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Dear Andrea

**Competition in Passenger Rail Services in Great Britain.**

The CMA published its discussion document and consultation on 17 July 2015 on Competition in Passenger Rail Services in Great Britain.<sup>1</sup> This is an important area of work that has the potential to improve outcomes for passengers and taxpayers.

I would also like to welcome the opportunity that this work has provided for the ORR and CMA to work closely together; illustrating the benefits of cooperation between the CMA and sector regulators on areas of shared interest.

Following publication of the CMA's discussion document, we commissioned a study from Arup/Oxera that will add to the evidence on the impacts that might be expected under each of the CMA's main options for reform. We expect to publish this study in December. We look forward to continued close working with the CMA as we continue to explore how these options might be implemented in practice.

In the meantime, we have set out our views on your discussion document below and would be happy to discuss with you any of its content. We are happy for this response to be published by the CMA and will be placing a copy on our website for reference.

Yours sincerely

**Joanna Whittington**

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<sup>1</sup> <https://www.gov.uk/government/consultations/competition-in-passenger-rail-services-in-great-britain>

## **ORR views on the CMA's report into Passenger Rail Services in Great Britain**

### **Summary**

1. While there is more work to do, in many ways GB railways is a success story. We have seen substantial growth in passenger and freight demand<sup>2</sup>, punctuality and reliability has improved<sup>3</sup>, passenger satisfaction is increasing<sup>4</sup> and the railway is more efficient<sup>5</sup>. The franchising system also provides a wide range of services, including allowing Governments to deliver against important social and regional policy objectives, with the revenue from profitable franchises approximately covering the costs of the loss-making ones. This has been achieved with an improving safety record, which has led to Britain's railways being one of the safest in Europe.
2. This is important context. It points to the need to frame the debate about competition in terms of how it might improve upon the outcomes that the railways currently deliver. This includes how we might realise the potential opportunities from more competition and also address known weaknesses of the current framework. In particular, on-rail competition (i.e. competition in the market), working in combination with franchise competition (i.e. competition for the market) can improve passenger choice, create incentives for innovation to improve customer satisfaction, raise operational efficiency, and enable better use of the network.
3. In this context, we support further consideration of the increased use of competition through a combination of the growth of open-access, franchise overlaps and parallel franchises (i.e. the CMA's options 1, 2 and 3). This combination would have the potential to provide Governments with a toolkit that could be used to introduce competition in the most suitable way, reflecting circumstances across the network. The CMA's option 4 would represent a very significant change from today's framework, requiring a very different approach to be taken to today's franchising model. Reflecting this we consider that the focus for reform should be around the other options at this stage, keeping option 4 as a potential model for the longer-term.
4. The current framework already provides for increased competition between franchised train operators (options 2 and 3), should Governments choose to make more use of it. But change is necessary to allow for effective choices between franchise and open-access operations (i.e. option 1). In particular, open-access operators (OAOs) would need to make an appropriate contribution to the costs of providing the network, and also contribute towards the costs of providing socially important services that are not

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<sup>2</sup> Between 2000 and 2013 we have seen a 56 per cent increase in passenger miles and a 22 per cent increase in freight tonnes carried.

<sup>3</sup> Over the last 15 years the main reliability measure has risen from 78% to 90%, albeit this is now under pressure.

<sup>4</sup> The independent National Passenger Survey shows a rise from 73 to 80 percent of passengers satisfied or very satisfied. The European Commission's Eurobarometer survey measures, Britain consistently has among the highest train service satisfaction measures in Europe, notwithstanding having one of the lowest rates of government subsidy.

<sup>5</sup> Network Rail's day-to-day costs of network infrastructure have been reduced by 35 per cent, saving £15 billion which has freed up resources to reinvest in a better network.

commercially viable. In return, they would secure the potential for greater access to passengers across the network.

5. These changes would then allow Governments to take a decision between whether franchise or open-access operations were more likely to deliver improved outcomes, without this decision being dominated by the potential adverse financial consequences to taxpayers of opting for open-access provision (which arguably detracts from the potential positive impacts of open-access on growth, industry revenues and passengers). In this way, with option 1 implemented alongside options 2 and 3, open-access growth has the potential to deliver for both passengers and taxpayers.

### **The potential for competition to improve outcomes**

#### *Nature of on-rail competition*

6. As the CMA sets out, competition takes two broad forms in terms of passenger rail services:
  - a. Competition for the market, through the franchising process.
  - b. Competition in the market, where train operators compete to attract passengers for similar journeys. This is 'on-rail' competition.
7. The current system of franchising creates competition 'for the market'. The bidding process encourages operators to increase revenue and reduce operating costs in order to increase premia (or equivalently, minimise subsidies) paid to Governments.
8. However, as acknowledged in the CMA report, the current system has not yielded all of the competitive benefit that was envisaged at the time of privatisation or that could be potentially achieved. For example, franchised operators are held relatively harmless to changes in the charging structure and so have weakened incentives to lower costs on the network. Most operators face limited competition between franchise bids which weakens ongoing incentives on pricing and service quality, while the fixed duration of franchises acts to weaken incentives on operators to innovate or invest in areas where there are longer-term pay-offs. The prescriptive nature of some franchise specifications can also limit the ability of operators to adapt to passengers' changing demands.

#### *On-rail competition can – and does – improve the outcomes from franchising*

9. On-rail competition between two franchise operators has the potential to improve outcomes and address some of these weaknesses. In particular, it can introduce competition on price and service quality, while also providing a stimulus to innovate. We have seen these benefits, as the CMA report notes, in a number of areas such as services between London and Birmingham.
10. For this reason we recognise the benefits that could arise from specifying franchises in ways that include a greater use of overlaps between franchise operators (the CMA's option 2). Similarly, in principle we support the idea that greater on-rail competition could be introduced by splitting franchise areas between two operators, potentially with similar but differentiated services (the CMA's option 3).

11. However, within a franchising approach, the benefits of on-rail competition are inevitably constrained by the requirements of the franchise agreement, the impact of fixed contract duration on incentives and the business model of the TOCs, which is tailored to delivering against the franchise agreement. In addition, competition between franchise operators would act to put downward pressure on prices and so have adverse impacts on the (net) revenue taxpayers receive. This effect would be particularly large if the franchise agreements directly or indirectly limit the potential for competition to increase services and/or passenger numbers; which might otherwise offset this impact.

12. In many cases, despite these disadvantages, franchising may still be the best option; sometimes with little or no on-rail competition. For example, where passengers value a ‘metro-style’ service – with high frequency and fixed stopping patterns – which uses all the available capacity, franchise models will tend to be preferred, with little opportunity for on-rail competition. Similarly, where services are mostly delivering social objectives, with few commercial opportunities, franchising may again be preferred; albeit that there may be opportunities for on-rail competition where commercial services exist.

*Open-access competition can improve outcomes in some markets*

13. On-rail competition from OAOs has a different set of advantages and limitations to competition for franchises and between franchise operators. In particular, OAOs bring potential benefits in terms of:

- a. Different business models, with the potential for greater cost reduction than can be achieved through franchising (where each franchise largely inherits the operational and cost structures of its predecessor).
- b. Stronger incentives on price and service quality reflecting the greater exposure to costs and revenues (without the impact of a time-limited franchise).
- c. These combining to support greater innovation in service offering and pricing and the ability to find new, under-served markets.

14. These benefits are reflected in the experience of open-access in GB, as set out in more detail in the CMA report. For example, the CMA provides evidence on the positive impact of OAO competition on pricing on the London to York route. The report also highlights how competition can improve service quality and innovation, evidencing various examples where OAOs have introduced a number of innovations including the offering of a wider range of tickets, free Wi-Fi and new information systems. More generally, open-access operators perform very well in the Transport Focus’ National Passenger Survey.

15. OAOs are free from franchise specifications and have the flexibility to change their strategy more quickly according to changing demand and customer preferences. So from a passenger’s perspective, greater on-rail competition can bring about a wider set of benefits around increased passenger satisfaction as a result of operators being more responsive. The CMA also puts forward evidence on how OAOs have been shown to have greater operational flexibility, make greater use of outsourcing and have lower staffing costs. The report also highlights that where there is competition, there are

greater incentives to put pressure on Network Rail to use capacity more efficiently.<sup>6</sup> More generally, the flexibility of OAOs points to the potential for these operators to realise efficiencies that are harder for the franchising process to deliver.

*To deliver for passengers and taxpayers, we need a mix of approaches*

16. The passenger rail market is far from homogenous so the appropriate form that competition takes in differing market segments is likely to vary. There are market segments where the combination of passenger preferences for metro-style services (with high frequency and repeating service patterns) together with limited capacity may make the only appropriate form of competition be ‘for the market’. Elsewhere, the prevalence of subsidised services and/or Governments wanting to specify the majority of services might mean that competition between franchise TOCs is most appropriate. While in long-distance services, many of which are currently or potentially profitable, there can be the opportunity to realise the additional benefits that open-access can bring.

### **Opportunities for improvement**

17. The current legislative and regulatory framework already allows for most of these forms of competition. But there needs to be changes to the current system if open-access is to provide benefits of competition for passengers and taxpayers without undermining some of the benefits that arise from the franchising process, in particular its ability to generate revenue to reduce the overall cost to taxpayers.

*The current framework for open-access has a number of shortcomings*

18. The current framework for market entry by OAOs was designed for relatively small scale entry, using under-used capacity to serve new markets. When applied to areas of the network where capacity is scarce, or to applications that are large relative to franchise operations, this framework raises a number of issues. In particular, it exposes the taxpayer to the risk that a significant open-access new entrant will materialise, with the financial risks that then might follow. In light of the importance of these effects, the process for applying for access is highly administrative, takes time and imposes costs and uncertainty.
19. We recognise that the current system carries risks for the taxpayer in that open-access has an uncertain set of revenue impacts (which ORR-sponsored research is currently seeking to explore in more detail). This includes the potential for OAO entry to abstract some revenue from TOCs and affect revenue streams to the Government. At the moment this risk is borne entirely by the tax payer, either through lower franchise premia at the time of bidding, or through lower payments during the franchise term. It should also be noted that this abstraction risk may be offset by the extent to which competition from OAOs improves the performance of franchise operators and/or highlights opportunities for further market growth.

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<sup>6</sup> The London Midland competition with Virgin West Coast and Chiltern Railways on the London to Birmingham service is used as an example and so is Grand central’s service from London to York.

*These pressures look set to increase over time*

20. We have seen larger and more complicated applications (including the West Coast Main Line (WCML) approval)<sup>7</sup> that include procurement of new rolling stock. Currently ORR is assessing multiple applications, including those from the franchise operator, on the East Coast Main Line. These were prompted by the identification of potential capacity following pressure from open-access applicants.
21. Looking ahead, there are a number of factors that put further pressure on the current framework for open-access and the linkages with franchising. First, recent investment in rolling stock and electrification is likely to free up rolling stock reducing one barrier to open-access entry. Second, the move to digital signalling will increase capability of the network albeit in ways that are difficult to predict. Third, HS2 will add a significant amount of new capacity, potentially freeing up capacity on the WCML.
22. In each case, open-access could seek to find opportunities to exploit, from which passengers may benefit, but which would expose taxpayers to risk.

*Open-access could help Government deliver its objectives*

23. This ability of open-access to operate flexibly and innovatively could be used to Governments' advantage and help to make use of these important investments in improved network capability. This relies on addressing the revenue impacts that we currently see for open-access, so that Governments can realise the benefits of open-access without the risks we see today.
24. As CMA sets out under its option 1, open-access could grow more sustainably through two main changes: reform to the current structure of charges; and the introduction of a levy to require OAOs to contribute towards loss-making services, mitigating adverse revenue impacts.
25. The current charging framework was designed in such a way as to incentivise the use of spare network capacity. So OAOs pay only Network Rail's marginal costs – which in aggregate represent only about 15 per cent of its revenues. But this charging structure is being applied to a network where there is now significant scarcity and forecast growth in demand for passenger and freight traffic. As CMA highlights in option 1, greater use of open-access competition would need to be supported by reforms to the charging framework to require OAOs to pay an appropriate share of fixed track access charges.
26. The Department for Transport and Transport Scotland, through their franchising programmes, have bottom-line exposure when OAOs compete with franchise TOCs. To reduce these risks of revenue abstraction CMA proposes that OAOs are required to contribute to the funding of unprofitable, socially desirable services through some form of levy; often referred to as a universal service, or Passenger Service Obligation (PSO) levy.

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<sup>7</sup> Application by Alliance which was approved by ORR a few months ago, to run the first open-access services on the WCML with Pendolino trains between London and Blackpool.

27. These changes would allow open-access to support the delivery of Governments' objectives, responding to changing circumstances, identifying opportunities for new services and – alongside franchising – making best use of step-changes in capability such as digital signalling and HS2.

28. Open-access also provides useful information to Government about market opportunities, business models and service innovations that it can incorporate into future franchising agreements. In addition, open-access competition can exert ongoing pressure on franchise TOCs – who benefit from a monopoly once the contract is let – encouraging them to be more responsive and innovative, and reducing the need for extensive specification of franchise requirements and the associated monitoring. In these ways, open-access can build on the successes of franchising.

*This points towards implementing an improved framework for open-access*

29. The legal and regulatory framework already allows for greater on-rail competition between franchisees. So, to address the above risks and provide the opportunity to realise the additional benefits of sustainable open-access competition, it is necessary to develop the ideas in option 1.

*Implementation will need to address a range of practical issues*

30. We are exploring charging options through our review of Network Rail's charging framework. A significant theme in the work to date is the potential for an improved understanding of cost and for charges to match more closely cost – not just in terms of short term wear-and-tear costs but also the costs of improving infrastructure. This increased cost reflectivity could help improve incentives for all train operators, establish more normal commercial relationships between customers and the network provider, and support cost reduction. This would be a useful first step to providing more sensible signals to open-access and other operators about which parts of the network to use.

31. This would not necessarily mean that open-access would pay precisely the same as franchise operators. Indeed, the High Court has recognised that open-access and franchise services are different, face different risks and may need to face different charges so that the overall effect is not discriminatory. There may be a range of mechanisms to reflect the particular circumstances and risks faced by open-access these could include:

- a. Transitional relief to match the higher risks faced by OAOs in start-up phase of their operations. This would provide a limited period of relief from some network charges until OAOs have been provided with the opportunity to enter and grow a sustainable passenger base.
- b. Retaining some elements of the current system for marginal open-access, where those only seeking short term guaranteed access would continue paying marginal charges.

32. In implementing option 1, there is a need for careful analysis of impacts and further engagement with stakeholders as detailed options are identified. In addition, further review is required of potential legal implications of introducing the PSO levy.

Government would either need to make use of primary legislation or transpose Article 12 of the Recast Directive<sup>8</sup>. Further detailed work would also be required to design the PSO levy to ensure that it:

- a. mitigates the risk to taxpayers (having regard to the potential for upside);
- b. provides investors with a clear basis on which to develop their business proposition; and
- c. supports an overall package of charges and levy arrangements that support effective competition between TOCs and OAOs, in terms of both the costs and risks different operators face.

33. We also need to consider the implications for existing OAO services, who have entered the market under the current ‘Not Primarily Abstractive’ rule and the current charging framework. This means that they have service specifications that limit abstraction, but also that would reduce commercial viability should they face equivalent charges to franchise TOCs. There is also a concern that OAOs may struggle to be financially viable if a PSO levy is imposed on top of all the fixed track access charge. One option is to increase the share of costs on OAOs over time, giving the OAO sufficient time to establish a sustainable commercial operation, including through changes to stopping patterns.

34. More generally, there will be a need to look at a number of related aspects of the framework – including the ORR’s approach to access decisions (such as the role of the Not Primarily Abstractive test) and potentially the nature and extent of franchise specification – so that the full benefits of open-access can be realised, including the potential for positive impacts on the franchising system.

## **Next Steps**

35. We consider it is important to understand the impacts of the various options. Reflecting this, we have commissioned Arup/Oxera to undertake a more detailed assessment of the likely impact of the CMA’s proposed reforms. The study will produce Impact Assessments (cost-benefit analysis) for each of the CMA’s options for reform. Each of the impact assessments will be compared against a baseline ‘do-nothing’ option. The study will outline key impacts for each option quantifying where possible or providing qualitative assessments. In addition, consideration of the operational and legal analysis of each option will be carried out. This study is due to be published in December and its findings may help inform the CMA’s final report.

36. We will continue to work on the reform of charges and will be publishing shortly our first consultation as part of a comprehensive review of Network Rail’s structure of charges for CP6 (2019-2024) and beyond. We will also be developing options on the PSO levy – these will take time, and will be a focus of our ongoing work.

37. We look forward to continuing engagement with stakeholders, Governments and CMA to identify how best to realise the opportunities that greater on-rail competition can

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<sup>8</sup> Directive 2012/34/EU

deliver. In particular, how we can work together to deliver a more sustainable model for open-access that will allow Governments to choose between the different models for competition, and deploy each of them where they are most suitable.