NetworkRail

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Dear Emily

Geographic differentiation of variable usage charges

I am writing further to our exchanges on the ORR's suggestion that there should be a move to a geographically disaggregated variable usage charge. For the purposes of my letter, I put aside the industry's general unease at such a suggestion.

I wanted to return to an issue that Paul Plummer raised in his letter of 24 April to Cathryn Ross. In that letter Paul reminded ORR that PR08 and indicative PR13 analyses indicate that the marginal cost of busy routes is lower than for quieter routes. If ORR determined that variable usage charges should be differentiated at Network Rail operating route type – or indeed if it were to follow any other approach to differentiation – then if the current marginal costing approach continued to apply to variable usage charging this would lead to perverse incentives for train operators to use busier parts of the network rather than quieter sections.

Discussing this point, Paul stated that:

"To make sense of differentiation by route type, one option would be to focus on the marginal cost at the point of the step change in asset management regime for each category of route.".

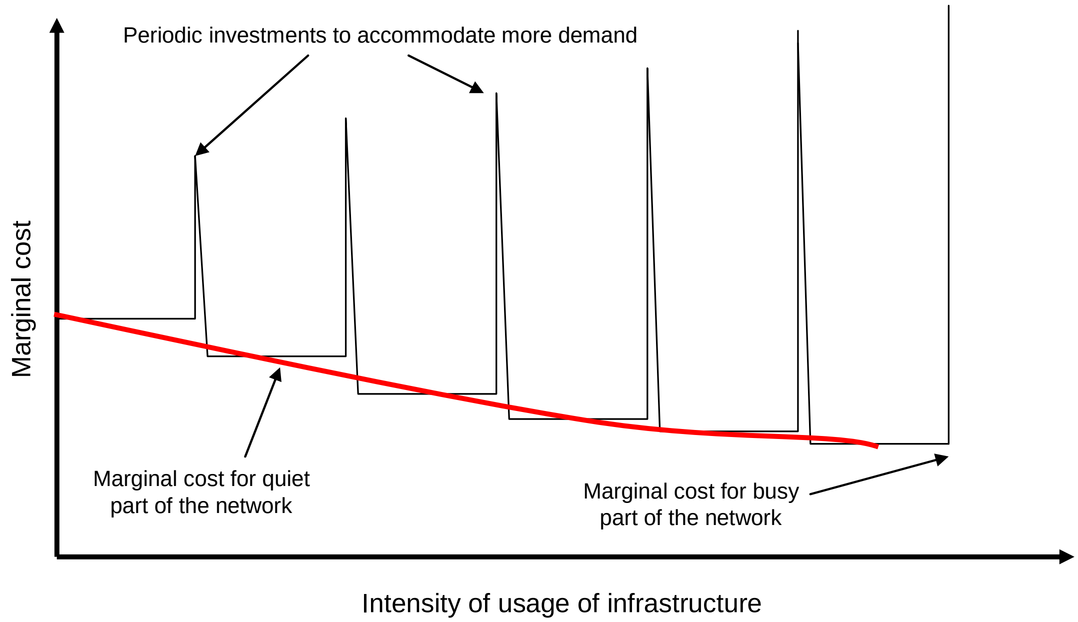
He added that:

"Unlike the existing methodology, we would expect this approach to result in charges which increase with the intensity of use".

I discuss each of these two points in turn, below.

Marginal Cost – existing methodology

The stylised graph, below, indicates the reason why we consider that the marginal charge of using parts of the network decrease with the intensity of its usage, based on the current charging methodology.

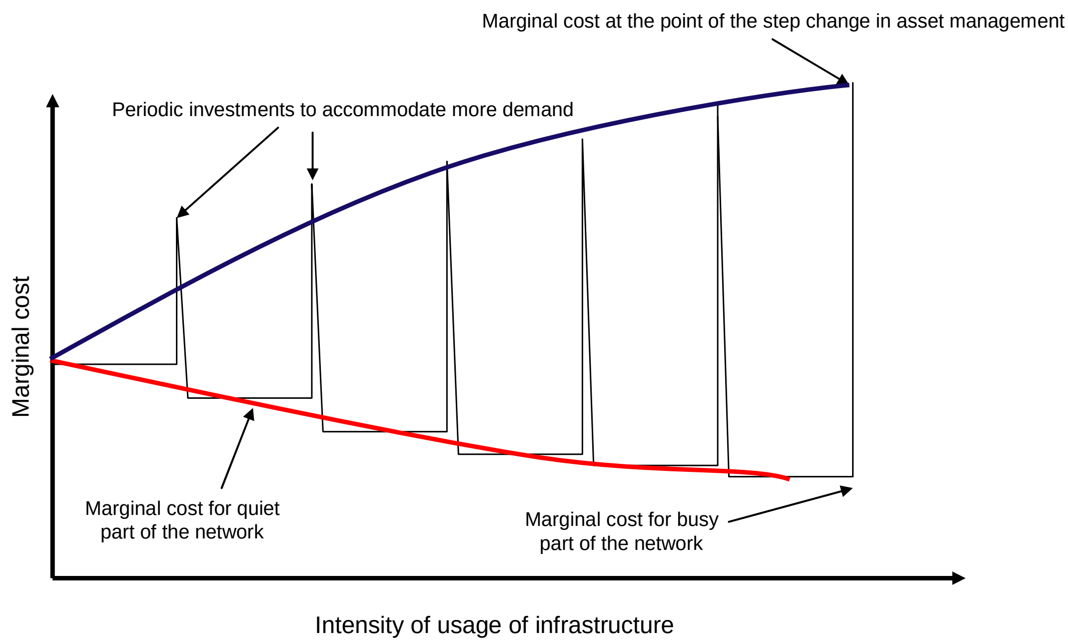


The black 'saw tooth' line indicates the marginal cost of operating a part of the network as its usage increases. The spikes indicate that at certain 'tipping points' of usage significant investments will be warranted. These investments will tend, on a total usage basis, to lower the marginal usage costs of the assets as usage increases (as indicated by the red trend line).

The incremental trains at the tipping point of new investments could, of course, be considered to have incurred very high marginal costs for Network Rail (as indicated by the arrows on the left hand part of the graph).

Marginal Cost – at Step Changes

The graph, below, illustrates a different methodology that could be used to better reflect the economic costs of increased usage of the network.



The super-imposed blue line illustrates the charging methodology using the marginal cost at the point of the step change in asset management. Such an approach would result in charges, which increase with the intensity of use. Such an approach would, of course, remove the perverse incentives of pricing the most congested parts of the network more cheaply than quiet parts.

Conclusion

As was suggested in Paul's letter of 24 April 2012, we consider that to avoid creating perverse outcomes from changes to the usage charges, extensive further analysis would be required on the subject. We consider that the best time to do this significant analysis would be after the conclusion of PR13. Once PR13 is concluded there should be much more industry resource available to consider this issue more thoroughly, including considering the approach suggested in this letter. This work, once concluded could help inform a potential change at the start of CP6.

I would be happy to take you and your colleagues through the analysis summarised in this letter, if you would find that helpful.

Yours sincerely

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Head of Regulatory Economics