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13 April 2016

Dear John

### **East Coast Mainline Access Rights: Response to ORR Letter of 24 March 2016**

Thank you for your letter of 24 March. We have set out, as requested, our comments on the annex to your letter and final representations on the applications (see attached Annex). To avoid repetition we have not revisited all of the points and evidence that we have previously submitted and discussed, all of which remain valid and important to consider. Rather we have focused comments around the various sections of the Annex.

It is however, appropriate to summarise context and principle on two specific points:

1. The underlying 'changing franchise circumstances' argument apparently now being formulated at this stage in VTEC's letter of 15 March<sup>1</sup>; and
2. The linkage between that, the various arguments that have been canvassed around potential impact on SoS funds and the NPA test.

Taking each of these in turn:

#### **1. Franchise Position and Open Access Risk**

A positioning argument now seems to be advanced in the concluding paragraphs of VTEC's 15 March letter that:

- VTEC assessed open access risk in its franchise bid (and therefore allowed for this factor in the amount of premium that it committed to pay to the public purse over the franchise term<sup>2</sup>);
- It did so on the basis of a commercial risk judgement that ORR would restrict its approval of any open access applications to very limited circumstances<sup>3</sup> and without any modelling beyond that used for previous applications; and

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<sup>1</sup> Most of the points of detail in the sections 1 to 10 of the letter are addressed by the points in ORR's annex of 24 March. We have commented (in the attachment to this letter) on these specific issues only therefore where a live point remains in addition to the views expressed by ORR and on which comment would add anything new at this stage

<sup>2</sup> Core Term 1 March 2015 to 31 March 2023 and potential for extension of up to 13 reporting periods (into 2024)

<sup>3</sup> "Markets which previously had poor levels of rail service". We note in passing that whilst the underlying assumption is clearly inaccurate it can and does apply to market segments in which air is heavily used rather than rail due to service design/location

- Any decision by ORR that differs from that commercial risk judgement would be wrong.

This approach to assessing open access risk contrasts sharply with the position taken by VTEC on other factors as noted in its letter of 15th March. These risk factors are amongst those that are regularly considered by franchise bidders, the relevant section of the letter is as follows:

*“VTEC Bid Fares Strategy and the response to increased OA in practice:*

*“There was some discussion at the hearing in relation to VTEC's Bid Fares Strategy for the VTEC Full timetable. However the strategy referred to at the hearing was compiled two years ago for a timetable that will not go live for at least another four years. That strategy is now irrelevant as it has been superseded due to:*

- *Fare regulation changes – loss of flex and RPI+ 0% until 2020*
- *Increased airline competition*
- *Significantly lower oil and fuel prices*
- *Different demand levels compared to bid”*

We identified in our letter of 24 February the assumptions that all bidders were obliged by the Department to take into account in relation to the level of service to be provided and in relation to both existing open access and potential future open access. The SoSRA drafting reflected the level of Core provision that was required and that in turn matched the full deployment of the IEP fleet.

The submission made by VTEC is effectively that a franchise bidder should be able to take one view on available capacity in making its bid but then subsequently be able to secure preferential rights over further available capacity (capacity not linked to, reserved by, or subject to any assumptions of its availability in the franchise specification).

That submission is clearly unsustainable<sup>4</sup>, as are the subsidiary arguments that:

- Open access must remain a marginal and/or small scale activity not open to any innovation even where the net consumer/passenger and wider economic benefits of the proposed service are significant;
- Any new service (in ECTL's case using half a path<sup>5</sup> of off-peak capacity only) commencing in May 2021 under two years ahead of the end of the franchise term would somehow cut across assumptions made 7 years earlier in such a way as to be regulatorily and/or legally impermissible;
- The regulator is not able to develop or refine modelling to inform the exercise of its duties; and
- Detailed modelling that has been subject to detailed expert review, scrutiny and independent audit (by an audit team with detailed expert and authorship knowledge of PDFH) should not be used because it is inconsistent with a risk judgement taken by a commercial party.

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<sup>4</sup> Factually and legally, including under the requirements of objective decision-making relating to applications under the RA 1993, Directive 2012/34/EU and the Railways Infrastructure (Access & Management) Regulations 2005

<sup>5</sup> In fact five paths a day in each direction, which is expressed for ease of reference as 0.5 paths per off-peak hour (in reality 1 service every other hour)

We observe that no applicant is contending that the VTEC Core Service should not be granted access rights<sup>6</sup>. That Core Service is the basis of the franchise operationally.

## **2. Relevance to NPA test and Impact on Secretary of State Funds**

We note that paragraphs 86 to 88 of the Annex mention potential consideration of the absolute level of abstraction. We are concerned that this would potentially involve an approach extending beyond the established five stage NPA methodology in the context of looking at potential impact on the Secretary of State's funds as one of the various different factors that must be weighed up under Section 4 duties. We cover this in more detail within the Annex.

### **Next Steps**

We note that the applications will now be submitted to the Board for decision and we look forward to hearing further from you with the decision. Can you please confirm whether you anticipate that the decision will be taken at the April Board and the date of the meeting? Alternatively whether you anticipate that the timing will be different to that?

If you would like to discuss any aspects of this letter and attached Annex in more detail, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Russell Evans', with a long horizontal flourish extending to the right.

Russell Evans  
Policy & Planning Director, FirstGroup Rail Division

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<sup>6</sup> Although existing open access operators have of course identified the impact on competition, their own services

## Schedule – Comments<sup>7</sup> on ORR Annex of 24 March 2016

### **Capacity**

We note the ORR's conclusions on available capacity as set out in paragraphs 1 to 10 of the Annex. These reflect the statements made at the hearing on 4th March and at which there was consensus that there will be additional available capacity of two Long Distance High Speed (LDHS) paths per hour, taking the total to eight and that there is capacity for 2.5 LDHS paths per hour into Edinburgh. We note the ORR's assertion that the incremental capacity will be available following delivery of committed schemes as contained within Network Rail's latest Enhancements Delivery Plan. We also recognise that at the hearing on 4th March Network Rail had no concerns with the ORR's conclusions on capacity.

The Annex suggests that the additional capacity would not be available prior to December 2020 given the required infrastructure and power supply work, which would delay the introduction of any of the applicants' proposed services. The implication of this is that any rights awarded by ORR can only be introduced at the same time, and preferably at a timetable change. This will ensure that no preferential treatment is given to one operator over another (should that be the outcome of the ORR's deliberations) and that the industry can develop an effective and robust timetable. We would also encourage, as was suggested by Hull Trains at the hearing on 4th March, that the ORR includes within any directions guidance to Network Rail on how the Events Steering Group should proceed particularly in respect of existing operators' services.

Paragraph 11 of the Annex discusses the ORR's position with regard to the East Coast Connectivity Fund (ECCF). This was debated at length during the 4th March hearing and we have already provided commentary on this fund in our letter of 23rd February 2016. FirstGroup remains unconvinced that the concerns raised by DfT with respect to this fund are valid. As we have already pointed out, the fund was intended to deliver incremental capacity and that this was relevant to ensure that the franchise specification of six trains per hour could be delivered, amongst other things including improved freight connectivity. As noted at the hearing the "Core" VTEC proposal delivers the franchise specification, which our proposal is based upon, however, as a result of creating the capacity for this level of service the infrastructure works unlock incremental capacity (as outlined in paragraphs 1 to 10). This incremental capacity is available for other users, a factor which was known at the time of the franchise competition for East Coast.

As we note above, the capacity (and associated rights) were explicitly not linked to the franchise specification. The Department obviously has different roles including as a funder of the network and as franchise specifier. On occasions those two roles are exercised alongside each other. On other occasions (including the ECML) they are consciously distinct. To seek to combine them retrospectively would obviously involve re-shaping the boundaries of a franchise specification already in operation; clearly that would not be practicable

The additional capacity, if allocated to a combination of proposals, will generate additional economic benefit, as the CH2M Hill work demonstrates, beyond that which is realised by allocating the capacity to the franchisee alone. In fact the greatest benefit comes from a combination of VTEC Full and ECTL (Option 15). So, whilst there is a consideration for DfT in respect of its role as the franchising authority, in its role as funder of the railway network, this result delivers an overall improved benefit. It therefore does not follow that the allocation of capacity to an open access operator will

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<sup>7</sup> As noted above we have avoided revisiting points and evidence already submitted. ORR has our position on those and we ask that they be taken into account

have a material impact on the Secretary of State funds. As noted above with the VTEC Core (i.e. 6 paths) approved and no SoSRA enacted, the DfT will continue to receive the contracted premium payments.

Finally we also point to the admission by VTEC at section 4 of its letter of 15th March that there are a number of factors that have materially changed since the compilation of their bid. The implication of this is that the final factors to be assimilated into any future franchise beyond 2023 will be materially different from those that it as one bidder, perceived in 2014.

This further reinforces that the shape of the future franchise (and impacts relative to the current franchise specification) will be determined far more significantly by multiple macro-factors than by the potential operation of a small number of off peak services operating from mid-2021.

### ***Performance***

We note and agree with the views set out at paragraphs 12 to 16.

### ***Operational viability and consistency with industry plans***

We note and agree with the views set out at paragraphs 17 and 18.

### ***Demand Modelling and Economic Appraisal***

We have reviewed paragraphs 19 to 83 and also Appendix H to the CH2MHILL report. The report provides a summary of the methodology and results for a new Option 16, which is a variant of our application.

Option 16 is titled “First Edinburgh, faster journey times”, however, it includes a range of different adjustments which include, but extend significantly beyond, journey time. These separate adjustments erode the benefits and reduce the NPA score of our proposal. These include:

1. Our London – Edinburgh services achieving comparable journey times to VTEC’s fast hourly London – Edinburgh service, which we believe is an overly optimistic outcome given the timetable constraints as detailed in our letter of 21 March 2016 (further information on this is also provided below);
2. Changes to the fares modelling so that fares increases are applied prior to crowding calculations. The impact of this is unclear in the analysis and it should be noted that our submission to ORR includes a commitment on fare levels, which we reiterate;
3. A reduced competitive response from VTEC compared to other options that have been assessed. Our view is that there is a range around the scale of the competitive response and the response modelled in Option 15 represents a much more likely outcome due to the competitive nature of the overall transport corridor; and
4. Adjustments to the economic appraisal adding a time dis-benefit to passengers travelling on our services to take account of the fact that our services are forecast to have high load factors. We would question the appropriateness of this adjustment because the CH2MHILL crowding model applies PDFH crowding penalties from PDFH 5.1. Using these factors will overestimate the perception of crowding on busy services. This is due to the ECTL proposition focusing on providing dedicated advanced purchase tickets with a seat reservation (i.e. similar to the low fare airline approach).

These are not factors which have been modelled for other applications and Option 16 does not reflect a likely scenario for our application in reality.

In summary, Option 16 is testing the sensitivity of a number of inputs and making adjustments to the methodology for assessing our application. The impact of each individual change has not been isolated in Appendix H and as such it is not possible to assess the materiality of each change. However, we note the narrative included within the Appendix on the impact of the changes, as follows:

*“Whilst all of the new modelling assumptions affect our projections, the main reasons for this increased estimated revenue abstraction is the faster journey times assigned to First’s services than modelled previously, and the change in approach to modelling VTEC’s fares response.”*

As such, whilst we are not able to determine the impact of each of the changes, it is clear from this that the assumption on journey times is crucial to the results and it is our view, as noted above, that the journey time’s modelled represent an outcome that is highly unlikely in practice.

As discussed at the Stakeholder meeting on 4th March, FirstGroup is content that carrying out the sensitivity test undertaken by CH2M Hill to remove the overtaking of our Edinburgh service (i.e. Option 15) was a reasonable additional variant within the evaluation. Whilst FirstGroup is comfortable with this approach, we do not expect to be able to achieve further improved journey times. Furthermore, as set out in our letter of 21 March 2016, it is not plausible for ECTL services to have journey times that are the same as VTECs. This is due to how the timetable would be constructed to use the capacity allocated, noting the frequency and calling patterns of the relevant services. In particular in the down direction the ECTL service has to follow the VTEC service as without this overtaking would be required. It is also worth reiterating that the original reason for our service being overtaken was because of the structure of the VTEC timetable against which we demonstrated that capacity existed for our proposed five trains per day.

We have also reviewed the .spg files supplied by ORR which were used as part of the evaluation of Option 16, and our view is that the timetables are not operationally viable and have the potential to overstate the achievable journey times of ECTL services (relative to those of VTEC). The main reasons for this are:

- *No consideration has been given to capacity and platforming at major stations*  
A fundamental part of our approach, and a view shared by Network Rail (ECML 2020 Capacity Report), is that the two fast Edinburgh trains can only be accommodated if they are flighted together to optimise the use of capacity. We have always maintained it is reasonable to carry out sensitivity tests with no overtaking, but this should incorporate the relevant flighting of trains. However in the files provided, in the revised down direction, whilst flighted correctly south of Newcastle, the proposed timings are simply not deliverable through Newcastle station due the assumptions made on platforming arrangements. Furthermore on the weekday up direction timetable there is an ECTL and a VTEC train both scheduled to depart Newcastle at 16:07, with the ECTL arriving in London 2 minutes ahead of the VTEC train. Whilst these are detailed points they are critical in determining the actual likely journey times of the relevant services.
- *There is not sufficient time to make the planned call at Morpeth*  
The time allowed between Newcastle and Edinburgh is 1hr 21 minutes, which is one minute less than the VTEC train which runs non-stop. The inclusion of the Morpeth stop increases the journey time to 1 hr 25 minutes.

- *Does not take account of late night variances to account for additional engineering allowance (which is eight minutes north of Newcastle)*
- *Creates a new position where ECTL overtake VTEC services between Edinburgh and London*

It is important to consider that if the exercise is to demonstrate the impact of comparable journey times with no overtaking, the same scenario needs to apply in reverse. The changes applied for Option 15 are representative and credible for the purposes of modelling. However in Option 16 ECTL trains overtake the slower VTEC trains, which is not the intent of the test.

We have considered and developed timetable solutions to these issues. These revised timetables do result in longer journey times. However, in the interests of expediency of the overall process, rather than undertaking further modelling we would be content that the ORR recognises these shortcomings of the modelled journey times in Option 16 and therefore reverts to those within Option 15 as the most realistic scenario.

To confirm, the timetables modelled in Option 16 are overstating the journey times and the level of modelled abstraction. This means that Option 16, at the very least, represents a lower bound for the result of the NPA test in respect of journey times.

We understand the ORR's objective with Option 16 and the desire to test the sensitivity of different aspects of our proposal. However, we believe it would be helpful to understand the incremental impacts of each of these changes so that the extent to which our proposal is being sensitivity tested (and the impact of all of these individual tests) can be made clearer. Certainly we believe it would be helpful for this to be articulated within the detailed report to the ORR Board. We would also question why each of the other options has not received a similar treatment. Given the large changes to journey times and fares being tested in Option 16, our view is that Option 16 represents at least the lowest bound for the NPA test and economic benefits and, notwithstanding our comments that not all factors have been considered in the modelling (see previous correspondence) the actual NPA test and economic benefit results will be closer to that contained in Option 15. Rather than undertake additional modelling, we would therefore be content if ORR acknowledged these issues and recognised that Option 15 is a more representative position in this regard.

CH2MHILL confirm in Appendix H that Option 16 "substantially exceeds ORR's threshold ratio of 0.30". This is strong evidence of the generative potential of our proposals because Option 16 represents, in our view, a lower bound for generation. Further to this Option 15 provides a clear insight into the potential upside of our application in terms of generation and economic benefits.

If Option 16 is in practice seen for the purposes of the assessment as a low probability "worst" case and is used to validate that even this unlikely scenario still passes the NPA test then we can accept that. If, however, it is to be reviewed as a primary application option for decision then clearly fairness would require that:

- the same modelling factors would need to be applied to other applications in further options/sensitivity variants; and also
- the incremental effect of the four separate sensitivity inputs are disaggregated and made visible to the applicants in looking at the effects.

To conclude, we believe it is important that when considering all the evidence that Option 15 is regarded as a much more realistic than Option 16 because it represents,

in our view, a more likely outcome in practice and is modelled on a basis consistent with the other scenarios applied to other applications.

### ***The funds available to the Secretary of State***

The ORR has ECTL's earlier submissions on potential impact and the points mentioned above in relation to the position during the current franchise are of course also relevant. During the current franchise the position is that the premium (and so the Secretary of State's funds) are of course unaffected - as the revenue risk falls to the franchisee and not the Secretary of State. Detailed robustness/stress tests are applied by the Department to all bids against the potential risk factors to ensure that the bid is deliverable and in addition significant bonds and guarantees are taken to ensure delivery and to avoid any impact on public funds.

Further, based on the timings now under discussion any open access provision will arise only for a short period toward the end of the franchise (late 2020 to 2023). Factually and legally therefore no impact on Secretary of State funds can logically arise for consideration during the current franchise whether under the established NPA test or under some additional more subjective test, providing that capacity to deliver the Core Franchise specification of six paths is approved.

In terms of the period beyond 2023, factually of course the network will by that stage be assimilating a very different situation - with HS2 capacity coming on stream in the near future, major devolution and economic re-shaping of the UK economy through regionalisation and major investment well underway, a proposed access charges review in 2017, implementation of the CMA's proposed Option 1 to increase significantly the benefits of on-rail competition together with different (and at this stage unknown) macro-economic and demographic changes over the next seven years. The shape of any future franchise would therefore be assessed at the time. It might seek to continue the current franchise shape and core proposition including the 6 LDHS paths. If that is done then that would be a continuation of the boundaries of the current "franchise asset" and again there would be no impact. In some franchises future capacity generated by particular schemes has been linked to the shape of the franchise parameters - with close linkage of specification between capacity, franchise and investment. On the East Coast franchise this was not done. To seek, in effect, to do that retrospectively would be to perceive an impact that does not/cannot in fact arise either on current facts or in the very different network and wider circumstances that will exist from 2023 onwards.

A combination of the Core (specified) franchise proposition and compatible, innovative open access delivers very significant levels of consumer and economic benefit. In fact the greatest level of benefit is derived with the VTEC Full (i.e. specified franchise plus an additional 0.5 paths) and ECTL service (Options 8 and 15). If it were proposed to overlay a subjective 'total amount' factor above the existing NPA test, the practical effect of this would be that this significant economic and consumer benefit may be lost. This is particularly so if an application that should be granted on the basis of an evaluation of objective net benefits was not approved.

Effectively any outcome of that kind would mean a regulatory view being taken that open access can in practice only be a marginal activity confined to relatively unimportant applications. This obviously would not reflect the wider recognition of the significant benefits of open access nor the aspiration for its role in the sector. That would give rise to significant concerns particularly if the underlying rationale were to be a perceived impact that is not in reality in play.

We are however confident that the detailed work done through this process to establish objective facts and analysis will be the basis of the decisions taken.



### ***Other Issues***

We are aware that existing open access operators are materially impacted by the VTEC proposals, with overtaking prevalent in the proposed timetable. We also note that the ITT for the ICEC Franchise required that bidders ensured there were no adverse impacts on existing open access operators:

“Bidders’ proposed train services must be deliverable alongside the following patterns of services... Open Access – full franchise term: Open Access services should be assumed to operate at current levels, with no significant worsening of journey times or turnaround times that affect the efficiency of stock working.<sup>8</sup>”

As such, and as noted above, we would expect that in any directions issued by ORR in relation to the applications for access rights that advise is given to ensure that a fair approach is adopted by the industry through the proposed Events Steering Group process. This will ensure that any unfair assumptions relating to existing operators are removed.

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<sup>8</sup> Table 5.2 (page 53) of InterCity East Coast Invitation To Tender 21 March 2014