



## **Arriva's comments on PR13 On-rail competition consultation, June 2013**

These comments are made on behalf of Arriva plc, its subsidiary Arriva UK Trains Limited and its wholly owned train operating companies, Arriva Trains Wales/Trenau Arriva Cymru Limited (ATW), DB Regio Tyne & Wear Limited (DBTW), The Chiltern Railway Company Limited (CR), Grand Central Railway Company Limited (GC) and XC Trains Limited (XC). Arriva is a wholly owned subsidiary of Deutsche Bahn AG (DB AG).

*Q1- Do you agree that we have identified the key barriers to open access competition? Do you consider that the steps we are taking will help to address these barriers or that there are other actions we should be taking? Do you agree that, given the plans for other work outlined above, the remaining barriers imposed by the NPA test are important?*

Arriva welcomes the ORR's intentions to find approaches which support an increase in the level of on-rail competition. Evidence collated over a material period of time and by several well informed bodies has demonstrated that on-rail competition brings significant benefits to passengers, operators and funders. These benefits come in many forms as detailed in your consultation paper, but the higher level of revenue growth for both the whole industry and for individual operators evident on passenger flows where on-rail competition exists appears to reflect the cumulative effect of all these benefits impacting on the market. It would be of significant benefit to passengers, operators and funders if this effect could be unlocked more broadly in rail as it has been so effectively in other key public service sectors which were also previously dominated by incumbent regional monopoly suppliers. Increased levels of competition can appear daunting to such incumbent suppliers but once a market place has matured the widespread benefits are self-evident. With the increased maturity of the rail sector, now is an ideal time to move on from the previous regimes such as moderation of competition.

Open Access operators have been and will continue to play a part in bringing on-rail competition to the rail sector. However, on-rail competition does and will continue to exist between franchised train operations. Therefore, an overarching policy approach which creates a positive environment where on-rail competition can unlock further growth is needed. Clearly, this needs to include consideration of the franchising process as well as the regulatory process for access and access charging.

The access policy, as with any process which has to balance competing or conflicting objectives, can act as a barrier to competition. However, if the process is transparent and consistently applied, this barrier can be dealt with by operators presenting suitable access applications. Grand Central has identified an additional issue associated with the application of the current access policy in that, in order to reduce the level of abstraction associated with a new access application, significant restrictions in calling pattern are sometimes stipulated as conditions of approving access contracts. However, these restrictions have increasingly become another constraint on Network Rail's ability to develop efficient timetables which maximise the available capacity.

One area where the access policy could be improved is related to the need for applicants to get some indication as to the probability of the success of their application. Whilst it is recognised that ORR can only make a full decision once all the elements of the process are complete, it would be beneficial if applications with a high probability of being unsuccessful were highlighted earlier than is currently the case. We recommend that adjustments likely to

be made by ORR to standard industry models such as MOIRA are codified and published. We also suggest a new early stage of a draft NPA test before full details of available capacity, network performance risk are available or substantial work is undertaken on a detailed timetable.

There is no doubt that Network Rail's approach to timetabling has led to significant delay to many applications for all types of operator who have sought to operate new or revised services. In many cases, early output from Network Rail has suggested there is no available capacity, extensive conflict with existing access rights and services and significant performance implications for even simple and small scale service improvements. Subsequently, following relatively simple reconsideration of the issues, these conclusions have been found to be invalid. It is therefore essential that Network Rail's current work to improve the timetabling process is progressed with a degree of urgency.

We believe this behaviour demonstrates that Network Rail is not effectively incentivised (or such incentives as exist do not bear upon the relevant functions) and lacks corporate commitment to create and sell more capacity, in particular where this can be achieved at no cost by timetabling solutions. It appears stuck in a view, unsupported by analysis or experience, that more trains means worse performance. Providing capacity to allow operators to run services is fundamental to Network Rail's role in the industry and it should prioritise the improvement of the processes which enables it to perform this task. The current charging regime does provide direct incentive through the Volume Incentive and other impacts are addressed through mechanisms such as the Variable Track and Capacity Charges. It is our experience that the issues which hamper progress are associated with poor process and a general lack of understanding and lack of impact of these mechanisms at an operational level.

It is rare that the desire to operate additional services emerges unexpectedly. The industry planning processes and the long development timescales of service improvements allow very early visibility to Network Rail of Operators' aspirations. As a result of these long planning cycles, it is very rare that operators present Network Rail with directly competing or wholly unexpected applications for the same capacity. Competition therefore manifests itself largely in a desire to compete in the market place rather than in the access application and timetabling process.

Clearly, the franchising policy adopted by DfT has a significant impact on the level of competition on rail and in the market. This is the case for competition between all types of operator including between Franchise Operators. Evidence would suggest that the creation of large regional operator monopolies has not maximised the growth of rail revenue through the provision of improved and more attractive customer service propositions. In fact, the areas where on rail competition has been a feature such as at Peterborough, Northallerton and between the West Coast, London Midland and Chiltern services, passenger growth has outstripped that seen in areas where there was no effective competition.

In addition to these issues, whilst some progress has been made towards an effective and liquid rolling stock market, suitable long distance high speed rolling stock remains scarce. New build options are available, but it is difficult to match the timescales for such projects with the timescales of the access process and the scale of investment with the period for which rights are currently likely to be granted.

While all of these factors act as barriers to the establishment of effective on rail competition, none alone is decisive. It is the cumulative effect that means that only the most committed and persistent applicants succeed in getting to the stage of operation. However, the most challenging aspect of the current access process is that it can only lead to the establishment of operations that are niche in nature, serving margin markets which have been previously

poorly served by rail. As a result, the commercial challenges of creating a viable and sustainable business are significant. On the other hand, this does mean that the teams involved are highly focused on cost control, customer service, innovation and passenger growth.

*Q2 - What implications do you think that industry developments such as ERTMS, electrification and changes in EU law could have for our approach to on-rail competition? Are there other developments that could have an impact on our approach?*

To date, the availability of capacity on the network has not, in the end, been a crucial factor in preventing the establishment of on-rail competition. Significant delays have been created by the persistent failure of the train planning process to identify and employ the actual level of available capacity, but in all cases, diligent and persistent work on the part of applicants has eventually led to sufficient capacity for all applicants to be found. This is true for both Franchised and Open Access applicants.

It is also the case that a mixture of an overt desire to run trains at memorable times often coupled with a covert anti-competitive desire to eliminate spare capacity has led to substantial waste of potential capacity on our main lines. Increasing the amount of capacity actually used will require changes to Network Rail's behaviour, specifically more capacity optimisation by using flexing rights and re-planning. It will also require a change from firm access rights to quantum, with appropriate spacing and journey time protection.

However, there will come a time when "the last path" is reached unless infrastructure developments lead to the creation of additional capacity. To date, infrastructure developments on a number of key routes have been focused, perhaps excessively, on adding operational robustness and the creation of additional capacity for freight traffic, neither providing any commercial return to the industry overall, rather than the creation of paths for commercial passenger services and adjustment of freight activity to avoid congested times and locations.

Electrification schemes could also increase capacity, but only if effective use is made of them. In particular, electrification schemes will only be able to unlock route capacity if there is extensive deployment of electric rolling stock with better acceleration and braking characteristics than the diesel rolling stock previously deployed.

ERTMS certainly has the potential to unlock additional capacity, especially on a mixed traffic railway, but to do so will require a conscious shift in the objectives and framework within which its deployment is being planned. Issues such as optimising braking curves, removing redundant signalling practices, raising and smoothing line speeds (in the knowledge that over-speed is impossible with ERTMS) would all contribute to increasing capacity, but are not evident to date. The industry will need to make capacity generation a specific project goal and integrate ERTMS capability into the timetable planning rules.

Proposed developments in European Railway Law in the 4<sup>th</sup> Railway Package proposed by the European Commission earlier this year are very relevant, in particular the concept of an "Economic Equilibrium Test" (EET), probably under harmonised guidelines, to assess whether the impact of a new open access service has an unacceptable adverse effect on public service contracts. We believe that the British rail industry, as the most liberalised in Europe, and particularly ORR has a special responsibility to input into the debate the experience and understanding we have gained. It is unfortunately the case that lobby groups elsewhere in Europe are trying to turn the EET into a means of preventing competition and ORR should be vocal in opposing this. We also recognise that the European Commission, whilst strongly advocating increased market opening and competition has a starting position in most member states of incumbent monopolies and has not always thought through how

some of its proposals would work in relation to the stated objectives to create a more open, competitive and successful sector. In particular we note that at present the EET:

- lacks a proportionality provision
- does not balance the benefit to passengers and wider economic benefits against the revenue impact on a public service contract
- does not consider reasonable adaptation or change on re-award of the public service contract
- is one-sided, offering no protection to existing open access operators from new public service contracts.

We urge ORR to take an active role in influencing this debate to enable a more commercial rail sector to emerge and not merely await legislation and then follow it.

*Q3. What are your views on Option 1? If we were to retain the current NPA test and structure of charges for open access what effect do you think changes to the economics of the railway and to capacity would have on the scope for and levels of open access competition? Do any factors other than those listed above favour (or not favour) Option 1?*

The structure of Network Rail's income streams and how these are channelled from government and operators is clearly laid out in the consultation document. However, although Open Access operators do not contribute to the fixed access charges, this is also true for additional services operated by Franchised Operators reflecting that incremental additions to the government specified services are not guaranteed to continue to operate and do not generate additional fixed costs.

It is noted that ORR would like to see a reduction in the size of the network grant; it is not clear how such a reduction would impact on the other elements of the charges structure. Again, it is worth noting that additional services above the level specified by government are not guaranteed to continue to operate and do not generate additional fixed costs. We would also observe that significant elements of the grant relate to the funding of Government-specified projects, backlog works from British Rail and Railtrack eras and deliberate deferral of charges, which it would be inappropriate, within the ORR's objectives of incentivisation and cost reflectivity, to load onto current and future operators and their customers. Also, given the marginal nature of current Open Access operations resulting from the application of the ORR's access policy and government's franchising policy, the ability of such operations to pay additional access costs is very limited.

We very much welcome and share the objectives that the consultation document highlights. Our experience and the evidence we have seen supports the view that on-rail competition creates a more customer-focused approach from all the operators involved. This increased focus on the passenger and their needs can be seen to drive faster growth in passenger numbers and revenue. However, given the current approach to Franchising with its understandably strong focus on the recovery of premium payments, devising a revised structure to address these objectives will be a complex task.

The Option 1 approach requires that a form of NPA test be at the centre of the process. We observe that the present test was inevitably developed on a theoretical basis before any cases existed and was necessarily based on forecasting tools developed by a unified state-owned monopoly railway. We now have documented evidence of actual open access and competitive operations and strongly believe this should be used to update the test to be more representative of what will actually happen. There has in parallel been a major change in retailing from inter-available tickets bought at ticket offices to Advance tickets bought by internet. This also requires changes to the NPA test. Specifically, experience shows that

MOIRA significantly over-estimates the abstraction that will occur at competed stations, whilst under-estimating the generation at station gaining the new service (under-estimation of radical improvement was a known flaw of MOIRA even before privatisation).

We also consider the treatment of diversion should be changed, not least because of the inconsistency between how it is applied to open access operations compared to competition between franchised operations on parallel lines (e.g. London Midland and Chiltern). We appreciate the obligation on ORR to calculate likely revenue loss to the franchised operator, however, more weight should be placed on the consumer benefit evident in the change of station, together with likely societal benefits of reduced traffic, etc. We suggest a limit, say of 10 miles, beyond which stations are not considered to be in the same market, together with codified rules on off-setting benefits for cases within 10 miles, including, for example, time savings, value of released train or car park capacity. We also suggest that MOIRA-based modelling is applied only to the inter-available part of revenue and all Advance ticket revenue be considered generated.

We also suggest elimination of duplication, for example when a new service pattern is introduced in stages, so that the NPA test is completed once and not repeated for related applications for individual trains in the pattern of services.

We welcome the proposal that the existing arrangement for approving access should remain in place both for existing open access operators but also as an option for future applicants. These arrangements have worked reasonably well to date and have allowed two open access operators to establish and grow viable businesses which have provided well regarded services to communities previously not well served by rail. It is clear that these services would not have been provided by any other operator including the incumbent franchised operators. These services have operated without material detrimental impact on the incumbent operators or impact on premium payments to government. The evidence available seems to suggest that this has occurred as a result of faster growth in overall passenger numbers at locations where competition takes place.

We believe that the changes to the NPA test we suggest above are proportionate and evidence-based and as such can and should be implemented at the start of CP5.

However, the existing arrangement for approving access, even modified as we suggest, are only likely to allow for small and slow growth of on-rail competition as the new services will inevitably have to be focused on niche markets not previously well served by rail. On that basis, we welcome the active consideration of alternative and additional processes as indicated by this consultation.

Nevertheless, it is a necessary implication of changing the process for approving access so as to lead to more on-rail competition that higher levels of abstraction should be allowed. In this situation, the ability of the new service to be able to pay a higher contribution to Network Rail's total cost may also increase and such a service should therefore expect, to the extent that it is commercially successful, to have to make an additional contribution. We do not believe our proposed changes to Option 1 materially alter this balance, which is more likely to be a significant issue with Options 2 or 3 and we consider it further below.

*Q4. What are your views on Option 2? Should the mark-up be calculated on the basis of 100% of excess abstraction? Do any factors other than those listed above favour (or not favour) Option 2? What do you think of the feasibility of building a commercial case based on policy as described here? What changes/guarantees/mitigations would be needed to make this work?*

In Option 2, the additional access charge to be paid by the new operator is linked to the additional revenue that may accrue to the new service as a result of a relaxation of the NPA test. This could expand the range of potential open access operations as it would in theory allow them to operate in markets which are not intrinsically niche. However, by linking the additional access charge directly to the additional revenue, it is unlikely that such a revised process would be more attractive than the status quo. In essence the open access operator would incur substantial extra costs carrying additional passengers from whom it would make no material net revenue after access charges. It would possibly be even more at risk of competitive (or even anti-competitive) response from the incumbent operator than in an NPA (Option 1) situation. Overall the business model would be much riskier. We believe it is proposed to be an ex-ante calculation; clearly if the calculated level of abstraction did not then happen the operator's financial person would be dire. Conversely, if ex-post calculation was used, its business would be unpredictable and no responsible owner could proceed on this basis. It could trade with apparent success against targets only to face a sudden reversal into losses. Either way we see no likelihood of Option 2 forming the basis of a material increase in open access operation.

If we tried to envisage a parallel in another industry it would be like allowing a competing shop to open only if its rent included all the revenue lost by existing shops. We do not believe much competition would arise under such a model.

We do not find the argument put forward for 'Ramsey' pricing to be soundly based when most passenger rail services face strong competition from the car (and plane for longer-distance services). There is no parallel with access charging for coal or nuclear fuel operations, which face no real competition.

Option 2 would also create, when compared to Option 1 a situation where a large number of extra passengers are carried and costs incurred to achieve this (more carriages, additional staff, etc.), but almost no extra revenue received. No rational business would choose to do this. We note in parallel that far from being hurt, franchised operators could achieve windfall gains, saving the cost of carrying passengers, but effectively still getting their revenue.

A further problem with this option is the future development of the charge, for example when initial access right come to be renewed or when the relevant franchise is re-let and the specification potentially changed. Paragraph 3.36a seems to suggest that the additional access charges may be reassessed at this time rather than rolled forward after indexing. The perverse effects of Option 2 could be moderated by reducing the percentage compensation, but it would remain a complex and unpredictable model, unlikely to attract much interest.

*Q5. What are your views on Option 3? What do you think of the feasibility of building a commercial case based on policy as described here? Are there any key practical or other issues that we have missed?*

Basing the level of additional access charges to be applied on the basis of the additional costs that arise for Network Rail has the potential merit of creating a clear pricing model against which a potential open access operator could consider the business case for its proposal and is thus much more likely to be the way forward. However, there are some practical problems, not least because the Variable Access Charge is supposed already to recover these costs.

In the Option 3a approach, use of the Fixed Track Access Charge of the relevant franchise, divided by its train mileage, is proposed, and an argument is put forward that this would somehow put the open access operator and franchisee onto a fair competitive basis. Aside from the judgement of Mr Justice Sullivan, referenced in footnote 22, we would point out that FTAC has been and remains subject to numerous arbitrary cost spreads since privatisation,

bears no relationship to costs incurred and is influenced by issues described earlier under Network Grant. Furthermore a major new distortion would arise in that a franchisee paying only VTAC on additional services (its FTAC is covered by its original franchise-winning business model), unlike an Option 3a open access operator, would be in a position to duplicate the open access services at lower cost to secure financial failure of the open access operator. This distortion could only be resolved if the franchisee also had its FTAC converted into a mark-up on VTAC. Notwithstanding the statement at 3.56, we do not consider such a model based on full allocation of costs would comply with the Access and Management Regulations and, because it would run so directly counter to European railway policy, would expect it to attract infraction procedures.

It is unclear if the intention behind Option 3b is an arbitrary mark-up or a process of identifying long-run marginal costs. We would not rule out either as a potential way forward, but whatever is used needs to be proportionate, give rise to predictable (preferably pricelist-type) charges and at a level that would enable viable services to be introduced and sustained.

Our suggestion for an immediate way forward would be to consider a mark-up based on a figure equivalent to the Volume Incentive that would arise from the scale of business proposed and that Network Rail should earn a regulated margin on the VTAC. The new Open Access service would not be included in the Volume Incentive paid by Government.

We welcome the statement in 3.58 that there is no point introducing mark-ups so high that this process does not give rise to any new services. Subject to this caveat on the level of charge, we consider it much more likely that Option 3 would give rise to new services than Option 2. We would point out that the risks of launching a new open access service are very high, given the substantial start-up costs, long asset lives in rail, uncertainty over long-term access rights and risk of competitive response from a monopolistic incumbent. The aspiration for mark-up should be modest, but we do support the value of Network Rail earning some margin on VTAC to incentivise it to create and sell additional paths.

*Q6 Do you agree that the process described would be appropriate under Options 2 and 3? If not, what changes would you make and why?*

The chief issue associated with the processes described for Options 2 and 3 relates to the extent that they depend on the modelling of revenues (Option 2) and costs (Option 3).

Assessing the revenues that will accrue to new services is recognised to be subject to a high degree of uncertainty, particularly when new markets are being created. Similarly, assessing the additional or incremental costs to Network Rail of an additional service would be subject to a high degree of uncertainty, particularly as these costs are subject to a high degree of variability associated with different policy approaches to the Network Grant.

If Option 3b forms the basis of a new category of open access the NPA test in its present or modified form would no longer be appropriate. We would, however, anticipate that applicants would provide an economic appraisal of their proposal and an assessment of levels of abstraction. The ORR in considering the application would balance these factors. The applicant would of course consider whether its business case could support the published access charge (including mark-up).

*Q7. Do you agree with the approach to estimating mark-ups, particularly the use of generation and abstraction forecasts to decide whether mark-ups should be applied and, in the case of Option 2, the size of the mark-up? Should OAOs be able to appeal the mark-up in the light of subsequent data?*

As noted above, there will inevitably be a high degree of uncertainty in the modelling of the revenues which would accrue to a new service. Therefore, it would be appropriate to allow access applicants to appeal the assessment of these revenues and the associated additional access charges. This approach is in any case only directly relevant to Option 2. For Option 3 it should be possible to adopt a price-list approach.

*Q8. Do you agree that no mechanism should be introduced to address Network Rail's additional revenue through mark-ups? If not, what mechanism should be used?*

We agree that no specific mechanism is needed whilst it continues to be the case that at each Periodic Review any over-recovery costs is taken into account. Should this change the matter would need re-visiting. Mechanisms already exist to incentivise Network Rail to work so as to maximise the effective use of the network. The problem appears to be that these are not affecting the behaviour of the relevant functions. We consider this is something ORR should pursue with Network Rail, possibly in relation to the Management Incentive Plan and internal procedures and briefing.

*Q9 Do you consider that, under any of the options considered in this document, the profile of mark-up payments should be tailored so as to address concerns over the ability of open access operators to pay in the early years of new services?*

We believe that if any mark-ups were of the size that it would be necessary to discount them in early years they would be so large that they would deter new open access under this model.

*Q10 Does the review of mark-ups at periodic reviews cause problems for OAOs' planning of their operations?*

Clearly, changes in the level of charges and/or mark ups that an operator is required to pay causes uncertainty. However, Open Access operators understand this risk and address it through their business planning. Fundamentally, this position is based on the knowledge of the transparency of the charges, the affordability of any mark ups and the ORR's duties to enable operators to plan their businesses with a reasonable level of certainty.

Hence, it should be expected that once an open access operator is granted access there will be no substantial change in the methodology or order of magnitude of charges for that operator, even if a subsequent review makes changes for new applicants.

We consider any proposal to review any mark-up reflecting abstraction, to be unreasonable and unworkable. While it is feasible to make an a priori assessment of likely abstraction, it is less clear how this can be reviewed and updated several years after the introduction of a new service given the myriad of influences which will have affected the situation – not least the changes which will have come about as a direct result of the competition between the existing and the new services.

## **Conclusion**

It is unclear in the consultation document the timescale proposed for change. We consider this is a particularly good time to change the framework as:

- there is sufficient evidence now from the first wave of open access operators to adopt a more evidence based policy
- a major re-franchising programme is to commence shortly, so clarity of the future structure would enable bidders to plan with full understanding of the risks. It would also enable client bodies to decide if they wish to allow change processes or risk-



sharing mechanisms (as were used in some earlier franchises) to minimise any net cost arising from that risk.

We urge ORR to make an early declaration of principles for the new regime and take immediate action to create the basis for additional sustainable open access operations:

- from the commencement of CP5 introduce an updated NPA test, based on experience, as described in our response to Question 2
- by April 2015 introduce a new category, effectively 'Option 3C' based on a mark-up equivalent to the Volume Incentive, plus a margin on VTAC,
- engage vigorously with European institutions to share best practice for on-rail competition and to influence future European Law to be a positive enabler in this field rather than risk being an obstacle
- integrate consideration of charging for open access in the wider review of charging for CP6, with the expressed intention of enabling viable businesses.