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Joe Quill.
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10th August 2012

Dear Joe,

**GB Railfreight Ltd. response to the ORR Periodic Review 2013 Consultation
on the Variable Usage Charge and on a Freight Specific Charge:**

General Comments:

1. Impact on Investment

The success of the UK Railfreight industry is well documented. The post-privatisation period has seen significant investment which has driven efficiency resulting in lower prices to end customers. Trains are now longer, heavier and better utilised than ever before. Freight operating costs reflect the years of hard work in driving efficiencies while service standards reflect the fact that customers now have a choice of supplier. Freight Operating Companies (FOCs) have driven performance improvements through investment in more reliable rolling stock. The industry has innovated and invested heavily in the post privatisation period.

Network Rail has also been a significant beneficiary of post-privatisation efficiencies in the rail freight industry. Benefits have been accrued by Network Rail (NR) through a reduction in the costs of conducting its maintenance activities through the competitive rail haulage market for NR's own maintenance trains.

This industry's success flows in large part from an effective open access regime which allows for incumbents and new entrants to enter markets and grow within a stable regulatory structure. These factors are critical to the creation of a market in which investment in long life assets is viable.

GB Railfreight (GBRf) is a product of this open access and competitive rail freight market. It entered this in 2001 and has grown its business every year since. Central to our growth has been the ability to invest in rolling stock, either with our own funds or via the rolling stock lessors (ROSCOs). Rolling stock that we or the ROSCOs have invested in on our behalf now totals some £200 million in value.

The proposal for a freight specific charge materially and adversely affects the long term operation of this competitive and efficient rail freight market. If adopted the proposals would:

- Be likely to strand investments already made in modern coal wagons;
- Materially affect the viability of future investment in the important Biomass market, a market that requires innovation and investment;

- Discourage the ROSCOs from investing in rolling stock to support growth;
- Disrupt the coal market which is central to the profitability of the FOCs;
- Impact on the viability of Scottish domestic coal production;
- Reduce our return on capital; and
- Reduce the value of our business.

The proposed changes are less about improving an already efficient freight industry and more an attempt to recover additional revenue, at any cost, from relatively inelastic sectors of the market, that can supposedly stand a higher charge than the current variable usage charge.

It's, therefore, rational for FOCs to conclude that, were this structure to be adopted for ESI coal and nuclear traffic, it would be extended, in the future, to other freight segments deemed to be able to make a similar contribution. This might be thought to be due to the relative inelasticity of the market or simply because investment and efficiencies made by the FOCs have generated an available profit stream. Freight operators, their suppliers, investors and rolling stock financiers (ROSCOs) would, therefore, be in a position where any profitable commodity sector could be targeted by the freight specific charge. GBRf does not consider this efficient nor does it think this generates the correct incentives to invest and innovate.

Over recent years other factors have impacted on the FOCs and we consider the ORR should be mindful of the total level of policy change which the industry has had to absorb. The application of fuel excise to the rail freight industry has substantially increased our operating costs. The progressive reduction of the intermodal grant, a small grant in value terms but very significant in terms of the profitability of intermodal traffic, is being absorbed. The removal of capital grants entirely has made investing in rail freight facilities more difficult. In fact the largest risks and changes in our industry result from Government and Regulatory policy changes.

2. Complexity and Transaction Costs

Several other proposed changes to regulatory policy are currently under consultation. The ORR must have regard to the total level of impact on the FOCs from the aggregation of all of these proposed changes and should evaluate the total direct financial impact on the FOCs, the increasing complexity and compliance burden and the secondary impacts on the market (customers, suppliers, investors).

There is a very real danger for individual consultations to be concluded in isolation when, in totality, after all changes are aggregated, a significant level of uncertainty, complexity and financial burden is being added to the industry.

3. Impact on the Rail Freight Market

Specific comments on the NERA and MDST market assessments are considered in the market section of this response.

GBRf accepts the argument that rail is, normally, the price-setting mode in the haulage of ESI coal, nuclear fuel and iron ore. As such, these commodities are relatively less elastic than other rail freight markets. However, the NERA and MDST analyses seem to conclude that a freight specific charge can therefore be levied without causing significant damage to the rail freight industry or the efficient operation of the rail freight market. GBRf strongly disagrees with this view.

A significant element of regulatory risk will be injected by this proposed change. Investment in new and efficient rolling stock will be adversely impacted and secondary markets such as rolling stock leasing, ports and mines will also be impacted.

Industry profitability is currently low as freight operators deal with reducing intermodal grant levels, the application of excise to rail freight fuel costs, tighter environmental regulations, a very uncertain future for the ESI coal market and the state of the UK economy. A significant change to the variable usage charge for PR13 would be very poor timing for the industry. Contract lengths vary across the market sectors, and on a customer by customer basis, with a number of contracts already extending into PR13, where the introduction of a freight specific charge will have to be met by the FOC.

The associated rail freight market for Biomass haulage is in its infancy but, already, known to be rapidly expanding over the next 10 years. There is the suggestion that Biomass will be exempt from the freight specific charge but perhaps only for CP5. This doubt is now causing an obvious and immediate problem, at odds with FOCs and third party customers investing in this market.

4. Conclusion

Fundamental changes to the charging structure need to be consulted and decided upon outside of the industry's normal commercial contracting timescales. Fundamental changes to the access charging structure should be made very infrequently and not each control period thereby taking account of the industry's 30 year investment timescales.

Changes to the structure and aggregate level of access charges should pass a test that they do not directly cause the stranding of investment made under the previous charging regime.

FOCs are already subject to changes in NR's cost base, however, GB Railfreight did not think that shifts in regulatory policy of such a fundamental nature would occur with such little notice. Changes in NR's cost base are slow to occur and can be managed. Changes in regulatory policy have the potential to upend the market and therefore result in long term damage.

Specific Comments on the Consultation Questions

Chapter 3 - Variable Usage Charge

7.14 Network Rail has already consulted on its estimates of variable costs. Do you have any further evidence, subsequent to Network Rail's consultation, that you wish to provide in relation to the process for estimating variable costs and average variable usage charges?

GBRf is concerned by the analysis of structures and the assessment of damage caused by bogied RA10 wagons of the sort that the industry has recently invested in. Specifically, GBRf considers that certain types of freight wagons on certain routes may be driving an unrealistic assessment of the general level of degradation to structures that is caused by these bogied RA10 wagons. GBRf believes that the HTA coal wagon needs to be examined and assessed separately.

There are over 1100 HTA coal wagons operating in the UK introduced from the late 1990s. They were the dominant wagon operating on the Settle and Carlisle line and still represent the bulk of the UK coal wagon fleet. They are unique in that they have a shorter wheel centre at 1830mm when the longer 2000mm is the standard.

This critical shorter wheel spacing together with its non RA10 compliant bogie spacing would be expected to cause damage to structures due to the concentration of load. This wagon is the most common type of coal wagon in use and it is materially different from the wagons built and accepted subsequently.

The reasons for the acceptance of this wagon to operate under RA10 conditions, rather than down rated to RA9, were the result of much debate at the time of the introduction of the wagon. GBRf is not seeking any further debate on the issue of acceptance of the wagon, however, we feel that the impacts of this wagon need to be isolated and compared to the now fully complaint wagons that are in use.

This HTA wagon would not be accepted to operate on the UK network if it was proposed today. The potential impact of this wagon on the network is therefore capped at the current level. No more of these HTA wagons will ever be accepted to operate on the UK network.

GBRf is also concerned that the effects of freight wagons, in general, on masonry under-bridges is being overstated. In many cases, freight trains already run at reduced speeds over these structures (by means of an RT3973 HAW permission) and, in doing so, already reduce wear and tear on the infrastructure. This doesn't seem to be acknowledged in any reports on the subject.

7.15 Do you agree with our analysis, which leads to a proposed confidence interval of 15% around Network Rail's estimates of variable usage costs?

As mentioned in previous consultations with Network Rail, a 15% confidence interval seems too high. GBRf wants to see far more rigour placed on inputting accurate data in the first place then have a far lower confidence interval, say +/- 10%. A pattern has emerged through Network Rail's reports on the subject - importing high averages with a high confidence level, leading to a high freight cap. Unfortunately, in stakeholders' minds, this approach means uncertainty and dilutes the perceived accuracy of the report - it's accuracy that's required.

7.16 Do you agree with our approach to estimating an adjustment to variable usage charges for long-run cost efficiency?

Yes.

Chapter 4 - Framework for a Freight Specific Charge

7.17 Do you agree with our proposed approach to satisfying the Access and Management Regulations with respect to levying a new freight-specific charge?

The proposed Coal ESI charges would significantly alter the patterns of importation, domestic production and rail haulage within the UK. While a mark-up might be possible under the Access and Management Regulations, GBRf considers that the impact of pricing certain traffics off the network is not consistent with this threshold test of what the market can bear. In particular, these proposals would have a disproportionate effect on Scottish opencast operations, which would be likely to cease.

7.18 Do you agree that the infrastructure costs allocated to freight operators - either for direct funding by freight operators, or explicitly subsidised by government - should be freight avoidable costs, including fixed costs, but not costs common between passengers and freight?

This depends on what is included within the definition of infrastructure. Costs should be limited to those that could be saved by Network Rail during the control period as a result of the removal of freight traffic. Costs such as the network requirement for ERTMS, which is to be funded by the DfT on a specific basis, should not be included. We agree that costs should exclude common freight and passenger costs.

7.19 Do you agree that we should retain our current definitions of particular categories of rail freight commodities as separate market segments?

We agree with the definitions of freight categories. We consider that the secondary effects in each commodity market (i.e. up and down the supply chain) should also be taken into account in order that the ORR understands the implications of the proposed changes. GBRf does not agree that the MDST work has sufficiently achieved this.

7.20 Do you believe that we have taken into account the appropriate factors in considering the efficiency of the proposed charges? Do you believe there are other factors we should take into account?

GBRf considers that the appropriate factors have been raised as issues within the consultation documentation but we do not see that the modelling exercises have quantified the impacts, nor has a clear conclusion been drawn as to the impacts of the changes proposed.

Importantly, GBRf feels that the ORR should consider the impact on the market for rolling stock finance which is central to the on-going development of the UK rail freight industry. Discussions about driving some traffics off the network (explicitly what these proposals do and are intended to do) materially damage the ability for FOCs to obtain finance for rolling stock investment.

By way of example, there are 2000 modern coal wagons currently in the market. A 10% reduction in tonne miles would reduce the demand for coal wagons by approximately 200 vehicles, equivalent to £25m in stranded investment. A regulatory policy change which strands assets with 75% of their useful life remaining will have a lasting impact on the industry. It is these secondary effects which we believe the ORR needs to fully consider.

7.21 Do you agree that our approach (of analysing rail freight traffic) addresses the relevant criteria, when considering to which market segments the charge should apply?

Broadly yes.

7.22 Do you agree that certain market segments should be exempt from the new charge?

Yes. All of them. Any reduction in a particular market (which, by definition, is more than the market can bear), brought about by these proposals, should not be deemed as acceptable.

7.23 What do you think is the most appropriate methodology for allocating costs, and what is your reasoning?

GBRf understood that the LEK freight avoidable cost study aimed to develop the understanding on this issue. However, we are concerned that the amount of time available to complete this task and the quality of data from Network Rail may not result in an sufficiently rigorous analysis.

7.24 Do you consider it is appropriate to cap the new charge for particular market segments according to its impact on the associated freight traffic (in addition to a constraint relating to relevant avoidable costs)? Do you wish to propose an alternative?

While we support the principle of the cap, we reiterate that if the cap is more than the market can bear, and if there is still significant variability in the potential charge faced by FOCs, then the market will not function efficiently. We cannot understand how an uncertain level of charge, over which the FOC has no control, leads to any better alignment of incentives or an efficient allocation of resources.

FOCs as well as rail freight customers and key suppliers (e.g. ports) require certainty so as to enter into long term contracts which support investment. GBRf considers that the variability in the level of charge and the possibility that the cap changes over time, or is applied to new market segments to be unworkable in the commercial reality of the UK rail freight market.

7.25 What should be the unit of the new charge? Please explain your reasoning.

For ESI coal a charge per tonne lifted would result in less disruption to the coal supply chain. This is because for the majority of coal delivered to the power station gate the price would increase by the same amount across all supply points and routes.

For Nuclear traffic, either a charge per tonne lifted or a rate per KGTM could be implemented although to reduce complexity GBRf considers that the charge should be levied on a similar basis to that developed for ESI coal.

However, if the ORR believes that, in future, freight specific charges may be extended to additional commodities then what is an appropriate charging structure across all commodities needs to be evaluated, given the desire to minimise complexity. If there's the possibility that, in future, the freight specific charge will be extended to cover additional commodities then the industry should be further consulted before the freight specific charging structure is developed for PR13, even if the charge is initially limited to ESI Coal, nuclear and iron ore.

For Biomass it is essential that the ORR rapidly formulates a clear policy as to how charges for this sector will be formulated beyond PR13 so as to ensure that the industry can invest and innovate for this developing market.

The implementation of any charge should be delayed until a date at which the ORR is satisfied will not result in a major cost to FOCs resulting from current haulage contracts which run into PR13.

Chapter 5 –Freight Avoidable Costs

7.26 Do you agree with our framework for estimating freight avoidable costs? Please explain any suggested changes to the framework, including your calculations (noting that there will be further opportunities to contribute to this work as the cost estimates are refined during the periodic review, for example in relation to Network Rail's strategic business plan).

GBRf has supplied calculations to LEK for some elements of the Freight Avoidable Costs Study. Specifically we do not accept that the removal of freight traffic reduces Network Rail's maintenance costs as was initially proposed by LEK. Our reason for this includes the fact that Network Rail's costs to deliver their own maintenance services without using the current competitive rail freight haulage market would be significantly higher. GBRf has provided, in confidence, its calculations to support this.

LEK suggested that additional rationalisation of the network could occur, were freight to be removed other than simply the discontinuation of freight only lines. It was even suggested that sections of 4-track railway may be able to be rationalised to 2-track if freight were removed from certain routes. GBRf considers that these highly subjective freight avoidable costs should not form part of the assessment. GBRf cannot envisage any elements of the 4 track rail network that, even in the absence of freight traffic, would, in practice, be rationalised to a 2-track railway.

LEK suggested that ERTMS fitment costs should form part of the freight avoidable costs assessment. ERTMS is separately funded by the DfT, as part of compliance with European interoperability standards.

ERTMS should not be included in the avoidable costs assessment in the same way as other sources of direct and indirect central government funding is provided to meet certain policy and compliance obligations.

Chapter 6 - Market Analysis

7.26 Do you have comments on our write-up, interpretation and application of the studies carried out by MDST and NERA? Is there any further evidence that you believe should be considered?

Table 6.1

In general, GBRf considers that the forecast percentage reductions in tonne kms are understated across the commodity groups. The clearest example of this is demonstrated with the MDST forecast change to the intermodal market.

Intermodal

Rail operators already currently price up to what the market can bear and are capped by the road haulage price for any route. Generally, for distances below 200 miles, some level of subsidy is required in order that rail can match the road haulage price. No more is paid by the DfT than what is required to equalise the economics of operating on these shorter distance routes. This is why routes from the South East ports to the Midlands by rail have always been subsidised.

Above 200 miles rail starts to see its economics match that of the road mode (subject to achieving a very high level of wagon utilisation on rail). This is why South East ports to the North West and North East now receive no, or very low levels of, subsidy. It's only at around the 300 miles mark that rail would be able to undercut road haulage. In practice, this length of haul only exists in the UK for the routes from South East ports to Scotland. However, prices in this segment are affected by the operation of maritime feeder services from those same ports to Scotland and so rail is price constrained even on these longer routes.

For it to be the case that £20.3m in net track access revenue could be raised from the intermodal market then it would have to be the case that rail operators could charge that right now. Presumably the justification as to why they cannot do this is that they compete with each other and thereby offer the market lower prices than road hauliers. If it's assumed that any of the increased VUC can be passed on, and the traffic retained on rail, then it must be the case that the FOCs are currently pricing below road haulage.

If this were the case then it would be expected for rail to have a very high modal share across the UK as shippers seek to use rail and save on their haulage costs. However we do not see rail modal shares across the UK, indicating rail undercutting road. We see traffic regularly switch away from the rail mode based on very small increases to rail transport rates.

There is, in fact, no capability to pass on any increase to this market. If rail priced above the equivalent road haulage service then that traffic will be lost, not in part but, in its entirety. Therefore it is difficult to explain how track access revenue would increase under such a scenario. The VUC could be set at double the level, but at that level the traffic would not be carried so overall track access receipts would fall. FOCs who understand the economics of this market know not to undercut road any more than is needed to make the carriage economic by rail for the shipper.

A £20m increase to intermodal track access charges can only be funded by FOC profits (currently estimated to be under £15m per annum PBT on all intermodal traffic) or by increased grant subsidy from DfT.

GBRf can only conclude that some of the MDST results do not stand up to reasonable scrutiny when the market realities are considered.

The ESI Coal Supply Chain

The NERA analysis ignores the fact that the current mix of supply points (imported to UK port, domestic mined in England and Scotland and the mix of routes operated) are a significant function of the current structure and level of track access charges (6.21 of the consultation). In the analysis, NERA assumes “no switching in coal sourcing and transport decisions as a result of the changes to charges”. When a significantly higher rate per KGTM is applied, the supply points and ports of importation will change, favouring the shorter distance routes. While this has been identified by the ORR in the consultation documentation, it has still not been sufficiently answered in the MDST additional work.

As a result of the freight specific charge on ESI coal, the routes operated will change along with the average length of haul. The average length of haul is key to determining the size of the market available to rail. This new supply chain will give rise to altered resource requirements from operators, with fewer wagons and fewer workers being required in a market that would be smaller.

Along with these mix and haul-length changes, there is also the possibility that the routes operated by a specific rail freight operator would be affected to a much greater degree than for another. For a specific haulier the new charges and consequential mix changes could be ruinous.

It appears that the impacts on the coal supply chain have not been modelled in sufficient detail to draw the conclusions the ORR is seeking to make.

As an alternative to a distance based charge, a “per tonne lifted” freight specific charge could be applied. However, a flat rate charge would adversely affect the shorter distance hauls favouring road haulage over rail on some routes. The most significant impact of a flat charge per tonne lifted would therefore be on domestic production of coal in England.

Section 6.75 of the consultation deals with the thresholds for a review of the charges. If a freight specific charge for ESI coal were to be adopted, GBRf would consider that it is consistent with the ORR's Section 4 duties to apply a threshold for a reduction in the market available to rail (based on a net tonne km basis) which would need to be far lower than the 10% quoted. We believe a lower threshold is appropriate given that it would take a significant period of time to identify the falling market size (as we will be looking at past data) and then to react to this information by instigating a review of charges and then for these new charges to take effect and halt the market decline.

Iron Ore

GBRf services the UK steel industry but it does not, currently, haul any iron ore. We are not aware of the current level of return on steel making activities in the UK but we are troubled when statements are made such as “we have also considered the potential for steel production to relocate as a result of an increased track access charge for iron ore, but consider this unlikely as we estimate the charge we have tested to represent an increase in steel production costs of around 0.1%.”

A 0.1% increase to steel production costs may sound small but it may represent a significant proportion of pre-tax earnings from UK steel making and therefore would represent a material reduction to the return on capital employed in this sector.

Furthermore, an increased cost of UK delivered iron ore may raise the cost of specific primary stages of the iron and steel production processes. This may create the incentive to import this primary feedstock to the steel making process thereby bypassing the importation and transportation of iron ore.

Nuclear

Nuclear fuel transportation operates in a very distinct market. The characteristics of the traffic, the customer and the supplier are not reflective of the same commercial pressures as exist in the wider rail freight market.

The nuclear fuels haulage market is characterised by one publicly owned and guaranteed company contracting with what is effectively an in-house supplier. The contracts for this haulage are not tendered and are not subject to any market testing. Any freight specific charge to this sector will ultimately be met by the taxpayer resulting in a zero sum financial result overall, albeit with more revenue to NR. Increasing or decreasing the level of charge will not create any incentive or disincentive to transport more or less traffic by rail.

However, GBRf considers that it does not make sense to single out nuclear fuel for specific application of a freight specific charge. We oppose a freight specific charge on this sector.

Biomass

We find the proposed approach to Biomass charging to be counter-productive. The consultation proposes not to levy a freight specific charge now but to “revisit the policy to coincide with the recalculation of its associated credit (subsidy) regimes (from 2017 for England and Wales)”. The subsidy regime will, surely, be set by the Department of Energy and Climate Change so that the taxpayer does not over-fund the desired market outcome nor result in any economic rents accruing to the generators. How then will it be possible to apply a freight specific charge to Biomass on the basis that the market can bear such a charge? For this to occur, the Biomass sector would need to be subsidy free and profitable by 2017. GBRf considers this highly unlikely.

The ORR’s policy of leaving open a revisiting of this charge in 2017, in practice, serves only to deter investment in this market segment. GBRf considers that a wholly more efficient market would be achieved by fixing a no-review period for biomass charges beyond CP5.

The recent DECC determination on renewables obligation credits (ROCs) has reduced the overall level of subsidy. NERA appear to be of the view that the process for the setting of ROCs credits will take into account any new level of track access charge. This appears to be incorrect.

The market for Biomass is discussed in the NERA and MDS studies in terms of current dedicated Biomass plants which are assessed as having an inelastic demand for rail haulage, together with the potential for future Biomass power stations which will be built and located at the UK ports. These new plants will not demand rail haulage services, it is stated. Additionally, it is assessed that investment by the rail industry will not occur in these markets as sufficient coal wagons currently exist and coal demand will fall to such an extent that the relatively bulkier Biomass, with its lower calorific value, can be transported with the existing fleet of coal hopper wagons. Therefore, it is concluded, there is no investment required in this market. GBRf views the development of the Biomass market very differently to this.

Biomass is most likely to be consumed at existing coal fired power stations either through co-firing, conversion or construction of new plants on those existing sites. GBRf estimates that there is the potential for significant volumes of Biomass transportation by rail, taking account of the bulking factor and calorific value of the commodity.

The NERA and MDST assessments treat the supply base as essentially one operator "railfreight" and ignores the fact that this is a competitive market where one operator may win market share from another. Wagons may therefore need to be acquired or leased by one operator rather than another. New wagon types may in future be developed given that the commodity (Biomass) is significantly different in terms of its specific density to that of coal.

The associated railfreight market for Biomass haulage is in its infancy. There is the suggestion that Biomass will be exempt from the freight specific charge but perhaps only until 2017. This causes an obvious and immediate problem with investing in this market.

Additional Comments on the Market Analysis

In section 6.39 it is argued that Scottish open cast mines will absorb the increase in track access charges because "once a site has been developed and is operational, for the most part it will be worthwhile for extraction to continue even if prices are somewhat lower than expected". While this may be true, such an approach could only be argued not to damage further investment in the market if suppliers were generating windfall profits. If however risk adjusted returns in this sector are at or below acceptable levels then such an action to tax or regulate based purely on the fact that investors have already dug their mine and have nowhere to go is damaging to the efficient operation of the market.

7.28 Do you agree with our proposal, on the basis of MDST's analysis, to not levy a mark-up on certain rail freight commodities, including intermodal, construction materials and metals?

Yes

7.29 Do you agree with our proposal to levy the proposed charge on ESI coal traffic?

No for the reasons stated previously in this consultation response.

7.30 Do you agree with our proposal to levy the proposed charge on spent nuclear fuel traffic?

No for the reason that we need to agree a longer term regulatory policy for the pricing of track access covering all markets and providing stability of access prices.

7.31 What views do you have on our analysis of the iron ore market segment? Do you consider that there is also a case for levying the proposed charge on iron ore?

No again for the reason that the industry needs more time to debate and agree a longer term regulatory policy for the pricing of track access covering all markets and providing stability of access prices.

7.32 Do you agree that we should revisit our policy on levying a charge for the biomass market segment to coincide with the recalculation of its credit (subsidy) regime (from 2017 for England and Wales)?

No.

7.33 Do you consider that the proposed charge should be levied on other (non ESI) coal flows?

No.

Please do be in contact if there is any further information or explanations required.

Yours sincerely,

Ian Kapur.
National Access Manager.