is broader (as in option A) there is an increased risk of capturing services outside the market segment that is able to bear a charge. This would negatively affect those services and, overall, may reduce new open access applications.

Conversely, the narrower definition (option B) may result in services that are able to bear charges falling outside the defined market segment. Because the ICC income would not be taken into account in the NPA test (with either options 1 or 2), it may result in fewer open access services being granted access. In addition, these services would then not be contributing towards fixed costs when they could bear them.

Regarding the NPA test, option 1 would make the test easier to pass than option 2. This means that option 1 would increase the chances of success for open access applications more than option 2.

### **Franchised operators**

In the event of increased open access entry, existing franchises may see a reduction their revenue from passengers (through abstraction by OAOs). This could, in turn, have an impact on funders, which we discuss below.

However, the competitive threat posed by OAOs may also spur greater operating efficiencies and innovation by franchised operators thereby growing the overall market and mitigating some of its initial revenue loss.

Any impacts, positive or negative, are expected to be greatest in absolute terms under scenarios A1, with the magnitude of the impact lessening in each of A2, B1 and B2.

### **Funders**

The potential impacts of these scenarios on funders have both positive and negative aspects.

The main positive impact on funders is that, compared with the 'do nothing' scenario, open access services classified as interurban would contribute towards Network Rail's fixed costs. All other things being equal, it would increase the proportion of Network Rail's revenue that comes from access charges and decrease the proportion funded directly by the governments. This potential reduction in government funding requirements would be greatest under scenario A1, followed by A2, B1 and B2.

There are two main potential negative effects on funders as a result of these scenarios. The first is the potential short-term effect of increased abstraction from current franchise operators. Where funders hold a degree of revenue risk (for example through cap and collar mechanisms, which transfer a degree of revenue risk from franchisees to funders, or in the case of concessions), revenues abstracted by open access services may result in a greater financial burden on funders. However, the effect is likely to be negligible in the case of cap and collar contracts as typical levels of abstraction are unlikely to result in revenues falling below the collar (lower limit).

The second potential negative effect on funders is the longer-term impact of an increase in competition from open access services on the future value of franchises. This is because a proportion of revenues that would otherwise be available to franchised operators is abstracted by OAOs. This loss of revenue would negatively affect funders over time as franchises are re-tendered.

Similar to above, the negative effects on funders are likely to be greatest under scenarios A1, with the magnitude of the impact lessening in each of A2, B1 and B2.

Overall, the impact on funders is likely to be negative. However, given the small size of the open access market and the incremental nature of the overall changes to the charges and access policy, the magnitude of this impact is likely to be relatively small.

### ***Promote competition on the railway***

All scenarios are expected to facilitate greater on-rail competition compared with scenario 0. OAOs in the interurban market segment would contribute towards fixed costs and this would be recognised in the NPA test, thereby increasing the likelihood that a new application is granted access rights.

### ***Promote positive impacts on customers***

Greater competition in the passenger services rail market could bring benefits to passengers. In its 2016 report on 'Competition in passenger rail services in Great Britain', the Competition and Markets Authority (CMA) identified a range of benefits for passengers that could arise from greater on-rail competition. The potential passenger benefits identified by the CMA included; lower ticket prices, increased service frequency, service quality improvements and increased service innovations.

However, an ICC will increase operating costs for interurban open access services and, while there isn't necessarily always a direct link between costs and fares, this could potentially lead to increases in fares for passengers currently using those services. Given the scale of the charge to be implemented, it is possible that OAOs are able to absorb the cost increase. In any case, the scale of any fare increases is likely to be small.



Under all scenarios, a higher proportion of passenger services may be provided by OAOs, in competition with franchised passenger operators. Therefore, all other things being equal, the passenger benefits described above would be greater than under scenario 0. The greatest impact would be under scenario A1, with the magnitude of the impact lessening in each of A2, B1 and B2.

## Additional considerations

We also consider the effect of allowing ORR a greater degree of discretion in defining the interurban market based on consideration of the following potential set of factors:

- market demand and straight-line distance (outlined above);
- stopping pattern;
- market geography;
- journey purpose;
- availability and quality of non-rail alternatives; and
- operating speed.

In general, we expect that a more discretionary approach would result in many of the same types, and scale, of impact outlined previously in this impact assessment. In this section, we outline some additional impacts that are likely to arise.

### ***Impact on operators***

Greater discretion would result in OAOs having less certainty during the application process over the costs that they are likely to face. This approach would also likely lengthen the application process for new services. Therefore, this approach could reduce the likelihood that new open access proposals come forward, with a negative effect on the degree of competitive pressure in the market.

On the other hand, greater discretion would potentially reduce the likelihood that an ICC is levied on market segments that are not able to bear it.

### ***Transitional costs***

A greater degree of discretion would result in higher transitional impacts as ORR would need to draft guidance on its assessment methodology during which period the definition of the interurban market would remain uncertain.

### ***Transaction costs***

Greater discretion may result in more information being required from potential open access applicants, which, in turn, would increase administrative costs.



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