Dear Paul,

I represent Fergusson Group Ltd , a UK wide supplier of solid fuels to the household , industrial and the power generation sectors.

I write to you with regards to Periodic Review 13 and specifically the consultation on the variable usage charge and freight specific charge. Fergusson are deeply concerned that the proposals described in this document could have a seriously detrimental impact on the viability of our own business, and also on the wider UK coal industry. This is not just a future issue – it is having an impact now – with successful long term relationships in doubt because of the uncertainty created by the draft proposals.

We have been working with our industry association, CoalImp, on this issue, and will be issuing a response to the consultation. However, given the severity of the potential outcomes. I would also very much appreciate the chance to meet, at your convenience, to discuss our views and concerns. To that end, can I ask if this is possible and what dates you may be available for a meeting in the latter part of July or into August.

Meantime, I take this opportunity to offer some high level views on the issue as follows.

Fergusson Group

Fergusson Group limited (FGL) is one of the UK's leading suppliers of solid fuels, with a growing export record. We deploy a flexible approach to coal sourcing, supporting indigenous UK producers, and importing from international markets through our bulk terminal at Hunterston in Ayrshire.

We have a leading position in the UK domestic "house" coal market, offering a wide range of fuels through national sales and distribution channels. We are also an established and growing supplier to the UK's lead coal generators including Drax, EdF, ScottishPower, RWE and EoN. Our processing facilities and supporting logistics allow us to prepare and deliver bespoke fuel blends to meet the diverse needs of these varied market segments.

Our business model, built up over decades, is heavily reliant on transporting coal from Scottish open cast sites and from Hunterston to the demand hubs further south.

Our presence in the market has been instrumental in delivering healthy competition and diversity of supply, particularly over recent times in which coal generation has been key to maintaining economic and secure power supplies for the UK. Fergusson provide a viable and economic alternative to heavily congested port and rail infrastructure further south.

This business model requires us to run several hundred thousand net tonne kilometres every year. Therefore, given the importance of freight operation to our business and the coal industry in general, we have serious concerns about ORR's proposals both in terms of the quantum of charge that is proposed and on the market distortions which will be created by a wholly distance based recovery model.

Potentially Serious Ramifications

We recognise that Government is seeking to reduce costs and subsidies, however we believe that these proposals would have potentially serious consequences for the industry and the UK in terms of the impact on jobs and investment in the coal production, port, transport and generation sectors. It could also have potential impacts on power prices and security of energy supply as indigenous coal is replaced by imported coal and gas..

Statutory Objectives

There is also a serious question as to whether proposals which we believe could result in up to 25% reduction in coal freight tonne kms are consistent with the statutory objectives of ORR. We are aware that this issue is of particular concern to the rail freight operators.

Cost Recovery – Winners and Losers

Recovering these costs by tonne kms will exacerbate the impact by distorting the established business models and creating winners and losers. In particular it will create material economic and competitive disadvantage for Scottish opencast, suppliers, ports, rail infrastructure and potentially result in significant closures and job losses.

From the consultation document it is clear that that rail costs charged by Scottish operators could rise by a factor of four, five or even more, but with much smaller increases for typical operators south of the Border.

Industry margins are already tight and the notion that these differential costs can be absorbed by the mining industry does not stand up to scrutiny as a review of recent financial performance will demonstrate.

Also, the prospect of local Scottish coal generation picking up all of this coal is not viable , given the planned closure of Cockenzie, and the uncertainty over the long term future of Longannet.

There is no clarity in the analysis as to how much of this Scottish tonnage could be replaced by either additional production from a consent constrained English mining sector, or through ports like Immingham which are subject to logistical constraint issues. Add to that the potential for significant volumes of biomass imports and the logistical situation becomes even more uncertain.

There is also the potential to shift at least some coal transportation to the road network, with all the implications that brings for road traffic volumes, pollution and road safety.

We question whether the "jam spread" of existing freight use only line costs should be considered a precedent in terms of how freight costs should be applied.

Cap on Charges

We find it difficult to assess whether the limiting factor in the analysis is full cost recovery, or what the market can bear. We are also concerned about the definition of the latter and the apparent assumption that a 10% reduction in business activity in any given market sector is acceptable. Under proposals where so much business activity and jobs are at risk at the geographical level, it does appear that the scale of the issue is is masked by the consideration of price elasticity and market impact as the national level.

From our perspective, no reduction in business activity is necessarily justifiable if its full ramification are not understood and it is based on policy decisions which could not have been anticipated and planned for.

Stranded Investments

This is the first time since rail privatisation that an increase in track access charge has been proposed, and also one that has such potentially discriminatory implications. We believe that these changes could not have reasonably been anticipated in terms of investment decisions already taken, including investments by our own company in capital equipment, long term port access, and contracted coal suppliers. We believe strongly that what is proposed is simply not acceptable in respect of historic long term investments, and neither does it offer a reasonable basis or degree of assurance for future investments.

ESI Strategy

We have major concerns around the impact analysis on the ESI. Whilst the method looks to be thorough, utilising known models and techniques, some of the input assumptions are open to serious questions for example the relatively high assumed tonnages of coal projected going forward. We are also concerned as to how the outcomes of the analysis link into UK energy strategy and policy. The references to 5% less coal generation, or up to 2 GW of early plant closures are critical points in relation to UK energy policy given the serious issues around security and affordability being faced over the coming years.

Rail Costs Transparency

We are not experts on the rail costs analysis but share the concerns of our colleagues in the rail freight operators about the correct identification of “avoidable fixed costs”, whether the projected savings could be realistically achieved, and the knock-on effect on the operation of the wider rail network of these proposals, particularly in Scotland and other areas remote from the centre of ESI demand. Much of the analysis appears to be top down, and we have not yet seen sufficient detail. We are also concerned that there has been little evidence presented to support the view that 100% of these “avoidable costs” are tonne kms related.

Conclusion

In short, Fergusson believe that the overall burden of these costs should be absolutely minimised and that a recovery mechanism should be selected to avoid creating significant regional distortions in an established industry. We also believe that further detailed analysis is required to underpin the cost modelling, and to consider the impact on the wider ESI on a joined up basis across both the railway and energy industries before decision are taken that have serious long term ramifications for all concerned.

I look forward to the chance to discuss these issue with you further.

Regards

John Campbell

Commercial Director

Periodic Review 2013 – Consultation on the Variable Usage Charge and on a Freight-Specific Charge

Response from Fergusson Group Limited

8th August 2012

Dear Mr Quill,

I am pleased to respond to the Consultation of May 2012 on behalf of Fergusson Group Limited (FGL).

FGL is one of the UK's leading suppliers of solid fuels, with a growing export record. We deploy a flexible approach to coal sourcing, supporting indigenous UK producers, and importing from international markets through the bulk terminal at Hunterston in Ayrshire.

We have a strong position in the UK domestic house coal market, offering a wide range of fuels through national sales and distribution channels. We are also an established and growing supplier to the UK's lead coal generators including Drax, EdF, ScottishPower, SSE, RWE, and EoN. Our processing facilities and supporting logistics allow us to prepare and deliver bespoke fuel blends to meet the diverse needs of these varied market segments.

Our business model, built up over decades, involves the transportation of significant volumes of coal from Scottish open cast sites and from Hunterston to the demand hubs further south. Our presence in the market has been instrumental in delivering healthy competition and diversity of supply, particularly over recent times in which coal generation has been key to maintaining economic and secure power supplies for the UK. FGL provides a reliable and economic alternative to often heavily congested port and rail infrastructure further south.

Given the importance of rail freight operations to our business and the coal industry in general, FGL has very serious concerns about ORR's proposals both in terms of the quantum of charge that is proposed and on the market distortions which will be created by a distance based recovery model.

We have been inputting to the response made by CoalImp (the Association of UK Coal Importers) of which we are a member. That response sets out the consensus views of the association membership and FGL is generally aligned with the detailed views expressed therein, including the specific responses to the questions raised in the consultation paper.

Given the potentially serious detrimental implications of the ORR proposals to the coal sector, we believe that it is also important for FGL to make a Company representation highlighting what we consider to be the key issues.

FGL recognises that Government is seeking to reduce costs across the board, however, we believe these proposals would have far reaching and unacceptable consequences for the ESI coal sector which cannot be justified on that basis.

The proposals represent a fundamental and unprecedented change in charging policy which would reduce the rail freight market, jeopardize historic and future investments and long term contracts, and place jobs at risk across the mining, ports, rail freight, and generation sectors. They could also have a potentially detrimental effect on power security and energy prices.

These outcomes are significantly exacerbated by the proposed distance related tonne kilometre charging method which would place very significant market distortions on the established industry structure, create "winners and losers" to an extent that could cause a number of market participants to suffer material detriment, and potentially destabilise the physical and commercial structure of the power station coal supply industry.

FGL questions whether it is within ORR's remit to impose changes which will have such serious impacts on the rail freight industry, and also on its customers in an electricity supply industry which is of national strategic importance.

There are a number of specific points which FGL wishes to highlight.

1 - Statutory duties of ORR

1.1 - The NERA market analysis presented by ORR concludes that a £10 increase per thousand net tonne km could result in a reduction in total tonnes of coal moved of 5%. The subsequent analysis from the MDST Stage 2 report associates the same £10 increase with a potential reduction of 23% in coal tonne kilometres.

1.2 – We understand that ORR's role is to regulate the rail market. On that basis we believe that there are serious question as to whether such a significant reduction in rail freight volumes is consistent with ORR's statutory duties, and also as to whether creating such material consequences for the coal generation market is solely within ORR's remit.

2 – Assessing what the market can bear

2.1 - FGL fundamentally disagrees with the proposed change in pricing policy, and the assertion that ESI coal 'can bear the increase', on which it is predicated. This unprecedented change will have a negative impact on jobs and investment in coal extraction, freight and generation, and a potential negative impact on power security and prices at a time when the industry is already subject to major impacts and uncertainty from energy and environmental policy developments.

2.2 - We do not believe in principle that an arbitrary and subjective 10% reduction in business activity in any given market sector is somehow 'acceptable'. We argue that no reduction in business activity is justifiable if its full implications are not understood, and it is based on policy decisions which could not have been reasonably anticipated and planned for by industry participants.

2.3 - Furthermore, ORR have not consulted on whether a 10% reduction in passenger traffic or revenues would be acceptable as a result of an equivalent pricing policy change to that

segment. FGL believes that this potentially leaves the proposals open to accusations of discrimination in terms of their application to ESI freight only.

2.4 - The NERA modelling exercise was commissioned to determine whether the market could bear paying increased track access charges. Given the final conclusion that the ESI coal market could shrink by 5% if charges are increased by £10, then it is very clear that the market cannot bear the increase without material detriment to business activity. When we consider the MDST2 conclusions around a 23% reduction in tonne kilometres in the same scenario, then we have further evidence that the industry and its associated logistics chain cannot bear the increased costs.

2.5 - The proposed 10% test of price elasticity and market impact is exercised at the national i.e. GB level. It is probably true that at this level of analysis, the price volatility in international coal prices is more significant than the proposed increase in rail track access charges. However, the definition of the market at GB level is arbitrary, and masks the potentially significant adverse impact at the regional e.g. Scottish or Welsh level. We highlight that the Scottish market is a significant market within its own right. It accounts for some 30% of GB coal production. From the consultation document it is clear that rail costs charged by operators for journeys from north of the border to the demand hubs in England could rise by a factor of four, five or even more, but with much smaller increases of one or two times for typical operators in England. This significant disparity means that if the Scottish market was considered a sector within its own right, then the market implications would exceed the 10% threshold several times over.

2.6 - This is illustrated very clearly in the MDST Stage 2 report which concludes that the proposals are likely to result in dramatic regional fluctuations. For example, with an increase of £10, the Ayrshire mines will lose 24% of their sales volumes even if they reduce their gate price by £2.50/tonne of coal. Likewise, Hunterston would see a drop in volumes of 41% even after reducing its port charges by £2.20/tonne.

2.7 - Should these supply points be unable to absorb any of the proposed increase in charges, then the geographic volume impacts would be likely to be even greater. Industry margins are already tight across the mining and rail freight sectors, and the notion that any significant differential costs can be absorbed does not stand up to scrutiny, as a review of recent financial performance of market participants will demonstrate. Whether through reductions in volume or pricing, or a combination of both, the detrimental consequences for the Scottish sector are very clear.

2.8 - From the points above, it is clear that recovering the additional costs by tonne kilometres will exacerbate the adverse impact by distorting the established business models and creating material winners and losers.

2.9 - In considering how infrastructure costs should be allocated for rail freight, FGL would draw ORR's attention to comparisons with how similar costs are recovered in the road haulage industry.

2.10 - In conclusion, FGL believe that the MDST Stage 2 analysis clearly indicates that the market cannot bear the modelled increases of £5, £10 or £15 per thousand net tonne km either at the GB level or the Scottish level. The increase will create material economic and competitive disadvantage for Scottish opencast producers, ports, and rail operators and

potentially result in significant closures, job losses, and lost investment, often in rural communities which are already economically disadvantaged.

3 – Impact on Investment and Structural Arrangements

3.1 - FGL believes that the unprecedented increase in track access charges, exacerbated by significant regional skewing, is inconsistent with ORR's duty "to enable persons providing railway services to plan the future of their business with a reasonable degree of assurance" and "otherwise to protect the interests of users of railway services".

3.2 - The previous consistent experience of price stability and efficiency gains through time has shaped the current industry structure, coal flows, and history of investment.

3.3 - FGL believes that such a dramatic increase and structural change in charges could not have reasonably been anticipated in terms of investment decisions already taken in the coal industry, and long term contracts already struck covering the period of 2014 onwards, on the basis of understood principles and experience.

3.4 - Therefore, we argue that the proposals are unreasonable. They will undermine existing investments, creating stranded assets in the mining, port, rail freight and generator sectors. They will undermine long term contractual arrangements struck on the basis of established principles and experience within the industry, leaving a number of significant commercial issues which could threaten industry performance.

3.5 - FGL also believes that the radically different basis for future pricing described in the proposals introduces a degree of uncertainty and complexity to the industry and certainly does not offer a reasonable basis or degree of assurance for future investments. We note that alternative modes of transport including road and sea freight are not subject to this degree of complexity.

4 - Market analysis

4.1 - FGL has significant concerns with aspects of the NERA modelling, in particular the modelled base case around projected coal demand from generation, and assumptions about future generating plant strategy with regard to the Industrial Emission Directive (IED). The forecasts employed appear significantly different from other industry views, including DECC's base case view. If the base case is flawed then there must be serious doubts around the validity of the modelled outcomes regarding track access charging, and the robustness of any ORR decisions arising out of that analysis.

4.2 – We appreciate that modelling work can never fully encapsulate the complexity of "real world" market conditions, however, with regard to MDST's modelling work we would highlight that there are a number of detailed factors which have a significant impact on actual coal supply patterns which are not obviously taken account of. These include coal specification (eg NOx and SOx content), station specific factors e.g. emissions, port specific factors including tonnage constraints and size of vessel which can be accommodated, and existing long term contractual arrangements for port capacity, coal supply and rail haulage.

4.3 – One specific point is the assumption that mine output is price-elastic and can be linearly increased or decreased. Generally this is not the case, and mines have to operate as close to maximum capacity as possible, to remain viable. Therefore, a 24% loss of volume market share for Ayrshire opencast mines could simply not be absorbed. It would likely lead to the complete closures of mines. Neither would it be practical for English deep mines to ramp up output to replace lost Scottish production. Either the GB market would shrink, or the lost indigenous production would be replaced by more imports.

4.4 – Neither the NERA nor the MDST reports have captured the potential impact of biomass on the whole coal demand, supply and logistics equation. The use of 2011 biomass data does not adequately inform decisions relating to freight charges for the post April 2014 period. Furthermore, the notion that increases in freight charges for biomass could be covered by future increases in ROC support levels is highly questionable, especially in the context of recently announced biomass support levels lower than those proposed in DECC's initial consultation. We believe that considerably more attention is required to be given to the logistical and economic impact of potential future biomass flows, especially considering the relatively higher bulk transport requirements of these lower calorific value fuels. A major uplift in co-firing or full unit conversion as a result of the new ROC bands will have significant implications for future port and rail capacities, and related commercial and investment decisions.

4.5 – Generally, it is not clear that the analysis has adequately addressed how much of the lost Scottish tonnage (imports and mined) expected under the proposals could be replaced by additional volumes from constrained English mines and ports. Add to that the potential for significant volumes of biomass imports and the logistical situation becomes even more uncertain.

4.6 - There is also the potential for the proposals to shift coal transportation to the road network, in conflict with Government and Local Council objectives.

4.7 - Despite the modelling issues described above, we do believe the Stage 2 Report captures the key outcomes implied by ORR's proposals, for example, the significant loss in business for one of the UK's principle coal-producing regions, and the potential for a major port having to "drop out of the English power station market".

5 - ESI Strategy

5.1 – FGL is concerned as to how the outcomes of ORR's analysis and the resulting proposals link into broader UK energy strategy. The references to 5% less coal generation, or up to 2 GW of early plant closures are critical points in relation to UK energy policy given the serious issues around security and affordability being faced over the coming years.

5.2 – We highlight that Coal fired power stations produce over a third of our electricity, and in recent winter months coal's share has risen as high as 50 per cent, as it proves highly competitive with gas.

5.3 - The UK energy market is undergoing a major transition driven by the objectives of carbon reduction, security and affordability. A range of UK and EU legislative changes will underpin this transition, including DECC's Electricity Market Reform, and the EU Industrial

Emissions Directive. There remains considerable uncertainty as to the precise nature and implications for coal generation of many aspects of these new legislative regimes

5.4 - It will take time to reshape our generation fleet and, in the interim, coal will remain critical to maintaining secure and affordable power supplies. Through this transition period it will be vital to ensure that coal generating plant does not close prematurely before the new low-carbon generation comes on line. It is, therefore, vital that rail-freight charging policy does not add to the existing levels of uncertainty, and that it is joined up with broader energy policy.

6 - Rail Costs Transparency

6.1 – FGL is not expert on rail costs but we recognise that the correct identification of "avoidable fixed costs" is key to ORR's analysis and proposals. On that basis, we are concerned that many of the cost elements appear to be high level estimates derived from engineering judgement rather than from firm cost evidence. We are also not clear as to why a 15% confidence interval is required. We would have expected that track maintenance and replacement costs would be more accurately forecast.

6.2 - We note that ORR has instructed Network Rail to undertake further analysis to determine freight avoidable costs. We question whether this task can be accurately undertaken within the indicated timeframe to the levels of assurance and quality required to inform such vital considerations as freight charges. We are concerned that a "top down approach" may be deployed rather that a more accurate and robust "bottom-up approach".

6.3 – We believe that the key consideration for appropriate costs must be whether they could be demonstrably saved if there was no freight. In addition, we do not believe that freight should pay for any costs that are attributable to existing, historic inefficiencies in the network infrastructure.

6.4 - We are unclear as to the implications for the maintenance, investment and wider use of the railways on the lines affected by lower freight volumes, especially in Scotland where we expect that the proportional impact on freight volumes would be most acute.

Conclusions

FGL fundamentally disagrees with ORR's draft proposals, the basis upon which they have been derived, and the means by which it is suggested they are to be applied.

We believe that, at the very least, the overall burden of these costs should be absolutely minimised and that a recovery mechanism should be selected to avoid creating significant regional distortions in an established industry.

Therefore, we request that ORR should revise its proposals to avoid significant detrimental impacts and to ensure that industry participants across the chain can plan their business with a degree of confidence, and build on the positive progress which has been made in the rail freight sector since privatisation.

We also believe that further detailed analysis is required to underpin the cost modelling, and to consider the impact on the wider ESI on a joined up basis across both the railway and energy industries before decision are taken that could have serious long term ramifications for all concerned.

John Campbell

Commercial Director