

ATOC Response to the ORR/DfT Consultation

Introduction

Train operators accept that in providing a public service in an industry that receives significant taxpayer support, it is right that they should be held to account in meeting their obligations to deliver a good service for passengers. This consultation is about where the line of accountability should sit: with the franchising authority (ie the DfT) as at present; or with the ORR which has hitherto had a limited role in holding franchises to account. It is an important question that will have a profound impact on the ability of the rail industry to become more efficient.

We have a simple set of tests to judge whether the changes discussed in the consultation are worthwhile. Will change result in:

- Simple and clear accountabilities
- Lower overall costs
- More scope for innovation by train companies
- Better ways to manage the financial consequences of change
- A stable and predictable environment within which train companies can plan and invest
- An appropriate focus on Network Rail.

Our conclusion is that the proposals set out in the consultation, and in particular those termed an "Additional Package of Reforms", do not pass these tests.

This response represents the views of all franchised train operators.

Simple and Clear Accountabilities

Rail is a service to the public which plays an essential role in the UK economy and which benefits from significant taxpayer support. Issues of accountability must be clear and understood by everyone.

Franchises are awarded following a competitive bidding process, the outcome of which is captured in a contract setting out numerous rights and obligations for both parties. At the heart of it is a financial agreement defining flows of money one way or the other between the two parties. The regulatory architecture embedded at privatisation was that the public authority procuring and entering into the contract is also the body that holds the TOC to account for meeting its obligations.

The strength and logic of this is that it keeps regulation (in the widest sense) and financial responsibility together, ensuring that the interests of both taxpayers and passengers are balanced.

If that link was broken by introducing an expanded role for the ORR, we believe balancing the interests of taxpayers and passengers would become much more

challenging; and that the outcome would be an upward drift in industry costs. This is dealt with further in the next section.

The consultation rightly says that many of the issues covered in the consultation paper are of great concern to the constituents of MPs, and that Ministers will always face questions at the dispatch box. Given this, and the fact that Ministers allocate public money to the rail industry, we accept that Ministers must be able to speak with authority on the industry. At present the line of accountability from franchisee to DfT ensures this is the case.

We have concerns that accountability would be neither simple nor clear if the ORR is given an expanded role:

- First, “who is in charge” will depend on which franchise is being discussed. The shift of accountability will only take place when a new franchise is let. It will therefore be years before there is a clear answer to the question of accountability. Split responsibilities would be replaced by confused responsibilities. This will not be understood by passengers or their political representatives. Even in a hypothetical situation in which DfT had passed all responsibility to ORR, Ministers would still need to speak on the rail industry, ensuring that confused responsibilities would be entrenched permanently.
- Secondly, the proposal breaks the chain which links the party that specifies the franchise and chooses a franchisee through a competitive process; and the party that subsequently manages the franchise to ensure the franchisee meets its obligations. This creates opportunities for buck passing if things go wrong and in so doing weakens accountability.

Lower Overall Cost

The DfT is accountable for the cost of rail to the taxpayer. It exercises that accountability through a number of routes. First, the Railways Act 2005 established the HLOS and SOFA process to ensure that at a strategic level appropriate funding is available to achieve what the government wants the railway to deliver. Second, each time the DfT lets a franchise it makes a more detailed assessment of affordability and uses the power of open market competition to secure the best terms available for delivery of the franchise requirements. Third, its role as regulator (in the widest sense) enables it to monitor the financial performance of a franchise once let. And fourth, it is able to decide whether and if so to what extent it wishes to amend the terms of a franchise during its operation – and take responsibility for any resulting financial adjustment.

The net effect is that the DfT has considerable control over decisions at every stage of the cycle that directly impact the cost of the railway, and the ability to balance the interests of taxpayers and passengers.

We have three major concerns relating to the control of industry cost that would arise from an expanded role for the ORR:

- We believe it is extremely likely that over time, regulation by the ORR via purposive licence conditions as suggested will drive industry costs up. The reasons for this are: first, the general experience across many sectors that increased regulation leads to increased cost burdens on business - the ORR will be no different to any other regulatory body in that respect; second, the ORR will not have financial responsibility for a franchise, so will exercise its regulatory function and oversight without having to give equal weight to the interests of both taxpayers and passengers; and third, the role intended for the ORR as “powerful passenger champion” will encourage it to give more weight to passengers than taxpayers. In the rail industry the evidence is clear that improvements do not always generate sufficient additional income to result in lower net cost. They are admirable objectives in themselves, but they can come at a cost, for which the ORR will not be responsible.
- Over the life of a 15-year franchise there is a significant risk that the ORR will impose new or tightened regulatory requirements on a franchise. These will carry a cost, but it will have been impossible at the bidding stage for the franchisee to assess what additional requirements may materialise over the franchise term, and what their costs will be. So bidders will face a new and unquantifiable commercial risk, for which they will have no choice but to include additional financial provision within their bids. This will reduce the value of franchises to the government.
- This in turn will limit the DfT’s headroom for making decisions about the appropriate levels of and balance between subsidy, fares and investment.

Taken together, these three points mean an increasing, rather than a declining, industry cost base and a diminution in value to the government of franchises. We were therefore surprised that the consultation document did not have a financial impact assessment.

Scope for Innovation by Train Companies

We support the Government’s aim of concentrating on outputs and allowing the industry to develop and implement innovative and value for money ways of achieving the objective. We also support longer franchises which give TOCs more opportunity to invest in solutions which deliver benefits to passengers and taxpayers.

This aim does not require an expanded role for the ORR and greater use of purposive licences. A better way, which achieves the objective without importing the risk and uncertainty associated with purposive licences, is through smarter franchise competitions which specify the objective the Government is seeking to achieve; leaves the development of the solution to each bidder; and then holds the winning bidder to account for delivery - of outcomes, not input actions. This

ensures that innovation is fostered in a way that is consistent with overall control of public expenditure.

Managing the Consequences of Change in a Cost Effective Way

We accept that there must be effective and value for money ways of managing changes in the franchise obligations of TOCs, and we accept the mechanisms for resolving the contractual consequences of “change” need to be kept under review.

We also recognise the concerns that have been expressed about the time taken to resolve the financial consequences of changes to franchise requirements and changes arising from periodic reviews. We share these concerns because train companies find dealing with franchise changes takes a disproportionate amount of management time, and can lead to delays in improvements or other worthwhile initiatives.

However, the starting point for improving matters should not be the presumption that introducing a third party – the ORR – to the process is the answer. The parties to the franchise agreement – TOCs and the DfT – should be in the lead in finding the best way to manage the financial consequences of change, and the right approach is to provide better mechanisms under the franchise contract to achieve that. There are well-established means in wide use in other sectors that could and should be utilised in rail franchises.

This is the approach we adopted with Network Rail in our review of the operation of the dispute resolution rules covered by RIDR. It was a successful exercise which resulted in a better toolkit of techniques to help the parties reach agreements, and a more professional way of resolving disputes.

We therefore see the way forward as a joint exercise by DfT and TOCs to undertake an initial review to (a) identify current problems and their causes, and having done this to (b) consider options for effecting improvements.

A stable and predictable environment within which train companies can plan and invest

We want to see longer, more flexible and output based franchises and we want train companies and owning groups to play a bigger role in investment on the right terms in the industry. We recognise that this represents a change to the current franchising regime, and that change is therefore needed in the approach of the franchise authority as well.

Regulated utilities have periodic reviews and any changes in regulatory requirements can be reflected in the periodic review settlement. This has generally worked well in the UK. Train operators are not however regulated utilities. They do not have periodic reopeners to take account of the costs of meeting changing licence requirements over a 15-year franchise.

A significant move to purposive licences will not therefore contribute to a stable and predictable environment within which TOCs can plan and invest. Regulatory risk will be created which can be avoided through the terms of an appropriate franchise contract, and which will give a considerably more predictable environment within which a TOC can plan and invest over 15 years.

An appropriate focus on Network Rail

The ORR was established at privatisation to fill the gap resulting from the creation of a monopoly entity not subject to market forces.

The biggest challenge for the ORR is still to exercise effective regulation of Network Rail. The scale of this challenge was highlighted in the report of Public Accounts Committee, July 2011, 'Office of Rail Regulation: Regulating Network Rail's Efficiency' which concluded:

"Overall we do not believe that the Regulator exerted sufficient pressure on Network Rail to improve its efficiency..."

The ORR's prime focus in economic regulation should continue to be the regulation of the monopoly infrastructure provider, which is the part of the industry that Sir Roy McNulty identified as having the biggest efficiency deficit.

Network Rail's programme of devolution into 10 autonomous regional business units is now a big opportunity for the ORR to raise its game and to change the environment within which TOCs and NR work. Strong and effective regulation of Network Rail, aimed at improved operational performance and reduced costs, will allow TOCs to provide better customer service to their passengers, improve value for money and enhance franchise value to the DfT. There is no doubt in our mind that were the ORR to focus on that task exclusively and successfully it would be championing, in a powerful way, the passenger interest.

Train companies are already actively working with Network Rail to realise the opportunities offered by: more aligned financial objectives; greater local accountability within Network Rail; local alliances; and other arrangements for sharing the benefits which come from closer working together. The ORR, working closely with the DfT, has a central role in facilitating these objectives.

The key priorities of the ORR should not change from those it was created to address. There should be no material broadening of the ORR's role in respect of TOCs while there remains much to be done to ensure Network Rail becomes a more efficient, customer-facing organisation, and to facilitate better whole industry working.

Conclusion

We believe the proposals set out in the consultation document on the “additional package of reforms” are deeply flawed and we do not support them. Moving some aspects of franchise monitoring for some franchises to the ORR and the greater use of purposive licences will not meet the tests of success we set out above. Such a move will confuse accountabilities, put upward pressure on cost, and divert the ORR away from its central task of regulating Network Rail towards other tasks requiring commercial skills very different to those which it has.

In our view, the way regulation should apply in the rail industry is that:

- A franchising authority with accountability for the state’s financial stake in the industry should enter into output-based, flexible contracts with TOCs and hold them to account over the life of a franchise, with a high level focus on outputs and consumer interest but without excessive micro-management. This requires DfT to raise its game if it is to continue in its current role as franchising authority in a way which supports the pressing need to deliver better industry value for money;
- Independent economic regulation by the ORR should continue to be applied to Network Rail, but the regulator needs to raise its game and focus energetically on deriving as much benefit as possible from the current devolution programme and on facilitating better joint working between TOCs and NR; and
- The industry’s two regulating authorities must develop a more constructive and pragmatic relationship (there have been clear tensions ever since privatisation) in order to play their part in addressing effectively Sir Roy McNulty’s call for better alignment of objectives and incentives among the different parts of the industry. It does not require a single regulator in order to be able to do this. The consultation document is a disappointing missed opportunity to consider options through which this relationship can be better aligned, rather than transferring significant responsibilities from one body to the other.

Answers to consultation questions

1. May we publish your response?

Yes. Our response includes the answers to these specific questions, in combination with the preceding fuller commentary we have given on the general principles.

2. Please comment on the general principles against which changes in responsibility for regulation of passenger franchises should be assessed.

The general principles against which changes should be judged and our comment against each are:

- Simple and clear accountabilities. Accountability will be split under the proposals. First because the franchise proposition will be developed by DfT and then monitored and changed by the ORR; and secondly because during the transition of a decade or more DfT and the ORR will both have the same role in respect of different franchises. These will make little sense to parliament or to passengers who want to know where responsibility sits for holding TOCs to account and for balancing taxpayer and passenger interests.
- Lower whole industry costs. For the reasons detailed above, we believe the proposals would increase industry costs.
- Encouraging innovation. We believe franchise reform which allows franchise bidders to translate a funder's objectives into solutions which can be contractualised offers a more direct and better value for money way of stimulating innovation than purposive licence conditions.
- Managing change. The DfT (with TOCs) needs to improve the contractual toolkit for managing change in franchise contracts. Involvement of the ORR would be counter-productive.
- A stable environment for TOCs to plan and invest. Purposive licences by their very nature create obligations in the future which cannot be anticipated at the time of bidding. This adds to risk, and risk adds to the cost of investment and diminishes franchise value for the DfT.
- Focus on Network Rail. Holding the monopoly supplier of infrastructure to account is the most important job of the ORR. There should be no material increase in the ORR role while there is a compelling need for more effective regulation of Network Rail.

3. Do you see any potential benefits or drawbacks in moving towards giving ORR an enhanced role in respect of franchise change?

We have covered this in Question 2 and in more detail in the sections preceding these specific questions. We oppose giving ORR an enhanced role in franchise changes.

4. Are there any representations you would like to make concerning ORR's role in holding Network Rail to account?

We have covered this in Question 2 and in more detail in the sections preceding these specific questions. There should be no expansion in the ORR role while there is a compelling need for more effective regulation of Network Rail.

5. Should ORR consider any revisions to its enforcement and penalties policies if it takes on a wider role? In particular, should ORR consider how and whether it could accept commitments to make improvements for passengers as an alternative to levying a penalty?

ATOC has long believed that the inability of the ORR to use fines levied on Network Rail for the benefit of passengers is a lost opportunity. We would support any move to allow financial penalties to be used for the benefit of passengers. This does not indicate support for ORR taking on a wider role.

6. Are there any specific points on which DfT and ORR should set out their proposed approach during the transition period?

We oppose a wider role for ORR.

7. Should ORR review its funding arrangements in the light of the changes proposed in this consultation?

Under any and all circumstances the ORR should be seeking, in common with the rest of the industry, to reduce its costs and reflect those reductions in its funding arrangements.

Specific proposals

8. Do you have any comments on the proposals for regulating complaints handling procedures?

9. Do you have any comments on any of the proposals for regulating DPPP's?

Transferring responsibility for DPPP and complaint handling does not offer material benefits. It is particularly difficult to see it being value for money given the need for two expert teams- one in the ORR and one in DfT- rather than one for many years to come, and fuzziness around accountability.

Even when the refranchising programme is complete, the best that can be expected is a continuation of what happens today. At worst there is the possibility of increased regulatory intervention which will simply add cost without countervailing benefits.

We recommend a financial and regulatory impact assessment is made before a decision is made on this point.

10. *Do you agree that the regulation of punctuality and reliability performance should be brought together in one place? Could this proposal work and what refinements could be made? Are there any alternative ways of doing this?*

We oppose an expanded role for the ORR in this area. Purposive licence requirements are the wrong means for competitively bid franchises.

11. *What are the key areas that should be covered by service quality measures and commitments? How should Government decide what to include in each franchise? Is there merit in having a core set of requirements that apply to all?*

We oppose an expanded role for the ORR in this area. Service quality requirements have been and should continue to be set and monitored by the franchising authority.

12. *Please comment on the specific benefits and disbenefits of the requirements on service quality measurement and commitments being enforced by licence rather than by contract.*

We have covered this in detail in the sections preceding these specific questions. Purposive licence requirements are the wrong means for competitively bid franchises.

13. *Do you believe that the proposed licence condition would provide effective and proportionate accountability for delivery of service quality standards? Would a transparency obligation, relying on reputational incentives, be adequate? Or should it be supplemented by a compliance obligation? Should the compliance obligation be subject to doing what is reasonably practicable to deliver it, for instance through a purposive approach similar to that being considered for performance?*

See the answers above on purposive licences.

14. *What would need to be set out in guidelines to ensure credibility and consistency of reporting against service quality measures and transparency for passengers? How do we ensure that we give sufficient clarity and flexibility for franchisees in guidelines?*

We do not agree with the premise behind this question.

15. *Do you agree with the approach set out on monitoring of compliance with the service quality commitments? In particular do you think that an adapted safety management maturity model could be applied in this context?*

The management tools used by TOCs in support of the achievement of outputs are a matter for each TOC and should not be prescribed by any public sector authority.

16. *Do you agree with ORR's proposed approach for service quality commitments*

of requiring improvement plans as a prelude to formal enforcement action?

This is essentially how the current regime works, and responsibility should not be transferred to the ORR.