

# Renaissance Trains Ltd

**new railways, privately financed**

## OFFICE OF RAIL REGULATION CONSULTATION

### THE POTENTIAL FOR INCREASED ON-RAIL COMPETITION

#### **An overview**

It would be wrong to start from the assumption that the existing open access operators are allowed by the regulatory system to compete with what might be described as Government Railways who control the operation of franchises in great detail and as a matter of course object through the regulatory process and other ways to any introduction or expansion of open access services regardless of the wider economic benefits that may be created.

It is only the persistence of a limited number of entrepreneurs that have found ways to run services within the very restrictive Moderation of Competition and not 'primarily abstractive' rules that has resulted in any market entry at all. The difficulty in creating a profitable business plan has resulted in only Hull Trains generating a return (after a loss making start-up period) although Grand Central has prospects of breaking even on the Sunderland route after four years' operation. Wrexham and Shropshire was closed before the break-even point was reached (perhaps as a result of the impatience of new shareholders following a transfer of ownership).

There is competition within the Government Railways structure where franchise routes overlap as a result of legacy timetables but this has not been regarded as an important market feature and this is reflected by decisions by the former Strategic Rail Authority to concentrate operations with a single franchise for a given route such as in Greater Anglia. The consultation paper notes the disbenefit to rail customers that has resulted.

#### **Customer Satisfaction**

The privatisation structure did see Heathrow Express established as an open access operator and this company together with Hull Trains, Grand Central and Wrexham and Shropshire, have constantly recorded higher levels of passenger satisfaction in the National Passenger Surveys than franchised operators.

A summary of the published data suggests this is primarily the result of higher standards of on board service, meeting and greeting at stations, and ensuring that passengers are cared for at times of disruption.

The railway business has always been about 'hard' skills such as engineering and operations and the 'soft' skills of a determination to always provide immaculate standards of customer care have proved an elusive goal for many.

The open access operators have also sought to provide a consistent level of service that is the same at the weekend as it might be for weekdays and generally does not discriminate between the business and leisure markets in terms of the product offered, a noticeably different approach to some franchised operators.

### **Moderation of Competition**

This is the mechanism that has allowed the franchised operators to retain a monopoly of the core long distance routes. Originally the intended privatisation model was to move progressively to a position where only 50% of a franchised operators' revenue would be protected from competition by a three stage relaxation in the Moderation of Competition which created a mechanism of nominating flows for protection. Within this process the current restrictions on calling at intermediate stations would have been removed.

The benefit of liberalising the market in this way was not implemented because it was considered the impact on the value of franchises would be too great. Instead a process that relies on judgement of individual applications is used, but it restricts new services from gaining approval for track access if there is the threat of a significant degree of abstraction. Applications turned down included a Harrogate – London service which Hull Trains wished to run in favour of an alternative service promised by the franchised operator which was subsequently not implemented.

### **Rolling Stock**

Promoters of open access services find that the provision of rolling stock is one of the greatest barriers to entry. Generally the financing conditions of rolling stock owners can be satisfied as a result of company structures adopted but the principal issue faced is the management of the national fleet by the Department for Transport that has no appetite for the requirements open access operators might have whether or not the economic benefits might be greater.

As there is little surplus rolling stock the result has been that greater costs have been incurred by new entrants as a result of operating vehicles that are more expensive to run than would have been the case if an open market in rolling stock provision existed.

Two examples can be quoted. In 2008 Renaissance Trains had developed a business plan that had widespread stakeholder support to operate services between Glasgow and destinations in England that were poorly served by through trains. An understanding was reached with a leasing company to hire Class 170 vehicles displaced from a TOC. Later in the process the DfT came forward with a plan that required the use of the vehicles on franchised services and this was given unquestioned priority. Thus the service proposed could not go ahead because no other suitable rolling stock was available.

The same had happened with plans for Wrexham and Shropshire services which resulted in the alternative of expensive locomotive hauled trains having to be operated – a factor that was a part of the subsequent failure of the business. Although a meeting was held with the appropriate Minister it was clear that decisions on the allocation of rolling stock were regarded as a matter for the DfT which is certainly not within the spirit of the Railways Act 1993 Act or the terms of Government direct agreements.

The only realistic answer to this issue at present is new build which requires certainty about track access rights and charges over a lengthy period of time to allow the rolling stock to be depreciated and its cost of use to be known.

### **Timetables**

The process is based on a hierarchy of rights which leaves a new operator having to develop a business plan based on occupying ‘white space’ on the graph. There are no rights in place so there is reliance on other operators to flex timings to secure optimum journey time. Freight operators are generally helpful but franchised operators on the whole are not seeing the issue as an opportunity to frustrate the competitiveness of the proposed service.

Network Rail has improved their approach to open access operators once firm rights for track access are established but there is a weakness in that agreements are tilted in favour of NR as it is not possible to negotiate incremental improvement to timings although this should not be difficult to achieve from the initial start-up position.

### **The questions to address**

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

#### *Causations*

#### **Productive efficiency (keep costs down)**

In any competitive market decisions have to be made about the price / service mix. The lowest cost service option is not necessarily the optimum answer in maximising the potential profit. The competition is varied in terms of the potential to generate model transfer, to stimulate discretionary spending, and to be a preferred supplier where on-rail competition exists.

For longer distance journeys most train operators have settled on a first class product that provides a varying level of complimentary catering, and a standard class product with either a buffet counter and/ or a trolley service, although a degraded offer may be

made at weekends in the apparent belief that business does not justify the cost of on board service provision.

The core elements of the product such as the provision and maintenance of rolling stock, driving the train, fuel / traction current supply, and meeting operational safety requirements for train despatch and response to operating events are determined at a higher level than day to day interventions.

Rolling stock provision and maintenance is the highest portion of operating costs. The capital element is largely a market based figure rather than reflecting any depreciation policy adopted by leasing companies. Maintenance costs reflect diverse strategies being carried out by vehicle builders, train operating companies, and other third party suppliers. For new rolling stock the design, build, and maintain strategy has produced cost efficiency.

For the future diagnostics transmitted by GPS to maintenance depots is improving availability but the diversity of equipment in use which was noted by McNulty brings the penalty of a wider expertise and spare part provision than would be the case with more vehicle standardisation.

Drivers are a valuable resource and the barriers to entry and cost of training mean train operators who want to vary the terms and conditions of employment to reduce costs are in a weak negotiating position. Open access and freight operators have emphasised the professional status of their staff and have achieved more flexibility in working practices as a result.

Fuel / traction current costs are largely subject to external forces although hedging can allow judgements to be made about the best time to purchase fuel for forward requirements. Conserving fuel by the elimination of wasteful driving techniques is something that competition would stimulate along with regenerative braking. Like most innovation finding the right solutions are more likely to emerge from open access operators that have a greater need to pursue productivity to deliver business cases given their restricted market presence.

McNulty found that driver only operations should be the default position but it remains questionable whether the train manager role disappears if the operational function is no longer required. A competitive environment would we believe continue to see a role for a train manager but in a customer service environment where there would be the incentive to combine the role with the provision of on board service. This can result in a reduction of the overall number of on board staff required in given circumstances. For longer distance services the greater certainty of demand as a result of internet based sales channels offers the prospect of tailoring the capacity provided to predicted sales. There are many prejudices to overcome that relate to the concept of a 'turn up and go' expectation for a predicable clockface timetables, and concepts about the

productive rostering of train crew but there is little doubt that at the moment load factors on many services are too low to justify running the type of trains used. One of the motives is also that the franchised operators to some extent backed by the DfT want to maximise track occupancy as a method of thwarting the promotion of services by open access operators.

### **Allocative efficiency (use resources where they are valued most)**

Managers from the BR era have plenty of experience of investment rationing and containing costs within an external financing limit. The market within which the railways are operating has changed very substantially since that period. There is now a stakeholder consensus that running high capacity trains between major population centres with a requirement for rail heading over substantial distances is a flawed strategy in terms of environmental and social policy objectives.

It follows that to provide through trains between London and areas with lower population densities such as Hull, and Sunderland will mean a business case that requires lower capacity trains.

However there is no reason why trains should not be coupled over common sections of the route a practice followed for a long period of time on the third rail network of lines in the South East. This has not happened elsewhere because of a general reluctance to design modern signalling systems for permissive block working and for the existing East Coast open access operators the constraint that other possible destinations such as Nottingham, and Sheffield via Grantham and Retford would fall foul of the artificial Moderation of Competition barriers.

The advent of the Train Protection and Warning System and future GSM-R has mitigated the risk associated with permissive working (coupling and uncoupling loaded trains at station en route) and there is little validity to objections to include the capability in all new signalling schemes at main line stations where there are junctions that serve other routes.

Train portion working is more widely practiced in Europe and to some extent the InterCity Express programme vehicles will have the capability to rectify this if the design of signalling is appropriate.

### **Dynamic Efficiency (new and better ways of doing things)**

In the longer term what initiatives might operators make within the anticipated train control technology and electrification that will be available in the next three decades? This period is chosen because it reflects the life of new rolling stock that might be acquired to operate services.

Clearly for longer distance services trains will be bi-mode with less emphasis on high capacity fixed formation rolling stock. A competitive market will accelerate this trend

and many more communities will find links to major population centres are improved as a result.

We are only in the early phase of understanding how internet based sales channels and smart card ticketing will change buying behaviour.

In the context of a 30-year life cycle nobody would have predicted in 1981 how the internet and its social networking use would alter how the customer approaches the purchase of any product.

The opportunity is to match service capacity more closely with demand. At the moment it is something of a finger in air exercise to pitch the price of on-line fares to fill seats that would otherwise be unused and in a competitive market there would be much more rigour about the reality of the capacity provided and the price at which it can be sold.

Some longer distance off peak services to the major centres of population would be likely to disappear – the maxim being that if revenue potential did not cover avoidable costs the services would not run unless there was intervention by stakeholders to specify the requirement.

Modern sales channels will bring a greater understanding of this with the analytical tools now available to track sales from when bookings open 12 weeks before trains run. Matching capacity to demand is one of the reasons why freight operators have enhanced their productivity enabling reduced unit costs which has generated growth in new markets. For passenger operators there are examples where the position has been in the other direction.

### **Understand and respond to passenger needs**

This is one of the big downsides of allowing monopoly franchise contracts. It's a like it or lump it situation once the franchise contract has been awarded and there is no effective collar on the train operators to do what is best for the customer. Of course customers' expectations are not always deliverable at an economic cost but all too often operational decisions are made that impact badly on the journey experience and a competitive environment will change that.

Whilst generally not in direct competition with the franchised operators the open access companies have to win new business from modal transfer or win discretionary spending choices and the consistently high rating for customer satisfaction show their intention and delivery of service that customers like.

### *Potential downsides*

#### **Reduced consumer protection**

How effective is consumer protection now? Much of the content of Passengers' charter clauses could be seen as sticking plaster to provide compensation for service failures rather than meeting passenger needs at times of service disruption.

The necessity for a 3-year period of fares increases at RPI +3%\* doesn't say much for consumer protection and is a reflection of the failure of the passenger sector to achieve significant levels of productivity that a competitive structure would generate as has been demonstrated by the freight operators and low cost airlines.

For many franchised train operating companies passengers' opinion is also poor and there has been a trend to circumvent the regulation of fares by altering 'off peak' definitions which has caused a sharp increase in ticket prices for some users.

\*recent Government action to revert to RPI +1% in January 2012 does not invalidate the background behind the original intention.

### **Loss of co-ordination benefits**

At the time of privatisation care was taken to ensure that network ticketing products such as railcards and tickets with inter-availability were retained and this process is managed through a modern day 'clearing house' in the form of the ATOC Rail Settlement Plan. There is no obvious reason why more on-rail competition would dilute these arrangements.

There is a trend to what is described as dedicated ticketing where the product is only available on services provided by the designated train operator. These are attractive to service providers as they are not subject to the pooled system of allocated revenue – ORCATS, but they are not suitable for all passenger needs. It is worth saying that the ORCATS system is seen to work well in that the allocation of revenue has when challenged and investigated been proved by passenger counts to be sufficiently accurate.

### **Reduced investment**

The most obvious observation is that in the competitive freight sector there has been a surge of investment in locomotives, wagons, and terminals that has resulted in high levels of productivity and reduced costs.

It is unlikely if a similar structure had been established in the passenger sector that vehicles with either below par customer service provision or poor availability and high maintenance costs would have remained in service.

The freight operators have largely withdrawn legacy equipment while the passenger sector has retained elderly vehicles in service with very poor standards of journey quality, and the penalty of high maintenance costs.

There is no evidence to suggest greater on-rail competition will reduce investment.

There is evidence that it will be stimulated in particular by the decision of both Deutsche

Bahn and Eurostar to acquire new trains in the competitive environment that the European Commission has created for International services.

### **Reduced economies of scale**

This is an old railway hobby-house which might be interpreted as a standard size fitting all. It has no place in a modern economy where individuals have the disposable income to exercise choice.

The evidence in a railway context is again in the freight sector which was privatised on the basis of one national operator with the addition of a separate intermodal business – Freightliner. The dominant market share that EWS inherited quickly diluted as new operators were formed with the result that there has been an all round improvement in customer service that has increased the rail share of the market and motivated substantial gains in productivity.

So contrary to reducing the economies of scale a diverse market has delivered exactly the opposite.

It will be the same if the monopoly nature of passenger operations is eroded. There is also some evidence available that the smaller franchises were more effective in addressing their markets such as Midland Main Line, Anglia, and Chiltern where in each case passenger growth far outweighed that of the bigger operators.

This can be accounted for by being closer to the customer and thus interpreting market needs, identifying the opportunities for modal switch and driving infrastructure capacity improvement by small scale initiatives such as signalling alterations that deliver value for money.

*Impact on taxpayer funding (premiums) etc.*

### **Overview**

It is very easy to adopt a status-quo situation where passengers using long distance services and some commuter services in London and the South East are effectively taxed though the premium payments to support secondary and rural services outside London. There is a reluctance to accept that the railway profit and loss account is not the only financial dynamic at work because if competition brings productivity and lower fares it will as McNulty observed see greater railway growth with all the benefits for other sources of Government revenue such as employee taxation and corporation tax. In the economic circumstances of the moment the biggest impact on taxpayer funding would be if the franchises were 'sold' with long term rights to operate services in a competitive rather than monopolistic environment. This would replicate the freight sector approach at privatisation although rolling stock assets would be likely to remain with their existing owners but note some recent freight market entrants have purchased

relatively new assets formerly owned by finance companies when there has been the opportunity to do so.

*The potential benefits of competition as described in Chapter 3 onwards in particular the potential for it to drive value for money by –*

### **Improving firms' responsiveness to passenger demands**

There is well founded data from the National Passenger Survey conducted by Passenger Focus. This provides illustration of the areas where passengers are less satisfied with the responsiveness of train operating companies than might be expected.

In the spring 2011 survey the weakest areas were –

Train factors	toilet facilities	40% dissatisfied
	ticket value for money	35% dissatisfied
	dealing with delays	28% dissatisfied
	staff availability	26% dissatisfied

Station factors	car parking	33% dissatisfied
	station facilities	29% dissatisfied

The provision of on board toilet facilities has not been given high priority in decisions made about vehicle cascades which has seen trains designed for short distance journeys utilised on lengthy secondary services. There are also occasions when operating disruption causes scheduled emptying of controlled emission equipment not to be undertaken so that the toilet tanks become full with the result that the facility is locked out of use. Operators in a competitive market can be expected to improve these aspects.

In the short term the ticket value for money indicator is likely to become worse given the decision to increase controlled fares by RPI +3% in each of the next three years. Although this is to be reduced to RPI +1% in January 2012 it will still result in an increase of 6.2% in controlled fares which will have a significant impact on disposable income given current national economic circumstances.

The ORR consultation assumption is that competition will reduce the average cost of fares and coupled with the expectation of higher levels of customer service improvement in this statistic might be expected.

In a competitive market train operators are likely to attach much more importance to looking after the customer interest at times of disruption whether these are for planned service alterations or out of course events. The meeting and greeting style adopted by

the present open access operators gives much higher staff profile which is probably why there is a translation to higher staff availability scores in the NPS.

There will be much more focus on the management of stations by train operating companies in the future given the structure adopted for the new Greater Anglia franchise where renewal and repairs will be come a TOC responsibility under long term leases from Network Rail. On-rail competition will increase income at stations by greater footfall which can be reflected in the rentals achieved for station retail outlets and as a justification for investment. It can be expected that the aims set out for better stations in the Green / Hall report will form a benchmark for performance in this respect that is capable of being funded.

### **Placing downward pressure on costs**

The freight market has seen reduced costs as a result of a number of strategies adopted by operators in a competitive market -

- Investing in new standardised rolling stock with cheaper lifetime costs

- A significant improvement in staff productivity such as extending the duties of drivers to cover commercial work

- Ensuring services that operate have an economic load factor

- Contracting out local activities such as shunting to firms with a lower cost base

These actions are driven by low barriers to market entry (British American Rail Services was a new entrant in 2010) and the fact that unsuccessful licensed operators fail if they are unable to win tenders from freight customers because of high costs.

The unfavourable passenger market comparison is a reflection of a belief that competition stimulus is provided by a franchise competition. Many good things that have happened in the freight market are constrained by the delivery plans that are part of the franchise contract. A number of these are – lack of control over rolling stock procurement, compensation provided under the cap and collar regime if the business plan forecasts are not achieved, and the requirements to run a specified timetable regardless of the economic circumstances and passenger take-up.

There is every reason to suppose that removing barriers to market entry would stimulate the actions that have been seen in the freight market which has promoted cheaper costs and product design to win new customers.

### *Any wider benefits of competition that should be taken into account*

The consultation paper describes outcomes in a variety of markets where competition drives a match between the product and market expectation at competitive prices.

*The extent to which benefits could be realised in GB passenger rail through increased on-rail competition, with particular reference on*

**The likelihood that increased on-rail competition would drive lower fares and improved service quality**

The evidence offered in the consultation paper regarding fares and from the National Passenger Survey suggests this is the case.

An aspect that should be considered is the increasing tendency to market dedicated rather than inter-availability ticket products. The reason for this is that the train operator receives all the income less any commission element from products that restrict travel to trains provided whereas the ORCATS allocation system calculates a proportion of the inter availability fare that reflects the customer travel options available on a turn up and go basis.

The outcome is that although the passenger pays a lower dedicated fare the train operator receives higher revenue. As the use of dedicated tickets restricts customer choice in the service used it is important that the journey experience does not bring about any motivation to revert to a more flexible ticket buying option.

Research available has shown that leaving aside commuter style journeys passengers using longer distance services make an average of 4 journeys per annum so the motivation to sustain a good journey experience to ensure repeat business is high.

**The potential for competition to drive cost savings and in particular the assumptions made by MVA in its modelling as summarised in chapter 6**

The productive efficiency elements are discussed earlier in this response.

*The potential for development in the sector, including technological change to increase the scope for greater on-rail competition in future. Please highlight in particular:*

**What developments you consider could take place**

A revolution is taking place in the way rail services are sold to customers with increased use of internet and mobile technology. This allows competing rail companies to identify product strengths and improve marketing accuracy. It brings an ability to adjust prices on individual services through the quotas available for different pricing bands of advanced ticket offers and ultimately allows services that cannot operate with earnings below avoidable costs to be identified.

Modern train control systems are allowing better use to be of infrastructure capacity. The availability of the Train Protection and Warning System and GSM-R radio signalling

will allow greater use of permissive working which has been unduly restricted in recent standards practice. The greater flexibility will allow more portion working so that trains can be coupled on heavily utilised core sections of the route before dividing the train to serve individual destinations thus producing better capacity utilisation. Of interest is that the two East Coast open access operators couple trains from each company when paths are restricted as a result of engineering work.

For train engineering remote monitoring and diagnostics will increasingly allow the potential for train failures to be greatly reduced as well as flagging up the requirement for component change during maintenance examinations which will reduce the downtime incurred for vehicles.

On Board operating functions continue to require the provision of staff with rule book skills on many services. As McNulty identified the default position should be driver only operation. The changes being made to the rule book and introduction of GSM-R based systems will make this a reality and will allow a greater emphasis on the on board staff being focussed on customer service.

### **How you feel it could facilitate greater on-rail competition (e.g. by increasing the efficiency of capacity utilisation)**

As discussed, by reduced headways and greater permissive working.

### **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**

This should be a part of the high level output statement negotiations with Network Rail for Control Period 5.

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

The consultation paper indicates that greater on-rail competition will generate more demand for rail services which may result in greater infrastructure capacity being required which under the current mechanism would increase the level of funding necessary for Network Rail enhancement work.

There is a lot that can be done within the existing physical capability of the network by small scale enhancement schemes that improve the headway and / or restore restrictive track layouts such as single lead connections and the design of track circuit overlaps. Line speed improvements on many secondary main lines are another source of productivity.

*Specific policy options that could be pursued to facilitate increased on-rail competition, including but not necessarily linked to those assessed in Chapter 6 including*

**Impacts on the flow of money in the industry and in particular flows of public funds;**

The protection of franchise value has dominated this debate. It seems to ignore the benefit that new operators bring in terms of regeneration, employment, and the supply chain.

It would be a mistake to believe that a financially led bid process for paths is a solution to make up the loss in premium income that may result from greater competition. Like franchise bidding this would be a process that is far removed from the aspect that really matters - the choice by customers of the product they wish to use.

You might as well have two franchises on a given route which would seem to negate the whole idea of competition and passenger choice as the conditions of fulfilling the contract for the right to operate services would be more important than meeting customer needs. Such an approach would be unlikely to deliver the benefits seen in the freight market.

Before the advent of the standardised track access contract promoters of open access services considered with Network Rail whether a form of risk share should be established in that the infrastructure owner would share revenue once both parties had paid for their allocated costs. In the current structure this would mean that NR would have an income line that reflected this joint venture approach and it could be a very timely way of bringing life to the devolved route administration that is currently being established.

**Impacts on key stakeholders including taxpayers**

The existing open access operators have been seen as beacons that serve their local communities which is reflected in the choice of suppliers, location of employment, and partnership arrangements to promote enterprise, education, and awareness.

These values are understated in terms of taxpayer benefits for as well as the headline value of employment the purchase of supplies is spread widely across the local economy which over time develops skill clusters that allows the formation of new businesses as expertise is developed to serve a wider market.

**Any issues associated with using financial bids as criteria for allocating network capacity, including any views on any complexities or administrative costs that this might introduce.**

This would be a mistake as it does not empower decision making by individual customers. It is an extension of the argument that franchise bidding is a sufficient competitive process to bring the benefits of competition.

There has not been a good experience with the franchise bidding process where examples can be given of train operators reducing the quality of customer service as the amount bid for track access rights is found to be unaffordable.

Any such competition would be far removed from the aim of creating a competitive market where the customer makes the choice about the service used. This requires an approach where an open access operator has clarity on the access charge in determining whether a business case can be developed to provide a service which can attract sufficient demand.

Capacity bids would almost certainly see a concentration of services on the busiest routes reducing the geographic spread of services as without some form of mitigation smaller centres of population and less prosperous regions would be the losers.

It is hard to see how the freight sector could respond to tenders from potential customers if there was no certainty about the track access charge. They would also need known access charges in prepared bids for the Modal Shift Revenue Support Grant.

**In drawing attention to any downside risks or costs associated with specific policy options also set out your thinking on how these costs and risks might be mitigated.**

The issue is really about franchise value and the premium system. Has this worked well? The answer has to be no. There are the examples of companies giving up franchises after bids that did not anticipate the economic circumstances that are now present and the need for cap and collar claims.

The fact that the franchised operators have not had the same motivation to improve productivity says a lot about the structure within which they are operating as compared to the freight operators who provide services in open market conditions with a level playing field regarding costs for infrastructure access of given equipment.



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1<sup>st</sup> December 2011  
Submitted by email