Response to the ORR consultation document "The potential for increased on-rail competition"

Summary

Stagecoach agrees with the basic premise that more competition is good for customers and that this applies to the whole of the rail industry. This should take the form of:

- Competition introduced into the rail infrastructure market,
- Full on rail competition where services can be run on a commercial basis, and
- A relaxation of the franchising and fares regimes.

We do not agree with the ORR's ascertain that there is a recognised lack of cost efficiency of train operators. The McNulty Report found the opposite. Whereas infrastructure costs are some 50% above the average benchmark in Europe, train operating costs are 5% below the European average[1]. We suggest that the ORR should therefore seek to address the competition deficit 'below rail' to enable improved regulation of Network Rail. Should ORR wish to pursue more 'above rail' competition, a more comprehensive competition model should be developed and analysed in the first instance.

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[1] "International whole industry including train operating cost benchmarking", Civity - *9 May 2011*

1. Introduction

Stagecoach welcomes this opportunity to comment on competition between passenger operators in the UK rail market in response to the ORR consultation paper of October 2011. Our response is based on our practical experience of the market as one of the UK's longest-serving private sector operators, having operated one of the first private trains in 198? and the South West Trains franchise since [1996]. This response is intentionally not exhaustive – it is not our place to replicate academics or consultants but to comment on our experience. The format of this response follows the questions asked in Section 7.13 of the consultation document.

Our comments are focussed at what we perceive to be the main purpose of the document (para 1 of the Executive Summary) which is to 'meet the value for money challenge that faces the industry'. We have interpreted this in its widest sense which means value for money not just to passengers but taxpayers. Only 55% of the population have used rail in the last year[2] and rail makes up only 2% of UK journeys, hence our focus on the majority taxpayer interest. ORR would appear to agree, expecting to see 'an overall benefit rather than, for example, benefits to passengers that were paid for by taxpayers' (para 2 of the Executive Summary).

Competition from modes other than rail (para 1.3) has been excluded from the ORR analysis. We operate in the real world of both 'on rail' and 'other mode' competition. For example, air is the majority passenger carrier between Scotland and London and as noted above, rail makes up only 2% of UK journeys.

We are also concerned that this consultation is aimed 'to stimulate debate about whether and how to move towards greater on-rail competition' (para 1.12), whilst recognising the options are not exhaustive and designed to illustrate the range and the associated issues'. To be a complete analysis, we believe that both franchise reform and fares regulation should be included. By concentrating on competition between open access and franchised operations, the range of competitive options is not sufficiently broad. Options such as the outright sale of franchises should be considered, which would have the result of delivering the increased competition sought by ORR. The ORR analysis has also excluded changes to the fares regimes – again to be comprehensive, such changes should be considered as part of this debate.

2. Our experience

Stagecoach has taken part in every round of franchising and refranchising since BR was privatised in 1995. We have therefore competed 'for the market' in many different ways, responding to the franchise authorities' requirements as they have developed over the years and have been successful in 1 in ?? of the franchise competitions in which we have taken part. This demonstrates that franchise competition is intense.

In competing 'for the market', we have had to take account of both known and unknown competitors, both on rail (particularly open access operators) and from other modes. For example in the 2004 and 2007 competitions for East Coast, we made

[2] Rail Trends, Great Britain 2010/11 - Rail Statistics Factsheet No. 1, DfT

significant allowances for lost revenue to other (open access) operators, money which in effect reduced the premium we offered to Government. The net result was an increase in the cost of the railway to the taxpayer.

ORR are keen to point out that open access operators bring passenger benefits (para 5 of the Executive Summary). However, as highlighted by our experience, and elsewhere in the consultation document, the taxpayer loses out (for example, para 6.16 where MVA found that an increased role for open access operators would increase the cost to the taxpayer).

Lastly, there is little evidence that open access operations are profitable, even at current levels of track access charges. WSMR has gone out of business. According to MVA (para 2.6.9 of the MVA report), the only Open Access operator to date to show a profit is Hull Trains. However, according to First Group's half-yearly results[3], growth in Hull Trains is behind its franchised operations:

Six months to:	Sep 11	Mar 11	Sep 10	Mar 10
Hull Trains	1.7%	0.4%	7.7%	(3.1)%
Total First	9.0%	6.0%	4.4%	2.8%

3. Potential and wider benefits of competition

We consider that the analysis of costs presented by ORR is rather superficial. The experience of a small number of small railway operations (open access operators running under 20 trains per day) has been extrapolated to businesses 10 or more times the size. MVA would seem to agree that this might misrepresent reality (para 2.6.10 of the MVA Report). Simply assuming that, because wage rates appear to be lower for open access operators, franchised operators can employ staff at similar lower rates is not practical in today's industrial relations climate. MVA would seem to agree stating that 'any gains from freeing operators from the constraints of existing salaries might be rather modest' (para 2.6.11 of the MVA Report). Additional, such cost saving might be offset by a loss of density (para 2.6.13 and 2.8.12 of the MVA Report).

ORR research suggests that cost saving of the order of 30% with franchising have been realised in Sweden and Germany, and have extrapolated this experience to the UK. This approach takes no account of the different franchising regimes or the size of franchises on offer. In Sweden and Germany, franchises are significantly smaller than in the UK, rendering extrapolation unreliable. Furthermore, Stagecoach and its fellow operators compete vigorously 'for the market'. Whilst this might reduce the amount of real-time head-to-head competition, the ability of such for-the-market competition to reduce costs cannot be ignored (Para 5.1). In summary, McNulty reports that UK operator costs benchmark well against Europe whereas the infrastructure maintainer does not compare well (Figures 1 and 2[4]).

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[3] FirstGroup plc half-yearly results for the six months to 30 September 2011
[4] International whole industry including train operating cost benchmarking, Civity - *9 May 2011*

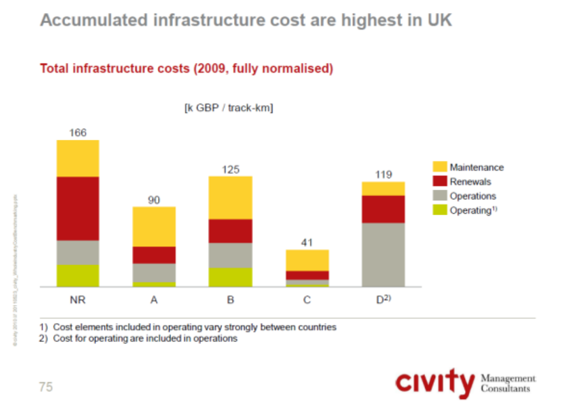

Figure 1: Infrastructure Costs

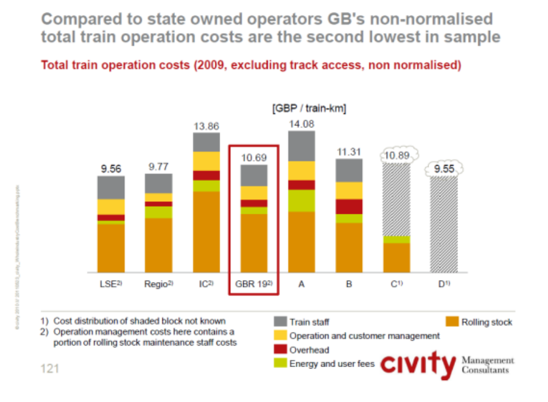

Figure 2: Operator costs

The MVA report concludes that on-rail competition is not in itself necessarily a driver of industry cost reduction. ORR reaches a similar conclusion (para 6.2) expecting ‘more on-rail competition to tend to have an ambiguous impact on total industry cost’.

A potential disadvantage of competition for paths is that open access is likely to be commercially attractive on those parts of the network that are full. Paths on a route are interdependent, and therefore, there is merit in a 'single guiding mind', or at least, some central coordination of all operators' aspirations to produce one coherent plan. Our experience is that this is most efficient if one entity can decide the markets which should be served and conduct the detailed planning of the timetable.

The Network Rail 'ESG' process is not dissimilar to the 'single guiding mind', however it is constrained by having to consider a predetermined list of aspirations which include some potential services which are more abstractive than addressing market needs. This results in a duplicative competition 'for the market', which may produce benefits for customers, but only at the expense of the taxpayer.

The advantage of having one TOC planning all services on a route is that it can trade off the benefits of serving different markets without the constraints of fitting around other operators services. This allows it to consider the compromises necessary to meet an altered market priority with a focus on maximising the infrastructure potential.

It would appear that Smith and Nash support this view in their report to the McNulty Review. They state that “It has also been argued that the existing approach to allocating capacity and producing timetables is not prescriptive enough and leads to seriously suboptimal results, and that a more centralised approach could give better use of capacity and higher traffic and revenue, following the Taktfahrplan principles developed in Switzerland (Tyler, 2009). An earlier modelling exercise found that rail revenue in Britain could be raised by some 6% on routes to London and 17% on other routes simply by better integrated timetabling, with no additional resources (Johnson et al, 2006) This of course is an issue relating not just to the efficiency of open access competition but also to the degree of prescription in service specifications in franchises.”[5]

[5] Rail Value for Money Study: Research Project on Unit Cost Reduction and Franchising, Andrew Smith and Chris Nash. January 2011

Finally, the ORR should consider possible risks to performance that introducing more operators may cause, as set out in para 5.34. For example there are some 16 different operators on the East Coast Main Line, a factor which cannot help the delivery of good overall performance.

4. Realisation of benefits

Passenger operation (‘above rail’) is just one part of the rail industry accounting for some [50%] of its costs. The remainder is related to infrastructure operation and maintenance (‘below rail’) where there is currently no competition. It is therefore interesting to note that ORR are considering introducing more competition into that part of the rail industry already subject to competition and ignoring that part of the industry where there is no competition. If the benefits of competition in passenger markets are improved services at lower prices, we see no reason that this policy should not be applied to infrastructure maintenance and operation.

The consultation document itself makes reference to the benefits of ‘increased contestability in a number of areas of infrastructure management’ (para 5 of the Executive Summary). It also states that ‘regulation has a key role to play’ (para 1.8). We agree and ORR should play that key role for the current infrastructure manager, using all the tools it has available, including competition.

Our experience in bidding for franchises where there is a possibility of open access operators is that value to the taxpayer is lost (see section 2). We do not agree that the ‘not primarily abstractive’ test has not ‘reduced the need for franchise bidders to take account of the revenue risk that results from open access competition’ (para 2.6). Bidders for franchises still need to take account of the revenue lost to open access, although the NPA test may reduce the quantum of deduction made from premia.

In para 3 of the Executive Summary, ORR point out that ‘it is important to clarify our position ahead of forthcoming franchise competitions so that firms are able to bid for passenger rail franchises with a reasonable degree of certainty’. These franchise competitions have already commenced with the InterCity West Coast competition underway. Whilst there are some known open access applications for the route, they have not been accepted by ORR and await a recasting of the timetable in [DATE][6]. Elsewhere, the franchise competition for InterCity East Coast is due to start in the middle of 2012, a date by which it is impossible for an open access operator to commence a service. The likelihood is that, far from delivering certainty, the ORR’s proposals for increased competition will deliver the opposite, namely more uncertainty, with a corresponding loss of value to the taxpayer with bidders having to make allowances for lost revenue amounting to hundreds of millions of pounds. Far from having ‘minimal impact on the revenues of franchised TOCs’ (para 4 of the Executive Summary), the opposite may be true in practice.

There is an inconsistency in the Executive Summary between the requirement to ‘have regard to the funds available to the Secretary of State’ (para 2) and ORR’s view in para 6 that ‘greater on rail competition would be desirable’ because ‘benefits to passengers that would significantly outweigh the cost to Government’ (para 5).

[6] Refer to ORR doc about West Coast

ORR's proposal would increase the amount of funds required. We would suggest it is for the Secretary of State to determine whether the estimated passenger benefits are value for money, considering the need for increased taxpayer support.

We also think that the analysis is deficient in an number of other areas, such as taking into account the transition costs of moving to the regime suggested, the possible loss of network benefits and the benefits of security of supply under a franchised operation where the DfT acts as Operator of Last Resort.

We would again rely on the findings of Smith and Nash for the McNulty Review concerning increased competition. They state "Three key conclusions emerge. Firstly, the extent of competition attracted will be very dependent on the level of track access charges, which greatly influence the scope for profitable entry. Secondly, if there are no constraints on entry, the most likely form of entry is 'cream skimming'; i.e. simply duplicating the most profitable services of the existing operator, and reducing their profits. Only on the busiest routes is it likely that head-on competition - high frequency duplicate services by two or more operators - can survive. Thirdly, it is likely that competition will generally lead to excessive levels of service and costs, for which the benefits to consumers will be more than offset by the losses of profitability to the existing operator. The loss of economies of density for the existing operator will exacerbate this tendency. The consequences of this loss of profitability may be a need for increased subsidies or the withdrawal of other services which were being cross subsidised from these profits."[7]

5. Potential developments

The broad thrust of ORR's conclusions is based on a lighter specification by DfT within franchises and greater availability of paths to open access operators. In particular, it seems to infer that DfT should specify only those trains that are socially necessary and which do not cover operating costs (i.e. are not profitable).Whilst we think that the assumptions made by ORR about the relative costs of franchise operators and open access operators in the long run will not be realised, there may be some benefit in exploring a free market approach whereby fully commercial services are competed for on the basis of an auction of paths without any franchise (para 5.31), and franchised services would be restricted to non-commercial services.

6. Impact on the taxpayer

This has been covered throughout this response.

7. Specific policy options

We believe that rather than seeking to deliver improvements by increased above rail competition, the ORR should address the competition deficit in the operations and maintenance of infrastructure. At the same time, a broader review of competition above rail should take place, including giving consideration to the operations of some lines without franchises.

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[7] Rail Value for Money Study: Research Project on Unit Cost Reduction and Franchising, Andrew Smith and Chris Nash. January 2011