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Dear Ben,

27 January 2012

**PR13 FREIGHT CAPS – CONSULTATION ON VARIABLE USAGE CHARGE (VUC)
AND FREIGHT ONLY LINE CHARGE INITIAL COST ESTIMATES**

This letter contains the response of DB Schenker Rail (UK) Limited (“DB Schenker”) to the consultation entitled “Freight caps – consultation on variable usage charge (VUC) and freight only line estimates” issued by Network Rail on 29 November 2011.

Introduction

1.1. Stability and certainty are crucial factors for the continuation and growth of the rail freight industry which depends on the private sector. The Periodic Review presents an opportunity to reinforce that stability and certainty but, equally, it 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 are proposals to review, restructure and possibly increase freight access charges.

1.2. With this in mind, DB Schenker has strongly supported the intention of ORR to place a cap on the level of freight track access charges well in advance of its determination. As previously demonstrated as part of the PR08 process, a cap is an important way of giving assurance for rail freight operators to plan their businesses and their investments with a reasonable degree of certainty, but more particularly, is important in giving confidence in the mode for both existing and potential rail freight customers.

1.3. DB Schenker is, therefore, pleased to respond to Network Rail’s initial cost estimates of its variable usage and freight-only line charges, the consultation of which is helpfully being undertaken at an early stage of the PR13 process. The level of these particular charges have a significant impact on rail freight operators and their customers and DB Schenker is, consequently, content that the outcome of this work will inform ORR’s consideration on whether or not caps on freight track access charges are appropriate and, if so, the level and scope of such freight caps.

1.4. Whilst the consultation relates particularly to the calculation and modelling of variable usage and freight-only line charges, nevertheless, DB Schenker also wishes to raise more

general comments on the various matters discussed in the consultation letter. These comments can be found below, whilst DB Schenker's views on the specific questions raised by Network Rail are set out in the Annexes to this letter.

1.5. However, notwithstanding the above comments, DB Schenker is concerned that the proposed caps on variable track usage and freight-only line costs are set too high and will, consequently, give a contrary message to that intended i.e. rather than giving the rail freight industry and its customers the degree of certainty and assurance they are looking for, it could instead cause concern that track access charges could increase substantially, potentially making them unaffordable for many traffic flows.

General Comments

2.1. With many businesses, particularly in the retail sector, looking to expand their use of rail, it is particularly important that cost uncertainty can be minimised as soon as possible. DB Schenker strongly supports the setting of a cap on freight track access charges during the first half of 2012 as a way of supporting business confidence. However, a cap will only be meaningful if it is set at a realistic level which gives a sufficiently small limit over and above the actual estimated levels of the charges concerned. A cap that is set too high is counter-productive as it will not give the assurance that is intended.

2.2. In addition, rail freight operators and their customers view freight track access charges in the round and, therefore, any cap must capture a sufficiently large proportion of total freight charges. Whilst progress has been made on variable usage and freight only line costs to the point that the level of prospective caps have been proposed, work on other elements (and potentially even new elements) of freight track access charges are not so developed. Caps based only on certain elements will be of limited value if subsequent decisions by ORR on the level of other freight track access charges, including the possible imposition of further additional charges, render such caps relatively meaningless.

2.3. ORR and DfT have been clear that any caps on freight track access charges should form part of a wider "freight package" including commitments by the rail freight industry to play its part in further reducing whole industry costs. DB Schenker is supportive of the need for rail freight to play its part in helping drive whole industry initiatives to reduce cost, but is concerned that the inherent complexities of developing such a package might delay decisions by the ORR on any meaningful caps on freight track access charges.

2.4. This would be regrettable as the key value of such caps is to give early certainty. DB Schenker trusts that the active role it continues to take in the industry reform process (including its participation in the Rail Delivery Group) together with the initiatives taken thus far by freight operators (e.g. in advancing a list of routes that Network Rail could maintain to a lower standard than is usually required for rail freight traffic) will give ORR the confidence to make an early determination on meaningful and realistic caps on freight track access charges.

2.5. ORR is also currently assessing the ability of rail freight markets to bear a 'mark-up' on direct track access costs, with additional particular work on the ESI coal, nuclear and biomass sectors. DB Schenker notes that this work will be subject to a further consultation by ORR later this spring and urges that a thorough and early consultation is undertaken as quickly as possible to help reduce customer (and potential customer) uncertainty not only in these market sectors but also across the entire rail freight market as a whole.

2.6. Network Rail has made clear its position that, should ORR conclude that some market sectors can bear a mark-up on the variable usage charge, this mark-up should not (as now) be limited to making a contribution towards the fixed costs of freight-only lines but should also be extended to network-wide common fixed costs. If permitted, this would be a major change of policy that does not yet seem to have been adequately explained or consulted upon by Network Rail or ORR. It is also not clear to DB Schenker whether or not DfT formally supports such a change in policy. DB Schenker suggests that ORR should set out quickly and clearly its position on this issue, including how it considers that any assessment of freight sector contributions to network-wide common fixed costs should be undertaken.

2.7. DB Schenker appreciates that decisions on the ability to pay are for ORR to determine and do not form part of this consultation. However, as already indicated above, any changes resulting from this further work have an interrelationship with any work on freight caps as both work streams have a significant effect on the continuing certainty and stability of rail freight. DB Schenker is positive that both Network Rail and ORR appreciate that any change to the current track access charges structure represents a real cost to both rail freight operators and their end customers, and cannot be passed back to Government unlike most passenger operators are able to via the passenger franchising process.

2.8. Consequently, DB Schenker expects a much higher quality and thoroughness when calculating and producing data relating to the costs associated with rail freight traffic than has hitherto been shared thus far and it counts on this being a high priority for both Network Rail and ORR.

2.9. DB Schenker is generally supportive of the principles included within the methodology adopted by Network Rail in its work on estimating its variable usage and freight-only line charges as they are based broadly on those used in PR08 but nevertheless, it still has a number of substantive reservations.

2.10. Much reliance is placed on VTISM and its supposedly cross-industry genesis and "wide use" across the rail industry. DB Schenker believes that undue emphasis is being placed on the cross-industry nature of VTISM and has not been greatly involved in the model's development, particularly how it might be used to predict track damage and hence short run incremental costs. Indeed during September 2011 it was only due to DB Schenker's strong intervention that the industry group working on VTISM was expanded to include substantive freight involvement.

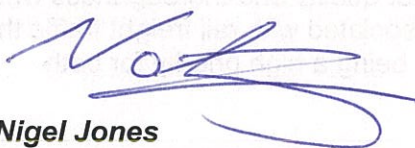
2.11. Since then, it has become clear from DB Schenker's participation in the industry (VTAC) working group that there is no universal agreement on the relationship between VTISM predictions and actual track damage, including some suggestions that VTISM over-predicts such damage.

2.12. For non-track costs, the assessment of variability relies heavily on engineering judgement. These judgements are particularly critical as they effectively lead to the proposed increases in variable usage and freight-only line costs. DB Schenker, therefore, expects ORR to scrutinise these engineering judgements in a thorough and transparent manner to ensure that they have been rigorously considered and fairly applied.

2.13. DB Schenker previously suggested that it would have assisted the consultation process if such a review had been undertaken prior to the industry workshop on held on 6 January. Unfortunately, that did not happen and DB Schenker has been unable to undertake its own review in the very limited time available as it has been extremely difficult to secure the services of appropriate specialist engineering expertise. DB Schenker would like to discuss quickly with ORR how such a transparent review might now be undertaken before final decisions are made.

2.14. DB Schenker notes that the cost estimates are *initial* cost estimates. DB Schenker is satisfied that these are sufficient to inform decisions on caps on freight track access charges, but suggests that further work is needed before it would be appropriate to move on to how these estimates can be used as the basis for specific charges.

Yours sincerely,



Nigel Jones
Head of Planning & Strategy

PP

DB SCHENKER'S COMMENTS ON THE SPECIFIC QUESTIONS RAISED IN NETWORK RAIL'S CONSULTATION LETTER

Q1. What are your views on the range of traffic scenarios (+5%, +10% and +20%) that we used to model costs?

DB Schenker considers that these scenarios are appropriate for estimating the variable usage costs for use by ORR in considering whether or not caps on freight track access charges are introduced and, if so, the level and scope of such caps. However, DB Schenker considers that similar scenarios which assume traffic reductions should also be modelled.

Whilst DB Schenker notes Network Rail's optimism by reference to the Initial Industry Plan that a situation in which traffic volumes reduce is unlikely, nevertheless, this should not prevent such scenarios being modelled. Even in cases where overall growth is predicted in the round, this could mask the fact that some market sectors may be declining whilst others are growing significantly. For example, this is particularly pertinent when comparing forecast volumes of coal traffic which are set to decline when compared to forecast volumes of intermodal traffic which are predicted to increase substantially. Furthermore, if route based charging is considered (which DB Schenker hopes that it isn't, particularly for national rail freight operators), certain routes may also have forecast reductions in traffic volumes that would need to be modelled so that the effects on variable track usage costs can be understood.

DB Schenker is, therefore, concerned that the model used by Network Rail to calculate the variable track usage costs (i.e. VTISM) is wholly unreliable in predicting scenarios under which traffic declines. This means that changes in variable track usage costs under scenarios where overall traffic or individual route or market sectors reduce cannot be assessed and understood. Given this, DB Schenker considers that Network Rail needs to develop other methods of assessing the movement of variable track usage costs in such scenarios.

Q2. What are your views on our proposal to use the +20% traffic scenario to estimate an average track vehicle cost per kgtkm?

For the purposes of estimating costs that will be used by ORR when considering whether or not caps on freight track access charges are appropriate and, if so, the level and scope of such caps, DB Schenker considers that use of the +20% traffic growth scenario is appropriate for the reasons given by Network Rail in the consultation document.

Q3. What are your views on our proposed 'top down' variability assumptions that we have applied in order to estimate non-track variable usage costs?

DB Schenker notes that Network Rail has reviewed and retained the 'top down' variability assumptions that it used in CP4 in respect of metallic under-bridge and embankment renewals and has increased its CP4 variability assumption in respect of signalling maintenance by 20% (from 5% to 6%). DB Schenker also notes that Network Rail has introduced further categories of variable cost hitherto seemingly not included within previous Periodic Reviews. These consist of brick and masonry under-bridge, culvert and minor point renewals; all with their own variability assumptions.

As mentioned in its general comments made in the covering letter, DB Schenker has been unable to undertake its own review of the engineering principles and cost assumptions in the very limited time available as it has been extremely difficult to secure the services of appropriate specialist engineering expertise. Therefore, DB Schenker has no substantial data with which it can challenge or confirm the accuracy of Network Rail's variability assumptions. However, given that the values for the original cost categories broadly mirror those used in CP4, they would appear for these categories to be appropriate. DB Schenker would question, however, the variability assumption used by Network Rail in respect of the new category of minor point renewals which is quoted at 44%. This seems extremely excessive for what is in effect a track asset that DB Schenker would expect to be covered in the 'bottom up' approach.

Q4. What are your views on our proposal to apportion costs between freight and passenger traffic based on the CP4 allocation methodology?

DB Schenker is content that the apportionment and allocation of costs is based on the methodology agreed and used for CP4.

Q5. What are your views on our proposal that the most appropriate way of placing a cap on charges is likely to be to determine a maximum average £ per kgtkm rate for freight traffic (as opposed to a maximum £m absolute value)?

DB Schenker supports Network Rail's proposal that the most appropriate way of placing a cap on freight track access charges is to determine a maximum average variable rate as this would be more easily understood than a total '£m' figure. However, DB Schenker considers that the variable rate should be expressed in terms of 'kgtkms' rather than 'kgtkm' as this would be consistent with the way in which freight variable track access charges are currently levied.

Q6. What are your views on our proposed confidence interval of +/- 20%?

DB Schenker is extremely disappointed that Network Rail has included a +/-20% contingency in its estimated variable usage costs. Whilst DB Schenker understands that this was the value used in PR08; that was because Network Rail had previously used a less precise cost model. In promoting its use of the VTISM model for CP5, Network Rail has advanced the argument that this model is a significant advance on previous models as it uses engineering science to accurately predict track degradation and the remedial effects of heavy maintenance and renewal. DB Schenker considers, therefore, that if the model is more accurate in producing information that can be used to estimate variable track usage costs, then this should be reflected appropriately in the contingency and should, therefore, certainly be less than the +/-20% used for CP4. Given Network Rail's confidence in the VTISM model, DB Schenker believes that the contingency should be no higher than +/-10%.

Q7. What are your views on our proposal that it would be prudent to cap charges at the upper limit of our +/- 20% confidence interval i.e. £1.81 per kgtkm?

DB Schenker notes that Network Rail's variable usage charge cost estimate is proposed at £1.51 per kgtkm, which is around 11% higher than the current CP4 average vehicle cost of £1.36 per kgtkm. Once the +20% contingency is added to this figure, the estimate becomes £1.81 per kgtkm which represents a 33% increase over the average CP4 vehicle cost.

Whilst acknowledging that this figure (£1.81 per kgtkm) is proposed solely for use in setting the cap on the CP5 freight variable usage charge and the actual value could be somewhat lower than this, nevertheless, a message that by far the largest element of freight track access charges could be increased substantially would, in DB Schenker's view, send entirely the wrong signal. DB Schenker recognises the need for the cap to have some flexibility, but a 33% increase is somewhat 'over generous' in its view. Rather than giving the rail freight industry and its customers the degree of certainty and assurance they are looking for, an overly inflated cap could instead cause concern that track access charges may become unaffordable for many traffic flows.

Q8. Do you have any other comments?

DB Schenker acknowledges that the work carried out thus far is aimed at producing an estimated average variable usage cost for use in setting a proposed freight track access charge cap. However, DB Schenker also believes that the further substantive work required to be able to produce the disaggregated costs down to vehicle type that will eventually be used to populate the CP5 vehicle price list needs to begin in earnest quickly as it is this information that will enable freight operators to gauge the effects of any changes in variable usage charges on particular traffic flows. DB Schenker requests that Network Rail produce an action plan with suitable timescales that will enable this work to be completed as quickly as possible.

Q9. What are your views on the freight only line definition established in PR08?

DB Schenker is content to use the same freight-only line definition that was used for PR08. However, it should be noted that the term 'freight' in the context of the definition should not include freight services operated on behalf of Network Rail to transport materials used in the maintenance, renewal and enhancement of the network. For example, a freight-only line leading to a quarry which supplies ballast to Network Rail should not be included on the list.

Q10. What are your views on the initial list of freight only lines set out in Annex B?

Whilst DB Schenker agrees with the majority of the lines specified in the freight-only lines list, it does have a number of comments to make on certain individual entries. These comments can be found in Annex 2.

In addition, DB Schenker believes that the Network Rail maintained and operated lines that run through the Port of Immingham should also be considered for inclusion in the freight-only line list. Whilst DB Schenker acknowledges that these lines currently comprise part of the Immingham Dock Railway, currently Network Rail charge ABP for the costs of their operation, maintenance and renewal and this cost is merely passed through to the freight operators that use these lines. Given that these lines are in effect 'ransom strips' because they join separate parts of the network and given the desire of the rail reform review to explore ways of reducing unnecessary complexity and cost, DB Schenker strongly believes that there would be benefits in treating these lines as part of the freight-only line network.

Q11. What are your views on the track kilometres contained in the freight only line list in Annex B?

Whilst DB Schenker agrees with the majority of the proposed track kilometre values specified in the freight-only line list, it does have a number of comments to make on certain individual entries. These comments can be found in Annex 2.

Q12. What are your views on the commodity traffic splits contained in the freight only line list in Annex B?

Whilst DB Schenker does not disagree with the majority of the proposed commodity traffic splits included in the Coal ESI/Nuclear Fuel freight-only lines list, it does have a number of comments to make over certain individual entries. These comments can be found in Annex 2.

Q13. What are your views on our proposed methodology to adjust for the fact that some lines carry multiple commodities? Where freight only lines carry multiple commodities our proposal would (consistent with the approach in CP4) be to charge those commodities deemed capable of paying toward fixed costs based on their share of total tonnage (kgtkm) conveyed on these lines?

DB Schenker considers that Network Rail's proposal in this regard seems appropriate.

Q14. What are your views on our proposed confidence interval of +/- 20%?

DB Schenker is disappointed that Network Rail merely proposes to adopt the +/-20% contingency for inclusion within its estimated freight-only line costs. Whilst this level of contingency may have been appropriate for PR08, DB Schenker would have expected Network Rail to have refined this value based on actual data collected since the start of CP4 to obtain a more accurate figure. Consequently, DB Schenker believes this figure should be reviewed by reference to actual relevant data.

Q15. What are your views on our proposal that it would be prudent to cap charges at the upper limit of our +/- 20% confidence interval i.e. £8.15m and £1.85m for coal ESI and spent nuclear fuel respectively?

DB Schenker notes that Network Rail's freight-only line cost estimates are proposed at £6.79m in respect of Coal ESI and £1.54m in respect of Nuclear, which represent a respective 29% and 83% increase over the corresponding CP4 values. Once the +20% contingency is added, these figures become £8.15m and £1.85m respectively representing a 55%/120% increase over the CP4 values.

Whilst acknowledging that these figures (£8.15m/£1.85m) would be proposed solely for use in setting the cap on the CP5 freight-only line charges and that the actual values could be somewhat lower than these, nevertheless, a message that freight-only line track access charges could increase substantially for Coal ESI and Nuclear would, in DB Schenker's view, send entirely the wrong signal. DB Schenker recognises the need for the cap to have some flexibility, but increases at these levels are somewhat 'over generous' in its view. Rather than giving the rail freight industry and its customers the degree of certainty and assurance they are looking for, such overly inflated caps could instead cause concern that, when also combined with the potential increase in variable usage charges, track access may become unaffordable.

Q16. Do you have any other comments?

DB Schenker notes that Network Rail has applied a 'mark up' to derive the total costs of the freight-only lines instead of using actual data. This is because Network Rail maintains that it does not have sufficiently granular estimates of related renewals costs. This has led Network Rail using a 24% 'mark up' on Coal ESI and a 14% 'mark up' on Nuclear. DB Schenker wishes to understand why Network Rail has not been

capturing relevant actual data so that instead of using 'mark ups' the estimated costs could have been based on actual data.

Network Rail has advanced an argument that should ORR conclude that some market sectors can bear a mark-up on the variable usage charge, this mark-up should not (as now) be limited to making a contribution towards the fixed costs of freight-only lines but should also be extended to network-wide common fixed costs. DB Schenker is concerned that this seemingly major change of policy, which appears not to have been advanced previously and if introduced will further add to the costs of operating rail freight in these market sectors create further instability. For this reason, DB Schenker suggests that ORR should set out quickly and clearly its position on this issue.

End
