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PR18 consultation on charges recovering fixed network costs

Thank you for the opportunity to comment on this consultation. GB Railfreight (GBRf) would like to provide a response on a question by question basis but will start with a general summary:

GBRf objects to any additional charges being levied on rail freight to recover fixed network costs. To date, GBRf have seen little or no real detailed work being carried out to attempt to understand why the rail network is so expensive and in some cases, offers such little value for money. If the industry is serious about supporting rail freight, and the obvious economic and environmental benefits that it offers, we would not be faced with such uncertainty of both the level of variable charging increasing and now the allocation of fixed costs. We probably do not need to share with you the tight financial situation that many operators face annually. To be clear, GBRf will, at every opportunity, seek to defend the interests of both ours and our customers' businesses for the benefit of the sustainability of freight on rail.

It is rare to read through an industry consultation and see such immediate reference to rail freight from the outset of the document. Often, GBRf observe that freight is mentioned as an afterthought in industry consultations but, in this case, it appears that freight is very much a focal point, perhaps more so than the franchise operators whom invest very little in the network and often find themselves in revenue support. This greatly concerns us.

Whilst GBRf offer a response to the questions posed as part of this consultation, perhaps it is worth dwelling on what efficiency or innovation Network Rail (NR) have offered during CP5 and why certain strategic decisions have seen:

a) Network maintenance and renewals decisions become a 'toss-up' between what work should be carried out.
b) Major investment projects delivered late and over-budget, with the benefits of said projects very rarely delivered or realised.
c) A holistic acceptance that devolution will be the answer to the complete inability to operate the network efficiently.
d) The fixed cost of the network continue to grow with seemingly a major level of overspend on HQ fixed costs at NR, as well significant spend on contractors who deliver work that is later aborted.

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e) An obsession with network performance at the detriment of a clear strategy for asset performance.

GBRf fail to understand why a business such as ours - that has made enormous strides in becoming more efficient to drive our marginal profitability - is increasingly threatened because a Non-departmental public body is essentially passing through their inefficiencies to us. If the Office of Rail and Road (ORR) could demonstrate how NR was becoming progressively more efficient, yet fixed network costs were still increasing, then GBRf would be more amenable to a mark-up in charging. This is not the case and we are not.

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?

GBRf does not see the need to introduce further market segments or any level of additional complication.

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?

ESI Coal

ESI Coal traffic has run on the network for many decades and helped form the building blocks of revenue-generation for the rail freight industry, particularly the growth of GBRf in the last decade. We appear to be at the point now where many in government and the wider transport industry are keen see its total removal from the network. Thus, we have seen, and will no doubt see further, a dramatic increase in charges applied to this commodity. Nonetheless, there are Power Stations that have invested in Flue-Gas Desulphurisation, and other innovative solutions to ensure a cleaner burn, and will generate energy from coal until at least 2023 – that is only based on existing government policy, which could change several times by then. GBRf would like to see the current level of Freight Specific Charging fixed at the current levels and increased no further – save for an annual RPI uplift. With no real viable alternative to rail, the cost of running Coal has become almost unsustainable, several years before we expect coal generation to cease.

GBRf assert that the CP5 analysis for ESI Coal charging was probably erroneous and a flawed strategy. The expectation that there would be an uplift in income to recover the cost of running coal services on the network was most likely offset by the reduction in service volumes. The increase in charging only added to the reduction in demand and did not in fact offer any additional income to Network Rail. Increased charging only serves to push towards the use of alternative fuels as generation from coal becomes more expensive. The same applies to levying this charge on Biomass, which will be discussed below, where an increase in rail costs adds to the overall increase in energy generation costs.

Biomass

The proposal to commence levying a charge on Biomass is incredibly disappointing to GBRf, particularly given the level of commitment and investment we have injected into this commodity, which in truth pales in comparison to end-user investment levels. The introduction of additional charges only serves to offer greater uncertainty for the long-term sustainability of Biomass. The end user investment in Biomass loading and discharge facilities for rail served traffic flows has been phenomenal, and has translated into a very positive news story for rail freight. The increase in services across the trans-pennine route and very shortly in the North East has been a real area of additional revenue uplift for the rail freight market following the downturn in coal volumes. Certainly, other commodities have helped to close this gap but from GBRf's perspective, our biomass contracts are worth approximately £13m per annum and are a key foundation of building our annual budgets.

The most worrying element of levying further infrastructure cost charges to rail freight commodities is the assumption that these charges can just be passed through to users of rail freight – our customers. We do not believe that the ORR have made any tangible attempt to understand the contractual agreements that FOCs are signed up to with our customers. The market can bear tests will not actually predict the reality of the flow of money, it is simply a high-level indicator taken at a certain point in time. These uplifted charges will tear a substantial proportion of profitability out of our customer contracts if, and most likely when, we are unable to pass the costs through.

In addition to our contracts becoming less profitable, and in some scenarios not profitable whatsoever, you are potentially starting to distort the commercial differentiators between operators. The FOCs do not have 'off-the-shelf' contracts with our end users, they are negotiated terms and conditions. Has ORR considered how any impact in charging may reduce further demand? The fact remains that the driver for any FOC to run rail freight services is to make money, if our profits are reduced then the risk is that we are pushed to deliver greater margins by selling our assets to more profitable services.

We are additionally concerned by the lack of consideration that the rail freight market has seemingly shifted towards investment in track-friendly rolling stock to reduce track 'wear and tear' – which is the basis of the variable charging. This is particularly true for biomass hopper wagons. Whilst this investment is a positive step for the rail freight market, the incentive to do this was financially trivial. The value of the investment in these assets, many of which operate on biomass flows, is in danger of becoming offset by the proposition to apply the Freight Specific Charge.

GBRf believe that by importing a charging levy onto Biomass you are eroding the advantage that this commodity currently has over road haulage, whilst trying to maintain that it is a rail-captive market. It is not impossible to develop a haulage solution using trucks rather than trains from Port to Terminal. This opportunity is further supported by the fact that that modern hybrid willow and poplar trees, which can be harvested at peak performance on a three-yearly basis, can offer a locally sourced alternative to importing from North America. Whilst GBRf appreciate that a modal shift may still be some way off, the impact of transportation costs will likely lower the demand for biomass and increase the demand for alternative energy, such as gas.

The theories that are presented throughout the consultation do not mirror the reality of trying to operate a profitable rail freight company in U.K. GBRf will only continue to grow profitably if the following can be assured:

1. Long term charging certainty
2. Sustainability of existing rail contracts based on the ability to guarantee our access to the network
3. Potential for further rail freight growth by identifying latent network capacity
4. Investment linked to incentives

The ORR, more specifically the Rail division, should be offering greater certainty, incentives and opportunities to the rail freight market. This proposal appears to find another way to tax what are moderately successful markets to extract margins from haulage contracts to pass through to fund an overpriced, poor value-for-money railway network. GBRf note the reference in the DfT guidance to the ORR where it is very clear that the government support our position on the needed for affordability, certainty and growth:

"The secretary of state wishes ORR to have regard to the affordability of freight charges and to ensure that the rail freight industry has sufficient clarity and certainty about the costs that they will face in CP6 as soon as possible. More generally, he wishes the ORR to take all appropriate steps to support the growth and development of the rail freight sector." [Para 21]

In 2016 the Network Rail Chief Executive was very clear that about the demand to embrace private investment in the network to help fund the growing railway. In the case of Biomass, this investment has been substantial. Overpricing and uncertainty of charges will only risk a scenario where the industry is left with once-valuable stranded assets, the investment in which is never fully realised, but the costs for which sit within company finances for many years to come.

GBRf continues as a business to seek to grow our biomass service offering and have built up, to date, a high-level of confidence in the long-term certainty that this offers GBRf – we are fearful that elements within this consultation document appear to put at risk this level of confidence and certainty that we currently enjoy. With this at risk, it will be challenging for GBRf to continue to make recruitment and training decisions specific to our Biomass haulage contract if it is not supported by a long term, sustainable government position on supporting Biomass.

Finally, GBRf are still unclear that the ORR really has an appreciation of both the benefits and costs of Biomass by rail. We do not believe that you have truly grasped the actual costs of running a biomass facility therefore we do not think that an accurate charging model can really apply. GBRf consider that a further Control Period without additionally charging Biomass services will offer a more accurate picture. The perversity of the policy on biomass is that the at one stage the market was subsided by Contracts for Difference (CFD's) that were offered to aid the economic drive for an investment in switching from Coal to Biomass, yet now it is being proposed that increased charging should be levied through the freight operators. GBRf would like to understand how the ORR are intending to fairly incorporate this into a strategy that supports sustainable rail freight growth? Given the extent of the investment made by not just generators, but also ports, GBRf fail to see the link between the inelasticity of the demand for rail in the biomass market and its profitability – particularly that the inelasticity determines that the market can bear the increased costs.

<u>**Other commodities**</u>

GBRf welcome the fact that both NR and ORR are not proposing to form any arguments that would see further charges applied to any other commodities that are not yet mentioned in this consultation.

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?

The additional evidence has likely been referred to in Question 2.2. To reconfirm, the most salient of these are:

1. A lack of understanding of freight contracts and the ability for FOCs to absorb any mark-up or pass through.
2. No clear understanding of the actual costs of biomass generation and thus an inability to develop a fair and reasonable charging model.
3. A diminishing confidence in the ability for ORR to accurately understand the profitability of rail freight haulage in U.K.

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?

None.

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?

GBRf considers that levying infrastructure cost charges at a rate per train mile for Open Access Operators (OAOs) is fair and will hopefully incentivise efficient passenger services. The main point is that OAOs must consider the additional fixed costs of adding new traffic. Empty seats need to be filled and train length needs to be determined by the required usage. If a longer train is necessary to make a service more efficient, then charging should not be constructed to exclude that ability. GBRf will heavily object to additional services being added to the network when in fact longer services could be a better option. The exact same argument applies for freight services that aim to run longer, heavier services as opposed to a greater quantum of services – such services should be rewarded with a financial incentive to operate in a way that makes best use of capacity.

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?

It is our view that it is important for passenger services to only operate if it is necessary. If there is a way of incentivising Franchised TOCs to reduce the number of trains run by varying infrastructure cost charges on an annual basis, then it may well highlight how pointless it is to run several sparsely populated trains per hour as opposed to a reduced quantum of services and higher load factors (more passengers on the train). This would free up capacity for all users and potentially offer greater opportunities for variable track access income by running more services over the infrastructure per hour. GBRf feel that the most suitable option will be the one that offers the greatest transparency and data to help determine value for money for network users. There is the opportunity here to reduce the short run fixed marginal costs. NR are incentivised to add traffic to the network, not just passenger services. GBRf are sure that a fine balance needs to be struck between the income received from operating services, and the short-run marginal costs that are paid by these services operating.

GBRf would expect that any reduction in passenger services running would see an actual reduction in cost, not a reallocation of costs passed elsewhere throughout the industry. We are alarmed by the position to incentivise TOCs to run more services to boost income, certainly in some areas of the country. Instead, GBRf would like to see passenger operators pay a far higher cost for operating services that offer very little return at the farebox. The freight industry has collectively worked hard to remove unused freight and deliver latent capacity. The same should be applied to TOCs. Therefore, we believe any option should incorporate this point.

Finally, we do not want any changes to charges or draft prices to be shared publicly until all operators have been consulted with, or at the very least, had an opportunity to review. GBRf will want to challenge these and are aware that in the assessment of OAOs profitability there was some dubiety in the results. We will want to test the accuracy of this.

We would like to highlight the following points that you can find on the ORR website that are pertinent considering this consultation. GBRf are not convinced that the freight-specific elements of this consultation fully align with your strategic objectives:

ORR's ambitions for the freight sector are grounded in our strategic objectives :-

• *'support a better service for customers' – use our powers to hold the industry to account for performance and standards of service across the railway network,*
• *'secure value for money from the railway, for users and funders' – strengthen incentives for the increased use of railway capacity, and more cost-effective investment in the network,*
• *'promote an increasingly dynamic and commercially sustainable sector' – support sustainable economic growth by promoting innovation and efficient long-term investment across the rail industry through the appropriate development of effective markets and regulatory intervention*

GBRf would be very keen to further engage with ORR and NR on this matter, in collaboration with key industry partners whose involvement is critical. If you have any further questions please feel free to contact me.

Yours Sincerely,

Carl Kent
Head of Strategy & Innovation
GB Railfreight

cc. John Smith
Duncan Clark