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Dear Jonathan,

Aligning incentives to improve efficiency

1. This letter contains the response of DB Schenker Rail (UK) Limited ("DB Schenker") to the consultation entitled "Aligning incentives to improve efficiency: Update and further consultation" issued by ORR on 3 May 2011 and the supplementary consultation letter issued by ORR on 1 June 2011.
2. DB Schenker has previously responded to the ORR's PR13 First Consultation on May 2011, and the Consultation on Incentives of November 2011. This response therefore needs to be read in conjunction with these, copies of which are attached for ease of reference.

Route level efficiency benefit sharing and Alliances.

3. DB Schenker continues to have reservations about route based efficiency benefit sharing schemes (REBS), for the reasons set out in our response in February. These primarily relate to the potential workload and administrative burden, together with serious reservations about Network Rail's ability to provide meaningful data to allow any serious consideration of freight issues on a route basis.
4. We have already requested that ORR takes stock, holistically, of the cumulative effect on rail freight of the many different proposals currently in play as part of PR13. REBS and Alliances are but one strand of many – and the sector faces the prospect of very significant and negative change. REBS and Alliances cannot sensibly be viewed in isolation. We look forward to such an impact assessment and suggest it would be helpful for ORR to conclude this before finalising their decisions on REBS and Alliances.
5. However if, notwithstanding these concerns, the ORR remains intent on introducing REBS, then DB Schenker recognises that any operator (with other than a *de minimus* level of activity) probably has little practical alternative but to try and participate in any

scheme in order to protect its own interests. It is increasingly apparent that the type of discussions and plans that will feature under both Alliancing and Network Rail's pursuit of CP5 efficiencies will potentially feature significant changes to working arrangements. Therefore, notwithstanding the need to follow agreed industry processes such as Network Change (and any other Regulatory protections that might be put in place), DB Schenker recognises that early engagement with other industry parties is likely to be desirable.

6. It is not yet clear to DB Schenker what the level of administrative burden relating to REBS schemes will be. DB Schenker's fear is that it will be considerable and that differences between REBS schemes on parallel or adjoining routes will create exponential complexity and administrative burden for FOCs and TOCs whose services cross these administrative boundaries.
7. DB Schenker remains concerned at the ongoing inability of ORR and Network Rail to agree on definitions of efficiency such that the current CP4 EBS scheme might be triggered. This does not bode well for CP5 – a clear understanding of the starting point/baseline and the definition/measurement of efficiency is essential.
8. DB Schenker's position on REBS can therefore be summarised as :
 - a. DB Schenker does not believe that participation in REBS should be compulsory. Governments can always make participation in any such scheme a Franchise requirement and it should be for the commercial judgement of open access and freight operators as to whether they participate or not in each scheme. Operators faced with potentially 10 schemes have to have some discretion.
 - b. If ORR concludes that REBS should be compulsory, DB Schenker would support a *de minimus* level/threshold; for any operator with an activity level on the route below such a threshold, participation would be discretionary.
 - c. DB Schenker remains strongly opposed to FOC revenue being included within REBS, for the reasons already set out in our February response. DB Schenker is not convinced that including FOC revenue in any equation will influence Network Rail (or other TOC) behaviour in the slightest or assist in focussing on infrastructure cost reduction/efficiency – or whole system cost reduction or efficiency – because of the artificiality of the relationship between Network Rail's cost reporting and the physical nature of freight traffic. The need for Network Rail to allocate or attribute even so-called freight variable costs underlines this. The freight business is dependent on cost allocation conventions to a very much greater degree than those passenger businesses which are essentially line-of-route.
 - d. There has to be some relationship between the ability of the parties to influence costs and the scheme itself. Network Rail costs that are "in scope" have to be realistically capable of influence by FOC and TOC behaviour/activity. The same applies to revenue – other than providing or denying access, the ability of Network

Rail to influence FOC or TOC revenue is limited.

- e. Notwithstanding the points made in c. and d. above, it remains the fact that FOC margins are so slim that any inclusion of FOC revenue or exposure to downside movement of NR Costs will result in unacceptable levels of risk.
 - f. Any revenue sharing arrangements should be bilateral between the parties – ie as part of an Alliance.
 - g. DB Schenker believes that all TOCs/FOCs should be incentivised to join in (rather than being forced or feeling obliged to join in) and this effectively means that REBS should be an “upside only” mechanism.
9. Where there is a “deep” Alliance, DB Schenker concurs with Network Rail that it would be sensible to adopt Option B. It is increasingly apparent that the key with “deep” Alliances will be the conduct and governance of the Alliances, and the involvement of all secondary operators. Providing the Alliance is operated in a spirit of transparency and openness, then Option B has to be the better way forward with respect to REBS.
10. DB Schenker would expect ORR to be satisfied that all Alliance financial information that was germane to REBS calculations was of sufficient rigour and that the Alliance baseline was proper and consistent with any REBS baseline. DB Schenker would expect all relevant financial information to be transparent to secondary operators (for example via the Alliance Stakeholder Board) or, if commercially sensitive, to be shared with and verified by ORR.

Exposing operators to changes in Network Rail's costs at a periodic review

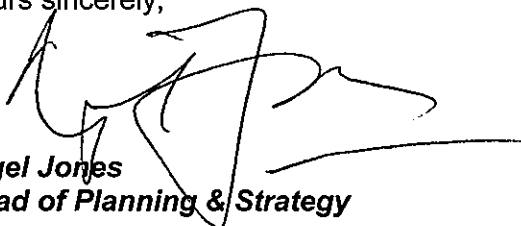
11. Freight operators are already exposed to changes in the Network Rail costs which we are subject to. Historically this has been limited to variable costs, but ORR are proposing a new charge as part of PR13 that relates to some elements (so-called Freight Avoidable Costs) of what are purported to be Network Rail's fixed costs relating to freight.
12. It is therefore unclear to DB Schenker if ORR intends Freight operators to be subject to yet another mechanism or potential charge in addition to the proposed Freight Specific Charge.
13. It is also unclear to DB Schenker what the relationship is between any such new mechanism and the 10 REBS schemes.
14. In any event, given the very limited ability of a freight operator such as DB Schenker to influence the nature and size of Network Rail's fixed costs, the purpose of such a mechanism is not clear to DB Schenker. If the purpose is to influence behaviour, DB Schenker believes strongly that sufficient alternative incentives on behaviour already exist.

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15. DB Schenker therefore has serious reservations about yet further administrative burden being placed by ORR on the rail freight sector.
16. DB Schenker believes that any such mechanism as suggested in the May Consultation documents is simply becoming too theoretical and complex and suggests that the ORR calculates any such effect and factors that into the calculation relating to access charges as part of each Periodic Review. This applies in respect of any carry-forward of REBS out (under) performance as well as any mechanism itself.
17. As recognised in the letter dated June 1, the supplementary proposal would have no impact on freight or open access operators, but would bring franchised operators into a more analogous position with freight and open access operators. Given the way that freight operators engage with the regulatory process at each Periodic Review, DB Schenker can understand ORR's intent in this matter and the supplementary proposal would seem to DB Schenker to be a pragmatic way forward.

If you have any questions, or would like clarification or amplification of any points, please do not hesitate to contact me.

Yours sincerely,



Nigel Jones
Head of Planning & Strategy