

Decision of the Office of Rail Regulation

DB Schenker Rail (UK) Limited

Relating to a finding of 2 August 2010 by the Office of Rail Regulation (ORR) that DB Schenker Rail (UK) Limited has not infringed the prohibition imposed by section 18 of the Competition Act 1998 ('the Act') or Article 102 of the Treaty on the Functioning of the European Union ('the Treaty').

Introduction

1. This decision relates to the pricing of DB Schenker Rail (UK) Limited (DBS) in respect of petroleum haulage by rail in Great Britain.
2. The rail freight haulage industry moves around 9%¹ of the total freight moved each year in Great Britain (GB). Of the rail hauliers in GB, DBS is the largest, carrying around half of all rail freight. Its ultimate parent company is Deutsche Bahn AG, the German state-owned rail company.
3. The main focus of ORR's investigation was a particular contract between DBS and ConocoPhillips Limited (CP), referred to henceforth as 'the Contract'. ORR investigated whether DBS's pricing of the Contract represented an abuse of a dominant position contrary to section 18 of the Act and/or Article 102 of the Treaty. The Contract started on 1 November 2009, and will run for a maximum of three years. The Contract is for the haulage of petroleum products between CP's Humber Oil Refinery near Immingham in Humberside and the Kingsbury oil storage facility in the West Midlands.
4. CP describes itself² as "*an international integrated energy company*". Its headquarters are in Houston, Texas in the USA. In the UK, CP, extracts, processes, refines and supplies oil and gas and related products.
5. ORR was first made aware of concerns relating to DBS's pricing of the Contract in October 2009 when interested parties including Freightliner Heavy Haul Limited (FHH), GB Railfreight Limited (GBRf), and a member of the European Parliament alerted ORR to the possibility that DBS's pricing could be so low as to be loss-making. ORR opened an investigation on 22 January 2010 by way of an unannounced site visit to one of DBS's offices, made under section 27 of the Act. ORR subsequently issued a number of notices under section 26 of the Act ('section 26 notices'), requesting information and documents from various parties between February and April 2010.
6. ORR exercises its powers under the Act concurrently with the Office of Fair Trading³ (OFT) in respect of agreements and conduct relating to the supply of services relating to railways⁴. ORR is also a National Competition

¹ Using 2008 data, measured by tonne-kilometre. See DfT *Domestic freight transport: by mode*.

² <http://www.conocophillips.co.uk/EN/about/Pages/index.aspx>.

³ See section 67(3ZA) of the Railways Act 1993.

⁴ The Office of Fair Trading, *Application to services relating to railways*, a Competition Act 1998 guideline published with the ORR, OFT 430, October 2005.

Authority (NCA)⁵ for the purpose of applying Articles 101 and 102 of the Treaty. Article 102 provides that any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States.

7. ORR did not reach a conclusion on the precise boundaries of the relevant economic market(s) or on DBS's position therein during this investigation. Neither was necessary for ORR to reach a decision given the outcome of ORR's financial analysis which showed that the Act could not have been infringed in this case. ORR has, however, made a number of observations about the possible market(s) in which the Contract operates.

8. ORR's analysis found that DBS's pricing was at a level above average avoidable cost (AAC), providing (before interest and tax) a contribution to fixed costs and overheads of at least⁶ [X]%. ORR did not find evidence to suggest that DBS's pricing was part of an anticompetitive strategy. ORR therefore did not find evidence of an infringement.

The facts

The industry

Rail freight haulage

9. Rail freight haulage is the movement of goods by rail. Customers are generally charged a price per tonne of freight hauled. Prices typically include a consideration of the nature of commodities being hauled and the distances over which they are transported.

10. In many cases rail freight haulage competes with other modes of transport including haulage by road. A key feature of rail haulage is that it can transport large volumes over long distances with significant cost advantages over other modes of transport such as road. This makes rail haulage particularly suitable for the transport of bulky goods such as coal, construction materials, shipping containers, and petroleum products to various types of industrial site.

11. Where a potential purchaser of rail freight haulage owns or leases its own wagons it can approach freight operating companies (FOCs) and ask for prices for a 'hook and haul' service whereby a FOC will supply a locomotive to haul the customer's wagons. Alternatively, a FOC may 'operate' whole trains on behalf of any customers that have their own locomotives and wagons, or a FOC may provide the full service which includes provision of the rolling stock itself.

⁵ Council Regulation EC 1/2003 and Regulation 3 of the Competition Act 1998 and Other Enactments (Amendment) Regulation 2004 SI 2004 No 1261.

⁶ ORR adopted an approach to its financial analysis whereby it tended to err on the side of high cost estimates.

Oil refining and storage

12. There are nine main oil refineries in the UK⁷. Each of these refines crude oil from different sources to supply a range of petroleum products, including: Liquid Petroleum Gas (LPG), petrol, diesel, jet fuel, gas oil, heating oil, and residues such as bitumen. The proportion of each distinct product that is derived from the refining process varies depending on, among other things, the source of the crude product⁸. Refining also provides the feedstocks for lubricants and petrochemicals which are the basis for plastics, paints, adhesives, detergents, resins, solvents, synthetic fibres and rubber. Once refined, individual petroleum products can then be transported from refineries to distribution centres.

13. The Petroleum Industry Association (UK) describes the UK downstream industry as follows:

“The UK downstream industry consists of over 200 companies involved in refining, distribution and marketing of petroleum products. They range from large, multinational oil companies, supermarket chains and independent retail groups, through to the independent retailer with a single site.

The main product of the downstream industry is transport fuel. This market is split into commercial and retail. The commercial market includes power generators, industrial, transport and agriculture customers, independent fuel distributors, the government and its agencies, public services and the military. The retail market covers fuels mainly sold from high street filling stations.”⁹

14. From distribution centres or storage facilities petroleum products are transported to the retail end of the supply chain. Retail customers include vendors of petrol for use in private vehicles. End user requirements tend to be in comparatively low volumes and transported by road vehicles over relatively short distances.

The main parties

DBS

15. DBS is part of the pan-European freight business DB Schenker Rail, which is in turn part of Deutsche Bahn AG.

16. DBS was established following the acquisition of English, Welsh and Scottish Railway (EWS) by Deutsche Bahn AG in 2007. At the time EWS was by some distance the largest of the independent FOCs that had been operating in GB following the privatisation of British Rail in the 1990s.

17. DBS’s principal activities are bulk freight (including commodities such as coal, steel, aggregates, and petrochemicals); intermodal freight (including

⁷ <https://www.og.decc.gov.uk/downstream/refining/index.htm>.

⁸ The Petroleum Industry Association
http://www.ukpia.com/industry_information/refining-and-uk-refineries.aspx.

⁹ The Petroleum Industry Association
http://www.ukpia.com/industry_information/industry-overview.aspx.

the movement of containers and swap bodies); international traffic via the Channel Tunnel; infrastructure maintenance support services for Network Rail; special passenger charter services; and train maintenance and driver hire.

18. DBS hauled 50.5% of all rail freight traffic in 2008/09 when measured on a tonne-km basis¹⁰. This share had fallen significantly in recent years, with DBS having lost significant volumes of traffic as a result of the 2008/2009 recession and competition from rival hauliers.

Other FOCs

19. Taken as a whole, Freightliner Group¹¹, including Freightliner Heavy Haul, is by some distance the second largest FOC in GB, with a share of around 37% of all rail freight tonne-km in 2008/09. The next largest FOC is GBRf¹², which has a share of around 5%.

ConocoPhillips

20. As noted above, this investigation focused on a particular contract between DBS and CP.

21. In the UK, CP, “*extracts, processes, refines and supplies oil and gas and related products to a variety of customers*”¹³. It is active in both upstream exploration and extraction and downstream refining and marketing. CP’s upstream exploration and production activities in the UK produced 81,000 barrels per day of oil equivalent during 2009. CP reports that it is the world’s fourth-largest non-government-controlled refiner, with crude oil processing capacity of nearly 2.7 million barrels per day globally¹⁴. Its Humber refinery is capable of refining up to 221,000 barrels of crude oil per day¹⁵. The products of the refinery are then distributed to its JET retail arm (of around 400 service stations) and a variety of customers including the commercial, aviation and marine industries.

Chronology of this investigation

Background

22. On 7 October 2009 ORR received an email from FHH which it described as, “[...] a very superficial outline [...]” of an instance in which it believed DBS had priced a contract on a loss-making basis.

¹⁰ All market volume data in this decision - ORR/10/42/17 - ORR - freight moved figures.

¹¹ <http://www.freightliner.co.uk/>.

¹² www.gbrailfreight.com/.

¹³ <http://www.conocophillips.co.uk/EN/about/Pages/index.aspx>.

¹⁴ See ConocoPhillips 2009 Fact Book: http://www.conocophillips.com/EN/about/company_reports/fact_book/Documents/10-0265%20Fact%20Book_WEB-lr.pdf.

¹⁵ See ConocoPhillips 2009 Summary Annual Report http://www.conocophillips.com/EN/about/company_reports/Documents/ConocoPhillips_09AR-Summary.pdf.

23. At a subsequent meeting with ORR on 29 October 2009, FHH explained that recent aggressive pricing by DBS had enabled it to win a number of key contracts within the industry. FHH explained that DBS's pricing of the Contract, in particular, had given it particular cause for concern. FHH told ORR that informal discussions within the industry had led it to believe that DBS had won this three-year contract by offering a price so low as to be difficult to explain in the absence of an anticompetitive motive.

24. ORR was also approached, around that time, by other third parties¹⁶ who were concerned about low DBS pricing, both of the Contract and more generally. ORR's reasoning for limiting its investigation to the Contract is provided at paragraph 27 below.

25. Following a short review of cost information and of the possible relevant markets surrounding the Contract, ORR concluded that it had reasonable grounds to suspect that the Chapter II prohibition had been infringed, thereby satisfying the relevant threshold in section 25 of the Act.

Investigation

26. On 22 January 2010¹⁷ ORR commenced an investigation by way of an on-site inspection at DBS's offices at Carr Hill in Doncaster. This inspection was conducted on a without notice basis under section 27 of the Act, which allows specified officers to enter the premises of a business and require that information and documents are provided to them. Following an agreement made during the inspection DBS supplied further documents to ORR on 29 January 2010.

27. ORR's investigation focused on DBS's pricing of the Contract specifically rather than on a wider cross section of DBS's business. ORR elected to adopt this narrow approach since ORR's dialogue with concerned parties suggested that DBS's pricing of this contract raised particular concerns above and beyond those raised by other contracts won by DBS around this time period¹⁸. ORR therefore considered that a narrow investigation was an appropriate and proportionate response, remaining open to the possibility of broadening its investigation to encompass further contracts if its analysis of the Contract or any of the materials gathered during the investigation gave it grounds to suspect the existence of a wider strategy of anticompetitive conduct.

28. ORR's decision to investigate rested on a concern that below cost pricing by DBS might lead to exit or scaling-down by its competitors, for example in terms of number of locomotives owned and/or leased and total size of workforce. Such exit or scaling-down could limit the ability of DBS's competitors to bid for future contracts, ultimately leading to less favourable terms being offered by DBS, particularly for those freight users who are captive to rail.

¹⁶ GBRf and Brian Simpson MEP.

¹⁷ <http://www.rail-reg.gov.uk/server/show/nav.2202>.

¹⁸ ORR/10/42/18 - Email from FHH to ORR, 03 November 2009.

29. ORR obtained further information in response to section 26 notices as summarised in the table below. Full chronology of the investigation is annexed.

Table 1 – Information requests

Request	Dates (all 2010)
First section 26 notice to DBS ('the first notice')	<ul style="list-style-type: none"> Request – 2 February Response – 16 February
First section 26 notice to FHH ('the first FHH notice')	<ul style="list-style-type: none"> Request – 8 February Response – 15 February
First section 26 notice to CP	<ul style="list-style-type: none"> Request – 9 February Response – 19 February
Section 26 notice to Network Rail	<ul style="list-style-type: none"> Request – 4 March 2010 Response – 11 March 2010
Second section 26 notice to CP	<ul style="list-style-type: none"> Request – 18 March Response – 26 March
Second section 26 notice to DBS ('the second notice')	<ul style="list-style-type: none"> Request – 23 March Response – 13 April
Section 26 notices sent to oil companies: Total UK Ltd, Petrochem Carless Ltd, Murco Petroleum Ltd, Petroplus Refining Teeside Ltd, Esso Petrol Company Ltd, BP Plc, Greenergy International Ltd, Star Energy Group Ltd	<ul style="list-style-type: none"> Request – 20 April Responses – 28 April to 7 May
Third section 26 notice sent to DBS ('the third notice')	<ul style="list-style-type: none"> Request – 29 April Response – 18 May
Second section 26 notice sent to FHH ('the second FHH notice')	<ul style="list-style-type: none"> Request – 30 April Response – 6 May

The Contract

30. The Contract was signed by DBS on 29 October 2009 and by CP on 11 November 2009¹⁹. It covers the haulage of petroleum products between CP's Humber Refinery at South Killingholme close to Immingham and the Kingsbury Oil Terminal in Kingsbury, Warwickshire²⁰. The Contract became effective on 1 November 2009, and will run, subject to the provisions of the agreement, until 31 October 2012. [X]²¹.

31. The Contract operates on a hook and haul basis. The wagons used to operate the Contract are leased by CP from VTG Rail UK Limited. The Contract provides for the movement of an annual volume of [X] tonnes with the potential to increase to [X] tonnes.

¹⁹ ORR/10/42/A2.7 *Master Services Agreement (No Construction)*.

²⁰ This decision sometimes, in line with naming conventions used within the industry, refers to the Humber Oil Refinery and Kingsbury Oil Terminal respectively as simply 'Immingham' and 'Kingsbury'.

²¹ ORR/10/42/A2.27 *Master Services Agreement (No Construction)*.

32. The Contract specifies a price to be paid to DBS by CP of £[X] per tonne (the Contract price²²) in its first year and subject to [X] inflationary increases thereafter. An important feature of the Contract price is that it potentially changes in line with underlying changes to wholesale fuel prices. The risk of variations in wholesale fuel unit costs (which account for a significant proportion of the costs of a haulier, particularly on a hook and haul contract) lies with the customer, that is, with CP.

33. Prior to DBS's successful bid FHH had held the previous two contracts for haulage between Immingham and Kingsbury with CP, having won both through competitive tender. The first of these ran from 2001 to 2004, the second from 2004 to 2009. EWS had held a contract with CP for haulage between Immingham and Kingsbury prior to 2001.

34. FOCs operating contracts for haulage between Immingham and Kingsbury have historically been and continue to be dependent on access to the DBS-controlled freight facilities and groundstaff which are based in the Kingsbury area. These facilities give FOCs access to various rail-connected industrial sites around Kingsbury, including, but not solely, the Kingsbury Oil Terminal.

Market definition and assessment of dominance

Key principles

Market definition

35. Section 60(1) of the Act sets out the principle that, so far as is possible (having regard to any relevant differences between the provisions concerned), questions arising in relation to competition within the United Kingdom are dealt with in a manner which is consistent with the treatment of corresponding questions arising in European Community (now European Union) law in relation to competition within the European Union. In particular, under section 60 of the Act, the OFT and the sector regulators including ORR given concurrent powers under the Act must proceed (so far as is compatible with the provisions of the Act) with a view to ensuring that there is no inconsistency with either the principles laid down by the Treaty and the European Court²³ or any relevant decision of it.

36. The European Court, in *United Brands v Commission*²⁴, set down that dominance refers to:

“[...] a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable

²² ORR/10/42/A2 *Master Services Agreement (No Construction) - Exhibit 'B' Compensation*.

²³ The European Court is defined in section 59 of the Act as meaning the Court of Justice of the European Communities (now the Court of Justice of the European Union) and including the Court of First Instance (now the General Court).

²⁴ Case 27/76 [1978] ECR 207, [1978] 1 CMLR 429.

extent independently of its competitors, customers and ultimately of its consumers”.

37. In order to assess whether an undertaking holds a dominant position, it is first necessary to define the relevant market on which that position might be held. The need to define a relevant market before assessing dominance has been established in European case law²⁵.

38. For the purposes of European Union competition law the relevant market usually comprises a relevant product market and a relevant geographic market. As stated in the *Commission Notice on the definition of the relevant market for the purposes of Community competition law*²⁶ (the ‘Commission Notice’):

“A relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products’ characteristics, their prices and their intended use.”

“The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighboring areas because the conditions of competition are appreciably different in those areas.”

39. This definition reflects the case law of the European Court.

40. The standard approach to market definition, as outlined in the OFT’s market definition guidelines²⁷ is that of the ‘hypothetical monopolist test’, the principles of which are also described in the Commission Notice. The approach involves identifying a focal product, which would constitute a relatively narrow market definition, and considering the ability of a hypothetical monopolist of that focal product profitably to implement a non-transitory price rise of say 5-10% above the competitive level.

41. If substitution would be enough to make the price increase unprofitable because of the resulting loss of sales, additional substitutes and areas are included in the relevant market.

42. The market can also be widened on the supply side to include goods and services from which other firms can swiftly switch in response to the price rise thereby constraining the hypothetical monopolist’s price to the competitive level. Having defined the product market, the process can then be repeated to define the geographical market both on the demand side and on the supply side.

²⁵ For example, in *Continental Can Co Inc*, JO [1972] CMLR 199, see paragraph 32.

²⁶ OJ C372, 9/12/1997, page 5, paragraphs 7 and 8.

²⁷ OFT 403 *Market Definition*.

Dominance

43. The legal concept of dominance has been defined by the European Court (in *United Brands*) as the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.

44. Dominance is related to the economic concept of market power, which as stated in the OFT Guideline Assessment of Market Power²⁸, “[...] *can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels*”. The guideline goes on to explain that “[a]n undertaking with market power might also have the ability and incentive to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation.” The guideline also states at paragraph 2.9: “*The OFT considers that an undertaking will not be dominant unless it has substantial market power.*”

45. A number of factors can be taken into account by competition authorities seeking to reach a conclusion on the existence or otherwise of market power. The market shares of an investigated party and of its competitors will usually be an important consideration. In markets where capacity is an important driver of companies' ability to compete, differences in companies' capacities might be more telling than their current sales of shares to customers. Barriers to entry and buyer power are both also potentially key. Barriers faced by would-be entrants or by existing competitors looking to expand might include sunk costs, poor access to key inputs and distribution outlets, economies of scale, network effects and exclusionary behavior by incumbents.

46. While holding a dominant position is not contrary to the Act, it is unlawful to abuse that position. As the European Court has stated, for example in *Michelin v Commission*²⁹, a firm in a dominant position “*has a special responsibility not to allow its conduct to impair undistorted competition on the common market.*” The court further explained: ³⁰ “*the actual scope of the special responsibility imposed on a dominant undertaking must be considered in the light of the specific circumstances of each case which show a weakened competitive situation*”.

47. As noted by Whish³¹:

“It follows that behaviour may be considered not to be abusive when carried out by some dominant firms but to be abusive when carried out by others [...]. The idea that the obligations on dominant firms become more onerous depending on the special circumstances of the case (to

²⁸ OFT Guidelines *Assessment of Market Power* (OFT 415), paragraph 1.4.

²⁹ Case 322/81 [1983] ECR 3461, [1985] 1 CMLR 282, paragraph 57.

³⁰ C-333/94P *Tetra Pak II* [1996] I 5951, paragraph 24; C-395P *CMB* [2000] I 1365, paragraph 114.

³¹ *Competition Law*, 6th edition, pages 184 to 185.

use the language of the ECJ in Tetra Pak), finds expression in decisions and judgments that seem to have turned on the degree of market power that the dominant undertaking enjoys [citing Tetra Pak; CMB; IMS Health [2002] 4 CMLR 111 and Deutsche Post AG [2004] 4 CMLR 598].”

Other cases in this sector

48. In November 2006 ORR published an infringement decision (‘the 2006 decision’) concluding that EWS had infringed the Chapter II prohibition and (the then) Article 82 by engaging in a course of anticompetitive conduct in the market for the haulage of coal by rail in GB.

49. ORR’s 2006 conclusion that the relevant product market was the haulage of coal by rail was the result of a detailed analysis of demand- and supply side substitutability. This analysis covered a wide range of issues relevant to the particular features of the haulage of coal by rail covering both product and geographic dimensions. Two particular key considerations with direct read-across to this investigation are briefly³² summarised below.

Demand side considerations – a ‘rail only’ product market

50. A key issue considered within the 2006 decision was the captivity of haulage customers to rail rather than other modes. ORR’s analysis found that most customers of coal haulage by rail (primarily generators of electricity) tended to enjoy limited, feasible alternatives to rail for the receipt of coal deliveries. Decisive factors included the large volumes involved, the relatively high transport and terminal handling costs of other modes, and the role played by road and planning restrictions.

Supply side considerations – a ‘coal haulage only’ product market

51. In the 2006 decision ORR found that even FOCs who were already hauling other commodities could not easily switch into coal haulage by rail. ORR found that the procurement of coal wagons (most freight wagons are specifically engineered to haul a particular type of cargo and have no other use beyond this) was a key barrier to such substitution. Would-be entrants faced considerable difficulties in adding to their coal wagon capacity, compounded by factors including stranding risk and long lead times. ORR concluded that these barriers were collectively sufficient to prevent even existing FOCs from moving quickly enough and on a sufficient scale, to impose an effective supply side constraint on a hypothetical monopolist supplying coal haulage by rail.

³² The 2006 decision considered a significantly wider range of potential direct and indirect constraints than briefly considered here.

This investigation - ORR's assessment

Background

52. ORR has not carried out a full market definition exercise or dominance assessment during this investigation. In the particular circumstances of this case ORR judged that the financial analysis required to establish whether or not DBS had priced the Contract below cost could be completed with relative expediency. This analysis would potentially, depending on its outcome, preclude the need for ORR to conclude on the relevant market(s) and DBS's position therein.

53. However, ORR's limited analysis, which focused on both the characteristics of the Contract and of the haulage of petroleum products by rail, generally allows some preliminary observations around the possible scope of the relevant product market, and how DBS's position within this market might be assessed. This decision falls well short, however, of reaching a definitive view on either issue.

Demand side considerations

54. The following paragraphs consider the likelihood of the haulage by rail of petroleum products being part of a rail only product market.

General characteristics of rail and other modes of haulage

55. The extent of, and limits to, competition between road and rail haulage are fairly well-known throughout the industry, and have been formalised in, for example, a series of pieces of work³³ that ORR commissioned from the economic consultants NERA in the 1990s. While road and rail freight are sometimes in competition with each other, in other instances they are more accurately viewed as complements rather than substitutes. In brief, given its relatively high fixed costs and relatively low variable (per mile) costs:

- Rail tends to have an advantage over road in situations where the volume of goods lifted is relatively high or where the length of haul is relatively long.
- Road tends to have an advantage over rail in situations where the volume of goods lifted is relatively low or where the length of haul is relatively short.
- The middle ground tends to be more evenly contested between the two modes, although one or other may be favoured by specific circumstances, for example:
 - road has an advantage where rail origin and/or destination depots are unfavourably located (particularly where no direct rail link exists and primarily rail-hauled traffic must therefore be delivered to and/or from rail terminals by road); and

³³ See, for example, *The Potential for Rail Freight*, NERA, 1997.

- rail has an advantage for particular types of traffic, for example security issues make the haulage of nuclear fuel incline towards rail.

56. Coal for electricity generation (where very high volumes of coal are transported over sometimes long distances) is a well-known example of haulage that tends to be captive to rail, as explained in some detail in ORR's 2006 decision. Other types of bulk haulage, including petroleum products, can be similarly difficult for road to compete for over longer distances.

57. Specific to petroleum products, pipelines, where capacity exists, typically have a substantial unit cost advantage over other haulage modes. An additional feature of pipelines as opposed to rail and road is that they provide improved safety for moving combustible liquids.

58. Geographic coverage, however, represents an important limitation to the scope of the competitiveness of pipelines. Although there are currently over 3000 miles of buried oil and gas pipelines in the UK, their coverage is not ubiquitous. Pipelines have very high up-front costs, and obtaining planning permission for new pipelines can be a time-consuming process. Contemporaneous documentation obtained from DBS showed that, as of October 2006, no new major pipelines had been built since 1983 or were planned³⁴.

59. Coastal shipping is somewhat similar to pipeline in that it has relatively low variable (i.e. per tonne delivered) costs and incomplete geographical coverage, being restricted to coastal sites. Rail's position relative to haulage via both pipelines and shipping tends to be that of a complement rather than a substitute. Whilst rail's unit costs are higher it plays a particularly important role where neither pipeline nor coastal shipping are feasible

Evidence from customers

60. ORR sent section 26 notices to all of the FOCs' major customers for the haulage of petroleum products. These notices asked a series of questions around, among other things, the extent to which customers viewed different modes of haulage as substitutes. CP was asked about the haulage covered by the Contract specifically, whilst other oil companies were asked about their wider requirements.

61. The responses that ORR received were generally suggestive of a very low degree of substitutability between rail and other modes amongst the current buyers of rail haulage for petroleum products. Customers considered that alternative modes (road and/or pipeline) represented poor substitutes because of high prices or practical issues such as capacity constraints at customer sites. Examples of this are provided below.

- BP – “[...] it has been BP's strategy to maintain delivery on rail for the duration of the grant. Should BP change its strategy and choose to

³⁴ ORR/10/42/B85 - EWS Industrial market assessment, Oct 2006.

*deliver the volume by any other means than rail, then there would be substantial costs [...]*³⁵.

- Exxon Mobile³⁶ - “[...] it is more economical to move large bulk volumes of bitumen over long distances by rail rather than road”.
- Petrochem Carless³⁷ - “[...] the volumes [of gas condensate] generated are sufficiently large that it would be impractical and uneconomical to move the gas condensate by alternative modes to rail.”
- Total UK (in respect of deliveries to Kingsbury) - “[...] is highly dependent on rail supply of indigenous product from Lindsey oil refinery”³⁸.

62. The only potentially contrary view came from Petrochem Carless with respect to mudoil (see above for its view on gas condensate): *“Historically, it [mud oil] was carried out mostly by rail, but as volumes sold over recent years have reduced, the overall cost difference between the two [road and rail] is minimal. The most economic option depends on the number of rail movements per year ...; with the main factor being the cost of the rail car hire which as a fixed annual cost”*³⁹.

63. CP’s response to the first notice indicated that it did not, at the time of putting out the Contract, consider other modes to be a viable alternative to rail:

“Specifically in regard to the Immingham-Kingsbury flow, there is no pipeline between the two locations and therefore the only cost effective method of transporting in excess of [x] tonnes of petroleum products from the refinery is via its rail load facility. This method of supplying Kingsbury terminal has been the sole mode of transport to this facility since operations first commenced [...] over thirty years ago. There are no reasons to believe the rationale for this supply route will change in the foreseeable future”⁴⁰.

Evidence from DBS

64. ORR’s section 26 notices sent to DBS did not include any questions specifically asking for DBS’s view of the extent of substitutability between rail and other modes, either for the haulage of petroleum products or any other

³⁵ ORR/10/42/E170.3 BP response to section 26 notice dated 20 April 2010.

³⁶ ORR/10/42/D164.5 Exxon Mobile response to section 26 notice dated 20 April 2010.

³⁷ ORR/10/42/E165.5 Petrochem Carless response to section 26 notice dated 20 April 2010.

³⁸ ORR/10/42/E168.4 Total response to section 26 notice dated 20 April 2010.

³⁹ ORR/10/42/E165.6 Petrochem Carless response to section 26 notice dated 20 April 2010.

⁴⁰ ORR/10/42/F181 ConocoPhillips response to section 26 notice dated 9 February 2010.

commodity. The issue was, however, addressed to some extent within some of the documents obtained by ORR during its site visit. Key extracts from relevant documents include the following:

- EWS Industrial Market Assessment dated 17 October 2006⁴¹ – “*In this stable and mature market, the modal transport preferences are now well-established and are unlikely to alter [...] Each mode fully exploits its infrastructure opportunities with little scope for arbitrage between differing transport modes based on relative price differences*”.
- Major Account Plan: ConocoPhillips Limited, November 2009⁴² - “*Rail’s vulnerability to road is low; high volumes & long lengths of haul*”

65. Specific and, in ORR’s view, telling evidence of the extent of substitutability between rail and road haulage for the Contract is provided by the documentation prepared by DBS to support its bid for the Contract. This document⁴³ included a fairly detailed attempt to estimate the costs, and thereby predict the possible bid levels, of the chief rivals that it anticipated bidding against. DBS’s analysis only covered other rail hauliers and did not explicitly model possible competition from other modes.

66. The following contemporaneous documents made references to the “*market*” that DBS staff considered the Contract to fall within.

- An internal email dated 29 October 2009 which is suggestive of an internal view of a market for the haulage of petroleum products by rail (in GB)⁴⁴:

“News of this win was closely followed by confirmation from TOTAL UK that Industrial had secured all of its business for the next five years [...] this now means that DB Schenker has 100% market share.”⁴⁵.
- An internal document, titled *EWS Industrial Market Assessment*, 17 October 2006, which is suggestive of an internal view of a market for the haulage of all petroleum products over all modes:

“Overall EWS’ market share is 8% of the 75.9mt of petroleum products moved [...] but 85% of the 7.1mt rail market.”⁴⁶.

⁴¹ ORR/10/42/B85.3 - *EWS Industrial market assessment*, Oct 2006.

⁴² ORR/10/42/B110.4 – DBS email from Roger Neary to Neil McDonald, et al, attaching document: *MAJOR ACCOUNT PLAN: ConocoPhillips Limited*.

⁴³ ORR/10/42/A11 – *ConocoPhillips Kingsbury tender*.

⁴⁴ ORR/10/42/B110 – Email from Paul Clews to Roger Neary about success with the ConocoPhillips contract.

⁴⁵ The reference to a 100% share makes it clear that DBS is here referring to a rail-only market, with 100% being only an approximation given that GBRf hauls a relatively small volume of mudoil and gas condensate on behalf of Petrochem Carless.

⁴⁶ Ibid footnote 44.

67. On balance ORR considers that none of these sources is reflective of DBS's view of the relevant market in a formal economic sense. Rather, stronger indications of DBS's view on the substantive extent of competition between rail and other modes are provided by the sources summarised at paragraphs 64 to 65.

Summary

68. The views of customers and DBS's contemporaneous documentation all suggest that a high proportion of the haulage of petroleum products that is currently carried by rail is captive to this mode and, as such, falls within a rail-only product market.

Supply side considerations

69. The following paragraphs consider the likelihood of the haulage by rail of petroleum products being part of a commodity specific (i.e. petroleum products only) or wider product market.

70. ORR concluded in the 2006 case that the relevant market was a coal-only as well as a rail-only market, i.e. that it was the haulage of coal by rail. This was because of the barriers to supply side substitution summarised briefly in paragraph 51 above.

71. Such barriers appear to be less prevalent in the haulage of petroleum products by rail. Significantly, the tendency for petroleum wagons to be owned or leased by customers rather than hauliers, should mean that hauliers active in other type of rail haulage (such as aggregates or intermodal) should, provided that they have sufficient locomotive capacity, be able to switch relatively quickly and easily into hauling petroleum products. This means that the exact boundaries of the relevant market in this case are not clear. It seems fairly likely that it is broader than the haulage of petroleum products only by rail.

72. A complete assessment of this issue, and indeed of the boundaries of the relevant geographic market, would be a time- and resource-consuming exercise. In the absence of the findings of such an exercise ORR has made no more than a few preliminary observations about any possible dominant position in one or more markets that might be enjoyed by DBS (or indeed any of its rivals).

Dominance

73. DBS's share of a possible market for the haulage of petroleum products by rail, as implied in the contemporaneous DBS quote reproduced at the first bullet of paragraph 66 above, would currently be close to 100%. However, such a market share might not in itself be conclusive as to market power. Significantly, two other FOCs in addition to DBS were able to put together a credible bid for the Contract given that ownership of specialist wagons was not a pre-requisite for bidders. In such circumstances DBS's high share of a possible market for the haulage of petroleum products by rail might not necessarily be evidence of significant market power on DBS's part.

74. As noted under the heading 'The main parties' DBS's share of *all* rail haulage, as opposed to the haulage by rail of petroleum products only, was

53% in 2008/2009. DBS may retain some incumbency advantages over other hauliers, as described in the 2006 decision, given factors such as its ownership of strategic sites and the size of its rolling stock fleet.

75. CP's response to ORR's section 26 notice was suggestive of some concerns it held at the possible strength of DBS's position vis-à-vis its customers following its win of the Contract. In assessing the merits of awarding the Contract to DBS as opposed to another FOC it listed, as a potential disadvantage, "*No competition after contract ends*"⁴⁷. ORR subsequently asked CP for its further views on this. CP explained that this comment had been one consideration within a high level discussion of possible medium to long term scenarios rather than being the result of a detailed analysis. CP told ORR that its decision to accept DBS's bid was based on a balanced consideration of cost effectiveness and sustainability.

76. In summary, the evidence gathered by ORR, whilst suggestive of a rail-only product market, is insufficient to conclude on either the precise boundaries of the relevant market or on DBS's position therein. DBS has a relatively high share of haulage by rail generally but a robust dominance assessment would require a full market definition exercise, and a full assessment of the extent of competition from both established players and potential entrants. ORR did not carry out either exercise during this investigation.

Assessment of conduct

Applicable legal principles

The relevant test for abusive conduct

77. According to the case law of the European Court, an 'abuse' is an objective concept referring to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is already weakened and which, through recourse to methods different from those governing normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition⁴⁸.

78. A dominant undertaking has a special responsibility, irrespective of the causes of that position, not to allow its conduct to impair genuine undistorted competition on the common market⁴⁹. This notwithstanding, the fact that an

⁴⁷ ORR/10/42/F181.243 – CP response to the section 26 notice of 9 February 2010.

⁴⁸ See, for example, Case 85/76 *Hoffmann-La Roche v Commission* [1979] ECR 461 ('HLR'), paragraph 91; Case 322/81 *Michelin v Commission* [1983] ECR 3461 ('Michelin I'), paragraph 70; Case C-62/86 *AKZO v Commission* [1991] ECR I-3359, paragraph 69; and Case T-228/97 *Irish Sugar v Commission* [1999] ECR II-2969, paragraph 111.

⁴⁹ Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 57, and Case T-228/97 *Irish Sugar v Commission* [1999] ECR II-2969, paragraph 112.

undertaking is in a dominant position cannot deprive it of its entitlement to protect its own commercial interests when it is attacked. Such an undertaking must be allowed the right to take such reasonable steps as it deems appropriate to protect those interests, although conduct cannot be allowed where its purpose is to strengthen that dominant position and thereby abuse it⁵⁰.

79. In *Claymore*⁵¹ the Competition Appeal Tribunal ('the Tribunal') stated that the relevant considerations for the application of the Chapter II prohibition include, amongst other matters:

- whether the actions of the dominant firm go beyond what may be considered 'normal' competition in a market where competition is already weak as a result of the presence of the dominant firm⁵²;
- whether the firm's conduct was reasonable and proportionate;
- whether the conduct was intended or likely to affect the structure of the market, by preserving or strengthening its dominant position.

80. In *AKZO*, the European Court established that pricing below cost by a firm that holds a dominant position within one or more economic markets can represent an abuse of a dominant position:

- pricing below average variable costs (AVC)⁵³ will often be presumed to be anticompetitive; and
- prices that are above AVC but below average total cost (ATC) may be abusive where such pricing is part of a plan to eliminate a competitor.

"70. It follows that Article [82] prohibits a dominant undertaking from eliminating a competitor and thereby strengthening its position by using methods other than those which come within the scope of competition on the basis of quality. From that point of view, however, not all competition by means of price can be regarded as legitimate.

71. Prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss, namely the total amount of the fixed costs

⁵⁰ Case 27/76 *United Brands v Commission* [1978] ECR 207, paragraph 189.

⁵¹ Case 1008/2/1/02 *Claymore Dairies Limited and Arla Foods UK PLC v Office of Fair Trading* [2005] CAT 30, §188.

⁵² See also the Opinion of AG Kokott of 23 February 2006 in Case C-95/04P *BA v Commission* ('the BA Opinion'), at paragraph 26.

⁵³ Average variable costs are calculated by dividing a firm's total variable costs by output.

(that is to say, those which remain constant regardless of the quantities produced) and, at least, part of the variable costs relating to the unit produced.

72. Moreover, prices below average total costs, that is to say, fixed costs plus variable costs, but above average variable costs, must be regarded as abusive if they are determined as part of a plan for eliminating a competitor. Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them.”

81. This approach to pricing below cost has been supported by the European Court in *Tetra Pak*⁵⁴ and by the Tribunal in *Aberdeen Journals*⁵⁵. In particular, the Tribunal affirmed that pricing below ATC but above AVC “is likely to be abusive when undertaken in anticipation of competitive entry or in order to undercut a new entrant.”

82. More recently, the European Commission has outlined its preferred approach to the analysis of costs in predation cases in its Guidance on enforcing Article 102⁵⁶. The Guidance builds on the principles established in *AKZO* and *TetraPak* and highlights the reliance the Commission intends to place on Average Avoidable Costs and Long Run Average Incremental Costs⁵⁷ in approaching the analysis of costs. It explains this approach as follows:

“25. Where available, the Commission will use information on the costs of the dominant undertaking itself. If reliable information on those costs is not available, the Commission may decide to use the cost data of competitors or other comparable reliable data.

⁵⁴ *Tetra Pak II* - OJ [1992] L72/1, [1992] 4 CMLR 551.

⁵⁵ *Aberdeen Journals Limited v Office of Fair Trading*, [2003] CAT11.

⁵⁶ Communication from the Commission — ‘Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings’ (Text with EEA relevance) Official Journal C 045, 24/02/2009 P. 0007 – 0020.

⁵⁷ Average avoidable cost is the average of the costs that could have been avoided if the company had not produced a discrete amount of (extra) output, in this case the amount allegedly the subject of abusive conduct. Long-run average incremental cost is the average of all the (variable and fixed) costs that a company incurs to produce a particular product. LRAIC and average total cost (ATC) are good proxies for each other, and are the same in the case of single product undertakings. If multi-product undertakings have economies of scope, LRAIC would be below ATC for each individual product, as true common costs are not taken into account in LRAIC. In the case of multiple products, any costs that could have been avoided by not producing a particular product or range are not considered to be common costs. In situations where common costs are significant, they may have to be taken into account when assessing the ability to foreclose equally efficient competitors.

26. The cost benchmarks that the Commission is likely to use are average avoidable cost (AAC) and long-run average incremental cost (LRAIC). Failure to cover AAC indicates that the dominant undertaking is sacrificing profits in the short term and that an equally efficient competitor cannot serve the targeted customers without incurring a loss. LRAIC is usually above AAC because, in contrast to AAC (which only includes fixed costs if incurred during the period under examination), LRAIC includes product specific fixed costs made before the period in which allegedly abusive conduct took place. Failure to cover LRAIC indicates that the dominant undertaking is not recovering all the (attributable) fixed costs of producing the good or service in question and that an equally efficient competitor could be foreclosed from the market.”

83. The OFT opted to utilise this approach in its analysis of allegedly predatory prices offered by Cardiff Bus⁵⁸.

“In the medium term, pricing below AAC is not in the economic interest of an undertaking, since by not providing the relevant output it would save more in costs than it would forego in revenue. In addition, the longer a dominant undertaking prices below AAC, the more likely it is that an equally efficient competitor would be forced to exit the market. This follows the same logic as the AKZO test as it has been applied in recent cases.

The OFT therefore concludes that AAC is the most appropriate measure in this case, as it is the logical extension of the AKZO test, and it is relevant to a consideration of whether Cardiff Bus' conduct resulted in a loss. It also identifies the extent to which an equally efficient competitor would be able to operate profitably.”

84. The case law and guidance all reflect a key underlying principle that in choosing a method of calculation as to the rate of recovery of costs, competition authorities are generally undertaking a complex economic assessment. Legal review of a competition authority's decision on this aspect of assessing abuse should be confined to reviewing whether the relevant rules on procedure have been observed, whether full reasons have been given, whether the facts have been accurately stated and whether there has been any manifest error of appraisal or a misuse of powers⁵⁹. There is, therefore, a degree of discretion for competition authorities in identifying the most appropriate approach to analysing costs in any given case.

85. ORR has taken the view that the most appropriate approach to assessing costs in this case is, in common with OFT's approach in Cardiff Bus, to focus on DBS's average avoidable costs. This approach represents a logical extension of the AKZO case where 'fixed' costs are incurred as a direct

⁵⁸ Decision of the Office of Fair Trading, No. CA98/01/2008, *Abuse of a dominant position by Cardiff Bus*, 18 November 2008, (Case CE/5281/04).

⁵⁹ See in particular, Case T 340/03 *France Telecom v Commission* [2007] ECR II 107, Para 129.

result of a particular investment decision that is relevant to an investigation. Further details of ORR's approach and its reasons for selecting it are set out in the description of ORR's financial analysis below.

Application of Article 102

86. Article 3 of Council Regulation 1/2003 requires of NCAs that where they apply national competition law to any abuse prohibited by Article 102 of the Treaty, they also have to apply Article 102.

87. An assessment of whether Article 102 applies to conduct requires a finding as to whether the conduct in question may affect trade between member states. In the context of this non-infringement decision, it has not been necessary to conduct a detailed market analysis and the reasoning for that is set out above under the heading *Market definition and assessment of dominance*. This also means that ORR has not conducted the degree of market analysis that would be necessary to reach a conclusion on whether the conduct at issue could have an effect on trade between member states. This has not proved to be necessary as the absence of evidence of an abuse means that ORR has concluded that it cannot make a finding of abuse under either Chapter II or Article 102 of the Treaty.

Burden and standard of proof

88. The burden of proving that conduct amounts to an abuse of a dominant position falls on the authority alleging the infringement⁶⁰. It is therefore for ORR to establish that DBS has acted in such a way as to breach section 18 of the Act or Article 102 of the Treaty.

89. The relevant standard of proof is the civil standard: that is, ORR must be satisfied that, on the balance of probabilities, the Act has been infringed. Further, in applying that civil standard, the more serious the allegation, the more cogent the evidence must be before it can safely be concluded that an allegation is established on the balance of probability. In *Napp*⁶¹, the CAT indicated that cases under the Act involving penalties are serious matters and strong and convincing evidence will be required before infringements of the Chapter I and Chapter II prohibitions can be found to be proved. The test is expressed as follows:

“It is for the Director to satisfy us in each case, on the basis of strong and compelling evidence, taking into account the seriousness of what is alleged, that the infringement is duly proved, the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be.”

90. This case involves an allegation of abuse of dominance in the form of charging for services below the cost of supply. A finding of infringement would normally involve both the imposition of a fine and also potentially directions to remedy the infringing refusal (in effect, a mandatory injunction). Infringements of the Act are serious matters as are the consequences that flow from such

⁶⁰ Council Regulation 1/2003/E, Article 2.

⁶¹ *Napp v Director General of Fair Trading* [2002] CAT 1, Paragraphs 108-9.

infringements, and the relevant standard of proof to be applied in this case will therefore require stronger evidence than less serious matters, as indicated in *Napp*.

91. Accordingly, ORR's concern in carrying out its investigation has been to establish whether there is strong and compelling evidence that all elements of the relevant legal test for an abuse of dominance have been met. The conclusions are set out below.

This case

Rationale for DBS's conduct

92. The rationale behind DBS's pricing of the Contract plays an important part in ORR's analysis, given the relevance of intent in the AKZO test.

93. A statement of DBS's strategy in pricing the Contract was provided in internal documents created by DBS in preparation for its bid for the Contract (see paragraph 105):

“DB Schenker's strategy is to win this business – additional revenue generation [...]

Jarvis Fastline & DRS are understood to be bidders and their pricing strategy will undoubtedly be very sharp – both will be keen to enter this 'blue chip' market sector.”

94. This statement appears to suggest that DBS's primary concern in pricing the Contract was to earn as much revenue, and hence profit, from it as possible. Such a motive would fall well within any rational interpretation of normal competition on the merits⁶².

95. ORR's scrutiny of the contemporaneous documents provided to it by DBS did not uncover any material that could amount to strong and compelling evidence that DBS's conduct in relation to its bid for the Contract was informed by an intent to exclude one or more of its rivals from the market⁶³. Nor was there anything in the surrounding circumstances which would lead to a reasonable conclusion that the pricing of the Contract must have been informed, at least in part, by an intention to eliminate competition⁶⁴.

96. In summary the contemporaneous evidence around DBS's pricing of the Contract (and of its pricing strategies generally) is not suggestive of any plan to eliminate a competitor. The key question for ORR therefore, returning

⁶² See paragraph 77 onwards above.

⁶³ In cases such as *AKZO* [Case C-62/86 *AKZO v Commission* [1991] ECR I-3359] and *Compagnie Maritime Belge v Commission* [Cases C-395/96 P etc [2000] ECR I-1365], the finding of predation was based on the existence of contemporaneous evidence that laid bare the intent of the dominant company to exclude its rivals by way of its pricing behaviour. In the case of *AKZO* this included direct threats.

⁶⁴ In *Aberdeen Journals*, the CAT highlighted that circumstantial evidence could potentially be relevant to the assessment of intent. A sustained period of pricing below ATC or selective price cutting could support an inference of intent to eliminate competition.

to the *AKZO* test⁶⁵, was to establish with a reasonable degree of certainty the relationship between the price offered by DBS to CP to secure the Contract and DBS's costs of fulfilling that contract. On this basis ORR carried out an analysis of DBS's revenues and costs with respect to the Contract with a view to assessing whether or not DBS's pricing of the Contract fell below average variable cost (AAC).

Financial analysis - outline

97. This section describes key high-level aspects of ORR's approach to calculating revenues and costs in this investigation.

Relevant cost benchmark:

98. ORR has based its analysis on an average avoidable cost (AAC) standard. The merits of this approach have been set out by the OFT in its decision in *Cardiff Bus*⁶⁶.

99. This approach had implications for ORR's approach with respect to two cost categories. Firstly, ORR considered whether the dedication of locomotive capacity to the Contract led to any costs that could otherwise have been avoided by DBS. Secondly, ORR's estimates included the cost of a small specific investment made by DBS in order to service the Contract, namely a van that it bought and which was used by train drivers to travel between Immingham and Kingsbury. DBS's contemporaneous calculations assumed that the purchase cost of this asset was written off during the life of the Contract. Both of these types of cost are relevant to a full assessment of the profitability of the Contract.

Level of output

100. ORR assessed the profitability of the Contract on a standalone basis. Doing so addressed the key question for this investigation of whether DBS's pricing of the Contract could have been profitably matched by an equally efficient competitor.

101. This approach is consistent with the approach taken by ORR to assessing the profitability of individual flows in the 2006 case, the way in which DBS's contemporaneous documentation appeared to view the profitability of the Contract, and the approach taken in *Aberdeen Journals*⁶⁷. In *Aberdeen Journals*, predation occurred as a result of the incumbent reducing its advertising prices and altering the format of one of three publications in response to a competitor's entry into the market. The CAT upheld the application by the OFT of the cost test to the Herald & Post only, which was the specific 'product' that represented the tactical response by Aberdeen Journals to competition.

⁶⁵ Case C-62/86 *AKZO v Commission* [1991] ECR I-3359.

⁶⁶ See paragraph 83 above.

⁶⁷ *Ibid* footnote 55.

The time period over which revenues and costs are measured

102. This can be a key issue in assessing the profitability of a particular good or service. Longer time horizons tend to mean that more costs become avoidable, as commitments expire and/or alternative uses of the existing resources become available.

103. ORR's analysis used a comparison between a single year's costs and revenues, specifically those of the first of the three years of the contract, i.e. the twelve months from 1 November 2009, sometimes referred to as 'year one' in the remainder of this decision. This approach is consistent with the way in which both DBS's contemporaneous calculations and FHH's first response (see below) viewed the profitability of the Contract.

104. ORR considers that a focus on a single year's worth of profitability data would not omit any important insights regarding the profitability of the Contract. None of the information reviewed by ORR suggested that any of the costs incurred by DBS as a result of winning the Contract are unavoidable within a one-year timeframe but avoidable within the remainder of the term of the Contract. Nor are there any reasons why year one profitability would be unrepresentative of the entirety of the Contract, given that the Contract price is indexed for inflation and that the cost of serving the Contract should be fairly predictable over the remainder of its life. A key exception to this latter point is the cost of fuel, but, as explained below, the terms of the Contract are such that the risk of any fluctuations in fuel prices are borne by the customer rather than DBS.

DBS's contemporaneous calculations

105. The starting point for ORR's financial analysis was DBS's own contemporaneous view, at the time of bidding in mid 2009, of the year one profitability of the Contract if DBS's bid were to be successful. Evidence of this view was obtained by ORR during its site visit, via a particular key document⁶⁸ titled *ConocoPhillips Tender*. In its response to the first notice, DBS explained that the document, "[...] was prepared for discussion with the DB Schenker project team for the Conoco tender. Its purpose was to help the project team to decide the price of DB Schenker's bid for the Conoco contract."

106. Supported by a series of spreadsheet models⁶⁹, this document set out an estimate of the year one profitability of the Contract, derived, in simplified terms, as follows.

- DBS used a forecast of the number of tonnes that it would haul under the Contract, together with assumptions on key variables such as railcar payload⁷⁰ and the number of wagons in each of its trains to estimate how many trains would be hauled in one year of the Contract.

⁶⁸ Ibid footnote 43.

⁶⁹ ORR/10/42/A33 COP WOSL cost model.xls.

⁷⁰ The capacity of each railcar measured in tonnes.

- Based on the above and a series of unit cost assumptions, DBS estimated the costs that it would incur hauling the Contract in aggregate and per-tonne terms.
- Given these cost estimates, DBS estimated the profits that it would earn under a range of different contract prices. DBS's calculations also included a scenario analysis. Notably DBS calculated the impact of different train lengths on forecast profits.

107. DBS's analysis showed that, under a central set of assumptions, its pricing of the Contract would be profitable provided that its pricing was not lower than £[X] per tonne⁷¹. DBS also calculated a "fully costed" cost estimate, which included a predetermined contribution to overheads, of £[X]. In other words, based on DBS's own internal assumptions, the Contract price of £[X] at which DBS won the Contract was profitable.

108. DBS's contemporaneous view of the profitability of the Contract formed the starting point for ORR's own analysis. ORR was mindful in this regard of the Tribunal's reasoning in *Claymore*. Notably, at paragraph 211 the Tribunal stated that a reasonably detailed understanding of the nature of the business is generally necessary when determining how particular costs should be allocated, and that how an undertaking itself treats costs internally will normally be an invaluable source of information.

109. It would not, however, have been appropriate for ORR to accept DBS's contemporaneous view that its pricing of the Contract would be profitable without subjecting this view to scrutiny. In particular, it would clearly be wrong for a competition authority to unquestioningly accept contemporaneous calculations as providing evidence that pricing was lawful if such estimates were partly a result of readily discernible inaccuracies or omissions. ORR therefore carried out its own analysis as set out below.

ORR's approach

110. ORR's financial analysis started with a review of the reasonableness of the assumptions contained within DBS's contemporaneous calculations. This review was primarily based on:

- ORR's knowledge of freight costs, supported by its own internal rail freight cost models⁷²;

⁷¹ This is the price at which the contract would break even based on what DBS termed the "direct costs" of the Contract, including an allocation of locomotive costs but not including a contribution to overheads. A lower estimate, calculated on a "marginal cost" basis, was also calculated by DBS, but ORR was subsequently advised by DBS that these figures did not form a key part of its decision making in bidding for the Contract.

⁷² As part of a wider review of access policy ORR undertook a study aimed at quantifying the freight value of time. Working with FOCs, the DfT, and Network Rail ORR developed a freight operating cost model for key freight markets, Details of this modelling exercise can be found at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.9833>.

- cost estimates provided to ORR by FHH in response to the first FHH notice ('FHH's first response'); and
- further clarifications and cost information provided by DBS in responses to the first, second, and third notices. In its response to the first notice DBS provided revisions to some of the parameters within its contemporaneous calculations. DBS argued that its revisions improved the accuracy of its estimates.

111. Following this review, ORR carried out further analysis in order to arrive at a central 'ORR estimate' of the cost of operating the Contract. This estimate was arrived at based on an updated version⁷³ of the spreadsheet model that underpinned DBS's contemporaneous calculations. ORR's aim was to arrive at an accurate central view of the profitability of the Contract. ORR intended this view to represent a reasonable expectation for DBS to hold about its own future costs at the time DBS was putting its bid together, given the information that was available to it at that time.

112. In some instances ORR faced potentially contradictory or ambiguous information and/or uncertainty over how to estimate particular costs. In such cases ORR's analysis deliberately erred on the side of, other things being equal, higher cost estimates. ORR adopted this approach given that both DBS's contemporaneous calculations and early iterations of ORR's own analysis suggested that DBS's pricing of the contract was profitable. This approach meant that ORR subjected DBS's contemporaneous calculations to a particularly rigorous level of scrutiny. As will be seen in the remainder of this decision, even using this approach, ORR's financial analysis found that the Contract had been priced profitably.

113. ORR's analysis measured one year's worth of income and costs relevant to the Contract, on a pre-tax basis, adjusted, as described below, to include the opportunity costs incurred by DBS by foregoing site access revenues.

ORR's financial analysis

114. The paragraphs below describe key details of the calculations carried out by ORR in its financial analysis. The description is not exhaustive but includes all of the non-trivial respects in which ORR departed from DBS's contemporaneous approach.

Underlying volume assumptions

Introduction

115. DBS's contemporaneous calculations, in common with most freight cost models, took a series of general volume assumptions as their starting point. As described at paragraph 106 above, starting with a forecast of the total tonnage that would be hauled under the Contract, DBS forecast how

⁷³ ORR/10/42/19.

many trains would be hauled per year with reference to the two key variables, of:

- the number of wagons per train; and
- railcar payloads.

116. A central assumption was that each of its trains would consist of a single locomotive hauling a total of 30 wagons. This assumption was important because, other things being equal, longer trains consisting of more wagons mean that a given tonnage of freight can be hauled using fewer trains, reducing costs in several categories.

117. DBS assumed that each of its wagons would carry a payload of 74 tonnes.

Evaluation of DBS contemporaneous view and ORR's estimate

118. Information and documents provided by DBS in its responses to ORR's section 26 notices, together with some of the sensitivity analysis within its contemporaneous calculations, suggested that it might be possible, at some point in the Contract, for DBS to reduce its costs by beginning to operate longer (36 wagon) trains. In a press release dated 24 November 2009 DBS announced that it had successfully completed a trial hauling 36 wagon trains between Immingham and Kingsbury⁷⁴.

119. ORR's final calculations, given ORR's approach of erring on the side of high cost estimates in instances of uncertainty, did not take the possibility of 36 wagon trains being hauled by DBS into account. The evidence available to ORR suggested that, whilst regularly hauling 36 wagon trains might be a possibility, it remains no more than this at present. The capacity of the three sidings at the Kingsbury storage facility is limited, such that investment in the terminal would be required in order to enable 36 wagon trains to be unloaded in a timely fashion.

120. The minutes of Network Rail's Route Investment Review Group for the "London North Eastern" and "Midland & Continental" areas, dated 3 March 2010, refer to the possibility of 36 wagon trains as follows:

"[...] Post meeting note: the one-off trial from Lindsey to Kingsbury was a qualified success, it is unlikely, due to the investment required to modify the terminal for longer trains that trains of this length will become the norm. As a proof of concept the exercise was useful, although in the short to medium term any increase in volumes conveyed to Kingsbury will probably arise through the operation of additional services at the current length [...]"⁷⁵

⁷⁴

http://www.rail.dbschenker.co.uk/cmsnews/news_article.asp?guid=%7BE99B32E0-7F50-437B-BBD9-AEAD56D80CE0%7D.

⁷⁵ ORR/10/42/E172a/ Email from Freighliner to ORR, attaching a note of Network Rail's Route Investment Review Group for the "London North Eastern" and "Midland & Continental" areas, dated 3 March 2010.

121. ORR's analysis final analysis assumed an average train length of 30 wagons.

122. ORR based its estimates on DBS's contemporaneous assumed payload of 74.0 tonnes per wagon. DBS's response to the first notice included, assuming on actual loaded data for a week in February 2010, a revised payload estimate of [X] tonnes per wagon. This higher payload, if maintained throughout a full year, would enable a given total volume of freight to be hauled using fewer trains. Given, however, the small sample size used in DBS's revised estimate and the seeming discrepancy between it and both DBS's own contemporaneous calculations and FHH's first response⁷⁶, ORR has, given its approach of erring on the side of high cost estimates, adopted DBS's contemporaneous assumed payload assumption in its final estimates.

123. In common with both DBS's contemporaneous estimates and FHH's first response ORR's analysis assumes an annual tonnage of [X].

Locomotives – capital costs

Introduction

124. A significant amount of locomotive capacity is needed to serve the Contract. Class 66 rolling stock represents by some distance the most common type of active freight locomotive within GB and is used by DBS to service the Contract, as it would have been by any other successful bidder.

125. The Class 66 locomotive fleets operated by GB FOCs are generally operated via long-term leases with specialist rolling stock leasing companies, such as Angel Trains.

126. DBS told ORR that it, "[...] does not operate a policy of dedicating locomotives to specific pieces of business, as it is more cost-effective to share locomotive resources among its customers"⁷⁷. Rather, DBS allocates locomotive capacity to individual contracts from a centralised pool using a series of weekly plans.

DBS's contemporaneous view

127. In DBS's contemporaneous calculations⁷⁸ the costs associated with its fleet of locomotives were classified as follows:

- "Leasing" costs, which were comprised of both depreciation charges incurred on owned locomotives and lease payments made to rolling stock leasing companies; and
- "Non leasing" costs, primarily made up of maintenance costs.

⁷⁶ The wagon payload in this response was very close to the one within DBS's contemporaneous calculations.

⁷⁷ ORR/10/42/D125.12 - DBS's response to the section 26 notice of 02 February 2010.

⁷⁸ A different approach was adopted in the "marginal cost" calculations referred to in paragraph 130 but as explained below these calculations did not form a key part of DBS's thinking.

128. DBS allocated a share of all its capital and noncapital locomotive costs to the Contract by ⁷⁹:

- adding together all of its locomotive costs for the year 2008, aggregated across all of its locomotives of all classes;
- dividing the figure obtained in the previous step by its total number of utilised locomotive hours for 2008 to give a locomotive cost per (utilised) locomotive hour; and
- multiplying this hourly cost by the number of diagrammed⁸⁰ locomotive hours that would be used per year in serving the Contract, to give a total allocation of locomotive costs to the Contract.

129. Based on this method DBS's year one allocation of locomotive capital costs was £[×]⁸¹. This corresponds to £[×] per tonne, assuming [×] tonnes are moved.

130. DBS's contemporaneous calculations did not fully distinguish between fixed and variable or avoidable costs. Whilst the documents that ORR was provided with during its site visit did include more than one set of cost estimates, including some calculated on what DBS termed a "marginal cost" basis, DBS's response to the first notice⁸² stated that these figures were, "[...] employed by DB Schenker only as a means of identifying a reference absolute base cost [...]", and that, "[its estimate of the marginal cost of allocating locomotive capacity to the Contract] [...] is not used in DB Schenker's pricing models to calculate the appropriate locomotive costs and is therefore irrelevant in this case."

131. ORR's evaluation of DBS's contemporaneous calculations therefore focused on what DBS termed⁸³ its "DBS Cost Model" set of figures. These, unless adjusted (see below for a description of ORR's adjustments), correspond more closely to an estimate of ATC rather than the AAC standard preferred by ORR for this investigation.

Evaluation of DBS contemporaneous view and ORR's estimate

132. Locomotive capital costs do not, with respect to the Contract, represent an avoidable cost to DBS. Other than a likely additional requirement for maintenance expenditure (see below) the dedication of locomotive capacity to

⁷⁹ ORR/10/42/D125.12 - DBS's response to the section 26 notice of 02 February 2010.

⁸⁰ A driver's 'diagram' is a work schedule detailing all the driver's required duties throughout the period of their shift of duty.

⁸¹ ORR's decision makes a distinction between 'capital' and 'noncapital' locomotive costs. The 'leasing' cost category within DBS's contemporaneous calculations was a slight misnomer due to it including depreciation on owned assets.

⁸² ORR/10/42/D125.9 - DBS's response to the section 26 notice of 02 February 2010.

⁸³ ORR/10/42/A11.

the Contract did not lead to any additional expenditures or opportunity costs being incurred by DBS.

133. DBS, at the time of bidding for the Contract and to date, had significant locomotive capacity available. This situation has arisen as a result of a very significant drop in DBS's freight volumes caused by the recession of 2008-2009 and the loss of traffic to competitors. The total number of tonne km hauled by rail in GB fell by 4% between 2006/07 and 2008/09 but for DBS specifically the fall over this period was 23%.

134. All of the class 66 locomotive fleet used by DBS to haul the Contract (in common with a significant majority of its haulage business) is operated on long-term lease with the leasing company Angel Trains. The terms of this lease agreement are such that⁸⁴, in broad terms, DBS is committed to leasing the fleet from Angel Trains for [X] from the date of delivery of the fleet⁸⁵ and has very limited scope to initiate an early termination of the lease.

135. The addition of the Contract to DBS's portfolio of existing contracts had a very modest impact on DBS's overall level of locomotive utilisation. At the time of bidding DBS had, in total, a little over 200 serviceable class 66 and class 60 locomotives in GB. Collectively these generate over [X] locomotive hours per year. The Contract generated an additional [X] locomotive hours p.a., an increase of less than [X]%⁸⁶.

136. ORR's view, based on its knowledge of the industry and of current market conditions, is that it is extremely unlikely that DBS will add to its existing locomotive capacity during the duration of the Contract, with the fact that it has won the Contract not being a material consideration.

137. DBS's response to the third notice⁸⁷ stated that:

"[...] DB Schenker's locomotive capacity at the time of the Contract bid was such that, at no point during the contract term [...] was there an anticipated need to buy or lease additional locomotives [...] That remains the position".

138. All of the above means that DBS's successful bid for the Contract did not, other than a need for additional maintenance expenditure (see below), lead to any additional locomotive-specific expenditures or opportunity costs being incurred by DBS. Its ability to bid for other work was not affected by the

⁸⁴ The lease gives DBS very limited scope for early termination in the absence of a locomotive being lost/stolen/destroyed. There is an obsolescence termination clause but it would be necessary to establish that all the locomotives had become economically obsolete to a material extent or regulation had made them materially economic. In these circumstances, a termination can be initiated by DBS subject to specified payment arrangements.

⁸⁵ The first locomotives to be delivered under this agreement arrived at Immingham in 1988, meaning that they will still be with DBS until after the end of the Contract in late 2012.

⁸⁶ ORR/10/42/E174.2 – DBS' response to the section 26 notice of 29 April 2010.

⁸⁷ ORR/10/42/E174.2 – DBS' response to the section 26 notice of 29 April 2010.

fact that it won the Contract. As such the appropriate estimate of avoidable cost in this category is zero.

Locomotives – noncapital costs

Introduction

139. As noted at paragraph 124, a material quantity of locomotive capacity is needed to serve the Contract. The noncapital costs of these locomotives represent an avoidable cost of the Contract. Whilst some maintenance costs may be incurred routinely as a result of periodic maintenance regimes, the key driver of such expenditure is the need to keep assets in a fit state for usage. Such expenditures need not be incurred to a comparable extent for locomotives that will not be in active use.

DBS's contemporaneous view

140. In DBS's contemporaneous calculations all locomotive costs (capital and noncapital) for the Contract were estimated using the method described in the previous subsection of this decision.

141. Using this method DBS allocated £[<] of noncapital locomotive costs to the Contract. Such costs were termed "*non-leasing costs*", being comprised of a combination of maintenance, "*production support*", and a mark up.

Evaluation of DBS contemporaneous view and ORR's estimate

142. As a first step in evaluating DBS's contemporaneous calculations, ORR compared them with the figures within FHH's first response. In this cost category, DBS's contemporaneous estimates were [<]% lower than the comparable figures provided in FHH's first response (under the heading of "*maintenance*"). FHH's estimates were calculated by applying a single annual maintenance cost per locomotive of £[<] p.a. to an assumed [<] fully dedicated locomotives. DBS's contemporaneous estimates were also considerably lower than the equivalent figures within ORR's bulk cost model (assuming two fully dedicated locomotives).

143. These discrepancies could be a result of one or both of substantive differences in working practices or underlying cost structures and differences in methods of estimation. Further, DBS's contemporaneous estimates were arrived at by applying an hourly rate calculated by dividing DBS's aggregate (over all classes of stock) locomotive costs by its aggregate locomotive hours, whereas FHH's figures were based on class 66 locomotives only. DBS's approach could lead to estimates that are not representative of the locomotives actually used to serve the Contract, if costs or utilisation differ materially across different locomotive classes.

144. ORR has based its estimates of this component of the cost of the Contract on the figures within FHH's first response, i.e. a total year one cost estimate of £[<].

145. Whilst this approach, in the absence of a detailed analysis of the reasons for differences between DBS's contemporaneous calculations and those in FHH's first response, runs the risk of overestimating DBS's actual

costs of serving the contract, it is appropriate for the purpose of this investigation since it:

- errs on the side of higher cost estimates (see paragraph 112);
- is based on the class of locomotive used to service the Contract rather than a blended average; and
- is consistent with ORR's own internal cost modelling.

Fuel cost

Introduction

146. Fuel represents a material category of avoidable cost incurred by DBS as a result of operating the Contract. The fuel consumed by freight locomotives is commonly referred to as gasoil. Fuel prices are volatile, determined by international markets. DBS, in common with FHH, calculates its fuel costs using price data provided by the information company Platts⁸⁸. To calculate the cost to a FOC of buying fuel, raw prices obtained from Platts must be converted into local currency and uplifted to reflect vehicle excise duty and delivery charges.

DBS's contemporaneous view

147. In DBS's contemporaneous calculations, total fuel costs for the Contract were estimated by multiplying⁸⁹:

- the total number of gallons of fuel that would be used in servicing the Contract (where the number of gallons used is equal to the number of trips multiplied by an assumed fuel economy of [x] gallons per mile laden and [y] gallons per mile un-laden;

by

- an assumed wholesale fuel cost of [z] pence per litre.

148. Using this method DBS's contemporaneous estimate of the year one fuel costs that it would incur in running the Contract was £[w].

Evaluation of DBS contemporaneous view and ORR's estimate

149. As explained in the preceding paragraphs, for a given mileage and tonnage of freight, fuel economy rates and the unit cost (e.g. per litre) of fuel are the two key drivers of a FOC's fuel costs.

150. The unit cost of fuel is relatively straightforward to verify using published wholesale gasoil prices. Whilst such prices are subject to considerable fluctuations over time, the terms of the Contract are such that the risk associated with any such fluctuations lies with CP rather than DBS. The Contract includes a mechanism whereby variations in wholesale gasoil

⁸⁸ <http://www.platts.com>.

⁸⁹ ORR/10/42/D125.15 - DBS' response to the section 26 notice of 02 February 2010.

prices beyond a specified level (referred to henceforth as the 'base price') feed through automatically into higher (in cases where gasoil prices are higher than the base price) or lower (in cases where gasoil prices are lower than the base price) prices paid to DBS by CP for haulage.

151. The Contract specifies that the price paid to DBS by CP will be £[X] per tonne when gasoil prices are equal to the base price. ORR undertook its financial analysis on an assumption that gasoil prices remain at the base price throughout the first year of the contract, and therefore that the price charged by DBS to CP will be £[X] per tonne.

152. ORR's assumed unit cost of fuel is largely unchanged from DBS's contemporaneous calculations. The one exception to this is that ORR has added an additional mark-up of [X] pence per litre charged to the delivered price of oil, following the receipt of information supplied by DBS in its response to the third notice.

153. As noted above, DBS's contemporaneous calculations assumed a fuel consumption rate of [X] gallons per mile when laden and [X] gallons per mile un-laden, giving an average fuel consumption rate of [X] gallons per mile.

154. In its reply to the first notice DBS supplied data showing an improved average fuel consumption of [X] gallons per mile overall. DBS explained that this figure reflected its actual fuel consumption for return journeys between Immingham and Kingsbury.

155. ORR has based its estimates on DBS's improved fuel consumption rate of [X] gallons per mile. This rate appears to be realistic, implying an inferior level of fuel efficiency than within FHH's first response and being consistent with ORR's approach of erring on the side of high cost estimates. This approach gives a total estimated year one fuel cost of £[X].

156. In its response to the first notice DBS supplied ORR with evidence of a further (i.e. beyond the achieved improvement referred to at paragraph 154) ongoing fuel efficiency programme being undertaken at its Immingham depot. ORR did not take this evidence into account given its approach of erring on the side of higher cost estimates.

Track access charges

Introduction

157. The track access charges levied by Network Rail are a key avoidable cost of all GB FOCs.

158. ORR publishes track access charges for all types of passenger and freight rolling stock on the GB rail network. FOCs pay a variable freight track access charge on a per thousand gross tonne mile (kgtm) basis. This charge is levied by reference to the weight and mileage of trains transported across the network. On top of this, additional 'capacity' charges are levied on a per train mile basis with variations depending on the routes used and time of day.

159. Variable track access charges are a function of the type of freight vehicle in use. The charges levied on freight wagons tend to represent a

particularly significant cost to FOCs given the number of wagons hauled per train. Most freight wagons which carry liquid fuel fall within a broad 'TEA' class. Within this class are two distinct types, namely TEA(P) and TEA(K) wagons. Track access charges for the former are considerably lower than for the latter. A key reason for this is that TEA(P) wagons are fitted with TF25 low track force bogies, which create relatively limited wear and tear on railway tracks.

DBS's contemporaneous view

160. DBS calculated its contemporaneous estimates of track access charges for the Contract as, given a set of volume assumptions as described earlier in this document, the sum of the following items:

- A variable track access charge for a class 66 loco of £1.96/kgtm, giving an annual charge of £[redacted].
- A variable track access charge for laden⁹⁰ TEA(P) wagons of £1.81/kgtm, giving an annual charge of £[redacted].
- A variable track access charge for un-laden TEA(P) wagons of £0.91/kgtm, giving an annual charge of £[redacted].
- A capacity charge rate of £0.16 per train mile, giving an annual capacity charge of £[redacted].

161. Using this approach DBS's contemporaneous estimate of the year one track access charge costs that it would incur in running the Contract was £[redacted].

Evaluation of DBS contemporaneous view and ORR's estimate

162. DBS's contemporaneous calculations were based on Network Rail's published charges for TEA(P) wagons. DBS has, however, confirmed in its response to the second notice that, "84 type TEA(K) wagons are used to service the Conoco contract". This means that, in practice, DBS primarily uses the TEA(K) type wagon which are more costly from a track access perspective.

163. By way of an explanation of its approach, DBS's response to the second notice argued that

"DB Schenker considers that the charges applied by Network Rail to date are incorrect and that the correct charging basis is as reflected in DB Schenker's pricing model for the Conoco contract. Specifically, DB Schenker considers that Network Rail has wrongly overcharged DB Schenker by applying [...] an incorrect wagon type classification [...]"

164. DBS's view is essentially that the particular TEA(K) wagons used to service the Contract should be reclassified as being of the TEA(P) type due to the fact that they have been fitted with 'track friendly' Low Track Force type TF 25 bogies (or otherwise attract lower track access charges than the full

⁹⁰ In practice track access charges are levied at a single rate and not divided by reference to the laden and un-laden state.

TEA(K) rate). DBS's contemporaneous calculations assumed that it would pay track access charges for wagons at the TEA(P) rate.

165. From the commencement of the Contract to the date of this decision DBS has been paying track access charges for the Contract at the higher rate. ORR has based its estimates on an assumption that these rates will prevail throughout the first year of the Contract. Given ORR's approach of erring on the side of high cost estimates in instances of uncertainty, the higher rate is more appropriate as a measure of what might have represented a reasonable expectation on DBS's part when it was preparing its bid. A similar assumption was made in FHH's first response.

166. ORR's final view of track access charges was constructed as follows:

- A variable track access charge for a class 66 loco of £1.96/kgtm, giving an annual charge of £[<].
- A variable track access charge for laden TEA(K) wagons of £1.96/kgtm, giving an annual charge of £[<].
- A variable track access charge for un-laden TEA(K) wagons of £1.96/kgtm, giving an annual charge of £[<].
- A capacity charge rate of £0.16 per train mile, giving an annual capacity charge of £[<].

167. This approach gives an estimate of the year one track access costs incurred in operating the Contract of £[<].

Driver costs

Introduction

168. A significant number of driver hours are needed to service the Contract. These hours generate a material avoidable cost to DBS. Other things being equal, DBS would have been able to operate with fewer driver hours had it not entered into the Contract.

DBS's contemporaneous view

169. DBS's contemporaneous calculations estimated driver costs for the Contract by⁹¹:

- adding together all the costs incurred as a result of employing drivers for the year 2008 across DBS as a whole, including the costs of, amongst other things, base workloads, Sunday pay, holiday pay, and training;
- dividing the figure obtained in the previous step by an aggregate number of paid driver hours worked for the same period across DBS as a whole; and then

⁹¹ ORR/10/42/D125.10 - DBS's response to the section 26 notice of 02 February 2010.

- multiplying the hourly rate calculated in the previous two steps by an estimated total number of diagrammed driver hours generated by the Contract across an entire year, calculated by multiplying the forecast number of trains per year by an average number of hours per train.

170. Using this method DBS's contemporaneous estimate of the year one driver costs that it would incur in running the Contract was £[X].

Evaluation of DBS contemporaneous view and ORR's estimate

171. DBS's contemporaneous estimate of year one driver cost was [X]% lower than the comparable figures provided by FHH in its response to the first FHH notice. DBS's contemporaneous view was underpinned by planned driver diagrams that assumed a significantly lower (a total of [X] hours per week rather than [X] hours per week) number of driver hours than FHH.

172. The third notice asked DBS to provide further evidence that would assess whether its contemporaneous assumptions with regard to hours had corresponded to the out-turn. DBS's response⁹² stated that:

“[...] current driver diagrams require [X] hours [X] minutes per circuit, [X] hours [X] minutes more than DB Schenker's initial estimate in the original driver diagrams (and therefore cost model)”.

173. DBS attributed this difference to:

“[...] unforeseen difficulties putting the intended manner of operation in place following award of the Contract, as it has not proven practicable to put in place suitable arrangements with ConocoPhillips regarding the stabling of locomotives at the Humber refinery. As a result, drivers – and therefore locomotives – continue to be based at DB Schenker's Immingham depot”.

174. DBS nonetheless went on to add that it:

“[...] continues to explore revised diagram arrangements with the specific aim of delivering reduced driver hours, in line with its original cost assumptions”.

175. ORR has based its calculations of the cost of the Contract on the (higher) number of driver hours per train provided by DBS in its response to the third notice, rather than on DBS's contemporaneous assumptions. Taken together with DBS's contemporaneous view of driver costs per hour (which was somewhat higher than the corresponding figure provided in FHH's first response), this gives a total year one estimate of £[X] for driver costs. This approach is consistent with ORR's overall objectives in carrying out its cost analysis, since doing so:

- makes use of more accurate, recent, data than included within DBS's contemporaneous calculations; and

⁹² ORR/10/42/E174.4 - 6 – DBS's response to the section 26 notice of 29 April 2010.

- errs on the side of higher cost estimates, producing cost estimates that are higher than assumed in both DBS's contemporaneous calculations and those provided by FHH.

Groundstaff costs

Introduction

176. Groundstaff are a class of employee employed by FOCs to carry out a variety of duties including operating hand points, carrying out manual coupling, and communicating with train crew. A significant number of groundstaff are needed to serve the Contract, both at the Immingham and Kingsbury sites.

DBS's contemporaneous view

177. In DBS's contemporaneous calculations groundstaff costs for the Contract were estimated by⁹³:

- adding together all the costs incurred as a result of employing groundstaff for the year 2008, including the costs of, *inter alia*, base workloads, holiday pay, and training;
- dividing the figure calculated in the previous step by an aggregate number of paid groundstaff hours worked during the same period; and then
- multiplying the hourly rate calculated in the steps above by an estimate of the number of groundstaff hours required to service the Contract.

178. Using this method DBS's contemporaneous estimate of the year one groundstaff costs that it would incur in running the Contract was £[X].

Evaluation of DBS contemporaneous view and ORR's estimate

179. DBS's contemporaneous calculations assumed that the Contract would require, per train (i.e. per return trip from Immingham to Kingsbury), [X] hours of groundstaff time at Kingsbury and [Y] hours of groundstaff time at Immingham.

180. FHH's first response, on the other hand, assumed that FHH would itself incur no groundstaff costs at Kingsbury (although, as discussed below, it would incur substantial costs as a result of the payment of access and groundstaff charges to DBS in return for the use of DBS's facilities at Kingsbury).

181. ORR's calculations include an estimate of the groundstaff costs incurred at the Immingham site only. This is consistent with ORR's treatment of the site access revenues foregone by DBS as a result of winning the Contract, as discussed below. As explained by DBS in its response to the

⁹³ ORR/10/42/E174.10-12 – DBS's response to the section 26 notice of 29 April 2010.

third notice⁹⁴, “*the discontinuation of access and groundstaff provisions to Freightliner Heavy Haul has not led to any increase in costs incurred by DB Schenker*”. DBS would have incurred the same level of groundstaff costs at Kingsbury regardless of whether its bid for the Contract was successful or not. As such, ORR has not treated such costs as being avoidable.

182. DBS’s contemporaneous calculations assumed a requirement of [X] hours of groundstaff time per train at Immingham. This figure is significantly ([X]%) lower than the corresponding estimate of [X] hours per train within FHH’s first response. FHH’s estimate took, as its starting point, an assumed [X] full-time groundstaff dedicated to servicing the Contract, whereas DBS’s contemporaneous calculations assumed that the Contract would only require a modest amount of additional time to be worked by a pool of [X] groundstaff employed at Immingham, whose total work time is spread across [X] different customer locations including the Humber refinery.

183. Presented with these different sets of calculations ORR was not in a position to arrive at a fully robust estimate of the avoidable cost of providing groundstaff for the Contract without a detailed investigation of the different possible working practices that could be employed by FOCs in the Immingham area. Because of this, ORR’s estimates use the figures provided by FHH. This approach, providing a final year one estimate of £[X], has the primary advantage of erring on the side of higher cost estimates. ORR recognises that this approach, given possible differences in working practices described by DBS and FHH, may lead to an over-estimate of costs.

Foregone revenue (access to DBS Kingsbury facilities)

Introduction

184. An additional consideration for ORR’s financial analysis was the revenue streams that were foregone by DBS as a result of it, rather than another FOC, winning the Contract.

185. Prior to commencement of the Contract, DBS had been earning £[X] p.a. in revenue from FHH in return for providing access to DBS’s facilities and groundstaff at Kingsbury. Winning the Contract meant that DBS would no longer benefit from these revenues. For the remainder of the Contract DBS continues to incur the cost of providing groundstaff at the Kingsbury site, meaning that these costs are not avoidable by DBS with respect to the Contract.

186. DBS’s contemporaneous calculations made no explicit reference to foregone revenues of this type.

Evaluation of DBS contemporaneous view and ORR’s estimate

187. It is appropriate for ORR to include relevant opportunity costs within its estimate of the avoidable cost of the Contract. DBS’s response to the third notice argued that, in relation to foregone revenues of this type:

⁹⁴ ORR/10/42/E174.10-11 – DBS’s response to the section 26 notice of 29 April 2010.

“DB Schenker is advised [...] that these figures have no legal or economic relevance to the assessment of DB Schenker’s pricing of the Contract. The long run opportunity cost of groundstaff is measured by the groundstaff input required and its cost per hour. This is a forward-looking measure and previous activities are not relevant.”

188. ORR is not persuaded by this argument. DBS would have continued to earn site access revenues if any FOC other than itself had been successful in bidding for the Contract. They are clearly relevant to assessing whether or not DBS’s pricing of the Contract would be profitable. ORR’s calculations include the full opportunity cost of £[<] associated with these foregone revenues.

Contract specific investment

189. A final, minor, cost category included by DBS within its contemporaneous calculations was a total of £[<] for what its contemporaneous calculations termed ‘other’ costs in year one. This total represented one year’s worth of the annualised cost of buying a second-hand van to transport train drivers between the Immingham and Kingsbury sites. ORR has included these costs within its calculations as an avoidable cost of the Contract.

Results of ORR’s analysis

190. The combined effect of the adjustments described in the previous paragraphs is summarised in Figure 1 below⁹⁵. In short:

- DBS’s contemporaneous figures formed the starting point for ORR’s analysis:
 - DBS’s own estimate of the total direct (i.e. excluding a mark-up for overheads) cost but including, as explained above, some costs that in ORR’s view are non-avoidable of servicing the Contract was £[<] per tonne.
 - ORR calculated an implied DBS contemporaneous view of the AAC of servicing the Contract of £[<] per tonne by subtracting £[<] per tonne from DBS’s original figure above.
- ORR carried out a series of adjustments to DBS’s contemporaneous estimates in order to arrive at its own estimate of AAC:
 - The adjustments to the various individual cost categories described above collectively give a preliminary ORR AAC estimate of £[<] per tonne.
 - The addition of foregone revenues from the provision of access to FOCs at DBS’s Kingsbury freight facilities gives a final ORR AAC estimate of £[<] per tonne.
- Finally, ORR calculated an ATC figure by adding DBS’s assumed allocation of locomotive capital costs and (as a proportion of other costs) [<]% contribution to overheads, giving an estimate of £[<] per tonne.

⁹⁵ The numbers within this figure and in the body of the text have been obtained by dividing annualised costs by [<] tonnes to provide per tonne figures.

191. The comparison between these cost figures and the Contract price in Figure 1 shows that the Contract price was higher than ORR's estimate of AAC. The gap between, given forecast volumes, AAC and revenues earned is sufficient to provide a contribution of just over £[X] to fixed costs and overheads, i.e. around [X]% of the total revenues of the Contract.

Figure 1 – Results of ORR's analysis

[X]

192. Whilst this contribution is fairly modest relative to the overall value of the Contract, it has to be interpreted in the context of, firstly, the recent economic climate (see the heading '*Locomotives – capital costs*' above) and its impact on FOCs including DBS, and, secondly, ORR's approach of erring on the side of higher cost estimates.

193. On this second issue, as explained initially at paragraph 112, in several instances ORR has erred on the side of using high cost estimates in its analysis. By way of an example, ORR's analysis unquestioningly accepted the estimates within FHH's first response of the cost of providing groundstaff at Immingham without detailed scrutiny (see paragraph 176 onwards). The adjustment made by ORR to DBS's calculations in this area has, other things being equal, the effect of reducing ORR's estimate of the Contract's contribution to fixed costs and overheads by roughly the same amount as the adjustment described in the previous paragraph, i.e. by around [X] percentage points.

194. In its responses to the first, second, and third notices DBS mentioned a number of factors to suggest that even its own contemporaneous cost estimates may have erred on the side of high numbers.

195. In addition to the adjustments to particular cost categories described under the individual cost category headings above, in its response to the third notice DBS provided ORR with a '*Profit Initiative Register*' for the Contract. This document set out how further profits could be earned from the Contract by, potentially, sending longer, heavier trains (as discussed above – see paragraph 118) and/or selling further value-added services to CP. DBS also referred to potential further cost savings that could be obtained as a result of fuel efficiency initiatives.

196. ORR's estimates did not take any of these additional factors into account. This is because of the uncertainty surrounding them and also ORR's desire to err towards using higher cost estimates.

197. Taken together, ORR's final cost estimates and the overall context in which the Contract was won are suggestive of a bid that, whilst not priced high enough to become hugely lucrative if successful, was nonetheless priced in such a way so as to make a successful bid a more attractive outcome to DBS than an unsuccessful one. In such circumstances DBS's pricing cannot be considered as being inconsistent with normal competition on the merits.

198. The key difference between ORR's analysis and the cost figures provided by FHH within FHH's first response are, firstly, ORR's exclusion of fixed costs (locomotive capital costs and overhead contributions) from its

calculation of AAC, and, secondly, ORR's use of a fuel cost that is internally consistent with the Contract price.

Conclusion

199. ORR's view is, on the basis of the evidence available, that DBS's conduct to date has not amounted to an infringement of Chapter II of the Act or of Article 102 of the Treaty.

Annex: Chronology of the investigation

Date	Event
20 January 2010	OFT confirms ORR as the competent person to investigate, under Regulation 4 of the Competition Act 1998 (Concurrency) Regulations 2004
22 January 2010	On-site inspection at DBS Carr Hill premises under section 27
29 January 2010	DBS provides documents that it agreed, during the section 27 visit, to send to ORR by 29 January
2 February 2010	First section 26 notice sent to DBS ('the first notice')
8 February 2010	First section 26 notice sent to FHH ('the first FHH notice')
9 February 2010	First section 26 notice sent to CP ('the first CP notice')
15 February 2010	FHH responds to the first FHH notice
16 February 2010	DBS responds to the first notice
19 February 2010	CP responds to the first CP notice
04 March 2010	First section 26 notice sent to NR ('the first NR notice')
11 March 2010	NR responds to the first NR notice
18 March 2010	Second section 26 notice sent to CP ('the second CP notice')
23 March 2010	Second section 26 notice sent to DBS ('the second notice')
26 March 2010	CP responds to the second CP notice.
13 April 2010	DBS responds to the second notice
20 April 2010	section 26 notice sent to Total UK Ltd
	section 26 notice sent to Petrochem Carless Ltd
	section 26 notice sent to Murco Petroleum Ltd
	section 26 notice sent to Petroplus Refining Teeside Ltd
	section 26 notice sent to Esso Petrol Company Ltd
	section 26 notice sent to BP Plc

Date	Event
	section 26 notice sent to Greenergy International Ltd
	section 26 notice sent to Star Energy Group Ltd
28 April 2010	Murco Petroleum Ltd respond to section 26 of 20 April
29 April 2010	Third section 26 notice sent to DBS ('the third notice')
30 April 2010	Section 26 notice sent to FHH ('the second FHH notice')
4 May 2010	Total UK Ltd responds to section 26 notice of 20 April
	Petrochem Carless Ltd responds to section 26 notice of 20 April
	Esso Petrol Company Ltd responds to section 26 notice of 20 April
	Greenergy International Ltd responds to section 26 notice of 20 April
	Star Energy Group Ltd responds to section 26 notice of 20 April
5 May 2010	BP Plc responds to section 26 notice of 20 April
6 May 2010	FHH responds to the second FHH notice
7 May 2010	Petroplus Refining Teeside Ltd responds to section 26 of 20 April
18 May 2010	DBS responds to the third notice