Network Rail’s response to ORR’s 2018 Periodic Review (PR18) consultation on charges recovering fixed network costs

30 November 2017

1 Executive summary

Network Rail welcomes the opportunity to respond to ORR's 2018 Periodic Review (PR18) consultation on charges to recover fixed network costs in Control Period 6 (CP6). We respond to each of the consultation questions in the detail of this response. However, first we summarise our position in relation to what we consider to be the key issues.

Franchised passenger operators' charges

In principle, we support being financially incentivised to accommodate additional trains on the network. As set out in response to ORR's December 2016 consultation on charges and incentives, we consider that the incentives that we currently face to grow traffic on the network could be improved. This will be particularly true in CP6, in light of ORR's decision to remove the Capacity Charge. Without the additional income that we currently receive from the Capacity Charge, we will be financially worse off when we run additional trains on the network. This is because, on expectation, we incur increased Schedule 8 costs as the network becomes busier.

However, we continue to be concerned that ORR's proposal, which is to change franchised passenger operators' fixed charges so that the amount of income that we receive varies depending on traffic levels, is too vague for us to form a definitive view. We also consider that ORR's proposals have the potential to expose us to additional financial risk in CP6. Our initial modelling of potential FTAC levels in CP6 indicates a potential increase from around £500m per annum to approximately £650m-£850m per annum. Therefore, if traffic levels were consistently just 1% per annum below forecast levels, this could result in us receiving around c. £30m-£45m less income over CP6.

It is important to remember that, like other network businesses, our fixed costs do not vary with small changes in traffic levels. Therefore, if we receive less income to fund these fixed costs in CP6 we would have to reduce activity and outputs in other areas such as renewals, which would be likely to impact network sustainability. This would be a disappointing outcome, given the importance that many stakeholders have placed on Network Rail significantly increasing its renewals activity in CP6.

Therefore, if ORR implements this sort of proposal ideally it would be asymmetric with the downside risk that we face being limited, reflecting our very limited ability to reduce our fixed costs if traffic levels fall. We believe that a good way to do this would be to:

- **Use a 'business as usual' traffic growth forecast which we have a reasonable expectation of outperforming**. We consider that the use of a 'business as usual' traffic growth forecast is supported by the latest statistical release published by ORR[1], which indicates that the number of passenger journeys by rail have fallen for the first time since 2009/10. If this reduction in passenger numbers persists, over time it could translate into fewer passenger train journeys.

- **Limiting our exposure to a relatively small proportion of our fixed cost base**. One option would be to set the overall level of CP6 fixed charges, which depend on traffic levels, at a

[1] Source: ORR Passenger Rail Usage 2017/18 Q1 statistical release available at: http://orr.gov.uk/statistics/published-stats/statistical-releases.

similar level in aggregate to current Capacity Charges which are due to be removed (i.e. £400m-£500m per annum). This should not result in a significant increase in our network-wide exposure to financial risk in CP6 (although there would be no direct link between income recovered through these new fixed charges and our Schedule 8 costs which the Capacity Charge is designed to recover). Our initial modelling suggests, however, that the total CP6 FTAC could be as much as twice Capacity Charges in CP5. This is because of different levels of grant in CP6 compared with CP5. ORR's proposals could, therefore, expose us to double the financial risk that we currently face from variations in traffic levels. We have very limited ability to absorb risk in CP6, due to the way that we are now funded. This emphasises the need to base any new fixed charges on a 'business as usual' traffic growth forecast which would limit the financial risk that we face, but also provide a financial incentive for us to accommodate additional trains on the network.

We also suggest that ORR discusses its proposal with Governments to confirm that this potential change to the charging structure is affordable and works within Governments' Statements of Funds Available. Any change in franchised passenger operators' fixed charges could be a direct pass through to funders under the terms of operators' franchise agreements. In this situation, Governments would either have to provide the rail industry with additional funding in order to support ORR's proposal, or reduce its funding to the industry elsewhere. In order for this proposal to provide us with a real financial incentive to add traffic to the network, it is important that we actually receive more money overall in CP6 if we outperform the original traffic assumption.

Finally, if ORR decides to implement its proposals we consider that it should do so in a way that is simple and readily understandable. Otherwise, we fear that the intended incentives on train operators and Network Rail will be significantly dulled, rendering the new charge an additional complexity which yields limited benefits.

Freight operators' charges

We support ORR's proposal to continue to levy freight charges designed to recover our fixed costs at commodity level. We also support ORR's proposal to continue levying these charges on ESI coal traffic and spent nuclear fuel traffic.

It is, of course, vital that ORR's evidence as to whether a commodity can afford to pay a contribution towards our fixed costs is robust. If charges were levied on commodities inappropriately this could result in rail freight traffic switching to road, which could have an adverse environmental and societal impact (e.g. increased pollution levels and congestion). We are, therefore, keen to ensure that ORR's evidence that suggests iron ore and ESI biomass traffic can afford to pay a contribution towards our fixed costs is robust. We note, for example, the apparent fragility of the GB iron and steel sector. We also note the fact that biomass receives Government grants, which could make ORR's assessment more complex.

Open Access passenger operators' charges

We support ORR's proposal that Open Access operators pay fixed cost charges, where they can afford to do so. However, it is important that ORR's analysis in this area is robust. We are very aware that Open Access operators' business models are potentially quite sensitive to small increases in costs.

We also support ORR's proposal to levy these charges on a £/train miles basis, subject to the billing constraints set out in the detail of this response. However, we consider that ORR should be clear as soon as reasonably possible in relation to how its access policy would change if Open Access operators were to pay fixed cost charges.

2 Responses to ORR's consultation questions

Question 2.1: Do you have any views on our proposal to retain the existing freight market segmentation by commodity, and not introduce further market segments for any of the existing commodities?

We support ORR's proposal to retain the current approach to analysing the freight market, which segments it based on the commodity being transported. We also support ORR's proposal not to create additional market segments by further disaggregating existing freight commodity types (e.g. splitting intermodal traffic into multiple markets segments based on journey length).

We currently levy fixed charges on freight operators at commodity level. Therefore, ORR's proposal to retain this approach for CP6 would mean that we do not have to make any changes to our billing system in order implement ORR's charging policy in this area. We consider this to be a significant benefit of ORR's proposal, given modifications to our billing system can take a significant amount of time to implement and be expensive relative to the value of freight charges designed to recover fixed costs (c. £1m in 2016/17).

We also consider that the current market segments are sufficiently granular to capture the ability of different freight flows to pay charges designed to recover some of our fixed costs.

Question 2.2: Do you have any views on our proposal to continue allowing Network Rail to levy infrastructure cost charges on freight trains carrying ESI coal, iron ore and spent nuclear fuel? Do you have any views on our proposal to allow Network Rail to levy infrastructure cost charges on trains carrying ESI biomass in CP6?

We support ORR's proposal to continue to allow us to levy charges designed to recover some of our fixed costs on freight trains carrying ESI coal and spent nuclear fuel.

It is, of course, vital that ORR's evidence as to whether a commodity can afford to pay a contribution towards our fixed costs is robust. If charges were levied on commodities inappropriately this could result in rail freight traffic switching to road, which could have an adverse environmental and societal impact (e.g. increased pollution levels and congestion). We are, therefore, keen to ensure that ORR's evidence that suggests iron ore and ESI biomass traffic can afford to pay a contribution towards our fixed costs is robust. We note, for example, the apparent fragility of the GB iron and steel sector. We also note the fact that biomass receives Government grants, which could make ORR's assessment more complex.

Consistent with our September 2017 consultation on the methodology for allocating our fixed costs to train operators in CP6, we suggest that the maximum level of any freight charges designed to recover our fixed costs should be based on the new cost allocation developed by Brockley Consulting. As we also propose in our September consultation on fixed costs, we consider that where freight services cannot afford to pay for all of the fixed costs attributable to them, if possible this should be made transparent as part of the grant to us from funders in CP6.

We suggest that as soon as reasonably possible ORR provides freight operators with an indication of the overall level of charges that it considers the relevant commodities would be able to bear in CP6. We consider that this would help operators to plan their businesses. We recognise that the level of variable charges in CP6 is not yet certain, and that the level of these charges could have a knock-on impact on the level of charges designed to recover our fixed costs. However, we consider that it is should still be possible for ORR to express a view on the overall level of charges (i.e. total fixed and variable charges) that it considers freight commodities can afford to pay in CP6. For example, whether freight trains carrying spent nuclear fuel could afford to pay higher or lower total charges than they are currently paying in CP5.

Question 2.3: Do you have any additional evidence around the ability to bear of any of the freight market segments reviewed by our consultants, which you would like to provide us to inform our final decision around which freight market segments are able to bear infrastructure cost charges in CP6?

We consider that an additional piece of relevant evidence which ORR should consider when setting the level of freight charges designed to recover our fixed costs is ORR's decision to discontinue the Capacity Charge for CP6.

Given freight operators are already paying these charges in CP5, this indicates that they should be able to bear the financial value that they are currently paying for these charges in the form of a charge designed to recover our fixed costs in CP6, assuming no other changes to the level of track access charges.

Question 3.1: Do you have any views on the results of the technical analysis undertaken to date on passenger market segmentation (and ability to bear?) Do you have any views around how these emerging findings could inform a passenger market segmentation?

As ORR acknowledges in its consultation, it does not yet have a fully developed market segmentation proposal. Therefore, it is not really possible for us to say at this stage whether we support it or not.

We appreciate the challenges (e.g. data limitations) associated with analysing the passenger services market. However, CEPA/Systra are clear that its analysis only demonstrates 'proof of concept' and that further work is likely to be required before implementing any changes to charges in CP6. We are concerned that ORR may not have sufficient time to carry out this additional work, and consult stakeholders on the detail of its proposals, ahead of its Final Determination.

In order to help stakeholders plan their businesses, we suggest that ORR sets out its position on the following areas as soon as reasonably possible:

- The different market segments which it considers comprise the passenger services market;
- The extent to which it considers that each of these market segments is capable of paying charges designed to recover some of our fixed costs;
- The level of granularity at which it plans to calculate operators' charges (e.g. operator-level, service group-level or service code-level);
- Whether for franchised passenger operators the level of incremental charges will be based on CEPA/Systra style analysis, or whether this analysis will only inform the level of charges paid by open access operators; and
- The impact on ORR's access policy (including the application of the NPA test) where Open Access operators pay charges designed to recover our fixed costs.

We are also very mindful that for Open Access operators, the findings of the CEPA/Systra analysis could significantly affect their business models. Therefore, it is important that this analysis is robust.

We note that Open Access operators will no longer pay Capacity Charges in CP6. Therefore, we agree with CEPA/Systra that CP5 Capacity Charges represent the minimum level of fixed cost charges that existing open access operators could afford in CP6, assuming no other changes to the level of charges.

We also consider that the findings by CEPA/Systra that major intercity and long-distance commuter routes generate the largest operating surplus, and that this surplus is lower on routes where there is competition, on the face of it appears reasonable. However, we note that this is very complicated to accurately assess.

ORR notes in its consultation that operating surplus might not be the right indicator of whether a group of train services can afford to pay charges designed to recover our fixed costs. Instead, it suggests that the willingness of passengers to pay higher fares on certain routes may be a better measure. We agree that there could be merit in exploring this area further. However, we are concerned that ORR may not have sufficient time to do so prior to its Final Determination. Particularly, if ORR wishes to undertake a review of the entire passenger services market in order to understand how passengers' willingness to pay higher fares varies across different routes. We also question the ability of train operators to pass increases in their costs onto passengers because many fares are price regulated through franchise contracts.

We also consider that ORR's CP6 charging policy should not create a perverse financial incentive to unduly financially favour one passenger service over another. For example, it should not create a situation where one operator on a particular section of route pays charges designed to recover our fixed costs and another does not (or pays charges set at very different levels). In this situation there would appear to be a financial incentive to favour services run by the operator that pays fixed charges (or the higher fixed charges), even though both operators could impose similar costs on our network and/or generate a similar level of benefits to society. However, in reality we would be unlikely to act on such an incentive, as the process for granting access to the network takes into account many other factors, and there are a number of safeguards in place to ensure that fair access to the network is maintained.

Consistent with our September 2017 consultation on the methodology for allocating our fixed costs to train operators in CP6, we suggest that the maximum level of any operators' charges designed to recover some of our fixed costs should be based on the new cost allocation developed by Brockley Consulting. As we also proposed in our September consultation on fixed costs, we consider that if Open Access passenger services cannot afford to pay for all of the fixed costs attributable to them, if possible this should be made transparent as part of the grant to us from funders in CP6.

Question 4.1: Do you have any comments on our proposal to levy any infrastructure cost charges on Open Access operators as a rate per train mile? Do you think there are any additional considerations we should include in our assessment of the different metric options?

We support ORR's proposal to levy charges designed to recover our fixed costs on Open Access operators on a £ per train mile basis, subject to any charges being levelled at either operator, Service Group or Service Code level (Service Code is the lowest level of granularity at which our billing system currently operates). Our cost allocation work found that train length was not a material driver of our fixed costs. Therefore, we consider train miles to be a more appropriate metric for charging operators than vehicle miles. Our billing system would not be able to accommodate the other potential option set out in ORR's consultation, which involved levying charges based on passenger miles.

If ORR plans to use our cost allocation work to inform the level of any new charge on Open Access operators designed to recover our fixed costs, we suggest that ORR is mindful of the fact that in this work we only allocate costs to Service Groups, not Service Codes.

We recommend that ORR continues to work closely with us in this area, and discusses its emerging charging policy, in order to make sure that we are able to implement any changes to the charging structure in our billing system prior to the start of CP6. This will be particularly important, given that ORR is not planning to express a view on whether Open Access operators can afford to pay charges designed to recover our fixed costs (i.e. whether a new charge should be introduced) until its Draft Determination.

Question 4.2: Do you have any comments on our proposed approach to varying franchised passenger operators' infrastructure cost charges in response to changes in traffic, on an annual basis. Do you have any comments on the particular approach we have proposed which is based on changes in timetabled traffic, or any of the other options we have considered in our assessment?

In principle, we support being financially incentivised to accommodate additional trains on the network. As set out in response to ORR's December 2016 consultation on charges and incentives, we consider that the incentives that we currently face to grow traffic on the network could be improved. This will be particularly true in CP6, in light of ORR's decision to remove the Capacity Charge. Without the additional income that we currently receive from the Capacity Charge, we will be financially worse off when we run additional trains on the network. This is because, on expectation, we incur increased Schedule 8 costs as the network becomes busier.

However, we continue to be concerned that ORR's proposal, which is to change franchised passenger operators' fixed charges so that the amount of income that we receive varies depending on traffic levels, is too vague for us to form a definitive view. We also consider that ORR's proposals have the potential to expose us to additional financial risk in CP6. Our initial modelling of potential FTAC levels in CP6 indicates a potential increase from around £500m per annum to approximately £650m-£850m per annum. Therefore, if traffic levels were consistently just 1% per annum below forecast levels, this could result in us receiving around c. £30m-£45m less income over CP6.

It is important to remember that, like other network businesses, our fixed costs do not vary with small changes in traffic levels. Therefore, if we receive less income to fund these fixed costs in CP6 we would have to reduce activity and outputs in other areas such as renewals, which would be likely to impact network sustainability. This would be a disappointing outcome, given the importance that many stakeholders have placed on Network Rail significantly increasing its renewals activity in CP6.

We also note that our recent cost allocation work indicates that the vast majority (c. 70%) of our fixed costs would continue to be incurred in the long-run even at minimal traffic levels (i.e. one train per day). We consider that in no circumstances should the amount of income that we receive to fund these long-run fixed costs depend on traffic volumes given they are not related to traffic levels, even in the very long-run.

If ORR implements this sort of proposal ideally it would be asymmetric with the downside risk that we face being limited, reflecting our very limited ability to reduce our fixed costs if traffic levels fall. We believe that a good way to do this would be to:

- **Use a 'business as usual' traffic growth forecast which we have a reasonable expectation of outperforming**. We consider that the use of a 'business as usual' traffic growth forecast is supported by the latest statistical release published by ORR[2], which indicates that the number of passenger journeys by rail have fallen for the first time since 2009/10 (passenger journeys fell by 2.7% in the first quarter of 2017/18). If this reduction in passenger numbers persists, over time it could translate into fewer passenger train journeys. It could also be the case that in CP6 passenger train operators are less likely to add new services, particularly over and above their franchise specifications, if track access charge payments in relation to these services increase.

- **Limiting our exposure to a relatively small proportion of our fixed cost base**. One option would be to set the overall level of CP6 fixed charges, which depend on traffic levels, at a

[2] Source: ORR Passenger Rail Usage 2017/18 Q1 statistical release available at: http://orr.gov.uk/statistics/published-stats/statistical-releases.

similar level in aggregate to current Capacity Charges which are due to be removed (i.e. £400m-£500m per annum). This should not result in a significant increase in our network-wide exposure to financial risk in CP6 (although there would be no direct link between income recovered through these new fixed charges and our Schedule 8 costs which the Capacity Charge is designed to recover). Our initial modelling suggests, however, that the total CP6 FTAC could be as much as twice Capacity Charges in CP5. This is because of different levels of grant in CP6 compared with CP5. ORR's proposals could, therefore, expose us to double the financial risk that we currently face from variations in traffic levels. We have very limited ability to absorb risk in CP6, due to the way that we are now funded. This emphasises the need to base any new fixed charges on a 'business as usual' traffic growth forecast which would limit the financial risk that we face, but also provide a financial incentive for us to accommodate additional trains on the network.

We suggest that ORR discusses its proposal with Governments to confirm that this potential change to the charging structure is affordable and works within Governments' Statements of Funds Available. Any change in franchised passenger operators' fixed charges could be a direct pass through to funders under the terms of operators' franchise agreements. In this situation, Governments would either have to provide the rail industry with additional funding in order to support ORR's proposal, or reduce its funding to the industry elsewhere. In order for this proposal to provide us with a real financial incentive to add traffic to the network, it is important that we actually receive more money overall in CP6 if we outperform the original traffic assumption.

If ORR decides to implement its proposals we consider that it should do so in a way that is simple and readily understandable. Otherwise, we fear that the intended incentives on train operators and Network Rail will be significantly dulled, rendering the new charge an additional complexity which yields limited benefits.

We also note the link between this proposed change to fixed charges and the current Volume Incentive mechanism, which is designed to encourage us to add traffic to the network. We will set out our position in relation to the Volume Incentive in more detail as part of our response to ORR's Volume Incentive working paper. However, in summary, we consider that the Volume Incentive should be removed for CP6 and that ORR's proposed change to fixed charges could provide us with a stronger financial incentive to add traffic to the network.

ORR's proposal to base charges on timetabled traffic levels

In principle, we support ORR's proposal to base adjustments to operators FTACs on timetabled traffic levels, rather than outturn traffic levels (i.e. including cancelled train services). As ORR notes in its consultation, this should in theory reduce the volatility of our income because there should be a smaller variance between forecast traffic and timetabled traffic levels, than forecast traffic and outturn traffic levels.

However, in order to base charges on timetabled traffic, it is imperative that the data system used to convert the timetable into annual train miles is robust. If the data system is not robust it could actually increase our income volatility, rather than reduce it. As ORR notes in its consultation, timetabled data from our NETRAFF system shows significant year-on-year fluctuations. We do not consider this system to be sufficiently robust for setting our income or operators' charges.

We will continue to explore the potential to use other data systems in order to robustly translate the timetable into train miles. However, if this is not possible, an alternative option could be to apply an evidence-based percentage uplift to the outturn traffic levels recorded in our billing system in order to adjust for cancelled services.

Any other points that you would like to make?

In its consultation ORR states that because charter services are not captured in industry data systems CEPA/Systra did not consider whether this segment of the market could afford to make a contribution towards our fixed costs. ORR notes that due to lack of data availability, analysis of this market segment would be very complex and potentially disproportionate to the size of the market.

Network Rail is supportive of the charter train sector and the benefits that it delivers for passengers and local communities. However, we also consider that it is important that ORR carries out is market can bear analysis in a non-discriminatory way. Therefore, we do not believe that the charter sector should be exempt from ORR's affordability analysis. Particularly, given there are some small segments of the freight market (e.g. iron ore) which ORR has analysed and concluded should pay charges designed to recover our fixed costs.

It may be the case that ORR analyses the charter sector and concludes that it cannot afford to pay charges designed to recover our fixed costs. However, this decision should be based on market analysis, rather than be assumed. If ORR requires additional information (e.g. traffic data) in order to inform its market analysis, we would be happy to provide this, where possible.