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The Government welcomes the opportunity to respond to the CMA's discussion document regarding passenger services on Great Britain's railways. It is a priority of this Government to ensure that the interests of passengers and taxpayers are placed firmly at the heart of our railways. It is for that reason that we are making major, transformational rail investments and why we operate a highly competitive franchising system. We are therefore always interested in discussion around this objective.

However, I do have certain concerns about the approach taken by the CMA on this issue, most particularly the level of consideration given to the potential detrimental consequences to passengers and taxpayers that could follow. These, alongside other issues, are considered in the attached response, which my officials would be very happy to discuss with you and with the CMA team.

**THE RT. HON. PATRICK M̄LOUGHLIN**

# Department for Transport response to the Competition and Markets Authority consultation on the discussion document “*Competition in Passenger Rail Services in Great Britain*”.

## Introduction

The Department for Transport (DfT) welcomes the opportunity to respond to the CMA’s discussion document on options to increase potential competition for passenger services on Great Britain’s railways and wishes to thank the CMA team for their engagement with the Department to date. There are important questions around the role that competition plays in the rail market and how competitive forces can best be harnessed.

The DfT is committed to ensuring that the interests of passengers and taxpayers are placed firmly at the heart of Great Britain’s railways, and is actively taking steps to further secure this objective, including through harnessing the benefits of competition. In particular, the DfT operates a highly competitive franchising process for the provision of passenger services, which has significantly evolved in recent years and is providing strong and improving outcomes for passengers and taxpayers. These outcomes have included:

- A dramatic growth in the number of passengers carried, doubling since privatisation to 1.65 billion passengers using Great Britain’s railways in 2014/15, significantly outpacing the growth seen in other major EU countries.
- Record levels of passenger satisfaction, again considerably higher than those observed in other EU countries.
- Average train operating company operating margins as a share of revenue were 2.9% in 2011-12; 20% lower than in 1997-98, demonstrating the effectiveness of the franchising process in driving efficiencies.<sup>1</sup>
- Positive results from recent franchise competitions, both in terms of enhanced outcomes for passengers, and substantially better financial outcomes for taxpayers.

It is against that background of strong support for competition and measures to improve rail services for passengers that we are responding to this consultation.

## Approach and introductory remarks

The role of competition in the delivery of rail services has been the subject of significant debate since the time of privatisation. DfT recognises that there are important strategic questions that must be addressed concerning how best to

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<sup>1</sup> KPMG – “GB rail: better services, better journeys and better value” – September 2015 - [http://www.raildeliverygroup.com/files/Publications/2015-09\\_rail\\_industry\\_dataset.pdf](http://www.raildeliverygroup.com/files/Publications/2015-09_rail_industry_dataset.pdf)

achieve the benefits of competition without harming the interests of passengers or taxpayers. We are concerned, however, that although the CMA has undertaken some useful work in this area, the report published for consultation did not adequately address those strategic questions.

In particular, we are concerned that the report did not properly address the following:

- **The protection of taxpayer interests:** With Government providing substantial financial support for the railway, both to fund operations and to invest in its future development, it is important that the impacts of any changes to the competitive environment for rail on Government funds are properly accounted for. We welcome the CMA's principle that any changes should be broadly revenue neutral for the taxpayer, but are concerned that this principle does not appear to be properly reflected within the analysis of options for enhancing competition.
- **The existing competitive market:** The report does not properly explore the benefits for passengers and taxpayers that have been achieved through the existing competitive franchising system. We are particularly concerned that the CMA has made use of comparator data drawn from the introduction of competition into markets which had previously been devoid of it. This would not be the case with the railway and we are concerned that as a consequence of this, the CMA's analysis may overstate the benefits of changes to the competitive environment. We note that the Office of Fair Trading found in its newspaper and magazine distribution market work that competition for the market can sometimes deliver better outcomes than competition in the market.
- **The social purpose of the railway:** A significant driver of Government spending on the railway is to ensure the provision of services which meet important social and economic needs, but which would not be commercially viable without subsidy. We are concerned that the CMA does not appear to have taken this into account and that some of the options considered by the CMA could constrain Government's ability to specify such services.
- **The measurement of passenger benefits:** The report largely approaches the issue of passenger benefits through the lens of fares. While recognising that fares are an issue of significant interest to passengers (albeit one that exists in a balance with the taxpayer interest), DfT would note that a broader range of issues can impact on passenger satisfaction, including crowding and performance. We are particularly concerned that some of the options discussed in the report would have the potential to impact negatively on the operational performance of the railway.

Despite these concerns, however, we welcome the CMA's interest in this area and would be pleased for the opportunity to work collaboratively with the CMA

to further advance thinking. In DfT's view, in order to present robust conclusions, it would be necessary to carry out further work on developing:

- a fairer charging regime which reduces the current subsidy granted to open access passenger operators via their protection from fixed track access charges (and from higher levels of capacity charge),
- greater protections for taxpayers from the abstraction of revenue, including a robust, sustainable and fully effective mechanism to provide assurance that the Government's unique ability to invest in rail will not be diminished,
- protections for the Government's ability to specify that constrained capacity may be used for services whose value is partly social and economic, rather than being purely commercial,
- a fuller assessment of the impacts of open access operators upon the health of the franchise bidder market, and
- a more comprehensive framework for managing the performance impacts of the increase in complexity that would arise from any increase in open access operations, accompanied by clear criteria for establishing when performance concerns would make it impractical to grant access rights to open access operators, with a recognition that the performance of the franchised operator should retain primacy. This should recognise the existing complexity of railway operations and the potential for services to impact upon each other.

The DfT welcomes the CMA's recognition of the importance of several of these issues. However, without an approach which properly and carefully analyses in detail the complexities of the rail sector, the DfT has concerns that the evidence base on which the discussion document's conclusions are founded is incomplete and could potentially mislead. Therefore it does not form an appropriate basis for properly considering changes, which could have a potentially far-reaching impact on the operation of the railway in Great Britain, and on passengers, taxpayers and investment. In our view, further work is required whether by, or in closer collaboration with, those with a specialist understanding of railway dynamics to provide an appropriate, evidenced basis for further consideration of this issue.

Our response to the consultation, therefore, aims to provide more information on these issues to help facilitate a fully informed discussion of this highly complex issue to inform future work. It also provides the DfT's high level views on each of the four options put forward by the CMA.

We would welcome the opportunity for further engagement with the CMA, perhaps by means of a workshop early in the New Year.

## **The CMA's approach**

As we mention above, Government remains strongly supportive of the role of competition in the rail sector to drive better outcomes for passengers and the taxpayer. However, the unusual characteristics of the rail sector, such as that

running one rail service will often physically prevent an alternative rail service being run, combined with the fact that the full social value of a given train is not captured in the revenue it generates, means that we have had to think carefully about how to use competitive pressures to drive improvements in efficiency and passenger experience, whilst also bringing benefits to wider society.

We therefore welcome a debate regarding practicable and appropriate recommendations about enhancing competition, which take account of this already considerable competition that exists for the market and the particular circumstances of the rail industry in Great Britain which, in addition to the points above, includes the almost unique feature of rail in the dynamic of splitting high fixed costs between farepayer and taxpayer.

However, we consider that it is important to recognise that competition is not an end in itself, but rather a means to deliver better services and value for passengers, taxpayers and society. We therefore consider that it is vital to ensure that the costs, as well as benefits, of enhanced on-rail competition are carefully analysed and taken into account to ensure that the railways operate in a manner to secure maximum benefits for passengers and taxpayers.

Against this background, the DfT continues to consider that the appropriate basis for the CMA to consider this complex issue would have been:

- **First** to define the objectives it was seeking to secure from changes to the existing rail structure, with clearer and more comprehensive definitions of both passenger and taxpayer interests.
- **Second** to examine the extent to which the existing system was effective in securing these objectives.
- **Third** to examine how potential future changes, within the framework of the existing structure, could further address these objectives
- **Fourth** to evaluate each option by establishing the incremental benefits of each option additional to the current position and planned steps, then
- **Fifth**, balancing those incremental benefits against the incremental costs which they give rise to clearly establish the net benefit of each of the options.

Following such an approach would also have enabled participants to engage in a structured, informed consultation process on the various options the CMA identifies.

However, after very carefully considering the CMA's report, we continue to consider that the report does not provide such a comprehensive approach, or otherwise a clear analytical framework to enable an informed consultation to take place.<sup>2</sup> Instead, we remain concerned that the CMA's approach appears to start from the basis that increased on-rail competition is the core objective, rather than as a means to an end, with the subsequent analysis then focussed

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<sup>2</sup> We say this after considering in detail the analytical framework for considering options as set out in Chapter 7 of the CMA's discussion document.

upon the achievement of that objective; additionally, we are unclear as to the basis of the CMA's premise that competition in the market must necessarily be more effective than competition for the market, particularly taking account of the particular circumstances of this industry.<sup>3</sup>

While we recognise that the Office of Rail and Road's (ORR) impact evaluation of these options will provide further analysis, we consider that its publication considerably after the close of the consultation period means that consultees have not been able to fully consider the implications of various approaches, and provide an informed commentary on them. In addition, we note that the ORR proposes to draw on the analysis that the CMA has undertaken for its Discussion Paper to inform the impact assessment, and we are therefore concerned that the issues we have noted with the econometric analysis (discussed in annex A) may be replicated in ORR's impact assessment.

However, notwithstanding these issues, we very much welcome the CMA's approach to certain of the practical issues, both in relation to current and upcoming franchises not being affected, the fact that any changes should be revenue neutral for taxpayers, and its recognition that any changes should not occur before 2023, and even then only on certain major Intercity lines. While we have concerns with aspects of the CMA's approach, particularly the extent to which its analysis effectively safeguards the principle of revenue neutrality, we consider those aspects of its position to be reasonable and appropriate to help provide greater certainty for industry participants.

## **The benefits of the competitive, evolving franchise system and the benefits of alternative approaches**

After carefully considering the CMA's approach, we consider that, on the basis of the evidence presented, the CMA appears to have overstated the benefits of moving to a different industry model; additionally, it appears to have understated the benefits to passengers of the current evolving, highly competitive model. We consider these issues below

### *The evolving, competitive franchising system and the role of specification*

The Government has enthusiastically used competition to meet its objectives through the method of competition for the market, considering it to be the most sustainably competitive model to deliver benefits to passengers and taxpayers in the particular circumstances of the rail industry. We therefore welcome the CMA's recognition that rail franchising has led to "*intense*"

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<sup>3</sup> In this regard, we note the OFT's analysis, after a very detailed consideration of the sector, that competition for the market in newspaper distribution was likely to be more effective than competition in the market (see: See the OFT's publications on newspaper and magazine distribution (at <http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/news-and-updates/press/2008/122-08>).

competition<sup>4</sup> between rail operators, which has generated benefits for passengers and taxpayers.

However, we have concerns about the position the CMA has taken regarding the “*detailed*” specification in franchise agreements, which we consider does not fully reflect the benefits obtained from the current franchising model and the effect of the franchising model’s evolution in recent years. We also have concerns regarding the lack of attention that the CMA pays to the requirement on Government to ensure that socially or economically essential, but commercially non-viable, services continue to be operated. Moreover, we are also concerned regarding the lack of emphasis on the role that Government intervention (via investment in rolling stock and fixed infrastructure) plays in addressing issues such as capacity and reliability, which directly impact upon passenger interests. In relation to each of these points, the DfT notes that it is not saying that the CMA has not considered them at all, but that its analysis in the discussion document does not give them the weight that their importance to passengers merits.

Turning to specification first, the DfT considers that specification is critically important in ensuring the delivery of socially and economically important services, which would otherwise not be provided, and in securing other vital characteristics for those services which the market would not provide, but which are of importance to passengers and the wider economy (e.g. additional capacity to prevent overcrowding on commuter routes, higher frequencies, faster journeys). The absence of specification would therefore have adverse consequences for passengers, regional development, connectivity and the environment; for instance, a purely commercial operator may not place sufficient weight on the potential for increased productivity in a city, nor on the discomfort experienced by crowded passengers who choose to continue to travel (or who have no alternative). We therefore consider that there is a legitimate and principled role for specification within franchises.

However, the DfT recognises that, notwithstanding the benefits of specification, there is clearly a balance to be struck to enable operators to innovate and provide new approaches to serving passengers. This is precisely why the franchising model has continued to evolve in recent years, with lessons from each franchise being incorporated into the design of future franchises. This is something the CMA briefly considers<sup>5</sup> and welcomes, but does not appear to have taken into full account.

The DfT considers it important to fully recognise that franchising policy, which will be applicable to future franchises which are the focus of the CMA’s discussion paper, has become less restrictive in terms of both the bidding process and in allowing additional services during the franchise:

- At bidding, operators are invited to make innovative propositions for service delivery and quality enhancements, and bids are now selected

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<sup>4</sup> CMA discussion document, paragraph 2.31.

<sup>5</sup> For example, at para. 1.20 of the CMA’s discussion document.

partly on the basis of the quality of the proposition offered, not just the price as in competitions up until 2012. In recent competitions this has resulted in bidders offering more trains, more capacity, more destinations, innovative compensation mechanisms and a variety of other passenger facing improvements, benefits which customers on recent franchises such as the Intercity East Coast, Thameslink, Southern and Great Northern and Essex Thameside franchises are benefiting from today. We would be happy to have a further discussion regarding the conduct of previous bidding rounds, and how this has manifested itself through innovative offers if that would be helpful.<sup>6</sup>

- There are now much stronger opportunities for franchises to develop improvements during the lifetime of a franchise, with fewer restrictions being placed in terms of enabling franchisees to develop additional services and quality enhancements. The DfT has, for example, introduced a residual value mechanism to incentivise investment beyond the franchise term, the importance of this has not, in the DfT's view been fully recognised by the CMA.
- The move away from providing revenue support,<sup>7</sup> and instead the provision of exogenous risk sharing mechanisms relating to GDP and central London employment where appropriate, means that franchisees are incentivised to provide additional services and make other improvements during the franchise term, where these are commercially viable. We do not consider this development, in particular, is well reflected in the CMA's analysis.

This shift towards greater freedom for bidders to innovate is demonstrated in the East Anglia Invitation to Tender, which was issued on 17 September 2015, which clearly sets out the DfT's approach to providing bidders with significant scope for bringing forward innovative approaches to serve passengers (see the box below).

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<sup>6</sup> Clearly such a discussion, relating as it does to the dynamics of the bidding process, would have to be on confidential basis and subject to Part 9 of the Enterprise Act 2002.

<sup>7</sup> Except in the very specific circumstances of the Thameslink, Southern and Great Northern franchise where revenue risk was retained by the Department due to the uncertainties of the Thameslink programme and the consequent difficulty in forecasting and managing revenue.



### East Anglia – Invitation to tender

The tender emphasises:

*“The Department is seeking ambitious and innovative Bids which are also deliverable. The competition evaluates and values quality in two ways:*

- i. By offering Bidders the opportunity to meet (and, where appropriate, exceed) the Department's minimum requirements for the East Anglia Franchise (“**East Anglia**”, “**EA**” or “**Franchise**”) set out in this ITT; and*
- ii. By assessing the deliverability of the proposals put forward by Bidders based on the evidence they have provided.”*

with the scoring system specifically considering, amongst other things:

*Initiatives to enhance the quality and reliability of the Train Fleet substantially beyond the requirements set out in section (A) above such that, in the Department's reasonable opinion, the requirements of Schedule 7.1 (Performance Benchmarks) of the Franchise Agreement are likely to be significantly exceeded;*

*Initiatives to develop, test or implement new and emerging technologies within the Train Fleet, where such technologies have clear potential to benefit the Franchise and its passengers and could be transferable to the wider rail market (e.g. modern information management systems such as remote condition monitoring, automatic vehicle inspection and condition-based maintenance);*

*Initiatives to improve whole-industry cost efficiency such as reducing the impact of rolling stock on infrastructure;*

**Recommendation 1: Before producing any final analysis of the franchising system, the CMA should consider the approach taken in recent tender rounds, and particularly should consider the East Anglia franchise as a reflection of the steps being taken to promote innovation and should, if appropriate, provide clear evidence to demonstrate that franchisees are deterred from innovation while open access operators are incentivised.**

The DfT fully expects the franchising system to continue to evolve in the future and has in place various steps to continue to develop franchising so that it is even more successful in the future in delivering benefits for passengers. For example, DfT is taking action to improve the bidding process and attract a wider pool of bidders through a number of ongoing policy initiatives. A particularly important recent step was the introduction of a **Pre-Qualification Passport**,<sup>8</sup> which simplifies the pre-qualification stage of the process, reducing the burdens on business of participating in franchise

<sup>8</sup> <https://www.gov.uk/government/publications/rail-franchising-pqq-passport-documentation>

competitions to facilitate even more competition in the future; this is major innovation in procurement practice for franchises, which was developed in close consultation in the industry, and demonstrates that the DfT is actively searching for ways to enhance competition in the future.

The DfT strongly considers that the CMA should give greater weight to the evolution of the franchise system, and considers that, if the aim is to ensure that passengers are better served in the future, the CMA should consider steps to further encourage competition within existing frameworks, rather than speculative steps, which may lead to adverse consequences for taxpayers and railway investment. This would include measures to ensure more effective competition for the market, for example by working with the DfT to ensure that it is possible to have an effective competition for each franchise.

**Recommendation 2: Before producing any final recommendations, the CMA should give greater weight to the benefits of the evolving franchising system and that, in producing any recommendations, the CMA should consider options for incremental change within the current franchise system as well as more radical options.**

### *Inappropriate comparators*

While the DfT recognises that any counterfactual is likely to have deficiencies, we consider that the deficiencies in the comparators identified in the CMA's report are considerable and serve to understate the benefits of the existing franchising system.

In particular, we note that the various comparators (UK rail freight, airlines, London airports, other EU countries) generally focus upon the benefits achieved from the introduction of any competition to a market where competition was significantly restricted. As the CMA explicitly recognises that the competition for the market is "*intense*" this is a wholly inappropriate basis for assessing potential customer benefits from further, incremental competition. For example:

- In relation to **aviation**, the most significant differences between the rail and aviation sectors in this context is the absence of any substantial public subsidy to the aviation sector (indeed, through Air Passenger Duty, the aviation sector is a net-contributor to the UK exchequer) and the lower fixed cost base in the aviation sector. These have significant implications for the competitive environment; the UK Government has a very limited role in specifying aviation services, effectively limited to a handful of public service obligation routes where the Government intervenes to maintain air links to geographically isolated regions, where the links would not be viable without subsidy. Outside of this sphere, which represents only a tiny section of the aviation industry, international treaties agreed at the ICAO and EU level prohibit Governments from any role in the specification of services. This is profoundly different in the rail sector, where the greater requirement for socially important services, and the more sharply focussed social obligations of the sector, require

more significant Government intervention. Additionally, it is important to note that rail has already adopted airline type pricing techniques, reducing the likelihood that additional on-competition would yield similar benefits to that realised in relation to airlines. Moreover, rail slot allocation generally has a greater degree of complication than airport slot allocation. It is therefore highly problematic, therefore, to use the aviation sector as a model for the rail competitive environment without first considering the differences in the funding and policy environment.

- In relation to other **EU countries**, we note that where competition in the market has been introduced, this has tended to be the first introduction of any form of competition to the relevant network (or part thereof). In those circumstances, as with the introduction of competition to utilities in the UK, it is unsurprising that has resulted in substantial welfare benefits for consumers – the dynamics of those sectors are profoundly different to the railway in Great Britain.

Conversely, we had understood, at an early stage of its work, that the CMA was considering comparisons with local buses in the UK, as an example of the potential implications of increased competition in the market. However, we note that the omission of this market from the CMA's analysis; this was somewhat surprising given that this is a particular area where the CMA has detailed experience following the market investigation reference, conducted by its predecessor the Competition Commission (CC) in 2008, and was a report where the particular issue of the effectiveness of competition in the market had been considered, with the CC concluding:

*“We found that there were factors in the market which tend to mean that head-to-head competition along a substantial part of the route is unlikely to be sustained.”<sup>9</sup>*

The DfT considers that the inconsistent use of comparators is inappropriate. Where such comparators should be used, we consider that they should have a strong analytical underpinning, be a reasonable basis for comparison and not be used on a selective basis. In that regard, we welcome the further work that we understand the CMA is considering into comparators as part of the next stage of its work.<sup>10</sup>

**Recommendation 3: Before producing final recommendations in this area, CMA should carry out more detailed analysis of the comparators used, taking closer account of the need to provide comparators which provide a more appropriate comparison to the particular circumstances of the rail sector.**

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<sup>9</sup> Competition Commission: *Local Bus Services Market Investigation* (2008) - [http://webarchive.nationalarchives.gov.uk/http://www.competition-commission.org.uk/inquiries/ref2010/localbus/pdf/00\\_sections\\_1\\_15.pdf](http://webarchive.nationalarchives.gov.uk/http://www.competition-commission.org.uk/inquiries/ref2010/localbus/pdf/00_sections_1_15.pdf). We cite this report not to show that the bus market is identical to rail, but merely to illustrate that these issues are complex and require careful consideration and detailed analysis.

<sup>10</sup> As communicated in the e-mail from the CMA to Cavendish Elithorn on the 5 October 2015.

## *Financial efficiency*

In respect of costs and fares, we have noted the material contained in Chapter 5 of the discussion paper, but consider that it overstates the efficiency of open access operations.

We welcome the fact that the CMA has drawn upon existing material, notably Sir Roy McNulty's Rail Value for Money report. However, we are concerned that the reading taken by the CMA of the McNulty Study is partial and incomplete and we have a number of significant methodological concerns surrounding the Leeds work. We set these out in Annex A and would be very willing to further discuss these issues with the CMA if that would be of assistance.

**Recommendation 4: CMA should revisit the assumptions employed in its analysis of rail efficiency.**

## **The consequences of the CMA's proposals**

In addition to overstating the potential benefits, the DfT is concerned that the CMA has not fully evaluated and set out the potential consequences of changes to the industry model.

## *Impacts on the taxpayer*

We welcome the recognition by the CMA of the potentially considerable impacts that could result from changes to the current system. Indeed, the DfT has shared specific calculations with the CMA regarding the negative implications for taxpayers of a small number of open access applications on one line in Great Britain to demonstrate the transformational impact on the funding requirements of the railway that could follow even relatively limited increases in open access operations which affect only a single line.

While welcoming this recognition, the DfT notes that the absence of any specific costed impacts is a major limitation in the discussion document. This means that consultees will be providing views without a clear and transparent calculation of the profound financial disbenefits that could flow from these options, with that information only potentially available following the ORR's impact estimation. Additionally, we note that, unlike the analysis of the potential benefits from increased on-rail competition, the CMA has not included any consideration of the impacts to taxpayers from these developments, creating a somewhat unbalanced analysis.

As we mention above, we welcome the CMA's recognition that changes should be essentially revenue neutral. However, this is clearly a very challenging goal to achieve, even with changes to track access charges. In particular, we have considerable reservations about the proposed PSO levy, particularly how it would be appropriately calculated and, equally importantly, how it would be sufficiently responsive to changing circumstances. If this is

not done correctly (should that even be possible), the fundamental framework for financing the railway would be altered with potentially significant consequences for passengers and taxpayers. Additionally, we consider that such an approach is likely to add further complexity to what is already a complex system of financial flows, which it is difficult to see being beneficial, and potentially impacting on industry incentives. Indeed, this approach would appear to carry a far greater degree of inherent complexity than the current franchising model. We look forward to the ORR's impact estimation on this issue.

### *Investment*

The DfT is also particularly concerned that the discussion paper appears to have taken a narrow approach to the assessment of passenger benefits, not placing sufficient weight on broader issues, most particularly rail investment, which the current system strongly supports through providing critical funds to support the Government's programme of transformational investments in Great Britain's railways.

For example, the business case for major investments such as the Intercity Express Programme (for more details on which, see the box below), which will have a transformational impact on rail travel on some of Great Britain's most heavily used routes, will be significantly negatively affected by major open access operations.

This is because when making an investment decision the Department takes account of the potential for the new revenue generated to off-set, to some degree, the investment costs. If an open access operator enters and captures this revenue it can have a dramatically negative impact on the investment case. In addition the Department considers a variety of non-revenue related benefits, which an open access operator will ignore, when determining the value for money of an investment. Finally the Department tends to have a longer term outlook than a commercial operator does when considering the case for investment.

What this means in practice is that the Department will make investments which are good for passengers and wider society that a purely commercial operator would not make, and that purely commercial decisions about what services to run will undermine the case for these investments.

**Recommendation 5: The CMA should show how a level playing field can practically be created to reimburse rail investment.**

### The Intercity Express Programme

- ▶ IEP is renewing the life expired trains of the East Coast and Great Western fleets, which were first introduced in 1976.
- ▶ 27.5 year / £5.7bn contract with Hitachi Rail
- ▶ IEP is a long term value for money solution:
  - ▶ **Environmentally better**– Over 40% less CO<sub>2</sub> than an existing intercity train.
  - ▶ **Faster & more frequent** – upgraded timetables start in 2019/20
- ▶ On the **Great Western Line** IEP will result in 40% more peak time seats, increase in frequency and improved journey times. On the Great Western east of Reading where track capacity is saturated, IEP will be much faster off the mark than an HST delivering more capacity on a very restricted but growing part of the network. On the **East Coast Mainline** IEP will result in 28% more peak time seats, increase in frequency and improved journey times. The performance characteristics enable it to accelerate faster from restricted speed areas such as the tight curves which are a feature of the East Coast north of Darlington

### *High speed rail*

Additionally, Government is strongly committed to the HS2 project, which is a vital part of its strategy to modernise the UK's transport infrastructure, support economic growth and rebalance the economy.

The business case for HS2 is seeking to ensure both the optimal use of the new high speed line and also the use that might be made of released capacity on the existing network. Any future strategy for rail competition will need to be reflective of these aspirations, value for money, and affordability. Critically, the case for HS2 relies on generation of an operating surplus, to offset the loss in revenue on the existing network and (partly) the construction and operating costs, and it would be extremely difficult to fund HS2 if such a surplus were not to be expected. However, presently the CMA sees this development as a means to free up capacity for other operators without explaining how the Government is to be held financially neutral.

A more detailed note on HS2 issues arising from the discussion paper is included at Annex B.

**Recommendation 6: CMA should revisit its approach to the impact of changes on critical, transformational investment in the railway, taking more account of it in the analysis**

## *Operational, capacity and performance implications*

As you will appreciate the railway operating environment is a highly complex one, with changes of the type potentially recommended by the CMA potentially leading to considerable implications for the effective use of capacity and the operational performance of the railway. In particular, the options being considered by the CMA could have the following adverse consequences of the type we have previously discussed and which are discussed in the CMA's discussion paper.<sup>11</sup>

- Inefficient use of capacity, due to the potential for a multiplicity of operators, with more varied journey times and stopping patterns, and using a wider range of rolling stock with different performance and reliability characteristics.
- Additionally, under a system where more competing operators were sharing a busy section of infrastructure, decisions on how to respond to disruption, for example in cancelling a block of services to enable recovery of normal operation, or introducing significant new services would become more difficult to manage due to the conflicting commercial interests involved.

We continue to consider that these give rise to considerable, real world impacts on performance. For example, on the **Brighton Main Line**, which the DfT considers that the CMA should consider in detail, the legacy of multiple competing operators has resulted in an inefficient timetable, poor operational performance (as well as a complex and in some respects confusing fares structure). Additionally, we would caution the CMA from placing undue weight on the evidence it cites in its discussion document that PPM on the East Coast Mainline improved following the introduction of open access services on that line; it is important to note that PPM improved considerably nationally during that period.

Additionally, it is important for the CMA to recognise that, unlike with franchised operators, there are no effective levers for the DfT to amend or remove an open access service which is producing particularly severe performance impacts creating risks of long term performance risks for the network.

Moreover, as identified above, it is the income provided by the franchised services that enables the funding of infrastructure investments to relieve capacity constraints. Under a different competitive system which reduced these incomes, Government's ability to invest would be constrained, creating long term capacity challenges.

We would welcome a further discussion with you on these operational and performance issues as you progress with your analysis.

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<sup>11</sup> CMA discussion paper, paragraph 6.40

**Recommendation 7: CMA should engage more closely with the real world potential operational impacts of increased competition alongside any final recommendations and should evaluate in detail the effects competition in the market has had on performance in the existing rail network and explain how risks would be managed.**

## Commentary on options

Owing to the reservations outlined above regarding the evidence base for and analysis within the discussion paper, we do not believe it would be practical to offer a fully detailed commentary upon each of the options put forward for consideration at this time. However, to assist the CMA, we have included a high level commentary on each of the options, which can be found at Annex C.

Additionally, we consider that it is important that both we and other consultees are given a further opportunity to provide comments on these options once the ORR has completed the impact estimation of them, so we can take full account of the ORR's findings when responding to the CMA.

## Conclusions

The privatised railway has proved remarkably successful at producing benefits for passengers and taxpayers. An evolving and flexible franchising system has been key to this success. We recognise that the current system is still evolving, but any attempts to improve it must be carefully designed so as not to compromise the benefits that have already been achieved, and must fully recognise and address the need to protect taxpayers and facilitate the smooth operation of the railway. The rail industry also has some unique and complicated features which also must be reflected in any changes to the competitive environment.

We very much welcome appropriate steps to further improve competition which recognise the particular dynamics of this complex industry – indeed we have led the development of the most liberalised railway system in the EU. However, we believe that limitations in the analytical approach mean that substantial further work is required in this area (either by the CMA or another body) to present a practicable set of options for further improvements which can provide a strong basis for consideration of options. We consider it will be necessary to involve those with knowledge and experience of railway dynamics to be closely involved to ensure practicable options are developed. This should include, for example, the CMA considering how this work could best be fed into Nicola Shaw's ongoing review of Network Rail's structure and finances.

Additionally, DfT would welcome the opportunity to work with CMA, so as to align it with work that is ongoing across the wider rail industry, and with the ORR as part of the impact estimation work. We would suggest that a workshop early in the New Year might represent an effective means of taking this forward.



We should also be very happy to discuss further any of the issues covered in this response.

**On behalf of the Secretary of State for Transport  
October 2015**

## Annex A: Commentary on the CMA's econometric analysis

The DfT has considered the CMA's econometric analysis in relation to efficiency. We believe CMA have characterised one of the study's findings particularly misleadingly:

- **CMA's focus on differences in input prices between Open Access Operators (OAOs) and Franchised Operators does not account for the specific characteristics of individual current operators.** For example, in order to operate 125mph services on the West Coast Main Line operators need to use tilting rolling stock, which has higher capital and operating costs than the non-tilting rolling stock used on the East Coast. This means that open access services (which are currently only operated on the ECML), appear to have lower rolling stock costs than franchised services. However, the comparison is misleading: if there were open access InterCity services on the WCML their rolling stock costs – and therefore raw input prices – would be much higher.

In addition, we also consider that the econometric analysis includes a number of significant limitations which substantially reduce its relevance in providing an appropriate indication of likely efficiencies, including:

- **We do not consider that the analysis has accounted for all of the differences between Open Access Operators (OAOs) and franchised operators.** As the CMA is aware, OAOs are free from certain specification requirements which should go some way towards explaining the cost differential between the operators. Failure to account for all of these differences could result in biased estimates of the “open access business model” effect. Additionally – as we describe in the main response – the decision to specify is associated with certain economic and social benefits, which the market alone would not deliver. A decision to simply remove these benefits could have considerable passenger disbenefits.
- **The scenario analysis assumes that the “open access business model” effect doesn't decline with size.** When the OAO market share size grows in the scenarios tested, the analysis assumes the relative efficiency of OAOs vis-à-vis franchised operators remains constant. However, if the reason they could generate these savings relates to the small nature of their operations and knowledge of specific markets, we would expect this effect to decline as they get larger. Failure to account for this in the scenario analysis of potential efficiencies could significantly overstate the benefits from expanding the presence of OAOs on the Network.
- **The scenario analysis assumes that OAO input costs don't decline with size.** The paper notes that OAO input prices are 29% lower than intercity franchised TOCs. This means the input prices they face in the scenario analysis are much lower than for franchised TOCs. However, this seems unlikely if the OAOs are expanding their operations so considerably, especially in the scenario where the entire market is

growing. Indeed, we note that the researchers actually acknowledge this without making any appropriate adjustment, noting that: *“the difficulty with this [assumption] is that as they grow larger in the UK, where the input markets are limited due to the physical dimensions of the infrastructure, these benefits [from lower input prices] may well disappear.”*<sup>12</sup> Again, failure to account for this in the scenario analysis could significantly overstate the benefits from expanding the presence of OAOs on the Network.

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<sup>12</sup> Leeds University: *Econometric Analysis of efficiency gains from on rail competition* (2015) - [https://assets.digital.cabinet-office.gov.uk/media/55a8cde240f0b6156000000b/Econometric\\_analysis\\_of\\_efficiencies.pdf](https://assets.digital.cabinet-office.gov.uk/media/55a8cde240f0b6156000000b/Econometric_analysis_of_efficiencies.pdf)

## Annex B – HS2

### Summary

- The HS2 project includes an approach for utilising capacity which will be released on the existing network when phase 1 opens in 2026.
- The process of service development, which is already underway, draws on inputs from a wide range of stakeholders to deliver optimal use of the existing and HS2 network.
- Using capacity in the best way is an important part of delivering the benefits of HS2. These benefits are envisaged to be distributed widely for different groups of passengers, reflecting the taxpayer's funding of the project.
- The future commercial contractual model for franchises operating on affected parts of the network has not been set at this stage in the project. However, some commercial options would not be consistent with the CMA's aims for on-rail competition.
- If released capacity is used for competing services, there is potential for the forecast revenues and benefits of HS2 to change, which could present a material risk to the value for money or affordability of the scheme.

### Using the released capacity

1. The CMA's discussion document makes reference in several places to the creation of additional capacity by HS2 (and other projects). The assumption in the discussion document is that this capacity provides scope for a significant increase in competing operations.
2. However, when HS2 Phase 1 opens in 2026 it is not intended that it will create scope for train operations designed primarily to compete in the way that the discussion document appears to envisage. This is because the Government plans to use capacity released by HS2 for train services designed to meet specific national and regional travel needs. Delivery of the benefits of HS2 requires Government to secure economic and connectivity benefits from the services operated on the conventional network as well as on the high speed lines. Operation of competing services would weaken the case for investment in HS2 as well as likely having an on-going detriment to the taxpayer.
3. The Strategic case for HS2 (November 2013) forms the basis of the hybrid Bill for Phase 1 of HS2 which Parliament voted in favour of at second reading. In the Strategic Case, Government sets out the following high level principles for planning the use of the released capacity that HS2 delivers:
  - an aim that all places with a direct London service retain a broadly comparable or better service after Phase One opens;
  - to provide additional commuter capacity where it is most needed;

- to spread the benefits of long distance and inter-regional services to the many towns and cities that can be served by the capacity created on the existing rail network;
  - to fully integrate Phase One services into the wider national rail network;
  - to provide capacity for the growing rail freight sector; and
  - to improve performance by making timetables more robust.
4. The Government has committed to carrying out service planning for 2026 and beyond in an open and transparent way with inputs from a range of stakeholders including passengers, the industry and local authorities. This work will ensure that the new high speed services operate alongside a carefully planned and procured pattern of franchised passenger services on conventional rail.
  5. The projected released capacity service pattern for the West Coast main line includes more stops on many services to increase connectivity, and less intensive use in order to ensure higher reliability than at present.

#### ***On-rail competition and post HS2 services***

6. In broad terms, a “high on-rail competition” service design for the post-HS2 network will differ significantly from one designed to meet the principles which the Secretary of State has adopted.
7. Instead of seeking to deliver the wide spread economic benefits envisaged in the business case, a competitively generated service pattern would tend to concentrate capacity on the most commercially viable intercity flows. Specifically, a drive to increase competition between conventional rail and HS2 would be likely to duplicate services for the main intercity flows already served by HS2, rather than release capacity for other uses such as regional connections or continuation of existing links. This could potentially provide excellent quality and cost for a small number of high yield, intercity markets – where passengers could choose between high speed and conventional rail. But there are major risks it would fail to deliver opportunities and benefits for other markets or indeed reduce current provision overall.
8. Whilst on-rail competition has not been adopted as a service planning objective for the post-HS2 network, passengers will certainly have choices about how to travel on some parts of the national network. The Government would expect some degree of on-rail competition to arise between operators which is likely to become evident over time.

#### ***Commercial models will affect operator incentives***

9. Operators (both HS2 and conventional rail) will not be operating on a ‘steady state’ railway for a significant period of time. Phase 1 opens in 2026 and phase 2 in 2033. Services on all relevant flows over a long

period will be subject to high revenue uncertainty, and potentially major timetable changes.

10. Devising commercial models to allow franchisees or other operators to take genuine competitive risk in this environment while securing value for money for the taxpayer would be highly complex. In a period of significant change operators would have very limited incentives to respond to on-rail competition. In general the options suggested for on-rail competition tend to underplay the challenges which would arise during periods of change and associated uncertainty – which are extremely common on the GB rail network.

## Conclusion

11. Officials are keen to assist the CMA in understanding more about how the Department believes its plans for HS2 will deliver the best outcome for a wide range of passengers across the rail network.

## Annex C – Commentary on options

### *Option 1 – existing market structure, but significantly increased open access operations*

As highlighted in the main body of our response, we have substantial reservations regarding this option and believe that there are significant gaps in the evidence base in support of it at this time. Some observations are set out below.

We consider, in particular, that any increase in the role of open access operators must be contingent upon all, and not just simply some of the following factors being fully analysed and addressed:

- a fairer charging regime which reduces the current subsidy granted to open access passenger operators via their protection from fixed track access charges (and from higher levels of capacity charge),
- greater protections for taxpayers from the abstraction of revenue, including a robust, sustainable and fully effective mechanism to provide a substantial level of assurance that taxpayers, and the Government's ability to invest in rail, will not be diminished,
- protections for the Government's ability to specify that constrained capacity may be used to specify services whose primary value is social rather than commercial,
- a fuller assessment of the impacts of open access operators upon the health of the franchise bidder market, and
- a more comprehensive framework for managing the performance impacts of the increase in complexity that would arise from any increase in open access operations, accompanied by clear criteria for establishing when performance concerns would make it impractical to grant access rights to open access operators, with a recognition that the performance of the franchised operator should retain primacy.

While we would have welcomed the CMA's analysis in relation to securing these issues, which may have formed a basis for further action, we note that the analysis on how these preconditions could be met is, at this stage, relatively limited. Without each of the above points being fully accounted for and clearly addressed, any move towards the implementation of option 1 would be likely to result in negative impacts on Government funds and a consequent reduction in funds available to invest in the railway. This will directly harm the interests of customers, both passengers and freight users, who will suffer from a worsening of crowding and reliability.

Finally, with respect to the practicability of these options, we note the various comments by the CMA which suggest that they are seeking comments from open access operators about their willingness to pay full track access charges. We would caution the CMA against merely accepting comments made by open access operators, without examination of relevant information (e.g. the financial impact of such a charging structure on existing open access

operations, where applicable). In particular, we note Mr Justice Sullivan's observation, in *GNER vs ORR, Hull Trains and Grand Central*<sup>13</sup> that "[interested parties] *have made it plain that their operations would not be viable if they had to pay a fixed track charge in addition to the variable track usage charge*".

This may suggest that further competition through this route may be limited. However, the attempt to remove an open access operator granted such rights from the network, if it is later unable to pay access charges, may not be entirely straightforward and could lead to legal challenge, and uncertainty in the interim.

### **Option 2 – two franchisees for each franchise**

While we would welcome a detailed analysis of this option to take forward consideration of this issue, we do not consider that the case has been made for this option. We consider that under this option, the primary competitive pressure would continue to be exerted by competition for the market, rather than competition in the market. On this basis, we cannot see that this option would deliver substantial commercial or economic benefits, while potentially leading to risks to taxpayers as franchisees include a greater risk premium in their franchise bids, ultimately reducing the net sums available to Government for railway investment.

Additionally, we do not believe that any marginal benefits arising would outweigh the very significant overhead costs associated with the increase in franchise competitions that would result, as well as the additional complexity and inefficiency that this option would introduce into service planning and contractual arrangements (for instance relating to station management).

Moreover, we consider that by better tuning the quality scoring metrics within the current franchising system, the DfT can ensure that an equivalent pressure to improve passenger experience can be exerted without incurring those overhead costs.

### **Option 3 – more overlapping franchises**

Again, we would welcome a detailed CMA analysis of this option to take forward consideration of this issue. However, we currently consider that this option will require substantial further development to be provide the basis for a viability assessment.

There are instances where franchise overlaps work to good effect at the moment, and the option leaves discretion to the procuring authority to make a determination, taking fully into account the interests of passengers, which routes are well suited to this sort of competition (for instance because the scale of demand and service intensity is such that the market can sustain multiple operators without losing significant economies of scale). This

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<sup>13</sup> [http://www.railwaysarchive.co.uk/documents/RCJ\\_Access2006.pdf](http://www.railwaysarchive.co.uk/documents/RCJ_Access2006.pdf)



approach does tend to point towards relatively tight train service specification, particularly because the 'socially necessary' level of service that government specifies for social and economic reasons may occupy the entirety of the capacity on certain routes. In the absence of clearly-specified requirements for both franchises, there would be a danger that both franchisees would chase the most lucrative routes and leave social needs unmet. Additionally, from the DfT's experience of the period where there were considerable overlapping franchises, before the adoption of the SRA model from 2001, it is important for the following issues to be taken fully into account.

- **Performance suffered due to sub-optimal timetables and allocation of rolling stock leading to adverse outcomes for passengers.** The SRA intervened and had to pay operators to remove services due to network congestion and performance difficulties caused by operators receiving approval for services which in practice were a performance risk. These services had been approved by NR and ORR.
- **Daily operational performance suffered due to multiplicity of operators.** This was a function of NR having to deal with multiple operators on the same route.
- **Making timetable or rolling stock changes that benefit passengers take longer.** This works on two levels. Firstly changes such as tweaks to timetables, improvements to connections and reallocating rolling stock can be taken by a group of decision makers at a train operating company. There is no need to meet, discuss and then negotiate with another train operating company or change a contract or involve ORR. Secondly, more substantial contract and service changes with the DfT can be implemented more easily when there is a single train operating company covering a wider area. Finally, major infrastructure upgrades such as Great Western electrification are likely to be easier to manage than when many operators are involved. It is not a steady state railway.
- **More and overlapping franchises would make other policy objectives more difficult:** In particular:
  - **Deep alliancing to realise efficiencies** as per South West Trains and Scotrail may become less likely
  - **Fares Simplification** would become more difficult
  - **Infrastructure investment** as there is greater risk of free-riders and more complexity in planning and implementation

Some further real world examples of challenges regarding this option could be provided from a recent tendering process (subject to the agreement of the CMA that they would be treated in the strictest of confidence).

**It is important to note that such issues could be the subject of further work to examine whether these issues could be effectively addressed in an effective and efficient manner. However, this work has not been done at this time making decision making on the back of this speculative**

#### *Option 4 – licensing multiple operators, subject to conditions (including public service obligations)*

The DfT is concerned that this option would be excessively complicated to implement.

Variant (a) would appear to involve a single controlling mind defining a set of timetables for the overall network, and then carving the full list of services into packages: an operator seeking a lucrative service would also have to take an unprofitable one. This seems to undermine potential innovation benefits, as the fundamental design of service structures is determined by the central authority. Defining the paths centrally in this way also limits operators' rolling stock choices: if operating particular paths, the operator would have to use rolling stock that is of sufficiently high performance to achieve the timetable, and there would be no point using anything better. We have seen various instances where franchise bidders (or franchisees) have developed timetables that are better for passengers; such market-driven innovations would be stifled in this centralised model.

The intention appears to be that paths would be allocated by auction / trading. We consider that the difficulty with this is that the cost of operating a particular train service is fundamentally dependent upon what other services are in operation. So in practice a franchising authority would have to auction packages of slots – in effect, tightly-defined franchises.

The idea that bidders could work out their own preferred packages of slots, and submit bids for those packages, is thoroughly unworkable. The inevitable result is that some slots will be in multiple bidders' packages and others not bid for at all. Such a process will not result in a set of bids for slots that are mutually compatible and arguably significantly more complex and costly than the existing franchising process.