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Dear Jerry,

Thank you for your [letter of 11<sup>th</sup> March 2019](#) regarding CP6 Freight charges resulting from our recently concluded periodic review (PR18). In your letter, you raised concerns around the potential adverse impact that increased regulatory and operating costs (including track access charges) may have on the commerciality of the rail freight industry in general and the freight construction service in particular. You also requested that we provide further clarifications on the process we followed to arrive at our decision to change the CP5 track access charges structure, including the science behind the new charges, treatment of Network Rail's engineering trains, and the compatibility between our policy and the incentives on train operators to invest in track-friendly rolling stock.

On 18<sup>th</sup> March 2019, we met you and your colleagues representing freight operators who run construction services. In this meeting, we provided clarifications on all the issues you raised in your letter. We are happy that the feedback we received from your colleagues who attended the meeting suggests that our explanations were satisfactory. This letter summarises the discussions we had but I am also attaching the [slide pack](#) we presented for more details on methodologies and the science behind the final levels of charges.

#### **PR18 Policy context and decision-making process**

1. The EU and UK legislative requirements mean that Network Rail must recover from train operators the full direct costs it incurs in the process of providing its services. There can be capping/phasing-in of any increase in charges but it must not be open-ended or indefinite. There must come a time when full costs are charged.
2. The main charge that recovers these direct costs is the variable usage charge (VUC). Specifically, it is designed to recover the operating, maintenance and renewal costs that vary with marginal changes in traffic. VUC is disaggregated by vehicle class and freight commodity to ensure its cost reflectivity. Broadly, heavier and/or faster vehicles incur a higher VUC, reflecting the relatively higher levels of damage that they cause.
3. Currently, the cost of repairing the wear-and-tear that train operators cause to the network is significantly higher than the charges levied to meet these costs. This is due primarily to the deterioration in Network Rail's efficiency and the capping of the VUC for certain operators (including construction) in PR13. As explained in our PR18 Final Determination (published [here](#)) and in our meeting of 18<sup>th</sup> March 2019, without policy intervention, the (uncapped) VUC would have to increase materially in CP6 to meet these costs. For example, while the VUC for construction is forecast

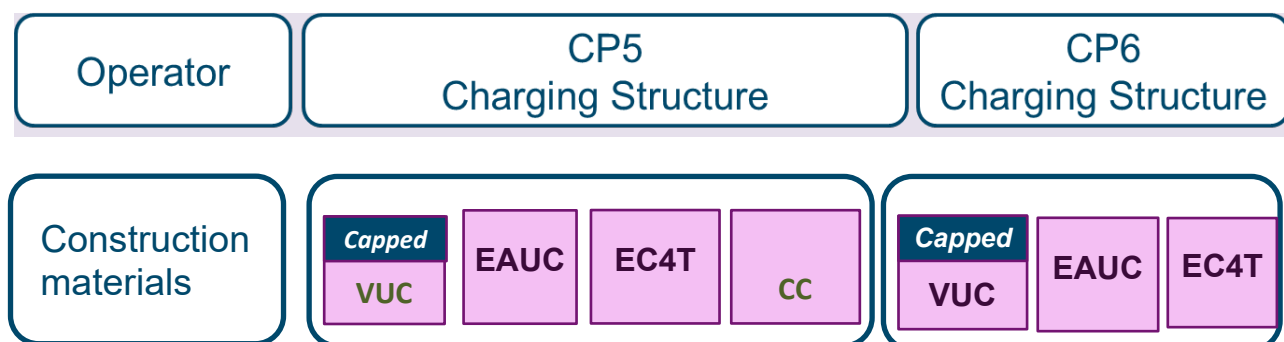
to increase by 8% from end of CP5 to the first year of CP6, it would have to increase by 58% if we did not intervene.

4. Our decision on CP6 track access charges aimed at simplifying the charging structure and providing both stability and predictability in charges until at least the end of CP7. When taking these decisions, we paid due regard to our statutory duties. These duties include promoting efficiency and economy on the part of persons providing railway services, having regard to protecting the interests of users of railway services, enabling persons providing railway services to plan the future of their businesses with a reasonable degree of assurance and having regard to the funds available to the Secretary of State.
5. In the process, we widely engaged with stakeholders through meetings and published consultations. We also undertook analysis to assess the financial impact on train operators of our decisions on the levels of contractual charges and incentives in CP6. We published a note explaining this analysis [here](#).

### Changes to the level and structure of charges

6. To simplify the charging structure, we decided to remove some charges and incentives that we thought were not working as intended (i.e. the route-level efficiency benefit sharing (REBS) mechanism, the volume incentive, the capacity charge and the coal spillage charge). We have also decided to rename all charges recovering fixed network costs “infrastructure cost charges” (ICCs). For freight services, this means that the freight only line charge and freight specific charge will be merged in an overall ICC. Figure 1 below summarises the changes in the charges structure facing construction materials.

**Fig 1. Structure of Charges for construction materials: CP5 vs. CP6**

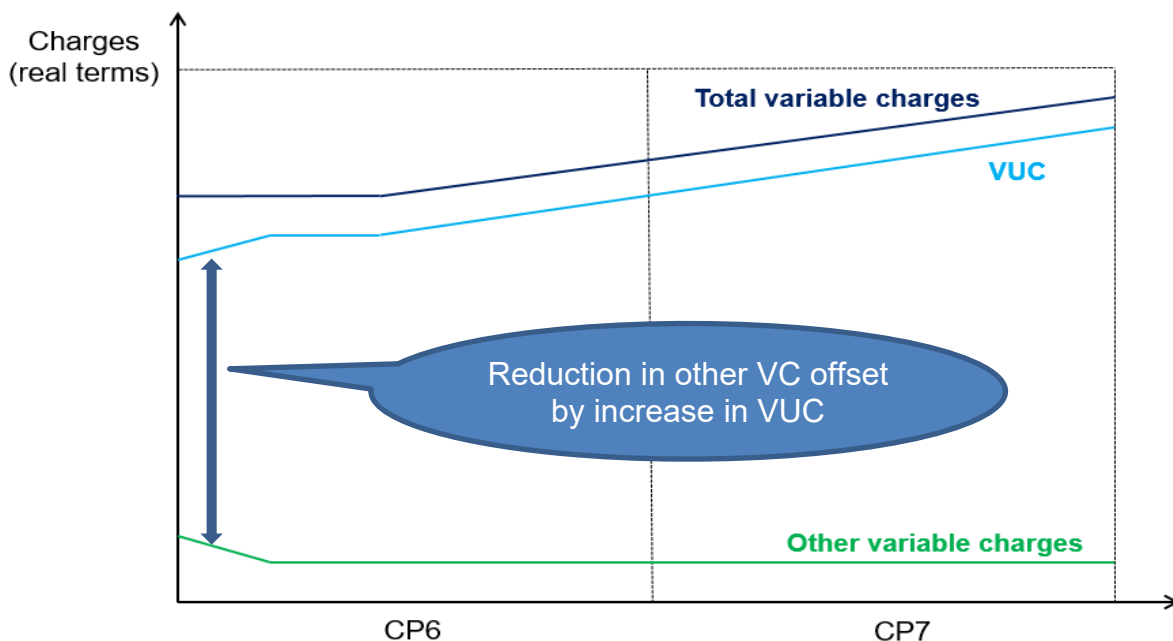


7. Furthermore, we decided to cap and phase-in the VUC so as to achieve full cost recovery at the end of CP7, i.e. after a period of ten years from the start of CP6.
8. When considering the capping/phasing-in of charges, we had particular regard to the impact on train operators’ total variable charges. In particular, we took into account the impact of our decision to remove the capacity charge and the coal spillage charge in CP6, as well as our decision to switch the indexing of charges from RPI to CPI. The financial implications of these policies are clearly spelt out in our final determination and its supplementary documents.
9. In particular, the decision to remove the capacity charge means saving for train operators. For example, freight construction services are forecast to save c. £0.57m each year (in 2017/18 prices, and relative to the final year of CP5) as the result of this policy. This is equivalent to c.4.5% of the total variable charges paid by the

sector in 2018/19. However, it also means a significant reduction in one element of total variable charges for Network Rail. Therefore, we decided to introduce a policy that ensures Network Rail is not made worse-off, by ensuring it recovers the same amount in total variable charges in real terms (i.e. before the effect of inflation is taken into account) in the first two years of CP6 as it did in the final year of CP5. As we decided to keep other variable charges (EAUC and EC4T) constant, this means a slight increase in VUC in real terms (see figure 2. below and the calculations in the slide pack).

10. Following our capping and phasing-in policy, the rail freight sector will benefit from a two-year adjustment period during which total variable charges are expected, on average, to stay constant in real terms. Then, the transition to uncapped levels will follow a steady straight-line 'glide path' to the end of CP7. The average real terms increase in total variable charges will be 10% between the end of CP5 and the end of CP6, and 26% between the end of CP5 and the end of CP7.
11. For **freight construction services**, the VUC rate will increase by c. 8% in real terms between 2018/19 and 2019/20. This means that Network Rail income from VUC paid by this sector is expected to go up from c. £12.5m in 2018/19 to c. £13.47m in 2019/20. On the other hand, the sector is expected to have paid c. £0.57m in 2018/19 through the capacity charge. From 2019/20, this charge will no longer be paid. Taking these two charges into account, the sector will see a 3.1% real terms increase in charges between the end of CP5 and the start of CP6 (from c.£13.07m to c.£13.47m). Note that all figures above are before inflation, in 2017/18 prices, and based on Network Rail's traffic forecasts.
12. The approach to phasing-in the increase in freight VUC rates for CP6 is explained in the attached slides but further details can also be found in a note that Network Rail published [here](#). Figure 2. below illustrates the path to full cost recovery at the end of CP7.

**Figure 2. Transition profile to full cost recovery<sup>1</sup>**



<sup>1</sup> Diagram is not generated directly from the underlying data. Illustrative only

### **VUC rates variability by commodity segment and potential modal shift**

13. Different types of vehicles/commodities impose different degrees of wear-and-tear costs on the network and it is important that, over time, variable charges reflect this. We explained this in our meeting and shared with you analysis illustrating how VUC rates vary for different freight commodities/vehicles (see page 19 and 23 of the attached slide pack, respectively). You can compare CP5 and CP6 VUC rates by vehicle using the online calculators published by Network Rail (CP5 VUC calculator [here](#) and CP6 VUC calculator [here](#) ). In CP5, the freight capacity charge was applied as a uniform rate ( average for all operators, service groups and commodities) in £ per train mile (see section 3 of the CP5 list of capacity charge rates [here](#) so you can easily work out the overall change in charges for typical freight trains).
14. In our final determination, our discussion focused on the average rate increases for the rail freight sector as a whole. This may have inadvertently concealed the significant variability in rates within the sector, with some vehicles and commodity segments facing rate increases much higher than the average. As we explained in our meeting, this variability of individual rates around the average reflects differences in the amount of wear-and-tear caused by different vehicles on the network and differences in the CP5 capping arrangements.
15. However, in our final determination, we also stated that we undertook the analysis to assess the impact that our policies would have on different freight commodities, based on each commodity segment's elasticity ([MDST, 2012](#)) and compared to the forecast traffic growth for that commodity segment ([MDST, 2017](#)). Our analysis showed that the proposed increase in total variable charges is not expected to result in a material contraction of any of the freight commodities (including construction materials). In fact, our capping/phasing-in transition profile acts to moderate the rate of increase in rates to uncapped levels for all freight VUC rates.

### **Incentives to invest in track-friendly wagons**

16. As discussed at the meeting, the underlying methodology for calculating VUC rates has not changed between CP5 and CP6. Therefore, there is still a financial incentive to invest in track-friendly vehicles, and we hope that stakeholders will continue to do this during CP6. The example we gave in page 23 of the slide pack shows that in CP6 the VUC rate applicable to a track-friendly JNAT wagon is 17% lower than the rate applicable to a less track-friendly JNAC wagon.
17. To help you better understand the financial benefits of investing in track-friendly vehicles, I encourage you to use the CP6 VUC calculator that Network Rail has published ([here](#)). This spreadsheet tool allows you to enter wagon characteristics, including bogie types, axle load, un-sprung mass, etc. and then calculate the relevant VUC rate for the concerned wagon type.
18. Following the meeting, we now understand that the confusion in this area arose because, as explained above, the majority of freight VUC rates increase uniformly by approximately 8% between the last year of CP5 and the first year of CP6. This change reflects our methodology for phasing-in the increase in freight VUC rates over CP6. As earlier explained, this 8% increase is designed to offset the financial impact of our decision to remove the capacity charge for CP6 (i.e. keep the overall level of freight charges the same for the first two years of CP6). In the latter years of CP6 most freight VUC rates gradually increase towards, however, do not reach, the 'uncapped' levels. The 'uncapped' level of charges continues to be lower for track

friendly vehicles than non-track friendly vehicles, therefore, retaining the financial incentive to invest in track-friendly rolling stock.

#### **Network Rail's engineering trains**

19. As also discussed at the meeting, we can confirm that the wear-and-tear costs associated with Network Rail's engineering trains are not spread amongst the rest of the bulk freight sector.
  
20. Hoping that this letter and the discussions we had at our meeting on the 18<sup>th</sup> March 2019 have clarified the concerns you had on our CP6 charging structure, colleagues and myself remain available to discuss any further issues you may have.

Yours sincerely

**Pedro Abrantes**