



THE POTENTIAL FOR INCREASED ON-RAIL COMPETITION

A response by the Chartered Institute of Logistics and Transport in the UK (CILT) to the Office of Rail Regulation's consultation paper dated October 2011. The Chartered Institute of Logistics and Transport in the UK ("the Institute") is a professional institution embracing all transport modes whose members are engaged in the provision of transport services for both passengers and freight, the management of logistics and the supply chain, transport planning, rail, government and administration. We have no political affiliations and do not support any particular vested interests. Our principal concerns are that transport policies and procedures should be effective and efficient and based, as far as possible, on objective analysis of the issues and practical experience and that good practice should be widely disseminated and adopted.

The Institute has a specialist Strategic Rail Forum, a nationwide structure of locally based groups and a Public Policies Committee which considers the broad canvass of transport policy. This submission draws on contributions from all these sources.

1 OVERVIEW

1.1 CILT agrees with the principle that effective competition can drive improved services, lowers costs and reduces prices. Open access operators have played a valuable role in identifying and running services which might not otherwise be provided (or only in rudimentary form), and are generally held in high regard by their customers.

1.2 However, their services account for only a small proportion of passenger rail transport in Great Britain, mainly because their business economics are fragile. Open access operation also affects the economics of franchise operators and may therefore increase the cost of the railway system to taxpayers. Their aspirations are frequently impeded by the objections of large incumbent franchisees and, in some cases, active use of the more significant resources at their disposal. The latter are of course underwritten by public funds.

1.3 If open access operation is to be encouraged, there is a need for change in the allocation of access charges, but this also needs to be

associated, if possible, with a reduction in the need for taxpayer support. CILT support the use of cost benefit analysis (CBA) to replace the Not Primarily Abstractive (NPA) test. CILT is not however convinced that path auctioning is the best solution, nor that such a change will provide sufficient benefits to justify the regulatory upheaval.

1.4 CILT therefore suggests that ORR considers an alternative approach whereby open access operators would pay a fixed track access charge, taking account of any potential loss of revenue to franchisees, to ensure franchisees (and hence taxpayers) are no worse off as a result of open access services. Where there was little potential revenue loss to incumbents, there would be a net gain to the taxpayer resulting from the more intensive use of Network Rail resources.

1.5 In this response, CILT broadly follows the consultation questions.

2 COMPETITION THROUGH FRANCHISING

2.1 Since franchising began, most competition has been for the franchise award and thus for the market, rather than competition within the market. However, neither DfT nor bidders are always well informed at the bidding stage and potentially worthwhile services sometimes get missed out. Once franchises are awarded, there is little competitive pressure on service quality other than through the National Passenger Survey.

2.2 The selection of which fares are regulated and which are not was based upon whether there was such competitive pressure. If there was pressure, the fares were not regulated.

2.3 Markets evolve over the period of the franchise and franchise operators may miss new opportunities. These limitations of the franchising process, as a means of instilling competition, will increase with longer franchises, although admittedly innovation, another weakness of the current system, may increase.

2.4 These weaknesses can be overcome partly through overlapping franchises. The principal example of long distance franchised services overlapping is between Euston and Birmingham. Here Virgin Trains at first increased services from 2tph (trains per hour) to 3tph and now London Midland has increased services from 1tph to 3tph. Chiltern Railways operates a third option between Marylebone and Birmingham Moor Street, and has recently introduced an accelerated '90 minute' service. These operators offer different levels of service (journey time, comfort, on-board service). Some tickets are inter-available, some are not.

2.5 In contrast, when overlapping franchise arrangements were withdrawn on the Great Eastern Main Line in 2004, whilst capacity, performance and cost-effectiveness were improved, this had some adverse effects on pricing and passenger growth. The resulting integrated timetable and fares did however make travel rather easier for users.

2.6 CILT considers that the relative merits of overlapping franchises and open access competition need to be considered in more detail.

3 IMPACT OF OPEN ACCESS OPERATION

3.1 Open access accounts for only 0.7% of overall passenger km and less than 2% of Intercity passenger km.¹ This is consistent with experience elsewhere in Europe. The probable reason is the high entry costs and poor commercial returns from open access operation plus substantial business risks, which explains why so far there has been no involvement of banks or private equity firms.²

3.2 Except for Heathrow Express, which does not compete with franchised operators, open access operation has been based almost entirely on the longer distance market. The average distance travelled (222km) far exceeds that on Intercity franchises (157km), partly because of stopping restrictions.

3.3 Where open access operation has been introduced, it has produced benefits:

- New direct journey opportunities, typical of open access operations, have generated more traffic for the railways, some of which has been diverted from other modes. However, the size of this benefit is unclear;
- Open access operation has widened choice for some passengers and the National Passenger Survey scores are consistently high;
- Open access operation has opened up new markets for rail;
- Staff costs are lower because of the 'new venture' nature of open access operators, which allows new terms and conditions of employment.

3.4 Unlike overlapping franchises, open access operation provides the potential for competition in all Intercity markets. In such markets, franchise operators are aware that open access operators could enter the market if they fail to perform. This is the contestability argument.

3.5 It is less clear whether and to what extent the same benefits could have been obtained more efficiently through franchisees, either at the bidding stage or during operation of the franchise. Thus a more flexible, less prescriptive approach to franchising by DfT and a more innovative approach to identifying additional paths by Network Rail might be very effective. What opportunities might exist for subdividing routes into sections, or a different combination of existing end-to-end paths? Might diversionary routes be used for open access paths?

¹ Source: National Rail Trends 2011/12.

² Franchise operations have attracted one company of this kind - Virgin – which has shown no interest in open access.

- 3.6 However, there are also disadvantages of open access operation:
- Abstraction of revenue from franchise operators, leading to a cost to the taxpayer;
 - The tendency for open access operators, which often operate on congested lines where there is sufficient demand to warrant more than one operator, is to run shorter trains. This is made possible by the lower track access charges and tolerance of overcrowding³ but may also lead to less efficient use of track capacity. This can be particularly inefficient if traffic grows significantly over the period of that open access agreement;
 - The costs, both for the industry and government authorities, particularly the costs of regulation in establishing over-arching industry processes to allow open access and in determining track access rights,
 - The diversion of senior management time at franchisees to put obstacles in the way of open access operators rather than enhancing their own service offering;
 - Making investment by franchise operators less viable in some instances and their impact less certain or sub-optimal in others;
 - Disruption of efficient timetabling and connections;⁴
 - The ability of open access operators to disappear almost overnight, as happened with Wrexham & Shropshire, with no replacement operation for the displaced passengers.
 - Loss of economies of traffic density, offsetting in part or whole the cost savings referred to above (see MVA/ITS for evidence).
- 3.7 The current system therefore benefits some passengers but appears to lead to an increase in system costs, which is borne largely by the taxpayer.

4 POTENTIAL EFFECT OF OTHER DEVELOPMENTS ON CAPACITY

4.1 The ORR discusses whether technical developments might alleviate capacity constraints and thereby release capacity for open access operation.

4.2 The European Train Control System (ECTS) offers considerable potential gains. New technology allows cab-based equipment to replace lineside signals. This gives improved operational performance and better system capacity by redefining the concept of the track section. Using continuous position reporting by the train, the section becomes a safe 'envelope', within which each train operates. The 'envelope' increases or contracts according to the speed of the train, its braking distance and other characteristics. This gives much more flexibility and the closer spacing of trains, without compromising safety principles.

³ Hull Trains runs at a 70% load factor but make no attempt to meet peak demand.

⁴ e.g. the prior allocation of paths to Grand Central enormously disrupted the process of negotiating the new standard hour East Coast timetable;

4.3 However, it is still early days, and widespread application of ETCS in Britain is still some years away. CILT considers that it would be unwise to count on ETCS providing much in the way of additional capacity in the shorter term.

4.4 Advanced booking backed up by modern ticketing technology may assist in the shift of passengers to less busy services. The effects though are likely to be highly dependent on the market concerned.

4.5 Smart technology may allow revenue allocation between operators through ORCATS⁵ to be replaced by operators being paid according to which carries each passenger. However, details of how this could be made to work (if at all), especially with inter-available tickets, are not resolved.

4.6 Imposing a value based capacity charge as proposed by ORR would promote the efficient use of infrastructure, although there are issues concerning its administrative costs.

4.7 CILT understands that future franchise agreements are likely to encourage the use of longer trains to accommodate growing markets. In general, it is difficult to justify running relatively short trains in situations where capacity is at a premium. One small capacity benefit that short(er) trains do provide is that they clear junctions that much more quickly, thus allowing the junction to be set up for the next movement.

4.8 However, these positive developments are unlikely to eliminate the capacity gap, but will merely reduce the rate at which it widens.

5 EFFECT OF CHANGES TO FRANCHISING MODEL

5.1 Franchise specifications are expected to become less prescriptive. This may encourage a more entrepreneurial approach in franchise operators, encouraging them to look beyond their current routes. Franchise operators are particularly likely to be interested in extending their boundaries to create overlapping franchises.

5.2 This may also make it more difficult for new open access operators to enter the market. However, when operating services outside the area encompassed by its own franchise agreement, the franchise operator would in many respects be like an open access operator.

5.3 Franchises are also expected to last for longer. This may mean more open access operation, as the longer the franchise, the more likely it is that new opportunities will arise in response to market changes. Whilst the

⁵ Whilst passenger counts have shown ORCATS to be quite robust, it is not always perceived as such and may still instil game playing.

incumbent franchisee may take advantage of such opportunities, they may also be taken up by both open access and other franchise operators.

6 USE OF COST BENEFIT ANALYSIS

6.1 There is evidence that many of the social benefits of open access operation are not captured in revenue. In principle, therefore, CILT agrees that Cost Benefit Analysis (CBA) should provide a better basis on which to make decisions about open access than the application of the Not Primarily Abstractive (NPA) requirement. CBA should allow all cost and benefits, and the impact on the taxpayer, to be quantified and compared. It must however be transparent and include *all* impacts. That includes the likely impact on investment.

6.2 CBA will however still suffer from the problems that affect the current approach, namely that there is little evidence on which to base estimates of how much traffic a new rail service may be expected to generate. It will therefore be necessary to ensure that the relevant data is available'

6.3 A model will also be needed that will allow generated rail demand, both on franchises and the open access operator services, to be estimated. These are generally of low frequency and on routes without other through trains.

7 ALLOCATION OF TRACK COSTS

7.1 At present, open access operators have fewer protections than franchise operators and their staff have fewer rights. They are therefore operating in a very different and far more risky commercial environment. So despite open access operators only paying for the variable costs of infrastructure, and not the much larger fixed track access charges (FTAC), their business economics are currently poor.

7.2 If FTAC is applied to open access operators as well as franchisees, it is likely to worsen their commercial prospects and result in even fewer applications.

7.3 If open access operation is to be expanded, the business economics need to be improved. This will be important in deciding whether and how much open access operators should pay towards fixed costs.

7.4 FTAC for open access operators could be set at some proportion of the estimated abstracted revenue, to ensure that they make no money from these passengers and allowing them to benefit only from generated travel revenue.

7.5 If accompanied by the auctioning of paths, this should result in paths being given to the operator who expects to generate the most additional value (benefits less costs) to the railway as a whole.

7.6 ORR favours auctioning but CILT has serious reservations. If it is for open access operators only, which are such a small part of the overall rail business, the costs of so doing are likely to be disproportionate to any benefits.

7.7 However, if and when franchising policy moves towards a bidding process as more and more franchises go into surplus, the auctioning of train paths to open access operators might be worthwhile.

7.8 Even if auctioning is used only for certain paths (e.g. those deemed suitable for open access operation), it may be difficult to integrate auctioning and timetabling. The normal timetabling process flexes requested paths (and station stops) to best fit the total capacity available. Given the interdependency of all rail services, including freight, how can a path for auctioning be defined when other paths are themselves uncertain and liable to variation? Auctioning will therefore add huge complexity and also hence time to what is already a difficult (and often fraught) process.

7.9 Even then, a CBA test will still be needed as many benefits and costs are not reflected in incremental revenue and costs on which bids would be based. But what happens if CBA and auctioning produce different results? Before embarking on auctioning, therefore, a pilot will be needed to assess the costs and the practicality of this approach.

7.10 If auctioning is introduced for open access operators, the extra payments made by them would contribute to infrastructure costs and be collected by Network Rail. ORR suggests a highly complex system of offsets and rebates. CILT feels that a simpler approach, which would ensure fairness and cost recovery, would be to reapportion Operations, Maintenance and Renewal Charges as on High Speed One when traffic over a 12 month period differs from the plan by more than 4%.

8 COMPENSATION MECHANISM

8.1 An alternative approach would be for the open access operator to pay a fixed track access charge, taking account of the loss of revenue to the franchisee(s) to ensure that they (and hence taxpayers) are no worse off as a result. ORCATS would provide a starting point for this calculation, pending the availability of more sophisticated techniques. The franchise operator that might have operated the services would be compensated for any loss of franchise value from losing the path. (This is the 'opportunity cost' of the path used).

8.2 Where that open access path was not otherwise used by a franchise operator, compensation would be zero, apart from the ORCATS effects.

8.3 The level of compensation could be determined through bilateral negotiations between the open access and franchise operators, with the open

access operator essentially buying the right to use the path from the franchise operator if a price could be agreed and there was a willingness to sell.

8.4 There are however Regulations⁶ that prohibit the trading of one operator applicant with another; these and the reasons they exist would need to be addressed.

8.5 There is also a risk that the franchise operator will set the price above its loss of franchise value, essentially to keep out a competitor. It would therefore be necessary for the open access operator to have a right of appeal to an independent but knowledgeable arbitrator. There is also the issue of path definition, although this might be easier to address bilaterally.

8.6 As with auctioning, this would create a market in paths but a much simpler one. The franchise operator would continue to be granted rights to use certain paths which it could then “sell” to the open access operator.⁷ The franchise operator and hence the taxpayer should then be no worse off. However, it is not clear whether this would increase open access operation. Consideration might also be given to further measures to encourage open access operation if this can be justified on CBA grounds and taking account of ORR’s duties.

8.7 The application of this or a similar approach to freight users, also open access but in a rather different sense, would need consideration.

9 CONCLUSIONS

9.1 In view of the complexity of auctions, CILT instead recommends that ORR considers in detail an approach whereby access charges are adjusted so that the open access operator would in effect compensate the franchise operator for any loss of franchise value from losing paths. This would complement Cost Benefit Analysis, which would be used by ORR to decide on open access applications.

9.2 Open access operation is however only a small market, and CILT feels that the most pressing challenges for the railway industry at present are to make the franchise system work more efficiently and effectively, tackle and relieve the capacity shortages, and to reduce unit costs.

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⁶ Access and Management Regulations 2005

⁷ In practice the payment might need to take place via Network Rail.

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