Competition and Markets Authority

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By email to rail@cma.gsi.gov.uk

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Dear Sir,

OFFICE OF RAIL AND ROAD IMPACT ASSESSMENT OF THE CMA'S OPTIONS FOR INCREASING ON-RAIL COMPETITION FINAL REPORT

1 Introduction

Alliance is pleased to have the opportunity to respond to the Competition and Markets Authorities (CMA) consultation on the ORRs impact assessment of the CMA options for increasing rail competition of passenger rail services in Great Britain. We note the objectives of this review are to seek improvements in the railways in Great Britain and benefits for passengers and taxpayers by reviewing whether greater on rail competition is desirable and deliverable.

With the current franchising system designed to extract maximum revenue from the passenger in the form of monopoly rents, some better way to protect the consumer whilst not impacting on the taxpayer needs to be considered.

We have examined the impact paper and comment on the assessment of each option below.

Our position is that we are in general agreement with the assessment findings and we support the view that Option 1 would deliver the best option for Great Britain and in particular passengers and government.

We believe that adoption of Option 1 could deliver the full competition benefits originally envisaged at privatisation. It was the intention of the Government at the time that privatisation would deliver more services on the basis of competition in the market (by open access) and fewer through competition for the market[1] under franchise agreements. However, in order to protect and stabilise the rail industry and protect government subsidy, immediately following privatisation, the ORR introduced its policy which moderated competition. This policy stated:

"The government's objectives were set out in "Gaining Access to the Railway Network" published in 1993. This document explains that it is the government's intention that on-track competition in the first generation of franchises will be moderated, but only to the extent necessary to ensure the successful transfer of British Rail's passenger services to the private sector and to ensure that taxpayers receive value for money for subsidising socially necessary services"[2]. In addition, the same policy consultation notes, at page 17: "*The longer term objective is one of fully open access".*

It is clear that privatisation was supposed to deliver more competition in the market, but unfortunately competition in the market has been restricted. In the book "Britain Competition undermined by politics"[3] Professor Stephen Glaister noted that the "*British experience may also illustrate the possibility of ending up with the worst of all worlds: to incur the costs of introducing competition but then to intervene to prevent that competition from delivering its benefits. If competition is to be the driving force for policy, government intervention is still necessary: but it must be intervention to promote genuinely competitive procurement and effective contract management. The moral of the British experience is that effective competition is possible in many dimensions of railway services, but that it is pointless for governments to introduce it unless they can deliver on the commitment to allow it to function".*

This problem of government intervention was also highlighted by the previous Rail Regulator, Tom Winsor in 2007 when he wrote: *Passenger rail franchising is another area in which the politicians just simply cannot let go. The new generation of franchises – introduced in the period 2004-2006 – are amongst the most restrictive contracts*

[1] Chris Bolt, ORR The restructured Railway in Great Britain: Performance and Prospects p16
[2] Competition for Railway Passenger Services 1994 para 1.8 page 11.
[3] Competition in the Railway industry 2006 Edward Elgar Publishing

imaginable. I did not have anything to do with designing them, I just objected to what was being done. The new model franchise stifles the most innovative flair that the train operators might have had. There is a great debate about how much scope for innovation that there might be, and Peter Kain takes up this story in his paper, but the franchisees would have some scope for innovation if the life had not been squeezed out of them. British passenger rail franchises are now little more than complex management contracts, and I think that is a big mistake. It is not necessary to tell the private sector operator in 400 pages that he needs government approval as to whether he is to breathe in, and that he may or may not get consent to breathe out. It is just too constrained.

It is also worth commenting that open access operators have driven more commercial behaviour by Network Rail in pursuing track access, and the experience of Grand Central on the ECML, and latterly GNWR on the WCML is evidence of ensuring Network Rail becomes more efficient in its 'identification' and then allocation of capacity.

This current review is taking place at the same time as several other rail reviews for example the Bowe report, the Shaw Review, and DfT ORR review. We note that this review is timely and has the ability to inform or take note of the likely impact each review may have.

2 A greater contribution from open access operators

Prior to commenting on each of the options we feel it would be helpful if we set out our views in relation to paying more in access charges and towards making a contribution towards the socially necessary services that operate under Public Service Contracts (PSC).

2.1 Fixed Track Access Charges

Open access operators have been criticised in the past for not paying the fixed track access charge. Indeed this is often cited as an unfair advantage that open access has and both the DfT and franchised operators have argued that as open access operators do not pay the fixed track access charge they should not be allowed access to the

Network. This is an area that has been clarified in the courts, but remains industry folklore and is simply misleading.

The fixed track access charge, as approved by the ORR, is not a charge covering the non-variable elements of operating a train on the network. The bulk of the charge is made up of government subsidy for Network Rail. It was the ORR and DfT who chose to funnel subsidy through franchised operators in order to make the infrastructure manager more customer focused.

In *GNER v ORR 2006*, and according to former regulator Tom Winsor[4] the Court decided that there is a critical distinction to the market segment, in which franchisees and open access operators obtain access to the infrastructure, and the market segment in which they compete for passengers on the same parts of the network.

The way in which franchisees and open access operators gain access to the network – the upstream market – are very different, even though the differences in the market for passengers – the downstream market – are much less pronounced. And it is the upstream market which matters most for the purpose of determining the legality of network access charging policy.

The Court determined that franchisees have very considerable advantages over open access operators when gaining access to the network. Franchises take over an existing established business and often risk is shared with government - open access operators have none of these protections. In fact open access operators are at a significant disadvantage because of the ORR's moderation of competition policy and the restriction of access that this places on potential open access.

The Court decided that these very different conditions justify a radically different charging regime as between franchisees and open access. This is now established case law.

The Court also accepted evidence that the level and profile of the fixed charge payable to Network Rail is a matter of indifference to franchisees, and called it "*an artificial construct*". We also note that franchised operators do not pay any additional fixed

[4] In a paper entitled "Open access operations – charging and competition" July 2006

charge for any additional services they operate after the start of the Control Period, whether or not they are contracted with the DfT.

In addition, it has been impossible to actually establish what the true fixed charge (excluding government subsidy) should be for the network. If the fixed charge was actually a true reflection of cost and not used by the ORR and DfT as a financial mechanism for subsidy, then it would be acceptable for open access to pay.

If there is a move to require open access operators to pay the fixed track access charge, then such a proposal will need to consider the full legal implications of the established case law determined in *GNER v ORR 2006.*

It is likely that before open access pays a fixed track access charge that the ORR Moderation of Competition policy would need to be withdrawn and arrangements for access to the network made easier. In addition, the fixed charge would need to be determined so it is cost reflective and that it does not contain government subsidy.

2.2 Public Service Obligation levy

Alliance is fully supportive of open access operators contributing to the funding of socially necessary services operating under a Public Service Contract (PSC). We note that this would be dependent on the UK government opting in on Article 12 of Directive 2012/34. We believe that payment towards Public Service Obligations (PSO) by way of any other means would be illegal under EU law.

In the impact assessment[5] it has been suggested that the PSO levy cover the loss in franchise premiums. For clarity this is not acceptable and would be illegal under EU law. We would argue that the PSO levy should follow the framework of Article 12 Directive 2012/34.

In addition, the PSOs themselves should also be defined in accordance with Regulation 1370/2007 currently they are not, although the current unclear position of PSO's is reflected in the document.

[5] Page 76 para7.6.1

3 Review of the Options

We have reviewed the four options put forward. We also note that there are other possible models that the industry could adopt. We raised this with the CMA prior to the ORR's impact assessment. In particular we refer the CMA to "*Assisting Decisions - Modelling the Impacts of Increased On–rail Competition through Open Access Operation – 22nd July 2011*". In due course we would hope that the CMA develop and examine other possible options with industry input.

The observations below assume that key enabling factors detailed earlier have been addressed in order to deal with the current incongruities in the industry structures that impact on-rail competitive interaction.

3.1 Option 1

Option 1 examines the possibility of an increased role for open access operators in return for a payment of a levy to support the Public Service Obligations (PSO) in franchise contracts.

We are supportive of this option on the basis that the franchises would be made up of PSOs alongside open access operators delivering the commercial services. However for this approach to succeed there would need to be a clearer identification of PSOs in accordance with Regulation 1370/2007.

In addition any PSO levy would need to be determined in accordance with EU law if it is to be enforceable.

We believe that this option will deliver the greatest benefits for Great Britain, the passenger and the government. It would also deliver the original aims of the government at privatisation – that is to deliver more competition in the market and move to greater provision of services via open access operators.

3.2 Option 2 and Option 3

These options would increase the extent of on-rail competition and therefore has the potential to unlock the associated benefits. However, the issue of the central role

played by the DfT in specifying and limiting the flexibility of franchise operators to respond to market conditions, as noted by Winsor, will restrict competitive response. This is particularly an issue with regard to the operation of commercial services. Therefore, for these options to be effective, the DfT would need to ensure that its involvement in the market related only to managing the provision of PSOs and protecting the taxpayer's interest.

It is worthwhile also noting that in 2011, MVA[6] modelled whether it would be better to split a franchise into two and have two franchised operators competing or whether it would be better to split the franchise in two and hand over one half to a new large scale open access operator. In its conclusions at page 7.4 MVA noted:

"…. the more significant benefits were achieved through relatively large scale open access operation and specification of franchised operator services , thereby allowing sufficient economies of density to maximise reductions and the cost to government"

In short, rather than split the franchise into two franchised operators the biggest benefits were modelled with a large scale open access operator and the franchise operator competing. We would suggest that the CMA review further examines the options included in the MVA report.

3.3 Option 4

This option proposes licencing multiple operators to operate services some of which would operate a number of PSO services. Any such arrangements regarding the provision of PSO services would need to be compliant with Regulation 1370/2007.

It is unclear from the assessment to what extent this model would cater for current operators like Grand Central who do not provide PSO services. That said there is no restriction under UK law that would prevent an open access operator from providing PSO services.

We would be supportive of this option if it allowed for operators to provide commercial services free of PSO obligations. However, the complexity and lack of clarity of this option means that we would need greater definition on this proposal. In addition we

[6] Assisting Decisions - Modelling the Impacts of Increased On –rail Competition Through Open Access Operation – 22nd July 2011.

feel that the provision of PSO obligations is best met by either direct award or franchise competition (as governed by Regulation 1370/2007).

4 Conclusions

Having considered the CMA's discussion document in detail, we believe that it is both feasible and desirable to increase the extent of on-rail competition in the commercial passenger market sector. We would agree with the CMA's suggestion that increased levels of on-rail competition in this market sector, implemented in an incremental manner in line with other industry structural changes would improve the rail industry's ability to deliver its core objectives by driving further growth in passenger revenue as a result of increased levels of choice made available to passengers.

We note the options put forward by the CMA. We are strongly in favour of a model where PSOs are clearly specified and defined in accordance with Regulation 1370/2007. We believe that if greater on-rail competition is to be successful then operators of commercial services should be free to operate as fully commercial organisations responding to market conditions within a framework of clear consumer protection obligations. We are supportive of operators of commercial services paying suitable contributions to the operation of the PSOs through levies and rebate payments towards enhancement costs. At the same time, the process for gaining access to the network would need to be made easier for operators of commercial services.

It is also not clear from the report if the position of current 'traditional' open access operators would remain, and whether this type of open access would still be possible. In view of the significant benefits open access has delivered to a great many communities and passengers, the protection and development of what has been a successful, if limited, intervention needs to be considered and safeguarded.

From the options so far available, Alliance believes that the development of Option 1 is the best option from these proposals to take forward by the CMA, providing that it is compliant with EU and UK law in the shape of Directive 2012/34 and Regulation 1370/2007.

Yours sincerely

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