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NETWORK CHARGES – A CONSULTATION ON HOW CHARGES CAN IMPROVE EFFICIENCY

1. This is the response by DB Cargo (UK) Limited (“DBC UK”) to the consultation document entitled “Network Charges – A consultation on how charges can improve efficiency” issued by Office of Rail & Road (“ORR”) on 10 December 2015.
2. This response is in three sections - General Comments, a short section on Freight Market structural changes and then responses to the Consultation Questions, organised by the chapter headings in the consultation.

General Comments

3. The UK rail freight industry is a success story of the post-privatisation era, described by the former CEO of the Office of Rail & Road “as the most transformed sector in the industry”. It has attracted private sector investment of c £2bn and in fifteen years has grown to account for a market share of surface transport of around 11% (up from 8% at privatisation).
4. Such growth has been achieved by a relentless pursuit of efficiency, striving towards customer satisfaction and strong control of costs.
5. Stability, certainty and confidence in the future is crucial for an industry that depends almost entirely on the private sector (whether in the form of shareholders, customers or debt providers) retaining confidence in the future.
6. The rail freight sector is highly competitive, with five main rail freight operating companies (FOCs) competing vigorously in all market segments. However, the rail freight industry's main competition is from road haulage or road based logistics services which set the price and service expectations in almost all market segments.
7. Key to maintaining growth and achieving modal shift will be the ability to match the prices and flexibility/simplicity of road haulage. Maintaining a simple structure and



competitive level of freight charges is fundamental in helping to achieve this.

8. In this context, it is important to remember that rail freight is strategically important for GB PLC and provides an essential service to industry. The rail freight industry delivers £1.6bn per annum in benefits to the UK economy and conveys goods worth over £30bn per annum. Examples of this strategic importance include:
 - a. From almost zero, rail has gained 10% market share of export automotive traffic in the last six years.
 - b. Over 40% of London's raw materials (such as aggregates and cement) are delivered by rail and rail plays an equally key role in other major conurbations.
 - c. Over 25% of all the deep sea containers that arrive or depart from the major UK deep sea ports are transported by rail.
9. Rail freight has a vital role to play in tackling transport-related carbon reduction, helping the UK Government to meet its climate change commitments and underpinning a greener economy. Transport currently contributes 21% of carbon emissions of which 7% originate from lorries. Given that rail freight produces 76% less carbon dioxide than road freight, it is clear that every tonne of cargo carried by rail rather than road makes a positive contribution towards reaching the targets.
10. Rail freight operators generate very low margins – before the recent dramatic decline in coal volumes, the five year rolling average profit margin for rail freight operators was 2.6%. This is vital in assessing the ability of the sector, and its customers, to absorb the impact of changes to access charges.

Market Changes

11. The rail freight sector is undergoing structural change with the well-documented reduction in the movement of coal to power stations with commenced in April 2015 as the result of changes in energy generation policy and the simultaneous impact of a globalized steel manufacturing market impacting seriously on traditional, core rail freight markets.
12. The disruption to cross-channel services caused by the migrants crisis at Calais has also impacted severely on international rail freight services since summer 2015, with over 50% of trains ceasing to run and the majority of other being heavily delayed.
13. The above two elements have had a seriously detrimental impact on FOC finances; in addition, coal to power stations was one of the sectors deemed able to afford mark-ups by the ORR during PR13. DBC UK anticipates that ORR will wish to revisit its PR13 conclusions on market affordability for PR18, but DBC UK suggests that this need not be a lengthy or complicated process. If concluded early, DBC UK believes that this would be helpful in assisting the ORR to assess impacts of different possibilities or options on freight charges.



14. Other market segments have exhibited strong growth in recent years, and this is forecast to continue with overall growth of c3% pa forecast until 2043 in the 2014 Freight Market Study. Growth market segments include Construction (e.g. aggregates and cement), maritime and domestic intermodal and automotive. As well as exacting price and service requirements, these segments have a different operational geography, broadly characterised by an increasing density southward from a line between the Humber and the North West.
15. The structure and level of access charges will be key to determining the ability of the sector to thrive in these growth markets. Customers, and potential customers, already find the rail access charging regime complex and difficult to understand; injecting additional complexity or increasing the overall level of charges will likely reinforce preconceptions that already inhibit rail growth.

Introduction and Wider Context

16. The structure and level of access charges are important for freight operating companies such as DBC UK. Not only are they an important cost element, but they send signals to customers and potential customers as to the rail industry's interest in moving freight.
17. As such, the regulatory framework together with strong, independent regulation is important for the rail freight industry to deliver an efficient, effective, transparent and affordable access and charges regime.
18. This consultation is taking place at a time when the fundamental structure of the railway industry is under review, and when the role and function of the ORR itself might be subject to change. Until the nature of any proposed structural change and its impact on regulation is clearer, it is important that any decisions taken now by the ORR allow for the possibility of downstream change.
19. For freight operating companies, the need for a simple, transparent and national regime of access charges remains clamant if the sector is to continue to thrive.
20. In addition, there is a need for an early and holistic impact assessment of any potential changes on customers and markets. During PR13, this cumulative impact assessment was often either absent, or not obvious, and individual charging elements of the regime often seemed to be developed in relative isolation.
21. In almost all rail freight markets, and especially in the key growth markets for the future, customers have choices between rail and other modes, particularly road. Therefore the structure and level of access charges have to allow, and incentivise, the use of rail to enable it to be competitive with road.



22. The consultation suggests that the structure of charges needs to be considered in “the wider rail context” There is some truth in this, but for rail freight the structure of charges needs to be considered even more widely.
23. The current structure of variable charges being based upon short-run marginal costs and more fixed costs (including freight fixed costs) being recovered directly by network grant is a close parallel to the situation faced by road freight - where the fixed costs of the national and local road network are funded directly by Government and road hauliers pay only VED and licensing costs. Although not an exact parallel, moving away from the current rail model to one deemed to be more “cost reflective” risks rail freight being placed at a competitive disadvantage.
24. Historically the structure and level of access charges have been narrowly focussed on rail infrastructure costs, and have not taken the benefits of rail freight (some of which are not within the railway balance sheet) into account. This has been a major weakness which we hope the ORR will address as part of PR18.
25. The economics of rail freight, and the fact that freight operating companies and freight customers are wholly exposed to changes in rail access charges, means that freight operating companies already participate strongly in the Periodic Review process.
26. In addition, the vehicle-specific variable charge approach has allowed track-friendly suspension systems to be incentivised and this should be encouraged further.
27. DBC UK also participated actively in the RDG Review of Charges and stand behind the conclusions, although some of the potential outcomes and changes would not be good for rail freight and would require mitigation if negative outcomes are to be avoided. Consequently, DBC UK supports RDG's response to this consultation.
28. During PR13, it seemed to DBC UK that undue time and effort was spent by ORR on relatively minor (in overall cost terms) freight-related charges, with larger cost elements receiving scant regulatory attention. We hope that a more balanced approach will be taken with respect to PR18.

Background and Approach

29. DBC UK acknowledges the efforts made by the ORR to establish frameworks and criteria to help establish the policy environment for charges. This is a welcome development and DBC UK acknowledges that as a “first attempt” there is unlikely to be consensus on all elements.
30. DBC UK regrets that the objectives for the review are essentially inward looking to rail and do not make any attempt to place rail in a wider transport context.
31. The consultation refers frequently to the ability of the charging system to improve outcomes. What those outcomes are needs clear and detailed definition. Equally “value” is a subjective term and the meaning(s) attributed to it by the ORR needs

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greater clarity in each case.

32. DBC UK is not convinced that the structure of charges in itself will materially change the ability, or willingness, of operators to help drive down infrastructure costs. Understanding the dynamics of infrastructure cost causation and management on a mixed traffic railway where knowledge of asset condition is often limited is technically specialist and for which there is no generally accepted solution. This is important as FOCs such as DBC UK do not possess such expertise, and cannot afford to do so within the competitive cost ceiling of the sector.
33. The ORR needs to be realistic about the ability of the industry to do this; where collaboration can lead to efficiency and productivity improvements with mutual benefit, some form of efficiency benefit sharing process would be appropriate. However the reluctance to endorse Route-based Efficiency Benefit Sharing demonstrates clearly the reluctance of train operators to take on infrastructure risk they could neither quantify nor control.
34. No such expectations or contractual obligations are placed on the road haulage sector with respect to the efficient maintenance and operation of the national road network.
35. The use of scenarios such the RDG "States of the World" adds value in providing frameworks, but some of these states are themselves generic and high level, needing further elaboration. For example, the state of the world regarding freight might apply with all the other states of the world, but is not the only possible scenario regarding freight.

High Level Options and Proposal

36. DBC UK notes the ORR does not appear to have considered "Do Nothing" as an option; whilst acknowledging that the current system is not perfect, the potential scale of other changes in conjunction with rail reform - and for freight the need to adjust to fundamental market changes - means that a longer period (e.g. two control periods) of stability in the structure and level of charges would be welcome. Even "minor" adjustments to current charges will, on the evidence of the last Periodic Review, involve considerable engagement and inject unwelcome uncertainty into the sector.
37. The options themselves are understandable but essentially inward facing to the rail sector. They each fail to acknowledge the structural differences between road and rail, and any move to introduce any element of them will likely worsen rail freight's competitive position with road.
38. It would be helpful if the ORR's proposal was clearly articulated and cross-referenced against Governments' ambitions for rail freight.
39. It is hard to see how any value-based capacity package could be easily and simply administered. In theory charges that reflect the value of external benefits might be attractive to freight; equally a charging framework where charges are higher when ...



paths are deemed scarce is likely to disbenefit freight. However given that freight rarely has routing options, either would still essentially represent an administrative rather than economic solution.

40. DBC UK believes strongly that value-based capacity charges should only be examined in conjunction with road pricing for heavy goods vehicles. This would allow consistency across modes.
41. DBC UK understands the theoretical attraction of the work set out in the infrastructure costs package, but is not convinced as to how this can be translated into charges without major impact. Limiting the work to the understanding of cost drivers for the next Control Period seems sensible.

Infrastructure Costs Package

42. It is hard at this stage to see any benefit to freight from the measures suggested in the Infrastructure Costs Package. Indeed, as the draft impact assessment makes clear, a more cost-reflective charging structure is very likely to result in higher access charges for freight. This was the ineluctable conclusion from the PR13 work.
43. It is not clear to DBC UK at this stage that the Infrastructure Costs Package would be consistent with the law applicable to access charges.
44. The statement that “this (package) may require reconsideration of the level and type of protections that might be necessary” for freight is deeply concerning. Any form of subsidy or grant (as suggested in paragraph 99) that would flow via the FOCs would be deeply unappealing – both for potential state aid and commercial reasons. Customers and investors will be less likely to commit to a mode of transport transparently dependent on levels of direct Government subsidy that will be subject to political (as well as regulatory) change and that will also need to form part of periodic Government financial settlements.
45. DBC UK would prefer that the level of access charges that are incurred by FOCs remain commercially viable in all market segments. That is likely to make competition with road more straightforward. In the event that this is not possible, DBC UK would strongly recommend that grant arrangements are directly between the funder(s) and the infrastructure manager.
46. DBC UK agrees that caps and exemptions are equally unattractive options as they would negate the theoretical purpose of establishing such a charge in the first place.
47. Network Rail’s freight costs on freight-only routes ought in theory to be more readily identifiable and capable of influence; however in practice infrastructure manpower, resource and materials are usually shared with adjacent mixed-traffic railway, and removing entire units in relation to the freight element is far from straightforward.



48. As well as assessment of how infrastructure costs might be attributed or allocated, cross-reference is always needed as to how infrastructure costs can be escaped.
49. On mixed traffic routes, models such as VTISM are used to attribute a proportion of infrastructure costs to freight, in turn forming an important element of the make-up of charges including variable charges. DBC UK remains unconvinced by the use of VTISM and has yet to see any compelling argument as to how costs attributed by VTISM can be mitigated, let alone escaped.

Value based Capacity Package

50. DBC UK agrees with the proposal to stop development of any value-based capacity package for the following reasons;
 - a. there is no clear or generally accepted understanding of what constitutes value;
 - b. unless any value-based capacity package aligned perfectly with charges based on short run marginal costs (which is exceptionally unlikely), it is hard to see how any value-based capacity package could align with the legal framework for freight access charges unless all the traffics concerned are deemed to have an ability to pay a mark-up.
 - c. there is frequently no choice as to routing for freight trains, and hence the actual usage of any value based system would be determined by administrative means rather by response to economic signals.
 - d. any path reservation charge would impact on freight operators and customers rather than passenger operators because of the different way in which freight uses rail capacity; this would likely make rail unattractive to customers and worsen rail freight's competitive position with road.
 - e. until competing modes are subject to a similar regime (e.g. road pricing), any such regime would likely place rail freight at a modal disadvantage.
 - f. a high proportion of freight services are amended weekly to avoid scheduled engineering work, which blunts the theoretical application of any such value-based package.
51. DBC UK's views on the Capacity Charge are well known; in its current form it is not linked to additional traffic as it is levied across all traffic and is little more than a tax. The purpose (and existence) of a Capacity Charge has to be reviewed as part of PR18.
52. DBC UK is not convinced that the Volume Incentive is any form of incentive to Network Rail, especially for cross-route traffics.
53. It is not clear to DBC UK to what extent Route Managing Directors even see a route split of access charges – even charges such as the Volume Incentive intended to influence behavior.



Improvement to short-run variable charges

54. DBC UK acknowledges that the current group of seven variable charges are seen as imperfect, but the evidence (for example by Credo) that these charges already provide incentives is powerful - and care is needed to ensure that attempting to change this in order to seek improvements does not result in inadvertent negative incentives.
55. DBC UK understands, and supports, ensuring that these charges are based on a sound methodology that achieves what is agreed to be the objective - reviewing the Capacity Charge and the Volume Incentive both fall into this category.
56. Similarly, there may be a case for rationalisation of some of these charges. It is hard to see any on-going value from a coal spillage charge given the;
 - a. significant reduction in the movement of coal; and
 - b. introduction in CP5 of a Freight Specific Charge which, inter alia, covered coal traffic.
57. The Consultation acknowledges that some customers - particularly freight customers - have expressed concern about the unstable and unpredictable nature of changes to charges such as the Variable Usage Charge. It is not immediately apparent how developing a further package of changes and alterations to such charges addresses this point.
58. For national operators in markets where road sets the market price, the prospect of geographical variation of charges is very concerning. Freight operators rarely have any realistic routing options, so it is hard to see how this could be anything other than an additional imposed complexity. DBC UK is concerned that the ORR appears to have no real understanding of the limited nature of routing options.
59. In addition some investment decisions - for example at terminals and ports - may have been influenced by the current access charging system which for many years has made no such distinction. It is entirely possible that the introduction of geographical variation in charges will favour one or more location against others, potentially introducing market distortions or even frustrating sunk investment.
60. Potentially varying variable charges by time of day seems almost identical in purpose and effect to the value based capacity package that ORR does not intend to pursue. If so, this seems peculiar and DBC UK would welcome clarification as to whether this is the case or whether it has misinterpreted the intention.
61. DBC UK sees no case for considering charges for externalities such as noise unless parallel financial regimes are introduced at the same time for other modes, to avoid modal distortions and rail being placed at a financial disadvantage.
62. There is a balance to be drawn between the pursuit of economic purity and the realities of the markets in which rail competes. It is important that the ORR



acknowledges this and very quickly makes clear how it proposes to take this area forward. DBC UK urges the ORR if at all possible to avoid the tensions and conflict that characterised the final stages of PR13 in respect of variable charges, and which did real and sustained harm to rail freight.

Supporting packages

63. DBC UK has no comments on the items relating to Open Access beyond asking the ORR to ensure that any arrangements made in respect of open access are neither inadvertently applied to freight nor become a *de facto* starting point for all users subsequently.
64. DBC UK does not find the suggestion of a charges calculator compelling. While superficially attractive, the need for key information (e.g. mileage which depends on routing) as well as vehicle type (given vehicle specific variable usage charges) means that any serious assessment would likely involve the same steps and tasks as today. DBC UK would prefer a simpler regime.
65. Introducing complexity as a test has merit and we would support this being evaluated.

Implementation and next steps.

66. DBC UK is pleased to see the ORR considering implementation issues at such an early stage and that ORR recognises the advantages of a stable regime.
67. That said, DBC UK considers that there should be a high hurdle for making any changes – i.e. a demonstrable benefit to customers that clearly outweighs the costs and administrative burden of change.
68. However DBC UK is extremely concerned at the proposal in paragraph 180 to even consider treating freight in the same way as franchised passenger operators. It is hard to understand what this might achieve (even in theory) given the very different business models of freight and franchising. It is also not clear to DBC UK how any such proposal would be consistent with the current legal framework for access charges.
69. If this is a serious policy option then that needs to be clarified with great urgency. If this is not a serious policy option, then DB would urge the ORR to reflect as a matter of urgency on the potential uncertainty this theoretical exercise might very well create in the rail freight sector.

If you have any queries or would like clarification or amplification of any of these points, please contact me.



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Yours sincerely,

A handwritten signature in black ink, appearing to read 'Nigel Jones', with a long, sweeping underline that extends to the right.

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Nigel Jones
Strategic Advisor

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