



OFFICE *of the*
RAIL REGULATOR

**NEW SERVICE OPPORTUNITIES
FOR PASSENGERS –
CRITERIA FOR EVALUATION
A CONSULTATION DOCUMENT**

Contents

Regulator's foreword	1
Summary of issues for consultation	3
Next Steps	5
Responses	7
1. Background to Consultation	9
2. Current Competition Criteria	11
Experience from Stage I.....	11
3. Proposed Criteria for Stage II Period	13
Introduction.....	13
OPRAF Planning Criteria	13
Criteria to be used	14
Role of the parties in submitting applications	18
Prevention of detriments to passengers.....	19
4. Allocation of Track Capacity	21
Introduction.....	21
Flexibility in use of capacity.....	21
The need for a balanced timetable	21
Allocating capacity on the 'full' network	22
5. Charging for Additional Rights	27
Introduction.....	27
Current charging criteria	27
Problems of the current system.....	28
Access charge to new entrant.....	29
6. Timing and process for receiving applications	31
Annex A : Letter to train operators of 21 February 1997	33
Developing new services to promote the use of the network	33
Criteria	33
Information requirements.....	34
Consultation.....	34
Keeping criteria and procedures under review	34

New service opportunities for passengers – Criteria for evaluation
A consultation document

Regulator's foreword

1. In March of this year, I indicated that my plans to encourage the development of new service opportunities for passengers under Stage II of my policy on Moderation of Competition, originally established in 1994, would go ahead as planned. From the September 1999 timetable, there will be significantly fewer restrictions on the introduction of new passenger services, thereby allowing train operators to develop new and innovative services. It may also mean more competition between operators, where this can be shown to be in the interests of passengers.
2. When I consulted¹ on the initiation of Stage II last October, consultees were especially concerned that the opening up of the network be effectively regulated. Consultees confirmed the importance of avoiding the potentially destructive elements of competition. It is essential, therefore, that this development takes place with appropriate safeguards that recognise the special nature of the market and the public interest in securing an integrated railway in which services supported by taxpayers are not undermined and network benefits are protected. This document represents my proposed approach to achieving this objective.
3. My policy towards the limited new services allowed under Stage I of Moderation of Competition was outlined in the 1994 policy statement² and restated in February 1997. I have now had some experience of how that policy has worked. In the light of that experience, I believe that this policy needs to be developed further. I propose that new service proposals submitted for my approval under the access provisions of the Railways Act 1993 should be evaluated using criteria that will be similar to OPRAF's Planning Criteria. In addition to the competition aspects of new service proposals, the criteria needs to address charging and capacity issues as the relaxation of the current constraints on new services has practical implications for both of these.
4. I hope that train operators will strive to promote new services which provide real benefits for passengers. I believe the approach proposed in this document represents a credible way of evaluating new services and one which provides safeguards for both passengers and the taxpayer. But I will want to consider responses carefully to ensure

¹ *New Service Opportunities for Passengers: A Consultation Document on the Development of the Competitive Framework for Passenger Rail Services*, Office of the Rail Regulator, October 1997

² *Competition for Railway Passenger Services*, Office of the Rail Regulator, 1994

that these objectives are delivered when new services are allowed to operate. I look forward to constructive responses to this consultation.

JOHN SWIFT QC

Rail Regulator

June 1998

Summary of issues for consultation

1. The key questions for the Regulator, as outlined in this document are:
 - Whether a framework which tries to consider as many of the relevant costs and benefits of a service and which draws on the OPRAF Planning Criteria for some of those variables is appropriate in evaluating new services (para 3.6).
 - How best to incorporate estimates of passenger benefits not captured through the farebox (para 3.14).
 - Which wider economic benefits should be included in the evaluation and how should they be estimated (para 3.15).
 - Whether it is sensible to reflect possible impacts on future franchise value (para 3.18).
 - Whether a discount rate of 6% is appropriate (para 3.19).
 - Whether proponents of new services should use their own assumptions in detailing the costs and benefits of the service or whether it would be more appropriate if the Regulator gave guidance (para 3.25).
 - Whether there is anything further the Regulator should be doing to avoid approval of access rights which are likely to be used in an anti-competitive manner or which could lead to an erosion of network benefits (para 3.28).
 - Whether the Regulator should continue to adhere to his current policy on allocation of capacity for the duration of Stage II (para 4.10).
 - Whether there are other changes that could be made to the charging framework before 2001 which would reduce transaction costs and aid the negotiating process (para 5.7).
 - What approach should be adopted in determining the access charge for open access operators (para 5.9).
 - Whether the processes outlined in Chapter 6 are appropriate for the evaluation of new services.

New service opportunities for passengers – Criteria for evaluation
A consultation document

Next Steps

1. The overall programme for the implementation of the procedures identified in the document is currently expected to be as follows:
 - 8th July - Seminar to which all train operators, Railtrack, funding bodies and RUCCs are invited.
 - 5th August - Deadline for responses to this consultation.
 - September 1998 - Publication of policy document to this consultation (timed to coincide with the issue of Stage II notices).
 - October 1998 - Operators provide initial details of new services to be run in September 1999.
 - December 1998 - Submission of access agreements or amendments to access agreements for new services to be introduced as part of the Winter timetable in September 1999.
 - September 1999 - New services begin operating as part of the Winter 1999 timetable.

New service opportunities for passengers – Criteria for evaluation
A consultation document

Responses

1. The Regulator seeks written responses to the questions raised in this document. He also intends to explore the issues raised at a seminar proposed for next month.
2. Responses to this consultation should be received at the address shown below by 5 pm on **Wednesday 22 July 1998**:

Michael Riordan
Office of the Rail Regulator
1 Waterhouse Square
138-142 Holborn
London
EC1N 2ST
Fax: (0171) 282 2046
E-mail: erg.orr@gtnet.gov.uk

3. It is our intention to place copies of all comments received in the ORR library. Submissions made in confidence will be accepted, but should be clearly marked as such. Where a submission is made in confidence, it should be accompanied by a statement to be placed in the ORR library that a confidential submission has been made, giving the reasons why the submission was made in confidence, and summarising that submission excluding the confidential information.
4. Additional copies of this document are available, free of charge, on request from the ORR library

Telephone (0171) 282 2001
Fax:(0171) 282 2045
E-mail orr@dial.pipex.com

or by writing to the Librarian at the above address.

New service opportunities for passengers – Criteria for evaluation
A consultation document

1. Background to Consultation

- 1.1 When the Regulator consulted on the initiation of Stage II, four key questions were asked:
- (a) which features of the railway industry need to be taken into account to decide whether relaxation of the constraints on competition will achieve overall benefits to passengers and taxpayers;
 - (b) what are the opportunities for new services and passenger benefits;
 - (c) to what extent should the train operators take the initiative in identifying opportunities for new services; and
 - (d) what are the main disbenefits for passengers and franchisees and what further controls are needed.
- 1.2 Following receipt of responses, and after conducting a programme of research, the Regulator decided that Stage II should proceed as planned but with adequate safeguards to protect passengers and taxpayers. A policy document was published in March outlining the arrangements for Stage II. Operators will, from the Winter 1999 timetable, be subject to competition on up to 20% of their nominated flows as measured by revenue. Train operators have until 30 June 1998 to submit their nominations to the Regulator. After a process of consultation, the Stage II notices will be published towards the end of September 1998.
- 1.3 A number of responses to the October consultation suggested that individual new service proposals should be evaluated on a case by case basis using criteria similar to OPRAF's planning criteria. In his March policy statement the Regulator welcomed this proposal.
- 1.4 When an operator wishes to run a competing service it will have to negotiate an access agreement with Railtrack. This agreement will have to be approved by the Regulator for it to be valid. This means that the Regulator has the opportunity to withhold his approval from new services which he believes are not in the public interest. The Regulator will be monitoring closely the development of competition to see that the interests of passengers and the taxpayer are protected.

New service opportunities for passengers – Criteria for evaluation
A consultation document

2. *Current Competition Criteria*

2.1 The new railway industry operates under a framework of negotiated contracts. The Railways Act 1993 requires that, with limited exceptions, all track access contracts, or any amendments, must be approved by the Regulator. The Regulator examines all such contracts to see that they are in the public interest. In deciding whether to approve these contracts the Regulator considers three main issues: capacity, charging and competition. These are dealt with in chapters 3-5. This chapter outlines the current approach.

Experience from Stage I

2.2 Stage I has substantially constrained the opportunities for the development of new services. However, the Regulator has had to consider some applications for new rights for services which compete with incumbents. His criteria for dealing with these services were outlined in the 1994 policy document³.

'The Regulator will necessarily have to consider all such applications by operators and proposals by the Franchising Director on their merits and on a case by case basis. The Regulator will take into account, in considering whether to approve access rights, the nature of the market being served and whether the effect of new entry would be primarily to abstract revenue from the incumbent operator, or whether it would potentially create new markets. He will not be sympathetic to proposals for new access rights which are primarily abstractive'.

2.3 In other words, if a high percentage of the revenue of a new service was abstracted from an incumbent operator and the amount of that revenue was significant, the service would not be approved unless there were passengers benefits which outweighed the abstraction effects.

2.4 These criteria reflected concerns about the potential consequences for the viability of the existing services and the passenger disbenefits arising if they were undermined. The Regulator was concerned, as he was when the franchises were sold, that incumbent operators should be able to plan their businesses with a reasonable degree of certainty. The level of abstraction of an incumbent's revenue provides an indication

³ *Competition for Railway Passenger Services*, Office of the Rail Regulator, 1994

of the extent to which the viability of an incumbent's service would be affected. Where the incumbent could show that the competitive new entry associated with the proposed access rights would undermine the viability of the existing services, then the Regulator would be minded to conclude that such access rights should not be approved.

- 2.5 This policy was clarified in a letter⁴ to the Managing Directors of all passenger train operators. This letter set out the criteria and procedures the Regulator proposed to adopt in evaluating new services where his approval is sought for new access rights which are not protected from competitive entry. This letter stated that

"provided the operator seeking new access rights can demonstrate that there is a reasonable expectation of additional passenger benefits, and the Regulator considers that the impact on existing services is not sufficiently great that the overall outcome is likely to be to the detriment of rail passengers, the Regulator would normally expect to approve those rights".

- 2.6 The Regulator restated this policy in the context of existing franchisees when detailing his objectives for passenger train and station operators⁵. He said that he generally welcomes proposals for new access rights and that such proposals are a signal of industry growth and development of passenger benefits which he believes everyone in the railway industry should be striving to promote. The Regulator has said that he

"expects to see operators using their access rights, or seeking modifications, to develop new services which benefit passengers".

- 2.7 The overall impact on passengers and the taxpayer will be the overriding test by which applications for new rights will be judged by the Regulator. The Regulator intends to continue using this overall objective. The framework and criteria by which he does that are proposed to be different from those under Stage I and are detailed in the next chapter.

⁴ *Developing new services to promote the use of the network*, Office of the Rail Regulator, 21 February 1997. This letter is reproduced at Annex A

⁵ *Regulatory Objectives for Passenger Train and Station Operators*, Office of the Rail Regulator, June 1997

3. Proposed Criteria for Stage II Period

Introduction

3.1 The previous chapter outlined the Regulator's current criteria for evaluating the competition aspects of new services not ruled out under Stage I of MoC. The Regulator now believes it is appropriate to develop those criteria, in order to ensure that the opportunities for new services presented by Stage II do not result in the erosion of network benefits or unjustified increases in costs to the taxpayer.

OPRAF Planning Criteria

3.2 Following a consultation with the industry, OPRAF published a document⁶ in which it outlined how it proposed to prioritise its fixed budget in terms of supporting loss making services. The framework encompassed an evaluation of the relevant costs and benefits of individual projects. The OPRAF document aims to quantify in financial terms as many of the costs and benefits associated with the new service proposal as possible. It looks at influences which are not only 'financial' but 'social'.

3.3 The Regulator welcomes the proposal made during the October consultation that individual new service proposals should be evaluated using criteria similar to OPRAF's own planning criteria. He believes that the use of such criteria would contribute towards achieving an effective evaluation of the impact of individual new service proposals, particularly when combined with a consultation process which allowed him to take account of the views of other parties such as local authorities whose overall transport objectives may be affected.

3.4 The wide scope of transport policy objectives requires an appraisal framework capable of dealing with many influences. The Regulator believes that a new rail service, which has the potential to compete with the existing service, is likely to affect both the market for rail services and it may also affect the overall market for transport. Therefore, he believes that he should take a wide-ranging approach to the evaluation of new service proposals. This will include not only all costs and benefits of the service, but also any longer term effects upon overall access charges and franchise value.

⁶ *Assessment of Passenger Rail Services, Planning Criteria: An Interim Guide*, OPRAF (1997). At some future date some or all of OPRAF's functions may be transferred to a Rail Authority

- 3.5 Every application for track access rights for new services will be dealt with on its merits. The Regulator proposes to conduct an assessment of the costs and benefits of new services considering primarily the same variables as are considered by the OPRAF planning criteria when he receives applications for the associated track access rights. This assessment will form the basis of the Regulator's conclusions regarding the balance of passenger and taxpayer interests. He will pay particular attention to the impact upon the Franchising Director's budget.
- 3.6 The Regulator also proposes to take account of any changes to the OPRAF planning criteria.

The Regulator seeks views on whether this methodology which tries to consider as many of the relevant costs and benefits of a service and which draws on the OPRAF planning criteria for some of those variables is appropriate in evaluating new competitive services.

Criteria to be used

- 3.7 Section 6 of the OPRAF planning criteria (pp.17-26) deals with the variables it proposes to include in an appraisal. This list below draws heavily on that section to detail the Regulator's proposed criteria:
- Railtrack costs;
 - Operator costs;
 - Passenger benefits captured through the farebox - revenue generated and abstracted;
 - Passenger benefits not captured through the farebox;
 - Wider economic benefits not captured through the farebox;
 - Change to value of the franchise.

Railtrack costs

- 3.8 It is likely that in accommodating a new service Railtrack will incur additional avoidable costs. The Regulator would expect to consider them to be costs for the purpose of the evaluation. It will be for Railtrack at the time of submission to provide the Regulator with appropriate evidence of its additional costs.

Operator costs

- 3.9 The operator of the new service, whether it be an existing franchisee or an open access operator, will incur additional costs in running the service. The Regulator expects to incorporate these avoidable costs in the evaluation.
- 3.10 The Regulator believes that benefits to passengers are likely to be the most important gains from any new services. Passengers' benefits can be measured by the value placed on service changes. Part of this value is reflected in the fare they pay and is captured in revenue through the farebox. However, there are likely to be some benefits that are not wholly captured through the farebox. Both types of benefit are dealt with below.

Passenger benefits captured through the farebox - revenue generated and abstracted

- 3.11 The Regulator believes it is likely that total revenue from the new service could reasonably approximate the farebox passenger benefits. Given the nature of the service it will inevitably contain an element of abstracted revenue. The impact of this abstracted revenue on the Franchising Directors budget will also have to be considered.
- 3.12 Abstracted revenue represents (in the event of no offsetting cost savings) a reduction in profit to the incumbent franchisee. At the time of refranchising, a loss of profit that can not be offset by cost reduction or competitive strategy would, other things being equal, be reflected in a higher subsidy bid by franchise bidders and inevitably an increase in subsidy paid by the taxpayer.
- 3.13 The above assumes that abstracted revenue will only impact on the Franchising Director's budget at the time of refranchising. In some circumstances the level of abstraction may be such that it impacts on the Franchising Directors budget before the end of the existing franchise. This may be in the form of the incumbent seeking to renegotiate the franchise. The possibility of this happening will also have to be taken into account when considering the new service and it is a question where the Regulator will be seeking the views of the Franchising Director.

Passenger benefits not captured through the farebox

- 3.14 As stated above the Regulator believes that the farebox may not adequately capture the entirety of passenger benefits. When evaluating the passenger benefits not captured through the farebox the Regulator believes that there are three categories of passenger whose welfare could be affected. Those are:

passengers who, before the existence of the new service, did not travel

The benefits to the above passengers are likely to be captured through the farebox. However, there may also be some additional consumer surplus accruing to those passengers which is not captured in the farebox.

passengers abstracted from other modes of travel

With regard to passengers abstracted from other modes of travel, it is likely that some of their welfare change will be captured through the farebox. Other welfare changes on the whole will not, i.e. time savings or losses from switching to rail, increased consumer surplus from switching modes.

passengers abstracted from incumbents

Changes to welfare for passengers abstracted from other operators is likely to be a function of a number of factors. Some of these passenger benefits will be captured in the farebox. The others will be a function of the list below:

- (a) changes to journey times
- (b) removal of interchanges
- (c) changes to frequency and restrictions associated with travel
- (d) changes to consumer surplus arising from different fares
- (e) changes to flexibility of fares
- (f) comfort factors, e.g. rolling stock quality, security, catering facilities.

The Regulator invites views as to how the above factors should be quantified to produce an estimate of passenger benefits not captured through the farebox.

Wider economic benefits not captured through the farebox

3.15 The Regulator believes that an overall analysis should include the broader economic benefits. This could be better environmental welfare and reduction in pollution from less cars on the roads. It could also include the benefit to road users from having other car users switching to rail.

The Regulator invites views on which of these wider economic benefits he should include in the assessment and how this could best be done.

Changes in franchise value

- 3.16 As stated above, competitive new services will inevitably contain some revenue abstraction and some revenue generation. In the case of a new service which generates net revenue, it remains possible for that service to be incorporated by bidders into a franchise bid at the time of franchise renewal. In other words, the Franchising Director may receive an improved bid⁷ because the bidder is able to offer this extra service as part of the package. This would generally be expected to be for a franchise other than the one from which the revenue is abstracted⁸.
- 3.17 However, in deciding whether to include such a value the Regulator, taking appropriate advice from the Franchising Director, would need to make an assumption regarding the likelihood of the service being included in a franchise bid. Such an assumption is likely to be a function of who operates it, i.e. franchisee or open access operator, how long the track access rights have been granted for⁹, when various franchises come up for renewal and other factors. Whilst the Regulator accepts that such an approach includes a degree of risk, due to the difficulties in estimating this change in franchise value, he believes that the alternative approach of ignoring it is likely to lead to an over-estimation of the detrimental impacts on franchise value as a whole.
- 3.18 The Regulator also believes that it could be extremely difficult to come to a reliable estimate for this change to franchise value because it is largely a function of the perceptions of prospective bidders.

The Regulator invites views on whether it is sensible to include this factor in the analysis. He also invites views on how this factor could best be estimated.

Discount rate and relevant time period

- 3.19 When comparing costs and benefits over time two other factors must be considered, the discount rate and the relevant time period. The Regulator is currently minded to

⁷ i.e. the bidder may request a lower subsidy from or pay a higher premium to the Franchising Director

⁸ As stated in para 3.12, a loss of profit to a franchise through revenue abstraction which cannot be recovered or offset by cost reduction would, other things being equal, be reflected in a higher subsidy bid by franchise bidders at the time of franchising and therefore result in a loss of franchise value

⁹ It is not known at this stage the duration of rights that open access operators will seek. However, in deciding on the duration to be approved the Regulator will have regard to the length of the relevant franchise

use a real discount rate of 6 per cent¹⁰. This is also the rate used by OPRAF¹¹. It may be necessary to use a variety of time periods to get a full picture of the effect of the new service, particularly where the analysis needs to reflect the effect on the value of franchises of varying length.

The Regulator invites views as to whether 6 per cent is appropriate. He would also welcome views on the most appropriate appraisal period.

Role of the parties in submitting applications

- 3.20 If the methodology outlined above is adopted, the Regulator will expect the parties to supply information on the variables mentioned above. This section considers the practicality of supplying information on the above variables.
- 3.21 The Regulator will expect Railtrack to supply information on its incremental costs. The Regulator will expect the operator to supply the necessary information to make a case for the new service. Firstly, information on revenue accruing to the service should be estimated. Where revenue is expected to be abstracted from other operators' services this should be made explicit (OPRAF, 1997 p.24). There two types of abstraction:
- abstraction through the working of ORCATS; and
 - abstraction through passengers switching to dedicated fares.
- 3.22 The operator should estimate how much abstraction will occur through ORCATS and how much will accrue through passengers switching to dedicated fares. He should also supply that forecast in terms of passenger numbers. The Regulator would expect to study any analysis provided by the operator closely and, possibly, to carry out his own analysis. Operators would have the option to provide independent analysis.
- 3.23 In making a revenue forecast the operator may elect to use industry models like MOIRA or carry out more disaggregated analysis using the assumptions contained in the Passenger Demand Forecasting Handbook (PDFH). The Regulator appreciates that not all operators will have access to these sources of information and, indeed,

¹⁰ This figure is drawn from Treasury Guidance "*Appraisal and Evaluation in Central Government*", 1997

¹¹ "For expenditure falling on its budget, OPRAF will adopt the normal real rate of discount, deemed to reflect society's opportunity cost of marginal expenditure. The discount rate is currently 6 per cent", (OPRAF, 1997: p.15)

they may not be suitable given the circumstances of the operation. For example, the PDFH does not handle large reductions in fares well. In those circumstances other means of revenue forecasting may be appropriate.

- 3.24 The operator should also attempt to quantify the passenger benefits not captured through the farebox and the wider economic benefits. The Regulator will have regard to the analysis provided in determining inputs to the evaluation.
- 3.25 Operators will need to explain and justify the assumptions they make when providing information. The Regulator is considering whether to provide guidance on revenue forecasting or on methods of estimating other variables.

The Regulator seeks views on the general question as to whether proposers should use their own assumptions or whether it would be more appropriate for the Regulator to provide guidance on how some of the variables detailed above (particularly wider economic benefits) should be estimated.

Prevention of detriments to passengers

3.26 There are a number of other issues which, whilst they would not form part of the evaluation, relate to the ability of train operators to use access rights anti-competitively. In particular, the Regulator would not expect to approve access rights where he had reason to believe that the train operator planned to use the rights in a way which would be likely to result in any of the following:

- Predatory pricing;
- Strategic acquisition of access rights;
- Predatory timetabling;
- Loss of through-journey opportunities;
- Loss of walk-on/interavailable tickets.

3.27 Guidance on the abuse of a dominant position is currently being developed by the Office of Fair Trading (OFT) and industry regulators under the terms of the Competition Bill 1998. The Regulator may, if he believes it to be appropriate, and following consultation, issue specific railway guidance.

3.28 The Regulator is concerned to ensure that network benefits are not undermined. When reviewing new service proposals he will take particular account of the obligations

placed upon the train operator by licence conditions, membership of industry-wide agreements¹², any relevant franchise agreement or Conditions of Carriage, to ensure that network benefits are not undermined.

The Regulator seeks views as to whether there is anything else he should be doing to avoid approval of access rights which are likely to be used in an anti-competitive manner or which could lead to an erosion of network benefits.

¹² In particular the Ticketing and Settlement Agreement

4. Allocation of Track Capacity

Introduction

- 4.1 This chapter outlines the Regulator's current policy on the allocation of track capacity, which he proposes to apply to requests for new rights under Stage II. With regard to questions over the allocation of track capacity, the Regulator will apply the tests which are set out in his policy statement¹³.
- 4.2 This section identifies the issues other than those relating to competition and charging which are likely to be of greatest significance to the Regulator in deciding the terms (if any) on which it will be appropriate to approve new track access rights.

Flexibility in use of capacity

- 4.3 The Regulator is concerned that capacity should be allocated in accordance with the public interest as expressed in section 4 of the Railways Act 1993. In regulating track access agreements he has used his powers to ensure that the availability of capacity for operators to provide services to passengers is not artificially limited by operators' contractual rights. In particular, this has meant limiting the extent to which the timetabling of services is specified in access agreements. Timetables are determined through established industry processes, into which public interest criteria are factored through the Decision Criteria with rights of appeal to the Access Disputes Resolution Committee and ultimately to the Regulator. Given that on certain key sections of the network the number of additional services which can be introduced at current levels of capacity is limited, the Regulator intends to maintain his emphasis on the flexible use of capacity.

The need for a balanced time table

- 4.4 The Regulator's policy on timetabling is set out in his recent policy statement¹⁴. The Regulator would expect that where an operator introduces new services on a flow already served by another operator, the overall timetable should reflect the requirement of passengers for a balanced and integrated service on the route. Track

¹³ *Criteria for the Approval of Passenger Track Access Agreements*, Second Edition, Office of the Rail Regulator, March 1995

¹⁴ *The Timetabling of the Railtrack Network: A Policy Statement*, Office of the Rail Regulator, June 1998

access agreements and the timetabling process should be geared to this objective. They should not be used by operators as sources of competitive advantage. The Regulator would not generally expect to approve access agreements which contained rights in respect of timetabling which gave an imbalanced timetable¹⁵.

- 4.5 In some circumstances it may be appropriate for provisions in access agreements to guarantee a balance of services around the clockface. But such provisions would inevitably impose some limitation on the flexible use of capacity, and might have implications for other passenger or freight services. A balanced timetable should, therefore, normally arise through the timetabling process. The Regulator has made clear his expectation that passenger train operators should work together and with Railtrack to develop the railway as a seamless national network¹⁶. He expects operators to approach the timetabling process in a spirit of openness and co-operation, and not with a view to game-playing. He would also expect Railtrack to use the Decision Criteria to distribute services sensibly across the clockface. In considering any appeal against an outcome of the Decision Criteria, the Regulator would expect to look favourably on a decision by Railtrack, all other things being equal, to flex one or more bids in order to ensure that 'where the demand of passengers to travel between two points is evenly spread over a given period, the overall pattern of rail services should be similarly spread over that period'¹⁷, even if the bids in question were in capacity terms capable of being met without flexing.

Allocating capacity on the 'full' network

- 4.6 Railtrack is obliged under the terms of its Network Licence to enhance and develop the network so as to meet the reasonable requirements of its customers. On sections of the network where spare capacity is becoming scarce and exceeded by predicted demand, the Regulator expects Railtrack to be developing proposals, in discussion with all relevant interests, to enhance capacity. In the short-run, however, circumstances may arise where immediate demand for capacity outstrips supply.
- 4.7 It is for Railtrack to determine whether it has capacity available to satisfy an operator's request for access rights, having regard to its existing obligations to

¹⁵ If an incumbent operator has rights to run a service departing at xx:00 and xx:30, the Regulator would not expect to approve an access agreement which gave a second operator rights to run at xx:59 and xx:29

¹⁶ *Regulatory Objectives for Passenger Train and Station Operators*, Office of the Rail Regulator, June 1997

¹⁷ *Railtrack Track Access Conditions*, Condition D4(g)

operators. The Regulator is entitled to assume that when Railtrack presents proposed new access rights for his approval, Railtrack is satisfied that it is able to discharge the obligations it proposes to incur. Operators who are dissatisfied with a determination by Railtrack that capacity is not available for services they propose to run may wish to consider whether they can make an application under section 17 of the Railways Act 1993 for the Regulator to direct Railtrack to grant them access.

- 4.8 Where there are competing demands for scarce capacity, not all of which can be satisfied in the relevant time-scale, it is in the first place for Railtrack to take a view on what the most appropriate use of capacity is, having regard to the stewardship obligations in its Network Licence. In some cases this may involve negotiating modifications to possible agreements, so that they become consistent with each other. In others, it may require that choices should be made between alternative proposals. The Railtrack account planning process will be important in identifying customer needs. The Regulator would expect that Railtrack would deal with all customers in a transparent manner, complying with its licence obligations in respect of non-discrimination. Early and clear information about capacity availability should be provided to customers.
- 4.9 Also, where there are competing claims on scarce capacity, the Regulator is likely to have a role through his approval of access agreements. Where Railtrack proposes to make capacity available to operator A rather than operator B, it will be open to operator B to register objections in the formal consultation on the proposal which Railtrack is required to undertake and report on to the Regulator. The Regulator may also decide to hold his own formal consultation, as well as examining the results of the one carried out by Railtrack. The Regulator would not expect to be asked to simultaneously examine incompatible proposed new track access agreements.
- 4.10 In considering proposed new access rights in these circumstances, the Regulator would have regard to the balance of his duties under section 4 of the Railways Act 1993. In particular, he would expect the following considerations, which are consistent both with his statutory duties and with policy statements he has made, to be relevant:
- clearly, it is reasonable for Railtrack to consider its commercial position in deciding to whom and on what terms it should grant access to the network. However, the Regulator will decline to approve track access charges which are inconsistent with his published criteria on charging (as outlined in chapter 5). The scarcity of capacity should not itself be a reason for Railtrack to earn high

shares of benefit from additional services. However, other things being equal, commitments to enhancement investment can justify a high share of benefit¹⁸. Any commitments which Railtrack makes in this respect should be capable of being enforced under Condition 7 of its Network Licence. It may be appropriate for access agreements to contain provisions which reinforce the link between charges and future investment, perhaps by providing for refund of charges if the proposed investment used to justify charging levels does not take place;

- the Regulator would not generally expect to approve agreements which specified the use of scarce capacity for long periods of time. If agreements included levels of access charges to finance a step change in investment a relatively long-term approval might be appropriate. But in such circumstances the Regulator would wish to assure himself that the interests of all users of the network were properly catered for in the proposed investment;
- in making any assessment of the relative benefits of different proposed new passenger services the Regulator will take advice from the Franchising Director about possible implications of the different proposals on his budget. He will also seek the Franchising Director's views about the passenger benefits associated with the different proposals. Given the duties and expertise of the Franchising Director he would expect to attach due weight to these views. The Regulator will also pay close attention to the views of PTEs and other local authority funders of rail services;
- in general, the Regulator would expect to be more sympathetic to services which were genuinely new than to ones which merely duplicated existing services (unless there was evidence that an existing market was significantly underserved). It is likely that a service which catered for an underserved market would have significant passenger benefits;
- the Regulator will bear in mind the needs of rail freight operators who, if they are to compete with road haulage, require assurances that capacity will be available to them at short notice. The Regulator notes the concern that creeping increases in the level of passenger services may restrict opportunities for rail

¹⁸ This represents the Regulator's current policy on investment. As stated in para 5.5 the Regulator is, at present, carrying out a review of the present structure of charges with a view to possibly implementing a more cost reflective structure with effect from 2001. This review is expected to deal with wider questions of charging for enhancement investment

freight to grow. In his recent policy document on timetabling (see para 4.4), the Regulator has encouraged Railtrack to take a more proactive stance in relation to the application of decision criteria to support the allocation of capacity for freight services where there is a reasonable likelihood that this capacity would be utilised during the currency of the timetable in question and where that is consistent with sharing the capacity of the network in the most efficient and economical manner. The Regulator expects to consult freight operators on proposed new services under Stage II.

The Regulator seeks views as to whether he should continue to adhere to the above policy for the duration of Stage II or whether there are any reasons for departing from it.

New service opportunities for passengers – Criteria for evaluation
A consultation document

5. *Charging for Additional Rights*

Introduction

5.1 As stated before, the Regulator considers three main issues when deciding whether to approve track access agreements: competition, charging and capacity. This chapter deals with charging considerations. At the moment, when train operators want rights to run additional services they enter into negotiations with Railtrack for a supplementary access agreement and agree a price to be paid for the additional slots. That price is examined by the Regulator to ensure that Railtrack is not abusing its dominant position and taking an inappropriate share of the benefit generated by the service, or discriminating unduly between different users of the network.

Current charging criteria

5.2 The Regulator currently applies the following criteria (Relevant Criteria on Charging for the Purpose of Part 9 of Schedule 7 of Franchised Passenger Track Access Agreements, Office of the Rail Regulator, 23 July 1997.) in evaluating additional track access charges:

- the charge must be equal to or greater than a reasonable estimate of the avoidable cost (of Railtrack) likely to be incurred in granting the additional access;
- the charge should reflect an appropriate share of the net benefit accruing through these additional rights;
- the appropriate share of benefit will in part reflect the risk assumed by the parties and the overall level and source of the benefit (where the majority of risk is borne by the train operator, the appropriate share of benefits for Railtrack will be low and in some cases may be zero);
- the charge should not unduly discriminate between the train operator and other franchised train operators or open access operators or between different types of access, e.g. a charter operated by on behalf of a promoter for a particular sporting event and a train operator operating additional trains for a one off sporting event.

- 5.3 The net benefit is defined as the revenue accruing to the service (abstracted or generated) less both Railtrack and operator costs. Where the train operator is bearing all or the majority of the risk the appropriate share of benefits for Railtrack will generally be low and may be zero. Where risks are shared by, for example, making the access charge dependant on the revenue or the profit (revenue minus Railtrack and operator costs) of the services, Railtrack can expect a higher share of benefit.

Problems of the current system

- 5.4 The present system of negotiated charges was put in place at the time of the first periodic review in 1995 as a means of introducing greater variability into Railtrack's access charges. The Regulator now has some experience to draw on. He has said (The Periodic Review of Railtrack's Access Charges: A Proposed Framework and Key Issues. A Consultation Document, Office of the Rail Regulator, December 1997.) that he has become concerned that the advantages of this negotiated framework have been outweighed by the disadvantages. Some of the problems of the current negotiated system are outlined below:

- transaction costs of negotiation for both parties tend to be relatively high for some small contracts;
- Railtrack has superior information on its costs, and the train operator has superior information on its costs and the likely revenue generated from the service. There is perceived reluctance on the part of Railtrack to share the details of its additional costs. There is similar reluctance on the part of some train operators to reveal their expected costs and revenues. This reluctance to share information has led, in some cases, to high prices some of which the Regulator has had to reduce;
- there is uncertainty as to the level of some of Railtrack's avoidable costs. In particular, Railtrack has acknowledged difficulty in estimating the performance cost of putting additional trains on a congested area of the network and has been working on improved methods for estimating these costs. Railtrack is attempting to introduce the most sophisticated of these methods - the MERIT model - around the network. The Regulator has urged Railtrack to share with operators the methodology by which performance costs are calculated so that the operator can have the opportunity to bring its judgment to bear on their estimation; and

- there are other difficulties arising out of the present system which are unrelated to Railtrack's costs. As explained above, Railtrack is entitled to a share of the net benefit of the services commensurate with the level of risk it takes. This 'benefit' is a function of the revenue generated from the service and is, at times, the subject of disagreement between the parties. This has led to uncertainty over what charge is acceptable.
- 5.5 The Regulator is, at present, carrying out a review of the present structure of charges with a view to possibly implementing a more cost reflective structure with effect from 2001. However, this will not affect the access agreements the Regulator expects to receive up to that date.
- 5.6 The difficulties with the current system has led the Regulator to consider if there are any improvements to the charging mechanism that could be introduced before 2001. With this in mind he has recently written to Railtrack asking it to prepare a Code of Practice for the negotiation of new access rights and consult its customers on it. The Regulator believes an agreed Code of Practice would go some way to smoothing out some of the difficulties encountered in the negotiating process. The Regulator has also encouraged Railtrack to be open about its costs with operators. As mentioned above, Railtrack has begun to do this by talking to operators about ways of measuring performance costs.
- 5.7 The Regulator believes that the current system, while imperfect, has the advantage of being well established. The industry also has the reassurance that the above problems are being addressed as part of the structure of charges review. Notwithstanding this, the Regulator is prepared to consider any workable suggestions which make the negotiating framework more effective in the interim before the periodic review conclusions are implemented.

The Regulator seeks views as to whether there are any other changes that could be made to the charging framework before 2001 which would reduce transaction costs and aid the negotiating process.

Access charge to new entrant

- 5.8 Under the above criteria franchisees running additional services pay Railtrack the avoidable cost of access plus a share of benefit. The question remains as to what an open access operator should pay. When the track access charges for franchised passenger services were set in 1995, an assumption was made about the likely level of open access income Railtrack would earn in the period 1995-2001. That figure

assumed that open access operators would not gain access to the track at short run avoidable cost but would also make a contribution to Railtrack's common costs.

- 5.9 Ensuring that open access operators do not gain access to Railtrack's network at short run avoidable cost could be achieved by taking account of the risk facing Railtrack when allowing competitive services on to the network. According to the Regulator's current guidance on access charges (outlined above in para 5.2), Railtrack is entitled to a share of the benefit of the service commensurate with the level of risk it takes. Where a new service abstracts revenue from an incumbent franchisee, there is a risk to Railtrack that the incumbent could, at some future date, seek to reduce its overall payment to Railtrack. This risk could be reviewed on a case by case basis, and if considered significant could be reflected in a higher share of benefit for Railtrack for open access services.

The Regulator seeks views as to whether the above approach is appropriate in determining the access charge the new entrant should pay. He also welcomes any other suggestions for determining the entrants access charge.

6. Timing and process for receiving applications

- 6.1 The first timetable in which new competitive services can be run will be the Winter timetable 1999. The Regulator expects access agreements for new services to be submitted before the end of 1998. In addition, the Regulator expects proposals to be submitted for informal guidance as early as possible after September 1998.
- 6.2 The Regulator expects to consult widely on applications for new services. He would expect to consult other affected passenger operators and passenger representatives as well as local authorities. Relevant freight operators will also be consulted. The Regulator will pay particular attention to the representations of the incumbent operator and of the Franchising Director and other funders. In some circumstances the Regulator will consider holding formal hearings with the industry.
- 6.3 The parties should submit relevant information to support their case as described in Chapter 3 when submitting their access agreement. The Regulator will use the information given to assess the costs and benefits of the new service and he may find it necessary to ask questions of the parties and seek copies of any independent analysis which has been carried out for the parties. The Regulator will expect to share this information with all affected parties, unless the provider indicates that it is commercially confidential. The Regulator will need to consider whether or not to attach the same weight to evidence that is submitted as 'commercially confidential' as compared to evidence which is open to general scrutiny.

The Regulator seeks views on whether the above processes are appropriate for the evaluation of new services, and in particular the issues concerning commercial confidentiality.

New service opportunities for passengers – Criteria for evaluation
A consultation document

Annex A : Letter to train operators of 21 February 1997

To Train Operator Managing Directors

Developing new services to promote the use of the network

1. One of the Regulator's statutory duties is to promote competition in the provision of railway services. He has said, in his policy statement on competition (Competition for railway passenger services, December 1994), that he remains convinced that there are substantial benefits to both train operators and passengers to be realised from an increase in competition. However, as you know, the Regulator decided that he should moderate competition in core markets to facilitate franchising. In some cases, this protection was subject to conditions allowing other named operators to seek to obtain new access rights as well as the incumbent operator. There are no contractual restrictions on Railtrack agreeing to provide access on other flows, although the Regulator indicated in his policy statement that he 'will not be sympathetic to bids for new access rights that are primarily abstractive'.
2. This letter sets out the criteria and procedures the Regulator proposes to adopt in evaluating competition issues where his approval is sought for new access rights which are not protected from competitive entry, or where protection is conditional.

Criteria

3. In line with the duties placed on him in section 4 of the Railways Act, the Regulator welcomes new competitive services which bring benefits to passengers. These benefits might come through improved frequencies, lower fares or new journey opportunities resulting from the introduction of through services or provision of improved connections. The Regulator will look to the operator seeking approval for new rights to explain the passenger benefits that are likely to result.
4. The Regulator recognises that the development of greater competition will involve a balance between the interests of the new entrant and of the incumbent operator. Where a new service might have a material adverse impact on existing services, the Regulator will, therefore, give the incumbent the opportunity to make representations to him. If an incumbent operator argues that the financial impact on its own services is sufficiently great to threaten their viability and risk their withdrawal, and that the

overall impact will be to the detriment of passengers, the Regulator will also seek the views of the Franchising Director (and PTE where relevant).

5. Provided the operator seeking new access rights can demonstrate that there is a reasonable expectation of additional passenger benefits, and the Regulator considers that the impact on existing services is not sufficiently great that the overall outcome is likely to be to the detriment of rail passengers, the Regulator would normally expect to approve those rights, subject to them also satisfying other existing criteria. (These are set out in Criteria for the approval of passenger track access agreements, second edition, March 1995.)

Information requirements

6. To effect this policy approach, the Regulator will look to operators proposing new rights to set out the expected passenger benefits when an access agreement (or modification to an existing agreement) is submitted for approval. The information provided should include an assessment of the expected financial implications of the new service, including abstraction from existing services. The basis of this analysis (in particular, the extent to which it is based on elasticities contained within the Passenger Demand Forecasting Handbook) should be stated. The information will extend that already sought in the context of the proposed access charges, as set out in my letter to TOC Managing Directors of 9 January.

Consultation

7. In order to understand the implications of new competitive services for existing operators, the Regulator will as explained above generally consult other affected operators and funding authorities before reaching a decision on whether to approve new or modified access rights. The operator seeking these rights should therefore indicate what part (if any) of the analysis provided in support of the proposal is confidential. If the Regulator believes that the proposal raises concerns which cannot be dealt with satisfactorily without disclosure of information regarded by the operator as confidential, he will discuss this with the operator. Where an incumbent operator argues that the new service could prejudice the viability of existing services, the operator proposing new rights will be given an opportunity to respond to the evidence put forward.

Keeping criteria and procedures under review

8. The approach set out in this letter, which has been discussed with OPRAF, is intended to assist train operators in planning for new services during Stage I of Moderation of

Competition. The Regulator recognises that in any particular case a factor may be relevant which is either not reflected in the criteria or is not given appropriate weight. While the Regulator expects this to happen only on rare occasions, he will be willing to consider taking that factor into account in an appropriate manner where it does. However, before doing so, where a materially different outcome would result, he would expect to consult those affected.

9. Comments on the approach set out in this letter would be welcome. The Regulator recognises that the criteria and procedures may need to evolve, and revised guidance issued, in the light of experience.
10. If you have any queries about the contents of this letter, or the information to be provided in specific cases, please contact Phil Smith (Manager, Competition Policy, 0171 282 2026).