Phil Dawson
Regulation and Track Access Manager
Virgin Trains East Coast
East Coast House
25 Skeldergate
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05 March 2015

Dear Phil,

East Coast Trains 48th, 49th, 50th 51st and 52nd Supplemental Agreements

In respect of the above supplemental applications Alliance has the following comments

1. General Comments and queries relating to all applications

1.1 East Coast capacity

The ORR has initiated a process to review applications on the ECML – this was communicated to the industry in letters dated 18th June 2014 and the 6th February 2015. The applications made by East Coast are only until the end of the current contract which is the Passenger Change Date 2016. However, we understand that it is the intention that the rights sought in these supplemental agreements will also be sought in a revised S17 application which has yet to be made and consulted upon. We are further concerned that the rights sought in these applications will in effect seek to be 'rolled forward' and seen as existing rights.

If the intention is then to include these in a revised S17 application, these rights are competing for capacity with the much earlier applications made by GNER. The ORR is responsible for the supervision of the consumption of capacity of the railway, and that includes ensuring that capacity is allocated to users – franchisees, open access operators, freight operators and others – on fair and affordable terms.

In 2006 a detailed Court decision was given on a challenge to the ORR brought by (the then) GNER. In arriving at its decision, the Court had regard to the purpose of Directive 2001/14/EC. It said:

"*The focus of the Directive is clearly on the need to ensure that all railway undertakings have equal and non-discriminatory access to [the upstream market for] rail infrastructure. In the upstream market, [the market for access to the rail network] franchisees have very considerable advantages over open access operators*"

The franchise, with state support, is seeking even further commercial advantage by looking to circumvent the established process by applying for rights in this way.

We would ask that the ORR notes that the rights sought in these applications should be seen as new rights required until the end of any revised S17 application that is still to be made, and if any are approved they should be contingent rights only.

1.2 Public Service Obligations (PSO)

We are not sighted on whether the services proposed in the supplemental agreements, and indeed in the whole franchise, are PSOs or whether these are state sponsored commercial services operating outside the franchise agreement. This raises a number of competition issues. Can you please confirm their legal status in this respect? In a separate document from the DfT (in respect of our own GNER applications), reference is made by the DfT to 'key' services. Can you please confirm which of the services within this application are 'key' services as outlined by the DfT in the document referred to?

Alliance has previously raised its concerns with the ORR in respect of other applications, (i.e. applications made previously on the WCML by Virgin and LM) that there is no need for such services to be specified as PSOs. Specifying highly commercial services in a premium-paying franchise is anti-competitive and goes against the spirit of the privatisation process and the EU liberalisation process as it seeks to limit or prevent on rail competition and therefore to foreclose the market.

This very issue has been highlighted in the EU "*Study on Regulatory Options on Further Market Opening in Rail Passenger Transport*" which states at 10.3.2:

The awarding procedures for public service contracts require careful monitoring by regulatory institutions. In states where the incumbent RU and the IM have close linkages, a close watch needs to be kept for side-deals influencing contract awards (e.g. infrastructure investment or locating facilities employing substantial numbers of staff). It may be that a European regulatory institution would be best suited for this regulatory task, since PSO contracts are awarded by government agencies.

The fact that the ORR must 'take guidance from the Secretary of State' makes its ability to remain independent on competition matters very questionable - whilst taking guidance from a body that will ultimately benefit from such guidance is contrary to the rules of natural justice.

Regulation 1370/2007 sets out the conditions that define public service contracts. This is detailed in Article 2(e) which states:

"*Public Service Obligation means a requirement defined or determined by a competent authority in order to ensure public passenger transport services in the general interest that an operator, if it were considering its own commercial interests , would not assume or would not assume to the same extent or under the same conditions without reward*;"

The commission definition of services of general economic interest recognises the commercial services provided by the network industries to be of general economic utility. Thus, where the market fails to adequately provide these services, member states are allowed to impose specific public service obligations on service providers to meet certain general interest requirements.

Whilst the DfT can specify what services it wishes to be PSO's, and it can also specify that a franchise contain some services that are "*more than cost covering*"[1] (i.e. profitable); and while it has a wide margin of discretion in defining a given service as a PSO and in granting compensation to the service provider, The European Commission has stated:

"*The commission thus considers that it would not be appropriate to attach specific public service obligations to an activity which is already provided or can be provided*

[1] Para 2.2.5 Communication from the commission on interpretive guidelines concerning Regulation 1370/2007 on public passenger transport services by rail and road

satisfactorily and under conditions, such as price, objective quality characteristics , continuity and access to the service consistent with the public interest, as defined by the State, by undertakings operating under normal market conditions . As for the question of whether a service can be provided by the market, the Commission's assessment is limited to checking whether the Member State has made a manifest error"[2].

With regard to the UK rail market, this must question whether the PSOs have been defined in accordance with the legal rules. In particular it is difficult to understand how a public service contract that is for a premium-paying franchise can be compliant with the rules and the spirit of liberalisation. This is particularly relevant to the 49th Supplemental Agreement where the current Sunderland service has been created at commercial risk and operates under normal market conditions (as defined by the legislation).

With regard to premium-paying franchises the question is whether there has been a manifest error made by the DfT in highly specifying such a large volume[3] of highly profitable services in a public service contract. Put simply, if the market can provide the same services there is no need to specify a PSO.

In addition, Article 4 of Regulation 1370 requires that the PSO is clearly defined, and Article 6 identifies the requirement for separate accounts so as to avoid cross subsidy of commercial services.

It was never intended that premium-paying franchises should have PSOs (which are state sponsored commercial services) specified in this respect, and a case can be made that, within the UK, there has been a manifest error in the definition of the PSOs.

We also note in the EU "*Study on Regulatory Options on Further Market Opening in Rail Passenger Transport*" at para 7.3.2.1 at page 176 it states:

[2] Para 48 Communication from the commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest. 2012/C 8/02

[3] Which may be 100% but until the franchise agreement is published the amount is unclear

The competition issues mainly concern the potential capability for 'excessively subsidised' incumbent RUs to compete unfairly with new entrant RUs: incumbent RUs could use their public subsidy to compete with open access RUs by cutting fares/running abstractive services in manner that would not be justified by the business case. This can be difficult to police even with powerful independent economic regulation.

If market opening for domestic rail passenger services were to be enshrined at an EU level, there is the potential for public bodies opposed to market opening to use public service contracts as a means of very largely preventing market opening by issuing public service contracts to the incumbent RU for all of the most important parts of the rail network. Indeed there have been complaints by some of the RUs interviewed in the course of the Study that this is already occurring.

The over-specification of PSOs in these applications is aimed at preventing market opening and in trying to remove on rail competition, an issue clearly identified by the EU. This will lead to market foreclosure for open access commercial services and is a significant competition issue, particularly as the passenger now pays 71%[4] of the cost of the railway.

2. Indemnity Provisions

We understand that the new franchise agreement contains indemnity provisions[5] in the event of the competition it faces from other operators, most notably open access competition. We understand this will be with regards to the impact open access competition may have on any 'potential loss' to the DfT by not being able to utilise the IEP fleet specified at phase 1 and phase 2 of the IEP project.

Alliance is concerned that this raises legitimate concerns about illegal state aid, especially as the DfT IEP procurement process has been condemned by the Public Accounts Committee (PAC), where the Rt Hon Margaret Hodge MP, Chair of the Committee of Public Accounts, said on 17 December 2014: *"The Intercity Express Programme was poorly managed from the outset".*

[4] ORR Rail income 2013-2014 £9bn passenger income - £12.7bn industry expenditure
[5] Secretary of State Risk assumptions (SOSRA)

Passengers, by far the largest contributors to the cost of the railways, and the significant benefits they get from competition, must not be penalised due to a flawed DfT procurement process and market foreclosure.

3. Specific issues with the applications

At this stage of the process set by the ORR, it would be reasonable to expect that any rights that may be granted are for contingent rights only, to ensure that no further access benefit is gained from these late applications which seek to circumvent the process.

3.1 The 48th Supplemental Agreement

The access rights sought cover the period from December 2015 until the end of the current contract in 2016. We have examined the current S17 application made by East Coast Trains which was made on the 28th April 2014 and we note that this application does not contain the additional services sought in the 48th Supplemental agreement. Please confirm the status of the services beyond 2016?

3.2 The 49th Supplemental Agreement

Alliance would again refer to the EU position on market opening and PSOs in particular where it states: "*The commission thus considers that it would not be appropriate to attach specific public service obligations to an activity which is already provided or can be provided satisfactorily and under conditions such as price, objective quality characteristics, continuity and access to the service consistent with the public interest, as defined by the State, by undertakings operating under normal market conditions. As for the question of whether a service can be provided by the market, the Commission's assessment is limited to checking whether the Member State has made a manifest error*"[6].

This is particularly relevant to the 49th Supplemental Agreement where the current Grand Central Sunderland service has been created at commercial risk and operates under normal market conditions (as defined by the legislation).

It has already been identified by the Court[7] that franchised services have significant advantages (over open access) in the upstream market, and whilst Alliance fully

[6] Para 48 Communication from the commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest. 2012/C 8/02

[7] 2006 GNER v ORR & others

supports competition, the fact that the monopoly supplier can seek unfettered access to the market to compete with a properly developed commercial service – by introducing state sponsored commercial services - is a totally alien concept in the UK. In any other industry the regulatory powers and the Enterprise Act would prevent such market dominance and distortion.

This application, which would offer a peak time arrival in London (something Grand Central is prevented from doing), would appear to be the forerunner of a number of further applications that would see the monopoly supplier use its significant access advantages and state support to try and drive competition from the market.

There are also a number of significant issues to be resolved operationally before these services could be accommodated if approval was given. These relate to whether a VTEC HST (2 power cars plus 9 trailer coaches) can be accommodated safely in the station and its immediate area, without a significant impact on the paths or performance of other trains. However, we recognise that Network Rail can only offer compliant and validated paths and so this concern will be resolved through discussions between Network Rail and VTEC.

3.3 The 50th Supplemental Agreement

The access rights sought cover the period from December 2015 until the end of the current contract in 2016. We have examined the current S17 application made by East Coast Trains which was made on the 28th April 2014 and we note that this application does not contain the additional services sought in the 50th Supplemental agreement. Please confirm the status of the services beyond 2016?

3.4 The 51st Supplemental Agreement

The access rights sought cover the period from May 2016 until the end of the current contract in 2016. We have examined the current S17 application made by East Coast Trains which was made on 28th April 2014 and we note that this application does not contain the additional services sought in the 51st Supplemental agreement. Please confirm the status of the services beyond 2016?

3.5 The 52nd Supplemental

The access rights sought cover the period from May 2016 until the end of the current contract in 2016. We have examined the current S17 application made by East Coast Trains which was made on the 28th April 2014 and we note that this

application does not contain the additional services sought in the 52nd Supplemental agreement. Please confirm the status of the services beyond 2016?

4. Summary

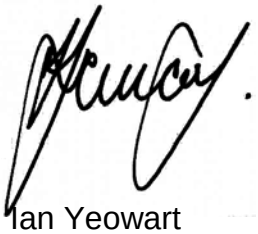
The over-specification of state sponsored commercial services in the East Coast Franchise has created a situation where the market for on rail competition has been distorted. Applications from a monopoly suppler to drive competition from the market using state sponsored commercial services are not only against the spirit of legislation, but may also be illegal.

We believe that the impact upon the Secretary of State's budget is made greater by a number of issues of its own making:

- The DfT defining a large and highly-specified group of services – which then requires the ORR to have further regard to guidance from the Secretary of State and also the impact on funds available.
- The significant cost and risk that has been laid at the taxpayer's door by a poorly managed Intercity Express Programme[8].

These issues should be reflected in any consideration of the impact on the funds available to the Secretary of State, as passengers must not be expected to forego the benefits of competition due to poorly managed processes by the DfT.

Yours sincerely,



Ian Yeowart
Managing Director

[8] Public Accounts Committee 17 December 2014

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