MODERATION OF COMPETITION:
FINAL CONCLUSIONS

May 2004
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Regulator’s foreword

1. This document sets out my final conclusions on moderation of competition (protection from on-track competition that might be afforded in the track access contracts of passenger train operators). It follows previous consultations with the industry, most recently in July 2003 on my draft conclusions. I am grateful to all those who responded to that consultation. Chapter 2 of this document describes the points raised and my conclusions on them.

2. Moderation of competition raises some difficult policy questions about the costs and benefits of allowing competition in a market like the railways, where almost all passenger train operators operate under franchises with the public sector and where access to the network is necessarily constrained. In what circumstances should an operator be given contractual protection from on-rail competition to facilitate investment? Should new services be approved where they would compete with existing services, given the implications for the revenue of incumbent operators and, ultimately, the budget of the Strategic Rail Authority? Chapter 3 of this document explains how I intend to approach such questions.

3. There will inevitably be some difficult decisions to take, both for me and for my successors, the Office of Rail Regulation. Our statutory objectives in section 4 of the Railways Act 1993 will not all point in the same direction and conflicting objectives will need to be balanced one against another. However, I believe that the document I am publishing today sets out a clear framework within which such decisions will be taken in the public interest and provides valuable guidance which will assure operators, funders and others in important respects.

TOM WINSOR

Rail Regulator

May 2004
1. **Introduction**

**Introduction**

1.1 This document sets out the Regulator’s final conclusions on moderation of competition (MoC)\(^1\). The policy set out in this document will be applied by the Regulator in considering track access applications from passenger train operators and should be read alongside the Regulator’s existing criteria and procedures for processing such applications\(^2\).

1.2 This document follows several earlier consultations on the subject of MoC. Previously, the subject has been dealt with in tandem with the Regulator’s proposals on changes to access rights (the voluntary and mandatory surrender or adjustment of rights and a use it or lose it mechanism). It may therefore be helpful to explain why this document deals with MoC alone.

1.3 Contractual MoC protection is an access right. In principle, therefore, it could be subject to provisions dealing with the surrender or adjustment of access rights, including their loss through non-use. When the Regulator consulted on MoC and changes to access rights in June 2001\(^3\), contractual MoC protection was envisaged as being relatively common. It was also proposed that a new Part J of the network code\(^4\) would provide for the mandatory surrender and adjustment of access rights, including rights to MoC protection, with the implication that the removal of rights against the operator’s will, but with compensation, would not necessarily be exceptional. Underlying these proposals was the policy of having long-term franchise and track access agreements, with the franchised operators undertaking significant investment.

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\(^1\) Contractual MoC is an access right and MoC protection gives an operator the right to be protected from on-rail competition on specified flows. A brief history of MoC can be found at paragraphs 3.2 to 3.7 of *Changes to access rights and moderation of competition: draft conclusions*, Office of the Rail Regulator, London, July 2003 (for convenience referred to as the July 2003 document in this one), available at [www.rail-reg.gov.uk/upload/pdf/177.pdf](http://www.rail-reg.gov.uk/upload/pdf/177.pdf).


\(^4\) The network code, also known as *The Railtrack track access conditions 1995 (Issue 3)*, available at [www.rail-reg.gov.uk/upload/pdf/tac_allparts_jul03.pdf](http://www.rail-reg.gov.uk/upload/pdf/tac_allparts_jul03.pdf) is published as part of the network statement of Network Rail Infrastructure Limited (Network Rail). It is a common set of rules applying to all parties to regulated track access contracts to which Network Rail is a party and is incorporated by reference into each bilateral contract with an access beneficiary (usually a train operator).
1.4 However, as the July 2003 document explained, there have been significant changes in circumstances since June 2001 which have implications for the Regulator’s policy on MoC (e.g. shifts in the policy on franchising of the SRA (Strategic Rail Authority), growing concerns regarding the capacity of parts of the network to accommodate new services and changes in European law). The original reasoning behind combining the two issues no longer holds sound, with both contractual MoC protection and provision for the mandatory surrender of access rights now both likely to be very much the exception. The Regulator has therefore decided to publish his policy on MoC separately to his final conclusions on access rights.

1.5 The Regulator’s final conclusions on changes to access rights will be published shortly. Those final conclusions will take account of responses to the July 2003 document on changes to access rights. They will also incorporate comments from freight operators and Network Rail on freight-specific processes for changes to access rights (a rocker mechanism to deal with the transfer of rights when rail freight haulage contracts move between operators and a mechanism to adjust cordon caps in freight track access contracts). His draft conclusions on these matters were published in December 2003. In this way, the Regulator’s final conclusions on changes to access rights will be comprehensive in their coverage.

Background

1.6 In the June 2001 document, the Regulator sought the industry’s views on a new policy on MoC to replace the stage II arrangements that expired on 31 March 2002. These were that:

(a) there would be no general extension of MoC protection beyond 31 March 2002;

(b) MoC protection in existing track access contracts would not be affected;

(c) the Regulator would consider applications for new contracts or amendments to existing contracts intended to provide for MoC on specified flows on their individual merits; and

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broadly, the Regulator envisaged that new applications for contractual MoC protection would only be granted where it could be shown that protection would generate worthwhile benefits that would be passed on to passengers or to the network generally, and which would not have occurred in the absence of MoC protection. He expected that this was likely to occur only where MoC provided protection for investment and/or protection from cherry-picking.  

1.7 In July 2003, the Regulator set out his draft conclusions on this issue, which, in particular, took account of important developments in the industry since June 2001 as well as the responses to the June 2001 document.  

1.8 The closing date for responses to the July 2003 document was 15 September 2003 and in total nine companies and organisations responded on MoC. They are listed at Annex 1 and their responses have been posted on the Regulator’s website. The Regulator is grateful for the industry’s response and the detailed and helpful comments made.  

1.9 This document presents the Regulator’s final conclusions and is structured as follows:  

(a) Chapter 2 sets out the Regulator’s views on the responses received to his draft conclusions on MoC set out in the July 2003 document. Although respondents generally welcomed the conclusions, there were a number of detailed concerns, particularly about protecting existing rights and investments; and  

(b) Chapter 3 provides a statement of the Regulator’s policy on MoC, taking account of the views discussed in Chapter 2. It covers:  

(i) the Regulator’s statutory duties;  

(ii) the scope for on-rail competition;  

(iii) protection from competing services that are primarily abstractive of incumbents’ revenue;  

(iv) MoC protection to encourage investment;  

(v) the duration of the policy on MoC protection; and  

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6 See paragraph 3.13 below.  
7 [www.rail-reg.gov.uk/server/show/ConWebDoc.5882](http://www.rail-reg.gov.uk/server/show/ConWebDoc.5882)
(vi) consistency with legal requirements.
2. **Moderation of competition: consultees’ comments and the Regulator’s response**

**Introduction**

2.1 This chapter comprises:

(a) a brief restatement of the Regulator’s draft conclusions, as set out in full in paragraphs 3.9 – 3.40 of the July 2003 document;

(b) a discussion of the views of those who responded to the July 2003 consultation; and

(c) the Regulator’s response to consultees’ views.

2.2 A statement of the Regulator’s policy on MoC is contained in Chapter 38.

**The Regulator’s draft conclusions**

2.3 Contractual MoC is an access right and, whilst most access rights provide operators with a right to do something (usually to run trains at particular frequencies), MoC protection provides operators with the right to be protected from something, namely on-rail competition on specified flows. It was devised principally because of a concern at the time of privatisation that unrestricted inter-operator competition would be perceived as a major risk by bidders for passenger franchises.

2.4 In the July 2003 document the Regulator said that he was minded:

(a) not to approve contractual MoC protection other than in exceptional circumstances. Those exceptional circumstances would involve planned investment that would not otherwise occur without contractual MoC protection; and

(b) not to approve MoC protection against cherry-picking because such cases would be identified and addressed by the normal procedures by which the Regulator considers track access applications, which include consultation with potentially affected operators and the SRA.

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8 Further information on the Regulator’s policy on competition generally is available at www.rail-reg.gov.uk/server/show/ConWebDoc.5058.
2.5 The Regulator acknowledged that the long-term nature of many investment projects and an operator’s need to have assurances in order to plan its business with a reasonable degree of assurance meant that, in cases where it is appropriate, MoC protection should be contractual. The Regulator said that each application for MoC protection would be considered on a case-by-case basis, but with the focus very much on the claimed benefits to passengers. The applicant would need to demonstrate that the benefits would outweigh the disadvantages and in his draft conclusions the Regulator described how he would assess such applications.

2.6 The Regulator said that he would only expect to approve contractual MoC protection on those flows necessary to achieve the proposed investment. The Regulator said that he would normally expect the MoC protected flows themselves to benefit from the proposed investment, but he would be prepared to consider arguments for protection of flows which would not themselves be the subject of investment where it could be demonstrated that without protection specific investment elsewhere in the franchise could not take place.

2.7 The Regulator said he could not envisage circumstances where contractual MoC protection would be granted retrospectively.

2.8 Finally, the Regulator’s draft conclusions said that his policy on MoC protection, once established, would remain in place unless there was a material change to the factors and reasons that led him to arrive at the policy in its stated form.

Consultees’ views

2.9 The majority of respondents supported the Regulator’s draft conclusions and welcomed his ongoing policy of not expecting to approve applications for access rights that are primarily abstractive.

2.10 A number of respondents sought confirmation that the Regulator’s proposals would not affect existing rights. For example, Tyne and Wear Passenger Transport Executive (Nexus) pointed out its track access agreement has a MoC provision which was agreed as part of the specific funding arrangements for the Sunderland Direct project and does not end until 2012. The exception to this viewpoint was Strathclyde Passenger Transport Executive (SPTE), which felt that continuation of existing MoC

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9 See Schedule 10 of the track access agreement (passenger services) between Railtrack PLC (as Railtrack) and Tyne & Wear Passenger Transport Executive (as Nexus) relating to the route between Pelaw Junction and South Hylton Station via Sunderland Station and dated 22 December 1999.
Moderation of competition: final conclusions

protection should be conditional upon delivery of service commitments and passenger
benefits and wanted the principle to be retrofitted into any extant MoC arrangements.

2.11 National Express Group plc (NEG) felt that, as operators were now taking a more
responsible attitude to timetable robustness in terms of providing for suitable
performance breaks by allowing more ‘white space’ in the working timetable, there
was a risk that such space in the timetable would be seen as an entry opportunity for
open access operators to exploit. The Go-Ahead Group plc (Go-Ahead) argued that,
where parties work to free capacity to support improved performance, that capacity
should not easily be converted into an opportunity for a further slot to be operated by
a third party. Go-Ahead argued that this would counteract the intended performance
benefits, perhaps to the detriment of the operator which had initially given up some of
its capacity. To combat this concern NEG suggested that the Regulator make a
statement that this ‘white space’ is sacrosanct. Go-Ahead and FirstGroup plc
(FirstGroup) stressed the importance of ensuring that strong mechanisms were put in
place to protect this type of performance-enhancing initiative and suggested that
strong guidelines be available to steer Network Rail towards the type of projects that
should have MoC protection.

2.12 In his draft conclusions, the Regulator said that there would be a stronger case for
MoC protection where an investment concerned new trains if the trains could be used
only on limited routes, because such an investment involved more risk than
investment in trains that could be used on most parts of the network. In most cases,
though, he did not consider that investment in new trains would require MoC
protection. Neither Go-Ahead nor FirstGroup accepted this. They both said that new
trains should not be distinguished from other investment because it is in the nature of
such investment cases that they are often based on use on particular routes with other
significant investment (e.g. investment in depots) closely related to that use.
FirstGroup said that, in practice, there are often serious constraints on the reallocation
of rolling stock and the revenue from the flows where it is deployed will be critical to
fund the investment. Go-Ahead also pointed out that the generally congested nature
of the network and other fleet deployment may seriously limit the ability to redeploy
trains elsewhere. It said that MoC should offer the opportunity to reduce revenue risk
and increase the efficiency of this type of new investment in the industry.

2.13 The SRA supported the Regulator’s draft conclusion that he should not expect to
approve applications for rights that would allow the running of services that were
primarily abstractive of incumbent operators’ revenue. In finalising his conclusions,
it asked the Regulator to note its views on competition between passenger service
providers as set out in its network utilisation strategy (NUS). It felt it was particularly important that the Regulator’s final conclusions reiterated his statement that operators seeking to introduce competing services must specify the benefits for passengers and the extent to which that service volume growth would lead to passenger volume growth.

2.14 The SRA also said that it and third party investors would require assurance that the benefits of their investment would be realised through the guarantee that access rights will be available to make use of such an investment. The SRA asked that the Regulator consider, where the case has been made, granting MoC protection in track access contracts for the period necessary to realise the benefits of the investment, which would not necessarily be related to the length of the franchise agreement. It drew the Regulator’s attention to paragraph 4.65 of his criteria and procedures document\(^\text{10}\) which recognises that agreements over ten years may be justified in exceptional cases, particularly where there is large scale, long-term investment. In such circumstances, it felt that the Regulator should also be prepared to consider granting long-term MoC protection irrespective of the length of the remaining life of the relevant franchise agreement (e.g. where a special purpose vehicle project is being used). The SRA believed that investors would not gain sufficient comfort if contractual MoC protection were limited to the duration of the relevant franchise agreement, with only a policy statement that the Regulator would be minded to extend that protection for a further specified period in one or more successor contracts. The SRA concluded that MoC protection should reflect the length of the track access agreement, which is not necessarily linked to the term of the franchise agreement.

2.15 Network Rail queried whether Annex 8 of the July 2003 document (process involved in assessing an application for MOC protection) intended a separate process of application by the operator to the Regulator for MoC protection, or whether the process would be part of the consideration of an application under sections 17 to 22A of the Railways Act 1993. It also suggested that, because the Regulator is looking to deal with applications on a case-by-case basis, consideration would have to be given to the implications for manageability and costs, including the funding of any systems the company would need to put in place.

2.16 SPTE felt that PTEs and other funders should have direct access to the MoC process being proposed in order to enable them to protect any relevant financial interests in

the outcome of any investment projects that they were sponsoring. For similar reasons, it was also concerned that the proposed protection under the provisions of the Passenger Access (Short Term Timetable Changes) General Approval 2002, which the Regulator proposed should be re-issued \(^{11}\), should be extended to require the consent of funders with a financial interest in the services operated by an existing operator, as well as the operator itself.

**Regulator’s response to consultees’ views**

2.17 A number of respondents were concerned to ensure that the Regulator’s proposals did not affect contractual MoC protection in existing agreements. The Regulator has always made it clear that his proposals for MoC do not in any way affect flows which enjoy contractual protection under the terms of existing access contracts. Such flows would continue to enjoy MoC protection until the date stipulated in the contract, subject to the relevant contractual provisions in each case (see paragraph 3.4 below).

2.18 The Regulator disagrees with SPTE’s proposal to revisit MoC protection in existing agreements because:

(a) the Railways Act 1993 gives the Regulator no powers unilaterally to amend an existing track access agreement;

(b) even if he had such powers, it would be undesirable to use them as SPTE suggests, given his duty ‘to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance’ (section 4(1)(g) of the Railways Act 1993); and

(c) in practice, it should also be unnecessary to do so, as the four agreements with contractual MoC protection all had the MoC provisions approved by the Regulator because they included significant investment that should bring clear benefits to passengers.

2.19 The Regulator fully recognises that train operators should not be disadvantaged where they have given up rights in order to improve network performance. The Regulator’s criteria for considering applications from passenger and freight operators state clearly that he would not expect to approve rights in such cases unless there has been a

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\(^{11}\) In the July 2003 document, the Regulator proposed to close a loophole whereby, in theory, a train operator could use the existing general approval to introduce a new competing service because the MoC exclusion in the general approval refers to the moderation of competition schedules in track access contracts and for most operators this provision is now spent.
material change in circumstances and only then after consulting other operators and taking into account the overall benefits of the application.12

2.20 In respect of investment in new trains, the Regulator remains of the view that generally they should not require MoC protection because, to the extent that new trains can be used on other parts of the network, the risk of the investment is reduced and the case for MoC protection weakened. However, this does not mean cases for MoC protection involving investment in new trains will automatically be ruled out. As with other types of investment, the Regulator will consider applications on their individual merits, including, as appropriate, arguments of the kind put forward by Go-Ahead and FirstGroup for why MoC protection could be justified in some cases where investment is in new trains. It is for the applicant to make an appropriate case and to satisfy the Regulator that the investment is worthwhile and that the absence of MoC protection would materially prejudice the investment.

2.21 The Regulator agrees with the SRA that it is important that an operator seeking to introduce a new competing service should have to specify the benefits to passengers and show that the increase in the number of services will also attract sufficient new passengers. These points are picked up in the Regulator’s policy statement on MoC set out in Chapter 3 (see paragraphs 3.16 to 3.19 below). In respect of the SRA’s points about duration of MoC protection, these are dealt with at paragraphs 3.30 to 3.34 below.

2.22 Network Rail queried the process for considering an application for MoC protection. The Regulator confirms that the process of applying for MoC protection would be done as part of the track access application process under sections 17 to 22A of the Railways Act 1993.13

2.23 Network Rail also asked the Regulator to consider the question of manageability and costs, including the funding of any systems it has to put in place to administer contractual MoC protection. The Regulator does not believe that Network Rail should be separately funded for any such costs. Under the MoC stage II arrangements, Network Rail had to do a lot of work to establish protected flows for all operators and


then to ensure that it did not sell rights to other operators in breach of those contractual protections. The Regulator’s policy now is to extend MoC protection only in specific cases where the applicant makes its case against what are quite demanding criteria. Protection for specific flows will therefore be very much the exception in future and should not involve Network Rail in materially increased costs.

2.24 SPTE asked the Regulator to consider giving PTEs and other funders direct access to the MoC process. As explained in paragraph 2.22 above, applications for MoC protection would need to be made under sections 17 to 22A of the Railways Act 1993. As part of his consideration of any application, the Regulator will routinely expect to consult other interested entities in the area in question, including any PTE likely to have an interest, together with any other bodies with a direct role in funding or specifying services, such as the Scottish Executive. However, he does not agree that PTEs and other funders should have direct access to the MoC process, as this would add extra complexity, especially for Network Rail. A funder’s contractual relationship is with the operator concerned and the onus is therefore on the funder to ensure that the operator keeps it fully informed and acts to protect any financial interests it has in the franchise. Moreover, the ORR’s website now contains extensive information on pending applications for access rights, including copies of the application itself, the associated application forms and other information. PTEs and others will be able always to see what has been applied for and where it is in the regulatory approval process.

2.25 Finally, the Regulator will re-issue the Passenger Access (Short Term Timetable Changes) General Approval 2002, which expires on 23 May 2004. On reflection, he considers that this general approval should be rather more restrictive than the current general approval, which permits new services to run under it for up to two timetable periods, subject to certain restrictions. The revised general approval will allow new services to run under it for a maximum of 28 days. The Regulator believes that this will cover the cases where the general approval is of real value (e.g. where an operator wants to run services for a one-off event, like a football match or concert), without allowing potentially controversial new services, including ones that could abstract significant revenue from an incumbent operator, to run for up to two timetable periods without specific approval. This approach will address SPTE’s concern by ensuring that significant new services are subject to full consultation,

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including with any PTE with an interest, as part of the Regulator’s usual consultation processes.
3. Moderation of competition: a statement of the Regulator’s policy

Introduction

3.1 The previous chapter briefly restated the Regulator’s draft conclusions on MoC, as set out in the July 2003 document, and provided a summary of the responses received and his views on them. This chapter provides a statement of the Regulator’s policy on MoC having regard to both his statutory duties and the responses received.

3.2 As the July 2003 document explained, there have been significant developments in the railway industry since the Regulator consulted on MoC in June 2001. As a result, the Regulator had to consider whether his earlier proposals on MoC still held good and, as argued for in the responses from The Association of Train Operating Companies (ATOC) and Railtrack to the June 2001 document, whether his proposals for MoC needed to be set in the context of his overall policy towards competition between passenger operators. The Regulator agreed that such a policy statement, taking account of recent developments, would help the industry put his proposals on MoC into context and his draft conclusions on this matter were set out in the July 2003 document.

3.3 The Regulator’s policy is set out below. It should be read alongside the Regulator’s criteria and procedures for passenger track access applications, as applications for MoC protection – or applications for rights that may involve competition with existing services – will need to be made under sections 17 to 22A of the Railways Act 1993 and follow the same procedures and timescales.

3.4 This policy does not affect flows which enjoy contractual MoC protection under the terms of existing track access contracts, which will continue to enjoy such protection until the date stipulated in the contract, subject to the relevant contractual provisions in each case. Equally, contractual MoC protection will not be used to protect an operator from competition that already exists on the network.

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15 Network Rail acquired Railtrack plc in October 2002 and formally changed Railtrack’s name to Network Rail Infrastructure Limited from 3 February 2003.
The Regulator’s statutory duties

3.5 The Regulator’s starting point in formulating his policies is his duties under section 4 of the Railways Act 1993. In particular in this context, he is under a duty to exercise his functions under Part I of the Act in the manner which he considers best calculated ‘to promote competition in the provision of railway services for the benefit of users of railway services’ (section 4(1)(d)).

3.6 The Regulator has also had regard to his other duties in section 4. Particularly relevant amongst these are the duties to exercise his functions under Part I of the Act in the manner which he considers best calculated:

(a) to protect the interests of users of railway services (section 4(1)(a));

(b) to promote the use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent that he considers practicable (section 4(1)(b));

(c) to facilitate the furtherance by the SRA of any strategies which it has formulated with respect to its purposes (section 4(1)(za)); and

(d) to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance (section 4(1)(g)).

3.7 The Regulator must also have regard to the financial position of the SRA in discharging his functions under Part I of the Act (section 4(5)(c)).

The scope for on-rail competition

3.8 The Regulator notes the following implications for on-rail competition from the SRA’s franchising strategy17:

(a) franchise agreements will be far more specific about the services an operator will run. This is an important development because, with the exception of a small number of services run by Hull Trains Company Limited between London and Hull, new on-rail competition since privatisation has to date been between franchise operators, rather than from new, open access operators;

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(b) franchise ‘remapping’ is reducing the number of franchisees and the scope for competition between them; and

c) franchise agreements – and track access contracts – will generally be shorter than was envisaged in June 2001, so there will be less scope for new entrants to provide services that benefit passengers by filling a gap in a franchise specification that has become out-dated.

3.9 The Regulator also notes the SRA’s views as set out in its capacity utilisation policy\(^\text{18}\) that, whilst competition between operators can bring benefits (e.g. on some parallel routes between major conurbations), the SRA supports the Regulator’s policy to date of not granting access rights to services that primarily abstract revenue from other operators and do not increase the overall market significantly.

3.10 Final decisions on the fair and efficient allocation of railway capacity are matters for the Regulator, taking account of his statutory duties in respect of the SRA’s strategies and financial position alongside all his other relevant duties under section 4 of the Railways Act 1993. But the SRA’s policies described above indicate that there is likely to be less potential for competition between franchise operators in future.

3.11 The Regulator has also noted that parts of the network are already running at or very close to full capacity. These routes are often the ones with relatively high passenger demand, which would be attractive to new entrants. In contrast, parts of the network with the greatest spare capacity are also likely to have relatively low passenger demand and therefore be unattractive to a new entrant (because the new entrant, unlike the incumbent franchisee, would not receive any subsidy for running services on those routes).

3.12 Taking all these considerations into account, the Regulator has concluded that, whilst on-rail competition between operators can bring benefits to passengers, there will in practice be limited scope for such competition to develop in the foreseeable future. He does not therefore believe that it is necessary, in order to give existing passenger train operators a reasonable degree of assurance to plan the future of their businesses, to grant contractual MoC protection other than in exceptional cases. These

\(^18\) Capacity utilisation policy: network utilisation strategy, SRA, London, June 2003, available at www.sra.gov.uk/publications/general default. This document sets out the SRA's views on the use of capacity on the network and, inter alia, defines a programme of route utilisation strategies covering ten major routes across the country and a long distance statement. Route utilisation strategies, once they have been published, will be particularly pertinent to the Regulator's consideration of track access applications.
exceptional cases would involve planned investment that can be shown would not otherwise occur without contractual MoC protection. The Regulator does not believe that it is likely to be necessary in future to grant contractual MoC protection against cherry-picking, as such cases would be identified and addressed by the normal procedures by which the Regulator considers track access applications. These procedures include consultation with potentially affected operators and the SRA. The reasons for his final conclusions on MoC in relation to investment and cherry-picking are set out below.

**Protection from competing services that are primarily abstractive in nature**

*MoC protection and competing services that are primarily abstractive in nature*

3.13 The Regulator acknowledges that competing services that are primarily abstractive of incumbents’ revenue without compensating economic benefits – cherry-picking services – are undesirable. Whilst the introduction of any new service is almost certain to bring some benefits to the passengers who use it, cherry-picking involves cases where such benefits are more than offset by other factors. Cherry-picking makes it difficult for existing passenger train operators to plan their businesses with very much certainty and it increases costs for the SRA (either in the short term, through contractual indemnities to franchisees, or in the longer term, through higher subsidies or lower premiums when a franchise is re-tendered). Over time, the extra uncertainty for existing operators and additional costs to the SRA will also have an impact on passengers, because operators will be deterred from investing and the SRA will have less money available to subsidise other services. Cherry-picking could also have a significant detrimental effect on the SRA’s ability successfully to implement its franchising strategy. It may also add to industry costs without sufficient compensating benefits.

3.14 In considering potential new services that would compete with existing services, the Regulator will therefore need to balance a number of his duties under section 4 of the Railways Act 1993, especially his duties:

(a) to exercise his functions in the manner which he considers best calculated to promote the use of the railway network for the carriage of passengers … to the greatest extent that he considers economically practicable (section 4(1)(b));

(b) to exercise his functions in the manner which he considers best calculated to promote competition in the provision of railway services for the benefit of railway users (section 4(1)(d));
(c) to exercise his functions in the manner which he considers best calculated to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance (section 4(1)(g)); and

(d) to have regard to the financial position of the SRA (section 4(5)(c)).

3.15 However, the Regulator has concluded that it is no longer either appropriate or necessary to have a regulatory policy establishing a standard form of contractual protection from cherry-picking, for the following reasons:

(a) there would be a considerable amount of detailed work involved for train operators, Network Rail and the Regulator in establishing which flows should be contractually protected, to what extent and over what period. The Regulator’s assessment would also be a difficult one to make because it would be made in the abstract: it would be unclear, when the protection was being considered, from what potential competition an incumbent would be protected, and what potential benefits such competition could bring;

(b) as indicated above, in practice competition from franchised or open access operators is likely to be very much the exception, rather than the rule, so the potential benefits of going through the process needed to give contractual MoC protection against cherry-picking are likely to be very limited;

(c) the absence of contractual MoC protection does not necessarily mean that an operator will face competition on flows that may previously have enjoyed contractual MoC protection. First, the prospect of competition depends on a potential entrant having identified a profitable entry opportunity and applied for relevant access rights. Second, whether entry is permitted will depend on whether the Regulator approves access rights permitting such competition. Before any such rights were approved, the Regulator would first consult all interested parties, including incumbent operators, against whose services the proposed new services, if approved, would compete. The incumbents would have every opportunity to make their case; and

(d) train operators should not be disadvantaged where they have given up rights in order to improve network performance. As stated at paragraph 2.19 above, the Regulator’s criteria for considering applications from passenger and freight

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operators state clearly that he would not expect to approve rights in such cases unless there has been a material change in circumstances and only then after consulting other operators and taking into account the overall benefits of the application.

The assessment of applications involving potential new competing services

3.16 The Regulator will therefore consider applications for rights involving potential new competing services in a way that is consistent with his criteria and procedures for the approval of passenger track access contracts. As with any other application for new track access rights, this will include, for example, consideration of whether there is sufficient capacity available to accommodate the rights sought, the performance impact on other operators, the net benefits to new and existing passengers and the impact the proposed rights would have on relevant SRA strategies.

3.17 Where there is clear evidence that revenue abstraction may be a material concern, the Regulator’s assessment will also look specifically at whether the new competing services would be primarily abstractive of the revenue of existing operators. The expression ‘primarily abstractive’ is not intended to imply a rigid benchmark. The Regulator considers that such a test would be unrealistic, given the uncertainties about forecasting future revenue effects, and would not allow all relevant factors to be taken into account. Instead, the Regulator will consider whether the overall effect of approving the proposed rights is likely to attract sufficient new patronage to rail such that this could be considered the primary impact of the proposal. If an application passes this test and is also acceptable against the Regulator's usual criteria for considering new track access rights (see paragraph 3.16 above), the Regulator would expect to approve the rights sought.

3.18 In order to inform the Regulator’s judgment in such cases, the ORR expects to carry out a full assessment of the revenue effects through the following five stage process:

(a) Stage 1 will use standard industry models of growth and patterns of changes in demand, notably the passenger demand forecasting handbook (PDFH) and

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21 The PDFH summarises existing knowledge on rail passenger demand forecasting and is based on information gained in some 175 research studies. It gives clear recommendations that enable users to forecast changes in demand in light of anticipated changes in circumstances.
MOIRA\textsuperscript{22} software, to make an initial broad estimate of the likely level of revenue abstraction and generation. However, MOIRA may not be a good guide to future revenue impacts where, for example, there are relatively few services on a particular flow at present or the new services would use have materially different fares than those offered by incumbents.

(b) Stage 2 will review the broad estimate produced in stage 1 in the light of information provided by:

(i) the operator proposing the new competing services;

(ii) incumbent operators potentially affected by the new competing services;

(iii) the SRA; and

(iv) any other interested parties, such as PTEs and Rail Passengers Committees.

To inform this assessment, the operator proposing the new services will be asked for its business plan, including:

(i) details of the forecast benefits to passengers using its services;

(ii) details of the proposed fare structure and pricing policies; and

(iii) forecast demand growth on the route (\textit{i.e.} the level of growth in overall rail passenger usage, as opposed to the impact on incumbent train operators).

The information provided by an incumbent operator is likely to comprise analysis illustrating the impact on its business, including the expected levels of abstraction\textsuperscript{23}. It may also provide demand forecasting analysis that is on a different basis or uses a different approach to that used by ORR in stage 1, if it considers this is likely to provide a more accurate estimate of likely impacts.

\footnote{MOIRA is a computer model which models the effect of changes in rail timetables on passenger demand and passenger train operator revenue. It is consistent with the PDFH and may be used in tandem with that document. Different versions of MOIRA exist for each train operator. The different versions apply the same principles, but the raw data about revenue, passenger numbers etc., at particular stations and in respect of particular lines is specific to the local area.}

\footnote{An incumbent’s passenger forecasts are likely to be based on its own particular version of MOIRA, which may provide a more accurate forecast of local/regional effects, based, for example, on the inclusion of all stations, not just the major ones.}
The realism of any forecasts will be assessed and ORR staff may request meetings with, in particular, the applicant and the SRA to facilitate this.

(c) Stage 3 will use readily available benchmarking and survey information from any comparable situations elsewhere on the network and, where available, from relevant independent surveys in order to refine the estimates produced by stages 1 and 2. It is likely that in some cases stage 3 will not be applicable as there will be few, if any, changes in competition on the network that are sufficiently close comparators to the situation being proposed and no independent survey information available.

(d) Stage 4 will consider the likely impact that the proposed new services would have one to two years after their introduction, on the basis of available relevant information, including information from the applicant, the SRA and incumbent operators. This is to identify material impacts that would not occur immediately on introduction of the new competing services. The likely effect would be a reduction in the estimated proportion of revenue abstracted from existing services, as more people who previously did not use rail become aware of the new services over time. This so-called ‘ramp-up’ effect is common with the introduction of new services that have different characteristics from those of an incumbent’s services. On the other hand, this stage may also consider circumstances in which abstraction may increase (e.g. if the operator of the new services were to change its pricing policy);

(e) Stage 5 will consider other relevant factors. Stages 1 to 4 will provide a quantitative estimate – almost certainly in the form of a range - of the revenue from the proposed new services that might be expected to be new to rail (i.e. generated revenue rather than abstractive). However, this figure needs to be put in context and other relevant factors may need to be assessed, including:

(i) the degree of confidence that can be placed in the various estimates derived in stages 1 to 4 (e.g. whether all or most of the evidence points towards a level of abstraction falling within a narrow range, or whether there is considerable uncertainty about the likely revenue effect); and

(ii) whether the levels of abstraction and generation are relatively evenly spread across the flows under consideration.

3.19 Having completed this five stage process, the Regulator will then consider whether the proposed rights are primarily abstractive in nature. As paragraph 3.17 indicates,
there will necessarily be a large degree of judgment involved in this decision. The Regulator will need to strike a balance between a number of his duties under section 4 of the Railways Act 1993, of which the most important in this particular context are likely to be:

(a) his duty to exercise his functions in the manner which he considers best calculated to promote the use of the railway network for the carriage of passengers … to the greatest extent that he considers economically practicable (section 4(1)(b)) – in particular, the Regulator would expect to consider the forecast level of generated revenue and any other material costs and benefits against the expected economic costs and benefits of running the new competing services. This would provide a general indication of the likely overall economic impact of approving the proposed rights;

(b) his duties to exercise his functions in the manner which he considers best calculated to promote competition in the provision of railway services for the benefit of railway users (section 4(1)(d)) and to protect the interests of users of railway services (section 4(1)(e)) – in particular, a relatively high level of revenue generation is likely to imply a relatively high level of benefits to passengers (e.g. through new or improved services to locations not currently very well served by rail, or by introducing additional services where there is currently suppressed demand due to overcrowding). The Regulator may also need to consider whether the benefits of additional direct services on a poorly-served route should be given extra weight; and

(c) his duties to have regard to the financial position of the SRA (section 4(5)(c)) and to exercise his functions in the manner which he considers best calculated to facilitate the furtherance by the SRA of any strategies which it has formulated with respect to its purposes (section 4(1)(za)) and to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance (section 4(1)(g)) – in particular, the Regulator will want to consider the absolute level of forecast revenue abstraction and the expected impact on the budget of the SRA (both short-term and long-term) and the finances of incumbent operators. For example, an application for a large number of rights could show a relatively low proportion of revenue abstraction, but still be very costly for the SRA or an incumbent. Similarly, the Regulator would want to take account of any mismatch between the expected revenue of the applicant from passengers transferring from existing services, compared with the revenue expected to be foregone by the existing
operator(s) of those services, with a consequential impact on the budget of the SRA. This consideration would be relevant if the fares proposed by the applicant would be significantly lower than the fares of existing franchised operator(s). These factors could lead to the Regulator deciding to place more weight on his duty to have regard to the financial position of the SRA, or the duty to enable existing operators to plan their business with a reasonable degree of assurance, than on his other duties.

MoC protection to encourage investment

Criteria for granting MoC protection to encourage investment

3.20 The Regulator has concluded that MoC protection to encourage investment may sometimes be appropriate. Unlike the arguments against contractual protection to prevent cherry-picking, the long-term nature of an investment project and the operator’s need for assurance in order to plan its business mean that protection in such cases, if approved, should be contractual.

3.21 The Regulator will consider all applications for contractual MoC protection on their individual merits, and expects to lay particular emphasis on the claimed benefits to passengers. MoC protection constrains the Regulator’s freedom in approving future access contracts, since it involves an effective pre-commitment on the part of the Regulator not to approve future access contracts that will permit competition on the protected flows. If the Regulator is to take such a step, he must be satisfied that the benefits of doing so outweigh the disadvantages. In particular, the applicant would therefore need to satisfy him that:

(a) the proposed investment is worthwhile (e.g. that it is justified on the basis of demand and/or capacity forecasts and can be shown not to be obviously undesirable, inefficient or unnecessary);

(b) the benefits of that investment will flow through to passengers either directly through improved services or indirectly through maintaining and improving the condition of the network (investment in respect of new trains is discussed in paragraph 2.20 above);

In such cases, the benefits to existing passengers of lower fares would be expected to be offset by a reduction in revenue for the existing operator(s), which in turn would lead to correspondingly higher costs for the SRA.
these benefits will be likely to exceed the benefits of any competition which might reasonably be expected on the flows concerned; and

other options have been fully considered and the benefits of the investment will either not occur or will be significantly more expensive to achieve in the absence of contractual MoC protection, having regard to the SRA’s financial position.

3.22 The process for testing an application is illustrated in Annex 2.

Process for considering any application to support investment

3.23 In considering any application for MoC protection to support investment, the Regulator will:

(a) consider the extent to which the proposed investment could benefit not only the operators’ own passengers but also passengers of other operators using the part of the network in which the investment would be made;

(b) consider how the proposed investment could contribute to the furtherance by the SRA of any of its relevant strategies; and

(c) have regard to the views of third parties, including other operators and PTEs. This can be particularly useful in identifying potential competitors on the specified routes and in gauging the likely impact of such competition.

3.24 In support of any application for contractual MoC protection, the Regulator expects the relevant operator to provide complete and cogent reasons based on business case-type analysis and supported by evidence. This could include evidence on the desirability of the proposed investment from demand surveys, evidence of the benefits that the investment is likely to bring using demand forecasts and capacity forecasts, and evidence of the likely impact of contractual MoC protection on the cost of the investment, using financial data.

3.25 The Regulator expects to consider the relationship between the proposed investment and the specific routes for which MoC protection has been requested. The extent of MoC protection requested should be proportionate to the investment proposed. The Regulator will only expect to approve contractual MoC protection on those flows necessary to achieve the proposed investment. The Regulator will normally expect the MoC-protected flows themselves to benefit from the proposed investment. However, he will be prepared to consider arguments for protection of flows which will not
themselves be the subject of investment where it can be demonstrated that without protection specific investment elsewhere in the franchise may not take place.

3.26 The Regulator considers that the size of the investment in itself is not directly relevant to his decision. However, he expects that the size of the investment will have a bearing on the benefits from the investment, which would be taken into account in his assessment of the costs and benefits from any contractual MoC protection.

3.27 The Regulator is unlikely to be persuaded by an argument that an operator should be granted contractual MoC protection because it has already undertaken investment in the expectation that such protection would be granted. An operator without contractual MoC protection should not undertake investment on the assumption that such protection will be granted. In all cases (and as with any access application) the Regulator encourages operators to contact the ORR to discuss their requirements at an early stage 25.

Form of protection

3.28 The Regulator has decided to retain a system of MoC protection based on specified flows because it has the advantages of clarity about what is protected and allows links to be made between MoC protection and the specific investment, with the exact degree of protection being considered on the merits of each case. This could, for example, include limiting MoC protection not only to specific routes but also to specific times on those routes (e.g., so that an operator only receives MoC protection on a route for the times during which it operates services).

3.29 The Regulator’s approach would allow MoC protection to be more closely targeted. In applying for MoC protection, an operator would have to specify whether it required protection for, say, only Mondays to Fridays or for the whole week. This targeting would allow the operator concerned the benefit of MoC protection whilst allowing other operators to run services which would not actually compete with that operator. In some cases, however, the Regulator accepts that MoC might only be effective where granted on a particular route at all times.

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Duration of protection

3.30 All requests for contractual MoC protection should specify and justify the duration for which protection is sought. Protection should not be sought for a period longer than that over which the costs of the investment are expected to be recovered.

3.31 Where an investment is to be carried out by a franchisee, the Regulator does not expect to approve MoC protection that extends beyond the length of the operator’s franchise agreement. Where an investment is to be carried out by a third party, such as a special purpose vehicle, and the payback period is greater than the length of the relevant franchise(s), the applicant should consider applying for approval of a new track access contract, or an extension of an existing agreement, of the necessary duration. Such an application would be considered against the requirements of Article 17(5) of Directive 2001/14/EC, which states that track access agreements ‘shall in principle be for a period of five years’, but that longer term agreements may be justified ‘by the existence of commercial contracts, specialised investments or risks’. It also provides for agreements lasting more than ten years ‘in exceptional cases, in particular, where there is large-scale, long-term investment, and particularly where such investment is covered by contractual commitments’.

An application would also still need to satisfy the criteria outlined in paragraph 3.21 above. If the Regulator were persuaded of the case for granting contractual MoC protection, but concluded that the proposed agreement or extension should be for a shorter period than the one sought by the applicant, he would be prepared to consider indicating that, without fettering himself or his successors, he was minded to extend that protection for a further specified period when approving a successor track access contract in future.

3.32 Where necessary or desirable, the Regulator may phase in MoC protection, not by delaying his approval of that protection but by delaying the commencement date. Thus, once an operator has received approval for MoC with a delayed start date, other operators would be allowed to acquire competing access rights but those rights would expire on the start date of the MoC protection. There would be no scope for an operator that establishes a competing service before the MoC protection commenced in these circumstances then to use this to deny the other operator MoC protection.

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3.33 The Regulator expects that the continuation of MoC protection will be conditional upon delivery of the passenger benefits indicated by the train operator requesting MoC protection and taken into account by the Regulator in granting it. The Regulator expects to require the inclusion in a proposed contract of a mechanism which will remove the protection granted, on a flow by flow basis, if the train operator fails to deliver its commitments on the benefits of the investment (e.g. regarding frequency and service patterns), unless that failure is established to be for reasons beyond the train operator’s reasonable control.

3.34 The Regulator does not intend in all cases to link MoC protection to the achievement of particular milestones towards the completion of the investment associated with the MoC protection, whereby particular review dates would be set at which the progress of that investment could be assessed and a decision taken as to whether protection should continue. However, he accepts that there may be situations where such a system would be useful (e.g. where long-term MoC protection is requested to facilitate investment over a long period). In looking at individual cases on their merits, there may be circumstances in which he would want to consider this approach further.

Duration of the policy on MoC protection

3.35 The Regulator intends that this policy, which applies with immediate effect, will remain in place unless there is a material change to the factors and reasons that led to the establishment of the policy in this form. Any future change in policy will not affect any contractual MoC protection that has previously been granted and which is still extant in a train operator’s track access contract.

Consistency with legal requirements

Competition Act 1998

3.36 Agreements and practices which are restrictive of, or which distort, competition – including by way of exclusivity provisions – may fall for consideration under the Chapter I or Chapter II prohibitions in the Competition Act 1998 (and, in so far as they may affect trade between EU Member States, the equivalent prohibitions in Articles 81 and 82 of the EC Treaty). In formulating the policy set out in this document, the Regulator has had regard to relevant competition law principles under these provisions. In particular, some of the arguments in favour of the Regulator's policy on MoC (e.g. that MoC protection may be appropriate to encourage investment) may also be relevant grounds for the contract to be treated as
exempt from the Chapter I prohibition under section 9 of the Competition Act 1998 (and, where applicable, to be treated as exempt from the prohibition in Article 81(1) of the EC Treaty under Article 81(3)).

3.37 However, while the principles that will be relevant for considering the terms of a track access contract under the Competition Act 1998 overlap to some degree with the Regulator's section 4 duties under the Railways Act 1993 (section 4(1)(d), for example, lays down a duty to promote competition for the benefit of rail users), the considerations to be taken into account are not identical. In deciding whether to approve a track access contract containing MoC protection under sections 17 to 22A of the Railways Act 1993, the Regulator must have regard to his duties under section 4 of the Act (discussed in paragraphs 3.5 to 3.7 above), which include factors other than just the promotion of competition. Moreover, the statutory duties in section 4 of the Railways Act 1993 do not apply to the exercise of powers under the Competition Act 1998.

3.38 The Regulator would therefore expect parties which submit a proposal to him for MoC protection in a track access contract to have ensured that the contract is compliant with EU and UK competition law. Parties should bear in mind that any track access contract (whether or not that contract has been approved by the Regulator pursuant to the policy set out in this document) can be challenged under competition law by third parties - either by way of private litigation in the courts or by way of a complaint to the competition authorities (subject to section 22(6A) and (6B) of the Railways Act 1993). Naturally, the courts and relevant competition authorities will need to apply competition law principles to such cases on their individual merits.

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27 The Office of Fair Trading and the Regulator have concurrent jurisdiction as competition authorities to examine claims under the Competition Act 1998 in regard to the supply of services relating to railways. The European Commission and, since 1 May 2004, the Office of Fair Trading and the Regulator have jurisdiction to consider the application of Articles 81 and 82 of the EC Treaty. Section 22(6A) and (6B) of the Railways Act 1993 provide, however, that the Office of Fair Trading and the Regulator may not, under the Chapter I prohibition or Article 81, make enforcement directions to the parties to modify or terminate an access agreement, or impose interim measures for this purpose.
Moderation of competition: final conclusions

European and human rights law

3.39 The Regulator, the SRA and the industry must ensure that their actions are consistent with the specific requirements and the overall purpose of a package of EU Directives (‘the Infrastructure Package’), which EU Member States were required to implement by 15 March 2003.

3.40 The Regulator is content that this MoC policy is consistent with the Infrastructure Package, notably Article 10 of Directive 91/440/EEC, as amended by Directive 2001/12/EC, and Article 17(2) of Directive 2001/14/EC. Article 10 of Directive 91/440/EEC requires access and transit rights to be granted to international groupings (as defined in Article 3 of Directive 91/440/EEC) for international services and, on equitable terms, access to infrastructure to be granted for international freight and combined transport goods services. The Regulator could not extend contractual MoC protection in a way that affected international services provided by international groupings, as track access contracts for such services fall outside his remit. MoC protection for domestic passenger services would not affect domestic or international freight services. Article 17(2) of Directive 2001/14/EC requires 'framework agreements' (‘track access contracts’ in Great Britain) not to preclude the use of the relevant infrastructure by other applicants or services. However, MoC protection would be on a flow-by-flow basis (see paragraph 3.28) and would not prevent other applicants or other services from using the infrastructure concerned. To the extent that it would restrict other passenger train operators from using the infrastructure, the Regulator would want to be sure that such restrictions were proportionate to the consumer benefits of the investment.

3.41 Section 6 of the Human Rights Act 1998 requires the Regulator, in the exercise of his functions, to act in a manner compatible with the Convention rights. The Regulator believes that the adoption of his policy on MoC is consistent with this duty. He must, in deciding what policy to adopt, work within the framework imposed by his statutory functions and the requirements of the EU Infrastructure Package. However, within that framework, the Regulator notes that his policy on MoC will involve no

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29 It should be noted that in any conflict between domestic legislation and European law, the latter has supremacy.
Moderation of competition: final conclusions

interference with existing contractual rights so as to raise any issue under Article 1 of
the First Protocol to the European Convention. He notes further that, so far as he may
require in future to determine applications for MoC protection or to scrutinise access
applications for potentially competing services (in accordance with the methodology
set out at paragraphs 3.16 to 3.19), he will do so in accordance with established
procedures, following consultation and subject as ever to judicial review. The courts
have consistently held that this is sufficient to guarantee the right to a fair hearing
conferred by Article 6 of the Convention.
# Annex 1: Respondents to the July 2003 document

The following organisations responded to the July 2003 document:

<table>
<thead>
<tr>
<th>Organisation</th>
<th>Date</th>
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</thead>
<tbody>
<tr>
<td>FirstGroup plc (FirstGroup)</td>
<td>19 September 2003</td>
</tr>
<tr>
<td>Great North Eastern Railway Company Ltd (GNER)</td>
<td>12 September 2003</td>
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<td>National Express Group plc (NEG)</td>
<td>27 August 2003</td>
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<td>Network Rail Infrastructure Ltd (Network Rail)</td>
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<td>South Central Limited</td>
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<td>Strategic Rail Authority (SRA)</td>
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<td>Strathclyde Passenger Transport Executive (SPTE)</td>
<td>12 September 2003</td>
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<td>The Go-Ahead Group plc (Go-Ahead)</td>
<td>19 September 2003</td>
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<tr>
<td>Tyne and Wear Passenger Transport Executive (Nexus)</td>
<td>15 September 2003</td>
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Annex 2: Process involved in assessing an application for MoC protection

Operator submits to the Regulator an application under sections 17 to 22A of the Railways Act 1993, seeking MoC protection in a track access contract

Regulator requests further information

Are the operator’s arguments for MoC protection clear and complete?

Yes

Does the application concern a worthwhile investment by the operator?

No

Reject application

Yes

Will the benefits of the investment flow through to passengers and/or the network?

No

Reject application

Yes

Are the benefits likely to exceed those from allowing greater competition?

No

Reject application

Yes

Is MoC protection necessary for the viability of the investment?

No

Reject application

Yes

Would granting MoC protection protect the applicant from existing competition?

Yes

Reject application

No

Approve MoC provisions in track access contract, subject to consultation