DB SCHENKER

By Appointment to
Her Majesty The Queen
Royal Train Operator
English Welsh & Scottish Railway Ltd
Doncaster

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Dear Chinua,

29 November 2013

HS1 LIMITED: FIVE YEAR ASSET MANAGEMENT STATEMENT – A CONSULTATION

This letter constitutes the response of DB Schenker Rail (UK) Limited' ("DB Schenker") to the consultation document entitled "*HS1 Ltd. Five Year Asset Management Statement*" published by HS1 Limited on 18 October 2013 ("5YAMS").

Whilst it is recognised that the consultation document covers a multitude of different issues, DB Schenker's response mainly concentrates on its key concern which relates to the charging framework for freight traffic together with the principles that have been used to derive the proposed freight access charges from the relevant costs.

Introduction

1.1. DB Schenker has been operating overnight freight services on High Speed 1 ("HS1") for around two years now. It remains firmly of the view that the line presents a unique opportunity of a fast link from the Channel Tunnel to London thereby enabling the transit of international rail freight to/from the UK via the Channel Tunnel to be accelerated, consequently helping to attract further modal shift from road to rail. HS1 also presents the UK's only realistic opportunity to accommodate larger gauge traffic to/from Continental Europe which will also further promote the growth of international rail freight through the Channel Tunnel.

1.2. With these advantages in mind, DB Schenker is about to significantly increase the number of overnight freight services on HS1, augmenting its current twice-weekly return service from London to Poland with a four days per week return service from London to Spain. This will increase the number of freight train movements on the line from 4 per week to 16 per week.

Key concern

2.1. In DB Schenker's view, the fundamental issue in ensuring that the regular operation of international rail freight services on HS1 continues to grow relates to the price of access. The fact that the price of access for freight on HS1 is proposed to increase by around 450% (700% if the current discount is taken into account) to £31.05 per train km,

will result in access to HS1 becoming wholly unaffordable. DB Schenker therefore, disagrees with the proposals in this respect.

2.2. To facilitate and encourage the use of HS1 for international conventional freight services during Control Period 1 (1 April 2010 to 31 March 2015), HS1 Limited, with the financial support of the Department of Transport ("DfT"), applied a discount to the access charges for such services operating overnight. This discount resulted in the normal rail freight access charge of £7.13 per train km (subsequently £6.92 per train km) being reduced to £4.00 per train kilometre, thereby offering freight operators a saving of around 42%.

2.3. The rail freight industry warmly welcomed this approach as a positive step by both HS1 Limited and DfT to encourage and support the growth of international conventional rail freight following the adverse commercial pressures resulting from the global recession. Consequently, the establishment of the discount has already played a direct role in enabling the introduction and growth of DB Schenker's international rail freight service between Poland and the UK and, more recently, has facilitated the imminent introduction of new traffic between Spain and the UK indicated earlier in this response. Given that the economics of international conventional rail freight are so fragile it is probable that the majority of these traffics would not have been transported by rail had the discount not been introduced.

2.4. Alongside this positive picture, however, certainty and stability are crucial factors for the continuation and growth of rail freight, particularly in respect of international rail freight services that need to overcome significant obstacles in managing transit across many different railway networks. The current discount on HS1 is due to expire at the end of CP1 (i.e. 31 March 2015) and DB Schenker understands from the consultation document that although HS1 Limited is proposing a reduction in overall freight costs for CP2 (1 April 2015 to 31 March 2020) by around 60%, which is of course welcomed, when translated into access charges this results in a proposed £31.05 per train km. Such a dramatic price rise is completely unaffordable and will effectively eliminate freight services from HS1.

2.5. DB Schenker understands that the primary reason why access charges for freight on HS1 are set to rise substantially, transpires from the way in which HS1 Limited derives its access charges for freight by spreading the entirety of its freight costs (both variable and avoidable) across the forecast traffic. For CP1, higher traffic forecasts coupled with the offer of a freight discount, generated access charges at a low enough level to enable freight services to commence operation on HS1 and subsequently grow. However for CP2, notwithstanding the subsequent decrease in overall freight costs, the revised forecasts and the curtailment of the freight discount has led to the prospect of freight access charges being set at an unaffordable level. It is deeply concerning therefore that all of the effort and funding put in over recent years by HS1 Limited, DB Schenker and DfT will have been in vain if the proposed increases are implemented.

2.6. Despite the rationale behind the structure of HS1 freight access charges as set out in HS1 Limited's companion paper entitled "*Approach to freight costs and charges in*

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PR14", DB Schenker fundamentally disagrees with the way in which the freight charges have been derived from the freight costs.

2.7. DB Schenker strongly believes that the principles of deriving freight access charges for HS1 should mirror the principles that apply to the UK national railway network operated by Network Rail Infrastructure Limited ("the national network"). This is because the relevant legislation set out in the Railways Infrastructure (Access and Management) Regulations 2005 ("the Regulations") which transpose into UK law the provisions of EU Directive 2001/14 (now merged into EU Directive 2012/34) applies equally to both HS1 and the national network.

2.8. Schedule 3 of the Regulations provides the following stipulations:

- *Sub-paragraph 1(4) - The charges for the minimum access package and track access to service facilities referred to in paragraphs 1 and 2 of Schedule 2 shall be set at the cost that is directly incurred as a result of operating the train service.*

- *Sub-paragraph 2(1) - In order to obtain full recovery of the costs incurred the infrastructure manager, with the approval of the Office of Rail Regulation under the access charges review or, in the case of a rail link facility, the Secretary of State through the development agreement, may levy mark-ups on the basis of efficient, transparent and non-discriminatory principles, whilst guaranteeing optimum competitiveness, in particular in respect of international rail freight.*

- *Sub-paragraph 2(2) - The effect of sub-paragraph (1) must not be to exclude the use of infrastructure by market segments which can pay at least the cost that is directly incurred as a result of operating the railway service, plus a rate of return which the market can bear.*

2.9. On the national network, all freight services pay a variable usage charge which conforms to sub-paragraph 1(4) of Schedule 3 of the Regulations. In addition, those freight services which are deemed by ORR to be able to afford a 'mark-up' on top of the variable usage cost (i.e. those services conveying ESI coal, Iron Ore or spent nuclear fuel) pay a contribution to the freight avoidable costs of the national network. This contribution (or 'mark-up'), which is levied by way of a freight only line charge and a freight specific charge, conforms to sub-paragraphs 2(1) and 2(2) of Schedule 3 of the Regulations.

2.10. Given that the freight services operating on HS1 belong to a market segment that ORR has deemed cannot afford to pay a 'mark-up', DB Schenker submits that such services should only be levied the variable element of HS1 Limited's freight access charge (i.e. £3.52 per train kilometre in CP2) and not a charge composed of variable ("OMRCA1") costs and avoidable ("OMRCA2") costs as this is contrary to sub-paragraph 2 of Schedule 3 to the Regulations.

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2.11. DB Schenker understands that HS1 Limited acknowledges that the principles it applies to freight charging on HS1 are different to those that ORR has determined should apply to the national network. This, HS1 Limited believes, reflects the wide range of possible interpretations of the current European regulations and cites recent European Court decisions in support. In this respect, HS1 Limited has stated that the levying of avoidable costs do not constitute a 'mark-up'. DB Schenker strongly disagrees. The European Court decisions relied upon by HS1 Limited (C-512/10 & C-545/10) to support its view appear at best unclear and at worst to have a contrary effect.

2.12. It is abundantly clear, however, from ORR's recent determination in respect of CP5 on the national network that ORR considers that freight avoidable costs do constitute a 'mark-up' and should only be levied on those market segments that can afford to pay them. Therefore, DB Schenker finds it inconceivable that different principles can be considered and applied by different infrastructure managers in the same Member State, particularly when the long standing principles applied to freight access charges on the national network have been determined consistently by ORR over many successive Control Periods.

2.13. DB Schenker also understands that HS1 Limited considers that sub-paragraph 3(1) of the Regulations supports its position. This provision enables infrastructure managers to set, or continue to set, higher charges on the basis of the long-term costs of a specific investment project (in this case the construction of HS1). However, to enable an infrastructure manager to rely on this provision, certain criteria must first be met. These are set out in sub-paragraph 3(2) of Schedule 3 of the Regulations as follows:

(a) the effect of the higher charges must be to increase the efficiency or cost effectiveness of the project; and
(b) the project could not otherwise have been undertaken without the prospect of such higher charges.

2.14. Whilst DB Schenker could understand how the provisions could apply to high-speed passenger train operation on HS1 (hence the levying by HS1 Limited of an infrastructure recovery charge on such services), it submits that the provisions cannot similarly be applicable to conventional rail freight operation on HS1. DB Schenker has seen no evidence to suggest that the construction of HS1 would not have been undertaken if HS1 Limited was not allowed to levy higher charges on the likely small number of conventional freight services operating on the line.

2.15. Notwithstanding the above representations, even if DB Schenker was to accept HS1 Limited's argument (which it does not) that avoidable costs should be levied across all rail freight market segments whether or not they can afford them, it would still have major concerns over the total amount of freight costs (i.e. £600k per annum) and those total costs being allocated across the forecast traffic volumes (i.e. 208 trains per annum).

2.16. Before setting out its detailed concerns in this respect, DB Schenker would again highlight the wording of sub-paragraph 1(4) of Schedule 3 to the Regulations which

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states "……*shall be set at the cost that is directly incurred as a result of operating the train service."* and sub-paragraph 2(2) of Schedule 3 to the Regulations which states "*The effect must not be to exclude the use of infrastructure by market segments which can pay at least the cost that is directly incurred as a result of operating the railway service, "*(emphasis added). The wording in both cases implies that it is the costs that are directly incurred as a result of operating the train/railway service that are key, not the costs of providing capacity and capability for an entire market sector such as rail freight as a whole.

2.17. With this in mind, given the forecast volumes used by HS1 Limited to derive the freight access charge, DB Schenker considers that the total freight costs of around £600k per annum cannot all be incurred as a direct result of operating the train service (i.e. the projected 208 trains per annum).

2.18. Firstly, it is clear that the freight loops (at Singlewell and Lenham) are not required to support a limited service of 208 trains per annum (i.e. 2 trains in each direction per week) which run overnight outside the operation of other services on the route. DB Schenker submits, therefore, that the costs of those freight loops cannot be a cost that is directly incurred as a result of operating the train service. In any case, DB Schenker considers that the freight loops would still be required even if no freight operated on HS1 because they are needed for HS1 Limited's own network infrastructure services.

2.19. Also, DB Schenker considers that the Ripple Lane Exchange Sidings costs should not all be allocated solely to the projected 208 trains per annum. Firstly, two freight trains a week in each direction on HS1 do not require the extensive infrastructure comprised currently in the Ripple Lane Exchange Sidings complex to enable that level of service to operate. Secondly, Ripple Lane Exchange Sidings are also used by domestic freight services operating to/from the Hansons Aggregates and Ford Car Plant facilities in the Ripple Lane/Dagenham area. In fact there are currently more domestic freight services using Ripple Lane Exchange Sidings than there are international freight services arriving via HS1.

2.20. Therefore, DB Schenker submits that the entirety of the costs of Ripple Lane Exchange Sidings should not be allocated to HS1 freight services. In addition, even if there were no domestic services using the facility, DB Schenker considers that the extent of the infrastructure at the facility is far greater than is required to service the 208 trains per annum projected.

2.21. With regard to the total costs of the Ripple Lane Exchange Sidings complex, DB Schenker is concerned that £250k per annum for the operation and maintenance of the facility remains overstated. DB Schenker has employed a maintenance cost calculation tool which has been used to model the cost of other freight-only infrastructure. This modelling resulted in an estimated maintenance cost of around £122k per annum. This, coupled with the fact that there should be minimal operations costs as the facility is signalled from Network Rail's signalling centre at Upminster, and ground operations are

provided by freight operators themselves, suggests that the figure of £250k per annum remains far too high.

2.22. Furthermore, the addition of £100k per annum to the costs of Ripple Lane Exchange Sidings to cover projected future renewals is also far too high in DB Schenker's view. The infrastructure is relatively new, is low speed and is used only for freight. It should, therefore, be expected to last for at least 40 years or so and, therefore, putting by a figure of around £50k per annum would seem much more appropriate to generate sufficient funds to set against future renewals.

2.23. Given the above representations, DB Schenker is firmly of the view that Ripple Lane Exchange Sidings should be transferred to Network Rail and become part of the national network. The infrastructure is not 'high-speed', is used more by domestic freight services than it is by those operating on HS1 and is already operated and maintained by Network Rail in any case. The transfer of ownership of the facility would ensure that such maintenance and operation is subject to the same efficiency targets that Network Rail is expected to achieve for other freight-only infrastructure on the national network.

2.24. DB Schenker also considers that HS1 Limited's freight specific costs (staff, professional fees etc.) are also too high despite HS1 Limited's statement that at £100k per annum they represent a cost level that is the minimum possible and there are considerable risks associated with it. DB Schenker would be interested in understanding what such risks would involve, given that there are only forecast two freight trains per week in each direction. For such a low level of freight traffic, DB Schenker would not expect any dedicated freight staff to be allocated, with any residual duties being encompassed within other roles. For example, in seeking efficiencies in respect of the national network, Network Rail has combined the accounts of some freight operators with those of passenger operators where the level of traffic does not warrant separate account management. For a forecast two trains per week in each direction, DB Schenker believes that HS1 Limited should consider doing the same.

2.25. HS1 Limited prudently highlights the risk that if there are no freight trains operating on HS1 that it would still incur the mothballing costs of keeping Ripple Lane Exchange Sidings and other freight specific loops in a condition sufficient to meet its Concession Agreement obligations. DB Schenker submits that if these mothballing costs (around £200k per annum) will be incurred by HS1 Limited even if no freight traffic operates on HS1, such costs cannot be "*directly incurred as a result of operating the train service*" and, therefore, should be deducted from the costs that are directly incurred, particularly as such costs would constitute fixed common costs ("OMRCB").

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Specific consultation questions

Q1. Are there any gaps in how we have addressed the Concession Agreement requirements for the 5YAMS?

3.1. DB Schenker does not possess sufficient detailed knowledge of HS1 Limited's Concession Agreement to enable it to ascertain whether or not there are any gaps that have not been addressed in the 5YAMS. The requirements set out in Table 5 of the 5YAMS appear to cover the issues DB Schenker would expect to see addressed.

Q2. Do you believe that the NR(HS) asset management plan assumptions are appropriate? Are there any additional assumptions required that have not been captured?

3.2. Whilst the asset plan assumptions used by NR(HS) seem appropriate, it appears to DB Schenker that they have not been applied sufficiently in respect of freight traffic operating on HS1. The forecast traffic volume for freight is a mere 208 trains per annum, yet the avoidable costs still reflect the capacity and capability for a service level far in excess of that amount.

Q3. Can you please confirm that we have properly captured the output requirements for customers?

3.3. The key output requirement for freight is a stable, certain and affordable charging regime together with flexible access to HS1 that will enable freight operators to compete with road transport providers. DB Schenker is pleased with the work HS1 Limited has undertaken to enable freight services to operate on HS1 during CP1. However, DB Schenker is concerned that this will not continue into CP2 as the proposed charging regime will become completely unaffordable thereby leading to the cessation of freight's use of HS1.

Q4. Do you have any comments on the appropriateness of our safety policy and approach in CP2?

3.4. HS1 Limited's safety policy and approach seems appropriate.

Q5. What other factors should we consider in developing our asset maintenance plans?

3.5. Freight specific assets do not require to be maintained and operated at the same standards as those assets required for high-speed passenger operation. Therefore, DB Schenker considers that there should be more appropriate and cost effective asset maintenance policies for freight specific assets.

Q6. Are there any other upgrades that we should be considering for CP2?

3.6. DB Schenker would be interested in understanding whether there are any planned

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upgrades to the freight capability of HS1, for example, facilitating 100km/h operation and enabling greater loads to be transported.

Q7. Do you have any comments on the appropriateness of NR(HS)'s CP2 cost plans?

3.7. DB Schenker is pleased to note that NR(HS)'s risk premium is proposed to be reduced to 5%.

Q8. Please comment on the benchmarking work performed – and its application in the CP2 plans and usefulness in driving efficiency from CP3 onward.

3.8. DB Schenker is disappointed that the benchmarking work does not appear to have taken freight costs into account. Had freight specific assets been benchmarked against comparable infrastructure on other networks, DB Schenker is convinced the proposed costs could have been even lower, particularly in respect of Ripple Lane Exchange Sidings.

Q9. Do you have any comments on the appropriateness of HS1's CP2 cost plans?

3.9. DB Schenker considers that HS1 Limited's freight specific costs (staff, professional fees etc.) are overstated at £100k per annum given that there are only forecast two freight trains per week in each direction. For such a low level of service, DB Schenker would not expect any dedicated freight staff to be allocated, with any residual duties being encompassed within other roles.

Q10. *Do you have any comments on the appropriateness of pass through costs in CP2? Have we properly captured the options to reduce pass through costs in the remainder of CP1 and CP2? Would you consider a rates review within the next 12 months?*

3.10. No comments.

Q11. Please provide comments on the robustness of our freight cost forecasts. Are there any factors that we have not considered?

3.11. DB Schenker has set out its detailed comments on HS1 Limited's freight cost forecasts in paragraphs 2.15 to 2.25 above. However in summary:

- Despite the proposed reduction in overall freight costs from CP1 to CP2, DB Schenker considers that the costs should in fact be much lower given the limited number of projected freight trains per annum. It appears HS1 Limited has maintained full freight capability and capacity and spread the costs of this over the limited number of freight trains forecast (i.e. 208 per annum). In DB Schenker's view, this means that costs are being allocated to services which do not directly require such costs to be incurred.

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- Freight Loops (Singlewell & Lenham) – these assets are not required to support the projected limited service of 208 freight trains per annum (i.e. 2 trains in each direction per week) running overnight. In any case, DB Schenker considers that the freight loops would still be required even if no freight operated on HS1 because they are needed for HS1 Limited's own network infrastructure services.

- Ripple Lane Exchange Sidings – the extent of the infrastructure at this facility is also not required to support the limited number of projected freight trains per annum. The facility is currently used more by domestic freight services than it is for international freight services using HS1. In modelling the costs of Ripple Lane Exchange Sidings, DB Schenker finds the costs to be double what it considers reasonable. The addition of £100k per annum for future renewals also appears overstated. DB Schenker submits that Ripple Lane Exchange Sidings should be transferred to Network Rail to become part of its freight-only network.

- Mothballing costs - HS1 Limited should 'net off' the projected £200k mothballing costs that it would still incur were there to be no freight operating on HS1. DB Schenker understands that such costs would constitute fixed common costs ("OMRCB").

- HS1 Limited's freight specific costs (staff, professional fees etc.) – DB Schenker considers that these costs are overstated at £100k per annum given that there are only forecast two freight trains per week in each direction. For such a low level of service, DB Schenker would not expect any dedicated freight staff to be allocated, with any residual duties being encompassed within other roles.

Q12. Do you support the work we are doing on reducing traction and non-traction power costs? Are there any other opportunities which you believe we should be considering?

3.12. DB Schenker supports the work HS1 Limited is doing on reducing traction and non-traction power costs. In particular, DB Schenker considers that HS1 Limited should focus on assessing transmission losses and seeking to reduce them accordingly.

Q13. Does our CP2 renewals annuity proposal of £16.5m p.a. correctly balance affordability with meeting long term asset renewal obligations?

3.13. No comment.

Q14. Do you agree with the assumptions/cost allocation in the financial model used to generate track access charges? If not, please provide an explanation.

3.14. DB Schenker disagrees with the assumptions/cost allocation in the financial model used to generate track access charges. This is because DB Schenker believes that whilst all freight services on HS1 should pay the variable OMRCA1 costs, only those belonging to market segments deemed to be able to afford a 'mark-up' should contribute towards

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the avoidable OMRCA2 costs. Further explanation of DB Schenker's arguments in this respect can be found in paragraphs 2.4 to 2.14 above.

Q15 Do you believe that an alternative to the CP1 freight supplement is required to support the continuation of freight traffic in CP2? If so, what is the right mechanism for this support?

3.15. For freight to continue to operate on HS1 beyond the end of CP1 it is essential that the level of charges in CP2 is no worse than it is currently. Under the current proposals, however, the level of charges is set to rise by around 450% (700% on current discounted charges). This substantial increase is wholly unaffordable and will result in driving freight services off of HS1. Therefore, something needs to be done to ensure charges for freight on HS1 remain affordable. As explained in paragraphs 2.4 to 2.14 above, DB Schenker strongly believes that the principles of access charging for freight on HS1 should mirror the principles used on the national network (i.e. all freight services should pay the variable OMRCA1 costs with only those belonging to market segments deemed to be able to afford a 'mark-up' should contribute to the avoidable OMRCA2 costs).

Q16. Do you agree with our proposal for each regulatory framework item?

3.16. DB Schenker is satisfied with HS1 Limited's proposals for each regulatory framework item with the exception of the structure of charges as it applies to freight on HS1. DB Schenker's reasons for this are explained in paragraphs 2.4 to 2.14 above.

Q17. Do you believe we have properly and completely identified the key risks?

3.17. DB Schenker believes that HS1 Limited has identified the key risks, particularly the effect the proposals will have on whether or not freight will be able to continue to use HS1.

Q18. Overall do you believe that this 5YAMS plan when delivered is the right balance of affordability and asset stewardship and that it will support a safe, reliable and great customer experience railway?

3.18. Unfortunately, DB Schenker cannot concur with this statement as the 5YAMS plan, when delivered, will make the operation of freight traffic on HS1 unaffordable and consequently, will effectively eliminate freight from the line. It is deeply concerning therefore that all of the effort and funding put in over recent years by HS1 Limited, DB Schenker and DfT will have been in vain if the proposed increases in freight access charges are implemented.

Q19. What are the three most important issues for you within these plans?

3.19. The three most important issues for DB Schenker within these plans are:

- The affordability of the access charging regime for freight.

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- The way in which the charging framework for freight has been structured.
- The interpretation placed on the relevant legislation to justify the proposals in respect of freight charges.

Conclusion

4.1. DB Schenker considers that rail freight on HS1 should be treated the same as rail freight on the national network, particularly in respect of the access charging framework. DB Schenker, therefore, disagrees with the way in which HS1 Limited has in effect totalled its forecast variable and avoidable freight costs and spread them across the forecast traffic volumes. For the reasons and arguments set out in this response, DB Schenker strongly believes that freight should pay the variable costs and contribute to any avoidable costs only where such services belong to a market segment that is considered to be able to afford to pay a further contribution. The freight market segment currently using HS1, however, cannot afford such a contribution.

4.2. DB Schenker submits that HS1 Limited's freight charging structure will lead to the exclusion of use of HS1 by market segments that can pay at least the cost that is directly incurred as a result of operating the service. Such exclusion, in DB Schenker's view, is in contravention of sub-paragraph 2(2) of Schedule 3 of the Regulations. Furthermore, DB Schenker argues that allocating the costs of maintaining HS1 Limited's entire freight capacity and capability (i.e. £600k per annum) across the very limited forecast traffic volumes (i.e. two return freight trains per week) is also in contravention of the Regulations. This is because those two return freight trains per week do not require the provision of the entirety of HS1 Limited's freight capacity and capability which supports the operation of much greater levels of freight traffic volumes.

4.3. Despite the differing views of the parties on the freight charging structure for HS1, DB Schenker hopes that they can continue to work together and with other relevant bodies such as ORR and DfT to find a viable solution to this fundamental issue to the future of freight traffic on HS1.

Yours sincerely,

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Nigel Oatway
Access Manager

cc. Geoff Jones HS1
Paul Stone ORR

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