Lindsay Durham
Chair
Rail Freight Operators' Association
C/o Freightliner Group Limited
3rd Floor, The Podium
1 Eversholt Street
London
NW1 2FL

Peter Swattridge
Head of Regulatory Economics
Network Rail
Kings Place, 90 York Way
London, N1 9AG

Cc: Andrew Allum (L.E.K.) and Emily Bulman (ORR)

4 June 2013

Dear Lindsay

L.E.K. report on freight avoidable costs

I am writing, on behalf of Network Rail, in response to your letter to Paul Plummer and Cathryn Ross dated 10 May 2013.

As you note in your letter, in its January 2013 decision document on the average Variable Usage Charge (VUC) and a Freight-Specific Charge (FSC)[1] ORR required us to update our estimate of freight avoidable costs ahead of its Draft Determination in June 2013. In particular, it required that we:

- Follow the recommendations of Arup in revising our estimate of variable usage costs (correcting its treatment of non-commercial freight);
- Make other refinements proportionate to their impact on the determined charge, in particular allocation of costs associated with the possessions regime (Schedule 4) with respect to spent nuclear fuel;
- Update the unit costs consistent with our Strategic Business Plan (SBP) and other best estimates (rather than low range estimates) of freight avoidable costs; and
- Refine the allocation of variable usage costs and netting off of other variable charges (with updated charge estimates).

To be transparent, we set out our proposed approach to updating our initial freight avoidable cost estimates in our consultation on the phasing in the FSC and other issues[2] which we issued in February 2013. We stated that we were minded to ask L.E.K. to review and update its original cost estimate, consistent with the guidance provided by ORR, above. We also stated that, given the considerable effort that went into developing the original cost estimate, we would be recommending that L.E.K. adopt a pragmatic approach to updating its original

[1] Available at: Consultation on the variable usage charge and a freight specific charge
[2] Available at: Closed consultations - Periodic review 2013 - Delivery plans - Network Rail

cost estimate. Furthermore, we noted that because ORR had taken a conservative approach to setting the level of the FSC (setting it based on its adjusted 'low' cost estimates), if the updated L.E.K. cost estimate was higher than the original estimate, or marginally lower, this would be unlikely to impact the level of the FSC in CP5.

We strongly disagree that we have, in anyway, sought to reposition L.E.K.'s estimate of freight avoidable costs as the Government 'subsidy' to the rail freight industry. Rather, we have merely asked L.E.K. to update its freight avoidable cost estimate, as required by ORR, using the same methodology that was discussed, in detail, with stakeholders when preparing its initial report. The purpose of this work is to inform the level of the FSC in CP5 and not to estimate the level of Government 'subsidy' to the rail freight industry. Indeed, in its updated final report L.E.K. has further clarified that the purpose of its work was not to assess the wider economic costs/benefits of rail freight and that in order to do this a range of other exogenous factors would need to be considered.

In addition, we were required by ORR to estimate our freight avoidable costs in the long-run (i.e. from CP5-CP11 taking into account forecast traffic growth) and as you have noted the forecast future increase in freight traffic volumes, which we welcome, results in a higher absolute freight avoidable cost estimate. However, in its report, L.E.K. also set out its freight avoidable cost estimates at CP5 average traffic levels. Its freight avoidable cost estimate based on average CP5 traffic volumes is considerably lower than its cost estimate based long-run average traffic levels. In its updated final report L.E.K. has also added a freight avoidable cost estimate at end-CP4 traffic levels.

In its report L.E.K. also clearly distinguishes between 'gross' (including costs currently recovered through track access charges) and 'net' (excluding costs currently recovered through track access charges) freight avoidable costs and presents these estimates side-by-side. We do not consider that L.E.K. places undue weight on its 'gross' freight avoidable cost estimate. If anything, we believe that its report places greater weight on the 'net' estimates as it was understood that it was these estimates that were likely to inform the level of the FSC in CP5.

We would also like to clarify that L.E.K.'s methodology does not assume that enhancement costs are fully avoided in the year(s) in which they are incurred. Instead, its methodology spreads these costs over the long-run, reflecting the long-life nature of the assets.

We strongly disagree that this work has been done without any consultation with stakeholders. Indeed, freight operators have played an active part in the work, for which we are grateful. Throughout the work to estimate our freight avoidable costs L.E.K. and Network Rail have been open and transparent. We note that L.E.K. has presented to the industry in relation to this issue on numerous occasions, met bilaterally with key stakeholders, and sought comments from stakeholders on detailed aspects of work as well as the report more generally. As you are aware, when we received your letter, on 10 May 2013, L.E.K.'s updated report was still draft and being consulted on. Moreover, we provided a longer window for stakeholder comments than the "*few days*" suggested in your letter. We first circulated L.E.K.'s updated draft final report for comment on 30 April 2013 (ahead of the monthly VTAC meeting where L.E.K. were due to present) then following the meeting we requested any comments on the draft report by close of business 17 May 2013. We understand why you would have preferred longer to consider the updated report, however, ORR required us to provide it with an updated cost estimate ahead of its Draft Determination, due to be published on 12 June 2013. We also sought to be transparent about the updates to the initial report by inviting L.E.K. to present at the monthly VTAC meeting and answer questions which stakeholders might have. It is important, however, that stakeholders do not consider the slides presented by L.E.K. at this meeting in isolation. These slides were developed with the express purpose of explaining to stakeholders the key changes to the initial report. Stakeholders seeking to understand the L.E.K. analysis should read the updated full report[3].

As you identify in your letter, the change to the 'low' L.E.K. freight avoidable cost estimate is principally due to:

- Increases in track maintenance and renewal costs as a result of using new Vehicle Track Interaction Strategic Model (VTISM) results for both the 'high' and 'low' end of the avoidable track variable usage avoidable cost range; and

- The inclusion of redundant freight property assets cost estimates increasing the 'high' freight avoidable estimate.

Overall, L.E.K. has sought to retain the principles established in its initial report.

The revised estimate of avoidable track variable usage costs was adopted following a review of our initial VTISM 'high' avoidable cost estimate by the independent reporter, Arup[4]. Arup concluded that the 'high' estimate of avoidable track variable usage costs was appropriate, subject to the correction of the treatment of engineering trains in the model run – the 'high' cost estimate used in L.E.K.'s initial report incorrectly assumed that track variable usage costs associated with engineering traffic would be avoided in the absence of commercial freight traffic when, in fact, they would continue to be incurred. As suggested by Arup, and required by ORR, we addressed this issue and provided the updated 'high' cost estimate to L.E.K., who updated its report. In light of Arup's findings, L.E.K. used the updated results for both the 'high' and 'low' end of the track variable usage avoidable cost range. Previously the 'low' end of the range was based on our work to estimate the level of variable usage charges in CP5, which was predicated on a small incremental traffic increase, rather than the removal of all commercial freight traffic, which we consider to be more relevant.

We accept that VTISM is a complex model and may be difficult to understand for some stakeholders. However, we have listened to stakeholders' concerns in relation to this issue and we organised for Serco to host a workshop to explain VTISM, in detail, and respond to any stakeholder queries. This workshop was attended by colleagues from the freight industry. We also note that VTISM has been independently reviewed several times as part of the periodic review process and has, generally, been found to be robust.

With respect to the inclusion of property assets in L.E.K.'s updated freight avoidable cost estimate, it is clear that, absent commercial freight traffic, Network Rail would be in a position to dispose of certain property assets thus generating income for the company. Due to time constraints, L.E.K. did not include a cost estimate in relation to property assets in its initial report although I understand that this issue was discussed with freight operators during the avoidable cost study. However, in its January 2013 decision document, on the VUC and

[3] Available at: Closed consultations - Periodic review 2013 - Delivery plans - Network Rail
[4] Available at: Closed consultations - Periodic review 2013 - Delivery plans - Network Rail

FSC[5], ORR estimated these costs to be between £0m-£22m per annum. The high estimate of £22m was based on amortised current rents, which ORR considered to be a prudent approach. In its updated report, L.E.K. adopted ORR's cost estimate with respect to property assets, an approach which Network Rail thinks is reasonable and, if anything, is likely to be conservative. We understand that ORR has already provided you with further information in relation to this cost estimate.

Consistent with other comments received, L.E.K. has reviewed your comments on its updated draft final report and made changes, where it considers appropriate. We provided ORR with L.E.K.'s updated final report[6] on 23 May 2013 for consideration ahead of its Draft Determination.

We note that, ultimately, the final decision in relation to the level of the FSC in CP5 rests with ORR, rather than Network Rail. However, ORR has already placed a cap on the maximum level of the charge. It is also worth bearing in mind that ORR's Draft Determination is itself a consultation, so RFOA will have a further opportunity to make representations to ORR with regards to this work if it wishes to do so.

If you have any queries in relation to the contents of this letter please do not hesitate contact Ben Worley (Ben.Worley@networkrail.co.uk) or myself.

We will shortly be publishing a copy of this letter on our website.

Yours sincerely

Peter Swattridge

Head of Regulatory Economics

[5] Available at: Consultation on the variable usage charge and a freight specific charge
[6] Available at: Closed consultations - Periodic review 2013 - Delivery plans - Network Rail