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Dear Ben

Freight Caps – consultation on variable usage charge (VUC) and freight only line charge initial cost estimates

Without prejudice this is the view of Freightliner Group Ltd. (FL) encompassing its subsidiaries Freightliner Ltd. and Freightliner Heavy Haul Ltd. Comments in italics should be treated as confidential and are not to be published.

We recognise that the work to date considers the emerging view on the variable costs of track, civils and signalling for CP5 and are not the charges freight operators may face following scrutiny by ORR, nor an efficiency overlay. We welcome the attempt at transparency and explanation of the methodology for these costs, as are the efforts to deliver a capped result for freight as early in the process as possible but would note that without including capacity charges and the possible scarcity and reservation charges the attempted relaying of certainty to customers and investors is undermined.

We understand that the Vehicle Track Interaction Strategic Model (VTISM) and Strategic Route Section Maintenance Model (SRSMM) are used to estimate the volume of renewal and heavy maintenance required under different levels of activity, a welcome step forward from the Infrastructure Cost Model (ICM) used in PR08, to which unit costs are then applied. With respect to this, we do have some specific concerns / comments:

a) We found the assumptions and numbers presented in the consultation letter difficult to follow, particularly when trying to see the steps taken between PR08 values and PR13 values. We would expect this to be made clearer;

b) As raised universally at the workshop (6 January 2012) we are not comfortable that the modelling is unable to produce meaningful results for a fall in traffic and that the baseline is a forecast value for 2013/14 rather than an actual activity level, e.g. 2010/11. As VTISM and SRSMM are "new" to the process of determining activity we would expect validation of these models' results against a known level of activity and the resulting renewal and maintenance experienced. At the risk of sounding too cynical, we are cautious of the perfect relationship between cost and traffic and would suggest that this could be a result of the method rather than the reality. As such, we would like to understand the method better to close out this concern as it would appear to contradict the "counter intuitive" results from modelling reduced activity. If true, the proposed increase in traffic levels from the baseline (+20%) is largely irrelevant as the £ per Kgtkm remains materially constant;

c) We reiterate a query raised at the workshop on the constituent elements that make up the baseline assumption of activity and request consideration of the relevance to the VTISM and SRSMM models of the balance between passenger, bulk freight and intermodal freight traffic. Whilst the overall baseline activity may well be reasonable, we question what impact a change in the intensity of the baseline and forecast traffic levels (bulk freight having heavier axle loads than passenger and intermodal) has on renewal and maintenance requirements on the disaggregated (by route) track model (VTISM). We would suggest that this is also considered with specific reference to the assumptions on civils (masonry under bridges) where the majority of the increase in costs lie;

d) We are concerned that, accepting VTISM and SRSMM are a significant evolution in modelling renewal and maintenance of track, Network Rail (NR) still feels a confidence level of +20% is necessary when proposing a cap for freight charges. We understand that by offering a freight cap NR is providing the sector with a "one-way bet", however, we would suggest that at the proposed level the resulting cap does not reflect confidence in their results (specifically VTISM and SRSMM as they calculate the lion's share, i.e. track at £242.4M or 85% of total variable costs) nor does it provide freight operators a sufficiently small departure from current charges to feel comfortable with its release to the wider market. We would strongly urge NR to revise the proposed confidence interval to a level that addresses these two factors, e.g. 5-10%, or perhaps sustain 20% for the top down modelling for civils and signalling - where there is the greatest uncertainty - and 0-5% for the calculated track costs;

e) Expressing the cost as £ per Kgtkm would be our preference as this is a familiar metric within the sector;

f) The detail provided has caused us concern regarding the movement of absolute costs with respect to the non-track variable costs (civils and signalling). For comparison, the table below details the annual average costs between PR08 and PR13 from the information provided in the consultation letter. It is clear that this is an incomplete dataset, which we ask is completed. However our primary concern is the movement of annual cost averages in certain cost categories that are very dramatic, e.g. metallic bridge renewal. Can NR provide a fuller analysis and explanation of these movements?;

		11/12 Prices & End CP4 Efficiency		
		PR08	PR13	Movement
Civils	Embankment renewal	33	32	(1)
	Metallic bridge renewal	95	49	(46)
	Brick & masonry underbridge renwal	#N/A	93	
	Cluverts renewal	#N/A	9	
	Total	**128**	**183**	**55**
Signalling	Maintenance	120	137	17
	Minor works points renewal	#N/A	12	
	Total	**120**	**149**	**29**

g) Furthermore, the increase in overall freight costs[1] is driven by changes in variability of cost assumptions between PR08 and PR13 for these two cost categories (civils +£10M and signalling +£5.4M). For the freight community these represent real cost increases if they translate into an increase in the charges levied, on a sector with historic low margins in a highly competitive market (intermodal in particular). NR's PR13 position appears to be that a top down approach is necessary when evaluating civils and signalling variable costs in light of the current state of NR's asset policies and reliant on internal professional opinion on a small data sample, "e.g. high profile viaduct failures in Scotland" (para 15, pg 6). Given this we would expect NR to offer rigorous justification of these views. A related example is the inclusion of the costs of accident damage by motorists at level crossings due to frustration at increased frequency of closing due to increased rail activity are classified as a variable cost to operators. We do not consider this a reasonable rationale for the conversion of these costs to variable and, along with any similar items, should be retained as fixed costs. Given the materiality of the impact these changes have, it is our intention to seek independent advice and look to further engagement from NR in rationalising these changes;

h) In PR08 the allocation of variable costs between freight and passenger operators used the TTCI model. We understand alternatives are being considered lead by NR, albeit with a clear preference for a modified TTCI / validate TTCI model by VTISM. However, our experience in PR08 was that TTCI was a "black box" model with some material inaccuracies in the inputs, e.g. weights and track characteristics of some vehicles types and even inclusion of some vehicles that we didn't recognised as being available to the UK;

i)We have reviewed the Appendix to the consultation letter detailing the Freight Only Lines (FOL) and note there is an increase between those identified in PR08 and an associated material increase on coal (+16%) and nuclear (+22%) costs. Unfortunately, we have been unable to review those additions and will revert with any issues as promptly as we can. We would emphasise the affordability condition and the additional analysis necessary to the elasticity work conducted by MDS Transmodal Ltd. that considers the competition from substitute goods, e.g. ESI coal competes against gas for power generation. In other words, ESI coal may

[1] 11% between initial cost estimate sand current charges

not be able to absorb any increase in Track Access Charges. Despite this the proposed continuance of allocation of cost by activity on multiple commodity FOLs seems reasonable and one we would support. Our earlier comment regarding the confidence interval (+20%) being too high applies to the FOLs cap too; and,

j) We strongly emphasise the need for transparency on the findings of the ORR's Reporters regarding the validation of the changes in variability and unit cost assumptions. This is important for operators to have confidence in the costs proposed. We understand the costs presented to date are initial estimates but they require intense scrutiny before they are used to set charges.

We are happy to discuss any part of our response and look forward to your comments on the specifics raised.

Yours sincerely

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