DB SCHENKER

By Appointment to Her Majesty The Queen Royal Train Operator DB Schenker Rail (UK) Ltd Doncaster

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

Telephone: +44 (0) 1302 577042
Mobile: +44 (0) 7801 905690
Fax: +44 (0) 20 833 8449
Nigel.jones@dbschenker.com

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

2 December 2011

Dear Joe

The potential for increased on-rail competition.

1. This letter contains the response by DB Schenker Rail (UK) Limited ("DB Schenker") to the consultation document entitled "The potential for on-rail competition" issued by the Office of Rail Regulation ("ORR") on 4th October 2011.

Introduction

2. DB Schenker is the UK's largest rail freight operator, but also operates a limited number of charter passenger trains per annum outside of the franchise system. Both of these areas of activity have been fully privatised and liberalised since 1996 through the auspices of the Railways Act 1993 which permitsany organisation that holds the requisite licences and safety authorities and has appropriate assets to be able to procure access and offer services on a commercial basis.

3. We understand and acknowledge that the consultation is focussed on competition between franchised TOCs or between franchised TOCs and open access operators of regular scheduled passenger services. DB Schenker currently has little experience of operating such services and accordingly has no formal opinion on the role of open access passenger services except in how they impact on DB Schenker's business. Our representations are therefore focussed on that impact.

4. However, that said, DB Schenker believes that its experience of the introduction and operation of liberalised, competitive markets in the freight and charter passenger markets may help inform ORR's deliberations and accordingly we also offer observations on the rail freight experience, the potential for competition to drive cost savings and the potential financial impact of open access regular scheduled passenger services.

...

DB Schenker Rail (UK) Limited
Registered Office:
Lakeside Business Park
Carolina Way
Doncaster DN4 5PN
Registered in England and Wales
Registered No: 2938988

Impact of Open Access services on DB Schenker's business

5. Firstly, it should be recognised that most competition in the rail freight sector is largely different to that envisaged for open access passenger services under ORR's proposals. Rail freight operators compete for haulage contracts with only the winner operating services for the customer concerned. This reflects the fact that freight services operate in reaction to demand whereas passenger services, on the other hand, operate in anticipation of demand. Therefore the introduction of competing passenger services could lead to a scenario where two "half empty" trains operate rather than one full train prior to the advent of competition.

6. Given this, the main impact of open access passenger services is therefore with respect to network capacity. The introduction of open access regular scheduled passenger services on the East Coast Main Line, for example, has contributed significantly to the reduction in the number and quality of paths available for freight leading to extended journey times, significant retiming and lengthy diversions.

7. The open access regular scheduled passenger services that have been introduced thus far have sought to open up new journey opportunities by identifying gaps in the market (i.e. operating direct services to London from major population centres that are not well served by franchised passenger TOCs, for example London to Hull or Sunderland). Therefore the impacts on capacity from existing open access regular scheduled passenger services that have been introduced under the current ORR policy have been from genuine growth. However ORR's proposals to open up and allow full competition on all routes would imply that competing passenger operators would be seeking to attract the same customers leading to inefficient use of capacity through larger numbers of competing services carrying the same number of passengers.

8. The consultation provides no detail on how capacity for increased passenger competition would be provided. DB Schenker is concerned that unless measures are taken to limit competition on capacity constrained routes, this would lead to a saturation of competing passenger services which would exhaust capacity for freight and which would in turn inhibit the well established and generally accepted forecasts of freight growth that underpin the Strategic Freight Network and Route Utilisation Strategies. It is already recognised that during current passenger commuting "peak" periods there is little or no capacity for freight. ORR's proposed policy could extend this situation across key routes throughout much of the day particularly given that competing passenger services are likely to comprise long distance high value "inter city" services on key routes such as the East Coast, West Coast, Midland and Great western Main Lines which are critical for the movement of rail freight.

9. As a result, DB Schenker believes that Strategic Capacity in the form of standard hour freight opportunities must be established on all key routes likely to be affected by the policy to ensure future freight growth forecasts can be accommodated before any increase in passenger competition is permitted.

Rail Freight Experience of competition and liberalisation

10. Rail freight customers generally welcome choice, largely because they perceive that the options inherent in competition give them competitive advantage and leverage in their relationship with suppliers.

11. It is generally acknowledged that prices to end-customers have reduced and innovation increased as a result of competition. However in DB Schenker's view this analysis is over-simplistic and perhaps misleading. This is because;

    a. prices to end-customers have unquestionably reduced in some markets, particularly those (such as ESI coal) where rail was historically the price setting mode.

    b. price "reductions" have frequently formed part of a more complex package of changes that includes product unbundling, more precise service specifications and stricter contract conditions relating to aspects such as mutual performance. Hence some elements of what might be perceived as "price reductions" are perhaps better viewed as "price or commercial separation".

    c. For some customers, the implications of unbundling have not always proved attractive. Retention of linked or network benefits has proved important to some customers; one of the impact of price reductions in some areas has been to increase cost pressure on others where there are shared or common costs.

    d. There has always been an element of cost attribution of common costs in rail freight as there is in almost all railway enterprises. On occasion this is described as cross-subsidy but the reality is that the relationship is almost always more subtle than that crude classification suggests. DB Schenker's experience has been that historic price reductions to customers such as the ESI industry significantly increased financial pressure on other business areas.

12. DB Schenker's experience is also that it is frequently the threat of competition that is significant in driving changes in behaviour and commercial approach as much as the competition itself. The largest price reductions in freight - again to ESI coal customers – happened before competition between FOCs for ESI coal commenced.

13. It is also generally perceived that with competition and new entrants comes product and market innovation. DB Schenker is not convinced that the facts and experiences within rail freight bear this out.

    New entrants to rail freight have concentrated on existing traditional rail freight customers and activities and have developed their businesses largely by abstraction of customers and volume from incumbent FOCs rather than true product or market development. Even cursory examination of the portfolios of FOCs will bear this out. This has led to accusations of "cherry-picking" and has meant that competition has generally been on price rather than service or product innovation – and this has suited existing end-customers.

14. As a result, it has often been incumbents and not new entrants who have developed new products and markets – eg EWS in developing mail and parcels traffic and international traffic via High Speed One. Exceptions to this have been some non-FOC third parties with innovations in equipment and technology (eg Isoveyors).

15. Considerable attention is paid in competitive analysis to the "barriers to entry" that apply in different markets, but comparatively little attention is paid to the penalties of incumbency, whether legacy equipment, working practices or contractual obligations. The lack of legacy issues is one reason why new entrants are able and willing to price commercial offers exceptionally keenly.

16. Most rail freight competition has similarities to the franchise process – ie it is for a contract or a given volume of business and when awarded stays with the FOC for the duration of the agreement. This is important in railway terms as it allows rail assets and capacity to be planned effectively.

    There are, however, exceptions to this model. One example is where customers have what are in effect framework contracts with more than one FOC and volumes change weekly/monthly/seasonally between FOCs. This happens with some ESI coal customers and there is concern that this leads to suboptimal use of rail capacity (and indeed other rail assets such as locomotives, wagons and traincrew).

    Open Access passenger services competing with parallel franchised services have characteristics that are even worse than the freight example above as each operator (both open access and franchised) would continue to operate services irrespective of the passenger numbers leading to worse impacts on rail capacity and resources.

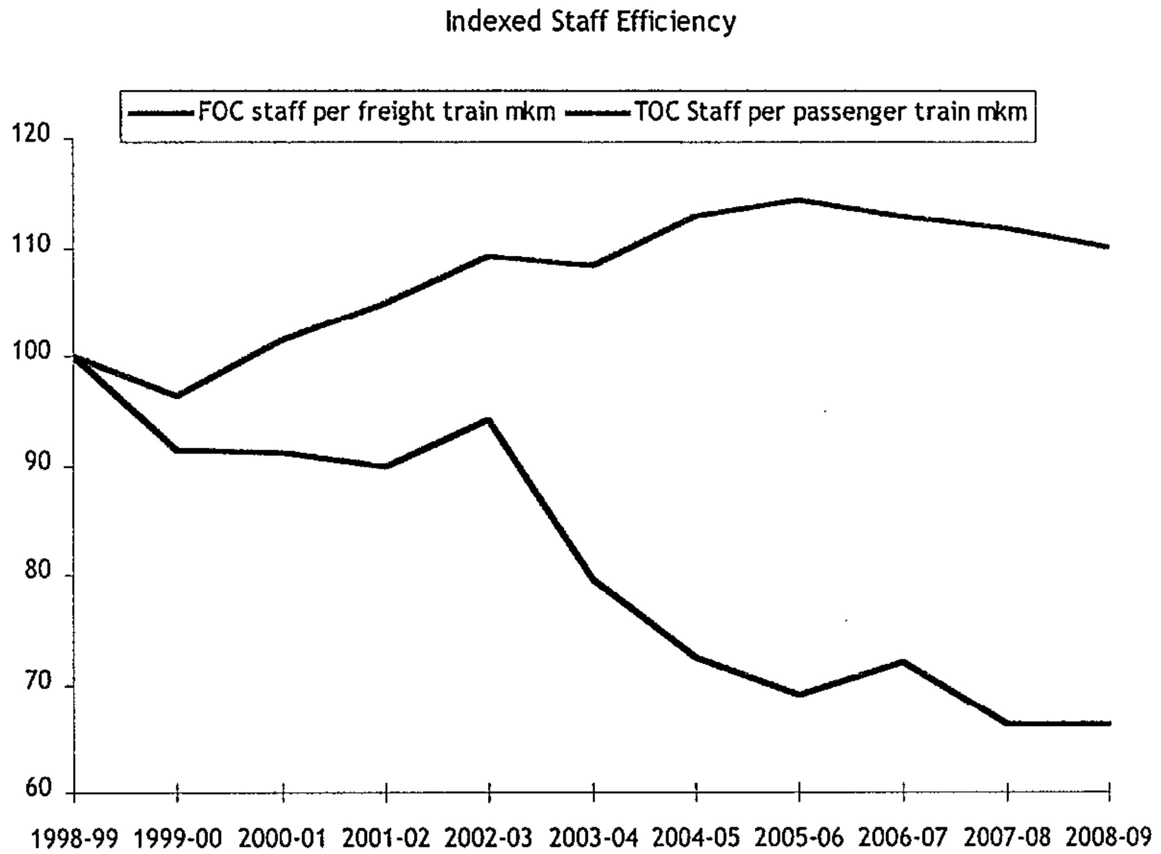
Potential for Competition to drive cost savings

17. *One conclusion of the McNulty "Rail Value for Money" study was:*

    "Faced by a competitive environment with other transport modes and with each other, the freight operators have focused on reducing costs and improving service. In their Manifesto for Rail Freight Growth, the Rail Freight Operators' Association and the Rail Freight Group (RFG) stated that: "Over the last 14 years rail freight operators have invested heavily in new equipment with low maintenance costs, reducing the assets they employ. Rail freight growth of 60% has been achieved using only half the locomotives and two-thirds of the wagons employed in the mid-nineties.".

    Figure 13.2 shows the relative efficiency performance of Freight Operating Companies (FOCs) and Train Operating Companies (TOCs) since 1998/99 as measured by the number of staff per unit of output.

Comparison of freight and passenger staff productivity (train-km)



18. Given the privatisation and liberalisation of the rail freight industry in 1996, the graph implies that the conclusion is seemingly obvious but in DB Schenker's view the picture is in fact far more than complex;

    a. The greatest percentage reduction in FOC staffing occurred between 1992 and 1997 – ie well before competition began - and was a response to :

        i. BRB's "Organising for Quality" organisation introduced in 1992.
        ii. Preparation for privatisation/sale.
        iii. Anticipation of competition.

    b. The means by which productivity improved was not simply related to cost reduction but was a complex mixture of :

i. Growth in tonne-kms operated, largely driven in the 1990s by movements of coal from Scotland rather than local source points but since the mid-2000s largely driven by increases in intermodal traffic and imported coal.
ii. Re-equipment with new locomotives and high capacity wagons for which the process was led by incumbents with new entrants following (e.g. the EWS developed Class 66 locomotive now provides the standard traction of most FOCs).
iii. Introduction of bigger and longer trains, where again the initiative was with incumbents and not new entrants.
iv. Reductions in yard working and intermediate handling of trains.

19. The rail freight evidence is therefore that the role of the incumbent is critical in actual productivity improvements and cost reduction; the key effect of new entrants was to force cost pressures by lowering prices, especially in markets where rail was the price setting mode.

20. The relationship between access aharging and competition is again complex and inherently political. The current freight access charging structure – and the relationship between the freight and passenger access charging regimes – developed over many years and through different Periodic Reviews and DB Schenker would counsel against extrapolating too much from the current VTAC/FTAC/Network Grant arrangements with respect to freight.

    Whilst acknowledging ORR's recognition that the freight access charging regime is different to the passenger regime, DB Schenker is concerned that any proposals to change the charging regime for open access passenger services might set precedents for future freight charging or have negative unintended consequences for freight (eg by any value-auction approach). It is not clear to DB Schenker how any value-auction approach would comply with the need for charges to be transparent and non-discriminatory.

    It is not clear to DB Schenker what the relationship would be between any value auction regime and proposals for scarcity charging.

Financial Impact of competition

21. Consideration of freight post-McNulty and within the Rail Reform process has led to concern that the value that freight historically generated (ie in the 1980s and the early 1990s), and which contributed to the fixed and common costs of the infrastructure, has been lost to the rail industry.

    DB Schenker recognises this view and would agree that the main beneficiaries of the price reductions of the late 1990s were the shareholders of National Power, Power Gen and British Steel and that neither Railtrack/Network Rail nor any FOC saw any lasting value created by this process.

Whether such benefits were passed on to consumers is not something DB Schenker is able to assess.

22. However it does seem to DB Schenker that since privatisation/liberalisation, progressive changes in the Track Access regime (partly due to EU legislation) have alongside the growth in FOC competition, resulted in :

    a. the establishment of a transparent and cost-reflective variable access charging regime that rewards track-friendly equipment.

    b. the historic contribution from sectors "able to pay" being eroded and customers seeing price reductions as a result. In some markets this has resulted in changes to the structural position of rail. It is important to recognise that any desire to change this would require further structural adjustment.

    c. the majority of "fixed" freight costs of the network being funded by Government via Network Grant. This is in fact a regime structurally similar both to the passenger railway, and more importantly, the road freight industry which is rail freight's principal competition.

Conclusion

23. DB Schenker hopes that its observations on;

    a. the experience of the introduction and operation of liberalised, competitive freight and charter passenger markets

    b. the potential for competition to drive cost savings and

    c. the potential financial impact of open access services.

    will help inform ORR's deliberations.

24. DB Schenker's principal concerns are;

    a. The impact of capacity on key routes, which can be mitigated by the prior establishment of Strategic Capacity in the form of standard hour freight opportunities.

    b. The potential for inadvertent negative consequences for freight (both existing business and planned growth) by setting precedents for future freight access charges on congested routes.

    c. Incorrect conclusions being derived from the experiences of on-rail freight competition being used to validate the assumed benefits of on-rail passenger competition.

DB SCHENKER

25. Please contact me if you would like any clarification or amplification of any of the points in this letter; we would, as usual, be happy to discuss this further and have no objection to the contents becoming public..

Yours sincerely

Nigel Jones
Head of Planning & Strategy