Periodic Review 2013: consultation on the variable usage charge and a freight specific charge – Network Rail’s response

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2. INTRODUCTION

2.1. Introduction

Network Rail welcomes the opportunity to respond to ORR's consultation on the variable usage charge and a freight-specific charge.

Rail freight plays a vital part in the country's logistics industry and is an important user of the GB network. Network Rail values freight operators as vital partners in the continued success of the railway. We also consider that there are societal benefits from moving freight traffic from road to rail. We will continue to work with the rail community to support initiatives that facilitate this, for example, the Strategic Freight Network.

As we stated in our response to ORR's first PR13 consultation, we recognise that rail freight operators face considerable competition from road hauliers and that road haulage enjoys simple charges and reasonable certainty about its costs. We believe that, as far as possible, rail freight pricing should strive to be simple and give as much certainty as is feasible to allow it to compete with roads. In considering changes to the rail freight regime we should all be mindful that the freight community could view even discussions of changes as unsettling.

We also believe that the freight sector has a continued role in driving efficiency and financial sustainability of the rail sector and the wider economy. Consistent with this, we consider that, where appropriate, freight should be seen to contribute toward the fixed costs of running the GB network. We also consider that, in the long-run, the rail freight sector will benefit from avoiding unnecessary reliance on implicit operating subsidy as improved transparency is key to sustainability.

In the remainder of this document, we respond to each of the consultation questions in turn and make the following high-level points:

- We support placing a cap on variable usage charges (VUCs) and consider a 15% confidence interval to be reasonable.

- We agree that there could be merit in quantifying the level of infrastructure costs allocated to freight operators on the basis of avoidable costs. However, we consider that it would be premature, at this stage, to foreclose the possibility of allocating an equitable proportion of common costs to freight traffic

- We consider that it would be appropriate to place an *ex ante* cap on the proposed level of any freight-specific charge, however, it would be impractical and potentially discriminatory to cap the total amount of revenue to be recovered through the charge. We believe that a better approach would be to cap the proposed freight-specific charge in terms of a forecast maximum decline in freight lifted rather than freight moved.

- Our preferred approach would be to levy any freight-specific charge on a thousand gross tonne mile (kgtm) basis.

- We agree that it is appropriate to levy any new freight-specific charge on ESI coal and spent nuclear fuel traffic. We also agree that, at present, there would be considerable merit in not levying the charge on biomass traffic. We would be more cautious about extending the proposed charge to other coal traffic and would not support levying it on the iron ore market segment.

2.2. Background

As you are aware, to inform this consultation we have been working with the industry to develop variable usage and freight only line charge cost estimates that could inform caps on certain freight charges in CP5. The work that we have carried out to date can be summarised as follows:

- **September 2011**: Network Rail published an industry letter setting out its proposed methodology for calculating initial cost estimates.

- **October 2011**: Network Rail presented its emerging analysis to stakeholders at the monthly variable track access charging meeting.

- **November 2011**: Network Rail published a consultation on its initial variable usage and freight only line charge cost estimates.

- **January 2012**: Network Rail hosted an industry workshop where it discussed its initial variable usage and freight only line charge cost estimates with stakeholders in more detail.

- **March 2012**: Network Rail published a letter concluding on the, above, November consultation proposing initial cost estimates that could inform early caps on freight VUCs and freight only line charges.

In addition, we have begun work to estimate our “freight avoidable costs”. We have commissioned L.E.K. Consulting (L.E.K.) to carry out this work and have sought to carry out this work in a transparent and collaborative way, and have summarised the industry engagement to date, below:

- **31 May 2012**: Network Rail hosted a ‘kick off’ meeting with stakeholders and L.E.K.

- **27 June 2012**: L.E.K. presented its proposed methodology to stakeholders at the monthly variable track access charging meeting.

- **5 July 2012**: L.E.K. presented an overview of the study at the supplementary workshop hosted by ORR to discuss this consultation.

- **25 July 2012**: L.E.K. presented its initial results to stakeholders at the monthly variable track access charging meeting.

We will provide the results of the L.E.K. study to ORR upon completion to inform its consideration of the level of any new freight-specific charge. In addition, we will also publish the study on our website so that it is available to interested stakeholders.

2.3. Structure of this document

ORR structured its consultation around the following headings and has asked stakeholders to respond to a set of specific questions relating to each of these topics:

- Variable usage charge;
- Framework for a freight-specific charge;
- Freight avoidable costs; and
- Market analysis.

The remainder of this document follows the same structure as ORR's consultation document and provides our responses to the consultation questions. In some instances, issues raised in the consultation document do not relate directly to one of the consultation questions, we have grouped our comments / responses to these issues under the heading "other remarks".

3. VARIABLE USAGE CHARGE

3.1. ORR's position

ORR summarised its position as follows:

- We asked Network Rail to estimate its variable costs and hence an indicative range for the average variable usage charge. Following consultation, it estimated average variable costs which were 5% to 7% higher than those calculated for CP4, excluding any changes to efficiency assumptions. Taking account of the changes it has made in response to its earlier consultation and the review of the independent reporter, we are broadly content with Network Rail's work on this to date.

- We are proposing a cap on the average variable usage charge, across all passenger and freight services, at £1.79 per kgtkm (2011-12 prices) for end CP4 efficiency. This is the best estimate of £1.56 per kgtkm plus a band of uncertainty of 15%. The charge would then be adjusted for determined improvements in Network Rail's efficiency, and our analysis to date suggests the associated reduction in the charge would exceed 15%.

- Network Rail has proposed a cap specific to freight services. We have announced our intention to implement a variable usage charge that is geographically disaggregated, but these proposals are as yet insufficiently advanced for us to be able to propose a cap specifically for freight services that would hold for a geographically disaggregated charge. However, we also recognised that it may not be possible to implement such geographically based charging at the start of CP5. Instead, therefore, we are proposing a variable usage charge cap for freight services that would hold for a nationally-based charge. The cap is as per Network Rail's proposal: £1.68 per kgtkm (2011-12 prices) for end CP4 efficiency, which is £1.46 per kgtkm plus a 15% confidence band.

3.2. Network Rail's current position

Responses to consultation questions

Q3.60 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?

We do not have any further evidence to submit to ORR at this stage. We consider that the variable usage cost estimates set out in our March 2012 conclusions letter are a reasonable basis for setting a cap on VUCs. Further to ORR's request in this document we will, however, review our variable usage cost estimates in respect of civils structures and earthworks.

Q3.61

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

A 15% confidence interval is consistent with what we proposed in our March 2012 conclusions letter. We, therefore, agree that this is reasonable.

Q3.62

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

At the last periodic review, ORR set VUCs at a long-run efficient level. It did this by applying a 34% overlay to our estimate of variable usage costs, reflecting maintenance and renewals efficiency improvement in CP4 and further catch-up efficiency in CP5. We would support setting VUCs at a level that takes into account the forecast efficiency improvement in the forthcoming control period (i.e. net of forecast maintenance and renewals efficiency improvement in CP5).

Other remarks

As you are aware, we continue to strongly oppose the implementation of geographically disaggregated VUCs at this stage. We strongly believe that such a move would be onerous and costly for the industry to implement in CP5. Furthermore, we consider that this policy would not contribute to the industry's CP5 cost reduction challenge in any meaningful way and could have perverse effects. As stated previously, we consider that there may be a case for a more fundamental review of charging but this should be separated from the current periodic review and should be seen more as an input into the next periodic review. To undertake such a review as part of PR13 would not now be practical or appropriate and it would be a major distraction from current priorities. Similarly, we do not consider that it would be desirable to implement fundamental changes in charges during a control period since this would undermine certainty as well as distracting from more urgent priorities. Consistent with this, you will be aware that the Rail Delivery Group (RDG) has written to ORR suggesting that any consideration of geographically disaggregated VUCs should be considered after PR13 has concluded.

We would urge significant caution when benchmarking our variable costs against other European infrastructure managers based on the ‘top down’ ITS analysis. As set out in our comments on the ITS work, we have substantial concerns about the assumptions in the study and the possible material methodological differences when benchmarking our costs against other European infrastructure managers. We agree that our bottom-up approach to estimating variable usage costs provides a better estimate of the costs to be recovered for charging purposes.

We welcome confirmation that if ORR places a cap on certain freight charges this will not affect our funding, even in the unlikely event that forecast costs exceed any caps set by ORR.

4. FRAMEWORK FOR A FREIGHT SPECIFIC CHARGE

4.1. ORR's position

ORR summarised its position as follows:

- We are proposing to introduce a new charge in CP5 for freight operators, to recover infrastructure costs caused by freight operating on the network but not currently recovered from other freight charges (we term these costs "avoidable costs"). These costs would not need to be incurred (and so would be avoided) by Network Rail if freight services were no longer to use the network. This new charge should serve to make freight charges more cost reflective and reduce cross-subsidy[1].

- In considering the implementation of any new charge for freight operators we have to take account of the Railways Infrastructure (Access and Management) Regulations 2005 (the Regulations), which implement Directive 2001/14/EC. The Regulations allow mark-ups (such as a charge to reflect the avoidable costs of freight) to be levied on top of the cost directly incurred (reflected in the variable usage charge) only if the market segment can bear the increase. In implementing any charge, we also need to balance our statutory duties, including having regard to the funds available to the two governments and allowing freight operators to plan their businesses with a reasonable degree of assurance.

- We are consulting on options for the units of the charge, for example a charge per gross tonne mile or a charge per tonne.

4.2. Responses to consultation questions

Q4.49 Do you agree with our proposed approach to satisfying the Access and Management Regulations with respect to levying a new freight-specific charge?

We agree that it is important that any new freight-specific charge is consistent with relevant legislation, including the Access and Management Regulations 2005. Moreover, we agree that ORR's approach to satisfying the Access and Management Regulations, through reviewing the extent to which any new freight-specific charge would meet the discreet aspects of the regulations, is

[1] The charge would replace the current freight-only line charge which recovers the avoidable costs of freight-only lines used by freight trains carrying ESI coal and spent nuclear fuel (which was around £5 million in 2010-11).

broadly appropriate. We note, however, that ORR is proposing the recovery of *avoidable costs* through any new freight-specific charges and that this does not equate to *full cost recovery* as permitted by the regulations. In order to fully recover our costs, it would be necessary to apportion an equitable share of common costs to freight traffic.

Q4.50 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?

We agree that there could be merit in quantifying the level of infrastructure costs allocated to freight operators on the basis of avoidable costs. However, we consider that it would be premature, at this stage, to foreclose the possibility of allocating an equitable proportion of common costs to freight traffic. When operating the network we necessarily incur costs common to both freight and passenger traffic and consider it reasonable that, where the market can bear it, freight traffic makes a reasonable contribution towards these costs. We recognise that the rail freight sector could find this, initially, challenging. However, ultimately, Network Rail needs to finance all of its costs. Conscious of the ‘cost challenge’, we consider that, as far as possible, all operators should contribute towards the full costs of using the GB network.

Moreover, we believe that to an extent ORR faces a policy decision in respect of the level of any mark-up on costs directly incurred to be recovered through the proposed freight-specific charge. This mark-up could range from marginal costs to fully allocated costs and, as noted above, we consider that that it is premature, at this stage, to foreclose the possibility of allocating any common costs to freight traffic.

Q4.51 Do you agree that we should retain our current definitions of particular categories of rail freight commodities as separate market segments?

We are mindful that freight operators manage their businesses on a ‘portfolio’ basis with their fixed costs shared across the various commodities that they transport. However, we consider that ORR should seek to recover a contribution towards our fixed costs only from those commodities that able to bear increased charges. We broadly agree that it is appropriate for ORR to retain its existing definition of particular categories of rail freight commodities as separate market segments. In PR08 segmenting the market in this way facilitated the recovery of fixed costs associated with freight-only-lines from ESI coal and spent nuclear fuel traffic (the market segments deemed by ORR in PR08 able to pay a mark-up on costs directly incurred). We would,

however, suggest that it would be sensible to include bio-mass as a discrete category / market segment given the likely growth in this area.

Q4.52

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?

We agree that it was appropriate for ORR 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. We note, however, that these factors are closely linked because one would expect a market segment that competes more closely with road to be more price elastic, reflecting the increased likelihood of traffic switching from rail to road in response to a price increase.

Q4.53

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

As noted in the consultation, the relevant criteria include the Access and Management Regulations 2005 and ORR's statutory duties as set out in Section 4 of the Railways Act 1993 and other legislation.

We agree that ORR's approach to analysing rail freight traffic (i.e. only applying any charge to markets that are the most inelastic and face little competition from road) broadly addresses the relevant criteria. In addition, we recognise that ORR has sought to balance potentially conflicting obligations under the Access and Management Regulations 2005 (e.g. not excluding market segments that can afford to pay at least the costs directly incurred) with its statutory duties (e.g. to have regard to the funds available to the Secretary of State).

Q4.54

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

We agree that, consistent with relevant legislation, certain market segments should be exempt from any new freight-specific charge. We respond to ORR's questions in respect of the detail of its market analysis, below. We note, however, that to an extent determining which market segments should be exempt is a policy decision that ORR faces because there is no criteria that states, for example, that if a market segment has a price elasticity of demand

more elastic than -0.1 it should not pay a mark-up[2]. This is an approach that ORR has devised.

Q4.55

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

As part of the our work on establishing the level of freight avoidable costs we have asked L.E.K. to consider appropriate metrics for allocating costs to different freight commodities. At this stage, we consider it is too early to say definitively what the most appropriate methodology for allocating costs is. However, due to the difficulty of the task we envisage that for some costs it will be necessary to adopt a pragmatic and relatively high-level approach to cost allocation, for example, using an appropriate traffic metric e.g. tonne miles.

Whilst we agree that, in principle, one could allocate costs that are common to more than one market segment in full to those segments deemed to be able to bear any new freight-specific charge, this appears to be inequitable. We would reiterate that, in our opinion, ORR has a choice in respect of the level of any mark-up and this could range from marginal costs to fully allocated costs.

Q4.56

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?

In order to provide freight operators with some assurance in respect of the maximum level of any new freight-specific charge, we consider that it would be appropriate to place an *ex ante* cap on the proposed level of charges. We believe, however, that it would be impractical and potentially discriminatory to cap the total amount of revenue to be recovered through the charge.

In respect of ORR's proposed traffic cap, we consider that a better approach would be to cap the charge in terms of a forecast maximum decline in freight lifted rather than freight moved. We consider that tonnes lifted is a more appropriate measure because it more closely reflects any switching between road and rail and whether the network is being used efficiently. Under the approach proposed by ORR, theoretically, the cap could be triggered where there has been a forecast 10% decline in freight moved but no decline in

[2] -0.1 represents a 10% reduction in demand in response to a 100% price increase.

freight lifted (due to journey rationalisation). Whilst recognising that any reduction in traffic is likely to be difficult for freight operators to absorb, we consider that it would not be appropriate to cap charges in this scenario where the same amount of ESI coal is being transported on the rail network. We believe that a forecast 10% decline in freight lifted would be a broadly reasonable basis for setting a cap on the proposed level of charges.

In addition to the *ex ante* traffic cap discussed above, ORR also proposes that the revenue generated from any new charge would also be subject to a cap, reflecting the costs to be recovered. We strongly consider that any revenue cap would have to be set *ex ante* and reflected in the determined charge rates, in order to avoid potential undue discrimination. We accept the fact that this approach could result in under or over cost recovery. If the revenue cap was not set *ex ante*, operators could end up paying materially different charges depending on whether they are transporting the relevant commodity before or after the revenue cap has been reached. This would be inequitable because operators could either benefit or be penalised purely as a result of the point in time at which they are operating on the network. In the extreme, two identical journeys, that cause exactly the same costs to be incurred, could be charged at materially different rates if these journeys happen to take place either side of the revenue cap being reached. We consider that our proposed approach would be consistent with freight only line charges in CP4, when ORR capped charge rates not revenue raised.

Finally, Table 4.2 in the consultation document appears inconsistent. It states that if traffic is forecast to fall by 5-10% ORR would consider reducing the charge, implying that the charge could be capped in line with a forecast reduction in traffic of less than 10%. However, it also states that if the forecast reduction in traffic is expected to exceed 10%, the charge would be reduced so that traffic is forecast to fall by no more than 10% on average. We would suggest removing the second row of the table and amending the criteria in the first row to “<10%”.

Q4.57 What should be the unit of the new charge? Please explain your reasoning.

We agree that any new freight-specific charge should be levied on individual journeys, rather than be a fixed charge determined in advance. Moreover, our preferred approach would be to levy the proposed charge on a thousand gross tonne mile (kgtm) basis. However, we recognise that the impact of such a regime may cause some difficulty, in the short term, for freight operators and their customers.

We believe that levying a charge on a kgtm basis would be more cost reflective than using tonnes lifted because one would expect there to be more avoidable costs associated with longer journeys. Furthermore, the kgtm metric

is widely understood and accepted by the industry and would also be relatively inexpensive to introduce from a Network Rail billing perspective.

We note that levying the charge on a kgtm basis is forecast to have a greater impact on freight traffic volumes if journey rationalisation occurs due to longer hauls becoming less competitive. This in turn could impact on the level of the charge if it is capped, as ORR proposes, based on a forecast decline in freight traffic. However, as set out above, we consider a better approach to capping the level of charges would be to do so based on a forecast decline in freight lifted rather than freight moved because this would better reflect any switching between rail and road and whether the network is being used efficiently.

We recognise that levying the proposed charge on a tonnes lifted basis may appear attractive because it would serve to mitigate against journey rationalisation. However, we believe that this approach would be less cost reflective than levying the charge on a kgtm basis. Specifically, it would result in very short and very long journeys paying an identical premium for transporting a commodity (assuming the tonnes lifted were the same) when in reality the avoidable costs associated with the respective journeys are likely to be materially different. Furthermore, because charges are not currently levied on this basis, it would be more expensive to introduce from a Network Rail billing perspective.

We consider that it would be unduly complicated to introduce a charge that is levied on a combination of kgtm and tonnes lifted and, therefore, strongly oppose levying the charge on this basis.

5. FREIGHT AVOIDABLE COSTS

5.1. ORR's position

ORR summarised its position as follows:

- Currently we have preliminary indicative estimates of the scale of total freight avoidable costs not funded by other freight track access charges (around £200m to £250m a year as a central estimate at current levels of efficiency). The revenue associated with the charge would be less than this if it were only levied on certain market segments. Network Rail is undertaking work, which will report in the autumn, to estimate freight avoidable costs. We expect it to engage with freight operators and others in undertaking this work, and we expect to use the company's estimates in making final decisions on a cap on the charge to recover freight avoidable costs. The costs will then be refined further and subject to independent review.

- We are consulting on options for allocating these costs between different market segments.

5.2. Network Rail's current position

Responses to consultation questions

Q5.25 Do you agree with our framework for estimating freight avoidable costs? Please explain any suggested changes to the framework, including your calculations (noting that there will be further opportunities to contribute to this work as the cost estimates are refined during the periodic review, for example in relation to Network Rail's strategic business plan).

We agree that it would be appropriate to replace the freight-only-line charge with any new freight-specific charge because freight-only-line costs are a subset of total freight avoidable costs. However, as noted above, we consider that, at this stage, it would be premature to foreclose the possibility of recovering an equitable proportion of common costs through the proposed freight-specific charge.

As ORR is aware, we have appointed L.E.K. to develop an updated estimate of freight avoidable costs and have been working with the industry to carry out this work in an open and transparent way. We will provide the results of this analysis to ORR upon completion to inform its consideration of the potential level of any new freight-specific charge. In addition, we will also publish the study on our website so that it is available to interested stakeholders.

6. MARKET ANALYSIS

6.1. ORR's position

ORR summarised its position as follows:

Rail freight market segment	Propose to levy a charge to recover market segment's share of freight avoidable costs?
Coal for electricity supply industry	Yes, subject to cap so that forecast traffic does not fall by more than a set percentage (10%?)[3]
Spent nuclear fuel	Yes
Iron ore	Yes (but we particularly seek stakeholders' comments on our analysis, recognising the theoretical possibility of excluding this market segment from use of the infrasturcture).
Biomass	Not as part of PR13, because the market is not yet sufficiently developed. But revisit for CP6 or point where subsidy is revisited (2017).
Coal transported for other purposes	We are considering this further.
Other freight market segments	No, on basis that these markets are more elastic and face greater competition from road freight. This approach is proportionate, consistent with our approach in PR08 with respect to freight-only lines, and with our statutory duties including our duty to contribute to the achievement of sustainable development.

6.2. Network Rail's current position

Responses to consultation questions

[3] The principle of the cap would apply to all market segments to which the charge is levied; but for certain market segments, such as spent nuclear fuel, the forecast demand impact of the charge is negligible so that the cap has little practical relevance.

Q6.83

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?

We believe that ORR's write-up, interpretation and application of the MDST stage 1 and NERA reports is broadly reasonable.

However, we consider that in writing up the conclusions of the MDST stage 2 report, in respect of other coal flows to cement works, ORR has misinterpreted the content of the report. ORR state that the MDST analysis indicates that cement (a subset of the construction materials commodity group) was relatively sensitive to increases in track access charges, and faced strong competition from road hauliers. Hence, it could be inappropriate to levy a charge on other coal, implying an increase in access charges for other coal would result cement traffic switching from rail to road. In our view, the MDST analysis indicates that it is other coal flows to cement works that face competition from road hauliers and it is these flows that could switch from rail to road in response to an increase in track access charges, rather than cement traffic.

Furthermore, we note that ORR's write up of the MDST stage 2 work in respect of ESI coal traffic identifies the analysis as being "indicative"[4] and "illustrative only"[5], highlighting that some important parameters were not based on empirical evidence or calibration. In addition, ORR states that, in practice, there are a number of constraints (e.g. quality of coal required and rail infrastructure bottle necks) that limit the rationalisation of journeys that MDST did not model explicitly. ORR's write up also indicates that MDST developed a new model (Coal Power Station Transport Model) in order to estimate the market response to large increases in track access charges. This gives rise to further concerns that the impact forecast by the model has not been scrutinised previously or validated in the market. Based on the limitations of the MDST stage 2 ESI coal analysis set out, above, and the caution with which ORR refer to it, we believe that, whilst informative, the results are too uncertain to be relied upon by ORR. Instead, we would suggest that ORR's decisions in respect of market analysis and capping any new freight-specific charge for ESI coal should be based on the NERA and MDST stage 1 reports, and any other relevant information.

As stated above, we believe that there would be considerable merit in capping any new freight-specific charge based on a forecast decline in freight lifted rather than freight moved. If ORR were to adopt this approach it would mean that the highly tentative MDST stage 2 analysis would be less relevant.

[4] ORR consultation on the variable usage charge and a freight-specific charge, page 56, bullet 3
[5] ORR consultation on the variable usage charge and a freight-specific charge, page 68, paragraph 6.53

At this stage, we do not have any further evidence that we believe should be considered. We note, however, that the market analysis in respect of ESI coal and spent nuclear fuel appears more comprehensive and robust than the analysis in respect of other market segments, including other coal and iron ore. Therefore, ORR should be particularly mindful of stakeholders' comments in respect of these other market segments.

Q6.84 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?

We agree that based on the MDST stage 1 analysis, and consistent with relevant legislation, that it is appropriate not to levy a mark-up on certain rail freight commodities. The MDST stage 1 analysis shows that the nuclear, coal and iron ore market segments to be less price elastic (forecast decline in tonne kms of 0%-1%) than the other market segments (forecast decline in tonne kms of 4.2%-14.8%) in response to a 100% increase in the VUC. We, therefore, understand why ORR is proposing not levying a mark-up on the latter group of market segments. However, as set out in more detail below, we would be cautious about extending the proposed charge to other coal traffic and would not support levying it on the iron ore market segment.

We note that there is not a prescribed benchmark that determines whether a market segment can bear a mark-up and, therefore, this decision will require an element of judgement.

Q6.85 Do you agree with our proposal to levy the proposed charge on ESI coal traffic?

Network Rail agrees with ORR's proposal that it is appropriate to levy any new freight-specific charge on ESI coal traffic. We consider that a reduction in ESI coal's current 'subsidy' will make rail freight more sustainable in the long run. Moreover, levying a charge on this market segment would also be consistent with the approach adopted in PR08 where ORR deemed that ESI coal traffic was capable of bearing a mark-up on the VUC and, therefore, become subject to freight-only-line charges.

Making ESI coal charges more cost reflective should also result in a reduction in the indirect subsidy to the electricity supply industry. At present, ESI coal traffic, and as a result power generators, generally only pay the marginal cost of using the rail network. Fixed costs are recovered from Government through the network grant. The analysis carried out by NERA assessed the impact of

higher ESI coal track access charges on electricity customers. It found that if ESI coal charges were to increase by £10 per thousand net tonne km this would have a negligible impact on wholesale and domestic electricity prices. Specifically, the weighted average wholesale electricity price would increase by about 0.5% and domestic users annual electricity bills would increase by less than 0.2% (£1 per year). This suggests that the end customers are likely to be able to bear the knock-on impact of higher track access charges.

The market analysis carried out in PR13 also clearly demonstrates that this market segment continues to be able to bear a mark-up due to it's extremely price inelastic demand:

- The MDST stage 1 analysis estimates that, in response to a 100% increase in VUCs, tonne kilometres would decline by only 0.4%.

- The NERA analysis shows that for a £10 increase (3-4 times current charges) per thousand net tonne km ESI coal lifted and ESI coal moved decline would decline by 4.6% and 5% respectively (assuming origins and destinations remain constant).

As noted above, whilst informative, we believe that the results of the MDST stage 2 ESI coal work are too uncertain to be relied upon by ORR. This work would, however, become more or less superfluous by capping any new charge on a tonnes lifted basis, which we consider to be a more appropriate measure.

Q6.86 Do you agree with our proposal to levy the proposed charge on spent nuclear fuel traffic?

Network Rail agrees with ORR's proposal that it is appropriate to levy any new freight-specific charge on spent nuclear fuel traffic. We consider that a reduction in spent nuclear fuel's current 'subsidy' will make rail freight more sustainable in the long run. Moreover, this approach would also be consistent with PR08 where ORR deemed that this market segment was capable of bearing a mark-up on the VUC and, therefore, become subject to freight-only-line charges.

Making spent nuclear fuel charges more cost reflective should also result in a reduction in the indirect subsidy to the electricity supply industry. At present, spent nuclear fuel traffic generally only pays the marginal cost of using the rail network with fixed costs being recovered from Government through the network grant. The analysis carried out by NERA also assessed the impact of higher spent nuclear fuel track access charges on electricity customers. It found that an increase in track access charges would not result in increases in customers' prices for electricity because the cost of nuclear fuel does not materially impact the electricity price.

The market analysis carried out in PR13 also clearly demonstrates that this market segment continues to be able to bear a mark-up:

- o The MDST stage 1 analysis shows that, in response a 100% increase in VUCs, tonne kilometres would not decline at all i.e. the commodity is perfectly price inelastic.
- o The NERA analysis also showed that spent nuclear fuel traffic is perfectly price inelastic. This was acutely illustrated by NERA's modelling of demand in response to a £100 per thousand net tonne km price increase, which showed no impact whatsoever on demand.
- o The MDST stage 2 analysis indicates that moving spent nuclear fuel by rail is already substantially more expensive than road haulage. However, rail is employed because it is perceived as being safer and more secure and thus a substantial increase in charges would not lead to a switch of cargo from rail to road.

Q6.87 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?

On the face of it, the market analysis carried out by ORR indicates that there could be a case for also levying the proposed charge on iron ore traffic:

- The MDST stage 1 analysis shows that, in response a 100% increase in VUCs, tonne kilometres would not decline at all i.e. the commodity is perfectly price inelastic.
- The MDST stage 2 analysis indicates that the road transport costs of transporting iron ore are currently around three times that of rail transport costs and as a result higher track access charges (+£5, +£10 and +£15 per thousand net tonne kilometre) would do little to change this balance.

However, in our view, the market analysis in respect of iron ore is less comprehensive than that for ESI coal and spent nuclear fuel. As such, we consider that ORR should be particularly mindful of stakeholders' comments in respect of this market segment. Moreover, because iron ore traffic does not serve the electricity supply industry, and is limited to a single flow between Immingham and Scunthorpe, we would not support levying the proposed charge on this market segment.

Q6.88

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)?

Network Rail agrees that, at present, there is considerable merit in not levying any freight-specific charge on the biomass market segment, but that ORR should revisit its policy in the 2018 Periodic Review (to coincide with the recalculation of the DECC credit regime). We consider that unlike other market segments identified as being very price inelastic, the biomass market is still in the early stages of development and, therefore, is subject to much greater uncertainty.

We believe that this view is broadly consistent with the market analysis carried out by NERA and MDST. NERA suggests that due to the emerging nature of biomass there is greater uncertainty about the impacts of increases in track access charges on demand for biomass. The MDST stage 2 analysis notes that although the propensity to consume biomass is a function of the level of subsidy that the Government is prepared to provide, the biomass flows that are envisaged do not generally exist at the moment and may be less likely to develop if charges are raised in the same way as for coal.

Q6.89

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

One the face of it, the market analysis carried out by ORR indicates that there could be a case for also levying the proposed charge on other coal traffic (or at least other coal traffic to steel blast furnaces):

- The MDST stage 1 market analysis indicates that, in response to a 100% increase in VUCs, tonne kilometres would decline by 1%.

- The MDST stage 2 analysis indicates that for the largest flows, related to steel blast furnace sites (e.g. Immingham to Scunthorpe), these can generally be considered captive to rail. However, for other coal traffic to cement plants, it is unlikely that there is a clear advantage to using rail relative to road.

We consider, however, that the market analysis in respect of other coal is less comprehensive than that for ESI coal and spent nuclear fuel. As such, we believe that ORR should be particularly mindful of stakeholders' comments in respect of this market segment. In addition, because other coal traffic does not serve the electricity supply industry, and a subset of this market segment

(flows to cement works) appears to be more price elastic, we would be more cautious about extending the charge to this commodity.

As noted above, we consider that ORR’s write up of the impact of higher track access charges on other coal flows to cement plants is not an accurate reflection of the MDST stage 2 report.