DB Schenker Rail (UK) Ltd
2nd Floor McBeath House
310 Goswell Road
London EC1V 7LW

Nigel Jones
Head of Planning & Strategy

Telephone: +44 (0)1302 577042
Fax: +44 (0)20 7833 8449
Mobile: +44 (0)7801 905690
nigel.jones@dbshenker.com

Joe Quill,
Office of Rail Regulation,
1 Kemble Street,
London WC2B 4AN

Dear Joe,

10 August 2012

Periodic Review 2013 : Consultation on the variable usage charge and on a freight specific charge.

This letter contains the response by DB Schenker Rail (UK) Limited ("DB Schenker") to the consultation document entitled "Consultation on the variable usage charge and on a freight specific charge." issued by Office of Rail Regulation ("ORR") on 17 May 2012.

DB Schenker's response is three parts:

1. This letter, which contains an Executive Summary of the key points DB Schenker is making;.
2. Part One, which contains a series of general comments germane to the consultation.
3. Part Two, which contains specific comments on the questions posed within the consultation document.

The Rail Freight Operators Association has written two letters to ORR - to Richard Price on 4th May 2012 and to Anna Walker on 22nd June 2012 - setting out a number of its concerns on the proposals in this consultation. Copies of those letters are included as Attachments 1 and 2 to this response. The points raised in those letters remain valid, and should be considered as part of this response.

Executive Summary

1. The proposed changes:

    a. will make the structure of charges too complex;
    b. will place rail freight at a further structural competitive disadvantage;
    c. represent a deeply concerning change to regulatory policy for freight charging;
    d. will inject considerable regulatory risk into sector; and
    e. risk damaging the already fragile financial position of freight operators such as DB Schenker which would potentially jeopardise future private sector capital investment.

2. In considering the balance of its duties in respect of these proposals, ORR has placed insufficient emphasis on the need for freight operators to be able to plan the future of their business with a reasonable degree of assurance. This is the opinion of a leading counsel whom DB Schenker has consulted.

3. ORR has made insufficient analysis of the potential second order impacts of their proposals on freight operators, ports and other affected third parties.

4. Geographic charges are extremely complex. Imposition of geographical disaggregation on the current structure would risk serious dislocation to the freight market. As such, the issues require very specific consideration for freight that cannot be undertaken in the time available for the PR13 process.

5. If the strategic direction in which ORR wishes the industry to proceed is based around geographic variation, then ORR should recognise that freight access charging effectively has to start again from scratch. This will require very extensive consideration to minimise perverse outputs and to ensure that the impact relating to any “winners and losers” is manageable.

6. With this is mind, DB Schenker considers ORR should leave the current structure of charges intact for CP5 in order to allow sufficient time for geographical variation of charges for freight to be properly considered for implementation at a later Periodic Review.

7. If this were to happen, ORR could still achieve some of its current policy objectives for CP5 in terms of certain freight traffics paying a greater contribution towards Network Rail’s costs associated with freight. This could be attained by adjusting the variable usage charge and by recalibrating the freight-only charge for those market sectors. However, any such increases must be kept sufficiently low that it can reasonably be absorbed, and that second order impacts are minimised.

8. DB Schenker supports a cap on variable freight usage charges. However, it is imperative that once agreed the cap has to apply for the entire Control Period.

9. All rail freight access charges resulting from this Periodic Review must be consistent across CP5 and additional charges should not be introduced during the Control Period.

10. Network Rail should undertake further work on the costs supporting the variable charge, particularly on structures in the light of the freight community’s Morgan Tucker Report.

11. To align with the recommendations of the Sir Roy McNulty ‘Rail Value for Money Study’ published in May 2011, freight charges should continue to be “administered centrally and levied on a national and homogenous basis”.

...

12. The administration of all charges, including any new or varied charges, should be as simple as possible. This would be achieved if the current structure of charges was retained.

13. Notwithstanding the above comments, if ORR decides to introduce a freight specific charge, then DB Schenker fails to understand how the proposed 10% cap would work.

DB Schenker is content that the vast majority of this response be made public, but would ask that paragraphs 11, 14, 15 and 16 in Part One together with Attachments 2, 3 & 4 be redacted on the grounds of commercial confidentiality.

As ever, if you have any queries or would like clarification or amplification of any of the points in this response, please contact me.

Yours sincerely,

Nigel Jones
Head of Planning & Strategy

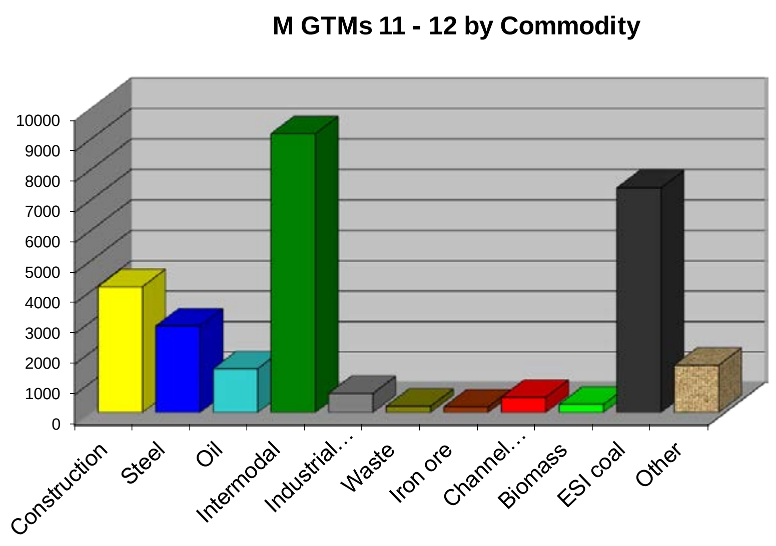
...

Periodic Review 2013: Consultation on the variable usage charge and on a freight specific charge

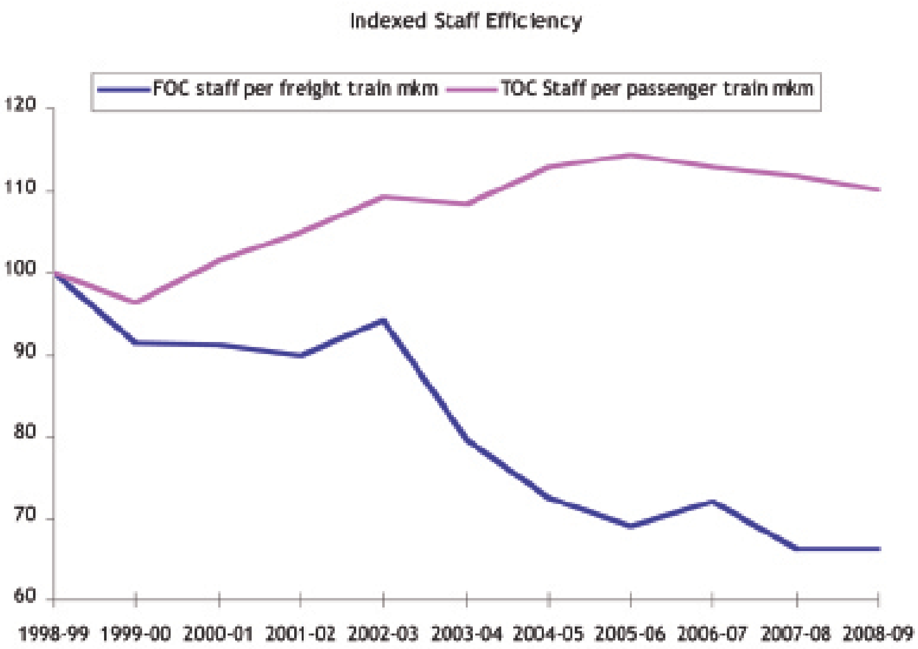
Response from DB Schenker : Part One – General Remarks

Introduction

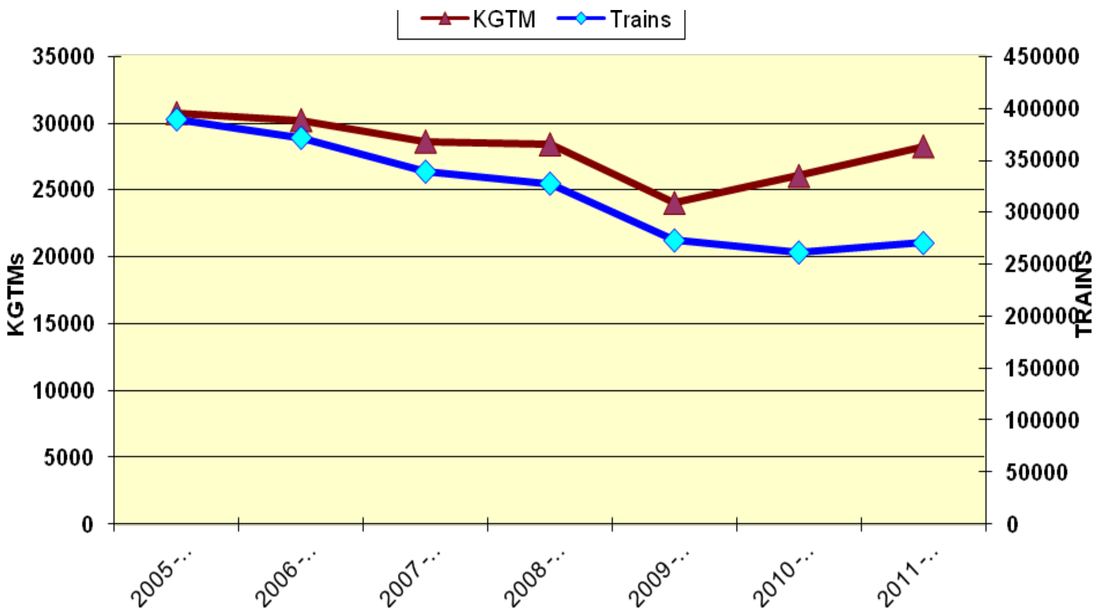
1. Rail freight is generally acknowledged as one of the major successes of the post-privatisation industry.
2. Sir Roy McNulty's "Rail Value for Money Study" published in May 2011 ('the McNulty Study') noted that the low point of rail freight traffic was in 1994/95 when 13bn net tonne kilometres were moved. From then, until just before the recession, rail freight activity increased by 68% to 21.9bn net tonne km. During the recession activity fell as demand for bulk, manufactured and consumer goods reduced. By 2011/12 the level of rail freight activity had recovered to 21.06bn net tonne km excluding infrastructure support services where activity totalled a further 1.86bn net tonne km. The sector then grew by nearly 10% between 2010/11 and 2011/12, with substantial increases in activity in intermodal (now the largest sector), construction and coal.
3. The McNulty Study also noted that "*this has been underpinned by some £1.5bn private-sector investment in rail freight equipment ….such as locomotives, wagons, yards, terminals and information systems. This investment has contributed to rail freight operators becoming increasingly competitive with each other and with other modes". "One result of competition has been a reduction in prices, where the beneficiaries have been rail freight shippers and their customers*".
4. Network Rail has published data for 2011/12 showing a breakdown by commodity which confirms that intermodal has now become the largest commodity on rail, with volumes comparable or in excess of coal. Construction and steel also continue to use rail for substantial volumes.



5. The McNulty Study also concluded that the rail freight sector had delivered considerable efficiency gains, as demonstrated by the chart set out below which shows how headcount efficiency has improved dramatically since privatisation.



6. Network Rail has recently published additional information that shows how rail freight has improved its productivity since 2005, with the kgtms per train improving by 32% over that period. This has been driven by longer trains, better utilisation, the effects of gauge clearance and innovative commercial partnerships with customers to improve value for money during the recession.



7. Rail freight volumes have recovered well from the recession, with strong growth in key sectors such as Intermodal.

The reasons for rail freight's success in the fifteen years since privatisation can be summarised as:

a. The impact of competition and the threat of competition, both internally within the mode and externally with road transport, which offers customers (& potential customers) choice.
b. Improved efficiency and innovation.
c. Improved service quality, underpinned by investment in new assets and systems.
d. Competitive pricing.

8. All things being equal, the sector will continue to evolve by developing innovative products for customers and responding to the ever-changing freight market. Supporting this will a continued focus on greater efficiency and competitiveness.

9. However, an important element underpinning the sector's success has been supportive political and regulatory regimes.

    a. Government policy over the past fifteen years has been consistently supportive of rail freight, but this has crystalised more recently into the publication of the "Strategic Rail Freight Network; The Longer Term Vision" in September 2009 and the establishment of the Strategic Freight Network fund as part of the 2008 Periodic Review Settlement.

    b. The 2001 and 2008 Periodic Review settlements in particular have changed the basis on freight access charging, most recently to be consistent with legislation set out in the Railways Infrastructure (Access and Management Regulations) 2005 ('the Regulations'). In general terms, the access charges paid by users have become transparent, non-discriminatory and have reduced substantially over time with the freight fixed costs of the network being funded by Government directly as part of the Network Grant. This has placed rail on a more equal footing with road transport and also helpfully acknowledges that many of the benefits of rail freight fall outside the railway balance sheet.

10. Rail freight continues to have prospects for strong growth as set out in the Initial Industry Plan. However these forecasts for the sector presuppose that there is no material change in the economics of the sector, or any substantial increase in political or regulatory risk.

Railfreight economics

11. I

12. Any potential changes to the access charging regime must take this financial position into account.

13. DB Schenker is also seriously concerned that both the MDS Transmodal and NERA analyses do not address the effect of an increase in track access charges on rail freight economics. This is because they have looked at markets individually, but not reviewed the interaction of one market with another nor the response of operators to the profitability of the overall market for rail freight.

14.

15.

16.

17. DB Schenker is surprised that neither MDS Transmodal nor NERA made any attempt to understand or factor in the actual contractual position with respect to ESI coal or Iron Ore.

18. In addition, access charges are not the only cost pressure being faced by rail freight operators. Increases in fuel cost, fuel duty and pension costs will all have an impact on the viability of rail freight. Whilst it might be theoretically possible to separate the effect of each of these issues, the combined effect is further financial pressure on the business.

19. Finally there comes a point in rail freight economics, which probably cannot be modelled, where investors and shareholders decide to spread the risk or invest elsewhere. There is

some evidence from institutional investors in rail freight terminals (i.e. crucially, in sectors that are not targeted for any freight specific charge on this occasion) that they are reaching this point given the apparent change in regulatory policy signalled by this consultation.

20. Each freight operator – and its owners – will have different “patience” points and different solutions. However, a significant diminution of freight operator financial results might conceivably lead to shrinkage in the number of freight operators in the UK.

The competitiveness of UK Industry

21. UK industry does not exist on a standalone basis but is in competition with manufacturing plants throughout the world. Global companies will make a choice where to place production sites based on production and distribution costs. The decline in UK manufacturing over the past thirty years is evidence of this. Tata at Scunthorpe is one example; already struggling to produce steel competitively at a time of global over-supply. Any increase in access charges for Iron Ore might seem in itself of only local importance but it will feed through to distribution costs and it is the cumulative competitive worsenment in the eyes of both the market and the Group’s owners that is key. If an increase in Iron Ore access charges adds to a negative appearance of competitiveness for steel making at Scunthorpe, then eventually a tipping point will be reached. Other branches of UK Government recognise this and have been working with Tata to try and support steel making in the UK.

Governments’ Rail Freight policies

22. There are five important reference sources for the Governments’ policies for rail freight;

    a. Strategic Rail Freight Network: The Longer Term Vision

    Published in September 2009, this remains the Government’s main rail freight policy, as confirmed in the recent Guidance to the ORR from the Secretary of State for Transport.

    b. The McNulty Study, which stated (inter alia) that;

    ”The Study recognises the importance of rail freight to the economy and the environment, and wishes to ensure that the various changes recommended by the Study further the growth of rail freight while ensuring that this sector of the GB rail industry makes a contribution to the achievement of value for money”.

    ”The rail freight industry delivers economic and environmental benefits to the UK economy. The industry has invested heavily and achieved significant cost reductions in a competitive market. The industry operates across the entirety of the GB rail network and will require the retention of a national and system-wide approach to activities such as capacity planning, network capability and timetabling if it is to capture further traffic from road”.

    The Study is conscious of the Secretary of State’s commitment in his written statement that accompanied the publication of the 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.”

c. Command Paper 8313 – “Reforming our Railways” which stated that;

”It [rail freight] is of strategic importance – rail freight delivers over a quarter of the containerised food, clothes and white goods, and delivers nearly all the coal for the nation’s electricity generation. Rail freight has expanded by 60% over the last decade, and expects to grow by a further 30% in the five years from 2014. The congestion and environmental harm from transferring such traffic to road would be enormous, and there would be significant road safety concerns as well.”

”There is fierce competition in the logistics market. Not all the external costs of road freight are paid by users of the road network, so there is a strong case for Government to continue providing support for the rail freight industry to create a level playing field. This has taken the form of:

●● rail freight only paying a proportion of the track charges paid by franchised passenger operators, as required by EU legislation;

●● targeted funding (through the mode shift revenue support scheme) to assist with the operating costs of running rail freight services where there are environmental and social benefits from doing so;

●● funding improvements to rail infrastructure to unlock key parts of the network for freight.

”The competitive environment has also forced rail freight to find significant efficiencies over recent years, and it has encouraged Network Rail to do the same. As a result, in an industry that has had difficulty in reducing costs, freight has made good progress”.

d. The High Level Output Specifications and the Secretary of State for Transports “Guidance to the ORR”;

Published in July 2012, these are key reference documents. The Secretary of State has restated her Guidance to the ORR and makes very specific reference to freight;

“The Government recognises the important role that rail freight plays in the nation’s logistics and in the achievement of the Government’s sustainable distribution objectives. The Government wishes to facilitate the continuing development of a competitive, efficient and dynamic private sector rail freight industry and is committed to ensuring that policies and regulations should work to this end and should not create unnecessary transactional costs or other obstacles to the achievement of these objectives and future growth”.

“In an industry where planning and operational decision-making are increasingly devolved, the Secretary of State wishes ORR to have regard, in exercising its statutory functions, to the importance of sustaining efficient and commercially predictable network-wide freight operations, including in decisions about access rights and charging structures”.

“The Secretary of State wishes the ORR, in developing any proposals, and in making decisions in relation to rail freight, to note particularly the Government's rail freight policy. The Secretary of State wishes to be advised by the ORR of, and to discuss with the ORR, any material measure which the ORR proposes to take or

policy which it proposes to pursue which would adversely affect the competitiveness of rail freight compared to other modes".

These are clearly strong statements.

e. Scottish Ministers' ambitions for Scotland's railways

Scottish Ministers have also set out their policy on rail freight in a document accompanying their High Level Output Specification, published last month.

"Scotland's rail freight network is important to Scotland's economy. Accordingly, the Scottish Ministers expect the ORR to pay due consideration to any changes to policy which may impact that network".

"In developing the track access charges arrangements for freight operators, the Scottish Ministers expect the ORR to use a mechanism which recognises the impact that freight operators have on the network but maintains the attractiveness of rail to freight customers, and which is adaptable to prevent the outputs of businesses in Scotland from becoming uncompetitive in their key markets".

23. There are clear and consistent themes within these references; both Governments value rail freight and the contribution it makes to the UK economy and to society in general. It is clear that both Governments wish rail freight to continue to grow and thrive and by definition this means that the policy and regulatory framework has to continue to support this.

24. In addition the McNulty Study makes specific recommendations in respect of rail freight access and access charging;

"The Study recommends that freight access charges should continue to be:

a. administered centrally and levied on a national and homogenous basis; and

b. compliant with European Directives".

25. It is not clear to DB Schenker why ORR has put forward proposals that are potentially at variance with the clear conclusion of the most major industry study for decades that ORR co-sponsored and whose conclusions ORR accepted.

The Office of Rail Regulation's policies on rail freight access charges

26. These are framed by the relevant legislation and ORR's statutory duties.

27. The ORR has to ensure any proposed changes are compliant with the Regulations, which is a transposition into UK law of EU Directive 2001/14. The essence of this is that train operators should pay a price that is at least equal to the costs they impose upon the owner of the infrastructure. In respect of freight, ORR's policy to date has been that costs should mean variable costs solely attributable to freight operations.

28. In addition ORR has a number of statutory duties enshrined in legislation, including in section 4 of the Railways Act 1993 (as amended). The ORR has to balance these duties when exercising its functions. So far as freight is concerned, the following duties are especially relevant:

    a. To protect the interests of users of railway services;

b. To promote the use of the railway network in GB for the carriage of goods… to the greatest extent it considers economically practicable;
c. To contribute to the development of an integrated system of transport of goods;
d. To contribute to the achievement of sustainable development;
e. To enable persons providing railway services to plan for the future of their businesses with a reasonable degree of assurance;
f. To have regard to any general guidance given by the Secretary of State or Scottish Ministers; and
g. To have regard to funds available to the Secretary of State.

29. As stated above in paragraph 9, regulatory policy to date has been supportive of rail freight and has helped create an environment where sustainable growth has been achieved, not least by giving private sector investors the confidence to invest in long run and not readily re-deployable assets.

30. This consultation signals a potentially fundamental shift in regulatory policy back towards a regime based on the perceived ability of end customers to pay. Notwithstanding the obvious pressures on public expenditure, this does not seem to be a major element of stated Government policy as evidenced in paragraph 22 above and this potential juxtaposition of political and regulatory policy with respect to rail freight is deeply concerning.

31. DB Schenker acknowledges that balancing relevant duties is complex, but does not believe that ORR has achieved an acceptable balance in respect of these proposals. In particular DB Schenker believes that ORR has not sufficiently taken into account the duty to allow freight operators to plan the future of their businesses with a reasonable degree of assurance.

32. This view is supported by John Swift QC, whom DB Schenker has consulted in this matter. His opinion is;

"It is correct that the ORR, for example in 4 in Key Messages has said that "In implementing any charge we need to balance our statutory duties, including having regard to the funds available to the two governments and allowing freight operators to plan their businesses with a reasonable degree of assurance" but it is far from clear how in practice the proposal does indeed enable the ORR to comply with that particular statutory duty. It must surely be seriously arguable that the combination of (a) unpredictable but significant loss of volume in the key ESI market as a result of that market having to absorb between £60-75m pa (5.13) ; (b) a net freight avoidable costs figure of between £192-241m a year (Table 5.1) which the ORR would seek to find from the freight users subject only to evidence that there would be an unacceptable switch from rail to road; and (c) no proper analysis of the likely reaction of freight users to this step change in charges, calls into question whether the ORR has given any or any proper weight to that duty or indeed to the objectives set at paragraphs 32-34 of the July 2012 Guidance from the Secretary of State or paragraphs 21 and 22 of the Guidance from Scottish Ministers".

33. Overall, this consultation has created unprecedented uncertainty and perceived regulatory risk. Whether it is the structure of charges, the level of existing charges or the level of potential new charges there is concern right across the sector – not simply with ESI coal, nuclear or steel customers. This in turn seriously risks a loss of confidence in potential customers and investors.

34. This stems both from the lack of assurance about the level and structure of future charges, but also from the perception that there has been a change in regulatory policy for freight which could, in future, also apply to other sectors.

35. In the absence of due and proper consideration of the impact upon freight operators and other affected third parties, the proposed charge should not be implemented.

36. In addition, ORR is urged to reach early decisions, not just on the cap for the variable charge, but also on the future structure of freight charges where retaining a simple, stable and affordable regime is essential.

Governments' road freight policies

37. The financial regime for rail freight's main modal competitor, road freight, is extremely simple. There is no system of road track access charges. Operators simply have to:
    a. be licensed – which costs c £400: and
    b. have an appropriate VED sticker which costs a maximum £1350-1850 per vehicle per annum.

38. In addition, road hauliers do not have to seek access rights or bid for slots between car and coaches carrying passengers – they simply "turn up and go". They also do not have to deal with line blockages for engineering work – whilst roadworks are plentiful, diversions are readily available and in practise these have little meaningful impact.

39. The economics of road freight are also much simpler. Commercial Motor Magazine estimates that fuel represents 40% of the running cost of an HGV – this is a much higher percentage than rail.

40. Recent regulatory policy for rail has placed rail freight in a position that is more analogous to road – with the fixed costs of the network being paid for centrally and a variable cost being paid for by VED.

41. There is no attempt to price road freight access by market sector or any perceived ability to pay – it is solely by vehicle type.

42. In January 2012 the Department for Transport consulted on the introduction of road user charging for Heavy Goods Vehicles. A simple annual tariff of £1000 per annum per vehicle is proposed – however for UK road hauliers this will be rebated in full, probably against VED.

43. There is thus a major discontinuity between the access and charging regime for road freight and the proposed access and charging regime for rail freight. The ORR's proposals will;

    a. genuinely add to the complexity of rail freight economics and charging;
    b. will widen the competitive disadvantage between the two modes; and
    c. will perpetuate the belief amongst customers, and especially potential customers, that rail freight is too complex.

Rail Delivery Group and Rail Industry Efficiency

44. DB Schenker – together with the other rail freight operators – has been engaging fully with the various initiatives emerging from the McNulty Study, including membership of the Rail Delivery Group and active participation in many of its working groups

45. DB Schenker recognises that the industry has to respond – and to be seen to respond – to the financial pressures on the Governments and to work to drive cost reduction and improve efficiency and value for money. The track record of the rail freight sector in this regard was acknowledged by the McNulty Study.

46. In response to the McNulty Study, the rail freight operators provided an initial list of those line sections for which, in their judgement, there was no reasonable foreseeable future freight use. This is intended to give Network Rail the opportunity to develop innovative maintenance and other asset strategies to deliver cost savings on those line sections. This is one example of where the rail freight community is prepared to embrace, and actively engage in, delivering rail industry cost savings.

47. In addition, the freight operators have been working hard with Network Rail to improve freight use of rail capacity, especially on routes where capacity is perceived to be scarce. The development of Strategic Capacity is a key component of this approach in that it gives freight operators the confidence to relinquish unused or underused capacity in the knowledge that business changes can be accommodated. This is another key element in allowing operators to plan their business with assurance.

The impact of the Rail Reform agenda

48. This consultation is but one element of the PR13 process that will impact on rail freight operators, their customers and sundry third parties. In addition, PR13 is but one element of the Rail Reform and post-McNulty Study agendas.

49. DB Schenker has had to try and assess the consequences of these proposed changes whilst simultaneously attempting to evaluate the impact of:

    a. The Refranchising programme.
    b. Network Rail devolution.
    c. Industry alliancing.
    d. Wider political devolution and decentralisation.
    e. Consultation of the capacity charge.
    f. Rail Delivery Group workstreams.
    g. The recent High Level Output Specifications and Statements of Funds Available issued by the Secretary of State for Transport and Scottish Ministers.

The complexity of rail freight access charging

50. This consultation does not even represent all of the elements affecting rail freight charges that fall to be considered under PR13.

Charge	**Note**
Variable Charge	Network Rail has proposed cost increases – not clear if assessment of future efficiencies will offset this. Already varies by wagon type, locomotive type and commodity.
Freight Only Line Charge	Currently applicable to Coal and Nuclear sectors. Network Rail has proposed cost increases – may be subsumed within any Freight Specific Charge.
Traction Electricity Charge/ Electricity Asset Usage Charge	Potential change presently unknown but likely EAU Charge will double from Network Rail's latest information.
Capacity Charge	Subject of separate consultation and will be recalibrated. Potential financial impact unknown.

Coal Spillage Charge	Network Rail proposed that the charge might double.
Freight Specific Charge	New charge proposed by ORR based on assessment of Network Rail's freight avoidable costs. Currently proposed to levy this on ESI Coal, Nuclear, Iron Ore, and potentially Biomass. Possibly subject to review of avoidable costs
Route Efficiency Benefit Sharing for 10 routes	Details unknown, but range and baselines will vary with each route.
New Capacity Utilisation Charge	Interface with existing capacity charge not clear.
Geographic charges	New development proposed by ORR. Potentially major impact on customers as would add further considerable complexity to the charging regime. Financial impact unknown at present
Schedules 4 and 8 recalibration and not compensating 100%	Impact unknown at present, but will be negative
Exposing operators to change in Network Rail's costs at periodic review	Depending on mechanism may, or may not affect freight.

51. DB Schenker is concerned that in considering individual changes in a disaggregated manner, the inter-linkages and cumulative effect on rail freight operators will not be apparent. As was set out in paragraph 16 above, the economics of rail freight are such that a holistic view of the cumulative impact is essential.

52. DB Schenker is concerned that no such wider analysis has yet been undertaken and there is, therefore, a substantial risk that ORR will make decisions that may have unintended or perverse consequences that will only become apparent towards the end of the PR13 process or later during CP5.

53. As can be seen from the table above, there is considerable uncertainty around the total level of charges, as well as in the way they will be applied. There is potential for the combined outcome to represent a significant increase in overall charge for all commodity sectors, as well as a considerably increased regulatory burden through the complexity of charges.

54. The proposal to cap freight charges is welcome, but this only covers the first charge in the above table. Presently, this would represent around 75% of the total freight charges, but with the addition of new charges and regimes, the capped charges will be a smaller proportion of the total exposure. A cap has no purpose if it is set at a level that is effectively meaningless.

55. Before ORR concludes on the implementation of particular charges, it is therefore imperative that an *overall* impact assessment for the freight sector is undertaken to look at the combined effects of these proposals, both on affordability and on regulatory burden. Alternatively, it should leave the current structure in place.

Better Regulation

56. DB Schenker would also urge ORR to consider whether these potential changes are in line with the principles of better regulation and the Guidance to the ORR recently issued by the Secretary of State for Transport.

57. In her Guidance to ORR issued in July 2012, the Secretary of State noted;

"*that the ORR has a duty under section 4(1)(f) of the 1993 Act to impose on the operators of railway services the minimum restrictions which are consistent with the performance of its functions under Part 1 of the Act. The ORR also has a duty under section 72 of the Regulatory Enforcement and Sanctions Act 2008 not to impose or maintain unnecessary burdens when exercising its regulatory functions. The Secretary of State wishes ORR to have specific regard to these duties and to demonstrate a proportionate approach that is consistent with the principles of better regulation when developing new and amending existing regulatory processes".*

58. The Secretary of State further noted that;

"*The Government recognises the important role that rail freight plays in the nation's logistics and in the achievement of the Government's sustainable distribution objectives. The Government wishes to facilitate the continuing development of a competitive, efficient and dynamic private sector rail freight industry and is committed to ensuring that policies and regulations should work to this end and should not create unnecessary transactional costs or other obstacles to the achievement of these objectives and future growth*"

59. DB Schenker would urge ORR to reflect on whether the proposals both within this consultation and more widely across PR13 in respect of rail freight are consistent with this element of the Secretary of State's Guidance.

End

Periodic Review 2013: Consultation on the variable usage charge and on a freight specific charge

Response from DB Schenker : Part 2 - Specific Comments on Consultation document

Variable Usage Charge

Q1 (3.60) Network Rail has already consulted on its estimates of variable costs. Do you have any further evidence, subsequent to Network Rail's consultation, that you wish to provide in relation to the process for estimating variable costs and average variable usage charges?

Network Rail Analysis

1. DB Schenker responded to Network Rail's consultation on Variable Usage Charge (VUC) and Freight Only Line Charge initial cost estimates on 27 January 2012 (see Attachment 3), and is pleased that a number of improvements have been made to Network Rail's proposals both during and after the consultation period.

2. However, DB Schenker remains concerned over Network Rail's approach to non track assets, particularly to masonry structures, where the simple linear approach to the variance between traffic levels and damage appears unduly simplistic. The rail freight industry has engaged independent consulting engineers, Morgan Tucker, to review Network Rail's assertion that there is a direct proportional relationship between costs and an increase in traffic on the network. In its report (see Attachment 4), Morgan Tucker believes that the relationship between growth and the increased costs of maintenance of brick and masonry arch structures is particularly complex and submit that it is not appropriate to make a direct linear relationship between the two as Network Rail suggest. Instead, Morgan Tucker considers that Network Rail should have taken into account a wider set of factors including:

    - Traffic Constitution
    - Geographic Spread
    - Quality of Existing Assets
    - Ages of Structures

3. DB Schenker supports the Morgan Tucker Report as it confirms its belief that Network Rail's approach in this area is overly simplistic and, therefore, fundamentally flawed. In this regard, DB Schenker also notes that ORR's own reporters have also raised major concerns over Network Rail's analysis and approach to the costs of earthworks and structures. Although these areas represent a small overall part of the variable usage charge, they are a significant driver behind the proposed increase in the charge. DB Schenker is, therefore, pleased that ORR is asking Network Rail to refine its analysis in these areas prior to making its final conclusions.

Cost variability for rail assets

4. As set out above, DB Schenker continues to have concerns over Network Rail's assessment of structures, and also with the assertion that certain wagon types, which are themselves incentivised through the charging framework established at CP4, are causing greater damage than could have been anticipated. The further analysis which ORR has requested Network Rail to undertake should look specifically at this area, taking into account relevant advice from wagon manufacturers.

5. Although DB Schenker recognises that some impacts might not be identifiable in advance, it does highlight the problem with setting incentive structures based on incomplete or undeveloped data. It is imperative that consistent messages are provided on the desired requirements as frequent changes in direction are not acceptable for those building and investing in equipment with 30-year asset lives.

6. DB Schenker would also agree with the increasingly widespread view that the continual use of the Settle and Carlisle route as a case study example is unhelpful, as its nature, geography and recent history is far from being typical or representative. Whilst some lessons may be drawn from experience on this route, it is inappropriate to scale it up as a proxy for any wider analysis of the network.

Efficiency Overlay

7. DB Schenker recognises that the translation of Network Rail variable costs to freight charges cannot be completed until the final efficiency targets for CP5 are confirmed. However, there is currently a lack of clarity as to how efficiency targets will be applied to the costs, and in particular the interaction with the CP4 efficiency targets (which looked at a 10 year horizon) and the forward basis for the CP5 targets.

8. DB Schenker would welcome clarification of the mechanics of the efficiency calculation, so that there are clear expectations of the level of efficiency that will be applied to the charges.

9. DB Schenker agrees in principle that the variable usage charge should be based on costs adjusted to reflect long run (i.e. longer than the CP5 framework) efficient state costs, but submits that the proposed cap on the variable usage charge should be set with an estimate of what these are likely to be rather than at end-CP4 efficiency levels. The ORR's current proposal on this is illogical and at variance with the overall intent of the efficiency overlay.

Evidence from other railways

10. DB Schenker would urge some caution in extrapolating too much from foreign benchmarking, including the ITS study. DB Schenker is disappointed that ORR has not yet made this work available for review, so it is hard to comment on it at this stage.

11. DB Schenker has considerable experience in foreign benchmarking, both in Europe and North America – and understands the criticality (and complexity) of ensuring that like is compared with like.

12. DB Schenker notes that the majority of the variable costs in the UK are being assessed using the VTISM model, which ORR's reporters state that they were 'generally happy' with. Any significant difference in levels of variability between Network Rail and other European railways would therefore need to be rationalised against the validated outputs of this model.

Geographic Charges / Capacity Charges

13. DB Schenker remains concerned at the potential impact of geographic charges on the freight market, potentially coupled with capacity charges on congested routes. Customers and industry third parties are already raising concerns over the impacts on their businesses, and are wishing to understand what the future charges framework for proposed facilities and rail flows might be.

14. The Government's recent High Level Output Specification, and the future development of the Strategic Freight Network, will provide increased capacity on certain routes for

freight, in some cases diverting traffic away from busy passenger routes. There are also routing options which need to be assessed in the next year or so as feasibility work for CP5 investment proceeds. It would be perverse if this planned infrastructure enhancement programme or routing options were undermined by a charging structure with different aims and objectives.

15. DB Schenker would, therefore, strongly support maintaining freight charges on a national basis, disaggregated by wagon type, as now.

16. DB Schenker would remind ORR of the conclusions regarding freight access charging reached by the Sir Roy McNulty Rail Value for Money Study published in May 2011 ('the McNulty Study') which stated;

    The Study recommends that freight access charges should continue to be:

    a. *administered centrally and levied on a national and homogenous basis; and*
    b. *compliant with European Directives*.

17. However, if the longer term strategic aim of the ORR is to introduce geographically disaggregated charges, then this should not be in addition to, or add further complexity to, the current freight variable usage charge structure, which is based on wagon/commodity type.

18. DB Schenker suggests that it would be necessary to consider replacing the existing wagon/commodity based structure with one based on route type. This would be a highly complex process which in itself would require considerable evaluation and development to minimise disruption both to customers and the dynamics of the market.

19. The incentive framework created by any geographic scheme must:

    a. be consistent;
    b. not unduly discriminate between customers and affected third parties;
    c. align with the routing strategy for rail freight being progressed under the Strategic Freight Network and other such developments;
    d. be set once, and remain consistent across future control periods. This is vital for freight customers seeking to make long term investments in facilities such as terminals.

    This may require regulatory intervention, as modelled results (e.g. from VTISM) will tend to vary with traffic levels, therefore making it possible for the relative charges for different routes to switch in subsequent control periods if traffic patterns change in response to price signals.

20. DB Schenker does not believe that any substantive work on any geographically disaggregated access charging option is possible within the PR13 timescale. In addition, such a potentially fundamental change ought not to be made during a Control Period, not least as it prevent businesses such as DB Schenker to plan for the future with a reasonable degree of assurance. DB Schenker is also aware of – and supports – the Rail Delivery Group's letter suggesting that consideration of geographically disaggregated variable usage charges should be considered after PR13 has concluded.

21. Unravelling the current access framework in a way that does not disadvantage end customers and operators or create winners/losers would be complex. If ORR's strategic intent is for the industry to pursue geographically disaggregated variable usage charges then DB Schenker would work with ORR to try and establish a logical and consistent approach that supports the further development of rail freight. The more complex the

system that needs to be reconstructed, the more difficult any such task would be. For this reason, DB Schenker would counsel ORR simply to retain the current access charging structure at this Periodic Review and not to introduce any further charges such as a freight specific or capacity charge for CP5.

22. DB Schenker also notes that the application of a capacity charge, in addition to any geographic disaggregation of the variable usage charge, has the potential to increase charges overall (not to mention add further complexity) and this must, therefore, be taken into account when assessing affordability.

Proposed Cap

23. DB Schenker strongly supports placing a cap on the variable usage charge, to give confidence to customers, potential customers, operators and other third parties , and broadly agrees with the methodology used to determine the cap. Furthermore, although it is pleased that Network Rail's confidence interval of 20% has been reduced, DB Schenker considers that a 15% confidence interval still represents a substantial potential uplift on the Network Rail's best estimates.

24. Notwithstanding DB Schenker's comments made above in respect of the proposed cap, it is concerned over the possibility highlighted in paragraph 1.4 of the consultation document, that ORR could set charges higher than the cap should further material evidence become manifest subsequently. This is counter- intuitive, and makes any certainty given by the existence of the proposed cap effectively redundant. Once the proposed cap is agreed, ORR must confirm that the average level of variable freight usage charges set for PR13 will not exceed that cap. As the purpose of the cap is to increase confidence and give certainty, it is important that this commitment is made to enable the rail freight industry and its customers and investors to plan the future of their businesses with a reasonable degree of certainty and assurance.

25. Notwithstanding the above comments, although the cap on the average level of variable usage charges will offer a degree of certainty, freight operators and their customers will still be exposed to considerable uncertainty at an individual traffic flow level as the variable usage charges for each particular vehicle type could still increase dramatically over current rates whilst still remaining within any overall cap. This is in addition to the current uncertainty in other aspects of the charging proposals, for example, geographic charges. This illustrates the fact that caps based only on certain elements will be of limited value all the while there remains a high degree of uncertainty over other elements.

Q2 (3.61) Do you agree with our analysis, which leads to a proposed confidence interval of 15% around Network Rail's estimates of variable usage costs?

26. Whilst it is pleased that Network Rail's confidence interval of 20% has been reduced by ORR to 15%, DB Schenker considers that a 15% confidence interval still represents a substantial potential uplift on the Network Rail's best estimates. As the majority of the variable usage costs are estimated using VTISM, DB Schenker would expect that greater levels of certainty should be possible, particularly if VTISM is fully validated. DB Schenker, therefore, considers that a 15% confidence level remains too high and would be disappointed if it was not further reduced to at least 10%.

Q3 (3.62) Do you agree with our approach to estimating an adjustment to variable usage charges for long-run cost efficiency?

27. DB Schenker supports ORR's proposal to adopt a similar approach to the one used for CP4 which resulted in Network Rail's variable usage charge being based on costs adjusted to reflect the long run efficient steady state costs.

28. However, DB Schenker does not support ORR's proposal to set the cap at end-CP4 efficiencies rather than using the actual CP4 average charge together with an estimate of CP5 efficiencies. Whilst DB Schenker accepts that there is a confidence interval associated with this efficiency adjustment, it would have expected some recognition of these factors in setting the proposed cap.

Framework for a Freight Specific Charge

29. DB Schenker has grave reservations about the ORR's proposal to introduce a new freight specific charge. Its concerns include;

    a. *The underlying principles of the new charge*.

    The proposal to significantly in increase the level of access charges paid by some market sectors is a significant change of policy for freight charging, it;

    i. moves away from charges recovering 'wear and tear' costs only;
    ii. can only be justified by allocation and attribution of common costs given the inability of Network Rail to accurately identify even a low percentage of its costs against activity with any confidence; and
    iii. suggests that it is acceptable in policy terms to reduce demand for rail freight in affected sectors by 5-10% per annum – i.e. that "pricing-off" demand is acceptable.

    b. *Implications for future Periodic Reviews*.

    This proposal has raised concerns across other market sectors. Notwithstanding that ORR only proposes to levy any such new charge on ESI coal, nuclear and possibly iron ore and biomass at this stage, it is clear that other sectors might in the future be subjected to such a charge. This is causing considerable unrest amongst customers, potential customers and third parties such as terminal developers. DB Schenker is aware that some customers fear that the regulatory uncertainty this has caused will frustrate their plans for capital investment in rail facilities (for which the payback period is often more than 5 and sometimes more than 10 years). Confidence in regulatory behaviour is thus vital. It would not be proper for DB Schenker to identify such instances in a consultation response, but DB Schenker will pass on these concerns bilaterally and in confidence to ORR.

    c. The interpretation of 'what the market can bear'

    The Railways Infrastructure (Access and Management Regulations) 2005 ('the Regulations') permit a 'mark up' 'where the market can bear it' so the relevant definitions are critical. DB Schenker considers that a significant reduction in rail volumes as a consequence of any such charge is not an outcome that should be expected from a proper consideration of 'what the market can bear'.

    DB Schenker notes that the MDS study, in assessing a doubling of variable track access charges concluded that the market impact on ESI coal volumes would be less than 0.5%; DB Schenker suggests that this is a more reasonable outcome that should be expected from "what the market can bear".

    In contrast, however, a £10 increase leading to a 23% reduction in ESI coal volumes (which in itself assumes behavioural change by ports and coal suppliers) would appear to DB Schenker to be something that the market cannot bear.

    DB Schenker is surprised and disappointed that ORR has done relatively little work on fine-tuning these analyses.

d. *"Second order" effects on other markets*

The relative lack of work on a definition of the market itself may be why ORR has not considered in any detail the effects of their proposals on freight operating companies such as DB Schenker, coal or other commodity suppliers and affected third parties such as ports. This is doubly disappointing as DB Schenker and other operators have been asking ORR for this analysis to be undertaken for some months.

For rail freight operators such as DB Schenker, potential impacts include:

i. accelerated volume reductions in the coal sector;
ii. potentially stranded assets, including locomotives and wagons;
iii. consequential job losses and depot closures;
iv. knock on effects on other market sectors from a smaller business base;
v. financial risk;
    - passing on the charge to customers
    - cash flow exposure and
    - the impact on FOC borrowing ability.
vi. inter-FOC competitive impacts; and
vii. the impact on potential new markets, such as biomass, through pricing uncertainty.

ORR will appreciate that analysis and quantification of these potential impacts has commercial sensitivity and DB Schenker would be willing to discuss these in more detail with ORR on a bilateral basis.

e. *Ability to invest*

The recent High Level Output Specifications set out what the two Governments wish the industry to achieve both in the next control period and over a longer timeframe. A key element of these specifications was a substantial programme of electrification that aims to increase the percentage of both passenger and freight services that are electrically hauled. In the case of freight, significant future capital expenditure in electric locomotives is likely to be necessary. It would be unfortunate if an inadvertent consequence of introducing a new freight access charge was to diminish the ability of, and appetite for, freight operating companies to consider such major capital expenditure.

f. *The balance between the potential dislocation of the market and the revenues raised*

DB Schenker would urge the ORR to consider most carefully if the scale of revenue raised by any freight specific charge is sufficient to justify the wider market concerns that the proposals have caused. This applies particularly to iron ore.

30. If ORR wishes to increase charges for ESI Coal, and other commodities, DB Schenker considers that any such increase must be sufficiently low that it can reasonably be absorbed without any significant loss of volume, and that any second order impacts are minimised.

Q4 (4.49) Do you agree with our proposed approach to satisfying the Access and Management Regulations with respect to levying a new freight-specific charge?

31. DB Schenker acknowledges that the Regulations permit a ‘mark up’ to be levied based on efficient, transparent and non discriminatory principles whilst guaranteeing optimum competitiveness. It is also aware that any such ’mark up’ 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 that the market can bear. In addition, DB Schenker understands that in setting access charges, ORR has to have regard to its statutory duties set out in section 4 of the Railways Act 1993 and other relevant legislation.

32. With regard to the criteria set out in the Regulations and by reference to ORR’s justification set out in paragraph 4.10 of the consultation document, DB Schenker has the following comments:

    a. *Transparency:* Whilst the charges are being consulted upon, the resulting charging structure will be complex – particularly when taken overall, and not just for the freight specific charge. The test will be whether the charging framework overall is sufficiently transparent.

    b. *Non Discriminatory:* The proposals will almost certainly have discriminatory effects between different end customers, ports and operators which have not yet been properly assessed.

    c. *Efficient Principles:* See consultation question 7 (4.52) below.

    d. *Optimal Competitiveness:* DB Schenker agrees that competition with road is a vital consideration when assessing a market sector’s ability to pay. However, that does not mean that sectors where road is not the price setting or dominant mode are immune from the effect of increased costs. Increased costs will affect business decisions, investment priorities and for multi-national businesses, the desirability of operating and trading in the UK (see consultation question 14 (6.83) below).

    e. *What the Market Can Bear:* The interpretation of this phrase is key to this consultation and to the proposals. As the Regulations and Directive give little guidance on its interpretation, DB Schenker considers that it must be assessed by ORR against:

        i. its statutory duties; and

        ii. The recent “Guidance to the ORR” from the Secretary of State and the separate “Scottish Ministers ambitions for Scotland’s Railways”.

    In particular, ORR should set out clearly why a reduction in rail freight volumes is acceptable against these criteria. DB Schenker also notes that charges must not be set so as to exclude a sector from rail which could afford to pay the directly incurred costs and considers that this is not, in itself, a definition of what the market can bear but rather a ‘backstop’ provision.

33. Whilst ORR in its consultation document has sought to set out a proposed approach to justify the introduction of a new freight specific charge by reference to the applicable legislation, there are two key areas which are not adequately explained as far as DB Schenker is concerned.

    a. The first concerns paragraph 3 of Schedule 3 to the Regulations which states “*the charging system shall respect the productivity increases achieved by applicants*”. As explained earlier in this response, the rail freight industry in general and DB Schenker in particular, have achieved significant productivity increases including many in the ESI coal market sector. These improvements, which include new higher capacity more 'track-friendly' wagons and the operation of fewer longer trains, were recognised in the McNulty Study, which states that faced with a competitive environment (both with other transport modes and with each other) rail freight operators have focussed on reducing costs and improving customer service employing techniques and methods to improve efficiency that should be shared with the rest of the industry. ORR's proposed approach does not appear to take account of the productivity increases achieved by rail freight operators as is required by the Regulations.

b. The second area concerns ORR's statutory duty "to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance". DB Schenker has taken specific legal advice from John Swift QC whose opinion on this is:

"The evidence suggests that the growth in freight on rail over at least the past decade has been contributed to by ORR policies to set freight on rail charges at average variable cost and to reduce those costs very substantially, by over 30 per cent. The liberalisation of the rail freight market has attracted new entry, which has been encouraged in part by the ORR's duty to enable freight operators to plan for the future with a reasonable degree of assurance. Such planning involves investment in capital and labour. The new policy may well be expected to have some adverse effects on freight operators arising from the size of the step change in charges to be introduced with effect from 2014 and the unpredictability of both recovery of those charges from users and the effect of the changes on demand in key markets".

"The July Guidances make express provision for the ORR to have regard to the future of freight on rail and the avoidance of adverse effects arising out of changes in the charging structure to be permitted by Network Rail. There is no effective machinery - other than the possible cap – for managing any possible adverse effects and thus on securing future investment by freight on rail operators. At present it is arguable that the Consultation paper is deficient in not taking into account, fully or at all, the consequences for the freight operators of a liability to fund costs up to a further £60- 75 million a year, and possibly a substantially higher figure were the ORR modelling to predict that more market segments could affords to pay the higher costs. There is thus a further period of regulatory uncertainty combined with a possible sequence of changes in regulated access charges which cannot, it would be argued, be consistent with the ORR's duty to enable freight operators to plan form the future with a reasonable degree of assurance".

34. The result of the proposal for a freight specific charge is thus a further period of regulatory risk and uncertainty which is not consistent with ORR's duty "*to enable* [freight operators] *to plan the future of their businesses with a reasonable degree of assurance*".

35. In summary:

a. DB Schenker is concerned that the freight specific charge, at the level proposed, may 'price off' demand.

b. The need for ORR to consider introducing a cap to ensure a reduction in traffic volume is controlled demonstrates that the proposed new freight specific charge cannot be borne by the market.

c. The consequential loss in coal volume will impact on freight operators, on ports and on coal production.

d. Although the level of increase in access charges is not understood for other sectors, it is likely to have similar “second order” impacts in the steel and nuclear sectors.

e. The proposal does not allow businesses such as DB Schenker to plan with any assurance and as such is not consistent with ORR’s Duties.

f. To the extent that ORR decides to increase access charges for any sector, (and see further comments below), DB Schenker considers that any increase must be sufficiently low that it can reasonably be absorbed without loss of volume, and that second order impacts are minimised.

g. If any increase is introduced, it must be done in an efficient and simple manner. There is, in fact, no reason why such an increase cannot be achieved within the current charging structure. This, unlike ORR ‘s current proposals would have the benefit of simplicity, and would minimise transaction costs for Network Rail and freight operators.

36. In light of these comments, DB Schenker considers that ORR should, before arriving at any decision, review its proposals in light of the July 2012 Guidance and carry out an assessment of possible “adverse effects” on freight operators and affected third parties of this potential new charge.

Q5 (4.50) Do you agree that the infrastructure costs allocated to freight operators - either for direct funding by freight operators, or explicitly subsidised by government - should be freight avoidable costs, including fixed costs, but not costs common between passengers and freight?

37. To the extent that any charges are levied, DB Schenker agrees that they should be limited to truly freight avoidable costs.

Q6 (4.51) Do you agree that we should retain our current definitions of particular categories of rail freight commodities as separate market segments?

38. DB Schenker agrees that the categories of rail freight commodities as shown are appropriate, although within those categories there may be distinct sub-sectors which warrant separate analysis. However;,
    a. ORR should consider introducing a further category for biomass.
    b. ORR should consider the interactions between markets and in particular that freight operators such as DB Schenker manage their businesses as an entity and not as a series of self-standing entities.

39. This segregation does not pick up important second order impacts affecting the market in other ways. For example, it does not pick up the effect on the market for the provision of rail freight services nor it does not pick up the effect on the affected third party markets such as for the provision of port services.

40. As the Regulations do not specify how ‘market’ is defined, DB Schenker considers it vital that these wider market impacts are also properly assessed. In the port sector, for example, the effect of these proposals is to create competitive advantage for some ports, and competitive disadvantage for others. The extent to which it is reasonable for rail regulatory policy to cause such effects needs to be considered and assessed.

Q7 (4.52) Do you believe that we have taken into account the appropriate factors in considering the efficiency of the proposed charges? Do you believe there are other factors we should take into account?

41. DB Schenker appreciates that assessing elasticity of demand was appropriate, but it is concerned that ORR and its consultants have adopted an overly-narrow approach in considering each market in isolation and without considering inter-linkages.

42. As ORR will appreciate, rail freight economics are more complex than that. Experience – for example in the coal sector when prices (including access charges) reduced substantially in the decade after privatisation – confirms that changes in rail freight pricing can influence and destabilise wider markets in ways that are often unpredictable. The decline of the English deep coal mining and open cast sectors after the late 1990s was undoubtedly influenced by the reduction in rail freight prices, particularly for coal haulage. The effects of this on both the industries concerned and the wider communities supported by their industries was very considerable and there was very significant customer, supplier, third party and political disquiet at the outcomes.

43. DB Schenker would, therefore, urge caution and counsel ORR to ensure it has considered all potential consequences before introducing a new freight specific charge at the levels inferred in the consultation.

44. Whilst DB Schenker agrees that road / rail competition is an important factor, the impact on freight operators, their wider business, investor confidence across the rail freight sector, and the interface of this proposal and other charging proposals also need to be considered.

Q8 (4.53) Do you agree that our approach (of analysing rail freight traffic) addresses the relevant criteria, when considering to which market segments the charge should apply?

45. Broadly, DB Schenker agrees with the criteria, but it considers that the assessment has given insufficient weight to wider impacts, and to other relevant markets.

Q9 (4.54) Do you agree that certain market segments should be exempt from the new charge?

46. DB Schenker considers that all market segments should be exempt from the new charge. For further comments see consultation question 14 (6.83) below.

Q10 (4.55) What do you think is the most appropriate methodology for allocating costs, and what is your reasoning?

47. In paragraph 4.1 of the consultation document, it is stated that the purpose of the freight specific charge is to '*improve efficiency by reducing cross subsidy and making charges more cost reflective*'. Given this aim, it is wholly perverse to suggest in paragraph 4.38 that costs shared between market segments could be allocated in full to some and not others.

48. Indeed it is arguable that even pro-rating costs by tonne-km or tonnes does not meet these criteria. The assessment of freight avoidable costs will identify costs associated with particular routes and resources which may not be evenly spread between commodities. For example, timetable planning resource may be disproportionately associated with the coal sector whilst performance payments may be more associated with intermodal traffic which tends to operate alongside passenger services. Pro-rata approaches may be mathematically pragmatic but they do not meet the criteria of cost reflectivity.

49. DB Schenker considers that the freight avoidable cost study should address the issues implicit in this question in more detail. This includes reaching a clear understanding of what is meant by cross-subsidy. This is a rather pejorative and not very helpful phrase in an industry where very few costs can be accurately identified to particular traffics. A

clearer understanding of what ORR seeks to achieve in terms of “cost reflectivity” would also assist that process.

50. DB Schenker accepts that if ORR does decide to introduce a freight specific charge during CP5 then a pragmatic solution is likely to be necessary. Such a solution will be easier to identify with a clearer understanding of the intent.

Q11 (4.56) Do you consider it is appropriate to cap the new charge for particular market segments according to its impact on the associated freight traffic (in addition to a constraint relating to relevant avoidable costs)? Do you wish to propose an alternative?

51. Any ‘mark-up’ must be set at a level that the market can bear as is clear from the Access and Management Regulations Therefore, if ORR considers that the effects of introducing its proposals are so uncertain as to need the insurance of a cap, it suggests to DB Schenker that those proposals are deficient as they should be set at a level that the market can bear at the outset.

52. Notwithstanding the above comments, it is wholly unclear to DB Schenker how the cap would be assessed, introduced, monitored and enforced. For example, how will the effects of any charge increase be separated from other effects on the market? Will the charge be ‘turned on and off’ according to traffic fluctuations and how will this be managed to avoid market distortions between operators and customers?

53. DB Schenker, therefore, considers that the suggested cap is unlikely to be workable. A better solution would be to set any increase at a very much lower level from the outset thereby avoiding any significant volume loss over and above any market trend.

54. Although there have been volume fluctuations in the coal sector in recent years, DB Schenker does not agree that these are an applicable test to determine whether or not the ‘market can bear’ any such charge that impacts on volume. Any reduction caused by an additional charge imposed by Government is over and above, i.e. in addition to, market fluctuations; the combined effect would very probably be greater than the ‘10% cap’. Also, market fluctuations can be up as well as down, whereas the charge is downside only.

55. Based on ORR statistics, since 2002/03, the annual change in coal volumes has increased on 6 occasions and reduced on only 3. Taking the last 5 years into consideration, it has risen on 2 occasions and fallen on 2. So whilst the market has absorbed changes of at least 10%, it has not done so consistently year on year, as is contemplated by this additional charge.

56. Paragraph 4.46 of the consultation document is particularly concerning, appearing to suggest that the cap would be 10% per annum. This has a number of effects;
    a. it creates a spiral of decline; and
    b. the annual change in the level of charge makes it impossible for operators to plan, and for customers to understand what rail will cost. Such effects are wholly unacceptable and are inconsistent with a key ORR duty.

57. Comparing the historic statistics, a 10% per annum reduction since 2002/03 would by now be a 61% overall reduction rather than a 13% increase under market conditions. Since 2007/08, a 10% per annum reduction would result in a 36% decrease instead of an actual fall of only 17% under market conditions. It is clear, therefore, that ORR’s proposal will impact on the market far more than “normal” market fluctuations.

58. Rebasing the charge annually also prevents operators and customers from planning their business with a reasonable degree of assurance. Likely consequences of this include:

a. shorter term contracts becoming the norm – which is unhelpful in an asset intensive industry;
b. implications for freight train operators, third parties and customers in terms of investments in resources, terminals and equipment; and
c. adverse effects on planning capacity on the network as train slots/access rights would be even more fluid than today. This would run counter to another ORR aspiration which is to improve the use of capacity by coal trains.

59. If any charge or increase is implemented, DB Schenker suggests that it is set at the start of the control period, at a level that will avoid traffic being 'priced off' the network and is constant throughout.

***Q12 (4.57) What should be the unit of the new charge? Please explain your reasoning*.**

60. Existing freight charging mechanisms are all based on the concept of weight and/or distance and DB Schenker considers that any new charges should not move away from this principle. Therefore, the counter proposal that that the new charge could be levied on the basis of tonnes lifted is not supported nor does it meet ORR's stated aim of making charges more cost reflective, for example, how can a tonne of coal moved 5 miles by rail incur the same share of avoidable costs as a tonne of coal moved 250 miles by rail?

Freight Avoidable Costs

Q13 (5.25) Do you agree with our framework for estimating freight avoidable costs? Please explain any suggested changes to the framework, including your calculations (noting that there will be further opportunities to contribute to this work as the cost estimates are refined during the periodic review, for example in relation to Network Rail's strategic business plan).

61. DB Schenker is actively participating in the study being undertaken by LEK for Network Rail that is aiming to produce an estimate (or estimates) of Network Rail's freight avoidable costs. However, DB Schenker has a number of serious concerns with the results produced to date. These concerns have been fully shared with LEK, Network Rail and ORR.

62. The starting point for this work has been informed by Network Rail's prior work which refined earlier analysis carried out by AEA Technology in 2005 on the feasibility of developing an avoidable cost approach to allocating and recovering fixed costs. DB Schenker notes that the AEA work did not consider freight in any detail and specifically stated that

"*The model has been developed in connection with the review of fixed costs and charges for franchised passenger services. As such it has not sought to consider freight specific issues in any depth. However the treatment of the totality of Network Rail's Business Plan costs has necessitated a high level "netting off" of non-franchise costs including those related to freight. As freight and other non-franchised operators' costs were not considered fully in the methodology the model output (sic), these have not been included in the results tables*".

"*There are several specific factors that could result in the model outputs being less reliable for freight;*

a. A key driver for the freight costs is the axle load parameter within the ETK metric. As discussed above, the parameters in this metric need to be updated.
b. Freight only routes have not been separately considered
c. Assumptions re freight business growth – in total and disaggregated

d. *Assumptions on freight routes".*

"*Therefore specific work on these and other freight issues would be appropriate were the avoidability of freight costs to be assessed*".

63. The earlier work by Network Rail, which LEK has used as its reference point, has not thus far been made available. Notwithstanding this lack of transparency and consultation, this has not prevented a range of £275m - £325m for Network Rail's freight avoidable costs (pre-efficiency) being widely quoted, including by ORR, and hence attaining some form of credence, if only by virtue of repetition. DB Schenker is extremely concerned that this "range", which seems to have no solid foundation, has shaped the remit for, and expectations from, the LEK study.

64. DB Schenker has been informed that the LEK cost estimates will not include any efficiency gains over the next 35 years, even though ORR is expected to require such significant efficiency gains around 15-20% for CP5 alone (as set out in the consultation). DB Schenker will expect that any final estimate of freight avoidable costs must be computed net of expected efficiency gains as it is vital that efficiency gains are included to avoid the risk of the total costs not being adjusted at a later stage.

65. The theoretical exercise being undertaken by LEK should answer the question "*what if freight didn't exist*" and not "*what if we removed freight*". In addition, DB Schenker is concerned that the primary definition used to allocate infrastructure to freight has been simply than there is no current passenger use. DB Schenker remains concerned that the lack of network rationalisation in recent years has led to a proportion of infrastructure being retained unnecessarily and being used because it is still there rather than being used because it is still required. DB Schenker believes strongly that the infrastructure costs taken into account for these calculations should be those of a notionally efficient infrastructure manager. DB Schenker is concerned that the effect of this is that the amount of infrastructure allocated to freight will be inflated and that Network Rail's inefficiency will be masked by the application of a freight specific charge.

66. Evidence from Network Rail to current Rail Delivery Group work looking at case studies on network optimisation in Wessex and Sussex suggests that some 7-9% of switches and crossings (used as a proxy for track infrastructure) are either surplus to requirement or so seriously underutilised that it is tantamount to the same thing. This reinforces the point that freight must not be penalised because of Network Rail's inefficient management of the network that has resulted in surplus infrastructure being retained. The methodology used by LEK means that such infrastructure risks being designated as freight avoidable whereas costs that are currently inefficiently incurred should not be included at all.

67. There are a number of cost categories included in the calculation that are already covered by existing charges and will, as far as DB Schenker is aware, continue to be covered by existing charges in the future. While those cost categories constitute 'avoidable freight costs', they must be removed from any determination of 'freight avoidable costs' that would be considered to support an additional freight specific charge. This will then avoid the current likely outcome that in order to produce cost estimates for these categories, LEK has had to replace existing methodologies for determining these costs with its own new methodologies, which will invariably lead to different results.

68. DB Schenker submits that the cost categories covered by existing charging methodologies that should be removed in their entirety from the LEK work include (but are not limited to) VTAC, Schedule 8, EC4T, EC4T Asset Usage Charge, Coal Spillage Charge, Freight Only Line Charge and Capacity Charge. DB Schenker also considers that costs covered by specific agreements, such as ERTMS, should also be excluded to

avoid unintended outcomes (see paragraph 75 below).

69. DB Schenker is seriously concerned that if LEK continues to include these categories simply "*because that is what the remit says*" then an inaccurate and significantly overstated value of freight avoidable costs will be generated which again risks gaining a measure of credence simply through repetition. Any caveats around the number will simply be forgotten or disregarded – the number will remain and risks gaining verisimilitude.

70. DB Schenker is not yet satisfied with Network Rail's calculations for freight only lines and has asked for sight of the FOL model Network Rail has used. Based on knowledge and historical analysis of work actually performed by Network Rail and predecessors on freight only lines, DB Schenker would expect the difference between standard unit rates and those assumed for freight only lines to be far greater than the 20% assumed by Network Rail. DB Schenker has asked LEK for evidence to justify such a small reduction.

71. DB Schenker does not find Network Rail's initial assessment of the savings in track and signalling renewals credible. Accordingly, it has suggested to LEK that it attempts to back-calculate the total cost of freight only line renewals from this data which might reveal the replacement rate that is implicitly assumed. DB Schenker strongly suspects that this would be rather higher than historic "real" data.

72. DB Schenker is also strongly of the view that VTISM is not a proper model for assessing significant variations that result in large step changes in cost – it was never intended for such a purpose and DB Schenker is not convinced the outputs are reliable. DB Schenker has asked LEK how it has satisfied itself of the suitability of the model for the purpose for which it is now being used.

73. Some of the enhancements assessed as "freight only" also generate benefits for passenger and residual network infrastructure traffics. DB Schenker acknowledges that this is a complex area, but suggests some allowance is made, for example, gauge enhancements that facilitate future electrification (including Great West Main Line and Cherwell Valley).

74. The ERTMS loco fitments costs should also not be included on the basis that there is industry and government agreement that freight operators should be held "harmless" from these costs. Including them in any freight specific charge will have the effect that freight operators will be charged for these costs.

Market Analysis

Q14 (6.83) Do you have comments on our write-up, interpretation and application of the studies carried out by MDST and NERA? Is there any further evidence that you believe should be considered?

75. DB Schenker has already commented extensively on the work of MDS Transmodal and NERA and, therefore, refers ORR back to these. DB Schenker also supports the comments in respect of the MDST and NERA work made in their submissions to this consultation by both CoalImp and the Rail Freight Group on behalf of the customers and end-users they represent.

76. DB Schenker is concerned that both the MDS Transmodal and NERA analyses do not address the effect of an increase in track access charges on rail freight economics. Whilst they have looked at markets individually, they have not reviewed the interaction of one market with another, nor the response of freight operators to the profitability of the overall market for rail freight.

77. It is implicit in both the NERA and MDS Transmodal analyses that any increase in access charges – whether via an increased variable charge or a new freight specific charge – would be passed through and paid in full by end customers. In DB Schenker's view this is naïve and ignores the reality of the market. DB Schenker has no doubt that within three years customers will have forced the supply chain (producers, ports and operators) to have absorbed any such increase – this has been the experience when ORR-led and other changes have reduced access charges.

78. DB Schenker has expended considerable energy in attempting to reconcile the different analyses of the coal market undertaken by MDS Transmodal and NERA, together with other industry forecasts and forecasts from DECC, let alone recent actual data for coal burned and coal moved by rail. There are, and remain, considerable differences. DB Schenker would urge ORR to ensure that the data on which ORR bases its decisions is aligned to the latest views from Government and the electricity coal supply industry.

79. DB Schenker urges ORR to consider whether, in the light of the MDS Transmodal work in particular, ORR would be in a position to deliver some of their policy objectives without direct and wider impacts on the rail freight, port or coal supplier sectors by maintaining the current structure of access charges but increasing the variable charge paid by ESI coal.

Q15 (6.84) Do you agree with our proposal, on the basis of MDST's analysis, to not levy a mark-up on certain rail freight commodities, including intermodal, construction materials and metals?

80. If ORR decides not to introduce a freight specific charge the question becomes academic. However if ORR decides to implement its proposal, then DB Schenker agrees that limiting the 'mark-up' to ESI coal and nuclear is correct.

81. DB Schenker would urge ORR to make an early, positive statement to this effect as this would help reduce some of the uncertainty in the market. However, ORR has to recognise that customers and affected third parties will remain concerned at the regulatory risk of extension of this charge at subsequent Periodic Reviews.

Q16 (6.85) Do you agree with our proposal to levy the proposed charge on ESI coal traffic:

82. DB Schenker remains concerned that levying an increase on ESI coal will have direct and wider impacts on the rail freight sector which have not been fully assessed. It firmly believes that ORR can deliver some of its policy objectives without direct and wider impacts on the rail freight, port or coal supplier sectors. It can do this by maintaining the current structure of access charges but increasing the variable charge paid by ESI coal. Any increase must be sufficiently low that it can reasonably be absorbed without any significant loss of volume, and that second order impacts are minimised.

Q17 (6.86) Do you agree with our proposal to levy the proposed charge on spent nuclear fuel traffic?

83. DB Schenker is not currently familiar with this sector and hence is not well placed to comment on either the sectors "ability to pay" or any second order impacts. However it would seem inevitable to DB Schenker that there are again likely to be wider impacts to be considered.

84. The freight avoidable costs associated with spent nuclear fuel, other than on freight only lines, are likely to be very small given the low traffic volumes.

Q18 (6.87) What views do you have on our analysis of the iron ore market segment? Do you consider that there is also a case for levying the proposed charge on iron ore?

85. DB Schenker has serious concerns about the potential impact on iron ore – which in reality is one traffic flow only. DB Schenker would strongly urge ORR to exclude iron ore from any 'mark-up'. This is because Tata at Scunthorpe is already struggling to produce steel competitively at a time of global over-supply. Any increase in access charges for iron ore might seem in itself of only local importance, but it will feed through to distribution costs and it is the cumulative competitive worsenment in the eyes of both the market and the Group's owners that is the key issue. If an increase in access charges adds to a negative appearance of competitiveness for steel making at Scunthorpe, then eventually a tipping point will be reached. Other branches of UK Government recognise this and have been working with Tata to try and support steel making in the UK. DB Schenker urges ORR to adopt the same approach.

86. It would be helpful if ORR could also specifically confirm that blast furnace coal and coke are not deemed "able to pay" any 'mark-up'.

Q19 (6.88) Do you agree that we should revisit our policy on levying a charge for the biomass market segment to coincide with the recalculation of its credit (subsidy) regime (from 2017 for England and Wales)?

87. DB Schenker agrees that it is not appropriate to introduce increased charges for biomass at this point for the following reasons:

    a. this is a nascent market which is very much in a "start-up" phase;

    b. assuming that the electricity supply market and Government policies develop in way that facilitates the use of biomass, very considerable capital investment in wagons and product handling facilities will be needed; and

    c. the scale of these investments, and their payback periods, may require ORR to give greater certainty that biomass will not be targeted at the next Periodic Review.

Q20 (6.89) Do you consider that the proposed charge should be levied on other (non ESI) coal flows?

88. As recognised by MDS Transmodal, other coal (including blast furnace coal and coke) are subject to strong competitive pressure both from road transport and product substitution. Where coal is used as a heat source (e.g. in cement production) substitution by other fuels (e.g. waste products such as shredded tyres) is a major risk. DB Schenker, therefore, strongly urges the ORR to exclude other coal flows from any 'mark-up'.

End