

# **Network Rail's consultation on its methodology for allocating fixed costs to train operators in CP6**

Ben Worley, 9 October 2017

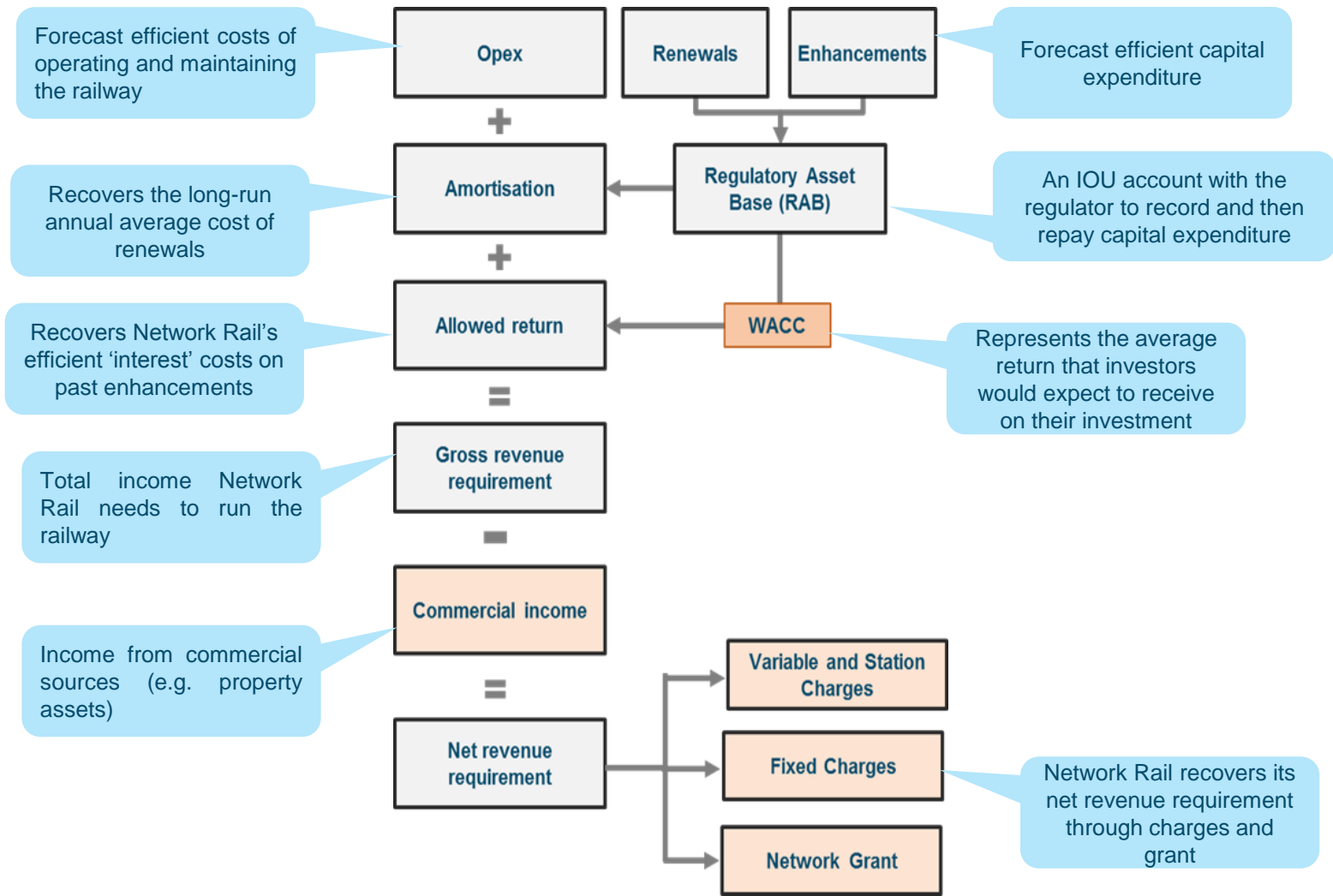
# Purpose of today

- ▶ On 22 September 2017 Network Rail published its consultation on the methodology for allocating fixed costs to train operators in CP6, which we will discuss and seek your views on today
- ▶ This consultation focuses on the methodology for allocating costs to train operators in CP6 (there is not an automatic link to charges). ORR will set charges in its Final Determination, we note that:
  - ORR still has to conduct its 'market can bear' analysis
  - The level of network grant in CP6 is not yet clear
- ▶ In summary, the consultation proposes introducing a new cost allocation methodology for CP6, reflecting the findings of the review that we commissioned by Brockley Consulting
- ▶ We are proposing using the new Brockley Consulting methodology to:
  - **Allocate our fixed costs to train operators** in CP6
  - That these new fixed cost allocations should form **the maximum level of operators' fixed charges**
  - **Inform the level of a transparent grant from funders** to Network Rail, where a market segment cannot afford to pay all of its fixed costs
- ▶ Brockley Consulting has presented to this group several times over the last two years and today represents the continuation of that engagement process

# Background

- ▶ Like other network industries, a significant proportion (c.80%) of the costs of the rail network are fixed
- ▶ At present, the fixed costs of the rail network are not allocated all train services on a consistent basis
- ▶ This means that it is not clear which train services cause our fixed costs to be incurred, and it is not possible to make meaningful like-for-like comparisons between different types of services
- ▶ There are currently examples of where our fixed costs have been allocated to a subset of train operators, using different approaches (e.g. FTACs and L.E.K's freight avoidable cost analysis in PR13)
- ▶ However, these approaches are quite simplistic. For example, FTACs allocate costs to operators at NR operating route-level based on operators' shares of traffic (e.g. train miles) on each operating route
- ▶ We are seeking to improve upon this approach for CP6 and employed an independent costing expert, Brockley Consulting, to review the current FTAC cost allocation methodology and suggest improvements
- ▶ A better understanding of fixed costs has the potential to improve industry decision making and our understanding of the distribution of funding/subsidy across the network
- ▶ We consider the new methodology developed by Brockley Consulting represents a step-change improvement in our understanding of the drivers of our fixed costs

# We are allocating our entire regulatory cost base



# Key changes proposed by Brockley Consulting

- Brockley Consulting proposes the following key changes to the current FTAC cost allocation methodology (more detail in our consultation and Brockley Consulting's report available [here](#)):

#	Area	Current FTAC method	Proposed new Brockley Consulting method
1	<b>Who are <u>costs</u> allocated to?</b>	Franchised passenger operators only on the grounds that only these operators pay FTACs	All operators (i.e. franchised passenger, freight and open access)
2	<b>To what extent do we 'chop up' the cost base geographically?</b>	Costs are allocated at NR operating route level which means 'local' costs are spread across all services on the route	Costs are allocated to c.3,100 individual track sections and then only allocated to the train services that use those track sections
3	<b>How are costs allocated to train services?</b>	Based on operators' share of traffic on each NR operating route (e.g. share of train miles)	Where possible, using an 'avoidable cost' approach which aims to establish a direct link between traffic and long-run costs
4	<b>How do we allocate RAB 'interest' costs on past enhancements?</b>	Between asset types based on forecast long-run renewals expenditure	Based on the replacement cost of assets which Brockley Consulting considered a reasonable proxy, over the long run, for past enhancement expenditure
5	<b>How do we allocate income in order to get from total costs to fixed costs?</b>	Mainly vehicle miles and electric train miles	Mainly based on available charging forecasts or in line with corresponding cost allocations (e.g. Rental income at managed stations is allocated in line with managed station costs)
6	<b>How do we treat cross-border services?</b>	The fixed costs of the England and Wales network are recovered through the FTACs of DfT-specified franchises and vice-versa in Scotland, reflecting the fact that the two networks are specified by different funders	Brockley Consulting does not distinguish between DfT and TS specified franchises when allocating costs. However, we apply a 'funder adjustment' in order to maintain the current funding arrangements between Governments

# Impact on operators' fixed cost allocations

## Data

- ▶ PR13 forecast of our 2018/19 cost base
- ▶ Operators' names as at October 2013
- ▶ Show changes in costs not charges
- ▶ Numbers reflect our 'funder adjustment'

## Key trends

- ▶ Allocation of costs to all operators
- ▶ Economies of scale on busy routes with a relatively modest number of civils assets and S&C (opposite is true on low traffic routes)
- ▶ Routes with a significant number of civils assets and/or S&C are inherently costly (e.g. major cities and 'hilly' areas)

Operator	FTAC Method (£m)	Proposed New Method (£m)	Impact (£m)	Impact (%)
Arriva Trains Wales	212	224	12	6%
c2c	50	47	(3)	(6%)
Chiltern Railways	52	64	12	23%
CrossCountry	245	186	(58)	(24%)
East Coast Main Line Rail	305	145	(160)	(53%)
East Midlands Trains	198	177	(21)	(10%)
Eurostar	-	0	0	-
First Capital Connect	267	177	(91)	(34%)
First Great Western	426	355	(71)	(17%)
Freight	-	566	566	-
Grand Central	-	16	16	-
Heathrow Express	-	6	6	-
Hull Trains	-	11	11	-
London Midland	174	150	(24)	(14%)
LOROL	44	46	2	5%
LUL Bakerloo	-	7	7	-
LUL District (Richmond)	-	3	3	-
Merseyrail	32	52	21	66%
Miscellaneous Passenger (demin)	-	30	30	-
National Express East Anglia	280	245	(35)	(13%)
Nexus	-	7	7	-
North Yorkshire Moors Railway	-	2	2	-
Northern Rail	263	394	131	50%
ScotRail	517	456	(62)	(12%)
South West Trains	279	263	(16)	(6%)
Southeastern	238	276	38	16%
Southern	258	216	(42)	(16%)
Transpennine Express	147	140	(7)	(5%)
Virgin Trains	478	202	(276)	(58%)
West Coast Railway	-	2	2	-
<b>Total</b>	<b>4,464</b>	<b>4,464</b>	<b>0</b>	<b>0%</b>

# Operators' avoidable fixed cost allocations

- ▶ Brockley Consulting also estimated operators' long-run avoidable costs
- ▶ Assumes a 'slimmed down' network to accommodate minimal traffic levels but that we retain current network 'connectivity'
- ▶ On average 27% of our fixed costs are avoidable in the long-run
- ▶ Avoidable cost estimates are important because it should not be assumed that all of the costs which can be allocated to an operator are capable of being avoided
- ▶ The £92m p.a. estimate of freight avoidable fixed costs is not comparable to the estimate made by L.E.K in PR13 of £42m-£249m p.a. (the L.E.K estimate included costs associated with removing network 'connectivity')
- ▶ Numbers reflect our 'funder adjustment'

Operator	Avoidable fixed costs (£m)	Minimal traffic fixed costs (£m)	Total fixed costs (£m)	Avoidable fixed costs (%)
Arriva Trains Wales	40	184	224	18%
c2c	19	28	47	40%
Chiltern Railways	12	52	64	18%
CrossCountry	42	144	186	23%
East Coast Main Line Rail	47	98	145	33%
East Midlands Trains	53	124	177	30%
Eurostar	(0)	0	0	-
First Capital Connect	73	104	177	41%
First Great Western	43	312	355	12%
Freight	92	474	566	16%
Grand Central	6	10	16	36%
Heathrow Express	2	3	6	41%
Hull Trains	5	6	11	44%
London Midland	43	107	150	29%
LOROL	23	23	46	51%
LUL Bakerloo	3	4	7	50%
LUL District (Richmond)	2	1	3	64%
Merseyrail	27	25	52	51%
Miscellaneous Passenger (demin)	8	21	30	28%
National Express East Anglia	73	172	245	30%
Nexus	2	5	7	27%
North Yorkshire Moors Railway	0	2	2	7%
Northern Rail	107	287	394	27%
ScotRail	113	342	456	25%
South West Trains	90	173	263	34%
Southeastern	119	158	276	43%
Southern	70	146	216	33%
Transpennine Express	45	94	140	32%
Virgin Trains	33	168	202	17%
West Coast Railway	(0)	2	2	-
<b>Total</b>	<b>1,195</b>	<b>3,269</b>	<b>4,464</b>	<b>27%</b>

# Transparent grant and franchise re-mappings

## Transparent grant

- ▶ We understand that ORR will consider operators' cost allocations and ability to pay before setting CP6 fixed charges
- ▶ At present, if a market segment cannot afford to pay fixed charges, the costs attributable to these services are included in franchised passenger operators FTACs (or grant instead of FTACs)
- ▶ This results in a lack of transparency in relation to which train services drive our fixed costs
- ▶ We consider that transparency of fixed costs has the potential to improve industry decision making
- ▶ Therefore, where a market segment cannot afford to pay all of the fixed costs attributable to it, we consider that this should be explicitly recognised in the form of a transparent grant to us from funders

## Franchise re-mappings

- ▶ Like other charges, FTACs are set at the start of each control period
- ▶ However, when franchised services transfer between operators it is necessary to adjust FTACs
- ▶ The operator 'receiving' the additional services should also 'receive' the relevant share of FTAC
- ▶ For CP6 we propose retaining a simple approach to calculating these adjustments to FTACs but basing adjustments on the % of train miles that have transferred rather than the % of vehicle miles, which was used in CP5
- ▶ This reflects the fact that that train length does not drive the level of our fixed costs

Operator (a)	Forecast train miles of services being transferred for year (b)	Total forecast train miles for year (pre-transfer of services) (b)	Forecast train miles of services being transferred for year as a % of total forecast train miles for year (pre-transfer) (d)	FTAC prior to transfer of services (e)	FTAC after transfer of services (f)	Impact (%) (g)	Impact (h)
A	10	20	-50%	50	25	-50%	-25
B	10	50		100	125	+25%	+25
			<b>Total</b>	<b>150</b>	<b>150</b>		



# Responding, key milestones and questions

- ▶ We are requesting responses to this consultation by close of play **17 November 2017**
- ▶ Please send responses to [RegulatoryEconomics@networkrail.co.uk](mailto:RegulatoryEconomics@networkrail.co.uk)

## Key future milestones

Key milestone	Information	Date
Network Rail's SBP	Network Rail's CP6 business plan, including cost forecasts	December 2017
Network Rail's conclusions on this consultation	Network Rail's conclusions on its proposed approach to allocating its infrastructure costs to train operators, calculating fixed cost charges, and draft CP6 price lists reflecting PR18 cost data	February 2018
ORR's Draft Determination	ORR's minded-to view in relation to setting structure of charges for CP6, including its views on our February 2018 conclusions	June 2018
ORR's Final Determination	ORR's final view which will ultimately set the structure of charges for CP6	October 2018

# Questions?