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Dear Stakeholder

Periodic review 2008: Charge to recover the costs of freight-only lines

1. We are reviewing freight charges as part of our 2008 periodic review (PR08). PR08 will determine Network Rail's outputs, revenue requirement and access charges for control period 4 (CP4), from 1 April 2009 to 31 March 2014. In February 2007, in our Advice to Ministers and framework for setting access charges (Advice to Ministers) document¹, we published our decision on capping freight-track access charges² for CP4³. The document set out cost ranges and caps for two freight-track access charges, as follows.

- The freight variable usage charge, which reflects the wear and tear costs of operating freight traffic on the railway network.
- A new charge to recover the costs of freight-only lines (to be paid only by freight trains carrying coal for the electricity supply industry (ESI coal) or spent nuclear fuel⁴).

¹ 'Advice to Ministers and framework for setting access charges', Office of Rail Regulation, February 2007. You can access this document at www.rail-reg.gov.uk/upload/pdf/316.pdf

² Track access charges are the charges that freight operators pay for access to the railway network.

³ A control period is a period of time, usually five years, over which the conclusions of a periodic review come into force. Control period 4 is the fourth control period.

⁴ Freight-only lines are railway lines used by freight traffic only. The full definition of freight-only lines is given in Annex C of Periodic Review 2008: 'Consultation on caps on freight track access

2. While the Advice to Ministers document set out our caps for the charge to recover the costs of freight-only lines, it did not give a final decision on the system to use for allocating Network Rail's costs to these lines or the system to use for levying the charge. These systems are important as they can have an effect on the level of charges for freight-only lines and will therefore affect freight operators and customers.

3. In June 2007 we consulted on our proposal for a system to allocate costs and set charges for freight-only lines⁵ in particular, on:

- whether our proposed system for allocating the costs of freight-only lines across market segments would be appropriate, and what effect this system would have; and
- whether our proposed charging system for recovering the costs of freight-only lines would be appropriate, and what effect this system would have.

4. This letter explains, following our consideration of the consultation responses, our decisions on the cost allocation and charging systems for freight only lines, which is that:

- costs should be allocated across freight only lines based on modelled line-by-line basis with costs allocated across market segments based on gross tonne-km; and
- costs of freight only lines should be recovered as a network wide mark-up on the ESI coal and spent nuclear fuel variable usage charge.

5. Further details of our decision are provided in the paper attached to this letter.

6. You can find copies of this letter in our library and on our website (www.rail-reg.gov.uk).

charges', Office of Rail Regulation, December 2006. You can access this document at www.rail-reg.gov.uk/upload/pdf/310.pdf.

⁵ 'Periodic Review 2008: Charge to recover the costs of freight only lines', Office of Rail Regulation, June 2007. You can access this document at: http://www.rail-reg.gov.uk/upload/pdf/cns-fgt_chrg_rev_only_line.pdf.

Yours faithfully

A handwritten signature in blue ink that reads "Paul McMahon". The signature is written in a cursive style with a large initial 'P'.

Paul McMahon

Charge to recover the costs of freight-only lines

Background

Current structure of charges

1. The current structure of freight track access charges was established by the 2001 freight charges review (FCR2001)⁶. Freight operators currently have to pay Network Rail a range of variable charges⁷ to reflect the costs they cause to the infrastructure. Freight operators do not currently contribute to fixed costs (costs that do not vary with traffic) or common (shared) costs. The Government currently pays freight operators' contributions to these costs as part of the network grant it pays to Network Rail. The new charge to recover the costs of freight only lines reflects the Government's statement in the 'Future of Rail' White Paper⁸ that: "Where lines carry only freight, and no passenger services, the freight operators will pay its full costs".

Our caps on freight charges

2. Our 'Advice to Ministers' document set out the range of costs and caps in two areas.
- The freight variable usage charge, which reflects the wear and tear costs of operating freight traffic on the railway network. Our estimated cost range was between £41 and £99 million a year (2005-06 price and traffic levels), with the cap set at £99 million, or 12.6% above current variable usage charges. We stated that there is a strong possibility that the final level of freight variable usage charges would be below the current level, once we have completed our assessment of Network Rail's strategic business plan
 - A new charge to recover the costs of freight-only lines (for certain freight traffic). Our estimated cost range for terminal freight only lines was £13 to £28 million a

⁶ 'Review of freight charging policy: final conclusions', Office of the Rail Regulator, October 2001. You can access this document at www.rail-reg.gov.uk/upload/pdf/136-fchargfincon.pdf.

⁷ Variable charges are charges that vary with the amount of traffic using the network.

⁸ 'The Future of Rail CM6233', July 2004, Department for Transport. You can access this document at www.dft.gov.uk/about/strategy/whitepapers/rail/thefutureofrailwhitepapercm6233.

year⁹. We concluded that only two market segments, Electricity Supply Industry (ESI) coal and spent nuclear fuel, should bear the costs of freight only lines¹⁰, and they should only bear the costs that they are responsible for. We capped the ESI coal charge at £13.9 million a year and the spent nuclear fuel charge at £1.4 million a year, with both charges phased in over CP4. As with the caps on variable usage charges, we expect the final level of charges to be lower than the cap when we have completed our assessment of Network Rail's strategic business plan.

Deciding on the final level of freight charges

Criteria for assessing systems for allocating costs and setting charges for freight-only lines

3. The new charge to recover the costs of freight-only lines needs to be consistent with our charging aims. These are:

- to promote the aims of our duties under section 4 of the Railways Act 1993 and be consistent with the wider aims and guidance from funders;
- to provide incentives for Network Rail, train operators, train manufacturers, rolling-stock companies and funders to make sure the network is used and developed efficiently;
- not to discriminate between users of the network;
- to be practical, cost-effective and fair;
- to be consistent with relevant laws, including the EU Directive 2001/14/EC;

⁹ The definition of terminal freight only lines is given in Annex C of 'Periodic Review 2008: Consultation on caps on freight only lines', December 2006, Office of Rail Regulation. You can access this document at <http://www.rail-reg.gov.uk/upload/pdf/310.pdf>.

¹⁰ This is consistent with the Railways Infrastructure (Access and Management) Regulations 2005. You can access the text of the regulations at www.opsi.gov.uk/si/si2005/20053049.htm - 1. The regulations put into practice Directive 2001/14/EC of the European Parliament and the Council of 26 February 2001 on the allocation of railway infrastructure capacity and the levying of charges for the use of railway infrastructure and safety certification. You can access the text of the Directive at www.rail-reg.gov.uk/upload/pdf/directive-2001-14-ec.pdf.

- to reflect the efficient costs caused of using the infrastructure (both to Network Rail or otherwise); and
- to make sure charges allow Network Rail to recover (but not over-recover) it's allowed revenue requirement.

Systems for allocating costs for freight-only lines

4. The costs of freight-only lines need to be allocated to ESI coal and spent nuclear fuel traffic, the two market segments that we have decided should pay the new charge.

5. There are a number of alternative approaches to allocating the costs of freight-only lines, including the following:

- modelled 'line-by-line' costs – where the costs of each individual freight-only line are taken directly from the Network Rail infrastructure cost model (ICM) or other Network Rail estimate of CP4 costs. These costs would then be allocated to a market segment using gross tonnage (train kilometres is a potential alternative to gross tonnage);
- aggregate level gross tonnage based allocation – where the total costs of all freight-only lines are allocated across market segments based on gross tonnage (or train kilometres);
- track length based allocation – where the costs of freight-only lines are allocated across freight-only lines based on the track length, with these costs then allocated to a market segment level using gross tonnage (or train kilometres); and
- bespoke allocation metric – where a bespoke allocation metric is developed to allocate costs across each freight-only line (this could include both track length and gross tonnage), with costs then allocated to a market segment using gross tonnage (or train kilometres).

6. Further, once costs had been allocated across freight only lines they need to be allocated across market segments using each line. In our consultation document, we outlined two alternatives to allocating costs across market segments: gross tonnage kilometres or train-kilometres on each freight only line.

7. In our consultation document, we proposed that costs for the relevant freight only lines should be allocated using modelled line-by-line costs and then further allocated across market segments using train kilometres.

Consultation responses

8. While we had previously concluded¹¹ on whether to introduce a charge for ESI coal and spent nuclear fuel, a number of respondents revisited the questioning of whether the ESI coal market could bear an increase in freight charges and raised concerns over whether such a charge would be discriminatory and so would not be consistent with our charging principles.

9. Notwithstanding the concerns about introducing a charge, the majority of responses supported our proposed approach to allocate costs across freight only lines on a modelled line-by-line basis and then allocate costs across market segments using train-km. Some respondents did suggest alternative approaches, for example EDF Energy proposed a track length then gross tonnage based allocation (as this gave an intermediate rather than the highest figure) and Network Rail proposed a modelled line-by-line and then gross tonnage allocation as it considered this was the best overall measure of the use of a freight only line.

10. Two respondents suggested that the ESI coal and spent nuclear fuel should not bear the costs of all the lines that they used. National Express suggested that costs should only be recovered where all traffic using a freight only line was either ESI coal or spent nuclear fuel. EWS suggested that ESI coal or spent nuclear fuel should only bear the costs of freight only lines where ESI coal or spent nuclear fuel made up the majority of traffic.

11. A number of respondents (EWS, Coallmp, Coalpro, E.ON, First GBRf, Freight Transport Association, RFG, Scottish and Southern Energy) expressed concern over the accuracy of the Network Rail's cost estimates. A number of respondents also raised concerns over whether we should conclude on the method for allocation of freight only costs without full knowledge of the final costs/charges.

Our decision

12. As we stated in our consultation document we are content that both the ESI coal and spent nuclear fuel markets can bear the cost of freight only and such a charge is consistent with relevant legislation and is therefore not discriminatory.

13. We are content that it is appropriate to conclude on the approach to freight only line charges at this stage in PR08, principally to provide clarity to the industry as early as

¹¹ Periodic review 2008: Advice to Ministers and framework for setting access charges, ORR, February 2007. You can access this document at: <http://www.rail-reg.gov.uk/upload/pdf/316.pdf>

possible on the new approach. In addition, the final level of costs would not alter our decision on the most appropriate system.

14. We do not consider that costs should only be recovered where freight only lines are used by only, or where the majority use is, ESI coal or spent nuclear fuel as this would not reflect the full costs attributable to ESI coal or spent nuclear fuel. Any limits could lead to disputes or perverse behaviour, for example it could encourage other traffic to use freight only lines to prevent the cost being borne by ESI coal or spent nuclear fuel.

15. After considering all the responses, **we have concluded that the most appropriate method of allocating the charge would be on a modelled line-by-line basis with costs allocated across market segments based on gross tonne-km.** We accept Network Rail's view that gross tonne-km is a better measure of usage than train-km for freight traffic as this takes account of the load as well as the number of trains using a freight only line.

Charging system for freight-only line costs

16. There are a number of ways that the costs of freight only lines can be charged to those market segments that can bear these costs. Our consultation document identified three alternative systems, which were:

- a fixed charge on freight-only lines – where operators pay a fixed charge for freight-only line they use;
- a variable charge applied on freight-only lines – costs could be added to variable charges on freight-only lines; or
- a variable charge across the network – costs could be added to variable charges across the network as a whole.

17. In our consultation document, we proposed to recover the costs of freight only lines through the addition of an amount to the variable usage charge across the whole network (i.e. additional pence per gross tonne-km amount for each vehicle in the variable usage charge price list for ESI coal and spent nuclear fuel). We considered that this approach would avoid some of the problems of the other approaches and would be simple and easy to introduce. We recognised that this approach would be less cost reflective, as traffic would pay an extra amount irrespective of whether it had used a freight only line. However, we were content that such an approach was not discriminatory as the allocation to each market segment was broadly cost reflective and the charge was recovering fixed rather than variable costs.

Consultation responses

18. Notwithstanding the concerns raised about implementing the charge raised above the majority of respondents supported our proposed approach to recover freight only line costs as a mark-up on the variable charge across the network, often this was because they felt this was the least discriminatory approach and if only because this was the least worst option. Network Rail support this approach.

19. EWS suggested that levying a network wide mark-up on the variable charge would be discriminatory as only 60% of ESI traffic uses freight only lines. EWS's preferred option would be to levy the charge as a mark-up to the variable charge on freight only lines because it considers that this would be transparent, would ensure that only those using freight only lines would pay the charge and would avoid some of the administrative problems with levying a fixed charge on freight only lines.

20. Freightliner suggested an alternative charging approach where the costs of freight only lines are levied on the basis of paths/rights (50% on each).

Our decision

21. We are content that recovering the costs of freight only lines as a network wide mark-up on the variable charge is the most appropriate approach:

- we have reviewed the evidence put forward by EWS on the use by ESI coal of freight only lines and are content that the vast majority of ESI coal traffic uses freight only lines (higher than the 60% suggested by EWS) and therefore applying a network wide mark-up would be appropriate;
- we continue to consider that other approaches, while potentially being more cost reflective are administratively difficult, with Network Rail suggesting that they could lead to disputes between operators and be overly complex; and
- we consider that an addition to the variable charge would be simple to administer and would not be discriminatory. As long as the allocation to each market segment broadly reflects costs, we consider that the charging system itself does not necessarily need to reflect costs at a customer level, especially as the charge is recovering fixed rather than direct costs and the problems with other approaches.

22. We have therefore concluded that the costs of freight only lines should be recovered as a network wide mark-up on ESI coal and spent nuclear fuel variable usage charges.

23. We propose that the charge is levied as additional pence per gross tonne-km on the existing variable usage charges for each vehicle in the variable usage charge price list (carrying ESI coal or spent nuclear fuel). The charge would be phased in over CP4.

24. The amount raised by the charge, the costs of freight only lines and the amount allocated to ESI coal and spent nuclear fuel may change during the course of CP4. We do not plan to include a wash-up mechanism to ensure that Network Rail does not over or under-recover its costs through charges. While the sums involved in any under- or over-recovery would be fairly small to Network Rail, they could be more important to freight operators. We therefore consider that Network Rail should take the risk of under-recovering its costs, with the amount added for ESI coal traffic based on the upper end of predicted future demand (that is a 15% increase by 2014-5)¹². For spent nuclear fuel, in the absence of any published industry forecasts, we consider that the amount added for spent nuclear fuel should be based on the latest available levels of traffic.

Next steps

25. The key next steps in PR08 that are relevant to freight charges:

- October 2007: Network Rail provides indicative charge proposals including vehicle price lists as part of its strategic business plan in October 2007. This should identify the variable charge mark-up to recover the costs of ESI coal and spent nuclear fuel freight only line costs.
- November 2007: We will be consulting on Network Rail's strategic business plan, including the indicative charge proposals.
- February 2008: We will publish our assessment of Network Rail's strategic business plan.
- April 2008: Network Rail provides any updates to its strategic business plan, including revised charge proposals, if necessary, following consultation and our review of the plan
- June 2008: We publish our draft determinations (which will include out our views on Network Rail's efficiency).

¹² 'Freight route utilisation strategy', Network Rail, March 2007. You can access this document at http://www.networkrail.co.uk/browse_documents/rus_documents/route_utilisation_strategies/freight/freight_rus.pdf.

- October 2008: We publish our final determination.
- December 2008: Final price lists published following our audit and approval of Network Rail's charge proposals.