



OFFICE *of the*
RAIL REGULATOR

**NEW SERVICE OPPORTUNITIES
FOR PASSENGERS**

**A CONSULTATION DOCUMENT ON THE
DEVELOPMENT OF THE COMPETITIVE
FRAMEWORK FOR
PASSENGER RAIL SERVICES**

TECHNICAL APPENDIX

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1. Introduction

- 1.1 This Technical Appendix to the Regulator's consultation document 'New Services Opportunities for Passengers' sets out the Regulator's view of the criteria and procedures he might adopt if he implements Stage II of moderation of competition. It is intended primarily as a practical guide for train operating companies who may shortly be required to prepare their moderation of competition proposals for Stage II and to that end it includes a Glossary to facilitate understanding of the complex technical issues involved. However, because there are a number of policy questions that would need to be resolved before implementation of Stage II can begin, these issues will also be of interest to other parties who would expect to be consulted during any implementation process, such as Railtrack, potential open access operators, the Franchising Director and Passenger Transport Executives. The decisions reached by the Regulator in the light of the results of this consultation will form a fundamental part of the future structure of passenger rail services; encouraging the development of new competing services while protecting the interests of passengers and providing protection for franchisees which will allow them to plan their business with a reasonable degree of certainty.
- 1.2 The Regulator's policy for moderating competition was set out in a policy statement "Competition for Railway Passenger Services", published in December 1994. The criteria and procedures for implementing Stage I of moderation of competition were published by the Office of the Rail Regulator in December 1995¹. Annex A of the Criteria and Procedures document is the draft model clause, incorporated into passenger track access agreements, which provides the mechanism for implementing both Stages I and II of moderation of competition.
- 1.3 The basic mechanism for Stage II of moderation of competition is defined in Schedule 10 of most passenger track access agreements². Because the mechanism is already contained in access agreements, it could only be modified by agreement between Railtrack and the train operators. In contrast with Stage I where all approved flows automatically enjoy protection from competitive new entry, protection in Stage II is based on allowing new entry on a specified percentage (by revenue) of the flows

¹ The Criteria and Procedures for the Approval of moderation of competition Proposals from Passenger Train Operating Companies

² Schedule 11 for LTS, Connex South Central and South West Trains

nominated by each operator. Flows not nominated will automatically become open for competitive entry. Operators will, therefore, tend to nominate flows where new competitive entry is a possibility. Nominated flows then become "contestable". Competitive new entry will be allowed on contestable flows up to a pre-defined competitive headroom, with such flows becoming "contested" when competitive entry occurs on that flow. A number of flows will begin Stage II as "contested" because they are already served by competing train services, and at no time during Stage II can a flow switch status from "contested" back to "contestable". (A contested flow is one on which two or more operators compete and no operator earns 80% or more of the total farebox revenue. A contestable flow is a flow which is potentially open to competition, although it may already be served by minor operators who between them earn less than 20% of the total farebox revenue, in addition to the major incumbent operator who earns 80% or more of the total farebox revenue.)

- 1.4 The key elements that will define the scope of Stage II protection for individual operators are:
- (a) the materiality threshold, which defines the farebox revenue threshold above which flows may be nominated for protection;
 - (b) the list of approved nominated flows (which may or may not include all material flows);
 - (c) whether a flow is already contested (and hence open to further competitive entry immediately); and
 - (d) the threshold for competitive headroom which will be 20% or less of the total farebox revenue of all approved nominated flows, or the actual level of existing competition if it is higher than 20%.

All of these factors are subject to review prior to the initiation of Stage II and this document is consulting on the approach the Regulator should take.

- 1.5 This appendix builds on previously published documents and experience gained in implementing and operating Stage I. It deals with a number of policy questions that will affect the significance of Stage II and with the criteria and procedures that would be applied during implementation and during the Stage II period, including:
- (a) a broad plan of the implementation process, including key dates;

- (b) the relationship between implementation of Stage II and the timetabling planning process;
- (c) the role of thresholds in protecting revenues;
- (d) the implications of common ownership of TOCs;
- (e) the treatment of alternative termini, special nominations and through flows;
- (f) nomination strategies and procedures; and
- (g) other procedural issues.

The policies, criteria and procedures presented in this document have been developed specifically for the purpose of consulting on the implementation of Stage II of the moderation of competition regime. No assumptions or inferences should be made on the basis of this document about competition policy beyond the end of Stage II on 31 March 2002.

2. Responses

2.1 The Regulator seeks written responses to the questions raised in this Appendix. He also welcomes informal discussion with passenger train operators and others with an interest in any issues raised. Furthermore, the Regulator intends to explore a number of these issues at the seminar proposed for October 1997.

2.2 Written responses should be sent by 21 November 1997, to:

Phil Smith
Manager, Competition Policy
Office of the Rail Regulator
1 Waterhouse Square
138-142 Holborn
London
EC1N 2ST

2.3 Unless they are marked as confidential, they will be placed in the ORR library at the end of the consultation period, and will be made available on request to interested parties.

2.4 Additional copies of this document are available, free of charge, on request from the Office of the Rail Regulator.

Telephone: 0171 282 2001;
Fax: 0171 282 2045;
Email: orr@dial.pipex.com; or
write to the Librarian at the address shown above.

3. Background: Results of Stage I and outline of Stage II

Stage I

- 3.1 Stage I of moderation of competition commenced on 2nd August 1996. Stage II of moderation of competition may commence at any date from 1 April 1999 and ends automatically on 31 March 2002³.
- 3.2 The implementation of Stage I resulted in approximately 4,200 point-to-point flows being protected from competitive new entry. These flows account for approximately 64% of total farebox revenue. A key determinant of the scale of geographic protection provided by Stage I was the approval of lower materiality thresholds for six train operators. (The materiality threshold is the means by which the minimum farebox revenue value of a nomination was set.) The effect of the lower thresholds, which range from 0.13% for ScotRail to 0.01% for Cross Country, was to treble the number of material flows protected from new competition. In terms of these six operators, the use of lower thresholds increased the percentage of their farebox revenue protected from between 13% and 43% (based on the standard 0.2% threshold), to between 41% and 49%.
- 3.3 Relatively few Stage I material nominations were rejected. Those that were fell into one of three categories:
- (a) flows which had been nominated because of rounding errors but actually fell just below the materiality threshold;
 - (b) flows where the frequency of service was very low, particularly if the frequency was low in relation to the majority of the operator's core business; and
 - (c) flows which the operator only served during off-peak periods, and which were eligible for nomination only because of the nature of zonal based revenue allocations.

³ Except Virgin West Coast which has Stage I arrangements extended until 2012, and Connex South Eastern which has Stage II arrangements extended until 2011 subject to a review by the Regulator in 2002

- 3.4 A number of material nominations were approved subject to conditions, which were intended to achieve one or more of the following objectives:
- (a) to allow other operators to develop their existing services, or in a small number of cases to develop new services;
 - (b) to limit the protection by time of day or day of the week, in order to allow the development of new services at times when the incumbent operator did not provide a service (e.g. to allow for development of sleeper services); or
 - (c) to provide incentives for operators to maintain existing service levels or risk losing protection.
- 3.5 Operators were also entitled to make additional nominations for protection during the Stage I period. The majority of these nominations were rejected, but a number were approved where the operator had shown that the flows were associated with recent investments by either the operator or a more usually a third party such as a Local Authority or a PTE, or flows where the farebox revenue did not show as material in the 1993/94 farebox revenue data but where the recent farebox earnings clearly exceeded the materiality threshold.
- 3.6 In addition to the nominated flows, operators also enjoy protection by means of two other mechanisms:
- (a) the approval of 354 nominations for alternative stations as part of the MoC arrangements which could be used as substitutes for stations on flows which are protected⁴. (These nominations included a number of stations that were nominated as alternatives by more than one operator - there were only 195 individual stations named. This ratio was more pronounced in London where 33 London stations accounted for 118 alternative termini nominations from 16 different operators); and
 - (b) quite separately, the need for any new access rights required to operate competitive services to be approved by the Regulator⁵.

⁴ For example, Finsbury Park is an approved alternative to Kings Cross for GNER and thus protection enjoyed by that operator on the Leeds and Kings Cross flow is automatically extended to the Leeds and Finsbury Park flow

⁵ The Regulator's policy has been set out in a letter to TOC MDs of 21 February 1997 - see Annex C

- 3.7 The results of the franchising process has led to two instances where common control of overlapping franchises has triggered a review of moderation of competition protection (i.e. the acquisition of West Coast and Cross Country by Virgin, and Midland Main Line and Central by National Express Group). This review reduced the number of protected flows by less than 50, whilst the total percentage of farebox revenue protected remains virtually unaltered. It is, as yet, too early to ascertain whether the relaxation of protection will lead to any services being introduced.

Stage II

- 3.8 Stage II is a more complicated mechanism than Stage I. The mechanics of implementation are more complicated, as are the implications for train operators. Stage II implementation, including finalising outstanding policy matters, processing nominations, issuing notices and development of supporting systems must be completed within approximately the next twelve months if Stage II is to start in September 1999.
- 3.9 In an attempt to eliminate confusion about what is "contested" and "contestable" and which flows are open to competition and which are not, it is proposed that a form of colour coding is introduced. The colours will reflect the status of individual flows at a snapshot in time, and make it easier to ascertain whether competitive new entry is permitted, as follows:
- (a) green: flows which are either "contested" or which have not been nominated for protection, upon which new competition is allowed irrespective of other factors; or
 - (b) yellow: flows which have been nominated and approved as "contestable", where new entry is possible within the constraints of the competitive threshold; or
 - (c) red: flows which have been nominated and approved as "contestable" but, because of the value of the flow, new competitive entry would breach the competitive threshold, and is therefore not allowed.
- 3.10 In Stage I individual flows were either protected or not for the duration of the Stage I period (subject to alterations resulting from change of control of a TOC). Stage II, however, is likely to see the status of flows change over the Stage II period. Flows which begin Stage II as contestable (yellow) may become either contested flows (green) upon the sale of competitive access rights and therefore open to further new

entry, or fully protected flows (red) as the 20% competition threshold is approached. Once a train operator has no yellow flows left then they have reached the point where they will not be subject to the threat of entry on any additional flows. Flows cannot change from green to red (i.e. from unprotected at the start of Stage II to protected) or generally from red to green (i.e. from protected to unprotected)⁶.

3.11 A presentation of a hypothetical operator's nomination, using this colour coding, is shown in Annex A.

Q1 The Regulator would like to know if you consider this "colour coding" useful to determine the status of a flow.

⁶ They could (a) if they are special flows and e.g. a condition is breached; or
(b) as a result of a review following change of control.

4. Implementation of Stage II

- 4.1 The implementation of Stage II will require the completion of the following activities:
- (a) resolution of the outstanding policy issues discussed in this document, and development of appropriate criteria and procedures, by means of consultation and publication of a subsequent policy, criteria and procedures document;
 - (b) preparation of appropriate baseline revenue data;
 - (c) processing of proposals in support of lower materiality thresholds;
 - (d) issue of the Stage II Initiation Notice by ORR;
 - (e) processing of the nominations submitted by operators; and
 - (f) in parallel with items a, b, c, d and e, development and testing of appropriate processes and systems for managing the sale of access rights for the Stage II period.
- 4.2 Implementation must be achieved within an overall time frame that is consistent with the requirements of the timetable planning process and must not place an undue burden on the procedures for approval of access rights.

Key dates

- 4.3 The basic framework identified in the moderation of competition schedule within track access agreements specifies two key dates. The first is 31 March 1998 by which time the Regulator must issue a Stage II Initiation Notice, assuming he maintains his current intention to issue such a notice and to start Stage II in 1999. This Notice must include:
- (a) the relevant financial period and approved basis which defines the baseline farebox revenue data to be used for Stage II purposes (see paragraph 7.1);
 - (b) the relevant percentages by which materiality, pre-existing contestability and competitive thresholds are set (see paragraphs 6.2 to 6.14);
 - (c) any through flows which the Regulator believes to be capable of being a contestable flow (see paragraph 6.19 and 6.20);

- (d) the Stage II Nomination date - the date by which operators must make their nominations (see paragraphs 5.1 to 5.6); and
- (e) any alternative mechanism for aggregating and attributing farebox revenue to be used for specific flows where the general mechanism (of using ORCATS) is not appropriate.

4.4 The second key date is the Stage II Nomination date, which is the date by which nominations are to be made to the Regulator. This date is defined in track access agreements as 30 June 1998 or such later date as may be specified in the Initiation Notice. The Regulator has no powers to bring forward the Stage II Nomination date.

The Stage II period

4.5 The Stage II Period is defined in track access agreements as running from the end of the Stage I period to 31 March 2002. The end date is fixed and cannot be changed. The Regulator can defer the start of the Stage II period by deferring the issue of the Stage II Initiation Notice. The start of the Stage II period will be deferred by one day for each day that the issue of the Initiation Notice is deferred beyond 31 March 1998 (for example, if it were decided to start Stage II on 1st October 1999 then the Initiation Notice would need to be published on 30th September 1998).

5. *Stage II timing issues*

Timetable planning

5.1 When the draft model clause for moderation of competition was issued in March 1995, the start of the Stage II period was expected to be 1 April 1999, in line with the Regulator's policy statement. At that time it was expected that the timetable planning process would, by 1999, require a shorter planning period. In practice, the timetable planning period has become longer. This is in part because of other demands made upon the output of that process, such as the initiatives currently in hand to facilitate the timely and accurate provision of train service information to passengers. Experience now suggests that the relevant initial timetable bids will need to be submitted by train operators:

- about December 1997 for the Winter 1998 timetable (which will be in effect on 1 April 1999);
- about July 1998 for the Summer 1999 timetable; and
- about October 1998 for the Winter 1999 timetable.

5.2 If train operators are to introduce new services that take full advantage of the increased potential of competition at the beginning of the Stage II period, they will need to include such services in their initial timetable bids.

Options

5.3 Even on the assumption that all Stage II nominations can be processed by 30 September 1998 (i.e. within 3 months of the earliest nomination date), there is not a practical solution that would enable train operators to submit initial bids for the Winter 1998 or the Summer 1999 timetable, each of which take full or partial advantage of the 1 April 1999 start date. The Regulator needs to consider the desirability of new services, permitted under Stage II being introduced in an uncoordinated manner that is difficult for passengers to understand.

5.4 If it is decided that introduction of new competing services not included in the public timetable is undesirable, then either:

- (a) the start of the Stage II period should be deferred until the start of the Winter 1999 timetable (see paragraph 4.5 for the relationship between deferring the start Stage II, and the issue of a Stage II Initiation Notice); or
- (b) Operators and Railtrack voluntarily commit themselves to not exploiting the opportunities of Stage II, and not introducing new competitive services before the start of the Winter 1999 timetable. This would ensure that no operator gained unfair advantage from the order in which Stage II nominations were processed. If the parties were minded to support the latter option the Regulator would be minded not to approve any access agreement that breached the spirit of such a commitment.

5.5 A third option would be to ensure that all nominations are received earlier than June 1998, thereby facilitating earlier issue of the MoC Stage II Notices, which in turn would allow operators to plan their Summer 1999 timetables with full knowledge of the opportunities open to them under Stage II. The early receipt of all nominations could only be guaranteed by bringing forward the Stage II Nomination Date. However, for reasons set out in paragraph 4.4, the Regulator does not consider such an option to be practicable.

The Regulator's preferred solution

5.6 The Regulator believes that the appropriate solution is to leave unaltered the Stage II start date. However, he would not expect to approve access proposals for access rights for new competing services which take advantage of the relaxed constraints of the Stage II arrangements, if those rights take effect before the Winter 1999 timetable (Option (b)). This will maximise synergy between Stage II implementation and the timetable planning process whilst minimising costs and workload for all concerned. This solution is also believed to be in the best interests of passengers as it minimises the possibility of unstructured change which could create confusion. Option (a) could only be achieved by deferring the issue of any Stage II initiation notice, which in turn, would inhibit the processing of nominations and thereby constrain train operators' freedom to adequately plan new services in time for appropriate bids to be submitted as part of initial bids for the Winter 1999 timetable. Option (a) is therefore considered by the Regulator to be a less desirable approach.

Q2 Train Operators and Railtrack are asked to comment on the Regulator's preference for Option (b) and to identify any alternative or supporting activities which they believe would minimise the scale of the timing problems outlined in the above paragraphs.

6. Specific Stage II technical issues

6.1 This section considers a number of specific policy issues that are of a technical nature and could, by the way they are implemented, have a significant impact upon the nature of on-rail competition during Stage II. The Regulator would welcome views on any of the issues raised.

Lower materiality thresholds

6.2 During the franchising process it became apparent that, in some cases, the degree of protection afforded to franchisees by the 0.2% general materiality threshold was so low as to leave franchises subject to a significant risk of new competitive entry across the majority of their business. Indeed, there were some doubts as to saleability of particular franchises. This led the Regulator to approve bids from six train operators for lower materiality thresholds ranging from 0.13% to 0.01%. These changes increased the total number of flows protected from competition from 1800 to 4200, whilst increasing the percentage of farebox revenue protected to between 41% and 49% for those operators with lower materiality thresholds.

6.3 The Regulator accepted that such lower thresholds were required for Stage I of moderation of competition because of the risks perceived by potential franchise bidders. No evidence was ever submitted, to show that the farebox revenues protected by these lower thresholds were actually at risk from new competitive entry. In principle the Regulator would prefer to limit the protection afforded to incumbent operators under the Stage II arrangements, such that it is only applied to flows where competitive new entry would seem to be an economically viable possibility. This would have the advantage of minimising the degree to which the development of new direct services is inhibited by the moderation of competition provisions.

6.4 The Regulator is therefore considering whether those operators who enjoyed the benefit of a lower materiality threshold during Stage I should be allowed to bid for an extension of that advantage into the Stage II period. In view of the doubts regarding the value of such thresholds the Regulator believes that such proposals should only be approved if they are supported by analysis which indicates a reasonable likelihood of economically viable new competitive entry.

6.5 To support this conclusion the Regulator commissioned, in the early part of 1997, consultancy advice with a view to evaluating the potential for new entry on low value

flows such as those which qualify as material only because a lower materiality threshold has been applied. The analysis compared the farebox revenue earned on sample flows with the likely costs of new entry. Consideration was also given to the practical aspects of new entry, such as the availability of train paths and suitable rolling stock. The results of this work suggested that there is little possibility of a franchisee facing significant competitive new entry on such flows, but, because the analysis tended toward the analysis of individual flows rather than considering the potential for new entry on a route basis, the results were not conclusive.

- 6.6 The approval of materiality thresholds for the Stage II period must be included in any Stage II Initiation Notice which the Regulator would expect to issue towards the end of March 1998. Affected operators will therefore need to submit proposals after the policy statement has been issued, but before an Initiation Notice has been issued. As this is likely to be a fairly short time period the Regulator proposes that the affected operators will submit proposals in draft prior to the issue of the policy statement. This should enable the Regulator to decide on any adjustments to the materiality thresholds within the limited time available, having completed appropriate consultation and evaluation in advance of the policy statement being issued.

Q3 The Regulator would like to take account of the views of any party who believes that the approval of a lower materiality threshold would influence the ability to operate or the economic viability of specific services, either existing or proposed. Incumbent operators who would be in a position to bid for a lower threshold are also requested to comment on the degree to which rejection of such a bid might affect their franchise and the practicality of the proposed method for dealing with threshold proposals.

Defining a pre-existing contested flow

- 6.7 In many cases, the degree to which franchisees will face potential new competitive entry on nominated flows will be defined by the number and value of those flows which are pre-existing contested flows. A flow that is defined as being a pre-existing contested flow⁷ will count toward the 20% competitive threshold and will be open to further new competitive entry. By counting toward the 20% threshold such flows will limit the degree to which new entry on other 'contestable' flows can occur. For example, an operator who nominates pre-existing contested flows which account for

⁷ A pre-existing contested flow is defined in Schedule 10 as a pre-existing open flow

18% of their contestable pot, will only face the threat of new competitive entry on flows which are worth less than 2% of its nominated flows.

- 6.8 The Regulator is required to define a pre-existing contested flow for an operator by means of the percentage of revenue earned by that operator on the flow. Setting the threshold too high would result in a large percentage of flows being defined as contested and therefore open to further new competitive entry. Setting the threshold too low would result in too many flows being defined as contestable when in effect the market in question is already being competed for.
- 6.9 The Regulator proposes to determine that a flow is already subject to pre-existing competition if the dominant operator on a flow earns less than 80% of the total farebox revenue. This reflects the Regulator's view that an operator with 80% or more of the total revenue is likely to be able to market train services with limited regard for niche competitors, whilst the other operators are unlikely to be able to compete for a significant share of the major operator's market. He notes that similar thresholds have been used by Regulators on the energy and telecommunications industries to judge whether competition is effective.
- 6.10 The Regulator also proposes to achieve the effect that a flow will be either contested or contestable for all operators. In effect this will mean that if an operator nominates a flow where that operator receives only 10% of the farebox revenue, then the status of the flow will be defined by the division of the remaining 90% of farebox revenue between other operators. Should any one of those operators earn 80% or more of the total farebox revenue on that flow then competition will not be regarded as effective and the flow will be defined as a contestable flow for all operators who nominate it. On the other hand, if the flow is served by operators who all receive less than 80% of the farebox revenue then the flow will be defined as a pre-existing contested flow for all operators. Achievement of this effect may require a conditional adjustment to the definition of pre-existing contested flow (pre-existing open flow) in the Stage II Initiation Notice. Annex B gives examples of where flows are considered contested or contestable using this formula.

Q4 Consultees are requested to comment on the adoption of 80% as the percentage for defining pre-existing competition.

Treatment of common ownership

- 6.11 The Regulator has indicated in his policy statement that any loss of potential competition that is the result of two or more operators coming under common control

should be taken into account when considering the protection from competition enjoyed by operators. For the purposes of implementing Stage II this policy could be given effect by means of either:

- (a) adjusting the materiality threshold to reflect the combined turnover of the relevant operators; or
- (b) evaluating the individual flow nominations in such a way as to not allow protection of flows where competition, or the potential for competition, has been lost.

6.12 During Stage I the Regulator decided to remove protection from individual flows when considering the renominations of Central Trains, Midland Main Line and Virgin Cross Country. The Regulator is minded to adopt a similar approach in Stage II. However, unlike Stage I where protection was only removed from flows where the significant majority of the existing services had come under common control, for Stage II the Regulator is minded to restrict protection from a wider range of flows where such action would have the effect of recreating the potential for competition in a particular market. This could include markets where one subsidiary operator provides the only direct services and enjoys the benefits of moderation of competition, but another operator under common control is responsible for setting the fares and service levels on alternative routes which require one or more interchanges.

6.13 Generally, adoption of the proposed policy would lead the Regulator to consider the revenue shares of operators under common control as a single percentage with regards to the definition of pre-existing contestability. For example, a flow where the farebox revenue is shared between two operators who are under common control and neither of whom is dominant, would not be defined as a pre-existing contested flow. Furthermore, it is envisaged that on a contestable flow where an operator is the only incumbent operator and another operator under common control obtains new access rights, then the status of that flow would be unchanged and would remain as contestable. The flow would not become contested and would not count toward the incumbent's competitive threshold.

Q5 The Regulator would welcome views from any potentially affected party, particularly where those views identify the scale of constraints created by this proposed policy.

The competitive threshold

6.14 The Regulator's policy statement identified a maximum threshold for contested revenue of 20% of an operator's total contestable revenue. The MoC schedule in track access agreements made provision for the Regulator to specify a lower percentage as the competitive threshold. To date no evidence has emerged to suggest that a threshold of 20% would create a significant risk of detriment to passengers, or a significant risk to franchise viability. Analysis of the existing levels of pre-existing contested flows suggests that a threshold of 20% would still produce an end result which would have most franchisees facing competition on a similar percentage of their core markets. The Regulator is therefore minded to include a competition threshold of 20% in the Stage II Initiation Notices, subject to the resolution of the issues concerning lower materiality thresholds.

Q6 The Regulator would welcome representations that enhance understanding of the likely impact of this policy or present alternative solutions to the problems raised by this issue.

Alternative termini

6.15 In line with the general relaxation of moderation of competition that will occur when Stage II begins, the Regulator believes that there is a strong case for toughening the criteria for approval of alternative termini / stations. Stage I of MoC included approval of 354 alternative station nominations, some of which would have had the effect of protecting a number of markets that are not currently served by a direct rail services. Alternatives were approved where it could be shown that the alternative provided reasonable access to final destinations / origins and that the journey times were increased by no more than 15 minutes. For Stage II of MoC it is proposed that alternatives will only be approved where the operator can show that the alternative has adequate access and facilities that will enable a competitor to provide services that would abstract significant revenue from an incumbent's protected markets. The Regulator also believes that the operator should be required to provide appropriate evidence regarding the operational practicality of using the nominated alternative.

Q7 The Regulator would welcome any representation concerning the criteria for approval of alternative station nominations.

Special nominations

6.16 Stage II of MoC has a provision which allows operators to nominate special flows. Such flows would be the equivalent of the additional nominations made during Stage

I. Such nominations would generally be expected to be treated as part of the operator's contestable pot, although there may be cases where a special nomination was approved, but would not be part of the contestable pot. Flows not eligible for nomination as a material part of an operator's contestable pot could be nominated as special flows. Such flows could be flows which do not yet exist, for example a flow which is associated with a new station that has been funded by the operator or a relevant funding authority. If the nominating operator can show that the economic viability of such an investment would be at risk without a degree of exclusivity, then such a nomination is likely to be excluded from the contestable pot.

6.17 Special nominations will be made by operators at the same time as their nominations for flows to be included in their contestable pot. Alternative termini nominations are a form of special nomination, and the Regulator expects to provide that any change of status on a flow will also affect the status of any alternative termini nomination. For example:

A flow between Station A and Station B is nominated as part of the operators contestable pot and is not a pre-existing contested flow. Station C has been nominated as an alternative to Station B.

- If Railtrack sell access rights on the flow A -B then it automatically becomes a contested flow (green) and will count towards the operators contestable threshold. Further new entry will then be permitted on both flows A-B and A-C.
- If Railtrack sell access rights on the flow A-C then the flow A-B automatically becomes a contested flow (green) and will count towards the operators contestable threshold. Again further new entry is then permitted on both flows A-B and A-C.
- If the flow between Station A and Station B had been a pre-existing contested flow (green) then it would have already counted towards the operators contestable threshold and the sale of new access rights on flow A-C would have no effect (as it would be green also).
- If competitive new entry on the flow between Station A and Station B would exceed the competitive threshold then it is protected (red) and flow A-C would also be protected (it would be red also).

6.18 Special nominations could also be used to nominate de minimis flows that an operator believes to be a key element of a route, which contains a number of de minimis flows, that could be strung together by a competitor into a viable competing service. This type of nomination might be appropriate where an operator has chosen not to seek a continuation of a lower materiality threshold, or had such a proposal rejected. Because such nominations, if approved, would protect part of an incumbent's existing business, they will normally be treated as part of an operator's contestable pot, in the same way as material nominations.

Q8 The Regulator would welcome views from operators as to the suitability of special nominations as an alternative to lower thresholds.

Through flow nominations

6.19 During Stage I nominations of through flows (those flows requiring a change of train) were permitted as additional nominations. Generally, such nominations were not approved as the Regulator preferred not to inhibit the development of new direct services. Stage II also makes provision for through flow nominations to be made. However, the MoC Schedule (Part 3, paragraph 1(d)) requires the Regulator to identify any such flow nominations as part of the Stage II Initiation Notice. The Regulator will allow such nominations to be made by TOCs, but expects to apply similar criteria to the approval of through flow nominations as he did during Stage I and, therefore, does not expect to approve very many, if any, through flow nominations.

6.20 The preferred procedure is to allow operators to nominate through flows during March 1998, after the issue of the MoC Stage II policy, criteria and procedures document. Any such nominations would then be consulted upon prior to the inclusion of any approved nominations in the relevant Stage II Initiation Notices. The timetable associated with this process is clearly somewhat challenging, but, the very small number of similar nominations received during Stage I indicates that this should not be a major concern.

Q9 The Regulator would welcome any representations from operators who may be inclined to make through-flow nominations, particularly representations regarding the criteria for approval of such nominations or the practicality of the proposed mechanism for making those nominations.

7. Procedural Questions

The baseline revenue data

- 7.1 The Regulator is required to specify the period for the farebox revenue data that will be used for analysing and evaluating the Stage II nominations. The Regulator believes that it is necessary to specify an annual period to avoid any potential distortion created by seasonal variations. Experience in providing the data for Stage I also suggests that it would not be practical to create a dataset based on anything other than a full financial year, particularly as the Travelcard income must be overlaid onto the basic flow data. As the Regulator is minded to use the latest available data, in order to reflect the latest developments in the industry, he proposes to specify the period as the 1996-97 financial year, as defined by the Rail Settlement Plan. The Regulator, in conjunction with OPRAF, is in the process of commissioning the analysis of raw data from the Rail Settlement Plan with a view to overlaying that data with the relevant revenues from zonal tickets such as the Travelcard. The results of that analysis would then be supplied to operators in time for them to use the data as a basis for making their nominations for Stage II. Current expectations are that the datasets would be supplied to operators around the end of 1997.

Q10 Representations are requested regarding the suitability of the 1996-97 data and of any special circumstances of which the Regulator should be aware.

Nominations: procedures and formats

- 7.2 Unlike Stage I, Stage II of MoC needs to be implemented over a relatively short timescale in order to fit with the appropriate round of the timetable planning process. It will be essential that appropriate systems are developed, by Railtrack, which will enable it to ensure that negotiations for new access rights are being conducted in the light of constraints created by the continual changes to flow status and by other services under development.
- 7.3 The Regulator believes that he has a key role to play in both assisting Railtrack to specify the requirements of such systems, and in ensuring the Stage II nominations by train operators are made in a format which facilitates easy data transfer. Therefore the Regulator is minded to require operators to make their nominations in an electronic format. That format would take the shape of an Excel spreadsheet, which includes the

revenue datasets that will have been supplied to operators by the Regulator prior to the nomination period.

Q11 Representations are requested regarding the use of EXCEL 5.0 as the preferred nomination format and of any special circumstances of which the Regulator should be aware

Glossary of words and expressions (as they are used in this Technical Appendix)

"Access Agreement"	A contract between a facility owner (e.g. Railtrack) and a Train Operator setting out the Terms and Conditions under which a Train Operator gains access to that facility (which can be a station, track or a depot).
"Access Rights"	The terms of an Access Agreement which determine the rights of the user.
"Additional Nominations"	Nominations made in Stage I which were not material, or were through flows, or flows which did not yet exist. Very few of these nominations were approved.
"Alternative Termini"	Stations which were nominated as the alternative to a station named in a point-to-point flow. e.g. if a TOC had St Pancras approved as an alternative station to Kings Cross then every time a flow from Station X to Kings Cross was protected, Station X to St Pancras was protected also.
"Baseline Revenue Data"	The revenue figures on which materiality thresholds and the Contestable Pot would be based.
"Common Control"	Where two or more TOCs have been acquired by the same business, such as Virgin acquiring West Coast and Cross Country or National Express acquiring 5 individual TOCs.
"Common Ownership"	The same as "Common Control".
"Competitive Threshold"	The percentage of a TOC's Contestable Pot, up to which competitive new entry is allowed.
"Competitive Headroom"	The amount, as a percentage of the contestable pot, on which competition will be allowed.e.g. if the competitive threshold is 20% and a TOC's current contested revenue is 15% then the competitive headroom is 5%.

"Contestable Flow"	A flow which is potentially open to competition, and may be already be jointly served by a dominant and minor operator.
"Contestable Pot"	The total TOC revenue from the flows nominated during Stage II, which include both contestable and contested flows.
"Contested Flow"	A flow on which two or more TOCs compete, and no TOC earns 80% or more of the total farebox revenue. A contested flow is open to competitive entry by any operator.
"De Minimis Flows"	Flows which are worth less than a certain percentage of the Operator's total farebox revenue, and so are not "material".
"Dominant Operator"	The operator who takes 80% or more of a flows revenue.
"Flow"	A journey from one station to another.e.g. London Paddington to Edinburgh Waverley is a flow, but London- Edinburgh is not.
"Green Flows"	Flows which are either contested, or de minimis, or have not been chosen by a TOC for protection and are therefore open to new competition.
"Initiation Notice"	The notice which announces the start, and the terms, of Stage II of moderation of competition.
"Incumbent Operator"	Any operator who has agreement to run a service on a particular flow prior to the start of Stage II.
"Lower Materiality Threshold"	A lower percentage to define the materiality threshold, which enables a Train Operator who may have a large number of small value flows to nominate a number of those flows for protection. e.g. a TOC may have 5000 flows, all worth £1k each, but he could not nominate any of them using the standard materiality threshold as only flows worth £10k are material. He could protect his flows only if he had a lower materiality threshold of 0.02%. (see "Materiality Threshold" for a list of TOCs with Lower Materiality Thresholds during Stage I).

"Material Flows"	A flow which is worth more than the Materiality Threshold (normally 0.2% but see "Materiality Threshold") of a TOC's total farebox revenue.
"Materiality Threshold"	The percentage at which a flow becomes material, and therefore can be nominated for protection. In most cases this was 0.2% during Stage I, apart from for the following TOCs: ScotRail (0.13%), South Wales and West (0.05%), North East (0.03%), Central (0.02%), North West (0.01%), and Cross Country (0.01%).
"MoC"	Moderation of competition - the mechanism used to constrain the introduction of new competition during the first few years of the franchising process.
"OPRAF"	Office of Passenger Rail Franchising.
"ORCATS"	The computer programme which apportions to individual TOCs passenger revenue on certain flows.
"ORR"	Office of the Rail Regulator.
"Point-to-point flow"	A flow on which a TOC serves the origin and the destination station.
"Pre-existing Contested Flows"	A flow that was contested prior to the initiation of Stage II.
"PTEs"	Passenger Transport Executives, who are statutory bodies subject to Local Authority control which are responsible for the planning and funding of passenger rail services in certain areas.
"Renominations"	When two TOCs come under common control they are asked to resubmit their nominations. Any flows which were previously competed on, but are now owned by the same business, had their protection removed.
"Red Flows"	A flow which will remain protected under Stage II because the TOC has no competitive headroom remaining, or the value of the flow exceeds the competitive headroom.

"Secondary Operator"	An operator who does not take the highest proportion of revenue allocated to a particular flow.
"Special Nominations"	Similar to Additional nominations in Stage I. e.g. Flows which may not be captured by the Stage II material rules but on which the operator seeks protection.
"Stage I"	The first stage of MoC, which started in 1996 and can end no earlier than 31 March 1999 but must end by 31 March 2002.
"Stage II"	The second Stage of MoC, which will begin at the end of Stage I and end on 31 March 2002.
"Stage II Initiation Notice"	The notice which will formally announce the end of Stage I and the Start of Stage II.
"TOC"	Train Operating Company, also known as Train Operator.
"Total Farebox Revenue"	The total revenue earned by a TOC on all flows, whether material or not, including revenue from zonal type tickets.
"Yellow Flows"	Flows which are currently contestable, and have the potential to change to either "Red Flows" or "Green Flows", depending on whether the "Competitive Threshold" is reached.

Annex A: Hypothetical operator's nomination

Flow	Total farebox revenue on flow (from ORCATS) £'000	TOCs revenue from flow			Materiality Threshold: 0.2%		STATUS	
		£'000	% of Total Revenue on flow	Contested?	Flow as % of TOCs Revenue	Material?	Flow as % of nominated Revenue	Colour Status
Nominated								
1	202.5	202.5	100%	No	50.0%	Yes	50.3%	Red
2	73.6	70	95%	No	17.3%	Yes	17.4%	Red
3	52.9	45	85%	No	11.1%	Yes	11.2%	Red
4	28.5	20	70%	Yes	4.9%	Yes	5.0%	Green
5	95	20	21%	Yes	4.9%	Yes	5.0%	Green
6	200	20	10%	Not	4.9%	Yes	5.0%	Yellow
7	15	15	100%	No	3.7%	Yes	3.7%	Yellow
8	11	10	90%	No	2.5%	Yes	2.5%	Yellow
Not Nominated (<i>de minimis</i>)								
9	0.5	0.5	100%	No	0.1%	No	N/A	Green
10	0.5	0.5	100%	No	0.1%	No	N/A	Green
11	0.5	0.5	100%	No	0.1%	No	N/A	Green
12	0.5	0.5	100%	No	0.1%	No	N/A	Green
13	0.5	0.5	100%	No	0.1%	No	N/A	Green
TOTAL		405			100%			

† other operator has 90% of revenue

Explanation of hypothetical operator

- TOCs Total Farebox Revenue is **405K**
- Total nominated as TOCs Contestable Revenue is **402.5k** (Flows 1 - 8)

- Materiality Threshold has been set at 0.2%
0.2% of TOCs Total Farebox Revenue=
0.2% of 405K = **0.81k** = Minimum value of a material flow
- Flows 9 to 13 cannot be nominated because they are all worth less than 0.81K
- Competitive Threshold is 20% of the Contestable revenue
20% of 402.5K = **80.5k**
- Pre-existing competition on 40K = 10% contestable revenue (Flows 4 and 5)
- Competitive Headroom = Competitive Threshold minus Pre-existing competition 80.5K - 40K = **40.5k** (ie. 10%)
- Flows 1-3 are RED because they already exceed 40.5K (or more than the 10% competitive headroom available)
- Flows 6-8 are YELLOW because they are worth less than 40.5K
- Flows 4-5 are GREEN because they are pre-existing contested flows
- Flows 9-13 are GREEN because they have not been nominated for protection (as they are not material)
- If another TOC bid for access rights on flows 6 & 7 (worth 35K) those flows would become GREEN and Flow 8 would become RED (because it is worth more than the remaining 5.5k)

Annex B: Examples of applying the definition of a pre-existing contested flow

To determine whether a flow is subject to pre-existing competition, the test is whether any one operator has a share greater than or equal to 80% - if they have, then the flow is not a pre-existing contested flow.

Nominating TOCs share of the flow revenue	Other TOCs share(s) of the flows revenue	Is this a pre-existing contested flow?
100%	0%	No
80%	12% + 8%	No
79.5%	20.5%	Yes
50%	25% + 25%	Yes
21%	79%	Yes
20%	80%	No
15%	40% + 45%	Yes
15%	85%	No
5%	81% + 14%	No

Shares which determine that the flow is *not* contested are highlighted in bold.

Annex C: Letter to TOCs dated 21 February 1997

DEVELOPING NEW SERVICES TO PROMOTE THE USE OF THE NETWORK

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

This letter sets out the criteria and procedures the Regulator proposes to adopt in evaluating competition issues where his approval is sought for new access rights which are not protected from competitive entry, or where protection is conditional.

Criteria

In line with the duties placed on him in section 4 of the Railways Act, the Regulator welcomes new competitive services which bring benefits to passengers. These benefits might come through improved frequencies, lower fares or new journey opportunities resulting from the introduction of through services or provision of improved connections. The Regulator will look to the operator seeking approval for new rights to explain the passenger benefits that are likely to result.

The Regulator recognises that the development of greater competition will involve a balance between the interests of the new entrant and of the incumbent operator. Where a new service might have a material adverse impact on existing services, the Regulator will, therefore, give the incumbent the opportunity to make representations to him. If an incumbent operator argues that the financial impact on its own services is sufficiently great to threaten their viability and risk their withdrawal, and that the overall impact will be to the detriment of passengers, the Regulator will also seek the views of the Franchising Director (and PTE where relevant).

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

Information requirements

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

Consultation

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

Keeping criteria and procedures under review

The approach set out in this letter, which has been discussed with OPRAF, is intended to assist train operators in planning for new services during Stage I of Moderation of Competition. The Regulator recognises that in any particular case a factor may be relevant which is either not reflected in the criteria or is not given appropriate weight. While the Regulator expects this to happen only on rare occasions, he will be willing to consider taking that factor into account in an appropriate manner where it does. However, before doing so, where a materially different outcome would result, he would expect to consult those affected.

Comments on the approach set out in this letter would be welcome. The Regulator recognises that the criteria and procedures may need to evolve, and revised guidance issued, in the light of experience.

If you have any queries about the contents of this letter, or the information to be provided in specific cases, please contact Phil Smith (Manager, Competition policy, 0171 282 2026).