



OFFICE *of the*
RAIL REGULATOR

**FRAMEWORK FOR THE APPROVAL OF RAILTRACK'S
TRACK ACCESS CHARGES FOR FREIGHT SERVICES**

A POLICY STATEMENT

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Regulator's foreword

I published in October 1994 a consultation document, *Framework for the Approval of Railtrack's Track Access Charges for Freight Services*, seeking views on the basis on which I should approve charges paid by freight users for access to Railtrack's network. I have received 46 responses, from a wide range of interested parties. I am grateful for the constructive comments they contained. I am now publishing my decisions on a regulatory framework which aims to give the right incentives for the development of freight on rail, while providing new protections for existing users.

Framework for Decisions

Parliament has given me the function of approving individual access agreements between freight operators and Railtrack and it has imposed duties on me. In particular, Parliament has given me a specific duty to promote the carriage of freight by rail. There is a widespread desire in the country to see the development of a strong and healthy rail freight industry, and one which can play its part in meeting the country's freight transport needs.

The decline in rail's share of the national freight market since the war has been well documented. This trend has reflected structural changes in the economy, the development of the national road network and technological change dramatically improving the services which rail's competitors have been able to offer. Regulatory decisions cannot reverse that decline, but they can put incentives on Railtrack to increase the attractiveness of the rail network to freight customers and to reinforce actions taken by government to encourage the transport of freight by rail. It has been my key objective to provide Railtrack with these incentives.

Main Conclusions

I have concluded that these aims will best be achieved within a framework of negotiation, rather than detailed regulated tariffs, in which Railtrack is able to attract onto the rail network all users who are able to pay at least their *avoidable costs*. In this way no user who is able to pay at least the direct costs imposed on the network should be denied the opportunity of moving traffic by

rail rather than road. I believe this will help to harness the potential of rail freight. But there is a balance to be struck. It is vital to maintain the attractiveness of the rail network to existing users as well as taking steps to attract new users.

I am, therefore, introducing checks and balances which address concerns expressed by those responding to the consultation.

- (a) *Protecting Railtrack's freight customers:* dependent customers must be protected from any abuse by Railtrack of its monopoly position. I am requiring Railtrack to change the basis on which it calculates the avoidable costs which form the minimum price it will charge for access. I am also introducing arrangements whereby proposed prices which come within 50% of an average notional upper limit calculated by Railtrack will be individually reviewed in detail by me before I approve them. Users will also benefit from the improvements in efficiency Railtrack will have to achieve both to meet the pricing controls I introduced in my policy statement on the level of passenger access charges and to eliminate the losses it currently makes on its freight business.
- (b) *Avoiding distortion in freight markets:* I am taking steps to prevent undue discrimination and undue cross-subsidy in Railtrack's charges. I will not permit Railtrack by its pricing decisions significantly to distort competition between freight users in the final markets in which they themselves compete.
- (c) *Promoting competition between freight operators:* competition will provide strong incentives for both existing and new freight operators to identify new opportunities for the use of rail to carry freight, and will itself be promoted by measures to allow Railtrack to give access to users who are able to pay at least the minimum costs calculated in line with my new guidelines.
- (d) *Reducing uncertainty:* it is also important that rail freight is not put at a competitive disadvantage by complexity and uncertainty in arrangements for gaining access to the network. I believe there is an important role for the Regulator in helping to avoid this danger by

having clear and flexible procedures for approving freight access agreements. To this end I published in December *Criteria and Procedures for the Approval of Freight Track Access Agreements*. I will also require Railtrack to publish information on its overall freight costs and revenues, and summary information on avoidable costs and charges.

The Future for Rail Freight

With the opening of the Channel Tunnel and the enlargement of the European Community, there are opportunities for rail to reassert its role in freight transport. And there is a widespread will for this result to come about. My decisions aim to provide for a sensible balance between this aim of promoting the use of rail to move freight and the need to protect existing users. And they do so by giving Railtrack clear incentives, but providing for sensitive regulatory guidelines. They provide a framework in which Railtrack and freight operators can work together to promote public interest objectives while pursuing their own legitimate commercial aims. I intend to keep these arrangements under continuous review to satisfy myself that they are working to the benefit of freight customers and both present and potential freight users of the rail network.

The New Framework

This policy statement marks the completion of my initial review of the pricing and competitive framework which will govern access to the rail network. In this statement, and in my recently published policy statements on the structure and level of Railtrack's access charges for passenger services and on competition for passenger services, I have sought to promote a new understanding between Railtrack, train operators and government to the benefit of rail users and the public interest.

John Swift QC
Rail Regulator
1 February 1995

1. Summary and Conclusions

- 1.1 In October last year, the Rail Regulator published a consultation document, *Framework for the Approval of Railtrack's Track Access Charges for Freight Services*, seeking views on his proposed approach to the approval of track access charges included in freight access agreements. Having considered the responses to the consultation, this policy statement sets out the Regulator's conclusions.

General Framework

- 1.2 The Regulator set out in the consultation document a possible framework for establishing track access charges for freight users which, in his view, would give Railtrack the maximum incentive to attract freight traffic onto its network, subject to regulatory safeguards. To this end, he suggested that access charges should be negotiated between Railtrack and its customers, but should be subject to regulatory criteria designed to prevent charges being excessive, distorting competition or resulting in cross-subsidies.
- 1.3 The Regulator recognises that this approach has advantages and disadvantages, as the responses to the consultation have identified, and that alternative approaches are possible (the responses are summarised in Appendix 2). He has given careful consideration to the points raised, and accepts that the application of a negotiated charging framework raises a number of potential problems. However, having regard to the weight of the arguments in the responses taken as a whole, he is still of the view that a negotiated approach to establishing freight access charges offers the best opportunity to develop Railtrack's freight business to the benefit of all current and potential users, but such a framework should include a range of protections for existing users to ensure that the following criteria are satisfied:
- (a) charges should be greater than or equal to the avoidable costs incurred by Railtrack as a direct result of carrying that particular freight flow;
 - (b) charges should be less than or equal to the "standalone" cost which would be incurred by a notional efficient competitor;

- (c) charges should not be higher or lower, after allowing for specific factors relevant to each case, than those for other operators or users to such an extent that they risk significantly distorting competition between rail freight operators or users; and
- (d) the structure of charges should broadly reflect the value to users of access to the rail network, and should enable Railtrack to recover its total freight-specific costs plus any expected contribution to the shared common costs of its passenger and freight services.

Application of Criteria

1.4 The Regulator has considered the way these criteria should be applied in the light of detailed comments made by respondents to the consultation document. He will introduce arrangements which are intended to ensure that charges negotiated between Railtrack and its customers meet the following objectives:

- (a) Railtrack should be able to recover at least its total freight-specific costs, thereby avoiding cross-subsidy between passenger and freight services;
- (b) cross-subsidies between individual freight users should be removed;
- (c) Railtrack's avoidable costs should be assessed with greater accuracy than at present;
- (d) charges should be subject to a regulatory ceiling, based on standalone costs and verified on a case-by-case basis where negotiated charges are more than 50% of Railtrack's initial estimate of standalone cost;
- (e) freight users should share in the cost savings that Railtrack is expected to make; and charges should not lead to a significant distortion of competition between freight operators or between freight users competing in the same final market.

Implementation

- 1.5 The Regulator has published separately a document setting out the procedures to be adopted in approving freight track access agreements. In approving individual agreements, he will normally want to verify that the criteria set out in this statement are satisfied. He has also concluded that Railtrack should provide information on its overall freight business and, in summary form, on individual charges and their relation to avoidable cost.

- 1.6 The Regulator will monitor the development of the rail freight market, and will keep the charging policy framework under review.

2. *General Framework*

- 2.1 The Government's proposals for Railtrack's track access charges for freight services were set out in *Gaining Access to the Railway Network* (Department of Transport, February 1993). This envisaged a system of negotiated access charges based on the value to each user of using rail infrastructure and subject to the constraints of covering avoidable costs and avoiding discrimination between operators competing in the same final market.

Negotiated charges

- 2.2 The Regulator indicated in his consultation document that he was minded to accept the principle of negotiated access charges. This was, in his view, the best way of simultaneously achieving the two key objectives of enabling Railtrack to recover its total freight-specific costs and of not pricing off the network individual freight flows which can cover their own avoidable costs.
- 2.3 If total freight access charges did not cover Railtrack's total freight-specific costs, this would mean that passenger services were cross-subsidising freight services or that losses on Railtrack's freight business were reducing its overall rate of return, either of which could lead to pressure for Railtrack to close some or all of its freight facilities. At the same time, the Regulator's duty with respect to promoting the use of the network for the carriage of goods means that he would not wish to see freight traffic which can pay at least its avoidable cost priced off the network. It is in the long term interests of all users, moreover, for Railtrack to avoid pricing potentially profitable flows off its network, since the remaining freight users might otherwise have to make a higher contribution to Railtrack's freight specific common costs.
- 2.4 Most respondents accepted these two objectives, and many agreed that they were most likely to be achieved under a framework of negotiated charges. Some respondents favoured a tariff based system, though none was able to suggest objective criteria which could be used to distinguish between "high value" and "low value" flows without pricing some flows off the network. Others, while supporting the general principle of negotiated charges, expressed concern at the high degree of uncertainty, the lack of transparency, and the

perceived complexity of a charging structure based on individually negotiated charges.

- 2.5 Some respondents favoured a system of indicative tariffs, which would provide a starting point for negotiations, but would also give potential customers some idea of the likely scale of charges. While recognising the potential advantages of making such information available, the Regulator considers that such tariffs would impose artificial constraints on negotiations between Railtrack and its customers, bringing similar problems of arbitrary boundaries and inflexibility to those which affect a fully-fledged system of tariffs, and failing fully to reflect the likely nature of the bargain between Railtrack and its customers.
- 2.6 The Regulator has concluded, therefore, that track access charges for freight services should be determined through negotiations between freight operators or users and Railtrack. However, there must be criteria and guidelines, backed by appropriate monitoring and review arrangements, which aim to ensure that negotiations produce results which are in the public interest. And those arrangements must be subject to the regulatory supervision provided by the requirement of the Railways Act 1993 that all freight track access agreements be approved by the Regulator.
- 2.7 The Regulator also recognises the concern expressed by some respondents that rail freight could be at a competitive disadvantage if potential users are not able quickly and easily to find out the approximate cost of using rail. Within this framework, he will expect both Railtrack and freight operators to act in a way which is likely to encourage, rather than discourage, potential customers to send freight by rail. It is important that the Regulator's own procedures for the approval of access agreements work smoothly to this effect.

Criteria to be Applied

- 2.8 The Regulator recognises that there is as yet little experience of negotiating track access charges. He also recognises that Railtrack is in a monopoly position as the owner and operator of the rail network, although its ability to exploit this monopoly position, particularly in the case of freight users, is limited by competition from other modes of transport.

2.9 In the consultation document, he set out four criteria which he was minded to apply when assessing the charges included in freight track access agreements submitted for his approval under section 18 of the Railways Act, or for his determination under section 17 of the Act. While many respondents made suggestions about the detailed application of these criteria, there was broad support for the overall framework.

2.10 Therefore the Regulator has concluded that, while every case will be judged on its merits, he should normally expect to apply the following criteria in his assessment of freight track access charges:

- (a) charges should be greater than or equal to the avoidable costs incurred by Railtrack as a direct result of carrying that particular freight flow;
- (b) charges should be less than or equal to the standalone cost which would be incurred by a notional efficient competitor;
- (c) charges should not be higher or lower, after allowing for specific factors relevant to each case, than those for other operators or users to such an extent that they risk significantly distorting competition between rail freight operators or users; and
- (d) the structure of charges should broadly reflect the value to users of access to the rail network, and should enable Railtrack to recover its total freight-specific costs plus any expected contribution to the shared common costs of its passenger and freight services.

2.11 These criteria aim to prevent Railtrack from levying charges which are excessive, which distort competition, or which result in cross-subsidies. Their application is described in section 3 of this document.

3. Application of Criteria

- 3.1 Respondents to the consultation document raised a wide range of questions about the way in which the proposed criteria would be applied. For rail freight to develop, both existing and potential users will need a clear idea of the likely impact of these criteria. Otherwise, while some users might ask the Regulator, under section 17 of the Railways Act, to determine the terms and conditions of access, others might simply switch to (or remain with) other modes of transport. This section deals with issues relating to the application of the criteria set out in section 2 above.

Avoidance of cross-subsidies

- 3.2 Many, but not all, respondents accepted the need to avoid cross-subsidies, either between passenger and freight services or between different freight customers. Some were particularly concerned to avoid a situation where they were effectively subsidising parts of Railtrack's network which they did not use. As explained in the consultation document, the use of appropriately calculated avoidable cost floors and standalone cost ceilings will ensure that there are no cross-subsidies, in the sense that all users will benefit from having access to a shared network, but these cost floors and ceilings need to be applied to groups of users as well as individual users.

Cross-subsidies between passenger and freight services

- 3.3 Railtrack's current projection of its income from freight access charges in 1995/96 is below its best estimate of total freight-specific costs. However, if it achieves cost savings consistent with the Regulator's recent conclusions on future levels of passenger access charges (*Railtrack's Access Charges for Franchised Passenger Services: The Future Level of Charges*, January 1995), and if it approaches individual negotiations in a way which will encourage the use of rail freight, it has every prospect of closing this gap within the next few years.
- 3.4 In line with the framework suggested in the consultation document, the Regulator has concluded that charges for franchised passenger services should not be increased to fund any shortfall of freight revenues below total

freight-specific costs. At the same time, in reaching his conclusions on the level of Railtrack's access charges for franchised passenger services over the period to 2000/01, he took the view that freight revenues were unlikely to make a material contribution to the shared common costs of Railtrack's passenger and freight network over the period as a whole.

- 3.5 The Regulator recognises that Railtrack may not be able to remove all losses on its freight business immediately. He is satisfied that the potential size of losses in the short term will not make it unduly difficult for Railtrack to finance its activities, and that there is scope for Railtrack to take managerial action to eliminate these losses. Any reduction in freight specific costs, or increase in revenue, will directly improve Railtrack's profitability. The Regulator believes, therefore, that the policy set out in this statement should provide Railtrack with both strong incentives and a clear opportunity to operate its freight business on a sound commercial basis.

Cross-subsidies between freight services

- 3.6 The Regulator shares the concern, expressed by some respondents, to avoid situations where other users of the network are cross-subsidising Railtrack's losses on certain freight only lines. This might occur, for example, where a freight-only line is shared by several users, since the total avoidable cost of the line may well be greater than the sum of the individual avoidable cost floors for each of the users of the line.
- 3.7 Failure to recover the avoidable cost of a particular line through negotiated access charges does not necessarily amount to cross-subsidy. This would only be the case if users of other parts of Railtrack's network were paying higher charges as a direct result of Railtrack continuing to operate the line at a loss. The Regulator believes that, in practice, losses on particular lines will generally reduce Railtrack's profits rather than increase charges for other users. This is because he has already determined the future level of passenger access charges, and because the policy set out in this statement will provide Railtrack with clear incentives both to attract additional freight traffic which can cover its avoidable cost and to maximise the contribution it earns from each flow.

- 3.8 It will be in Railtrack's commercial interest, therefore, to move over time to a position where it can recover the total avoidable costs of freight-only lines (or other self-contained parts of its network) from the users of those lines, including any money which is provided by government through the Track Access Grant. The policy decisions taken by the Regulator aim to provide Railtrack with both incentives and opportunities to do this.
- 3.9 The Regulator will expect Railtrack in future to be able to identify the avoidable costs of freight-only lines and other self-contained parts of its network. Where Railtrack still makes a loss on particular lines, the Regulator will be concerned that this should not lead to higher charges for users of other parts of Railtrack's network.

Definition of avoidable cost

- 3.10 The overriding principle which the Regulator believes should apply to the calculation of avoidable cost floors is that they should include only those costs which are genuinely avoidable with respect to an individual freight flow. For an existing freight flow, the cost floor should include only those costs which Railtrack would avoid if that particular flow left the network; for a new freight flow the floor should include only those additional costs which Railtrack will incur as a result of that particular flow coming onto its network.
- 3.11 Following discussions with Railtrack, the Regulator has drawn up a set of guidelines for the calculation of avoidable cost floors. These guidelines are summarised in Appendix 3, excluding mechanical details of the calculation and individual adjustments agreed between the Regulator and Railtrack.
- 3.12 The methodology set out in these guidelines differs in several ways from that previously used by Railtrack to calculate avoidable cost floors. The main differences are that:
- (a) no return on existing assets should be included in the avoidable cost floor – if Railtrack is unable to earn a full return on a particular asset, this means that the asset is overvalued and should be written down, rather than providing any indication that a freight flow should not run;

- (b) some long run costs are now excluded from cost floors for traffic on lines which are shared with other freight flows - this takes account of the fact that some long run maintenance and other costs associated with these routes are common to freight as a whole rather than specific to any individual flow;
- (c) on single-user freight-only lines, the cost floor should not include costs which can be clearly identified as not avoidable by Railtrack, even if it closes the entire line; and
- (d) a new methodology has been adopted for calculating short run variable costs on freight-only lines which takes account of cost variations associated with different types of locomotive and wagon.

3.13 The first three of these changes will lead to some reductions in avoidable cost floors, though the Regulator recognises that in practice it will be difficult to identify particular costs which are not avoidable to Railtrack, while the fourth should improve the accuracy of the calculations. However, the changes will have little impact on Railtrack's total freight specific costs, and therefore should not necessarily lead to lower access charges for existing freight flows, even where charges are currently at or close to the cost floor. Where a customer would otherwise have agreed to a particular charge, based on the value of access to the rail network, that charge may still be appropriate even though the cost floor is now lower.

3.14 The Regulator hopes that the reduction in avoidable cost floors will enable rail to attract new freight traffic, which might previously have been considered unprofitable, but this will depend on the efforts made by both Railtrack and the freight operators to attract new business. The prospect of efficiency gains leading to future real reductions in Railtrack's costs means that traffic which may be marginally profitable at present should become more profitable in future.

Avoidance of Excessive Prices

3.15 Although rail freight faces strong competition from other modes of transport, Railtrack may still be able to negotiate high access charges in some cases, either because some customers are dependent on rail or because of the high

value of the traffic. In those circumstances, the Regulator will wish to ensure that Railtrack does not exploit its monopoly position as owner of the rail network and seek to negotiate charges which are excessive.

Standalone cost ceilings

3.16 A key protection against excessive charges is the criterion that access charges should not exceed a standalone cost ceiling. Almost all respondents to the consultation document supported the use of such ceilings, and put forward a wide range of suggestions as to how they should be calculated. The Regulator expects that standalone cost ceilings will be relevant to a relatively small number of freight flows, and believes that these will be best dealt with on a case-by-case basis. He will consider whether it would be appropriate to issue guidelines when he has had an opportunity to assess the extent of commonality between the individual cases for which standalone cost calculations will need to be performed.

3.17 In cases where charges are more than 50% of Railtrack's initial estimate of standalone cost, therefore, the Regulator will require Railtrack to carry out an individual assessment of its proposed charges. There are three principal ways in which he will expect this assessment of standalone costs to differ from Railtrack's current "reference charge" calculation:

- (a) it should use specific data wherever possible, rather than the single national average used by Railtrack;
- (b) it should relate to the costs of a notional efficient competitor, and should therefore exclude costs which reflect inefficiency; and
- (c) it should take account of the opportunities for the notional efficient competitor to attract traffic from other existing freight flows.

He will discuss with Railtrack the way in which these should be applied in the context of any particular case.

3.18 In most cases, the Regulator would expect standalone cost calculations to be based on the costs of operating the line in question, rather than the costs of a newly built facility. An alternative approach, for example based on a "bottom

up" study of the costs of an alternative facility using current best engineering practice, could prevent Railtrack from recovering the ongoing costs it incurs from continuing to operate a particular line. Nevertheless, the ceiling should be adjusted to take account of general efficiency improvements which Railtrack is expected to make in the medium term, and any specific savings arising from more efficient operation of the route in question.

- 3.19 The Regulator also considers that any assessment of standalone cost should make some allowance for the ability to share facilities where several high value freight flows are using the same route. The Regulator does not believe it would be appropriate for Railtrack to be charging each of these flows at or near the standalone cost of a dedicated facility; equally he would not want to apply standalone cost ceilings in a way which removed Railtrack's incentives to attract additional traffic onto particular routes. He also recognises that this calculation may not be straightforward, for example because it may need to take account of two or more flows with different origin and destination points and which share a particular route for only a small part of their total journeys over different parts of Railtrack's network.

Excessive prices below standalone cost

- 3.20 Some respondents expressed the view that charges could be excessive, even if they were below the cost of a standalone facility, and proposed other forms of cost ceilings, for example based on a multiple of avoidable cost. The effect of this would be to set a different ceiling and to adopt a different approach to that set out in paragraphs 3.16 to 3.19 above.

The Regulator has concluded that the approach outlined in those paragraphs is an appropriate means of preventing excessive prices. It is based on a specific assessment of the facts in the limited number of cases where the issue arises, rather than on an inevitably arbitrary and generalised formula.

- 3.21 If individual users felt that Railtrack's charges were excessive, even though they were below the standalone cost ceiling, they would be able to ask the Regulator to direct Railtrack, under section 17 of the Railways Act, to enter into an access contract and to specify the charges to be included in that contract. The Regulator accepts, however, that a framework of negotiated charges, based on the value of access to the rail network, is likely to lead to

significant differences between the access charge and the avoidable cost for particular flows, and does not consider that such differences *per se* are an indication of excessive prices.

Sharing of efficiency gains

3.22 A further reason why charges might be considered excessive is if they fail to take account of expected improvements in Railtrack's efficiency. The Regulator has established a control of RPI-2 to apply from 1996/97 to Railtrack's track and station access charges for franchised passenger services to ensure that cost savings are passed on to those operators. He expects that Railtrack will take steps to ensure that improvements in its efficiency which will be required for it to meet these price limits are also reflected in efficiency improvements in its freight business, and that these will help to eliminate losses it currently makes on that business.

3.23 The Regulator believes that all of Railtrack's customers should have some expectation of being able to share the benefits of expected efficiency improvements, but that this should generally be determined by the outcome of negotiations between Railtrack and its customers. He has concluded, therefore, that he should not specify particular price change provisions (such as an RPI-X type formula) either for inclusion in individual access agreements or to apply to Railtrack's total income from freight access charges. Where a contract lasts for several years, the Regulator believes that Railtrack and its customers should be free to negotiate over both the starting level of charges and the profile of these charges over the length of the contract. Nevertheless, he will expect all long term contracts to include suitable provisions to determine the change in access charges for the remaining years of the contract.

Distortion of Competition

3.24 The Regulator accepts that negotiation might lead to significant differences in the prices charged for apparently quite similar freight flows. Price variations, in themselves, do not necessarily mean that charges are unduly discriminatory; indeed they are an integral feature of a negotiated charging framework. Nevertheless, the Regulator will be concerned to avoid situations where significant price differences are likely to distort freight users' choices of how

to gain access to Railtrack's network, or where they risk distorting competition between freight users in the final markets in which they themselves compete.

- 3.25 Under the new structure of the rail freight industry, a freight user can enter a single contract, covering both train operation and access, with one of the new freight operating companies which have been created from British Rail's former freight business. Alternatively, it can negotiate directly with Railtrack for access rights, in which case it can either enter a separate contract for train operation with one of the freight operating companies, or it can become a train operator itself. The Regulator is concerned that differences in access charges should not bias the choice between these different ways of obtaining access, or between different freight operating companies. It is important therefore that Railtrack should not quote different rates for the same, or similar, access rights to either freight users or freight operating companies.
- 3.26 The Regulator recognises that the level of access charges will affect the competitive position of freight users in the final markets in which they compete. It would not be right for two users, who were otherwise in a similar competitive position, and where the freight flows were broadly similar, to be charged significantly different amounts for rail freight. At the same time, the Regulator accepts that the process of negotiation will inevitably lead to some price differences, and that the competitiveness of freight users in their final markets will often depend more on other factors, such as their efficiency and location, rather than on their respective track access charges.
- 3.27 A number of respondents to the consultation document argued that Railtrack is a monopoly supplier and therefore it should be denied the opportunity to set relative freight access prices on any basis other than simple objective cost differences. The Regulator does not agree that price differences resulting from negotiation will necessarily represent an abuse of monopoly power. Railtrack is a supplier of services that have different value to different users. These objective differences have as great a part to play in price determination as do cost differences. In any case, Railtrack's market power in the freight market is, for the main part, limited. In a great many markets, irrespective of the commodity being transported, competition between rail and other modes of transport may mean that Railtrack is a price taker and not a price maker.

3.28 Nonetheless, users need protection from any potential abuse. It is important that pricing flexibility does not lead to excessive charges for individual flows which are dependent on rail. The Regulator has therefore concluded that a framework based on negotiated charges is the right way forward but that it must include within it protections, checks and balances to ensure that prices are not excessive and that they do not distort competition. The Regulator does not believe that it is possible to set out generally applicable rules which will prevent such distortions automatically. He will consider each case on its merits following the approach to implementation described in the next section.

4. *Implementation*

- 4.1 The consultation document set out the way in which the Regulator expected to carry out his assessment of charges included in applications for approval of freight track access agreements under section 17 or 18 of the Railways Act. He has since published a further document (*Criteria and Procedures for the Approval of Freight Track Access Agreements*, December 1994) which sets out his approach in more detail.

Procedures

- 4.2 In the case of agreements submitted under section 18, where Railtrack and the freight operator or user have agreed terms, the Regulator will require Railtrack to supply with each proposed access agreement details of the cost floor, calculated in line with the guidelines he has prepared, and its own simple "reference charge" calculation of standalone costs. He has also agreed with Railtrack a format for providing this information which will enable him to analyse it quickly, in line with the criteria set out in this statement. This information will also enable the Regulator to develop a database of information on costs and charges for different types of freight flows, which will help him to identify whether individual proposals might involve undue cross-subsidy or undue discrimination.
- 4.3 In any case where the proposed charge is more than 50% of Railtrack's reference charge calculation, the Regulator will normally require a more detailed assessment of standalone costs, on the basis described in section 3 above.
- 4.4 In the case of an application under section 17 from a customer unable to agree terms with Railtrack, the Regulator will expect Railtrack to provide broadly similar information to that required for agreements submitted under section 18.

Verification and Monitoring

Provision of information

- 4.5 Some respondents argued that the availability of more information would increase the likelihood of a successful outcome of negotiations between Railtrack and its customers, and nearly all were in favour of Railtrack publishing specific information on its freight business. The Regulator recognises the value of making available general information on Railtrack's freight business, and also providing some information on the range of avoidable cost floors and track access charges for Railtrack's freight business as a whole. He has concluded, therefore, that a wider range of information should be made available to actual and potential users than they have at present. His preference would be to agree with Railtrack information to be published by it rather than to publish information directly himself.
- 4.6 He will discuss with Railtrack the precise form of information to be provided, but he expects that this will include:
- (a) Railtrack's total income from freight access charges;
 - (b) the volume of freight traffic, both in total and broken down by type of commodity;
 - (c) Railtrack's freight-specific costs, in total and broken down by function (maintenance, renewals, traction current, signalling, electrification, etc.); and
 - (d) a single scatter diagram showing a representative range of avoidable cost floors and access charges, both expressed in £ per gross tonne mile.
- 4.7 There are a number of other potentially useful indicators, for example showing average maintenance costs per mile for each Railtrack zone, but which would be neither sensible nor practicable to calculate separately for Railtrack's freight business rather than for its network as a whole. Decisions on these data will need to be taken in the wider context of what information should be published relating to Railtrack's network as a whole.

- 4.8 The Regulator believes that additional information on these lines will enable freight users to negotiate constructively with Railtrack, without requiring any sharing of commercially confidential information. He does not believe that he should require Railtrack to make information on the avoidable costs of individual flows available to freight operators or users. He will nevertheless encourage arrangements between Railtrack and potential access beneficiaries for mutual exchange of information beyond that provided for above, where this can be achieved by agreement between the relevant parties.

Monitoring and review arrangements

- 4.9 The Regulator will keep his guidelines on avoidable cost calculations under review. He will wish to explore with Railtrack any opportunities for obtaining new or updated data which will improve the accuracy of these calculations, and he will review their continued suitability in the light of lessons learned from particular cases which have been brought to his attention.
- 4.10 More generally, the Regulator is mindful of the concern expressed by some respondents that, whether because of the actions of Railtrack and freight operators or due to other factors, a framework of negotiated charges could act to discourage, rather than encourage, potential users from carrying freight by rail. He will monitor the development of rail freight, and make relevant comparisons with other modes of transport. He will keep the policy set out in this statement under review, and will be prepared to amend the polity if that is necessary better to discharge his duties under section 4 of the Railways Act. He sees no necessary reason for freight charging polity to be reviewed only when franchised passenger track access charges are next formally reviewed and, if necessary, would expect to develop polity over time in the exercise of his function of approving freight access agreements.

Appendix 1: List of Respondents

Government

Department of Transport

Network operators (including prospective network operators)

Central Railway Group Limited

Railtrack PLC

Societe Nationale des Chemins de Fer Franqais

Train operators (*including prospective train operators*)

British Railways Board

FL 2000 Ltd*

Loadhaul*

Mainline Freight

Management Consortium Bid Ltd*

Prism Developments Limited

Project Freightliner*

Railfreight Distribution

Transrail*

Freight users

British Nuclear Fuels plc

British Steel plc*

Buxton Lime Industries Limited

Esso Petroleum Company Limited

Mendip Rail Limited

National Power PLC**

Nuclear Electric plc*

Plasmor Limited

PowerGen plc*

The Potter Group (Holdings) Plc

Thamesport (London) Limited

Rail user groups

The Freight Transport Association

Merseytravel

Private Wagon Federation

Rail Freight Group

Yeovil and District Rail Action Group

* indicates a response which is confidential to the Office of the Rail Regulator

Companies

CAIB UK Ltd

Railstore Ltd

Tiphook Rail Limited

Local government

Association of District Councils

Association of Transport Co-ordinating Officers

Convention of Scottish Local Authorities

East Midlands Rail Consortium

Passenger Transport Executive Group

Surrey County Council

West Sussex County Council

Institutes and academic organisations

Chartered Institute for Transport in the UK

Consultants

David Clayton

New Markets Limited

Passenger Transport Networks

Scott Wilson Kirkpatrick & Partners

Individuals

Mr P R Brewer

Mr R D P Smith

Appendix 2: Summary of responses to the consultation document

1. The Regulator published in October 1994 a consultation document, *Framework for the Approval of Railtrack's Track Access Charges for Freight Services*. This set out the Regulator's proposed approach to the approval of track access charges for freight services, and sought views both on the overall framework and on seven specific issues:
 - (a) whether the two objectives, of recovering Railtrack's total freight-specific costs and of not pricing off the network individual freight flows which can cover their own avoidable costs, can be achieved in any way which does not rely on negotiated charges;
 - (b) whether a standalone cost ceiling provides sufficient protection against excessively high charges and, if not, what further measures are required;
 - (c) the proposed criteria to be applied to freight access charges;
 - (d) the proposed framework to apply to the overall level of Railtrack's income from freight access charges, and in particular the extent to which dependent customers should expect to benefit from lower access charges as a result of improvements in Railtrack's efficiency;
 - (e) the principles on which avoidable cost floors should be calculated, how they should be applied, and in particular the issues to be covered by the methodology to be agreed with Railtrack;
 - (f) the calculation and use of cost ceilings, based on standalone cost or other concepts, which could be used to establish the maximum level of Railtrack's track access charges for individual freight flows; and
 - (g) the proposal that Railtrack should be required to publish information showing the level and trends in its freight costs and revenues, but not information on individual flows.

2. The Regulator received 46 responses from a wide range of interested parties, who are listed in Appendix 1. Except for those submissions marked as confidential to the Office of the Rail Regulator, copies of responses have been placed in the Library of the Office of the Rail Regulator and are also available (with a charge for copying) from the Library on request (tel: 0171-282 2001).
3. The views of respondents are summarised briefly below.

General Issues Raised by Respondents

4. A large number of respondents emphasised the fact that rail freight faces very strong competition from road transport. Some pointed out that road users are not charged directly for the use of infrastructure or required to fund a return on the value of the road network. Others pointed out that road hauliers are able to respond quickly to enquiries from potential customers, whereas the procedures required to carry freight by rail are seen as complex and time-consuming.
5. Some respondents expressed general concerns about the overall framework, questioning whether the parties would be willing to enter genuine negotiations, and whether they would have appropriate incentives to attract new business.

Issues Raised in the Consultation Document

Whether the two objectives, of recovering Railtrack's total freight-specific costs and of not pricing off the network individual freight flows which can cover their own avoidable costs, can be achieved in any way which does not rely on negotiated charges

6. Opinion was divided between those who agreed that negotiated charges offered the best way of achieving the stated objectives, and those who favoured some form of tariff. Most of the latter favoured some form of banding or differential mark-up, so that certain flows would pay more than others. Many of those who supported negotiated charges did so because they did not think that suitable objective criteria could be found for a workable system of banded tariffs.

7. One intermediate option put forward was a system of indicative tariffs, which would provide a starting point for negotiations with Railtrack. This would provide greater transparency and would allow potential customers to carry out initial desk evaluations.

Whether a standalone cost ceiling provides sufficient protection against excessively high charges and, if not, what further measures are required

8. There was general agreement that standalone cost ceilings were likely to apply in only a minority of cases, and some respondents thought such ceilings would provide sufficient protection against excessive pricing.
9. Others expressed doubts, stating that the standalone cost ceiling might be too high to provide adequate protection. It was suggested that this problem could be addressed by some form of cost ceiling linked to Railtrack's avoidable costs.

The proposed criteria to be applied to freight access charges

10. A number of respondents supported the proposed criteria, though some raised questions or offered suggestions as to how the third criterion (that charges should not be substantially higher or lower, after allowing for specific factors relevant to each case, than those for other operators or customers competing in the same final market) should be applied.
11. Opinions ranged from those who believed that any form of differential pricing would distort competition to those who believed that the Regulator should not be concerned about any price differences. Some suggested that the appropriate test was to avoid distorting competition in the end market, while others suggested that price comparisons should be based on the commodity being transported rather than the end market.
12. A small number of respondents questioned the need to avoid cross-subsidies, either between individual freight flows or between passenger and freight services.

The proposed framework to apply to the overall level of Railtrack's income from freight access charges, and in particular the extent to which dependent customers

should expect to benefit from lower access charges as a result of improvements in Railtrack's efficiency

13. Some respondents argued that Railtrack's total freight revenues should not exceed its total freight-specific costs, though in some cases this was based on the belief that this would mean that freight services were cross-subsidising passenger services. Other arguments advanced for this were that freight was a marginal user on a predominantly passenger railway, or that this surplus could be used to reduce freight access charges or to fund infrastructure renewals. Some agreed that any surplus should be used to contribute towards the shared common costs of Railtrack's passenger and freight network.

14. Opinion was also divided on the sharing of Railtrack's efficiency gains. Some argued that users should not automatically benefit from improvements in Railtrack's efficiency, while others suggested that only dependent users should benefit, and a third group proposed that all users should benefit, in most cases through an RPI-X formula included in individual access contracts or applied to Railtrack's total freight revenues.

The principles on which avoidable cost floors should be calculated, how they should be applied, and in particular the issues to be covered by the methodology to be agreed with Railtrack

15. There was strong support for the propositions that cost floors should exclude costs which Railtrack cannot avoid, that the timescale for avoidability is important, and that Railtrack should be prepared to negotiate over changes in service specification which are likely to impact on its costs.
16. Some respondents also questioned the justification for including specific items in the cost floor, particularly the return on capital, signalling and operations costs, and opportunity cost.

The calculation and use of cost ceilings, based on standalone cost or other

concepts, which could be used to establish the maximum level of Railtrack's

17. A large number of specific suggestions were made on the calculation of standalone cost ceilings. Many argued that the ceiling should be based on the costs of an efficient competitor, and should take account of opportunities to share the cost among several users. Opinion was divided over whether the ceiling should be based on the cost of other modes of transport where these would be less expensive than a standalone rail facility.

18. A small number of respondents supported the continued application of Railtrack's reference charge, though some adjustments were suggested to improve its accuracy and to take account of potential improvements in Railtrack's efficiency.

The proposal that Railtrack should be required to publish information showing the level and trends in its freight costs and revenues, but not information on individual flows

19. Most respondents were in favour of Railtrack publishing as much information as possible, with some arguing that this should extend to providing information on individual cost floors. Others thought that this would undermine Railtrack's negotiating position.

20. A large number of suggestions were made for specific information which might be published. These included:
 - (a) freight-specific costs, including changes over time and broken down by function, by geographic area, by route and between freight-only and shared lines;

 - (b) freight revenues, including changes over time and broken down by commodity, by geographic area, by end market, by train weight/volume and by journey distance;

(c) charges, presented in scatter diagrams and plotted against distance, commodity or geographic area, and also split between fixed and variable charges;

(d) miscellaneous traffic, investment, capacity and technical data.

Appendix 3: Summary of Guidelines for

Calculation of Avoidable Cost Floors

1. The following general principles should be adopted for the calculation of avoidable cost floors:

- avoidability should be assessed over an appropriate timescale, particularly for flows which are likely to be short-lived;

Short run maintenance and renewal costs

2. Short run maintenance and renewal costs for all flows should be calculated using unit cost data for the relevant locomotive and wagon types. For freight-only lines, unit costs should be adjusted in line with observed cost differences between freight/passenger lines and freight-only lines.
3. Unit cost figures should be adjusted in April of each year by RPI-2 per cent.
4. Traction current costs should be calculated using modelled electricity consumption rates and the actual purchase price paid by Railtrack for traction current.
5. For flows of known short term duration, or flows which are unable to support expenditure on infrastructure renewals, the cost floor should exclude renewals costs

and other costs which could be avoided only beyond the expected life of the flow.

Long run maintenance and renewal costs

6. For shared infrastructure, long run maintenance and renewal costs should be calculated using long run unit cost data, adjusted to ensure that they reflect the long run costs which are avoidable to individual freight flows. These unit costs should also be adjusted by RPI-2 in April of each year.

7. For single user freight-only lines, the cost floor should be estimated using specific data where possible, and should be adjusted so as to exclude identifiable costs which Railtrack would still incur even if the current sole user leaves the network.

Other long run costs

8. Other costs (such as signal operations, control, opportunity costs and investment) should be included only where they can be identified as avoidable to a particular freight flow.

9. No return on existing assets should be included in the cost floor.

Appendix 4: List of ORR Publications

Guidance on third party liability and insurance	April 1994
Penalty fares rules	April 1994
Competition for railway passenger services: a consultation document	July 1994
Framework for the approval of Railtrack's track access charges for franchised passenger services: a consultation document	July 1994
Guidance on licensing of light maintenance depot operators	July 1994
Guidance on licensing of non-passenger operators	July 1994
Guidance on licensing of passenger operators	July 1994
Guidance on licensing of station operators	July 1994
Railway operations and the environment: environmental guidance: a consultation document	July 1994
Meeting the needs of disabled passengers: a code of practice	August 1994
Criteria for the approval of passenger track access agreements	September 1994
Framework for the approval of Railtrack's track access charges for freight services: a consultation document	October 1994
Railtrack's track access charges for franchised passenger services: developing the structure of charges: a policy statement	November 1994
Competition for railway passenger services: a policy statement	December 1994

Criteria and procedures for the approval of freight track access agreements	December 1994
Framework for the Approval of Railtrack's Track Access Charges for Freight Services	October 1994
Retailing of tickets at stations: a consultation document	January 1995
Railtrack's access charges for franchised passenger services: the future level of charges: a policy statement	January 1995