

5 Views of the Department of Transport, the Director of Passenger Rail Franchising and the Rail Regulator

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5.1. In this chapter we summarize the evidence we received from the Department of Transport (DOT), the Franchising Director and the Rail Regulator, together with a submission from Dr Stephen Glaister of the London School of Economics, an economic adviser to the Rail Regulator. Certain points made by the Rail Regulator and by Dr Glaister appear elsewhere in this report (especially in Chapter 4).

Department of Transport

5.2. By way of background the DOT told us that its role in relation to the railways industry was becoming less concerned with supervision of BRB and more one of general oversight of railway policy. Day-to-day Government relations with the passenger railway were now handled through OPRAF. So far as the bus and coach industry was concerned both sectors had long been deregulated and the DOT's role was essentially in keeping a watching brief. Statistics for the bus and coach sectors were published following an annual survey but information on the coach market alone was very limited.

5.3. In relation to the sequence of events leading to the inquiry which is the subject of this report, the DOT said that at that time the Franchising Director had little discretion but to award the franchise despite the existence of competition concerns. Subsequently the Franchising Director's instructions had been amended to allow him to take into account the policies of other Government departments which affected franchising, including competition considerations.

5.4. The DOT said that although the NEG/MML merger had raised some competition concerns, these needed to be put in the context of an excellent deal for the taxpayer and for rail users. The DOT was also of the view that NEG's continued participation in the franchise bidding process would help to secure deals of similar quality in future competitions for other rail franchises.

5.5. The DOT said that NEG was established as the main supplier of inter-urban coach services throughout much of the UK. Passengers derived considerable benefit from NEG's nation-wide network of coach services, and the national booking, seat reservation, timetabling and through-ticketing systems which supported it. NEG placed great emphasis in its advertising and marketing on the quality of its coach services throughout the country, and the extent of their geographical coverage. It followed that, from a marketing perspective, the company would lose considerably from any diminution in quality of service on particular routes, and that passengers would be likely to suffer should NEG be deprived of its services in major corridors like that between London and the East Midlands conurbations. The DOT also noted that it did not receive a significant volume of complaints about anti-competitive behaviour in the coach market.

5.6. Because NEG's services were subcontracted to other operators, and because the frequency, price and quality of those services was specified in detail in contract, in the view of the DOT it should be possible easily to identify any material change in the quality of service which NEG provided on its coach routes in the MML corridor.

5.7. In terms of competition between coach and rail, the DOT's general view was that the railways served largely different segments of the UK travel market from coaches and buses, and that competition between modes was generally limited. Car was the dominant competitor to both modes. Across Great Britain as a whole, over 85 per cent of passenger mileage was by car. In contrast, rail accounted for only about 5 per cent of total passenger mileage, and bus and coach for 6 per cent. Any competition between coach and rail services was likely to be dwarfed by the scale of competition which both modes faced from the private car.

5.8. However, for longer journeys, and in some corridors for medium-length journeys, there was a market overlap between coach and rail for those without access to private cars, whose primary concern was low costs. Coach services were not greatly used by the time-sensitive business market segment. The market overlap was therefore greatest for leisure travellers where the sensitivity of demand to price changes was higher and the market power of NEG significantly constrained.

5.9. The DOT said that coach travel in the MML corridor was much cheaper but took much longer than rail travel. The scale of the differentials involved was such that a very large narrowing of the price differential would be required before a significant number of passengers transferred from one mode to the other.

5.10. Furthermore NEG's passenger profile was dominated by passengers on low or fixed incomes and many of the journeys were discretionary. It followed that should NEG attempt to raise coach fares as a means of exploiting its market power in coach and rail services, most of NEG's passengers, faced with higher coach fares, would simply travel less frequently, by car, or not at all. It seemed unlikely that many would transfer from coach to rail.

5.11. The DOT said that there was no reason to suppose that, because it had acquired MML, NEG wished or intended to effect a significant transfer from coach to rail, or vice versa. NEG's franchise contract envisaged that it would achieve significant growth in rail usage on MML, but its revenue projections were broadly in line with those forecast by franchisees on other rail routes. The contracts let so far showed that private sector ownership of franchises would also create significant scope for improvements in the efficiency of the passenger railway industry. There was no reason to suppose that the reduction in subsidy payments for these could or would be brought about by effecting a major transfer of customers from coach to rail.

5.12. Further, a deterioration in coach services, or an increase in their price, would serve to lower the already low barriers to entry for other, competing coach operators, especially on individual corridor routes. It was therefore most unlikely that the merger of MML and NEG's coach services would lead to a deterioration in service levels or quality on either mode.

5.13. The DOT said that it believed the risk of NEG abusing its position of owner of both the coach and rail services was small, but should the MMC conclude that the merger raised significant competition concerns, it believed the best solution would lie in a package of purely behavioural undertakings. It ought to be possible to agree a package whereby NEG effectively guaranteed existing coach fares, frequencies and service standards for the lifetime of the MML rail franchise. The DOT did not favour divestment as a remedy.

Director of Passenger Rail Franchising

5.14. The Franchising Director took the view that the segments of the UK travel market served by railways were largely different from those served by coaches and buses, but that there might be competition in some corridors between coach and rail for leisure passengers and for those primarily concerned about low fares. He also believed that the deregulated coach market afforded protection to consumers in the event that an incumbent coach operator sought to raise fares or reduce service quality. This was because the costs of entry to and exit from the market were low.

5.15. Passenger travel in the UK was dominated by the private car. Some 85 per cent of passenger mileage was accounted for by the car and some 5 per cent each by rail and buses or coaches. Survey evidence from a study in northern England suggested that of people who travelled by coach about one-third regarded the car as a viable alternative; of those travelling by rail about half regarded the car as a viable alternative.

5.16. It had been widely recognized in the rail business that the opportunities for raising prices in leisure markets were limited. In addition, studies suggested that competition between rail and coach on InterCity

services was not generally material. Protection was afforded to captive customers on coach or rail by those who had alternative means of travel, notably the car.

5.17. The Franchising Director did not believe that NEG's franchise bid for MML (with its improvements to rail services and representing good value for the taxpayer) was based on exploiting coach passengers or off-peak rail passengers. The undertakings offered by NEG would largely maintain the competitive position of the coach operations in terms of price, quality and service frequency. The alternative proposition that NEG would exploit its rail franchise passengers when freed of coach competition—assumed, unreasonably, that:

- (a) The regulation of rail fares and services, along with the rather more important competition from the private car, would be ineffective in preventing MML from exploiting its captive customers. This did not appear to be borne out by price elasticity information.
- (b) Coach fares would be significantly higher in the post-merger situation than previously.

It should also be borne in mind that NEG's income from the five reference services was £3.8 million compared with MML's annual passenger income of £65 million.

5.18. OPRAF was managing the franchise for MML to ensure compliance with the obligations contained in the franchise agreement and in particular that the service improvements and other commitments were provided within the time-scales agreed. There were also a number of performance standards that MML must comply with, for example maximum number of train cancellations, which were monitored periodically.

5.19. The incremental level of support negotiated by OPRAF in letting the MML franchise was substantially lower than the next cheapest bid at the short-listing stage. The bid also offered a higher level of service. The strength of the NEG bid (which had been compared with a base case, had been checked for internal consistency and was offered by a robust company) was clearly illustrated once full account was taken of the undertakings proposed by NEG to meet the concerns of the competition authorities.

5.20. The Franchising Director believed that the conclusion clearly favoured behavioural undertakings, once wider public interest issues than competition policy criteria were taken into account. He noted that NEG had offered to limit the APEX rail fare on MML to the RPI: such a change could by mutual agreement be incorporated in the franchise agreement and enforced.

The Rail Regulator

5.21. The Rail Regulator told us that he believed the introduction of on-rail competition would bring benefits for customers. He had accepted, however, that immediate unrestrained on-rail competition, between existing TOCs and new entrants, could frustrate the franchising process, to the detriment of rail users. This had led to his seeking to promote competition where new services were not primarily abstractive, whilst at the same time moderating on-rail competition where necessary in order to facilitate franchising. This policy meant that no new competitive services would be able to operate until 1999, and from then until 2002 (when the policy would be reviewed) only 20 per cent of a TOC's revenue on nominated flows would be exposed to competition. However, in order to promote the consumer interest the Regulator had sought to ensure that the extent of potential for on-rail competition between franchisees should be preserved, so as to maintain the existing competitive incentives.

5.22. Since competition between train operators had been moderated, it was particularly important that incentives from competition with other modes were, at minimum, preserved at existing levels in order to protect the interests of rail users.

5.23. In the case of NEG's acquisition of the MML franchise, the Rail Regulator considered that the central issue was the balance between the desire to create the most advantageous competitive environment and the more immediate benefits for rail users generated by NEG through the franchising process.

5.24. He believed that actual competition, or the threat of competition, would provide the maximum incentive for operators to reduce prices and to deliver innovative consumer benefits. This argument applied equally to competition between modes, such as between coach and rail. Whilst the Passenger Service

Requirement (PSR) and the fares control regime, set by OPRAF as part of each franchise, would fix a minimum floor for frequency of services and a ceiling for price increases, they would not create incentives to develop innovative frequency improvements or other service enhancements or generate price-based competition strategies.

5.25. The Rail Regulator said that the key market in which coach and rail competed was that part of the leisure market where the user did not have access to a car. Recent research into 'rail differential pricing' indicated that approximately 26 per cent of passengers on five separate routes would have used bus/coach services if rail had been unavailable. The report also indicated that the majority of the remainder would not have travelled at all if rail were unavailable. It was a reasonable assumption that increased coach fares would allow a competing rail operator to raise prices or to reduce capacity available at those prices, particularly the unregulated APEX and Super APEX fares, to a corresponding degree without losing market share. More significantly, a coach operator would have an incentive to compete on price in an attempt to capture market share from the rail operator, which in turn would encourage the rail operator to maximize the price competitiveness of its products. These incentives would be significantly reduced if both coach and rail operator were part of the same company, if there were also barriers to entry in the coach market. Whilst such behaviour by NEG might induce a new coach operator to enter the market (such entry on rail not being permitted before 1999 at the earliest) the Rail Regulator considered that the effectiveness of such new entry was likely to be limited given that only NEG was able to offer network benefits to coach passengers comparable to those available to rail users.

5.26. He therefore believed that the coach market provided an important constraint on leisure fares and a unique incentive on the rail operator to develop innovative service packages for that part of the leisure market which did not have access to a car.

5.27. In assessing the overall public interest, a balance needed to be struck between the potential future benefits of competition in the market and the service enhancements offered by NEG as a result of competition for the market (that is, the franchising process). Benefits generated by the franchising process included: a lower subsidy cost to OPRAF (with premium payments to OPRAF from 2001) and thereby to the taxpayer; a commitment to buy 12 new trains; and a subsequent increase in service frequencies on a number of key MML flows to and from London. On the other hand, the Rail Regulator observed that these benefits did not result from the merger as such but from the bidding process. Also NEG was not contractually committed to these service enhancements in that if it did not order the new trains by a specified date, the franchise would revert to a standard seven-year term.

5.28. The Rail Regulator said that he had readdressed the issue of lost competition between coach and rail in this case in the light of the outcome of the franchising process. He remained of the view that there was a significant potential public interest detriment and that the possible loss of the short-term benefits of the franchising process did not outweigh this detriment. He believed that the case for a fully competitive market was even greater if NEG succeeded in growing the market as suggested by its franchise bid.

5.29. He did not believe that behavioural remedies were adequate. He believed that only a structural remedy provided an adequate solution. This could require divestment of either the coach or rail business although he acknowledged the difficulties the latter option might cause. Divestment of relevant coach services coupled with behavioural undertakings enabling the new operator to gain network benefits would be the ideal solution. A solution of this sort would preserve the benefits already secured by the franchising process, whilst maintaining the incentives generated by vigorous, effective coach competition.

Dr Stephen Glaister, Department of Geography, London School of Economics

5.30. Dr Glaister is Cassel Reader in Economic Geography at the London School of Economics and has specialized in the economics of transport, particularly in economic regulation and deregulation. He was a member of the Government's first Advisory Committee on Trunk Road Assessment and has been Specialist Adviser to the Parliamentary Select Committee on Transport. He acted as adviser to the DOT on bus deregulation. He was a non-executive director of London Regional Transport from 1984 until 1993. He is currently an economic adviser to the Rail Regulator.

5.31. Dr Glaister said that the public interest implications of common ownership of the MML rail services and the Midlands to London NEL coach services hinged crucially on two issues:

(a) the cost structures of the two businesses; and

(b) whether there were, or might in the future be, significant barriers to competitive entry to the coach market.

5.32. In his view there was asymmetry in the cost structures. Coach fares and service levels were cost-determined, whilst the relevant leisure rail fares were largely demand-determined. Technological differences led to product differentiation which would survive under either regime of ownership. If there was free competitive entry to coach markets then common ownership was unlikely to damage the public interest seriously. If NEL coaches enjoyed the benefits of significant barriers to competitive entry then common ownership posed a threat to the travelling public interest, especially if NEG's ambitious plans for expanding leisure rail markets were to fail and it adopted a retrenchment strategy involving treating coach and leisure rail as a monopolistic cartel.

5.33. Train operation was a relatively high fixed cost and low variable cost business. Providing extra capacity was expensive, but carrying extra passengers when there were empty seats on existing services was profitable because, even if incremental revenues were low, the incremental costs were negligible.

5.34. In contrast, long-distance coach services had more or less constant unit costs: negligible fixed costs and high variable costs. Coaches were much more 'divisible' and operationally flexible than trains. When more capacity was needed NEL contracted for more coach trips to be supplied.

5.35. Rail and coach had evolved a system of product differentiation (based on the respective technologies and cost structures), whereby coach charged lower fares for a product most passengers found inferior.

5.36. A railway like MML was traditionally considered to serve two generic markets, business and leisure. For rail, commercial decisions about speeds, frequencies and standards of service and capacity provision were largely driven by business (and in some cases commuter) markets.

5.37. Rail leisure travel was something of a joint product. Because the capacity had been provided to serve the business and commuting markets, the long-run marginal cost of serving the leisure market was low, except at a few peak times.

5.38. Coaches did not serve a business market and they had little commuting. The coach market was largely made up of those on relatively low incomes, who were willing to accept poorer quality of service in return for a cheaper ticket. Relatively few coach travellers had a car available for their trip.

5.39. There were two reasons why rail did not find it commercially advantageous to match all coach fares and thereby take most of the coach market: limits to the amount of spare capacity available from serving the core rail markets; and the railways' sophisticated system of price discrimination. In order to offer sufficiently low fares to undercut coaches and put them out of business the railways would risk diluting the revenues they took from their existing leisure rail passengers.

5.40. Dr Glaister said that if coach fares or service levels were changed in such a way as to cause passengers to switch from one mode to the other, then there would be scope for commercially driven price changes for leisure rail.

5.41. There were factors suggesting that barriers to competitive entry to the coach market might not be severe, including the lack of formal barriers and a lack of complaints or other evidence that the competitive market was fundamentally failing to operate.

5.42. On the other hand there were reasons for believing that there might be barriers, including: NEL's ability to offer interchange between its service (interlining); network benefits available to NEL in ticket selling; NEL's advertising-and in particular the problem facing a new operator on a London corridor route of promoting his service in London; issues of coach station access and capacity; and the threat of retaliation from NEL against competitive new entry.

5.43. In relation to the merger and the public interest, Dr Glaister said that if there was barrier-free entry into the coach market then the situation was straightforward. However, if there were substantial barriers to

competitive entry on the coach side common ownership would create opportunities to damage the coach market for the benefit of overall profit. If there was monopoly power in the coach market then the common owner of rail and coach would seek to maximize overall profit by treating the two as a co-ordinated whole-much as would a cartel.

5.44. The way to expand the market and raise revenues was to reduce fares, not to raise them. So NEG's proposals implied that rail fares overall should be reduced rather than raised. Even if the primary target was the business market it was likely that its strategy would create more seats to be filled by leisure passengers-by reducing their fares-at many times of the week. However, BRB had been seeking to expand its markets in a profitable way for years, albeit without the cost-saving benefits that rail privatization may bring. Against this background NEG's plans appeared to be ambitious. It was necessary to consider the possibility that its expansionist plans failed and they were then thrown back on to a monopolistic contraction of both rail and coach markets at increased fares-but, again, only if there were substantial barriers to competitive entry to the coach market.

5.45. Dr Glaister noted that there might be some benefits from common ownership, including inter-availability of tickets and co-ordination of bus and rail services (for instance, bundling rail tickets and timetables with coach services to NEG's EMIA). However, he tended to discount these arguments on the grounds that either separate owners would have incentives to agree to the arrangements in order to turn the consumer benefits into profit, or they were practices which would normally be viewed with suspicion as potentially anti-competitive, or both.

5.46. Looking to the future, Dr Glaister noted that coach markets were income-sensitive and a recovery from the general recession of recent years could help generate coach traffic. But in other respects the prospect for coach markets did not look good. On the demand side, a threat was the continuing growth in car availability. On the supply side, the industry had been privatized and deregulated for ten years and it was unlikely that there would be major new efficiency gains. New speed limits and loss of access to the third lane of motorways would significantly increase coach journey times. Road capacities would not be greatly increased under current policies, whilst general traffic levels would increase. So congestion would become worse. Unit costs would probably rise in line with real earnings (the bus industry being labour-intensive), unless there were to be a large change in taxation on coaches or fuel.

5.47. In relation to rail's future prospects, leisure markets were likely to be affected by increasing economic activity in much the same way as coaches. Growing car ownership was a threat, not least because of the fact that so much car ownership growth was in second cars which therefore became available for leisure use whilst the first car was being used for work purposes.

5.48. The most significant change was the privatization of rail itself. The aspiration of bidders for franchises was to reduce the rail cost base. This would have little impact on rail/coach competition at times when rail already had spare capacity because the costs of carrying extra traffic at these times was already negligible. However, it created the opportunity for profitable expansion of overall capacity, and this was the intention of NEG in the case of MML.