

VIRGIN FARES CASES

1. The Rail Regulator has received 32 complaints from passengers and their representatives alleging abusive behaviour by Virgin West Coast (providing services on the West Coast Main Line) concerning changes to the level and conditions applying to certain fares for services on various routes, including those between London and Manchester and London and Liverpool. This notice sets out the Regulator's considered position on those complaints.

Background and jurisdiction

2. The Regulator has responsibility for applying the Competition Act 1998 in relation to conduct and agreements which relate to the supply of services relating to railways (as defined by the Railways Act 1993 as amended by the Transport Act 2000). The fares policies of the train operators come under this jurisdiction. Chapter II of the Competition Act prohibits undertakings which hold a dominant position from abusing that position. The charging of excessively high prices may amount to the abuse of a dominant position. Under Section 25 of the Competition Act the Regulator may conduct an investigation if there are reasonable grounds for suspecting that the Chapter II prohibition has been infringed.

3. Where, as in this case, the Regulator is in receipt of complaints, a two-stage initial analysis is conducted. First, the Regulator formulates a view (having made such enquiries if any as he thinks appropriate) on whether reasonable grounds exist for a full investigation. Secondly, if satisfied that reasonable grounds exist, the Regulator then exercises the discretion conferred on him by the Competition Act as to whether a full investigation is in all the circumstances merited.

4. The Competition Act amends the Railways Act 1993 so that the Regulator, in performing his functions under the Competition Act, should not have regard to his duties under section 4 of the Railways Act. However, in exercising his discretion, the Regulator may have regard to matters covered by his section 4 duties insofar as they are matters to which the Director General of Fair Trading could have regard in exercising his powers under the Competition Act.

5. The Regulator attaches a high degree of importance to the enforcement of the prohibitions contained in Chapters I and II of the Competition Act. However, the discretion conferred on him permits him also to take account of other considerations. These may in any given case include:

- the establishment of priorities in the exercise of his functions under the Competition Act;
- the materiality of the infringing agreement or conduct alleged;
- the probability of finally establishing the existence of the infringement;
- the time and resources required to complete the investigation balanced against other means of securing general compliance with the competition rules; and
- the impact of the investigation on the development and maintenance of other forms of competition to which regard may be had under the Competition Act.

6. The Regulator has in the present case approached his task having regard to the considerations described above.

Passenger rail franchises

7. Passenger rail franchises are contracts with the SRA, and are let at the end of a competitive tender process conducted by the SRA. The franchising process is one where potential operators compete to offer a range of services over a group of routes. In doing so, potential franchisees need to assess their expectation of the overall costs and revenues which they will be able to achieve, and any adjustment and rebalancing of individual fares that may be appropriate for the purpose. When franchises are let by the SRA, certain fares are controlled by having price caps placed on them (and are deemed “regulated”) while other fares are left unregulated.

Approach to the Chapter II analysis

8. In order to establish whether an unregulated fare is abusive by being excessive the Regulator would first have to establish that a franchisee was dominant in a relevant market and then that the relevant fare or fares were excessive. In this case, the Regulator has sought independent economic and legal advice on the appropriate approach to assessing dominance and assessing whether fares are excessive where a franchised operator is dominant.

Market definition and dominance

9. A market is defined by assessing what substitutes are available for the product concerned. (Technically one product is a substitute for another if a rise in its price leads to consumers switching consumption to the other.) The standard approach is set out in the Competition Act guidelines and assesses which substitutes are sufficiently close to provide a competitive constraint. In transport markets this approach usually suggests that narrow markets are appropriate, as passengers will want to travel between two points and will typically not find travelling to alternative destinations or at alternative times a sufficiently close substitute. The Regulator’s preliminary view, as set out in the draft Competition Act guidelines “Application to railways services”, is that markets are typically likely to comprise origin and destination pairs at particular times (such as peak and off-peak).

10. In such narrow markets it is likely that Virgin West Coast would be dominant. Barriers to entry are typically high in this industry due to the need to arrange access to the infrastructure network (on which capacity is currently, and for the foreseeable future, constrained at key points) and to lease or buy appropriate rolling stock.

Assessing whether fares are excessive

11. Prices may be said to be excessive where they stand in no reasonable or justifiable relationship to the economic value of the service supplied. In relevant EC caselaw, “economic value” is typically determined by reference to the costs of the service in question, or by reference to the prices for comparable services. The Regulator is required by section 60 of the Competition Act to interpret the Act as far as is possible to ensure that there are no inconsistencies with the principles of EC caselaw. However, excessive prices are not to be confused with high prices, nor the competition rules with general price control regimes; and competition authorities in the United Kingdom and elsewhere have traditionally been reluctant to apply the competition rules to declare prices to be excessive, otherwise

than in the most clear-cut of cases¹, or in circumstances where additional abusive behaviour (such as unjustified price discrimination) is also present.

12. Particular complexity and difficulty attaches to the examination of allegedly excessive prices in circumstances where individual relevant markets comprise part of an overall network, particular fares form part of an overall charging matrix, and any determination of the economic value of individual services is likely to call for the allocation of high fixed and common costs.

13. In this case, this has led the Regulator to consider a two-tier approach to the assessment of alleged excessive pricing amounting to an abuse.

14. The first involves looking at the network comprised in the franchise as a whole, and determining whether profits (and by implication prices) are excessive. Here account requires to be taken of the competition at the time the franchise is let (paragraph 7 above). This form of competition should normally ensure that, overall, the operator is not able to earn excessive profits over the life of the franchise. That is to say, competition for the grant of the franchise extracts the expected monopoly rent over the course of the franchise at the time the franchise is let, taking into account the price caps applying to particular fares. The expected monopoly rent in this case is the additional profit a monopolist would be expected to be able to earn over the course of the franchise as a result of its market power. Operators set individual fares so as in aggregate to recover the fixed costs of operating the franchise (including routes on which fares are regulated at time of franchise award) and the common costs of different services (at different times of day or between different routes). Individual fares may be perceived as high without an implication that they are excessive: in order for any individual fare to be excessive, there would need to be evidence that excessive profits (i.e. significantly and persistently in excess of Virgin's cost of capital) were being earned across the whole franchise.

15. The Regulator generally agrees with this approach to the issue of excessive pricing. It recognises the importance in the circumstances of this industry of competition for (as well as in) the market and the reality of how network franchises are operated. The long term interests of passengers are taken into account during the process leading to franchise award through competition for the market. That form of competition would be liable to be undermined if freedom in setting individual unregulated fares were thereafter constrained, particularly in the early years of the life of a franchise, and at a time when overall franchise profitability is not excessive. If, in the years following grant of a franchise, a change of circumstances not foreseeable at the time of franchise grant, or brought about by behaviour by the franchisee which is itself abusive, then permits windfall profits to be made over the franchise as a whole, the matter can be re-addressed. In the present cases, however, the Regulator has considered the returns being earned by Virgin West Coast as a whole and has no reasonable grounds to believe these are excessive.

16. The Regulator has also considered whether it is appropriate to establish the "economic value" of particular fares. But in that assessment, various factors necessarily fall to be taken into account. First, the fact that operators sell a range of tickets both on the same service and across different services suggests that normal competition would lead to a range of different fares in any event, as operators sought to optimise passenger traffic flows. Second, the process of assessing whether prices are excessive

¹ See for example the discussion at paragraphs 4.7 to 4.10 of the OFT's March 1999 Guidance Notes on The Chapter II Prohibition which states (paragraph 4.10): "Given the uncertainties in estimating what an undertaking's cost of capital should be, prices would have to allow profits which *significantly* and persistently exceeded its cost of capital before an abuse could be established".

in relation to costs involves attribution of fixed and common costs to particular fare types. Any calculation of profitability will depend very largely on the cost attribution method used. In principle, operators in network industries enjoy a degree of flexibility in cost allocation, and while the Regulator can in the course of an investigation devise and apply a scheme of cost allocation, to do so is complex, intrusive and gives rise to practical difficulties. Third, while it is possible to compare individual fares with those for particular services offered by other operators, difficulties arise in establishing comparability (including on service quality) of the services in question (not least because of flexibility taken towards pricing of individual services within different networks). Given the complexity and costs involved in such a consideration the Regulator does not consider that there are sufficient grounds to undertake such an exercise in the present case, since there is no evidence that the relevant train operator is earning excessive returns on its total franchise business

17. In circumstances where (as here) overall franchise profitability was not excessive, the Regulator would be unlikely to conclude that particular fares were excessive unless they stood in no observable reasonable relationship to “economic value”, determined having regard to the considerations described in the previous paragraph. At that stage, it would also be necessary to confirm that there was no objective justification of an otherwise apparently excessive fare.

Conclusions

18. The Regulator has assessed the complaints on the facts before him, and in light of the preceding considerations, and reached the following views.

19. While the Regulator has reasonable grounds to believe that Virgin would be dominant in one or more relevant markets, he does not on the evidence before him have reasonable grounds for suspecting that Virgin has behaved or is behaving abusively in charging excessive prices for the reasons set out in paragraphs 14 to 17 above. The conditions for a full investigation under Chapter II of the Competition Act are thus not met.

20. Were the Regulator to take a different view (in concluding that reasonable grounds did exist), he would on the facts currently before him be minded, having regard to the considerations listed in paragraph 5 above, not to proceed with that enquiry. This is, of course, without prejudice to the exercise of his discretion under the Competition Act on any future occasion, or the use of any other powers that may be available to him.