Response to the CMA policy paper: Competition in Passenger Rail Services in Great Britain

Summary

1. Virgin Trains and Stagecoach Group plc welcome the Competition and Markets Authority (CMA) discussion document (the Document) concerning competition in UK passenger rail services.

2. There is strong evidence that competition can deliver benefits to passengers through lower fares, better service quality and innovation. It can increase rail's modal share from the private car, its biggest competitor. Taxpayers benefit too through improved efficiency and reduced costs of delivering the country’s national rail network.

3. The current franchising model has delivered significant benefits for consumers and the taxpayer as a result of competition “for the market”. However, we believe the benefits of competition should be realised across the major inter-city rail routes through full on-rail competition where services can be run on a commercial and profitable basis.

4. The current confused and damaging mix of both open access services and franchised networks does not provide a level playing field, with biased track access and ticketing regimes. This hybrid "cherry-picking" arrangement offers poor value for money for taxpayers, is an inefficient use of network capacity and, at worst, risks franchise failure. For example, the East Coast franchise has produced significantly lower revenue growth compared to other inter-city franchises over the last 15 years because open access has been abstracting revenue and blocking timetable optimisation.

5. Most importantly, it singularly fails to maximise the benefits of competition for rail passengers, undermining service performance and choice, as well as resulting in more complex and less integrated ticketing.

6. Of the options proposed by the CMA for inter-city routes, we consider a system of licensing multiple operators subject to appropriate conditions is the best way forward (i.e. option 4). A letting agency - either the Department for Transport (DfT), Office of Rail and Road (ORR) or an independent government body - would auction bundles of paths from a pre-written national capacity statement. This licensing system could be successfully operated on the major intercity routes.

7. We believe that such a licensing system would be complicated to set up and deliver and therefore we suggest that, if introduced, it is piloted on one route initially. Options include:
   - on the expiry of the Great Western franchise;
   - on the expiry of the Virgin Trains East Coast franchise;
   - on expiry of the new West Coast mainline franchise; and
   - on HS2 when it commences operation.

8. This increased on-rail competition, with increased flexibility in fares and service provision, could deliver commercial and customer-focused decisions, significantly improving industry efficiency, and benefitting passengers and taxpayers. Safeguards are required to avoid
potential operational risks of this system, such as declining operational performance; conflicting priorities; loss of network integrated ticketing and other passenger benefits; inefficient capacity management and rolling stock allocation.

10. Where franchising continues, we believe that there is an opportunity to deliver benefits to the industry and its customers more rapidly.

- Firstly, the current increasingly detailed specification and obligations within franchises, as well as a lack of incentives, are undermining development and improvement of the nation's railway. Better, quicker and more customer-focused outcomes could be achieved through the greater commercial freedom and a less prescriptive approach within the existing franchise geography, with no open access regime. This would involve the provision of greater flexibility over rolling stock, timetables, the geography of operations, and fares and ticketing regimes.
- Secondly, the major area of competition deficit in the rail industry that should be urgently addressed by the ORR and the CMA is rail infrastructure management and delivery.

11. We believe increased but fair competition on inter-city routes along with less prescriptive specifications elsewhere could enhance the current proven franchised system, which studies show in its current form has in itself delivered economic benefits up to £7.2billion in 2013 alone ("What is the contribution of rail to the UK economy", Oxera: 2014). The improvements would significantly enhance the value to the taxpayer from its significant investment in the rail network and deliver more quickly and effectively the improvements demanded by customers, Transport Focus and Government.
1. Introduction

1.1 Virgin and Stagecoach welcome the opportunity to comment on the proposed options for increasing competition in passenger rail services in Great Britain set out in the Document published in July 2015. Our response is based on our extensive experience as operators of public transport. Stagecoach has operated services since 1980 across several different countries and modes. Stagecoach has operated UK rail franchises since privatisation beginning with South West Trains in 1996 and East Midlands Trains since 2007. Together, we operate in our partnership on the West and East Coast Franchises. All this makes us the largest provider of franchised passenger rail services in Great Britain. Our response should be read in conjunction with the response prepared by the Rail Delivery Group (RDG).

Additionally, as noted in the discussion held at the CMA offices on 21 September 2015 (the round table), there are a number of errors and issues in the Document that need to be addressed, and a full impact statement made available. We would also refer to the Stagecoach response to the DfT consultation on Franchise Reform in October 2010. In this and other documents, we have consistently been arguing the case for increased but fair competition throughout the rail industry.

1.2 Our starting point is that franchising is a proven and effective model for the delivery of rail services, which are subject to competition from cars, coaches and airlines. Competition “for the market” has driven up the quality of rail services for consumers, ensured value for money for taxpayers and helped contribute to growth in the UK economy. The model has also delivered growing revenues to government, providing it with the capacity to reinvest in improving rail services and infrastructure. Previous research published by the Rail Delivery Group has shown that, against a background of franchising, consumers have benefitted from a better railway:

- **Safety**: Britain has the safest railway in Europe.
- **Passenger growth**: Britain’s railway is the fastest growing network in Europe. Between 1998 and 2011, journey growth in Britain was 62% compared to 33% in France, 16% in Germany and 6% in the Netherlands. Up to one third of the 4% average annual increase in rail journeys since the mid 1990s has come from the changes to the industry model.
- **Value for consumers**: discounting by train companies has contributed to the number of train journeys doubling since the mid-1990s. In 2012-13, 47% of passenger revenue came from discounted tickets, up from 36% in 2002-3.
- **Increased train services**: Between 1997-98 and 2013-14, the number of planned services has increased by 28%, up to 7.27million from 5.69million.
- **More punctual train services**: 1.4billion punctual journeys are made a year – up 600 million compared to 1997-8.
- **Taxpayer value**: between 1997-98 and 2012-13, money paid by private train operators to Government to reinvest in more and better services has increased 400%, from £390million to £1.96billion. At the same time, average train company operating margins are 2.9%
- **Customer satisfaction**: passengers rate Britain’s railway as the best major network in Europe, according to a survey of 26,000 people published by the European Commission.
- **Economic benefits**: the franchising model in itself delivered economic benefits of up to £7.2billion in 2013 alone. Some £3.9billion a year in tax is generated by
the railway and its suppliers, returning to the public purse almost all of the £4 billion that the government invests in rail.

1.3 Nevertheless, we believe that there are opportunities to deliver further benefits to consumers and taxpayers through competition “in the market”.

2. Comment on options proposed by CMA policy paper

2.1 The CMA is seeking views on four options of open access models. We are pleased that in the Document, the CMA itself recognises the benefits achievable on parts of the rail network from competition “in the market” rather than from competition “for the market” through franchising. In addition to a number of “hybrid” scenarios (options 1, 2 and 3) where the current open access arrangements are somewhat increased, the CMA also consider a further option (option 4) of full open, on-rail competition. We believe that this model of full and fair competition is the only way forward.

2.2 Concerning the options presented in the Document, we have the following comments.

Option 1 (significantly increased open access operations (OAOs) within existing market structures): We do not consider that this option is feasible without compensation to the incumbent TOCs who have to bear the impact of increased competition. Without this, allowances for the revenue impacts will be made in pricing franchise bids, with a corresponding adverse impact on taxpayer funds.

This option is a continuation of the current unsatisfactory situation surrounding open access. The recent increase and threatened increase in unfair competition from OAOs puts at risk the benefits achieved through franchising. It is a confused and damaging mix of open access services and franchised networks that does not operate on a level playing field, with biased track access and ticketing regimes. This hybrid “cherry-picking” arrangement offers poor value for money for taxpayers, is an inefficient use of network capacity and, at worst, risks franchise failure. For example, the East Coast franchise has produced significantly lower revenue growth compared to other inter-city franchises over the last 15 years because open access has been abstracting revenue and blocking timetable optimisation.

Any increase in OAOs would require a level playing field with regard to access charges. OAOs pay no fixed track access charges. For example, if Virgin Trains East Coast did not have to pay fixed track access charges and a premium to DfT, fares could be dramatically reduced.

Option 2 (two franchisees for each franchise): This option would be expensive for taxpayers, as the ability to cross subsidise would be removed. Timetable freedoms would be reduced thereby stifling innovation. Assuming that this option still included traditional OAOs in addition to the two franchises, further uncertainty would result which might mean even lower premiums.

Option 3 (more overlapping franchises): We do not support this option. It is like a watered down version of option 2 which would result in a postcode lottery for customers. Some would benefit from competition with cheaper fares and resultant lower premiums. Meanwhile others, with less competition, would contribute a larger share to funding of the railway.

Option 4 (licensing multiple operators subject to conditions) most closely aligns with our view of how competition “in the market” might best be implemented. Our understanding of
and support for this option is predicated on the assumption that it would replace the current mix of franchises and open access competition on selected inter-city routes. We support the principles of “level playing field” competition, where operators compete on a like for like basis, as opposed to the current structure where franchise operators have obligations which OAOs do not have. We recognise the benefits that could be delivered to passengers through both pricing and service quality innovation, but which will only materialise if competing operators were afforded appropriate commercial freedom from restrictive fares agreements and overly prescriptive service obligations. The design and administration of the licensing arrangements would be critical to the success of this model, and options around central design, path trading, path pricing and path/rights sales should be carefully considered to avoid creating perverse market incentives or risking the provision of socially valuable services in a commercialised environment.

2.3 We suggest that Option 4 is implemented as a pilot on one route initially. Once proved successful, we suggest that the scope of on-rail competition could be extended to other inter-city routes. Service innovation and competitive influences can open new markets and gain mode share for rail from private car – its biggest competitor. A letting agency (DfT, ORR or an independent government body) should auction bundles of paths based on a pre-written capacity statement. We recommend that a licensing system, if introduced, is piloted on one route initially. Options include:

- on the expiry of the Great Western franchise;
- on the expiry of the Virgin Trains East Coast franchise;
- on expiry of the new West Coast mainline franchise; and
- on HS2 when it commences operation.

2.4 Similar outcomes might be achieved in those areas where franchises remain, such as south-east commuter networks. This would require giving real flexibility to franchisees, rather than the very limited and decreasing freedoms currently on offer through franchise agreements. Franchised passenger operators have been requesting increased flexibility for many years (for example, refer to the ATOC response to DfT consultation document ‘Reforming Rail Franchising’ in October 2010). Whilst the franchising authorities have made limited recognition of the need for greater franchise flexibility, there is little evidence of real moves in this direction. Indeed, in recent franchise competitions, even more detailed specifications and committed obligations have been required by DfT.

3. Managing challenges associated with increased competition
3.1 The nature of the railway as a combination of public service provider and private commercial business means the effective identification, packaging and assignation of access rights is crucial to avoiding operational inefficiencies. We identify a number of areas where operational issues may arise through increased on-rail competition, including:

- worsening of performance as more competing services operate on existing infrastructure;
- loss of network benefits for passengers, particularly integrated ticketing;
- negative effects on the ability to recover from delays due to conflicting interests and priorities of a number of operators;
- inefficient use of scarce capacity as timetable planning becomes more complex; and
- inefficient rolling stock allocation across the industry as smaller, commercially focused open access operators lose economies of scale and density.

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3.2 In order to mitigate these issues, the relevant letting agency (whether that be DfT, ORR or an independent government body) may be required to undertake the central specification of a national “base” capacity statement against which competing operators could be allocated slots.

3.3 This should be combined with an appropriately designed charging regime which reflects path value, the funding required to induce operation of socially necessary services, and any costs associated with more operators on the network, including worsening of performance and disruption of other operators’ services.

3.3 We caution that the kind of perfect information required for efficient outcomes in this scenario is extremely unlikely to be achieved, and risks of inefficiency in the allocation of rights could negatively affect service delivery, passenger benefits, and the funding position of government, which should all be carefully considered in the further development of any options.

3.4 The main benefit sought by the CMA appears to be lower fares. Existing franchised operators have developed many reduced fare options since privatisation such that more than a million journeys are now made each week using cheaper Advance fares, four times more than in 2005-06. We also note that the overall average price paid per passenger mile has largely remained flat in real terms since 1997-98, whilst the prices of other utilities have risen by up to 98% (“Growth and Prosperity”, ATOC. 2013). The fact that fares have not reduced is a combination of several factors. Over 50% of fares are subject to Government regulation. The current regime has not changed since the days of British Rail, and benefits taxpayers significantly through the premiums that are contracted on the basis of ongoing fares regulation. These fares also cover fixed track access charges to which OAOs are not subjected. Franchised operators also compete in the general transport market that includes car, coach and air which also impacts the setting of fares.

3.5 The current system of revenue allocation is also skewed in favour of OAOs. In order to compete on the same basis, franchise operators should be able to sell “walk up”, dedicated fares that have the flexibility that passenger want (see section 6.2 below). Currently the Ticketing & Settlement Agreement only allows franchised operators to offer inter-available “walk up” tickets the revenue from which is allocated by ORCATS (the revenue allocation system for rail), with some of this revenue allocated to OAOs, even though the passenger did not travel with them. Smart ticketing will enable the money to follow the actual passenger journey rather than relying on ORCATS or similar systems to allocate revenue from walk-up fares. Correct allocation is essential to remove the perverse incentives to offer dedicated fares to a greater extent than is necessary purely for demand management, thus reducing the opportunity for customers to benefit from the flexibility of inter-operable fares.

3.6 In supporting Option 4, Stagecoach also believes that the stunning success of commercial bus networks in the UK provides clear evidence of the value of “in market” competition to customers and taxpayers. Under this model, the quality and reliability of bus services has improved, investment has continued throughout the recent challenging economic climate which has impacted the public sector, fares offer good value for money, and customer satisfaction with buses is high. At a time where the CMA is seeking more competition in UK rail, it is odd that serious consideration is being given to reducing competition in UK bus networks through franchising proposals which would cost taxpayers more and risk worse services and higher fares for passengers.
3.7 We list below typical examples of the evidence in favour of full “in market” competition:

- Transport Focus, in its most recent surveys of passenger satisfaction, found across the English areas it surveyed, that bus passenger satisfaction was 88% and satisfaction with “value for money” was 83%. Across the UK rail market, it found 80% overall satisfaction and 45% satisfaction with “value for money”. Transport for London’s most recent bus passenger survey found overall satisfaction of 85%.

- Independent transport consultants, TAS, found that in 2012/3, the franchised bus network in London consumed 35% of public spending on buses for 15% of the UK population. Spend in the capital was almost four times the level in the other major English city areas where buses operate in an open, competitive market. Despite that, customers pay more for their franchised services in London and are less satisfied with services than in the non-franchised systems in the rest of England.

- Weekly bus travel in English regions is around £16.50 compared with more than £20 in London. In real terms, the average ticket price in the commercial market has fallen since 2011, despite operator costs continuing to rise at a faster rate than inflation.

4. Comments on Assumptions in CMA Consultation Paper

4.1 As set out in Section 1, we think that some of the assumptions in the Document are questionable, as set out below. We would also highlight the need for an impact assessment which is made available to consultees and affected parties before decisions are made. This matter was highlighted to the CMA at the “round table”.

4.2 P73 para 4.5.1: The advance fares quoted look very different from each other. In practice the fares on similarly timed trains are normally closer than that. The walk-up fares quoted show the impact of the absence of a level playing field. OAOs can offer dedicated walk-up fares and keep all of the revenue. Franchised operators have to share their walk up revenue through ORCATS but are explicitly excluded from offering dedicated walk-up fares where they are the lead operator.

4.3 P75. Our analysis of East Coast revenue trends is different from the CMA. Flows which have competition have over performed other flows in terms of journey numbers, but have significantly under performed in revenue terms at a national level. When the impact on the franchised operator alone is considered, the impact is more severe. This is the revenue impact that has to be filled by the franchised operator in the short term and the tax payer in the long run. Moreover, this revenue shortfall has to be compared against significantly higher overall industry costs. Not only will the franchised operator's costs not decrease, despite the revenue loss, but also the OAO will have the additional costs of its new operation. We suggest that the conclusion in this Document paragraph is reviewed in the light of the current independent review commissioned by ORR.

4.4 Paras 5.6, 5.10 and 5.11. These sections seem to portray franchised operators as being inefficient. Whilst the McNulty report (‘Realising the Potential of GB Rail’, May 2011) considered that an overall 30% saving in UK rail costs was achievable, he did highlight the fact that “above rail” costs (i.e. operator costs) in UK were cheaper than elsewhere in Europe. Consistently arguing that OAO costs are lower than franchised operators ignores the high regulatory and contractual burdens placed on franchised operators of the overly prescriptive specifications. An “apples with apples” comparison is required. Also, OAOs make higher margins from customers and do so in part because they do not have the same
prescriptive requirements or costs as franchised operators, not necessarily because they are more efficient.

4.5 In fact, what the CMA should be considering is the efficiency benefits that could be obtained by the ORR having improved visibility on “below rail” (i.e. infrastructure) costs by benchmarking different regions or zones, possibly with different contractual structures. This is the major area of competition deficit in the rail industry that should be attracting the attention of ORR and the CMA.

4.6 Para 6.82. The impact would be very significant, and while DfT’s calculation do not take account of the dynamic benefits of competition, nor, we suspect, do they take account of the impact on average yield that this would result in. The East Coast franchise has significantly under performed in terms of revenue growth compared to other intercity franchises over the last 15 years since open access has been abstracting revenue and thwarting timetable optimisation.

4.7 Para 6.8.7. The risk for OAOs is small compared to the franchised operators’ risks in forecasting revenue over a 7-10 year period with no flexibility in costs and uncertainty over the level of competition that they will face, from OAOs but also from air, car and coach. There is no underused capacity on intercity routes, and using the existing capacity more intensely has significant performance impacts.

4.8 Para 6.103. Rather than the 37.5% figure quoted for revenue on inter-available tickets, our analysis shows that 83% of revenue is on inter-available tickets, which is what the customer wants, although much of that revenue is in practice on flows where only one operator provides the service.

5. Conclusion

5.1 Franchising has proven over many years to have been a highly effective model for the delivery of passenger services on the UK rail network, providing good services to customers and value for money for taxpayers. Nevertheless, we share the view of the CMA that there are opportunities to leverage further benefits on some routes through more effective competition.

5.2 The recent increase and threatened increase in unfair competition from OAOs puts at risk the benefits achieved through franchising by creating uncertainty in the franchising process resulting in lower premiums.

5.3 Stagecoach and Virgin recommend a new system of licensing rail operators and allowing them to compete directly on inter-city routes specifically. This would replace both franchising and the current confused and damaging open access regime on these routes. A pilot should be undertaken on either the East Coast, West Coast, or Great Western routes.

5.4 The DfT, ORR or an independent government agency would openly auction bundles of routes based on a nationally agreed capacity statement. The licensing system would allow for multiple operators to compete on inter-city routes on a level playing field, help drive lower fares and improved services for customers, make the most efficient use of scarce network capacity, and protect the interests of taxpayers.
5.5 The rest of the UK rail network, such as south-east commuter networks, would continue to be managed through franchising with no open access arrangements due to operational, capacity and commercial constraints.

5.6 This balanced proposal reflects the diversity of the country's rail network. It would significantly enhance the value for the taxpayer from its significant investment in the rail network and deliver more quickly and effectively the improvements demanded by customers, Transport Focus and government.