On-rail competition: Consultation on options for change in open access

09 August 2013

Introduction

East Coast operates 155 trains per day along the East Coast Main Line, connecting London with key cities including York, Leeds, Newcastle and Edinburgh. East Coast operates in a highly competitive market, with on-rail competition on the majority of the routes it operates, airline competition at Leeds, Edinburgh and Newcastle and the car alternative with the M1 and A1 along much of the route.

Executive Summary

The UK rail industry is a story of success within the wider travel market competing with airlines, coach travel and the private car. This document is very narrow in its focus on "on-rail" competition without recognising the wider market.

Where Open Access exists, despite its significantly lower cost base, it is only made commercially viable through a high level of abstraction from existing operators. Therefore, we do not believe that the Not Primarily Abstractive (NPA) test is the key obstacle. It merely promotes perverse outcomes such as increased industry costs for limited passenger benefits.

The inappropriately named NPA test itself needs to be revised and we suggest improvements as part of this response.

We firmly believe that all operators should pay access charges, on the same basis, reflecting the costs incurred and relative value of the capacity being sold. East Coast is ready to work with industry colleagues in the RDG regulatory and contractual reform group to achieve this.

East Coast Response

East Coast appreciates the opportunity to respond to this policy area.

This policy review should form part of the wider structure of charges (and incentives) debate. We believe that access to the rail network should incur fair and cost reflective charges for immediate operations and for longer term costs. Where elected representatives pursue social objectives for rail travel (and we fully recognise that rail travel has many positive externalities) that may not support fair cost reflectivity, we seek full transparency, so that the public and passengers are sighted on how their money is spent.

On-rail competition is an important part of the UK rail industry, delivering benefits to passengers. On the East Coast Main Line (ECML), extensive competition exists in a variety of forms. There is competition between franchise passenger operators:

- East Coast and First Capital Connect (FCC) for King's Cross <> Stevenage, Peterborough.
- East Coast and Cross Country for Doncaster, York, Darlington Durham, Newcastle, Alnmouth, Berwick, Dunbar, Edinburgh and beyond
- East Coast, Cross Country and First Transpennine Express (FTPE): York, Darlington, Durham and Newcastle.

There is competition between franchise passenger operators and open access operators:

- East Coast and Hull Trains (since 2000) for King's Cross <> Grantham, Retford, Doncaster and Hull
- East Coast and Grand Central (since 2007) for King's Cross <> Doncaster, York, Northallerton

Whilst your consultation concentrates on on-rail competition, we are also in direct competition with airlines on our key routes:

- London < > Newcastle - British Airways and Flybe,
- London < > Leeds - British Airways
- London < > Edinburgh - British Airways, Virgin Red, Air France and Easy Jet.

In addition, for almost every flow there is competition from private car and coach services. In short, we operate in a very competitive environment, more than any other franchised train operator.

We seek an on-rail competition framework that is straight forward and simple to understand and which gets as close to the principle that each participant should pay an equitable share of costs. This is the best way to influence behaviour and incentivise all industry players. We recognise that charges have the potential to serve the purpose of cost recovery as well as provide signals for the efficient use and allocation of capacity. We welcome competition, so long as it is on an equitable footing.

Under the current arrangements, where Open Access only pays the marginal costs, this incentivises commercial activity that might not otherwise occur and can lead to perverse outcomes – marginally profitable businesses at best abstract the majority of their revenue from profitable businesses. This is not an efficient use of capital. The current arrangements are even more perverse when you consider how scarce capacity is on the ECML. Indeed, capacity is so scarce, that significant investment intervention is required to increase capacity to meet the aspirations of operators. Therefore, a regime where some operators only the variable (marginal) charge, is wholly inappropriate.

We believe that this consultation must really be seen in the context of the wider charging framework rather than being viewed in isolation. We would also be happy to work with other operators and the ORR to develop a new charging framework for the ECML with a simple tariff for every path on the ECML. The tariff would be linked to NR costs to be recovered, and reflect the economic value of the path, with all operators paying the same tariff.

We recognise the ORR's duty to promote competition in the provision of railway services, but this must not become an overriding imperative at the expense of the ORR's 16 other statutory duties such as allowing operators to plan the future of their businesses with a reasonable degree of certainty and the regard it must have to the funds available to the Secretary of State. Whilst we recognise that the ORR has a degree of discretion when weighing up its statutory duties, that discretion is not absolute.

One of the key benefits of the Open Access Operators is the ability to offer lower fares than East coast because they have a lower regulatory cost base – they do not have to pay fixed track access charge or return a premium to the government (these costs represent c35% of our costs). However, the table below illustrates that despite these cost advantages, Open Access Operators only offer comparable fares that are at best 27% cheaper than the intervailable fare and at worst, only 11% cheaper (Grand Central supper off-peak York< > London fare).

Doncaster - London	EC Any Permitted	HT	GC	HT % Any Permitted	GC % Any Permitted
Anytime Return	£ 210.00	£ 154.00		73%	
Off-Peak Return	£ 136.00	£ 114.00	£ 113.00	84%	83%
Super Off-Peak Return	£ 83.20	£ 69.00	£ 66.90	83%	80%
York - London					
Anytime Return	£ 249.00				
Off-Peak Return	£ 154.00		£ 123.60		80%
Super Off-Peak Return	£ 98.00		£ 87.50		89%

Note that the GC off peak fares (£113.00 and £123.60) are actually sold as an 'Anytime' fares, but given that GC do not have any services that arrive into London from York with the 'Anytime' restrictions, the comparison above is with the Off-Peak fare.

Another important principle is the ability of all operators to be able to compete on an equal footing. As such, we also believe that franchised operators should be allowed to compete on walk up ticket prices (franchised lead operators are currently barred from offering dedicated walk up tickets to customers on the day in standard class.)

It is interesting to note that passenger growth over the past 4 years on our Edinburgh < > London market is 39.5%, whilst there is no open access on this route we have successfully competed with air, seeing modal shift in favour of rail. The York < > London market has only grown by 14.6% in the last four years, a market where we compete with open access but not air! Similarly, Doncaster < > London, where we compete with both Hull Trains and Grand Central has only been 11.7% over the past 4 years.

In terms of the Not Primarily Abstractive (NPA) test, given that it actually allows 77% abstraction, we believe the name of this test is highly misleading. Anything that is 51% abstractive can only be described as 'primarily' abstractive – perhaps the test could be renamed the Not Grossly Abstractive (NGA) test?

Q1- Do you agree that we have identified the key barriers to open access competition? Do you consider that the steps we are taking will help to address these barriers or that there are other actions we should be taking? Do you agree that, given the plans for other work outlined above, the remaining barriers imposed by the NPA test are important?

No. The market for rail is derived demand – demand for travel rather than for rail itself. There are several alternatives to rail – air, coach, car, all of which complete on journey time, comfort and price. The argument seems to be that because open access only operates 1% of rail journeys, the NPA test is not working. This statistic is misleading – in the markets that Open Access operate in, they have a much larger market share. Open Access has a 17% market share of the York< >London market and 30% share of the Doncaster < > London market. Open access would actually pass the NPA test on the vast majority of rail routes in the country. Therefore, there is a huge opportunity for Open Access to expand further, without the need to water down this important protection to franchised operators and ultimately the funds available to the Secretary of State. On the basis of our analysis, Open Access is really only a potential benefit for people who live in sizeable locations 2-3 hours from London that don't have a direct service to London but do have a regional hub with good services and significant revenue opportunity where abstraction can be disguised by a change in station used. Realistically these are all around Yorkshire and the North West. There are several options around Manchester – Rochdale, Blackburn etc and Leeds – Barnsley, Huddersfield, Bradford and Halifax. Little interest has been shown in the South West, as beyond Bristol, there are limited options for developing new markets.

Whilst the NPA test provides some protection to these routes, there are many, many other routes that open access could compete on and use their skills at generating new business and serving new markets without the constraints that franchised operators have.

East Coast's regulatory cost base is such that open access operators will be able to undercut East Coast prices by at least 35% as c10% of our costs are fixed track access charges and c25% of our costs are premium payments to DfT, neither of which are payable by open access. The DfT then uses this premium to subsidise other operators operating non profitable routes that would not otherwise run. Every time a new open access service starts up, less money is available to the Secretary of State to reinvest in rail. To put this into context, open access operations on the East Coast has abstracted well over £100m that could have been used to reinvest in rail. Current abstraction is in the region of £25m - £30m pa. Given the limited profitability of Open Access Operators, the current model of allowing significant abstraction subsidises an unprofitable business model that increases industry costs and reduces the funds available to the Secretary of State.

We believe that there needs to be far greater transparency on the abstraction within the industry and would be happy to work with the ORR on developing a reporting framework for franchised operators and open access operators to report on this in a consistent and transparent way.

We believe that it is not the NPA test that is the real barrier to increased open access and that ORR should carry out a separate study to better understand why open access is not pursuing other parts of the network where the NPA test would be easily passed. Perhaps there is not more open access because the franchised operators are already providing a competitive service within the wider travel market?

We also believe that the NPA test should be updated and improved upon. The NPA test currently allows 77% abstraction – we believe this is too generous. It only requires an open access operator to generate 23% of its revenue. However, this is not a requirement for 'pure' generation i.e. new business to rail – it can include passengers switching from one station to another. This is not growing the rail market. We believe the permissible abstraction should be lower, and certainly fall over time. This would give Open Access more of an incentive to grow the new markets.

Another failure of the NPA test is that it is applied on the best information available at the time i.e indicative train paths rather than the actual train path that ends up in the timetable. This is particularly important for decisions relating to proposed services that are on the cusp of passing the NPA test. The actual train path offered by Network Rail may be have an improved journey time and therefore lead to additional revenue abstraction. We therefore believe that it would be better for the test to be re-run when Network Rail finalises the timetable. This re-run would not stop the new service from operating, it would merely be used to assess more accurately the level of abstraction. If the new service failed the NPA test at this stage, the abstraction over and above what is acceptable should not be allowed. This would effectively act as a cap on abstraction, but would allow the service to run, thus achieving the benefits of competition, but at the same time being mindful of the impact on the funds available to the Secretary of State. We believe that the NPA test should be re-run after all subsequent timetable changes and increases in service quantum. We also believe that the test should be run whenever rights are being extended and whenever new rights are being sought – important safeguards that will ensure that open access is really bringing the benefits and growing the market in the way that it says it is. This improvement would be consistent with your statutory duties to consider the funds available to the secretary of state and would help protect long term franchise value.

The NPA test also ensures that a new OAO does indeed serve new markets – without the requirement to generate new business (even if it only needs to encourage existing passengers to switch to a different station), at least there are new journey opportunities created to new destinations. Without the NPA test, there would be no incentive for OAO to extend their existing services beyond York / Doncaster (the key revenue abstraction stations). Therefore the NPA test is an important tool for the ORR to achieve its statutory duty to promote new markets.

Q2 - What implications do you think that industry developments such as ERTMS, electrification and changes in EU law could have for our approach to on-rail competition? Are there other developments that could have an impact on our approach?

These developments should increase the capacity of the network. Whist these developments require significant investment, the beneficiaries of the new capacity should be charged for this on an equitable basis.

It must be questionable whether granting the new capacity to OAO would constitute illegal state aid? At the very least, any OAO benefitting from this investment would be receiving a state subsidy and the ORR needs to be transparent about this.

In terms of other investments such as the £422m investment in CP4 and £240m ring fenced ECML Connectivity Fund – these are significant investments that together, will increase capacity on the ECML. We believe that it would be wholly inappropriate for open access to benefit from this additional capacity on the basis of only paying costs on the marginal (i.e. paying variable track access charges only). This does not reflect the costs incurred of providing that additional capacity. We will return to this point later.

Q3. What are your views on Option 1? If we were to retain the current NPA test and structure of charges for open access what effect do you think changes to the economics of the railway and to capacity would have on the scope for and levels of open access competition? Do any factors other than those listed above favour (or not favour) Option 1?

OAO currently abstracts £25m-£30m revenue from East Coast per annum. It is debatable how much additional revenue has been generated for the reasons raised above. OAO have abstracted well over £100m since the first Hull Trains Service operated in 2000. We believe that the industry needs to be more transparent about revenue abstraction, and more importantly, about the opportunity costs of increased open access. What services would need to be axed if further abstraction was permitted? We believe that the NPA test should remain and be improved in the ways described in Q2 above. As discussed in Q1, we believe that the NPA test in its current form could be passed for the vast majority of routes in the UK.

Q4. What are your views on Option 2? Should the mark-up be calculated on the basis of 100% of excess abstraction? Do any factors other than those listed above favour (or not favour) Option 2? What do you think of the feasibility of building a commercial case based on policy as described here? What changes/guarantees/mitigations would be needed to make this work?

In terms of Option 2, we fundamentally disagree with the principle that you have two bites at the cherry i.e. if you fail the NPA test, you can still operate as long as you pay some of the difference by way of a mark-up. If the service doesn't pass the NPA test, by its nature, the service is primarily abstractive.

In terms of the mark up, we agree that any mark-up would have to reflect the costs and revenue abstracted, albeit for the entire service, not just the revenue abstracted beyond that permitted by the NPA test. Our rationale for this is because our Fixed Track Access charges only represent approximately 10% of our cost base, whereas the premium we return to government represents c25% of our costs. Simply just paying the Fixed Costs element would result in a disproportionate profit for the OAO at the expense of the public purse.

We would also question the rationale of paying the mark up to NR – NR, faced by two competing applications for capacity could end up being incentivised to sell capacity to the OAO because they will receive the VTAC plus mark up whilst the franchised operator would only pay the VTAC. NR should not be incentivised to allocate scare capacity in this way. There would have to be back to back arrangements with the funders to ensure NR did not profit by this regime.

We also note that open access creates uncertainty for bidders (which resulting in lower premium bids to DfT). We would therefore recommend that additional Open Access on a route should constitute a Franchise Change within Franchise Agreements. Whilst this would increase costs to DfT, these costs could then be directly covered by the suggested mark up paid by OAOs.

Q5. What are your views on Option 3? What do you think of the feasibility of building a commercial case based on policy as described here? Are there any key practical or other issues that we have missed?

Option 3 is even worse than option 2 as the mark up would only cover the fixed costs. Given the split in premium (paid to DfT to reinvest in rail) and fixed costs (25% v 10%) – this option would allow an OAO on the ECML to make an inflated profit as the OAO would abstract the equivalent of the premium and fixed costs, but only pay a small mark up covering the fixed costs. This would be at the expense of the UK taxpayer.

In addition, you stated in paragraph 3.39 (d) that this method would provide some benefit to those parties who lose out as a result of abstraction above the level permitted by the NPA test. Please could you explain the benefits to East Coast of this approach as we can't see any?

It's also worth noting that due to the way Network Rail is funded (the net revenue requirement is 76% funded by the network grant) FTAC is not a true representation of NR's fixed costs. We believe that the Network Grant should be abolished, with fixed costs borne by all those who use the network. This is a matter for the Charges Review for CP6.

Other comments:

In terms of Option 3, we believe a simple look up table could be created (like your simple example on p33) with a rate based on total FTAC / total train miles, to give OAO more certainty on the likely mark up.

We agree with the principle that if the NPA test is failed (so the new service is primarily abstractive) the mark-up should be calculated on the basis of the entire service, not just that part of abstraction above the test level. This principle is a very good one and should be mirrored in Option 2 also. In addition, if the NPA test is failed when subsequently applied (such as the extension of access rights or granting of new access rights), the mark-up should be calculated on the basis of the entire service.

In terms of Option 3B, the so called 'open access specific charge' – the calculation of mark ups based on charges that better reflect the costs caused by open access operation i.e. to pay the charges that cover their share of all open access avoidable costs. We believe that this principle should be extended to investment in additional capacity. The ECML is capacity constrained. The Government, through the HLOS, is investing £662m (£422m in CP4 and £240m in CP5) on the ECML to increase capacity and create a 7th Long Distance High Speed path per hour. The beneficiaries of those paths should pay the costs incurred for creating the capacity. We believe that there needs to be a fundamental review of access charges and costs should be incurred by the user. It would be wholly inappropriate to allocate these paths to open access operators on the basis of paying only the variable charges. It could be argued that once the franchised operator requires additional capacity, it is no longer appropriate to charge open access on the basis of marginal costs – the charges should reflect the investment costs as the investment would not be necessary if the OAO did not exist. So the true cost of Open Access must also include all avoidable costs i.e. the cost of increasing capacity.

Q6 Do you agree that the process described would be appropriate under Options 2 and 3? If not, what changes would you make and why?

Overall the process appears reasonable. As mentioned above, if the new service fails the NPA test, the mark up should apply to the entire service (not just the element of the abstraction above the permitted level). However, as mentioned above, we believe that the NPA test should be applied more frequently – we suggest every timetable change with the results published, giving the entire industry transparency how it is working. If, due to timetable improvements, abstraction grows beyond the allowable levels, a mark up should be charged to the OAO to cover the unauthorised level of abstraction. Regular re-running of the NPA test, will help you determine whether your test is actually fit for purpose. A subsequent failure of the NPA test would not be used to stop an established OAO's service, it would simply identify whether it is still appropriate for the service to operate on its current basis i.e. would a mark up now be appropriate. This test should be on going. As detailed in the consultation, given the experience is that after a few years, OAO becomes more generative, this should not be an issue of OAO.

Given the safeguard to OAO – that once its application is successful, the mark up can be accurately calculated and then OAO would have the opportunity to 'take or leave' the proposed mark up. This safeguard would also remove most of the risk to OAO in Option 2 (mark up based on actual revenue abstraction).

Q7. Do you agree with the approach to estimating mark-ups, particularly the use of generation and abstraction forecasts to decide whether mark-ups should be applied and, in the case of Option 2, the size of the mark-up? Should OAOs be able to appeal the mark-up in the light of subsequent data?

Setting of initial mark ups – some comments:

Option 2 – where the NPA test has failed, the mark up should be based on the entire revenue abstraction, not just the element over above the permissible revenue abstraction.

Option 3A – this should also be the case is the Network Grant was abolished so that the FTAC was a true reflection of NR's costs.

Option 3B – this should include the costs of investment in new capacity.

If generation is less than was forecast and abstraction much higher than forecast, put bluntly, the service should not be operating. This risk should be borne by the OAO. The OAO will then be incentivised to generate new rail revenue from the new markets it serves, rather than rely on abstraction. This, in our view, is how the system should work. If the mark up is 'too high' for an OAO, it will know what this is before it actually operates the service and therefore will be able to make an assessment of the risks to its business case. We therefore do not see why a subsequent appeal for the mark up would be necessary.

Q8. Do you agree that no mechanism should be introduced to address Network Rail's additional revenue through mark-ups? If not, what mechanism should be used?

Given that the franchised TOC (and therefore DfT) suffers the revenue abstraction, it seems absurd that NR should benefit from this. The money should go to DfT or through an annual wash up if initially collected by NR. NR must not be incentivised to sell capacity to OAO rather than franchised operator. An annual wash up (between NR and DfT) would be easy to implement.

Q9 Do you consider that, under any of the options considered in this document, the profile of mark-up payments should be tailored so as to address concerns over the ability of open access operators to pay in the early years of new services?

Depends if you allow a two tier system to operate (NPA and mark up) – if this is allowed, I would argue that a substantial discount already exists in that 77% of revenue is allowed to be abstracted. We believe that the allowable abstraction should fall over subsequent years as the OAO grows the new markets. It would act as an incentive to grow the new markets. The NPA test should be applied at every timetable change and reduce say 5% year on year. We are happy to work with the industry to develop an equitable model.

Q10 Does the review of mark-ups at periodic reviews cause problems for OAOs' planning of their operations?

No comment.

Enquiries

Please address any enquiries to:

Phil Dawson, Regulation & Track Access Manager
East Coast Main Line Company Limited
East Coast House
25 Skeldergate
York, YO1 6DH

E: phil.dawson@eastcoast.co.uk