Periodic Review 2013: Consultation on the variable usage charge and on a freight specific charge

Response from Rail Freight Group

July 2012

1. Rail Freight Group (RFG) is pleased to respond to the ORR's consultation on the variable usage charge and on a freight specific charge. This response may be placed on ORR's website in full.

2. RFG wrote to Richard Price on 28 May setting out our initial concerns on the proposals in this consultation. A copy of that letter is attached to this response. The points raised in that letter remain valid, and should be considered as part of this response.

Summary

3. In summary, we support the ORR undertaking early analysis of freight charges, and of the proposals to place a cap on variable charges. Although some issues remain with the work on variable charge, we are broadly content with the approach to date.

4. Overall however we are concerned that the proposals in the consultation, and in other parts of ORR's PR13 work, have the potential to destabilise the rail freight sector, and damage customer and investor confidence.

5. In particular, the proposed charging structure is unduly complex, and there remain many uncertainties over the impact of potential changes on operators and customers, which will not be addressed by the cap – for example, geographic charges.

6. We are concerned at the very large increases in charges proposed for ESI Coal and other traffics. The proposal that the charge should be set to target a 5-10% reduction in volumes is particularly concerning as it suggests a change in regulatory policy towards pricing off demand which, if established as a principle, will severely affect confidence in Government policy for rail freight and consequently in investment in the sector.

7. We consider that the level of reduction in freight tonne-kms is excessive, and does not fit with the test of what the market can bear. We note that the MDS analysis of a 23% reduction already assumes that the supply chain could absorb some of the increase – the volume impact would therefore be even higher if that did not materialise. The proposal to cap at a 10% reduction pa does not appear to be workable, and 10% pa still remains a significant impact on the sector, greater than previous trends.

8. We would therefore propose that ORR

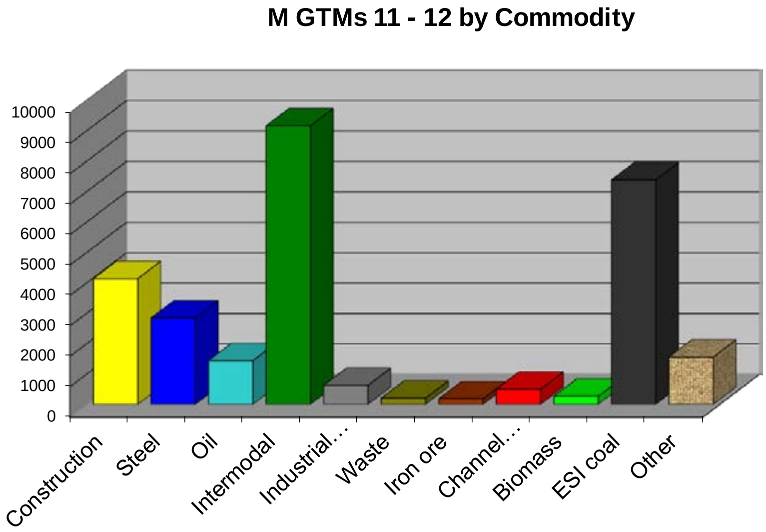
    a. Cap variable charges as proposed, and provide clarity on the likely range of efficiency overlay, to build customer confidence
    b. Continue to levy freight access charges on a simple, national basis, to minimise complexity
    c. Reconsider the likely level of increase for ESI coal and other commodities that the rail freight market, and end consumer market can bear. If any increase is to be levied, it should be sufficiently small to avoid significant reduction in volume, and minimise second order effects.

General Comments

Context for the Freight Market

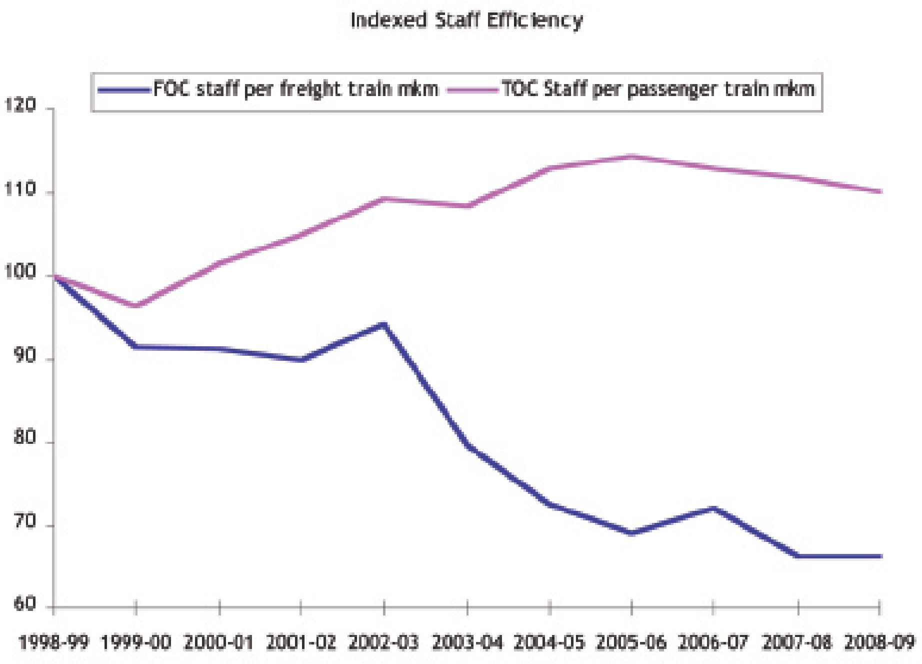
9. Through difficult economic times, the rail freight sector has sustained its performance in recent years. The last full year to March 2012 saw a 10% increase in total freight moved, with construction materials up 7% and intermodal up 11%. Coal volumes were up by 18% in the year.

10. Using Network Rail's data, the 2011/12 breakdown by commodity shows how intermodal has now become the leading commodity on rail, with volumes comparable or in excess of coal. Construction and steel also sustain sizeable volumes on rail. (Note that these gross tonne-km results are slightly different to the ORR statistics which are shown as net tonne-km)



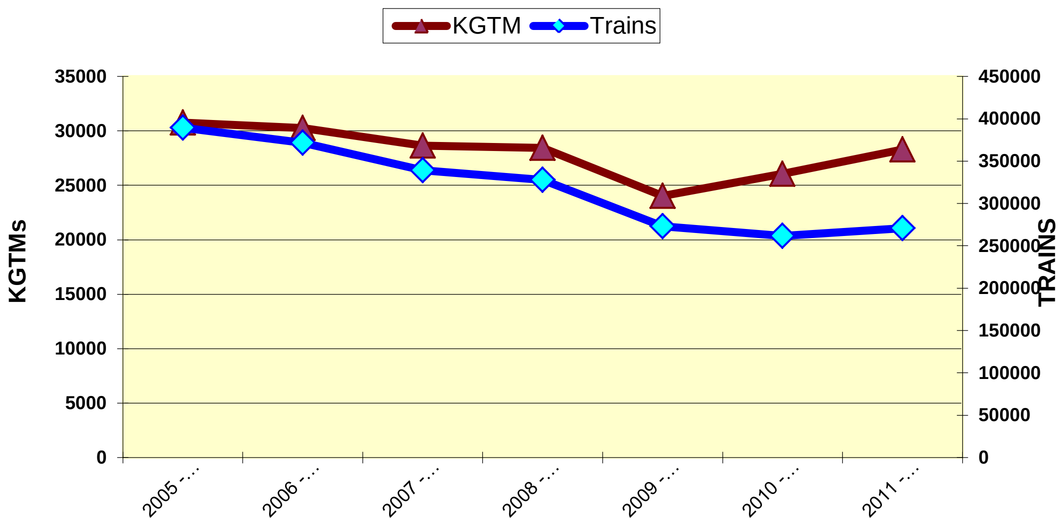
11. Intermodal volumes have now grown consistently year on year since 2002/3, including through the recession.

12. Since privatisation, and, as recognised by Sir Roy McNulty, the rail freight sector has delivered considerable efficiency gains, as demonstrated by the graph in the ‘Realising the Potential of GB Rail’ (Rvfm) report’.   The chart shows how headcount efficiency has been improved since privatisation, driven by the competitive marketplace, and also through investment in modern equipment.



13. Further information provided recently by Network Rail also shows how rail freight has improved its productivity since 2005, with the KGTM’s per train improving by 32% over that period. This has been driven by longer trains, better utilisation, the effects of gauge clearance and, perhaps through the recession, a drive by customers to make the best use of the services and facilities which they have.

14. These charts demonstrate that the rail freight sector is continuing to grow, and also to evolve to respond to the changing market. And importantly for this consultation it continues to strive for greater efficiency.



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15. Rail freight is of course wholly in the private sector and operates in a competitive market between rail operators and with road freight. Competition has led to improved service quality, allows customers choice both on rail and between modes and keeps prices for end customers competitive. It could also be argued that competition is driving innovation in the sector.

16. However, although the rail freight operators are succeeding in growing their businesses, profit margins remain thin. Their ability to absorb additional financial exposure is slim.

	FL	DBS	GBRf	DRS	Industry Total
Y/E	26/03/2011	31/12/2010	31/12/2010 (9 months)	31/03/2010	2010
(£ millions)					
Turnover	293.4	401.0	43.6	45.0	783.0
PAT/(LAT) (excl. Asset Sales)	3.3	(13.0)	0.8	2.3	(6.6)
PAT Margin (excl. Asset Sales)	**1.1%**	**(3.2%)**	**1.9%**	**5.0%**	**(0.84%)**

17. In summary therefore, the rail freight market continues to grow and continues to improve its own efficiency. However, the financial and competitive environment remains tight.

Government Policy and Rail Freight

18. The policy context for this review is framed by the McNulty Review, the Government's Command Paper and the recently published High Level Output Specification and Guidance to ORR, as well as by the relevant legislation and ORR's statutory duties.

19. These documents set out the need for continued pressure on cost reduction and efficiency across the rail sector, but also demonstrate Government support for rail freight and for ensuring that rail freight can continue to function as a competitive and increasingly efficient sector.

20. Rail freight operators have been engaging fully with the various initiatives emerging from these documents. For example, the rail freight operators have provided an initial list of those line sections where they would forgo future rights, allowing Network Rail to downgrade the route and materialise cost savings. We are unaware of the progress in assessing this list, which we note has not yet had wider consultation. Nonetheless, it is further evidence that the freight community is prepared to embrace the need for cost savings.

21. However, none of the recent Government publications has suggested that a change to regulatory policy for rail freight which, effectively, reduces demand, should be pursued. There is also no compelling evidence in these documents that the rail freight sector, and its pricing structure, is a significant contributor to the costs of the UK rail network.

22. In her recently reissued Guidance to the Office of Rail Regulation, the Secretary of State clarified Government policy in respect of rail freight;

> *The Government recognises the important role that rail freight plays in the nation's logistics and in the achievement of the Government's sustainable distribution objectives. The Government wishes to facilitate the continuing*

development of a competitive, efficient and dynamic private sector rail freight industry and is committed to ensuring that policies and regulations should work to this end and should not create unnecessary transactional costs or other obstacles to the achievement of these objectives and future growth.

In an industry where planning and operational decision-making are increasingly devolved, the Secretary of State wishes ORR to have regard, in exercising its statutory functions, to the importance of sustaining efficient and commercially predictable network-wide freight operations, including in decisions about access rights and charging structures.

The Secretary of State wishes the ORR, in developing any proposals, and in making decisions in relation to rail freight, to note particularly the Government's rail freight policy. The Secretary of State wishes to be advised by the ORR of, and to discuss with the ORR, any material measure which the ORR proposes to take or policy which it proposes to pursue which would adversely affect the competitiveness of rail freight compared to other modes.

23. We would therefore expect the conclusions of this consultation to take account of this Guidance.

24. There are also questions around how ORR have chosen to balance its duties, and in particular whether undue weight has been given to the duty to have regard to the funds available to the Secretary of State perhaps at the expense of the duty to promote the use of the railway for the carriage of passenger and freight, and the duty to enable companies to plan their businesses with a reasonable degree of assurance.

25. Uncertainty on the variable charge, new charges such as capacity charges and also the structure of charges is causing concern right across the sector, and risks a loss of confidence in potential customers. This stems both from the lack of assurance about the level and structure of future charges, but also from the perception that there has been a change in regulatory policy for some market sectors which could, in future, also apply to other sectors.

26. An early decision, not just on the cap for the variable charge, but also on the future structure of freight charges would help to address this, so long as a simple stable and affordable regime is retained.

Complexity

27. This consultation is only part of the work programme for PR13 which will directly impact on the rail freight operators and their customers. We are concerned to ensure that the overall impact on freight operators is considered, and that the changes are not ‘salami sliced’ into a series of individual consultations which are concluded on case by case.

28. At present, the proposed changes relevant to the financial risk and exposure of freight operators can be summarised as follows;

Charge	Potential Change	Note
Variable Charge	+5%?	Unclear how cost increases, and future efficiencies will offset. Already varies by wagon, locomotive and commodity.
Freight Only Line charge	Increase of around £1m	For Coal and Nuclear sectors
Traction Electricity Charge/ Electricity Asset Usage Charge	?	Potential change presently unknown
Capacity Charge	?	To be recalibrated
Coal Spillage Charge	X2	Initial work suggests level of this charge might double
Freight Specific Charge	£50-60m	For ESI Coal, Nuclear, Iron Ore, subject to review of avoidable costs
Route Efficiency Benefit Sharing for 10 routes	-£8m to +£20m	Noting that range and baselines may vary with each route.
New Capacity Utilisation Charge	?	Interface with existing capacity charge also unclear at this stage
Geographic charges	?	Although overall could be broadly neutral, likely to have different impacts for each operator and customer
Schedule 4 and 8 not compensating 100%	?	Impact unknown at present, impact negative
Exposing operators to change in NR's costs at periodic review	?	Depending on mechanism may, or may not affect freight.

29. As can be seen from the table, there is considerable uncertainty around the total level of charges, as well as in the way they will be applied. There is potential for the combined outcome to represent a significant increase in overall charge for all commodity sectors, as well as an increased regulatory burden through the complexity of charges.

30. The proposals to cap freight charges, as discussed below, are welcome, but in any case only cover the first two charges in the above table. Presently, this would represent around 75% of the total freight charges, but with the addition of new charges and regimes, the capped charges could well be a smaller proportion of the total exposure.

31. Before ORR conclude on the implementation of particular charges, it is therefore imperative that an *overall* impact assessment for the freight sector is undertaken to look at the combined effects of these proposals, both on affordability and on regulatory burden. ORR should consider how the charging structure could be simplified considerably for nationwide freight operators, in line with the principles of better regulation.

32. ORR may also wish to consider whether some of the proposed new charges also represent a mark up to the variable charge and must therefore be subject to the

affordability test, or whether the legislation allows them to be considered outside this test. It would be helpful if this could be clarified.

33. The proposed structure for rail compares to the road sector, where the charging regime comprises an annual VED charge, plus fuel duty. Even proposals for lorry charging recently consulted on by Government were based on a simple annual tariff. The proposed complexity will therefore place rail freight at a competitive disadvantage when tendering for business, and will perpetuate the belief that rail freight is too complex.

34. We note that Sir Roy McNulty recognised these points, concluding that;

*The Study recommends that **freight access charges** should continue to be:*

- *administered centrally and levied on a national and homogenous basis; and*
- *compliant with European Directives.*

35. This conclusion is at odds with proposals to differentiate freight charges by market or geography, as currently proposed.

Specific Comments on Consultation document

Variable Usage Charge

3.60 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?

Network Rail Analysis

36. RFG has responded to the NR consultation, and we note that a number of improvements have been made during and after the consultation period.

37. We remain concerned over NR’s approach to non track assets, particularly to masonry structures, where the simple linear approach to the variance between traffic levels and damage may be unduly simplistic.

38. We note that ORR’s reporters have also flagged concern over NR’s analysis for earthworks and structures. Although these areas represents a small overall part of the variable charge, they are a significant part of the increase in charge. We are therefore pleased that ORR is asking NR to refine its analysis in these areas prior to final conclusions.

Cost variability for rail assets

39. As outlined above, we continue to have some concerns over NR’s assessment of structures, and also with the conclusion that certain wagon types, which are themselves incentivised through the charging framework established at CP4, are causing greater damage than could have been anticipated.

40. The further analysis which ORR have requested NR to undertake should look specifically at this area, taking advice from the wagon manufacturers.

41. Although we recognise that some impacts could not be identified in advance, it does just highlight the problems with setting incentive structures based on incomplete or immature data. For wagon manufacturers and suppliers, it is imperative that consistent messages are provided on the desired requirements. Frequent changes in direction are not acceptable for those building equipment with 30 year asset lives.

42. We would also suggest that the persistent use of the Settle and Carlisle route as a case study example is unhelpful, as its nature, geography and recent history make it untypical. Whilst lessons may be drawn from experience on this route, it would not be appropriate to scale it up as a proxy for network wide analysis.

Efficiency Overlay

43. We recognise that the translation of NR variable costs to freight charges cannot be completed until the final efficiency targets for CP5 are confirmed. However, there is considerable confusion regarding the application of efficiency targets to the costs, including the interaction with the CP4 efficiency targets – which looked at a 10 year horizon – and the forward basis for the CP5 targets. This needs to be clarified, so that there are clear expectations of the range of efficiency which may be applied to the charges.

44. We would also urge ORR to consider whether a 10 year efficiency deal can again be applied in this charges review, to support the long term growth forecasts and industry investment over the period.

Geographic Charges / Capacity Charges

45. Although not part of this consultation per se, we remain concerned at the potential impact of geographic charges on the freight market, potentially coupled with capacity charges on busy routes. Customers and developers are already raising concerns over the impact on their business propositions, and wishing to understand what the future charges framework for proposed facilities and rail flows might be.

46. The Government's recent HLOS, and the future development of the Strategic Freight Network is likely to provide increased capacity on certain routes for freight, in some cases diverting traffic away from busy passenger routes. There are also routing options which need to be assessed in the next year or so as feasibility work for CP5 investment proceeds. It would be perverse if this work was undermined by a charging structure with different aims and objectives.

47. We would therefore strongly support maintaining freight charges on a national basis, disaggregated by wagon type, as now.

48. As above, we are concerned by the overall complexity in charges which is being proposed. In particular the application of geographic charges on top of wagon based charges will multiply the already extensive set of freight charges, and it is unclear how any clear incentive will be possible in such a system. ORR should prioritise the critical areas it wishes to incentive for freight operators and focus on that.

49. Further, if ORR decides to proceed, any incentive framework set by geographic charges must be set once, and remain consistent across future control periods. This is vital for freight customers seeking to invest in facilities such as terminals. This will require regulatory intervention, as modelled results, e.g. from VTISM, will tend to vary with traffic levels, and it would be possible for the relative charges for different routes to 'flip- flop' at subsequent control periods if traffic moved routes in response to a price signal.

50. We also note that the application of a capacity charge, in addition to geographic breakdown of variable charge, has the potential to increase charges overall. This must therefore be subject to the affordability test.

Evidence from Other Railways

51. We note the work being undertaken by ITS on benchmarking levels of variability with other European Railways, and await its publication.

52. Other similar benchmarking studies have found it difficult to secure comparable data across other railways. The ITS study should therefore be mindful of this.

53. We note that the majority of the variable costs in the UK are assessed using the VTISM model, which ORR's reporters were 'generally happy' with (para 3.35). Any significant difference in levels of variability between NR and other European railways would therefore need to be justified against the validated outputs of this model.

Proposed Cap

54. We strongly support placing a cap on the variable charge, as a way of building business and investor confidence. We broadly agree with the methodology used to determine the cap. However, a 15% confidence interval still represents a fairly substantial potential increase in rates, and this emphasises the need for clarity over the expected efficiency ranges from PR13, as applied to freight charges.

55. We are concerned over the comment in para 1.4 which states that material evidence during PR13 could cause ORR to set charges higher than the cap. This is counter-intuitive, and makes the proposed cap almost purposeless. If the cap is agreed, ORR must confirm that the variable freight charges set for PR13 will not exceed the cap. As the purpose of the cap is to increase business confidence, it is important that this commitment is made to enable businesses to plan with some degree of certainty.

56. It is of note that even with the cap on variable charges in place, freight operators and their customers are still exposed to considerable uncertainty in other parts of the charging proposals, for example from geographic charges.

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

57. As the majority of the variable costs are estimated using VTISM, we would expect that greater levels of certainty should be possible, particularly if VTISM is fully validated. We therefore consider that 15% remains 'high side'.

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

58. We are content with this approach, which sets freight caps at end CP4 efficiency levels. However we would expect actual charges, when confirmed, to reflect long-run CP5 efficiencies. ORR should consider whether a similar approach to 10 year efficiencies could be included for CP5, as was for CP4.

Framework for a Freight Specific Charge

59. We are particularly concerned with this section of the consultation, which seeks to establish a new freight specific charge. Our concerns are;

    a. *The precedent and principle of the new charge*. The proposals to significantly in increase the level of charge for some sectors is a significant change of policy for freight charging, moving away from the charge recovering 'wear and tear' costs only. The consultation also suggests that an explicit aim of the charge is to reduce demand for rail freight in affected sectors by 5-10%.

       The policy decision to price off demand for freight is particularly concerning, and raises concerns across other market sectors. It does not appear to be backed up in the recent Guidance, and it is unclear how ORR have concluded that this is acceptable.

    b. The interpretation of 'what the market can bear' The Regulations permit a mark up 'where the market can bear it'. The definition of this is critical to this debate. We would consider that a significant reduction in rail volume as a consequence of the charge would not fit with a definition of 'bear it'. We note that the MDS study which assessed a doubling of VTAC concluded that the market impact would be less than 0.5%; this, for example, might well be within the definition of what the market can bear. However, a £10 increase leading to a 23% reduction (which itself assumes behavioural change by ports and pits) would appear to us not to be something that the market can bear. We are surprised that further assessment of other increases between these points has not been undertaken.

       The proposals to cap the impact of the charge appear unworkable as described – and in any event it is unclear why this is a better solution than simply setting a lower mark up. A 10% reduction is itself difficult to accept as meeting the criteria.

    c. Second order effects on other market sectors. Whilst the market analysis has addressed the direct impacts on the specific sectors, wider second order effects have not been addressed, such as the impact on the market for freight operators, or, to any significant degree, ports, producers or the supply side. For the rail freight operators, impacts include a faster reduction than anticipated from previous coal forecasts, consequential job losses and depot closures, knock on effects on other sectors from a smaller business base and financial risk of passing on some part of the charge to customers.

60. If ORR wishes to increase charges for ESI Coal, and other commodities, we consider that the increase must be sufficiently low that it can reasonably be absorbed without any significant loss of volume, and that second order impacts are minimised.

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

61. We note that the Access and Management regulations permit a ‘mark up’ to be levied, subject to the principles set out in para 4.10 of the consultation, and subject to the test of whether the market can bear it.

62. As outlined above, we are concerned that the freight specific charge, at the level proposed, acts to price off demand. The forecast reduction in freight traffic suggests that the proposed increase cannot be borne by the market, because the consequential loss in volume will impact on the freight operators, on ports and on coal production. Although the level of increase is not understood for other sectors, it is likely to have similar impacts in the steel and nuclear sectors.

63. To the extent that ORR decide to increase charges for any sector, (and see further comments below), we consider that the increase must be sufficiently small that it can reasonably be absorbed without loss of volume, and that second order impacts are minimised.

64. If an increase is introduced, it must be done so in an efficient and simple manner, which minimises transaction costs for Network Rail and freight operators.

65. In regards to the criteria set out in the Access and Management Regulations, and as per para 4.10 of the consultation, we note as follows;

    a. *Transparency*; whilst the charges are being assessed on a consultative basis, the resulting charging structure is likely to be complex – particularly when taken overall, and not just for the freight specific charge. The test will be whether the charging framework overall is sufficiently transparent.

    b. *Non Discriminatory* The proposals could have discriminatory effects between different end customers, ports and operators which have not been fully assessed.

    c. *Full Recovery of Costs* The charge should not over recover. Full recovery may also not be achieved if the market cannot bear such a level. Any increase will of course be a contribution to cost recovery.

    d. *Efficient Principles* See consultation question below.

    e. *Optimal Competitiveness* We agree that competition with road is a vital consideration when assessing market sectors. However, that does not mean that sectors which do not compete with road are immune from the effect of increased costs. Increased costs will affect business decisions, investment priorities and for multi national businesses, the desirability of trading in the UK.

    f. *Market Can Bear* The interpretation of this phrase is key to this consultation and to the proposals. As the Regulations and Directive give little guidance on its interpretation, we consider that it must be assessed by ORR against their Statutory Duties, and Guidance from the Secretary of State. In particular, ORR should justify why a specified targeted reduction in rail volumes can be justified against this criteria. We note that charges must not be set so as to exclude a sector from rail which could afford to pay the directly incurred costs. We consider that this is not, in itself a definition of what the market can bear but rather a ‘backstop’ provision.

4.50 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?

66. To the extent that any charges are levied, we agree that it should be limited to freight avoidable costs.

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

67. We agree that the categories of rail freight commodities as shown are appropriate, although within those categories there may be distinct sub sectors which warrant analysis.

68. However, this segregation does not pick up important second order impacts affecting the market in other ways. For example, it does not pick up the effect on the market for the provision of rail freight services. It does not pick up the effect on the market for the provision of port services. As the Regulations do not specify how 'market' is defined, we consider it vital that these market impacts are also properly assessed.

69. In the port sector, for example, the effect of these proposals is to create competitive advantage for some ports, and competitive disadvantage for others. The extent to which it is reasonable for Government policy to cause such effects needs to be assessed.

70. For the freight operating sector, no proper assessment of impacts has been included. . Such an assessment needs to cover;

    a. The impact of accelerating the decline in coal traffic ahead of that forecast by DECC on rail freight businesses
    b. The competitive impacts of targeting longer distance flows
    c. The impact on other market sectors from a overall reduction in FOC's business
    d. The impact on operator finances from risk and cash flow exposure to the new charge, the impact on their borrowing ability
    e. The impact on potential new markets, such as biomass, through pricing uncertainty.

71. The initial impact assessment shown by ORR at the 5 July seminar makes no attempt to incorporate such factors, even on a qualitative basis.

4.52 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?

72. We agree that road / rail competition is an important factor. However the impact on freight operators, their wider business, investor confidence across the rail freight sector, and the interface of this proposal and other charging proposals also needs to be considered.

4.53 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?

73. Broadly we agree with the criteria, but we consider that the assessment has given insufficient weight to wider impacts, and to other relevant markets.

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

74. Yes.

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

75. In para 4.1, it is stated that the purpose of the freight specific charge is to 'improve efficiency by reducing cross subsidy and making charges more cost reflective'. Given this aim, it is wholly perverse to suggest in para 4.38 that common costs could be allocated in full to some market segments.

76. Indeed it is arguable that even pro- rating costs by tonne-km or tonnes does not meet these criteria. The assessment of freight avoidable costs will identify costs associated with particular routes, and resources which may not be evenly spread between commodities. For example, timetable planning resource may be disproportionately associated with the coal sector. Performance payments may be more associated with intermodal traffic which tends to operate alongside passenger services. Whilst pro rata approaches may be mathematically pragmatic they do not meet the criteria of cost reflectivity.

77. We consider that the freight avoidable cost study should address this issue.

4.56 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?

78. We certainly agree that the mark up should be set at a level that the market can bear. We do not agree that this should necessarily be via a 'cap' but by setting any increase at an appropriate level in the first place.

79. It is wholly unclear how the cap would be assessed, monitored and enforced. For example, how will the effects of any charge increase be separated from the effects of the market? Will the charge be 'turned on and off' according to traffic fluctuations, and how will this be managed, to avoid market distortions between operators and customers?

80. We therefore consider that the cap is unlikely to be workable, and a better approach would be to set any increase at a very much lower level from the outset. The level of any increase should be set to avoid any significant contraction for freight operators.

81. Para 4.46 is particularly concerning, appearing to suggest that the cap would be 10% per annum. This has a number of effects (i) it creates a spiral of decline (ii) the annual change in the level of charge makes it impossible for operators to plan, and for customers to understand what rail will cost. This is unacceptable.

82. Although there have been historic fluctuations in the coal sector, we do not agree that this is an applicable test for 'market can bear'. Any reduction caused by an additional charge imposed by Government is over and above market fluctuations; the combined effect could well be greater than the '10% cap' depending on how this was measured. Also, market fluctuations can be up as well as down, whereas the charge is downside only.

83. Based on ORR statistics, since 2002/03, the annual change in coal volumes has increased on 6 occasions and reduced on only 3. Taking the last 5 years, it has risen on 2 occasions and fallen on 2. So whilst the market has absorbed changes of at least 10%, it has not done so consistently year on year, as proposed by this charge.

84. Comparing the historic statistics, a 10% pa reduction since 2002/03 would by now be a 61% overall reduction, whilst market trends have lead to a 13% increase. Since 2007/08, 10% pa would be a 36% decrease, whilst the market has fallen by 17%. So it is clear that this proposal is considerably more penal than market fluctuations.

85. Rebasing the charge annually also prevents operators and customers from planning their business with certainty, and would likely lead to short term contract becoming the norm. This has implications for the operators and customers, but also for access planning / rights etc. which may change at each contract change.

86. If any charge or increase is implemented, we therefore suggest that it is set at the start of the control period and is constant throughout. The financial implications for Network Rail would need to be assessed, but we consider that they are more able to bear the risk than freight operators.

***4.57 What should be the unit of the new charge? Please explain your reasoning*.**

87. Applying any charge 'per tonne' would reduce some of the potential impacts for remote ports, operators and domestic producers and is therefore attractive. However it introduces additional billing complexity as other charges are levied per tonne-km.

88. If any increase was sufficiently small that it could be absorbed without significant market contraction, such that second order effects were minimised, then existing billing mechanisms might suffice. Any larger increase may be best 'per tonne'.

Freight Avoidable Costs

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).

89. We are engaged with the study being undertaken by LEK for Network Rail, estimating freight avoidable costs. The methodology of the study appears robust to date.

90. As outlined above, we are concerned that any distribution of freight avoidable cost is undertaken in line with ORR's objectives for cost reflectivity and the elimination of cross subsidy. Simple pro rata approaches may not be adequate.

Market Analysis

6.83 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?

91. We note the studies undertaken by MDST and NERA. We do not have further specific evidence to add.

92. We note however that the studies themselves do appear to produce quite different results, which have not been reconciled with each other. In particular, NERA's analysis of coal moved produces considerably lower impacts than MDS's.

	MDS Phase 1	**MDS Phase 2**	**NERA**		
Change	VTAC Doubled	+£10	+£5	+£10	+£15
Change in tonnes	?	-2.6%	-2.1%	-4.6%	-7.4%
Change in tonne-km	-0.4%	-23%	-2.4%	-5%	-8.1%

93. It is also of note that the NERA results for coal lifted and moved are quite considerably different to the current position. So for example, Table 6.3 of the consultation shows a base case for coal moved of 27,889 net million tonnes km, whilst the actual outturn results for 2011/12 from ORR Statistics were only 5,460 net million tonne km. Comparing tonnes lifted, NERA's analysis shows 178m tonnes, the most recent ORR statistics 44.4m tonnes. Even allowing for the fact that some ESI coal is not rail fed, the gap between the modelled and actual results is surprising and at least worthy of further explanation.

94. There is also no analysis of how the modelled results compare with Government forecasts for coal generation. Freight operators will base their business plans on such forecasts, and it should be clear what impact these proposals have over an above what might have been expected. Certainly, post 2015 plant closures, most commentators would expect some period of stability in volumes.

95. The MDS analysis also makes certain assumptions about the behaviour of ports and pits in absorbing some part of the price increase. The results of the phase 2 study (23% reduction) are predicated on a behaviour change in the supply chain. Whilst this may well be the likely outcome, we consider that there should also have been a base case scenario, against which the sensitivities could be compared.

96. The two MDS studies show that the tonne-km are sensitive to the level of increase, with the range from 0.4% to 30% across increases of doubling the current variable, to £10 extra. It is therefore surprising that further sensitivity analyses have not been done to look at increases between these two points.

97. This is important because, if ORR are to proceed to levy an increase on ESI coal, they should consider whether lower levels of increase can deliver some of their objectives whilst minimising the direct and wider impacts on the rail freight sector.

6.84 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?

98. Yes. An early, positive statement from ORR on this matter, and on other charges affecting these commodity sectors would be welcome.

6.85 Do you agree with our proposal to levy the proposed charge on ESI coal traffic:

99. We are concerned that levying an increase on ESI Coal will have direct and wider impacts on the rail freight sector which have not been fully assessed We are also concerned that the proposed cap may be unworkable.

100. If ORR wishes to increase charges for ESI Coal, and other commodities, we consider that the increase must be sufficiently low that it can reasonably be absorbed without any significant loss of volume, and that second order impacts are minimised.

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

101. Whilst the analysis does not show a significant impact, there are again likely to be wider impacts to be considered, not least around the certainty for future investment in the nuclear sector.

102. In any event, the avoidable costs associated with spent nuclear fuel, other than on freight only lines, are likely to be small given the low volume of traffic. The indicative values should be confirmed as soon as possible.

6.87 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?

103. The impact of these proposals on the steel sector are complex. Whilst the actual level of the increase may be small, the additional costs to the sector could well be material particularly in making larger investment decisions. Although it is unlikely there would be reversion to road, increases might change the 'tipping point' for steel production at particular locations.

104. The steel sector could also be exposed to increases in the delivered price of coal as well as iron ore, which further compounds this effect.

105. Given the fragility of domestic steel production, there is significant concern over the application by ORR of price increases, both in terms of actual investment decisions and also in terms of the political perspective. We would therefore consider that the increase should not be levied.

6.88 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)?

106. We agree that it is not appropriate to introduce increased charges for biomass at this point. Indeed, as the market on rail is in its infancy, we consider that ORR needs to set stable conditions to support a growing market.

107. This is particularly important as considerable investment in wagons and equipment will be necessary. Deferring the decision till 2017 may not be sufficient to achieve this, and we would suggest that any change is not undertaken until at least the start of CP6, when the market for biomass is much clearer.

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

108. As the analysis suggests that there is significant potential for reversion to road, we do not consider that charges for other coal traffic should increase. The cement market is slowly increasing its use of rail for finished product, but this is highly price sensitive to road, and therefore changes in any aspect of rail costs could compromise the viability of increased rail use across the supply chain.

Annex : Previous Letter to ORR

Richard Price
Chief Executive
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

Rail Freight Group
7 Bury Place
London WC1A 2LA
T +44 (0)203 116 0007
F +44 (0)203 116 0008
W www.rfg.org.uk

28 May 2012

Dear Richard,

Consultation on the variable usage charge and on a freight specific charge

I thought it might be helpful to write now to let you know our initial thoughts on the consultation document on the variable usage charge, and on a freight specific charge. We will of course be working through the document in detail, and consulting with our members, and will submit our full response by the closing date. We also note that some elements of the proposals are expected to evolve over the consultation period. However, it may be helpful to you to understand the issues which are already raising concerns with us and our members.

We understand the context in which this consultation is issued, and the need to improve the finances of the rail industry. We do not, in principle, have a problem with ORR reviewing the structure or level of charges to see whether better industry outcomes can be achieved without detriment to the rail freight operators and their current and potential customers. However we presently have significant concerns that the proposals as set out could have major repercussions for the stability of rail freight, for investor confidence, and for the prospects of continued growth.

Duties and Powers
In the consultation, you have gone to some lengths to explain the framework underpinning these proposals. This is helpful, but has raised a number of concerns. Firstly, there are questions around how you have chosen to balance your duties, and whether undue weight has been given to the duty to have regard to the funds available to the Secretary of State perhaps at the expense of the duty to promote the use of the railway for the carriage of passenger and freight, and the duty to enable companies to plan their businesses with a reasonable degree of assurance.

There is also concern over how ORR has interpreted the legal definition of ‘what the market can bear’. We have been surprised that a 10% drop in traffic has been deemed to be acceptable under this criterion. This is critical because, whatever the desired outcome on ESI Coal, the definition also sets a precedent which could be seen to apply to other market sectors now or in the future. For example, the MDS analysis suggests that doubling the variable charge would cause the intermodal sector to fall by 12% - not so far from the ‘acceptable’ 10% threshold. This message is not helpful for building confidence in the customer, potential customer and supplier bases who are looking to make long term investment in the rail freight sector. It might be helpful if there could be some additional clarification around this point ahead of the August deadline, linked to an explanation of how such reductions fit with the ORR's duties as summarised above.

Variable Charge
We note the work that is on-going to refine the estimates of variable costs and the translation into charges. We will provide our detailed comments on this in our full response. Certainly, any rise in the variable charge is unwelcome. We are also concerned at the assertion that the increase in variable charge arises from the introduction of newer wagon types, which are themselves incentivised through the charging framework established at CP4. Although we recognise that some impacts could not be identified in advance, it does just highlight the problems with setting incentive structures based on incomplete or immature data. For wagon manufacturers and suppliers, it is imperative that consistent messages are provided on the desired requirements. Frequent changes in direction are not acceptable for those building equipment with 30 year asset lives

Specific Freight Charge
We recognise the expectation that the ESI coal sector should make an increased contribution, and note the analysis which suggests that there would be minimal downstream impact on electricity prices. Those in the coal and generation sectors will no doubt have their views on this analysis. However, for us, the principle concern is whether this new charge can be effectively levied without damaging the rail freight sector.

Although it is likely that the majority of any additional charge can be passed to some extent, the size of the charge to be levied will be a considerable financial risk for the rail freight operators. The most recent available data shows the freight operators made a combined profit after tax of 0.8% on a turnover of £839m, a loss of 0.5% if asset sales are excluded. The impact of a £50-60m risk (as suggested in the analysis) on those businesses is therefore considerable, and certainly, the existing profit margins are not likely to be able to absorb downside events. Even if the charge is passed on in full, there are cash flow risks to be managed which are sizeable. Of course, the coal market is already forecast to decline, and, although volumes rose in the last financial year, the overall trend has been declining. But these proposals are likely to accelerate that decline, and create much greater risk for the operators than anticipated. It is unclear what actions the operators would take faced with this scenario, but market exit and consolidation cannot be ruled out.

We acknowledge the proposal to cap the charge at a10% traffic reduction, but it is not clear that this is workable in practice and certainly needs more development. The suggestion that the charge would be rebased annually, and that it would increase as traffic levels fall further add to the risk and is unacceptable.

There are also concerns over the iron ore, nuclear and other coal sectors which we will discuss with our members and include in our full response.

Complexity and Overall Impact

This freight specific charge is only one of the areas where ORR is proposing to introduce new charges or change the structure of charges. The variable charge may well increase. The impact of geographic charges are not yet understood, and could adversely affect some operators and traffic flows. Capacity/scarcity charges are yet to be developed and are likely to be an additional cost. Yet there is no assessment of the total impact on freight operators and the freight market, either in terms of overall affordability, or whether the complexity of the charging structure will be an over onerous regulatory burden to these businesses. We would urge you to undertake such an impact assessment as soon as possible. We would also ask you to consider whether there might be mechanisms for levying the freight specific charge in a way which insulates the operators from the financial risk of passing on the charge.

It must be remembered that road, with which rail freight competes directly, has no such complexity. VED is a simple annual charge, and even the current proposals for lorry charging are based on an annual tariff, meaning that road hauliers are able to quickly respond to customer requests. Rail is already viewed by many businesses as too complex and difficult to understand, and these proposals will compound that position.

Freight Avoidable Costs

We note that Network Rail are undertaking further work to determine the level of the freight avoidable costs. This is welcome. We would expect the results to demonstrate not just the level of cost, but also the ways that it could be reduced and efficiencies increased over time. For example, if coal traffic reduces, it should be clear how the avoidable cost will reduce if, say, track or signalling can be removed or mothballed. The freight sector will not expect to continue paying the avoidable costs of infrastructure where traffic has ceased, even if the saving cannot be realised until some time in the future. The allocation between commodities should also be considered; if the aim is to eliminate cross subsidy then pro rata approaches may not be sufficient.

I know that we will have the opportunity to discuss the consultation with you at the July workshop, and at other industry meetings. We will also make sure that our members are briefed on the proposals and encourage them to make their informed responses to you, to help your considerations towards an appropriate outcome for all.

Yours sincerely,

Tony Berkeley
Chairman