Response to the Office of Rail Regulation consultation document - The potential for increased on-rail competition

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1 December 2011

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1 Summary Propositions

That UK inter-city passenger business is freed from the flawed 1994 command economy approach to franchising.

That at least two operators are granted rights in perpetuity on each inter-city route (subject to regulation)

A more rational or 'efficient' basis is used for charging inter-city TOC access to the network

That initially the East Coast main line is used to demonstrate the benefits of non-monopoly access.

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2 Responses to specific ORR questions

Introduction

"Timid and Tinkering" - was the title I used for a submission to DfT on the future of franchising and it could be used again when commenting on the wording in 7.3

"such a scenario would represent a significant departure from the status quo without stepping so far into the unknown as to create unacceptable uncertainty or risk"

I appreciate the constraints on the ORR but there are serious structural inefficiencies in the flawed 1994 based approach - see 6 a page 13

The UK needs to move on from the uncompetitive thus costly and inefficient monopoly franchises.

5.5 The DfT and TS are in a position to bring about change through modifications to franchise policy. They could achieve this by one or both of:

- *Specifying the number and boundaries of rail franchises such that there were a greater number of franchise overlaps; and*

- *Franchising fewer rail services such that capacity on the network was available to enable a larger number of open access services.*

5.6 The potential for the second of these two types of change to bring about benefits to passengers and taxpayers could be facilitated and complemented by changes to ORR's approaches to access and charging that firstly, enabled a greater amount of head-to-head competition and, secondly, increased the contribution to infrastructure costs made by open access.

I absolutely agree – but it seems we have a lack of long term policy or that facile word 'vision', certainly as regards intercity rail travel.

See 6 b – page 14

Suggestion – be bold - nothing can be worse for the taxpayer, the customer and employees than the existing, ever changing, often failing and costly existing inter-city monopoly franchises.

Responses to the *questions in 7.13*

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

As stated in 2.2 99%of services are franchised – but on the EC (East Coast) route there are some choices and there was choice on the Chiltern Line.

Purely as a consumer it is marvellous to have choice. Choice of service, of price, of conditions eg you can purchase a ticket on the train and not be 'fined' as a walk-on passenger

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:

Improving firms' responsiveness to passenger demands

One has to question whether imposed monopoly franchise holders have any real need to focus on passenger demands.

If business gets tough - don't bother, blame the economy, if traffic increases - take the money!

Placing downward pressure on costs

The access pricing structure with the set franchise holders fixed cost element does not put pressure on overall rail cost reduction.

Access charges based on the full cost (annualised present worth calculation (see 5 f - page 10) with a sensible level of utilisation would make operators aware of cost and thus their pricing and track utilisation practices.

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

- Operators would be more inclined to constructively challenge NR. This ties in with the notion of route managers.

- In perpetuity franchise holders would invest for the long term and develop UK's expertise in contemporary rail operation.

- True competition would bring innovation

- The UK could lead in rail operation practice – let's be proud of our abilities

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

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

Fares might be lower for basic rail services. BUT operators might increase fares and justifiably so if they delivered what the customers wanted. Profits would flow **to** the industry and the taxpayer.

Without competition, as at present, customers' needs and wishes can and often are ignored.

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.

Realising bid premiums should be considered a highly dubious concept – witness practice to date . Why not focus on TOC's making real profits – revenues - paying realistic access charges and corporation tax on company profits (subject to HMRC tax policy being applied properly)

Cost savings could be made – but is this cost saving or utilisation gain - see 5 a-c - page 7

Long term (in perpetuity) TOC's could really interact with NR and work to produce cost savings

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:

What developments you consider could take place

A proper (full recovery of cost - see 5 f - page 10 access pricing regime would reveal true cost of rail.

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

Single monopoly franchise holders do not necessarily have capacity utilisation as a prime driver - see 5 a - page 7. They may run trains that are not needed – they may just be focused on marginal cash generation.

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.

A move to true open access - this needs to get underway immediately - at least on a controlled, test basis.

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

Inter-city rail should not be a cost to the taxpayer and should contribute to achieving environmental and other goals – eg fewer car journeys but rail has to be attractive.

The tax payer would not subsidise the inter-city operators and would gain from a possible franchise charge surplus and from corporation tax from operators. VAT (why not?) on rail travel could contribute to the exchequer.

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:

Two or more competing operators with out time limit access.

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

There should be an increased flow of funds to NR - if not then inter-city rail travel has fatal problems.

Having an all in access charge (based on a 50 or other long period cycle) may result in surpluses or deficits in any one year, eg where major capital works are periodically required. With a clear understanding of the amounts funders (pension funds etc) should be happy to invest. If there was a surplus (a build up to future capex) then a sinking fund arrangement could be put in place - or cross funding for other routes. But reliable figures and openness is required.

Impacts on key stakeholders including taxpayers

Choice for travellers, challenges for operators, innovative thinking, more money for rail and no subsidies from the taxpayer.

Any issues associated with using financial bids as a criterion 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.

Hopefully all the TOC's circling around to win a monopoly cash flow business will accept they have to pay an economical access charge (per train etc). They will seize the opportunity run a profitable venture.

The ORR will have the task of selection based on quality.

3 Vested interests

NONE apart from wishing the UK to have a vibrant rail industry with inter-city passengers having choice and taxpayers value for money.

4 Context of this response

The comments on the proposal are addressed to inter-city (to use that established term) routes. As a base for further reference in this paper I have classifed rail operation in the following economic groups.

Intercity - the main line routes out of London also some classified as cross country.

Urban - the London and other significant conurbations where rail is an essential contributor to the local economies.

Rural - lightly used cross country, branch lines etc - BUT maybe of significant use for freight

Freight - freight sharing routes of the above three groups or where freight is the sole user

NR - Infrastructure provider - Network Rail

5 Basis for the propositions

a . Franchises and the analysis in the paper may be too focused on volume rather than profitable revenue.

5.9 Under the NPA test, new open access services are only approved where the revenue that they are projected to take (or 'abstract') from franchised operators will be more than offset by passenger benefits. Our analysis when assessing access applications is strongly focused on the impact of granting capacity to open access operators on franchise revenues. A key indicator that we use to assess the impact of open access is the ratio of generated (by open access) to abstracted (from franchised operators) revenues. We would not normally approve services with a revenue generation / abstraction ratio of less than 0.3. This approach leaves open the possibility that we would reject access applications that, in an extreme case, both benefited passengers and increased the ***aggregate amount of profits*** *available to franchised and open access operators.*

BUT do existing franchise holders really chase maximum revenues and profits? Do they not maximise passenger numbers times whatever revenue they can extract? They often chase cash flow

AND what is wrong with making profit - after charging appropriate access charges income would flow **to** NR and the taxpayer (plus corporation tax form TOC profits)

b The present system encourages poor use of capacity

4.11   Capacity constraints caused by the existing franchising system

Anecdotal evidence.

As a very regular traveller on the East Coast and West Coast routes, and less so on Western and Midland, all I can say is that my average cost per journey has fallen considerably over the last 4 years. On the East coast route National Express and now East Coast (EC) may (or may not) be filling trains but actual revenue extracted from me has fallen.

Maybe I am very lucky but I do wonder if the undoubted increase in rail travel is delivering for TOC's and potentially for NR though access charges the profits it ought? There may well be figures for intercity TOC revenue per passenger (or passenger/km) over the last few years which disprove my 'luck'.

The current franchising system with the large fixed cost element inevitably leads to a TOC trying to maximise utilisation and revenues - though often with sacrifice to profit. They need the NPA protection!

c Is best use being made of paths

This is a follow on from b. The point is that the MVA report, and marketing thinking generally, is focused on revenues and increasing them. Revenue is a good indicator and driver of economic growth and success. BUT might EC not be better running half the number of trains - eg why a train almost every half hour to Edinburgh?

Single monopoly operators can in a sense be lazy - good enough service - a captive market, prices that get enough cash flow - there is no need to fight for revenue, cost reduction and profits.

There is evidence that a single monopoly operator can be 'lazy'. The revamp of the EC timetable - aided by, or under the guise of RUS (Route Utilisation Strategy) considerations has meant fewer services calling at Peterborough. Also I understand that EC would prefer not to run through to Glasgow, Inverness and Aberdeen.

You could argue that such practices mean that it is the franchises which are not primarily abstracting what they ought. If one or more other operators were allowed paths then they could seek revenues, profits and then properly cover the cost of access.

There must be scope for more imaginative timetabling and services. The 17.30 from Edinburgh (ex Aberdeen) to London is often busy but gets quieter after York. Could an operator not run say Perth to Peterborough trains - with good connections?

The question is: Does the present system not deter franchise holders from being truly innovative, trying to lure passengers, not always with the cheapest price.

If there were two or more significant TOC's paying a proper access rate (with a minimum number of trains so that the tax payer was protected) operators would then have to consider revenues - value for money but also profit.

d Should fares reduce?

7.5

MVA's analysis assumes average ***fare reductions*** *(by both franchised and open access operators) of 10-15% below the current level. Given the current level of intercity fare elasticities we would not expect cuts of this magnitude to have a very significant negative impact on revenues - - - .*

This assumes fare reduction but with the assumed increase in volumes overall revenues might increase - thus through pure 'efficiency' or utilisation everyone wins

- cheaper fares for passengers
- more revenue for the TOC's
- less expense for governments

But is there increased profit in this approach - is there the ability to pay fully for access and relieve the taxpayers burden?

I am of the opinion that too often 'efficiency' meaning utilisation of assets is confused with straightforward cost reduction - see 6 iii Ill defined terms.

e The business model is flawed

Fixed term businesses based solely on extracting operating cash flows is flawed.

The business model is all about the short term. If companies had the access rights for a long enough period they could purchase their rolling stock - (or lease if they chose). They would have a real interest in infra-structure condition, although still with no need for direct ownership. They would become true partners of NR.

Cost reduction

3.18 ---- the 2011 VFM study, which notes that "…Faced by a competitive environment with other transport modes and with each other, the freight operators have focused on reducing costs and improving service":

• On prices - "…One result of competition has been a reduction in prices, where the beneficiaries have been rail freight shippers and their customers"; and

*• On costs – "Over the last 14 years rail freight operators **have invested heavily** in new equipment with low maintenance costs, reducing the assets they employ- - - -..*

An accounting change that is already affecting behaviour in other sectors is the proposed significant change in the accounting for leases under IFRS - some of the financial magic associated with off balance sheet finance will be removed.

Why the middlemen? They only add cost.

For many (smaller) businesses leasing is the only practical means of financing capital expenditure. But it is not the only way. Under the present franchising system costly leasing is forced on TOC's

Today there may be a realisation in the world that no real wealth is created by simply shovelling money around, although there are very powerful lobbyists which want to protect their easy methods of cash generation.

The wrong people - or rather mindsets may be attracted to the industry.

There are very many good people in the industry, but the short term - grab cash flows, mindset may well attract those with limited vision.

f The need for properly priced access

The notion that a cost of network access can be found by multiplying a regulated asset base by a required rate of return is very vague or nonsensical. The 'value' of the asset based is highly subjective and a justifiable required rate could extend over a wide range. When privatisation was being implemented I believe the Treasury had to significantly cut both the asset base value and the required rate of return on it to arrive at access charges that would be tolerable to commercial investors.

Costing

The Law - EU or UK can be invoked to stifle sane plans, EU national champions flout the law (with the aid of their governments)

5.37 - - - - *"…In order to obtain full recovery of the costs incurred the infrastructure manager, with the approval of the Office of Rail Regulation under* *the access charges review or, in the case of a rail link facility, the Secretary of State through the development agreement, may levy mark-ups on the basis of efficient, transparent and non-discriminatory principles…”*.

This seems to be open to interpretation!

But it is no different from utterances from Deutsche Bahn (DB)

"The German rail network has been open for use to all TOCs authorized in Germany without discrimination since 1994. DB Netz AG independently ensures non-discriminatory access to our infrastructure. - - - - the marketing of customer-oriented track usage offers and the creation of conflict free timetables in close collaboration with the TOCs"

But what does this mean in practice?

Access charges could be based on any asset base that was willed. Why not be as honest as possible about the cost of access - rates per major route, for conurbations, rural and freight lines. Then governments, regulators and ultimately the tax payers could make rational decisions about rail operation and further investment.

As NR is hinting in its suggestion for cancelling some 10bn of debt there is significant sunk cost in rail. Access charges could be calculated for each significant class of route based on the average annual cost (AW - annual worth) for maintaining routes at their safe and efficient operating utilisation for say, a period of 50 years.

For sustainability the average annual cost would include the annual operating costs, annualised periodic cost of major refurbishment and also annualised cost of significant replacement eg of bridges.

At present there seems to be vagueness about operating and capital costs but this can be addressed.   NR has already claimed savings from revising accounting policies in this area.   Any material enhancements (presumably agreed with the operators) which would allow increased paths, lower costs etc would increase the access charge - contra-ed by the ability to increase earnings.

Essential to a fundamental shift in TOC performance and obtaining VFM will be a move away from accepting that there is one bundle of fixed costs associated with a monopoly franchise. With NR producing route Profit & Loss accounts and analysis of what repairs and renewals are required over a life cycle period (say 50 years) then it is not beyond the wit of man to calculate a fair access charge for routes.

Summary example of costing a "per train", "per path (or other base to be decided)" charge for all intercity passenger operators on a route. Effectively all would be treated as open access but the cost covering all fixed and variable costs set for a realistic anticipated level of activity.

1. Calculate the annual worth of the capital and operating costs of the route over say 50 years.

2. Deduct the annual expected marginal cost contribution from freight (more freight traffic in the future would be bonus to NR (and the taxpayer)

3. Deduct the annual expected marginal cost charged to urban / rural trains which use parts of the route

4. Divide the balance by the number of paths, route miles or some other base. It may need to consider axle weight etc, but it should be possible to identify a clear base.

For the length of say the EC route from London to Edinburgh this charge per train (or other) ought to be affordable. **If** this number is too high then it raises the issue - can intercity ever be profitable - would we not be better with busses?

NR and thus the taxpayer would be relieved of any cost, urban/rural freight would to a degree be subsidised and any capacity usage above the set level would give a further contribution to NR.

The calculation (and if repeated for other routes) should help in reconciling total NR costs, also identifying what causes the NR costs.

There must be many useful and challenging PhD projects that could based on UK Rail economics - maybe the ORR should sponsor some?

g A test of TOC's real commitment to rail

A test for the proposals in this paper would be to ask potential TOC's:

"if you have freedom to be commercial, own your own rolling stock etc but have a real competitor:

a would you be interested in the franchise?

b would you commit for ever"

I hope, I believe, there are some who would relish the challenge - I fear some responses to the ORR paper will defend the status quo.

6 Further Considerations

a Flaws in the existing franchise system cannot be ignored

Flaws in the existing franchise system cannot be ignored as they are a major impediment to cost reduction and delivering value for money

Before privatisation it was naively suggested that rail could be like air travel with trains leaving London and competing for the 'flight 'to Scotland. Passengers would have choice.

Why do we have the monopoly franchises on intercity routes?

The answer and supporting arguments originated in the ORR paper

Competition for railway passenger service - a policy statement

Published by the Office of the Rail Regulator December 1994

But why the flaw of the single (monopoly) franchise holder - It was never meant to be like this in 2011 and there is evidence to date that this approach does not work.

The current approach fails

a) Franchise holders have demanded more money from government
b) Franchises have been handed back (when it suits the franchisee)
c) Franchises have not been popular with customers
d) Franchise holders have no need to commit long term investment
e) The financial model favours chasing cash flow over service and profit.
f) Governments and thus taxpayers have to heavily support the rail system
g) Passengers have no choice of providers - no choice on what they pay
h) The workforce has no long term certainty of employment or conditions.

From the 1994 paper

"In summary, I believe that a period of exclusivity, followed by a further period of restricted competition, is necessary for the development of a more competitive environment in the longer term"

I do not think sensible proposals can be made for minor opening up of access (hence the provocative title "timid and tinkering") without recognition of the fundamental flaws and failings in the existing UK franchising system.

The comments on franchising system is in relation to inter-city routes and do NOT extend to the Urban, Rural or Freight services where wider concerns of economic benefits are very pertinent.

b A 'big picture', 'blue skies' or whatever view of intercity rail in the UK today and tomorrow

If you stand back and look at how intercity UK rail operates today and maybe for 15 years and more into the future - it is let's say, strange - unless we wake up

The 'offer' !

We have privatised rail - sounds good - entrepreneurship, no 'dead-hand' of the state and competition - that magical word.

We have EU pressure (not yet domestic) to have open access

What we get

The passenger and the taxpayer have to suffer, and on evidence to date overpay for imposed TOC's that have no real interest in the long term.

The DfT 'light touch' whilst seemingly sensible is really only good for the TOC's - they can do what suits them - 15 years in the rail industry is short term.

We attract companies (and mindsets) which have no need to consider the long term - they only need chase cash flows - and these are secure.

There are many good dedicated people out there who have to work within the very (strange) set-up that we have in the UK. My plea for opening access is to let this talent work for the good of rail - not be limited by the franchise system into which the UK seems to be locked.

Once again the comments are addressed to inter-city, Urban and rural rail services may well be best served by **'slick operators'** for periods of 5, 10 or 15 years. The services levels, types of rolling stock etc all of which may have to be heavily subsidised are a matter for politicians, economic well being, and the tax payer.

c Questioning 'truths' or 'myths' - Intercity rail service is not a "human right"

That inter-city rail travel from every possible station at any reasonable time is a right for all - this myth needs to be debunked. It is not that rail is a "rich man's toy" rather there are several alternatives with which apparently over 90% of the population are happy – in the UK well under 10% of the population use rail. Inter-city rail travel is a minority sport and I'd question whether cheap fares alone (in crowded environments) are going to result in a modal shift as suggested in 6.7.

d Ill defined terms

Am I alone in being critical of the way words are bandied around? I am of the opinion that there has been and continues to be serious misunderstanding of the real state of the UK railway industry as words are used very loosely

from the ORR paper

7.6 On **costs**, MVA's analysis assumes that for a given density of operation significant **cost savings** (with an assumed value of 20%) can be achieved by open access operators. The basis for this assumption is the recognised lack of **cost efficiency** of GB train operators. ITS/MVA explain this assumption on costs by saying that, *"…Overall, our view is that a reasonable central range for the scenarios for **efficiency savings** (other things equal) is 20-30%. The basis for this view is essentially that franchising has not achieved what would have been expected and that direct competition, via open access, could drive out the **savings** not yet achieved*

Do the words' meanings change with context?

*7.6 On **costs**, MVA's analysis assumes that for a given density of operation significant **cost savings** (with an assumed value of 20%) can be achieved by open access operators.*

What do these words mean? Are the open access operators to be cheap operators - lower paid and less staff - lower cost rolling stock or is it efficiency in that the fixed costs of rail access are better utilised - the network is more efficient.

*The basis for this assumption is the recognised lack of **cost efficiency** of GB train operators.*

What is 'cost efficiency' - more outputs from the input costs? Is this not then conventional efficiency = great outputs from a given level operational costs and use of assets

*ITS/MVA explain this assumption on costs by saying that, "…Overall, our view is that a reasonable central range for the scenarios for **efficiency savings** (other things equal) is 20-30%.*

Are these now efficiency = utilisation savings rather than any actual cost reduction?

*The basis for this view is essentially that franchising has not achieved what would have been expected and that direct competition, via open access, could drive out the **savings** not yet achieved*

Are these "savings" of actual costs = cost reduction or utilisation efficiency?

Other examples of loose usage are in this extract from a paper I wrote for NR members in September 2009 regarding Network Rail's discussion of and claims of success on cost reduction and efficiency : -

I have found time to extract some diverse sayings on 'efficiency' RH = Rick's letter, PP = Paul Plummer's letter, ARA = NR Annual Report and Accounts.

Efficiency
*"Rail must go further to improve **efficiency** and reduce costs" page 2 PP*
These are separate but related issues

*"--- to make further **efficiencie**s by holistically reviewing the whole railway system in a way that would improve the passenger experience, encouraging more people to chose rail and thereby generating greater revenues." PP p2*
Greater revenues do not mean that NR is more efficient - it could mean better or more 'efficient' use of the infrastructure.

"This might mean operators managing and delivering investments at most stations" PP p2
This is not efficiency but moving costs to the operators - I was going to say the private sector - but the customer will end up paying!

"--- should be cautious about attempting to control costs by reducing renewals and improvements." PP p2
Good to see that 'efficiency' gained by simply not maintaining or investing is challenged.

"Value for money

*The savings highlighted above are a good indication of increased **efficiency**. ----- by delivering more for less, and spread its overhead costs over a busier network, the average costs per mile travelled have improved significantly" ARA p12*
But again does more revenue, better utilisation really mean more efficiency?

*"High levels of investment and greater **efficiency**" ARA p13*

*"Targets have been achieved, **efficiencies** have improved --- ARA p15*

*"We are slightly ahead on asset condition, performance and **efficiency** n comparison to our CP4 delivery plan" ARA p15*

Clear and consistent definition of terms would help analysis. I think part of the problem of understanding NR's progress on cost reduction is that they and the ORR at times speak in different languages.