Centre for Policy Studies

Rail's second chance

Putting competition back on track

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SUMMARY

- Twenty years on from privatisation, rail passenger traffic has doubled; and is expected to double again by 2030. More people are now travelling by train than at any time since 1929 on a rail network half the size.

- Yet the public subsidy required to run the railways has doubled in just over ten years (to £4.16 billion in 2010/11). The cost of rail tickets is the highest in Europe.

- The 1992 rail privatisation White Paper anticipated "more competition, greater efficiency and a wider choice of services more closely tailored to what customers want."

- These principles have been betrayed: today, franchised rail operators have an effective monopoly on the core long-distance routes. This has restricted any significant on-rail competition from developing.

- Rail freight was privatised at the same time as the passenger sector but has benefitted from strong competition. This has led to significant investment in new rolling stock, high levels of productivity and reduced costs to satisfy customer

demand: between 1998/9 and 2008/9, freight operating companies *reduced* their unit costs by 35%, while the passenger operators *increased* costs by 10%.

- A small part of the passenger rail network is also open to competitive pressures. On the East Coast Main Line (ECML), two operators – Grand Central and First Hull Trains – have shown that competition can lead to more journeys, higher revenues for the train companies, lower fares, more and happier passengers.

- New data for this report shows the significantly beneficial impact that competition can bring. At ECML stations:
  - passenger journeys increased by 42% at those stations which enjoy rail competition, compared with 27% for those without competition;
  - revenue increased by 57% where competition occurs compared to 48% for those stations without competition;
  - average fares increased by only 11% on those stations with competition, compared to 17% at those stations without competition.

- In addition, in the official rankings of passenger satisfaction of the 31 main train companies, the companies that came first and second were those which are running competitive services – Grand Central and First Hull Trains.

- Following the West Coast Main Line fiasco, the model for awarding rail franchises is now in disarray.

- Ministers at the DfT should seize the opportunity to restructure new franchises to enable far greater competition to flourish across the UK rail network.

1. 20 YEARS SINCE RAILWAY PRIVATISATION

> *"Our objective is to improve the quality of railway services by creating many new opportunities for private sector involvement. This will mean more competition, greater efficiency and a wider choice of services more closely tailored to what customers want."*

John MacGregor, Secretary of State for Transport, *The Privatisation of British Rail,* White Paper, July 1992[1]

The number of passengers carried on the UK rail network is set to top 1.5 billion for a calendar year for the first time since the 1920s. Both passenger numbers and the number of passenger miles travelled have risen 50% in ten years, effectively doubling since rail privatisation in 1993 (see Figure 1).[2]

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1 HMSO, *New Opportunities for the Railways,* July 1992.

2 Between 1987-88 and 1994-95, the volume of passenger journeys fell slightly but, since privatisation, the number of journeys has increased every year with the exception of 2009-10. Since 2009-10, there have been two years of increased growth.

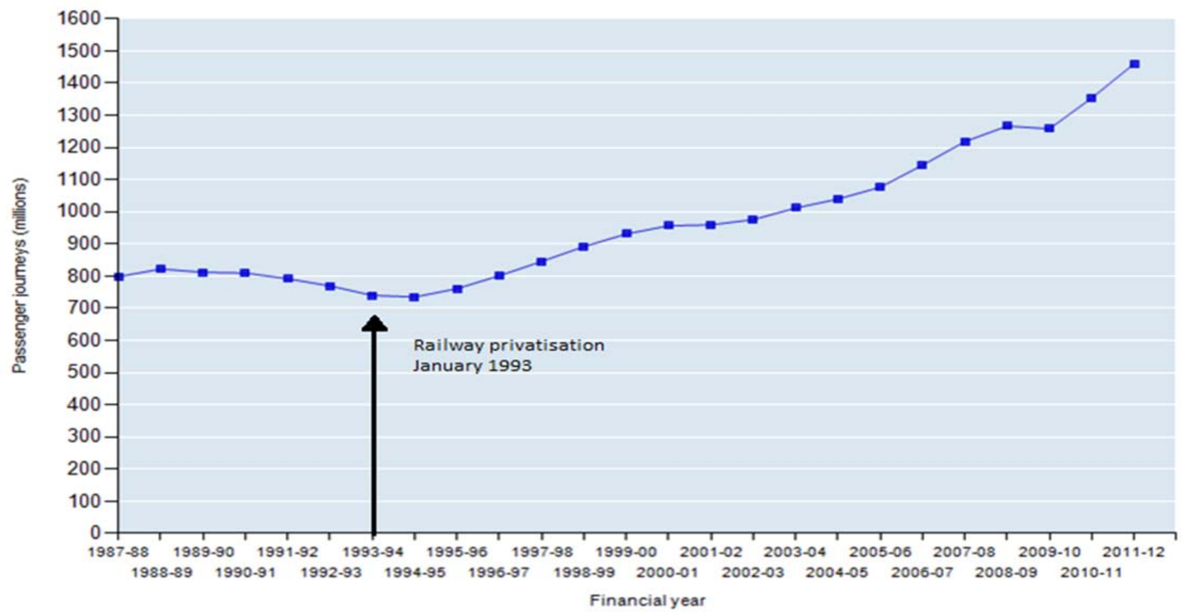
External factors that have contributed to the increase in passengers numbers over the last 20 years include:

- the increase in the UK population;
- the increase in motoring costs, especially fuel and insurance for younger drivers;
- the continued attraction of London both for employment and as a tourist or shopping destination;
- the general rise in GDP, at least up until 2007.

Following privatisation the industry has also made itself much more attractive to passengers through:

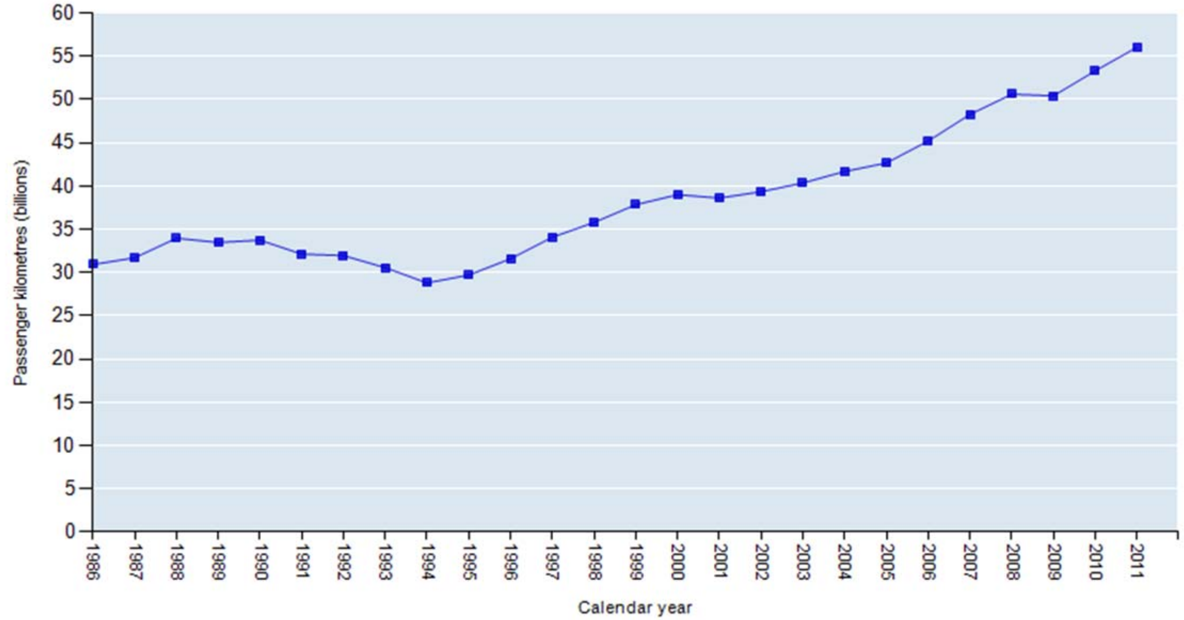
- increased frequencies;
- better station environments;
- new rolling stock (at least in some areas);
- more reliable trains and better punctuality;
- new ways of buying tickets, especially through internet advance purchase.

Figure 1: British passenger journeys (millions) 1987 – 2011



Source: Office of Rail Regulation

Figure 2: British rail passenger kilometres (billions) 1986 – 2011



Source:Office of Rail Regulation

Higher taxpayer subsidies

The growth in rail passenger traffic over the last 20 years has come at a cost to the taxpayer: the subsidy for the railways has – rather than falling as was expected at the time of privatisation[3] – more than doubled recently, from a low of £1.68 billion in 2000/01 to £3.9 billion in 2011/12 (see Figure 3). This increase is largely explained by the explosion in infrastructure costs following the Hatfield train crash in 2000 after which significant safety improvements were carried out across the whole network.[4]

Network Rail's expenditure last year was £8.5 billion. More than half of this (£4.5 billion) was spent on infrastructure renewals and enhancements. Perhaps more surprising is that nearly 18% (£1.47 billion) of all expenditure went on financing Network Rail's debt mountain which now stands at £26.5 billion.[5]

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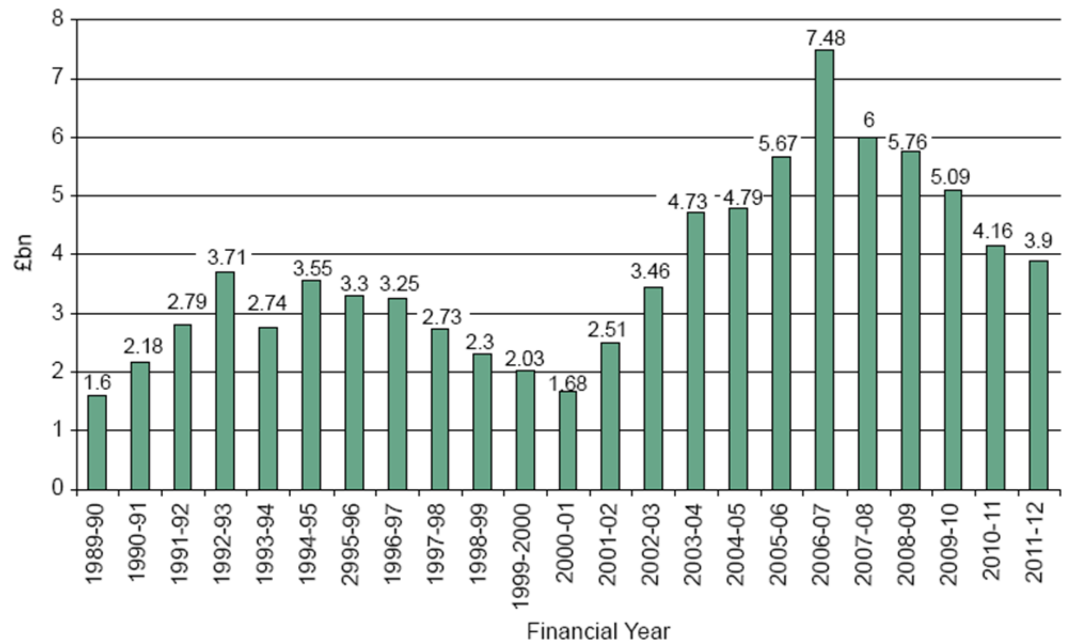
3 *Rail 2020*, House of Commons Transport Committee, January 2013.

4 The Hatfield rail crash in October 2000 changed the face of the rail industry forever. It precipitated the birth of Network Rail and led to the creation of a new law of Corporate Manslaughter. Four people were killed when an express train on the East Coast Main Line derailed after travelling over a broken rail. Investigations rapidly revealed that engineers knew the track was in poor condition but had neither replaced it, nor imposed a speed restriction.

5 John Redwood MP has also uncovered substantial losses made by Network Rail on its derivative trading: for example, in the financial year to March 2011, Network Rail reported a loss of £251 million trading on the money markets. In the following year, another £93 million was lost. As Redwood says: "At their last annual balance sheet date, there were total liabilities of £1.2 billion in derivatives. It was as if Network Rail had been running its own investment bank." See *Daily Mail,* "On track for disaster with Network Rail", 23 July 2012.

Figure 3: Rail subsidy (2011/12 prices)



Source:Department for Transport

A failure of competition

Competition, with an acknowledgement of some subsidy to maintain loss-making but essential services, was at the heart of the original privatisation plans. The White Paper was clear:[6]

> *"The key to success is a reliable, efficient operation offering high quality services to users. The introduction of competition through greater involvement of the private sector and the ending of (British Rail) BR's monopoly in the operations of services will be instrumental in achieving this."*

Yet this aim – to introduce competition on service frequency – was not realised: today, we have a national state-sponsored infrastructure monopoly interacting with a series of local state-sponsored rail operator monopolies or 'railopolies'. It is now being suggested that these monopolies should work more closely together as "alliances". Consequently, the degree of Department for Transport (DfT) micro-management has led to more government involvement in rail operations than was even the case with the nationalised BR.

As a consequence of the government's deep involvement in the operational aspects of rail, it is now less able to stand aside from the political fall-out of operational issues than it was before privatisation. This is reflected by the reaction to last year's collapse of the West Coast Main Line franchise award and popular discontent with recent fare rises.

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6 *New Opportunities for the Railways – The Privatisation of British Rail*, HMSO CM 2012, July 1992.

The emergence of long duration, highly-prescribed rail franchises

Most passenger rail services are provided by franchised operators, who contract with government to provide specified services for a number of years.[7] Train companies bid for these franchises on the basis of the amount of funding they would require, or the premium they would be prepared to pay, in order to run these services.[8] The winner is the company seeking the lowest subsidy or offering the highest premium.

The most recent blow for this model was the collapse of the DfT's competition to award the franchise to run rail services on the West Coast Main Line (WCML) from 2013. This collapse in process has already cost the taxpayer £55 million and could top £100 million.[9]

In the past, several franchises were awarded on the basis of the promise of large premiums to be paid by the train operators towards the end of the franchise following subsidies paid by government at the start. The flaw in this arrangement was that companies could collect the subsidies at the beginning of the agreement and then opt out of their contract when they were due to pay premiums back towards the end of the agreement. For

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7 Since devolution, train companies can be appointed by central government, the Scottish and Welsh governments or Transport for London.

8 In these franchises, the DfT sets out a comprehensive and prescriptive service standard for each rail route. It will specify, for example, how many trains an hour should run between Birmingham and Manchester, with details of intermediate stops.

9 Oral evidence by DfT Permanent Secretary, Philip Rutnam, to Commons Public Accounts Committee, 14 December 2012.

example, National Express East Coast committed to pay a £1.4 billion premium to the Department for Transport (Dft) over seven years from 2007. In 2009 it was announced that it planned to default on the franchise, having failed to renegotiate the contractual terms of operation, with its parent company stating that it would not provide any further financial support necessary to ensure that National Express East Coast remained solvent. The service then had to be taken over by the Department for Transport.

The emergence of open access rail companies

There is a small but ambitious and determined group of “open access” rail companies who are becoming increasingly recognised for their innovation, quality of niche service, high passenger satisfaction and competitive fares.

These services are fully commercial. They receive no subsidy and pay no premium to government. Open access companies identify an opportunity to run a service which is not currently being provided by a franchised service. They then apply to the Office of Rail Regulation (ORR) for the necessary track access rights and to Network Rail for train paths in the timetable, paying the same fee as other operators who want to run additional trains on the network. This access charge is based upon the type and number of vehicles operated.

Open access provides one of the key elements for genuine on-rail competition: new non-subsidised entrants can compete with existing franchise holders and can challenge on price and service. In addition, they can introduce new routes and exploit new rail markets to satisfy growing rail demand, at their own risk.

While small in overall terms, they have significant potential and represent an important opportunity to revolutionise the industry: there are currently four open access passenger operations in the UK. Of these, Eurostar and Heathrow Express are largely self-contained and serve distinct markets, and are not necessarily relevant to an expansion of the model.

Grand Central and First Hull Trains are more interesting: they represent a model which could be replicated in many parts of the country where open access successfully operates alongside, and in competition with, franchised rail operators. They serve large cities and towns on and off the main franchised routes on the East Coast Main Line (ECML) franchise.[10]

For example, the open access operator, Grand Central, now runs services to Sunderland and West Yorkshire from London. It has shown that it is possible to exploit significant unmet demand through a small number of daily services off the

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[10] The ECML has had a chequered history: two operators – GNER and National Express East Coast (NXEC) have both abandoned their contracts. GNER failed due to the collapse of its parent company (Sea Containers) and NXEC due to inability to generate forecasted profits. One problem was the inflexibility built into the franchise agreements. NXEC, for example, had assumed passenger growth of 10% per year in their bid. This left no room for manoeuvre when the recession struck in 2008, causing a drop in passenger revenue. Trains on the ECML are now run by the state-owned franchise East Coast, operated by Directly Operated Railways (DOR).

Grand Central services provide a competitive service from London to York and Doncaster (competing directly with the nationalised 'East Coast' service). It also acts as an important 'feeder' market to the high speed main line.

First Hull Trains compete with the franchisee, East Coast, at Retford, Grantham and Doncaster before reaching Selby and Hull.

franchise route. These new services have also led to significant private-sector infrastructure regeneration to stations on the routes served by these non-franchised services.[11]

Open access operators have proven that they can generate new journeys and attract new passengers. Grand Central now runs 16 trains on the ECML while First Hull Trains operate 14. Out of a total of about 180 trains a day on that line, the open access services only represent around 15% of the train paths but their passenger per vehicle per mile market share is around just 5% of the passenger-per-vehicle-mile market.[12]

It is these open access rail companies that can provide the model for finally achieving the key aim of the 1993 privatisation: the introduction of competition. And given the recent collapse in the DfT's franchising model, there is today an opportunity to seize the initiative. For more competition can help train companies respond to the growth in demand, can increase innovation and passenger satisfaction, while reducing fares and subsidies.

Europe shows it can be done

Precedents for more on-rail competition already exist in Europe. Though France has no passenger competition at all on the main network, Germany allows independent operators to run some

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11 For example, Wakefield Kirkgate in West Yorkshire and Eaglescliffe station, just outside Middlesbrough, have and are being substantially redeveloped by the private sector following the introduction of new routes by open access operators.

12 Open access services on the ECML operate alongside East Coast, Trans Pennine Express, Northern, First Capital Connect and Cross Country franchised services.

regional lines through franchise competition. Norway and Sweden have some limited competition, but mostly for specialised services such as Flytoget between Western Oslo and the city's main airport at Gardemoen. Perhaps most surprising are the recent developments in Italy and the Czech Republic.

Italy's NTV is Europe's first private open access operator of 190mph high speed trains; its new Italo service competes directly with state-owned Ferroviadello State Italiane trains on many of its intercity routes, including fast trains between Rome and Milan. In the Czech Republic, in December 2012, LEO Express commenced open access operations and now runs five trains a day in each direction between Prague and Ostrava, again competing head on with state-owned rail operator CD.

Importantly, Europe's open access services, although still small, are less niche and generally access large markets.

The need for political will

Despite the evidence that open access operators benefit passengers at no cost to the taxpayer, the DfT remains hostile to more on-rail competition.

It will therefore require political determination to break down the barriers erected by the DfT which currently prevent more non-subsidised rail competition. But there is a mandate: encouraging open access rail operators was clearly signalled in the pre-2010 Conservative party policy proposals:[13]

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[13] *Conservative Rail Review: Getting the Best for Passengers,* February 2009.

> *"We would promote open access. We will ensure that the people who run passenger train services, including open access operators, have a stronger say in how our railways are run."*

And open access operators fit well with the Coalition's enthusiasm for themes such as localism, 'rebalancing the economy', transparency and innovation in public services.

Now is therefore the time for the Coalition to free up Britain's railways to far more open access operators to the benefit of all concerned.

2. HOW RAIL COMPETITION IS BLOCKED

In terms of competition, the UK rail industry resembles that of the airline industry in the 1970s. Then a handful of operators flew routes determined by national governments with few pricing pressures, little innovation and limited cost control incentives. Following liberalisation, a wide range of new operators quickly opened up new routes, introduced direct ticketing and competed aggressively on price. The same opportunity exists in the rail network, if the DfT were prepared to embrace competition.

Resistance to competition

In addition to the existing open access services, several other services have been proposed but opposed by franchised operators and the DfT; and rejected by the ORR.

For example, Alliance Rail Holdings and Grand Central proposed open access services on the West Coast Main Line to connect new North West markets with London, in competition with Virgin, but were initially ruled against. Alliance Rail Holdings is now having its West Coast Main Line application reconsidered by the Office of Rail Regulation (ORR). This decision, expected later this year, is a key test for the DfT and the ORR.

One step forwards…

Interestingly, a recent DfT paper recognises the beneficial potential of competition on costs: it looked at rail freight as an example and concluded that competition can indeed drive down costs, both for the operator and for the infrastructure provider:[14]

> *"The competitive environment has also forced rail freight to find significant efficiencies over recent years, and it has encouraged Network Rail to do the same. As a result, in an industry that has had difficulty in reducing costs, freight has made good progress. Government seeks to repeat this approach with similar success for passenger services."*

Note that freight operators bear the consequences of changes in track access charges. As a result, freight operators argued strongly for a reduction in Network Rail's costs in their Periodic Reviews in 2003 and 2008. The franchised passenger operators have no such incentive and have not challenged Network Rail's costs.

…two steps back

But three paragraphs earlier, the Paper presents a contradictory view:

> *"Government values the benefits of competition that open access can bring, such as greater choice and lower fares for some passengers. However, these benefits must be set against the need to*

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[14] HMSO, *Reforming our Railways – putting the customer first*, 2012.

> *reduce the overall cost of the railway to taxpayers. Open access operators are only charged marginal track access costs compared to franchised service operators who are charged full track access charges. Given the UK's financial position, Government does not therefore at this stage support an increase in open access competition."*

But why is it credible that freight competition drives down rail industry costs but passenger competition drives costs up? How does the DfT expect to repeat freight's success if it explicitly rules out introducing more competition into passenger services?

The DfT's analysis is misleading for two other reasons: the method of allocating charges to use the rail network; and the means by which the DfT and ORR assess the impact of competition on franchise holders.

Charges for using the rail network

There are three types of track access charge – fixed, variable and capacity:

- Fixed track access charges are designed to recover Network Rail's fixed costs across the services specified by the DfT. They are paid by franchise operators as a 'pass through' from government to Network Rail. They are intended to fund the basic rail infrastructure. If there were no freight operators or open access passenger operators, this fixed charge would remain unchanged.

- Freight operators, open access operators and franchise operators who want to add services pay variable access charges which are designed to cover the additional Network Rail costs created by this extra usage.

- In addition they pay capacity charges which are supposed to compensate Network Rail for costs which may result from lower overall reliability created by the extra trains.

This means that open access operators pay the same real costs as franchise operators but without the ability to access the same markets.

The DfT's outdated approach to assessing the impact of competition

The DfT – rightly – wishes to maximise its income or minimise the subsidies paid from franchise agreements. In its eyes however, it still sees monopolistic franchises as the best way of achieving this.

The Office of Rail Regulation (ORR) and its predecessors have operated the concept of "Moderation of Competition" (MoC) since privatisation, on the basis that while competition is good for passengers, it is difficult to reconcile with a franchise model.

MoC was initially introduced to reduce uncertainty in an immature market. It was based on the idea that a franchise operator could lose revenue to other operators, thereby diminishing the value of the franchise and thus either reducing the premium paid by franchisees or increasing the subsidy paid by government. However, the ORR has said that it does not believe MoC should be continued in the next round of franchises.

That is welcome. There is, however, an additional method of assessing the impact of competition, the "not primarily abstractive test" (NPA). This is used to assess whether or not a new service will fundamentally damage the viability of franchised services. For new routes and operators, it attempts to model how many new passenger journeys will be generated and how much “abstraction” from existing services will take place.

This NPA test uses forecasting models developed by British Rail in the 1970s. If the test forecasts a new service to be primarily abstractive, then the ORR is unlikely to grant the application. This significantly restricts the ability of new operators to enter the market unless they focus on completely new routes. These of course may not be financially viable.

The NPA model is also based on old travel patterns. Much has changed since the 1970s of course, not least the development of internet ticketing. Most passengers used to travel on tickets giving rights to travel on any relevant service between two points. Today, only 30% of passengers do this, most choosing to pick specific trains to get value for money. The NPA forecasting models do not take this into account.

Consequently the NPA test, which has held back market development and rail competition, is no longer appropriate or fit for purpose. It was introduced in 2004 before the new open access operators had detailed operational and commercial data. This market is now much more mature with detailed data showing that open access operators do indeed generate significant new traffic rather than simply take passengers from existing services. The NPA should be abolished.

How monopoly franchise holders deter new competition

In 1998/9 Virgin gave up running direct trains from Shrewsbury to London Euston. In 2008, a new open access rail operator, Wrexham & Shropshire (W&S), restarted the service from

London Marylebone with more comfortable carriages and an easy to understand fare tariff. In the spring of 2010, W&S scored a 99% satisfaction rating, the highest rating in the history of the National Passenger Survey from Passenger Focus, the independent rail watchdog.[16]

However, W&S had to modify its initial bid after facing fierce resistance from Virgin, the holder of the West Coast Main Line franchise. Virgin used the "Moderation of Competition protection" clause in its franchise agreement to argue that competition from W&S could result in potential losses to its own operations. As a result of Virgin not being prepared (or being under any obligation) to give any concession on their monopoly rights, W&S was barred from stopping at, or carrying passengers from, various stations on its routes: For example, although W&S called at Wolverhampton, it was not allowed to carry passengers between there and London; and while it passed through Coventry, it was not allowed to stop there.

Early in 2011 W&S ceased operations after a review concluded there was no prospect of the business ever returning a profit based on its limited operations. The franchise holder had successfully seen off an innovative and popular competitor. W&S's business plan could have been more robust but Virgin's successful defence does show the opposition and challenges from the bigger rail companies to those attempting to provide on-rail competition.

There is also some evidence to show that some franchise holders are consciously introducing and operating services which are solely designed to prevent open access services

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16 National Passenger Survey,*Passenger Focus*, Spring 2010.

from being set up. For example, in 2009 open access operator Grand Central was looking to send new trains to Bradford. The DfT and the then franchise holder National Express sought to send new trains to Lincoln and Leeds, even though they were unaffordable and had poor loads, in order to fill the rail slots.[17]

The collapse of the rail franchising award process in 2012 and the certainty that no new long-distance rail franchises will now be awarded until 2014, at the earliest, represents a huge opportunity to boost future rail competition. The DfT should therefore re-examine its tendering process to ensure that open access operators are able to compete effectively with future franchise holders.

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[17] *Transit*, "NXEC confident of seeing off twin threats", 12 September 2008.

3. THE ECML: A CRUCIBLE OF COMPETITION

The two current open access companies, Grand Central and First Hull Trains, are now large enough to enable the impact of the competition to be assessed. And the evidence is clear: increased on-rail competition can deliver higher passenger demand, higher revenues and lower fares for passengers. Reports commissioned by the ORR indicate that competition between rail operators has resulted in:[18]

- faster journey times and/or higher frequencies;
- lower average fares;
- less crowding in response to the higher number of seats;
- choice of suppliers for passengers;
- incentives to cut costs for all operators;
- innovation in ticketing and overall service.

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[18] See ORR/Ove Arup, *On Rail Competition Analysis*, 2009; CERRE, *Options for increasing competition in the Great Britain rail market*, 2010.

The impact of competition on passenger numbers

Has competition generated higher passenger growth rates compared with examples which are only served by a single monopoly franchise operator?

New data taken from the LENNON[19] rail ticket database illustrates the change in journeys, revenue and yield (average fares) between 2007 and 2012 for ECML stations, some of which enjoy competition and some of which do not. It shows that:

- passenger journeys increased by 42% at those stations which enjoy rail competition, compared with 27% for those without competition;
- revenue increased by 57% where competition occurs compared to 48% for those stations without competition;
- average fares increased by only 11% on those stations with competition, compared to 17% at those stations without competition.

In Figure 6, the change in passenger growth experienced by those ECML stations which enjoy competition are represented by the dotted trajectories, while those without competition are shown using solid lines. The average change for all stations is the thicker solid line. The charts show that, for example, at Leeds, the absence of competition correlates with low passenger growth and low passenger revenue.

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19 LENNON is Latest Earnings Networked Nationally Over Night. It is operated by the Association of Train Operating Companies (ATOC) and manages the allocation of all ticket sales/revenues to Train Operating Companies (TOCS) in the UK.

Figure 6: Growth in passenger journeys from those stations with and without competition, ECML (south) 2007 to 2012

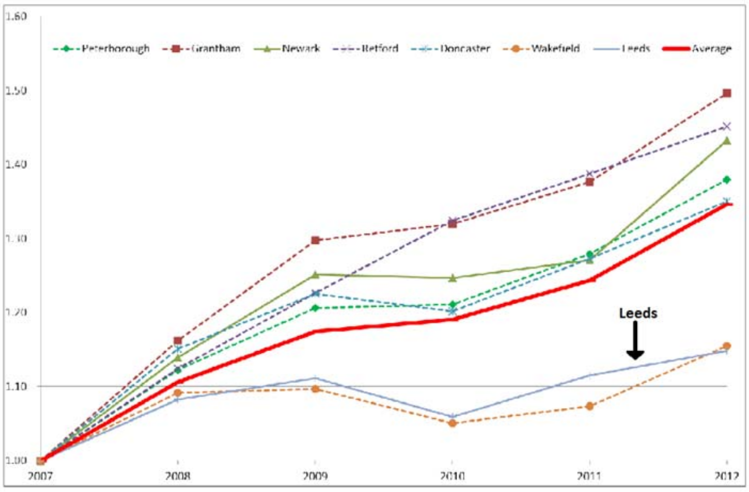
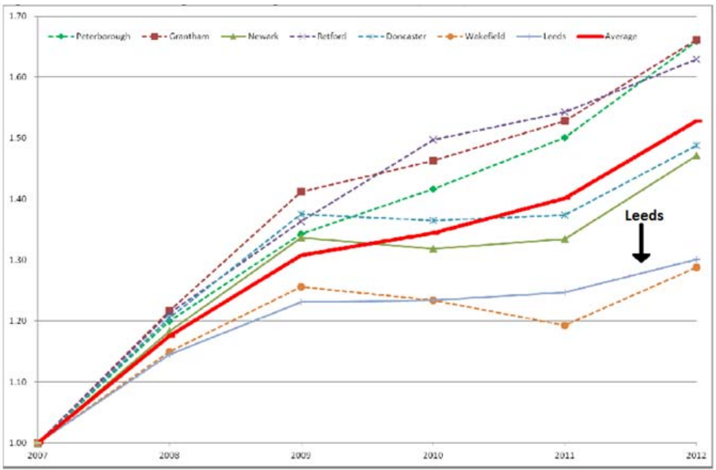
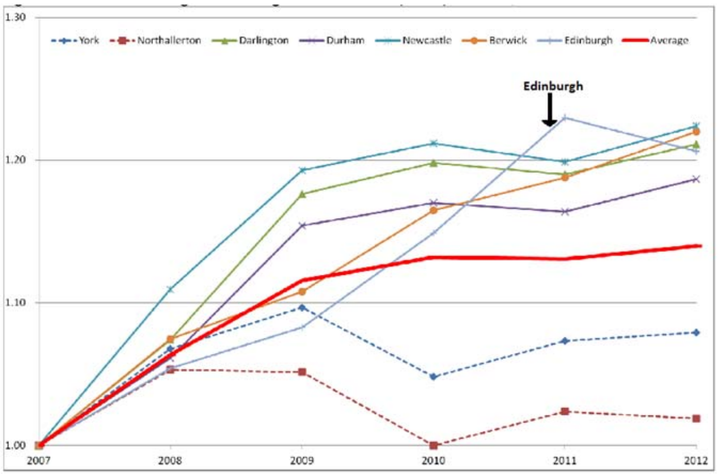


Figure 7: Growth in passenger revenue from those stations with and without rail competition, ECML (south) 2007 to 2012



Ticket prices on those routes with competition have been stable and in many cases lower than in 2010 but at competition-free Edinburgh, for example, fares rose sharply between 2009 and 2011.

Figure 8: Change in passenger yield (average fares) from those stations with and without rail competition, ECML (north) 2007 to 2012



Source: AECOM analysis

York: a case study of how competition works

A comparison of new passenger and yield results for the large ECML rail hub at York, which enjoys competition, shows a significant increase in passenger journeys since 2008. Whilst the open access competitor at York has been successful in terms of attracting new passengers, the franchise holder has also seen passenger numbers grow.

Figure 9: Growth in passenger journeys at York since 2008 showing growth in franchised service (EC) and overall rail services (including open access)

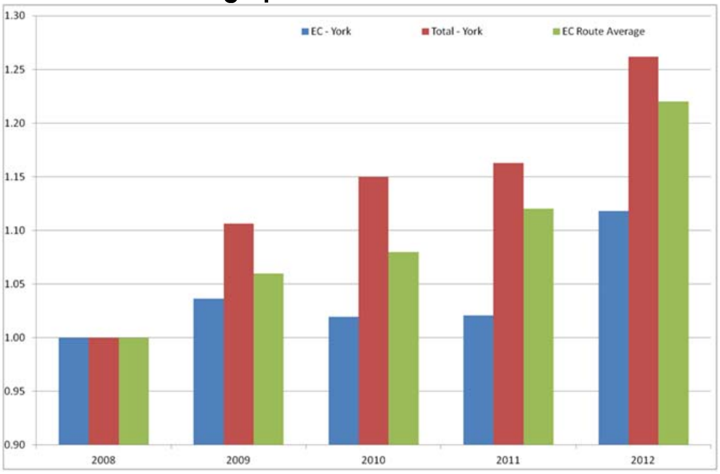
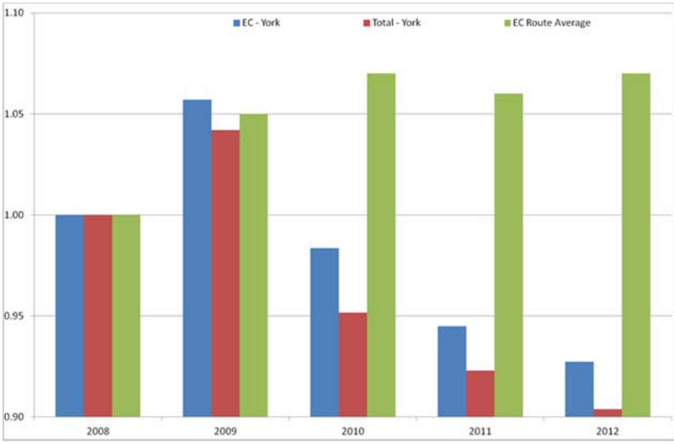


Figure 10: Reduction in revenue yield (fares) at York since 2008; against the franchised operator's average along the whole ECML route



Source: AECOM analysis

Competition helps the franchise holder pay the premium

Traditional thinking in the DfT has been that more competition and open access on long-distance rail routes will reduce the premiums that franchise holders are able to pay to government. In other words, more competition will lead to a fall in government revenues.

But, again, the experience on the ECML suggests otherwise. As Figure 11 shows, East Coast/Directly Operated Railways, the interim operator of the East Coast franchise, paid the largest premium of all long-distance operators in 2011/12 at £187.7m, a significant increase on both previous years. This does not suggest that franchise value has been affected by open access competition from both Grand Central and Hull Trains; on the contrary it has been of benefit.

Figure 11: Train Operator Profits and Subsidies 2009-12

		Operating Profit for year (£m)			Subsidy for financial Year (£m)		
	Year end	2009	2010	2011	2009/10	2010/11	2011/12
Arriva Trains Wales	31 December	13.8	15.3	20.5	128.6	129.8	136.8
c2c Rail	31 December	3.8	9.7	14.7	-3.3	-6.4	-12.1
Chiltern Railways	31 December	-4.3	-16.4	-57.1	8.8	-16.7	6.5
Cross Country	31 December	-8.4	-12.9	-30.0	65.5	31.4	6.7
East Coast (Directly Operated Railways)	31 March		1.3	4.6	-46.1	-170.7	-187.7
East Midlands Trains	30 April	3.4	-27.8	-34.0	10.0	-22.3	-40.4
First Capital Connect	31 March	5.4	-2.0	2.5	-89.1	-136.4	-162.7
First Great Western	31 March	-12.8	9.4	-52.3	-2.9	-103.7	-110.1
London Midland	03 July	-0.3	-4.7	-2.7	102.4	67.3	65.3
London Overground	31 March	3.8	0.8	7.5	N/A	26.0	26.1
Merseyrail	08 January	12.5	13.3	14.9	N/A	70.6	74.7
National Express East Anglia	31 December	19.9	19.3	29.6	-97.4	-108.9	-72.6
Northern Rail	08 January	30.3	37.9	35.2	106.4	68.4	96.7
First ScotRail	31 March	22.5	20.3	15.6	271.0	290.0	305.0
Southern	03 July		3.0	18.5	48.0	-102.3	-16.7
Southeastern	04 July	16.0	6.6	21.8	122.8	218.2	86.7
South West Trains	30 April	15.3	24.1	47.5	-137.7	-177.6	-228.6
Virgin Trains	05 March	67.5	49.4	34.3	50.0	-167.9	-165.7

Negative Subsidy indicates premium paid to Government

Source: *Rail 2020,* Commons Transport Select Committee, 2013.

4. THE WIDER BENEFITS OF COMPETITION

Passengers

For passengers, open access allows some measure of competition and choice on long-distance routes. In particular for those booking in advance, the benefits are similar to those of low-cost airlines, with competitive services to a wide range of destinations, albeit with fairly low frequencies. For example, on the ECML travelling to or from York or Doncaster, the provision of non-stop services has also shortened journey times; while from Halifax in West Yorkshire or Selby in North Yorkshire, open access has provided a direct connection to London.

As well as shorter journey times and improved connectivity, open access operators also perform well in terms of passenger satisfaction. In the latest National Passenger Survey (NPS) it is striking that open access companies top the performance tables. For overall satisfaction, value for money, punctuality/reliability, comfort and dealing with delays the open access companies topped the survey.[20]

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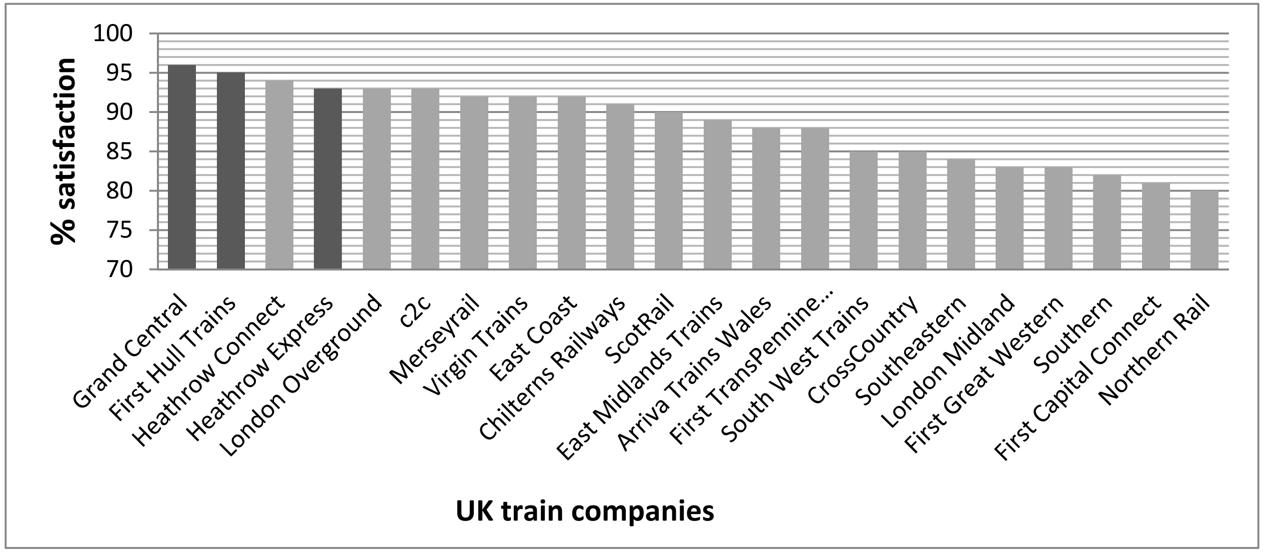
[20] National Passenger Survey, *Main Report Autumn 2012*, published 29 January 2013.

Figure 12: Passenger satisfaction by train company – Autumn 2012



Note: Open access operators in darker shade

Source: National Passenger Survey, Autumn 2012 (released January 2013).

The correlation between competition and satisfaction also works in the less well-performing parts of the network. The Northern franchise, for example, receives one of the largest subsidies of all and endures low satisfaction levels.

The local economy

Availability of transport links is a vital element in making a location attractive for business. Rail's overall importance for the economy is well understood, with 1 billion out of 1.4 billion total journeys being for business or commuting. But the value of good rail links on local economies are sometimes under-estimated, not least by the DfT's model which doesn't take into account the wider economic benefits – such as job creation – associated with new direct rail links with London.[21] In this model, decisions about whether to proceed with investments are dominated by issues such as the potential time savings for existing passengers. But this model excludes wider factors such as lower fares and direct connections, which are currently treated as secondary factors.[22] A parallel here is the apparent DfT obsession with speed for the proposed HS2 line, over other important factors such as seamless direct connections with major airports like Heathrow.

Recent work by the Northern Way, a group of local authorities and business groups, placed great emphasis on connectivity without having to change trains, again not something the traditional model would value. Research from Systra, a leading

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21 *Britain Relies on Rail*, Network Rail, 2010.

22 A major part of the attraction of open access operations on the ECML, for example, is that they are the only operators to offer direct regular services to London from towns and cities such as Sunderland, Halifax, Hartlepool and Selby.

transport and rail consultancy, also shows that the need to change trains on a rail journey can suppress demand for that service by as much as 50%.[23] Chambers of Commerce and local political leaders whose towns and cities enjoy open access rail services have emphasised their support.[24] For example, the Bradford Chamber of Commerce has stated:

> *"It keeps Bradford on the map, offers a less expensive option to local people, and has created job opportunities in the area as well."*

Similarly, the Hull Chamber of Commerce is in no doubt about the importance of the effect of on-rail competition:

> *"Hull Trains have done an outstanding job for the city in improving our rail service from one a day return with GNER to seven a day now."*

The North East Chamber of Commerce has stated:

> *"The Hartlepool (open access) rail link has assisted in securing inward investment to the Enterprise Zones around Hartlepool and Stockton. There is evidence that companies are more willing to look at the area because of the rail link."*

The same effects could also apply if open access competition were allowed to flourish on other lines, particularly on the West Coast Main Line.

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23 Greengauge 21, *Strategic Choices*, 2008/9.

24 This feedback follows CPS enquiries with each respective Chamber of Commerce in January 2013.

The benefits for the taxpayer

It is now clear that where franchise holders co-exist and compete with open access operators, then the franchise holder as well as the open access operator can both enjoy passenger growth with no "premium abstraction".

Improved connectivity to under-served locations by open access operators can even help to reduce overall rail subsidies.[25] For example, Grand Central's West Yorkshire service offers a direct London train for towns and cities in West Yorkshire. Without this service, passengers would have to change to reach London. This is now provided with no taxpayer subsidy and the route has seen market growth of 192% since its introduction in 2010.

The taxpayer also faces little risk with open access operators. Unlike franchises, they are fully independent commercial operations which receive no subsidy and are not able to transfer risk to the government. Compared to the broken contracts on the ECML and the cost of the WCML franchise debacle in 2012, this can only be welcomed.

Perceived risks from more open access

In the eyes of the DfT and some franchise holders, the perceived risk of allowing more open access rail competition is that they would "cherry-pick" the supposedly profitable routes while disregarding the unprofitable ones.

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25 Forecasting work by Steer Davies Gleave for the DfT has shown that the benefit-cost ratio is higher for some locations to be served by open access services, rather than franchised services because highly prescribed/high cost franchises have higher incremental costs than open access operators.

This is the logic behind the 'Moderation of Competition' protection in franchise agreements, which prevented open access operators competing and stopping on some of the franchised service's main routes.

This brings out the biggest challenge for expanding open access. The franchise system grants medium-term monopolies and freezes out competition on many routes where new operators might be viable. Under the current rules, open access operators can provide niche services but are never going to be allowed to compete fully on the key national lines.

But these rules are clearly wrong: the evidence in this paper shows franchises and open access operators can successfully compete and co-exist, all in the interests of the network as a whole, the franchise holder and passengers.

Implications of encouraging more on-rail competition
Franchises for long-distance routes must now be reconsidered. In particular, open access operators must be allowed and encouraged from now on to operate alongside franchises.

The ECML is the obvious candidate for piloting this new model. It has two growing and successful open access operators and a franchise which has been abandoned twice and is now in state hands. By not re-letting the franchise as a conventional, exclusive contract in 2014, but enabling more open access within it, the DfT could enable more competition to emerge and further exploit the success for the franchise holder.

One critical issue is the conflicting priorities, interests and lack of innovation of the ORR by failing to offer more slots to open access operators, it has acted too often as a drag on competition and not held Network Rail to account for its progressive failure to properly identify and make available capacity on the rail network. A new independent body – an Office of Rail Competition and Utilisation (ORCU) – should be set up with a mandate to:

- encourage as much competition as possible between train companies and to free up as many routes as possible;
- ensure that Network Rail is incentivised to maximise the capacity available on all routes through its role in the timetabling process;
- identify and explain to Ministers and Parliament the benefits of more rail competition, how it can reduce industry costs and boost passenger satisfaction;
- act as an official link between open access operators and the DfT;
- detail, in light of the rail franchise collapse of 2012, how open access should play a bigger part alongside soon to be re-let franchises.

The role of the Office of Rail Regulation would then be limited to ensuring that Network Rail delivers its obligations cost-effectively.

The opportunity in 2013

Importantly, on the West Coast Main Line, the ORR has a key opportunity to approve new open access services later this year. Alliance Rail Holdings proposes new open access trains to serve poorly connected towns and cities in the North West, Cumbria and Yorkshire with London.

Will it seize this opportunity?

5. LEARNING THE LESSONS OF FREIGHT

Rail freight was privatised at the same time as the passenger sector and has benefitted from strong on-track competition. Just as competition has yielded many benefits in the passenger sector (in the few places where it has been allowed to operate), so too has competition seen a revival in rail freight. Investment in new rolling stock, high levels of productivity and reduced costs have generated growth in new markets.

Rail freight is open access. It does not receive a subsidy, pays variable track access and competes. Today there are five registered rail freight operators in the UK; DB Schenker, Freightliner, GBRf, DRS and Colas. Operators know that they will go out of business if they do not compete effectively.

An important customer benefit of rail freight competition is that it means that distribution is not captive to a single company. Even if they never in fact change operator, customers like to know that they can. Some customers, such as the power generators who rely on large and regular trainloads of coal (and increasingly biomass) from ports, regularly contract with more than one operator, which also insulates them against problems with one company. It is hard to imagine a company (such as a major retailer) being prepared to use rail if they had only one choice of operator – and even more so if that was government-owned.

Responding to a changing market

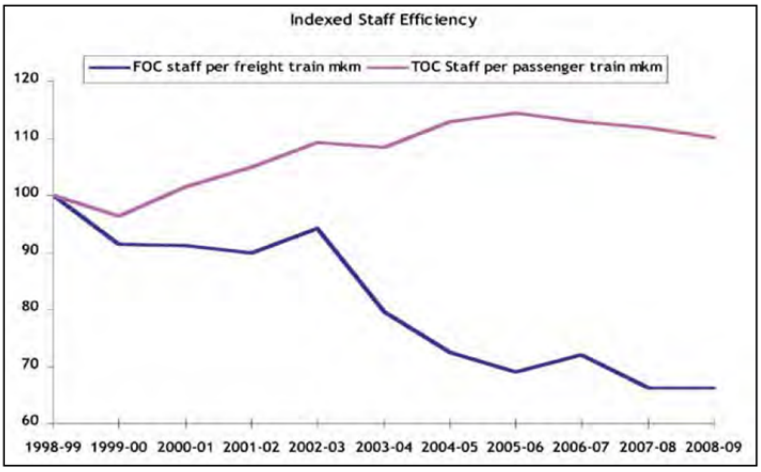
The freight market has changed radically since privatisation. At that time, it was dominated by certain types of bulk flow, especially coal, and still encompassed wagonload freight, where small volumes were concentrated into bigger trains running between key locations.

Many of freight's traditional markets, including locally mined coal, have declined. But there has been a phenomenal growth in container traffic, most of which has originated from terminals at ports such as Felixstowe and Southampton. The freight companies have responded to the market and tailored their services to match demand as far as possible. A good example is the huge change in the way coal is moved; no longer from domestic mines but now largely imported, from ports direct to power stations.

If freight operators had been granted exclusive 10-year franchises, there would not have been either the flexibility or incentive to innovate to satisfy the market. As it is, the freight business has struggled to meet demand for bigger containers as much of the network is not designed for very high or wide loads. Network Rail is only slowly adapting key freight routes.

Competition has encouraged companies to reduce their costs: between 1998/9 and 2008/9, the freight operating companies had reduced their unit costs by 35%, while the passenger operators saw increased costs of 10%.

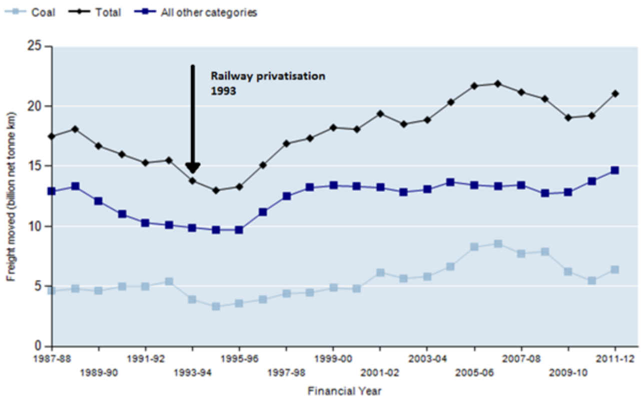
Figure 13: Staff productivity – freight and passenger operating companies (FOCS/TOCS)1998 - 2009



Source: DfT, *Realising the Potential of GB Rail,* May 2011

The result has been a 50% growth in freight traffic (in tonnes kilometres) since privatisation, with half the number of locomotives and two thirds of the wagons used at the time of privatisation as Figures 14 and 15 show.

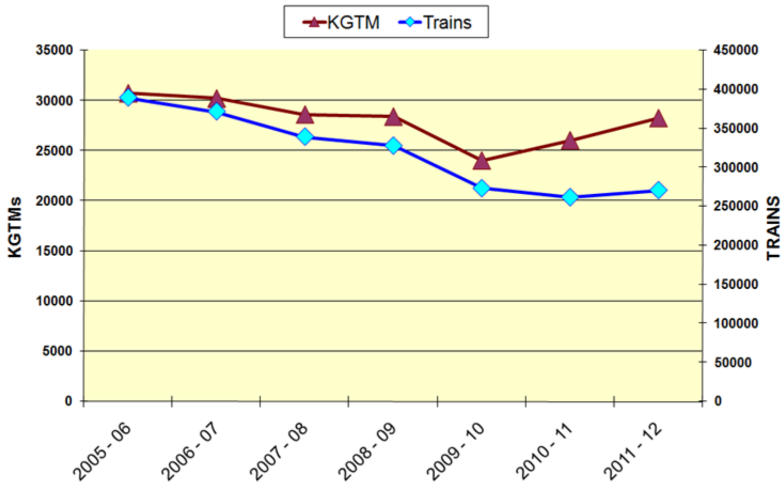
Figure 14: Freight moved by rail (billion net tonne kilometres) 1988 – 2012



Source: Network Rail

In the last seven years the volume of goods moved against the number of trains used shows a considerable efficiency gain.

Figure 16: Volume of rail freight v train numbers 2005 -12 (KGTM means 1000 Gross Tonne Miles)



Source: Network Rail

6. CONCLUSION

The Government faces a great opportunity.

After last year's collapse in rail franchising, it has the chance to enable more competition on the passenger rail network. This would boost efficiency, reduce costs and deliver more passenger choice, where capacity exists. And it would enable the Government to fulfil its ambitions to 'put customers first', as its recent Command Paper pledges.

The DfT and the ORR should therefore drop their opposition to new long distance open access services on these routes and elsewhere on the UK rail network.

The future of franchising

The West Coast Main Line franchise problems have delayed the re-letting of other franchises whilst the DfT ponders the Richard Brown report on the future of franchising and the recent Commons Transport Select Committee's *Rail 2020* report.[28]

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[28] HMSO, *The Brown Review of the Rail Franchising Programme*, January 2013; Transport Select Committee, *Rail 2020*, 2013.

This has created further congestion in an already hectic period of franchise renewal over the next two years. It is probable that this will lead to delays in new franchises being awarded.

The DfT must now respond to the need to reform the franchise system: the present model for encouraging, facilitating and operating the supply of passenger services could and should be so much better. Far greater open-access competition should be at the heart of future franchise agreements while the Moderation of Competition concept and the “not primarily abstractive test” should both be abolished. A new Office of Rail Competition and Utilisation (ORCU) with a clear mandate can facilitate and drive and deliver these new opportunities. Competition, not the protection of monopoly, must be the guiding principle behind reform.

Twenty years since railway privatisation and the industry has a genuine opportunity to embrace the initial ambitions of more competition and more private sector investment. The franchise chaos of 2012 has allowed a window for new thinking and better policy. The railways might not get another chance.

GLOSSARY

ATOC:	Association of Train Operating Companies
BR:	British Rail
DfT:	Department for Transport
ECML:	East Coast Main Line
FOC:	Freight Operating Company
KGTM:	1000 Gross Tonne Miles
LENNON:	Latest Earnings Networked Nationally Over Night
MoC:	Moderation of Competition
NPA:	Not Primarily Abstractive
NPS:	National Passenger Survey
NR:	Network Rail
ORCU:	Office of Rail Competition and Utilisation
ORR:	Office of Rail Regulation
TOC:	Train Operating Company
WCML:	West Coast Main Line
W&S:	Wrexham and Shropshire

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