

ORR impact assessment of the CMA's options for increasing on-rail competition – FirstGroup plc response

Background

1. FirstGroup plc (“**First**”) is a public limited company operating public transport services in the UK, Ireland and North America. It is listed on the London Stock Exchange and operates five business divisions:
 - (a) First Student: this business division provides student transportation services in North America;
 - (b) First Transit: this business division provides public transit management and contracting in North America;
 - (c) Greyhound: this business division provides scheduled intercity passenger coach services in North America;
 - (d) First Bus: this business division operates local bus services in the UK and Ireland; and
 - (e) First Rail: this business division provides passenger rail services in the UK.
2. First currently operates two rail franchises, Great Western (“**GWR**”) and TransPennine Express (“**TPE**”)¹ plus an open access passenger operation, First Hull Trains (“**FHT**”). First also operates the Croydon Tramlink service on behalf of Transport for London.
3. First has also submitted an application to the Office of Rail & Road (“**ORR**”) to operate a further open access operation on the East Coast Mainline (“**ECML**”) between London and Edinburgh.
4. As an operator of both franchised and open access passenger services, and with its recent experience of bidding for franchises and applying for open access operations, First is well placed to offer a balanced response to the ORR’s impact assessment (the “**Impact Assessment**”) and the assumptions that underlie it.

Analysis of on-track competition

5. The Impact Assessment sets out a ‘conceptual framework’ for considering the impact of increased on-track competition. However, in First’s view, that conceptual framework tends to oversimplify certain aspects of the rail market. Relatively broad statements are made that competition is likely to lead to reduced prices, improvements in efficiency and changes to the operating model. While it is right that in some circumstances, competition can lead to each of those outcomes, different economic models of competition can lead to very different results in terms of how competition impacts prices, cost efficiencies, service improvements, product differentiation, service quality, investment and innovation etc.
6. The Impact Assessment does not set out a clear economic model that underpins its analysis of each of the options for increased on-track competition. As a result, it is not clear that the effects which it hypothesises will arise as a result of increased competition are accurate, or fully take into account the dynamics of the market. For example:

¹ Currently a joint venture with Keolis (UK) Limited. From 1 April 2016, First will be the sole operator of the new TransPennine Express franchise, awarded to First in December 2015.

- While the impact on price, service quality and product differentiation is considered by the Impact Assessment, there appears to be limited consideration of how these various parameters might interact with each other. These interactions are important to understand the overall likely passenger outcomes from competition of different types. For example, if increased competition leads to new entry that was differentiated from the franchise operator, or of a higher product quality, the impact of such new entry on prices is likely to be very different than if new entry occurred with a less differentiated product.
 - The Impact Assessment's analysis of dynamic competition (including investment and innovation) is relatively limited. While the Impact Assessment notes that competition may increase innovation, it is not clear what model of competition, where firms compete on investments and innovation, the ORR has in mind. Similarly, the Impact Assessment does not appear to analyse how increased investment and innovation may impact an operator's ticket pricing strategy (i.e. it may seek to recoup some/all of that additional investment cost from customers through increased prices).
 - The Impact Assessment seems to envisage a situation where rolling stock may not be used optimally – for only limited periods during the day – this may well result in increased costs and inefficiency. There may also be similar issues with regard to depot availability and staffing.
7. In First's view, the nature and type of competition that will occur under each Option is likely to be driven by local features of the markets in question. A broad analysis that assumes the same effect of competition across local markets is unlikely to give accurate predictions about the overall effect. Instead, a bottom-up analysis may be more suited to properly understand the impact of increased on-track competition in different local areas, and therefore which of the Options considered in the Impact Assessment are most appropriate. For example:
- Different local markets may be more or less able to support increased Open Access competition. Benefits to passengers from competition are more likely to arise in areas where new services can be developed, and benefits are therefore more likely in those areas with capacity to accommodate additional train paths. A detailed consideration of those markets in which such competition is likely to bring benefits would be necessary to really understand the impact of introducing Option 1, for example. First has already set out some of the key considerations, including capacity constraints, in its response to the CMA's discussion paper.
 - Other local supply and demand factors are likely to influence the nature and strength of additional competition under each of the potential Options. For example, local customer preferences and demand patterns are likely to shape the product offerings of any Open Access Operator, or overlapping franchise provider, which in turn will also influence the degree to which prices change as a result of such competition. On the supply-side, the degree to which there is existing strong competition from other modes of transport such as coach, air or the private car, (which the Impact Assessment notes it has not been able to consider) will influence the degree to which increased on-track rail competition will change passenger outcomes. Similarly, the introduction of new rail services will also have a significant impact – this will be particularly acute with the introduction of HS2 and Crossrail. For example, when Crossrail is fully operational, it is anticipated that it will provide the vast majority of Reading to London local services, currently provided by GWR, significantly increasing local on-track competition.
8. As well as setting out its overall conceptual framework, the Impact Assessment considers empirical analysis of the impact of greater competition, citing evidence from examples of increased competition in the UK, examples from overseas, and examples of competition between

other modes of transport. Drawing on these empirical examples, the Impact Assessment then feeds in various assumptions about the impact of competition on prices, costs and the product offering to produce a quantification of the overall impact of introducing Option 1, 2 or 3.

9. However, the empirical evidence cited by the Impact Assessment (which drives the results of the quantification exercise) is relatively limited and refers to very specific examples. It is not clear that the results of this type of empirical evidence can be extrapolated in the way suggested in the Impact Assessment to support a much broader quantification exercise. For example:
 - In relation to price competition between franchise providers and Open Access Operators, the Grand Central Rail and the FHT examples are considered. However, given the substantial local variation as discussed above, it is not clear that such examples can provide more general empirical results.
 - The Impact Assessment refers to examples of open access operations in mainland Europe. While the report acknowledges that these may represent an “upper bound” on the impact of changing the type of competition in the GB rail sector, it is important to note that in many of the examples, the open access operator competes with dominant state operators with little or no competition. Conversely, in the UK’s franchised market, competition *for* the market has already driven significant increases in revenue generation and efficiency, meaning that comparisons with other European markets may have very little relevance to the UK.
 - The Impact Assessment refers to a study by Wheat and Smith which finds that Open Access Operators have lower costs. We note that the Impact Assessment recognises that employment legislation (in particularly TUPE) and labour market characteristics could restrict the ability of Open Access Operators to exert significant downward pressure on labour costs if their role was expanded. However, despite this, under Option 1 the Impact Assessment assumes a certain reduction in labour costs, which in light of the above may not be a robust assumption.
 - More generally, the rail industry is characterised by high levels of fixed costs. Rather than reducing costs, further fragmentation of operations could well lead to higher unit costs which might not have been picked up by the empirical studies.
 - The actual demand response from any increase in competition will be driven by the degree of substitution between products (i.e. how easy is it for customers to switch between one operator and another) and the potential for overall market growth. While there is good evidence on the potential for market growth, there is relatively little/no evidence on passengers’ willingness to substitute between products. Developing empirical evidence of customer choices would be important if the true impact of on-track competition is to be properly understood.
10. There are also a number of further assumptions that are made with little/no evidence or justification, as well as some issues which are only partially addressed, each of which could have a material impact on the Impact Assessment’s findings:
 - The Impact Assessment only looks very briefly at how pension past service liability for a particular franchise is funded, and yet this is likely to form a material part of any operator’s own assessment - changing franchise economics would have an impact on this.

- The Impact Assessment also asserts that having more "customers" would lead to greater cost pressure on Network Rail and cause it to be more efficient. It seems equally plausible that greater fragmentation could mask the impact of poor performance rather than highlight it. The fact that Network Rail would still have a duty to treat its customers equally could mean that they adopt a "take it or leave it" cost structure where each pays the same (higher/non-negotiable) price, potentially leading to an increase in the cost of paths rather than a decrease.
11. In addition, the Impact Assessment fails to take account of two specific factors affecting the Great Western franchise, each of which would be likely to have a detrimental impact on the overall outcome:
- Firstly, by taking the current timetable as its base, it gives spare paths to Open Access Operators that will not exist from December 2018 as these will become part of the integrated December 2018 Intercity Express Project ("IEP") timetable which is specified through SLC3 (i.e. there are no vacant mainline paths post December 2018).
 - Secondly, the IEP units have already been procured and are funded, along with significant infrastructure investment (Great Western Enhancement Programme ("GWEP")) to provide a particular set of outputs. The operating and maintenance contracts for these units are long-term (i.e. over 25 years) and complex and cannot easily be altered or disaggregated. The scenario testing ignores the significant additional costs that will be incurred by the franchisee and Government as a result of any change in quantum used, average mileage or changes in maintenance requirements. There is also the need to ensure that the overall outcomes associated with the investment in GWEP and IEP are achieved – something that the outputs of the current Great Western franchise (as contracted) achieves.

Analysis of the impact on competition for franchises

12. The Impact Assessment recognises that competition for franchises is intense, but notes that there is limited competition between franchise bids. It then states that "As in any market, where there are limits to competition there will be a reduction in consumer welfare."²
13. This statement is too simplistic. Overall consumer welfare will be determined by the level of competition on-track but also the level of competition for franchises, and these two stages of competition interact with one another. A broad statement that greater on-track competition will improve consumer welfare – without properly understanding the interaction of such on-track competition with competition for franchises – is therefore potentially misleading.
14. The expected degree and nature of on-track competition will influence franchise bidders' strategies, the nature of their bid, the appetite to take on investment and ultimately their appetite to bid at all for a particular franchise. The Impact Assessment recognises that the greater risk associated with on-track competition might impact premiums that bidders for franchises are able to offer.
15. However, the Impact Assessment does not discuss the fact that potential increases in risk associated with greater on-track competition might affect bidders' appetites to take part in franchise competitions. This effect is likely to be exacerbated by the relatively low profit margins in rail (the Impact Assessment seems to assume a 5% margin is the current norm for franchised

² Page 1, Executive Summary, ORR Impact Assessment.

operators, whereas 3% seems more accurate in practice³), meaning that a negative change in the risk/reward balance in franchising could well make bidding unattractive per se (particularly if franchises remain heavily prescribed and controlled by the franchising authority in ways that limit the franchisee's ability to respond to competition), and ultimately might substantially change the degree of competition that is likely to materialise for franchises in the future

16. To the extent that there is substantially more risk facing a franchise bidder as a result of increased on-track competition, but also uncertainty about the nature and intensity of on-track competition that is likely to materialise, it is likely that competition for franchises is likely to be reduced. In addition, increased risk and greater uncertainty could also mean that substantial risk premiums are added into contracts by funders and suppliers, in particular the rolling stock companies, further increasing the costs borne by operators. This could potentially result in certain suppliers/funders exiting the market, thereby decreasing competition in one of the key upstream markets and potentially further increasing industry costs overall.
17. All else being equal, a reduction in competition for franchises is likely to reduce consumer welfare and taxpayer funds. The analysis in the Impact Assessment of that trade-off – between greater on-track competition and reductions in franchise competition – is, however, relatively limited. This concern with the analysis set out in the Impact Assessment is further exacerbated by the incomplete analysis of the nature and form of on-track competition, as discussed in the previous section. Without a more complete and robust analysis of the nature of on-track competition, including in different local markets, it is difficult to get a reliable understanding of the impact of such competition on bidding for franchises.

Analysis of dis-benefits of competition

18. Even setting aside the concerns set out above in relation to the Impact Assessment's economic model and empirical evidence base, there are some potential other dis-benefits from greater on-track competition which are not fully considered in the Impact Assessment. For example:
 - The transport sector more generally recognises that passengers want simplification of fares and smart ticketing. On-track competition could well lead to the proliferation of products and might make inter-available ticketing more difficult.
 - On-track competition might also have strong implications for service quality. If, for example, two operators provide services instead of one, and each has operator-specific tickets, the effective service frequency may be reduced for anyone who has a return or multi-trip ticket.
 - More generally, ensuring a well-connected network might be more difficult if there is greater fragmentation among the operators. As set out in First's response to the CMA discussion paper, the current franchising framework delivers and protects network benefits (e.g. through inter-available fares and the requirement to apply the TSA).
 - Commuter and freight customers require a degree of stability in the network, but it might be that on-track competition does not occur in a way that supports such stability. If that is the case, the DfT/ORR/CMA may need to take a relatively interventionist approach to managing and regulating competition in order to ensure stability of the network. However, such an

³ For further discussion of margins in the rail industry, see for example RDG's publication Britain's Railway, Britain's Future (<http://www.raildeliverygroup.com/about-us/our-vision/britains-future-britains-railway.html>)

approach may undermine the extent to which competition can really drive innovation, as well as increasing the administrative costs associated with the system.

19. Overall, while the Impact Assessment is comprehensive in places and deals with a number of the major issues, First is concerned that, as a result of the concerns set out above, it is not clear that the numbers presented by the Impact Assessment are based on sufficient economic evidence for them to be meaningful.
20. First would be happy to discuss any of the above points in more detail, or any other questions or issues that they may raise, with the ORR, CMA or their representatives.