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Dear Chris

OFFICE OF RAIL REGULATION'S PROPOSED DECISION ON APPLICATIONS FOR THE TRACK ACCESS RIGHTS NECESSARY TO OPERATE ADDITIONAL PASSENGER SERVICES ON THE EAST COAST MAIN LINE – VERSION FOR PUBLICATION

We have now had the opportunity to consider the content of your 'minded to' letter of 27 January. While we are grateful for the short extension you have granted in the time available to comment on your letter, we still believe that ten working days is quite inadequate. However in the time available we have attempted to supply as full a response as possible.

Our comments seek to take account of the Arup report of 27 January 2006 that we did not receive in full until 8 February. In the time available we have been able to undertake an analysis of this report – had we more time we would have undertaken a more comprehensive review.

We have also found that the reasoning in your letter is not as detailed as we would have expected. This has made it more difficult to understand the rationale of your decision. It is regrettable that you were unable to agree to our request for a meeting to clarify many of these issues. We think that other interested parties would also have found such a session useful. The Secretary of State finds that regrettable, having regard to the far reaching consequences of your decision.

We approach this matter from the perspective of being both the franchise letting authority and a major and last resort funder of passenger rail services. In that context we are mindful of the need:

- to bring about year on year improvements in the reliability and punctuality of existing passenger services.
- to obtain optimum value for money from the public resources committed to the railway; and .
- to have an affordable and sustainable railway by operating within the public resources available.

Government recognises the benefits that open access can bring and the benefits of competition both in terms of service provision and fares. However, mindful of the above, it is important that an operator seeking to introduce a new competing service should be able to demonstrate the benefits to passengers and show that the increase in the number of services will also attract sufficient new passengers. Government believes that access rights should not be granted for services that primarily abstract revenue from other operators and do not increase the overall market significantly without compensating economic benefits.

When the SRA wrote to you on 28 June 2005 in connection with Grand Central's proposals, it expressed three concerns

1. the level of abstraction in Grand Central's proposals could have a serious impact on the public purse;
2. the right balance between abstraction and generation did not appear to have been struck; and
3. the operational feasibility of the proposals was open to question and capacity constraints at Doncaster were likely to be exacerbated.

We recognise that a lot of work has gone into refining the proposals since then. However,

- we remain concerned about the level of abstraction and the required amendments to existing access rights in order to accommodate Grand Central's services and the impact this will have on our existing franchises;
- our own analysis suggests that the overall economic impacts of the proposals for Grand Central are negative;
- we believe the decision has implications for future franchise competitions;
- we believe the decision has implications for the long term development of the ECML by constraining the RUS; and
- we are concerned that the decision may not represent the best economic use of capacity on the ECML.

In relation to all these factors, on our analysis, the ability of providers of railway services to plan the future of their businesses with a reasonable degree of assurance and the funds available to the Secretary of State in relation to railways

and railway services are adversely affected. These are of course matters that you are obliged to take into account.

Financial impact

We have provided separate financial and economic analysis to the ORR to support our representation. That analysis is redacted from the published version.

Economic benefits

Our analysis of the economic benefits of the revised proposal (3 Grand Central paths) shows the overall economic impacts to be negative, with an NPV of -£46m over a 10 year appraisal period. The negative result is because Grand Central's revenue is primarily abstractive and the additional user and non-user benefits are insufficient to offset the incremental operating costs of these services. The Arup report found strong positive economic benefits. Our view is that Arup's estimate of user and non-user benefits appear disproportionate in relation to the level of generated revenue and are surprising since such ratios are not usually observed. We have not been able to replicate Arup's results using the same model.

Access Charges

We note ORR's view that its approach to charging for access is compliant with relevant law. Article 7 of Directive 2001/14/EC states that charges for the minimum access package and track access to service facilities is to be set at a cost that is directly incurred as a result of operating the train service. The essential thrust of the Directive is that charging should be fair and non-discriminatory. This is borne out by statements in the Directive such as:

"The charging and capacity allocation schemes should permit equal and non-discriminatory access for all undertakings and attempt as far as possible to meet the needs of all users and traffic types in a fair and non-discriminatory manner" (para 11 of the preamble);

"Charging and capacity allocation schemes should allow for fair competition in the provision of railway services" (para 16 of the preamble);

"It is important to minimise the distortions of competition which may arise, either between railway infrastructures or between transport modes, from significant differences in charging principles" (para 32 of the preamble);

"Any charging scheme will send economic signals to users. It is important that those signals to railway undertakings should be consistent and lead them to make rational decisions" (para 35 of the preamble).

"To prevent discrimination, it shall be ensured that any given infrastructure manager's average and marginal charges for equivalent uses of his

infrastructure are comparable and that comparable services in the same market segment are subject to the same charges” (Article 8(2)).

The principles relating to non-discrimination and comparability as regards average and marginal charges have all been incorporated into UK law through The Railways Infrastructure (Access and Management) Regulations 2005.

While we can understand an approach which is designed to reduce barriers to entering the rail industry thus improving competition, the fact that open access operators do not have to pay a share of the fixed charge seems to us to go against these principles. On the basis of the above we would expect, for example, all long distance operators on ECML to be charged on the same basis, all other things being equal.

We welcome your statement that you are minded to include an access charges re-opener in the track access contracts of both Grand Central and Hull Trains to take account of any changes to the current framework as part of the 2008 review. However that is some way off. We believe the issue should be examined before then.

Statutory duties

We agree that the starting point in terms of your approach towards open access applications is your statutory duty “to promote competition in the provision of railway services for the benefit of users of railway services” (s4(1)(d) of the Railways Act 1993). However, as your decision notes, ORR also has to have regard to its other duties in section 4. These duties do not have an order of priority. Moreover, they may not point in the same direction and may conflict.

It is, of course, for ORR to decide how to balance its statutory duties in reaching a decision. For our part, the duties do not all point in the same direction. You may well agree with this, but you have taken the view that the duty which carries the greatest weight in this case is the duty of promoting competition. The consequence of this is that new open access applicants may expect to benefit from this precedent, and expect their applications to be favourably received even where:

- so far as we are aware, no timetable exists to demonstrate how the new operator’s trains will be accommodated;
- it is necessary to insert 'carve out' provisions in other operators' Access Agreements (flexing of train paths) to ensure the accommodation of the new services;
- independent economic analysis gives only qualified support;
- so far as we are aware, the operating plan depends upon unspecified rolling stock.

It may, of course, be the case that Grand Central's business case does provide the necessary assurances in these respects. We have not had sight of that business case which supports the provision of 3 return services between London and Sunderland but we believe these are matters that you would want to take into account.

In relation to the second bullet point above, we are also concerned at what could be perceived as an inconsistent approach in terms of the willingness to flex paths to facilitate Grand Central's application but not GNER's application for additional services.

The promotion of competition must be for the benefit of users of railway services. We remain to be convinced that there is justification for the promotion of the benefits to Sunderland passengers above those of Leeds when the economic appraisal finds in favour of Leeds, and that this weighs more heavily than the needs of other passengers on the route who may find their trains retimed to accommodate the new services, or performing less well because of them.

Section 4 (1)(a) deals with the protection of the interests of users of railway services. We are surprised to observe the weight you appear to have given the high level of responses from the general public which you have received. While this expression in favour of one proposition is of interest, we do not believe it is necessarily to be regarded as a valid statistical measure of what the population served by the whole East Coast service may want. It is debateable whether, for example, members of the public living in Leeds realised that the granting of additional services to Sunderland would have had an impact on the frequency of services to Leeds. Had they known that, they might well have written to you in large numbers. We would be interested to hear the results of any similar survey conducted by GNER or others.

Section 4 (1)(b) requires promotion of the use of the network. The RUS workstream is designed to assess whether best use is being made of the network, and to recommend, in the event that demand is found to exceed supply, which of the competing traffics should be accorded priority. This decision appears to pre-empt the results of the RUS work by Network Rail. We believe the RUS should have been completed (if necessary by having Network Rail re-prioritise their programme of Studies) before a decision was reached. The granting of rights for ten years means that a commitment will exist that will have to stand, thus creating a potential obstacle to the implementation of the strategy.

Section 4 (1)(g) is designed to enable providers of railway services to plan the future of their businesses with a reasonable degree of assurance. The 'minded to' decision in our view clearly fails this test. In bidding for franchises, bidders must naturally be aware of the potential for competitive new entrants to seek to share their prime markets. Hitherto, they have believed that new access rights will not be granted to competitors

- whose main source of income will come from abstraction from the revenues of franchised operators; and
- whose trains will require the flexing of parallel franchise services.

Henceforth there will be a view, not only among new entrants but also among existing holders of franchises and access agreements, that the future of their businesses is less certain than before. As a result, we can expect to see more caution exercised by bidders, which may be reflected in lower bids, and a potential reduction in premium or an increase in subsidy required.

This makes it difficult to fulfil the requirements of Section 4 (5)(c) because the estimate of the funds available to the Secretary of State will reduce in these circumstances.

We also think ORR's duty "to promote measures designed to facilitate the making by passengers of journeys which involve the use of the services by more than one passenger service operator" is relevant in terms of the impact of flexing on existing operators' services and the connections that they offer into the ECML and other routes.

Our conclusion on the balancing of the various statutory duties is that there are certainly a number of them that point firmly away from granting the Grand Central application, while there are a number of others where the effect is broadly neutral. Whether this is sufficient to outweigh the benefits of competition that you refer to is the key question. However, in looking at this we also think that ORR is allowed to take into account the robustness and deliverability of what Grand Central propose. Our analysis of where the balance lies points away from granting the Grand Central application.

Capacity and performance

We are not satisfied that there is sufficient evidence to support the view that the performance impact will be acceptable, and, since the detail of the paths assumed to be used by Grand Central is not available, we have no information on how you have arrived at this view.

Yours sincerely

Mike Mitchell
Director General of Rail