Responses to our May 2012 consultation on the variable usage charge and a freight specific charge

March 2013

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Consultation responses

Introduction

1. As part of our consultation on the VUC and Freight Specific Charge, we directed a number of questions to stakeholders in our May 2012 consultation[1], and we have welcomed their responses[2]. This document presents a summary of the responses to the consultation questions listed in the May 2012 consultation document.

2. We have considered all submissions received from stakeholders and our responses to these submissions are also detailed throughout this annex. In a number of cases we have responded to stakeholder concerns in our conclusion on average variable usage charge and a freight specific charge document dated January 2013[3], which we refer to as our January document throughout this document.

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?

Respondents' views

3. A number of stakeholders welcomed setting the cap on the VUC early, saying that this sends a good message to freight customers and investors. However, certain stakeholders were disappointed that a decision on a cap was deferred (from earlier in 2012). The British Ports Association considered that the lack of clarity on the exact level of the VUC cap had been problematic when trying to estimate the likely

[1] Consultation on the variable usage charge and a freight specific charge, May 2012, http://www.rail-reg.gov.uk/pr13/PDF/freight-charge-consultation-may2012.pdf

[2] We have published responses to our consultation. They can be found under the heading "responses" on our web page for the consultation, http://www.rail-reg.gov.uk/pr13/consultations/freight-charges.php

[3] Rail freight: conclusion on the variable usage charge and a freight specific charge, January 2013, http://www.rail-reg.gov.uk/pr13/PDF/freight-conclusions-jan-2013.pdf

impacts upon the sector and had created an atmosphere of concern and uncertainty in the freight and transport industry.

4. RFG was concerned over a comment in the consultation which stated that material evidence during PR13 could cause ORR to set charges higher than the cap. RFG considered that this was counter-intuitive, and make the proposed cap almost purposeless.

5. A number of respondents remained concerned over Network Rail's approach to estimating the contribution of non-track assets to the variable usage cost. These respondents considered that the cost elements appeared to be high level estimates derived from engineering judgement rather than from firm cost evidence. RFG was particularly concerned with the variable usage cost estimates of masonry structures. They considered that a simple linear approach to the variance between traffic levels and damage may be unduly simplistic. GBRf was also concerned that the effects of freight wagons on masonry under-bridges was being overstated, given that in many cases freight trains already run at reduced speeds over these structures. A few respondents also wanted to draw ORR's attention to the key points made by Morgan Tucker in its Technical Review (discussed in our January document)[4].

6. Network Rail considered that the variable usage cost estimates set out in its consultation were a reasonable basis for setting a cap on VUCs but said it would review the variable usage cost estimates relating to civil structures and earthworks (which, as we explain in our January document, it has subsequently carried out).

7. Whilst RFG and FGL were pleased that ORR had asked Network Rail to refine its variable usage cost estimates, FGL questioned whether this task could be undertaken accurately within the indicated timeframe. FGL was concerned that a "top down approach" may be deployed rather that a more accurate and robust "bottom-up approach".

8. Freightliner and RFG also had some concerns with the persistent use of the Settle and Carlisle route as a case study example. Both suggested that it was inappropriate to scale up these results directly as a proxy for network wide analysis. Freightliner would expect Network Rail to base their modelling on a more representative sample of routes.

9. ATOC considered that charges should be cost-reflective and incentivise improvements to vehicles that reduce track damage. RFG and GBRf were concerned about the conclusion that certain wagon types that are incentivised through the CP4 charging framework cause greater damage than could have been

[4] We have published the Morgan Tucker report, http://www.rail-reg.gov.uk/pr13/PDF/freight-vuc-morgan-tucker-jun12.pdf

anticipated. GBRf was concerned by the assessment of damage caused by bogied RA10 wagons, in which the industry has recently invested. Specifically, GBRf considered that certain types of freight wagons on certain routes may be driving an unrealistic assessment of the general level of degradation to structures caused by these bogied RA10 wagons. RFG said that analysis should look specifically at this area, taking advice from the wagon manufacturers, as it considered frequent changes in charges for different wagon types are not acceptable for those building equipment with 30 year asset lives.

10. Freightliner considered that Network Rail do not appear to have modelled the future changes in wagon mix which will use the rail network. Freightliner suggested that, due to existing Government policy, coal, which is transported in 100 tonne wagons, is expected to decline by 6% by the end of CP5, whilst intermodal volumes with a typical wagon weight of 46 tonnes are forecast to increase by 23%.

Our response

11. As noted in our freight decision document, we have listened to and understand the rail freight industry's argument that early certainty is important in allowing them to plan their businesses in competition with road haulage. We have therefore set a cap on the average variable usage charge for freight services in advance of our PR13 final determination of the charge. While it is possible that charges in CP5 will be higher than they were in CP4 they will not exceed the cap that we set out in our January document.

12. In response to concerns about deferring the decision on the cap, concluding on matters such as this is difficult when we have not yet had the opportunity to assess Network Rail's strategic business plan and its methodology for attributing variable usage costs to different vehicles. We believe however we have balanced the uncertainty that we face with the freight industry's desire for certainty and predictability to plan their own businesses and to allow their customers to plan theirs.

13. Morgan Tucker raised several potentially material issues, and therefore we asked Network Rail to respond to its report. As discussed in further detail in our January document, we consider that Network Rail has responded to the key points raised using evidence-based arguments. We also consider that Network Rail has provided persuasive evidence regarding the cost variability of each of the categories of asset in question.

14. Network Rail has also provided further evidence (including examples) in support of its methodology for estimating the cost variability of brick and masonry underbridges, including arguments against Morgan Tucker's claim that annual renewal expenditure on the Settle and Carlisle Line should be reduced by more than 85% to reflect its extreme topography: Network Rail provided examples from other parts of the network which support its analysis.

15. In principle, we agree that significant changes in the relative size of the variable usage charge for individual vehicle types are unsatisfactory and, given that the charges are intended to reflect the relative scale of infrastructure wear and tear from individual types of vehicle, should not occur. However, it is also important that all relevant parties, whether they are manufacturers, funders, passenger or freight operators or the infrastructure manager, are vigilant in considering and anticipating the implications of different attributes of rolling stock for infrastructure costs. We consider that this culture of vigilance is incentivised by Network Rail applying the best available evidence to calculate cost reflective charges. To balance these considerations, particularly where major changes to relative charges are proposed, we require a high level of confidence when approving charges that the changes result in a significant improvement in cost reflectivity.

16. Freightliner argued that the wagon mix would change in a particular way, and that this had not been modelled by Network Rail. We note that Network Rail has calculated charges by assuming the same wagon mix for both the variable costs and the traffic. In Freightliner's example, all other things being equal, a change in wagon mix would result in both variable costs and charges revenue being lower than Network Rail has modelled, but the effects should to a very large degree cancel each other out. We therefore consider Network Rail's approach to be reasonable.

(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?

Respondents' views

17. Whilst Network Rail agreed that a 15% confidence interval is reasonable, many respondents considered 15% to be too high.

18. A number of respondents considered that track maintenance and renewals costs could be more accurately forecast. RFG and Freightliner suggested that greater levels of certainty should be possible given that cost estimates are based on the validated VTISM model. Freightliner suggested that a 15% to 20% confidence interval just on the civils and signalling cost estimates would seem a more reasonable approach. DRS, INS and NDA considered that the proposed 15% confidence interval suggested that Network Rail is not confident of the data being input to VTISM. RWE believed that Network Rail should undertake further work to reduce the level of uncertainty in variable charges.

19. A number of respondents said that a 15% confidence interval represented a substantial potential increase in rates. Freightliner considered that this was unpalatable to their customers and such a high rate would have significant adverse impacts on most markets. Certain stakeholders proposed that a 10% confidence interval was more realistic.

Our response

20. We have listened carefully to the points made and concluded that an early cap on the variable usage charge is appropriate for this periodic review, not least because there has been wider uncertainty associated with our work to establish a mark-up in the form of a freight specific charge. Providing certainty on the cap at this stage does however mean that there remains some uncertainty because work on charges is not yet complete. This uncertainty is reflected by the use of a confidence interval and we have chosen to set this at the 15% level discussed in the May consultation.

21. Work by consultants Serco for Network Rail undertaken subsequent to the consultation, and which we outline in the January document, suggested that the 15% confidence interval may in fact be an underestimate. However because we understand that assurance at this stage is important for industry confidence we have retained the 15% interval in order to facilitate an early decision on the cap.

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

Respondents' views

22. A number of respondents were content with levying the VUC cap (rather than the actual charge) based on end CP4 efficiencies excluding the adjustment for CP5 improvements in efficiencies.

23. As regards setting the charges, Network Rail supported setting VUCs at a level that takes into account the forecast efficiency improvement in the forthcoming control period. CoalImp, Clydeport and SCCL considered that it is only correct that long run cost efficiencies are included. RFG also expected actual charges to reflect long-run CP5 efficiencies, but believed that ORR should consider whether a similar approach to 10 year efficiencies could be included for CP5, as it was for CP4.

24. Freightliner noted that the consultation states that the CP4 charge quoted by Network Rail should be reduced by 16.5% to give the actual CP4 average charge but was confused as to why this adjustment is not 12% (the efficiency assumption). It also noted that paragraph 3.57 states that, based on the assumption of a 15% efficiency target, charges would reduce; however, this does not appear to take into account the 12% brought forward efficiency from end CP5 applied in CP4. Freightliner asked for further clarification on how the charges in the consultation have been calculated.

Our response

25. In our January document we confirmed that the final variable usage charge will be adjusted to account for expected gains in Network Rail's efficiency during CP5. Consistent with our policy for CP4[5], we will set these variable charges on the basis of costs at the level of efficiency we expect Network Rail to achieve at the end of CP5 but, given the present uncertainty over the size of the CP5 efficiency challenge, the cap is set assuming end-CP4 efficiency.

26. Given Freightliner's concern about difficulty in following the logic of some of the adjustments for efficiency, we sought to aid interpretation with a worked example set out in our January document[6]. We have also held a separate meeting with Freightliner in which we explained the calculation.

27. The process for setting the efficiency challenge for Network Rail in CP5 has now begun and will be concluded as part of our final determination in October 2013.

Other Issues

Respondents' views

28. Many respondents voiced concerns at the potential impact of geographic charges on the freight market.

Our response

29. We have listened to and understood the arguments made by our rail freight industry stakeholders that introducing geographical disaggregation into the current charging scheme would increase complexity and reduce the industry's ability to compete with road. As a result we have decided not to proceed with geographic disaggregation of the variable usage charge in CP5.

[5] In the PR08 determination the expected CP5 efficiency challenge was used, rather than that for CP4, to enable Network Rail to recover variable usage costs based on the long run efficient steady state cost (paragraph 19.17).

[6] See pages 34-36 for a worked example on how the efficiency adjustment might affect the level of charges.

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?

Respondents' views

30. Network Rail agreed that ORR's proposal would meet the Access and Management Regulations but noted that the recovery of avoidable costs does not equate to full cost recovery as permitted by the regulations.

31. A number of stakeholders considered that the framework does not satisfy the Access and Management Regulations in a number of respects. Several respondents thought the freight specific charge to be discriminatory for various reasons, including:

(i) it discriminated due to its application to freight only;

(ii) the Access and Management Regulations do not permit different treatment between markets segments;

(iii) it discriminated between different electricity input fuels, indirectly changing the economics of such generation;

(iv) it discriminated by location, geographically disadvantaging those players located away from ports and having a disproportionate effect on Scottish and indigenous coal production;

(v) it was inappropriate to allocate all common freight costs to one market segment that was deemed capable of bearing the charge; and

(vi) it failed to demonstrate proportionality in the application of any proposed freight specific charge to each segment of the freight market amounts to discrimination.

32. RFG, Freightliner and Campaign for Better Transport were concerned that the proposals may not be fully transparent, arguing that the resulting charging structure was likely to be complex.

33. Energy UK considered it important that the principle of cost-reflective charging is followed and that charges do not result in some sectors being subsidised while others have to pay their way. CoalPro believed that the costs attributed to freight only operations were wrongly attributed to a significant degree and that there was a consequent over-recovery. RFG also considered that the charge should not over-recover costs.

34. A number of stakeholders thought that the requirement for mark-ups to be allowed only if the market segment can 'bear the increase' had not been met. Some respondents did not accept that a reduction in an overall market segment of up to 10% was within what the market can bear. Others considered that any reduction in the rail freight market was more than the market can bear and any increase must be capable of being absorbed by that market without reducing the size of the market.

35. RFG, FGL and Freightliner considered that a £10 per ktkm increase, which was estimated to lead to a 23% reduction in coal tonne miles by rail, was not something that the market can bear. RFG was surprised that further assessment of other increases between these points had not been undertaken. Clydeport, SCCL and CoalImp argued that no reduction in business activity was justifiable if its full ramifications were not understood and where it was based on policy decisions which could not have been reasonably anticipated and planned for. Freightliner considered that the assessment of what the market can bear should take into account all charges in total and not just certain elements of charging.

36. A number of respondents said that any assessment of what the market can bear was based on an entirely subjective and arbitrary assessment of what was considered acceptable. RailFuture and ATH did not believe it is the role of ORR to put a premium on access charges on the basis of what it believed the market would bear. VTG strongly disagreed with the principle of charging based on 'what the market can bear', since road freight has no such philosophy. Given that the Access and Management Regulations give little guidance on the interpretation of 'what the market can bear', RFG considered that the proposal must be assessed by ORR against their Statutory Duties and Guidance from the Secretary of State.

37. A number of stakeholders were concerned that the proposal may be inconsistent with the ORR's statutory duties. DBS recognised that balancing duties is complex, but did not believe ORR has achieved an acceptable balance in respect of these proposals. A number of respondents believed that a major emphasis has been placed on the funds available from Government at the expense of other duties. Energy UK considered that the proposal transfers freight avoidable costs from taxpayers to a similar set of consumers in the form of energy customers and therefore questioned the extent to which the charge actually increases value for money for the taxpayer. Various stakeholders questioned whether the significant reduction in rail freight volumes and the proposed 10% reduction in the coal business, is consistent with the statutory duty to promote the use of the railways.

38. SSE questioned how the impact on the ESI market and power generation sector was consistent with the duty that requires ORR's proposals to allow the rail market to plan ahead with reasonable certainty. DBS considered that this consultation has created unprecedented uncertainty and perceived regulatory risk and seriously risks a loss of confidence in potential customers and investors. DRS, INS and NDA

considered that an increase in the level of access charges would affect sustainable development and the use of the railway infrastructure.

39. RFG was concerned that the freight specific charge acted to price off demand and this did not appear to be backed up in the Secretary of State's recent guidance to ORR. A number of respondents also pointed to the Secretary of State's guidance to ORR. Transport Scotland expected that freight charges would be fully supportive of the aims of the Scottish Ministers and their commitment to increasing the use of rail for freight. The Welsh Government was concerned that the proposals aimed specifically at a reduction in rail freight flows in certain sectors and this seemed to be at odds with UK Government and EU policy. Eggborough also believed this was in direct conflict with other policies to move more commodities onto the rail network.

40. Freightliner considered that there was a risk that ORR was in effect asking Network Rail to implement charges that are abusing a dominant position as laid out in the Competition Act 1998 and the Enterprise Act 2002. DRS, INS and NDA considered that ORR might benefit in explaining to the industry how they considered compliance with the Act and the Access and Management Regulations had been achieved.

41. DB Schenker also questioned how Paragraph 2(3) of Schedule 3 to the Access and Management Regulations had been applied. DB Schenker said freight operators had achieved significant productivity increases including many in the ESI Coal market sector. These improvements which including higher capacity more 'track-friendly' wagons and the operation of fewer longer trains, were recognised in the McNulty Study, which stated that faced with a competitive environment (both with other transport modes and with each other) rail freight operators have focussed on reducing costs and improving customer service employing techniques and methods to improve efficiency that should be shared with the rest of the industry. ORR's proposed approach did not appear to take account of the productivity increases achieved by rail freight operators as is required by the Access and Management Regulations.

Our response

42. We have considered carefully the points made by stakeholders. Rather than repeating our response to the issues in this document, we refer you to our extensive legal analysis contained in Chapter 4 paragraphs 4.11 to 4.37 of our January document, which responds in the round to the issues raised by consultees as set out above.

43. However, in particular, we agree that Paragraph 2(3) of Schedule 3 of the Access and Management Regulations requires the charging system to respect the productivity increases achieved by the applicants. We consider that our conclusions on the freight specific mark-up concur with this because in our

assessment as to whether a charge should be levied to any of the market segments, we have not taken into account freight operators' productivity increases.

(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?

Respondents' views

44. Network Rail agreed that there could be merit in quantifying the level of infrastructure costs allocated to freight operators on the basis of avoidable costs. However, Network Rail considered that, where possible, operators should contribute towards the full costs of using the rail network, and therefore foreclosing the possibility of allocating an equitable proportion of common costs to freight traffic would be premature. IPR also said that all costs should be included in freight avoidable costs and that costs should apply across all industry that makes use of the rail network, based upon volumes transported.

45. To the extent that any charges are levied, RWE, RFG and CoalPro agreed that cost should be limited to freight avoidable costs.

46. A number of respondents did not agree that the infrastructure costs allocated should be freight avoidable costs. A number of stakeholders believed that at least some of the freight avoidable costs are subjective and theoretical. Freightliner, CoalImp, Clydeport and SCCL considered that such costs would be based on an unrealistic scenario of commercial freight being removed from the network. However, they acknowledged that the costs of maintaining and renewing freight-only lines and Network Rail's freight staff are real costs that are incurred. Bristol Port Company considered that this was an arbitrary selection of costs.

47. CoalPro considered that the identified freight avoidable costs were excessive and should be restricted to costs solely attributable to freight. Freightliner, CoalImp, Clydeport and SCCL did not object to the inclusion of other costs that could be demonstrated to be directly saved if there was no freight but did not believe it to be correct to include savings that would be achieved by assuming that the network could be remodelled over a 35 year period.

48. A number of respondents did not accept that freight should pay for any costs that are attributable to existing, historic inefficiencies in the network infrastructure, for example including the maintenance of infrastructure that was inefficient. GBRf considered that costs such as the network requirement for ERTMS

should not be included. Freightliner was concerned that efficiency had not been properly considered in the proposed methodology being adopted by L.E.K.[7]

Our response

49. Network Rail argued in its consultation response that where possible operators should contribute towards the full costs of using the rail network, and that it would be premature to foreclose the possibility of allocating an equitable proportion of common costs to freight traffic. We do not consider that this is premature because our consultant's analysis of rail freight markets suggests that pricing according to principles of fully allocated costs could result in substantial reductions in traffic and transfer to road haulage, with associated reductions in overall efficiency, including impacts on the environment.

50. We think that setting charges to recover freight avoidable costs is an important step for normalising commercial relations with Network Rail. By stating clearly in May 2012 that we were minded that any freight-specific charge would be set on the basis of recovery of estimated freight avoidable costs (rather than, for example, fully allocated cost), and focused on particular rail freight market segments to which the charge might apply, we reduced uncertainty for the industry.

51. We do not agree that the concept and development of freight avoidable costs are subjective. We explained in our May consultation that the costs we presented at that time were indicative. The freight avoidable cost estimates presented in our conclusions are based on objective, independent analysis commissioned by Network Rail from L.E.K. We set out arguments in our January document in support of the concept, and of the variables used in reaching our conclusions.

52. L.E.K calculated freight avoidable costs by taking the average future costs over 35 years (a long time period was taken for this, as for the calculation of the variable usage charge, to lessen the distorting impact of renewal cycles). We agree with this approach in that it is not appropriate to take account of historic costs inefficiently incurred. In addition we agree with L.E.K's approach to calculate costs of the network starting from its current state, rather than some paradigm of an efficient network, because its approach is analogous to the basis for cost recovery in a normal commercial context. L.E.K's costs are calculated using unit costs consistent with Network Rail's expected level of efficiency for the end of CP4.

53. In relation to ERTMS costs, we note that the Network Rail/L.E.K. analysis includes estimates of future infrastructure costs relating to ERTMS fitment, which represent planned enhancements to the network. We believe it is reasonable to include these costs in the estimates of freight avoidable costs, as they are

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[7] L.E.K. (October 2012) "Estimating freight avoidable costs". http://www.networkrail.co.uk/publications/delivery-plans/control-period-5/periodic-review-2013/orr-publications-on-PR13/

currently committed costs which would not be incurred if commercial freight traffic were removed from the network. The L.E.K. analysis of ERTMS-related costs is set out on page 90 of its report[8].

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

Respondents' views

54. A number of respondents broadly agreed that it is appropriate for ORR to retain its existing definition of particular categories of rail freight commodities as separate market segments. SEStran agreed that it made reasonable sense to target those sectors where the resulting impact would be least. GBRf considered that the secondary affects in each commodity market should also be taken into account in order to understand the implications of the proposals.

55. Various respondents did not agree. RFG said that this segregation did not pick up important second order impacts affecting the market in other ways, such as the effects on the market for the provision of rail freight services. RFG considered it to be vital that these market impacts are also properly assessed given that the Access and Management Regulations did not specify how 'market' was defined. Moreover, RFG thought that there might be distinct sub-sectors which warranted analysis within the commodity categories. Freight on Rail considered that coal traffic could not be isolated from other traffic as a reduction in coal traffic would have knock on effects on other parts of rail freight (e.g. locomotive use, maintenance and terminal costs across other commodities).

56. Bristol Port Company thought that additional categories would become necessary as the market develops, including an immediate need to consider biomass. Network Rail also considered that it would be sensible to include biomass as a discrete market segment given the likely growth in this area. However, CoalImp, Clydeport and SCCL said that biomass was intrinsically linked to ESI coal, when used for co-firing for electricity generation. CoalPro considered that no distinction should be made between coal and biomass for the ESI market to avoid discrimination and distortion of competition.

57. A number of respondents believed that track access charges should not be discriminatory between market segments. EDF did not understand the logic of exempting certain individual rail freight market segments if they contributed to the costs directly incurred. SSE and EDF believed that the proposal to charge only certain sectors would represent a cross subsidy.

[8] L.E.K. (October 2012) "Estimating freight avoidable costs". http://www.networkrail.co.uk/publications/delivery-plans/control-period-5/periodic-review-2013/orr-publications-on-PR13/

Our response

58. We refer you to Chapter 4 of our January document, which responds to the issues raised by consultees as set out above.

59. We have discussed points relating to biomass in our biomass consultation[9].

(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?

Respondents' views

60. Network Rail agreed that it was appropriate to consider the elasticity of demand and the extent to which rail freight competes with road when assessing the efficacy of any new freight specific charge. RWE also considered that the appropriate factors had been taken into account.

61. Many respondents did not agree that the appropriate factors had been taken into account in considering the efficiency of the proposed charges. RFG considered that wider second order effects had not been addressed, such as the impact on the market for freight operators, or, to any significant degree, ports, producers or the supply side. Specifically, RFG said that an assessment needed to cover:

> (i) the impact of accelerating the decline in coal traffic ahead of that forecast by DECC on rail freight businesses;
>
> (ii) the competitive impacts of targeting longer distance flows;
>
> (iii) the impact on other market sectors from an overall reduction in FOCs' businesses;
>
> (iv) the impact on operator finances from risk and cash flow exposure to the new charge, the impact on their borrowing ability; and
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> (v) the impact on potential new markets, such as biomass, through pricing uncertainty; and
>
> (vi) the impact on wider business, investor confidence across the rail freight sector.

62. CoalImp, Clydeport and SCCL considered that historic, inefficient infrastructure would duplicate some charges that feed into the freight avoidable cost figure. GBRf felt that the impact on the market for rolling stock finance should be considered.

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[9] Consultation on a freight specific charge for biomass, February 2013, http://www.rail-reg.gov.uk/pr13/consultations/biomass.php

63. GBRf was concerned that a significant element of regulatory risk would be injected by this proposal. A number of respondents said that investor and customer confidence was important for continued growth and for their commitment to rail. Potter Group was concerned about increased complexity and administration. DBS said that retaining a simple, stable and affordable regime was essential. DBS was also concerned that implementing individual policy changes in a disaggregated manner meant that inter-linkages and the cumulative effect on rail freight operators will not be apparent. It argued that the proposal should not be implemented if the overall impact on freight operators was not properly considered.

64. Many respondents were concerned that the proposal would lead to intermodal shift with more freight going on road as an unwanted consequence of the new charge. DBS considered that the financial regime and economics for road freight was much simpler than that for rail freight and the proposal will widen the competitive disadvantage between the two modes. Freightliner was concerned that the values that the DfT assigns to modal shift had not been taken into account. ATCO considered that the resulting modal shift will have implications for both road congestion and the nation's carbon footprint.

65. Kier considered the transfer of environmental and social impacts overseas to be of concern and said that the proposal had not considered it. ASLEF was concerned that the impact of the proposed changes on employment in the industry was not considered in the consultation. Freight on Rail believed that the proposal would directly affect jobs and bring about redundancies in the FOC workforces.

66. CoalPro believed that the overall effect on the electricity generation market for coal should be considered, as well as wider energy and economic policy considerations. DRAX questioned whether the effects on the electricity market had been properly assessed.

Our response

67. We have set out our conclusions on the efficiency of the charge with respect to rail market segments, and the competition with road haulage, in paragraphs 4.38 to 4.79 of chapter 4 of the January document. Our examination of the wider impacts of the charge, under the headings of domestic coal mines, spent nuclear fuel, electricity customers, other parts of the ESI supply chain, steel industry, freight operators, and overall impacts is set out in the paragraphs 4.80 to 4.109 of our January document. Annex B of the document is our cost benefit analysis.

68. In our May consultation we stated that in assessing the efficiency of the new charge we would take account of the elasticity of the relevant markets (i.e. how demand for rail freight might fall or rise as a results of higher charges) and the extent to which commodities are captive to road, because a switch to road may be inefficient, for example by worsening road congestion.

69. Respondents did not disagree with the criteria we proposed to use but many argued that we should widen our efficiency assessment to take account of wider impacts such as impacts on other markets. We think it is good practice to consider the wider impacts of a policy, for example because it makes the implications of the policy more transparent and may allow unintended consequences to be mitigated. We have also received guidance from Scottish Ministers to consider whether any charge would prevent the outputs of any business in Scotland being competitive in key markets. One of our statutory duties requires us to have regard to this guidance when concluding on this policy. We have therefore considered wider impacts of our proposals including an analysis of the cost and benefits of levying a FSC. For example, we have specifically considered impacts on the Scottish mining industry and electricity consumers in respect of our decision on ESI coal. Such second order impacts have been important, for example, in our decision to phase in the new charge.

70. We have also addressed these issues in carrying out a cost and benefits analysis of the FSC which takes account of many of the wider impacts raised by respondents – weighing the overall benefits of the new charge against costs. This analysis shows continuing with the subsidy for these market segment, as compared to reducing the subsidy through a FSC, provides a benefit to cost ratio of approximately one, which is very much lower than many of the alternative uses of public funds, for example with respect to rail freight infrastructure enhancements.

71. It is relevant for us to consider the impact of the policy on commercial freight operators to the extent that this impacts on competition and hence on customers. We also have a statutory duty to allow rail operators to plan their businesses with a reasonable degree of assurance. In our January document we set a cap on the charge, which reduces uncertainty for the industry, its customers and investors, and we concluded that we would defer implementation of the charge to April 2016, at which point the charge would be phased in gradually, allowing operators to plan their businesses. We consider responses specific to biomass separately in our biomass consultation.

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

Respondents' views

72. Network Rail, GBRf, and RFG broadly agreed that ORR's approach to analysing rail freight traffic addresses the relevant criteria. Network Rail considered that ORR has sought to balance potentially conflicting obligations under the Access and Management Regulations with its statutory duties. However, RFG considered that the assessment has given insufficient weight to wider impacts and other relevant markets.

73. A number of stakeholders did not agree. Bristol Port Company believed ORR has simply applied two criteria (ability to pay and inability of the sector to accommodate a modal shift) which penalise a sector that has no alternative to rail. SSE considered it unacceptable that ORR could openly choose to charge one market more for the same service because, in its view, that market is making better returns. DRS said we had not considered if there were an inelastic market segment whose profit margins were so low that the operator/customer could not financially afford the charges. INS and NDA thought the analysis of the spent nuclear fuel market was inadequate.

74. FGL, Eon and ATH considered that the definition of the market at GB level was arbitrary and masked a potentially significant adverse impact at the regional level. FGL suggested that the Scottish coal market was a significant market within its own right and, if it were considered separately, the market implications would exceed the 10% threshold several times over. FGL said this was illustrated in the MDST Stage 2 report which concluded that the proposals were likely to result in dramatic regional fluctuations. Furthermore, should the coal supply points be unable to absorb any of the proposed increase in charges, as had been assumed in the report, the geographic volume impacts would be likely to be even greater.

75. Transport Scotland was also concerned that increased charges by tonne-km would have a disproportionate impact on the price of coal from Scottish sources (ports and mines) to power stations in England, when compared with English sources (ports). Transport Scotland believed that this could present serious challenges to the security of coal supply for energy generation in Scotland, putting at risk the long term future of Longannet Power Station and affecting future propositions such as Summit Power's plans to invest in the construction of a coal-gasification plant in Grangemouth. Transport Scotland considered that these implications had not been explored thoroughly enough in the consultation document and supporting evidence.

Our response

76. We set out our assessment of wider impacts of a freight specific charge as part of our January document. We also explain the legal framework we have applied (see in particular paragraphs 4. 28 to 4.31), including setting out the most relevant statutory duties, and hence the duties to which we attach most weight.

77. We do not agree that it is unacceptable to charge one market segment more than another for equivalent access to infrastructure when the market segments have varying elasticities and compete to differing extent with road and therefore have different impacts on the environment, society and the economy. To do so allows gains in efficiency and value for money while minimising the negative impacts of the associated charge on the environment and road congestion. Moreover, we consider that the Access

and Management Regulations envisage that market segments may be treated differently, notably so that those market segments that can pay at least the cost that is directly incurred as a result of operating the railway service are not excluded from use of the infrastructure.

78. We consider that providing a subsidy for ESI coal transported from Scotland to England and not to ESI coal transported within England would be likely to amount to unjustified discrimination which would be contrary to the requirements of the Access and Management Regulations. In addition, we also consider that such an approach would be at odds with the Access and Management Regulations because we do not think it would be efficient to provide a subsidy for long distance ESI supply over shorter distance supplies.

79. Our policies are not, and should not be, devised to influence energy policy, such as security of electricity supply. We have considered the potential for unintended consequences of our policies, and as part of this have endeavoured to establish if such a policy would of itself result in issues of security of supply. We have not received evidence or analysis to support this.

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

Respondents' views

80. A number of respondents agreed that, consistent with relevant legislation, certain market segments should be exempt from any new **freight-specific charge. Network Rail argued that, to an extent, determining which market segments should** be exempt is a policy decision that ORR faces because there are no criteria giving precise grounds for exemption.

81. A number of respondents did not agree. IPR, CoalPro, CoalImp, Clydeport and SCCL believed that track access charges should not be discriminatory between market sectors. IPR and RWE considered that, to this end, all market segments should be included in any charging framework and it should apply to both passenger and freight services. GBRf said that all market segments should be exempt. Bristol Port Company thought there was no logic in applying a different charge to rail traffic based on commodity, as road vehicles do not pay a differential usage charge for roads subject to the commodity they are carrying.

Our response

82. We do not agree that it is discriminatory to treat differently segments of the rail freight market which have varying elasticities and compete to differing extent with road and therefore have different impacts on the environment, society and the economy. To do so allows gains in efficiency and value for money while minimising the negative impacts of the associated charge on the environment and road congestion. Moreover, we consider that the Access and Management Regulations envisage that market segments may

be treated differently, notably so that those market segments that can pay at least the cost that is directly incurred as a result of operating the railway service are not excluded from use of the infrastructure.

83. Franchised passenger services already contribute substantially to fixed infrastructure costs through the fixed charge (which freight services do not pay), and we are examining ways in which open access passenger operators might also contribute to fixed infrastructure costs[10].

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

Respondents' views

84. Network Rail noted that L.E.K. has been asked to consider appropriate metrics for allocating costs to different freight commodities. Network Rail considered that it was too early at that point to say definitively what was the most appropriate methodology for allocating costs but envisaged that, due to the difficulty of the task, it would be necessary to adopt a pragmatic and relatively high-level approach to the allocation of some costs, for example using an appropriate traffic metric e.g. tonne miles.

85. RFG considered that the assessment of freight avoidable costs would identify costs associated with particular routes and resources that may not be evenly spread between commodities. Whilst pro rata approaches may be mathematically pragmatic, they did not meet the criteria of cost reflectivity. RFG considered that L.E.K.'s study should address this issue.

86. GBRf was concerned that the amount of time available to complete this task and the quality of data from Network Rail may not result in sufficiently rigorous analysis.

87. RFG considered it to be wholly perverse to suggest that common costs could be allocated in full to some market segments given the purpose of the freight specific charge is to 'improve efficiency by reducing cross subsidy and making charges more cost reflective'. CoalPro said that the analogy with a business allocating common costs to more profitable activities was simply wrong because to do so offends against basic management accounting principles and because ORR was not running a business.

Our response

88. In our review of consultation responses we noted concerns about the quality of the data and time available to carry out the necessary work. Network Rail appointed L.E.K. to develop estimates of allocations of costs to commodities as part of its assessment of freight avoidable costs. L.E.K has taken

[10] See "the potential for increased on-rail competition" (October 2011), http://www.rail-reg.gov.uk/pr13/consultations/orr017.php

account of geographical differences, and hence differences with respect to market segments, when allocating some cost categories, in particular enhancement costs and freight only line costs. For other cost categories it has used appropriate traffic metrics and other metrics, including gross tonne km, train km and delay minutes. We, with assistance from Arup as reporters in certain areas, have reviewed both the method and resulting allocations. We have concluded that the overall approach to calculating freight avoidable costs is reasonable and that that allocation method is appropriate for setting caps.

89. The methodology that L.E.K. used to derive commodity allocation metrics is clearly set out in its report[11].

90. We note concern expressed by RFG and Coal Pro regarding possible allocation of some common costs to particular market segments. L.E.K's approach does not do this. We agree with RFG that it is important that the allocation of costs is cost reflective, and think that L.E.K.'s approach has achieved this aim.

(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?

Respondents' views

91. A number of respondents welcomed the inclusion of a cap to ensure the transfer from rail to road is limited to a specific ceiling. Network Rail considered that it is appropriate to provide freight operators with some assurance in respect of the maximum level of any new freight-specific charge. However, it also said that it would be potentially discriminatory to cap the total amount of revenue to be recovered through the charge and suggested that any revenue cap would have to be set ex ante and reflected in the determined charge rates. Network Rail believed a better approach would be to cap the charge using a forecast maximum decline in freight lifted, rather than freight moved, as that more closely reflects any switching between road and rail and network efficiency.

92. A number of stakeholders did not believe the cap proposed by the ORR to be a viable proposal. Respondents questioned how any change in rail traffic flows can be accurately modelled and attributed to the new freight charge, disentangling them from external market changes in what is a very volatile and complex market. Freightliner did not understand how the capping proposal would operate. RFG was also unclear how the cap would be assessed, monitored and enforced.

[11] L.E.K. (October 2012) "Estimating freight avoidable costs". http://www.networkrail.co.uk/publications/delivery-plans/control-period-5/periodic-review-2013/orr-publications-on-PR13/

93. Some respondents said they were unclear as to whether the cap would be an annual figure or apply to the whole charging period. RFG and Freightliner considered that rebasing the charge annually makes calculating charges complicated, prevents operators and customers from planning their business with certainty, and would likely lead to short term contracts becoming the norm. Both respondents suggested that the charge be set at the start of the control period and remain constant throughout.

94. Certain respondents questioned how the figure of 10% for the cap was arrived at. Energy UK and DRAX considered that there is no justification, either legal precedent or economic assessment, to substantiate why a 10% figure is "reasonable" and ASLEF also considered the figure to be rather arbitrary. DBS said that a cap has no purpose if set at a level that is effectively meaningless and SEStran believed that the ceiling should be less than the proposed 10%. DRS, INS and NDA considered it inappropriate to set charges that would result in a 10% reduction in traffic, given the associated knock on effects. CoalImp, Clydeport and SCCL said that the market impact is assessed at the national level, which is arbitrary and masks the potentially devastating impact at the regional level.

95. RFG and SSE considered that a mark-up should be set at a level that the market can bear not via a 'cap' but by setting any increase at an appropriate level in the first place. SSE said a cap provides no assurance on the level of charge that could be imposed. RFG considered that, although there have been historic fluctuations in the coal sector, this is not an applicable test for 'market can bear'. Respondents noted that market fluctuations can be up as well as down, whereas the charge is downside only. GBRf considered 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. DRAX considered that a cap on what the market can bear should be applied to the rail freight market and not the energy market.

96. RWE said that any cap undermines the principle of cost reflective charging. SSE considered that further clarity is needed on what these costs are and whether they are disaggregated and collected from each chargeable market sector or whether all costs are recovered on a set price basis from the chargeable sectors. Centrica considered that an alternative could be to apply the charge only to new supply chain routes and new volumes with no cap, allowing for operators to factor in the costs before deciding between supply routes.

Our response

97. Having listened to consultees' views, we decided not to use forecast impact of the charge on traffic as a basis for determining the FSC and to balance our statutory duties by other means. Instead, we have approached formulating the charge on a different basis, which we set out in our January document.

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

Respondents' views

98. There were mixed views from respondents regarding the unit of the new charge.

99. Network Rail, RWE and DRAX considered that levying the proposed charge on a tonne km basis should be the preferred approach. They said this would be more cost reflective as one would expect there to be more avoidable costs associated with longer journeys. Network Rail and DRAX also considered it to be consistent with the current basis of charging, widely understood by the industry, and so relatively inexpensive to introduce from a billing perspective. DRAX also said that a tonne km unit charge would enable Network Rail to focus freight investment in the most heavily used areas and would release capacity on the railway for passenger use in other areas.

100. However, a number of stakeholders considered that a distance based charge would discriminate against long distance flows. CoalPro, Bristol Port and Eggborough said that this would particularly disadvantage Scottish producers. Freightliner, CoalImp, Clydeport and SCCL considered that it would cause structural changes in coal traffic routes and affect competition between different ports and mines. They suggested that this would put at risk jobs and investments associated with longer distance movements, which have been established on the basis of current arrangements. Eggborough considered that it will unfairly impact on those businesses that have made investments in longer rail distances prior to this announcement.

101. A number of stakeholders supported a charge based simply on tonnes carried, as this would reduce some of the potential impacts for remote ports, operators and domestic producers. IPR considered that it would ensure all market segments are treated fairly and equitably. Eggborough suggested that such an arrangement would maintain a level playing field in the market place and ensure that a fair market price stays available to all in the associated and connected industries. Freightliner considered that it would be transparent and easy to understand for all customers, and would enable freight operators to show it clearly in invoices to customers.

102. On the other hand, a number of stakeholders said that a charge based on tonnes lifted would be more likely to lead to modal switch on short distance routes. CoalPro, CoalImp, Clydeport and SCCL considered that the additional costs associated with modal transfers may significantly change overall economics in favour of road. Network Rail and RFG also said that it introduces additional billing complexity as other charges are levied on a tonne km basis.

103. GBRf considered that, if it was possible that the freight specific charge could be extended in future to cover additional commodities, then the industry should be further consulted before the charging structure is developed for PR13.

Our response

104. We agree with respondents who said that a charge per tonne moved is more cost reflective; it should therefore incentivise efficiencies more effectively. We share the concern of those that argued that a charge per tonne would be more likely to lead to transfer to road freight on short distance routes. We do not agree that charging on a tonne per mile basis would be discriminatory as it would be applied equally to all and would be cost reflective. We do accept that – like any cost-based charge – it could have a greater effect on some customers (i.e. those that generate more infrastructure cost) than others and we took the effect of such a charge into account in our consideration of how it might be implemented.

105. The FSC is to be levied as a mark-up on the variable usage charge, and the units for both of these charges, for freight services, will be per thousand gross tonne miles (per kgtm). The freight-only line charge is currently levied on this basis. By levying the freight specific charge on the same basis as the freight-only line charge, we have ensured that there will be no additional complexity associated with the charge.

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.

Respondents' views

106. RWE agreed with the framework for estimating freight avoidable costs. Network Rail agreed that it would be appropriate to replace the freight-only-line charge with a new freight-specific charge, because freight-only-line costs are a subset of total freight avoidable costs, but it considered it premature to foreclose the possibility of recovering an equitable proportion of common costs through the proposed freight-specific charge.

107. RFG and Freightliner said that great care was needed in the allocation of freight avoidable costs to commodity groups to ensure that there is no cross subsidy and that costs are apportioned in line with ORR's objectives for cost reflectivity.

108. A number of respondents did not agree with the framework for estimating freight avoidable costs. GBRf, DRS, INS and NDA considered it to be subjective with too many variables which could impact the

outcome. They thought that the estimate of £200M-£250M indicated that there is no specific formula to determine this cost and the problem is compounded by lack of accurate data. SSE also considered the work to be vague and suggested that the data required to attribute costs fairly and accurately were not readily available.

109. GBRf did not accept that the removal of freight traffic reduces Network Rail's maintenance costs because Network Rail's costs to deliver its own maintenance services would be significantly higher without using the current competitive rail freight haulage market. It also considered that ERTMS should not be included in the avoidable costs because it is separately funded by the DfT to meet certain policy and compliance obligations.

110. Freightliner did not consider that the AEA Technology report "Recovery of Fixed Costs" a suitable basis to make even an estimate of freight avoidable costs. It said that the work focused primarily on franchised TOCs, and therefore did not appear to be relevant to freight. Freight-specific issues were not considered in any depth. Freightliner also noted that L.E.K. has been asked to assume that the network remained as now and not to assume a future efficient network. It considered this to be in conflict with the Access and Management Regulations, which state that charges should be set on an efficient basis. It did not think that a 35 year cycle, on which L.E.K. has been asked to model costs, was appropriate for structures, many of which are over 150 years old.

111. CoalImp, Clydeport and SCCL considered that twenty one new people in Network Rail's freight planning team should not be included in the cost estimate, as they had been employed to improve current network performance and not for CP5 planning.

Our response

112. We explained in our May consultation that the costs we presented there were indicative. Further work that Network Rail has undertaken subsequently has been used to address concerns about data quality and subjectivity. Network Rail appointed L.E.K. to assess freight avoidable costs and we, with assistance from Arup as reporters, have reviewed both the method and results. As a result we have concluded that the approach to calculating freight avoidable costs is robust. We do not agree that the concept of freight avoidable costs is subjective and set out arguments in our January document in support of it and of the variables used in reaching our conclusions.

113. In relation to the implications for maintenance costs L.E.K.s estimates allow for Network Rail continuing to require freight services e.g. to deliver materials to site and to allow for the fact that provision of these trains would attract a commercial price.

114. We agree that great care is needed in the allocation of freight avoidable costs to commodity groups, *inter alia,* to ensure that there is no cross subsidy and that costs are allocated using a cost-reflective methodology. We discussed this with respect to our response to question 7.23 (from paragraph 83 of this document).

115. In relation to ERTMS costs, we note that the Network Rail/L.E.K. analysis includes estimates of planned enhancements to the network including ERTMS. We believe it is reasonable to include these costs in the estimates of freight avoidable costs, as they are currently committed costs which would not be incurred if commercial freight traffic were removed from the network.

116. We consider that the 35 year assessment period represents a reasonable period over which to estimate long-term avoidable infrastructure costs, consistent with the approach used for the variable usage charge. Although some assets have longer lives, some of the relevant assets included in the assessment of future long-term avoidable costs, such as train communication systems, have asset lives considerably less than 35 years.

117. We consider that the costs relating to Network Rail staff employed specifically to work on freight issues should be included in the estimated freight avoidable costs, as these roles would not be required if freight were removed from the network. As we explain in Annex A of our January document, we consider that Network Rail/L.E.K. estimates of these Network Rail staff costs are not unreasonable for this category of cost. We note that page 31 of the L.E.K. report explains that in total 84 roles would not be required if freight were removed, and provides further details on the estimates of these staff costs.

Chapter 6 – Market analysis

(7.27) 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?

118. We have written up the responses under the following headings:

(a) Comments specific to the NERA analysis;

(b) Comments specific to the MDST analysis; and

(c) Wider comments or comments that apply to both studies.

The consultants' reports can be found on our consultation web page.

Respondents' views on the NERA analysis

119. Many respondents said that the base case forecasts did not align with the DECC central forecast. DRAX considered that it would have been much more appropriate to use the latest official government figures and projections and to do otherwise risked putting in place potentially conflicting policy instruments across different government departments. RFG noted that there was also no analysis of how the modelled results compare with Government forecasts for coal generation and said it should be clear what impact these proposals had because freight operators base their business plans on such forecasts.

120. A number of stakeholders suggested that analysis undertaken by NERA was fundamentally flawed in its understanding of the electricity market. CoalImp, Clydeport and SCCL noted that in 2012 and 2013 the base case statistics show a step change up in coal demand compared to recent years. They argued that, although this has occurred in the first half of 2012, for the subsequent year a number of coal stations had already announced early closure. They also considered the increase in demand in years 2015, 2017 and 2019 to be implausible and saw no justification for any increase in demand post 2013, given LCPD closures and the increasing impact of carbon price support, until plants equipped with carbon capture and storage were established to a significant degree.

121. Some respondents said that the reference to the Industrial Emissions Directive appeared over-simplified and imperfectly understood, stating that the Transitional National Plan option was not mentioned.

122. CoalImp, Clydeport and SCCL considered that the ROC banding review and the potential major increase in co-firing or full conversion had major implications for port and rail capacities and future investment decisions. IPR questioned whether biomass conversions stated in the recent ROC banding announcement had been included in the analysis. GBRf said that NERA appeared to be of the view that the process for the setting of ROCs credits would take into account any new level of track access charge, and that this was incorrect.

123. A number of respondents noted that the report assumed "that the proportions of coal that each power station sources from and transports via different routes remain unchanged". They considered this to be a flawed assumption and therefore thought that the real impact on the freight market and on individual operators was overlooked These respondents said that analysis of rail freight traffic should take into account the potential for switching sources of coal that could be caused by proposed track access charges.

124. CoalImp, Clydeport and SCCL said that the analysis undertaken by NERA was primarily focussed on the effect of any increase on the customers of rail freight, something that was not of primary concern to ORR. The question of market elasticity was focussed on analysis of the electricity market rather than in the

rail freight market, where elasticity is clearly affected by the length and cost of the haulage. EDF considered that the likely impact was a switch to gas-fired generation at the expense of coal-fired generation, resulting in less coal being moved to the detriment of the rail freight sector.

Our response on the comments specific to the NERA report

125. A number of respondents questioned NERA's base case ESI coal demand forecast, in particular NERA's forecast of ESI coal in later years was substantially higher than that of DECC. One of the reasons for this was that NERA used coal and gas price forecast from a different source (Bloomberg). To address this we asked NERA to prepare a revised base case using price assumptions consistent with DECC's, and remodel impacts. NERA has prepared a technical note [12] setting out the differences between its forecasts and DECC's and how this affects the impact on the demand for ESI coal. Under its revised forecast, demand for coal remains quite insensitive to the FSC, for example levying an additional charge of £5 per thousand net tonne km (equivalent to a FSC, excluding fright only line charge cost, of £4 per thousand gross tonne miles, i.e. the level of the cap on which we have concluded) reduced the demand for coal in each year of CP 5 by between 1% and 5%.

126. Some comments related to the extent to which NERA's modelling took into account impacts of EU Directives (which NERA modelled as endogenous investment decisions, i.e. whether to invest in reducing emissions or to limit and / or cease generation), or other factors. More generally, several consultees noted that the ESI coal sector will also be undergoing regulatory changes over the coming years and were unclear how we could accurately assess the impact of the charge on this sector. Overall, there is broad consensus that future demand for coal is subject to high levels of uncertainty, due to a large number of factors such as level of uptake of renewables and movement of international gas prices. We have taken this into account by asking NERA to model several base coal forecasts (in their original report and revised note), and we have found that in each case the FSC has little impact on demand for coal.

127. We have discussed comments relating to biomass and the associated ROC in our consultation on biomass.

128. A number of consultees noted that NERA did not model changes in transport patterns. We asked MDST rather than NERA to model transport patterns. The transport patterns have limited impact on the price of delivered coal (because an increase in the price of longer distance flows could generate substitution of shorter distance flows), and so while transport patterns are important for understanding the distribution of impacts, they are of limited relevance to NERA's modelling of the electricity supply industry.

[12] NERA (October 2012) The impact of changes in access charges on the demand for coal: update to NERA May 2012 assessment; see the consultation webpage.

129. We agree that the energy market, modelled by NERA, is not of primary concern to ORR. We have examined the potential impact on this market because some stakeholders have argued that demand for coal for electricity generation is highly sensitive to price, for example due to close substitution with gas. If demand were highly elastic, it would be less efficient to levy a charge on this market segment. NERA's analysis, however, confirms that demand for ESI coal changes little in response to track access charges.

Respondents' views on the MDST analysis

130. GBRf considered that the forecast percentage reductions in tonne kilometres were understated across the commodity groups, citing as an example MDST's conclusion that the charge raising additional revenue in the intermodal market segment as being invalid because the market was competitive.

131. Freightliner did not agree with the assumptions on HGV rates and suggested that the rates were very simplistic if they did not assume any back loads. It said that in the open trailer market there would always have backloads over long distances and this would drastically change the HGV rates charged.

132. Network Rail believed ORR's write-up, interpretation and application of the NERA and MDST stage 1 reports to be broadly reasonable but was concerned that the impact forecast by the MDST stage 2 report model has not been scrutinised previously or validated in the market. Because of the limitations of the analysis it believed that, whilst informative, the results were too uncertain to be relied upon and suggested that decisions should be based on the NERA and MDST stage 1 reports, and any other relevant information.

133. FGL and ATH said that mine output was generally not price-elastic and could not be linearly increased or decreased. Mines had to operate as close to maximum capacity as possible, to remain viable. Freightliner considered that MDST's production increase assumption was inaccurate as mine output for these pits was likely to be constrained by physical and commercial factors. A number of respondents said that the analysis undertaken was subjective and, given the implications of the conclusions, further work was required to understand the potential impacts.

134. Some respondents considered that certain factors which impact on actual coal supply patterns were not accounted for in MDST's modelling work. Contractual arrangements, coal specification, station specific factors, port specific factors, coal supply and rail haulage were listed as factors not considered in the analysis. GBRf concluded that some of the MDST results did not stand up to reasonable scrutiny when the market realities were considered. RFG noted that MDST made certain assumptions about the behaviour of ports and pits in absorbing some part of the price increase and suggested that there should be a base case scenario to compare sensitivities of the assumptions.

135. Various respondents considered that the modelling was not sophisticated enough to determine plant-level consequences. A number of stakeholders said that there has been no analysis of the profitability of the various Scottish mining companies and that, given present coal prices, the assumption that some of the increase in charges could be absorbed by these producers is flawed. IPR considered that further analysis should be undertaken to investigate the likely impact on coal generator margins.

136. Some respondents considered that there was no recognition of port or shipping costs that affect the delivered price of coal to the power stations. GBRf said that prices were affected by the operation of maritime feeder services from ports to Scotland and so the price of rail is constrained on these longer routes. The British Ports Association was concerned that the analysis has failed to recognise that sensitive shipping markets and freight routes could be severely altered and certain ports unfairly disadvantaged by the proposal. CoalImp, Clydeport and SCCL noted that there is no analysis of rail freight capacity on the key routes.

137. RFG stated that the studies themselves appeared to produce quite different results, which have not been reconciled with each other.

138. Freightliner was disappointed that MDST did not appear to have modelled the impacts of increasing charges on a per tonne basis, given it is one of options proposed by ORR.

Our response on the comments specific to the MDST report

139. GBRf's challenge regarding the MDST modelling of intermodal traffic reflected discussions made during the preparation of MDST's report, which included meetings with stakeholders and comparisons of data on particular flows (i.e. origin / destination combinations). The difference of opinion may have related to alternative assumptions regarding rail freight grants (which are relevant to intermodal and other market segments where rail competes with road, so are not relevant to the market segments to which the FSC will apply). While accepting that intermodal is a highly competitive market segment, if we assume that the grants are held constant then MDST's reasoning and results seems to us to be intuitively correct: that some rail flows will have greater competitive advantage relative to road and shipping than others, and that it is with respect to these that additional revenue from higher charges would accrue.

140. We asked MDST to consider back loads further in the context of ESI coal traffic between Scotland and England[13]. MDST argued that such backloads would not have a material impact on road haulage rates, for reasons including necessity of cleaning the equipment when switching commodities and mismatch of origins and destinations.

[13] MDST (January 2013) Analysis of rail and rail costs between coal mines and power stations; see the consultation web page.

141. A number of consultees questioned the analysis undertaken by MDST in its stage 2 report. In particular the assumptions around the responses of coal pits and mines and ports. We asked MDST to model the impacts of a FSC on transporting ESI coal. In its stage 2 report at page14, MDST modelled both the potential for flows to switch to road and also the potential for different ports to be used and mines to vary output (as, stakeholders have explained, mines tend to operate at 100% or not at all, this would take the form of changes to decisions about whether to invest in new mines or potentially early mine closures). In its subsequent note "Analysis of road and rail costs between coal mines and power stations", MDST sets out the relative competitiveness of the two modes with respect to mines in Scotland.

142. We explained in our May consultation that we considered MDST's modelling of mine and port responses to the charge, in its stage 2 report, to be illustrative rather than definitive forecasts because the parameters used were derived from industry knowledge rather than calibration of actual behaviour. This contrasts with MDST's modelling of road and rail competition for particular journeys, for which MDST has used its well established and calibrated GB Freight Model. It is the shift between road and rail that is particularly important in assessing external costs and benefits. Shifts between rail and shipping do not raise the same issues.

143. A number of comments relate to particular constraints (contractual constraints, capacity bottlenecks and other physical constraints) not being modelled. All such constraints, some of which may only be relevant in the short term, would tend to reduce the impact of the charge, so that MDST's modelling may result in an overstatement of the impact.

144. Some respondents argued that we should analyse the impact of the charge with respect to businesses' profit margins in order to understand the impacts of our proposals, for example with respect to the profit margins of mines and electricity generators. We think that such analysis would be flawed for a number of reasons. First, it would pre-suppose that the charge could not be passed on, whereas our analysis shows that with respect to electricity generators and freight operators much of the charge can be passed on, ultimately to electricity customers (and we have shown that the impact on electricity customers is very small). Second, it would conflate profitability (which takes account of sunk costs) with the case for continuing to trade in a particular good or service (which is a function of incremental revenues and cost associated with the continued activity); it is the latter which is relevant for determining impacts in terms of freight moved and economic activity. Third, we are limited by our statutory duties in the weight we can give to consideration of bankruptcy of individual mines or generators; but in any event it would be spurious to analyse the impact of the charge on profit margins for these businesses in isolation because other volatile

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[14] See note 63

factors would affect profit margins to a much greater degree, notably international coal, gas and electricity prices. Fourth, profit margins may not be a reliable measure of the financial health of individual businesses within a group because of considerable scope for intra-group transactions.

145. Differential port costs and shipping costs were modelled to the extent that they were implicit in the current traffic patterns (for example high use of a particular port may reflect its relatively low costs). We consider this to have been appropriate and proportionate to the policy being assessed.

146. The analysis did show potentially significant changes to shipping routes and freight markets. Given that the charge we have concluded on is cost reflective, we do not consider this to be discriminatory (see also our legal analysis contained in Chapter 4 paragraphs 4.11 to 4.37 of our January freight decisions document).

147. MDST's stage 1 and stage 2 reports were not directly comparable because they tested quite different charging scenarios: up to 100% increase in variable usage charges compared to at least 200% increases. They were not, however, inconsistent or contradictory.

Respondents' wider comments

148. Many respondents considered that the NERA and MDST analysis provided good assessment of the likely impact of higher track access charges but there were a number of criticisms around modelling assumptions and the wider impacts of higher charges not included in the modelling carried out by consultants.

149. DBS considered that the analysis did not address the effect of an increase in track access charges on rail freight economics, particularly as regards interactions between markets and the response of operators to profitability. DBS believed that the studies have looked at markets individually but have not reviewed the interactions of these markets. GBRf considered that the NERA and MDST assessments treated the supply base as essentially one operator and ignored the fact that it was a competitive market where one operator may win market share from another.

150. DRAX noted that the consultation document suggested that ESI Coal accounted for 24% of rail freight; however, MDST and NERA were asked to test their analysis of market segments on the basis that ESI Coal accounted for 30% of the gross tonne km on the network. Given this discrepancy, the apportionment of freight avoidable costs would reduce from £60m - £75m down to £46m - £58m.

151. DRS, INS and NDA were concerned that the analysis undertaken in respect of the spent nuclear fuel segment was not particularly thorough and the conclusions appear to be based upon an unsound understanding of the segment and upon unsound assumptions.

152. Certain respondents said that the references to biomass and the future investment decisions of generators appear to be highly subjective, with little demonstrative evidence to support the statements. Freightliner considered that this could not be used as a basis for decisions. CoalPro believed that any implication that greater subsidies might be available to compensate biomass for higher track access charges is unwarranted by the evidence. FGL considered the analysis had not captured the potential impact of biomass on the whole coal demand, supply and logistics equation. Furthermore, the use of 2011 biomass data does not adequately inform decisions for the post April 2014 period, for which long term contracts have already been struck.

Our response on wider comments

153. We accept that it is difficult for rail freight operators to adapt their businesses to sudden large changes in track access charges (including potentially changing the portfolio of services that they offer), and this has informed our decision to delay the implementation of the FSC and phase the charge in gradually over CP5. We disagree with GBRf that NERA and MDST assumed that there was only one operator; on the contrary we argue that the modelling implicitly assumes that rail freight services are competitive both without and with a FSC (and for that reason all such charges needed to be passed on to customers or others in the supply chain).

154. The calculation of freight avoidable costs and its associated revenue have been updated subsequent to DRAX's comments.

155. We discuss spent nuclear fuel in question 7.30 below (paragraph 175 onwards). We have discussed points relating to biomass in our biomass consultation.

(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?

Respondents' views

156. A number of respondents agreed with the proposal. Network Rail understood why ORR had proposed not to levy a mark-up on the latter group of market segments. RFG also said it would welcome an early, positive statement from ORR on this matter, and on other charges affecting these commodity sectors.

Despite agreeing, DRS, INS and NDA were concerned that the MDST Report was not a correct and thorough assessment of the likely impact of such a levy on the spent nuclear fuel segment.

157. IPR did not agree with the proposal and said that any charging structure should be applicable to all users of the rail network to ensure all market segments are treated fairly and equitably. CoalPro, CoalImp, Clydeport and SCCL considered that there should be no mark up in order to avoid discriminatory effects and potential breaches of EU legislation.

Our response

158. Most respondents agreed with our proposal not to levy a mark-up on certain commodities, based on MDST's analysis. We do not agree with IPR's argument that the mark-up should apply to all commodities, as this would not satisfy the legal frame work, which we have explained in Chapter 4 paragraphs 4.11 to 4.37 of our January document.

159. We discuss spent nuclear fuel in question 7.30 below (paragraph 175 onwards).

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

Respondents' views

160. Network Rail and RWE agreed with ORR's proposal to levy any new freight-specific charge on ESI coal traffic. Network Rail said that a reduction in ESI coal's current subsidy would make rail freight more sustainable in the long run. It considered that making ESI coal charges more cost reflective should also result in a reduction in the indirect subsidy to the ESI, pointing to NERA's finding that it would have a negligible impact on wholesale and domestic electricity prices. Network Rail also noted that the market analysis demonstrated that, because of its price-inelasticity, this market segment was able to bear a mark-up.

161. The majority of respondents did not agree with the proposal to levy the mark-up. CoalPro, CoalImp, Clydeport and SCCL considered that the proposal was discriminatory in its application to freight only. IPR did not believe the charge should be levied on ESI coal traffic while other market segments were exempt. CoalPro and Unite considered that the proposal would introduce wide-scale market distortions both between market segments and within the ESI coal segment. Transworth believed that the proposal would impact on the competitiveness of coal versus gas and other fuels.

162. SSE considered ORR's analysis of the ESI market and its ability to bear increased costs to be incomplete and based on unrealistic assumptions. Kier said that there was no evidence base presented in the consultation to support the assertion that coal producers could absorb this increase in track charges.

CoalImp, Clydeport and SCCL said that it would have a negative impact on jobs and investment in coal production, generation and freight as well as a potential negative impact on power security and energy prices. DRS, INS and NDA considered that the market studies have shown that there could be modal shift and reduction in traffic with pits, particularly in Scotland, becoming unviable with potential closures and redundancies. Transworth also said that the proposal would have adverse impact on the Scottish coal industry, since coal could be imported through east coast ports and railed a short distance to power stations. Because of this, EDF said that the proposal risks increased the UK's dependence on energy imports. CoalPro said that the potential impacts on UK coal production and the effects of replacing this by imported gas or coal were simply ignored. Freightliner, Eggborough and IPR considered that the proposal would accelerate the decline forecast in the coal market. CoalPro considered that, when coal-fired power stations were ageing and needed to make major investment to meet new policy requirements or to close, further increases in rail freight charges might be the tipping point. Energy UK and CoalPro believed that the proposal failed to take these wider policy considerations into account.

163. Many respondents noted that the ESI coal sector would also be undergoing regulatory changes over the coming years as a result of the Industrial Emissions Directive and Electricity Market Reform implementation. Energy UK said it was unclear how the ORR could accurately assess the impact of its proposals on the power generation sector given the changes that the sector would experience in the next decade.

164. SSE said that the proposal added complexity to an already complex environment at a time when generators were required to make major investment decisions. Eggborough urged that the proposal be deferred and reassessed at the next review when the ESI future would be more defined and certain. CoalImp, Clydeport and SCCL considered that at the present time coal should be exempt or that no additional charge should apply.

165. DRAX considered that the proposal did not allow ESI coal generators, producers or importers to plan their businesses with a "reasonable degree of assurance".

166. Freightliner considered coal mined in Scotland to be particularly vulnerable to modal shift to road because it was mainly transported by road to the rail terminal for transfer on to rail.

167. Transworth considered that the resultant reduced profitability of generation would adversely affect its ability to grow the amount of freight on rail. VTG considered the loss of coal business likely to have wider ramifications for the competitiveness of rail freight. Freightliner said that, as a result of the proposal, the routes operated would change along with the average length of haul, which was key to determining the

size of the market available to rail. Furthermore, this new supply chain would give rise to altered resource requirements from operators, with fewer wagons and fewer workers being required in a smaller market. RFG and the British Ports Association were concerned that the proposal would not take into account the wider impact on the freight and maritime sector. DBS said that it was imperative that an overall impact assessment for the freight sector be undertaken.

Our response

168. We are keen to improve the extent to which the charges that Network Rail's customers pay reflect the costs they impose on the network. More cost reflective prices help to drive cost savings and send better signals to Network Rail and its customers for the efficient provision and use of access to the network, which is itself a scarce resource. More cost reflective charges also improve transparency – making it clearer who pays for what and what they receive in return. In our view, the freight specific charge is an important step in improving value for money.

169. To date, rail freight has benefitted from subsidy, even where, as is the case for ESI coal, spent nuclear fuel and iron ore, it cannot easily or economically switch to road. This does not represent value for money for the taxpayer. By introducing a freight specific charge for these commodities, we will increase the extent to which they contribute to the costs that freight imposes on the rail network.

170. We received many submissions and representations from stakeholders in the ESI coal industry following our consultation in May 2012. We understand their concerns and have taken their views into account by:

(i) capping the charge, net of the freight-only line charge, at £4.04 per kgtm, for ESI coal which is around half the indicative level we consulted on in May 2012;

(ii) deciding not to introduce the freight specific charge for any of three market segments until year 3 of CP5, i.e. 2016-17. This will give the affected businesses time to adapt to the charge. In particular it will give the ESI coal industry greater scope to adapt at a time of particular change and uncertainty (for example due to the coming into force of the Industrial Emissions Directive (IED) Directive in 2016 and increasing use of renewables); and

(iii) deciding to phase the freight specific charge in gradually, for example at 20% of its final level in 2016-17, 60% in 2017-18 and 100% in 2018-19.

171. We have taken our statutory duties into account and listened to stakeholders and their concerns by recognising the particular effects that the charge will have on the ESI coal sector.

172. We have explained why we do not consider the charge to be discriminatory (see Chapter 4 paragraphs 4.11 to 4.37 of our January document). We consider that it reduces distortion of competition between coal and other ESI fuels (notably gas, which is not transported by rail) by making the price for delivered coal more cost reflective. We have addressed most of the points made regarding modelling in response to the previous question. As stated previously, our policies are not, and should not be, devised to influence energy policy, such as security of electricity supply.

173. We presented evidence regarding the ability of coal producers to absorb increases in track access charges through NERA's analysis of output over time, which showed steady levels of production in the face of wide fluctuations in costs and other factors.

174. We have considered in great detail the potential for a freight specific charge to result in a switch of ESI coal from rail to road haulage (see paragraphs 4.54 to 4.59 of our January document).

175. We have discussed impact on rail freight in paragraphs 4.101 to 4.104 of our January document.

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

Respondents' views

176. Network Rail agreed that a reduction in spent nuclear fuel's current 'subsidy' would make rail freight more sustainable in the long run. It considered that making spent nuclear fuel charges more cost reflective should also result in a reduction in the indirect subsidy to the ESI and that the market analysis clearly demonstrated that the market segment continues to be able to bear a mark-up. RWE agreed with the proposal, while Eggborough considered that this fuel was the most inelastic and understood why this market was targeted.

177. A number of respondents did not agree. CoalImp, Clydeport and SCCL were concerned about the potential discriminatory effect of such charges. EDF believed that levying a new freight charge on the basis of a lack of competition from road freight and inelastic demand was flawed as it exploited the exposure of the operator to the rail network.

178. Magnox stated that it used both road and rail and therefore already had the infrastructure to support a shift away from rail transport. It suggested that this demonstrated a degree of elasticity that has been ignored in the analysis. DRS, INS and NDA were also not convinced that this market was as inelastic as assumed in the report and were therefore concerned that ORR was considering applying no cap to the proposed freight specific charge.

179. Transworth considered the nuclear sector to be the only one immune to increased access charges but believed that such increases would ultimately find their way back to HMG via the NDA. Magnox, on the other hand, considered that any substantial increase in the irradiated fuel rail transport costs would be unlikely to receive additional funding from the NDA and as such would take funding away from decommissioning activities that reduced hazard and on-going operating costs. This would increase the overall cost of decommissioning the reactors at the taxpayers' expense. Unite also said that increasing the cost of access charges to this industry would lead to an increase in government debt at a time when it was looking to invest in more nuclear generation to assist with plans to combat greenhouse gas emissions.

180. RFG thought there were likely to be wider impacts, not least for future investment in the nuclear sector. EDF Energy did not believe that the secondary impact on plant life extensions had been factored into NERA's modelling.

181. RFG suggested that the avoidable costs associated with spent nuclear fuel were likely to be small given the low volume of traffic. ATCO was also not convinced that this traffic caused significant wear and tear on the system, in view of limited train lengths. Magnox did not believe that the analysis of the income receive from the charge took into account the planned decline of irradiated fuel transport, noting that it has just three sites left to de-fuel their reactors. These would progressively complete de-fuelling over the next 4 to 7 years depending on operational performance.

Our response

182. We have explained why the freight specific charge is consistent with our legal framework and is not unduly discriminatory in Chapter 4 paragraphs 4.11 to 4.37 of our January document.

183. In our May consultation we explained that based on the analysis carried out by NERA we did not expect demand for nuclear energy to change as the result of the freight-specific charge. Indeed, even with a charge of £100 per thousand net tonne km. NERA found no impact on modelled output from nuclear generators, noting that nuclear plants have low variable costs of production relative to competing technologies.

184. Analysis by MDST shows that transporting spent nuclear fuel by rail is already more expensive than by road. Our understanding and the advice we have received in the form of consultation responses is that the decisions to transport spent nuclear waste by rail is primarily driven by nuclear security concerns; and these decisions are taken by the bodies best placed to weigh up the significance of those security concerns. It is important that these bodies face appropriate price signals by which to make these decisions, which is what a freight specific charge achieves.

185. A number of respondents argued that a freight-specific charge would not result in an overall reduction in the level of subsidy because it would result in another government agency, the Nuclear Development Authority, paying higher charges to DRS. To the extent that this is true we consider the charge is still beneficial since it increases the transparency regarding the source of costs, namely the nuclear industry rather than railway. In practice it is not clear that the charge would simply lead only to a switch of subsidy since there may be scope in commercial contracts to pass some of the cost onto the commercial generator. Generators may benefit from the freight-specific charge because of higher margins resulting from increasing costs of delivered coal. The freight specific charge in itself reduces government debt.

186. It is important that the particular characteristics of this traffic are taken into account when estimating its freight avoidable costs, and we consider that the methodology developed by L.E.K. has largely done so. However we have asked Network Rail to revisit the allocation of schedule 4 costs for this traffic, because these costs have a substantial influence on the charge. (This would only affect the freight specific charge if Network Rail's estimate of costs, based on the best available evidence, i.e. a form of central cost estimate, was found to be below the cap.) In addition, Network Rail needs to demonstrate to its customers that the traffic forecasts are consistent with the costs it calculates for freight-only lines.

187. Taking account of our market analysis and stakeholders responses we have decided to levy a freight specific charge on spent nuclear fuel market segment. We have set a cap on the level of the charge at £11.64 per thousand gross tonne miles, excluding the freight only line charge, and have concluded that it should be phased in over CP5 from 2016 onwards.

(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?

Respondents' views

188. A number of respondents believed there should be no new freight-specific charge for the iron ore market segment. Network Rail did not support levying the proposed charge on iron ore as traffic was limited to a single flow between Immingham and Scunthorpe. TATA Steel considered that, given only one iron-ore consuming steel plant in the UK (Scunthorpe) with an inland location, the proposal was a direct tax on one particular operation. CoalImp, Clydeport and SCCL were concerned about the potential discriminatory effect of such charges. Network Rail considered the market analysis in respect of iron ore to be less comprehensive than that for ESI coal and spent nuclear fuel.

189. GBRf said that 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 would therefore represent a material

reduction to the return on capital employed in the 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, creating an incentive to import it. The All Party Parliamentary Group also thought that semi-finished slab steel could be imported from Ijmuiden or Port Talbot resulting in the closure of one or more of Scunthorpe's four blast furnaces, part of the coke oven plant and a portion of the Concast plant, with consequent job losses. Despite this, large numbers of trains would still run between Immingham and Scunthorpe but these trains would not pay the freight specific charge since they would be conveying slab.

190. Respondents were also concerned that, given the fragility of domestic steel production, the application of price increases could affect business and the steel industry in the UK. Transworth considered that even a small increase in charges would have a large impact when up to five million tonnes a year of iron ore are being moved. Freightliner suggested that business in the UK will only continue if it were competitive with other countries. A number of respondents considered that increases might change the 'tipping point' for steel production at particular locations. TATA Steel said that it was disappointing not to see an international perspective reflected in the report and consideration given to its impact. It thought the proposals would be severely detrimental to its business. DRS, INS and NDA considered that comments at workshops suggest that this market was not as inelastic as the studies indicated.

191. RFG said that the steel sector could also be exposed to increases in the delivered price of coal as well as iron ore, which further compounded this effect.

192. TATA Steel also said that the proposed changes would add uncertainty and complexity to an already fragmented charging structure. Quoting for spot opportunities were already more complex on rail than road and the proposal would diminish the rail industry's ability to offer short lead time movement solutions leading to greater road use.

193. Unite said that increasing the cost of transporting raw iron ore would increase the price of rail replacements and new trains manufactured in the UK.

Our response

194. We explained in our May consultation that iron ore traffic currently consisted of a single flow that is captive to rail. Our consultants MDST analysed the transport costs of this flow by rail and other modes, consistent with its analysis of other market segments. We do not agree that the charge represents a tax on a particular operation. Rather the charge represents a reduction in subsidy from which users and operators on this flow benefit. Although iron ore is a single flow, it has consistently been treated as a

separate market segment for the purpose of setting track access charges, and historically this market segment has borne higher track access charges.

195. Analysis by our consultants MDST suggests that road transport is around three times the cost of rail. The same rationale for reducing this subsidy to iron-ore applies as to other commodities where we consider there is a low propensity to switch to road.

196. We recognise that the steel industry is experiencing difficult economic conditions which are affecting business decisions, such as investment. However, iron-ore is only one contributor to the finished price of steel. The impact of a charge set at the level of the of the caps announced in our January document is sufficiently small that it is reasonable to assume it would be a very small factor in any investment decisions and would not lead to the exclusion of this market segment.

197. Stakeholders were concerned about the impact of a freight specific charge on industrial coal for this commodity. As discussed in paragraph 211 below, we have concluded not to levy a freight specific charge on industrial coal.

198. We agree that the charge could potentially increase the price of new trains manufactured in the UK, though consider that this effect would be negligible.

199. Taking account of our market analysis and stakeholders responses we have decided to levy a freight specific charge on the iron ore market segment. We have set a cap on the level of the charge at £2.96 per thousand gross tonne miles and that it should be phased in over CP5 from 2016 onwards.

(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)?

Respondents' views

200. A number of respondents agreed that, at present, there is considerable merit in not levying any freight-specific charge on the biomass market segment. They considered that the biomass market is still in the early stages of development and that stable conditions are required to support the growing market.

201. Network Rail said that ORR should revisit this policy in the 2018 Periodic Review to coincide with the recalculation of the DECC credit regime. RFG considered that deferring the decision until 2017 may not be sufficient, and suggested delaying until at least the start of CP6, when the market for biomass is much clearer. Freightliner and Eggborough said it would be more appropriate not to change charges for at least

the next two control periods to enable private sector investment. Freightliner also suggested that additional analysis should be undertaken before any decisions to increase charges are made. The British Ports Authority said it would be more sensible to suspend it completely or at the very least move it in line with the Government's 2020 ROC targets.

202. Many respondents considered that simply deferring the decision on biomass charging adds further uncertainty to the investment case at ports and on the railways as well as at power stations. It could risk deferring biomass related investment decisions and/ or result in the premature closure of existing coal plants that have the potential for enhanced biomass co-firing. SSE considered that there seems to be a lack of realisation that these investment decisions are being made now.

203. CoalPro, EDF Energy and Unite noted the inter-relationship between coal and biomass. CoalPro considered the two should be considered together, with the same outcome applied to both to avoid market distortion, and a decision should not be delayed. Unite said that favouring biomass may lead to far less efficient and more expensive generation.

204. EDF Energy said that the decision should be independent of the level of support available to biomass as part of the RO and the perceived maturity of the market. It did not agree with the ORR's proposal to defer the decision on biomass freight in this periodic review and did not believe it appropriate for the ORR to determine further cross-subsidies for biomass.

205. CoalImp, Clydeport and SCCL said that regulatory uncertainty on track access charges for biomass would undermine Government energy and climate change objectives. DRAX considered that any projects supported under the RO should be excluded from any new rail freight charges now and in the future, as the Government Response to the RO banding has now been published and there will be no further opportunity to increase the level of support to cover increased rail charges.

206. Centrica said that the definition of biomass will need careful consideration since biomass is not exclusive to the power industry and there is a heightened risk of unintended consequences for a variety of industries if biomass is subjected to an asset specific charge.

Our response

207. In our May consultation we proposed deferring a decision on levying the freight specific charge on biomass until 2017 because of the emerging nature of the market.

208. However, many respondents requested that ORR make a decision about whether to levy the FSC on biomass, as part of this review in order to reduce uncertainty as many investment decisions are being

taken now. We agree with this. We launched our biomass consultation on 15 February 2013, and our responses to the points made here are set out in an appendix to that document[15].

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

Respondents' views

209. The majority of stakeholders who responded to this question agreed that the proposed charge should not be levied on other non ESI coal flows. Network Rail considered the market analysis in respect of other coal to be less comprehensive than that for ESI coal and spent nuclear fuel. In addition, because other coal traffic does not serve the ESI and a subset of this market segment (flows to cement works) appears to be more price elastic, Network Rail would be more cautious about extending the charge to this commodity. Network Rail considered that ORR had misinterpreted the MDST analysis by stating that it indicated cement is relatively sensitive to increases in track access charges and faces strong competition from road hauliers. Network Rail considered that it is other coal flows to cement works that face competition from road hauliers and it is these flows, not cement, which could switch from rail to road in response to an increase in track access charges.

210. CoalImp, Clydeport and SCCL believed that analysis of these other sectors would demonstrate that they would be at even greater risk from increased charges than ESI coal. TATA Steel considered that this proposal would make it less viable for its Port Talbot steel making plant to source coal from UK suppliers and could have a massive negative impact on certain sectors of what remains of the UK coal industry.

211. RFG said that the cement market is slowly increasing its use of rail for finished product but this is highly price sensitive to road and changes in any aspect of rail costs could compromise the viability of increased rail use across the supply chain. ATCO did not favour any measures which resulted in additional journeys transferring to road and RWE noted that the transfer of rail traffic to road is not in the wider societal interest.

Our response

212. We have considered carefully the consultation responses we have received and we accept that rail faces substantial competition from road haulage for a significant number of flows in this market segment. Competition with road haulage, and transfer to road, is a key consideration of whether a mark-up would be efficient, as set out in the legal analysis in our January document. As we do not think it would be efficient, we have decided not to apply the FSC to other coal traffic.

[15] Consultation on a freight specific charge for biomass - February 2013

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