Our Ref:
Your Ref:

Freightliner Limited
3rd Floor, The Podium
1 Eversholt Street
London NW1 2FL
Tel: +44 (0) 20 7200 3919
Fax: +44 (0) 20 7388 8421
Email: JohnstonA1@Freightliner.co.uk
Web: www.freightliner.co.uk

Joel Strange
Senior Regulatory Economist
Network Rail
Kings Place
90 York Way
London
N1 9AG

6 September 2012

cc: Emily Bulman & Rob Mills, ORR

Dear Joel

Periodic Review 2013 – Consultation on the capacity charge July 2012

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 Comments or tables in italics should be treated as confidential and are not to be published.

Executive Summary

We believe that the consultation should encompass the following fundamental issues for rail freight raised by the continuance of the capacity charge in its current guise. The issues we have identified are:

1. The negative impact on rail freight competitiveness versus road;
2. The validity of the capacity charge as a mark-up on rail freight;
3. The over recovery of costs by the capacity charge;
4. The need for greater transparency on the baseline and marginal rate used;
5. The disparity of the total capacity charge received and Schedule 8 payments made by Network Rail, e.g. £169M v. £80M respectively in 2011/12;
6. The possible absorption of the capacity charge into the Schedule 8 regime; and,
7. The real behavioural impact of the capacity charge on players.

It is our contention that the capacity charge in its current form only impacts rail freight, over recovers the incremental cost of increased activity and does not deliver industry wide incentives for capacity efficiency. As such, we strongly urge NR to consider abolishing an explicit capacity charge and use the more effective Schedule 8 regime as a vehicle to drive capacity efficiency. We have addressed the specific questions in the consultation at the end of this response.

1. Rail freight competitiveness

1.1. This consultation is one of many consultations that make up the Periodic Review process. **The**

underlying theme of all of these consultations appears to be increased charges or increased exposure to risk. We would emphasise that rail freight operators (FOCs), unlike franchised passenger operators (TOCs), do not have any franchise protection against changes in charges or degrees of risk.

1.2. The compound effect is considerable and creates an environment of great uncertainty, which is not shared by our road competitors. The impact of uncertainty is very unhelpful in attracting new customers or securing contract renewals with existing customers thereby damaging the economic sustainability of rail freight. This is manifested through existing and potential customers finding rail significantly more complex and difficult to understand versus the road alternative. The capacity charge is seen as a surcharge by our customers who certainly do not, nor want to, understand the justification for this charge. This undermines genuine opportunities for sustained modal shift and makes private sector investment[1] in long term assets harder to justify.

1.3. Consequently, we would suggest that such proposals are not aligned to the Office of Rail Regulation's (ORR) duty to promote the carriage of goods by rail. The case in point being there is no equivalent to the capacity charge for road freight operators and no mechanism to incentivise efficient use of road capacity. Therefore, without wider market considerations the impact of charges falls short.

1.4. We would like to take this opportunity to remind Network Rail (NR) that rail freight is one of the success stories of privatization and has achieved considerable efficiencies over the past decade and a half. This has been recognised, independently, by the McNulty Study and NR:

- ✓ The rail freight sector directly contributes £870 million to the UK economy and supports output of £5.9bn;
- ✓ The rail freight operators have achieved a 32% improvement in staff productivity since 1998/99 and 48% growth in tonne kilometres since 1994/95 with half the number of locomotives and two thirds of the wagons employed at that time;
- ✓ The benefits of rail freight that fall outside the railway balance sheet but benefit the road network and the economy are:
  - £772 million per annum in congestion costs;
  - £133 million per annum in road infrastructure costs;
  - £68 million[2] per annum in CO_2 costs;
  - Pro-rata 42 road deaths at a value of £78.8 million; and,
  - There has been over £1.5bn of private sector investment in rail freight since 1996.

1.5. Allied to this we would highlight the recent and robust support of HM Government (HMG) in promoting rail freight. On 29 November 2011 the Secretary of State for Transport said:

<u>"The Government supports the transfer of freight from road to rail, where it is practical and economic to do so and fully recognises that rail freight can generate valuable benefits for society where it provides an alternative to road haulage. Rail can deliver goods quickly, efficiently and reliably and help reduce both congestion on our roads and levels of carbon emissions. To secure this longer-term growth and modal shift, rail needs to be able to compete effectively with the use of road by heavy goods vehicles"</u>

1.6. Furthermore, the Secretary of State and Sir Roy McNulty both recognised that the

[1] FOCs and customers
[2] FL Intermodal traffic only, c. 80% of the market

development of a more devolved railway created risks for rail freight and that the changes proposed must protect the interests of freight operators on the network.

1.7. As such, it is disappointing that, in our interpretation of Network Rail's (NR) consultation paper on Capacity Charges, this consultation is totally inward facing and does not consider, or acknowledge, the wider implications of their expectation that there is likely to be an increase in the capacity charge faced by rail operators. In other words, freight operates in a wider sphere and we would urge that capacity charges are only implemented on rail users at the time when there is an equivalent road charge.

2. Validity of the capacity charge to rail freight

2.1. We question the provenance of the capacity charge. Our understanding of the relevant EU Directive (2001/14/EC) would categorise the capacity charge as a mark-up (Article 8/1) given its current characteristics. Therefore, its application to rail freight is subject to an affordability test by commodity. Given the elasticity of most rail freight commodities we respectfully suggest the capacity charge is not applicable.

2.2. Furthermore, the consultation identifies that the capacity charge is netted off against the fixed charge and suggests that it would net of any attributed avoidable freight costs, i.e. the capacity charge is treated as a mark-up. Treatment as a mark-up is only justifiable for commodities deemed able to pay fixed costs.

2.3. We recognise this is an area for the Office of Rail Regulation (ORR) and that the charge has been in place for ten years. During prior Periodic Reviews we have raised concerns over the validity of the capacity charge for freight and contend its current form[3], as a mark-up, invalidates it for most freight commodities.

3. Over recovery of costs by the capacity charge

3.1. Whilst FL agrees that the capacity charge should be administratively simply and non-discriminatory, we believe it has over recovered costs in two ways:

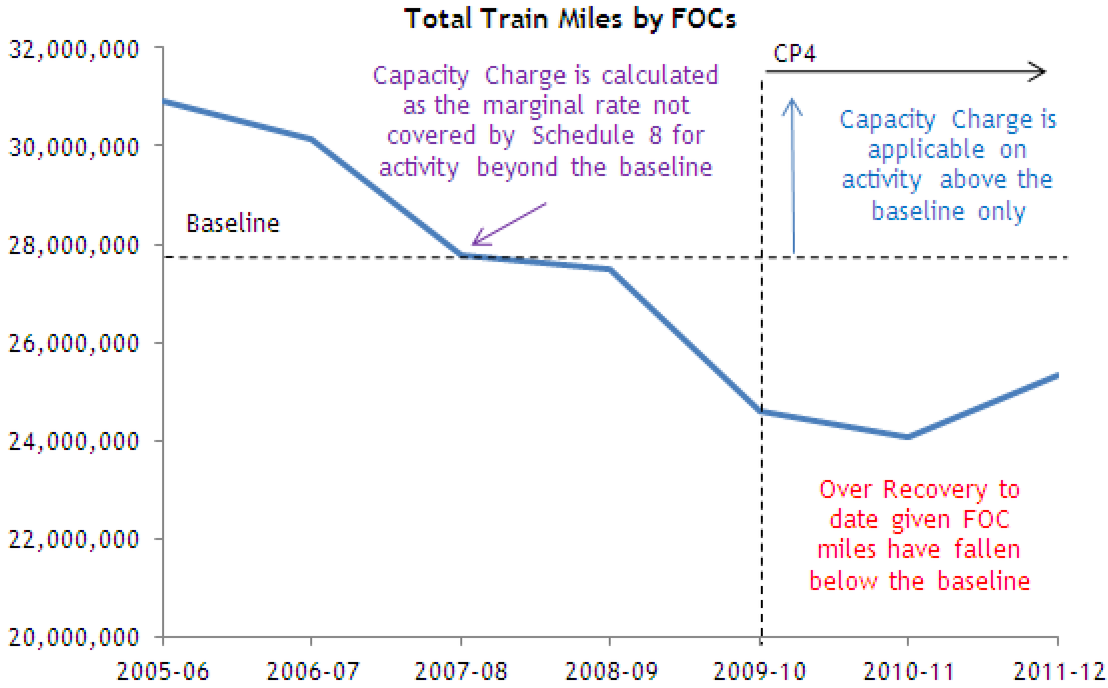
3.1.1. The marginal cost of additional traffic has been calculated but then applied to all traffic moved resulting in an over recovery. We would suggest this should be rectified using the following formulae to calculate an average rate that can be applied to all traffic and updated periodically[4].

$$\sum\big((Marginal\ Rate\ \times Forecast\ Train\ Miles) \div (Baseline\ Train\ Miles + Forecast\ Train\ Miles)\big)$$

3.1.2. The graph below illustrates that actual rail freight train miles have fallen and offers a visual representation of the non-incremental traffic recovered by the capacity charge in CP4 to date against an assumed 2007/08 baseline of activity.

[3] We recognise there is a disconnect between the actual application of the charge and the regulated position but are unable to ignore the consequential reality

[4] Consistent time elapse with other elements of the performance regime and metrics of activity used (train miles / Kgtm)



3.2. It is clear that freight has reduced the train miles run indicating an increased efficiency delivered through longer heavier trains. This is further illustrated by the increasing K net tonne KMs per train, Kgtm per train and miles per train in the graph at Para 6.4. The over recovery in the first three years of CP4 from rail freight is estimated at £12.1M[5], which has arguably cross subsidised the impact of the increase in passenger mile, where the capacity charge is netted off the fixed charge.

3.3. It seems unfair that freight operators, who have improved utilisation, will have to bear any increase in the capacity charge in CP5 to pay for increases in the number of passenger services, whilst any increased charge to passenger operators will be deducted from the fixed charge. The capacity charge is a real cost to rail freight operators who already operate on small margins (table below).

(£ millions)	FLG	DBS	GBRf	GBRf	DRS	Industry Total
Y/E	26/03/2011	31/12/2010	31/03/2010	31/12/2010	31/03/2010	2010
				(9 months)		
Turnover	293.4	401.0	57.2	43.6	45.0	840.3
PAT/(LAT) (excl. Asset Sales)	3.3	(13.0)	3.0	0.8	2.3	(3.6)
PAT Margin (excl. Asset Sales)	**1.1%**	**(3.2%)**	**5.2%**	**1.9%**	**5.0%**	**(0.4%)**

4. <u>Transparency: baseline and marginal rate</u>

4.1. FL's main concern with the setting of the capacity charge for CP4 was a lack of transparency in the baseline activity used and the calculation of the charge. For CP5, NR have indicated that the capacity charge will increase, which we find concerning before any work to recalibrate the charge has even started or when the baseline activity against which the increase is expected is unconfirmed. The

[5] Assumes no weekend discount so an overestimation but the magnitude is of the right order assuming the baseline of activity for CP4 was 07/08

only obvious reference to a baseline we found is the point of introduction of capacity charges in 2002. Our concern lies in the implication that the capacity charge will be calculated against the level of traffic at the time of the introduction of the capacity charge over a decade ago without recognition of the following two items:

4.1.1. We would suggest that since there have been two Periodic Reviews since the introduction of capacity charges where the costs (fixed and variable) of the rail network are assessed in light of an agreed baseline of recent activity and the expected change in activity over time (forecast), the cost of additional traffic is already baked into the charges levied during CP3 & 4. Therefore, the activity baseline for assessing the capacity charge should be the same as that used for assessing CP5 network costs.

4.1.2. We would draw attention to NR having received considerable funds as part of the CP3 & CP4 settlement to improve train performance and increase network capacity. In other words, where there has been investment made to enhance the network to enable more services any deterioration in performance levels (including reactionary delay) should not be in proportion to the increase in services as the enhanced network is designed to be more capable of a busier timetable. We would also suggest that NR performance targets should reflect this irrespective of NR's actual performance.

4.2. Furthermore, we would suggest there is a direct link to any parallel re-calibration of Schedule 8 for CP5 given the common theme of performance on the network. Section 5 covers this in more detail, however we understand that NR has proposed to rebase the freight Schedule 8 benchmarks on the 2 years commencing 1 April 2010. If benchmarks are to be set over this period, or another period as agreed, this must also form the baseline for any calculation of the capacity charge. We suggest it would be incorrect and illogical to baseline the capacity charge against a different timeline as any actual historical performance figures have been achieved with the level of trains running at that time.

4.3. We do expect that the calculation of the charge for CP5 to be totally transparent and available to all operators, including the justification of any discounts[6] applied for freight.

5. Reconciliation to Schedule 8

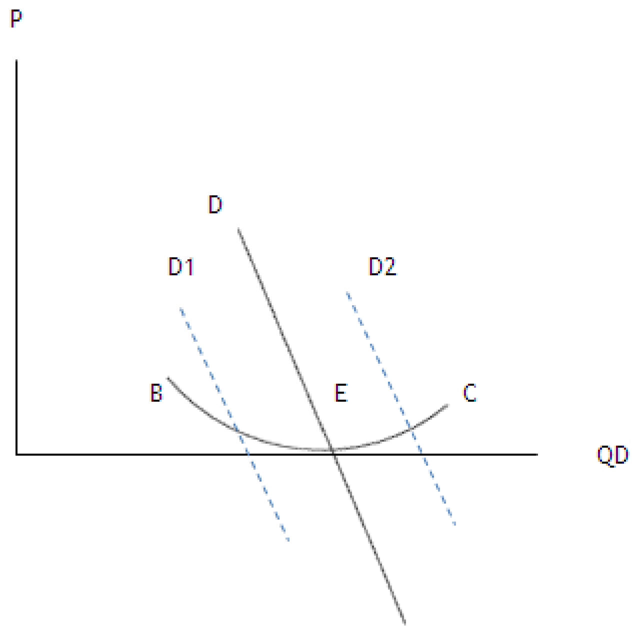
5.1. The consultation paper does not consider the link between the capacity charge and the freight Schedule 8 benchmarks. Because freight operators' Schedule 8 payments are based on the actual delays to other operators[7], there is increased difficulty in recovering from incidents caused by freight operators.

5.2. In recognition of this, the freight operator benchmarks are adjusted each April in proportion to the growth in train miles for the previous year. There is obviously a direct correlation here with the capacity charge and the two sides of the equation need to be considered in parallel to ensure that the equilibrium of the capacity charge and the performance regime does not become unbalanced. In other words, the current mechanism is time-lagged for the freight operators against the actual growth and the adjustment is directly proportion to the change in total train mileage, which is unlikely to reflect

[6] Freight enjoys a 10% discount due to the "flexibility" for diversion etc. but it's not clear how this is derived
[7] Rather than passenger operators' Schedule 8 payments which are based on actual delays to self

the true effect.

5.3. NR has recognised this perversion for capacity charges and suggested three possible functions to calculate the impact of additional services on the network; exponential, constant elasticity and asymptotic. The graph below illustrates our understanding of the relationship as asymptotic where at the baseline (D) there is no cost and the value of moving either side (more or less activity) increases the further away from the baseline. Once this function has been validated, the same function should be used to adjust the freight operator benchmark in Schedule 8 as there will be no difference on the impact of recovery from a NR caused incident or a freight operator caused incident.



5.4. **We have been confused by the relative size of the capacity charge payment and the payments made by NR under Schedule 8. NR's Regulatory Financial Statement 2011/12 states that total net Schedule 8 out payments for the year were £80 million, whilst capacity charge income was £169 million**. Given that the capacity charge is "to allow Network Rail to recover additional Schedule 8 costs associated with the **increased** difficulty of recovering from incidents of lateness as the network becomes more crowded", i.e. only part of the Schedule 8 cost, we are unsure as to why a capacity charge of over double the Schedule 8 payments can be justified especially as NR failed to reach their regulatory targets on performance, which presumably took into account the forecast growth of traffic during CP4. If NR had done so, Schedule 8 payments would have been considerably lower noting that the assumed Periodic Review Settlement on performance is zero. We would be grateful if NR could set out the calculations for the payments and explain the logic of the relative size of the payments.

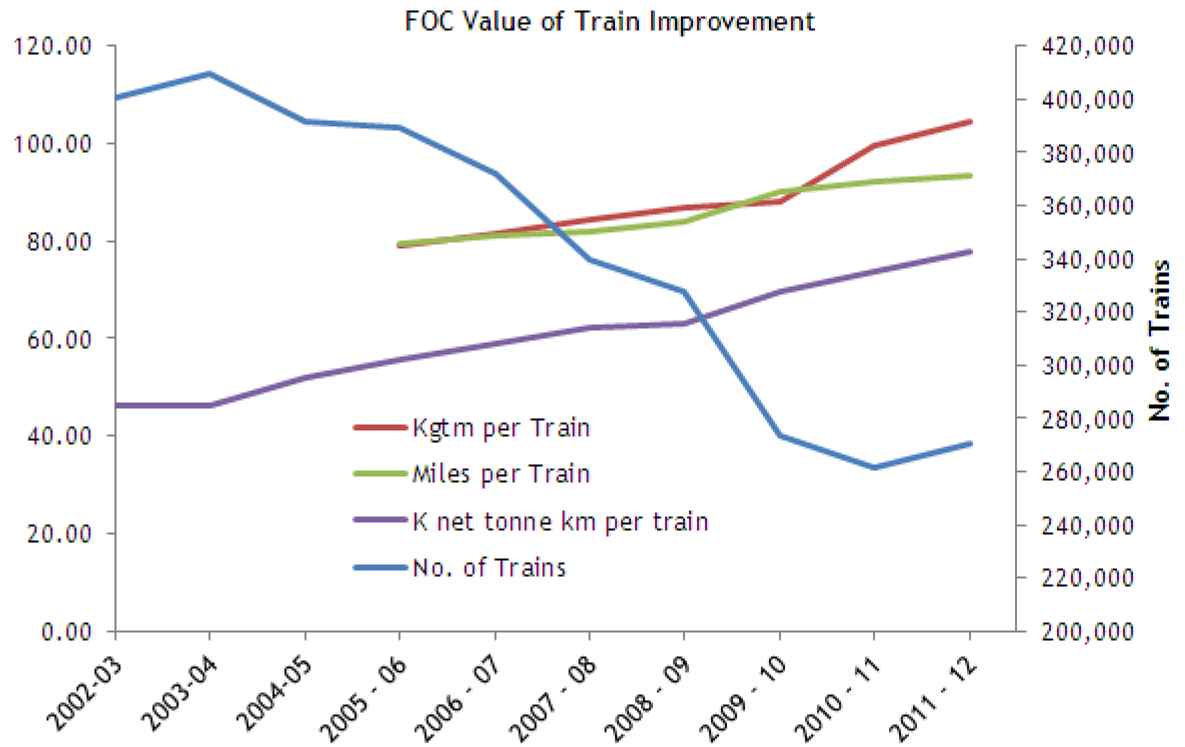
5.5. We would also suggest that by folding the capacity charge into the Schedule 8 performance regime, e.g. by adjusting the benchmarks for NR and FOCs, the incentives for capacity maximisation would be strengthened for freight, passenger and NR plus it avoids the potential illegitimacy of capacity charges for freight. We recognise this as a new development and one that will require further work to which we are willing to engage with to achieve a robust and practical solution.

6. Behavioural impacts on players

6.1. Network Rail states that the recalibration of the capacity charge “will form a significant part of the industry’s efforts to make more efficient use of capacity”. In theory we understand the logic that there is an incentive. However, in reality we challenge whether this really is the case, particularly for franchised passenger operators?

6.2. For passenger operators who are constrained by their franchise specification (even in the new world with a number of station calls per day) and who are also likely to be protected through their franchise agreement from any changes in these charges, it is hard to see that the capacity charge will have any impact on decisions. If this charge was real to franchised passenger operators and they had the freedom to do so it may have some impact on their consideration of running marginal assets around half empty in the off-peak and using valuable capacity which could have broader benefits. We believe by absorbing the capacity charge into Schedule 8, i.e. converting it into a real cost, the incentive is greater to correct this behaviour.

6.3. For freight operators, who do operate in an open market the charge is treated as a simple surcharge (mark-up) to the Variable Usage Charge. There is no road equivalent so the charge only applies in part of the market, not the complete freight transport market. The capacity charge per train mile the capacity charge does create an incentive[8] for freight operators to run longer trains, rather than more trains as illustrated in the graph below. This improved efficiency does mean that NR reactionary delay costs should have fallen.



6.4. FL believes there should be an incentive on NR to improve the management of recovery from incidents and therefore the impact of additional services on the network. It is disappointing that this is not mentioned in the consultation. As far as we are aware the capacity charge since 2002 has not

[8] We should note there is considerable other commercial imperatives to running longer trains

incorporated any targeted improvements from NR in this regard. It would seem prima facie that there is considerable catch up to be taken into account here.

6.5. We do recognise the role of the capacity charge in guarding against NR being dis-incentivised from accommodating increased traffic. We would urge NR to ensure that this is briefed out to staff as our experience is that local performance targets are not adjusted to accommodate additional traffic and local Network Rail staff are reluctant to agree to new services as they are seen as a perceived risk to their performance targets.

6.6. There may be some impact on decisions of funders at the margin, but we note that capacity charge is considered to be an offset to the fixed charge. Therefore the actual incentive is likely to be marginal at best.

7. Specific Consultation Questions

7.1. We have provided answers to the posed questions as per the consultation document but believe the fundamentals identified above need to be addressed as a priority.

Question 1 – do you agree that, beyond the arrangements that are currently in place, capacity charge tariffs that vary across time should not be introduced?

FL supports NR's position to not introduce capacity charges that vary across time and agree this would be over-complicated and could lead to unwanted and not optimal behaviours. More generally we do not support any complicated charges that create theoretical incentives when they do not apply in other parts of the freight transport market (i.e. road). However, it should be recognised that a time neutral capacity charge does not create material incentives but is in effect a surcharge.

Question 2 – do you agree that the weekend discount should remain in place? Do you agree that the magnitude of the discount should be revisited, and informed by analysis undertaken as part of the capacity charge recalibration exercise?

FL agrees with the weekend discount and it makes sense to recalibrate all the parts of the capacity charge at the same time.

Question 3 – do you agree that the capacity charge should be disaggregated to train service code (rather than train service group level) in CP5?

It is not clearly stated but we assume that this question applies to passenger operators only.

Question 4 – what are your views on developing a tool to calculate capacity charge tariffs for new or amended service codes? How could this be best accommodated contractually?

It is not clearly stated but we assume that this question applies to passenger operators only.

Question 5 – do you agree that all freight operators should pay the same single capacity charge tariff in CP5. What are your views on the level of discount applied to freight services?

It is imperative that all freight operators pay the same level of charges, anything else would lead to discrimination. We note that the reasoning behind the 10% discount for freight operators is because of the high level of flex that NR may apply in the timetabling of freight services. There has been no change in these arrangements, see no logic in changing the principle but could argue it should be a higher discount. We would contend whether a further discount should apply to take into account that nearly 2/3rd of freight services run over night and virtually all freight services do not run through London in the peak but only use off-peak capacity. This may already be taken account of but the calculations to date have been opaque so we do not know.

Question 6 – do you agree with Network Rail's proposals in relation to the de-minimus threshold?

It is not clearly stated but we assume that this question applies to passenger operators only.

Question 7 – what are your views in relation to arrangements for handling large timetable changes in CP5?

FL would not support an arrangement whereby the level of capacity charge changed during the Control Period unless necessary for alignment with other elements of the performance regime. It is paramount to our ability to compete with road and in order to make investments that charges are fixed for as long as possible. We suggest that, as far as possible, no changes are made until at least the following Control Period.

RECALIBRATION OF THE CAPACITY CHARGE: ISSUES AND OPTIONS

7.2. We urge Network Rail to ensure that the calculations behind the proposed capacity charge are transparent in all elements. This chapter discusses the methodology options but does not discuss the proposed baseline level that will be used, this seems to us to be fundamental.

Question 8 – Do you consider that the proposed methodology for recalibration of the capacity charge described above and detailed in Appendix 2 is appropriate?

We need to understand what baseline is proposed.

Question 9 – Do you agree that the CUI should be used as the basis for capacity charge recalibration as part of PR13?

Whilst noting that the CUI methodology has been demonstrated to be flawed when used for timetabling purposes and does not reflect individual flaws on the infrastructure it is probably a reasonable proxy for overall capacity use. We are not aware of any other methodology available so are unable to offer a viable alternative. Can Network Rail confirm that they have calculated CUI for every route 24/7? We were not aware that this data was available. Any calculation using CUI should be manually adjusted to take into account locations where enhancements have been made with the aim of increasing capacity or reducing performance risk.

Question 10 – What are your views about accounting for other determinants of reactionary delay as part of the CP5 recalibration of the capacity charge?

We support NR's proposal to invite consultants to suggest an appropriate methodology. This needs to include areas where the network has been enhanced and therefore where improved capacity has been created and/or where there have been performance benefits. However, we urge caution that a consistent method, supported with evidence, should be found and caution against the use of random examples being extrapolated or "operational judgement" being used in place of bottom-up data.

Question 11 – What are your views about the functional form used to model the relationship between reactionary delay and capacity utilisation?

We accept the implicit relationship being exponential in nature, i.e. as traffic increases the cost of delay rises more quickly. We would suggest that if accepted for capacity charges there should application to the Schedule 8 adjustments.

Question 12 – How do you think the industry can guard against analytical risk in the capacity charge recalibration? In the unlikely event that statistical recalibration approached described above is not fully successful, how should we proceed to secure a capacity charge which is fit for purpose in CP5?

In reality it is only freight operators who feel a real impact from changes in capacity charges. We would suggest that capacity charge could be folded into Schedule 8 by way of adjustment to the benchmarks applied.

CHANGES IN THE CAPACITY CHARGE IN CP5

Changes in passenger revenue

7.3. We note that TOC revenue has increased by 55% since the Access Charges Review 2000. Could NR please clarify whether this increase includes or excludes RPI adjustments over that time? as the capacity charge has been adjusted by RPI annually. We are also aware that the number of passenger trains has considerably increased over this period. Surely the relevant figure to use here is increased revenue per train mile?

7.4. We also note here that the ORR is currently reviewing Schedule 8 payment rates and that this will need to link directly into the work on recalibration of the capacity charge.

Changes in capacity utilisation

7.5. NR state that "on a localised basis, enhancement and other schemes have often managed capacity very effectively". NR argue that the resulting additional services result in more reactionary delay. We do not agree that this is necessarily the case at all but quite the opposite if the infrastructure has been upgraded to cope with more services. It is also imperative that NR have a target to improve incorporated into the capacity charge methodology. This appears to be absent in NR's suggestions.

Question 13 – How should changes in the capacity charge between CP4 and CP5 be managed?

If the charge is an increase as NR has assumed, this will be very difficult to manage. It will be difficult for freight operators to explain to our customers that they will have to pay additional charges because there are more passenger services on the rail network. Our customers will not be having that conversation with their road suppliers. Any increase in charges is only likely to lead to modal shift to road.

INDUSTRY ENGAGEMENT AND MILESTONES

7.6. FL was critical of the capacity charge in the last Periodic Review (2008) primarily because there was a total lack of transparency. We welcome NR's proposals to have a more transparent process for PR13.

Question 14 – Do you support the creation of a capacity charge working group? How do you consider that its membership should be decided? What should be its remit?

FL would like to participate in capacity charge working group. It will be interesting to note the proportion of freight operators versus passenger operators who wish to attend. Our initial thoughts on remit would be to consider the material issues raised by the responses to the consultation and resolve to finding a pragmatic and mutually acceptable solution.

Question 15 – Do you have any further views or suggestions about our approach to stakeholder engagement in relation to the capacity charge?

FL would like to see the data presented in detail so we can analysis them ourselves. We do not want high level PowerPoint presentations with little detail.

Question 16 – Do you prefer fewer and longer consultations or more regular and shorter?

Ideally fewer and shorter, but will take more regular and shorter.

Question 17 – Do you have any further views or suggestions about our approach to stakeholder engagement in general?

FL would like to see earlier consideration of the issues and consultation with the industry in CP6, particularly with regard to structural changes to charges that do not need to be left so late in the process. Uncertainty of future charges is very unhelpful to freight operators who are attempting to enter into contracts with customers and justify investments without any government protection. Greater transparency and sufficient time to understand changes only aids us in this effort.

We are willing to discuss this response in more detail if it would prove helpful to the process.

Yours sincerely

Angus Johnston

Business Development
Freightliner Limited