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Agenda

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Open access: the price of fair competition

A recent High Court decision regarding the GB rail regulator's access charging regime supports the regulatory treatment of open access operators competing alongside franchisees. However, by suggesting the need for a level playing field for all operators seeking access, the decision arguably implies an effects-based test for price discrimination. This could potentially set a precedent for EU competition policy, which has to date tended to focus on the form of discrimination. Nonetheless, strict limits to the implementation by infrastructure managers of alternative forms of price discrimination are likely to remain

On July 27th, the High Court made a landmark ruling to resolve a bitter dispute between the Office of Rail Regulation (ORR) and Great North Eastern Railway (GNER).[1] While the decision in favour of the ORR is supportive of existing rail access policy, it has much wider implications for other European rail networks, broader regulated infrastructure sectors, and perhaps even the treatment of price discrimination under EU competition law.

The case arose from the ORR's decision to grant track access rights on the congested East Coast Main Line to Hull Trains and Grand Central—'open access' operators—rather than the principal franchisee on the line, GNER. Since GNER bid a substantial premium of £1.3 billion as recently as March 2005 to retain its East Coast franchise, it regards the decision as a major threat to the profitability of its operations, contributing to current discussions with the Department for Transport (DfT) over the future of the franchise. As the receiver of bid payments, the DfT has also raised an eyebrow at the ORR's decision, stating that if the risk of access decisions in favour of open access operators becomes more widespread, potential franchisees may be much more conservative in their bidding—leading to reduced premia, or increased subsidies from government.[2]

While the interests of the major stakeholders are clear, the economics behind the ORR's decision and GNER's legal challenge are considerably more complex. GNER's complaints incorporated a range of arguments, including allegations of state aid and even the infringement of its human rights, arising from the alleged appropriation of its franchise.

The most interesting debate, however, concerned the fundamental issue of whether the existence of open access operators is legally permissible, at least under current arrangements. Under existing GB rail policy, the treatment of franchisees clearly differs from that of open access operators. Most striking is the fact that franchisees must pay the fixed access charge—which

Open access versus franchise train operators

Franchise operators currently manage the vast majority of train services in Great Britain. Regional franchises are auctioned by the DfT at regular intervals. Open access operators do not hold a franchise but apply for the right to operate individual train paths wherever they anticipate it to be profitable. As part of the franchise, there are a number of contractual benefits that do not apply to open access operators:

- **protection from changes to access charges by the rail infrastructure manager (Network Rail);**
- **protection from volume risk;**
- **moderation of competition from open access operators that are 'primarily abstractive' of franchisees' existing revenue, rather than generative of new passengers;**
- **a contract with government to provide services, while open access operators enter on an entirely commercial basis.**

Franchisees contribute to Network Rail's costs in maintaining the network through both a fixed charge and a variable charge depending on the number of passengers and trains they actually operate. Open access operators are required to pay only the variable charge. GNER has complained about this.

Source: ORR (2006), 'ORR's Decisions on Application for the Track Access Rights Necessary to Operate Additional Passenger Services on the East Coast Main Line', April.

GNER claimed amounted to 60% of its total access charges[3]—while open access operators are exempt. GNER argued that this amounted to discriminatory pricing treatment, which is not permissible under EU competition law and rail Directives. Had its argument been upheld, the existing policy towards open access operators would have to be changed, potentially threatening their long-term future. However, given that GNER's argument was rejected, the path could be open to more extensive open access operations, although there may also be considerable repercussions for future franchise agreements, which might take more explicit account of the risk that access rights on congested routes could be passed to open access operators.

GNER's challenge therefore amounted to the allegation that the ORR's decision to grant track access rights to open access operators violated the duty on the regulator transposed from EU Directives to ensure that:

> An infrastructure manager's average and marginal charges for equivalent uses of his infrastructure must be comparable and comparable services *in the same market segment* must be subject to the same charges. [emphasis added][4]

Chalk and cheese

The ORR conceded that if the relevant market was the downstream market for rail passenger services, it essentially had no defence, since passengers are not particularly exacting in their choice of operator and are as happy to travel with open access operators as franchisees. It argued, however, that the relevant market was instead the upstream market for access to the network infrastructure, and that, in this relationship, franchising and open access are very different operations to the extent that they are in different market segments.

The High Court agreed, suggesting that while a literal reading of the legal requirements might support GNER's broad market interpretation, reference to the purpose of the legislation made it clear that the intention was 'to ensure transparency and non-discriminatory *access to rail infrastructure* for all railway undertakings' (emphasis added).[5] Thus, according to the High Court, non-discrimination is to be achieved with regard to upstream access rather than the downstream market. For example, if two very similar parties applied for network access under equivalent circumstances, charging each a different price would be discriminatory.

The High Court extended this logic to demonstrate that only by taking account of differences in the conditions under which operators seek access to infrastructure can discrimination be avoided. Thus, not only does discrimination occur when similar parties are treated differently, but also when different parties are treated similarly.

There are major differences in the conditions under which franchisees and open access operators seek network access (see box above); indeed, the High Court stated that 'any attempt to draw comparisons … is an attempt to compare chalk with cheese'.[6] Returning to the semantics of the legislation, franchisees and open access operators were effectively considered to be in different market segments, and could therefore be charged on a different basis.

Promoting fair competitive access

The differences between open access and franchise operators might suggest that the High Court had proposed a simple test for discrimination (and implicitly of whether two operators are within the same market segment) based only on comparison of operators' characteristics and the form of discrimination. Yet, it can be argued that, as a result of its reference to the legislation's broad purpose in ensuring non-discriminatory access, the High Court has set a more rigorous test:

> GNER's case has focussed attention on the fixed track charge in isolation, but it is only one element of a wider, and much more complex picture. Imposing the fixed track charge on open access operators, while holding all the other parts of the picture constant, would not result in a non-discriminatory charging regime for access to the railway infrastructure, but in a regime which was manifestly unfair to open access operators.[7]

That test might be phrased as follows: are *all* factors that affect the ability of operators to gain access to infrastructure reflected in the access charges, such that they can each obtain access on equal terms? If not, the charges have the potential to be discriminatory. In this formulation, the High Court's test is based on the *effects* of the ostensibly discriminatory treatment—ie, it depends on whether the *effect* of the charging policy is to place all operators seeking access in an equivalent competitive position.

In the GNER–ORR case, having taken into account the contrasting conditions under which open access and franchise operators seek access, ensuring an equivalent competitive position for all parties was considered to be achievable only by waiving the fixed charge for open access operators. There are three principal reasons why this might be the case.

– The fixed charge could be considered to equalise the conditions under which the two operator types seek access (although no attempt to quantify and compare the impacts was made by the ORR or the High Court).

Thus the fixed access charge could be regarded as the 'fee' paid by franchisees for additional revenue protection.

– The variable charge paid to the infrastructure operator is the same for both open access and franchise operators, and this is the charging component that influences the marginal decision of operators in applying for access to run additional marginal services; fixed charges are (in economic theory) irrelevant, since prices are set with reference to marginal cost only.

– The High Court argued that the fixed charge is an 'artificial construct' of the financial mechanisms underlying the rail franchising process.[8] In practice, fixed charges are a residual amount, after government grants, required by Network Rail to achieve full cost recovery; since franchisees know the level of the fixed charges for the whole franchise period, a higher fixed charge will translate directly into a lower bid for the franchise. In short, fixed charges do not affect the ability of franchisees to profitably obtain access.

Each of these reasons has different implications. For example, the first suggests a more proactive regulatory policy to equalise the conditions of access. Nevertheless, the prominent conclusion is that the *effects* of the ORR's differential charging treatment are conducive rather than detrimental to the aim of ensuring non-discriminatory access.

Wider implications of the court's decision

The principles enumerated by the High Court could have wider repercussions. First, interpreting discriminatory pricing on the basis of its effects (rather than simply its form) might set an important precedent. Admittedly, this approach is already explicit in EU competition law; Article 82(c), which addresses price discrimination, prohibits:

> applying dissimilar conditions to equivalent transactions with other trading parties, *thereby placing them at a competitive disadvantage*. [emphasis added]

Yet, in practice, there has arguably been less focus on the latter requirement. For example, in *Corsica Ferries*, the European Court of Justice omitted any reference to competitive effects, and in the European Commission's various decisions regarding price discrimination at airports, little attention has been given to the issue.[9] There has been concern over this approach, and if the High Court's decision sets a precedent, this may induce a considerable shift in emphasis for cases brought under EU competition law. (Note that price discrimination was explicitly excluded from the European Commission's Discussion Paper on the reform of Article 82 policy.[10])

A second implication is that two-part tariffs may have gained an exemption from findings of price discrimination. This argument could be based not only on the specifics of the GNER case, namely that the fixed charge was an 'artificial construct', but also on the general economics principle that fixed charges do not affect marginal decisions, and hence the ability of any operator to obtain access. While this could present a green light to this form of fixed cost recovery across European networks, a major caveat is required for the above arguments.

In practice, fixed charges avoid introducing competitive distortions only where they are not so large as to push smaller operators off the network, or equivalently to create a barrier to entry. As a 2003 case against Deutsche Bahn demonstrated, if the fixed charge is set so high that only the incumbent operator can afford to meet it, the effect is to deny other operators fair access to the network.[11] Assessing the maximum level of fixed charges before such distortions arise is clearly a difficult task, particularly since it is often an exercise in counter-factuals; would a smaller operator enter if the fixed charge were lower?

The primary alternative to two-part tariffs as a means of efficient fixed cost recovery is Ramsey pricing. Under Ramsey pricing there are no fixed charges, but mark-ups are added to variable charges in inverse proportion to a particular operator's demand reaction to the higher charges (its price elasticity of demand). Thus, the most sensitive operators face the lowest mark-ups, encouraging them to maintain volumes, and thereby ensuring maximum network utilisation. If the High Court's decision permits two-part tariffs, the question arises as to whether this extends to Ramsey pricing, since this is an attractive option for many rail infrastructure managers.

On the one hand, since Ramsey pricing is a means of efficient cost recovery based on mark-ups independent of cost, it would seem to receive some endorsement, with the court recognising that:

> the ORR is entitled to consider the fixed track access charges levied on franchise operators as 'mark-ups', i.e. payments made to Network Rail over and above the costs 'directly incurred',[12]

and with the EU rail Directive 2001/14 providing that:

> in order to obtain full recovery of the costs incurred by the infrastructure manager a Member State may, if the market can bear this, levy mark-ups on the basis of *efficient*, transparent and non-discriminatory principles. [emphasis added][13]

On the other hand, if the effects-based test of discrimination outlined above is to be applied, Ramsey

pricing has quite different implications from two-part tariffs. First, variable charges necessarily differ between operators under Ramsey pricing, immediately affecting marginal access decisions. Second, any such charging variations would be unlikely to compensate for other differences in the conditions under which operators seek access because the difference in charges must be driven primarily by the demand elasticity of individual operators. This relates to a third point, expressed by the High Court:

> [under the ORR's tariffs] since both [open access and franchise] routes are open to all would-be operators without discrimination, 'no discrimination can be inferred from such a system'.[14]

Under Ramsey pricing, however, the mark-ups are more closely associated with individual operators, which consequently have less freedom to opt for an alternative set of pricing arrangements and associated access conditions. The effects of Ramsey pricing might therefore be inconsistent with fair access in upstream markets.

Conclusion

Through its decision to interpret franchisees and open access operators as different 'market segments' on the basis of upstream market conditions, and, under the interpretation presented here, implicitly to apply an effects-based test for discrimination, the High Court has established an important precedent. This affirms that differences in the conditions under which operators seek access *must* be reflected in charging principles to ensure non-discriminatory access. Open access operators are therefore entitled to have the fixed charge waived, since this does not distort the competitive position of franchisees and, indeed, may even equalise access opportunities by compensating for the contractual benefits enjoyed by franchisees. In the future, European courts considering cases of alleged price discrimination may have a higher regard for such considerations.

While this is a permissive decision that endorses the fairness and legality of two-part tariffs, there are likely to be limits to how far differential charging practices can be extended. Not only are high two-part tariffs likely to prove discriminatory where they act as a barrier to entry for smaller operators, but alternative forms of price discrimination, such as Ramsey pricing, may also have economic effects that result in a distortion of fair access. Such effects would have to be analysed on a case-by-case basis.

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[1] *R (on the application of Great North Eastern Railway Ltd) v Office of Rail Regulation*, [2006] EWHC 1942 (Admin), [2006] All ER (D) 414 (Jul), (Approved judgment), July 27th 2006.
[2] ORR (2006), 'ORR's Decisions on Application for the Track Access Rights Necessary to Operate Additional Passenger Services on the East Coast Main Line', April, p. 77.
[3] *R (on the application of Great North Eastern Railway Ltd) v Office of Rail Regulation*, op. cit., para 19.
[4] 'Railways Infrastructure (Access and Management) Regulations (2005)', Statutory Instrument 2005 No. 3049, The Stationery Office, section 4(1).
[5] *R (on the application of Great North Eastern Railway Ltd) v Office of Rail Regulation*, op. cit., para 46.
[6] Ibid., para 74.
[7] Ibid., para 75.
[8] *R (on the application of Great North Eastern Railway Ltd) v Office of Rail Regulation*, op. cit., para 64.
[9] See Whish. R. (2001), *Competition Law*, Fourth Edition, The Bath Press: Bath, pp. 661–2.
[10] European Commission (2005), 'DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses: Public Consultation', December.
[11] OLG Düsseldorf, WuW/E DE-R 1184.
[12] *R (on the application of Great North Eastern Railway Ltd) v Office of Rail Regulation*, op. cit., para 62.
[13] Directive 2001/14/EC on the allocation of railway infrastructure capacity and the levying of charges for the use of railway infrastructure and safety certification, February 26th 2001, Article 8(1).
[14] *R (on the application of Great North Eastern Railway Ltd) v Office of Rail Regulation*, op. cit., para 81.