Phil Dawson
Regulation and Track Access Manager
Virgin Trains East Coast
East Coast House
25 Skeldergate
York
YO1 6DH

07 April 2015

Cc Mark Garner, Network Rail

Ian Williams, Office of Rail Regulation

Dear Phil,

Track Access Contract between Network Rail Infrastructure Limited ("Network Rail") and East Coast Main Line Company Limited ("East Coast") Section 17 Application

In respect of the above application Alliance has the following comments

1. Comments on the Form P application

1.1 East Coast capacity

The ORR has initiated a process to review applications on the East Coast Main Line (ECML) – this was communicated to the industry in letters dated 18 June 2014 and the 6 February 2015. East Coast in its 48th, 49th, 50th 51st and 52nd Supplemental Agreements and this section 17 application has attempted to circumnavigate this process. The rights sought in the 48th, 49th, 50th 51st and 52nd Supplemental Agreements must be viewed as competing applications for capacity. Alliance is

concerned that the rights sought in these applications have been presented as rights simply to be 'rolled forward' and seen as existing rights. These rights are competing for capacity with the much earlier applications made by Alliance via 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.

Alliance is very much of the view that because of the importance of competing applications for the same capacity, and with the GNER application seeking to introduce the shortest ever journey time between Scotland and London, that the ORR should hold an industry hearing so that the competing applications can be examined and judged openly.

1.2 Section 3 The proposed contract or amendments

We note that contract is a long term track access contract based on commercial justification. We note that the justification is based upon the "*significant investment in rolling stock (£3.4bn)".*

Alliance does not believe a case can be made for a contract over five years duration based on this investment. The investment has already been committed by the Department for Transport (DfT) irrespective of whether a track access agreement

exists. This has been recognised by the Public Accounts Committee which reported specifically on the purchase of the class 800 fleet that:

> *"The Department's decision to purchase the trains leaves all the risk with the taxpayer. By deciding to buy the trains directly the Department has taken on the risk that if fewer new trains are needed in future taxpayers would need to cover the costs of any resulting financial shortfall."*

As the fleet has been purchased by the DfT and the risk is underwritten by the taxpayer it is incorrect to claim this as a justification that East Coast can make in order to secure a contract over five years duration.

Alliance is also aware the First Great Western has recently announced its intention to procure a fleet of 7 x new 9 car and 22 x new 5 car Hitachi sets to replace HSTs between Paddington and Devon and Cornwall. It is clearly possible to mitigate any risk identified by the Public Accounts Committee by the over procurement of IEP for the ECML.

1.3 Section 3.2 Terms not agreed with the facility owner

Alliance notes that "*Network Rail is supportive of the existing quantum in Part A on a quantum only basis and is not contested for the full term of the track access contract*" As part A includes the rights sought in the 48th, 49th, 50th 51st and 52nd Supplemental Agreements, please can Network Rail confirm if this is the case and if it is, why it is able to support the rights sought when there are known competing applications for capacity?

1.4 Departures from Office of Rail Regulation (ORR) model passenger track access contract

This states that "*This agreement is based on the Passenger Track Access Model Contract"*. Whilst this is not untrue it is misleading as it is not based on the latest version of the model contract published by the ORR in February 2015. For example in schedule 8 the latest version of the model contract has not been used.

In addition, the departures from the model contract have not been identified nor explained which is a requirement of the form P under para 3.3. For example East Coast has not explained why it is necessary to replace clockface with interval in tables 3.1.Please can East Coast provide a revised version of the contract based on the February 2015 contract showing marked up changes.

1.5 Section 4 The expression of access rights and the use of capacity

We note that the proposed contract represents the services agreed with the Secretary of State within the franchise agreement dated 9 December 2014.

We are not sighted on whether the services proposed in the franchise agreement are Public Service Obligations (PSO), whether these are state sponsored commercial services operating outside the franchise agreement or whether they are Open Access services operated by East Coast. This raises a number of competition issues. East Coast needs to confirm their legal status in this respect. As East Coast is a legal signatory to the franchise it should fully understand which services in its franchise agreement are PSO and which are not. There is a significant distinction between a Public Service Obligation (PSO) and a franchise agreement (which is a Public Service Contract (PSC)).

This is important in order to satisfy that the services procured under regulation 1370 are indeed PSO services. In addition there is a legal requirement under regulation

1370 to account for PSO services (note - not franchised services) separately from services operated commercially by East Coast

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 European Union (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' brings its ability to remain independent on competition matters under significant scrutiny - 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 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 this application where the market currently provides services to Teesside, Bradford and Sunderland.

[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
[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

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 (as per the Altmark case)

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:

> 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 the application 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

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

a significant competition issue, particularly as the passenger now funds 71%[4] of the cost of the railway and the DfT funds only 19%. The DfT is effectively trying to deprive passengers of the benefits of competition.

1.6 Section 4.3 Flexing Rights and Section 4.4 Journey Time Protection

We note that East Coast has submitted a proposal which contains significant constraints in terms of the split of quantum, calling pattern, interval flex and journey time protection. This is in effect a hard wired proposal because of the interaction between the rights and how they have been specified. The proposals go against work recently carried out as part of the Rail Delivery Group's (RDG) review of schedule 5 at which East Coast is represented. At these meetings we note that East Coast has been supportive of the principle that a franchised operator will only have interval OR journey time protection and not both.

This contract is, in our opinion, hardwired and would breach the provisions of the Railways Infrastructure (Access and Management) Regulations 2005 in particular paragraph 18(3). Bearing in mind that the ECML will be subject to timetable recasts in order to optimise the capacity on the route this contract would make it extremely difficult for Network Rail to plan the network efficiently.

1.7 Section 4.6 Franchise obligations

Please note our comments in paragraph 1.5 above relating to PSO's. Again we request that East Coast provide a full list of the PSO services contained in its franchise agreement.

1.8 Section 4.9 Route Utilisation Strategies

In paragraph 3 we note the comment "*A uniform fleet, together with a standardised calling pattern supports the requirement for more effective utilisation of network capacity".* While this statement has some merit – although flighting of trains can offer much better utilisation - this is not what is being proposed in this contract. We note

[4] ORR Rail income 2013-2014 £9bn passenger income - £12.7bn industry expenditure

that a small fleet of short formed 25 year old Class 91 and Mk 4 vehicles (225s) will be retained by East Coast to operate their 'fast' services from Edinburgh to London. This is further commented on later. The application also claims that the short formed 225s will be able to keep to the timings of a class 800 unit. We have concerns about this claim particularly in relation to braking capability. East Coast needs to provide the evidence to prove that these short formed 225 sets offer the performance stated.

1.9 Section 5.3 Monitoring of services

We would expect to see a reopener for schedules 4 and 8 in the contract.

2 Indemnity Provisions

We understand that the new franchise agreement contains indemnity provisions[5] in the event of the competition it faces/may face 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".*

It is also worth noting that in the past the DfT has attempted to argue that if it does not get the East Coast paths the business case for the IEP will be undermined. This is clearly incorrect, as alternative uses for the fleet can be found, and even within this application East Coast seeks to utilise 25 year old 225 (not 140mph capable) rolling stock. We also note that First Great Western has announced its intention to seek to order a further 29 Hitachi (7 x 9 car and 22 x 5 car) units in addition to the 50 units already ordered.

[5] Secretary of State Risk assumptions (SOSRA)

3. Review of the proposed Track Access contract

3.1 Model contract

The draft contract does not appear to be based on the latest model contract. The departures from the model contract have not been identified nor explained which is a requirement of the form P under para 3.3. For example East Coast has not explained why it is necessary to replace clockface with interval in tables 3.1. Please provide a revised version of the contract based on the February 2015 contract showing marked up changes.

3.2 Schedule 5

3.2.1 Proposed schedule 5 structure

We note that East Coast has created a table 2.1 which has individual trains protected by having a schedule 5 that seeks to protect the firm rights to a calling pattern, clockface, journey time and specified equipment. This combination of over specified firm rights leads to individual train protection. For example we note in Part A table 2.1 description 1.2 that an evening peak train can, through the combination of the schedule 5 rights only be moved up to 5 minutes forward. Given also that the headway from King's Cross is 3 minutes the actual usefulness of the flex is just +3 minutes. In effect this is an illegal hardwired contract in places and it would be difficult if not impossible for Network Rail to plan a recast timetable with such highly specified rights. This is disappointing as East Coast has been party to the work being done by the RDG on a more flexible approach to access rights. It seems that despite taking part in these work streams that East Coast has applied for rights that conflict with the work being carried out at the RDG.

In Part A Table 2.1 description 1.5 we note that East Coast has proposed that the timing load is a 125. This service currently operates with a majority fleet of class 225s. On this service the 225s perform better than the High Speed Train sets operating at 125 timings. The proposal by East Coast is to time these York services at the slower timing load. Can East Coast confirm that all five London to York

services and return have been validated (by Network Rail) at 125 timing load and that the rights sought can be accommodated

The calling patterns are very specific (presumably driven by the franchise SLC), this over specification leads to very complex and specific access rights beyond what is necessary. For example we note that in Part A Table 4.1 description 1.1 and 1.2 these services have the same calling pattern, and yet the quantum has been split because of different specified equipment. This leads to hardwiring of the services. A much simpler set of firm calls needs to be produced to give some contractual protection sought but within the rules.

In Part B Table 2.1 we note that in descriptions 1.12, and 2.15 that these are proposed to have a firm right to a 125 or 225 timing. There should be only one firm right to the timing load. This is an area in the model contracts which requires some further development by the ORR as forcing an operator to have only one firm right can potentially reduce capacity on a route. This could preclude the use of the infrastructure by another operator and could lead to a breach of the Railways Infrastructure (Access and Management) Regulations 2005 para 18(4)

In summary, the schedule 5 rights sought need to be simplified further and significantly more flex added into the contract. We suggest that schedule 5 is reviewed by East Coast to remove the elements where individual trains are in effect illegally hardwired. The calling patterns need to be revised to reach a sensible compromise of East Coast having certainty and Network Rail having flexibility. East Coast will need to decide whether it wishes to have a firm right to intervals OR journey time or it will need to justify why it needs both. In any event the level of flex in the proposed contract is certainly not enough, particularly in relation to interval flex (which is proposed to be +5 minutes). A flex of +- 30 minutes for hourly services and +-15 minutes for 30 minute intervals would be more realistic.

3.2.2 Services competing with Open Access services

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 relevant to all of Grand Central's services. The North East service is at risk at Sunderland, Hartlepool and Teesside, and the West Riding service is at risk at Bradford and the wider West Yorkshire. These services have been created at significant commercial risk and operate 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 supports competition, the fact that the monopoly supplier can expect unfettered access to the market to compete with a properly developed commercial service – by introducing state sponsored commercial services and/or PSO services - is a totally alien concept in the UK. In other industries such market dominance and distortion by the monopoly would be prevented. This will be an important decision for the ORR and the Competition and Markets Authority (CMA), particularly with reference to its full Section 4 duties and the Enterprise Act.

In this proposed new contract we see a clear attempt by the monopoly supplier to use its significant access advantages to try and drive competition from the market and prevent new access, to the disbenefit of passengers, who now fund 71% of the cost of the railways.

[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

4 Other comments regarding the contract

The contract needs to be based on the February 2015 model contract and show all bespoke deviations from this.

A “Use of railway infrastructure reopener” should be included as without this the contract is not compliant with the Railways Infrastructure (Access and Management) Regulations 2005 Para 18(5). The contract should contain a schedule 4 and schedule 8 reopener.

Downgrading of East Coast’s Edinburgh – London services - 225 operation

There are a number of misleading statements within the application, in particular surrounding East Coast’s proposals for services to and from Scotland. At 3.1 East Coast state that the introduction of IEP to the route will increase LDHS capacity by up to 40% per hour, however in relation to Edinburgh, East Coast indicate at 4.5 it will operate its ‘fast’ services using 25 year old 225s in 7 car formation.

Capacity

The introduction of an IEP and a short formed 225s will actually see franchise capacity reduce in each hour when there are two services. It is not clear how the use of short 25 year old trains with reduced capacity will enable East Coast to accommodate “the significant growth in demand and revenue and enhance rail’s competitive position verses air [the major flow] and car” stated in its application.

The Network Rail Long Distance market forecasts (2012-2043) shows the Edinburgh - London market demand growth as 370%, the highest of all the LDHS services. East Coast has made no provision to accommodate this growth, instead looking to reduce seating capacity on this vital route.

Without competition this may well see East Coast use its market dominance to control its reduced capacity through pricing measures. Alliance via GNER will increase capacity to meet growing demand, will offer the fastest ever journey times between Scotland and London (to bring forward by 20 years the benefits of HS2), and the significant benefits of competition will also control prices – as evidence

clearly shows already happens on the ECML where Grand Central and Hull Trains compete with the franchise services.

Performance

In a recent submission to the ORR about GNER's application (now on the ORR website), the DfT stated its concern that additional performance risks will be imported if phased out Class 225s were used on the route and that the performance of these trains is "significantly worse than the contracted performance of the IEP trains".

That 'risk' though appears acceptable if it is proposed by a franchised service, and provides an insight into the veracity of any of the arguments used by the DfT to counter competition, and questions the accuracy of any of its objections.

Operational Timetable

Although the detail is not included within the application, it is clear that East Coast is seeking to use every further piece of available capacity by manipulating the timetable and the rolling stock to prevent others entering the market. East Coast could comfortably service the markets mentioned in its application without the need to operate up to 7 LDHS paths per hour. Indeed at every ECML meeting attended by the DfT its intention was to operate 6, not 7 LDHS services every hour.

The change only came about following significant pressure from Alliance on Network Rail regarding the available capacity, which at that time was suggested as being 7 LDHS per hour. The recent Network Rail capacity report made it clear there were 8, and possibly more. This has driven extreme behaviour by East Coast, seeking now to retain 25 old 225s to try and 'fill up the capacity' to prevent the legitimate aspirations of others – even where this means a significant downgrading of services between England and Scotland.

Initially IEP was specified in various formations and traction packages – with proposals for attaching/detaching seeking to make best use of very valuable capacity. Subject to the critical argument still to come on anti-competitive behaviour,

this appeared particularly relevant in providing 2 hourly services to Harrogate/Bradford, with 2 x 5 car trains splitting/joining at Leeds.

No such proposals appear now to exist, with East Coast instead looking to occupy valuable paths in every hour to prevent entry by others. This is particularly disappointing as the aspirations of every stakeholder could be satisfied if such an anti-competitive position was not adopted.

5. Summary

The contract as proposed by East Coast contains little flexibility which is contrary to the Railways Infrastructure (Access and Management) Regulations 2005 para 18 (3) and the recent guidance and directions from the ORR. The overall effect of the proposed contract is to, in effect, hardwire the East Coast services. Hardwiring is illegal.

It is disappointing that despite attempts by the RDG to broker agreement between operators and Network Rail on developing greater flex in contracts that East Coast has submitted a contract that looks to undermine that work. That said we note that the driver for these highly specified rights appears to be the franchise specification. It is a contract that has been developed in order for East Coast to increase its monopoly and to drive non-franchised competition off the network. It is also noted that this contract directly targets the commercially developed markets of Grand Central and seeks to prevent market entry by Alliance.

East Coast is seeking to downgrade services between Scotland and London by reducing overall seating capacity and re-introducing 25 year old 225s to the network. Despite identifying it as a performance risk for others, it does not identify it as a performance risk for itself.

East Coast is also seeking to ossify capacity not only via its contract, but also by utilising available capacity to serve markets with independent services that could as easily be served by better use of the capacity with splitting/joining. This would allow most, if not all of the aspirations of others to be delivered.

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 and prevent access for others by using state sponsored commercial services is not only against the spirit of legislation, but may also be illegal and the competition authorities may need to investigate.

These issues must be fully reflected in any decision, as passengers must not be expected to forego the benefits of competition due to monopolistic behaviour and poorly managed processes by others.

Yours sincerely,

Ian Yeowart
Managing Director