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Department
for Transport

Alex Chisholm
Chief Executive, CMA
Victoria House
37 Southampton Row
London WC1B 4AD

From the Secretary of State
The Rt. Hon. Patrick McLoughlin

Great Minster House
33 Horseferry Road
London
SW1P 4DR

Web site: www.gov.uk/dft

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Alex Chisholm,

The Government welcomes the opportunity to respond to the CMA's consultation on the Impact Assessment of competition options, which has been commissioned from Oxera and Arup by the ORR. We were pleased by the recognition that the importance of this issue, and the scale of the potential impacts, means that a comprehensive evaluation is required.

However, I do have some significant concerns about the methodology Oxera and Arup have adopted in the Impact Assessment. In particular, I am concerned that the assessment presents substantially more positive conclusions in respect of the economic impact of open access competition than can be justified by the evidence. I am also concerned that insufficient weight has been placed upon the substantial operational obstacles relating to the options. The enclosed note sets out the Department's concerns in more detail.

My officials remain happy to engage with the CMA to assist in the development of its evidence base and I am pleased that a workshop on this issue has been scheduled for February.

THE RT. HON. PATRICK McLOUGHLIN

CMA POLICY REVIEW OF PASSENGER RAIL SERVICES

Department for Transport response to the CMA's consultation on the Oxera/Arup Impact Assessment commissioned by ORR

Thank you for the opportunity to comment on the "Impact Assessment of the CMA's Options for Increasing On-Rail Competition" (the Impact Assessment), which was commissioned from Oxera and Arup by the Office of Rail and Road (ORR). DfT welcomes steps to ensure that passengers are placed firmly at the heart of Great Britain's already successful railways. We are also supportive of the role of competition to drive better outcomes for passengers and taxpayers, as demonstrated through the operation of a highly competitive franchising system for passenger rail services.

However, as we also identified in our response to the CMA, and as the CMA itself recognises, there are considerable complexities arising from the introduction of further on-rail competition in the light of the specific physical, organisational and regulatory circumstances of the rail sector. It is for that reason that we consider that detailed consideration of these issues need to be taken, on the basis of a carefully considered evidence base, to fully answer the below key issues:

- Fair and reasonable track access charges, which do not unduly advantage open access operators.
- A robust framework for ensuring that changes have a neutral impact on taxpayer, a principle which the CMA supports.
- A detailed consideration of the impacts of any changes on the franchising system and the ability of the taxpayer to invest in the railways (including through HS2).
- A robust framework for the management of performance impacts arising from increased open access.
- Robust protections for the Government's ability to specify services which are vital for communities.

It is with some disappointment that, in our considered view, the Impact Assessment does not substantially address these issues, providing only limited further evidence to inform a robust consideration of the benefits and costs of increased on-rail competition. **We consider that further detailed work to address the above issues remains a pre-condition for a decision on any changes to current arrangements.**

Our high-level observations on the Impact Assessment are below, following some brief comments on the process used to prepare it. These should not be taken to indicate the range of detailed comments regarding the limitations of the analysis that we have, but to provide an indication of core areas of concerns which have a material impact upon the Impact Assessment's conclusions.

Engagement during the production of the Impact Assessment

In the light of the DfT's specific, important role in relation to railway services and the fact that the CMA's recommendations are intended to be made to Government, we were somewhat disappointed not to have had more of an opportunity to be engaged in

discussions around an advanced draft of the document before its finalisation. While some early conversations did take place with Arup/Oxera, we consider that a more engaged process, which drew on the DfT's experience of economic appraisal of train service delivery, would have assisted in the preparation of a document which more fully addressed the core issues which we have set out above and provided a framework for future action.

Substantive comments

Having examined the Impact Assessment in detail, we have a number of significant concerns about the approach to assessing benefits and costs which it contains, which impact considerably on the results obtained. **We consider that it is important that the CMA fully considers the implications of these concerns before drawing conclusions to inform recommendations.**

We explain below the most significant of these concerns, which relate to the following issues:

- That the assessment presents substantially more positive conclusions in respect of the economic impact of open access competition (Option 1) than is justified by the evidence.
- The capacity assumptions used in Option 1.
- That the report places insufficient weight on the substantial operational obstacles in respect of Option 2 and Option 3.¹
- The deliverability of core issues, most particularly the PSO levy.
- The approach with respect to specification.
- The franchising modelling employed.

However, before considering these particular issues, we have a fundamental overarching concern about the presentation of the results of the Impact Assessment. As the report itself states:

*"it should also be noted that the analysis excludes a range of potential impacts (such as impacts on service quality, capacity and reliability) that are assessed qualitatively and are not captured in the economic appraisal of the options."*²

An analytical approach which quantifies potential benefits, but provides only a qualified description of disbenefits, will inevitably provide a fundamentally unbalanced and misleading assessment, and is, in no meaningful measure, an appropriate cost/benefit analysis, which is the core of an impact assessment. Additionally, with respect to the comment in the Impact Assessment that unquantified factors would be "*relatively*

¹ We have not commented on the analysis in Option 4 on the basis it is incomplete. We would, however, note that we have significant reservations over the appropriateness of comparisons deployed in this option.

² Impact Assessment, page 3. We note that no fewer than 10 distinct relevant issues were explicitly excluded from the quantification of impacts (see page 59 to 61 of the Impact Assessment).

minor”,³ we consider that this is incorrect and note that there is absolutely no evidential basis in the Impact Assessment for such an assertion.

It is of critical importance that the absence of this quantification does not mislead the CMA as to the potential considerable adverse effects that may arise in relation to certain of the options being considered and which we consider must be carefully analysed.

The Option 1 analysis – positive conclusions on welfare

The impact assessment concludes that *“of all the options assessed, Option 1 is likely to deliver the highest level of benefits – primarily through lower fares for passengers but also as a result of improved efficiency – although the net effect of Option 1 is not positive in all scenarios.”* While we would note that the presumed net effect of this option is not positive in all scenarios, we are concerned that assumptions and methodology have been applied which presents a significantly more positive assessment than would be the case if more appropriate assumptions were used.

We note that for many of the assumptions used, it is unclear on which basis they were selected (indeed, the Impact Assessment itself makes clear that the *“response of franchise operators to competition is unclear”*) and, in our considered view, they are inappropriate. For example:

- The overall methodology is explicitly based on the presumption that *“economic theory would suggest that the introduction of increased competition would create stronger incentives to create efficiency”*, with a figure of 10% then included on that basis with regard to fares assumptions. In addition to the assumption having very limited evidential basis, as the quote above demonstrates, it also takes absolutely no account of the competition already existing as part of the franchising system, which is fully recognised by the CMA and in the Impact Assessment as *“intense”* leading to *“incentives to minimise costs”* – this is a considerable analytical limitation.⁴
- The allowance made for the potential change to the charging structure and the PSO levy, which is a core element of Option 1 is inappropriate and is likely to eliminate or substantively reduce any fares benefit which may exist. By way of example, the CMA should be aware that in relation to the ECML, recent DfT analysis on ECML showed FTAC and premium accounted for half of operating costs of the franchisee; the level of adjustment undertaken therefore in no way reflects impacts of this kind and must be treated with extreme caution.⁵

³ Impact Assessment, page 60.

⁴ The limited analytical basis for the assumptions employed is made clear by the fact that, in relation to each of Options 1 and 2, the same rationale is used to justify two different efficiency assumptions (of 5% and 10%), with no explanation as to the reasoning for the difference. We note that the text surrounding that assumption makes reference to the bus industry; we note that the CMA did not include that industry as a comparator in its analysis despite it initially considering this; it would be reasonable to assume that it had done so on the basis of limitations in the comparability of the bus and rail markets.

⁵ We consider that, in particular, the adjustment made (for example, on page 77 of the Impact Assessment) to account for these issues does not reflect the scale of the impact.

In the light of the importance of the fares position in driving the results, these are considerable deficiencies which are likely to substantially drive the benefits observed.

The Option 1 analysis – capacity assumptions

We are also unclear from the Impact Assessment that there is any robust basis for the assumptions made about the capacity and service increases following on from Option 1. While this is clearly a significant aspect of the analysis, we consider that it is inappropriate to conclude that the simple presence of open access operators on the network, which appears to be the exclusive justification for this position,⁶ will inevitably result in capacity increases. In particular, we consider that the use of essentially anecdotal evidence in these circumstances is inappropriate and disregards the incentives that franchised operators have to vigorously challenge Network Rail to provide more capacity.

Options 2 and 3

We do not consider that there are no “*significant ... operational issues*”⁷ associated with these options. In our assessment, based on our experience of letting franchises and managing overlapping franchises, this is not the case. In particular:

- The challenges associated with letting franchises concurrently, particularly for the effective letting of a less valuable franchise in Option 2, where it is questionable that a sufficiently competitive market would exist to maximise benefits for taxpayers and passengers.
- The contractual and financial incentives for both the Department and TOC bidders on overlapping franchises would be complex and would create significant financial risks directly related to higher levels of unpredictable competition. Franchise competitions fundamentally rely on bidders being able to predict revenues with a reasonable degree of confidence at the point of bid. In cases where this confidence is reduced, there are a range of options for handling the increased risks, but it is likely that the Department would have to consider offering specific financial protections within contracts. Protections of this kind would tend to remove or dilute the incentives to compete on fares or service offers that overlapping franchises are intended to create. Additionally, such an approach may have significant disbenefits in operational terms. As we previously explained, the legacy of the Brighton Mainline is an instructive example, where previous overlapping franchises have resulted in a highly inefficient timetable, poor operational performance for passengers and a complex, and, in some cases, confusing fares structure.
- There are significant additional transaction costs for both Government and the private sector.

⁶ Indeed a sole instance in relation to Grand Central seems to be the only evidence advanced in the Impact Assessment for this major assumption (set out at page 68 of the Impact Assessment).

⁷ Impact Assessment, Page 5.

An approach which does not give sufficient weight to these operational impacts creates significant risks for the operational performance of the railway which require careful analysis and, in our view, quantification.

Deliverability and protection of taxpayers

With respect to deliverability, the CMA clearly recognised in its discussion document that the impact of any changes in this area should be neutral to the taxpayer.

The DfT was therefore interested in exploring the extent to which the Impact Assessment considers and devises a viable, practicable PSO mechanism. However, the Impact Assessment does not propose any, deliverable operational model, preferring instead a short “*simplified*” model, which it accepts is an “*approximation*” with further detailed work needed on designing the scope of the levy, its legal basis and to address “*the technical challenges of designing such a levy*,”⁸ indeed the Impact Assessment is clear about the “challenges” of PSO levy design, which means that Option 1 would place “*government funding at greater risk than in the status quo*”, particularly the fact that the situation will be dynamic meaning that it would be “*difficult to estimate [the levy] with precision*”.⁹

We remain very concerned that, despite acknowledgement of the importance of the principle of taxpayer neutrality, there remains no indication of a viable alternative model which reflects the particular circumstances of the rail industry in Great Britain; indeed the Impact Assessment is clear about the “challenges” of PSO levy design, which means that Option 1 would place “*government funding at greater risk than in the status quo*”.¹⁰ The absence of any viable approach in relation to this issue remains a considerable issue, with the failure to do so representing a considerable risk to taxpayers and investment in the railways, which is vital to securing significant passenger benefits. In this content, we would caution the CMA against advocating a significant programme of reform, which brings significant risk, on the basis that further work may provide an answer to this issue; in our assessment, the design and deliverability of a PSO levy must be established first.

Specification

An underlying theme of the impact assessment is the commentary regarding the adverse impact of specification in limiting innovation.¹¹

However, as we have demonstrated to the CMA in our response to its discussion document, it is important to note that the competitive franchising model is a competitive, evolving one. In particular, recent competitions such as the East Anglia franchise demonstrate a more outcome focussed approach to franchising, encouraging ambition and innovation amongst bidders; additionally, the franchise management process is considerably more flexible and open to change than may be suggested by the Impact

⁸ Impact Assessment, page 76.

⁹ Impact Assessment, page 110

¹⁰ Impact Assessment, pages 109 to 110

¹¹ See, for example, Impact Assessment, page 12

Assessment. However, it is also important to note that specification to secure a range of social, economic and environmental benefits will continue to be important – in particular such an approach, reflecting the legitimate need of Government, accountable to Parliament, to secure specified benefits for passengers and communities which rely on rail, is an important feature of our railway.

Additionally, we note that there appears to be a misunderstanding of the legal position regarding operators of last resort in the Impact Assessment, particularly the suggestion that funders would have to step in where an open access operator ceased to operate, potentially in an area where a franchised operator, subject to lower levels of specification, had withdrawn.¹² This is legally incorrect (the obligation to ensure continuity of services applies only to franchised services). In addition, in the absence of the availability of a statutory transfer scheme and the contractual early warning indications of the type in place for franchisees, it would be extremely difficult for the Department to deliver continuity of services previously run by an open access operator. This runs a considerable risk of services being lost to communities, at least for a significant period of time, due to the specification approach suggested – this would clearly be unacceptable.

Franchises used in modelling scenarios

Furthermore, we note that the scenarios modelled in relation to options 1 to 3, each appear to be in relation to different franchises, with the GWM excluded from Option 2, and the ECML and WCML excluded from Option 3. We have noted the rationale included in the report in Impact Assessment for the approach to Option 3, but note that there is no justification for this approach included in relation to Option 2. The CMA should be aware of the very limited analysis underlying these later options when it is considering its analysis, in addition to other specific concerns set out above.

Concluding remarks

The DfT remains committed to putting the interests of passengers at the heart of Great Britain's railways. It also welcomes further steps to improve competition which recognise the particular circumstances of the rail industry, setting out a number of questions which it considers must be answered. However, we consider that the Impact Assessment leaves most of these questions in much the same place as they were before its production. In our view it does not substantively take forward the debate.

That is not to say that we do not welcome a strategic discussion around competition on Great Britain's railways that fully addresses the proper role of on-rail competition and how that can be reconciled with other priorities, including the maintenance of a healthy, vibrant, competitive franchising market.

We look forward to discussing these issues in the forthcoming workshop between the CMA team and DfT officials.

¹² Impact Assessment, page 3