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Dear Rob

Periodic Review 2013 – Consultation on Schedules 4 and 8 possessions and performance regimes November 2012

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 Comments (*in italics*) or tables and graphs where clearly identified should be treated as confidential and are not to be published.

EXECUTIVE SUMMARY

- Freightliner (FLG) supports the underlying principles and structure of Schedule 4 and 8 as liquidated sum regimes.
- We are concerned that there appears to be some fundamental misconceptions about the "net" cost to Network Rail (NR) of the operation of these schemes. We would urge a more holistic consideration of the whole industry and freight sector behaviours and the associated impacts when considering the recalibrations.
- Before tilting the balance further in favour of Network rail and against freight operators, we suggest that cognisance is taken of the fact that Network Rail appears to have already benefitted to the tune of nearly £1BN from the Schedule 4, Schedule 8 and Capacity Charge regimes since 2004/05[1].

Schedule 8

- Freightliner has fundamental concerns that the proposals for revised benchmarks and payment rates, when taken collectively, would result in unintended consequences that reward poor performance and punish improved performance over the long term. As proposed to date, the recalibrated elements would change the balance in overall risk faced, force behavioural changes and threaten investment in CP5.
- Freightliner strongly advocates that the proposals for revised benchmarks are reconsidered on the basis of long term incentives and behaviours rather than looking at one control period in isolation.
- Freightliner is profoundly opposed to the setting of Network Rail's benchmark at the period when ORR were considering an enforcement order because of Network Rail's failure to meet their CP4 regulatory target.
- The proposals, as consulted, would result in increased risk and subsequent cessation of marginal

[1] Financials sources from ORR Schedule 4&8 Consultation (Nov 2012) and NR regulatory financial statements

flows. This would undermine the achievements of the sector to date and result in modal shift to road.

- The calculation of payment rates to passenger operators and freight operators has not been undertaken on a consistent basis and we are unaware of any justification for this difference. We propose that the calculation of freight operator payment rates is revised to include the marginal revenue effect.
- The value of delays that should be attributed to freight trains has increased ahead of RPI during CP4 and the payment rates should be updated to reflect this.

Schedule 4

- The current regime does not fully compensate freight operator or their customers for the costs and losses caused by possessions or the wider impact on society of modal shift to road.
- The cost to Network Rail of Schedule 4 payments must be considered in the context of the greater savings to Network Rail of an efficient and acquiescent possessions process.
- The current freight rates deliver misaligned signals to Network Rail in deciding possession timings and consideration should be given to increasing the rates to at least those applied at the beginning of CP4 and / or to reflect the increased average number of tonnes per train (and subsequent reduction in number of train services).

INTRODUCTION

This consultation is one of many consultations that make up the Periodic Review process. **Unfortunately, the underlying theme of all of these consultations appears to be increased charges or increased exposure to risk for freight operators.** We would emphasise that rail freight operators, unlike franchised passenger operators, do not have any franchise protection against changes in charges or degrees of risk.

We support the current principles and structure of the Schedule 4 and 8 regimes. However, we stress the need to recognise the net impact of significant movements in the ratios that exist between the benchmarks and payment / bonus rates on operator behaviour and financial sustainability following the results of the individual recalibration analysis.

We re-iterate that rail freight is one of the success stories of privatisation and has achieved considerable efficiencies over the past decade and a half. This has been recognised, independently, by the McNulty Study, successive Secretaries of State for Transport and Network Rail:

- ✓ 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 other benefits of rail freight that fall outside the railway balance sheet but benefit the road network and the economy include:
  - £772 million per annum in congestion costs[2];
  - £133 million per annum in road infrastructure costs[3];
  - £68 million per annum in CO2 costs[4];
  - Pro-rata 42 road deaths at a value of £78.8 million[5]; and,
  - There has been over £1.5bn of private sector investment in rail freight since 1996.

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[2] Analysis based on data contained in Mode Shift Benefit Values: Technical Report April 2009, DfT – 2015 values expressed in 2010 prices

[3] DfT's freight Mode shift Benefits Values April 2009 x lorry journeys (ORR national rail trends) by average mileage

[4] Delivering a sustainable Transport System: The Logistics Perspective, DfT (December 2008). Please note that this figure probably under-estimates the real value of CO_2 following the publication of the Stern report in 2007 which has not been taken account of in these calculations

[5] DfT's Unit 3.4 The Safety Objective values one fatality at an average of £1.876m on all road types and times of day multiplied by the 284 road deaths in 2009 involving HGVs

In addition, modal shift of freight to rail has received robust support from HM Government. On 29 November 2011 the Secretary of State for Transport said:

"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".

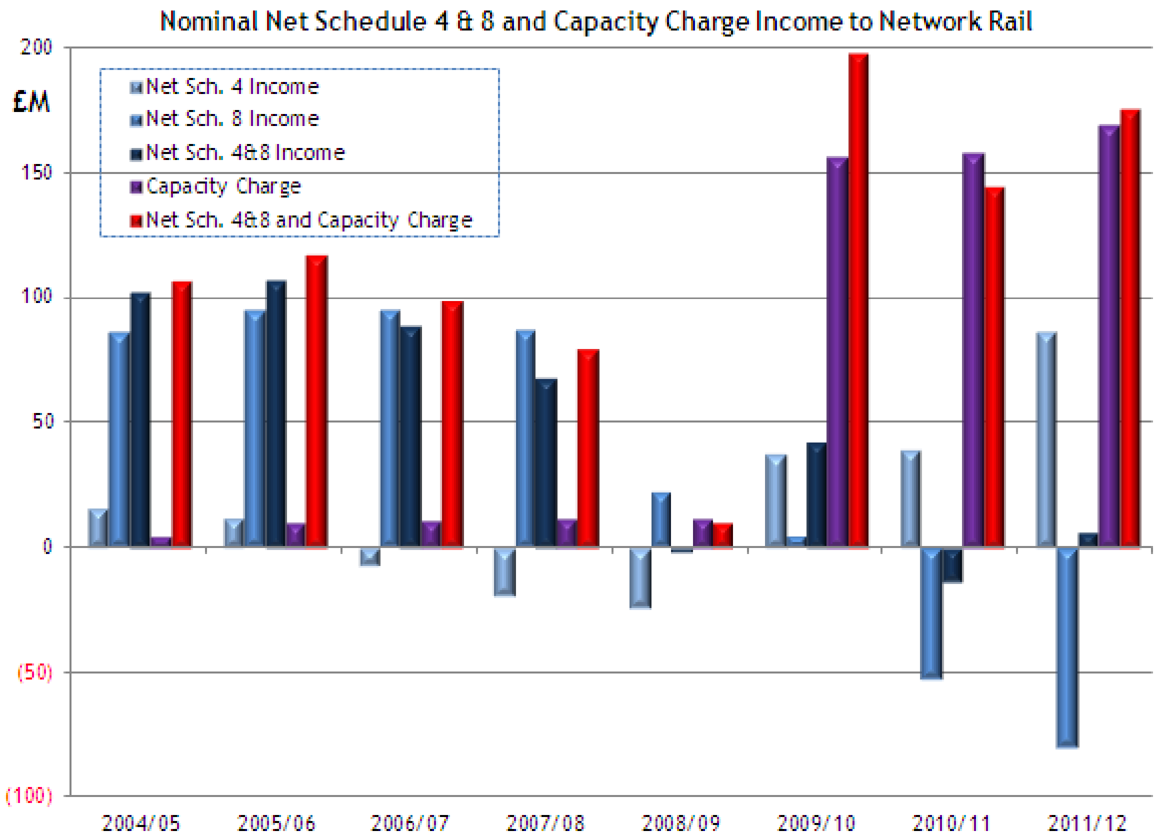
These statements have been backed up by considerable investment by Government: £380M in the Strategic Freight Network (SFN) between 2009-14; and, a further £200M committed to the SFN between 2014-19 to support the growth of rail freight.

In addition to the proposed changes to the Possessions and Performance regime, the Office of Rail Regulation (ORR) are proposing a number of other policy changes in the Periodic Review 2013 (PR13) that will undoubtedly have significant financial implications for freight operators. Coupled with the announced increases in track access charges, e.g. the introduction of the Freight Specific Charge and increase in Variable Usage Charge rates, Freightliner is concerned that the ORR has not considered the overall financial risks that will be felt by the freight operators.

Freightliner believes that the proposals, as consulted, would result in increased risk and subsequent change in freight operator behaviour which could undermine the achievements of the sector to date, resulting in the reversal of hard-won modal shift from road to rail since privatisation.

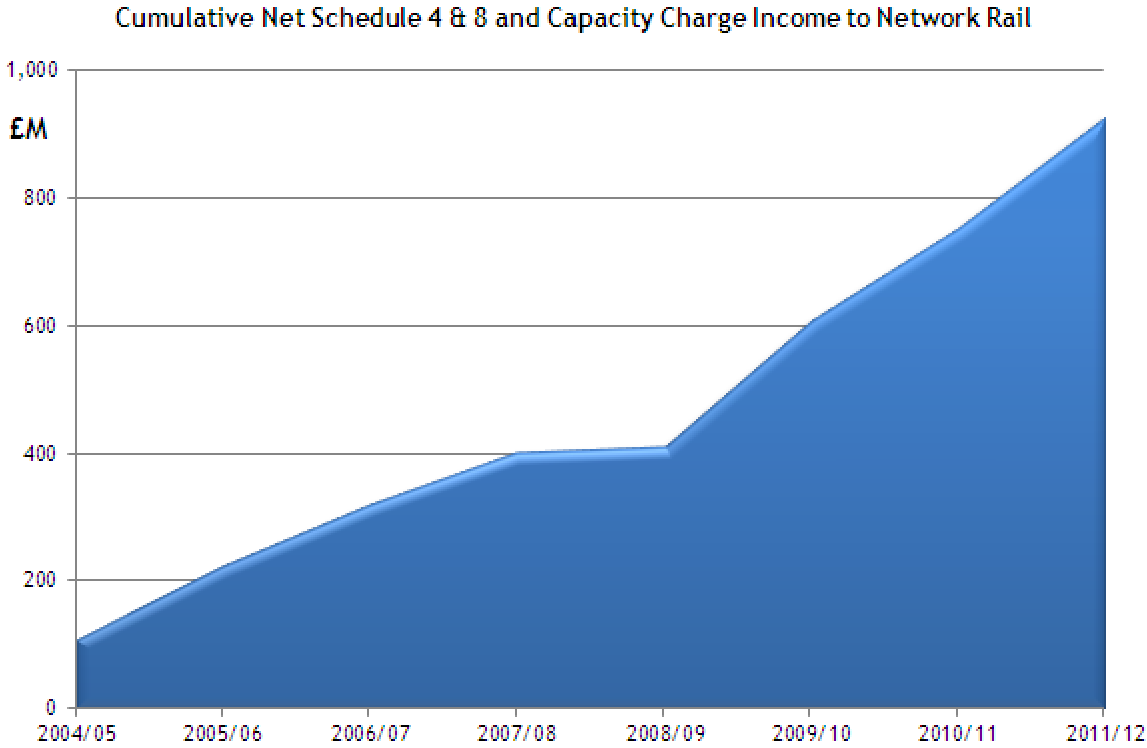
Capacity Charge as part of Schedule 8 income

We note that the graph on page 23 of the consultation document excludes the income that Network Rail receives from the Capacity Charge. The Capacity Charge is supposed to compensate Network Rail for the marginal impact on Schedule 8 payments of growth in activity on the network[6] (as measured by train miles) within a Control Period (CP). If these payments were included within the graph the Schedule 8 income to Network Rail rises very considerably in every year from the beginning of CP4, as the graph demonstrates below.



[6] Network Rail's Periodic Review 2013 – Consultation on the capacity charge (July 2012)

Far from actually suffering financially from the performance, possession and capacity regimes the cumulative impact of the above actually represents a £1BN net income to Network Rail as can be seen in the following chart.



This seems counter-intuitive given that much of it is to compensate operators who are net victims of delays, network congestion and possessions.

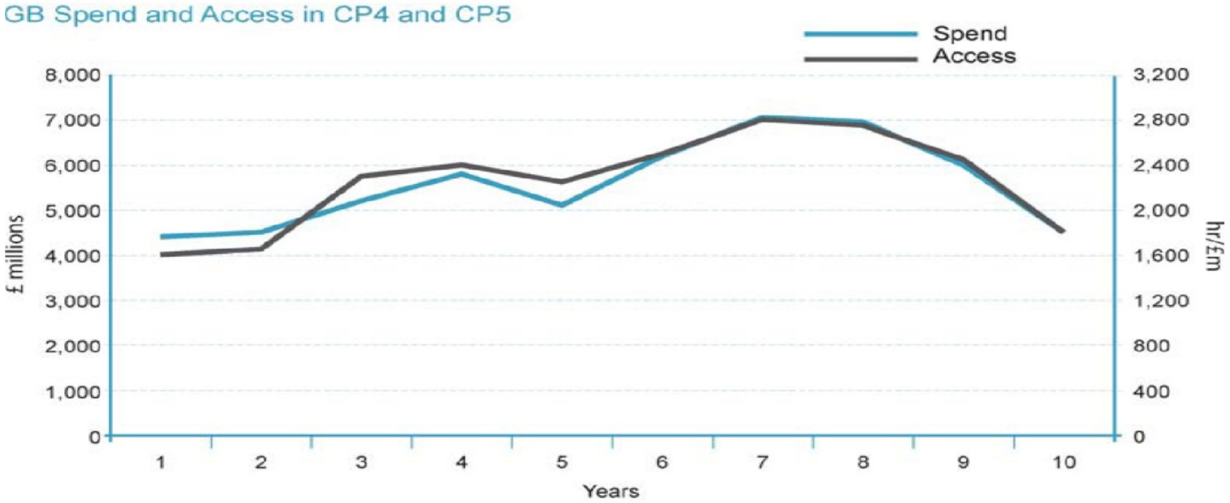
Principles and Purpose of Schedules 4 & 8

Freightliner supports the continuation of the Schedule 4 and 8 regimes as liquidated sum regimes. We would highlight that practically the regimes are primarily incentive schemes that have the framework to encourage the "right" behaviour throughout the rail industry. The Schedule 8 regime, in particular, creates clear incentives to both operators and Network Rail which has resulted in material and sustained good performance.

SCHEDULE 4 POSSESSIONS REGIME

The Schedule 4 possessions regime must be considered in terms of the whole industry impacts rather than just in terms of the payments made by Network Rail to operators. We do not think that more payments to operators should be considered necessarily as a "bad thing" but must be considered in the wider context of the behaviours of all parties. The overall cheaper option may be for Network Rail to take access that requires more Schedule 4 payments to operators but results in larger savings elsewhere. The incentives must be set so that both parties are equally incentivised to engage and work more closely together to find the optimum solution. It is disappointing that the ORR does not consider in its consultation a more holistic view in terms of how to achieve a better industry outcome.

This must also be considered in the context of the additional access that Network Rail will require during CP5. The graph on page 74 of Network Rail's Strategic Business Plan (copied below) indicates that considerably more access will be required during CP5 (years 6-10) than in CP4 (years 1-5). This is in part to catch up on CP3 and CP4 renewals and to implement the considerable CP5 enhancement programme. The cost of Schedule 4 regime should be considered in the context of the overall cost efficiencies of gaining access for these programmes.



<u>Link between Schedule 4 and planning of possessions</u>

The Schedule 4 regime provides some liquidated compensation to operators for the impacts of Network Rail taking possessions. It also gives Network Rail clear financial signals to determine when to take possessions. In this respect we have concerns that Network Rail use the Schedule 4 rates to calculate the assumed costs and losses to freight operators of possessions. This is clearly incorrect as the current Schedule 4 rates are not intended to and do not cover the precise costs and losses incurred by freight operators.

We are very concerned that assumptions based on Schedule 4 payment rates will lead Network Rail to make sub-optimal decisions with regard to timing of possessions that do not properly account for whole industry costs or impacts, including the impact to wider society of modal shift to road. Network Rail has already stated in their Strategic Business Plan that they are planning to take more possessions during mid-week nights and less at weekends.

It is not transparent to us how they have reached this conclusion as they have not discussed it with us. We are concerned however that the existing low freight Schedule 4 rates are a major contributory factor in this changing policy. In other words, disruption to freight services is potentially the default because they are inherently “cheaper” to disrupt than the passenger operator services, even though this does not reflect the actual costs and losses or impacts on customer’s supply chain and to wider society. Furthermore, there is undoubtedly a longer term impact on demand from customers who have received an inconsistent service (the marginal revenue effect). This is harder to quantify but could be modelled.

In order to prevent such potentially perverse decisions we would advocate that the Network Rail payment rate to freight operators must be sufficiently high to provide a genuine incentive for Network Rail not to default to possessions in traditional freight hours of operation and be set at a value that more nearly reflects the actual costs and losses of freight operators. There is a case for government to support Network Rail in an increased level of payment as there are considerable benefits to Network Rail to enable more efficient possession planning and to the UK that fall outside the railway balance sheet (> £1 billion per annum, page 2) that could be lost if disruption to freight operator’s services caused modal shift to road.

<u>Regime to incentive parties to work together</u>

An effective Schedule 4 regime should act as an incentive for freight operators to work with Network Rail to more easily accommodate disruptive possessions despite the impact on our services. Freightliner believes that the level of liquidated compensation paid to freight operators far outweighs the financial savings that Network Rail gain from being able to plan possessions and undertake work in an efficient manner. By reducing the compensation paid to operators through Schedule 4, this relationship could be further skewed to the point that there will be little incentive for freight operators to accept the greater level of disruption that is planned in CP5 (see graph on page 5).

Were this to happen, it is likely that the number of disputed possessions will greatly increase, consequently generating increased costs to Network Rail and more lost time taken up whilst the

Network Code Part D process is followed. With there being less incentive for operators to show 'goodwill' there is also likely to be an increase in instances of late notice changes to possessions being cancelled. This appears to be a completely different direction of travel to the rest of the industry and the Rail Delivery Group (RDG) as they seek to develop an effective framework for alliancing and aligned incentives in line with the McNulty Review.

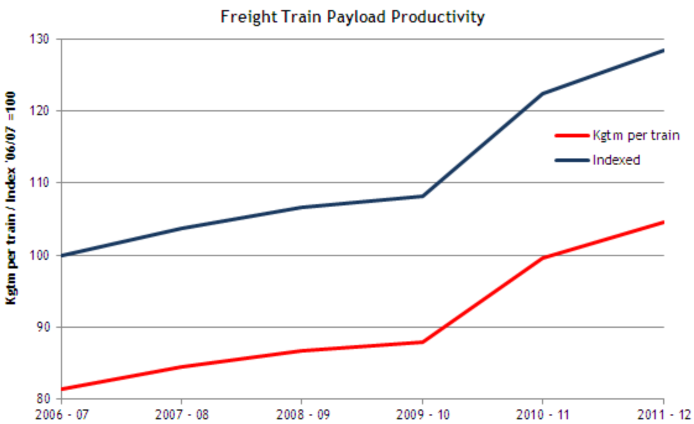
Access Charge Supplement

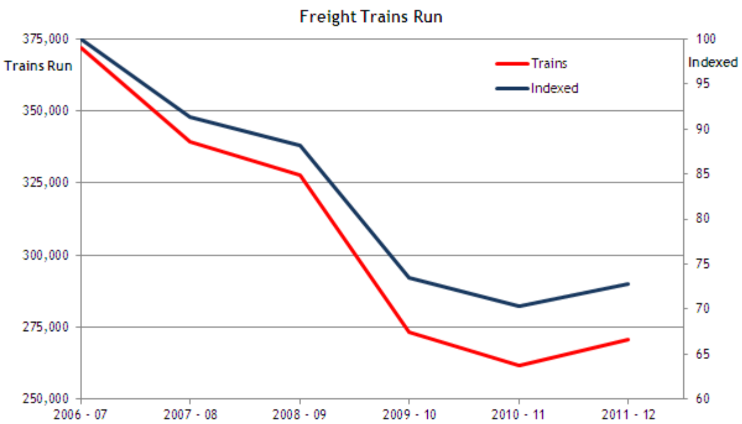
We note that freight operators do have the option of buying financial parity (in terms of receiving the full freight compensation value calculated) if we pay an Access Charge Supplement (ACS). An ACS is currently paid by the passenger operators. However, we contend that where this would be an upfront and direct cost to freight operators (with the incumbent risk of non-recovery) the passenger operators are in effect funded for the cost of their ACS through their franchise agreements. We do not see this as a level playing field and suggest it is unreasonable to expect freight operators to pay the ACS for "equality" or argue that passenger compensation is funded by passenger operators and not the taxpayer.

Value of Schedule 4 Rates

The Schedule 4 freight rates have been reduced during CP4[7] by ORR because total compensation to freight operators exceeded Network Rail's allocated CP4 funding allowance, following more disruption to freight services in particular areas than originally anticipated in the first year. This reduction further weakens Network Rail's incentive to treat freight and passenger equally and to properly account for the full impacts on the rail industry in their decisions.

Therefore as a minimum, we would propose the Schedule 4 freight payment rates revert to their pre-adjustment values and additionally that the Category 2 rates are adjusted to take into the increase in the average tonnes per train (and subsequent reduction in trains run). Network Rail calculations show that since the benchmark year of 2006/07 kgtm per train has increased by 28.4% and that in the same time frame trains run have reduced by 27.2% as demonstrated by the following graphs.





7 31% reduction on any possession agreed after November 2011 but any possessions agreed prior to November 2011 at the old rate irrespective of when they actually occur

We believe that it would be unfair on freight operators not to reflect these changes in productivity and subsequent more efficient use of the network achieved since the rates were last set and would create little incentive for further efficiency gains in CP5. We would highlight that as the number of trains on the network has proportionately reduced in line with kgtm growth per train the overall impact on Network Rail's payments should be neutral.

Level of Budget

Given that the original budget was set at the estimated level of Network Change compensation in 2006/7 (£9M + 50%) and the level of change is planned to considerably increase during CP5, because of the planned enhancement schemes there is a strong argument that the Network Rail budget of £13M should be increased to reflect the additional Network Change compensation that would have been paid in CP5. We are also aware that Network Rail has stated in their Strategic Freight Business Plan that there will be an increase in renewals work to catch up on CP3 and CP4 backlog so there is a further case for an increase in funding in CP5 versus CP4.

We believe that any increase would still represent a net gain to government via the efficiencies that Network Rail could achieve through an effective possession plan and the wider economic and environmental benefits of retaining freight movements on rail that fall outside of Network Rail's balance sheet (as previously explained).

Proposed Detailed Changes to Schedule 4

We would like to propose some detailed changes to the Schedule 4 regime with a view to improving the practicality of the regime:

A particular element of severe disruption that Freightliner believes is currently not appropriately compensated for is that caused by the diversion and / or retiming of trains due to pre-planned ("early notice") possessions. Freightliner understands that a clear distinction is made between possession-induced disruption, according to whether it constitutes "late notice" or "early notice" disruption. The compensation for these types of disruption is administered through the Service Variation and Cancellation (SVC) in Schedule 8 and Early Notice Possession (ENP) in Schedule 4 respectively.

Freightliner acknowledges that the ENP regime is not designed to compensate for the "full" costs of disruption. However, various issues have occurred which have further eroded the differential between the actual costs of possession disruption and the requisite compensation values. The modification provisions have been outlined previously. Augmenting this is the clear increase in freight operator's variable costs: fuel costs (and consumption), driver costs etc., which have occurred since the analysis that underpinned the 2009 introduction of the ENP regime was undertaken. As such, Freightliner believes that this element of possession-induced disruption is not adequately compensated.

Furthermore, it is also acknowledged that the ORR believes that "planned" disruption should attract a form of compensatory "discount" when compared with compensation payable for "on the day" disruption. Whilst the intuition for this may be theoretically sound, Freightliner's experiences of possession planning, the ENP and the SVC regimes suggests that in many cases, irrespective of the timescales notified for possession-induced disruption, the overall effect on train running is similar and in some cases identical.

As a proposed solution to address this gap, Freightliner suggests that specific provisions of the SVC (late notice) regime are made applicable to the ENP regime. These are:

- An additional reversal movement over those planned to be included as a "Category 1 trigger" within the CP5 ENP regime.
- The existing ENP diversionary threshold ("trigger") of an extra 10 miles to be reduced to 5 miles to align with late notice provisions.
- The current ENP retiming threshold ("trigger") of 60 minutes to be reduced to 30 minutes to align with existing arrangement for late notice possessions.

Freightliner believes that the above proposal allows the necessary changes to be undertaken peripherally rather than imposing fundamental changes to the existing regime's administrative framework. Furthermore, Freightliner does not believe that the above proposals would be overly burdensome to the existing regime's funding arrangements. We would be happy to elaborate on the above proposals within subsequent industry working groups.

<u>End customers</u>

Freightliner does not believe that there would be any benefit in Network Rail consulting directly with end customers over forthcoming possessions. Indeed given the complex and lengthy process and frequent changes to plans we would be concerned if they did. Freightliner already has regular contact with its customers and will fully engage them when they are likely to be affected by any possessions, particularly where their train will be cancelled or part cancelled because of gauge restrictions. Freightliner aims to make using rail services as simple as possible for its customers and the possession planning process certainly does not achieve that.

The customer is not aware of the resourcing implications (in terms of adjusted plans for drivers, locomotives and wagons) of any planned possessions so consequently may not be best placed to fully understand the resulting implications to their services. Therefore, to avoid confusion and mis-communication Freightliner would prefer that the freight operator involved remains as the primary point of contact with Network Rail. Network Rail does not ultimately run any trains and our customers are not theirs, we are their customer. It is our view that Network Rail should no more venture into our customer or supplier chain than we should theirs.

SCHEDULE 8 – PERFORMANCE REGIME

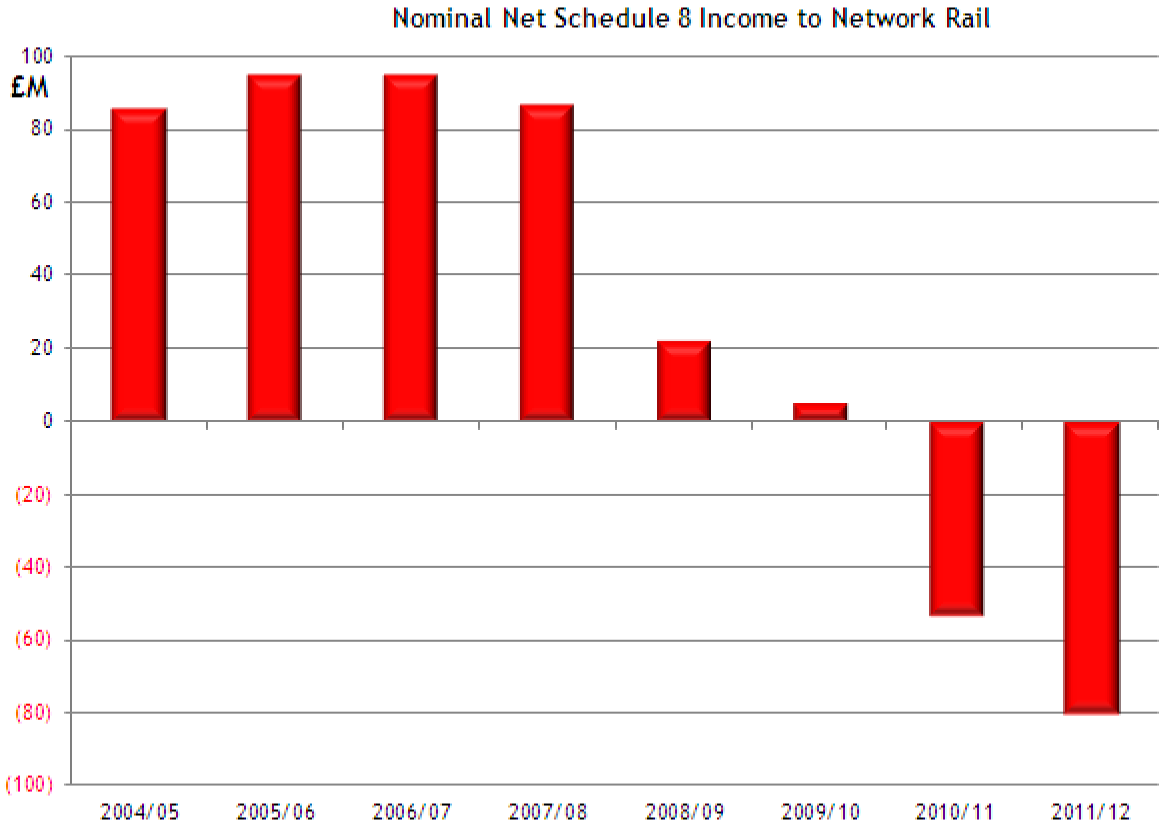
The Schedule 8 regime provides compensation, or reward, to operators and Network Rail for their respective performance impact on the network[8] and financially incentivises all parties to continually improve their performance on the rail network. Historical performance data indicates that Schedule 8 has a strong pedigree for incentivising improving operational practice and investment among operators and NR[9] (page 4). We support a continuation of a single regime applicable to all freight operators thereby avoiding competitive advantage of one operator over another.

Freightliner has fundamental concerns that the proposals for revised benchmarks and payment rates, taken collectively, would result in unintended consequences which reward poor performance and punish improved performance over the long term. As proposed the recalibrated elements would change the balance in overall risk faced, force behavioural changes and threaten investment in CP5.

It appears that each element of the regime: the Network Rail benchmark, the freight operator benchmark, the Network Rail payment rate and the freight operator payment rate are being considered separately but the impact of the change in risk profile for each party has not been assessed. The proposals, as consulted, would result in increased risk and subsequent consolidation of marginal flows that undermine the achievements of the sector to date, and result in modal shift to road.

Freightliner fundamentally objects to Network Rail's benchmark being set at performance levels of 2010-12 as this was a period when Network Rail were performing considerably below their Regulatory target and indeed the ORR were seriously considering issuing an enforcement order. This is illustrated by the net Schedule 8 income in the graph below.

[8] Measured as delay minutes per 100 miles travelled
[9] NR acts as a clearing house between operators as well as a participant



Freightliner strongly advocates that the proposals for revised benchmarks are reconsidered on the basis of long term incentives and behaviours rather than looking at a sample subset during one control period in isolation. The risks of taking a short term view are:

a) Individual and discrete recalibration of the NR and operator benchmarks and payment rates are likely to result in sub-optimal operational behaviour in CP5 in that operators (or Network Rail) are incentivised to perform below their benchmark in order to secure a lower benchmark in CP6.

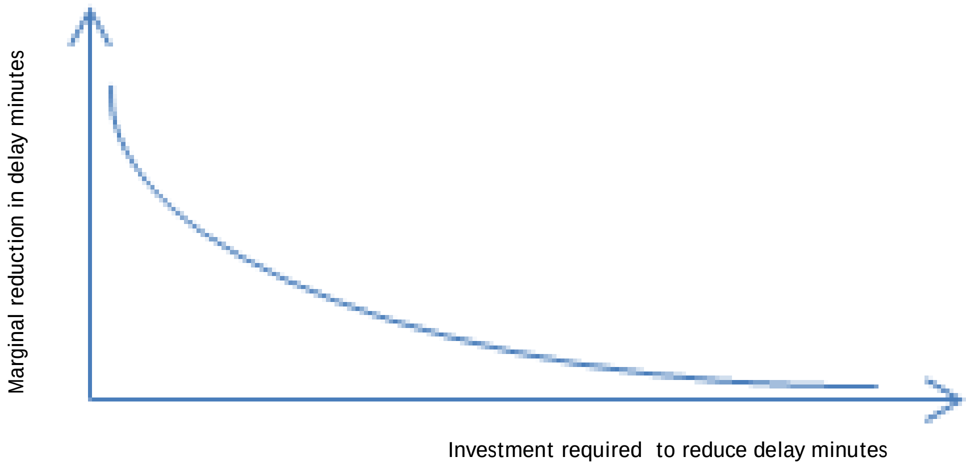
b) Significant adverse shifts lead to inertia in the necessary investment to improve performance due to the short payback period (max 5 years) and the loss of into perpetuity returns. The performance improvement to date has been driven at least in part as a consequence of investment by NR in the network and by operators in rolling stock. The financial consequences of the performance regime have enabled the positive investment cases and ultimately the decision to allocate scarce capital.

The calculation of payment rates to passenger operators and freight operators has not been undertaken on the same basis and we are unaware of any justification for this difference. We propose that the calculation of freight operator payment rates is revised to include the marginal revenue effect.

Freightliner supports setting bonus rates at 100% of the payment rate in order to strengthen the incentive to beat a benchmark. We support the Schedule 8 payment rates remaining at 100% of calculated cost and revenue loss and agree with the commissioned Steer Davies Gleave (SDG) analysis that less than 100% payment rates would not materially alter NR or operator behaviour. It seems appropriate for RPI indexation to remain consistent with other areas of the Periodic Review (PR).

<u>Freight Operator benchmark recalibration</u>

Freightliner objects to the proposed sample period (2010/11 & 2011/12) being used to recalibrate the freight benchmark. Resetting the benchmarks each control period based on a small sample (2 years data) removes any long term incentive to improve performance and perversely encourages poor performance in the sample benchmark years in order to benefit from a “higher” benchmark in the next control period. It also ignores the fact that moving towards zero delay becomes increasingly expensive (see below illustrative graph). We would suggest that we are further along the curve to the right than Network Rail as evidenced by our more stable performance (page 4).



There are 4 further consequences:

a) Freight operators would in all likelihood have to pay out on their performance from Day 1 of CP5 even though performance is materially no worse than today, although the sample period would appear to reflect better performance than the recent trend;

b) New or even existing freight traffic, with predominantly low margins, are at risk as the penalty payment of running late could eradicate any margin (or even push the service into loss) resulting in the stopping of the service. For these services the social and economic benefits that rail freight brings to UK plc. would also be lost;

c) Irrespective of what happens to the Network Rail benchmark the business cases for performance enhancing investments already made by freight operators in CP4 would be significantly undermined. These necessarily assumed a similarly balanced regime beyond CP4; and,

d) Freight operators would only have the confidence to invest further in CP5 if there was a very short payback, i.e. within the Control Period, and during the later years of the Control Period there would be no incentivise to invest at all. We believe this is a fundamental flaw with the proposed methodology for calculating the benchmark.

For equality with our position on the Network Rail benchmark, we propose a position where the exit CP4 freight benchmark is carried forward into CP5. The Rail Freight Operators' Association (RFOA) wrote to the ORR in September 2012 with a proposition that the freight benchmark is reset to CP4 entry level (2.63 mins per 100 train operator miles). This compromise delivered a 17% reduction on the estimated CP4 exit point (3.16 mins per 100 train operator miles)[10] and settled between the CP4 exit point (3.16 mins per 100 train operator miles) and the sample actual freight benchmark[11] (2.28 mins per 100 train operator miles).

The RFOA proposed compromise sits within the historic ratio between Network Rail and the freight operator benchmarks and does not fundamentally move the risk profile towards the freight operators who are least able to bear it. The RFOA proposal gives up much of the performance improvements made by freight operators during a period of increased overall network activity (circa 3% Compound Average Growth Rate (CAGR)) whilst reducing the cliff edge of risk that freight operators would otherwise be facing.

[10] 2.4% increase in Total Network Mileage adjusted by the congestion factor of 1.5 on the 12/13 FOC benchmark (Adjusted Train Operator Benchmark, ATOB, methodology)

[11] NR indicative November 2011

		Schedule 8 Benchmarks: Mins per 100 miles		
		NR	FOC	Ratio
CP4	2009/10	7.58	2.63	2.9
	2010/11	7.14	2.63	2.7
	2011/12	6.77	2.89	2.3
	2012/13	6.57	3.05	2.2
	2013/14	6.39	3.16	2.0

Furthermore, by resetting to either the CP4 exit or entry benchmark the regime still retains an incentive for freight operators to continue to invest to sustain or improve performance over control periods. The business case for investment is stronger if it includes avoiding a penalty payment plus possibly receiving a bonus payment versus solely avoiding a payment penalty. This improves the likelihood of investment being made in what is a competitive and capital constrained environment.

Freightliner agrees that the CP5 freight operator benchmark should continue to be adjusted for changes in overall activity on the network and that the method of calculation should take into account evidence being collected as part of the update of the capacity charge.

Schedule 8 NR Benchmark

We note with some concern the ORR proposal that the NR benchmark for CP5 should be the average actual delay caused between 2010/11 and 2011/12. Freightliner cannot support this proposal as it rewards failure and sends completely wrong messages about long term incentives. If applied, Network Rail's new benchmark would be materially higher (estimated >25%) than the exit CP4 regulatory target (6.39 mins per 100 train operator miles). This would reward Network Rail for failing to deliver the ORR required level of performance in CP4 and undermine the funding Network Rail received in CP4 to deliver improved network performance.

The years chosen were the two years before the Freight Performance Board (FRB) was formed (at the behest of the ORR) and represent a period when the ORR were considering issuing a regulatory enforcement order. The focus of the FRB, with the joint effort of Network Rail and FOCs has resulted in an overall considerable improvement in Network Rail's performance for freight services. It would seem perverse to "bake" into future performance years that were deemed failures (see graph page 9). We cannot accept these years as the new baseline and we are very surprised that the ORR has put this forward as a proposal.

We note that Network Rail's Strategic Business Plan (SBP) will influence ORR's think regarding the benchmark set. The freight operators have agreed in principle a new regulatory measure for Network Rail's freight performance called the Freight Delivery Measure (FDM). It measures the number of trains not arriving within "x" minutes of time caused by Network Rail failure. It is felt that this measure more directly matches customer experience than delay minutes per 100 miles. The freight operators have not yet agreed the target for this measure with Network Rail but we would expect any target to be no worse than the equivalent regulated exit CP4 position for delay minutes. It should be noted however that the new FDM measure data does not directly correlate with the current delays per 100 miles and therefore the two measures are not directly comparable.

Ratio between the benchmarks

The ORR does not appear to have considered the balance of risk impact of changing the ratio between the Network Rail benchmark and the Freight Operator Benchmark. These benchmarks should not be considered in isolation, they must be considered together. The current proposals, which potentially set Network Rail a far easier target than the regulated end of CP4 benchmark and the freight operators a far harder target than exit CP4 benchmark compound together to make a massive step change in risk and cost to freight operators. We do not believe that this impact has been considered or assessed by the ORR.

The ratio between the NR benchmark and FOC benchmark was on average 2.4 for the last 2 control periods (see below table – note CP3 is a Freightliner specific average and CP4 is an average for all freight operators following the change to avoid competitive advantage instigated during PR08 determinations) but the current ORR proposal could result in a ratio as high as 4:1. This would be a fundamental shift in the balance of risk in the regime to NR's advantage, on the back of having performed poorly. We would reiterate that the regime should be constructed in such a way as to create long term not short term incentives.

	Average	NR	FLG	Ratio
Benchmark per train	CP3	10.03	4.21	2.4
Benchmark per 100 miles	CP4	6.89	2.87	2.4

As a minimum, we would expect the Network Rail benchmark entry to CP5 to not be greater than the exit Network Rail benchmark from CP4. It is unfair to set Network Rail's CP5 target substantially above a level Network Rail has already proven it can attain and beat during CP4. As such, we would struggle to comprehend the rationale if the CP5 Network Rail benchmark was set above the regulated target exit point of CP4.

In addition we would expect a regulated industry such as Network Rail, with such large public subsidy to have a continued improvement trajectory into CP5 and with particular regard to freight services we believe there is still room for improvement. We also note that Network Rail is separately funded through the Capacity Charge for impacts on performance from increasing train movements on the network.

Schedule 8 Payment Rates

Freight Operator Payment Rate

Freightliner notes that the purpose of the freight operator payment rate to Network Rail is to reflect the average impact of a minute of delay caused to other operators. Freightliner supports in principle the continued use of a blended average which is the same on all routes subject to validation of the passenger operator rates[12] used and NR's proposed amendments[13] to calculating the weighted average.

However, Freightliner is concerned that these rates will increase considerably, which in turn will considerably increase the risk born by freight operators in operating trains on the network. The current Schedule 8 calibration is already highly geared. If a freight train causes just 15 minutes delay to other services the current cost is £556, which is more than a typical average profit on a train. If the risk of performance delay becomes even greater this will lead to rationalisation of services, effectively precluding certain traffics from rail and will result in modal shift to road. We therefore urge consideration of whether significant movement in rates in CP5 is a desired solution, i.e. what is the inflationary impact on industry costs if the passenger operators' rates increase and will it lead to an improved performance outcome or cause perverse and undesired outcomes?

We also note that higher passenger operator rates would increase the Capacity Charge payment, which has the effect of increasing costs for operators for operating services. In other words, it is inflationary to industry base costs. This could have the perverse effect of forcing rail services off the network that have far higher economic and environmental values than the increased performance.

NR payment rate

The current NR freight payment rate provenance has been ascribed to a mid-point of submitted costs of delay by freight operators during the Periodic Review 2008 (PR08)[14]. ORR has performed a review of the current studies on the cost of delay to freight operators and indicated a broad range in which the current payment rates are towards the top-end. We contend that none of the values in the original submissions or subsequent referenced studies include marginal revenue loss. Therefore the current rate is actually under-estimated and importantly not consistent with the rate received by passenger operators.

The marginal revenue impact should compensate a very real impact that affects freight operators' ability to retain business to rail because of poor unreliability. An extreme but real example was the

[12] For instance, rates for the South East commuter network should to a large extent be excluded as FOCs don't run on this part of the rail network, particularly during "peak times" when passenger rates are at their highest.
[13] *"Proposed Methodology to Calculate the Freight Train Operator Compensation Payment Rate in CP5"*, Nigel Salmon, October 2012
[14] Adjusted annually by RPI

lost business to rail following the Hatfield accident and the subsequent speed restriction on the rail network. 100,000 container movements per year by rail at a value of £44 million per year revenue and £10 million profit into perpetuity were lost because the disruption forced customers to invest in short sea feeders in order to maintain their ability to export goods. This business has not been and never will be recovered back to rail at this level of profitability.

We therefore propose that a study is undertaken which considers what the marginal revenue effect on freight operators is of delays to their services. The ORR is funding work to review the marginal revenue effect on passenger operators and it seems equitable that a similar study is undertaken to understand the impact on freight operators. Additionally we note that the value of delay to freight operators has increased faster than RPI over CP4. This is demonstrated by the earlier graphs (page 7) that illustrates the 28.4% increase in freight Kgtm per train[15] and a 27.2% decrease in trains run since the benchmark year of 2006/7. This clearly demonstrates freight operators are running longer and heavier trains with more volume of goods per train, so the impact of delay to each train has a greater value[16].

From what we understand, the driver for value of delay increases to passenger operators is fare increases and number of passengers per service. We estimate these factors would need to have risen by an average 5.2% CAGR (in excess of RPI) to match the equivalent value added by freight since 2006/07.

<u>Ratio of Payment rates</u>

It appears that there has been no assessment undertaken by the ORR of the impacts together of increasing the freight operator payment rates and retaining the existing Network Rail payment rates. Just as with the setting of benchmarks it is important to consider the overall impact on costs and risks of the change in both payment rates.

The proposal as made by ORR would also increase the risk and cost held by freight operators, although we do not yet know how much the payment rates to passenger operators will increase by, so this is an unknown factor.

If, for example, the passenger rates increased by 25%, freight operators would have to improve by 5% for every 4% that Network Rail improved - just to keep the payments neutral. Given that freight operators have less scope for improvement than Network Rail (having already invested to replace the majority of their rolling stock with modern equipment) this does not appear very fair.

We propose that to neutralise the step change in increased cost and risk to the freight operators the current Network Rail payment rate to freight operators payment rate ratio of 52%[17] is sustained into CP5. The Network Rail payment rate could be set once any passenger increase is known.

An alternative could be would be to increase the current Network Rail payment rate to freight by 28.4% to recognise the increase in weight and therefore in value of freight trains since 2006/07. This however still excludes the Marginal Revenue Effect and it is unclear currently how this would impact on the balance of risks of the whole regime.

<u>Schedule 8 Bonus Rates</u>

In theory Freightliner, in a scenario where the benchmarks are fairly set, believe that all bonus rates should be 100% of their respective payment rates because:

a) Schedule 8 should be financially balanced, i.e. the incentive to further improve performance should be symmetrical to the incentive to avoid causing delay;

b) There is a strengthened incentive to improve beyond the benchmark set and the business case for investment improves; and,

c) We are not convinced there is a risk to small operators or new entrants from this change. As a small operator the ability to ensure good performance (benchmark beating) is potentially easier than for larger and more operationally complex operators. However, any risk perceived is mitigated by the Annual Cap or Incident Charge provisions.

However, we are very concerned that the proposals as they stand reward Network Rail with an easily obtainable benchmark which they are likely to beat and punish the freight operators for improving

[15] Network Rail supplied data
[16] The number of trains run has also declined thereby reducing congestion on the network
[17] (£37.10 to £19.13 for 2012/13)

making our target very hard to beat. In this scenario we would support the retention of the 50% bonus rates to protect freight operators from making large unaffordable payments to Network Rail.

Cancellation threshold

The current base level cancellation payment does not cover the costs losses incurred by a freight operator when a train is cancelled on an unplanned basis. We contend that the higher payment rate should be applicable to all services, as this more closely reflects actual costs and losses. This would increase Network Rail's incentive not to cancel services. Currently, it is perverse that a train that is cancelled costs less than a train suffering more than 95 minutes of delay.

As a minimum we would not expect the threshold for the higher rate to be set at any lower than during CP4. Currently the 0.41% threshold applies to all services ran (undistinguished by flow) and is rarely triggered, as such the below threshold compensation value usually applies (as the poor NR performance on the individual flow has been "absorbed" by the number of trains ran in other traffic flows). Where there is a big incident the higher rate of compensation would be more reflective of the disruption (and the costs and losses) and the impact on an individual customer that the individual flow has incurred.

Freightliner would therefore like to propose that the threshold principle is applied to the numbers of trains ran periodically at the **individual train service group level**, rather than the periodic summation of all service groups operated by a FOC.

Time delay to settling Schedule 8

We support the ORR's minded position not to extend the timing for settling Schedule 8 between NR and operators as rationalised by no material improvement on incentive and significantly increased complexity resulting in additional administrative burden (increased industry cost).

Incident caps

This appears from our point of view to be a case of "if its not broken don't fix it". We understand the position that Network Rail's core competency is not to provide insurance services. However, in reality it is not practical or affordable to procure this type of insurance in the private sector. Any such insurance would be on a bespoke basis, which makes it prohibitively expensive and would be subject to so many exclusions that it would not be worth having.

The current system is a practical way of pooling the risk across freight operators and in proportion to their size does not import great risk to them. We understand that Network Rail has calculated that the existing Access Charge Supplement has broadly covered its exposure above the caps over the last two years. Freightliner suggests that the current system is left unchanged - noting that the rates should be recalculated based on CP4 data.

We suggest the Incident caps are effective protection for operators, in particular small operators or new entrants and Network Rail is best positioned to provide a cost effective regime that does not unnecessarily add to total industry costs or impose large risks on smaller players in the market.

Annual caps

The Annual cap provides protection to operators, particularly small operators and new entrants. We support a default cap for smaller outfits with perhaps an automatic ratchet against volume growth and a bespoke arrangement for larger operators set a level which is unlikely to be routinely reached.

The provision of these caps in the private insurance market is not readily available or affordable, as like for the Incident Caps, if available these would be prohibitively expensive and the exclusions would negate any worth in the policy.

Freightliner can see no compelling reason to fundamentally change the existing provisions. To do so would cause unnecessary costs to freight operators, which are not borne by our road competitors.

Severe weather

Freightliner does not support any amendment to the Schedule 8 benchmarks to reflect severe weather. We are unclear as to the scope of any proposal but would caution that defining severe weather and the point at which it becomes severe is largely opinion driven and would lead to unnecessary disputes. We would also be concerned if Network Rail were not properly incentivised during severe weather to run as near normal service as possible.

We would contend that any such exclusion would have to result in re-benching and adjusting the payment rates as the current benchmarks and rates take into account that there will be some severe weather on average in a year. This seems to be an unnecessary complication.

We are very concerned about the mis-alignment of incentives that the consultation appears to advocate and the adverse financial and operational impacts that this could have on the freight sector. We would welcome a meeting with you as soon as possible to explain this further.

Yours sincerely

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