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By email

Dear colleague

PR13 - Freight caps

In its first Periodic Review 2013 (PR13) consultation¹ ORR notes that freight operators are *“fully exposed to changes in variable track access charges made at a periodic review”*. In addition, it highlights that *“freight operators may have long term agreements with certain customers, which they must price on the basis of their understanding of how their incremental costs may change over the period of the contract”*.

In the Periodic Review 2008 (PR08) ORR took account of the particular circumstances freight operators face by placing a cap on freight variable usage charges and freight only line charges well in advance of its final determination. As part of its PR13 first consultation ORR requests views on whether it should once again put a cap on certain freight charges in advance of its final determination. It notes that such a benefit could be linked to commitments by the freight community to reduce whole industry costs.

We understand that, subject to consultation responses, ORR is considering placing a cap on freight variable usage charges and freight only line charges in advance of its final determination. In order to facilitate this we have begun the process of estimating freight variable usage costs and freight only line costs for Control Period 5 (CP5). We would like to do this work in a transparent and consultative way.

¹ ORR, Periodic Review 2013 First Consultation, 25 May 2011.



Consistent with this, this letter sets out our proposed methodology for calculating the cost estimates that could inform freight caps in PR13. It also includes proposed timescales. As set out, later in this letter, we are planning to consult formally on freight caps in October 2011 and conclude in January 2012. We will, of course, consider modifying our approach after our consultation if compelling evidence or information emerges. Of course, final decision making in relation to this issue rests with ORR, however, our planned programme of work is designed to deliver a shared understanding of our proposed methodology.

Broader context

It should be noted that because freight variable usage costs are a subset of total (passenger and freight) variable usage costs, the proposed methodology set out below is relevant to both freight and passenger operators. Although the primary purpose of this work is to estimate freight variable usage costs we also intend to be transparent about the variable usage costs associated with passenger traffic. We are, therefore, copying this letter to passenger operators.

Variable usage charge methodology

The variable usage charge is designed to recover our operating, maintenance and renewal costs that vary with traffic. In economic terms, this reflects the short run incremental cost. The charge ensures that we are compensated for the wear and tear that results from additional traffic on the network.

We propose estimating total (passenger and freight) variable usage costs using broadly the same methodology as in PR08. That methodology uses a 'bottom up' approach to estimating track variable usage costs, and a 'top down' approach to estimating other (e.g. civils and signalling) variable usage costs.

The vast majority of variable usage costs relate to track wear and tear. Set out in Table 1, below, is a breakdown of Control Period 4 (CP4) annual variable usage costs which illustrates this point:

Table 1: CP4 annual variable usage costs (pre efficient 2006/07 prices)

Asset	Proportion of Total Variable Usage Costs (%)	(£m)
Track	89.1%	243.4
Civils	8.4%	23
Signals	2.5%	6.8
Total Variable Usage Costs		273.2

In PR08 we estimated total track variable usage costs using the Infrastructure Cost Model (ICM) track module. However, in PR13 we propose using the Vehicle Track Interaction Strategic Model (VTISM) for estimating track renewal and heavy maintenance costs. We consider that using VTISM in this respect represents a significant methodological improvement, building on the CP4 approach using the ICM. VTISM was developed for the cross-industry group Vehicle/Track Systems Interface Committee (V/T SIC)², in response to the need to directly relate rolling stock characteristics and track characteristics to track damage, and thus to renewal and maintenance requirements. It is employed across the industry because it uses engineering science to accurately predict track degradation costs and the remedial effects of track maintenance and renewal. We consider that it would deliver more robust cost estimates than the ICM which used indirect proxies, such as track service lives, to estimate costs. Using VTISM to calculate variable usage costs is consistent with our approach to planning future renewals and maintenance around VTISM outputs. It is also consistent with our approach to PR13 more widely where, for example, VTISM will inform our Initial Industry Plan (IIP) submission.

In moving from the ICM track module, used in CP4, to VTISM we are mindful that we would not want to lose the good work that was done in CP4 on freight charges. We are also very aware (as we acknowledge in our response to ORR's first PR13 consultation) that the freight community could view even discussions of changes as unsettling given the extent to which it faces fierce competition from road hauliers. We are keen to conduct this work, in conjunction with ORR, in a manner that minimises unnecessary uncertainty for our customers. To this end we are keen to work closely with the freight community in relation to this issue. ORR, in turn, wishes to make it clear that it will approve charges that balance its statutory duties, including its duty to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance.

To estimate total track variable usage costs using VTISM we propose adopting broadly the same methodology as in PR08. Specifically, we propose:

- Establishing total track base costs.
- Estimating how these costs change assuming +/- 5% and +/-10% traffic scenarios.

² V/T SIC is a cross-industry group which aims to develop understanding of the vehicle/track interface and use this knowledge to assist industry in moving towards a more optimised, whole life, whole system solution. V/T SIC has representation from across industry including Network Rail, ATOC, Freight Operators, RoSCos, RIA, DfT, ORR and RSSB.

- Identifying changes in costs compared to changes in traffic and calculate an average vehicle cost per thousand gross tonne miles (kgtm) for all traffic types.
- Multiplying the average vehicle cost per kgtm by the base level traffic forecast to estimate total track variable usage costs.

For other assets (e.g. civils and signalling) we propose estimating total (passenger and freight) variable usage costs by applying ‘top down’ estimates of cost variability based on expert judgement. This methodology is consistent with the approach we adopted in PR08.

Total variable usage costs comprise the sum of track and other assets variable usage costs. We propose apportioning these costs to freight traffic based on equivalent thousand gross tonne miles (ekgtm), this approach is consistent with how costs were apportioned in the CP4 variable usage charging model.

As part of this process we will calculate discrete average vehicle cost rates for freight and passenger traffic.

We note that as part of its first consultation ORR is investigating further an option for geographic disaggregation of the variable usage charge. While we have set out our initial view that we are on balance against a move to geographic disaggregation of the variable usage charge in our response to ORR’s consultation, we consider that the proposed methodology set out above would result in a variable usage cost estimate that could inform a cap on either network wide average or geographically disaggregated variable usage charges. The sum of geographically disaggregated variable usage cost estimates equals the network wide cost estimate.

As mentioned earlier in this letter, over the last year or so, there have been a range of discussions held in various technical forums across the industry to help inform the development of VTISM. One of these forums is V/T SIC, which has a broad spread of members. There is now a need to engage on the policy aspects of variable usage charges. One of the policy discussions will be how VTISM can help inform cost reflective variable usage charges for the wheel / rail interface.

Freight only line charge methodology

The current freight only line charge is designed to recover a proportion of the fixed costs of freight only lines. It is levied as a mark-up on the variable usage charge on a £/kgm basis.

We propose estimating the total freight only line costs using broadly the same methodology as in PR08. Specifically, we propose:

- Identifying the freight only lines.
- Calculating the total cost of these lines reflecting as accurately as possible the known asset volumes, asset management policies in force, and the appropriate unit costs.
- Using traffic data allocate costs to the commodities operating on the lines.
- Deducting the variable costs associated with the traffic on the freight only lines because these will be recovered through the variable usage charge.

We will consult on the list of the freight only lines that form the basis of our cost estimate.

Market analysis

The freight only line charge is only levied on segments of the market deemed to be able to bear the fixed cost of freight only lines. ORR will conduct a market analysis that reviews the ability of different market segments to bear the fixed costs of freight only lines as part of PR13. In PR08 it concluded that only two market segments had the ability to bear these costs, coal for the electricity supply industry (coal ESI) and spent nuclear fuel.

Commitments to reduce whole industry costs

In its first consultation, ORR notes that placing an early cap on certain freight could be linked to commitments to reduce whole industry costs. We strongly support the reduction of whole industry costs and believe that there is merit in exploring the potential cost savings that could be realised from the careful removal or degrading of freight capability on some routes. We are currently discussing this issue with the Rail Freight Operators' Association.

Timescales

Set out, below, are our proposed timescales for the possible freight caps:

- **October 2011:** Network Rail issues a two month industry consultation that includes indicative variable usage charge and freight only line charge cost estimates for the purpose of potential freight caps.
- **November 2011:** ORR concludes on whether it wishes to place a cap on certain freight charges, and the timetable for doing so.

- **January 2012:** Following careful consideration of consultation responses, Network Rail will conclude on its consultation.

In summer 2012 we are aiming to issue a detailed consultation that explains how we propose translating our variable usage charge and freight only line charge cost estimates into indicative individual vehicle charges. This consultation will inform the proposed individual vehicle charges in our January 2013 Strategic Business Plan.

As part of our two month consultation we will set up a workshop to discuss with stakeholders, in some detail, our proposed approach to placing a cap on freight variables usage charges and freight only line charges.

If you would like to discuss any aspect of this letter please do not hesitate to contact Ben Worley (Ben.Worley@networkrail.co.uk) or myself.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Peter Swatridge', with a stylized, cursive script.

Peter Swatridge

Head of Regulatory Economics