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Dear David

Criteria for determining compensation in relation to the voluntary surrender or adjustment of rights (*Changes to access rights: final conclusions, June 2004*)

Further to our response on 18 June 2004 to the final conclusions document, this letter provides comments as requested on proposed criteria at paragraph 4.13 of the document. Our main comments relate to the need to ensure that there is no disincentive on the parties to the achievement of optimal industry solutions and that there is enough clarity on the scope, methodology and definitions relating to compensation to ensure that disputes can be avoided. These comments are set out in detail below.

Clarity on use of criteria

Currently the draft criteria refer to the "voluntary" adjustment or surrender of rights. However, Part J does not use this terminology. Network Rail believes that the criteria need to be explicit such that the purpose of the criteria is defined as relating to only expert determination under J2.11.1. Furthermore, 'matters to be determined by the arbitrator or expert' are not restricted to just compensation (see J10.3). It is proposed, therefore, that any criteria published by ORR should be specified as for the purpose of determining compensation related to J2.11.1.

Consistency with Part J

The overall draft of the criteria gives the impression of being based on the supposition that compensation will be payable by Network Rail to the operator. However, there may be cases in which no cost savings can be made or even where Network Rail could face net losses. In these circumstances it could be the operator paying compensation to Network Rail. J2.3, J2.11.1 and J10.3.1 all provide for payments to Network Rail or the sharing of 'Relevant

Financial Consequences'. Given this we consider that the criteria need to be drafted so that to the reader they are evidently consistent with Part J. Our comments below deal with this point in more detail.

Structure of draft criteria

The 7 draft "criteria" listed at paragraph 4.13 of the final conclusions as (a) to (g) are a combination of criteria, supporting methodology, definitions and scope. The overriding criterion is at (a), plus (g) when relevant. The scope of the compensation calculation is provided at (b), (e) and (f) and the methodologies for calculating costs and incomes are at (c) and (d). For clarity, it would be more helpful if the key criteria were listed as such and scope, methodology and definitions were supporting statements to the criteria.

Key Criteria

It is important to ensure that there is no disincentive on the parties to the achievement of optimal industry solutions. In the case of a voluntary surrender or adjustment of rights by an operator, the operator has a choice about whether or not it wishes to proceed once the terms have been determined. An optimal industry solution would by necessity mean that neither party should need to face a financial worsenment. However, Network Rail still needs protection that it would not face a net loss as a result. We believe that a new criterion is therefore needed which should explicitly set this out. We also believe that there should be no "ransom strips" which may prevent the achievement of optimal industry solutions. This relates more to the other categories of changes to access rights and we believe this should continue to be considered in the context of network code reform.

The draft criteria specify the period of compensation being 'the remainder of the operator's access agreement from giving up the rights' (4.13(a)) and that 'it should take account of any compensation payments made by the SRA through the operator's franchise agreement' (4.13(g)). There is no recognition of Network Rail's funding control period end date in relation to the track access agreement end date. However, where the track access agreement is to end beyond the current control period and where Network Rail were expected to pay net compensation to the operator, this could lead to an unsupported loss for Network Rail (and therefore breach the suggested key (new) criterion set out above). It therefore follows that either measures of net present value should not be projected beyond the end of the current control period or that a funding mechanism may need to be required for Network Rail's expected "savings" in the future, e.g. eligibility for such savings to be included in the Regulatory Asset Base (RAB). To the extent the ORR concludes that the financial consequences beyond the end of the current control period should be included in the level of compensation the funding mechanism for Network Rail would need to be reflected in the process (e.g. Annex 4 of the final conclusions document). Criterion (g) would also need to

provide for such a funding mechanism, and amended accordingly (e.g. 'it should take account of any compensation payments made by SRA through the operator's franchise agreement and any agreed Network Rail RAB addition in relation to the surrender of rights in question').

The drafting of criterion (a) refers to "expected" loss of profit. Use of "forecast" would be a more appropriate and is more consistent with general business practice. In certain circumstances, there could be a 'gain' in forecast profits for either party so it would be logical for "or gain" to follow the word "loss".

Scope of compensation calculation

Draft criteria (b), (e) and (f) provide the scope of the calculation. We have no comments on criterion (b) – comments on (e) and (f) are set out below in the section on definitions.

Methodology

Draft criterion (c) provides the methodology for determining the baseline for revenue data. The operator is in charge of the timing of proposals and therefore has the ability to apply so as to take advantage of a recent period where special factors may have boosted profit. We suggest that the methodology should explicitly take account of any special factors. Further to this the industry would normally forecast changes in income using demand/revenue Passenger Demand Forecasting Handbook (PDFH) models such as MOIRA (TOCS/SRA use) and SCORES (Network Rail use). It would seem appropriate to reference these key industry tools within the methodology.

Draft criterion (d) specifies the cost areas to be included and the methodology of calculating "avoided costs" at underlying value rather than "precise contractual value". It is assumed that "underlying" means "actual" incurred cost. In business profit terms it is difficult to understand why there should be a difference between the measures – if there is a difference this could be usefully dealt as a definition and explained.

Definitions

Definitions of costs and revenues to be included are contained within criteria (d), (e) and (f). The only explicit definitions are operator activity related but no Network Rail activities are included. It is arguable that definitions should be kept at a high level (costs, income and profits) and let the arbitrator or expert to call for the relevant data. If detailed definitions are to be included they need to be very comprehensive (e.g. also car parking and retail income for example for operators) and explicitly include Network Rail activities too. We would prefer the former approach but with a definition of profit. Profit

can be expressed at many levels - Operating Profit before Interest and Tax through to Net Profit after Interest and Tax. There is also the treatment of Exceptional and Extraordinary Items to be considered in defining profit. We believe the criteria should be specific on which definition of profit should be considered.

Please let me know if you have any questions. I am copying this to John Larkinson at the SRA.

Yours sincerely

John Boon
Access Contract Policy Manager