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Dear Joe,

Re: The potential for increased on-rail competition

Thank you for the opportunity to comment on your consultation on *'The potential for increased on-rail competition'*, and the MVA / ITS final report on *'Modelling the impacts of increased on-rail competition through open access operation'*. This letter sets out our response to your consultation. There are two annexes to the letter: Annex A sets out our answers to your specific consultation questions; and Annex B some observations on the MVA / ITS report.

Background

Before commenting on the specifics of your consultation, I have taken the opportunity to set out a few observations by way of background.

The GB franchising and regulatory model was effectively designed to balance the needs of competing requirements in a way which optimises value to the taxpayer and rail users. In allocating train capacity, the rail infrastructure franchising regime and the regulated access regime has to balance myriad competing demands for it. The most notable competing demands are: freight versus passenger; and long-distance versus suburban trains. It is a feature of the industry that rail infrastructure is used and shared by trains serving several different markets. But there are also competing demands between operators, for the same or similar services.

Network infrastructure is expensive to build and maintain and is characterised by very long asset lives. Because of this, there is a need for considerable care and effort in planning and coordinating its use so as to maximise value from it. The best way to use the infrastructure will also change over time, requiring measurement, challenge and adjustment to continually re-optimize the mix of usage.



In an unconstrained 'world', some parts of the country would be served by more trains, for example on the profitable East and West Coast Main Lines. In other parts of the country, fewer trains would be likely to be run, or services would follow different stopping patterns, for example on Northern England suburban routes. One of the main constraints that exist is the finite capacity on the most sought-after parts of the network. Another complexity is, that for large parts of the network, the main benefit from running trains are societal or economic e.g. aiding economic growth, for example increased mobility of labour; environmental benefits; and/or reducing road congestion by moving heavy and slow lorries to rail.

Competing needs for the railway are balanced through various mechanisms including: passenger train franchising, the sale of access rights, and the periodic regulatory review process. Franchising is clearly critical, in that it makes very high-level decisions about the appropriate 'supply' of passenger trains in each part of the country, which remain more or less fixed for the life of the franchise. Currently there are around 20 franchises covering the GB network.

Some of the franchises are for profitable train services, such as those on the West Coast Main Line (WCML). For these areas of the country, the franchise specification will have the purpose of restricting the franchisee's access to the network, to allow operators of less profitable services to be run, such as suburban commuter trains.

Other franchises are loss-making and the government has to subsidise the train services specified in them. For these areas of the country the franchise specification will mandate trains to run that would otherwise not do so as they would be loss-making for the train operator.

The premia and subsidies resulting from the various franchise competitions also allow cross-subsidies to be made between the 'commercial' and the 'social' passenger train services.

The franchising and regulated track access processes are, therefore, crucial to the debate as to any potential increased role for competition for passenger train services. When thinking about the possibility of increased on-rail competition, consideration should also be given to how best to constrain passenger train services via franchising to maximise exploitation of the rail infrastructure whilst balancing the commercial and societal roles of the network. Consideration will also be needed to ensure that such changes are made cognisant of any impact on the cross-subsidies elicited from franchising. Unconstrained competition for access to the rail network would be likely to lead to the loss of vital services for commuters and potentially significant increases in net subsidy to the running of passenger trains from the 'unbundling' of cross-subsidies.

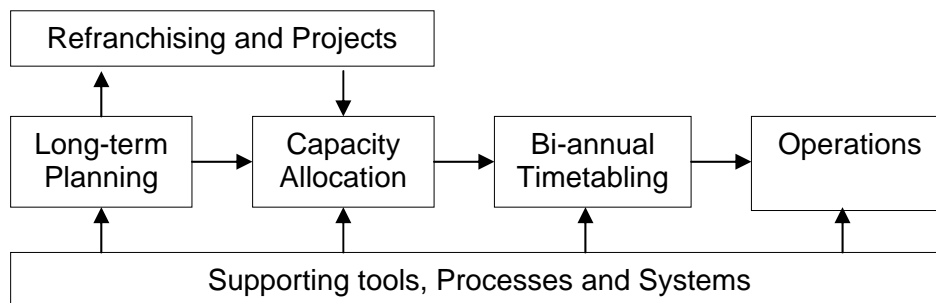
As the Initial Industry Plan and our response to ORR's first PR13 consultation outlined, Network Rail and a number of train operators are currently engaged in negotiations for



arrangements that align behaviours, through shared incentives, to work more closely together. The formation of alliances between Network Rail and train operating companies will facilitate a more collaborative working approach ‘on the ground’, and are aimed at delivering greater whole industry benefits.

Such ‘virtual’ integration is most likely to take place between Network Rail and the lead operator on a route. In a situation where an increased number of operators are running trains on the network, it may be that effective alliancing arrangements could be more difficult to achieve. In considering how far these relationships can be taken, we believe it is important that on-rail competition policy does not hinder the full industry benefits of ‘virtual’ integration from being realised. We do, however, recognise that all operators need to be treated fairly, and that in this regard the role of a System Operator would be critical.

We are developing our thinking on how we can improve the overall capacity planning process. Within Network Rail this comprises a number of key sub-processes, illustrated below which are supported by generic tools and processes. More explicit definition of these processes is key to our improvement plans and this also underpins the concept of a System Operator. This concept will become increasingly important as a result of Network Rail devolution, alliancing and potentially concessions so that we can still operate a seamless network from the perspective of both operators and users.



Potential benefits from on-rail competition

In your consultation document you talk about your view that greater on-rail competition would be likely to deliver benefits in terms of improved value for money in the passenger rail sector. We consider that it is important to think of value for money in terms of whole industry costs including the impact of such changes on the cost of Network Rail operating the network.

Network Rail is committed to managing the rail network in the most efficient and cost effective way. To the extent that increased on-rail competition can deliver this, we would fully support it.



In theory, we consider that greater on-rail competition could deliver benefits to the passenger rail market. In particular, we see it being likely to yield higher levels of service quality to rail passengers. This has certainly been the case with the current open access operators who tend to score higher levels of passenger satisfaction than franchised operators¹. We also consider that greater passenger choice would be likely to increase the overall size of the rail market, with resultant higher societal benefits.

We are less confident that on-rail competition could bring benefits through increased technological innovation or significant cost reductions. We discuss these in more detail below. We also recognise the concern that increased competition could reduce franchise value and therefore increase the subsidy requirement for a given level of services and this may not always be in the best interests of users or taxpayers.

Innovation and service quality

To date, open access operators have used relatively old diesel powered rolling stock, which could suggest that they are less well placed to take risks on innovative rolling stock than franchisees could be. Franchisees have the benefit of more stable, longer-term business models. Open access operators will need to be much more focussed on short-term profitability and are less likely to be able to make long-term investment commitments.

However, evidence does suggest that open access operators are good at providing smaller scale passenger facing innovations such as on-train WiFi, or different forms of on-board catering.

Cost reduction

Open access operators would be competing with franchised passenger operators, who enjoy significant economies of scale and density benefits, which could make it difficult for them to yield cost savings.

If it was concluded that there should be a shift from the current franchising model, to creating smaller franchises or encouraging more open access, there could also be a number of second order 'knock-on' effects that should be considered. For example greater numbers of train operators could lead to increased administrative complexity; this may not be consistent with the aim to reducing whole-industry costs. This does not appear to be considered in ORR's consultation.

¹ Passenger Focus, National Passenger Survey: <http://www.passengerfocus.org.uk/research/nps/content.asp>



ORR's position

As discussed above, in theory, Network Rail considers that there may be merit in greater on-rail competition. However, we have some observations and questions about ORR's proposed position as set out in its consultation document.

Increasing on-rail competition

It was not entirely clear what the steps would be to actively increase on-rail competition. In particular, we are unclear as to whether ORR is proposing to intentionally leave some capacity free for open access operation after the franchise process. If this were to be the case, we consider that such capacity would need to be pre-determined, and we would be well placed to input into such decisions.

Wider cost-benefit test and the 'not primarily abstractive' test

We would like to know more about how the 'wider cost-benefit test', proposed by ORR, would work in practice.

We agree that the current 'not primarily abstractive' test (NPA test) limits the extent to which open access operators are granted access to the network. This is manifested in significant restrictions on stopping patterns.

It is our understanding that the current NPA test also uses cost-benefit analysis techniques to assess the extent to which proposed open access services may provide economic benefits despite revenue abstraction. We would be interested to know what additional factors, if any, would be included in the proposed 'wider cost-benefit test', compared with those in the current NPA test.

We would also like to better understand whether the proposed 'wider cost-benefit test' could, in theory, approve rights regardless of whether the services are primarily abstractive of franchised passenger revenues i.e. would revenue abstraction be assessed at all?

In addition, if there is some assessment of revenue abstraction, will it affect the level of services approved, or the proposed 'value-based charge'?²

The role of access charges & auctions

Introducing new access charges, which would replace the need for the NPA test, may be beneficial in reducing current barriers to entry for open access operators, and opening up more of the network to such operators. However, we consider that there are potential alternatives to such an approach, which should also be considered. For example, where open access operators' proposals include commitments to contribute funding or unique expertise for specific infrastructure projects, we consider that this would provide an effective

² ORR (October 2011), 'The potential for increased on-rail competition – a consultation document', paragraph 7.9.



way to open up additional capacity under the current arrangements. In addition we consider that there could be merit in splitting current 'large' franchises into smaller ones.

The extent to which a new 'wider cost-benefit test' and the proposed 'value-based charge' could facilitate greater on-rail competition will depend on the degree of specification in franchise agreements. If the proposed 'value-based charge' is not linked to the associated revenue abstraction from the incumbent, it is difficult to see how this would mitigate the perceived risks to the incumbent franchised passenger operator.

We would like to better understand the proposed 'value-based charge', and pose the following questions:

- Would the auction be carried out after Network Rail determines available capacity?
- At what stage in an open access 'request' would the 'wider cost-benefit test' be carried out?
- Would the auction be carried out for bids for paths, or groups of paths?

Auctioning of capacity means that the actual size of the access charge payable by the open access operator is unknown; we make some observations concerning this:

- Not knowing the level of charges may make business case development by potential open access operators difficult.
- The revenue risk to the incumbent franchised operators, posed by the possibility of competing open access, would be unknown. This uncertainty is likely to decrease the value of franchises by bidders.
- This would have an unknown effect on our revenue requirement, in terms of income through access charging and so may also increase the risk buffer required to assure the company of its ability to finance its activities.
- There may be a risk of 'free-riding' at the point where an open access operator identified spare paths, as another operator may 'free ride' on this work and bid for the same paths.

Undue discrimination

ORR considers the possibility that present open access operators could continue to have access to the network on the basis of only paying variable usage charges (VUC), but 'new' open access operators would be required to pay toward the fixed costs of railway infrastructure. As ORR itself identifies, this could be construed as creating undue discrimination. We would welcome greater clarity from ORR's as to why it considers this would not constitute undue discrimination.



ORR discusses that it is required to set access charges consistent with EU legislation, in particular EU Directive/2001/14/EC³. We would be interested to know how ORR could define the market segments for the purposes of the additional access charges, which would justify charging more than the short run marginal costs of access to the network.

Impact assessment

Open access, albeit modest in its scale, has been a success story with regards to identifying 'niche' or under-served markets not specified through the franchise process. Given the potential significance of any changes in policy with regard to open access, we welcome ORR's statement that *"any specific policy changes [in this area] would be subject to an impact assessment"*.

Our emerging position

Network Rail considers its role is to act as the custodian of the rail network on behalf of the nation. We therefore believe that we have an important responsibility to enable decisions about the way in which capacity is best used to achieve the best overall societal outcomes. We consider that this is best done whilst being mindful that the railway serves several different markets, and that some parts of the network are more suited to on-rail competition than others.

As mentioned earlier, Network Rail is committed to managing the rail network to deliver the best value for existing and future users, the economy and the environment. To the extent that increased on-rail competition can be more effective in delivering this, we would fully support it.

Franchising process

The franchising process is crucial to the role of on-rail competition. We consider that there would be merit in increased transparency about the franchising process. Explicit articulation of the aims of each franchise along with a more transparent cost / benefit analysis of various service options could yield significant improvements.

We also consider that there could be a role for more franchise overlaps to facilitate competition for key rail corridors. In addition, we think that there may be merit in having services provided through more than one franchise for some parts of the network, where currently there is just one. This would have the twin advantage of still allowing sensible the management of capacity allocation and introducing more competition. An alternative to having one franchise and a number of different open access operators could be to have two

³ ORR (October 2011), 'The potential for increased on-rail competition – a consultation document', paragraph 2.14.



franchises. It would be helpful if ORR's consultation discussed the merits and issues with such an approach.

Scope for competition

It appears to us that the scope for on-rail competition may be limited by the fact that much of the network is running trains that yield societal rather than purely financial benefits. We consider that some parts of the network are more suited to on-rail competition than others, e.g. profitable long-distance intercity passenger and freight services. It might be sensible to focus on these in the first instance rather than trying to create a network-wide solution that may only work in certain parts of the country.

In order to retain the ability to trade-off competing needs for access to the network, we consider that it would be best to, first determine capacity allocations, and then decide whether on-rail competition is appropriate or beneficial.

The charging regime

Any proposed changes to the charging regime should be clarified as early as possible, including details as to how auctions may work, so as to inform the forthcoming re-franchising and in the case of freight operators, remove market uncertainty.

If a 'level playing field' is sought between franchisees and open access operators it appears to us that it is not just Fixed Track Access Charge (FTAC) charging policy (and the relevant portion of network grant) that should be considered. The cost of operating a route through the franchise model could be considered to be as set out below:

$$\text{Franchise premia} - \text{Franchise subsidy} + (\text{Network Grant} + \text{FTAC}) + \text{VTAC} + \text{Operator specific costs}$$

By considering changes to just FTAC, it appears that ORR would only be partially addressing the lack of a 'level playing field' between franchisees and open access operators. In routes where franchisees pay a premium to operate trains, if open access operators only paid FTAC and VTAC there would still be a disparity between their competitive positions, with open access operators being at an advantage as they would not pay any premium charges.

Conversely, in routes where franchises are subsidised through their franchises to operate services, open access operators would be at a disadvantage if they were required to pay FTAC and VTAC.

Putting aside the complexities of dealing with franchise premia and subsidies, franchisees bid for 'bundles' of routes, some of which are profitable and some of which are loss making. In considering ways to level the playing field between open access operators and franchisees, thought would need to be given as to how to address this. It is unclear how, in practice, to protect franchise value from open access operators 'cherry picking' only profitable routes.



Capacity allocation

As 'custodians' of the network, we want to enable the best use of it, and consider that we are well placed to play an important role in considering what the most efficient use of railway infrastructure. Over time, with devolution, alliancing and potentially concessions there could be a role for a System Operator within Network Rail to take on responsibility for this. Regardless of this, we also consider that there is an important role for regulation, to ensure that this is done fairly.

We are not currently persuaded that the franchise process should deliberately leave some capacity free for more open access competition. Such an approach would seem to risk under-utilising the network and lead to potential loss of direct and societal benefits.

Summary

We welcome ORR's consultation, which is a useful addition to the debate about the role of on-rail competition. Network Rail is committed to allocating and utilising rail capacity to deliver the best value for existing and future users, the economy and the environment. To the extent that increased on-rail competition is more effective in delivering this, we would fully support it. However, the practicalities of trying to introduce more on-rail competition should not be underestimated. We also consider that there are alternatives to ORR's proposal, which should also be considered.

If you like to discuss this response with us in more detail, feel free to contact me at Peter.Swattridge@networkrail.co.uk. We would be content for you to publish all of our response as we do not consider it to be commercially sensitive.

We look forward to hearing more on your conclusions following this consultation.

Yours sincerely,

Peter Swatridge

Head of Regulatory Economics, Network Rail



Annex A: Responses to consultation questions

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

We broadly agree with ORR's assessment of the theoretical benefits of greater on-rail competition. Theory would suggest that more competition would lead to reduced prices, more varied services. Regarding costs, as we state in our letter, we are more reserved about the level of cost savings that could be achieved by increased open access operators given that they do not enjoy the economies of scale and density that their franchised competitors do.

2. 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; and
 - Placing downward pressure on costs.

In the context of our own reform plans, we recognise that competition, where appropriate, can have positive effects. In our response to ORR's first PR13 consultation, we outlined our future plans to embrace more competition, namely through the introduction of contestability into infrastructure projects, our consideration of whether to let an infrastructure concession, as well as developing plans to engage with suppliers much earlier in the delivery of projects.

We consider that implementation of these reforms will provide powerful cost reduction pressures, and benchmarking opportunities to further drive efficiencies.

Our response also stressed the importance of the regulatory framework allowing and supporting us to compete in other markets that may not be related to 'core' railway activities. We consider that this is necessary to deliver the full benefits of competition, since it will provide us with further benchmarking opportunities, allowing us to 'test' ourselves and learn from others.

In relation to the benefits of on-rail competition we consider that similar benefits could be realised, although a 'horses for courses' approach is required given the heterogeneous nature of the railways. As previously stated, some parts of the network are more suited to competition than others, for example, long distance intercity passenger and freight services.

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

We consider that MVA was right to consider non-user benefits of competition in its analysis, as well as user benefits. It is important that the impacts of competition on the wider economy are captured. Perhaps the most significant benefit of on-rail competition may be to grow the overall size of the rail market.



We consider that one of the benefits of open access operators is their ability to discover 'micro-markets' which are not specified in the franchise process.

4. 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; and
 - 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

Please see our responses to questions 1, 2 and 3, above.

5. 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;
 - How you consider it could facilitate greater on-rail competition (e.g. by increasing the efficiency of capacity utilisation)
 - 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.

In theory, we agree that greater on-rail competition can deliver benefits to the passenger rail market. In particular, we see one of these benefits as being higher levels of service quality to rail passengers. We are more reserved about the possibility that on-rail competition can bring benefits through technological change where they are competing with franchised passenger operators which enjoy significant economies of scale and density. Although, as we discuss in our letter, evidence does suggest that open access operators are good at providing smaller scale passenger facing innovations such as on-train WiFi, or different forms of on-board catering.

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

We broadly agree with the analysis in ORR's consultation; however we consider that it is static. There is evidence to suggest that the rail market would grow as a result of more competition. Such growth should also yield tax receipts for HMG.



7. 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:

- Impacts on the flow of money in the industry, and in particular on flows of public funds;
- impacts on key stakeholders including taxpayers; and
- 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 risk might be mitigated.

To reiterate the points made in our letter, by considering changes to just FTAC, it appears that ORR would only be partially addressing the lack of a 'level playing field' between franchisees and open access operators. For example, in routes where franchisees are paying a premium to operate trains, if open access operators only paid FTAC and VTAC there would still be a disparity between their competitive positions, with open access operators being at an advantage as they will not be paying any premium charges.

While the potential downsides are considered briefly in section 3.3 of the consultation document, on a general note, we consider that it is important to take into account the impacts of competition (i.e. benefits and dis-benefits). The possible disadvantages of greater on-rail competition include the administrative complexities introduced by auctions, or complex models to share FTAC, as well as the administrative burden of dealing with a greater number of operators. We would need to be mindful of the Decision Criteria, and how the application of these might change. We consider that it is key to reduce whole-industry costs.

Given the work being undertaken on creating alliances with train operators, in line with the recommendations from the McNulty report, we consider that there is a possibility that having a greater number of open access operators within the given route may adversely affect this work-stream. It may not be appropriate to limit the depth of alliance arrangements to accommodate requirements of open access operators where the alliance can deliver greater whole industry benefits.



Annex B: MVA/ITS Report – Assisting Decision: Modelling the Impacts of Increased On-rail Competition through Open Access Operation

The conclusion that more competition led, in all scenarios, to a higher cost to the taxpayer is perhaps unsurprising. Much of the rationale for running train services, currently, is that to do so yields wider societal benefits. It cannot, therefore, be surprising that if greater on rail competition leads to more trains being run that the direct financial consequence would be to increase the extent to which taxpayer subsidy would be required. The appropriate question could, therefore, be whether these additional services would have net positive outcomes for society? Another way of looking at this would be to say that were all train services that are currently subsidised discontinued the taxpayer support for the railways would reduce. This would, however, miss the point that the train services are net contributors to GB societal wealth.

All analyses of greater or less passenger train service provision should, therefore, consider both the direct financial consequences and the wider societal effects.

It is unclear from the MVA / ITS analysis as to whether consideration has been given to the extent to which greater on rail competition would increase the demand for rail services as well as the supply.

There is clearly a lot of detail and many assumptions that underpin the MVA study. While we have not focused on each of these in any detail, we would like to make the following high-level observations:

- One of the central conclusions of the study is that FTAC mechanisms could be used to ensure that excessive open access operator profits are returned to government, to compensate for any value removed from the franchise. As our response to the consultation has identified, we believe that in order to 'level the playing field' consideration must be given to franchise premia / subsidy as well.
- MVA's literature review contained some very interesting analysis on the impacts of competition from other sectors and their relevance to the rail industry. When reviewing the applicability of experiences from other sectors, however, we believe that there are two key features of the passenger rail system that merit further consideration:
 - subsidy; and
 - the nature of the rail network and the need for coordination, in particular where capacity is constrained.



For example, when considering low cost airlines we would observe that they generally use spare capacity at regional / secondary airports, and that the features of 'network' and subsidy do not apply.

- We note MVA's analysis focused on both user and non-user benefits, which we believe is appropriate. In relation to non-user benefits, however, we consider that it should extend beyond environmental, accident, indirect taxation and highway decongestion. Wider economic impacts should also be considered, for example the impact of on-rail competition on economic growth.
- We note that MVA's model is based on a one-year steady state appraisal, and that much of its analysis had been completed before the publication of the McNulty report. The McNulty report, and the industry's response (the September 2011 Initial Industry Plan) was predicated on franchised operators achieving cost efficiencies by a variety of means.
- We consider, therefore, that discussion of current and planned industry reform is critical when considering the scope of possible cost reductions as a result of increased on-rail competition. It is very likely that this would impact the modelling assumptions used in report relating to efficiency.
- Linked to the above, we consider that the impact on franchised operators' costs as a result of longer franchises, in particular, would merit detailed consideration.
- We note that the scope of the study did not include consideration of operational and political implementation issues. We would highlight, however, that the extent of introduction and approach both require careful consideration, and that for the industry to fully understand and discuss the consequences of any departure from current policy, these issues need to be further explored.

