

CMA discussion document: competition in passenger rail services in Great Britain – FirstGroup plc response

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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 services in North America;
 - (d) UK Bus: this business division operates local bus services in the UK and Ireland; and
 - (e) UK Rail: this business division provides passenger rail services in the UK.
2. First has two rail franchises, First Great Western (“**FGW**”) and First TransPennine Express (“**FTPE**”)¹ plus an open access passenger operation, First Hull Trains (“**FHT**”)². First also operates the 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 CMA’s discussion paper and the options it proposes.

Rail privatisation has delivered significant benefits

5. The current system of franchising, augmented by open access competition where appropriate, has provided significant customer and taxpayer benefits. As the CMA notes, the period since privatisation has seen a “remarkable renaissance” of the UK passenger rail industry.
6. The success of the private franchising model is due in part to the added value First and other private train operators have brought to the railways through innovation and investment, not managing decline, as British Rail was regularly forced to do.
7. There are other dynamics within franchising which have contributed to rail's renaissance. Franchisees are incentivised to deliver on ambitious franchise bids, with the risk of failure not being purely hypothetical (as proved by the East Coast franchise example). Franchisees have also proven themselves as effective delivery agents, working with DfT in the implementation of its high level output strategy and other major industry investments, such as in the case of FGW, the remodelling of Reading station and environs, the introduction of IEP and preparation for Crossrail and HS2, even where benefits may not be for the then immediate franchise.
8. While the CMA has understandably focused primarily on ticket prices as an indicator of how ‘well’ the market is operating, Industry research indicates that customers are just as concerned

¹ A joint venture with Keolis (UK) Limited.

² Please note that, as of July 2014, First owns 100% of the share capital of Hull Trains Company Limited and that therefore FHT is no longer a joint venture operation.

with punctuality and reliability, where there has been significant improvements, despite the increased use of the network.

9. In addition, the privatised rail industry has been able to continue to deliver, and augment, the social benefits offered by an effectively integrated network. It has responded to the licence obligations placed upon it which require it to operate subject to standardised conditions and ticketing arrangements with inter-available, turn up and go fares, while also developing new products and travel opportunities and improved passenger compensation. There is however a trade-off to recognise and weigh-up between the mandated structure of network benefits to present a degree of commonality for customers across the industry and what might be achieved by alternative, more independent structures.

Ongoing upheaval in the rail industry

10. As identified in the CMA's paper, the rail industry has undergone a series of major upheavals in recent years and is still facing a series of further upheavals, not least the possible restructuring of Network Rail.
11. The ORR proposal to facilitate a more devolved Network Rail structure mirrors a broader political move towards greater devolution, across a number of sectors including public transport. With the introduction of the Cities and Local Government Devolution Act during the course of the current Parliament, we expect to see a significant shift towards cities having a greater input into specification of public transport provision (potentially of the underlying network infrastructure as well as of the service specification – see preceding paragraph), often aligned to broader non-transport objectives.
12. Any changes made to the industry structure will need to take into account this political move towards greater local and regional control, and the inevitable impact it will have on the rail industry, both in the short- and medium- to long-term.
13. Moreover, any changes need to take into account the overall operational complexity of the rail industry – even apparently minor changes can have significant unintended consequences. For example, government has led a strategic national investment in new, high speed trains being introduced onto the East Coast Main Line and the Great Western Main Line. The investment has been founded on an integrated long term train availability and reliability regime with the vehicle suppliers to operate over nearly three decades. Future service developments now need to take into account the impact on these arrangements - will they be consistent with the obligations (and the ability) to make use of the train provision which has been committed to be paid for?
14. The complex interaction between private finance and Government funding also needs to be carefully considered when adjusting the industry structure. Changes which increase competition will almost inevitably also introduce greater risk for operators. This will in turn make investment less attractive for external funders due to a greater risk of default. This may lead to greater demand for Government guarantees (or at least reduced payments to Government, reflecting the increased risk), reducing the benefit for taxpayers.

The industry is competitive

15. As the CMA notes, competition *for* the market:

“...has been intense, with franchise competitions attracting a significant number of credible bidders...There appear to have been real benefits, evidenced by the reverse over the past two

decades of the previous long-term decline in usage of Britain's railways and, over the past decade, a material increase in passenger satisfaction..."

16. It is worth noting that we remain in the very early days of the 'new' franchise model – to date, only Essex Thameside and ICEC have been awarded and operated under the post-West Coast franchise model, plus the Thameslink Southern Great Northern management contract franchise. However, what can be observed from the limited examples available to date is that competition for the market is delivering significant benefits, demonstrating genuine innovation and offering significant value for Government (i.e. outperforming the Government's comparator model).
17. Furthermore, there is increasing competition from franchise operators with other modes to further grow demand for passenger rail services, not least with domestic air operators. For example, services operated by the FTPE franchise between Manchester and Scotland take approximately 3 hours and 30 minutes (on average). The rail share of the combined air/rail 'market' on this route has increased from circa 50% in 2008 to over 80% in 2015. The increase in rail's share of the 'market' reflects timetable improvements and competitive pricing, including the availability of low fares such that the current average standard class one-way fare is £25. FTPE have deployed sophisticated yield management techniques to attract and manage demand which together with marketing activity has been a key driver of the observed mode switch from air to rail.
18. There also continues to be significant competition between franchises *in* the market where overlaps occur – for example, as the CMA has recently identified in its decision on East Coast, where it analysed rail on rail competition on a series of overlaps, finding prospects for a substantial lessening of competition on two flows. In other areas the competition between franchises may be more intense (as for services between London and Birmingham).
19. It should however be recognised that the current franchise structure is substantially designed to support the Secretary of State in delivery of his statutory duties to see a network of rail services provided. The statutory duties established under the Railways Acts do include a duty with regard to the promotion of competition, but this is in a context of a broad range of other duties which need to be observed.³ As well as meeting those statutory duties, there are significant societal benefits from the provision of a comprehensive network of rail services, connecting communities, providing a beneficial system effect and with profitable flows being fed and complemented by lesser flows.

³ The statutory duties on the ORR and the Secretary of State under section 4 of the Railways Act 1993 include at section 4(1) (as amended) duties as follows:

"(zb) to promote improvements in railway service performance;
(a) otherwise to protect the interests of users of railway services;
(b) to promote the use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent that it considers economically practicable;
(ba) to contribute to the development of an integrated system of transport of passengers and goods;
(bb) to contribute to the achievement of sustainable development;
(c) to promote efficiency and economy on the part of persons providing railway services;
(d) to promote competition in the provision of railway services or the benefit of users of railway services;
(e) to promote measures designed to facilitate the making by passengers of journeys which involve use of the services of more than one passenger service operator;
(f) to impose on the operators of railway services the minimum restrictions which are consistent with the performance of its functions under this Part or the Railways Act 2005 that are not safety functions;
(g) to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance."

20. The Secretary of State commonly summarises his objectives for a franchise in the Invitation to Tender document for that franchise⁴, seeking to fulfil a wide range of objectives extending beyond competing in the market, which itself is not generally included as an express objective. So for example, and in response to concerns over state aid law, the routes over which a franchise can operate are prescribed, so that they may not compete off the relevant franchise routes. Also franchisees are required to undertake a broad range of obligations designed to support and invest in rail operations and infrastructure which a purely market-driven operator may choose to avoid. While these most obviously include the still extensive service specifications which are required to be fulfilled, further examples include commitments with regard to station property, requirements to make payments into industry technology funds, the application of building and environmental standards and the requirements to maintain very extensive bonding and financial guarantees.
21. This current approach to franchising is a development from earlier formulations and there should be learning from past approaches. In the early days of franchising, franchises were less specified and there was ability for franchisees to compete off their franchise routes, while at the same time track access arrangements dampened competition through the structure of "moderation of competition". There may have been concern at the impression that this was leading to opportunistic behaviour making sub-optimal use of limited infrastructure capacity. Subsequently services became far more heavily specified, overlaps have been eliminated and franchises included change adjustment protection, where the SRA or DfT specified changes in services of another franchisee which impacted on revenue.
22. During the period of the earlier franchises, track access rights were also specified in more detail. This was a critical part in the structure of the franchise process – as the track access contract represented the franchise "dowry" and the assurance of the ability to operate services required to fulfil the franchise. Without this, the risk of inability to fulfil the franchise specification and potentially to lose paths to competing demands (if not necessarily competing operators) may well have been too great. Since the development of more completely specified franchises, with fewer overlapping franchises, the risks associated with track access have diminished and attention has been placed on maximising the use which can be made of the infrastructure. To support this goal, track access rights are proposed to be diminished in detail, so they become less specific and increasingly related just to "quantum". Developments in the approach to

⁴ A current example is the ITT for the East Anglia Franchise which sets out the headline franchise objectives as follows (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/461470/east-anglia-invitation-to-tender.pdf at Table 2.1 on page 10):

- *Help the economy of East Anglia to thrive by offering good quality rail services for passengers to and from the region and across the region with service levels that reflect the specific requirements of the different markets served, all while working within the affordability constraints on public funding.*
- *Realise the benefits from rail investment in East Anglia through a transformation in operations and ensure journey time, frequency, reliability and connectivity benefits for passengers are delivered.*
- *Deliver excellence in passenger service through an innovative approach to all aspects of the passenger journey. Achieve consistently high standards of performance in the operation of train services and minimise passengers' inconvenience in the case of disruption.*
- *Secure whole industry efficiencies and help reduce overall industry costs by working in partnership across the rail industry*
- *Support local communities to help deliver local transport integration, local regeneration and investment in and around stations*
- *Improve social and environmental sustainability to reduce carbon emissions, use resources effectively and build skills and capability within the business and the supply chain."*

competition in the market may well call for this to be re-visited, as operators strive for the degree of assurance on access which is needed to enable them to plan with reasonable certainty, fund investment and commit to franchise obligations. This may create a potentially damaging tension between maximising infrastructure capacity and providing operators with enough assurance as to what services they will be able to operate.

23. We welcome the CMA's recognition that any further change in approach would necessarily be a medium to long term development, which would be able to be taken into account through franchise award processes. We consider the current East Coast award was a case where the potential for open access was a matter well signalled in advance to bidders and so able to be taken into account by them. It is important that this or greater transparency is repeated. Depending on the extent of competition envisaged, the franchise terms themselves may need to be revisited to give effect to the outcome of decisions on the extent of competition in the market to be promoted. This will require an assessment of how much a franchise's economic equilibrium may be affected and what should be the response.
24. We address open access operations at paragraphs 31 to 41 below.

Capacity constraints

25. The CMA has rightly identified that there are currently a number of network capacity constraints in many areas under the current system. We believe that many of these constraints will continue to limit the ability to introduce greater competition in the market in future, regardless of the system which determines the operation of passenger rail services.
26. Technological innovations such as new signalling technology will undoubtedly have a positive impact on the utilisation of network capacity, but it is not currently anticipated that they will have a significant impact at major termini or at certain major 'bottlenecks', where the physical constraints (e.g. of numbers of platforms or junctions) will remain. Specifically, many of the London termini are already operating at or near maximum efficient capacity and there would be little or no scope to introduce any additional services even following the introduction of new technology.
27. It is notable in this regard that there is a significant difference here between the passenger rail industry and the airline industry. In rail the system of charging and allocation is subject to a legal framework (Directive 2012/34/EU) and the physical constraints of operating trains on the railway infrastructure require all the movements of each train from leaving the depot in the morning to returning at night to be fitted into the timetable. Particular train slots fit within the larger diagram for the train concerned. This must take account of the needs of all traffic types on the network. It is unlawful for slots to be traded. There is not the same flexibility as may exist in the airline industry to consider a slot departing or arriving at a station in relative isolation.
28. The capacity constraints are not limited to track infrastructure. Rolling stock is also a consideration. Rolling stock is very capital intensive and often specialised in its use. It is not efficient for the industry to carry any material spare capacity. While some old stock may be about to be released by the introduction of new trains, the costs of bringing this up to the standards required to continue in service beyond 1 January 2020 (for example through automating doors and changing toilet systems) coupled with its existing age means that it may be prohibitively expensive for it to be retained. If the current franchise structure were to be remodelled to introduce more competition between franchises in the market, the flexibility of fleet solutions to support this would require very careful investigation. Splitting fleets to

support this risks introducing inefficiency and increased performance risks. In some cases this may not be easily achieved either because of current physical constraints (e.g. the current depot provision available to support the fleets) or contractual arrangements (e.g. such as the long term TARA structures in support of the IEP fleets on the East Coast and Great Western lines).

29. Our conclusion is that opportunities for open access and competition best apply where there is a managed amount of capacity available to be allocated to them. The East Coast Main Line is a case in point where a limited amount of capacity is available between destinations which make operations viable. In other cases, the current pressures on the network may mean that the implications for existing services of introducing competition is not acceptable (e.g. the societal benefit in continuing a certain level of freight or local/regional services may outweigh the benefits of an additional inter-city service). This will require detailed review by route and having regard to the particular set of circumstances, which may change over time.
30. We anticipate that there will be some real opportunities in the future – these will arise where more capacity is added to the network, not least HS2. HS2 itself is likely to offer more of a step-change than the likely marginal opportunities which may otherwise exist on the more steady state and increasingly congested existing network. It is right that there is careful consideration and planning for how the industry will approach these step-change events.

Open access

31. Open access operation has proven in the UK that it can be an undoubted success, leading to new services to previously under-served locations on the network and acting as a test bed for innovation.
32. There are important considerations in support of successful open access operations. Typically we see a small but sufficiently viable scale, with available capacity to operate a commercially attractive service, connecting markets which can be developed to provide sufficient demand. There are vulnerabilities to operating costs (and a dependency on not losing diagramming efficiencies from poor timetabling) and regulatory change. However there are strengths from small-scale, well-managed and commercially focused operations which can respond rapidly to their customers.
33. We support the CMA's studies which demonstrate that well positioned open access services can stimulate the market and grow demand. However we would urge caution in placing too much reliance on non-UK comparators. Relevant differences include the nature of the comparison with sometimes un-reformed incumbent operators, whose responses to open access have themselves sometimes been judged anti-competitive. It is also a fact that the UK rail environment is very different, with a mixed access network and an established framework to deliver and protect network benefits (e.g. through inter-available fares and the requirement to apply the TSA).
34. However, the current system of applying and securing approval for open access is time-consuming, costly and very uncertain. The current East Coast Main Line application process serves to highlight challenging issues such as securing consensus over the availability of paths, the nature and extent of expensive and time consuming performance modelling required to verify the potential for operations and the more detailed bases for deciding between competing applications. These issues are particularly significant in an open access arena, given the scale and timescales for the investments necessary to underpin operations being started and then

run to the point that they can become self-sustaining. A balance needs to be struck between addressing important issues and creating further barriers to entry.

35. First would welcome a simplified and more transparent process for open access applications, which we believe would lead to the implementation of more open access operations and the concomitant customer benefits. This may be developed from ensuring greater clarity over paths available for open access over key corridors, so that there is less issue over the question of availability of capacity. The next stage is to bring greater clarity to the tests for allocation of those paths, both as between open access operators and between open access and franchised operators. This is likely to develop with increased regulatory experience in these areas.
36. First considers that the latest CP5 changes to track access charges have addressed concerns over the levels of charging for new open access operations, assuming no radical changes to current operating models. First notes that open access operators do not have the benefit of the franchise agreement change mechanism, which enables franchisees to pass through regulatory change to charges. Therefore any regulatory changes to open access charges will need to be of a nature and to a timescale which takes account of the ability for at least then existing open access operators to respond. Given the nature, extent and timescales involved in rail investment, any significant adverse changes are likely to require a considerable time period for operators to be provided a reasonable opportunity to respond.
37. Depending on the nature of the changes proposed, these timescale requirements could range from delayed application of the changes or their restriction from applying to existing operators, to relating their application to providing some increased assurance of the quality and duration of the track access rights which the operators have permission to use (for example by extending the duration of access contracts beyond the standard five year term to ten or more years).
38. It is conceivable that a move to a very much wider open access model, with a far greater proportion of services provided through open access rather than franchised operators, would require a much more radical overhaul of the approach to charging, with the farebox directly funding Network Rail to a greater degree, from both franchise and open access operators. However this would call for a very significant re-engineering of industry finances and would be a major undertaking. While it might be necessary to support some more extreme proposals for a market driven industry, we do not consider it within the scope of the current proposals.
39. There are significant differences between franchised operations and open access operators, and the underlying objectives they are required to achieve. Franchisees are subject to a broad range of detailed specification and a responsibility to deliver on a wider range of public utility service commitments, whereas open access operators can focus on a more targeted delivery of service. Not handling how the two interact with care could risk cross-subsidy, unfair competition, increased aggregate costs and damage to network benefits with wider societal value.
40. The complexity of the underlying systems coupled by the scarcity of capacity suggests that a pricing methodology for access may not be more than part of any answer for resolving the balance between franchised and open access operations. There will be an ongoing role for making regulatory decisions over the allocation of access.
41. In First's view, this supports a conclusion of permitting open access where there is available capacity without unduly prejudicing freight and public service operator/franchisee needs, but necessarily on a controlled basis. This cause will be advanced by increasing certainty of where there are available paths on strategic routes and supporting these by an assured, long term

open access charging methodology, with clear criteria to guide how competing calls for the available capacity will be resolved.

Conclusions

42. First welcomes the CMA's discussion paper, and agrees that, where appropriate, greater competition in the market could lead to customer benefits without an unduly adverse impact on the taxpayer.
43. Any changes need to take into account the successes that franchising has brought, as well as the potentially lengthy period of ongoing upheaval that the industry already faces from the proposed changes in infrastructure, the devolution agenda and a number of large infrastructure projects. Now is not a good time to add a further dimension to this major period of change.
44. In First's view, options 2, 3 and 4 in the CMA's paper pose too great a risk of adverse unintended consequences to the ability of the industry to continue delivering a safe and reliable service while continuing to deliver good value both to rail users, the wider national economy and the taxpayer.
45. On this basis, we believe that option 1 (existing market structure, but significantly increased open access operations) is the most likely to achieve the benefits the CMA has identified while continuing to ensure that customers also benefit from the significant advantages that the existing franchised system delivers – reliability, punctuality and the broader societal benefits of a comprehensive network.
46. We also recognise that within the next two decades HS2 will be bringing very significant change to the network, with much needed increased capacity being made available. This does present a challenge over how that capacity (and perhaps more significantly the capacity which it releases) will be best allocated, used and charged for. Planning for this will need to start now.