Department for
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Joe Quill
Office of Rail Regulation
1 Kemble Street
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Dear Joe,

The potential for increased on-rail competition consultation, October 2011

This is the Department for Transport's response to the ORR's consultation document "The potential for increased on-rail competition".

The ORR's consultation and the Department's response are focussed on on-rail competition from timetabled open access passenger operations. Open access freight operations are a separate issue, as are irregular special passenger trains, neither of which we discuss in this response. Our comments below should therefore be read in that context.

As you are aware, the Department is engaged in a major programme of franchise re-letting over the next 2-3 years. To secure the best possible value for money for both passengers and taxpayers from this programme, potential franchise bidders will need early clarity around the extent of on-rail competition in the future. While we welcome your investigation we are very keen to see early conclusions drawn, to ensure that regulatory uncertainty does not undermine the value of those franchises and thus put further pressure on industry finances.

The consultation document and the supporting report from MVA Consulting and ITS Leeds describe various scenarios for increased on-rail competition through the introduction of more open access services. We note that in every case except one the predicted outcome is an increase in the level of subsidy required by the railways. (The exception is an implausible scenario where large-scale open access operations are assumed to reduce unit costs by 30% but franchised operators unit costs do not subsequently change over time).

The Department's primary concerns relate to the funds available to the Secretary of State for the purposes of his functions in relation to the railways. The conclusion we draw is that although an increase in on-rail competition might deliver passenger benefits it is far from clear that it would help reduce the costs and improve the efficiency of the industry, which is our principal concern in the light of the jointly commissioned Rail Value for Money study. Indeed it is more likely that that such a move would give rise to a greater call on public funds. That being so, the Department cannot support the proposition that more open access services should be introduced.

In assessing the potential impact of an open access service on the franchised railway, and while accepting that the ORR must balance its statutory duties, the Department would nevertheless expect the ORR to give very careful consideration to its duty to have regard to the funds available to the Secretary of State for the purposes of her functions in relation to railways and railway services and to the principles of the HLOS/SoFA process.

The consultation document also highlights the impact of the current charging regime and suggests that Open Access Operators might benefit from a reduction in the restrictions applying to approval of access rights in return for a contribution towards fixed infrastructure costs. We believe this suggestion may have merit, if it can be demonstrated that such changes would not be incompatible with the way in which the operators can be said to operate in different markets or with the statutory Charging Principles, and would not adversely affect the funds available to the Secretary of State over the short or long term. We would welcome the opportunity to work with ORR to explore options for change.

Further detailed comments on some of the specific issues raised in your consultation document are attached as an appendix to this letter.

Yours sincerely,

Nick Bisson

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Appendix

Detailed comments on issues raised in the consultation document

The effects of existing on-rail competition

The primary mode of competition in the rail industry is competition for train operating franchises. The Department awards franchises on the basis of best overall value and we can confirm that the tendering process is extremely competitive and has delivered significant benefits for the taxpayer. However, we acknowledge that this has been achieved mainly through revenue growth and there is scope for greater emphasis on unit cost reduction in future franchise competitions.

On-rail competition between franchised operators exists on many of the main routes as set out in paragraph 4.7 of your document (and it is wrong to describe this as 'a small number of instances' as in paragraphs 2.1 and 4.9). We believe that on-rail competition between franchised operators causes some downwards pressure on unregulated fares and costs, though the extent of competition is limited by fares regulation and the use of inter-available tickets. Those arrangements deliver important benefits which we are not prepared to forego in order to promote more effective competition.

On-rail competition between franchised and open access operators is limited to parts of the East Coast Main Line and adjoining routes. The Department accepts that the services provided by Hull Trains and Grand Central increase the choices available to passengers and may have a limited impact on fares. However, the published accounts of both companies show that they currently operate at a loss, and as much of their revenue is abstracted from franchised operators, it is clear that their costs substantially exceed the new revenue generated. We estimate that the overall impact of their operations is to increase the net cost of the railways by around £30m per year.

We are concerned about the prospect of decisions on access to the network for open access operators that impose an additional burden on taxpayers and we are willing to work with you to explore how the situation can be remedied.

The potential benefits and disbenefits of competition

It is generally accepted that competition causes a supplier to become more responsive to its customers and to minimise its costs.

A passenger train operator is normally subject to fierce competition from road transport and in the case of long distance operators, from domestic air services. Franchised train operators are also subject to intense competitive pressures at the point of bidding for a franchise, a point recognised in the MVA report which concluded that there was little difference between the benefits delivered by competition <u>for</u> the market and competition <u>in</u> the market. Therefore we believe that the train operating environment is already sufficiently competitive to deliver the available benefits.

The Department acknowledges that the effects of competition have been blunted to some extent by the revenue support / share arrangements included in recent franchises. We intend to adopt a different approach in the future which will leave normal competitive pressures in place whilst giving franchised train operators some protection from external economic fluctuations and retaining a Change mechanism to deal with unforeseen events.

We would expect that the introduction of further competition by operation of duplicate services or fragmentation of existing services between multiple operators might deliver some further passenger benefits (though fragmented service provision might also produce passenger disbenefits), but would be likely to cause a significant increase in overall costs even if more competition led to reduced unit costs for each individual train operator.

A key function of the Department's franchising process is to ensure that train operators are required to provide economically and socially desirable services. If greater competition was introduced by transferring some services to open access operators with complete market freedom, it is likely that the combined effect of each individual operator's response to competition would lead to a worse overall service through duplication of services in the most lucrative markets and withdrawal from economically desirable but less profitable traffic flows. The MVA / ITS report presents some evidence of this in the case of local bus services.

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

As described above, we estimate that the impact of the current open access operations on the East Coast Main Line is to increase the net cost of the railways by around £30m p.a. which is ultimately an additional cost to taxpayers.

The MVA/ITS report describes various scenarios where additional open access services are introduced or existing franchised services are transferred to open access operation. The main benefits claimed arise from a reduction in fares. Although we would wish to see downwards pressure on fares in the future, current Government policy is to increase regulated fares in real terms for 3 years to help finance investment. Introducing greater competition in order to reduce fares would appear to further increase the financial burden on taxpayers which is not consistent with Government policy.

The MVA/ITS report claims that the loss of revenue and increased profit margins arising from greater open access competition would be largely off-set by reduced operating costs. Their model assumes that open access operators have an intrinsic cost advantage of 20% over franchised operators, they can achieve a further 12% saving from lower staff costs and that, in some examples, their services can be provided by shorter trains.

The Department believes that these assumptions are over-optimistic and that in reality the costs incurred by an open access operator (excluding access charges) would be more similar to those incurred by a franchised operator. This appears to be the position at present (Table 2.7 in the MVA/ITS report shows costs per vehicle km of £2.20 for East Coast, £2.30 for Grand Central and £2.90 for Hull Trains) and we believe that the potential for reducing unit costs that was identified in the McNulty study is equally applicable to franchised and open access operators. Any 'economy of density' from larger-scale open access operations would be off-set by the need for longer trains to provide sufficient capacity at peak times and might not occur at all if the new open access services were provided by a new operator. Also we do not believe that transfer of existing services to open access operation would necessarily lead to a reduction in staff costs because of the need to retain and recruit staff and because TUPE would need to be considered.

Therefore, in summary, it appears that increased open access competition would lead to an increased burden on taxpayers to offset lower revenue, higher operator profits and higher operator costs due to additional services. This is demonstrated in East Coast

Option 2 in paragraph 6.22 of your consultation document, though we believe the net cost is higher than shown for the reasons explained above.

Potential changes to access charges

Your consultation document suggests that, in return for relaxation of the 'not primarily abstractive' test, open access operators might pay a mark-up above the variable track access charge and that this mark-up might be determined by competitive bidding rather than by a fixed formula.

In principle we agree that there could be a case to change the current access charging arrangements so that open access passenger operators make a contribution to the fixed costs of the network and so compensate the Government for the loss of franchise premiums. The Charging Principles in the Access and Management Regulations 2005 allow for a mark up in any market segment and this could already be considered by ORR.

A competitive bidding approach to setting access charges for open access services could be difficult to administer, would be uncertain in its outcome for the planning of businesses and would not necessarily ensure that additional taxpayer support was avoided. Therefore we believe that a formulaic approach is likely to be preferable.

We would expect a revised access charging regime to apply equally to all open access operators, in line with the clear intent of the Access and Management Regulations. We recognise that imposing changes to existing contracts might present some difficulties, but we are clear that if a new approach is agreed, it should apply to applications for renewal or extension of access rights for current open access services.

A revised access charging scheme would need to take account of the additional infrastructure costs incurred when a route enjoyed by an open access operator is upgraded. All operators usually benefit from such upgrades, either directly through service improvements or indirectly from improved route performance and increased demand. The costs of upgrades can be substantial – for example the Control Period 5 Initial Industry Plan proposes £500m be allowed for East Coast Main Line capacity and performance projects. Therefore, where additional infrastructure is provided to meet growth in demand, the principle should be that, subject to the Charging Principles, open access operators contribute to the costs of such infrastructure if they are to use it.