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**OFFICE OF RAIL AND ROAD**

12 May 2016

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Dear applicants and Network Rail,

### **Applications for access to the East Coast Main Line (ECML)**

1. We have carefully considered the applications for track access contracts with Network Rail Infrastructure Limited (Network Rail) made by East Coast Main Line Company Limited (Virgin Trains East Coast, VTEC), East Coast Trains Limited (FirstGroup) and Great North Eastern Railway Company Limited (GNER). These were originally submitted to us under section 17 of the Railways Act 1993 (the Act) between February 2014 and March 2015.

2. We have approved the applications made by VTEC and FirstGroup to run new services between London and Edinburgh, Harrogate, Lincoln and Middlesbrough, though some access rights will have to start later than the applicants requested due to the timing of necessary enhancements. We have rejected the GNER applications. This letter explains the reasons for our decision.

3. We will now work up with the parties the detailed access contracts that we will direct Network Rail to enter into. In the FirstGroup contract we will include some additional requirements to help ensure FirstGroup makes steady progress as it develops its services and secures rolling stock, and to reduce the risk its contract unnecessarily locks up capacity.



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4. Our decisions clear the way for Network Rail to coordinate the normal industry processes of timetable development and performance modelling for the ECML. We expect the industry to work collaboratively to mitigate any performance risks identified.

## Background

5. The applications considered were:

- (i) From the franchisee VTEC to increase its services to make use of new IEP (Intercity Express Programme) rolling stock. The application would add more trains to Edinburgh through the day<sup>1</sup>, existing services would be extended to Harrogate and Lincoln in alternating hours and a new 2-hourly Middlesbrough service would be added;
- (ii) From GNER for a fast new hourly Edinburgh service, calling at Newcastle and occasionally Stevenage, and using new tilting Pendolino trains;
- (iii) From GNER for 7 return trains/day between London and Bradford/Ilkley and 4 return trains/day between London and Cleethorpes (via Doncaster), using new Hitachi bi-mode trains; and
- (iv) From FirstGroup for 5 off-peak return services a day between London and Edinburgh calling variously at Stevenage, Newcastle and Morpeth, using new trains comparable to IEP rolling stock.

## ORR's role and approach

6. Under the Act we have an approval function in relation to track access contracts between Network Rail and train operators and amendments to them. If Network Rail and a train operator cannot agree the terms of a contract, the train operator can apply to ORR to issue directions requiring Network Rail to enter into a contract as determined by ORR under section 17 of the Act. These applications were all made under section 17.

7. We must decide track access applications in accordance with our duties as set out in section 4 of the Act and take the decision we consider is best calculated to result in the right balance of those duties. The weight we place on each duty is a matter for us depending on the circumstances of each case. Where the duties conflict we balance them against each other to help us reach a decision.

8. Although our duties are wide ranging, our experience generally is that a subset tend to be especially relevant to access decisions with the others not pointing strongly one way or the other. In this case we considered all our duties; these were the most relevant:

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<sup>1</sup> VTEC is already temporarily extending some existing London-Newcastle services to Edinburgh.

- promote improvements in railway service performance<sup>2</sup>;
- protect the interests of users of railway services;
- promote the use of the network for passengers and goods;
- promote competition for the benefit of rail users;
- have regard to the funds available to the Secretary of State for certain purposes and his guidance; and
- enable operators to plan the future of their businesses with a reasonable degree of assurance.

9. Taking our published guidance and the features of these applications into account, we focused on these inter-related issues:

- (a) The available **capacity** and **performance** implications of new services;
- (b) The **costs and benefits** of the alternative uses of capacity, given there will be insufficient capacity to accommodate all the applications (see below); and
- (c) The **financial impacts** of the applications (including on existing open access operators, the franchisee VTEC and the Secretary of State).

10. Our criteria and procedures<sup>3</sup> state:

“We would not expect to approve competing services that would be primarily abstractive of an incumbent’s revenue without providing compensating economic benefits. To enable us to consider whether the proposed rights are primarily abstractive in nature we have established a five-stage test which we would apply when:

- (a) A new open access service would compete with franchised services and so impact on the public sector funder’s budget;
- (b) ...
- (c) A new open access or franchised service would compete with an existing open access service, where that new service could force the existing open access operator to withdraw from the market and reduce overall competition on the network.”

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<sup>2</sup> Defined as reliability, avoidance or mitigation of overcrowding and journey times being as short as possible.

<sup>3</sup> Paragraph 4.43.

11. We have a long-standing policy of not approving new open access services that we consider are “primarily abstractive” of an incumbent’s revenue (**the NPA test**). In practice this means we will not normally approve new services that do not generate at least 30p of new revenue for every £1 abstracted from incumbents.

12. The NPA test result gives us some insight into the likely balance of the costs and benefits of a proposal and an indication of the relative financial impacts. But the test does not cover everything we must consider. In particular, it does not look at the absolute financial impacts; we looked at these separately when assessing these applications.

13. We have modelled the NPA ratios of all the applications. In light of representations received from an open access operator, we have additionally considered the extent to which VTEC’s application might force an incumbent open access operator to withdraw its services to any significant extent and reduce overall competition on the network.

### **Industry consultation and engagement with applicants**

14. In advance of submitting the applications to ORR, and in line with our criteria and procedures, industry and statutory consultations were carried out for each of the applications. Several train operators and other stakeholders responded to these. The responses and further correspondence relating to them can be found on [our website](#).

15. The concerns raised by consultees for each application through these consultations generally related to the availability of capacity, the effect on performance and the impact on the funds available to the Secretary of State.

16. In addition to industry and statutory consultations, when reviewing applications we may hold discussions with the parties, seeking and clarifying the information we need to make our decision. In this case we have engaged fully, holding multiple bilateral meetings with the applicants, Network Rail and DfT, and we have kept other key stakeholders informed through meetings, letters, emails and our website. We held three industry hearings on 12 June 2015, 14 October 2015 and 4 March 2016. Full transcripts of these hearings can be found on [our website](#), as can other key documents including Network Rail’s analysis of capacity choices on the route.

17. In the hearings we discussed and explained our emerging conclusions on the capacity position on the ECML, performance risks and the economic modelling we commissioned from consultants CH2M which included the NPA test. We gave applicants opportunities to challenge the results and provide additional information in support of their applications, and we adjusted aspects of the modelling in response to some of the points made. Following our last hearing on 4 March, we wrote to all the parties on 24 March, available [here](#), to summarise our position on the points raised by stakeholders and the analysis undertaken. We invited final submissions by 13 April.

18. A specific issue arose towards the end of our process in respect of a request from an applicant to see the CH2M model. We refused this request because the model contained confidential, commercial information relating to various train operators.

This confidential material was integral to the model and attempting to remove it in order to share the model with an applicant would have rendered the model meaningless. Instead, we consider our extensive engagement provided a more practical means for applicants to test the functioning of the model, which in any event formed only one part of the evidence we considered. The applicant who requested to see the model suggested we share it with that applicant's economic consultants under a confidentiality agreement. We did not see that there was sufficient incremental benefit in doing so, given the audit already carried out by Systra and the cost and time that this would have involved.

19. In reaching our decision we considered carefully all the material provided by the applicants and others including passenger and freight train operators on the route, Transport Focus, MPs, private individuals, local groups and the Secretary of State.

### **Capacity, performance and other issues affecting every application**

#### *Capacity*

20. We set out our view of the ECML capacity position in paragraphs 1-11 of our 24 March letter to the industry. Network Rail agreed with our analysis.

21. Using rounded capacity figures, there are currently 6 Long Distance High Speed (LDHS) off-peak paths/hour in use out of London Kings Cross, with an additional path available now in some hours. Given Network Rail's current plans for various infrastructure works, there should be capacity for 7.5 off-peak LDHS trains from the start of the May 2021 timetable. A further 0.5 may be available but we considered using it may carry risks to the availability of freight paths and connectivity (meaning it might be necessary to reduce some intermediate stops).

22. The key uncertainty we considered was around the completion of infrastructure works. In particular, DfT noted it may review the case for the ECML "connectivity fund"<sup>4</sup> works in light of our access decisions.

23. However, DfT did not provide evidence that allowed us to understand the strength of the current business case for the fund or details about how that case could be affected by our decisions. Moreover, any review by DfT would need to take account of how VTEC's own proposals depended on connectivity fund works and how Network Rail might be liable to compensate operators in the event it could not provide contracted capacity. We have therefore proceeded on the basis of Network Rail's current enhancement plans.

24. In rounded terms, additional capacity for LDHS services over and above that used by VTEC and open access today has been requested for up to: 1.0 path/hour for an additional VTEC Edinburgh service, 0.5 for a new VTEC Middlesbrough service, 0.5 for a

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<sup>4</sup> A fund overseen by the East Coast Programmes Board and intended to improve capacity and reduce journey times on the ECML over the 10 years starting 2014-15.

new FirstGroup Edinburgh service, 1.0 for a new GNER Edinburgh service and 1.0 for a new GNER Cleethorpes/West Yorkshire service.

25. As stated, these figures are rounded. For example, the FirstGroup Edinburgh proposal is actually for just 5 return services/day. This means it could be combined with (say) the VTEC Edinburgh and Middlesbrough services without materially exceeding the capacity we would be content to approve without seeking further assurances on connectivity and freight impacts.

26. On the basis of this capacity analysis, there is insufficient capacity for all applications since, even allowing for rounding, the applications combined with services running today would require more than 8.0 paths/hour. We therefore needed to consider the costs and benefits of the available options.

27. There are proposals being developed by other operators that would use ECML capacity. For example, the Scottish Ministers have an aspiration to increase local services to Berwick and (potentially) two new local stations in Scotland, and we have received representations from local stakeholders about these. DfT's new TPE franchise also includes a requirement to extend an existing hourly Liverpool - Newcastle train through to Edinburgh (which could help meet the Scottish aspirations) and to extend a York train to Newcastle. However, we did not consider it appropriate to incorporate either proposal in this process because we had not formally received applications for any of these services. We will of course consider any applications we receive in future.

### *Performance*

28. On the basis of high-level modelling, and before any mitigation, Network Rail suggested the Public Performance Measure of punctuality and reliability (PPM) could fall by up to 2 percentage points as a result of increasing the number of off-peak LDHS services out of Kings Cross from today's 6/hour to 8/hour. VTEC and DfT argued performance impacts should be modelled in detail ahead of approving access rights. There are standard industry tools to do this but they would require multiple timetables to be prepared, tested and evaluated and introduce considerable further delay to our decision-making. More fundamentally, we believe that this type of modelling, if undertaken, would add very little to what is already known. This is because of the uncertainties around forecasting use of capacity, timetabling and enhancements several years into the future.

29. VTEC argued a 2 percentage point reduction on average PPM could result in a £20m p.a. loss of passenger revenue. However, we noted that some modelling had already been done to support VTEC's plan to increase services by 1.5 trains/hour as set out in its franchise bid; this showed performance could be increased simultaneously with the proposed extra services. DfT told us it thought this modelling was robust. Parties also emphasised the positive reliability impact of the new rolling stock being proposed by all the applicants (with similar operational characteristics to VTEC's IEP rolling stock) and the possible benefits of developing a more regular repeating pattern for ECML services.

30. We therefore considered that the 2 percentage point estimate provided some indication of the upper end of the likely range of performance impacts before any mitigation was undertaken. However, taking into account the factors outlined above and the potential for the timetabling process to improve on Network Rail's initial estimates, our judgement was that, in this case, it was appropriate for us to direct Network Rail to sell capacity on the basis of its broad understanding of the route in advance of the detailed timetabling work needed to analyse performance, and that performance impacts should not be a major factor in deciding these applications.

#### *Feasibility and consistency with industry plans*

31. We considered all the applications were operationally feasible in principle.

32. We considered all the applications appeared broadly consistent with industry plans for the ECML, although we noted these were old and due to be refreshed.

#### *Modelling approach*

33. We commissioned CH2M to analyse many of the costs and benefits of the applications for us. CH2M modelled service options using a combination of industry-standard modelling<sup>5</sup> and, consistent with industry guidance, some bespoke modelling (a gravity model and modelling of competitive response).

34. CH2M's work has been subject to significant scrutiny by all parties over an extended period, and the results have been audited by Systra.

35. The key results were presented as point estimates, but there is inevitable modelling uncertainty around these estimates. The use of different options and sensitivities helped us to understand the significance of these uncertainties.

36. The robustness of the modelling results has been challenged by several parties. Indeed, a review by CH2M and Systra – prompted by questions from VTEC – identified a modelling error that had not been picked up in Systra's audit; this affected the results for two applications, albeit only to a relatively small degree. Any complex modelling carries risks of errors and audit processes cannot offer complete assurance over the results.

37. Some parties, including VTEC in its most recent submissions, emphasised how the modelling results have moved significantly over time. However, it is important to distinguish between changes resulting from our ongoing engagement with parties (which included changes to the timetables used in the modelling and changes in the modelling

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<sup>5</sup> This consisted of MOIRA, which is industry-standard software to estimate the revenue impact of new and altered services based on journey time factors, and formulae and values from the Passenger Demand Forecasting Handbook (PDFH).

approach) and errors such as that identified in paragraph 36. The latter accounts for relatively minor changes to the modelling results.

38. Key methodological challenges<sup>6</sup> centred on:

- (a) Whether the modelling approach was consistent with industry best practice and, in particular, PDFH. We were satisfied the modelling approach was consistent with PDFH and Systra's audit provides further assurance on this. This issue related particularly to the application of the gravity model, and to the assessment of the GNER Cleethorpes/West Yorkshire application (see below).
- (b) The treatment of the IEP order and whether the contracted rolling stock should be treated as a sunk cost. This related to the assessment of the VTEC core option (see below).
- (c) The extent of competitive response by VTEC and how it should be modelled.

39. On (c), we could see no good argument why there would not be some form of competitive price response by VTEC to the entry of either GNER or FirstGroup services to Edinburgh. There is, however, genuine uncertainty about the strength of these effects, which we managed through testing different approaches to modelling them.

40. DfT commissioned its own analysis by consultants SDG of most of the service options we considered. GNER and FirstGroup both criticised the assumptions made and the approach taken by SDG in its analysis. We have explored the differences between the SDG and CH2M/Systra approach. SDG's approach differed with respect to all three methodological challenges set out above. In addition, SDG's report, which was finalised in March, assumed slower journey times for the FirstGroup service to those that we ultimately considered to be realistic. More generally, however, SDG's results were supportive of the VTEC proposals though not of the open access proposals.

41. DfT also emphasised its view that results should be presented in terms of a benefit-cost ratio, with the cost being the costs to the taxpayer. However, we did not think doing this would support the analysis of the applications against our statutory duties, particularly as we carried out our own analysis of costs to the taxpayer through our analysis of the impacts on the Secretary of State's funds (see paragraphs 54-56 and 82 onwards).

42. Overall, we were satisfied the CH2M modelling results were fit-for-purpose as a means of informing our understanding of the magnitude of key impacts, in particular about many of the costs and benefits of the applications (noting the importance of modelling

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<sup>6</sup> Some parties have also highlighted concerns with the air-rail modelling. We and our auditors have considered these arguments and we have both set out our views in the published material.



uncertainty, the use of sensitivities, the potential for non-modelled factors and differences to the SDG work). This was on the basis that: the modelling was prepared by a firm with extensive experience of rail passenger demand modelling; it was audited by a firm with similar credentials; the results were subject to significant stakeholder scrutiny; and the results have been reviewed by ORR staff. Whilst these results were a significant source of evidence for our decision, they were not the only source.

### *Modelled service options*

43. In discussion with stakeholders we developed a large number of service options for assessment from the four applications we received.

44. The options included some key components of the VTEC application, for example, VTEC's proposed new service to Middlesbrough, where the elements of an application could sensibly be assessed separately and where there were possible differences in impacts.

45. In considering the economic modelling results, we made the following changes to the modelled options (the option numbers are taken from the CH2M report which is available on our website):

<b>Action</b>	<b>Reason(s)</b>
We set aside option 11: GNER Edinburgh without tilt capability.	Not proposed by GNER (the analysis was requested by DfT and illustrated the importance of tilt).
We replaced option 6: VTEC Middlesbrough with option 6b.	Option 6 analysis included significant crowding effects that are unlikely in practice, as VTEC would reallocate rolling stock. Option 6b removes these crowding effects.
We set aside options 7 & 9: FirstGroup Edinburgh.	We did not think the FirstGroup Edinburgh service would operate as a 'slow' service as modelled here, as it was unlikely to be timetabled to be held while VTEC services overtake.
We added a new option 15 for FirstGroup Edinburgh, but ultimately set it aside.	Even after removing the overtake manoeuvre, we did not think the FirstGroup Edinburgh service would operate at materially slower journey times to those of the equivalent VTEC services, when minor differences in stopping patterns were considered.
We added a new option 16: FirstGroup Edinburgh	We thought the FirstGroup Edinburgh service would likely be timetabled with speeds comparable to the VTEC service. We also wanted to make changes reflecting on challenges from stakeholders and the auditor, Systra. These included changing the approach to modelling VTEC's competitive response (reducing these impacts) and changes to the modelling of fares so they better reflected our view of likely fare levels. More information about these changes and other assumptions was included in annex H to the CH2M report.

46. To be clear about the FirstGroup Edinburgh options, the issue was that options 7 and 9 and to a lesser extent 15 assumed Network Rail would timetable FirstGroup services to be very slow relative to a VTEC train with an equivalent stopping pattern. We did not consider these to be realistic timetables and therefore we did not consider these options as the basis for our decision.

47. Some of CH2M's refinements to its modelling of fares for option 16 were also relevant to the GNER Cleethorpes/West Yorkshire application. However, we did not ask CH2M to update its modelling of fares in that option because it was not, in the event, material to our decision on that application.

## **Assessment of options**

### *The NPA test*

48. CH2M's and our own modelling showed the remaining service options were likely to have NPA ratios above our 0.3 benchmark. We have therefore not rejected any application on the basis that it did not meet the NPA test threshold.

49. However, our criteria and procedures make clear that achieving the NPA test threshold is not determinative. In particular, since there is insufficient capacity to accommodate all the proposed new services we must exercise a large degree of judgment in deciding what the balance of costs and benefits of the available options is likely to be. As explained above, we commissioned CH2M to analyse many of these costs and benefits, discussed below. The sequencing of the options here reflects an order that eases explanation; it does not reflect that the analysis was undertaken or conclusions reached in this sequential way.

### *GNER Edinburgh*

50. This application was modelled as option 2 in the CH2M report. The results for this option excluded the costs of necessary investment in tilt capability. GNER suggested these costs might be around £30-35m (this and other values being in 2010 prices, unless stated otherwise). Network Rail declined to offer a view. Our view was that this was likely to be a very low estimate. When the NPV (+£46m) was adjusted for these costs, it was likely the option would have a near-zero or negative NPV. Further, we considered other operators would be unlikely to make use of the tilt capability for the foreseeable future, we did not identify any further material positive impacts that were excluded by the modelling, and we considered a less frequent service (as suggested by GNER to us as potentially viable) would probably have a lower NPV, due to the fixed nature of the necessary infrastructure costs.

51. We did not think the benefits from additional competition would be sufficiently large so as to materially affect our assessment of these net benefits.

52. Applying all our statutory duties, we rejected the GNER Edinburgh application because its costs are likely to exceed its benefits and the benefits are likely to be low relative to the alternative uses of capacity proposed.

*GNER Cleethorpes/ West Yorkshire*

53. This application was modelled as option 1 in the CH2M report. The option had a strong positive NPV (+£185m), in part reflecting new direct services between London and Cleethorpes, Grimsby and Scunthorpe, and services to a new station proposed for East Leeds. The NPV was of a comparable scale to the VTEC core (option 3, +£198m) and the additional net benefits from moving from VTEC's core to its full application (an increase of £182m). The benefits per path used were also similar. These differences did not provide a strong basis for preferring any of these options over the others, in light of inevitable modelling uncertainties.

54. However, our view was that option 1 would result in significant absolute levels of revenue abstraction, modelled at £44m p.a. On franchise expiry and re-franchising, this would probably affect the Secretary of State's funds by several hundred million pounds in NPV terms. Shorter-term, the franchise agreement could lead to these costs falling to VTEC, for the last few years of the franchise (noting uncertainties around when services would start).<sup>7</sup>

55. These financial impacts would have been reduced had the application focused on serving (say) just the Cleethorpes line – this line has no direct services to London at the moment and we have previously approved applications whose main impact is to provide such new direct services. However, GNER told us this was not commercially viable on its own; it told us a 6 trains/day service to West Yorkshire could be viable, but in our view this would still result in unacceptably high levels of abstraction.

56. On balancing our statutory duties, particularly those to promote improvements in railway service performance, protect user interests and promote competition against our duty to have regard to the Secretary of State's funds, we saw the abstraction as a significant adverse impact for this option. This was the case both in terms of the absolute scale of the impact and when the impact and overall benefits were viewed relative to the VTEC core and full proposals (which were, to different degrees, seeking the capacity needed for option 1). We therefore rejected the GNER Cleethorpes/West Yorkshire application.

*VTEC core (existing franchised services + additional Edinburgh service)*

57. There is a strong presumption in our approach in favour of the continued use of current access rights. This applies to the ~5 paths/hour that VTEC currently uses on the

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<sup>7</sup> We understand the franchise agreement would pass 80% of these costs to DfT if VTEC did not secure the core application.

ECML. But the VTEC core proposal – option 3 in CH2M’s report – also included an additional new hourly path for Edinburgh.

58. This option had a strong positive NPV but there were issues with the potential impact on other operators and the appropriate treatment of IEP rolling stock costs.

59. Grand Central said VTEC’s proposals could have a devastating effect on its business, putting sustainability at risk and hindering future growth.

60. In line with our criteria and procedures, we have no policy of offering unlimited protection to existing open-access operators from competition. However, we have carefully considered the risk that additional VTEC services might force Grand Central to withdraw services to any significant extent, potentially reducing competition (see paragraphs 10 and 13).

61. CH2M’s modelling suggested an impact on Grand Central’s revenue of order £7m p.a. if we approved all of VTEC’s proposals, of which £5m p.a. resulted from the additional Edinburgh service in the VTEC core application (in 2014-15 money values). Grand Central suggested the impacts could be higher; however, it did not explain why and on reflection we saw no reason to adjust the modelling results. Grand Central’s operating profits in 2014 were £2.8m on a turnover of £32m.

62. We undertook high-level modelling of how these impacts might affect future levels of profitability. We extrapolated 2014 operating profits using a range of reasonable long-distance market growth scenarios, which are lower than its recent actual growth, and compared this to the modelled impact from VTEC’s additional services. This analysis also ignored whether/how Grand Central would react to the increased competition. In light of the information available, including our modelling of the range of potential future impacts, we considered the impact on Grand Central of the proposed VTEC services in combination and separately by option. We decided it was reasonable to conclude Grand Central was unlikely to be forced to withdraw services to any significant extent as a direct result of VTEC’s additional services.

63. An issue raised by both Grand Central and Hull Trains was that the actual timetables operated on the ECML could significantly affect the impact new franchised services would have on them. Several stakeholders expressed their nervousness about the strong position of VTEC in the industry timetabling process for the ECML.

64. It may be helpful for us to set out our expectations in this area. When developing any timetable, Network Rail must bear in mind its obligations to treat all operators fairly, as embodied in the decision criteria in part D of the industry network code. In particular, franchisees do not get priority in the timetabling process just because they are franchisees. The timetable should be the best overall timetable taking account of the desirability of shorter journey times, matching the spread of services to demand,

maintaining and improving performance, efficient asset utilisation and other criteria set out in part D. The Event Steering Group<sup>8</sup> and other industry processes should enable all relevant operators to participate equally in a fair and transparent way. Well established industry dispute resolution processes offer additional protection should any operator be aggrieved with the outcome.

65. With regard to the appropriate treatment of the contracted IEP rolling stock that would be used for these VTEC services, we thought a proportion of these costs were economically sunk. It was less clear how we should treat these costs against our statutory duties. However, if we approved the VTEC core services the treatment of these costs would not be relevant. Accordingly, we have not considered them further in this decision.

66. Overall, in line particularly with our duties to promote railway service performance, protect user interests and have regard to the Secretary of State's funds, we approved the VTEC core proposal including an additional hourly path, given the clear evidence of strong net benefits and our judgement that it is unlikely Grand Central will be forced to withdraw services to any significant extent as a result.

67. We will direct Network Rail to agree firm rights<sup>9</sup> for VTEC's existing 5/hour LDHS services from December 2017 when its current access contract expires. However, Network Rail's advice was that enhancements are needed on the ECML to enable an additional hourly service to run, in particular, 4-tracking at Woodwalton and grade separation at Werrington. These projects are currently due to be completed in time for the May 2021 timetable. We will therefore direct Network Rail to agree firm rights for the additional hourly path for VTEC from May 2021 rather than from May 2019 as VTEC originally requested.

68. In addition we will direct Network Rail to agree contingent rights for the additional hourly path for VTEC from May 2019. Contingent rights will allow the path to be utilised should the projects be delivered early or found not to be needed after all.

#### *VTEC extensions of existing services to Bradford, Lincoln & Harrogate*

69. CH2M modelled these aspects of VTEC's application as options 4 and 5 in its report. We did not identify any significant adverse impacts from these extensions. The capacity for these services is not contested by other applications.

70. CH2M's modelling indicated these services could have a negative impact on Grand Central revenues of order £0.5m p.a. (on top of the impacts arising from VTEC's other

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<sup>8</sup> Event Steering Groups are formed by Network Rail from funders and timetable participants. They advise Network Rail on how best to manage events that will require major changes to the timetable.

<sup>9</sup> Train operators can have two types of access rights: when timetabling, Network Rail must first accommodate firm rights held by operators. Contingent rights are only accommodated if there is space after all firm rights are dealt with.

proposals). We considered Grand Central was unlikely to be forced to withdraw services to any significant extent as a result of the additional impacts from these services.

71. In line with our duties, and particularly those to promote railway service performance, protect user interests and promote use of the network, we approved the VTEC extensions to Bradford, Lincoln and Harrogate on the basis of the clear evidence of net benefits from better serving these communities. We will direct Network Rail to agree firm rights for these service extensions from May 2019, as requested by VTEC.

#### *VTEC Middlesbrough*

72. This element of the VTEC application was proposed to deliver a new two-hourly service to Middlesbrough from May 2020. This option was modelled as option 6b and updated in appendix I of the CH2M report. It had a positive NPV, but it was low in absolute terms and in terms of the NPV per path. The benefits included speeding up some other VTEC services by moving stops into the Middlesbrough service.

73. VTEC and DfT stressed that the Middlesbrough services would support crowding relief on these and other services in the region. This suggested the modelling potentially understated the benefits.

74. The modelling also showed the VTEC Middlesbrough service could reduce Grand Central's revenues by some £1.5m p.a. (on top of the impacts arising from VTEC's other proposals). We considered Grand Central was unlikely to be forced to withdraw services to any significant extent as a result of the additional impacts from these services.

75. In line with our duties, and particularly those to promote railway service performance, protect users and promote use of the network, we approved VTEC's new Middlesbrough service given the modelled benefits and the potential for additional crowding benefits.

76. VTEC intended these services to start in May 2020. In light of the necessary enhancements outlined earlier, we will direct Network Rail to agree firm rights from May 2021, with contingent rights from May 2020.

#### *FirstGroup Edinburgh*

77. FirstGroup proposed an off-peak, single-class 5/day return service between London and Edinburgh. Following discussions with the applicant, we considered this service is likely to have a similar on-board offer to VTEC's standard-class offer. Average fares are likely to be lower than those offered by VTEC. FirstGroup offered to make a low fares commitment. This would not be simple to enforce and we took the view that fares should be determined by commercial pressures, such as the balance between supply of seats and demand.

78. We modelled several different timetables for the FirstGroup application, but ultimately we took the view the timetable modelled under option 16 was the most realistic.

In addition, accounting for challenges made by stakeholders and Systra, CH2M made changes to the fares modelling for this option.

79. The NPV for option 16 was significant (+£77m) and the NPA ratio was above our 0.3 threshold. NPV per path was also comparable to other options, which was notable given off-peak paths are typically used for less valuable services.

80. DfT challenged the NPA ratio result due to the methodological issues set out in paragraph 38. DfT argued the NPA ratio would be 0.22 if the analysis was undertaken without a gravity model and any competitive response. However, we considered that competitive response was likely and the use of the gravity model was reasonable. Even adjusting for possible overstatement of generation by the gravity model at Morpeth, the option would still pass our NPA threshold.

81. In addition, the NPA ratio was calculated against an assumption that all of the VTEC applications had already been approved. The NPA ratio should ideally be calculated against current services excluding the alternatives being compared. On that basis the ratio would likely have been higher. We therefore remained satisfied the application was likely to pass the NPA test.

82. The results indicated a significant absolute level of abstraction of order £24m p.a.. In interpreting this figure we noted that the baseline was the full VTEC service so revenue was abstracted partly from new services that did not have access rights; we do not normally calculate abstraction on that basis. We also considered the general levels of uncertainty in the modelling.

83. Both the Secretary of State and DfT officials emphasised the current state of the public finances and the limited resources available to the railway.

84. Set against this is an argument that the franchise faces several risks of which abstraction impacts from open access operators is just one (see paragraph 88).

85. Parties have also emphasised the Government's ability to take mitigating steps by implementing the provisions in European legislation that permit a levy to recover the costs of providing loss-making services (as suggested by the Competition & Markets Authority). The Secretary of State has said "I will now explore options for potentially implementing the CMA's recommendations, including legislation if required"<sup>10</sup>. However, we cannot know whether legislation would be enacted or the extent to which it would mitigate the impacts so we have not taken this possibility into account when reaching our decision.

86. The eventual impact on the Secretary of State will also be affected by the decisions we take on PR18 and the structure of charges. In December 2015 we published a consultation document on network charges in which we said there was a need to consider

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<sup>10</sup> Hansard: Rail Reform - Written statement (HLWS609), 17 March 2016.

whether some open access operators should make a greater contribution to network costs, particularly where capacity is scarce and most valuable.

87. We cannot anticipate the impact of either of these possible developments now. Therefore, we have not taken the potential reforms into account when reaching our decision. But there is no reason why we would give any comfort to FirstGroup (or any other operator) about how our future decisions might affect it.

#### *Impacts on VTEC*

88. Under its franchise, VTEC would be exposed to the loss of abstracted revenue for the final years of its franchise agreement. It argued that FirstGroup services could have a serious impact on any profits it generated in these years. When assessing these arguments we noted:

- (a) The modelling was of steady-state effects, so if FirstGroup took time to build its market share, the impacts on VTEC would be lower.
- (b) The scale of other uncertainties that VTEC faces around revenues or costs over the term of the franchise could be more significant than the impact of FirstGroup's services (in 2014-15, the franchise generated ~£750m revenue implying a 1% variation would represent a ~£7.5m p.a.).

89. A further issue was the extent to which VTEC should have / did consider this risk when bidding for the franchise. When making its bid, GNER's proposals for the ECML were known. DfT also specifically asked bidders to submit a scenario with open-access entry. In this respect, VTEC argued it relied on the combination of the protections offered in the franchise agreement and its belief that Network Rail had told it that capacity was limited to 7 LDHS services per hour.

90. We considered how these issues related to our statutory duties; most obviously they related to the duty to enable operators to plan their business with a reasonable degree of assurance. However, VTEC accepted that the prospect of an open access application was known when it was bidding and we did not think it was reasonable for VTEC to believe the capacity position was fixed, given the inevitable uncertainty surrounding available capacity and the specific history of flux in respect of ECML capacity. We also considered whether a decision to approve FirstGroup's application would lead bidders in future franchise competitions to discount their bids or seek additional protections from the Secretary of State to reflect the revenue risk to them of our approach. This was relevant to our duty to have regard to the funds available to the Secretary of State.

91. Against these considerations, we noted that the FirstGroup services were not novel in the sense that they did not serve any new rail destinations, but there were aspects to the application which would give passengers more choice (notably the single-class, low-cost offer from a new entrant on the route). This contributed to the application's NPV and NPV/path.



92. On balancing our statutory duties, particularly those to promote railway service performance, protect user interests, promote use of the network and promote competition, against our duties to have regard to the Secretary of State's funds and to enable operators to plan their businesses with a reasonable degree of assurance, we decided to approve the FirstGroup application with firm rights starting in May 2021. If in the event the services can start before then (say because necessary infrastructure projects are delivered early and the rolling stock is available), FirstGroup will be free to apply for earlier access rights in the usual way.

93. There remain key uncertainties about delivery of the FirstGroup services. FirstGroup will need to take a view on the charges that would be likely to apply in future, as well as the risk of legislative change to introduce any Government levies (as envisaged by the CMA's report into on-rail competition). Further, the services could be reliant on the successful completion of a number of infrastructure works. We want to avoid a situation where FirstGroup unduly delays implementation of its services because of these uncertainties, blocking capacity that could otherwise be used. For this reason, we will direct Network Rail to enter into an access contract including conditions requiring FirstGroup to secure appropriate rolling stock by a particular date and to demonstrate steady progress as it develops its services.

### **Contract Duration**

94. Track access contracts longer than 5 years must be justified by the existence of commercial contracts, specialised investments or risks.

95. We are satisfied the VTEC contract can run until 2025, as VTEC requested, noting it will expire 2 years beyond its franchise. This is because our policy is to treat franchise contracts as commercial contracts that can justify a duration longer than 5 years and the overlap will ensure an incoming franchisee has rights to operate its services while it makes arrangements with Network Rail for a new track access contract.

96. Similarly, we are satisfied FirstGroup's access contract can run for 10 years from 2021 given the significant specialised investment FirstGroup will be making in new rolling stock.

97. A copy of this letter will be placed on our website.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Larkinson', written in a cursive style.

**John Larkinson**