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Dear Philip,

ORR consultation on on-rail competition: Options for change in open access – Network Rail's response

We welcome the opportunity to respond to this consultation. We consider that the issues relating to on-rail competition and open access are very important.

1. Executive summary

Open access passenger operators, (referred to in this document as OAOs), provide niche but important services to passengers. ORR's consultation covers important issues which could have a significant impact on how open access services may develop in future years. This consultation discusses a number of issues, including the importance of having a stable regime, the question of which parties should contribute to the fixed costs of running the railway, identifying and reducing barriers to enter the market and ensuring incentives for all parties do not become distorted through any changes in policy. We summarise the key points of our response, below.

- There is an argument that OAOs should contribute to the fixed costs of the railway, but not at the expense of discouraging economically viable traffic flows.
- We consider that ORR has identified a good range of options for reforming open access charging policy.
- We think that consideration should be given to the likely financial impact of these options across the whole railway value chain, and the behaviours they would drive.
- We strongly believe that Network Rail should be financially incentivised to grow all traffic including open access.

- Our recent work on the recalibration of the capacity charge for PR13 shows that charges on the East Coast Main Line should be considerably higher than the level currently being levied - to more accurately reflect the additional Schedule 8 costs we face. OAOs are concerned that such increases could jeopardise their financial viability. This illustrates the importance of charges and incentives on OAOs and the vulnerability of their business models to changes in charging arrangements.

- We consider that any adjustment to Network Rail's funding, in relation to the collection of an open access fixed charge, should be dealt with clearly and explicitly.

- We consider that open access charging policy should be considered over the longer term. We feel that it is an area that should be discussed at the RDG[1] working group on regulatory and contractual reform, as part of the RDG-led accelerated review of charges for CP6. The CP6 review needs to be more fundamental and so may be a useful way in which to tackle these issues

2. Structure of response

This response covers and number of issues, including specific responses to the consultation questions in Annex A. The response is structured as follows:

- Introduction and background
- Barriers to entry
- Incentives
- Dealing with over-recovery by NR
- Practical issues and implementation
- Conclusions
- Annex A – Network Rail's responses to consultation questions

3. Introduction and background

We welcome the opportunity to respond to this consultation. We consider that the issues relating to on-rail competition and open access are very important.

Network Rail is committed to generating outstanding value for customers and taxpayers. To the extent that increased on-rail competition can facilitate this, through the creation of new journey opportunities for passengers or improved utilisation of the network, we would fully support it.

The GB franchising and regulatory model was designed to balance the needs of competing demands on the railway in a way which optimises value to the taxpayer and rail users. Franchising policy is an area most likely to have an impact on ORR's proposals. For

[1] Rail Delivery Group

example, longer franchises may mean that short/medium term changes in passenger demand may not be met by franchisees and so OAOs may be able to fulfil this demand. Conversely, more flexible franchises may reduce the scope for open access where franchises are more readily able to 'flex' services to meet demand.

Network infrastructure is expensive to build and maintain, and is characterised by very long asset lives. Because of this, there is a need for considerable care and effort in planning and coordinating its use so as to maximise value from it. The best way to use the infrastructure will also change over time, requiring measurement, challenge and adjustment to continually re-optimise the mix of usage.

We consider that on-rail competition has brought benefits to the passenger rail market. In particular, OAOs provide direct services to locations previously offered only a limited or no service. OAOs have provided high quality services resulting in valued passenger experiences. Current OAOs tend to score high levels of passenger satisfaction[2].

We consider that greater passenger choice is likely to increase the overall size of the rail market, resulting, potentially, in higher societal benefits including the regenerative effects that improved rail provision can offer. OAOs have been successful in identifying service gaps and in providing challenge to franchised passenger operators. OAOs have also taken innovative approaches to their operations, in particular with their fares structure.

The franchising and regulated track access processes are crucial to the debate as to any potential increased role for competition for passenger train services. When thinking about the possibility of increased on-rail competition, consideration should be given to how best to specify passenger train services via franchising to maximise exploitation of the rail infrastructure, whilst balancing the commercial and societal roles of the network. Consideration will also be needed to ensure that any changes are made cognisant of impacts on the cross-subsidies elicited from franchising. It is worth noting that unconstrained competition for access to the rail network would be likely to lead to the loss of vital services for commuters and potentially significant increases in net subsidy to the running of passenger trains from the 'unbundling' of cross-subsidies.

4. Barriers to entry

Currently, OAOs are required to pass the 'not primarily abstractive' (NPA) test before being granted access rights. The NPA test is passed if the new services are deemed not to be primarily abstractive of the incumbent franchisee's revenue. The NPA test can be considered to be somewhat opaque, with the results difficult to predict. We understand that it is considered to act as a significant barrier to entry to the market, both in terms of the perception of complexity around the test, and the need to 'pass' the constraints set. OAOs are fully exposed to market forces unlike franchised operators, which often have financial stabilisers in their franchise agreements. Therefore, we recognise that potential OAOs require a stable and transparent regime, to allow them to build viable business models.

Further to this, the NPA test may 'force' OAOs to bid for services which are 'sub-optimal', in network usage terms. In particular, calling patterns are often designed to pass the NPA test with trains not stopping at stations that would generally 'make sense' in terms of journey

[2] Passenger Focus, National Passenger Survey: http://www.passengerfocus.org.uk/research/nps/content.asp

opportunities, timetable robustness or optimisation of range of services on a line of route. From a passenger perspective, the existence of trains which do not call at key locations (or call to ‘set down only’) because they are OAOs can be highly confusing.

Overall, we see potential merits in ORR’s proposals to relax the NPA test, as this is likely to result in better use of capacity, with open access services calling at additional stations where it is economically appropriate or operationally opportune, to do so.

Network Rail has recently conducted a number of focused interviews with aspirant and existing OAOs. These highlighted a desire from aspirant operators for the NPA test to be conducted earlier in the process. This would provide more certainty in business planning for operators and reduce the likelihood of abortive work within Network Rail’s capacity and timetable planning teams.

4.1. Options in consultation

ORR consults on four options:

Option 1: status quo, under which access is not granted if the NPA test is failed.

Option 2: OAOs would pay a charge based on the level of revenue abstracted over and above the currently permitted level, in return for a partial relaxation of the NPA test.

Option 3a: OAOs pay a charge based the current FTAC paid by franchise operators, in return for a partial relaxation of the NPA test.

Option 3b: OAOs pay a charge based on an estimate of the avoidable costs it incurs, in return for a partial relaxation of the NPA test.

We think that ORR has identified a good range of options. However, we believe that consideration should be given to the likely financial impact of these options across the whole industry value chain, and the behaviours that they would drive. This would affect Network Rail, OAOs, franchised operators, funders and taxpayers (through the franchise competition process).

We discuss the potential impacts of each of the options, below.

4.2. Option 1

Option 1 is attractive in that it would cause no additional transactional costs and would continue a regime that is at least reasonably well understood. However, it is clear that OAOs consider that there are barriers to entry in the existing arrangements. The current policy has not encouraged a huge number of new open access proposals, suggesting that the return for aspirant operators is not currently excessive.

4.3. Option 2

Option 2 appears to be reasonable, in that it aims to ensure that franchisees are made no worse off by the entry of a new non-franchised operator in their operating areas. However, we note that this would be a marked difference to current access charges which are all cost-based. Clarity about the details behind such an approach would be important before a full appraisal of its pros and cons could be carried out.

4.4. Options 3a

Option 3a would have the advantage of being consistent with other charges, in that it would be a cost-based approach. This approach could lead to OAOs seeking to selectively enter the market where the FTAC is significantly lower than expected revenue abstraction. Services of this nature could well be primarily abstractive.

4.5. Option 3b

Option 3b could result in the same impact as that caused by option 3a, with operators seeking to selectively enter the market where the avoidable cost-based charge is lower than the expected revenue abstraction. It would be broadly consistent with the new freight specific charge in CP5 – which seeks to recover a contribution to Network Rail's avoidable costs caused by freight trains. This approach is likely to be very complex, in practice, given the experience of estimating freight avoidable costs[3]. Further to this, our understanding is that this type of charge would need to be calculated each time an operator seeks to run a new open access service, which may increase complexity and introduce significant uncertainty for aspirant OAOs.

5. Incentives

5.1. Charges and incentives for OAOs

Variable charges, in particular capacity charges, and Schedule 8 are all important issues to consider in OAOs building business cases. For PR13, a recalibration of the capacity charge has been carried out for the first time since 1999. This shows considerable changes, in particular on the East Coast Main Line, where usage patterns have significantly changed over the last 15 years. OAOs have suggested that if the recalibrated capacity charge rates were adopted in CP5, it could threaten their continued operation. This illustrates the extent to which OAOs' business models are vulnerable to changes in the charges and incentives regime. ORR should be mindful of the extent to which it can, itself, introduce uncertainty for OAOs from changes in the charging regime. We consider ORR should bear this in mind in concluding on its consultation.

5.2. Incentives for Network Rail

We consider that, working with prospective OAOs, Network Rail can improve use of existing capacity, and seek ways to 'unlock' capacity. This is a key focus for Network Rail in its system operator role. We strongly believe that the various financial incentive mechanisms for Network Rail should be consistent with this objective, so as to support our aim of delivering outstanding value for customers and taxpayers.

ORR has recently proposed, in its PR13 draft determination[4], that capacity charges in CP5 will not be adjusted to reflect the recent Schedule 8 recalibration. This proposal means that

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[3] As an example, the work to quantify the avoidable costs of freight took around a year to complete.

[4] Available at: http://www.rail-reg.gov.uk/pr13/consultations/draft-determination.php

Network Rail would not recover the additional Schedule 8 costs it faces in accommodating additional traffic. We are very concerned that this proposal, if implemented, would have the effect of leaving Network Rail with little or no financial incentive to grow traffic on certain parts of the network.

Typically high value parts of the network require trade-offs in decisions around capacity allocation and performance, and potentially additional investment in order to unlock additional paths. Providing effective financial incentives to Network Rail, to continue to seek ways to maximise use of the railway, would be a key enabler to further growth in open access operations.

5.3. Incentives for incumbent franchised operators

In considering ORR's proposals, we are unclear as to whether any new policy may restrict franchised operators from applying to run incremental services. It would be helpful if ORR could clarify its position on this. Conversely, it is important that franchised operators are not incentivised to fill all spare capacity to the detriment of potential OAOs.

Additionally, we consider that increased certainty around the level of open access competition could reduce the risk to franchisees, thus maximising franchise value for DfT (Department for Transport) and Transport Scotland.

6. Dealing with over-recovery by NR

6.1. Adjustment at a periodic review

ORR proposes to take into account any over-recovery by Network Rail (via the potential open access fixed charge) at the next periodic review. We would like to understand, in more detail, how this might work.

6.2. Adjustment through the volume incentive

ORR highlights that there may also be an offsetting impact on the volume incentive, if it were to exclude open access traffic from that mechanism. We consider that this approach may give rise to potential undue discrimination, if Network Rail's incentives to grow traffic are differentiated by type of operator. Furthermore, OAOs may not support the removal of an incentive which they may consider helps incentivises Network Rail to assist their growth.

We consider that any adjustment to Network Rail's funding in relation to the collection of an open access fixed charge should be dealt with explicitly and clearly.

6.3. Using over-recovery to fund Network Rail costs

There is also an argument that the 'over-recovery' may be a useful contribution to any costs Network Rail may incur in accommodating additional paths for OAOs, for example the costs of timetable modelling or additional enhancements to 'unlock' capacity.

7. Practical issues and implementation

Under the current regime, there is a risk of the working timetable being constructed around bids for additional paths that might have to be removed much later in the process, following failure of the NPA test. This carries the risk of leading to significant unnecessary work for the industry and, as it might not always be possible to re-write such a timetable to reflect the removal of these paths, a risk of sub-optimal timetables.

We suggest carrying out the NPA test earlier in the timetable process. In addition, we suggest that the size of the potential fixed charge to a prospective open access operator under option 2 or 3 being made clear as early as possible in the process. This could allow operators to assess if their business cases still hold.

We understand that ORR is keen to conclude on its open access charging policy in time for the awarding of new franchises over the next few years, however we believe there would be merit in considering any potential changes to OAO charging arrangements over the longer term. The options presented in this consultation relate to the transitional period, we think that consideration should be given to whether it is helpful to make changes in this period without clarity about the long-term aims of this policy. We feel that it is an area that should be discussed at the RDG working group on regulatory and contractual reform, as part of the RDG-led accelerated review of charges for CP6. The CP6 review needs to be more fundamental and so may be a useful way in which to tackle these issues.

We would welcome early discussions between aspirant OAOs, ORR and Network Rail.

8. Conclusions

Some stakeholders consider that OAOs should contribute to the fixed costs of the railway, particularly where there is competition for available capacity, or infrastructure investment is required to increase capacity or deliver acceptable performance although not at the expense of discouraging economically valuable traffic flows. We believe that there is some merit in this suggestion. A key point in considering potential changes to the open access regime, and the charges that OAOs pay, is to have a clear policy on which parties should fund Network Rail's fixed costs. We consider that fixed costs should, as far as is possible and practical, be recovered from those who cause them to be incurred or enjoy the benefits of the infrastructure. However, we feel that clarity in this area from ORR would be welcomed by the whole industry.

We strongly believe that Network Rail should be financially incentivised to grow all traffic including open access through effective existing mechanisms, for example the capacity charge and the volume incentive. We are very concerned by the proposed 'de-linking' of the capacity charge and schedule 8 rates that ORR discusses in its PR13 draft determination.

We welcome the forthcoming RDG-led accelerated review of charges for CP6. We consider that potential changes, in the way that open access passenger operators are charged for access to the GB network, is an area for the group to consider. Before significant changes are finalised, we consider that ORR should, working with RDG, construct a 'whole industry' impact assessment of any proposals to change the charging arrangements for OAOs.

If you would like to discuss any part of this response, please contact me directly. We are content for this response to be published on your website.

Yours sincerely,

Peter Swattridge

Head of Regulatory Economics, Network Rail

ANNEX A – NETWORK RAIL’S RESPONSES TO CONSULTATION QUESTIONS

Question 1: *Do you agree that we have identified the key barriers to open access competition? Do you consider that the steps we are taking will help to address these barriers or that there are other actions we should be taking? Do you agree that, given the plans for other work outlined above, the remaining barriers imposed by the NPA test are important?*

Our Response

The ‘not primarily abstractive’ (NPA) test can be considered somewhat opaque, with the results difficult to predict. We understand that the NPA test is considered by some stakeholders to act as a significant barrier to open access entry to the market. Overall, we consider there to be potential merit in ORR’s proposals to relax the NPA test, as this is likely to result in better use of network capacity with services calling at all stations where it is economically appropriate to do so.

Question 2: *What implications do you think that industry developments such as ERTMS, electrification and changes in EU law could have for our approach to on-rail competition? Are there other developments that could have an impact on our approach?*

Our Response

ERTMS should provide additional capacity – there will, however, be competing demands for the use of that capacity. It is important that there is a clear approach to how this capacity will be allocated. Franchising policy is an area very likely to have an impact on ORR’s proposals. For example, longer franchises may mean that short/medium term changes in demand may not be met by franchises and so OAOs may be able to fulfil this demand. Conversely, more flexible franchises may reduce the scope for competition where franchises are able to flex services to meet demand.

Question 3: *What are your views on Option 1? If we were to retain the current NPA test and structure of charges for open access what effect do you think changes to the economics of the railway and to capacity would have on the scope for and levels of open access competition? Do any factors other than those listed above favour (or not favour) Option 1?*

Our Response

Option 1 is attractive in that it would cause no additional transactional costs. However, it is clear that there are barriers to entry for potential open access entry. Reforms in franchising policy are likely to have the largest bearing on the scope for open access competition.

Question 4: *What are your views on Option 2? Should the mark-up be calculated on the basis of 100% of excess abstraction? Do any factors other than those listed above favour (or not favour) Option 2? What do you think of the feasibility of building a commercial case based on policy as described here? What changes/guarantees/mitigations would be needed to make this work?*

Our Response

Option 2 appears to be ‘neat’ in that it aims to correct the impact of OAOs on franchised services. It could be designed so that franchisees are made no worse off by the entry of a new non-franchised operator. However, we note that this would be a marked difference to current access charges which are all cost-based. We would be interested to further understand how money raised by this mechanism would be transferred between relevant parties.

In terms of whether the mark-up should be based on 100% of the revenue abstraction, (over an above the currently permitted level), we think it is important to ensure that whatever approach is decided is applied consistently. It may be worth examining this further to ascertain the extent to which the level of the mark-up starts to price OAOs out of the market.

Question 5: *What are your views on Option 3? What do you think of the feasibility of building a commercial case based on policy as described here? Are there any key practical or other issues that we have missed?*

Our Response

Option 3a would have the advantage of being consistent with other charges, in that it is cost-based. We understand that the potential result of this approach would be that OAOs may selectively enter the market where the FTAC is significantly lower than expected revenue abstraction. ORR should ensure that it fully understands the impact of this before making any changes to its policy.

Option 3b is likely to result in the same impact as that caused by option 3a, where operators seek to selectively enter the market where the avoidable cost-based charge is lower that the expected revenue abstraction. It would, however, be broadly consistent to the new freight specific charge in CP5 – which seeks to recover a contribution of the avoidable costs caused by freight. Under this approach it is likely to be very complicated to estimate the avoided costs[5]. Further to this, our understanding is that this type of charge would need to be calculated each time an operator seeks to run a new open access service, which may increase complexity and uncertainty.

Question 6: *Do you agree that the process described would be appropriate under Options 2 and 3? If not, what changes would you make and why?*

Our Response

It would be useful to set out how long an open access operator would have to decide whether ‘take or leave’ the mark-up. Also, it is not clear what happens to any mark-up revenue once it has been collected.

Question 7: *Do you agree with the approach to estimating mark-ups, particularly the use of generation and abstraction forecasts to decide whether mark-ups should be applied and, in the case of option 2, the size of the mark-up? Should OAOs be able to appeal the mark-up in the light of subsequent data?*

Our Response

We note that Network Rail is expected to take a significant role in calculating charges. We agree that this is reasonable; however we would like to reiterate that we would need sufficient notice to calculate new charges and agree internal processes to bill any such charges.

It would also be helpful to be clear with regards to the length of any access rights granted to OAOs. Network Rail would be concerned about granting long access rights if they were specified at a detailed level, as we believe that this could ‘ossify’ timetables and be likely to lead to sub-optimal usage of capacity.

[5] As an example, the work to quantify the avoidable costs of freight took around a year to complete.

The proposal in relation to the right of appeal appears to be inconsistent with any such rights with other charges which are sometimes calculated on the basis of a forecast. It would also be asymmetric, unless Network Rail (or the funder) also had the right of appeal if income is significantly higher than forecast.

Question 8: *Do you agree that no mechanism should be introduced to address Network Rail's additional revenue through mark-ups?*

Our Response

ORR proposes to take into account any over-recovery by Network Rail (via the potential open access fixed charge) at the next periodic review. We would like to understand, in more detail, how this might work.

ORR highlights that there may also be an offsetting impact on the volume incentive, if it were to exclude open access traffic from the calculation of the volume incentive. We consider that this approach may give rise to potential undue discrimination, if Network Rail's incentives to grow traffic are differentiated by type of operator. Furthermore, OAOs may not support the removal of an incentive which they benefit from.

We consider that if there needs to be an adjustment because of the open access fixed charge, the adjustment should be dealt with clearly and explicitly.

Question 9: *Do you consider that, under any of the options considered in this document, the profile of mark-up payments should be tailored so as to address concerns over the ability of OAOs to pay in the early years of new services?*

Our Response

We consider that there could be merit in potentially introducing a phasing profile for new open access charges so as to give new operators more time to build their businesses. We note that a 'phasing-in' approach is likely to be used to introduce new freight fixed charges during CP5.

Question 10: *Does the review of mark-ups at periodic reviews cause problems for OAOs' planning of their operations?*

Our Response

We understand that open access passenger operators are keen to have certainty beyond a periodic review, especially since they are not given the same protections as afforded to franchised operators. However, it is important that decisions are not taken that would ossify the usage of the network or fetter ORR's ability to potentially vary the GB charging model in the future.