



ASSOCIATION of TRAIN OPERATING COMPANIES

Mr Paul McMahon
Deputy Director, Railway Markets & Economics
Office of the Rail Regulation
One Kemble Street
London WC2B 4AN

26th August, 2010

A handwritten signature in black ink that reads 'Dear Paul,'.

Consultation Paper on High Level Review of Track Charges: ATOC Comments

Thank you for the opportunity to make additional comments on the work you are doing on track access charges in advance of your consultation letter in October.

The Objectives of Charging

There is one area which we believe should be addressed which did not feature in an obvious way in the list of ORR objectives for charging set out in your letter, or in the criteria used by CEPA to judge options. This is the objective of promoting a financially stable rail sector that is capable - within reasonable bounds - of absorbing economic shocks without recourse to the taxpayer.

What we have at the moment is the following:

- Variable access charges account for 4% of NR's income and rather less of its expenditure. Network Rail receives 89% of its income in the form of a fixed lump sum.
- Franchised TOCs have limited ability to change outputs because of commitments to the DfT and TS.
- Even if franchise TOCs could vary output, Network Rail is almost wholly insulated from the impact of a downturn in demand.
- When an economic shock occurs that adversely affects revenue, the impact is transmitted to the bottom line of TOCs in the first instance, but then through

revenue sharing mechanisms in the franchise agreement on to Government. The wider supply chain in the rail industry plays a smaller part in absorbing demand shocks than in other industrial and service sectors of the economy.

The reform of franchising initiated by Government is likely to give franchised train operators a bigger opportunity to vary outputs in line with actual demand. This step has the potential to make franchised operators more financially robust in the face of demand shocks, and hence less prone to require additional Government support in economic downturns.

But with the current arrangements on variable access costs, the contribution played by Network Rail in containing aggregate expenditure is very small. A 10% reduction in franchised train kilometres would reduce TOC costs by only £13m. Hence, if Government decides that there should be greater scope for TOCs to vary output to match demand, and track charges remain as now, we would continue to be in the position where infrastructure charges are largely invariant to demand and where shocks end up with Government or with franchised TOCs.

It is this that led us in our franchising paper to recommend that variable access charges should be increased from the current levels.

We recommend therefore that when undertaking further work on the shortlisted options, proper account is taken in the evaluation of their impact on the financial stability of the industry.

The Shortlisted Options

In your discussion of the six charging approaches considered by CEPA you select four for further consideration. We are doubtful of the merit of including a regional short run incremental cost (SRIC) approach. This would give the same average level of costs as now, but, based on the work done for PRO8, it is likely to result in charges that are higher than today on lightly used lines, and lower costs on the busiest routes. A charging approach that produces such an outcome does not seem to address the objectives that are set out in the papers or the additional objective we have suggested; indeed it appears to make most of them worse.

We recommend that you reconsider the inclusion of regional SRIC in your shortlist of options.

Alignment of Incentives

We support the aim of achieving a closer alignment of incentives between Network Rail and TOCs. Cost benefit sharing in which Network Rail shares in a fixed proportion of train operator revenues is one way to achieve this. But so too is a regime where variable

access charges for TOCs are increased. The key point is that the high level objective of achieving greater alignment of incentives between TOCs and Network Rail is an important one that should be given prominence in the next stage of the review.

I hope that this is helpful. I look forward to discussing this further with you and your colleagues.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Alec'.

Alec McTavish
Director, Policy & Regulation

Tel: 020 7841 8006