Response to ORR consultation

Network Charges – a consultation on how charges can improve efficiency

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Freightliner Group

March 2016

Introduction

This is the response of Freightliner Group Limited encompassing its subsidiaries Freightliner Limited and Freightliner Heavy Haul Limited to the Office of Rail and Road (ORR) Periodic Review 18 (PR18) consultation *Network Charges – a consultation on how charges can improve efficiency*. Freightliner welcomes the opportunity to respond to the consultation

Freightliner has been working with the Rail Delivery Group (RDG) over the last two years as part of their Review of Charges work programme. This has involved considerable work and engagement and we think that this work has helped to clarify the most important issues that should be considered by the ORR as part of their PR18 review.

Executive Summary

Freight operators are fully exposed to changes in the level and structure of charges, making this is a very important consultation for the rail freight industry.

The productivity, congestion and environmental benefits delivered by rail freight off the railway balance sheet have been valued at £1.6bn per year. The prize for having a competitive and sustainable rail freight sector is substantial and it provides Government excellent value for money. Careful handling is required to ensure that the loss of economic benefits is not greater than any increased charges.

Government has stated its support for the rail freight sector. Claire Perry MP has reaffirmed Government's commitment to work with the sector to help enable growth. The Department for Transport (DfT) and Transport Scotland are developing rail freight transport strategies and these developing strategies recognise the importance of having charges, and a charging structure, that supports growth and captures the benefits of rail freight off the railway balance sheet.

The sector currently faces a number of challenges as a result of the rapid decline of a number of rail freight's traditional commodities, in particular coal for electricity generation. It is more critical at this time that rail has a backdrop that supports competition with road; future growth will be led by sectors dominated by road, in particular intermodal, and a competitive charging regime will be vital to deliver this.

The charging regime is pivotal in the economics of rail freight. The industry is clear – stability, simplicity and certainty, in the level of charges and the charging regime, are required to create a backdrop that facilitates investment, and gives confidence to customers and enables growth.

It is pleasing that the ORR has recognised the complexity and uncertainty created by previous charging reviews as a gap in its consultation.

However, the proposed breadth and depth of changes to charges contemplated in this consultation could result in radical change to both the level and structure of charges for freight operators; this does not address the identified gap.

The consultation of such radical options itself creates uncertainty and instability. The ORR notes the importance of stability; we urge ORR to reassess the charging options with stability in mind. Given that value based charges have been pushed into CP7 there is a risk that the industry will enter a perpetual state of uncertainty.

The introduction of geographically based variable charges for freight services would be very complex. Any increase in complexity of charges is unhelpful in competing with road.

We propose a simple two tier freight charging structure based on a variable usage charge (direct costs) and a mark-up charge where the market can bear it and that the Capacity Charge is incorporated into adjustments to Network Rail's Schedule 8 benchmark. This would align the charges much more clearly with the European legislation and improve transparency for freight operators and their customers alike. It would also reduce complexity for Network Rail, decreasing cost and bureaucracy.

The ORR is urged to consider the impacts of its proposals on the freight transport market, not just looking inwardly to the railway.

The Recast of the First Railway Package and the Implementing Act on direct costs reaffirms the principle that track access charges should be set at the cost that is directly incurred as a result of operating the train service, and mark-ups beyond direct cost can only be charged when the market can bear it. There needs to be coherence between the European legislation and the charging options presented by the ORR; it is not clear from this consultation whether this has yet been assessed.

Freightliner supports the work to better understand Network Rail's costs so that better and more informed decisions can be made. An increased understanding of costs does not necessarily have to be transposed into access charges.

The aim should be clarity on what the charging regime is trying to achieve, bearing in mind over 90% of services are operated by franchised operators, who are largely protected from changes to access charges, and run services that are nearly all reflected in the franchise specifications. The RDG Review of Charges identified that there is little opportunity in the current "State of the World" for network charges to positively influence behaviour.

Most of the changes to charges proposed will only impact <10% of train services; those operated by freight and open access operators.

There are already administrative processes, such as the approval of rights process that can be used to influence behaviour.

Freightliner supports the ORR in not taking forward the value-based capacity package.

OVERVIEW

Government's support for rail freight

The benefits to the UK economy of having a competitive, vibrant and growing rail freight sector are recognised by Government. Claire Perry MP in a speech to the Institute of Civil Engineers, discussed the remarkable growth of the sector since privatisation and the potential to grow further and reaffirmed that the "government wants to work with the rail freight industry to realise that growth"[1].

Both Transport Scotland and the Department for Transport (DfT) recognise the importance of having charges and a charging structure that supports rail freight growth. In its 2015 rail freight strategy consultation Transport Scotland offers "broad support [for] the industry's calls for some degree of long term certainty in the charging regime" and as a result are planning to "revise the Scottish Government Guidance to ORR to better reflect rail freight and the need for a stable regulatory environment to support growth".

The DfT has recently launched their Rail Freight Strategy Advisory Group with the aim of meeting "ministers' commitment to support the growth of rail freight". The 'Charging and support regime' is one of the key pillars of this group and this is looking to, amongst other objectives, to "improve long-term certainty of charging and support regime".

With clear appetite from Government to facilitate rail freight growth and recognition that the charging regime is a central plank in assisting this growth we ask that the ORR is cognisant of how network changes should support these aspirations.

Benefits of rail freight

Rail freight provides efficient logistics solutions to Great Britain's businesses and makes a significant contribution in facilitating economic growth, by increasing the productivity competitiveness of UK businesses. Rail freight also creates benefits to the UK by contributing to the government's environmental targets and reducing congestion.

Across Great Britain as a whole, the productivity gains and the congestion and wider environmental benefits generated by rail freight, are worth over £1.6bn per annum to the UK economy[2]. Should rail freight grow in line with forecasts the economic benefits generated by rail could increase to nearly £4bn per annum in today's money.

The prize for having a competitive and sustainable rail freight sector is substantial and it provides Government excellent value for money. Using the data from Control Period 5 (CP5) review of charges, and taking into account the support received from the taxpayer, net of track access charges paid, rail freight generates between £6 and £25 of benefits to the UK economy for every £1 of taxpayer support. This calculation is shown in Table 1.

Table 1: Rail freight value for money

	High	Low
LEK Avoidable Cost	£311m	£134m
Freight Charges paid to NR	(£87m)	(£87m)
Revenue support (MSRS)	£18m	£18m
Net support to Freight	**£242m**	**£65m**

Economic benefits to UK plc.	£1,649m	£1,649m

1 The remarkable rise of rail freight, DfT, 2015
2 Freight Britain, Rail Delivery Group, 2015

Value for money ratio	6.8	25.2

The reduction in freight volumes resulting from an increase in charges would cause the economic benefits to disappear at a faster rate than the additional costs recovered from higher charges.

This highlights the importance of ensuring that the benefits that fall outside the railway balance sheet are understood when evaluating the future charges and incentives regime.

Scale

Freight charges currently equate to < 2% of Network Rail's total income (including enhancement funding). In this context consideration should be given as to how complex freight access charges should be and whether complexity brings any actual benefits to either the freight operator or their customer or to Network Rail.

Legal framework - European Legislation

When considering network charges and the structure of the charging regime it is important to be cognisant about the aspects of the regime which are prescribed by legislation. We note that in accordance with EU directive EU/2012/34/EU track access charges should be set at the cost that is directly incurred as a result of operating the train service, and that market sectors should not be excluded if they are unable to pay more than the direct cost.

To avoid ambiguity and different interpretations between Member States the Commission Implementing Regulation (EU) 2015/909 was passed in June 2015 on 'the modalities for the calculation for the costs that is directly incurred as a result of operating the train service'. Article 4 outlines which costs are non-eligible costs and therefore cannot be considered in the calculation of direct-costs. This implementing regulation does not appear to be referenced by the ORR in its consultation document.

Any charging proposals should comply with this Implementing Regulation and the impact assessment should consider compliance against this legislation. We note that "fixed costs relating to the provision of a stretch line which the infrastructure manager must bear even in the absence of train movements" are excluded from the definition of direct costs. The legislation is designed to ensure that the calculation of direct costs by the infrastructure manager only includes "costs that it can objectively and robustly demonstrate that they are triggered directly by the operation of the train service" and that those that do not vary with traffic should not be subject to a direct cost-based charge.

Mark-ups above the 'direct costs' are only allowed if they can be borne by the market. The strong competition with road and the low margin returns of freight operating companies suggest that the rail freight sector would be unable to bear such mark-ups in most commodity classes. This is supported by the elasticity work produced by NERA and MDST during Periodic Review 13 (PR13), and was accepted by the ORR.

Understanding the legislative backdrop is crucial when analysing the charges and incentives regime. In considering any cost allocation and subsequent revised structure of charges the ORR should be clear in considering which costs are deemed 'direct costs'. Based on some of the option packages proposed by ORR in the consultation it is not clear from the work to date, that costs are identified as direct or otherwise.

Overall level of charges

This consultation considers predominantly the structure of charges, but not the level of charges. The level of charges is very important to the rail freight industry.

During the PR13 process there was a similar approach by the ORR. In the early stages of the review there was much discussion on structure of charges and this appeared to be broadly acceptable to the freight industry. The costs behind the structure did not become apparent until 2013, and then that it became apparent that access charges could approximately double. This resulted in somewhat of a crisis, which all parties worked on together to resolve, but this was at a very late stage in the periodic review.

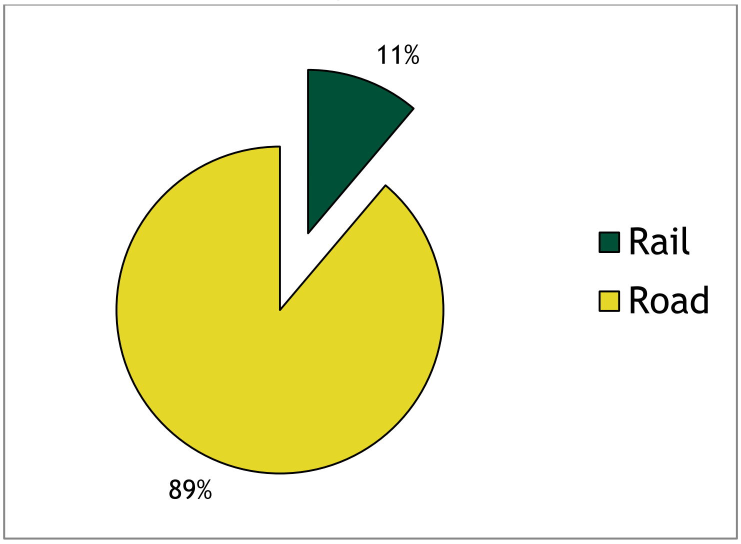
We urge the ORR to consider the level of charges at an earlier stage in the review, and in particular to ensure that there is a holistic approach to the level of charges, rather than considering each type of charge or incentive separately. We suggest that an impact assessment of the holistic impact be undertaken before any changes are implemented.

The market

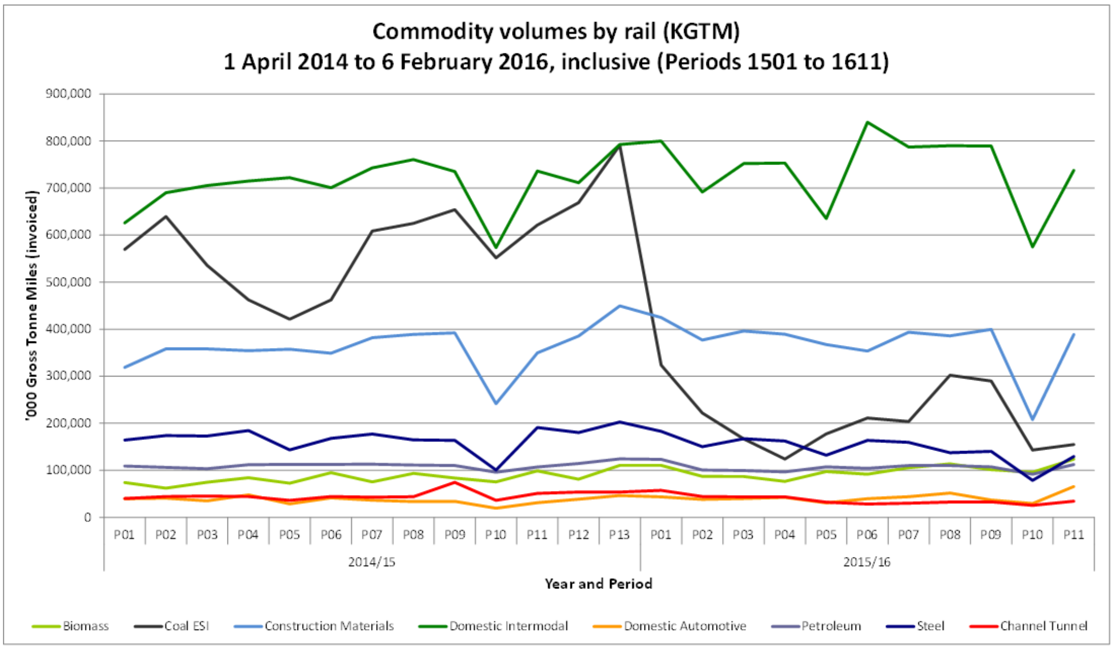
Freightliner, like other rail freight operators specialises in moving goods by rail. However the market in which we operate is much broader than the railway, it is a cross-modal market where customers will choose a mode of transport and a supplier based on price and service quality.

As such there is no such thing as a rail freight market, there is only a freight transport market. Any changes to the level and structure of costs borne by each mode will directly impact on their competitiveness with other modes. In the draft impact assessments this factor has not been adequately taken into account and there are assumptions that a different charging structure will change behaviours on the rail network, this needs to be considered more widely to ensure that cross modal behaviour is also considered and that there are not unintended consequences that impact on modal share.

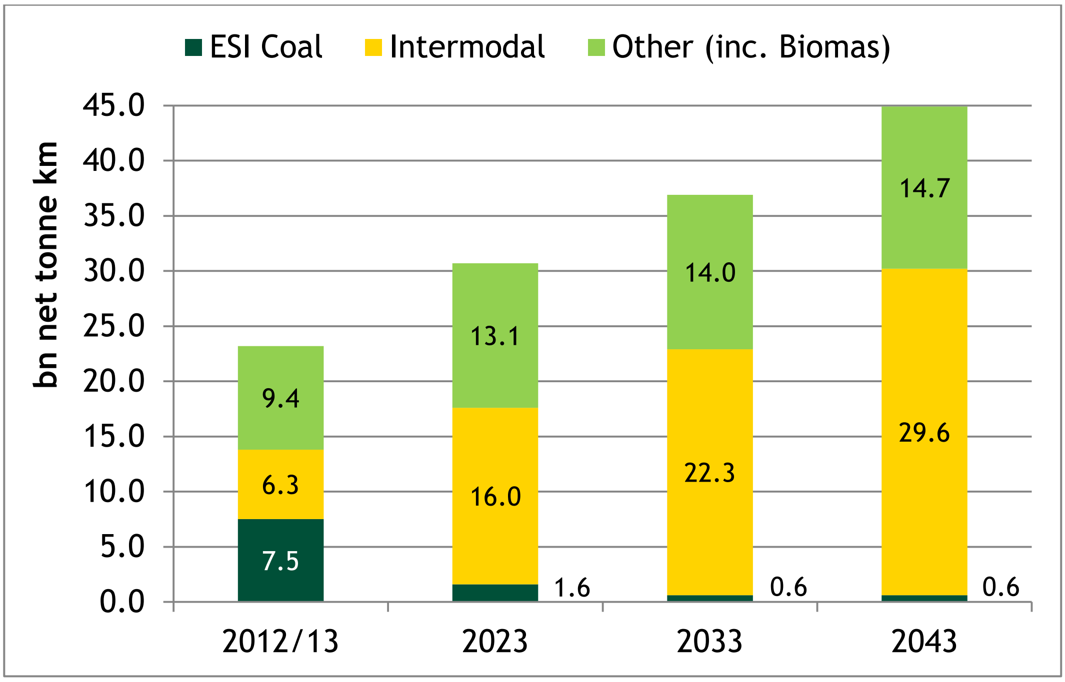
Mode share of surface freight market - Source: DfT



Until recently there have been some commodities moved by rail, where the rail mode could be considered captive, particularly the movement of coal for electricity. This was reflected in the Control Period 5 charges when there was a mark-up on these commodities, through for example the Freight Only line Charge and the Freight Specific Charge. However the coal market is now in a major structural decline; year on year volumes have dropped by some 70% - see below graph. This trend is likely to continue as all coal-fired power stations are scheduled for closure by 2025.



However against the backdrop of a declining coal market, the projections in Network Rail's Freight Market Study highlight a tremendous opportunity for rail freight and suggest that, with a positive environment, rail freight volumes could double over the next 30 years. These unconstrained forecasts are clear - future growth will largely be driven by the intermodal sector. See below graph:



The decline in traditional markets will see rail freight increasingly competing in sectors which are dominated by road, making it more important than ever before that the cross-modal impacts of any revision to the level or structure of access charges for rail freight operators is carefully considered. There is a real risk that changes to the charging regime could distort the transport market in favour of road and lose the benefits of rail freight that fall outside the railway balance sheet.

Against this backdrop, and particularly in light of the addition of Highways England into the ORR's portfolio, we urge ORR to properly consider the impact that network charges have on the cross-modal freight transport market.

Supporting rail freight

As discussed above, the structural changes within the rail freight sector make this a critical time for the industry. It is important for the industry that the periodic review process does not create additional shocks on top of the challenges already evident within the sector. Stability and simplicity are repeatedly highlighted as being key attributes of a charging regime that supports rail freight and we urge the ORR to strive for this, in line with the complexity gap identified by the ORR in the consultation document.

S***tability***

Following the destabilising PR13 process the need for stability in the industry is well supported. Transport Scotland in its rail freight strategy offered broad support for the long-term certainty of charges. In this consultation the ORR allude to the instability created in the last periodic review process.

In that context it is disappointing that the ORR is considering a **radical** change to access charges (and by inference the level of charges) paid by rail freight in the PR18 process.

Instability over the future level of access charges and the effect of these charges for customers is unhelpful in re-assuring potential new customers that rail should be their mode of choice and might lead to investments being made outside of the UK due to perceived risks as a result of the continued uncertainty.

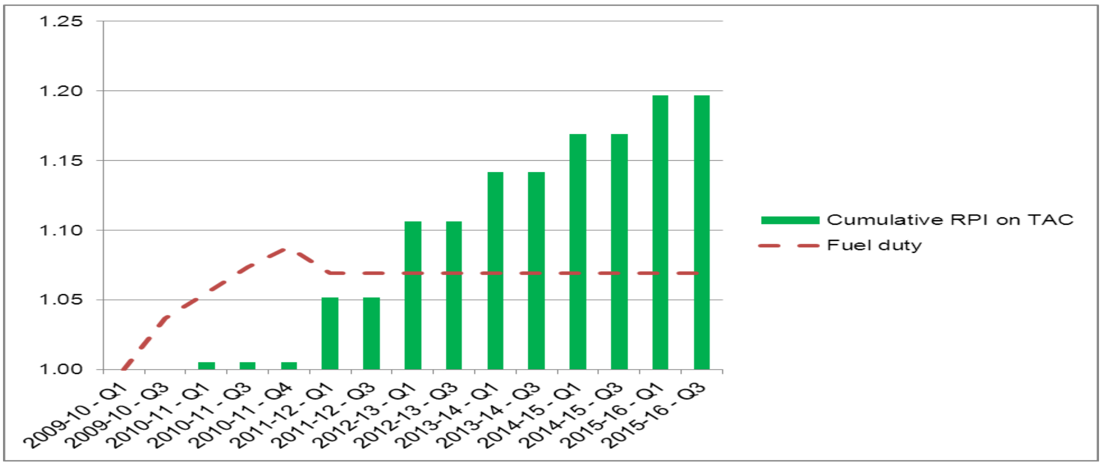
The industry had hoped that PR13 would have marked the beginning of a period of stability in network charges, however based on this consultation this does not appear to be the case. We are struggling to accept the case that future predictability of charges would be more certain after CP6, especially as options for possible value-based charging in CP7 have been identified. It is difficult to understand how another round of structural upheaval will lead to stability.

Simplicity

Changes to the track access charges for rail freight should consider the cross-modal implications of any change, reflecting the impact on the wider market rather than just focusing on how rail operators could change behaviour on the railway. With the addition of Highways England into the ORR portfolio the ORR is better positioned to consider the cross-modal implications of network charges in this periodic review process.

Road hauliers benefit from very simple charges for using the UK road network, paying an annual VED charge per lorry and fuel duty on diesel. Rail operators already face a far more complex set of charges paying a variable track access charge, a capacity charge, coal spillage charge, freight only line charge, freight specific charge, electric asset usage charges, connection charges, fuel duty as well as facing other compulsory costs not borne by the road operators, such as a statutory requirement to have £155 million public liability insurance, British Transport Police fees, access dispute committee levy, delay attribution board levy, RIDR levy, CAHA levy, and RSSB charges. Rail has to interact with many more stakeholders with varying complexity and administrative burden.

The graph below shows the increases in fuel duty compared to the RPI increases that have been added to track access charges since 2009. This excludes the approximately £25 million a year increase in track access charges that will be applied by 2018/19 following the PR13 final settlement (as assumed in the Final determination for CP5). Even without any changes to track access charges during the periodic review process the charges paid by rail have risen by 12% more than fuel duty since 2009.



Freightliner suggests that the current charges for freight could be simplified, without causing too much disruption to the market or affecting the behaviours currently incentivised, i.e. track friendly rolling stock.

We suggest that:

- Coal spillage charges and electrified asset charges are merged into variable charges where appropriate (technically the coal spillage charges is not cost reflective because it is charged per tonne mile instead of per tonne. Of course coal can only fall off the wagons once, however given the vastly reduced size of the coal market it is not worth spending a lot of effort revising this).

- Freight Only Line, and Freight Specific Charges are merged to create a mark-up charge, which contributes to fixed costs where the market can bear such costs

This would result in a far more simplified structure of two charges, and would align the charges much more clearly with the European legislation and improve transparency for freight operators and their customers alike. It would also reduce complexity for Network Rail, decreasing cost and bureaucracy.

Certainty of charges

The current five-year charging periods can create unnecessary uncertainty in the sector, and we suggest that longer term regulatory and charging regimes offer greater certainty. The ORR's policy on access agreements recognises the importance of granting 10-year access agreements to provide the certainty needed to support investment – indeed the ORR have recently approved a new 10-year track access contracts for several freight operators from December 2016.

We argued that a ten year access framework is just one of the key elements to deliver an environment that provides confidence to customers and enables investment. Certainty in the long-term charging regime and over future track access charges is another key plank in creating an environment which enables investment.

In that context, the current 5-year cycle of setting access charges does not dovetail well with the long-term investment required in assets. In contrast road operator charges for use of the road network are stable; fuel duty has been frozen since March 2011, but before that changes made were minor tweaks. Fuel duty is also dis-connected from the actual cost of the road network.

We would therefore urge the ORR to consider a framework for freight track access charges, which creates an environment where investors have confidence that significant changes are not under consideration, to enable growth in rail freight and modal shift from road.

We ask that the ORR consider setting freight access charges for at least a 10-year period or even into perpetuity (like road) until a material change is deemed necessary for a particular reason, for example the introduction of road charging, and only then if that change has a positive impact.

We recognise that a transition period of changes to charges has been helpful in previous control periods and is a tool that can be used to help businesses prepare for change. It can however add to complexity and uncertainty.

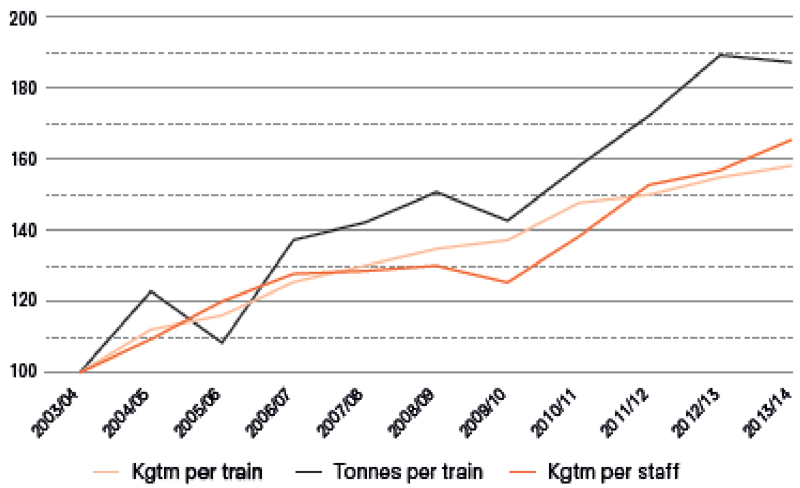
Investment

Stability and certainty in the long-term charging and regulatory regimes is important for freight operators to be able to plan the future of their businesses with a reasonable degree of assurance and is essential for operators, customers and third-parties to make investments in their logistics chain to increase the capability of rail freight. Investment needs to align over all these entities to deliver modal shift to rail.

Investments from all parties have been crucial in growing rail freight volume across Great Britain by 80% since privatisation and continued investment from all parties will be required to drive further efficiency and performance gains and grow volumes. However, in order to convince new customers to make rail part of their logistics chain they need to have certainty over costs. Use of rail often requires investment by the customer, operator or a developer in rail connected terminal facilities or systems and sometimes requires a change to the existing supply chain and how it delivers. In parallel, operators will also need to invest in rolling stock as well as training staff. Investments of this type are long term, for instance the asset life of locomotives, wagons and cranes is typically 30 years. In contrast road lorries have a typical asset life of 7-8 years. Newly recruited rail drivers take 1 year to become productive versus a few weeks for lorry drivers.

Since privatisation rail freight operators have invested over £2 billion in rolling stock and other long-term assets. This investment has driven reliability improvements and efficiency gains. According to work undertaken by KPMG on behalf of the Rail Delivery Group – Freight Group £1.1 billion[3] of productivity gains a year have been created by the rail freight operators, much of this as the result of this investment. See below graph showing productivity achieved by rail freight operators since 2002/3.

3 Freight Britain, Rail Delivery Group, 2015



Indexed rail productivity (2002/03 = 100)

Sector Profitability

The rail freight sector is a very low margin sector; in 2012/13 the five largest operators made a profit before tax of £27 million[4]. The on-going structural changes within the industry as a result of the decline of coal will inevitably led to a considerable reduction in revenue and further challenge the profitability of the industry. Ideally, changes to access charges should be kept to a minimum to not create any additional shocks during this transition and restructuring period.

In that context it is important to consider both the level of charges as well as the structure of the charging regime. Any increases in track access charges could have a serious impact on the viability of the future of the players in the UK rail freight industry as increases in costs are very difficult to pass on to the customer and inevitably are borne, at least in part by the supplier – in this case the rail freight operator.

Any increase in track access charges would risk a future shrinkage in the size of the UK rail freight market and potentially a reduction in the number of competitive players. Increasing charges would also reduce the economic benefits generated by rail freight at a faster rate than the additional track access charges are recovered.

National Charges

Rail freight charges are currently based on an average national charge. We would be very concerned if a system was introduced that resulted in different charges on different routes, that added complexity, but actually resulted in no benefits to either the rail freight operator or Network Rail.

Route or area based charging, would not only make calculating the charges and therefore quoting prices to customers much more difficult and time-consuming, but would also result in investment needed by Network Rail in complex billing procedures, as freight trains traverse many different routes/areas.

Complex rules would have to put in place to manage trains that were diverted off their normal route in times of perturbation, and during engineering work on a planned and unplanned basis.

4 Keeping the lights on and the traffic moving, Rail Delivery Group, 2014

As the choice of route for a freight train is determined on the basis of customer demand, available capacity and network capability, such as gauge clearance and maximum load it would be rare that differential route or area access charges would be able to influence which route is used by a freight operator. Therefore the introduction of such charges will have limited impact, whilst increasing bureaucracy and exacerbate what is already a complex regime. We urge the ORR to conduct an impact assessment which considers what percentage of trains that could actually be re-routed, and what benefit this is expected to bring, before considering introduction of geographically based charges.

There is no indication that the government is considering, or indeed likely to introduce a road charging system for lorries, or route differential charging. Therefore any geographically based charge on the rail network would likely undermine the competitiveness of rail freight and should only be considered if there is an equivalent system on the road network. This is especially important in the context of the structural changes in the rail freight sector that will see rail freight increasingly competing directly with road.

Purpose of charges - who is being incentivised?

The market and regulatory regime in which the franchised passenger operators operate is of course completely different to that of freight operators. Currently franchise operators (who run over 90% of the trains in Britain) are largely protected from changes to access charges. The train specification in current franchises is heavily specified by governments and the operators have little flexibility in choosing where and when to run services. The RDG work identified that incentives are unlikely to result in any material change in behaviour from franchise operators.

Similarly any changes over time in the access charges due from franchise operators will be reflected in the revised income that they receive from the DfT. These changes will be reflected in the changes to the Network Grant currently paid by the DfT to Network Rail. There will be no net difference in the money paid by Governments.

Care should be taken not to make changes where the real impact will only affect the < 10% of operators that are not franchised. The inability to use charges as a mechanism to positively influence behaviour was clearly identified as a key issue in the RDG's Review of Charges.

Background and Approach

The ORR has identified 4 gaps in the current regime:

1) **The existing charging structure has limited ability to drive down costs, encourage efficient decision making and to achieve value for money.**

We agree that the existing charging regime has limited ability to drive down costs. As the ORR is aware, it has only really been the freight operators who have challenged Network Rail's cost base during past periodic review processes. Whilst franchised operators are protected from changes in access charges through their franchise agreements it is very difficult to see what impact any change to the access charges would have in this area. We do not understand how dividing up the fixed costs in a different way will, by itself,create the desired outcome.

We do strongly support work by Network Rail to better understand their cost base and the cost drivers in a more aggregated way. Having this data available will enable better decisions to be made, and a better understanding of the cost base will help identify opportunities to drive down costs.

However it should also be recognised the difficulty that Network Rail will have in understanding their cost base with a high degree of accuracy. This point was acknowledged by Hendy who argued that the unknown condition of assets “gives surprises when works are carried out in places undisturbed for many years”. He used the Great Western Electrification as a case study to highlight how significant cost overruns and delays can occur when the condition, or even location, of assets is not known at the outset. These challenges underline the difficulty of accurately calculating Network Rail’s cost base. Working towards a better understanding of the cost base for informational purposes is nonetheless an ambition we support.

A good example of when having a better understanding of the cost base would be beneficial is when Network Rail propose a Network Change. There is rarely any financial information included in the proposal. If Network Rail clearly and transparently articulated the cost saving they would make by implementing the proposal and what other options they had considered, with corresponding costs, it would put pressure back on the operator to make an alternative financial case if they felt unable to support the proposal.

We note that the Route Efficiency Benefit Sharing (REBS) scheme that was introduced for CP5 was opted out by all but one operator in the country. This type of scheme could have some merit but clearly needs to be reviewed to ensure that it is taken up by the train operators. An upside only scheme at the margin could incentivise and capture the benefits of cost savings and would enable participation by all operators.

2) **the existing charging structure falls short of providing specific and strong incentives for the efficient provision and use of the network**

We agree with the identified gap. However it should be noted that there are other administrative mechanisms that do support choices about use of the network. These include the approval of access rights by the ORR, and use-it-or-lose-it and rights review clauses, in part J of the Network Code. It should be noted that economic levers are not necessarily the best way to incentivise better behaviour, especially if genuine choice is limited or imperfect information exists. There is a risk that too many economic levers can cancel each other out so failures persist.

Over 90% of the trains that operate on the network are franchised services where the train specification is heavily specified by government. Unless there is a radical change in franchise policy going forward, which at the moment has not been indicated (and even then it would take a decade to fully take affect), there would be no or very little impact on these services by having a charging structure that incentivised efficient use of the network.

Freight operators would be impacted by the introduction of charges that encouraged efficient use of capacity. It is difficult to see how this could be done without making charges even more complicated and/or increasing the total charges paid versus today.

If a charging system that encourages efficient use of capacity were to be introduced it should also consider the loadings on a train. Is a one car passenger train with a handful of passengers on board that runs every day more or less valuable than a freight train with 30 wagons that runs in a path three days a week? We would expect the ORR to account for utilisation of network capacity holistically, not just count whether a train runs or not.

Particular rail freight sectors would be impacted by such charges, for example the aggregates sector. Specific services may only run 2 or 3 times a week, depending on the turnover of the terminal. If paths had to be paid for on the days of the week that the train did not operate, this would increase the overall cost of rail, and potentially lead to modal shift to road, and a loss of the off-railway balance sheet benefits.

There is already a Rail Delivery Group – Freight Group work-stream that has been reviewing under-utilised freight paths. Freight operators have to date voluntarily relinquished 2,479 freight paths and 687 of these have been converted to Strategic Capacity.

Strategic Capacity

There are more gains that could be made in this area but there needs to be a greater focus on making the Strategic Capacity process work properly and also on creating additional Strategic Capacity on key freight corridors.

Why do we need Strategic Capacity?

Freight services operate in reaction to demand whilst passenger services operate in anticipation of demand.

In order to optimise the timetable freight and passenger services should be planned at the same time

By identifying standard freight paths in off-peak timetable hours on key routes when existing services are not timed, spare capacity in the timetable can be identified for freight.

There are many benefits to identifying such capacity for freight:

1. it gives confidence to customers and operators that capacity is available for growth and will support private sector investment in rolling stock, terminals etc.,

2. it enables the timetable to be optimised at the planning stage,

3. it would ensure that the planned benefits from investments such as through SFN are realised,

4. it will create a better base for future long term planning of infrastructure by enabling better understanding of what spare capacity is available for future freight services,

5. where paths are identified they can be used for short term and very short planning - saving time for both Network Rail and planners as the paths are already validated against the rest of the timetable,

6. the spare paths can be used as a performance buffer, allowing late running trains to be slotted into them - providing a pre-canned validated path, and

7. if operators are confident that spare capacity exists on key corridors they will be more open to giving up under-utilised paths in their own portfolio of access rights. This will help to create a virtuous circle of better-utilised capacity

There are several challenges at the moment which mean the process is not working properly:

At the start of the process not all of the paths were validated against the timetable and this has caused some issues when operators have bid for paths that subsequently transpire not to be valid. This has led to a lack of confidence in the process. Work has started to validate the paths by Network Rail.

The list of paths has not been developed in a strategic way but is based on what has been given up so far. A process where spare capacity on key routes is managed more strategically is needed.

The paths are not contractually protected - some important paths have been bid through by passenger operators and have disappeared- also leading to a lack of confidence in the process.

The DfT is setting up a working group to develop Strategic Capacity as part of their Rail Freight Strategy

Any changes in the charging structure designed to incentivise the efficient use of the network, e.g. through reservation charges, need to be supported by a reliable and dependable strategic capacity process.

3) The existing charging structure may not support effective competition between different types of passenger operators.

This gap is correct but we would suggest that this is a much wider topic than just how charges are structured.

The RDG Review of Charges through its States of the World analysis considers this issue. The competition is considered most effective during the franchise bid as margins are deemed to be unattractive without exclusivity for an extended period. Changing this requires DfT buy-in, without which it should not be considered within this consultation.

4) Charges have changed at control periods in a way that has created uncertainty for users of the network.

We agree with the ORR's identified gap and are pleased that the problems caused by the last periodic review process have been recognised. It is unclear how this identified gap is consistent with the radical structural review of charges that is being proposed by the ORR in this consultation.

Freightliner urges the ORR to only make changes to the structure of charges if there is a very clear reason, and a calculated benefit, in doing so Freightliner encourages the ORR to simplify charges for freight, rather than further increasing their complexity, which is contemplated in the consultation.

Questions

To what extent do the packages of options represent the key strategic choices to improve the existing charging structure?

Freightliner does not support the strategic choices proposed in the consultation to change the charging structure. We do support work to understand better the costs and cost drivers of the rail network on a more aggregated and transparent basis and also get a better understanding of the values on and off the railway balance sheet of different types of services.

We strongly support the notion that more work should be undertaken by Network Rail to understand their cost base and the drivers of costs. Notwithstanding the difficulties highlighted above in accurately calculating the cost base, there is currently a lack of data available and very limited transparency surrounding cost data. Before any allocation of fixed costs is contemplated this data should be made more transparent. It would seem unlikely that such data will be available on a line by line basis, as contemplated in time for it to support the PR18 process.

Careful thought is needed as to what is meant by fixed costs. Different lines are in very different conditions, much of which is related to their historical status and investment profile going back over many decades. It is unclear whether the proposed allocation of fixed costs would be forward or backward looking or both, and over what time period fixed costs would be considered. The lines that have historically had little investment may be more expensive going forward.

Some routes, for example may have bridges or tunnels that were built up to 190 years ago that now require complete refurbishment or replacement. Other routes may be built on challenging ground conditions where once in a hundred years major stabilising is required. Many costs, such as the above examples, may not even be known at a fixed point in time and are related to local geography and geology rather than being costs that can be directly compared between line sections.

Understanding that the railway is a very long term infrastructure network is important. It is unclear what the benefits are of allocating long term costs on a line section by line section basis to specific train services, when they may vary widely.

Fixed costs can be allocated by many different methods and 10 economists would be likely to come up with 10 different theories. Great care is needed not to cause unnecessary rail industry displacement from the arbitrary allocation of fixed costs to different flows of traffic.

During the PR13 process Network Rail employed the consultant LEK to undertake some work to evaluate freight avoidable costs on a network wide basis. This work was useful in giving more transparency to the DfT and Transport Scotland in understanding the costs that could be saved in theory over the long term if there was no freight on the rail network. It would seem more appropriate to update this more modest piece of work for freight rather than try to allocate every fixed cost across the country to an operator.

We note that in accordance with 2012/34/EU and the associated implementing act on direct costs, fixed costs are not eligible as direct costs and can only be charged if the market is deemed to be able to bear it. This has not yet been part of the ORR's impact assessment work.

Would you expect the infrastructure costs package to deliver more (or fewer) benefits than the value-based capacity package at this stage and, if so, why?

The greatest benefit from Network Rail better understanding its cost base would be the better decision-making.

Allocating fixed costs to different operators would not make any difference in itself given that franchise operators are protected from changes to charges. Incentives within the franchise agreement or a upside only benefit sharing scheme would both in our view bring greater benefits (providing that any benefits could be retained by franchise operators).

We do not understand the ORR’s rationale for intervention that “Cost-reflective charges would also send better signals to Network Rail and its customers around the provision and use of the network capacity.” As many costs of a rail network are fixed, and often vary because of geographic and geological differences, the key driver of unit costs is likely to be the number of trains operating on a route. It is highly likely that the unit costs per train will be much lower on busier routes than on less busy routes – this would in theory encourage more use of busier routes and less routes of quieter routes.

In the example described by the ORR, it is likely that the per train costs of the Brighton to Eastbourne route will be much more expensive than the per train costs of the Brighton to East Croydon line. So as a consequence, the unit cost would fall on busy routes theoretically attracting more traffic, thereby increasing congestion and generating further administration or an economic lever to rectify.

As such it is unclear to us what positive behavioural change would occur if these costs were allocated.

What costs and benefits do you see with the infrastructure costs package? Do you think our draft impact assessment is missing any significant impacts or has misrepresented the impacts?

We agree that better cost information will help to support better decisions and will help Network Rail to reduce costs. DfT/ORR 'nudging' in this area could produce benefits but to properly harness savings a reformed efficiency benefit sharing scheme could be developed.

It must be recognised that operators only have limited control to influence Network Rail's costs. And therefore there is little benefit in exposing operators to charges which reflect all the infrastructure costs.

The required data is not available at the moment and as discussed above there are challenges to calculate it with a high degree of accuracy. Until the industry is confident in the quality of Network Rail's data on costs, we do not support whatever data is available being allocated as charges. We must have confidence in the data first.

There are many different ways in which fixed costs of a network could be allocated to train services, none of which are necessarily right or wrong. Given the fixed nature of the rail network, care is needed not to cause displacement of train services for no benefit, as the fixed costs are still there.

With regard to freight, any allocation of fixed costs cannot be automatically charged but should be considered in relation to a market can bear test in line with the EU Regulations. A 'mark-up' can only be charged on the basis of ability to bear such a charge. We suggest that the freight avoidable cost work undertaken by LEK in PR13 is used, and or updated, to allocate avoidable cost to the freight sector. This is a very different proposal to the full cost allocation contemplated in the consultation.

We note that the Impact Assessment discusses 'compensating' freight via a Government grant. Further work is required to clarify how such a grant would be paid without creating longer-term uncertainty for freight. We note that the Mode Shift revenue Support Grant (MSRS) needs to receive State Aid clearance every few years, and must compete for budget at every Comprehensive Spending Review. This creates a great deal of uncertainty for rail freight operators and their customers and it is crucial that a scenario where operators are compensated via a grant does not further increase this uncertainty, and is carefully considered. A solution via the charges framework would be the best solution.

To what extent do you think the benefits of this package can be realised by more information rather than the use of charges?

Freightliner is of the view that much benefit can be realised by Network Rail properly understanding their cost base and this being transparent to the rest of the industry.

For example when Network Rail is contemplating choices that impact on engineering work timings and locations they should be sharing their options and the costs with operators to enable decisions. We understand that this is work in progress but we have not yet seen this working in practice.

An upside only efficiency benefit sharing scheme would be effective in incentivising cost savings. This could happen without the complexities of allocating fixed costs on a line by line disaggregated basis, but can be approached at the margin as opportunities arise.

What costs and benefits do you see with the value-based capacity package? Do you think our draft impact assessment is missing any significant impacts, or has misrepresented any impacts?

We agree that the ORR is correct not to take this work forward for CP6. It would be both complicated and costly to establish a methodology that directly links charges to the value of capacity.

The theory behind this work simply does not apply when there is no open market for rail services. Franchised passenger services are heavily specified by the government and for freight, the rail sector is only part of the freight transport market.

We note that the ORR includes social benefits in its suggested value calculation but it is unclear how or who would actually pay these values to Network Rail as they fall outside the railway balance sheet.

We do however support further work on the relative values of different types of services, including the benefits that accrue off the railway balance sheet. Better understanding the relative value of different capacity options would enable improved decisions on the allocation of capacity and improve transparency. We suggest however that these calculations are not used to inform the charging structure.

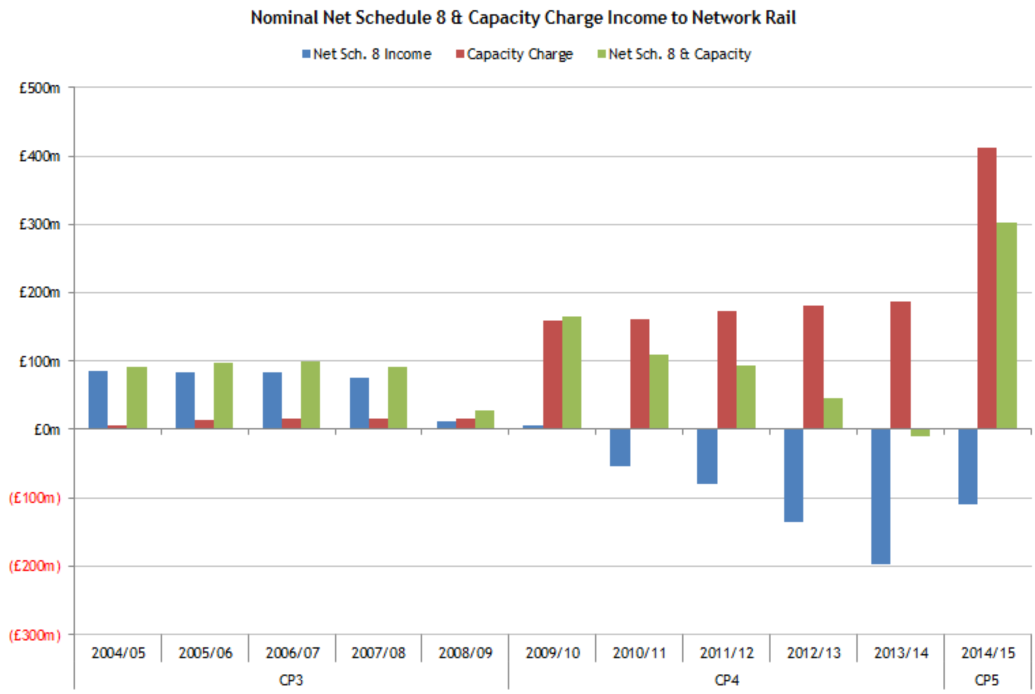
<u>Capacity Charge</u>

The RDG work programme has identified an industry consensus that the Capacity Charge should be reviewed. It is not clear from the consultation document whether this is the intended case. The Capacity Charge is ill-named and does not relate to value as described by the ORR, but it is related to additional Schedule 8 costs occurring when there is increased use of the network. The current Capacity Charge is fundamentally flawed as it over recovers the actual costs (the charge recovers the marginal cost for the next train, for all trains, not just over a prescribed baseline).

One of the strong recommendations coming out of the RDG Review of Charges work was to review the Capacity Charge. At the end of the PR13 process the industry had to agree a sub-optimal solution for the Capacity Charge for CP5 because time had run out to review it properly.

We strongly urge the ORR to consider the Schedule 8 Performance Regime and Capacity Charge holistically. We have consistently contended that the current application of the Capacity Charge over-recovers against this liability and requires a fundamental change for it to deliver against its stated function (see below graph).

The charts below illustrates our view of the over-recovery to NR since CP3 against both passenger and freight operators - cumulatively, £1.1bn since start of CP3.



Source: NR Regulatory Financial Statements

Within the current Schedule 8 the Freight Operator benchmark is already adjusted annually to take into account the total change in all train network mileage against the previous year. This is a simple adjustment and we see no reason why a similar adjustment could not also be applied to the Network Rail benchmark annually. This would be straightforward and would avoid the current over recovery that Network Rail makes from the Capacity Charge. We have previously submitted an explanatory note giving background to the RFOA proposal, please see attached as Appendix 1. We remain of the view that the RFOA proposal is the only technically correct and economically pure version of the capacity charge.

<u>Volume Incentive</u>

The current volume incentive scheme appears to have no impact on Network Rail and should be reviewed. While it is very important for Network Rail to balance the trade-off between performance and capacity, this would be best considered within its regulatory targets. It is unclear how a financial target would actually provide a real incentive on a company wholly owned by government.

Due to the focus on performance based regulatory targets, Network Rail staff are very focussed on performance and improving utilisation of the rail network and optimising the timetable is not a core priority.

In the role of System Operator there should be targets on network efficiency that have as much weight as performance related targets, in order to rebalance the equilibrium.

Would you expect a better understanding of costs to be an essential precursor to value-based charges?

No; value-based charges are about the value of the service, not the cost of the infrastructure. Charges are recovering direct costs incurred not market pricing.

To what extent do you think the benefits of this package can be realised through more information alone, without passing that into charges?

Information about value of rail services on and off the railway balance sheet could enable better decisions about allocating rail capacity. This could be done through the capacity allocation process and does not require an extremely complicated charging system to enable it.

What options would you expect to see in a long list of improvements to Network Rail's short-run variable charges?

What options do you see as a priority for this package

The current Capacity Charge is flawed and should be completely reviewed, as discussed earlier.

As discussed above, the current volume incentive scheme appears to have no impact, is not understood by most staff and it is unclear what happens to the money, even if Network Rail over-achieve in this area.

However, we do recognise the need for Network Rail to be incentivised to make the best use of capacity and to increase the number of trains that both bring in revenue and value off the railway balance sheet. At the moment regulatory targets are very much weighted to performance and a better balance is needed between performance and efficient use of capacity.

VTISM is not transparent or easily understandable to operators. We would like to understand more about how this model works, and what influences its outputs.

Freightliner previously raised some questions about the VTISM model that were not addressed in the PR13 process. We submitted a report from TTCI to Network Rail, and copied to the ORR on 11th February 2013; we request this is considered and further work is undertaken to ensure that VTISM is reviewed. A copy can be supplied if required.

Transportation Technology Center Incorporated (TTCI) is the parent company of TTCI (UK) Ltd who undertook work on understanding track damage mechanisms and the pricing of such in CP4 on behalf of the Network Rail and can be considered experts in this area.

TTCI identified several areas in the Serco report that warrant further investigation including the regression analysis. The resolution of any of the queries raised could potentially have a large effect, particularly at the extremes of the factors considered, e.g. fast or slow operating speeds or at high or low un-sprung masses. The report recommended that further analysis is undertaken in the following areas:

- The data sampling method to select the routes and their representation of the population of track in the network.
- The period used to calculate average traffic and tonnage.
- The values for each of these operating conditions selected.
- The correlation between the three vehicle factors - axle load, operating speed, and un-sprung mass.
- Review accuracy of the model, particularly at extreme values of the factors.
- Further analysis on the normality of the residuals and variation of the fits versus the residuals.
- Review of the underlying data to understand the best-fit lines on the charts.

- Review underlying data to understand the method and confidence levels of the extrapolation with regard to the unexpected results at operating speeds of 100mph under all axle loads and at 75mph under 25 tonne axle loads.

Geographic charging

We do not support the taking forward of the work to disaggregate the Variable Usage Charge. There is no geographically varying charge for road users. We see that a disaggregated charge would introduce immense complication - in working out how many miles each train traverses over each line, in calculating costs to enable quotes to be provided for customers (noting that the road competition can do this in a matter of hours), in billing from Network Rail.

Geographical variable usage charges are also likely to lead to perversities, meaning it is cheaper to traverse busier routes than quieter ones. This could result in another charge being introduced to offset the perversities (though it is unclear what the legalities of this charge would be if the charge could not be borne by the market).

The Route level efficiency benefit sharing scheme proposed for CP5 was flawed; virtually all operators opted out of it. We do believe that there is some merit in this sort of scheme but as an upside scheme only. Operators do not have sufficient influence over Network Rail's costs to take the risk of sharing any over-spend. However there is the opportunity to save costs in certain areas and this has been lost in CP5 by the lack of a suitable efficiency benefit sharing scheme.

The freight charges should be simplified so that there are only two charges - the variable charge and the mark up charge (see page 9). This would simplify charges for users and increase transparency. We would expect that this is split by relative damage sustained to the network in order to incentivise friendlier rolling stock that reduces maintenance. Many operators have already made such investments, and so to change tack now would undermine previous incentives, and damage the efficacy of any future price signals.

What costs and benefits do you see with this package?

We assume that the overall income from variable charges would not radically change as Network Rail fundamentally updated the VTISM model for CP5.

To have any meaning at all variable access charges would have to be heavily disaggregated - otherwise they are just a different average. A heavily disaggregated variable usage charge would be extremely complicated to calculate and to bill. Rules would have to be put in place, for example where trains are diverted, through a requirement of Network Rail (e.g. around a possession) and not at the request of the train operator. Many freight services are diverted around possessions every night and at the weekend so the practical operation of this would have to be considered in any implementation plans.

The cost of implementing a system that could calculate how many miles each train travels over each route and then apply a charge from a look-up table that already is disaggregated by wagon, empty and loaded and by commodity would be very expensive and we would be surprised if this could be designed and implemented in time by 2019.

We note that the ORR suggest a **charges calculator** could be developed. However this would presumably require the operator to enter the mileage on each route section - this would result in a manually intensive calculation.

We agree with the ORR that complexity of implementation should be tested before an option is developed in detail.

We are struggling to find a positive in the implementation of this charge in terms of behaviours. It will make no difference to passenger operators - they must use the route on which the station they need to call at is located! It would have little influence on the routing of freight services as most routes are chosen because of weight and gauge restrictions and where paths are available.

IMPLEMENTATION

Do you have any views on options for implementing a new structure and what would be the impacts of these options?

We understand the structure of charges has the potential to impact different groups in different ways. In developing the options in this consultation (particularly in the draft impact assessments) , have we drawn out the implications for different groups? Please explain your response.

As a freight operator we do appreciate the references throughout the consultation to the need to consider freight and whether it can bear an increased level of charges, and that it may be appropriate to introduce mechanisms to recognise the wider benefits of rail freight. We welcome the fact that this is acknowledged.

However, we do not think the complexities of introducing varying variable access charges, disaggregated by each line section has been properly appreciated. We do not consider such complexities to be "perceived" – they are very real. It is not just a question of populating a very large spreadsheet. The complication is working out how many miles each train traverses over each line section, both for the purposes of quoting customers and for Network Rail billing operators.

Rail is already a far more complicated mode than road for customers to understand. Freight operators work very hard to simplify the rail product for customers but it would be detrimental to rail modal share to make it even more complicated.

Further discussions

Although we do welcome the opportunity to respond to the options contained in this consultation there is a real risk that the presentation of such radical changes to network charges which are presented in this consultation will itself create uncertainty and instability in the rail freight market and amongst rail freight customers.

Given the work that funders are doing to promote the rail freight industry on the back of the significant economic benefits that the sector generates, we urge the ORR not to jeopardise this by creating unnecessary instability in the charging regime.

If you would like any further information or require any clarification on any of the issues identified please do not hesitate to contact us.