# Promoting competition on Britain's railways

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**A response to Tony Lodge's Beesley lecture[2]**
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## Introduction

Tony Lodge's lecture on how to promote competition on Britain's railways brings a complex subject to life. Tony has been a passionate advocate of the benefits of consumer choice and competing train services, and I welcome the challenge he gives to us as regulator, to policy makers and to the industry to focus on the benefits for consumers in the decisions we make.[3]

I need to make one 'without prejudice' comment - we have three open access applications before us at the moment, to run very different kinds of new passenger service on the East Coast Main Line. I am not going to comment on those today, and the comments I make here are without prejudice to the decisions the ORR Board needs to take on those cases.

It is however a good sign that there is interest in running new services from different businesses serving very different markets. It illustrates the innovative

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[2] Tony Lodge: Promoting competition on the railways – the Beesley lecture (Centre for Policy Studies, London, 2015)

[3] In the lecture I referred to the animations on open access competition inspired by Tony Lodge's work. They can be found here: https://www.youtube.com/watch?v=d0_IORzvFwA

thinking, entrepreneurialism and business-led thinking about how best to serve consumers that you get with competition.

My own Beesley lecture in 2012 set out how rail is most unusual in the extent of detailed decision-making and micro-management from central government.[4] This is true both in comparison with other regulated sectors such as energy and water, and even with other sectors in which the public sector is active or dominant, such as health services and criminal justice. It is essential that government is clear on what it wants to achieve for the substantial amounts of taxpayers' money it invests; but it is equally important that we see rail businesses themselves taking the lead on how best to design and deliver rail services which provide value for money and reflect what customers want. Competition is one way in which that can happen.

Indeed, ORR sees competition as a key means to deliver against our statutory duties; not least due to our specific duty to promote competition. But, it is also an important means to deliver against a number of our other 21 Railways Act duties, including:

- delivering choice and service quality for consumers (protecting users & service improvements);
- encouraging greater efficiency (promote efficiency & economy); and
- supporting the efficient use of the network (promote use of the railway).

However, as Tony Lodge acknowledged, there can also be a tension at present between greater use of competition and the potential for new entry to abstract revenue from franchise services, and thus to increase the cost borne by funders and taxpayers. The ORR has a statutory duty to consider these impacts as well.

The passenger rail market is far from homogeneous. The appropriate role of competition, and the form it takes, varies. We can describe the various markets in a number of different ways, but consider the following three passenger market segments:

In many metropolitan areas, the need for intense capacity use and frequent tube-style services may limit the scope for competition to the initial tender for the contract. Similarly, where subsidy is prevalent and objectives are largely

[4] Richard Price: Towards a more efficient railway: The Beesley lecture, 1 November 2012 (Institute of Economic Affairs/Office of Rail Regulation, London, 2012)

social, it may be competition to reduce the cost of public service provision that is more likely to dominate.

Elsewhere, inter-urban services – with a mix of stopping and fast services – might provide an opportunity for competition between two franchise operators, offering similar but differentiated offers, as we see between London and Birmingham.

And for long-distance services – many of them currently or potentially profitable – there can be an opportunity for franchised operators to operate alongside open-access operators, as we see today.

Indeed, we see open-access as part of a wider landscape where competition – in all its forms – can improve outcomes, for rail users. But to allow competition to deliver, we need to build on what works, and address the known weaknesses of the current system – weaknesses that can make open-access quite unattractive to parts of government, and limit the potential for open-access to complement franchising.

## Context: the railways are a success story

Britain's railways are a great success story.  We have seen substantial growth in passenger and freight demand. Between 2000 and 2013 we have seen a 56 per cent increase in passenger miles. Over the same period, freight tonnes carried has increased by 22 per cent although has been driven in part by significant growth in coal which is now set to decline. The market for freight train services is competitive, and has consequently seen the biggest transformations in service quality, punctuality and efficiency since privatisation.

Contrary to what you read in the press – and notwithstanding that it could sometimes do better – the punctuality and reliability of services has improved. Over the last 15 years the main reliability measure has risen from 78% to 90%, albeit this is now under pressure.  Passenger satisfaction is up: the independent National Passenger Survey shows a rise from 73 to 80 percent of passengers satisfied or very satisfied – and on the European Commission's Eurobarometer survey measures, Britain consistently has among the highest train service satisfaction measures in Europe, notwithstanding that is also has one of the lowest rates of government subsidy.

The railway is also more efficient – though again there is further to go. Over the last two control periods, Network Rail's day-to-day costs of network infrastructure have been reduced by 35 per cent, saving £15 billion which has freed by resources to reinvest in a better network. Franchises are now likely to make a net contribution to the network costs, after a couple of years where income and subsidy of passenger services roughly net out to zero.

And whilst some fares have increased significantly - meeting a greater proportion of total cost - recent ORR analysis shows that when adjusted for longer journeys, this increase has been around 1 per cent a year over the last decade; in part, reflecting that many tickets are sold at a discount.

In our view, the appropriate use of competition will help the industry to build on these successes

## Promoting competition across the rail industry

On rail competition is one part of ORR's work to increase the role of effective competition, as competition can play an important role in delivering against our statutory duties, for passengers, freight users and taxpayers. In addition to working closely with the Competition and Markets Authority on its review of on-rail competition, the ORR is looking to make more use of competition in a number of ways:

- effective competition casework: for example, as part of our ongoing CA98 case, we recently consulted on important undertakings in the freight container market;
- we reviewed compliance with the Competition Commission's orders in the rolling stock market;
- we conducted our Retail market review – ensuring ticketing practices support competition; and
- we are developing better data on costs and performance across Network rail's geographic units – the routes – so that we can apply comparative regulation.

## On-rail competition and passenger service franchising

Let me turn now to on-rail competition specifically, and start with some of the key features of franchising.

The franchising system has delivered significant benefits, reflected in the gains in passenger satisfaction and performance I described earlier. Franchises are delivering more services – roughly a 20 per cent increase in train miles since 2000. They have been a vehicle for delivering investment in both infrastructure and rolling stock. Along with growing demand, and efficiency gains on the infrastructure side, they have helped to reduce net subsidy to the railways as a whole. Indeed, more generally, one can see franchising as a key part of Governments' overall strategy for the railways.

But franchising has seen some challenges. We have seen operator failure and the financial exposure for taxpayers that comes with it. There have been major difficulties associated with managing a large and complex tender process – which the Department for Transport has been addressing in recent franchise competitions. Franchising also has some inevitable limitations.

There is periodic competition for the market that seeks to identify what passengers want over the next 7-10 years, and perhaps longer. This means that franchising authorities need to work hard to maintain incentives to perform throughout the franchise period. I am sure this is not news to you, but civil servants are not always good at discerning what passengers want – now let alone in 7-10 years' time - and are not often best placed to find innovative solutions or to find under-served markets. And the process of developing timetables for franchise services has not sufficiently challenged Network Rail to find and deliver all of the available capacity on the network. Incentives to improve productivity have also been hard to establish.

Tony Lodge's work illustrates how open-access operators offer the potential to address some of these limitations:

- they are business-led. Open access operators have a strong record of innovation in terms of service quality;
- they have also found opportunities for growth that many thought did not exist;
- they have also pushed Network Rail to identify available capacity.

And yet we are not yet making much of the opportunity of on-rail competition. Over the last decade-and-a-half, we have seen a policy under successive governments of reducing overlaps between the franchises over time.  This has removed consumers' ability to choose between operators on some key flows, such as Gatwick, Ipswich and Reading to London.  Open-access is also still marginal in scale – last year representing just three-quarters of one per cent of total passenger train miles.

I should point out that few in this debate are seeking an end to franchising. Instead, there is scope to build on its successes, to ensure it works in customers' interests going forward and see if there are opportunities to improve the overall approach to passenger services, including whether competition can play a larger role, whether between franchised operators or with open access.

## Network access, charging and capacity

Today's framework is under pressure which could threaten the benefits it delivers, and with it opportunities for incremental improvement. The current system – and in particular the charging framework – was designed to price, incentivise the use of spare network capacity.  So open access operators pay only Network Rail's marginal costs – which in aggregate represent only about 15 per cent of the cost of the network.  Franchised operators on the other hand pay this, plus a share of the fixed costs (costs that their passengers ultimately face).

But this charging structure is being applied to a network where there is now significant scarcity and forecast growth in demand for both passenger and freight traffic. The Department for Transport – through its franchising programme – has significant bottom-line exposure where open access services compete with its franchised operators.  From the Department's perspective, open access competition therefore risks undermining its ability to pay for new rolling stock, infrastructure and to cross-subsidise socially important loss-making services.  Consequently governments can often see open access as a threat to their objectives, rather than as an opportunity

The current system, the framework of charges, and the exposure of taxpayers through the franchising programme make the ORR's statutory role as the guardians of efficient and non-discriminatory access to the network a very difficult one. We have to balance our duties to promote competition and the use of the railway against our duty to have regard to the funds available to the secretary of state. And we do this robustly.

It is not always a comfortable position to be in, with the regulator effectively required to weigh up the benefits of new services against the potential impact on major Government procurement decisions, in line with our statutory duties. But we do the job robustly using the best available analysis, and on that basis we have approved new services onto the network recognising the benefits of competition and innovation for consumers. Since the 1993 Railways Act, ORR has:

- considered 25 open-access applications;
- rejected 9 of them;
- approved 13, including many incremental extensions to open-access services; and
- has 3 under consideration now, for new services on the East Coast Main Line.

A number of the recent applications have been larger and more complicated. An example is the application by Alliance which we approved a few months ago, to run the first open access services on the West Coast Main Line, with new Pendolino trains between London and Blackpool, serving currently underserved communities along the way.

We see these challenges today, as the ORR assesses the three competing applications for access to the ECML. The issues are hotly contested, and the strength of views expressed by all parties is not surprising. Applicants for new entry have expended large amounts of time, effort and resource in developing their plans, working out what they believe customers want and what they will pay for it, and making their case. Governments meanwhile have gone through a complex process to procure franchised services and to join these up with investment projects funded by taxpayers and fare-payers. It is no surprise that the Department for Transport often sees open access as a threat to its objectives and does not currently support its expansion

## Benefits of open access competition

Nevertheless, as Tony Lodge described, open access has shown its ability to identify new working practices and to innovate – for example we have seen on-board wi-fi; a better retail experience, different tickets (eg carnets) and greater price differentiation; and more personal on-board service. All of these have contributed to greater consumer satisfaction – the open access operators rank consistently towards the top of Transport Focus's passenger satisfaction league tables, based on their National Passenger Survey. And these innovations are often adopted by the franchised operators too, as they respond to the competition, improving the experience of their customers.

We believe that on-rail competition can help in a number of other ways too. We have seen in other industries that informed customers can play a significant role in helping the regulator to hold network monopolies to account and to support price control processes.

In aviation, Ryanair and EasyJet put huge pressures on airports to become more efficient, and ensure a better balance between consumers and the regulated business in regulatory debates. Whilst it might not feel like a good thing when they are all taking pot-shots at the CAA, it helps improve outcomes. In energy, we have seen Centrica challenging price controls – again, a dynamic that can improve outcomes.

We already see some of this in rail, as the commercial freight sector is hugely involved. Greater diversity and more commercial services could broaden this and – coupled with some cost exposure for franchise operators – could unlock a more dynamic approach to holding NR to account.

Lower network costs and a better performing Network Rail are clearly in customers and taxpayers interests. More generally, there is also potential for greater participation by open access operators to improve outcomes for governments:

In a tight fiscal environment, where funds need to be invested wisely in new capacity, open access applicants have helped to support better use of existing capacity. We have seen very effective challenges from operators to Network Rail's capacity analysis, often leading to additional train paths being found to serve more passengers.

They demonstrate different business practices, such as improved efficiency in turning around and dispatching trains at busy stations.

Where there are step-changes in capability or capacity – for example the arrival of HS2 or new network management technologies – the commercial pressure and innovation of open-access could help government and industry realise the full benefits of these strategic projects.

Open access could also support devolution, as smaller, commercial operators (not primarily focused on the interests of central Government) could potentially innovate and identify new ways of working with local transport authorities.

## Securing the benefits of on-rail competition and addressing taxpayer exposure

But to make a reality of these benefits we need to address the underlying causes that currently make open-access a threat to Government and which obscure these potential opportunities.

So how might this be done in practice?

The CMA's report on on-rail competition highlights two key components to addressing the adverse impacts of open-access:

- first – the reform of access charges; and
- second – the introduction of a funding mechanism for loss-making but socially desirable services.

Starting with the reform of access charges, the ORR is already working on a significant project to reform the charging framework as part of the next periodic review of Network Rail. We will be publishing our first formal consultation towards the end of this year, but there is clearly potential for this work to support open-access growth.

A significant theme in the work to date is the potential for an improved understanding of cost and for charges to match more closely cost – not just in terms of short-term wear-and-tear costs but also the cost of providing infrastructure. This increased cost reflectivity would help improve incentives on all train operators and help to establish a more normal commercial relationship between customers and the network provider, and help the focus on cost reduction. But, it would also provide a basis for charges to reflect the cost of providing infrastructure, where there is significant demand to use that capacity. This would be a useful first step to providing more sensible signals to open-access and other operators about which parts of the network to use.

This would not necessarily mean that open-access would pay precisely the same as a franchise operator. Indeed, the court has recognised that open-access and franchise services are different, face different risks and so may need to face different charges so that the overall effect is not discriminatory. So we also need to explore how charging works for open access. This might involve a range of mechanisms to reflect the particular circumstances and risks faced by open-access. For example, there may be a case for a limited period of relief from some network charges, until open access operators have been provided with an opportunity to enter and grow a sustainable passenger base – matching charges to how risks are particularly high in the start-up phase of operation.  Similarly, we need to think about whether and how we might protect existing open-access operators from any changes in charges

The second main component is how to address the potential for open-access operators to adversely affect government income, and to increase costs to taxpayers.  We are still in the early stages of developing options for this mechanism. But clearly one of the key features would need to be to offset – to some degree – adverse financial impacts on taxpayers.

We could try to calculate the impact on taxpayers precisely and do so for each open-access application. However, this would imply a high degree of uncertainty about the cost of entry and also implicitly assumes that it is possible to calculate the impact of open-access with this level of precision. Instead, our current thinking is focusing on whether we can find a way to construct a relatively simple levy – effectively a public service obligation levy - that would mitigate the risk to taxpayers but would also provide investors with a clear basis upon which to develop their business proposition. For example, it might take the form of a set rate per passenger km, perhaps set at different levels for congested and less congested parts of the network.

This levy would not, therefore, perfectly match abstraction from the taxpayer – an amount that it is impossible to calculate anyway. However, we are aiming to identify a levy design that is gives predictability to potential open access operators and their investors, but which represents good value to taxpayers. There may be times when the levy income falls short of abstraction, but would there also be times when it might exceed this – driven by the growth open-access might bring and the positive impact on franchise efficiency.

One important consequence of these changes is the potential to loosen the operation of the current tests applicants for new services are subjected to, to assess whether or not they are ‘primarily abstractive’. The test is applied as part of the current framework for balancing ORR’s duties, and assesses whether new services stand to make money primarily by taking passengers from franchised services (harming the taxpayer) rather than growing the market.

This is a hotly contested issue in its own right, and we are looking closely at how far new entrants' services can help to grow the rail market as a whole, not just on their own services.  But one of the test's possible effects is to encourage new entrants to design convoluted routes and services to pass the test, rather than primarily to meet the needs of consumers.  By finding a different way to address the exposure of the taxpayer, there is the potential to give new operators much more commercial flexibility to develop new services.

This is complex, and we are still working on the problem.  You will see a consultation on our high-level charging options later this year.  We have engaged experts to help us to understand the impacts of the CMA's options so that we can establish how they could be introduced in practice.  And we continue to develop options for how a levy might work – recognising that, ultimately, this is a decision for government and parliament – as it is most likely that this will require legislation.

## Conclusion

To conclude, we see good reasons to support greater use of competition, to improve outcomes for passengers, freight users and for taxpayers.  In many cases on the railway choice is good for consumers and creates incentives for innovation to improve customer satisfaction, operational efficiency, and to use network capacity better.

Indeed, we see significant benefits from Government's franchising approach, and greater use of overlapping franchises and competition between franchisees could provide the best way to deliver competition in many parts of the network

However, open-access has the potential to deliver a range of additional benefits over and above those that franchise competitions can deliver alone. In this way, open-access can support Government's objectives and complement franchising.  Competition 'for the market' and 'in the market' can work side-by-side, with the suitability of each approach depending on the circumstances across the network.

We are working towards reforms to charges that could address the inefficient signals for the use of capacity in the current framework, and help to address the exposure of taxpayers. The other part – the levy – requires legislation, and thus sufficient support from Government for the potential gains that open-access can bring.

Is this likely to happen? Well there is support in Government for the role that competition can play in opening up regulated markets. But, we also see open-access as a way of making franchising better. New rolling stock, digital signalling and HS2 could all release capacity and put pressure on a model that seeks to limit open-access growth through an ever-growing set of franchised services

This is not going to be easy. But we believe that on-rail competition is an important part of achieving a rail industry which constantly raises its game on customer satisfaction, efficiency and innovation. It puts more power in the hands of consumers – and also gives the industry itself more of the lead in shaping how services are developed and delivered. This is something we take for granted in other markets but which in rail is too often thought of as the province of the government or regulator. We believe there is an opportunity for open access and broader on-rail competition to develop in a sustainable way. This is why ORR is working now on how this might be implemented, and continues to work closely with the CMA on this very important programme.

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