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8th February 2012

Dear Richard

PERIODIC REVIEW 2013 (PR13) CONSULTATION ON INCENTIVES - FREIGHTLINER RESPONSE

This is the response of Freightliner Group Ltd (representing Freightliner Limited and Freightliner Heavy Haul Limited) to the Periodic Review 2013 consultation on incentives. Freightliner is content for this response to be published on the ORR's website with the exception of any text in *italics*, which we consider to be commercially confidential.

Freightliner is keen to continue engage with the Office of Rail Regulation (ORR) in detail with regard to the Periodic Review as the decisions made will directly impact on our business and future ability to grow rail freight in the UK.

LINK TO PREVIOUS RESPONSES

This consultation on incentives covers many of the same areas of the ORR's First Consultation on PR13 published in May. Freightliner responded in depth to this consultation on 2nd September 2011. In many areas of the consultation we do not feel that there has been much development of the shape of the proposals since the previous consultation and therefore many of the points made in our previous letter are equally relevant to this consultation. In this response we aim to not repeat the points put forward on 2nd September 2011, but request that the points raised in the previous letter should continue to be taken into account in the development of policy for PR13.

In particular we reiterate the importance of the overall level of charges to freight operators who compete directly with lorries (who use the road free and without restrictions at the point of use) and the simplicity of charges in enabling freight operators to respond quickly to new business opportunities.

UNDERSTANDING THE PR13 OBJECTIVE

In the developing scenario of alliances developing between large passenger franchised operators and Network Rail it will be specifically important that measures are included to ensure that Network Rail do not forgot the needs of other smaller operators and take their needs into account when making decisions.

There is a risk that in developing measures that work for franchised passenger operators, that these will have a negative impact on freight operators. In particular the needs of freight customers are not always as well understood as they are not directly under the control of government. Rail is already considered by many potential customers who are used to using road as slow to respond, complicated and inflexible, in order to attract new customers the rail offering needs to be as straightforward and reactive as possible and the industry framework can greatly assist the freight operators in delivering this.

We would also reiterate that for many customers the product they are buying is not just the movement of freight on a chain but a complete logistics offering including for example storage and other value added services such as cleaning. The important thing is that rail can be integrated into an overall product that matches the outputs as the equivalent offering using road, but it cannot be considered as an isolated product.

The priorities for Freightliner for CP5 are:

Stable, simple and predictable access charges set at a level that positively enables competition with road operators
Access to efficient and consistent paths on the rail network that deliver journey times that can compete with road, including increasingly at weekends
A Network Rail who are incentivised to make our services reliable and consistent
A scenario where Freightliner and Network Rail are incentivised to make the other more efficient but not to the detriment to the long term sustainability of the network

ALIGNING NETWORK RAIL AND TRAIN OPERATOR'S INCENTIVES TO INCREASE EFFICIENCY

Freightliner supports the principle of efficiency benefit sharing whereby the operators are incentivised to make Network Rail more efficient.

In our response to the previous consultation we raised the issue regarding clarity of what counts as efficiency. At the current time this issue appears not to have been resolved for the year 10/11 as we are waiting an announcement in this respect by the ORR. This issue is not addressed in your consultation but it is clearly very important as all parties must have a clear understanding of what they are aiming to achieve. We are keen to engage further with the ORR in this area.

We are concerned that such an incentive scheme will drive dominant passenger operators to want to reduce network capability not frequently used by themselves such as crossovers, loops and connections. Given that once taken out it is prohibitively expensive for a freight operator to fund replacements care is needed that future flexibility is not totally removed from the network.

In many areas Network Rail need to do more work to understand their costs. The recent consultation undertaken by Network Rail highlighted a still undeveloped understanding of the costs of freight only lines.

Freightliner does not support the proposed sharing of downside risk. We are concerned that the ORR are proposing to make participation in the efficiency benefit sharing mechanism compulsory and therefore participation in the downside risk compulsory. This is of great concern to Freightliner as the holding of this risk, perceived or otherwise will have an impact on things like banking covenants and the ability to raise capital for investments.

We also remind the ORR that the profits made by freight operators are very low, and not of the scale of passenger operators and not as high as 6% as suggested in paragraph 15. of Annex B (noting that the 6% excludes tax – which seems unreasonable as it is compulsory). The nature of competition between operators and with road operators has resulted in a low margin industry with typical profits after tax being in the range of +2.5% to -2.5% (results from the last few years bear this up). The results of the 4 major freight operators for the year ending 31st March 2010 show a combined loss after tax (excluding the sale of fixed assets) of £17.8 million which equates to -2.3% of turnover.

The analysis in Annex B predicts a worse case scenario of a down side risk of 20% of profit based on a 6% profit margin. If profit margin is only 2% then the same risk equates to 50% of profit margin. Such a risk is unacceptable to Freightliner and we would rather opt out of the scheme altogether if this level of risk is being imposed, despite the potential upsides.

We would like to understand more about the modelling work that is presented in Annex B. It appears to be very theoretical and we have concerns about the assumptions made when there is no experience of this regime (noting the remaining uncertainties about measuring CP4 out-performance). Our questions include:

- on the basis of what evidence is it assumed that the standard deviation is 3%?
- on the basis of what evidence is it assumed that the worse case is Network Rail's costs are 5% above the baseline?

In particular we do not think it is appropriate to introduce the downside scenario for CP5 for the following reasons:

- During CP5 the efficiency benefit sharing mechanism will not be "turned on" for franchised passenger operators with existing franchise agreements therefore in some Routes these operators will not have an incentive to work with Network Rail to reduce their costs. The consequences of this should not be carried by others.
- There is too much uncertainty regarding the operation of the scheme to introduce the risk of considerable paybacks. As mentioned above there is currently a lot of uncertainty about how efficiencies will be measured. We would suggest that stage 1 of the regime should be upside only and that when more is known and understood about how the regime is working in practice this could be reviewed for CP6.
- Freightliner does not understand how a mix of the ability to have "bespoke" regimes and a general downside risk can be fair. By their nature "bespoke" regimes will be upside only, so the large operator in one Route can set up bilateral upside "bespoke" agreements, "cherry picking" the biggest opportunities to be "carved out" of the formulaic approach, while **all** the operators in the route have to risk sharing in the downside of everything else. This is fundamentally unfair and we could not accept such a proposal.

Freightliner has many questions and concerns with regard to the proposal for "bespoke" arrangements and how these will impact on other smaller operators on a route.

We would be concerned that bespoke upside only arrangements could be entered into by a dominant operator who may concentrate on large bespoke deals and then may not have the time or the inclination to also participate in the general scheme as the potential gains would be lower and harder to achieve than the bespoke arrangements. Such behaviour would impact on the smaller operators in the general scheme, particularly if there was downside sharing.

What are the criteria for entering into a bespoke regime? What happens if Network Rail refuse to enter into a bespoke regime, will there be the ability to appeal?

Another issue is how bespoke deals for freight operators could be done without discriminating against other freight operators. However, it would not be fair to exclude freight operators altogether from being able to reach bespoke deals.

Another concern is how a bespoke deal may directly impact on the operations of a smaller operator and how this would be consulted/agreed. The efficiency benefit sharing scheme should also not be a mechanism to force secondary operators to make or accept changes against their will which are not in their interests, for example to possession patterns.

What would be the incentive not to agree everything on the basis of bespoke deals, which could be banked as upside risk rather than participating in the general scheme?

We recognise that there is tide of support for bespoke arrangements and that is difficult to swim against that but there are many problems that have to be worked through before they should be introduced. It is disappointing that further work has not already been undertaken in this area prior to the consultation. This needs to be addressed urgently

On a minor point it is essential that all freight operators are treated the same and we do not think it is appropriate for smaller freight operators to opt out of any scheme, equality to all is essential.

Freightliner reiterates that it does support the principle of the mechanism and is keen to engage to work with the rest of industry to find a balanced approach which creates the right incentives without disproportionately impacting on minor operators.

POSSESSIONS AND PERFORMANCE REGIMES

This section of the consultation seems to focus on passenger impacts but we assume that the comments made broadly refer to freight operators as well.

There does not seem to have been much development of ideas in this area since the previous consultation in May so our comments are relatively limited.

Freightliner welcomes the decision by the ORR to broadly continue with the existing frameworks for Schedule 8 and Schedule 4. We support these decisions as we are strongly of the view that Network Rail must be incentivised to improve access and reliability to the Network. It is also helpful that all parties understand the existing regimes and this should make it easier to set achievable targets for improvement.

Freightliner supports the continued use of liquidated payments for both Schedule 4 and Schedule 8. They may not be cost reflective in every case but it is easy to administrate for both parties. The volume of incidents and possessions that have to be dealt with very week makes a bespoke scheme impractical and far too onerous to deal with.

Paragraph 5.21 suggests a review of whether it would be appropriate to lag payments on the passenger regimes. It is unclear whether this would also apply to freight but this appears to be a rather bizarre and unnecessary complication. Whilst continual delays do have an impact on customer perceptions and long term decisions made by customers the majority of impact is direct and on the day, and it is important for both the perpetrator and the victim that the financial impact is felt as near as possible to the event (you wouldn’t smack a dog two days after it had pooed on the carpet!).

There is a strong argument to increase the payments for both Schedule 4 and Schedule 8 to increase the incentive on Network Rail to work ever harder at reducing delays and possession lengths. The impetus on the latter at the beginning of CP4 has drifted badly since and Network Rail clearly need stronger incentives to improve working practices etc during possessions.

We welcome the work that ORR proposes to do to look at the transmission mechanism of Schedule 4 and 8 in Network Rail. We would expect this to improve as a result of devolution and more local accountability.

We note that the ORR is still intending to review whether the Schedule 8 should be “turned off” where there is vertical integration. We remain unsure that this would work unless the vertical integration area was exclusive to one operator as the regimes of other operators including freight operators would need to be accounted for as part of the “star” model.

Schedule 4

The payments received by FOCs under Schedule 4 have already been reduced by a third with effect from September 2011. Even before the reduction the payments made did not cover the full cost of the impact of the lack of availability of the network, now with the reduction payments have been reduced to what could be considered a nominal amount.

We do not consider that the Schedule 4 payments act as a sufficient incentive to Network Rail and we are concerned that the relative difference in value between passenger and freight payments is considerable and because of the reduction in freight payments has widened and is likely to lead to future behaviours from Network Rail that put even further pressure on freight operators' ability to offer a consistent service to their customers.

We are disappointed by the comment made in paragraph 5.19 of this section regarding longer weekday overnight possessions. The statement about cancelling the last and first weekday services appears to overlook the needs of freight operators. Overnight weekdays is the key time for moving freight services and often the only time that quality paths can be obtained particularly as in recent years freight services have been increasingly squeezed in the daytime by longer peak periods and increased frequency passenger off-peak services.

Additionally the social and economic value of a freight service is likely to have a much higher social and economic benefit than a late night or weekend passenger service. The work done by Network Rail last year on the East Coast Main Line demonstrated that the social and economic value of an additional freight service was about 3 time higher than that of an additional off-peak intercity service. We suggest that rather than making this simplistic and overarching statement that the ORR should suggest a line by line review so that the best value solution is found for each line.

We would like Network Rail to be positively incentivised to encourage more weekend freight services. As well as the increasing demand for more weekend services, particularly from retail customers more weekend services make freight operators more competitive versus road and increase the capacity of freight that can be moved rail without physically increasing the capacity on the ground. There is no current incentive for more weekend services, in fact it could be argued that Network Rail are incentivised not to allow more services at the weekend or on weekend nights as this might increase their Schedule 4 payments.

We note that the ORR is considering changes to Schedule 4 to take into account extreme weather. As Schedule 4 is predominantly about pre-planned disruption we think that this would be more appropriate for Schedule 8.

Schedule 8

We believe that it is of paramount importance that the Performance Regime continues to be a national regime. Whilst it may be appropriate to set Network Rail performance targets on a regional basis to ensure that there are clear incentives for local staff it would be very difficult if the contractual regime was anything but national. It is also important that perversities are not created which encourage one route to blame another or "game" against other routes so that there are arguments about which route caused delay.

We note the ORR's comments about planning to undertake a full recalibration as part of PR13. This will also directly impact on freight operator payments made to Network Rail as freight operators pay on the basis of the star model. This is also an important factor in balancing the freight performance regime where the other half of the regime is Network Rail payments to freight operators to contribute to their costs and losses. We would be concerned if the regime became unbalanced i.e. if the payments made by freight operators to Network Rail were not at the same ratio (once the appropriate balance of minutes is taken into account) to that paid by Network Rail to freight operators.

We note that the ORR is not going to develop a kinked payment curve for the passenger Schedule 8 regime. We would also suggest that the kinked payments in the freight regime are removed. Freightliner has found these difficult to work with during CP4 as we never understand at the time of an incident the cost of the incident. This makes briefing staff on the consequences of their actions more difficult too. It also makes it more difficult to make a business case for improvement projects. We would suggest returning to a one rate regime which is simpler for all.

We understand the ORR will also be looking at a proposal so that all parties are incentivised to run during extreme weather. We understand the logic of this but are concerned about what is considered extreme weather and who should decide this and that there still should be an incentive to do the best possible. It is true to say that Network Rail has put a lot of effort in over the last year to deal with snow impacts, and this should be welcomed. Would they have done this if the Schedule 8 had been turned off last winter?

Network Rail has issued in our view an extreme amount of “Force Majeure” notices over the last 12 months. Whilst currently these do not impact on the performance regime we would not support a regime whereby every time it is a bit windy or there is localised flooding the Schedule 8 gets switched off. For example we do not consider that the snow and cold weather currently being encountered is sufficiently severe to enable opt out of the regime. We would only expect such a measure to apply in very widespread, extreme and prolonged conditions only i.e. a once in 5 year event, not every month. We are concerned that if this proposal was implemented this would lead to disputes over what was severe weather or not.

ACCESS CHARGES

Freightliner has had some difficulties agreeing rates with Network Rail for new vehicles in CP4. Network Rail has not been clear in stating what information they expect to be provided when new vehicles have been introduced. They have retrospectively insisted that T-gamma information is provided for new vehicles even though existing equipment is not modelled on this basis. As the cost of a t-gamma model is in the region of £30,000 per vehicle we have been reluctant to provide this information.

The work that Network Rail commissioned from Manchester Metropolitan University in this area stated that that the model didn’t produce the expected results. Freightliner wrote to Network Rail on 22 July 2011 asking for a meeting with MMU so we can understand the model better as did not thought there was any benefit moving to an output based methodology of calculating charges which involved considerable expense for operators if there was no confidence in the model. To date we have had no reply from Network Rail but we understand that they intend to take this work forward shortly.

We are very keen that this is properly sorted for CP5. It must be clear before new equipment is designed and built what information is required to be provided to calculate access charges and on what basis access charges will be calculated.

In principle we encourage bespoke arrangements where they lead to the “right thing” being done. We would not expect any bespoke arrangement to impact on the competitive position between freight operators; it is an important principle that all freight operators pay the same charge for the same wagon.

CAPACITY UTILISATION INCENTIVES

Volume incentive

We welcome the decision that the ORR will continue with a volume incentive to encourage Network Rail to grow freight volumes. The current volume growth incentives are not well briefed or understood throughout Network Rail and because of the recession and changes to electricity coal volumes moved by rail will not be reached. As previously stated we would like Network Rail to have an incentive that creates ongoing incentive to grow freight at the margin, i.e. a credit for every new service that is launched, based on a % of the economic and environmental benefits. This would create an incentive to grow rail freight but also recognise that Network Rail have little impact on the overall market, notably electricity coal. This would recognise that the benefits of rail freight fall in the main outside the railway balance sheet (i.e. the benefits are reduced road congestion, carbon etc).

Capacity Charges

Freightliner understands the principle that more trains on the network increases delay. The current capacity charge is cost that should reflect this, noting that for the current charge there is no transparency as to how it is calculated. It is not an incentive on the operator, just an additional cost. Network Rail are not incentivised by the charge either as they in theory collect the charge to cover 100% of the incremental costs of the performance regime.

Currently this is not reflected in Network Rail's target for performance improvements. In the future, as modelling of performance outputs gets more sophisticated and levels of performance more predictable we would expect the target to take into account the impact of more services as well as this being accounted for in the charging regime.

We have been urging the ORR for some years to make the modelling on the calculation of the capacity charge more transparent. It is still unclear what the volume baseline of train movements is considered to be and therefore how and on what basis the incremental effect is modelled. We note that Network Rail are intending to recalibrate the calculation of the capacity charge, we expect this to be undertaken in a consultative and transparent manner. We have had no indication from Network Rail when this work might be published.

When the CP4 charges were set there was a complete lack of transparency of how this charge was calculated or how or when the benchmark for business levels were set, or on what assumed growth it had been calculated. Given that overall freight volumes have reduced in CP4 and the number of freight trains has reduced even further (because operators have driven efficiencies and are now moving longer and better loaded trains on average) we are currently in a position whereby every freight train is paying a capacity charge for the marginal impact on performance of growth yet Network Rail are not only receiving the charge but additionally actually benefitting in this respect because of less freight trains.

Capacity Utilisation

Freightliner welcomes better transparency and clarity around capacity utilisation as described in Box 7.4. However we would expect any such monitoring to both measure the use of a train path but also to measure the use of the train, i.e. the number of people on the train or the number of boxes or number of net tonnes of goods on the train. Any measure that only looks at path use will discriminate against freight trains and not give an accurate reflection of how capacity is being utilised.

Freight operators have been pushing for some time for capacity to be identified in the timetable for future freight growth as this would enable the timetable to be constructed in a more holistic way and would give confidence to potential customers that new services can be accommodated. We are disappointed in the continued slow progress in this area, and although there is some Strategic Capacity identified in the December 12 timetable it is just little parts of paths and not through paths on the key routes, so it is of little practical use. If Strategic Capacity was properly identified on key routes it would both give a better understanding of what capacity is actually available for freight growth (we are strongly of the view that there is less than he common view as many "freight" paths are used by empty coaching stock and test trains etc) and would also give more confidence to freight operators to give up under-utilised paths.

We are not sure however how the proposed measure measures Network Rail's performance in this area in optimising the timetable. As previously stated we believe that more emphasis should be placed on Network Rail in ensuring that they have the optimum use of existing capacity before putting forward capital investment solutions. We continue to be of the view that Network Rail do not place sufficient emphasis on the importance of train planning in their organisation and capacity utilisation is one key element of this. Empirically we believe that there is an opportunity in this area to get better value of the existing rail network by better capacity utilisation.

There needs to be a better balance in this area between incentives to grow and performance incentives to ensure that Network Rail don't have a negative incentive to grow services. More work is needed to better understand the link between capacity utilisation and performance.

We would also like to see incentives on Network Rail to consider energy usage in their development of the timetable. It is estimated that every time a freight train stops and starts again 45 litres of additional gas oil are used. Timetables that are designed to minimise the number of times trains stop (apart from at station for passenger trains) would help the whole industry to reduce costs and carbon outputs.

One key issue for freight services is the amount of time spent in loops when the locomotives are still using diesel but are not going anywhere. We would like to see an incentive on Network Rail to reduce the average amount of time that freight trains spend in loops, this would have the added benefit of reducing journey time for freight trains which in turn would enable freight operators to be more efficient as better utilisation of capital intensive rolling stock. Reducing the number of freight trains in loops would also help to make the overall timetable more efficient as the time taken by a freight train slowing down into a loop and then accelerating out of a loop uses a lot of precious capacity.

Reservation Charges

Overall we support the ORR's decision not to take forward reservation charging at this time.

The freight operators are engaging with the coal power generation industry to understand whether any different system may improve utilisation of electricity coal paths. The coal power generation industry has reported that due to government policies on future energy split more flexibility rather than less may be needed in the future as some coal power station are used as a back up to other modes such as wind. Further work is needed in this area to understand the opportunities and whether there are any practical solutions, however this should be concentrated on routes where there is an opportunity cost only.

Scarcity Charge

We continue not to support the auctioning off of capacity noting that this would impact on freight's ability to compete with road and in the case of passenger franchise this would ultimately be funded by government (through increased or reduced subsidy depending on the operator). We also remind the ORR that simplistic charges are of paramount importance to freight operators as road operators face no complicated charges at all, they simply pay fuel duty, a charge that varies by time of day and geographic area sounds horribly complex.

We would also be concerned that such a system would favour larger operators who could buy capacity and strategically block off smaller operators.

It is unclear how the ORR's proposal would work and whether all capacity on a route would be auctioned off. We understand that the ORR intends to undertake an impact assessment on freight markets. The routes that are the most congested (the WCML and the ECML) are routes that are key for intermodal traffic, which is the most price sensitive against road.

Areas raised in our September letter not addressed

There are several issues that we raised in our September letter that have not been addressed in this consultation paper and we remind the ORR that we are keen for these to remain on the agenda.

Strategic Capacity to enable future freight growth

We and other freight operators are worried about whether capacity will be available in the future for freight growth on in particular the key freight route of the West Coast Main Line but also on other major routes, particularly where new services are planned (IEP and Crossrail being examples). With the support of ORR and DfT freight operators have been pushing Network Rail to identify available freight capacity on key growth routes for freight. We are frustrated by the progress of this work stream but we do believe it is very important not only to the rail freight industry and giving comfort to customers and potential customers but also to passenger operators who have their own business plans which will use existing spare capacity on key routes. In this context we would like Network Rail outputs not only to include a measure on better utilisation of capacity but more transparency and clarity on what capacity is available today.

Connection Agreement Charges

On the basis of the Network Rail model on connection agreement costs we are concerned that the future bill for connection charges could be higher than for track access charges. We would like to see an increased focus from the ORR in this area in evaluating the Network Model and ensuring that there is fair and equal treatment across all operators.

Please do not hesitate to let me know if you would like to discuss any of these points.

Yours sincerely

Lindsay Durham
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Freightliner Group Limited