Periodic Review 2013 – First Consultation

Response from Rail Freight Group

August 2011

1. Rail Freight Group (RFG) is pleased to respond to the ORR's first consultation on Periodic Review 2013. RFG recognises the importance of this periodic review, particularly in the current context of rail reform and cost reduction, and will be pleased to participate throughout the review.

2. RFG supports the approach to the review outlined by ORR in this document, and at the recent seminars. We recognise that the consultation is at an early stage of the work programme, and that much greater detail will need to be established before decisions can be made. Our comments therefore also reflect this, and will evolve during the development of the review.

3. Overall, RFG supports the ORR in taking a rigorous approach to Network Rail's costs and efficiencies, and to ensuring that the outcomes of PR13 support whole industry cost reduction. We have some concerns that the proposals particularly for the structure of charges could lead to unnecessary complexity for operators, and may not therefore achieve the desired aims. We would support the proposals to reach an early settlement for freight although the details of any proposed commitments need to be established.

4. Our details comments on the consultation are provided below;

Chapter 3 (our objective for PR13)
Q1 Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?

5. We agree with the proposed objective for the review, in particular ensuring that access charges are affordable, and acting in support of competition.

6. For freight, we would also add that the review should recognise the commercial and competitive environment in which rail freight operates, and the modal choices available to its customers. It should also recognise the acknowledged environment and economic benefits of rail freight growth.

Chapter 5 (high-level timetable)
Q2 Do you have any views on our proposed timetable for the review? Do you need further information to plan your involvement with PR13?

7. We have no views on the overall timetable. As outlined above, we would support the proposals for an early settlement on freight charges, although the details of any cost reduction commitments will need to be considered in detail, and against the overall context of rail reforms.

8. Generally, we would support an approach to closing out issues as early as possible through the review, in order to simplify the later stages of work, which can give longer term comfort and certainty to those considering longer term investment in the use of rail freight.

Chapter 6 and annex B - Price control separation and Network Rail devolution

Q3 Do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate? Is the information we are requiring Network Rail to produce set at the right level? Do you have views on the information train operators should produce?

Q4 Which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?

Q5 Do you think there should be further separation of the price control for Network Rail's operating routes and, if so, which aspects of the price control should be separated?

9. Broadly, we have no strong view over the disaggregation of Network Rail's financial and other data to England & Wales, and Scotland, or indeed to operating route level. However, (and see paragraph 37 below), we do not support a move from disaggregation of costs to geographical charges

10. At this stage of devolution, we would not support 'ring fencing' Network Rail's finance by route, as this would appear to limit flexibility and may have adverse impacts on outputs in areas where efficiencies are more difficult to deliver. We recognise that this would need to be addressed – along with many other issues – if operating concessions are to be let.

Chapter 6 and annex C - Outputs

Q6 Is the current approach to defining obligations in terms of outputs the best approach? What outputs should be defined? Should there be a move to more use of outcome based obligations? Would another approach be appropriate such as specifying inputs or intermediate measures?

11. Generally, we are content with output based obligations. However, there may be some case for considering input or intermediate measures in certain areas. This might focus on areas of underperformance, or where there is a risk of perverse incentive – for example in reducing activity levels as a substitute for efficiency.

Q7 What are your views on how we should compile and present 'scorecards' of Network Rail's performance in CP5?

12. We are sceptical of introducing obligations on freight customer performance, as, generally, freight customers experience will be based on the overall performance of their service, and not just that of Network Rail. The customer surveys undertaken by ORR, and by Network Rail demonstrate this effect. The survey size of freight customers is also small which can distort the results, and also lead to 'fatigue' from interviewees.

13. However, we do support output measures which are useful to freight customers, as well as to freight operators. For example, delay minutes is a useful measure for Network Rail and operators, but meaningless to a potential customer. Freight Performance Measure is a more useful measure for customers, although there are some concerns about the way it is calculated.

14. The current measure of network availability (PDI-F) has not proved to be a success and we understand that replacement output measures are under consideration. This is an important issue for freight, and there should be an incentive on Network Rail to improve, not just stay static.

Q8 Should we make more use of 'whole system' outputs over which Network Rail does not have full control, or focus on more narrowly defined outputs which the company is fully responsible for?

15. There may be some areas where Network Rail should be incentivised to work with industry partners to deliver change. However we would resist the use of whole system outputs which de facto extended the scope of regulation into the business of the freight operators.

Q9 How should output obligations be defined in the context of devolved Network Rail routes with separate price controls?

16. For freight we would generally support nationwide output measures. It is difficult to see how many of the relevant measures could be meaningfully disaggregated.

Q10 How should the balance between the number of output obligations and their individual significance be struck?

17. Overall, we would support a smaller, focused set of output measures, but there may need to be a broader set of 'second order' obligations, perhaps (see Q6) including input or intermediate measures to prevent perversities.

Q11 Should Network Rail's output obligations include a specific safety requirement, different from its legal obligations?

18. No comment.

Chapter 6 and annex D - Incentives

Q12 Do you have views on how the effectiveness of the existing financial incentives can be improved?

19. Generally, we would support measures to increase the accountability of the Network Rail Board, and the Route Directors to achieving efficiency outputs. This may be achieved through a much improved Management Incentive Plan as well as by ongoing consideration of Governance arrangements. At present, neither is working satisfactorily, and the MIP process continues to be abused with little or no enforcement by either the members or ORR.

20. Schedule 4 and 8 regimes appear to work well overall for freight operators, but we recognise that there are specific workstreams underway to address issues in these areas. It is important to retain simple nationwide approaches.

Q13 Do you have views on how the effectiveness of Network Rail's incentives to make best use of capacity could be improved?

21. We agree that the current incentive framework may not be sufficiently strong to encourage Network Rail to seek growth. However, in considering changes, it is important to ensure that the framework incentivises growth which delivers the

balanced strategic objectives of the rail network.

22. We are concerned that certain measures, such as scarcity charges and possibly revenue sharing will encourage Network Rail to prioritise capacity for those operators which generate the greatest cash, not necessarily those which generate the greatest social, environmental or overall economic benefits for the UK. A balance of incentives is therefore necessary. The current volume incentive, whilst somewhat blunt, does at least achieve this.

Q14 Do you agree that we should include a regional efficiency benefit sharing mechanism calculated at the Network Rail route level? Are there further issues about how a regional efficiency benefit sharing mechanism should be introduced which you want to highlight?

23. Although we can understand the reasons for considering benefit share mechanisms, (indeed a mechanism already exists in the access contracts for freight operators), the details of such approaches are complex. We would want to ensure that such measures did not incentivise output reductions (e.g. for freight capability) ahead of true efficiency gains. It is unclear if such approaches would work under the current franchise structure.

Q15 What are your views on exposing franchised passenger train operators to changes in Network Rail's costs at a periodic review?

24. In principle we support exposing franchises to Network Rail's costs. This would put franchises on a comparable basis with freight and open access passenger operators. In fact without franchises being exposed to such changes, it is questionable whether any changes to incentive structure are worth pursuing. However we recognise the difficulties for DfT / Transport Scotland in this area which will need to be addressed.

25. The use of 'review points' within longer franchise contracts, where, in effect, subsidies/premia can be reset, may also negate these benefits, and may in fact lead to perversities in behaviour as review dates approach.

Q16 Do you believe that Network Rail should share in train operator revenue and/or costs? Are there further issues about introducing a revenue/cost sharing mechanism which you would highlight?

26. Given the current financial performance of the freight operators it is unlikely they would wish to enter revenue sharing mechanisms with Network Rail. Such approaches tend to act against the principles of wholly private sector, competitive freight operations. Any move for Network Rail to share in revenue with passenger franchise operators could, introduce perverse incentives on Network Rail which could disadvantage freight operators.

Q17 We would welcome your views on possible bespoke arrangements for enhancement efficiency benefit sharing and whether there is a need for additional measures to increase the contestability of expenditure?

27. We agree that that there may be a case for bespoke arrangements for enhancement efficiency benefits in certain cases. As above, there must be protection for outputs such as freight capability which may not be of value to the party participating in the scheme. If a potential benefit share is with a freight

operator, competition issues between operators may need to be considered.

28. Network Rail should be encouraged to determine whether increased contestability for expenditure can help to deliver cost savings.

Q18 Are there further new incentives which you believe should be introduced and what would the benefits be?

29. We agree that there is no case for an environmental charge particularly where this is not applied to competing modes.

Q19 Are there other interactions between incentives (and the wider regulatory framework) which we need to take into account?

30. No comment.

Chapter 6 and annex E - Financial framework

Q20 What are your views on the duration of the control period?

31. We recognise the balance between risk, and duration of control period. There is a case for longer term settlements on the structure and level of access charges, which can provide longer term certainty for operators, and also aligns with moves to longer franchises. There is also an argument for reducing industry workload by moving to a longer control period, or perhaps by moving to a lighter review process for alternate reviews. If calculated correctly, the variable charge should vary only by the efficiency target and should not require frequent review.

32. We are unclear why the payment of Network Grant as track access charges is seen as beneficial. Given the various pass through clauses, the impact on franchised operators is neutral, and Network Rail's income is unaltered. The treatment of any elements of freight fixed charge must be considered, as this is currently paid as part of Network Grant. Move to pass this through the freight operators would then create the need for new subsidies, which would be unpopular as well as requiring state aid clearance.

Q21 Do you think that we should retain the single till approach rather than moving to a dual till approach?

33. Single till is likely to give Network Rail most flexibility to run its business efficiently.

Q22 Do you think that our overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

34. No comment.

Q23 Network Rail faces a number or risks. At this stage, do you have any views on how general inflation risk and input price risk should be addressed?

35. Network Rail should have considerable 'buying power' and as such should be in a strong position to manage input prices. We note the link to regulated outputs which may be more difficult to adjust. Nonetheless, they should be incentivised to manage price risk to the extent possible.

Q24 We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

36. No comment

Chapter 6 and annex F - Structure of charges
Q25 Do you consider that our charging objectives remain appropriate?

37. We support the charging objectives. Under the first objective F.8 (a), ORR may wish to clarify the 'wider objectives of funders', and the relationship between funder sponsored services and those of others in this context.

Q26 What are your views on the geographical disaggregation of variable usage charges?

38. We understand the premise that the structure of charges can be used to incentivise behaviour. We consider that this is most likely to be successful where;

    a. The overall structure is straightforward and clear, and the number of charging objectives is small;
    b. The desired changes are in the gift of the operator to deliver;
    c. The likely outcomes align with the overall objectives of the railway;
    d. The potential for perverse outcomes is minimised, overall and between competing operators on the network.

39. We are concerned that the combination of proposals in this Annex will lead to a charging structure so complex that any incentive effect will be lost. With (say) ten geographic areas, variations by wagon and locomotive type, additional charges and such like, the calculation of access charges can only be mechanistic, and the resulting charge judged only on its affordability.

40. We remain unclear on the incentive effect of geographic charging for freight operators and customers, particularly where routing options are limited and constrained by factors such as train length and gauging. The likely impact will be to price off certain services on routes with high charges, which may not be consistent with charging objectives.

41. It is also unclear whether translating infrastructure costs into charges will necessarily give the ideal incentive structure for capacity management – i.e. more lightly used routes may not necessarily have lower charges than heavily used routes, which acts against moves to divert freight onto secondary routes.

42. Overall therefore we consider that geographical disaggregation of charges for freight is likely to add significant complexity to freight charging, but may not deliver any demonstrable benefits to the network.

43. Recognising however the political sensitivity around disaggregation, we accept that this may be an area sensibly progressed for franchised services, particularly with the move to devolution in Network Rail. We would suggest that charging for freight should be kept on a national basis.

Q27 What are your views on introducing a charge levied to reflect network *scarcity?*

44. The current capacity charge mechanism does not appear to have had any incentive effect on operators or Network Rail, but has merely served to increase charges. It is clear that it must be reformed, or abolished. For example, whilst it is intended to compensate Network Rail for an increase in traffic, it has not been rebated during recent periods of downturn in traffic.

45. The purpose and structure of any scarcity charge must be set against the overall charging objectives. Clearly, such a charge would mean that remaining paths on congested routes would tend to be applied for only by companies with the greatest available cash flow, not necessarily by services with the greatest overall economic and social value to the UK. This would tend to move capacity allocation away from the current set of principles towards a purely financial basis. It is unclear to us that this is in the best interests of the rail network.

46. We therefore consider that scarcity charging must be considered alongside a wider appraisal of the capacity demands on congested routes, and, if established, done so in a way that protects the overall social and economic benefits of the network.

Q28 What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

47. The holding of freight paths is an emotive issue. Despite this, since the last review of charges, little analysis has been done to determine the extent to which;

    a. Freight operators are actually holding excess capacity in access contracts, as opposed to unused freight paths being in the timetable;
    b. This is acting as a detriment to other freight or passenger operators;
    c. A reservation fee would be sufficient to change behaviour.

48. The reform of Part J, and its implementation in practice by Network Rail and operators, is still incomplete. The lack of urgency in this process may suggest that, in reality, the issue is less acute than some believe.

49. The holding and usage of paths is perhaps most likely to be inefficient for ESI coal traffic, where the nature of the operations, and the constant changes in demand and supply points, and the nature of track access contracts may lead to over capacity – albeit that much of the business operates on short term paths. Attempts to persuade generators to become more involved in path allocation have, thus far, been unsuccessful. It is unclear that applying a reservation fee to the freight operators will be a sufficient lever to change the behaviour of the generators.

50. We would therefore suggest that, ahead of reservation fees being applied, more detailed analysis is undertaken, particularly around ESI coal paths, to determine whether other measures are possible, and how the reservation fee could or could not help drive behaviour. This may also need to include other elements of charging relevant to this sector, such as fixed charges on freight only lines (and any attempt to increase the scope of this), coal spillage charges and such like.

Q29 Should passenger open access operators pay charges that exceed variable costs. How should charges be calculated?

51. Charges for passenger open access operators are not *per se* a matter for RFG. However, as both freight and open access passenger services operate in the private sector, on a commercial and competitive basis, there may be precedent in the approach to freight fixed charges which were considered at the last review. The issues of affordability, and of simplicity may be relevant.

52. Open access operators (freight or passenger) are often stated as being ‘marginal users’ on the basis that they pay only the variable charge. As a consequence they also face certain restrictions, e.g. for freight in time of day, journey time etc, for passenger in calling patterns. A move to levy the fixed charge would therefore suggest that open access operators should enjoy the same access conditions, in full, as franchised operators.

53. We note that the consultation on this area has not yet been published.

Q30 What are your views on the proposals to improve incentives to reduce traction electricity consumption?

54. We support moves to metering in principle, but note that the technology to support metering must also be available for freight locomotives.

Q31 Should we put a cap on certain freight charges in advance of our determination and should these be linked to other changes?

55. We support an early resolution on a cap for certain freight charges. This is an important factor in building business certainty for operators and customers, particularly in tendering for work.

56. We are happy to explore the link between any such cap and other changes, in the scope of overall approaches to cost savings by all operators on the network, and other changes which may emerge from rail reform. An early discussion on the suggested changes and proposals would be valuable.

Q32 Do you have views on the interactions between these possible changes and when they should be implemented – for example whether some changes should only be introduced after other changes have 'bedded in'?

57. As outlined earlier, we are concerned at the potential complexity of the range of suggested charges. There may be a case for prioritising the most important changes in CP5. In any event, it is critical that the Network Rail systems are fully capable of calculating, and accurately invoicing ahead of implementation of new charges.