25 January 2016

James Lambert
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Competition and Markets Authority
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Dear James,

Virgin/ Stagecoach response to the ORR's report "Impact Assessment of the CMA's Options for Increasing On-Rail Competition"

Introduction

Thank you for the opportunity to respond to this report. We are pleased that the issue of open access and the future franchising of long distance routes is being discussed in this way. These routes offer an opportunity to ensure that passengers and taxpayers obtain the maximum benefit of the railway and the options discussed in this report allow the debate to continue in a constructive and hopefully fruitful way.

Our key conclusions are:

- Options 1-3 offer minimal increased competition while still leaving a franchise open to the threat of current style unfair open access competition. Both of these features will erode franchise value and therefore premia to government.
- On the East Coast Mainline, according to the report's figures, Option 1 will result in a reduced premium of £68m (2010 prices). However, this looks low, and our own estimates suggest a possible loss of £500m over the years 2020 – 2023 of the VTEC Franchise should certain of the current proposals proceed.
- Effectively, it will take taxpayer income and transfer it to increased open access operator ("OAs") receipts.
- The passenger benefits envisaged can only be achieved through competition if there is less regulation in the market (I.e. less specification), otherwise timetables and service specifications are ossified in Franchise Agreements.
- There is a serious flaw in the assessment of the various options - Option 4 (which delivers the best overall outputs for the taxpayer and passengers) has not been subject to a full qualitative assessment.
- Regardless of the option chosen, two key principles are clear: a customer-focused system operator needs to manage capacity provision effectively and a more sophisticated revenue allocation system is required to ensure the benefits of a changed approach are realised.

Key Issue: Abstraction from Franchised TOCs

As the report states, "the current arrangements are not without risk to franchise revenue" but we do not agree that the current application process "is designed to limit the level of abstraction". The current Net Primarily Abstractive (NPA) test sets a minimum generation abstraction ratio of 0.3. Therefore, generation divided by abstraction cannot be less than this value. What this means is that an open access

applicant is allowed to abstract a massive 77% of its revenue from existing operators on the network. In addition, OAs do not need to pay the Fixed Track Access, Capacity charges or a Premium to Government. All of this syphons money out of the system, to the profits of OAs and to passengers, but not to taxpayers. OAs can pass on some of these savings to the passenger in the form of lower fares further exacerbating the level of revenue abstracted. We strongly urge a rethink to ensure there is a level playing field for all operators that compete across each of the long distance routes.
We also note that the results the recent Leigh Fisher study into the "Evidence of revenue generation and abstraction from historical open access entry and expansion". The report concludes that open access has been highly abstractive of franchise revenue over the last 15 years with a generation abstraction ratio of 0.3 only being achieved in some circumstances despite the existing operators serving many new markets such as Sunderland and Hull. The scope for further open access expansion without severe abstraction from existing operators is now severely constrained.

Comments on Options 1 to 3
As acknowledged by the report, the CMA Options 1-3 will have a significant negative impact on franchise premium payments as they all result in lower fares. Hence, they will result in a net increase in subsidy from the taxpayer to the rail industry at a time when the industry and Government are trying to reduce it. The assessment of Option 1 estimates a reduction of some £68m (2010 prices - table 34) in franchise premium per year on the East Coast Main Line alone. Our own review of the current open access applications on the ECML suggest that this figure is an underestimate, and the revenue abstraction could be as high as £500m over the years from 2020 – 2023. This figure is consistent with the figures derived by CH2M Hill in their recent report for ORR[1]. Other things being equal, this will mean less money available for investment in the network, and the impact of this on future capacity should be considered in the impact study. Effectively, this option will take taxpayer income and transfer it into increased OAs' profit margins.

Option 1 as interpreted by the report is much more than a simple expansion of open access competition as it is today. Modifications are proposed to provide a more level playing field through introducing FTAC and a PSO levy for OA operators. However, as noted above, while this would be an improvement on today's situation, there is still a financial loss to Government.

Options 2 and 3 are variations on the system in place today. Option 2 seems to have many of the disadvantages of option 1 without offering many of the benefits offered by freedom from specification allowing the operator to innovate. Moreover, the option does not always release any significant new competition. For example option 2a on WCML (fig 13 p 73) only offers competition between London and Milton Keynes, Rugby, and on the Coventry to Birmingham corridor where competition already exists between Virgin Trains and London Midland. There is a similar lack of competition in the options considered for the other routes.

The report does not consider any new competition on the big flows such as Manchester and Liverpool to London. The splitting of franchises into various routes will not increase competition unless there are significant overlaps with like for like services. If the routes are split so that one franchise runs the stopping, less profitable services and another franchise runs the more commercial services, we are

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[1] Assessment of Applications for Track Access on the East Coast Main Line 15th January 2016; table 35 on page 6-64 with adjustment to 2020 demand and price levels.

simply going to end up with a passing of premium from one franchise to subsidise another. Meanwhile this option would still be open to additional current style open access competition leading to further erosion of franchise values and hence premium.

Similarly, Option 3 would offer an erosion on franchise value (£65m NPV in Fig 39 on p 104) with minimal benefits apart from a 'postcode lottery' of fares reductions while leaving the door open to conventional open access as in Option 2.

Both Options 2 and 3 would result in no discernable passenger benefits and all the constraints of a more rigid Government specification.

Options 1-3 all involve the majority of services specified by Government, and we believe it is unlikely that this will be able to achieve the maximum benefits for passengers unless the specification were to be much more flexible than today. The report notes that "prescriptive franchise specifications can limit the scope for operators to innovate"; hence the need to consider Option 4.

Option 4

There is a serious gap in the assessment of the various options - Option 4 (which potentially delivers the best overall outputs for the taxpayer and passengers) has not been subject to a full qualitative assessment. We do not understand why this exercise has not been undertaken.

Option 4 delivers the best way to make up for the shortfall in premia payments resulting from increased competition by allowing the full benefits of private sector operation through flexible specifications. This can only be achieved by Option 4. Therefore, we are disappointed to see that a full quantitative assessment has not been made of this option, and urge this option to be treated in the same way as Options 1-3. We do not agree with the Legal and Operational Assessment undertaken in the report that the implementation of Option 4 will require a major overhaul and be operationally complex. While, we recognize that it would be more difficult to implement than Options 1-3, this option is the only one that has a chance of being positive for both the passenger and the taxpayer, and it is therefore worth the effort. As we set out in our previous response to the CMA Policy Paper in October 2015, the full benefits of private sector option, enabled by Option 4, will include:

- Services tailored to the needs of passengers, enabled by freedom to build timetables that match demand and supply, rather than being constrained by an ever increasing list of mandated political trade offs
- Maximized returns to Government through efficiency savings
- Lower fares for passengers driven by competition and enabled by lower costs

The full efficiency savings of private sector operation and associated benefits to passengers (lower fares), revenue (timetable freedom) and costs (efficiency savings) as set out by the report can only be achieved through the fully competitive model in Option 4.

While Option 1 as evaluated by the report would introduce major costs to the taxpayer without introducing the full benefits of competition, it could provide a stepping stone towards Option 4. In this scenario, Option 1 could be developed further much further such that all (or at least the vast majority) of services on a route were let to open access competition possibly with some license conditions attached. The remaining services would be the subject of a franchise. When a stable long-run environment has been reached, these remaining franchised services would then be operated by OAs.

Thus option 1 could be seen as a stepping stone towards full implementation of Option 4 where full efficiency savings and innovation can be achieved.

Alternative to the PSO Levy

We suggest an alternative way to provide for a PSO levy would be to auction the paths for a one off lump sum payment for, say, 10 years access, every 10 years. This would enable OAs to pay their fair share of industry costs and enable some compensation to the tax payer for the use of the network. While using Option 1 as a stepping stone, impacts on Government funds through lower franchise premium payments could be minimised to a certain extent by setting the level of open access competition to be experienced at the bid stage. This would come with a guarantee that no further open access would be approved during the franchise term. This option would have many of the benefits of option 4 and the remaining franchised operations could be reduced over time.

Other Issues with the Report

We also take issue with many of the observations made by the report, especially in Section 5. For example, there is little discussion of their finding concerning the difference in costs between OAs and franchised operators, especially the possible reasons for this. Could the difference result from the highly specified requirement of Government in franchises and for franchised operators to provide "network benefits"? Furthermore, the report notes *"despite operating at small scale and density, open access operators' costs are broadly in line with those of franchised TOCs when the cost effect of running stations is stripped out"*. This is hardly a ringing endorsement for the current open access arrangements, and the Option 1 proposals will only *increase* OA's costs. Moreover, OAs tend to rely of their sister TOCs for certain back office functions which would be inefficient for a small TOC to provide (e.g. control and train planning). The evidence presented in section 5.3.2 was widely discredited when presented in the MVA study in 2011, on the basis that a like-for-like comparison between contracts was not possible. As for service quality, the report would benefit from correctly observing that it was, in fact, a franchised operator (GNER) that was the first to introduce WiFi to trains in the UK in 2004. The same company introduced yield management well before OAs did. These are just a few examples of inaccuracies throughout the report.

System Operator Needs to Effectively Manage Capacity from an Operator Perspective

All of these options have the major problem that the ability for the private sector to alter capacity allocation would be severely limited. They would therefore rely on a competent and energised system operator which was incentivised and capable of maximising customer benefits from the existing infrastructure. The System Operator will need to be able to balance the needs of each operator within the network and come to a consensus while keeping passenger needs at its heart.

A Sophisticated Revenue Allocation System will be Required

The ORCATS revenue allocation system is struggling to cope with the level of on rail competition today, let alone that envisaged by CMA. Any increase of competition of the order proposed by CMA would need revenue to follow the passenger. Even in today's competitive environment, a disproportionate amount of management time is spent addressing revenue allocation disputes.

Improvements can be achieved by removing inter-available tickets but this represents a massive customer dis-benefit, likely to outweigh any of the claimed benefits from competition. So a system where smart type tickets can be tracked to the service used and revenue allocated through a back office. This is likely to be possible in the medium term, but is not trivial or imminent.

Summary

We believe that Option 4 proposed by the CMA has not received a fair and equal assessment in this report. We also believe that there are number of inaccurate assumptions in the quantitative assessment of Options 1 to 3. However, we are pleased to see that the report recognises the reduced income for taxpayers of current system of open access, the highly restrictive nature of current franchises and the qualitative benefits of Option 4, fully competitive services.

Yours sincerely

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