

5 Views of the Department of the Environment, Transport and the Regions, 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 DETR, the Franchising Director, the Rail Regulator and Dr Stephen Glaister of the London School of Economics, an economic adviser to the Rail Regulator.

Department of the Environment, Transport and the Regions

5.2. The DETR said that, following the privatization of the passenger operations of the railways, its current activities included the creation of a strategic rail authority and an examination of the scope for stricter regulation of the railway industry. In the short term at least the intention underlying the Government's review of transport policy was to improve the system as it stood. It appeared unlikely that there would be any immediate reorganization at a structural level. There would be an emphasis on reducing the need for travel and on getting public transport to take a high proportion of travel.

5.3. On the question of competition between different modes of transport, the DETR stressed that some 90 per cent of all journeys were made by car. For the purpose of analysis the public transport market had to be disaggregated according to several factors, including whether the journeys were local or inter-urban, the reasons for travel, whether passengers had access to a car and passengers' socio-economic grouping. For business travel, rail and air were the main competitors to the car, but for leisure travel the choice of modes also included the coach. Competition between rail and coach, however, affected only a narrow part of the market.

5.4. The DETR believed that the competition detriments likely to arise from common ownership of overlapping coach and rail operations were often overstated. The domination of the private car on most routes within the UK posed a significant competitive challenge to both public transport modes. The DETR was not aware of any clear evidence that a dominant supplier of coach and rail services in a particular corridor would be able or willing to maximize revenues by effecting a deliberate shift of passengers from coach to rail—a shift which could be achieved through a policy of increasing coach fares and/or reducing the frequency and quality of services. In the DETR's view an operator like NEG would find it difficult to pursue such a strategy with any success, particularly given the high price elasticity of demand for leisure travel. NEG's national brand image could well suffer as its services became less attractive on particular routes, and it might well lose revenue as potential passengers decided either not to travel at all or to travel by car instead of by coach or train.

5.5. The DETR accepted, on balance, that overlaps between inter-urban coach and rail services could nevertheless give rise to potential competition detriments, particularly for those coach users in the leisure market who did not have access to a private car.

5.6. Commenting on public transport integration, the DETR told us that it was too soon to be clear about whether common ownership of different modes of transport within a particular area was beneficial to the public. Such initiatives as had occurred, for example in joint marketing and in information provision, had been small and localized and it was not clear whether the advantages arising from closer integration depended on common ownership or if they could be achieved without it. Any synergy between bus and rail had not been a criterion in awarding the franchises and the DETR considered that the issue of ownership was probably not central to achieving integration of transport. It was more important to examine initiatives which seemed worth promoting and then to look at the mechanisms for providing incentives for transport operators to put these in place. There had been some experiments between bus and train companies in separate ownership and if any of these initiatives was successful in generating significant additional travel, especially in off-peak periods, operators elsewhere might be encouraged to follow. At the moment it remained to be seen to what extent they were self-financing.

5.7. The evidence of NEG's performance as a train operator was that it was among the more dynamic and committed of the franchisees, for example in terms of placing orders for new rolling stock as a means of investing to increase passenger use. Although NEG did not directly run coach services, it procured network services, operated a UK-wide ticketing agency and regulated by strict specification the services of the operators with which it contracted. There were no problems and very few complaints about the way the service was run.

5.8. As a bus operator, particularly via WMT, NEG was bringing in new vehicles and was pursuing a quality partnership with West Midlands local authorities for the upgrading of certain routes. The high profitability of WMT had not been the source of any concern to the DETR.

5.9. The DETR understood the coach/rail competition concerns to have centred on two routes. On one of these-Birmingham-Leicester-there was already coach competition from Midland Fox. On the other route, Nottingham-Birmingham, it believed there was a rival coach operator. If this was the only route in the Central Trains area where there might be a problem, the DETR believed that any concerns were *de minimis*.

5.10. The DETR argued that in the event of an adverse public interest finding, in view of the very small number of routes where problems might arise, there was not a strong case for seeking undertakings. It would sympathize with a conclusion which required none at all.

5.11. On the issue of the Schedule 14 assurances there had, at the time of the franchise negotiations, been concerns regarding NEG's dominance in public transport in the West Midlands. Whilst the DETR considered that NEG would have had no expectation at the time of the agreement that the assurances might not be legally enforceable, it would be appropriate to implement them through competition law if there were no other effective means.

Director of Passenger Rail Franchising

The franchising process

5.12. The Franchising Director described the franchising process, which had started with the issue of a pre-qualification document calling for expressions of interest. The Franchising Director had then assessed potential bidders' financial and managerial ability to run a rail franchise and had issued an invitation to tender to those judged to be pre-qualified bidders. In most cases indicative bids had been called for and a shortlist of three or four companies drawn up from which final bids had been invited. The key number in all bids had been the level of subsidy required over the period of the franchise or, in a few cases, the premium that the bidder would pay. Bidders had been given no indication of the level of subsidy for which the Franchising Director was looking, although the indicative bid stage had been used to suggest to them where they might consider improving their bids in terms of value for money. The Franchising Director had taken a

clear view from the outset that once final bids had been submitted there would be no negotiations about the level of subsidy.

5.13. The aim of the franchising programme had been primarily to promote competition *for* the market. Competition *within* the passenger rail market was the concern of the Rail Regulator, who had been consulted by the Franchising Director during the letting process. As far as competition between modes was concerned, the locus was primarily with the DGFT and it had always been the Franchising Director's practice to advise bidders to seek guidance from the OFT. The Franchising Director had had little discretion at first to take account of wider competition issues but after the NEG/MML inquiry he had been instructed by the Secretary of State to take into account any Government policies which were relevant to the provision of passenger services, and these included competition considerations. In the purely hypothetical circumstances of the best bid for a rail franchise having given rise to serious competition concerns, the Franchising Director would have had to make a judgment on whether to award the franchise to the best bidder or the under-bidder.

5.14. The franchise agreements provided significant protection for the interests of passengers. The TOCs had to run, as a minimum, the level of service specified in the PSR and were bound in to fares regulation for the duration of the franchise on certain ticket types which the Franchising Director judged would provide the right balance between, on the one hand, allowing market flexibility and innovation and, on the other hand, protecting customers. The agreements also included provisions, as appropriate, about capacity or load factors and about other matters such as standards at stations.

5.15. The Franchising Director had an ongoing responsibility to ensure that TOCs complied with the obligations contained in the franchise agreements, in particular that service improvements and other commitments were provided within the agreed timescales and that performance standards were met. Monitoring was carried out by franchise managers in OPRAF, who were in close contact with the TOCs. There were in addition quantitative systems that routinely generated performance details of each franchisee in terms of punctuality, reliability and capacity and checks of compliance with the fares regulation system. There would be a twice-yearly audit of compliance with the franchise agreement, supplemented by specific audits where appropriate. The Franchising Director's initial response to unsatisfactory performance would be informal discussion with the TOC concerned. If that did not resolve the matter, there were various stages of formal procedure, culminating in the TOC being declared in default of the franchise agreement. The Franchising Director was empowered by section 55 of the Railways Act to initiate enforcement action.

Competition in the passenger transport market

5.16. The many difficult issues raised by rail-to-rail competition were primarily the responsibility of the Rail Regulator although opportunities for competition were currently constrained by his moderation of the potential entry of TOCs into new markets.

5.17. The Franchising Director considered that the segments of the UK travel market served by railways were largely different from those served by coaches and buses but there might be competition in some corridors between coach and rail for leisure passengers and for those primarily concerned about low fares. For short journeys, coaches and buses sometimes competed effectively with local trains. He believed that the deregulated coach market generally afforded protection to consumers in the event of an incumbent coach operator seeking to raise fares or reduce the quality of service. This was because the costs of entry to and exit from the market were low. The dominance of NEG did not in itself falsify that view. As NEG subcontracted its coach services there was already the capacity to fill any gap in a market it might vacate. The Franchising Director accepted, however, that there were network benefits from a national operation that might be endangered if NEG were to withdraw from part of its existing services. He believed that the joint ownership of rail and bus/coach operations could provide useful synergies for customers arising, for example, from integration of services and provision of information.

5.18. Passenger travel in the UK was dominated by the private car, with some 85 per cent of passenger mileage accounted for by the car and some 5 per cent each by rail and bus/coach. A merger between a bus or coach operator and a rail franchisee would, therefore, account for a very small proportion of the total travel market in the relevant area.

5.19. The Franchising Director understood the concern that some groups of customers (usually identified as the relatively poor or those without access to a car for discretionary travel) might be open to exploitation if competition between coach and rail services was reduced. He believed, however, that the interests of these groups was protected far more than was generally acknowledged. The ability of an operator to discriminate between different segments of its market depended on there not being sufficient customers prepared to switch to car. In the case of rail services, for example, the issue would be whether, if fares were increased, passengers would switch to car in sufficient numbers to make the fare increase unattractive to the operator. If that were so, passengers without access to a car would be protected by the non-captive customers' ability to switch modes, because the operator would be unable to discriminate between customers when setting fares or the quality of service. In order to retain its non-captive customers it would need to offer the same standards to all customers. The Franchising Director pointed out that there was some survey evidence that many coach passengers (approximately one-third in one survey) stated that the car was their alternative mode of transport.

The effects of the merger

5.20. In the event that NEG tried to push passengers from coach to rail, which had higher fixed costs and lower incremental costs, other bus or coach operators would step in and the threat of this happening could probably prevent NEG from reducing service levels on its coaches. Within the West Midlands area, there was a key distinction in that Centro was retaining the revenue from the rail services which NEG ran on its behalf.

5.21. There had been benefits in a number of franchise operations, particularly as a result of an improved degree of integration between bus and rail services, for example in through-ticketing arrangements. The Franchising Director saw potential scope for this in the West Midlands, where NEG owned one of the largest bus operators. The scope for co-operation between coach and rail operators was less obvious.

5.22. The Franchising Director had no immediate concerns about NEG's management of its five rail franchises. It had set up a separate trains division and it appeared that, as a group, it was highly devolved, with each business run as a separate unit. The Franchising Director required all franchisees to ensure that the rail businesses could be handed back or sold as distinct units. Any action to blur that distinction would be unacceptable.

Remedies

5.23. In the event of an adverse public interest finding, performance undertakings were preferable to the divestment of coach services and would probably be sufficient to meet any concerns.

5.24. Commenting on the Schedule 14 assurances given by NEG in the Central Trains franchise agreement, the Franchising Director said that they were essentially a contract between NEG and Centro, and separate from the franchise agreement. He had no clear locus to enforce these assurances through his own enforcement powers but would have no concerns about an MMC recommendation which included an alternative means of enforcing the assurances.

The Rail Regulator

Competition between TOCs

5.25. The Rail Regulator told us that the franchising process had gone well. Besides the reduction in subsidy, passenger numbers had, on average, increased faster than general economic growth, although it was too early to say whether this was a direct result of franchising. The car was the main competitor to rail and there was no doubt that in some cases rail routes had attracted passengers from congested parallel road routes. There were examples of TOCs using special offers to promote rail travel as an alternative to the car.

5.26. The introduction of on-rail competition would bring benefits for customers. The Rail Regulator accepted, however, that immediate unrestrained on-rail competition between existing TOCs and new entrants could frustrate the benefits of the franchising process, to the detriment of rail users. This had led him to seek to promote competition where new services would bring benefits to rail users, while at the same time moderating on-rail competition where necessary in order to facilitate franchising. In essence no material new competitive services would be able to operate until 1 April 1999, and from then until 31 March 2002 (when the policy would be reviewed) new competition would be limited to 20 per cent of a TOC's core business flows, by revenue. This threshold would take into account existing competition, which might already be at this level or greater. However, in order to make certain that consumer interests were best served, he had ensured that any pre-existing competition between TOCs had been preserved and that TOCs which already operated services in competition with other TOCs could increase services subject to securing the necessary additional track access agreements from Railtrack.

5.27. Where two or more franchises had come under common control the Rail Regulator had been keen to ensure that the opportunities for competition that existed under separate ownership were not lost. Each case had been evaluated and some point-to-point flows that were previously protected from new entry had lost that protection where the only significant on-rail competition had been provided by another TOC which came under the same ownership.

Management of rail franchises under common control

5.28. Under the terms of the franchise agreements NEG, like other companies controlling multiple franchises, had to maintain the separate TOCs as distinct entities. There were controls within the agreements over the extent to which different activities could be integrated. It was clearly envisaged by NEG and others controlling more than one franchise that there would be benefits from carrying out some functions at the group level. The Rail Regulator had proposed that there should be licence modifications to ring-fence the individual TOCs and ensure that if, for example, some activities were provided at a group level, it would be on an arm's length basis with no cross-subsidization. He believed that the modifications he was seeking, together with the terms of the franchising agreements, would reinforce the maintenance of the individual TOCs as separate business units.

Competition between rail and other modes

5.29. Given that competition between TOCs had been moderated, it was particularly important that incentives from competition with other modes were, as a minimum, preserved at existing levels in order to protect the interests of rail users. Where franchises were awarded to companies also operating bus and coach services, the central issue was the balance between, on the one hand, the desire to create the most advantageous competitive environment and, on the other hand, the benefits for rail users generated directly by the franchising process and opportunities for enhancing services subsequently. In particular, where a franchisee also controlled local bus services, it was recognized that there would be scope to co-ordinate bus and rail services, moving towards an integrated public transport system.

5.30. PTEs were interested in increasing the use of public transport in their areas. They had played significant roles in the franchise awards and had possibly been able to achieve more in transport integration than was the case previously. Outside their jurisdiction, one of the factors in which the Rail Regulator was interested was better intermodal links and co-ordination of rail and bus services.

5.31. Competition, or the threat of it, would provide the maximum incentive for TOCs to reduce prices and to deliver innovative consumer benefits. This argument applied equally to competition with other modes, such as coach or bus. However, in some cases, the control of fares and service frequencies exercised by a PTE limited the degree to which competition from other modes could influence the benefits enjoyed by rail users, because PTEs set fares and frequencies on the basis of transport policies rather than simply by economic incentives. With current levels of funding it was unlikely that any competitive action by bus or coach operators would lead to rail users enjoying either lower prices or improved frequencies on PTE-supported services.

Passenger demand

5.32. The Rail Regulator told us that passenger demand depended on several factors. The franchising process had led to changes in the way it was forecast but there were uncertainties in how competition would develop. Price elasticity varied with type of travel and tended to be higher for leisure travellers than for business or commuting. Quality of service was critical as a means of competing with the car.

5.33. There were currently capacity constraints: the availability of suitable rolling stock was relatively limited in the short term and this could act as a constraint on the development of new services. The extent to which new train deliveries and the renegotiation of existing rolling stock leases would release this constraint towards the end of the decade was not yet clear. There were few infrastructure constraints, but those on the Coventry-Birmingham corridor could affect the introduction of new services, particularly in peak hours. The use of price to influence demand therefore meant that TOCs had to plan ahead to meet changing circumstances and, in a structure which was becoming market-driven, had to strive for revenue increases to meet the targets set by their franchise agreements.

Competition to Central Trains

5.34. Actual or potential competition existed in virtually all cases where NEG's coach and rail services overlapped and, where potential opportunities for on-rail competition had been lost following the award of both the Central Trains and MML franchises to one owner, the Rail Regulator had removed Central Trains' protection under the moderation of competition arrangements. This would create the prospect of emerging competition, providing appropriate commercial incentives and maintaining protection for passenger interests.

5.35. The Rail Regulator was not in a position to define the probability of new entry on individual flows but told us that the value placed by bidders on the protection granted under the moderation of competition arrangements indicated the sensitivity of franchisees to the threat of new entry. He believed that, in the absence of actual new entry, the threat of it was likely to act as an equally effective competitive incentive for incumbent operators. Although there was no scope for entry on the route between Nottingham and Birmingham, it was difficult to make a case for an adverse public interest finding on the basis of this one instance.

5.36. The Rail Regulator expected the second stage of the moderation of competition (commencing on 1 April 1999) to have only a limited effect on Central Trains because a significant percentage of its core business revenues were already competed for and the associated flows were likely to be defined as facing 'pre-existing' competition. These flows would be opened to further new entry but Central Trains would have the advantage of knowing on which flows such entry was most likely.

5.37. On intermodal choice, there was evidence that potential rail users fell into one of three segments: those who chose between train and car; those who chose between train and coach or bus; and those who chose between train and not travelling. Outside the West Midlands, Central Trains had traditionally competed in the last two segments on price and quality. In a commercial environment the bus and coach market would provide an important constraint on rail fares in the West Midlands and offer the rail operator a unique incentive to develop innovative services for that part of the leisure market which had no access to a car.

Effects of the merger

5.38. In the West Midlands Centro specified the characteristics of the rail services and the fares and frequencies. Because of this controlling influence, which was driven by transport policies rather than commercial incentives, the Rail Regulator believed that the loss of competition resulting from the common ownership of WMT and Central Trains would not lead to significant detriments for rail users, and the merger should not be expected to operate against the public interest. Indeed, there might be greater co-operation between rail and bus, yielding potential public interest benefits in terms of increased integration which might be unobtainable without the merger.

5.39. That NEG's combined ownership of Central Trains and WMT and its interest in the Midland Metro light rail facility could give it scope for abuse of its dominant position was a valid concern but Centro had

approved the franchise. Any uncertainty about the enforceability of the Schedule 14 assurances might have to be met by undertakings but it was unlikely that NEG would deny Centro the degree of supervision it regarded as essential to the award of the franchise.

5.40. Where Central Trains was the lead operator and NEL also operated a coach service between two points, the Rail Regulator believed that the presence of other TOCs would provide effective competitive incentives. Common control of Central Trains and NEL would not allow NEG to raise prices for rail services beyond the level which would be possible without common control, because of the increasing potential for other incumbent operators to introduce cheaper dedicated products.

5.41. The Rail Regulator did not consider that the merger would lead to public interest detriments, whether in the form of higher prices, lower service levels, the possibility of discrimination or abuse of those funding the service. Within the West Midlands area, so much of the viability of the franchise depended on the establishment of goodwill with Centro that, as long as overall controls on fares were determined by the Franchising Director, it was not obvious how NEG could use its combined operations to produce any detriments.

5.42. There were no detriments for rail passengers which would warrant NEG being required to divest all or part of Central Trains. Furthermore, because of the influence of Centro, the Rail Regulator did not consider there to be any justifiable undertakings which could have a significant impact on the benefits enjoyed by rail users. If the MMC found the merger to be against the public interest, any remedies should apply solely to WMT.

5.43. He suggested that the MMC consider what he called regulatory objectives, which would increase the accountability of dominant forces in the supply of public, and publicly-funded, transport services. It would be desirable to see multi-modal operators given certain objectives and outputs so that they contributed to the overall aim of increasing public, as against private, transport services. Clear regulatory objectives would be reflected in local activities and would need to be monitored. As far as rail use was concerned, the regional Rail Users' Consultative Committees could be involved in this process. Furthermore, such information as arose from these objectives could be used to assist the Franchising Director when franchises came up for renewal.

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

5.44. Dr Glaister is Cassel Reader in Economic Geography at the London School of Economics. He is a consultant and a non-executive member of the Council at the Office of the Rail Regulator and was a full member of the board of London Transport between 1984 and 1993. Dr Glaister accompanied the Rail Regulator to a hearing at which he presented the following views, which are shared by the Rail Regulator.

The importance of integration

5.45. Dr Glaister told us that in the context of transport policy the public frequently used the terms 'co-ordination' and 'integration', either interchangeably or together, and with a variety of meanings. 'Co-ordinated and integrated public transport' was often used as shorthand for cheap, highly subsidized public transport, but there were more substantive interpretations of the phrase.

5.46. Within densely populated urban areas travellers often made complicated trips involving several mode changes. Integration could mean improving the layout of interchange points, optimizing the timetables (co-ordination), making information readily available and ensuring that tickets were either interavailable or common. Travel cards facilitated travel because they dispensed with the need for cash transactions at each stage and made complex and frequent trips cheaper. Dr Glaister said that the Rail Regulator recognized the benefits of these measures. Integration could also mean the bringing together of different strands of public policy, for example land use planning and public transport.

5.47. Since the 1930s there had been a controversy about public intervention in normal commercial activity in transport. It could be argued that, if passengers benefited from co-ordination and integration, they should be willing to pay and the operators should be left to provide the facilities. There were counter-

arguments, namely that no sub-group of operators could on its own capture the system-wide benefits of integration; opportunities for monopoly exploitation outweighed commercial benefits of co-operation; administrative costs of co-ordination to operators might outweigh the cash benefits; and operators would be too short-sighted and incompetent to see their common advantage. There had been suggestions that the introduction of joint ticketing might be an attempt to establish agreements restricting competition. Interavailable season tickets could include bulk discounts, loyalty bonuses, product bundling, revenue pooling and the establishment of a cartel which raised barriers to entry.

5.48. There was therefore a tension between the desire to promote inter- and intramodal competition as a means of protecting user interests and the desire to interfere with competitive outcomes to secure the public interest in co-ordination and integration. This was analogous with the tensions which faced the Rail Regulator on rail matters. It was legitimate for local authorities to strike a balance, as they did, subject to scrutiny by competition authorities.

5.49. Under the Road Traffic Act 1930 local authorities used the system of bus route service licensing to influence fares and restrict competition so that they could cross-subsidize routes to fund what they judged to be important public service obligations. The philosophy underlying the Transport Act 1985 was that this had restricted competition against the public interest. The Government of the day considered that commercially-worthwhile integration would evolve in a free market and should be judged under normal competition law. This did happen, and the current situation in the West Midlands was a case in point: while participation in Centrocard and Busmaster was voluntary for bus operators, rail franchisees were required to join.

5.50. In contrast to the position under bus deregulation, PTAs had managed to keep a significant degree of control over local rail services, latterly through the franchise agreements. While many had felt frustrated by their loss of control of the commercial bus market, they had been able to regain significant influence through the tendering of non-commercial services, negotiation, and the brokering and administration of common ticketing systems. A major contribution of local authorities in respect of bus services was the promotion of traffic management activities such as park-and-ride schemes and bus lanes.

5.51. Dr Glaister noted that, under the London Regional Transport Act 1984, London Regional Transport had a general duty to co-ordinate passenger transport activities. One of the reasons why bus deregulation had not been introduced in London was a perceived conflict with this duty.

Competition between modes

5.52. For long-distance, intercity travel, intermodal competition was recognized as being important in securing efficiency and passenger choice. Dr Glaister said that the Rail Regulator believed the coach market could provide an important incentive to rail operators where there was no prospect of on-rail competition. There was also a degree of intermodal competition in London, where the rail network was more extensive than in any other city. In general, however, in large urban areas the two modes were complementary rather than competitive: rail offered larger, trunk services, while buses distributed passengers locally, including to and from railway stations. In these circumstances competition within, rather than between, modes provided the important disciplines for efficiency and passenger choice.

Conclusion

5.53. Integration and co-ordination had different interpretations but in urban areas some real public benefits arose from local authority intervention in the outcome of open competition. The larger PTAs had been very active in this and had struck a balance involving rail and bus franchises for non-remunerative services, as well as introducing measures such as integrated common ticketing and physical works to ease interchange. Intramodal competition remained an important market discipline, while intermodal competition existed but was seen as less important in local conurbations. It was for local authorities and others to judge whether the balance between competition and integration was reasonable but Dr Glaister doubted that it would be seriously distorted by a degree of common ownership of bus and rail.