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Dear Gordon

A greater role for ORR regulating passenger franchises

Introduction

Thank you for the opportunity to comment upon the joint consultation by ORR and DfT on the potential for an expanded role for ORR in respect of new passenger rail franchises.

This letter draws together the response of FirstGroup and all of its rail operations: First ScotRail, First TransPennine Express, First Capital Connect, First Great Western and Hull Trains.

FirstGroup is supportive of the ATOC consultation response on the role of the ORR. In particular, we agree with ATOC's conclusion that the "additional package of reforms" and the suggested general move towards purposive licence conditions does not fit with the commercial / contractual relationship underpinning the franchise agreement and will confuse accountabilities and increase both costs and uncertainty. We support the key points set out in the ATOC response and so do not seek to repeat all of them in our own response.

We set out our overall comments on the issues raised by the consultation set out below.

Economic regulation vs contractual relationship

At its heart the consultation is based on the premise that having a single regulator for the industry is necessary to take a whole industry view and to align incentives applied to both Network Rail (NR) and passenger TOCs.

Whilst at face value this seems attractive, the premise ignores the fact that NR and TOCs are very different types of entity with different motivations and differing relationships with funders. The franchising approach, based on competition for the market, is very different to economic regulation of a permanent monopoly supplier. A franchise represents a contract between the DfT as funder and the operator based on the requirements set out when the contract was let, based on the DfT's view of the correct balance between taxpayer and passenger interests. Changes can be made to the outputs that DfT wants from the franchise via the change mechanism in the franchise contract.

This differs from the ORR's role as economic regulator where it has statutory duties to promote what it sees as the best overall outcomes for the railway, based on its interpretation of how to balance the competing requirements of its decision criteria. In the case of regulating NR, neither of ORR or DfT have a firm contract with NR. Instead ORR sets out high level outputs to be delivered within a funding envelope for a 5 year control period, to be measured against high level "purposive" licence conditions which NR must satisfy. This approach allows ORR to use its discretion to interpret how NR meets its obligations against changing requirements, but does so against a relative loose set of NR outputs and a requirement to ensure that the revised outputs can be delivered within the agreed funding envelope.

This interpretative approach as to whether standards have been met just does not fit with the firm contractual relationship at the heart of the franchise agreement, and introducing purposive obligations as an overlay to the existing franchise approach of contracted outputs will create uncertainty, double jeopardy and in our view will increase costs.

The consultation argues that a move to a regulated outputs approach is required to allow franchise specifications to move to being based on higher level outputs. To date we have seen little evidence that the franchising procurement process or the new franchise contract structure will move away from being tightly specified and controlled contracts. Indeed, as they represent significant contracts for the taxpayer, it can be argued that this approach is not wrong. FirstGroup has argued that higher level output specifications can help deliver improved outputs and greater efficiency, but we see the greater part of this benefit as coming from setting a less prescriptive specification at the bidding stage to allow bidders to compete to propose innovative ways of delivering the required outcomes cost effectively. Once a winning bid is selected we have been comfortable with contracting to deliver the outputs that are in the proposal - we accept that retaining an ongoing flexibility over outputs is difficult to achieve within a contract.

Additional package of reforms

We do not support the proposed move to expand the ORR's role to include the monitoring and enforcement of:

- Train service performance; or
- Service quality standards.

The key question has to be whether a move to a regulatory approach would be more effective than the current contractual one for both of these areas. In our view in both cases the current contractual arrangements are effective in setting hard targets for the TOCs to meet and have set the right framework for TOCs to achieve significant improvements in both areas. The operators' performance in driving down TOC on self delays and cancellations has not been mirrored by NR meeting its regulatory targets on performance. Similarly, the introduction of SQMS or Squire regimes has driven a step change in customer satisfaction with stations and trains, due to its focus on attention to detail. FirstGroup are strong believers in this approach and have introduced SQMS voluntarily into First TransPennine Express where it was not part of the franchise agreement and we also measure our performance on additional measure over and above those prescribed in the contract.

On top of the contractual requirements, the TOCs have strong commercial imperatives to continue to push for better results on both operational performance and service quality as improved passenger satisfaction is directly linked to revenue and profit growth. They also directly impact our reputation and the prospects for

winning new franchises. Our operations cover a representative cross section of TOCs and we see no less drive to improve performance in our regional operations compared to the more “commercial” intercity operations, which makes us unconvinced of any need for or better outcomes from a regulatory approach.

The regulatory approach is necessary for NR as they do not have a direct commercial incentive to improve operational performance or service quality without it. Sch 8 gives a direct revenue incentive to better manage NR caused and network delays, which is why NR focus on the delay minute metric, but there is less focus upon the wider performance measures such as improving PPM or reducing cancellations. Similarly, there is little commercial requirement for NR to improve the service quality at TOC SFO stations which is behind the need for regulated asset stewardship measures, but we feel these high level licence conditions are in no way as effective as the contractual (or voluntary) SQMS regimes in delivering improved customer facing outputs.

We agree that there is an issue with a lack of consistency of objectives on operational performance between the operators and NR. However, that is something that could be better addressed by the DfT and ORR agreeing how best to set consistent and aligned objectives within their own respective contractual or regulatory arrangements, rather than needing to transfer the responsibility to just one regulatory body. As TOCs would still be operating within franchise contracts if there needs to be a change in performance targets to be delivered to better align them with NR’s objectives, the ORR would still need to agree with DfT that the new ones are built into the franchise at the specification and contract stage.

There may be a perception that ORR needs to have direct control over TOCs’ performance obligations in order to ensure that TOCs are required to cooperate with NR to produce and deliver performance plans. In our view this is a weak and theoretical justification for a change – TOCs have a strong commercial incentive to drive up overall performance on PPM and CASL and work hard to agree detailed Joint Performance Improvement Plans (JPIPs) with NR. Indeed in our experience it is the TOCs who are pushing NR harder for improvements than they would need just to meet their regulatory targets.

We also see that many of the perceived benefits of agreeing aligned performance or customer facing service quality objectives are likely to come out of the current move towards alliances or bi-lateral agreements between TOCs and the NR devolved Routes. This should deliver these benefits without the disruption of a simultaneous change in the overarching wider regulatory framework.

We see no advantage to passengers or taxpayers in delivering better performance through a move towards a regulatory oversight over TOCs performance and, for the reasons set out in the previous section, we can only see the move to purposive licence conditions in this area as increasing uncertainty for franchisees and resulting in an upward cost pressure which will ultimately come back to the taxpayer.

Complaints handling and DPPP

Transferring the policy setting and monitoring of these activities from DfT to ORR, who already has the enforcement role, would appear to be an administrative tidying up of accountabilities. We believe that the ORR already has access to all the data it needs in these areas without needing the ability to direct compliance, but we do not have a strong view either way as to where these matters are best managed.

We understand the desire to reduce the administrative work undertaken within DfT

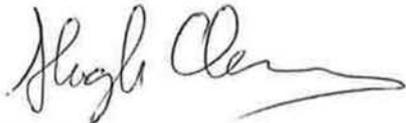
to allow it to reduce headcount. However, do not see these changes (or the wider propose shift in role from DfT to ORR) as delivering any improvement in efficiency and there is a risk that the costs of these functions become more opaque and ultimately may rise.

Conclusion

The fact that our response rejects the underlying approach being proposed by both DfT and ORR is not a position that we take lightly. It indicates our strong belief that the changes are unnecessary, will increase not reduce costs to taxpayers and will distract ORR away from their core role of driving greater efficiency and improved operational performance from the monopoly supplier Network Rail.

Please do not hesitate to contact me if you would wish to discuss any of the points raised in this response in more detail.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Hugh Clancy', with a long horizontal flourish extending to the right.

Hugh Clancy
Commercial Director, Rail