

**Excessive pricing complaints and franchised
passenger services**

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OFFICE OF RAIL REGULATION

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Introduction

1. On 22 November 2007 we, the Office of Rail Regulation (ORR), published a plain English guide: *Complaints about rail fares and car-park charges – the role of competition law*¹, (the guide). The guide summarised the approach that we plan to take in addressing excessive pricing complaints made under the Competition Act 1998 (CA98) regarding franchised passenger services (in particular fares and car-park charges). This paper, published on 22 January 2008, contains more detail on the analysis behind the guide and is intended for those with a basic knowledge of the CA98.

Background

2. The guide is a plain English, readily accessible, summary of a review of the application of competition law to franchised passenger services that we carried out over the summer and autumn of 2007. Our review drew on a number of different information sources, including:

- a review of past ORR decisions and other publicly available documents including various Department for Transport (DfT) publications;
- analysis of recent customer complaints;
- a review of the relevant case-law;
- further economic analysis; and
- fact-finding meetings with the DfT.

3. This paper sets out our approach arising from the review which took account of the position up to November 2007. We will continue to treat each complaint we receive on its individual merits and in doing so keep our approach under review. Should we encounter strong evidence that appears to conflict with our underlying assumptions, we would revisit our position.

Scope of the review

4. We carried out the review to assess the application of CA98 to franchised passenger services. We did not consider (and, therefore, this paper does not include an assessment of) the application of other powers available to us under the Enterprise Act 2002 or under sector-specific legislation. We also only considered the application of CA98 to the services sold by franchised passenger operations, meaning that the scope of our review did not extend to non-franchised operations such as Heathrow Express and Hull Trains. We would consider the facts of any complaints that we receive regarding the

¹ http://www.rail-reg.gov.uk/upload/pdf/comp-cmplnts_rlfrs_cpk_chrgs.pdf

services sold by such operators based on their merits, using principles analogous to the ones set out in this paper where applicable.

Overview of our approach

The legal test for excessive pricing

5. The first hurdle that we would have to clear in proving that a train operating company (TOC) was pricing at a level which was so high that it represented an abuse² would be to show that the TOC under scrutiny held a dominant position. Neither our guide nor this paper discuss this issue in depth (although we do discuss certain circumstances in which we might quickly be able to identify that a TOC did not hold a dominant position without the need to engage in a detailed analysis).

6. The focus of both publications is on the question of whether a dominant position, should it be proven that one exists, has been illegally abused. As explained below, we think that the particular circumstances under which TOCs operate are such that abusive conduct will very rarely arise. On this basis, it will often be advantageous for us to consider, where informative evidence is readily available, the question of abuse first without expending time and resources on exploring questions of market definition and dominance.

7. The second hurdle that we would have to clear in proving that a TOC was pricing at a level which was so high that it represented an illegal abuse of a dominant position would be to show that prices were excessive. The approach taken in the relevant case law follows the key two-stage legal test set out in *United Brands*³. This test assesses whether:

- the difference between the costs incurred and prices charged is excessive; and
- if so, whether a price has been imposed which is either unfair in itself or when compared to competing products.

8. In *United Brands*, prices were found to be excessive because they bore “no reasonable relation to the economic value of the product supplied”, making their imposition an abuse of a dominant position. The concept of “economic value” is therefore a key factor in assessing whether a price is illegally high.

9. Whilst not representing a sufficient⁴ condition in itself for proving the existence of excessive prices, higher than expected profits can sometimes point to the existence of pricing that represents an abuse of dominance. Profitability data therefore often represents

² Under Chapter 2 of the Competition Act 1998/ Article 82 of the EC Treaty

³ Case 27/76 *United Brands Co. and United Brands Continental BV v Commission* [1978] 1 CMLR429.

an important factor in identifying whether prices are at an excessive level. . Whilst there are a number of general difficulties associated with assessing profitability from a competition perspective⁵, the particular circumstances of franchised passenger services are such that particular care would have to be taken when attempting to make inferences from profitability data. This is explained in the Franchise payments and Franchise competitions sections below.

10. Our interpretation of the two-stage test set out in *United Brands*, in the context of a franchised passenger service is that, in order to establish that a TOC had engaged in excessive pricing we would have to show that **both** of the following conditions had been satisfied:

- the TOC in question had been able to earn profits that had not been captured at the franchise competition stage; and
- the TOC had set a fare/car-park charge or group of fares/car-park charges within its franchise at a level that was high when compared to competing products.

11. This is a very high threshold. The remainder of this paper discusses the approach that we will take in assessing complaints given this test.

Franchise payments

12. The key role played by government in the running of the railways introduces a number of potential complications in assessing TOC profitability for the purposes of addressing a complaint about excessive pricing.

- Franchise premium and subsidy payments play an important role in determining the financial performance of franchised TOCs, since premium (subsidy) payments form a high proportion of the total costs (income) of a number of TOCs.
- TOC revenues (which primarily come from fares but also include other services such as car parking and catering) are typically not sufficient to cover the total cost of operating a franchise (i.e. all of the costs incurred both by TOCs and by Network Rail). This means that in general franchises are 'loss-making' in terms of the total underlying costs of providing rail services (see, for example, Table 3 of *National Rail Review*, Q2 2007-08, ORR, <http://www.rail-reg.gov.uk/upload/pdf/343.pdf>).

13. We think that an assessment of TOC profitability carried out for the purposes of a CA98 investigation should focus on profits as they would appear in the company accounts of the TOC under investigation. It should not look at a whole industry perspective. We think that focusing our assessment on the company under scrutiny is consistent with *United Brands*, which states that an undertaking has acted illegally if it "*has made use of the*

⁵ See, for example, the OFT/Oxera report *Assessing profitability in competition policy analysis*, July 2003

opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition”.

14. The total costs incurred by Network Rail would therefore only be relevant to our assessment to the extent that they were recovered via the track access charges levied on TOCs. The part of Network Rail's costs that are recovered by means of direct grants from the DfT would not play any part in profitability calculations carried out as a means of assessing a complaint of excessive pricing. This means, for example, that:

- TOC profits that were high net of subsidy/premium payments should be viewed as being (potentially) excessive regardless of whether ticket revenue covered Network Rail's costs; and
- a case where TOC ticket revenues were substantially higher than total industry costs should not be viewed as indicative of 'excessive' profits if the TOC's own profits after premium payments were modest.

15. The latter case could arise as a direct result of TOCs being incentivised to exploit any ability that they had to set high prices (subject to the constraint of any regulated fares) in order to maximise their chances of winning at franchise auction by virtue of, amongst other factors, the amount of the premium they can then offer.

16. The next section involves a discussion of the implications of the DfT's franchising process for estimates of TOC profitability. It explains why, even in a hypothetical case in which there were no difficulties in arriving at robust profitability estimates and identifying whether they were 'excessive', excess profits will only be earned in exceptional circumstances.

17. It is also important to recognise that in the event of us moving a complaint to a full investigation stage, carrying out a robust profitability analysis to the requisite standard would not be a straightforward matter. We would face a number of difficulties in attempting to carry out such analysis. Two important examples of the likely problems are listed below⁶.

- *Identifying a normal rate of return* – this would be a complex task; and
- *Common costs and the role of price discrimination* – A very high proportion of the costs incurred by TOCs are common between a number of products. For example, a fare such as 'peak standard-class travel between station A and station B' shares many of its underlying costs with other services that are off-peak, first class, and that offer travel between different pairs of stations that are on the same line. In these circumstances, arriving at meaningful cost estimates for individual fare types

⁶ See *Analysing allegedly excessive prices charged by train operating companies, A report for ORR by NERA*, March 2001: http://www.rail-reg.gov.uk/upload/pdf/nera_id280301.pdf

might well be prohibitively difficult. It is standard practice in most transport industries for different fare types (such as peak/off-peak and standard/first class) to be priced at different levels in a way that can be characterised as 'demand-down' rather than 'price-up'. Because of this, a profitability analysis carried out at for the purposes of addressing an excessive pricing complaint might have to be carried out at a highly aggregated level. These difficulties may not apply to the same degree to a similar analysis of the provision of car-parking services..

Franchise competitions

18. The DfT awards franchises to TOCs based on a detailed set of selection criteria⁷. An overview of the DfT's franchise award process is described in the DfT's *Rail Franchise Replacement Process Manual*⁸. Historically and as a result of this process, TOCs have tended to earn modest levels of profit once franchise subsidy or premium payments are taken into account. TOCs bidding to run a franchise are required to commit to offering a certain service level over the course of a franchise in return for the receipt of a series of subsidy payments, or, in the case of profitable franchises, the payment of a series of premium payments. This commitment is subject to 'cap and collar' risk-sharing arrangements between the DfT and TOCs as set out in, for example, *Implications of Amending Franchise Agreements*, NERA report for ORR, July 2006⁹. These arrangements have the effect of, to some extent, reducing the risk inherent in franchise agreements from a TOC perspective.

19. If competition between bidders is effective, a firm submitting a bid that anticipated supernormal profits after subsidy/premium payments would be unlikely to win the franchise competition and would lose out to firms offering to 'give up' a higher proportion of profits by way of higher premium payments or lower subsidies. This means that a competitive franchise auction should be expected to result in normal levels of profits for the winning TOC. Given that all TOCs face a degree of uncertainty over future outcomes at the franchise bidding stage, out-turn (rather than expected) profits may be somewhat higher or lower than the normal level if the key drivers of profits (for example, the level of demand and costs) differ substantially in the out-turn from their mean expected level. High profits that result from discrepancies between mean expected and out-turn demand and cost conditions should not be viewed as excessive.

⁷ The devolved administrations in Scotland and Wales have taken on responsibility for rail franchising (Scotland since April 2004 and Wales since April 2006). First ScotRail's franchise runs until at least 2011 and Arriva Trains Wales' franchise runs until 2018. Therefore, we focussed on DfT's franchising policy and selection criteria, as it has not (to our knowledge) been diverged from to date.

⁸ *Rail Franchise Replacement Process Manual*, Department for Transport, 6 July 2006. Available at: <http://www.dft.gov.uk/pgr/rail/passenger/franchises/railfranchisereplacementproc3345>

⁹ *Implications of Amending Franchise Agreements*, NERA report for ORR, July 2006. Available at: <http://www.rail-reg.gov.uk/upload/pdf/incentives-nera.pdf>

20. If franchise competition is effective and whole-franchise profits (net of franchise subsidy/premium payments) are consequently restricted to a normal level, the same will be true of the profitability of individual services (such as operating a particular passenger route or running a car park) within a franchise. The subsidy/premium profile that a winning bidder commits to in its franchise bid reflects the total (expected) cash generating capability of the franchise, with different services within the franchise likely to exhibit varying levels of underlying profitability. An analysis of the profitability of an individual service within a franchise would require the identification of a notional service-specific subsidy or premium payment. Each of these service specific payments should reflect the contribution of the individual service in question to the overall subsidy or premium level. This will result in only normal profits net of subsidy/premium payments being earned for an individual service if the aggregate subsidy or premium payment itself implies only normal net profits at the whole franchise level.

Implications of franchise payments and competitions for excessive pricing complaints

21. As explained at paragraph 13 above, we think that an assessment of TOC profitability carried out for the purposes of a CA98 investigation should focus on profits as they would appear in the company accounts of the TOC under investigation. This means that franchise premium payments should be treated as costs of the TOC, and conversely that franchise subsidy payments should be treated as income.

22. This approach means that the exploitation of customers (for example, defining 'exploitation' as charging prices that are higher than other prices for similar services, or charging fares that are high relative to a measure of average cost) could only be considered to be an abuse in those (atypical) circumstances where premium/subsidy payments are set at a level that did not capture fully any scope for exploitation over the life of the franchise. In other words, high prices could not be illegal when the TOC had competed away any supernormal profit by means of high premium/low subsidy payments at franchise let.

23. This leaves two distinct types of situation in which supernormal profits may not have been competed away at the franchise competition stage, namely where (see, for example, *Analysing allegedly excessive prices charged by train operating companies, A report for ORR by NERA*, March 2001 for a more detailed discussion):

- competition for the franchise has been ineffective; or
- a TOC has received a 'windfall' by exploiting an aspect of the market that could not have been anticipated at the time of franchise bidding.

24. In our view (informed by our assessment of market circumstances and past events), these circumstances will rarely arise. We have no reason to suspect that past franchise competitions have not been efficient (see, for example, the National Audit Office's report

The Award of the First Three Passenger Rail Franchises, October 1996¹⁰), and are similarly unaware of any significant historic potential for the exploitation of windfalls by TOCs.

25. It would not, however, be appropriate for us to assume as a starting point, without further evidence, that all franchise competitions will always be efficient. Similarly, it is possible that, in the future, there might be instances of TOCs exploiting windfalls that could not have been anticipated at the time of franchise bidding, and that were consequently not built into their expected profits and franchise bids.

26. Because, however, of the likely rarity of the circumstances set out at paragraph 23, and the relatively time- and resource-consuming nature (for all parties concerned) of attempting to assess these factors, we intend to initially apply a series of shorter, simpler, tests (which we term 'filters') to complaints in order to quickly identify those complaints where there is no likelihood of us being able to successfully pursue a case.

27. We have developed a set of factors derived from the case law on dominance and, in relation to excessive pricing, the two-stage test in *United Brands* set out at paragraph 8. In summary we will look for evidence as to whether or not:

- the TOC under scrutiny is not dominant in the supply of the service that is the subject of a complaint (because there are alternatives available to passengers);
- the fare/charge in question bears any relation to its economic value supported, for example, by the presence of a regulated fare; or
- the fare/charge in question can be seen to be at a reasonable level by means of a comparison with a fare/charge which that was itself set in competitive circumstances.

28. We discuss these filters below. In cases where complaints have passed through all of these filters, we may have to carry out further analysis, aimed at assessing whether it is possible that either of the circumstances set out at paragraph 23 has transpired. This further analysis might entail, for example, the analysis of franchise-level profitability data, or further dialogue with government and/or TOCs in order to better understand the circumstances of price increases.

Filters to be applied to complaints

29. We discuss the filters that we will apply to fares and station car-park charges in turn below.

¹⁰ *Office of Passenger Rail Franchising (OPRAF): The award of the first three passenger rail franchises*, National Audit Office, 23 October 1996, HC 701 1995-1996, ISBN: 0102914966,

Filters to be applied to fares complaints

30. We will take the view that a complaint about a fare is insufficiently promising to justify us opening an investigation where any the following conditions apply:

- the fare is itself regulated or is constrained by a regulated fare;
- the fare is comparable to that for a journey where competition may exist or where a fare is regulated (this can be used where two routes have sufficient similarities to allow a yardstick comparison, for example London commuter routes of a similar distance and journey time);
- the fare is for first class travel; or
- passengers have a viable alternative to rail for the journey in question.

Fare regulation

31. The governments' system of fare regulation provides the first and possibly most important of our filters.

32. The DfT is responsible for fares regulation policy for all franchised operators other than First ScotRail, whose fares are regulated by Transport Scotland and Arriva Trains Wales, whose fares are regulated by the Welsh Assembly Government, Transport Wales. At present, there is no difference between their approaches. Passenger Transport Executives (PTEs) and Transport for London (TfL) are also involved in setting fares within their respective spheres of influence. However, generally, the main responsibility remains with the DfT.

33. A detailed description of the DfT's approach to fare regulation is set out at Appendix A of the Strategic Rail Authority's *Fares Review Conclusions 2003*¹¹. A few key aspects of this regulation are summarised below.

34. The DfT regulates fares through franchise agreements with TOCs. Broadly speaking, there are two main types of regulated fare, namely:

- commuter fares (including standard day single and return tickets and season tickets (weekly, quarterly and annual) within the London Travelcard Zone and certain other major suburban areas including Cardiff and Edinburgh; and
- protected fares (including weekly season tickets that are not included in the commuter fares basket and long distance saver return tickets).

¹¹ *Fares Review Conclusions 2003*, Strategic Rail Authority, June 2003. Available at: <http://www.dft.gov.uk/consultations/archive/2002/farespolicyreview/faresreviewconclusions2003>

35. Fares are largely regulated where the DfT's assessment of market conditions has led it to believe that price controls were necessary to protect the interests of rail users, for example because a high proportion of passengers are captive to rail. It also regulates saver return fares for off peak travel over distances greater than about 50 miles.

36. Fares are grouped together in baskets. A limit is applied to a weighted average of the basket. Most TOCs have two baskets: one for commuter fares; and another for protected fares. Until 2014 (for TOCs other than Southeastern)¹², the DfT has set the limit on price rises at the Retail Price Index (RPI) plus one per cent (RPI +1%) per year. Another cap is applied to each individual fare within the basket: any individual fare can rise by up to RPI +6% per year. This allows TOCs some flexibility to adjust individual fares by more or less than the average increase for the basket. TOCs can use this flexibility to reflect market conditions in their fares structures, promote growth or manage capacity, and to correct anomalies or control overcrowding.

37. Zonal fares structures can also be a form of fares regulation. For example, the DfT recently required TOCs to introduce zonal rail fares in the London area. It did so by putting a requirement into relevant franchise agreements. The first tranche (for single and day return fares) was introduced in January 2007.

Why we consider that a regulated fare could not be illegally high

38. Our view is that TOCs are entitled to have a very strong expectation that pricing up to or within the cap set by the DfT is legal. We have not carried out an assessment of whether the DfT's fares regulation policy is sufficiently detailed to constitute a legal direction that would exclude it from CA98, and note, in this respect, that there are no restrictions in the regulated fares basket on TOCs going below the cap. By pricing up to the level of the fares cap, however, TOCs are acting in accordance with a government policy expressed through a binding franchise commitment that is explicitly designed to protect certain categories of captive consumers from exploitation.

39. We further note that, in aggregate, regulated fares have fallen in real terms in the period since privatisation, despite an overall increase in the cost of funding the railways over the same period. TOCs do have the scope to increase individual fares within the overall basket by up to 6% per year (up to 8% per year for Southeastern) in real terms. However, our analysis of previous fare complaints does not suggest to us that there are any instances of individual regulated fares having been increased at the highest permitted individual level over a number of years.

Fares that are constrained by regulated fares

40. Our view is that an individual fare could not be considered to be excessive if constrained (held down) by another fare that is itself regulated. The most important

¹² Southeastern's limits are RPI + 3% for the weighted average of the fare basket as a whole, and RPI + 8% for any individual fare.

example here is that where a fare for an off-peak journey is less than a regulated peak fare for the same journey, we would not consider it possible that the off-peak fare could represent an example of illegal pricing given the arguments on regulated fares set out above. Where prices are below a level that has been held to be a reasonable charge to a group of captive consumers, we would not consider (in the absence of strong evidence to the contrary) that we had grounds to suspect that they were illegally high.

First class fares

41. We view first class travel as a premium product, whereby passengers choose to pay higher fares in return for a higher quality of service, as happens in other transport industries such as aviation. As such we would expect to see a mark-up between first and standard travel without an assumption that the law has been broken. As a general presumption we will assume that the level of first class fares reflects the extra economic value of this product to customers. Historically the ratio of the price of first and standard class tickets in rail has been similar to, say, the corresponding ratio for business and economy class tickets in short-haul air travel. Our view on this issue might be subject to change if this similarity were no longer to apply.

Passengers have a viable alternative to rail

42. We would envisage this type of filter only being used in the fairly exceptional circumstances where readily available information existed on the viability of substitute modes (such as air or coach), for example via analysis carried out by the Competition Commission ('CC') as part of a merger investigation. In most instances, the market definition and dominance analysis that we would need to carry out would be sufficiently time- and resource-consuming to make this kind of test impractical for use as a primary filter.

Filters to be applied to complaints about station car-park charges

43. Whilst the DfT policy on fare regulation applies to a significant proportion of fares, such regulation does not apply to station car-park charges. There are, however, a number of filters that we think it will be appropriate to use in assessing complaints about station car-park charges. In all cases, we think that the onus should be on the complainant to say at the outset why these factors do not apply, i.e. why there are no alternatives to using a station car park.

44. We will consider that a complaint about station car-park charges is insufficiently promising to justify a full investigation being opened in cases where:

- there are realistic parking alternatives available to passengers driving to the station;
- the station is readily accessible via alternative modes of transport (for example because of the existence of a park and ride facility);

- there is scope for passengers to avoid high car-parking charges by parking at an alternative station;
- realistic alternatives are available to the entire rail journey itself (this may be true in some circumstances but would be unlikely in the case of, for example, London commuter routes); or
- car-park charges are in line with those at a station within the same region where comparable car-parking facilities are likely to face effective competition (this can be used where two car parks have sufficient similarities to allow a yardstick comparison, for example at stations within the same region serving London commuter routes with a similar level of train service).

A degree of scrutiny will be required in order to determine whether the above factors exist and all the material facts about a particular car park, its location and its comparators may not be immediately available. The factors are, however, not sequential, and if on initial scrutiny we find one or other of the above factors is present we will take the view that the complaint is not sufficiently promising to justify our carrying out further investigations.

Alternative car parks within the vicinity of the station

45. We will filter out complaints in cases where there are realistic parking alternatives available to passengers using the station. In order to be classed as a realistic alternative, competing facilities would need to be:

- suitable in terms of opening hours and charging structure to allow commuters to leave their cars parked for the requisite number of hours (for example, at least 10 hours in the case of commuters);
- within a reasonable walking distance of the target station. We took this to be about one kilometre or just over half a mile, as this is about 15 minutes' walk at average pace; and
- large enough, when compared with the station car park, to enable sufficient switching to hold down prices.

We will consider both on-street parking and dedicated car parks as potential alternatives.

Alternatives to driving to the station

46. Determining whether there are alternatives to driving to the station is another means of eliminating unpromising complaints. If, for example, an urban station has numerous connecting bus routes and/or a park and ride scheme we may consider that there are realistic alternatives. This would lead us to sift out the complaint due to there being insufficient evidence of dominance. This would not hold, however, if driving were the only viable way to get to the station (if for example, there were no regular public transport

services, the nearest residential area was not within about a kilometre, or there were no footpaths).

Alternative station car parks

47. We will filter out complaints in cases where there is scope for passengers to avoid high car-parking charges by parking at an alternative station. In order to be classed as a realistic alternative, facilities would need to be:

- likely to be priced competitively (i.e. in circumstances where there is likely to be competition);
- within reasonable travelling distance of the subject station (less than around 15 minutes' drive); and
- served by train services that provide a realistic alternative to those from the subject station.

Alternative modes of transport

48. Another means of identifying unpromising complaints is to make a preliminary assessment of whether there are realistic alternatives to using rail for the whole journey from that station. As noted above for fare complaints, we would envisage this type of filter only being used in the fairly exceptional circumstances where readily available information existed on the viability of substitute modes (such as air or coach), for example via analysis carried out by the CC as part of a merger investigation. In most instances, the market definition and dominance analysis that we would need to carry out would be sufficiently time- and resource-consuming to make this kind of test impractical for use as a primary filter.

Conclusions

49. Our work over the summer and autumn of 2007, drawing on analysis and evidence available at the time, has led us to conclude that the scope for excessive pricing in a franchise context is very limited. It might exist where:

- competition for the franchise is inefficient; or
- windfall profits are made.

50. We will use the filters explained at paragraphs 29 to 48 to sift out unpromising complaints before exploring the efficiency of the competition for the franchise or the existence of windfall profits.

51. We will continue to keep this policy under review in the light of changing market circumstances and the governments' fares policy.