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Dear stakeholder

First consultation on the station Long Term Charge in CP5

Introduction

1. The purpose of this letter is to begin the process of stakeholder consultation in relation to the structure and level of the station Long Term Charge (LTC) at both franchised and managed stations in Control Period 5 (CP5). The letter also describes our proposed methodology for calculating the charge on the basis of Network Rail's expected expenditure in the next control period and beyond. This letter does **not** relate to other station charges, such as facility charges and charges for qualifying expenditure at managed stations[1].

2. As we set out in detail, below, our proposed changes to the LTC are fairly modest in nature. That said, we are keen to learn lessons from previous periodic reviews, and ensure that there is ample time for the industry to discuss and agree the most appropriate way forward in relation to the LTC in CP5. It is for this reason that we are consulting on the station LTC now.

3. We have set up a series of cross-industry workshops to consider the CP5 station LTC. We will hold the first workshop on 17 October 2012 in Manchester, and a second on 1 November in London. We have been in touch with a number of stakeholders in relation to these workshops. If you have not signed up to date, but would like to the attend one of the meetings, please contact me using the details above.

[1] Network Rail is currently preparing to set Fixed QX in CP5 and hopes to be ready to start informal negotiations with train operators early in the next financial year. The aim of these informal negotiations will be to try and address any concerns before the issue of the formal offer, and reach agreement well before the start of CP5. We are also meeting ORR to outline our proposals and gain their agreement and support.

4. This consultation is one of several being issued by Network Rail over the summer and autumn of 2012 in relation to track and station access charges. These consultations are being issued against the backdrop of ORR's periodic review 2013 (PR13) of Network Rail's access charges and outputs for CP5. The periodic review is ongoing, and ORR's final determinations will be made in the autumn of 2013.

5. Any responses to this consultation should be received by **9 November 2012**. Responses by email are preferred. All responses will be placed on Network Rail's website, and may be quoted in documents issued by Network Rail and other parties. Please indicate clearly if you wish all or part of your response to remain confidential to Network Rail. You may also wish to indicate whether your response can be shared with ORR but is otherwise confidential. Where your response is made in confidence, please provide a statement summarising it, excluding the confidential information, which we will publish.

Current structure of the station Long Term Charge

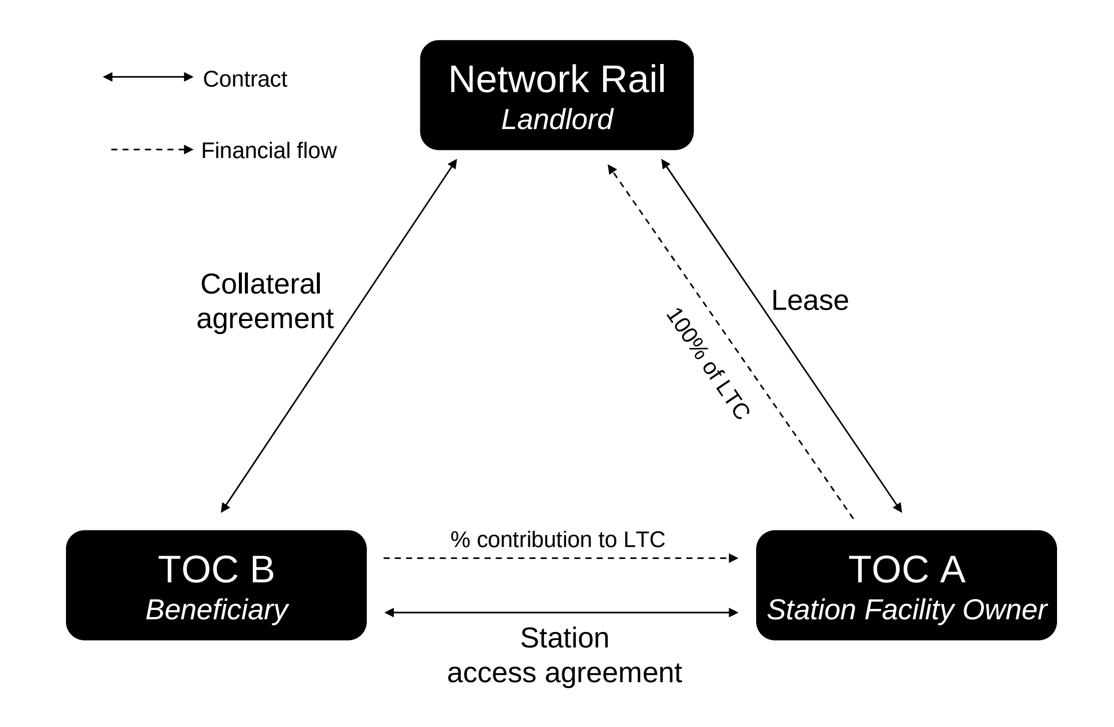
6. The station LTC allows Network Rail to recover the efficient maintenance, renewal and repair (MRR) costs associated with the stations it owns. The LTC is a regulated charge, and is determined by ORR at each periodic review. The current arrangements were developed in PR08 to assist greater transparency of spend for each Station Facility Owner (SFO), and also to support greater involvement by SFOs in station works planning, as part of the integrated stations planning initiative.

7. In CP4, there is a separate LTC for each station, but charges are set so as to provide a reasonable expectation of MMR spend over the course of the control period at the SFO portfolio level. In particular, LTCs for CP4 are based on total expenditure levels for operational property buildings' MRR across each SFO's portfolio of stations within the control period. This total spend figure is disaggregated to individual station level, based on a formulaic measure reflecting, *inter alia*, station size and importance. The CP4 arrangements do not give rise to a direct correlation at an individual station level, between the LTC levied and the anticipated cost of works proposed.

Contractual framework

8. At franchised stations, the train operator holding the lease – the SFO – pays 100% of the LTC to the landlord, Network Rail. The SFO is then responsible for granting access to other train operators (known as beneficiaries) which wish to use the station. The SFO can then recover a proportion of the LTC from beneficiaries, according to beneficiaries' proportion of services using the station. A collateral agreement also exists directly between Network Rail and the beneficiary, under which Network Rail and beneficiaries agree to observe and perform their respective obligations under the Station Access Conditions (SACs). These arrangements are illustrated in Figure 1, below.

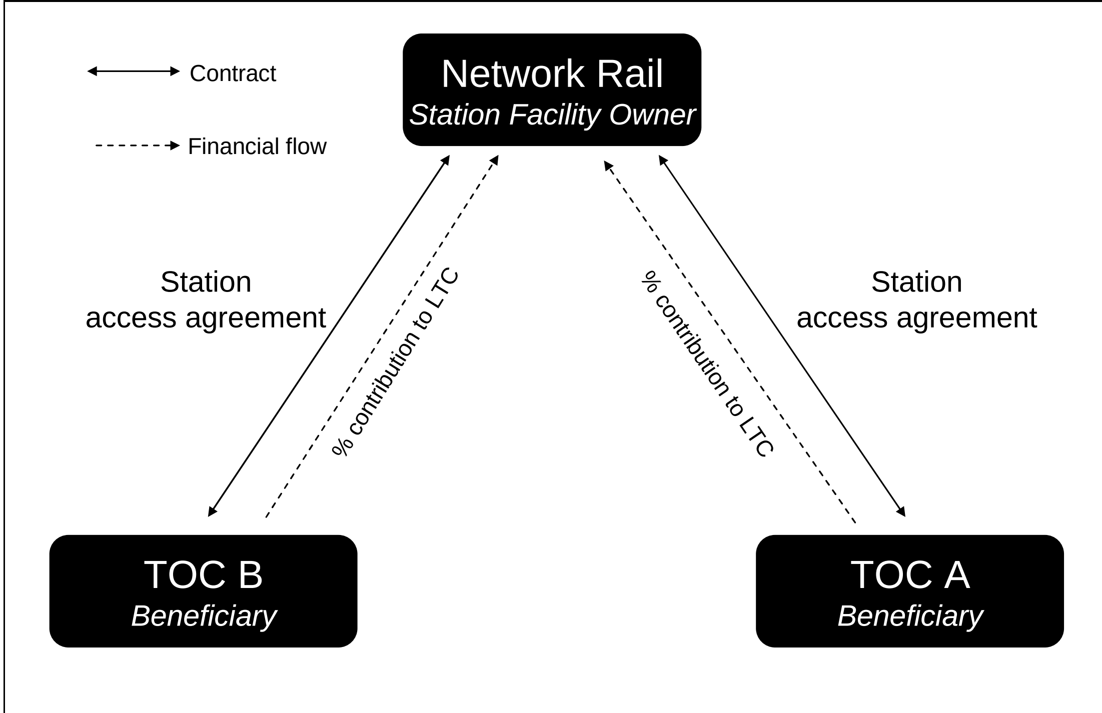
Figure 1 – Contractual and financial arrangements at franchised stations



Source: Network Rail

9. The arrangements are simpler at managed stations. Whilst Network Rail does not operate any train services, it is the SFO for managed stations. It charges LTCs directly to beneficiaries, according to the percentage of services operated at each station. These arrangements are illustrated in Figure 2, below.

Figure 2 – Contractual and financial arrangements at managed stations



Source: Network Rail

Network Rail's overall proposal for station LTC in CP5

10. In our view, the current LTC regime:
    - is well-understood within the industry;
    - provides a direct link between income and expenditure which supports integration of wider works proposals;
    - provides strong incentives for Network Rail to achieve and outperform its financial efficiency targets at stations, whilst continuing to deliver outputs to customers and funders; and
    - is simple to calculate and revise.

11. With the exception of the items discussed in paragraph 12, below, we propose that the structure of the LTC remains the same in CP5. In particular, as is currently the case, we suggest the following:
    - The annual LTC is to be levied at a constant level for each year in CP5, albeit with uplifts for RPI inflation[2].

[2] ORR is currently consulting on proposals under which it would fix *ex-ante* in its calculation of Network Rail's revenue requirement, the assumption for inflation in each year of CP5. It is unclear at present as to whether this mechanism would apply to the charges levied by Network Rail, including

- Property rent per SFO portfolio is not to be netted off of the LTC. Rather it will be netted off in the single till calculation. This means that station income and expenditure is dealt with similarly at both managed and franchised stations, with all train operators contributing to the long term costs of stations that they use.
- That the cost of capital associated with stations should continue to be excluded from the LTC[3].

Consultation question 1
Do you agree that the established LTC structure should be retained in broadly its current form in CP5?

Consultation question 2
Do you agree that the cost of capital associated with stations should continue to be excluded from the LTC?

12. Having reviewed the experience of the past three years, however, we propose making two adjustments to the charging regime. These adjustments relate to the scope of works covered by the LTC, and the manner in which the charge is collected. Specifically, we suggest:
    - the inclusion of station information and security systems (SISS) within the LTC cost base; and
    - a move to portfolio charging (rather than station-specific charging).

13. We believe that these changes will accentuate and consolidate a whole-system, portfolio-centred approach, and reduce administration costs. The full rationale and implications of these proposals are set out below.

Inclusion of SISS costs in the LTC cost base

14. SISS systems comprise customer information screens; closed-circuit television equipment; and public address equipment[4]. They are key components of the passenger experience at stations. Much attention has been given recently to the need for improved means of communication with passengers, and ORR has itself consulted on this topic.

15. For CP4, the costs of SISS MRR were included as part of Network Rail's general telecommunications settlement, and as such were recovered by means of fixed charges. The agreed costs were not reflected in the LTC calculation, which was wholly derived from the operational property MRR totals. With hindsight, this was an anomaly.

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the station LTC. Detail of this proposal can be found here: http://www.rail-reg.gov.uk/pr13/consultations/financial-issues.php.
[3] Network Rail's cost of capital in relation to stations is currently recovered through fixed charges.
[4] SISS does not include assets that relate to track, signalling and other assets located at stations.

16. We propose correcting this anomaly in CP5, for both franchised and managed stations. In particular, we propose that SISS costs are recovered, at the level of the portfolio, by means of the LTC in CP5.

17. We consider that there are particular benefits associated with moving SISS costs into the LTC cost base for SFOs. Including SISS costs within the LTC cost base will:
    - promote cost reflexivity so that costs would fall directly to those SFOs benefiting from expenditure;
    - mean that operators would not contribute indirectly to Network Rail's SISS costs in instances where full or partial responsibility for SISS MRR is transferred to SFOs;
    - afford improved visibility of station works programmes;
    - provide for increased involvement of SFOs in station work planning and prioritisation; and
    - assist financial and equipment migration to SFOs in instances of transfer of stations MMR activities to SFOs in Anglia, and potentially other routes, in future.

18. It should be emphasised that **our proposal of recovering SISS costs by means of the LTC should not affect Network Rail's overall financial settlement, or the overall level of costs paid by franchised operators**. This is because these costs would otherwise be recovered by means of fixed charges.

Consultation question 3
Do you agree that SISS costs should be recovered by means of the LTC rather than fixed charges in CP5?

Portfolio charging

19. The current regime allocates specific charges to each station. These are in turn billed to each SFO at an individual station level, with each station being treated as if it were an individual and free-standing property entity. This does not reflect the fact that franchisees obtain a complete portfolio of stations through the franchising process. Moreover, this process is administratively burdensome for both SFOs and Network Rail, creating the risk of input or payment error. Moreover, it generates complex account statements and the resulting billing queries.

20. We, therefore, propose moving to a portfolio charging structure for **franchised stations** for the LTC in CP5. In particular, we propose that each SFO would receive a single regular charge, reflecting the agreed settlement figure across its whole portfolio. This charge would be subject to RPI indexation. Payment terms would be set in accordance with the agreed mechanisms described in the SACs. For invoicing purposes, the SFO would receive just one charge for the LTC at the portfolio level, rather than one charge for each station.

21. It is recognised that a SFO may need to recover some of the proposed portfolio LTC from users at some or all of its stations. In our view, this could be achieved by providing operators with a percentage breakdown of total portfolio costs by station, which could then be used for purposes of onward charging. This would be based on the long term MRR costs (rather than the within control period costs). An illustration of the information to be made available to each SFO is provided in Table 1, below. Under such an approach, total LTC changes resulting from indexation, or station transfers to other SFOs, could be calculated relative to the opening portfolio LTC position. We note that the proposals therefore involve **no loss of information** relative to the current arrangements.

Table 1 – Illustration percentage breakdown of portfolio costs by station

	Percentage of portfolio
Station A	40%
Station B	20%
Station C	15%
Station D	15%
Station E	10%
Total	**100%**

22. To be clear, we are **not** proposing changes to parties' rights or responsibilities under the SACs. We would envisage contractual changes being limited to amending SACs Annexes so that they present a total portfolio charge, together with a percentage split, along the lines of the table above. Paragraph 3 of Annex 9 would relate, for example, to 5% of £x, where £x is a sum equal to the portfolio figure.

23. We consider that changes to the current billing arrangements, and expression of the individual station charge as a percentage of the portfolio total, would be simple to implement. These changes will require only minor amendments to the SACs, since the charge is recorded and defined in the annexes of the conditions. The present definitions in the SACs are themselves out of date, and the changes described in the preceding paragraphs provide an opportunity to ensure that the SACs remain up-to-date and consistent.

24. From time to time, it may be appropriate to adjust the portfolio-level LTC for reasons other than updating for RPI indexation. Possible reasons for adjustments could include, *inter alia*:
    - changes to the size of the portfolio and franchise remapping; and
    - recovery of station-specific LTC variations associated with enhancement activity.

25. In the case of a change in portfolio size, we would envisage the SFO receiving the new stations would receive an additional portfolio charge, along with a percentage breakdown of costs by station, as detailed below. This would then be incorporated into a single portfolio charge at the next control period. We would expect the SFO from which these

stations were being transferred would see an equivalent reduction in its total portfolio charge, with the percentage breakdown by station recalculated. This would go through the current change processes, with the involvement of the same parties – including ORR – as is currently the case. Any adjustments not relating to indexation will be agreed with operators and communicated in a clear and transparent manner. Not only would this approach simplify the bulk of the SFO charging arrangements, but also highlight more clearly where variations have occurred.

26. For the avoidance of doubt, we propose retaining billing at station level for facility charges, or where new stations are added during the control period, and will retain station-by-station billing for **managed stations**. This will better reflect Network Rail's route structure in light of devolution.

Consultation question 4
As a general principle, do you agree that the industry should move to a portfolio charging structure for the LTC in CP5?

Consultation question 5
Do you agree with the specific approach to portfolio billing described in the preceding paragraphs?

Stations expenditure

27. As set out in detail, below, we propose that LTCs are set so as to recover expected expenditure at stations. Network Rail has gone to considerable lengths over recent years to develop a comprehensive and robust suite of tools for forecasting costs associated with both operational property and SISS at stations. The forecasting approach follows a risk-based methodology, drawing on real-time risk and asset condition data taken from Network Rail's asset management database, OPAS. Unit costs are based on a set of values provided by construction economists Franklin and Andrews, and have subsequently been agreed and used as a basis by bottom-up planners across Network Rail.

28. The forecasting approach represents a considerable step forward compared to the modelling undertaken during PR08[5]. In contrast to the PR08 approach, which was based on a model of steady-state renewals and did not reflect asset condition, the current tools take careful account of asset condition and risk in developing work banks. Moreover, in PR08 charges were based on a 'top-down' spend figure that was then disaggregated to individual station level, based on formulaic measures reflecting, *inter alia*, station size and importance. By contrast, the current approach is 'bottom-up', taking a 'station-by-station' view, and is based on an aggregation of detailed individual projects generated through the application of policy 'on the ground'.

[5] The PR08 approach to estimating costs has been discontinued.

29. We expect that these tools will be exposed to a rigorous auditing process over the course of the periodic review. Although this assurance process remains in its early stages of specification, the most likely scenario is that Network Rail's independent reporters will undertake this exercise on behalf of ORR. In addition, operators have visibility of the CP4 work banks through the integrated station planning process. It is expected this will remain the same for the CP5 work banks.

30. Tables 2 and 3, below, present forecast expenditure levels in CP5 at franchised and managed stations respectively. These figures are on the basis of the Initial Industry Plan (IIP), published in September 2011[6]. These figures are provided for information purposes only, and should be regarded as indicative. These numbers will be updated as part of the Strategic Business Plan (SBP), which is due to be published in January 2013.

Table 2 – IIP forecast expenditure at franchised stations, CP5, 2012/13 prices, £m

		14/15	15/16	16/17	17/18	18/19	**CP5 Total**
Pre-efficient	SISS	35.70	19.83	26.07	5.59	8.60	**95.78**
	Operational Property	134.09	139.93	140.62	138.90	134.09	**687.63**
	Total	**169.78**	**159.77**	**166.69**	**144.49**	**142.68**	**783.41**
Post-efficient	SISS	34.56	18.58	23.64	4.91	7.31	**89.00**
	Operational Property	129.80	131.13	127.56	120.33	112.45	**621.26**
	Total	**164.35**	**149.71**	**151.20**	**125.24**	**119.75**	**710.26**

Table 3 – IIP forecast expenditure at managed stations, CP5, 2012/13 prices, £m

		14/15	15/16	16/17	17/18	18/19	**CP5 Total**
Pre-efficient	SISS	11.72	0.84	7.40	0.19	4.34	**24.49**
	Operational Property	42.05	72.36	32.27	26.61	25.85	**199.15**
	Total	**53.78**	**73.20**	**39.67**	**26.80**	**30.19**	**223.64**
Post-efficient	SISS	11.35	0.79	6.71	0.16	3.69	**22.70**
	Operational Property	40.71	67.80	29.27	23.06	21.68	**182.52**
	Total	**52.06**	**68.59**	**35.99**	**23.22**	**25.37**	**205.22**

[6] The figures for operational property relate to Network Rail's current stations portfolio (including, for example, stations in Anglia, Essex-Thameside and the West Coast franchise). The figures for SISS exclude Anglia. The numbers for operational property are a component of the wider operational property category reported in Network Rail's regulatory accounts. The numbers for SISS are a component of the telecoms category reported in the regulatory accounts.

Translating expenditure into charges

31. We propose that the station LTC is set to recover the efficient expenditure at stations set out in our SBP. We describe, below, how we propose translating the expenditure into LTCs for both franchised and managed stations, and provide an illustration based on IIP projections.

Franchised stations

32. Mirroring operators' past concerns, we consider that LTCs should provide a reasonable expectation of MMR spend across the control period at the SFO portfolio level for franchised stations. We therefore propose the four-step procedure set out in Box 1, below, for converting expenditure forecasts into charges for CP5. This is similar to the approach adopted in PR08.

Box 1 – Proposed methodology for translating expenditure into charges at franchised stations in CP5
Step 1 Establish average annual long term expenditure by station, using the tools described above. We expect that it will be appropriate to compute the average over the course of 35 years (CP5 to CP11). As explained below, this step will be important in providing operators with reasonable long-term cost estimates at the station level, which can then be used by SFOs to charge beneficiaries for the use of stations. *Step 2* Aggregate these annual average costs by station to the level of the SFO portfolio. *Step 3* Apply generic overlays – for both operational property and SISS assets – to reflect SBP end-CP5 efficiency assumptions. *Step 4* Apply an adjustment such that the total LTC paid by each SFO at the level of the portfolio over the course of CP5, is equal to projected expenditure.

33. We consider that this approach is appropriate because it:
    - recognises TOCs' historic concerns with respect to ensuring that charges paid mirror expected expenditure, at least at the level of the portfolio, over the control period;
    - provides SFOs with reasonable estimates of costs at station level which can be used to recover funds from other beneficiaries, and will be necessary if ORR determines that billing by station will be required in CP5; and

- by ensuring that costs are fully recovered within each control period, ensures that there should be no over or under-recovery of expenditure at stations over the long term.

Consultation question 6
Do you agree with the proposed methodology for translating expenditure into charges at franchised stations in CP5?

Managed stations

34. Our proposal for calculation of charges for managed stations is simpler, and is again based on a similar methodology to that adopted in PR08. The proposal is set out in Box 2.

Box 2 - Proposed methodology for translating expenditure into charges at managed stations in CP5
Step 1 Establish average annual long term expenditure by station, using the tools described above. For managed stations, it may be appropriate to calculate the average cost over a longer period to avoid 'lumpiness'[7]. This approach was pursued in PR08. *Step 2* Apply generic overlays – for both operational property and SISS assets – to reflect SBP end-CP5 efficiency assumptions.

Consultation question 7
Do you agree with the proposed methodology for translating expenditure into charges at managed stations in CP5?

35. Ultimately, the LTC will be based on ORR's determination of expenditure at stations, which will factor in its assessment of the scope for efficiency savings in relation to these assets.

Illustration based on IIP

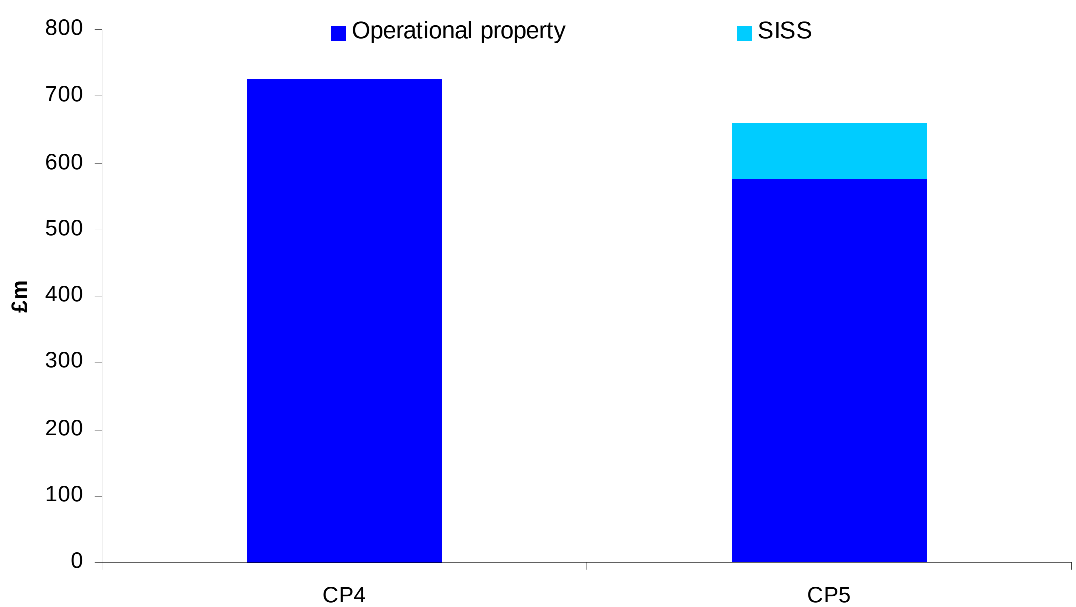
36. Our plans for both operational property and SISS at stations will be finalised over the coming months and submitted as part of the SBP. Until these figures are finalised, it will not be possible to provide stakeholders with proposed LTC figures. However, we recognise that stakeholders may find it helpful to have a high-level indication of the overall magnitude of station LTCs in CP5, and how they might compare to CP4. We

[7] We are currently in the process of developing long term expenditure forecasts at managed stations.

therefore provide aggregate figures on the basis of IIP projections for franchised stations, below.

37. In PR08, ORR's determination projected a Network Rail income from the LTC of £724m in CP4 (2012/13 prices) [8]. On the basis of the IIP and the proposal for calculating LTCs set out in Box 1 above, the broad magnitude of LTCs levied in CP5 is likely to be considerably lower than in CP4. As noted, above, we propose that the LTC is set on the basis of end-CP5 efficiency. On the basis of this assumption and the IIP projections, we would expect to raise £577m in relation to operational property from LTCs in CP5, a reduction of approximately 20% compared to CP4. When SISS costs are included, we would expect CP5 LTC income to be approximately £658m in CP5 (again on the basis of the IIP). Recall, however, that these SISS costs would no longer be recovered by means of the fixed charge, which will be reduced by the same amount. This information is summarised in Figure 3, below[9].

Figure 3 – Comparison of LTC charge base in CP4 and CP5 IIP, 2012/13 prices



Source: Network Rail

[8] *Periodic review 2008: Determination of Network Rail's outputs and funding for 2009-14*, pp 335. Available at: http://www.rail-reg.gov.uk/upload/pdf/383.pdf. The Determination set LTC income at £593m for CP4. Inflating to 2012/13 prices using a factor of 1.222 gives £724m.

[9] The figures for operational property relate to Network Rail's current stations portfolio (including, for example, stations in Anglia, Essex-Thameside and the West Coast franchise). The figures for SISS exclude Anglia.

Transfer of MRR activities to SFOs

38. We recognise that the LTC may not apply in the same way to stations where MRR activities are being transferred to SFOs, for example in Anglia. Subject to cost data being available, we propose computing (but not necessarily charging) LTCs for all stations – including ones that may not be Network Rail responsibility in CP5. Whilst we recognise that LTCs will not be applied in full to these stations e.g. in Anglia, calculating a 'shadow' LTC may prove useful going forward.

39. It may be appropriate for Network Rail to continue to recover sunk capital costs associated with these stations that are embedded in Network Rail's Regulatory Asset Base (RAB). This will help ensure consistency between Network Rail's RAB, portfolio of assets, debt and charges. ORR has recognised this issue and we will continue to discuss this with ORR and funders.

Consultation question 8
What are your views about the LTC in light of the transfer of MRR activities to SFOs on some routes?

Industry engagement and milestones

40. We propose engaging with the industry in relation to resetting the LTC for CP5 through meetings and written consultations. We have set up a series of cross-industry workshops to consider the station LTC during CP5. We will hold the first workshop on 17 October 2012 in Manchester, and a second on 1 November in London. We have been in touch with a number of stakeholders in relation to these workshops. If you have not signed up to date, but would like to the attend one of the meetings, please contact me using the details above. We will also provide regular updates to the VTACs development meeting, which has been set up to discuss and steer all charging issues as part of PR13. We would, of course, welcome suggestions from stakeholders as to how we can best engage with operators in relation to the LTC during PR13.

41. Table 4, below, sets out the principal milestones associated with the LTC work programme.

Table 4 – Principal milestones	
September 2012	First LTC consultation
October 2012	First LTC workshop, update to VTACs development meeting
November 201	Technical work on LTC starts
March 2013	Draft pricelists made available
December 2013	Final pricelists made available
April 2014	Implement new LTC

Consultation question 9
What are your views about our proposals for industry engagement as part of the process to set LTCs in CP5?

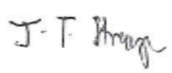
Conclusion

42. This letter is intended to begin the process of stakeholder consultation in relation to the structure and level of the station LTC at both franchised and managed stations in CP5. It also describes our proposed methodology for calculating the charge on the basis of Network Rail’s expected expenditure in the next control period and beyond, and invites stakeholders’ views in relation to this and other matters.

43. We would welcome stakeholders’ views on the consultation questions, or on any other matter relating to the stations LTC in CP5. We ask that responses to this consultation are received by **9 November 2012**. Full details of how to respond are contained in the introduction to this letter.

44. We look forward to discussing the issues set out in this letter with the industry.

Yours faithfully



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