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Dear Stakeholder

Proposals for a rebate mechanism for investors in large-scale enhancements – final conclusions

1. In December 2005 we published a letter consulting on proposals for a rebate mechanism for investors in large-scale track infrastructure enhancements^{1,2}. This proposed mechanism forms part of our policy framework for investment and should help to address one of the barriers to investment by enabling investors to recover a fair proportion of the costs incurred in funding an investment scheme where competitors benefit from the use of the enhancement

2. With the exception of Network Rail, our proposals received general support amongst consultees, but some concerns were expressed about the possible degree of complexity involved³. Further consideration of the legal framework, views expressed during the consultation process and the practicalities of implementing such a mechanism, resulted in a number of amendments to our proposals and the development of thinking on the detailed application of the mechanism.

3. Therefore, in December 2006 we published a second letter consulting on our draft conclusions on the proposed mechanism. The letter asked stakeholders for views on the following issues:

- (a) Whether they still believed there was merit in implementing the proposed mechanism, given its inherent complexity;

¹ Including track, civils and signalling enhancements.

² The letter is available at <http://www.rail-reg.gov.uk/upload/pdf/rebate-letter.pdf>.

³ Responses are available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8176>.

and, if so, requested their views on:

- (b) The revised scope of the mechanism;
- (c) The methodology for calculating the rebate, and in particular our proposals for simplification;
- (d) Our proposals for dealing with enhancements that create additional capacity or an alternative route;
- (e) Our proposal to implement the mechanism through applications under section 17 to 22A of the Railways Act 1993, rather than the Network Code; and
- (f) Our proposal to keep the mechanism under review.

4. Following an industry workshop on 15 February 2007 to discuss a number of the outstanding issues in detail, we received eight responses to our consultation letter⁴. We have also held bilateral meetings with stakeholders on particular issues where appropriate.

5. We intend to implement the mechanism broadly in line with our draft conclusions, though we have clarified the policy in a number of areas. In particular:

- (a) We have clarified the scope of the mechanism, including the circumstances under which an operator would be required to pay any rebate charge in place, and provided guidelines as to our expected definition of a 'competitor' for the purposes of this policy;
- (b) We have clarified the way in which we expect the rebate charge to be calculated in practice, and in particular how to reprofile the rebate so it is the same in each year while allowing for depreciation; and
- (c) We have clarified the way in which we expect the mechanism to work for capacity enhancements. The clarifications are intended to address a number of concerns raised by the freight industry in particular.

6. In the attached paper we set out our final conclusions on the proposed rebate mechanism.

7. We believe that the benefits from this simplified form of the rebate mechanism are potentially considerable relative to the expected costs of implementation. These benefits

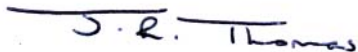
⁴ Respondents are listed in Annex A. Responses are available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8579>.

are elaborated on in the attached policy conclusions. However, we recognise that the exact costs and benefits resulting from implementation of the mechanism are uncertain. In particular we consider it is difficult to quantify *ex ante* its full benefits in any meaningful way since it is not possible to predict how many additional investments will proceed with the rebate mechanism in place.

8. We therefore intend to review the impact of the mechanism a year after implementation, or once a reasonable number of applications have been made. Should it transpire that the proposed policy, once implemented, causes costs to be incurred which exceed the benefits, we would amend or remove the mechanism as appropriate.

9. We believe it would be appropriate to allow Network Rail some time to prepare suitable internal processes for dealing with applications under the rebate mechanism before its implementation. The intended start date for the implementation of the mechanism is therefore 3 September 2007.

Yours sincerely

A handwritten signature in black ink that reads "J.R. Thomas". The signature is written in a cursive style with a horizontal line above the first part of the name.

John Thomas

Proposals for a Rebate Mechanism for Investors in Large-Scale Enhancements – Final Conclusions

Background

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).

2. In October 2005, we published our conclusions on our new policy framework for investments, which aims to facilitate investment in the railway by addressing a number of barriers to the delivery of efficient investment. We have implemented the framework by establishing clear roles and responsibilities and, where appropriate, new approaches to enable these barriers to be overcome. These are set out in our investment guidelines, published in March 2006⁵.

3. One such barrier is the inability under current arrangements of third party investors to recover a fair proportion of the costs incurred in funding an investment scheme where other parties benefit from the use of the enhancement.

4. In some instances, third party investors are required / may wish to invest in an enhancement to the rail network. Such enhancements may range from the construction of a new spur or link to the upgrading of an existing line. The ownership of the enhancement does not, however, reside with the investing entity, but instead resides with Network Rail or other infrastructure owner and operator, which then also has responsibility for its subsequent operation, maintenance and renewal.

5. Once the enhancement is operational, any train operator can apply to the infrastructure owner and operator for access to it. If granted, the charge for access is payable to the infrastructure owner and operator, and as a general principle reflects the marginal cost of providing access⁶. Under current arrangements, therefore, a third party funder cannot charge operators directly for access to an enhancement in which it has invested. Consequently, operators may be able to 'free ride' on the investments of others.

⁵ <http://www.rail-reg.gov.uk/upload/pdf/277.pdf>

⁶ See Chapter 2 of our June 2006 document *Periodic Review 2008: Structure of track access and station long term charges*, available at <http://www.rail-reg.gov.uk/upload/pdf/291.pdf>

6. This 'free rider' problem means that the investing entity could perceive itself to be at a competitive disadvantage, reducing the promoter's incentives to invest and ultimately meaning that a beneficial investment may not go ahead.

7. The need to address this barrier to investment was highlighted during the consultation process on the Investment Framework⁷, with a number of freight industry consultees in particular indicating that investment projects were being stalled as a result of the free rider problem. In December 2005, we therefore published a letter consulting on initial proposals for a rebate mechanism for investors in large-scale enhancements, aimed at addressing this barrier to large-scale investment.

8. Our initial proposals for a rebate mechanism received general support from the industry⁸. However, some consultees expressed concerns about the possible degree of complexity involved. Further consideration of the legal framework, views expressed during the consultation process and the practicalities of implementing such a mechanism, resulted in a number of amendments to our initial proposals and the development of thinking on the detailed application of the mechanism.

9. In December 2006 we therefore published a second letter consulting on our draft conclusions on the proposed mechanism. This was followed by an industry workshop on 15 February 2007 to discuss a number of the outstanding issues in detail. We subsequently received eight responses to our consultation letter⁹. We have also held bilateral meetings with stakeholders where appropriate on particular issues highlighted in the responses.

10. This iterative process has been crucial in ensuring that our policy proposals are as robust as possible and unintended consequences are avoided. Almost all respondents believe there is merit in implementing the proposed mechanism, despite its complexities. In general, respondents supported the principle that these complexities can be addressed through bespoke contract provisions.

⁷ Responses to the initial consultation on our policy framework for investments are available on our website at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.7125>

⁸ Responses are available on our website at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8176>.

⁹ Respondents are listed in Annex A. Responses are available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8579>.

11. In addition, we have simplified the mechanism as far as possible. We have adopted a pragmatic, rather than theoretically pure, approach and have attempted to make the mechanism easy to use and implement as far as we believe is appropriate.

12. Therefore, we now believe that the benefits from this revised form of the rebate mechanism could be significant. However, we recognise the inherent complexities of the mechanism and that its implementation will not be costless. Due to the nature of the mechanism, it is difficult to quantify *ex ante* the costs and, particularly, the benefits in any meaningful way. The key benefit of the rebate mechanism is that it will make it possible for beneficial investments currently blocked by free-riding problems to go ahead. The exact level of such blocked investments is clearly largely unobservable *ex ante*.

13. We therefore intend to review the impact of the mechanism a year after implementation, or once a reasonable number of applications have been made. Consequently, should it transpire that the proposed mechanism causes costs to be incurred which are greater than the benefits, we would consult on amending or removing the mechanism as appropriate. For further information on how we intend to carry out the review and the success criteria for the policy, see the relevant section below.

14. We consider that the rebate mechanism is consistent with the charging principles set out in Schedule 3 of the Railways Infrastructure (Access and Management) Regulations 2005 (the Regulations). In particular, we believe that the higher charges upon which the rebate mechanism depends are capable of falling within the exception to the general principle that charges should be set at the cost that is directly incurred for specific investment projects. We have developed criteria to assist in determining whether this exception applies.

Objectives of the rebate mechanism

15. As set out in our two consultation letters in December 2005 and December 2006, the objectives of the proposed mechanism are:

- (a) To ensure that an entity choosing to invest in a track infrastructure 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;
- (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; and

- (d) To be straightforward conceptually, relatively simple to implement and operate, and transparent.
16. All respondents have agreed with the above objectives.

Summary of our proposals

17. We are introducing the rebate mechanism broadly in line with our proposals set out in our December 2006 draft conclusions, though we have clarified the policy in a number of areas.

18. In summary:

- (a) Third parties investing in track enhancements to the network can apply to Network Rail for a rebate charge to be put in place. This charge will be levied on operators that are liable to pay the charge (see paragraph 33) and that access and benefit from the enhancement in question. Government-funded schemes are outside the scope of the mechanism;
- (b) The rebate charge will be a flat (index-linked) tariff per train service benefiting from the particular enhancement;
- (c) The charge will be payable to Network Rail (or other applicable network owner / operator)¹⁰ as a premium to the access charge. Network Rail will then have responsibility for distributing the tariff received to the appropriate investing party(ies), the rights to which will be set out in the relevant access contract or access option;
- (d) The level of the charge should be calculated by Network Rail and be based on the average cost of the investment (see paragraph 47);
- (e) The charge will 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, the mechanism for paying rebates to the investor will survive, unless the investor has been appropriately compensated for its investment;
- (f) The mechanism will be implemented through applications under section 17 to 22A of the Railways Act 1993; and

¹⁰ Where we refer to Network Rail the reference applies equally to any other applicable rail network owner/operator.

(g) Initially at least, we will scrutinise all applications for a rebate carefully.

Alternative approaches

19. Other approaches may be available to encourage cooperation between investors and potential beneficiaries, e.g. through joint funding.

20. It is important to emphasise that the rebate mechanism provides would-be investors with an alternative route for facilitating network enhancements, and that it is aimed particularly at investors potentially placed at a competitive disadvantage as a result of the 'free riding' of the enhancement by other operators.

21. Parties remain free to adopt the approach they believe is most appropriate in their particular circumstances. Indeed, we expect investors to explore any other available alternatives before applying for a rebate, if they believe these are more appropriate. The rebate mechanism does not remove any of the existing remedies already available through our Investment Framework.

Conclusions on the scope of the rebate mechanism

22. The scope of the mechanism is unchanged from our draft conclusions. We will review the appropriate scope once the mechanism has been running for at least a year.

Eligible types of investment

23. Initially at least, the rebate mechanism will be limited to track infrastructure enhancements, i.e. enhancements to track, signalling and structures. We will consider extending the scope to include station and depot schemes once the mechanism is up and running. If the scope were extended, suitable provisions would need to be introduced into the station and depots codes.

The access and management regulations

24. As explained in our December 2006 draft conclusions, we need to be satisfied that the rebate mechanism is consistent with the charging principles set out in Schedule 3 of the Railways Infrastructure (Access and Management) Regulations 2005 (the Regulations)¹¹.

25. We consider that the higher charges upon which the rebate mechanism depends are capable of falling within the exception to the general principle that charges should be

¹¹ See <http://www.opsi.gov.uk/si/si2005/20053049.htm#sch3>

set at the cost that is directly incurred for specific investment projects. We have therefore developed criteria to assist in determining whether this exception applies. In doing so, we have sought to balance appropriately our various policy objectives, particularly with respect to encouraging efficient investment in the network on the one hand and ensuring that users are not inefficiently priced off the network on the other.

26. The key principle is that potential investors will need to demonstrate that without the rebate mechanism (i.e. the prospect of recovering an element of the investment from the higher charges) the investment could not go ahead.

27. In particular, investors will only be eligible for the rebate mechanism if they can demonstrate to Network Rail (and us) that they satisfy one of the following criteria:

- (a) The funder is a private sector third-party funder and:
 - (i) is not being funded for the investment through other mechanisms (e.g. franchising arrangements or grants);
 - (ii) there is a stand-alone business case for the investment in the absence of the rebate and free riding;
 - (iii) there is a real likelihood of free riding on the investment by competitors, which would mean that the project could not be undertaken without the prospect of such higher charges; and
 - (iv) the funder has explored thoroughly the possibility of joint funding arrangements before applying for the rebate mechanism.

OR

- (b) The funder is a public sector third-party funder (e.g. Transport for London (TfL), Passenger Transport Executives (PTEs)) and:
 - (i) is not being funded for the investment through other mechanisms (e.g. Transport Innovation Fund (TIF) grants);
 - (ii) the scheme represents value for money in the absence of the rebate;
 - (iii) funding constraints mean that the scheme could not proceed, or would be delayed with significant adverse effects, without the prospect of recovering higher charges via the rebate, due to a lack of available funding;
 - (iv) the prospect of recovering higher charges via the rebate would ease the funding constraint; and

- (v) the funder has explored thoroughly the possibility of joint funding arrangements before applying for the rebate mechanism.

28. In both cases, we expect funders to provide robust evidence that the criteria set out above are satisfied at the time of their application for a rebate.

29. We are not automatically excluding enhancements due to commitments under section 106 agreements¹² or similar provisions from the rebate mechanism. It will be the investor's responsibility to make the case for eligibility. For example, the investor may be able to argue successfully that without the rebate, the commitments under section 106 would be so financially onerous that the whole development may not proceed. However, we expect that such schemes generally will be unable to satisfy the above criteria, as, arguably, in most cases these schemes are likely to proceed regardless of whether the mechanism is available.

30. A number of stakeholders have questioned the inclusion of public sector third parties within the scope of the mechanism. Our discussions with TfL and PTEs suggest that, though there is value in potentially having access to the rebate mechanism as an alternative means of funding projects, in reality they are unlikely to call upon it or satisfy the relevant criteria above. This is primarily because their preference is to secure joint funding arrangements up front, but also because where this is not possible and funding constraints bind, the funds flowing from any rebate charge are unlikely to be sufficiently certain to ease funding constraints. Indeed, TfL has informed us that they are not considering applying for a rebate for any of their schemes in development and we are not aware of any schemes for which other public sector parties are currently considering applying for a rebate.

31. Government (i.e. DfT and Transport Scotland) is outside the scope of the mechanism. This is because Government already has a number of processes available to it to fund investment schemes, which are not generally available to other public sector bodies. These include the periodic review process, whereby investments are funded through the RAB (or potentially in-year), the logging-up mechanism for investments identified between periodic reviews, and the franchise regime¹³.

¹² Section 106 of the Town and Country Planning Act 1990. See http://www.opsi.gov.uk/ACTS/acts1990/Ukpga_19900008_en_5.htm#mdiv106

¹³ See ORR, February 2005, *Policy Framework for Investments: An initial consultation*, paragraphs 2.5-2.13 for further details. This document is available at <http://www.rail-reg.gov.uk/upload/pdf/223.pdf>.

32. Where Government wishes to obtain partial funding from beneficiaries, we recommend that it generally does so by agreeing joint-funding arrangements up front.

Requirement to pay the rebate charge

33. An operator accessing and benefiting from an enhancement funded by a third-party investor for which a rebate charge is in place will only be required to pay the charge if:

- (a) The third-party investor is a private sector entity and is a competitor of the accessing operator; or
- (b) The third-party investor is a public sector third party.

34. The onus is on the applicant for a rebate charge to set out and justify the definition of a “competitor” with respect to the investment in question. However, in general:

- (a) where the investor is a passenger train operator, we would expect that its competitors would most often be other passenger train operators, whether franchised or open access; and
- (b) similarly, where the investor is a freight operator, we would expect that its competitors who might “free ride” on its investment would most often be other freight operators who benefit from the enhancement.

35. Where the investor is not a train operator, free riding may also arise where competitors of the investor were able to obtain benefits from the investment as a result of train operators accessing and benefiting from it. This can be illustrated using the example of a network enhancement made by a port (“port A”) that faces competition from a nearby alternative port (“port B”), where benefits may flow to port B as a result of train operators using the enhancement to access port B. We will not exclude from the rebate mechanism enhancements made by investors that are not train operators. As in the case of investments funded by TOCs or FOCs, it will be the investor’s responsibility to make the case for eligibility. However, we consider that this case presents a number of additional complexities, mostly because the rebate charge would be payable by the train operators which are not the investor’s direct competitors. Therefore, in practice it is likely to be more difficult for investors that are not train operators to make their case for eligibility. For example, in these circumstances we would expect the investor to provide additional evidence that benefits gained by train operators using the enhancement and benefiting from it would also flow to the investor’s competitors as a result of this usage.

36. The above is a broad guideline for potential investors as to how we expect “competitors” to be defined. The exact definition may differ from case to case. Ideally, the definition of “competitors” would be determined by reference to the relevant market

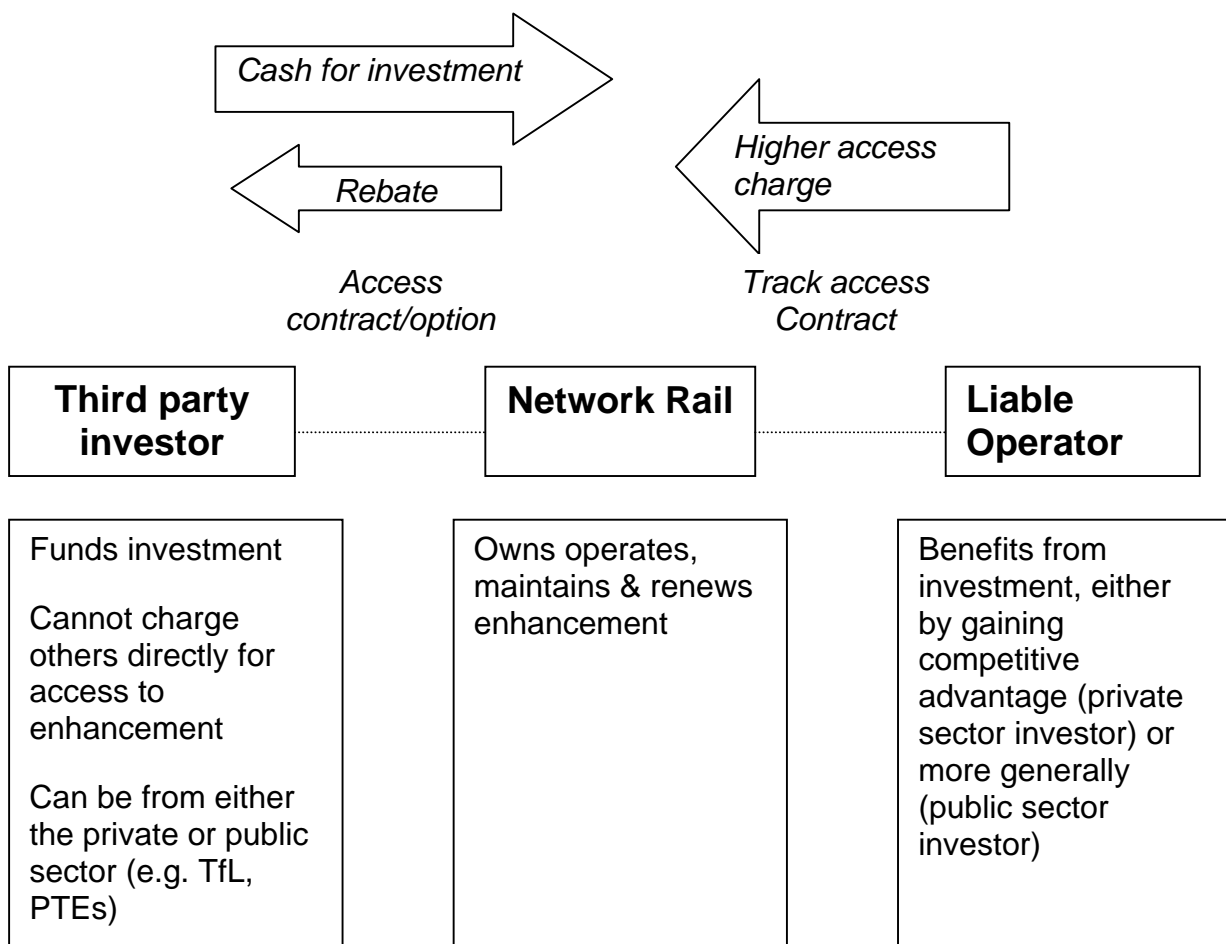
segment(s). However, we believe that instituting such an approach with respect to the rebate mechanism would result in significant practical difficulties, as well as risk introducing perverse incentives. As the guideline reflects, our overall intention is that applicants take a practical approach to defining “competitors” rather than undertake an onerous full market segment-based analysis.

Conclusions on the operation of the mechanism

37. Where a rebate charge is put in place, any operator that accesses and benefits from that enhancement and is required to pay the additional charge (see paragraph 33 above), will pay the rebate charge to Network Rail as an uplift to its access charges. Network Rail will then pay the rebate element of the charge on to the investor.

38. Figure 1 summarises how payment flows will work in practice.

Figure 1: Paying and receiving the rebate



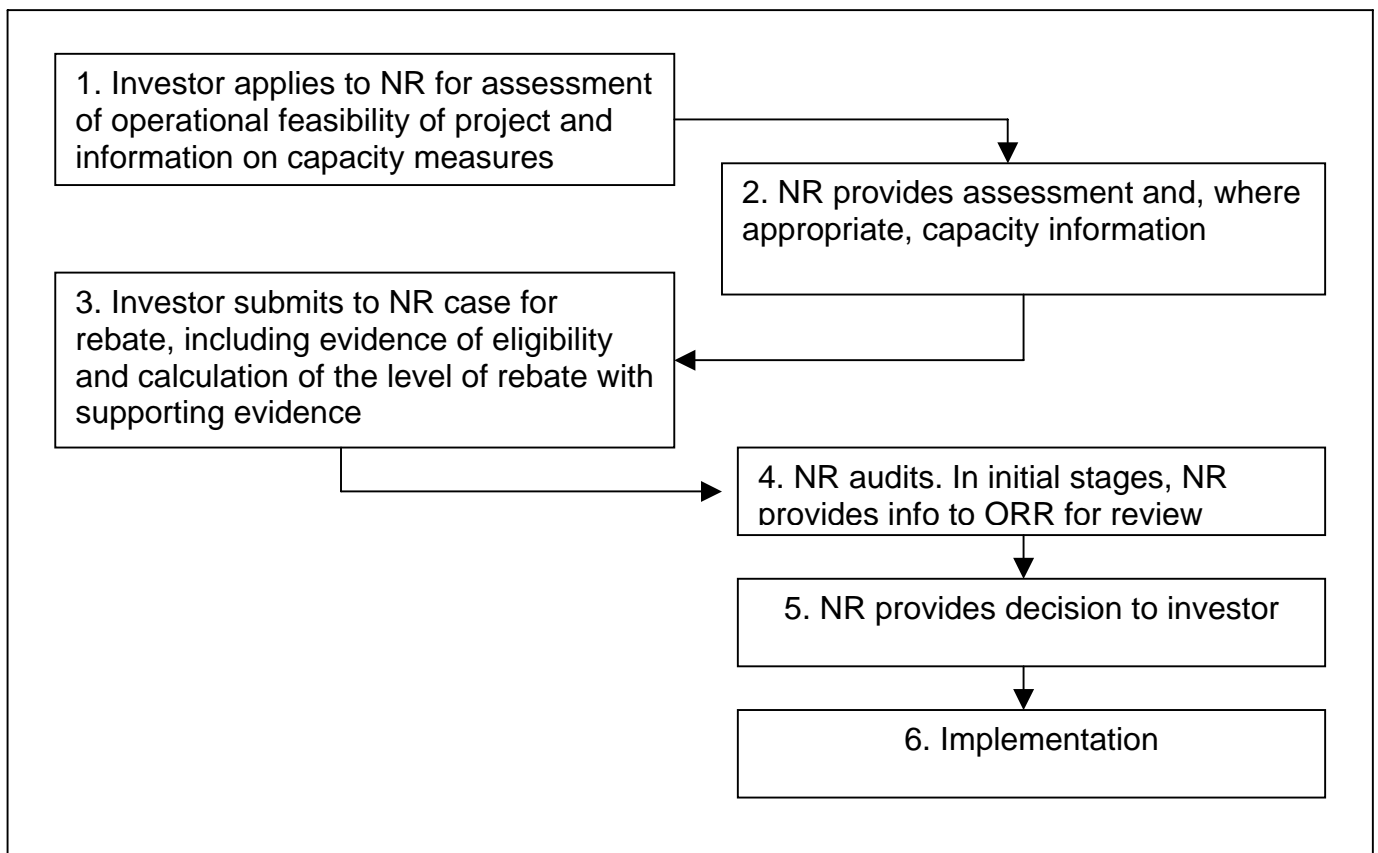
Conclusions on the application process

39. Potential third-party investors are responsible for setting out and justifying to Network Rail, in the first instance, their case for higher charges and accompanying rebate charge, and the level of that charge. As mentioned above, investors will have to demonstrate that the enhancement satisfies the eligibility criteria set out in paragraph 27 above.

40. Network Rail will be responsible for assessing the eligibility of the enhancement and its consistency with the Regulations. In line with its new responsibilities for developing station and track access charges, Network Rail will also have responsibility in the first instance for verifying the level of the rebate proposed by the investor. At the time an application for a rebate is made, we would expect Network Rail to consult potentially affected operators on the application before reaching a decision on the eligibility of the investor and the appropriate level of the rebate.

41. Figure 2 sets out the steps in the process.

Figure 2: Steps in applying for a rebate



42. Network Rail should acknowledge receipt of the investor's request for an assessment of the operational feasibility of the scheme and capacity information within 12 working days, in line with the timescales set out in its "Investing in the Network" guidelines¹⁴. In normal circumstances, we would expect Network Rail to respond to the investor within 30 working days, providing the results of its assessment and, where appropriate, any relevant capacity information required, or, in exceptional circumstances, a full justification of why a different timescale may be required given the particular circumstances of the scheme.

43. The investor will then submit a complete application for a rebate to Network Rail, including evidence of eligibility and the calculation for the proposed level for the rebate, with supporting evidence. Again, Network Rail should acknowledge receipt of the investor's complete application within 12 working days. We would then expect Network Rail to provide a final decision on eligibility and level of the rebate to the investor, or a full justification for an alternative timescale in exceptional circumstances, within 30 working days from receiving the complete application.

44. We will keep the mechanism under review. If in light of experience, amendments were needed, we would look to make changes at the end the first year of implementation, subject to the number of applications received in the period (see relevant paragraphs below).

Interaction with Access Options

45. An application for a rebate can be made under an existing access contract or, more likely, as part of an application for an access option.

46. We are consulting separately on our policy for the approval of track access options¹⁵.

Conclusions on the calculation of the rebate

47. As set out in our December 2006 letter, the level of the rebate should be set equal to the average annual cost of the investment per relevant path available, calculated as:

$$\text{Average annual cost}_t = \left(\frac{\text{Total annual investment cost}_t}{\text{capacity measure}} \right)$$

¹⁴ http://www.networkrail.co.uk/documents/3802_Section13AccompanyingMaterial.pdf

¹⁵ <http://www.rail-reg.gov.uk/upload/pdf/313.pdf>

where the total annual investment cost is calculated as:

$$\text{Total annual investment cost}_t = \text{annual depreciation charge} + (\text{NBV of investment}_t \times \text{annual cost of capital})$$

and:

- (a) The net book value (NBV) of the investment cost is the total efficient cost¹⁶ to the investor of the enhancement (excluding financing costs and after allowing for depreciation). Incremental operating, maintenance and renewals costs may also be included in the investment cost, consistent with our policy set out in our March 2006 investment guidelines¹⁷.
- (b) The depreciation charge is that implied by depreciating the enhancement on a straight-line basis over the *ex ante* payback period¹⁸ of the investment (rather than the asset life), as set out in the access contract for the investing entity.
- (c) The default value for the cost of capital is Network Rail's prevailing allowed rate of return, in the year in which the enhancement is financed. Investors may propose an alternative cost of capital but will need to provide compelling and robust evidence as to why the proposed rate is more appropriate than the default rate.
- (d) The capacity measure is the anticipated capacity of the enhancement available to beneficiaries. Where accessing the enhancement does not necessarily imply benefiting from it, e.g. a gauge enhancement, relevant capacity may be significantly below the total capacity of that route section. (Annex B provides an example) We recognise that assessing existing and newly created capacity is not straightforward. However, the investor will need to make assumptions about this to develop his business case, and so the onus is on the investor to provide robust evidence as to the level assumed.

¹⁶ As set out in Chapter 3 of the October 2005 Investment Framework final conclusions (<http://www.rail-reg.gov.uk/upload/pdf/255.pdf>) and Chapter 4 of the March 2006 Investment Guidelines (<http://www.rail-reg.gov.uk/upload/pdf/277.pdf>)

¹⁷ <http://www.rail-reg.gov.uk/upload/pdf/277.pdf>

¹⁸ For private sector investors, this is defined as the number of years it will take for the investor to recoup the initial investment cost, making the project financially viable. For public sector third-party investors, this is defined as the number of years of rebate required for the investment to proceed.

48. Box 1 provides a simple worked example of how the level of the rebate should be calculated.

Box 1: Worked example of calculation of rebate charge

Initial net book value (NBV) of investment	£300,000
Anticipated payback period	10 years
Real pre tax cost of capital ¹⁹	6.5% real (NR's allowed return for 2006-07)
Capacity measure	20 paths / day => 7,300 paths / year
Depreciation charge = £300,000 / 10 = £30,000	
Total investment cost _{t=1} = £30,000 + 6.5% x £300,000 = £49,500	
Total investment cost _{t=2} = £30,000 + 6.5% x (£300,000 - £30,000) = £47,550	
Total investment cost _t = £30,000 + 6.5% x (£300,000 - £30,000 x (t - 1))	
Equivalent Annual Total investment cost ²⁰ = $£300,000 \times \frac{(6.5\% \times (1 + 6.5\%)^{10})}{(1 + 6.5\%)^{10} - 1}$ = £41,731	
Rebate = £41,731 / 7,300 = £5.72 / benefiting path	

Partial use of an enhancement

49. In some instances it may be possible for an operator to access and benefit from only part of an enhancement for which a rebate charge is in place, for example, where the enhancement concerned is a gauge enhancement of a considerable length of track or the

¹⁹ The example uses a real pre tax cost of capital because this is Network Rail's currently allowed return. Therefore, the resulting charge is in real terms and should then be indexed to inflation. However, the investor will be able to propose alternative approaches, e.g. using a nominal cost of capital.

²⁰ We use the equivalent payment approach to reprofile (in a Net Present Value-neutral way) the declining total investment cost based on the NBV of the investment, so that the rebate charge is the same in each year (except for indexation).

investment involves two separable enhancements (e.g. gauge and capacity). At our February workshop, a number of stakeholders felt that it was important for the additional charge incurred by an operator to reflect the proportion of the enhancement concerned that it benefits from.

50. We understand this argument. However, we are also keen to ensure that the mechanism is as simple as possible. An appropriate balance needs to be struck between ensuring economic purity and retaining simplicity. Applicants for a rebate charge should propose a methodology for calculating the rebate charge due when only part of the enhancement is used, or explain why they do not think such a methodology is appropriate in their case. For example, a gauge enhancement could be split into four parts based on the configuration of the network with a quarter of the total rebate charge being payable for accessing and benefiting from each part. As we explain above, at the time an application for a rebate is made there should be an opportunity for potentially affected operators to comment on this and other issues. Respondents to the consultation are also able to propose alternative methodologies. Complex methodologies are not encouraged. Amendments proposed to track access contracts or options to include rebate charges will also be subject to the consultation processes outlined in our Criteria and Procedures documents²¹.

Multi-party funding

51. As set out in our draft conclusions, where an enhancement is funded by more than one entity, we would expect the following principles to apply:

- (a) The eligibility of each funder for a rebate should be considered separately, against the principles set out in paragraph 27 on 'eligibility' above; and
- (b) The rebate available to eligible funders should be the proportion of the investment funded by these funders multiplied by average annual cost (as set out in paragraph 47 above). Consequently, if all funders are eligible for the rebate, the total rebate payable by competitors accessing and benefiting from the enhancement will be the average annual cost. Where one or more funders is not eligible to receive the rebate, the total rebate payable will be less than the average annual cost. It remains for the eligible funders to decide how they want to allocate the total rebate received between each of them.

²¹ See <http://www.rail-reg.gov.uk/server/show/nav.202> for Passenger trains and <http://www.rail-reg.gov.uk/server/show/nav.204> for Freight trains.

52. However, it may be that such an approach is not appropriate for all joint-funding arrangements. Multi-party funded enhancements would therefore need to be looked at on a case-by-case basis.

Resetting the level of the rebate

53. As explained in our draft conclusions, the level of the rebate charge should be set upfront at the *ex ante* average cost for the duration of the payback period set out in the investor's access rights.

54. In the interests of providing certainty, we have concluded that the level of the rebate, once set, should not be reassessed.

Conclusions on the use of the mechanism in specific scenarios

55. In our initial consultation letter and draft conclusions, we identified two specific scenarios that raise difficult issues in relation to the calculation of the level of the rebate. These were:

- (a) Capacity enhancements; and
- (b) Enhancements creating an alternative route.

56. We discussed these in detail at our two workshops and they were commented on in the consultation responses. Drawing on these discussions and the consultation responses, we have reached the following conclusions in these areas.

Capacity enhancements

57. Where the enhancement concerned is an increase in the capacity of a route, we believe that the appropriate default position is for the rebate to be payable only by incremental users, i.e. those services that would not have been able to run in the absence of the capacity enhancement, and that fall within the scope of the rebate mechanism. This means that existing services, although potentially benefiting at the margin from lower congestion, will not pay the rebate charge; the rationale for this being that they are not free riding on the investment.

58. To illustrate, if:

- (a) The capacity of the existing route is 100 paths / day, of which 90 are currently used, and
- (b) The enhancement increases the capacity available to 150 paths / day,

then:

- (a) The first 10 additional services would use paths 91-100 and so would not be subject to the higher charge, and
- (b) Any further services run would use paths 101-150 and would potentially be liable to pay the rebate charge.

59. The appropriate capacity measure for calculating the level of the rebate would be 50 (150-100) in this case.

60. Where access rights that have previously been exempt from the rebate charge expire and are renewed, as a general principle it is assumed that they would remain exempt from the rebate charge, unless they are benefiting from the enhancement. However, whether or not these renewed access rights should remain exempt will need to be looked at on a case-by-case basis, in order to ensure that outcomes are not created which are inconsistent with the objectives of the mechanism or our section 4 duties.

61. Where exempt rights expire and are not renewed (or are renewed but without remaining exempt), then, in the illustrative example above, the 101st service would no longer be required to pay the higher charge. If the expired access right is subsequently used then the new right would effectively be an incremental right, and the operator would be required to pay the higher charge. In other words, the right would 'go to the back of the queue'.

62. We believe that this approach will ensure that the business risk associated with the enhancement remains with the investor, while providing transparency and fairness to operators. The approach should also be reasonably straightforward to implement through the inclusion of a mechanism in the underlying access contract that provides for an adjustment to the higher charge in specified circumstances.

63. We recognise that under this approach there is a potential incentive to retain access rights that are exempt from the rebate charge, irrespective of whether they are being used. However, we do not believe that this incentive is a function of the rebate mechanism per se, as it would exist anywhere where network capacity is being fully utilised. In both cases, other mechanisms in place to promote the efficient use of access rights (e.g. Part J of the Network Code) should mitigate concerns.

64. Certain freight consultees have queried what would happen upon a transfer under Part J, in particular in the situation when a competing freight operator wins a tender for the incumbent freight operator's business. If the incumbent's relevant access right is transferred under Part J during the original term of the right, the charging arrangements will not change (i.e. if a rebate charge was not payable before the transfer, it will not be

payable following the transfer). Where the access contract of the operator receiving the right expires ahead of the access contract of the incumbent, the transferred right would expire in line with the receiving operator's access contract, as per our current policy. However, any exemption from the rebate charge associated with the transferred right would retain its original life (as if it was still held by the incumbent), surviving the expiry of the receiving operator's access contract if necessary. If this were not to be the case, the incumbent freight operator would have an unfair competitive advantage.

65. For the purposes of calculating the rebate charge, the onus is on the investor to justify the volume of capacity created as a result of the enhancement (see paragraph 47 above).

66. As stated above, we intend to keep the mechanism under review, particularly in relation to capacity enhancements. If, in the light of experience, amendments are needed, we will look to make changes at the end of the first year of implementation (or before if necessary), subject to the number of applications received in the period.

Alternative routes

67. Where the enhancement concerned is a link creating an alternative route, and an operator that falls within the scope of the mechanism chooses to use the alternative route, (for example because it is much shorter or enables a 'better' slot to be obtained), then the operator should pay the higher charge.

68. However, if the operator would prefer to use the existing route, but Network Rail is able to require it to use the new link through the Network Code, we can identify two cases:

- (a) If the route alteration is one-off or short term, e.g. due to emergency diversion from the main route, all parties concerned will face costs and benefits. It is also clear that such use does not place the investor at a competitive disadvantage. We have therefore concluded that, for simplicity, no rebate charge is applicable in these circumstances.
- (b) Where Network Rail decides that it is appropriate for an operator to use the alternative route on a long-term basis, we similarly propose that the default position should be that no rebate charge is applicable. This is because if Network Rail wishes to re-route an operator along the alternative route on a long-term basis, even where that operator would prefer to continue to use the main route, it is likely to be to realise performance benefits and/or accommodate additional capacity; for which it may obtain incentive payments and which would have whole industry benefits. Requiring Network Rail to pay the full rebate charge in these circumstances may create perverse incentives: Network Rail will only have the incentive to divert traffic if the benefits it obtains from relevant incentive

mechanisms (e.g. volume incentive, performance regime) outweigh the additional costs incurred, and therefore whole-industry benefits may be lost if Network Rail has to pay the rebate.

69. We recognise that this approach may not always be optimal, and we will review this aspect of the policy carefully.

Conclusions on the implementation of the mechanism

70. Any change in the access charge payable currently requires a change in the operator's track access contract. 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 (for example, an access charges review). 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 or, in the absence of agreement, under section 22A, where the amendments permit more extensive use. It is, of course, also possible that a new entrant would apply for rights to benefit from the enhancement as part of an application under section 17 or 18. Such an application will be subject to our usual consultation processes, which are outlined in our Criteria and Procedures documents.

71. The investor/operator will also need to have an arrangement with Network Rail that provides for the payment of any rebate to it in an access contract (either an access option or access agreement). It will be at this stage that consideration is given to whether the application satisfied the requirements under paragraph 3 of Schedule 3 of the Regulations (see paragraph 27 above).

72. Where an operator's use of a track infrastructure enhancement that is subject to the payment of the rebate charge requires a change to its access contract, implementing the higher access charge is straightforward. For example, many 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 to be enhanced to a higher gauge, a change to the contract would be required before that slot could be used at the higher gauge. We could therefore require a change in the access charge as part of the approval process.

73. We are aware that in theory a user's existing access rights may enable it to benefit from an enhancement for which another investor has paid without requiring a change in its access contract. We have concluded that where an operator's existing property rights may enable it to take the benefit of an enhancement, it is not at this time appropriate for the rebate mechanism to cover this possibility. However, we will monitor these cases and review the mechanism as necessary.

74. We have concluded that implementation as part of an application under section 17 to 22A of the Railways Act 1993 is the more appropriate way of implementing the revised access charges to cover the rebate. We believe that it is important that there is regulatory oversight of these charges at least in the initial stages. In addition, an important advantage of implementation through applications under section 17 to 22A is that the drafting could be developed to fit the particular circumstances of each scheme.

75. The mechanism will therefore be implemented by including provision for payment of an appropriate supplemental access charge (the rebate) from any applicant under section 17 to 22A receiving ORR approval for the use of access rights created by an eligible investment scheme.

Affordability of the rebate

76. Certain consultees have raised concerns about the affordability of any rebate.

77. As stated in paragraph 15, one of the explicit objectives of the rebate mechanism is to ensure that the level of the rebate does not foreclose efficient access to an enhancement. As we explain elsewhere in this document, at the time that an application for a rebate is made there will be an opportunity for potentially affected operators to comment on this and other issues.

78. In addition, we would not expect this to be an issue in most cases, as operators will generally have the choice of not taking advantage of the enhancement and therefore not having to pay the rebate for their existing traffic.

Post-implementation review of the mechanism

79. As mentioned above, we intend to review the impact of the mechanism a year after implementation, or once a reasonable number of applications have been made.

80. The success criteria against which we will assess the effectiveness of the mechanism will include the following:

- (a) Investors believe that the identified barrier to investments, namely the inability of third party investors to recover a fair proportion of the costs incurred in funding an investment scheme where other parties benefit from the use of the enhancement, has been overcome;
- (b) The mechanism has been relatively simple to implement and operate, and transparent. It has provided 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;

- (c) As a direct or indirect²² consequence of the mechanism, investors have put forward investments that they would not have considered carrying out in the absence of the mechanism; and
- (d) The costs imposed on Network Rail from administering the mechanism have not been higher than the value of the investments undertaken.

81. We will consult the industry on whether the mechanism has met the success criteria above. We also expect to ask Network Rail to quantify any additional costs incurred from administering the mechanism.

²² E.g. due to further incentives introduced by the mechanism for joint funding schemes or using alternative approaches.

Annex A: Respondents to our draft conclusions letter

We received responses from the following organisations:

- Department for Transport,
- EWS,
- Freightliner,
- Hutchinson Ports UK,
- Network Rail,
- Rail Freight Group,
- Strathclyde Passenger Transport,
- Transport for London.

The responses are available on our website at:

<http://www.rail-reg.gov.uk/server/show/ConWebDoc.8579>.

Annex B: Assessing relevant capacity

This Annex provides an example of how the relevant capacity measure, for the purposes of calculating the level of the rebate, would be assessed for an enhancement where accessing it does not necessarily imply benefiting from it. An example is a gauge enhancement. It is possible, and in many cases likely, that a number of operators would access the gauge-enhanced line without benefiting from it.

The example set out in the table below considers a gauge enhancement on a part of the network that is predominantly used by passenger services: 90 of the 100 paths available per period are used by passenger services, who do not benefit from the enhancement. The remaining 10 paths are available to freight services, which may or may not benefit from the enhancement.

If the relevant capacity measure is taken to be all the paths available, i.e. 100 per period, then, as shown in column A in the table below, the investor will be implicitly paying considerably more per benefiting path than a competitor would have to pay in order to benefit from the enhancement: £242 / path versus £10 / path. The free-rider problem therefore remains largely unresolved.

If, instead, only that capacity that is able to benefit from the enhancement is considered in the relevant capacity measure – so, in the example, 10 paths / period – then there is a better match between the amount that the investor implicitly pays per path and the level of the rebate: £175 / path versus £100 / path.

	Column A	Column B
	Considering all capacity	Considering only paths potentially able to benefit
Total investment cost / period	£1,000	£1,000
Paths available / period	100	10
Capacity measure	100	10
Rebate charge / path	$£1,000 / 100 = £10$	$£1,000 / 10 = £100$
Expected investor usage / period	4	4
Expected number of benefiting competitor paths / period	3	3
Total charge received	$3 \times £10 = £30$	$3 \times £100 = £300$
Implied cost / path to investor	$(£1000 - £30) / 4 = £242$	$(£1000 - £300) / 4 = £175$
Rebate charge as % implied cost to investor	$£10 / £242 = 4\%$	$£100 / £175 = 57\%$