Arriva's comments on 'The potential for increased on-rail competition - a consultation document, October 2011'

These comments are made on behalf of Arriva plc, its subsidiary Arriva UK Trains Limited and its train operating companies, wholly owned Arriva Trains Wales/Trenau Arriva Cymru Limited (ATW), DB Regio Tyne & Wear Limited (DBTW), Grand Central Railway Company Ltd (GC), The Chiltern Railway Company Limited (CR) and XC Trains Limited (XC) together with jointly owned Alliance Rail Holdings Limited (Alliance, with its subsidiary companies). We also previously operated jointly owned Wrexham, Shropshire and Marylebone Railway Company (WSMR). Arriva is a wholly owned subsidiary of Deutsche Bahn AG (DB AG).

We welcome the opportunity to comment on the ORR's thinking on the potential for more direct competition for passengers between train operators, its desirability and likely consequences. We consider that our ownership of both franchised and open access train operators, together with our experience of rail operations in six other European countries, where a variety of regulatory and contractual structures apply, helps us to understand the implications and benefits of different approaches. We are pleased to comment below on the specific consultation questions in paragraphs 1.13/7.13 of the consultation document and also some general related issues.

We do not seek that all or any part of our submission is treated as confidential.

The effects of existing on-rail competition, in particular on price, number and nature of service, service quality, and costs

The potential for on-rail competition within the passenger sector of the industry has been managed by ORR under the policy outlined in the *Criteria and procedures for the approval of track access contracts* and the *Moderation of competition* documents. These introduced the framework by which any new Open Access operator would be judged in seeking to obtain access rights.

This framework, including the 'Not primarily abstractive' test, together with the form of franchising adopted to date, have limited the scale of new open access competitive ventures such that they represent only a small part of the overall rail market. Nevertheless, Hull Trains and GC have been successfully established. They are economically beneficial for the communities and markets served, have added extra capacity and new direct journey opportunities to the national rail network and have acted as a significant catalyst to improvements in efficiency by both Network Rail and franchised train operators. Indeed, there has been only one minor open access example, WSMR, which has not proved sustainable.

Open access operators are more responsive to the market and this is evidenced by the consistently higher customer satisfaction scores they achieve. Ticketing is more flexible and although their fares are not regulated, competition has not just ensured their tickets are pitched at attractive levels, but has also on the East Coast Main Line (ECML) led to price competition from East Coast (and its predecessors). Although such competition has been generally limited to the stations and departure time ranges of the open access operators, it shows what could be achieved for many more passengers by a significant expansion of open access operations.

The evidence recently provided to ORR by GC and the earlier analyses of historic revenue information by Arup and others all indicated the overall rail market value has been increased in those situations where there has been competition between rail operators. We consider that a greater level of engagement between operators, MVA/ITS and ORR before this consultation was issued would have allowed more evidence to be included in the analyses supporting the consultation document.

There is no example in UK passenger rail of a competitive market that has been outgrown by a monopoly supplied comparator. The majority of identified competitive markets have outgrown their comparators by a significant factor. For example the majority of GC's revenue can be shown to be generative. If this empirical evidence were incorporated in the MVA/ITS analyses by discounting the stated reduction in overall market revenue, then the case for more widespread competition would improve. For example in the East Coast Option 2 (Figure 4 and para. 6.24) the quoted "cost" to government would be reduced to approximately zero.

The potential benefits of competition as described in chapter 3 of this document onwards, in particular the potential for it to drive value for money by:
o Improving firms' responsiveness to passenger demands; and
o Placing downward pressure on costs.

On rail competition has the potential to improve responsiveness to passenger demands, as evidenced by the very high levels of passenger satisfaction obtained by open access operators. Improved satisfaction can only assist in improving the industry's revenue base and hence its affordability to Government.

Whilst open access operators take on substantial commercial risk, they do have the benefit of being able to design and establish their businesses from scratch. They can pay what is necessary to recruit and retain staff in the markets they serve and their employees recognise that customer satisfaction and business success are necessary for their continued employment, as is the case in most normal industries. GC for example chose to make its own cost-effective pension arrangements and not join the Railway Pension Scheme, but has had no difficulty in recruiting and retaining good employees.

These key drivers of efficiency are weakened with franchised operations under the current model as a result of the combined effects of:

- Government's concern and legal duty to provide continuity of service
- franchising policies of very short mobilisation periods and short franchises
- the way deliverability is marked in franchise award
- TUPE Regulations.

The rail freight sector shows relevant evidence, as reported in the McNulty Study, of the benefits of competition in bearing down on costs. Not only have new entrants been able to establish themselves with lower-cost business models, but the different industry structure for freight has allowed scope for incumbents to become significantly more efficient too.

Any wider benefits of competition that should in your view be taken into account.

Open access operators create competition for route capacity and have acted as catalysts in identifying such capacity. On the ECML GC was instrumental in identifying significant capacity for its own and other operators' new services, much of which is now being used to the benefit of passengers. GC, Hull Trains and Alliance have remained engaged, for example in the Holistic Timetable Project and through consultations on future route strategy, in showing how combinations of targeted investment and timetable re-planning can provide still more paths. Open access operators also provide additional train capacity on their routes at no cost to Government. In contrast, franchised train operators under the current model generally rely on the Government to fund new or additional stock and often believe it is not in their interests to identify additional route capacity.

Alliance is also seeking capacity on the West Coast Main Line (WCML) and, whilst some in the industry have claimed the route is full, has identified over 30 validated train paths within the current timetable. Significantly more would be available through a comprehensive timetable revision, such as is likely once the route Event Steering Group has finalised its work as envisaged by the ORR in its WCML Decision of March 2011.

The new services introduced by open access operators give rise to wider economic benefits as has been confirmed by the analyses ORR has conducted in respect of track access applications and as also shown in the consultation. We note that economic benefits calculated on a similar basis are routinely used to support the funding of infrastructure projects undertaken by Network Rail and service enhancements by franchised operators. By using open access as the delivery mechanism there is no funding cost to Government to deliver these benefits.

Open access operators bring additional investment to the rail industry, creating jobs, the holders of which pay taxes, whilst the operators themselves also contribute taxes.

New rules that would encourage additional open access operations and give them confidence to invest would give rise to two major benefits:

- additional train capacity provided by private investors at no cost to Government
- traffic attracted off the road network, easing congestion costs and reducing the necessity for road improvements.

The extent to which benefits could be realised in GB passenger rail through increased on-rail competition, with particular reference to your views on:
o The likelihood that increased on-rail competition would drive lower fares and improved service quality; and
o The potential for competition to drive cost savings and in particular on the assumptions made by MVA in its modelling as summarised in chapter 6 of this document.

The evidence from rail and other industries is that more competition will drive improved quality of service and competition on price. It is important to recognise, however, that the principal competitive force is and will remain car travel, with air travel material for certain very long flows. The on-rail competition model is most likely to be successful and deliver benefits in medium to long-distance travel, especially on the principal intercity routes.

We consider that in major commuter networks, where traffic congestion limits the effectiveness of road as a competitor, making commuter fare regulation appropriate, and satisfaction is driven primarily by capacity and performance, it is unlikely that on-rail competition can contribute materially. In such circumstances other competitive models such as, where subsidy is necessary, competition for the market by franchising are likely to be more effective.

We generally agree with the assumptions described in the evaluation in chapter 6, but make a number of detailed comments.

- Fares elasticity (6.13). In many of the markets relevant to open access, elasticity is indeed around 1 and in some cases exceeds this figure. A key driver for open access operators is to use their skills and research to seek out such markets. In consequence we believe that in most cases total industry revenue has increased more than total costs, so avoiding any net cost as suggested.
- Cost to taxpayer (6.17). We believe that much of the alleged cost to the taxpayer in the MVA/ITS work is actually a result of the rigidity of franchise agreements in fettering the ability of a franchised operator to make the sort of reasonable adjustment to prices and products that would be considered normal in other industries. However, the impact of open access is actually relatively minor in relation to other cost shocks that franchisees are already required to absorb and consequently must price in bids. To the extent such adverse financial effects might genuinely be caused by open access, they could be avoided by more flexible franchise contracts.
- Capacity (6.20). The overcrowding dis-benefit is overstated, perhaps because an incorrect inference has been drawn from present open access operations that only small capacity trains would be used. Open access operators are very alert to the reputational and revenue damage likely to be caused by overcrowding and if they were able to operate on the principal routes would provide trains of higher capacity than is typically the case now. This is also likely to reduce the claimed producers' surplus.
- Access charges (6.20). It is unclear how these are estimated. We comment below on the principles.
- Government position (6.26). In the event that open access operators were as profitable as suggested there would of course be a significant extra corporation tax benefit to Government that does not appear to have been included. We consider this would make Option 2 positive to Government as well as Option 4.

The potential for developments in the sector, including technological change to increase the scope for greater on-rail competition in future. Please highlight in particular:
o What developments you consider could take place;
o How you consider it could facilitate greater on-rail competition (e.g. by increasing the efficiency of capacity utilisation)
o What would need to happen in order for these developments to increase the scope for more on-rail competition, and in what time period you believe they could take place.

We consider the most valuable changes would be:

- alteration in variable track access charges, the Volume Incentive and licence obligations such that Network Rail has both effective financial incentives and a clearer regulatory duty to find paths and target investment on creating capacity. This would help it overcome its over-cautious and conservative approach and make it more like suppliers in other industries in wishing to sell more of its product
- a more collaborative route planning and investment process, applying lessons from the success of the Strategic Freight Network management process to the passenger business
- simplification of station charging
- clear rules and guidance for the new regime, including time periods for each stage, windows when applications are open and opportunities to bid into future timetable years to allow lead times for investment in trains and driver training
- acceleration of adoption of cross-acceptance, transposition of TSIs and removal of specific British rules (including NNTRs) to enable rolling stock to be purchased at lower cost and with less acceptance risk
- adoption of ERTMS to enhance capacity, with implementation following a clear plan and only when fully interoperable equipment may be purchased, with acceptance subject to standard European tests
- consideration of whether there is any actual requirement for franchises on the ECML and WCML or whether public interests can be protected by licence conditions and/or purchase only of socially required facilities not provided commercially
- change in the access contract regime to sell long-term (minimum 20 year) quanta of paths with quality criteria regarding intervals and journey times rather than specifically timed paths. This would strike a balance enabling investment to be justified, whilst avoiding the dis-benefits of ‘hard-wired’ paths blocking development.

We consider these measures could be introduced at the start of CP5 and real benefits would commence very soon after.

The potential impact of more on-rail competition on the taxpayer.

In the long term the MVA/ITS analysis, experience in the rail freight sector and evidence from UK passenger rail indicate that the larger revenue base and lower costs encouraged by competition would result in an improved fiscal position, reducing the cost to taxpayers. Our more detailed comments on the evaluation options in chapter 6 are above and, particularly if accompanied by franchise reform, we do not envisage any cost to Government and hence no additional tax burden. We do envisage net benefits to the economy, specific benefits to both rail users and non-users exceeding the MVA/ITS estimates and new or expanded tax-paying entities being created.

We consider two major benefits for the taxpayer would be:

- significant additional capacity provided on rail services without any requirement for taxpayer funding explicitly or by foregone premium when provided by a franchised operator
- greater transfer from road to rail, giving rise to benefits in reduced congestion and avoidance of need to fund road improvements.

Specific policy options that could be pursued to facilitate increased on-rail competition, including but not necessarily limited to the ones we assess in chapter 6, including:
o Impacts on the flow of money in the industry, and in particular on flows of public funds;

o Impacts on key stakeholders including taxpayers; and
o Any issues associated with using financial bids as a criteria for allocating network capacity, including any views on any complexities or administrative costs that this might introduce. In drawing our attention to any downside risks or costs associated with specific policy options you should also set out your thinking on how these costs or risks might be mitigated.

Our comments above on potential developments are also relevant to this question. Policy options that would improve the industry's fiscal burden should include:

- on-rail competition should be encouraged for activities that cover their marginal operating cost
- franchise specifications should not be drawn up that unnecessarily consume route capacity, particularly to serve secondary stations
- access charging should assist start-up businesses, for example by allowing the first year or two at only short-run marginal cost, before any additional charge starts

We support the proposition in para. 5.30 that "If access charges to open access operators were set so as to capture (a proportion of) the value of network capacity to the operator, it could be possible for open access to take away at least some business from franchised operators, bringing the benefits of competition without a major detrimental impact to the taxpayer."

However, we do not consider the use of financial bids as a criterion for allocating network capacity is practical or desirable. Access charges must be compatible with EU legislation, including EU Directive/2001/14/EC, and the Railways Infrastructure (Access and Management) Regulations 2005. We do not see that an auction approach can in any way be compared with the permissible concept of mark- up. The latter is clearly rooted in the requirements of the legislation that charges are, inter alia, transparent and reflective of cost.

At a practical level a train path, unlike an airport slot or a berth in a harbour, is not a fixed and easily definable or tradable asset. The quality and earning potential of a path will vary over time according to what other paths are planned and sold on a route, something that will not be predictable at the point of auction. It would be counter-productive to the general thrust of ORR's policies, and destructive to achieving the benefits of competition, if train paths were to be 'hard-wired' purely in order to clarify their future value, in order to assist an auction.

Charging policy is currently underpinned by the 2006 High Court decision, which found, inter alia, that the fixed charge was an "artificial construct". Consequently we do not accept it would be appropriate for the current fixed charges to franchised operators to be simply shared pro rata with open access operators. We do, however, consider the present approach of charging only a Variable Track Access Charge, which matches as closely as practicable the short run marginal cost to Network Rail of the operation of the train, fails to properly incentivise Network Rail. Whilst there is also the national Volume Incentive scheme, this appears too remote and insufficiently understood to influence management behaviour.

We have concern that a congestion supplement might merely become a device to price off demand, create unearned profit for Network Rail and create unfair competition between open access and franchised operators, as the latter would factor it into their bids (or receive it through the Change Mechanism). There may be scope, however, to develop a supplement linked to joint route planning by which current and prospective operators on a route share the funding cost of agreed capacity enhancement schemes.

We believe an equitable access charge for new applications following a change in policy should be based on:

- short run marginal cost (i.e. the present VTAC approach)
- contribution to renewals relating to causation by the open access operator
- enhancements, to the extent these benefit the open access operator

a reasonable margin contributing to overheads and profit.
In return for this greater contribution, the Not Primarily Abstractive test would cease to be used.

We believe the proposal to use cost/benefit analysis to judge new service applications is likely to provide a way forward. We consider, however, that an important methodology change from the WebTAG approach must be made. This would be to exclude loss of motoring tax income as a cost against rail service improvements. Whilst Government may see logic in including this to help manage its budget when looking at policy options, it is clearly a transfer payment and should play no part in a fair cost/benefit appraisal.

This new approach should apply only to new open access applications. Current operations and applications under consideration before the new rules apply have specific business models based on the present rules that may not be able to withstand application of this new approach. It should be a matter of choice for these operators whether they wish to re-apply for the same or similar rights under the new rules.

A change in the mix of open access and franchised operators should not in itself reduce Network Rail's income. However, we do see it as beneficial to improving the behaviours of Network Rail that they should see significant financial gain in creating and selling more train paths. We also consider that substantial parts of the Network Grant and Fixed Track Access charge should properly be met by the Government rather than any train operator:

- historic debt, including that from Railtrack, establishment of Network Rail and the funding of backlog works
- enhancements based on direction by Government through the HLOS and otherwise, and by the direction of Network Rail to select projects using of social cost-benefit analysis (these are effectively Public Service Obligations and should be fully reimbursed by Government under European rail legislation)
- costs relating to freight over and above the freight VTAC (it would be discriminatory to allocate these to passenger operators)
- costs relating to the benefits of having a national rail network to the economy and non-users.

Franchised TOCs are currently constrained in their ability to vary their service offer in response to increased open access competition, for example by reducing, re-pricing, retiming or withdrawing services where these may become unprofitable and a reasonable service remains available to users whether provided by the franchise or an open access operator. Allowing such flexibility to franchise operators would have benefits very much greater than just avoiding negative impact from competition.

We would be pleased to discuss any of the comments in this response and to assist ORR in the further consideration of this issue.

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