Freight mark-up charges

December 2016

This document has been published alongside [‘Improving incentives on Network Rail and train operators: A consultation on changes to charges and contractual incentives’].

Policy	**Charges - freight mark-up charges**
Policy area	Freight mark-up charges: merging FOL and FSC
Background	In CP5 there are two separate freight mark-up charges designed to recover fixed costs of the network allocated to freight traffic. The freight only line (FOL) charge recovers the fixed costs of freight only lines, i.e. those that would not be needed if freight traffic ceased using them. The freight specific charge (FSC) recovers freight avoidable costs, i.e. costs that Network Rail could avoid if freight services did not use its infrastructure (net of the costs recovered by variable charges and FOL charge). Both charges are levied based on the market can bear test, with market segments being defined in terms of the commodities carried. Only those commodities that we deem to be able to bear additional costs to those directly incurred (which are recovered through variable charges) pay the mark-ups. In CP5, three freight market segments pay mark-up charges: coal for the electricity supply industry (ESI), spent nuclear fuel and iron ore. Both charges were capped in CP5.
Which of the PR18 outcomes does this charge/incentive deliver against?	The network is efficient: • Provide Network Rail with effective incentives to lower cost. The network is better used: • Ensure operators take costs of service into account when using the network; and • Ensure all parties are incentivised to maximise value of capacity in use.
Problem under consideration with the current charge/incentive The FOL was introduced in PR08 for CP4, while FSC was introduced in PR13 for CP5. For reasons of transparency, we agreed with Network Rail’s conclusions that the two charges should be kept separate for CP5. This is because FSC was to be phased in	

over the duration of the control period and the added transparency would help industry understand the new charge.

Both charges are levied at a flat rate (per gross tonne miles) as mark-ups on charges for costs directly incurred, on those market segments that we determine to be able to bear additional costs. In our PR13 Final Determination we stated that, in principle, the FSC and FOL charge could be treated as a single charge. We concluded that this policy area should be revisited in PR18.

What is the scale of the issue & who is impacted?

The direct impact is on FOCs that have to calculate two separate charges. The administrative cost is likely to be modest in size but this simplification in the charging structure will remove the unnecessary administrative burden on the freight industry.

Options to be considered	
Option 0: Do nothing	• Under the do nothing scenario, there would continue to be two mark-up charges for freight that freight operators would have to be billed for.
Option 1: Combine the FOL charge and FSC	• Combine FOL charge and FSC into one freight mark-up charge.
Assessment of options	
Assessment of option 1 (combine the FOL charge and FSC)	• The purpose of this incremental change is to simplify the administration of freight mark-up charges. There is no evidence to suggest that the two charges should be kept separate. On the contrary, in response to our December 2015 consultation on charges, RDG and Freightliner expressed a view that there should only be one freight mark-up charge. • Combining the two charges will not have an impact on the overall level of costs recovered through a single freight mark-up charge (although the level of the charge could change as a result of a recalibration of the market can bear test and any changes to cost directly incurred charges). • In addition, under the infrastructure costs package we are proposing to extend Network Rail's cost allocation methodology to freight operators. Thus, at the implementation stage it should be straightforward to roll two freight mark-up charges into a single charge.
Recommendation	• Option 1: combine the FOL charge and FSC

Next Steps

- Obtain industry views on this proposed option through our December 2016 consultation on charges and incentives. These will inform our next steps in terms of working together with Network Rail to develop the implementation plan.

Policy	Charges – freight mark-up charges
Policy area	Freight mark-up charges: updating underlying cost allocation methodology
Background	As above
Which of the PR18 outcomes does this charge/incentive deliver against?	The network is efficient: • Provide Network Rail with effective incentives to lower cost. The network is better used: • Ensure operators take costs of service into account when using the network; and • Ensure all parties are incentivised to maximise value of capacity in use.

Problem under consideration with the current charge/incentive

One of the objectives of our charges review is to improve the extent to which the charges that Network Rail's customers pay reflect the costs that they impose on the network. This not only results in improved transparency of who pays for what and what they receive in return, but also sends better signals to Network Rail and its customers for the efficient provision and use of the network.

FOL charge and FSC are currently levied on freight operators using a freight avoidable cost allocation methodology developed by Network Rail's consultants, LEK, in PR13. It estimates a range of the theoretical long-run annual cost savings to Network Rail that would result from removing commercial freight traffic from Network Rail's existing network (defined as freight avoidable cost). The total estimated cost is then allocated between services carrying different types of commodities.

The new cost allocation methodology, developed by Brockley Consulting for Network Rail, allocates Network Rail's total revenue requirement to all operators. This involves an avoidable cost element, but also an allocation of costs that do not vary with use (even in the long run) – so called 'common costs'. Using this methodology to allocate costs to all operators, including freight, even on a notional basis, would ensure one single approach was used across the network and for all operators.

The actual level of mark-up charges set for freight operators in CP6 would depend on the results of a recalibration of the market can bear test, with the costs allocated through Network Rail's new methodology forming an upper bound.

What is the scale of the issue & who is impacted?

The current FOL charge and FSC methodology uses the estimates of freight avoidable costs that were calculated for Network Rail by its consultants, LEK, and verified by independent reporters. The lower end of the range of avoidable costs was used for setting mark-ups (£278m per annum in CP5). For commodities assessed as being able

to bear these mark-ups, the charges were phased in gradually over the duration of CP5 (0% in years 1 and 2, rising to 20% in year 3, 60%in year 4 and 100% in year 5). The level of fixed costs that will be allocated to freight under the new methodology is not yet clear, because it has only been applied to a pilot area rather than the whole network. However, it is likely that the estimates will be higher than under the LEK methodology (partly because of the inclusion of common costs). Freight operators that currently do not pay freight mark-up charges might pay them in CP6 if the recalibration of the market can bear test confirms that they can afford to pay the additional cost. The level of the mark-up charges will depend on a range of factors, such as the level of variable charges determined through PR18 (which could be affected by both policy decisions, e.g. on the capacity charge, but also recalibrations, e.g. of the variable usage charge), the level of network grant and the level of costs that different market segments are deemed to be able to bear (which will be determined through our recalibration of the freight market can bear assessment).	
Options to be considered	
Option 0: Do nothing	• Under the 'do nothing' option, freight mark-up charges would continue to be calculated using the current LEK methodology. • However, we are also proposing in our consultation that the new cost allocation methodology developed by Network Rail be applied to passenger operators (both franchised and open access). Therefore, continuing to use the LEK methodology to set freight mark-up charges could add unnecessary complexity to the charging regime and reduce its transparency.
Option 1: Apply Network Rail's cost allocation methodology to freight	• Under this option, the new cost allocation methodology developed by Network Rail would replace the current avoidable cost methodology developed for PR13.
Assessment of options	
Assessment of option 1 (Apply Network Rail's cost allocation methodology to freight)	• This would improve transparency regarding the level of costs allocated to freight. • The level of costs allocated to freight might be higher than under the new cost allocation methodology. However, freight mark-up charges are subject to the market can bear test which means that these charges will be set at a level deemed affordable, i.e. a level that will not price any freight market segments out of the rail market.
Recommendation	• Option 1: Apply Network Rail's cost allocation methodology to freight.
Next Steps	

- Engage with the rail freight industry through our December 2016 consultation to seek views about our proposal to extend Network Rail's cost allocation methodology to freight. These views will inform our next steps when supporting Network Rail in their implementation of the new methodology.
- Recruit consultants to support us in carrying out the market can bear test by undertaking the key market analysis needed to inform our decision.

This publication is available at orr.gov.uk

Any enquiries regarding this publication should be sent to us at orr.gov.uk