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Response

## **Rail competition**

CMA consultation

**October 2015**

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## Table of Contents

<b>1. Introduction</b> .....	<b>2</b>
Background – devolution of rail franchising powers.....	2
Our understanding of the CMA’s consultation paper .....	3
Our position .....	4
<b>2. The value of open access operations</b> .....	<b>5</b>
<b>3. Financial versus wider economic objectives</b> .....	<b>6</b>
<b>4. Tax-payers’ funding and value for money</b> .....	<b>6</b>
<b>5. Operational planning and network performance</b> .....	<b>7</b>
Demand v capacity growth .....	7
Efficient use of capacity .....	8
Value for money .....	9
<b>6. Our views on the proposed options for reform</b> .....	<b>9</b>
Option 1 .....	9
Options 2 and 3.....	9
Option 4 .....	9

## 1. Introduction

- 1.1. **pteg** represents the six English Passenger Transport Executives<sup>1</sup> (PTEs), and successor bodies such as Combined Authorities, which, between them, serve more than eleven million people in Tyne and Wear, West Yorkshire, South Yorkshire, Greater Manchester, Merseyside and the West Midlands. Nottingham City Council, Transport for London (TfL), the West England Partnership and Strathclyde Partnership for Transport (SPT) are associate members of **pteg**, though this response does not represent their views.
- 1.2. PTEs and Combined Authorities are the main strategic transport planning bodies outside London. They plan, procure, provide and promote public transport in some of Britain's largest city regions, with the aim of delivering integrated public transport networks accessible to all.
- 1.3. We have responded to ORR's consultation on this topic in 2013 and welcome the opportunity to engage with the CMA's on-going work.

### Background – devolution of rail franchising powers

- 1.4. Our members have long been involved in the development of local and regional railway networks, and we therefore understand the vital contribution which modern, integrated public transport can have in supporting economic growth. However, funding and spending decisions made by central government and Network Rail have not always kept up with the pace of growth in city centre economies and its impact on rail demand. As a result, train services in the Midlands and the North of England now have some of the highest levels of crowding and some of the oldest and least reliable rolling stock in the country.
- 1.5. Against this background, **pteg** has campaigned for greater devolution of rail franchising powers as a means of achieving higher levels of investment and of ensuring that public funding supports the development of city region economies in the most effective way. We believe that local transport authorities are better placed to specify and manage franchise contracts, and to engage with the infrastructure provider, than remote civil servants. These arguments are recognised by central government and good progress is being made towards devolution of franchising powers in the North and in the West Midlands, building on the successful examples of Merseyside, London and Scotland.
- 1.6. Rail North, the new client body responsible for the Northern and Trans-Pennine franchises due to be awarded later this year, has now been formally established as a partnership between DfT, PTEs and other Local Transport Authorities (LTAs) in the North of England, supported by an executive team based in Leeds. It is expected that the current partnership arrangements will help Rail North develop its capacity and capability, with the expectation that, following this transition period, rail powers will be fully devolved to local stakeholders in the North of England.
- 1.7. A similar proposition is being developed in the Midlands under the banner West Midlands Rail (WMR). At present, WMR is a partnership of all the upper tier authorities in the West Midlands region. The initial objective is to move towards a formal partnership arrangement with the DfT, similar to Rail North, which would award and manage the next London Midland franchise, due to begin in 2017. In time, the intention is for the Inter-City and West Midlands

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<sup>1</sup> Some PTEs have been abolished with their functions transferred onto successor bodies, such as Combined Authorities. In this response, we take PTEs to mean both single purpose metropolitan transport authorities and their successor bodies where relevant.

commuting services currently operated by London Midland to be split into two separate franchises, with WMR taking over as the single client for the local network.

- 1.8. More detailed information, including a redacted version of the partnership agreement between Rail North authorities and the DfT, can be found on the Rail North and West Midlands Rail websites, [www.railnorth.org](http://www.railnorth.org) and [www.westmidlandsrail.com](http://www.westmidlandsrail.com).
- 1.9. On the infrastructure side, LTAs in the North of England are being given the opportunity to influence future funding levels and investment priorities across all transport modes, under the Transport for the North initiative. A similar discussion with government has also begun in the Midlands, under the name Midlands Connect. The long term strategies developed by Rail North and West Midlands Rail will form key inputs into these processes.

### **Our understanding of the CMA's consultation paper**

- 1.10. For the purpose of clarity, in this section we summarise below our understanding of the key points in consultation paper.
- 1.11. The CMA believes that there would be a number of benefits from a greater degree of on-track competition, including:
  - more innovation
  - better quality of service
  - improved use of available capacity
  - lower infrastructure costs
  - lower operating costs
  - happier (if lower paid) train operating staff
  - lower fares
  - greater passenger satisfaction
  - higher patronage.
- 1.12. However, the CMA also acknowledges that there could be some problems in both achieving a greater degree of on-track competition and as a result of it, for example:
  - Current capacity constraints on the network currently limit the practical scope for actual new entry by open access operators;
  - Revenue abstraction from franchised operators would decrease premium payments to government;
  - The risk of open access entry could inflate bid costs;
  - Open access operators would typically be below the minimum efficient scale (ie, they would be small and hence benefit less from economies of scale than franchised operators);
  - The financial viability of rail operations could be reduced with a higher rate of bankruptcy as a result;
  - Open access operators would be free-riding on past investment, implying a decrease in available funding for future infrastructure improvements;
  - Cream-skimming of profitable routes with a reduction in the amount of money available for subsidised services;

- More competing operators would make network planning/operation more complex, decrease reliability, and make it more difficult to recover from disruption;
- There could be bottlenecks in the rolling stock market, preventing open access operators from sourcing required trains;
- More limited supply of inter-available tickets.

1.13. The consultation document discusses most of these points and largely concludes that most of these issues could be ultimately overcome or otherwise mitigated in some way.

1.14. Having concluded that more on-track competition is both desirable and achievable the CMA then sets out four options for how this could be achieved in practice:

1. Remove the 'primarily abstractive' test (meaning any open access application would be accepted provided a train path could be identified) and require open access operators to make a greater contribution to the cost of infrastructure and of subsidised services.
2. Create directly competing franchises (i.e., split the timetable currently operated by one franchisee between two companies)
3. Redesign the franchise map so as to increase the degree of overlap between different franchises
4. Move from a franchising to a licensing regime (in simple terms, this is analogous to the deregulated bus market, although track capacity means the system would probably be more static in practice and based on something akin to grandfather rights, as used to allocate airport capacity).

1.15. The CMA emphasises that these are intended as long term proposals aimed at inter-city routes (East Coast, West Coast, Great Western), and that they are not intended to apply to commuting services.

### **Our position**

1.16. While we agree that on-track competition can potentially deliver some of the benefits claimed in the consultation document, we largely disagree with the CMA's assessment of the likelihood that the obstacles and negative implications identified by the CMA can be overcome. We feel that the CMA has taken an overly optimistic view of the impact of on-track competition, based on a skewed interpretation of the evidence obtained to date.

1.17. In our view, it is neither feasible nor desirable for open access operations to play a substantially greater role in the delivery of rail services in Great Britain. Fundamentally, we believe that a greater degree of on-track competition would increase uncertainty and industry costs, it would hinder progress towards greater devolution of franchising powers in English city regions and it would also make it more difficult to deliver the integrated public transport networks which underpin the growth of city region economies.

1.18. We discuss these issues in more detail in subsequent sections, which are structured as follows:

- Section two discusses the advantages and disadvantages of on-track competition from a passenger perspective
- Section three discusses the trade-offs between financial and economic objectives, noting that substantial economic externalities are intrinsic to the existence of the rail network.

- Section four discusses the implications of on-track competition for public finances and the value for money of public spending.
- Section five discusses the implications of on-track competition from an operational and network performance perspective.
- Section six gives our views on the four proposals in the consultation document.

## 2. The value of open access operations

- 2.1. **pteg** accepts that on-rail competition can produce benefits where it acts reduce fares, increase service levels or introduce product innovations. In particular, we recognise that open access operators have in some cases widened the range of destinations available from certain areas served by our members.
- 2.2. However, it also needs to be recognised that greater on-track competition can lead to a more fragmented network, growing confusion amongst passengers, and hence a worsening perception of the rail product.
- 2.3. Industry research shows that passengers value a more frequent service, not only on local commuter networks but also on longer distance routes. It is also true that many passengers rely on interchange between different services in order to get to their final destination. The ability to get on the next available train, the possibility of coordinating ticketing and timetables between different operators and the offer of guarantees over missed connections are important features of a well-coordinated network, which the current franchised system is able to offer to some extent and which we would like to see strengthened and developed. However, these features are often lost under open access and can be more difficult to achieve when a single operator is replaced with two or more overlapping franchises.
- 2.4. The consultation document points to some evidence that new entry by open access operators has had a number of positive effects, in particular on patronage. No one would dispute that the introduction of new direct links, more frequent, cheaper or faster services does increase patronage at those stations where these effects are felt, whether services are operated by open access, franchised or government owned operators. However, this does not necessarily mean that, either the network-wide effects are positive, or that the same effect could not have been achieved more effectively through the existing franchising system or other regulated models.
- 2.5. In our view, the evidence considered by the CMA is inconclusive at best and more work needs to be done, both to evaluate the local impact of open access operators and to understand the network wide impacts of on-rail competition. Although the CMA has chosen to focus its attention on evidence supportive of on-track competition and of open access, our members have quoted evidence pointing in the opposite direction, which we would be happy to discuss with the CMA if this would be of value.
- 2.6. Where open access operators have been found to out-perform franchised operators, we feel that it would be more useful to try to understand the underlying factors explaining this difference rather than simply to attribute it entirely to open access and move to recommend changes to the regulatory framework. As the CMA itself recognises, its proposals are long term. The franchising system (or some alternative regulatory mechanism for controlling network access) is likely to remain the dominant framework in any event. If there are ways in which the franchising system could be improved in the short term to better meet the needs of passengers, then this is surely something we should be focussing on.

- 2.7. In summary, we do not take it as given that more on-rail competition is always in the best interest of passengers and believe that there is the need for a regulatory mechanism to mediate the interests of train operators, other rail industry stakeholders and passengers.

### **3. Financial versus wider economic objectives**

- 3.1. Some of the proposals put forward by the CMA hinge on the assumption that all costs and benefits of open access services can be internalised. Put simply, passengers pay to get on trains, operators then use this revenue to cover their own operating costs, to compensate other operators for abstracted revenue (if any competing franchised operators remain) and to make a contribution towards infrastructure costs. In this scenario, passengers' willingness to pay encompasses the full economic value of the rail service, no subsidy or entry tests for open access operators are required and an efficient outcome will follow.
- 3.2. We believe that there are two main flaws with this argument:
1. As we argue in our 2014 report 'A heavy load to bear'<sup>2</sup>, all service groups are in receipt of a degree of government support, once full infrastructure costs are taken into account. This means that, without some form of government intervention, there would be no railway.
  2. Farebox revenues only capture a portion of the economic value of the rail network. As we show in our reports 'The economic value of rail in the North of England' and 'Destination growth'<sup>3</sup>, rail networks generate considerable positive externalities, mainly in the form of reduced congestion for other transport users and of wider economic benefits linked to agglomeration and increased productivity. These externalities are intrinsic to government support for the railways and play a key role in franchise specification, capacity allocation and new investment decisions. The role of externalities can vary significantly between services. In the case of short distance commuting trips into the centre of large urban areas they can significantly outweigh fare-box revenue. On the other hand, they are likely to make a relatively small proportion of total economic benefits for long distance journeys between smaller towns or cities.
- 3.3. Any system that sought to focus purely on financial, rather than economic, incentives would inevitably lead to sub-optimal decisions and a worse overall outcome for society. In practice, such an approach would likely skew investment and capacity allocation decisions in favour of some inter-city routes over commuter and regional services, thereby contributing to increased congestion, lower productivity and lower economic growth in large urban areas. As we see it, discussions over the regulatory framework which governs the railways cannot be had without consideration for the wider objectives which the railways are trying to meet.
- 3.4. Given these considerations, we believe that it is important for the existing system for evaluating open access applications to remain. We are also opposed to measures which would replace broader economic criteria with narrower financial incentives in the context of industry decision making processes, including investment and capacity allocation decisions.

### **4. Tax-payers' funding and value for money**

- 4.1. As set out in the introduction to our response, local authorities in the North and the Midlands are in the process of obtaining greater powers over the planning and delivery of local rail

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<sup>2</sup> <http://www.pteg.net/resources/types/reports/heavy-load-bear-towards-fairer-allocation-rail-industry-costs-regional-rail>

<sup>3</sup> <http://www.pteg.net/resources/regional-rail>

services in the West Midlands and the North of England. This process will ultimately result in PTEs, Combined Authorities and other local government bodies having a much more significant financial stake in the running of the railways.

- 4.2. As such we have a keen interest in both reducing rail industry costs and in managing the different types of risk which franchised operators and, ultimately, franchising bodies are exposed to. The regulatory framework governing on-rail competition could have an important impact in both areas and we feel that this needs to be more fully acknowledged and understood.
- 4.3. As set out in the consultation document, open access operators can, and generally do, abstract revenue from franchised operators. One way or another, this ultimately results in higher public sector costs, either in the form of higher subsidy requirements in-franchise or as the result of financial failure on the part of the incumbent franchised operator. This higher burden on tax-payers may reduce the value for money of the franchise services purchased, and could represent a worse outcome for society.
- 4.4. One way to address this issue is for open access operator to compensate other stakeholders for the loss of revenue incurred and this is a proposal which we would strongly support.
- 4.5. However, what is of real concern to us is the fact that merely the possibility of new open access entry would drive up the cost of franchise bids, as operators seek to build this risk into their financial forecasts. This would effectively make the railways more expensive for no apparent gain. It is important that the CMA takes into account the impact of regulatory changes on this type of financial risk and its knock-on effects on operator behaviour.
- 4.6. Similar issues would also occur in the context of overlapping franchises when not all operators are under the authority of the same franchising body.

## **5. Operational planning and network performance**

- 5.1. The consultation document argues that future investment in new infrastructure and modern signalling systems will significantly increase line capacity, thereby making it possible to meet the CMA's long term aspiration to run a much greater number of open access services on the network.
- 5.2. We disagree with this assessment and instead believe that significant open access expansion is neither feasible nor desirable from an operational perspective. Our view is based on arguments relating to demand growth, efficiency and value for money.

### **Demand v capacity growth**

- 5.3. Although network capacity will continue to increase over time as the result of new investment, so will demand. The consultation document implies that new technology and infrastructure will create spare capacity which will be left free to be taken up by new open access operators. However, there is no quantitative analysis to show that capacity expansion will outpace demand growth.
- 5.4. In fact, many routes in the North of England and the Midlands are already severely overcrowded and, in general, investment in new capacity has largely lagged behind demand growth. Analysis by Network Rail suggests that demand on regional rail networks could more than double over the next three decades and we therefore can't see how there is likely to be



any significant spare capacity to the destinations, and at the times, that people most want to travel to.

- 5.5. Given infrastructure constraints, a substantial proportion of the expected additional demand will need to be catered for by franchised operators, through train and platform lengthening, rather than through additional train services. Where capacity for new services is to be provided, most of this is likely to be ear-marked for new franchised services to cope with anticipated patronage growth.
- 5.6. The consultation document points to the introduction of modern signalling systems as a new development which will significantly enhance line capacity on long distance routes. While this may well be the case, capacity at the largest stations remains the key bottleneck in many parts of the network. And finding a path through regional networks will remain challenging in any event, given the mix of fast and slow services and the degree of overlap between many routes.
- 5.7. Yes, it is possible that some spare capacity will continue to be available during off-peak periods and at under-served stations, which could be usefully be taken up by open access operators but the fact remains that there are unlikely to be enough gaps for open access to ever serve more than a very small proportion of the overall market.

#### **Efficient use of capacity**

- 5.8. One way in which capacity can be increased without new investment is by optimising the design of services, routes and timetables. This can be particularly important where there is a mix of services and complex service patterns.
- 5.9. One very simple example that illustrates this point is that a one 10-car train requires half the infrastructure capacity of two competing 5-car trains, while providing a broadly similar level of passenger capacity.
- 5.10. The consultation document suggests that open access operators can make a positive contribution to this process by identifying gaps in the timetable. While it is true that individual operators can probably help at the margins, producing a timetable which maximises capacity is a highly complex task which requires a significant degree of central planning and coordination between stakeholders. The process also needs to be guided by a prioritisation framework which takes into account both financial and wider social and economic objectives.
- 5.11. The process which we describe in the previous paragraph seems far better suited to a franchising regime, which implies a considerable degree of planning and stability, than to an open access approach. We believe that a decentralised timetable planning approach implied in an explicit move towards open access would necessarily make a less efficient use of available capacity.
- 5.12. It also seems obvious to us that a timetabling strategy which had the explicit objective to allow for a significant proportion of unallocated capacity, in the event of an open access operator deciding to step forward, would, by definition, represent an inefficient use of capacity.
- 5.13. Finally, the timetabling process is likely to become increasingly complex as the number of separate operators, and the degree of overlap between their network of services, increase.

### **Value for money**

- 5.14. Rail infrastructure is an expensive asset. It also represents a sunk cost which cannot be recovered once it has been incurred. This means that (1) the strategic planning process has a vital role to play and (2) investment decisions require a good estimate of future service patterns in order to determine the likely return of alternative options.
- 5.15. The implication of these arguments is that there is unlikely to be a significant degree of spare capacity as the result of new investment (otherwise these schemes would not represent good value for money) and that, in order to justify future investment decisions, there needs to be a credible commitment by train operators or franchising authorities towards a long term service plan.

## **6. Our views on the proposed options for reform**

- 6.1. The CMA's consultation document sets out the following four options for how a greater degree of on-track competition could be achieved in practice:
1. Remove the 'primarily abstractive' test and require open access operators to make a greater contribution to the cost of infrastructure and of subsidised services.
  2. Create directly competing franchises covering a broadly similar area.
  3. Redesign the franchise map so as to increase the degree of overlap between different franchises.
  4. Move from a franchising to a licensing regime.

### **Option 1**

- 6.2. We are strongly opposed to the removal of the 'primarily abstractive' test.
- 6.3. However, we support the CMA's proposal to require open access operators to make a greater contribution towards the cost of infrastructure and of subsidised services where they are deemed to abstract revenue from franchised operators.

### **Options 2 and 3**

- 6.4. We do not believe that the consultation document has made a compelling case for the introduction of changes to the franchise map which would increase the degree of on-track competition between franchised operators. We made a number of arguments relating to passenger perceptions, the achievement of devolution and wider economic objectives, as well as public finances and operational planning which would advise against the CMA's proposals. We would suggest that these arguments are more fully explored by the CMA in its subsequent work.

### **Option 4**

- 6.5. In relation to option four, we do not believe that this is either operationally feasible or desirable, and we would therefore advise against pursuing this further.