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2 September 2011

Dear Richard,

PERIODIC REVIEW 2013 FIRST CONSULTATION

This letter contains the response by DB Schenker Rail (UK) Limited ("DB Schenker") to the consultation document entitled "Periodic review 2013 First consultation" issued by Office of Rail Regulation ("ORR") on 25 May 2011.

Introduction

1.1. Since privatisation, the UK rail freight industry has been successful. It has attracted private sector investment of around £1.5bn and has grown by 47% in fifteen years representing a market share of surface transport of around 12% (up from 8% at privatisation). Rail freight directly employs around 4,700 people and keeps over 100 million tonnes of freight off the roads each year. Rail freight's success has been in the face of adversity including the collapse of the railway network in 2000, the bankruptcy of Railtrack, Government policy on the fuel duty escalator and 44 tonne lorries. Growth of 68% was being achieved before the 2008 global economic crisis and subsequent recession which led, not unsurprisingly, to a temporary reduction in overall freight movements. However, since 2010 overall freight volumes have started to grow again.

1.2. Such growth has been achieved by a relentless pursuit of efficiency, striving towards customer satisfaction and strong control of costs. These efforts are recognised in Sir Roy McNulty's "Rail Value for Money Study" published in May 2011, which states that faced by a competitive environment (both with other transport modes and with each other) rail freight operators have focused on reducing costs and improving customer service employing techniques and methods to improve efficiency that should be shared with the rest of the industry.

1.3. Over the last 10 years, the rail freight industry has benefited from both the independence of ORR and the support of ORR for growing rail freight. Throughout this time ORR has had regard for its statutory section 4 duties in making policy decisions about rail freight. In particular, ORR's decisions during the PR01 and PR08 freight charging reviews were fundamental to the development of rail freight.

1.4. Since 2008, rail freight operators have maintained their focus despite the deepest UK recession in living memory which had a major adverse impact on UK industry and trade. In part, they have been able to do this because of the stability and certainty provided by the UK regime for rail freight (i.e. the access regime enshrined in PR08 and the investment by Governments in the Strategic Freight Network). Such stability, certainty and confidence in the future is crucial for an industry that depends almost entirely on the private sector (whether in the form of shareholders, customers or debt providers).

1.5. The Periodic Review presents an opportunity to reinforce that stability and certainty – but, at the same time, it also represents a risk. The very act of undertaking a Periodic Review with the associated uncertainties about the funding of the infrastructure provider, the high level output specifications and the process for matching the two creates uncertainty. This uncertainty is multiplied when there is a possibility that ORR will review and restructure freight access charges.

1.6. DB Schenker urges ORR to leave the structure and level of freight access charges unchanged so that rail freight operators can offer existing and potential customers the certainty of transport costs they need. This overwhelming necessity for stability is reinforced by the myriad of other uncertainties that the rail freight industry faces which include:

- the continuing uncertainty in the global financial markets and its effects on trade and the movement of goods;
- the cost of fuel, which has increased significantly over recent years;
- the rise in fuel duty, which has similarly increased;
- the possibility of the introduction of heavier and longer lorries – the Government is due to make an announcement on the possible introduction of longer semi-trailers during this autumn;
- increasing congestion on the national railway network which can limit the rail freight industry's ability to respond quickly to changing customer requirements;
- other transport initiatives that impact directly on the rail freight business - including the construction and operation of Crossrail and aspirations to introduce further long distance and high frequency passenger services on routes critical for existing and future rail freight;
- the continuing rail reform process, including Network Rail devolution. The role of ORR in providing reassurance to the wider rail freight industry during the rail reform process will be vital; and
- continuing uncertainty about the attitude of some other industry parties towards rail freight.

1.7. In addition, the rail freight industry's main competition remains from road haulage or road based logistics services. The major opportunities for rail freight are in these sectors as recognised by the industry forecasts that underpin the vision for the Strategic Freight Network endorsed by Government in September 2009. The key to achieving modal shift will be the ability to match the prices and flexibility/simplicity of road haulage. Maintaining the current structure and level of freight charges is fundamental in helping to achieve this. Therefore, in the face of these uncertainties and strong modal competition, the rail freight industry relies on ORR to help its plans and aspirations for significant growth.

1.8. The outcome of the Comprehensive Spending Review reaffirmed Government's belief that investing in rail freight helps to drive economic growth with Government's investment in the Strategic Freight Network remaining intact. In this context it is important to remember that rail freight is strategically important for GB PLC and provides an essential service to industry:

- Over 25% of the electricity consumed in the UK is generated by coal that has been moved by rail.
- Over 40% of London's raw materials (such as aggregates and cement) are delivered by rail and rail plays an equally key role in other major conurbations.
- Over 25% of all the deep sea boxes that arrive or depart from the major UK deep sea ports are transported by rail.

1.9. Sir Roy McNulty's "Rail Value for Money Study" recognised that:

- the rail freight industry delivers economic and environmental benefits to the UK economy;

- the rail freight industry directly contributes about £870m to the nation's economy but the real economic benefits are much greater. The total contribution to the economy after also taking into account the indirect and induced effects is around £5.9bn per annum;

- rail freight uses 70% less carbon per average tonne mile than road freight. In addition, rail freight's emissions are up to five times lower than road and, therefore, presents greater decarbonising potential than any other traffic using the rail network;

- enabling rail freight to expand and thrive is a responsibility of the whole rail industry;

- rail freight operators generate very low margins – in 2008/9 this was a cumulative loss of 2.8% after tax;

- freight access charges should continue to be administered centrally, be levied on a national and homogenous basis and be compliant with European Directives; and

- existing regulatory protections for freight and other users of the network are retained and, where necessary, strengthened to reflect the new interfaces emerging as a result of industry restructuring.

1.10. The importance of protecting rail freight was also recognised by the Secretary of State in his written statement that accompanied the publication of the Rail Value for Money Study's Interim Submission on 7 December 2010, in which he said "*I am also clear that the changes the Study is proposing must protect the interests of freight operators on the network*".

1.11. Despite this, DB Schenker understands that there may be pressure on ORR to review whether certain market segments of the rail freight business could pay more towards Network Rail's fixed costs of operating the network. In PR08, ORR concluded that only coal for the electricity supply industry and nuclear traffic could afford to bear a 'mark up' on directly incurred incremental costs and that this would only be in respect of the freight-only line infrastructure that these market segments use.

1.12. DB Schenker sees no reason why this should alter as nothing has changed since 2008 to lead it to believe that other market segments could now afford to pay a 'mark up'. In fact, the recent global economic crisis and recession that have severely affected world trade and the movement of goods serve to reinforce DB Schenker's belief. Furthermore, DB Schenker would argue that these recent events together with the impact of environmental legislation would question whether the electricity supply industry coal market segment can still afford to pay a 'mark up' at current levels let alone being able to contribute further towards fixed freight-only or even common costs.

1.13. DB Schenker would hope that when considering the structure of freight charges for CP5, ORR will always have in mind the provisions enshrined in The Railways Infrastructure (Access & Management) Regulations 2005, particularly that:

- "the infrastructure manager must ensure that the application of the charging scheme…….results in equivalent and non-discriminatory charges for different railway undertakings that perform services of an equivalent nature in a similar part of the market";

- "……. the infrastructure manager must ensure that the charging system in use is based on the same principles over the whole of his network";

- "the charges for the minimum access package and ……..shall be set at the cost that is directly incurred as a result of operating the train service";

- ['mark ups' based on efficient, transparent and non discriminatory principles] "must not exclude the use of infrastructure by market segments which can pay at least the cost that is directly incurred as a result of operating the railway service, plus a rate of return which the market can bear"; and

- "the charging system shall respect the productivity increases achieved by applicants".

Given the productivity increases that have been, and continue to be, achieved by the rail freight industry (as recognised in the McNulty Rail Value for Money Study) the last bullet point above is particularly pertinent.

1.14. DB Schenker would welcome early discussions with ORR to establish whether there is any way of shortening the timetable relating to the consideration of freight charges, particularly given that the overall timetable for PR13 has already been curtailed due to awaiting the outcome of the Rail Value for Money Study.

1.15. In the last (PR08) review, ORR listened to the rail freight industry and recognised its need for stability and certainty and DB Schenker hopes that ORR will assume a similar position in this review. In these unprecedented times a strong message now from ORR that rail freight access charges will be left more or less unchanged in CP5 will give the industry the certainty and stability it needs, will allow it to grow again as the economic climate improves and to achieve the modal shift necessary to meet the vision of the Strategic Freight Network.

1.16. DB Schenker proposes that ORR should retain freight charges at their current levels (subject to inflationary increases less the agreed efficiency factor set for Network Rail for CP5) as well as retaining the current national structure of freight charges without introducing more complexity for example, through the imposition of regional based charging and/or additional charging elements such as scarcity and reservation charges.

1.17. DB Schenker believes that the proportion of Network Rail's income that is represented by freight charges is comparatively small. Therefore, a doubling of freight charges would make very little difference to Network Rail's overall income but would almost certainly put rail freight operators out of business and lead to at least a halving of the amount of freight on rail.

1.18. Given the disproportionate effect of changes in freight charges between the operators and Network Rail, DB Schenker invites ORR to settle the freight charges element of the PR13 review quickly and in the manner described above.

Specific Comments

2.1. DB Schenker's comments to ORR's specific questions raised in the consultation document are contained in the Annex to this letter.

Summary of Key Points raised by DB Schenker in its response

3.1. DB Schenker summarises the key points in its response as follows:

- There needs to be early certainty for rail freight operators over the structure and level of charges that they will face in CP5.
- ORR should retain freight charges at their current levels (subject to inflationary increases less the agreed efficiency factor set for Network Rail for CP5) as well as retaining the current national structure of freight charges without introducing more complexity (e.g. regional charging by Network Rail route).
- There need to be specific enforceable safeguards for national operators such as DB Schenker to protect them against any adverse effects on their businesses from Network Rail's plans for devolution or, potentially, to offer concessions. It is particularly important that any process of disaggregation does not inadvertently damage network benefits or increase costs elsewhere.
- As a private sector operator competing in the highly competitive national and international freight markets, it is inappropriate (as well as highly complex) for DB

Schenker and other freight operators to have to disaggregate costs and revenue down to the level of Network Rail's routes.

- DB Schenker is opposed to the introduction of scarcity and reservation charges for rail freight (which are optional and not mandatory) as these charges will add complexity thereby discouraging freight traffic from using rail. DB Schenker instead favours better use of non-financial mechanisms. In this respect, DB Schenker acknowledges the recent introduction of a mechanism to create, manage and safeguard Strategic Capacity and notes that ORR is currently proposing major changes to Part J of the Network Code.

- There is no justification for ORR to increase the application of 'mark ups' on rail freight access charges to other market segments or indeed to other types of cost (e.g. common costs).

- Defining obligations in terms of outputs is in principle the best approach. To be effective, outputs need to be clear, simple and capable of measurement without undue management time, effort or expense.

- As a principle for rail freight, ORR should focus on more narrowly defined outputs for which Network Rail is fully responsible and leave wider "whole system" rail freight outputs to the market.

- DB Schenker urges ORR to always bear in mind the lack of sector regulatory obligations placed on the rail freight industry's principal modal competitor, the road haulage industry and that freight end-customers have choice, both of mode and of rail freight operator.

- ORR should take full account of the relevant and applicable provisions enshrined in The Railways Infrastructure (Access and Management) Regulations 2005 as they apply to PR13 in general and rail freight in particular.

I can confirm that this response contains no information of a commercial and/or confidential nature that would prevent ORR from publishing it on its website or quoting from it if considered necessary. I can also confirm that DB Schenker remains willing to discuss any aspect of its response with ORR should this be considered helpful.

Yours sincerely,

Nigel Jones
Head of Planning & Strategy

Annex

DB SCHENKERS RESPONSES TO ORR'S SPECIFIC QUESTIONS

This Annex contains DB Schenker's responses to the specific questions posed by ORR in the consultation document.

- ***Chapter 3 (ORR objective for PR13)***

Q1: Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?

1. In principle, DB Schenker supports ORR's proposed objective for the review. However, given that the key issues that form the wider context for PR13 (paragraph 3.2 of the consultation document) include increasing demand by passenger and freight customers and the devolution and reform of Network Rail, DB Schenker considers that specific mention should also be made of:

- providing safeguards for nation-wide operators such as the freight companies;
- supporting private sector investment outside of franchises (e.g. by freight companies or in strategic rail freight interchanges);
- recognising the commercial and competitive environment in which rail freight operates; and
- recognising the acknowledged environmental and economic benefits of rail freight growth.

- ***Chapter 5 (High level timetable)***

Q2: Do you have any views on our proposed timetable for the review? Do you need further information to plan your involvement with PR13?

2. DB Schenker considers that certainty and stability are crucial factors for the continuation and growth of the rail freight industry which depends on the private sector. As previously stated, the Periodic Review presents an opportunity to reinforce that stability and certainty – but it also represents a risk. The very act of undertaking a Periodic Review with the associated uncertainties about the funding of the infrastructure provider, the High Level Output Specifications and the process for matching the two creates uncertainty. This uncertainty is multiplied when there is a possibility that ORR will review and restructure freight access charges.

3. DB Schenker welcomes ORR's intention to place a cap on the level of certain freight access charges well in advance of its determination (paragraph 6.62(f) of the consultation document) but suggests that ORR should, as it did in PR08, significantly shorten the timescales relating to decisions on rail freight.

- ***Chapter 6 & Annex B (Regulatory framework and key issues – Network Rail devolution and price control separation)***

Q3: Do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate? Is the information we are requiring Network Rail to produce set at the right level? Do you have views on the information train operators should produce?

4. Disaggregation of financial and other data to route level is clearly important for the success of Network Rail devolution. As a general principle, DB Schenker is supportive of cost management and decision-making being devolved to the lowest level of any organisation where they can most effectively be managed. However, the individual routes of Network Rail are not separate entities per se as together they form part of a national network and in many cases share common asset and operating practices and characteristics. It is important that any process of disaggregation does not inadvertently damage national network benefits or increase costs elsewhere. National operators, such as DB Schenker, have no "natural fit" between the services their customers require them to operate and the organisational boundaries of Network Rail's routes. Typically, national operators will operate services over three or four routes – in the case of DB Schenker this will often be many more.

5. In terms of transparency of train operator financial information, DB Schenker is a private sector business operating in the highly competitive freight market, with strong competition from other rail operators and road hauliers. It is therefore inappropriate (as well as exceptionally complex and artificial) to disaggregate freight company costs against NR routes. It is implicit in both McNulty and the PR13 Consultation document that rail freight companies would not be expected to be subject to the same expectations as Franchises, but for the avoidance of doubt this should be set down explicitly.

6. Whilst DB Schenker fully appreciates that disaggregated financial information (or even price controls) does not inevitably imply disaggregated access charging, it is inevitable that management behaviour within Network Rail will be influenced in a way that is potentially disadvantageous to national operators. ORR needs to set out very clearly how the interests and activities of national operators such as DB Schenker will be safeguarded.

Q4: Which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?

7. In principle, DB Schenker supports the approach that was previously adopted by ORR for PR08 (i.e. with similar efficiency and cost of capital assumptions for both Scotland and England & Wales). Unless Governments are minded to demand specific regional exceptions, DB Schenker sees no reason to change this position. In particular, DB Schenker urges ORR to ensure that a simple, national access charging structure is retained for rail freight.

Q5: Do you think there should be further separation of the price control for Network Rail's operating routes and, if so, which aspects of the price control should be separated?

8. DB Schenker is not convinced that the costs and effort of establishing separate price controls for Network Rail's operating routes will be justified at this early stage of the devolution process.

Furthermore, DB Schenker is not sure how the routes would address the necessary balance of route and national required outputs, costs and enhancements in a mature and responsive way. DB Schenker, therefore, remains concerned about the need to adequately protect and develop network-wide benefits and would need to understand much more about how “ring-fenced” each route’s financial settlement might be.

- ***Chapter 6 & Annex C (Regulatory framework and key issues – Network Rail success in control period 4)***

Q6: Is the current approach to defining obligations in terms of outputs the best approach? What outputs should be defined? Should there be a move to more use of outcome based obligations? Would another approach be appropriate such as specifying inputs or intermediate measures?

9. DB Schenker agrees that defining obligations in terms of outputs is in principle the best approach. To be effective, outputs need to be clear, simple and capable of measurement without undue management time, effort or expense.

10. DB Schenker urges ORR to always bear in mind the lack of sector regulatory obligations placed on the rail freight industry’s principal modal competitor, the road haulage industry. Moving away from reliance where possible on the discipline of the market would place rail freight at further competitive disadvantage. It is partly for this reason that DB Schenker does not support outcome related obligations. ORR cites an example of such a potential outcome as “*an improvement in freight user satisfaction*”. However, such a subjective outcome would have no easy measure and a statistically small sample size. Freight end-customers have choice, both of mode and of rail freight operator, and this ought to be sufficient.

11. There may well be occasions when using input or intermediate measures would be appropriate, particularly in cases where a continuing achievement of outputs may mask an underlying deterioration of the network that will remain undetected until it is too late to rectify (e.g. gauge corner cracking preceding the Hatfield accident). However, DB Schenker believes in principle that Network Rail should generally be given the ability (in conjunction with their customers) to determine how specified outputs might be achieved.

Q7: What are your views on how we should compile and present 'scorecards' of Network Rail's performance in CP5?

12. DB Schenker suggests that a key area for ORR to examine is how Network Rail achieves a proper balance of route and national issues to ensure that the obligations for all of Network Rail’s customers (and end users) are understood and appropriately delivered.

13. DB Schenker, together with the other members of the Rail Freight Operators Association (“RFOA”), has already suggested a framework to Network Rail of metrics for CP5 that covers performance, network availability, capacity, journey times, network capability and seeks to address this balance for rail freight. This framework would contain a mix of regulatory enforceable metrics and bilateral plans that would be commercially confidential between the parties. RFOA is in discussion with Network Rail to develop a strategy for taking this framework forward.

Q8: Should we make more use of 'whole system' outputs over which Network Rail does not have full control, or focus on more narrowly defined outputs which the company is fully responsible for?

14. As a principle for rail freight, DB Schenker believes that ORR should focus on more narrowly defined outputs for which Network Rail is fully responsible and leave wider “whole system” rail freight outputs to the market. Unlike the passenger franchises, rail freight is a private sector activity with strong competition in which end-customers have choice both of mode and of rail freight operator. End customers can – and do – ‘vote with their feet’ if their rail freight operator or the wider rail freight industry does not deliver the service they require. The only monopoly activity within the supply chain is Network Rail which is why DB Schenker considers that regulatory activity relating to rail freight should focus on the Network Rail elements being delivered at an appropriate price and pace, and in a non-discriminatory way.

Q9: How should output obligations be defined in the context of devolved Network Rail routes with separate price controls?

15. The rail freight market in the UK is a nationwide market in which freight flows are driven by market needs which have no relationship to Network Rail route boundaries. Typically, rail freight flows cross at least three or four Network Rail routes and in many cases it can be more.

16. It is essential for rail freight that it is able to compete with the road haulage industry whose usage of the road network is free at the point of use and not subject to route or other operational boundaries. This means that rail freight needs to retain an access regime that is similar, if not identical, to the one in place today (i.e. one that is simple to understand, applies nationally and is consistent and non discriminatory).

17. DB Schenker is not convinced there is any case for changing the PR08 establishment of separate price controls for England & Wales and Scotland (reflecting the different funding regimes) and maintaining GB wide access charging for rail freight.

Q10: How should the balance between the number of output obligations and their individual significance be struck?

18. DB Schenker supports a relatively small number of specific output obligations with respect to rail freight and believes that the structure and size of the PR08 output obligations were broadly fit for purpose. As set out in paragraph 13, RFOA is already in discussion with Network Rail about some potential augmentation of these for CP5.

Q11: Should Network Rail's output obligations include a specific safety requirement, different from its legal obligations?

19. DB Schenker already takes comfort from the fact that Network Rail already has enforceable legal obligations (including in its network licence) that incentivise it to operate its network safely. DB Schenker would, therefore, need to be convinced that another separate output relating to safety would add benefit. Currently, it remains unconvinced.

- ***Chapter 6 & Annex D (Regulatory framework and key issues – Improving incentives)***

Q12: Do you have views on how the effectiveness of the existing financial incentives can be improved?

20. In principle, DB Schenker supports financial incentives that assist:

- the achievement of output targets and efficiency gains by Network Rail; and
- incentivising and holding to account Network Rail's Executives and Management to achieve or outperform these.

21. There is a current suite of financial incentives including Schedule 4 (Possessions Regime), Schedule 8 (Performance Regime), CP4 Efficiency Benefit Sharing Mechanism and the Volume Incentive. DB Schenker would expect these to be reviewed as part of the PR13 process, although it was clear at the recent ORR Schedule 8 industry workshop that there was little appetite from the industry for fundamental changes to the current freight Schedule 8 regime in particular, which was only introduced at the start of CP4.

22. Central to such a review should be ensuring there is clarity as to the purpose of each incentive and transparency as to the effect on all affected parties. For rail freight, it is important to retain simple, nationwide approaches.

23. DB Schenker is sympathetic as to the potential attraction of contestability, but would urge ORR to ensure that;

- any route infrastructure management concession is readily comparable to activity on other routes, including freight activity; and
- suitable safeguards for nationwide operators such as DB Schenker are developed and in place before any concession is let – these might include (inter alia) the system operator role and appropriate Licence conditions. DB Schenker concurs with the safeguards identified as necessary by the McNulty Report i.e.;
    - national operations and timetabling;
    - national capacity allocation and capacity planning;
    - national approach to network capability;
    - national approach to infrastructure maintenance and renewals planning (including co-ordination of engineering works); and
    - retaining and, where necessary, strengthening regulatory protections for freight.

24. DB Schenker is concerned that the financial incentives on Network Rail to grow rail freight are not strong enough and would be keen to work with ORR and other rail freight industry partners on proposals to incentivise Network Rail to grow freight at the margin. This would need to reflect that many of the benefits of new freight services are realised outside the railway balance sheet – but some form of credit to Network Rail (perhaps against the RAB) might be appropriate.

Q13: Do you have views on how the effectiveness of Network Rail's incentives to make best use of capacity could be improved?

25. DB Schenker is supportive of making best use of capacity, but is not yet convinced that major changes are needed to existing mechanisms.

26. DB Schenker is not convinced that the introduction of scarcity and reservation charges will be effective and that it might result in serious unintended consequences. Such charges have to be considered within the wider charging objectives and the current capacity allocation principles. There would be a risk that capacity would be allocated on the basis of an applicant's ability to afford rather than any assessment of need or best use. This might particularly disbenefit the rail freight industry where it is acknowledged many of the benefits of rail freight growth lie outside the railway balance sheet. DB Schenker instead favours the use of non financial mechanisms such as those enshrined in Part J of the Network Code which ORR is currently proposing to strengthen further. The recent introduction of provisions intended to create and maintain Strategic Capacity in Part D of the Network Code will also give confidence to freight operators that surrendering under utilised paths will not automatically mean they are lost to other uses.

27. The rail freight industry has developed long term growth forecasts that are iterated with all stakeholders (including Network Rail, Freight Operating Companies, DfT, Transport Scotland, Transport for London, ATOC, Rail Freight Group, Freight Transport Association and ORR). These support the development of the Strategic Freight Network which the SFN Steering Group (on which all stakeholders sit) debates and oversees to ensure that suitable capacity and capability is available. This process does suggest interventions and infrastructure enhancements, but acts as a filter to ensure that "Predict, Manage and Provide" is already the rail freight way.

28. The Strategic Freight Network is based on a series of principles, many of which are specifically intended to improve the use of capacity and which include:

- moving to longer and heavier trains with a standard intermodal train length of 775m being the long term aim;
- employing efficient operating characteristics (avoid looping and seeking efficient paths) that maximise the use of capacity and improve environment impact of trains simultaneously;
- seven day /24 hours capability on key routes; and
- electrification of key freight routes.

29. DB Schenker suggests that a wider appraisal of capacity demands on congested routes would have value – for example running additional rail freight services instead of lightly patronised passenger services during off-peak periods. It has already been shown by work on the East Coast Main Line that many freight trains have a greater economic value than lightly loaded off-peak passenger trains.

Q14: Do you agree that we should include a regional efficiency benefit sharing mechanism calculated at the Network Rail route level? Are there further issues about how a regional efficiency benefit sharing mechanism should be introduced which you want to highlight?

30. DB Schenker understands the attraction and supports the principle of regional efficiency benefit sharing mechanisms, but has concerns as to the involvement of freight operators and the potential adverse impacts on rail freight. It is critical to DB Schenker that all users of a route would be able to participate in any such schemes. However, freight operators such as DB Schenker who operate over many, if not all, routes face the prospect of having to participate in multiple schemes, each of which might be different. That could be a considerable administrative burden and increase transaction costs.

31. In this event, it becomes doubly relevant as to whether the quantum of potential benefit would be sufficient. The worked example in Table D5 suggests that only the primary TOC will have a major financial incentive. For secondary TOCs, the balance between potential reward and impact of input might be very much more problematic.

32. If potential reward is linked to Track Access Charges, would this be in proportion to variable or fixed & variable track access charges? DB Schenker has concerns that basing a REBS scheme on a system which itself is based on different principles for different sectors of the industry will potentially be discriminatory. If this is the case, how will secondary users be incentivised to participate other than through fear of being disadvantaged because of the relationship that will develop between Network Rail and other REBS scheme participants?

33. A further major concern for DB Schenker is how an appropriate balance will be struck between national and route priorities/markets when the primary intention of a REBS scheme is local or regional focus. It is also important that one party's ideal of efficiency does not become another party's output reduction – especially where the target of efficiency has no value to the other party participating in the scheme or where they are not in a position to assess its proper value to other users.

34. This is a complex area and DB Schenker has serious concerns at the potential impacts on secondary users.

Q15: What are your views on exposing franchised passenger train operators to changes in Network Rail's costs at a periodic review?

35. DB Schenker is sympathetic to the need to develop an incentive for franchise operators to engage with Network Rail (and in the PR13 process) on Track Access Charges and Network Rail's underlying costs in the same way that the rail freight industry (and especially DB Schenker) does. It does not seem to DB Schenker to matter if this focus is primarily on variable costs and charges. DB Schenker is aware that finding an appropriate mechanism to simulate the commercial pressure faced by DB Schenker and other freight operators lies in the relationship between the Governments and their franchisees in Franchise Agreements, an area currently under review.

Q16: Do you believe that Network Rail should share in train operator revenue and/or costs? Are there further issues about introducing a revenue/cost sharing mechanism which you would highlight?

36. DB Schenker notes that it is superficially attractive for any mechanism to work both ways, but is not convinced that this should be an automatic feature of any agreement. It would seem best that it would only apply where both parties agree it is appropriate. In this respect, the difference in size and scale between Network Rail (even at a route level) and corresponding train and freight operators has to be put in context.

37. DB Schenker does not believe that Network Rail sharing in freight operator revenue/cost would be appropriate as:

- Rail freight is a fully private sector, highly competitive activity.
- The financial position of freight operators is such that they cannot afford it (the McNulty Review confirmed the thin nature of freight operator margins).
- End customers will not pay anything additional to cover this.
- Network Rail activity can be only a minor element of the supply chain and there is little logic in Network Rail sharing in revenue or benefit from non-Network activities.

38. An additional complication is that as rail freight is a competitive market, any regime would have to be even-handed between freight operators to avoid any potential discrimination.

Q17: We would welcome your views on possible bespoke arrangements for enhancement efficiency benefit sharing and whether there is a need for additional measures to increase the contestability of expenditure?

39. Freight enhancements tend to be infrastructure related – e.g. the provision of loops, signalling changes to improve headways or changes to permit longer trains. It is relatively easy to establish comparators for freight only track work as there is a UK market for non-Network Rail track work, but it is much less easy for anything involving signalling given the more restricted nature of the supply market and complex interfaces with Network Rail (and other network operators). The high cost and long timescales for freight connections remain very big issues, especially given future rail freight growth forecasts and the need for more strategic rail freight interchanges. DB Schenker suggests that some international benchmarking and potential contestability in this area would be appropriate.

Q18: Are there further new incentives which you believe should be introduced and what would the benefits be?

40. DB Schenker agrees that there is no case for an environmental charge, particularly where this is not applied to competing modes.

Q19: Are there other interactions between incentives (and the wider regulatory framework) which we need to take into account?

41. DB Schenker agrees that wherever possible it is preferable to try and drive behaviour and achievement of outputs in a positive way via incentives. However, ORR is faced with regulating a complex industry with multiple users/requirements which do not always sit easily together. Therefore trade-offs and balances are required, and it is unlikely that such a complex series of equations will be achieved solely via incentives. DB Schenker would therefore welcome ORR setting out in detail its views on what other protective mechanisms (e.g. Licence conditions) would be needed and how the balance of positive incentives and negative checks will be managed.

- ***Chapter 6 & Annex E (Financial framework)***

Q20: What are your views on the duration of the control period?

42. DB Schenker recognises that there is a complex balance between risk and duration of a control period. DB Schenker is not convinced that there is any case for reducing the length of the control periods as this would increase uncertainty and reduce stability. The length of time for the Periodic Review process itself would also not favour shorter (and, therefore, more) control periods.

43. There is a case for a longer duration, especially for fully-commercial activities such as rail freight and to underpin investments in rolling stock and terminals. Longer term settlements on the structure and level of access charges also help to provide long term certainty and stability for operators and customers and also align with the move to longer franchises.

Q21: Do you think that we should retain the single till approach rather than moving to a dual till approach?

44. DB Schenker is not convinced there is any case for moving from the single till approach to a dual till approach.

Q22: Do you think that our overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

45. DB Schenker accepts that it is better for ORR to give Network Rail a relative amount of freedom to decide how to achieve the range of outputs, trajectories and enablers that will be set for them as part of PR13.

46. However it remains clear that Network Rail is a fundamentally risk averse company. This manifests itself in different ways – the slow speed and pace of processes and the level of contingency applied at each stage of the GRIP process being two examples.

47. If Network Rail is going to change and become more responsive, as is intended by devolution, then the senior and middle management of Network Rail have to become more empowered and given freedom to make more decisions. It is inevitable that during this transition mistakes will be made – it is impossible for 100% of decisions made to be correct. The reaction

of the Network Rail Board/Executives, ORR and Governments to genuine mistakes made as part of this transition will be critical.

Q23: Network Rail faces a number or risks. At this stage, do you have any views on how general inflation risk and input price risk should be addressed?

48. All businesses face risk. Private sector businesses have to take on board full inflation and input price risk unless they can negotiate some back to back arrangements with their customers - hence why freight customer contracts typically have price variation clauses linking prices to an index. However if reality is different to the index, then the risk tends to remain with the operator – and the operator might well be committed contractually to providing services on terms which have become unfavourable. Operators simply have to chase efficiency within the boundaries they have.

49. In principle there is no reason why Network Rail cannot be in a similar position. Equally Network Rail has very considerable buying power and in some sectors is close to being a monopsony. DB Schenker would expect Network Rail procurement to be capable of achieving world class prices in almost all of its activity.

Q24: We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

50. DB Schenker has no comments on this issue.

- ***Chapter 6 & Annex F (Structure of charges)***

Q25: Do you consider that our charging objectives remain appropriate?

51. Yes.

Q26: What are your views on the geographical disaggregation of variable usage charges?

52. Whilst DB Schenker is not opposed to the principle of the disaggregation of variable usage charges by geographical areas, it does, however, believe that this would introduce a further scale of complexity and uncertainty to the rail freight industry which operates on a national, not regional, basis. The current charging structure applied to rail freight with its vast array of usage charges by locomotive/wagon type, locomotive/wagon sub-type and commodity carried when combined with other charges such as capacity, EC4T asset usage, coal spillage, coal spillage investment and freight-only line already oversteps the bounds of simplicity. The prospect of further complexity being applied to rail freight would make it even more difficult for it to compete with its major competitor, the road haulage industry, who has the certainty that its fixed licence fee will enable use of the entire national road network.

53. As stated above, variable usage charges for freight are already complex. To calculate an overall charge per train many individual elements need to be understood and applied to the usage charge price list. These include, locomotive type, wagon type (there can be many different types of wagons on each train), wagon sub type, commodity, weight of locomotive, tare and gross weight of each wagon and distance from origin to destination. The prospect of applying further complexity by having different usage charge rates for different geographical

areas would further discourage the use of rail for freight as it would take much longer to ascertain the track access charge (which represents a substantial proportion of a train's costs) for each service thereby increasing response times to end customers.

54. Under the current national freight variable charging system, at least a freight operator knows which variable usage charge rate will apply without the need to wait for Network Rail to offer a path so that the routing can be ascertained. This would not be the case if there were different variable usage charge rates on each route as freight operators would need to wait until Network Rail confirms the routing before the charges could be accurately calculated. Furthermore, even after a path has been secured, the routing known and the charge calculated, if Network Rail then decides to divert the train onto an alternative route either at short notice or in a future timetable, the charge would need to be recalculated thereby adding uncertainty and risk to the freight operator.

55. As a result of the above, DB Schenker considers that the freight variable usage charges should remain on a national basis to avoid further complexity as well as avoiding discouraging freight customers from using rail freight to transport their goods.

Q27: What are your views on introducing a charge levied to reflect network scarcity?

56. DB Schenker opposes the introduction of a scarcity charge which would undermine the stability and certainty that the rail freight industry needs to thrive. Such a charge, which is not levied on road hauliers for using the national road network, would introduce added complexity into the structure of freight charges for little or no benefit. DB Schenker instead favours the use of non financial mechanisms such as those enshrined in Part J of the Network Code which it understands ORR is currently proposing to strengthen further.

57. Furthermore, DB Schenker notes that Schedule 4 of The Railways Infrastructure (Access and Management) Regulations 2005 specifies that the infrastructure charge may include a charge to reflect the scarcity of capacity of the identifiable segment of the infrastructure during periods of congestion. DB Schenker considers this to imply that scarcity charges are optional and should only be applied to identifiable segments of the infrastructure during periods when those segments are congested. In addition, regulation 25(5) of those same Regulations, suggests that the infrastructure manager is not able to levy a scarcity charge unless it has produced a capacity enhancement plan for the congested segment of infrastructure in question or has failed to implement any actions set out in such a plan.

58. DB Schenker submits, therefore, that the Regulations do not appear to contemplate the introduction of a national scarcity charge applying to the entire network 24/7.

Q28: What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

59. DB Schenker opposes the introduction of a reservation charge. It considers that existing mechanisms such as Part J of the Network Code (which is currently subject of an ORR review) act to ensure that operators hold appropriate access rights whilst recognising the need for freight operators to have some flexibility in the use of the network if they are to be competitive with other modes. Furthermore, the recent work by the industry to introduce a mechanism which places obligations on Network Rail to develop Strategic Capacity on key routes will also give

confidence to freight operators that surrendering under-utilised paths will no longer automatically mean that they will be lost to other uses. It is also important to bear in mind that the rail freight industry's main competitor, the road haulage industry, does not have to pay reservation charges to use the road network.

60. The prospect of an additional charge is also unwelcome at a time when track access charges could increase. It is not clear how the reservation charge would be set to be financially neutral for freight operators. Nevertheless, even if the effect of the additional charge is proven to be financially neutral, DB Schenker is certain that its introduction would still significantly increase complexity and the costs of administering the mechanism. DB Schenker does not believe that increasing the cost of railway operation for little or no benefit is an appropriate policy for ORR to adopt, particularly considering that the charge is optional, rather than mandated, under The Railways Infrastructure (Access and Management) Regulations 2005.

Q29: Should passenger open access operators pay charges that exceed variable costs. How should charges be calculated?

61. DB Schenker has no comments on this issue.

Q30: What are your views on the proposals to improve incentives to reduce traction electricity consumption?

62. In principle, DB Schenker supports the move towards the fitment of meters to electric traction to more accurately measure and charge for the use of electricity as this should better incentivise operators to reduce consumption. However, for operators with relatively small fleets of electric trains that traverse many different routes both with ac and dc supply (such as DB Schenker), the benefits of opting for metered consumption must be proven to outweigh the costs of fitment and maintenance of the equipment as well as the ongoing time and effort in collecting and applying the necessary data.

63. DB Schenker notes that the proposals to improve incentives to reduce traction electricity do not appear to include the ability for certain traction units to be able to use regenerative braking capability (i.e. putting unused electricity back into the system).

Q31 Should we put a cap on certain freight charges in advance of our determination and should these be linked to other changes?

64. ORR listened to the rail freight industry and recognised its need for stability and certainty in its previous PR08 review. DB Schenker, therefore, strongly urges ORR to recognise these needs for this review also. Placing a cap on the level of certain freight access charges well in advance of its determination (paragraph 6.62(f) of the consultation document) will obviously go some way towards helping to mitigate the concerns of the rail freight industry over the outcome of the review. However, DB Schenker believes that ORR should go further and should consider retaining freight charges at their current levels (subject to inflationary increases less the agreed efficiency factor set for Network Rail for CP5) as well as retaining the current national structure of freight charges without introducing more complexity for example, through the imposition of regional based charging and/or additional charging elements such as scarcity and reservation charges. The proportion of Network Rail's income that is represented by freight charges is comparatively small so a doubling of freight charges will make very little difference to Network

Rail's overall income but would almost certainly put rail freight operators out of business and lead to at least a halving of the amount of freight on rail.

65. ORR's proposals to place a cap on certain freight charges should not, however, be linked to other changes. Given the express needs of the rail freight industry for stability and certainty, the placing of a cap on certain freight charges well in advance of ORR's determination is the right action to take and should be viewed as a standalone proposal without conditions. Similarly, as a responsible freight operator, DB Schenker will continue to work with industry partners to identify ways to reduce whole industry costs, again as standalone proposals, as this is also the right action to take.

Q32 Do you have views on the interactions between these possible changes and when they should be implemented – for example whether some changes should only be introduced after other changes have 'bedded in'?

66. Until the various possible changes have been discussed, developed and agreed it is very difficult to determine whether certain changes should be introduced after others have taken effect or whether they should all be introduced at the same time at the start of CP5. However, whatever possible changes may be determined for CP5, particularly in respect of rail freight, DB Schenker urges ORR to ensure that such changes are agreed quickly so that there is a reasonable degree of certainty going forward.

End