



OFFICE *of the*  
RAIL REGULATOR

**COMPETITION FOR RAILWAY  
PASSENGER SERVICES**

**A CONSULTATION DOCUMENT**



# Contents

---

<b>Regulator's foreword</b> .....	<b>5</b>
<b>Introduction</b> .....	<b>7</b>
<b>1. Background</b> .....	<b>9</b>
Policy Context.....	9
<b>2. Principles</b> .....	<b>13</b>
<b>3. Access Charges for Passenger Operators</b> .....	<b>19</b>
Negotiated Charges.....	19
Equalised Access Charges .....	20
Access Deficit Charges .....	23
Controlled Competition in Contestable Markets .....	26
Conclusions on Charging for Open Access Operators .....	28
<b>4. Access Rights</b> .....	<b>29</b>
Information Requirements .....	29
Procedures .....	30
<b>5. CONCLUSIONS</b> .....	<b>32</b>



# *Regulator's foreword*

---

## **Introduction**

This consultation document considers one of the most important questions which the Regulator needs to address, namely the extent of moderation of competition for franchised passenger services. In this foreword I outline the subject matter of this document and explain why I am issuing it.

## **The Regulatory Context**

The limits to or the extent of competition that will be allowed are likely to be defined - for the first generation of franchises - in the access contracts between Railtrack and the train operators.

As the Rail Regulator, I am required by Parliament, under the provisions of the Railways Act 1993, to approve the terms and conditions of all access agreements entered into after 1 April 1994.

There are access contracts already in place. British Rail obtains access to Railtrack's track and stations through an agreement made on 1 April 1994. However, the Secretary of State and I have agreed that by 31 March 1995 the new Train Operating Companies within British Rail, i.e. those designated for franchising by the Franchising Director, should have their own individual access agreements with Railtrack. The access agreements impose a number of obligations and confer rights on both parties, and incorporate Railtrack's charges for access to its network facilities.

I believe that there are a number of important issues relating to the level and structure of Railtrack's access charges. I have therefore published today a separate consultation document "Framework for the Approval of Railtrack's Track Access Charges for Franchised Passenger Services". That document sets out in more detail my proposed approach to the approval of the terms and conditions of access contracts entered into by Railtrack and the train operators.

## **The Way Forward**

I have requested responses to this consultation document by 8 August 1994. Following consideration of these responses, I plan to issue a policy statement in the Autumn setting out the approach I want to follow in considering proposals for the moderation of on-track competition for the first generation of franchised passenger services.

J A Swift QC

## *Introduction*

---

This consultation document considers approaches which the Rail Regulator might adopt when considering proposals for the moderation of on-track competition for the first generation of franchised passenger services. It is published as an invitation to submit views, advice and comments on key issues in this area.

Section 1 of the document sets the context for the review, then Section 2 puts forward a number of principles which the Regulator is minded to apply when considering individual proposals. Section 3 identifies options for setting track access charges for open access (i.e. non-franchise) passenger operators, and Section 4 discusses the definition of access rights, together with information requirements and procedures. Conclusions are set out in Section 5.

In the light of comments received on this document, the Regulator plans to be able to issue a policy statement by September 1994, setting out the course he expects to follow.

The Regulator has sent copies of this document to those parties who have a readily identifiable interest in the issues as an invitation to consult. They include Railtrack, the Office of Passenger Rail Franchising (OPRAF), British Rail, Passenger Transport Executives (PTEs), other rail transport organisations, rail consultative committees, and appropriate Government departments - Department of Transport, the Treasury, and the Department of Trade and Industry. He is also seeking the views of other industry regulators, and would of course welcome comments and views from anyone with an interest in the important issues raised in this document.

Submissions should be made in writing to be received by 8 August 1994. Unless there is a clear indication that respondents wish their submissions to remain confidential, they may be published, or quoted publicly, by the Regulator. Responses should be sent to:

J A Rhodes  
Director, Passenger Services Regulation  
Office of the Rail Regulator  
1 Waterhouse Square  
Holborn Bars  
138-142 Holborn  
London EC1N 2SU

Any respondent who wishes to have an informal discussion before replying in writing should also contact J A Rhodes in the first instance.

Additional copies of this document are available on request from the Press Office, Office of the Rail Regulator (Tel: 071282 2002).

# 1. *Background*

---

- 1.1 The Government intends to privatise British Rail's passenger services by awarding a series of franchises for their operation. In other industries, a franchise typically gives the franchisee certain rights of exclusivity in return for the rights and obligations he has to satisfy. In the case of franchises, competition usually takes place for the franchise itself, rather than within the market in which the franchisee operates: However, the Government has also restructured the railway in such a way as to encourage direct competition between train operators in providing passenger services. This creates a tension, particularly because the award of railway franchises will usually involve the payment of subsidies. The Government believes that the potentially conflicting objectives of franchising and competition can be resolved by "moderating competition" and has asked the Regulator to consider proposals for moderating competition on a case by case basis.
- 1.2 The purpose of this document is to set out, for consultation, the Regulator's preliminary views on the general approach he is minded to adopt in considering proposals put to him. In some of the key areas, more than one approach is possible, and the Regulator would particularly welcome views on the prospective advantages and disadvantages of different choices.

## **Policy Context**

- 1.3 The Government, in its objectives, instructions and guidance to the Franchising Director, has instructed him to develop a programme which will lead to 51% or more of passenger services being operated under franchise agreements by 1 April 1996. Franchisees will clearly need to know about the competitive environment in which they are expected to operate. In most cases the limits to, or extent of, the competition that will be allowed will be established through access agreements giving train operators the right to use Railtrack's infrastructure.
- 1.4 The initial access agreements in place between British Rail and Railtrack were determined by the Government. It is, however, the Government's intention that these should be replaced by access agreements approved by the Regulator during the course of 1994/95 in parallel with the incorporation and vesting of British Rail's train operating units as separate subsidiary companies. These regulated access agreements will therefore provide the first opportunity for the Regulator to determine the competitive environment for the longer term.

- 1.5 In carrying out his functions, the Regulator is guided by his duties under section 4 of the Railways Act 1993. These require him to act in the manner which he considers best calculated:
- (a) to protect the interests of users of railway services;
  - (b) to promote the use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent that he considers economically practicable;
  - (c) to promote efficiency and economy on the part of persons providing railway services;
  - (d) to promote competition in the provision of railway services;
  - (e) to promote measures designed to facilitate the making by passengers of journeys which involve use of the services of more than one passenger service operator;
  - (f) to impose on the operators of railway services the minimum restrictions which are consistent with the performance of his functions;
  - (g) to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance.
- 1.6 In addition, he is required to have regard to the financial position of the Franchising Director, and to act in a manner which he considers will not render it unduly difficult for network licence holders (principally Railtrack) to finance their activities. Other duties relate to safety measures, environmental effects, the interests of disabled users, and fares and service quality of non-franchised private sector operators in possible monopoly situations.
- 1.7 Until 31 December 1996, the Regulator also has a duty to take into account any guidance given to him by the Secretary of State. The Secretary of State provided guidance earlier this year. The principal elements of the guidance which are relevant to matters considered in this document are:
- (a) that the Regulator should facilitate the achievement by the Franchising Director of his objective of securing that railway passenger services in Great Britain, other than exempted services, are provided under franchise agreements as soon as reasonably practicable.. It is the policy of the

Government that competition on routes to be franchised should be moderated to the extent necessary to ensure the successful launch of the first generation of franchises;

- (b) that the Regulator should discuss with the Franchising Director proposals he will be putting to forward to the Regulator for the moderation of competition on particular routes. These may include proposals for the exclusive use of infrastructure by a franchisee, where the Franchising Director judges this is necessary for the expeditious franchising of the services concerned;
- (c) that the Regulator should discuss with Railtrack, and consult the Franchise Director on, proposals Railtrack puts to him relating to access contracts, including access charges, negotiated with an operator wishing to run services other than under a franchise agreement [or under certain other agreements with or directions issued by the Franchising Director]. The Regulator should exercise his powers under sections 17 to 22 of the Act [to direct facility owners to enter access agreements; to approve access agreements and amendments; to exempt facility owners from the need for regulatory approval of or the Regulator's power of direction over access agreements; and to prepare and publish model clauses for inclusion in access agreements] in accordance with such proposals (as finalised following such discussions);
- (d) that the Regulator should not require or approve access agreements which permit access to Railtrack's network for railway passenger operations which, pending franchising of services operated by BR or its subsidiaries, may prejudice or significantly interfere with the Franchising Director's franchising programme. Before requiring or approving any access agreement in respect of an operator wishing to run a railway passenger service other than under a franchise agreement, the Regulator should consult with the Franchising Director and have regard to the representations he makes as to the likely effect on his franchising programme of granting such access.

1.8 The Government's objectives are also set out in the document "Gaining Access to the Railway Network" which it published in February 1993. This document explains that it is the Government's intention that on-track competition in the first generation of franchises will be moderated, but only to the extent necessary to ensure the successful transfer of British Rail's passenger services to the private sector, and to ensure that tax payers receive value for money for subsidising socially necessary services.

- 1.9 This then is the policy context set out in statute and by Government, which the Regulator will take into account in determining his own approach to the moderation of competition.

## 2. *Principles*

---

- 2.1 The Regulator wants to see railway passenger services develop in a way which makes them more responsive to customers' needs, offering a better range of products at prices they can afford. Competition, or the threat of it, will create pressures on train operators both to reduce their costs and to become more innovative. British Rail already faces competition on many of its services from other modes of transport, but there is a concern that passenger rail's competitiveness in some markets should be better. There are also markets where British Rail has a significant share and the incentive to innovate may be blunted.
- 2.2 British Rail currently organises its service patterns and fares policies in order to maximise corporate revenue. To the extent that conflicts or competitive pressures arise between train operating units, the Board will seek to resolve or suppress them in what it perceives to be the corporate interest. The opportunity which franchising provides is that there need no longer be a centrally determined range of products on offer or suppression of competition where the pressure for it already exists. Franchising should therefore create some new competitive opportunities. Firstly, there will be a competitive bidding process for the award of franchises. Secondly, where the services of franchises overlap, or where they provide alternative routes to the same destination, competition may be expected to arise between them to serve the market they cover.
- 2.3 However, the Regulator is concerned that any rights of exclusivity granted to franchisees should only be the minimum necessary to achieve the Government's immediate objectives. If widespread rights of exclusivity were granted, franchisees would face direct competition only at the margins created by the definition of franchise boundaries. Elsewhere, there might be little stimulus to improve service provision above the required minimum, with a risk that in many areas the timetable would tend to ossify. Railtrack and the rolling stock leasing companies would be denied the opportunity to make better use of their assets, and the intended benefits of restructuring the railway would not flow through to the customer. Moreover, if the exclusive rights in franchises finished at different times there would be no obvious point at which it might become possible to move to a more competitive regime in the future.

- 2.4 Nevertheless, the underlying economics of the railway make the introduction of competition a difficult challenge. The passenger railway network as a whole and most of the services within it require subsidy. British Rail has tried to minimise the call on public funds by using the operating profits from its core businesses to cross-subsidise the more heavily loss making activities. Rail, like other public transport operations, contains an inherent element of cross-subsidy within it, because it is offering a relatively standard product to serve markets which differ widely geographically and at different times of the day or week. Even on a single line of route, the profitable service one way may be a loss maker in the reverse direction as the rolling stock returns to serve the profitable flow again.
- 2.5 In addition to this, British Rail uses profit from some services to reduce the subsidy requirement on those which are maintained for social rather than commercial reasons. Within a franchise, the franchisee may operate both "commercial" and "social" services. Such operators are vulnerable to raiding by competitors if the latter are able to serve the profitable flows while avoiding the poorer markets the incumbent has to serve. In these circumstances, the incumbent suffers a loss of profit with which to cross-subsidise poorer performers and the requirement for subsidy from the taxpayer will go up or the pressure to reduce or withdraw services will increase.
- 2.6 These features will have as much impact on the Franchising Director's position as they have had on British Rail in the past. His budget will be cash limited by the Treasury every year. The Government has made it clear (in the White Paper for example) that it would not expect the restructuring of the railway of itself to lead to closures. On-rail competition against services where British Rail is currently able to extract an element of monopoly profit will tend to lead to a transfer of benefit from taxpayers' subsidy to rail users, putting either the Franchising Director's financial target or his service coverage target at risk.
- 2.7 The Government, in its guidance to the Regulator, has asked him to make decisions on the moderation of competition in the light of proposals put to him by the Franchising Director. The purpose of these proposals will be to assist the process of franchising while containing the cost to one which the Franchising Director can afford. In these circumstances, the Regulator currently expects that his approach will be to seek to maximise the opportunities for competition while recognising and reflecting in his decisions the constraints under which the Franchising Director will be working. In considering proposals for exclusivity, he will regard them as derogations from a fully open access regime which remains the aspiration for the longer term. Proposals which seek merely to create centrally determined pockets of competition

within a general framework of exclusive rights are not likely to secure widespread benefits for consumers.

- 2.8 It may well be the case that some benefits from competition will flow to consumers simply through the process of bidding for franchises, i.e. competition for the track as distinct from competition on the track. For franchises of short duration the successful bidder may be able to earn a sufficient return only by improving services during the period of the franchise. For longer franchises, however, the competitive impact of the bidding process will wear off unless the franchisee is open to actual competition or, in its absence, the franchise agreement creates the right incentives towards improvement.
- 2.9 Supporting the approach outlined in para 2.7 above, the Regulator is minded to apply a number of more detailed principles to the consideration of individual proposals. He would welcome comments on them. The suggested principles are as follows:
- (a) *Moderation of competition must be considered in the context of the other key elements of franchise specification.* For this purpose, the other key elements of the franchise specification are likely to be minimum service levels, quality targets (including load factor targets where appropriate) and fares regulation (if any). The Regulator will want to be provided with evidence that where it is proposed to give franchisees rights of exclusivity, the other key elements of the franchise specification are likely to give consumers the protection which in other circumstances they could rely on market forces to provide.
  - (b) *Access charges must be calculated on a basis which does not unduly discriminate between operators competing in the same market.* Achievement of this principle is a necessary pre-condition for any access regime to comply with the law. There are, however, considerable problems in determining how it should be applied in practice. The next section of this document reviews the issues and options.
  - (c) *Passenger operators must be given rights of access to facilities needed to provide services on a fair basis which does not unduly discriminate between them.* The purpose of this principle is to emphasise that where competition is permitted, the ability to compete should not be frustrated by the creation of artificial barriers to entry. It is a point which will be of as much concern to franchisees where they need to share facilities as it will be to open access operators.

- (d) *In framing proposals for individual franchises, the Franchising Director should explain the implications for franchise generated competition.* This proposition emphasises the need to look beyond the confines of the franchise under immediate consideration in making any proposals for moderation of competition. The key questions will be whether the terms of the franchise under consideration will restrict the franchisee from providing competitive services elsewhere on the network (e.g. by restricting the uses to which rolling stock can be put); and whether rights of exclusivity proposed for one franchise will limit the service development opportunities of a subsequent neighbouring or overlapping franchise. The Regulator may also need to consider the appropriateness of allowing a franchisee with rights of exclusivity to compete against other operators whilst remaining immune from retaliatory competition itself.
- (e) *The Regulator will seek to reach a common understanding with the Franchising Director about the circumstances in which fares co-operation should either be allowed or required.* The Regulator has a statutory duty, reflected in conditions in passenger licences, to exercise his functions in the manner he considers best calculated to secure the provision of network benefits and, in particular, through-ticketing. The Franchising Director has the power to require the provision of interavailable tickets and has been instructed by the Secretary of State to do so where he believes the benefits will outweigh those of price competition and service diversity. The terms of the through-ticketing condition in licences make it possible for different schemes to be submitted to the Regulator to approve as satisfying the condition. Such schemes could include ones offering interavailable tickets, though the Regulator, because he is not a competent authority which can impose public service obligations, is not able to require interavailability. Consequently the Franchising Director has been taking the lead in developing schemes to provide both through-ticketing and interavailability to replace British Rail's current arrangements for meeting its licence obligations. In general, the Regulator would not be likely to object to co-operative arrangements between operators, whether mandatory or voluntary, provided that it can be shown that their intended effect is to enlarge the rail passenger market by offering more attractive products, and not to improve profits by restricting choice and competition.
- (f) *Operators should be allowed to provide a combined service where their franchised rolling stock assets would not enable them individually to meet the*

*Franchising Director's minimum service specification for a particular flow.* The Franchising Director may decide, in the light of the level of demand and economy in the use of resources, to require two franchisees to provide a combined service. In reaching decisions on the relevant access agreements, the Regulator would want to understand the basis on which such decisions had been taken, because their effect might be to restrict opportunities for competition.

- (g) *Proposals for moderation of competition must be justified by reference to the degree of financial exposure a franchisee would face in the absence of such protection, and be supported by professional advice as to the effect on saleability or sale proceeds.* While it may be the case as a matter of theory that any additional competition will increase the risk to franchisees and hence affect saleability and the subsidy budget, general assertions will not be sufficient. Since the Government has asked the Regulator to consider proposals for moderation of competition on a case by case basis, it has implicitly recognised that these issues are a matter of judgement and degree. The Regulator will therefore need to understand how much moderation is necessary, and how sale proceeds would be affected, in order to weigh those points against the benefits that competition, or the threat of it, would bring. He has already invited the Franchising Director to consider what supporting evidence his professional advisers might supply in relation to saleability or sale proceeds. The Regulator may also find it helpful to have some analysis of income within each franchise, in order to understand the revenue and the markets which may be at risk from competition. Finally, there may be cases where the Regulator would suggest that bids for franchises should be invited on both an exclusive and a non-exclusive basis, to try to establish the value which the market would attach to exclusivity.
- (h) *Any proposals for moderation of competition should analyse how the transition to a fully competitive regime would be affected.* Since the longer term objective is one of fully open access, the Franchising Director will need to avoid proposing restrictions on competition which would make the objective as difficult to achieve at the end of the first generation of franchising as it is at the start. One possible approach would be to time limit exclusive rights and give them a common termination date.



### ***3. Access Charges for Passenger Operators***

---

#### **Negotiated Charges**

- 3.1 The regime proposed in the Government's document "Gaining Access to the Rail Network" is one of administered charges for franchisees. Railtrack estimates its total future revenue requirement from which is deducted anticipated income from unregulated activities (such as property rents) and access charges expected to be paid by open access passenger and freight operators. The resulting figure, the control total, is the sum which the Franchising Director underwrites. When bidding for franchises, franchisees will be advised of the associated variable costs (usually a small proportion of the total) and Railtrack's allocation to them of joint and fixed costs which will be fixed in the short to medium term. The Franchising Director therefore underwrites the great majority of the costs associated with having a national rail network.
- 3.2 For open access passenger operators, the Government proposes a negotiated charges regime. The floor for those charges will be the variable costs associated with the traffic, supplemented by a contribution negotiated between Railtrack and the open access operator. The Government will set Railtrack a target level of contribution above variable costs to be earned from open access passenger operators. This target is taken into account in setting the control total to be underwritten by the Franchising Director. The theory behind this approach is that Railtrack will have an incentive to offer capacity to any traffic capable of making a contribution, however small, to its joint and fixed costs, and that the process of negotiation with the operator will extract from the latter the maximum revenue arising from its ability or willingness to pay. This approach to charging is therefore seen as the means both of maximising the use of the network and of maximising financial contributions towards it - both highly desirable objectives.
- 3.3 However, such an approach sits uneasily with the process of franchising and the underlying economics of an industry whose overall size and shape is determined by subsidy. The problems are as follows:
- (a) Negotiations between Railtrack and open access operators may fail to capture the full amount of their potential contribution. The market in question does not yet exist and there will inevitably be a good deal of uncertainty about the profitability of new marginal services operating in addition to the core franchised network.

- (b) At the time at which they make bids, franchisees are unlikely to have reliable information about the extent of the competition they might face and the impact of competition on the finances of their franchise. In such circumstances, they are likely to err on the side of caution, discount the risk excessively and thus reflect less than the full value of the franchise in their bids.
- (c) The Franchising Director is not an innocent bystander in all of this. He has both network coverage and financial targets to achieve. He is, in effect, underwriting the whole of Railtrack's passenger network through the franchising process and, like British Rail, relies on the elements of cross-subsidy within railway operations to contain the cost to his budget. Open access entry will inevitably reduce the franchisees' ability to cross-subsidise loss making services, and the threat of open access entry is therefore likely, in aggregate, to lead to lower franchise bids. Studies commissioned by the Department of Transport and British Rail have indicated the possibility of a substantial loss of net revenues on franchises with a high income base if unrestricted open access operation is permitted.

3.4 So we are faced with a paradox. The charging regime which, superficially, is designed to maximise entry into the market and use of capacity would have the effect of undermining the financial position of the Franchising Director who underwrites the core business of the network. He is likely to want to protect his position and that of franchisees by seeking widespread rights of exclusivity, with the potentially damaging consequences for the long term future of the railway industry referred to in para 2.3 above. The Regulator has therefore commissioned further studies to see whether a different approach to charging for open access operators could enable the Franchising Director's financial and network coverage objectives to be achieved while at the same time permitting some new entry into the market and competition. The charging regime described above inevitably brings financial loss to the Franchising Director and franchisees once open access operation is anticipated or admitted. Alternative approaches have therefore examined ways of mitigating or compensating for that loss.

### **Equalised Access Charges**

3.5 Equalised charges is a shorthand term to describe an approach which envisages that all passenger operators, whether open access or franchisee, on a particular route, would pay the same price per unit of operation for access to a particular part of the network. Such a charging regime could operate in a variety of ways. If open access operation added to the overall volume of service, there might be an equivalent

reduction in the franchisee's access charges; or the unit charge for both operators might be reduced; or the whole of the additional income might go to Railtrack; or there might be some permutation of the three. Whichever option was adopted, the open access operator would face an access charge which would at least price off some of the traffic which might theoretically have been admitted under a negotiated charges regime. In some circumstances, however, the charge might turn out to be less than Railtrack could have achieved through negotiation. Generally, therefore, equalised charges would give Railtrack less commercial freedom in seeking to achieve its target contribution from open access operators.

- 3.6 A number of choices would also be available as methods of determining the price for the unit of charge. All would share the characteristic of providing an automatic means of recovering Railtrack's joint and fixed costs between operators and services. Options considered have included train miles, vehicle miles and passenger revenues.
- 3.7 Consideration of the alternatives of train miles and vehicle miles highlighted some specific characteristics of railway economics. In the case of a typical Intercity franchise, using train miles as the basis of recovery created an almost complete barrier to entry. Vehicle miles created almost no barrier at all and left the incumbent's income base almost as exposed as would be the case with negotiated access charges. Intercity franchises are likely to be more vulnerable to competition for two reasons. Firstly they tend to have the highest income base and greatest ability to earn a profit margin over direct operating costs. They are the most attractive markets in which to compete. By the same token there is little or no financial attraction for operators to compete in many of the markets served by former NSE or Regional Railways train operating units (TOUs).
- 3.8 Secondly, however, Intercity has traditionally served its markets with long, high capacity, high cost trains. Those trains need high load factors in order to earn an adequate return on the equipment and Intercity service patterns and frequencies have been designed to achieve high load factors. A competitor using short, low capacity, low cost trains will often be able to find opportunities to fill the gaps between relatively infrequent Intercity services. It need only capture a relatively low market share to remunerate the cost of its own equipment. But in doing so, even allowing for growth in the market as a result of enhanced frequency, it is likely to prevent the Intercity operator from achieving the target load factors it needs. Moreover, with inflexible, fixed capacity train sets, Intercity would be hampered in mounting a competitive response.

- 3.9 This analysis highlights a risk that proposals for exclusivity may arise not simply in response to the risk of revenue diversion as a result of competition. They might also arise to protect the ability of franchisees to fund the initial asset values ascribed to different types of rolling stock. If part of the Intercity fleet requires monopoly power to restrict service frequencies and achieve high load factors in order to operate profitably in some markets, exclusive rights will simply delay the process by which the rolling stock supply industry develops products which can operate effectively in competitive markets. This may point to a conclusion that some Intercity operations may need a limited period of exclusivity, regardless of the charging regime, simply to give them time to reconfigure their fleets.
- 3.10 Leaving the rolling stock issue to one side, using service volume (train or vehicle miles) as a means of recovering Railtrack's joint and fixed costs seems to have the effect of either blotting out nearly all competition or offering very little financial protection to the incumbent. The Regulator therefore decided to focus on passenger revenues as the basis of recovery, on the basis that the revenue earned by each service would provide a reasonable approximation to ability to pay, and would therefore approach most closely the theoretical objectives negotiated charges were intended to achieve.
- 3.11 The attractions of such an equalised access charge could be that it could render administered rights of exclusivity unnecessary (leaving aside the rolling stock issue) and that it could permit Railtrack to share with franchisees the risks and rewards of variations in the economic cycle. The charge would have to be structured in such a way as to allow Railtrack to retain some of the benefit of selling capacity; but this could be done, for example, by fixing the unit price for a period of several years. Franchisees would also have the comfort of knowing, when they made their bids, that any competitor would face an access charge calculated on an identical basis to theirs; and that the charge itself would create an entry barrier which reduced their exposure to competition. The administrative burden on both the Franchising Director in proposing and the Regulator in deciding on rights of exclusivity on a case by case basis would be avoided.
- 3.12 While in theory such an approach to charging may possess these attractive properties, the harsh realities of railway economics tend to undermine them. The industry does not earn sufficient profit to pay for all of Railtrack's joint and fixed costs on this basis. Those costs represent over 40% of all passenger revenues. "Taxing" passenger revenues in this way would create a very high entry threshold, but would still leave

some incumbent operators exposed to a risk of income dilution on their most profitable services.

- 3.13 Perhaps more seriously, this form of equalised charges would create powerful incentives for perverse behaviour. There is no causal connection between Railtrack's joint and fixed costs and the incidence of passenger revenues. The rate at which these charges would be levied would vary between franchises and their effect as a barrier to entry would therefore be arbitrary and difficult to predict. Moreover, Railtrack's joint and fixed costs would indeed become variable in the eyes of the train operator, even though they are not variable in reality except in the very long term. Train operators would have every incentive to get out of services which earned on average a margin of less than 40% over direct operating costs, even though such services could make some contribution towards the joint and fixed costs. Detailed timetable specifications would have to be included in franchise agreements to prevent this happening - thus entrenching inflexibility instead of removing it.
- 3.14 The Regulator would welcome comments from respondents. Equalised access charges have many attractive properties in that they provide an automatic method of moderating competition. But before the Regulator could endorse such an approach, it would be essential to find a satisfactory means of resolving the drawbacks identified in paras 3.10, 3.12 and 3.13 above.

### **Access Deficit Charges**

- 3.15 Standardised approaches to charging designed to recover Railtrack's full costs run up against the problem that the industry earns insufficient revenues. Access deficit charges provide a different approach. They acknowledge that Railtrack's full costs will have to be covered by a combination of income from customers and Government subsidy. The purpose of an access deficit charge is to contain the risks to the subsidy budget by providing compensation from open access operators for a reduced capacity for internal cross-subsidy within franchised services as a result of competition.
- 3.16 The theory has been recognised in the British Telecom (BT) licence. BT's ability to meet its universal service obligation at a standard price throughout the country relied to an extent on cross-subsidy, and the presence of a competitor would reduce BT's ability to cross-subsidise that service. Condition 19 of BT's licence therefore allows it to include in the charges competitors pay to use the network an element of compensation for the loss of profit to be used for cross-subsidy. Although the Franchising Director and franchisees do not have a universal service obligation in quite the same way, there are some close analogies. The Franchising Director must

continue to secure the provision of passenger services across the network unless consent to closure is given; and he has to do so within an annual cash limited budget.

- 3.17 The calculation of an access deficit charge raises severe problems of practicability. BT has never in fact used its power under licence condition 19. Identifying the incidence and extent of cross-subsidy within rail markets presents an awesome challenge. However, as with access charges, there are three possible approaches - administered, negotiated and formulaic.
- 3.18 An administered approach might involve a requirement upon open access operators to relieve a franchisee of the burden of particular loss making services when competing in profitable markets. Determining a consistent basis for such arrangements might present insuperable problems. A means would have to be found of identifying poorly performing services to associate with potentially profitable slots in a way which did not worsen the economics of providing the loss making services. A means would also have to be found of binding the open access operator to provide the loss making services even though the franchise agreement provides the only means of compulsion on train operators to provide services. The open access operator might be kept under an obligation by becoming a sub contractor of the franchisee, for loss making services, but it appears unlikely that anybody would want to compete under those conditions.
- 3.19 The negotiated approach envisages a somewhat different way of structuring payments under the access charging regime. The Government's current regime is that franchisees become liable for the whole of their access charge, including Railtrack's joint and fixed costs, and that once incorporated in regulated access agreements, their contribution remains unchanged for a period of years, except for the small proportion that varies with service output or Railtrack performance.
- 3.20 An alternative would be to quote to franchisees and make them liable for only their variable costs. This would put them in a similar position to open access operators, who pay a negotiated contribution above this threshold. Franchisees' contributions would be determined through the process of bidding for franchises. The charging regime would thus give both types of operator the same incentives when making decisions about service provision.
- 3.21 Under this scenario the Franchising Director would then be directly responsible (rather than indirectly through franchisees) for meeting the balance of Railtrack's costs, and his contribution would be the subject of an annual negotiation between the two parties. This would be able to take account both of any variation in the

Franchising Director's annual cash limit, and of the extent to which open access operation actually materialised.

- 3.22 Such an arrangement would therefore have the benefit of facilitating competition on the track without creating perverse incentives for train operators. The major drawback is the complete lack of transparency in charging for infrastructure that would result. It would also mean that for the indefinite future a substantial proportion of Railtrack's income would be subject to public policy risk rather than being embedded in contracts.
- 3.23 A formulaic approach would look at the re-allocation of income rather than the reallocation of charges with the advent of open access competition. BR's current income allocation models are able to project (on the basis of standardised assumptions about frequency, journey time and interchange elasticities) the income that different timetables will generate for different fare types and their distribution between train operations. The models do not reflect any differences in quality between operators. Using such models, it would be possible to forecast the net income loss (i.e. after allowing for growth in the total market as a result of enhanced frequencies) an incumbent would face purely as a result of the addition of open access services to his timetabled services. That diversion of revenue could provide the basis of an access deficit charge which, having been assessed at the outset, could remain unchanged for as long as the open access operator continued to provide the service on which it was based. It would be incorporated in the open access operator's access charge and used to abate the charge of the franchisee.
- 3.24 As is the case with equalised charges, the aim would be to facilitate competition by avoiding the need for administered rights of exclusivity and allowing competition to happen on core markets where it is most appropriate rather than on peripheral markets. Moreover competition would tend only to take place where the overall growth in the market was sufficient to pay for the open access operator's other operating costs and would thus benefit the financial health of the industry as a whole.
- 3.25 However, like the other approaches examined there may be some drawbacks. Growth due to frequency enhancement tends to be small, and BR tries already to optimise service frequency with this in mind. The only opportunities for an open access operator to earn a profit would be by capturing that growth or "beating" the forecasts of the model. The normal revenue transfer to the additional services would have to be surrendered as the access deficit charge. This means that competitive opportunities may be limited to instances where BR has been unable to optimise frequencies itself.

The entry barrier is likely to be just as significant as would be the case with an equalised charge, reflecting the poor underlying economics of the industry.

- 3.26 Calculation of the charge would require dependence on forecasting models. Those which BR has developed were not designed with this purpose in mind and may be incapable of withstanding the detailed scrutiny to which access charges would be subject. The approach suggested would also take no account of the competitive response of the incumbent. By timetable adjustment he might automatically recapture part of the lost revenue. Should he also retain an unchanged access deficit charge in these circumstances?
- 3.27 Railtrack would have no incentive to sell capacity unless it was able, either to keep a share of the access deficit charge, or to negotiate an additional contribution above it from the open access operator. This would reduce still further the opportunities for an open access operator to compete profitably.
- 3.28 This method of calculating an access deficit charge therefore seems worth pursuing only if the open access operator is able to retain a significant proportion of the transferred revenue. Whether there is any proportion that would give adequate protection to franchisees while permitting a reasonable level of competitive entry would have to be tested empirically. The problems of dependency on network wide forecasting models and the appropriate treatment of the incumbent's competitive response would also need to be resolved.

### **Controlled Competition in Contestable Markets**

- 3.29 The technical approaches which attempt to limit the extent of competition automatically through access charges or access deficit charges seem on current analyses either to provide insufficient protection to the Franchising Director's budget or to suppress most competition without providing any obvious route towards easing market entry at a later date. The Regulator hopes that the consultation process which this document will start will establish whether any of the technical options described above, or indeed some other variant, can be structured in such a way as to protect the immediate financial interests of the Franchising Director; while creating opportunities for competition to benefit the industry in the longer term.
- 3.30 However, the Regulator has also considered whether it would be possible to introduce greater certainty into the negotiated charges approach combined with administered rights of exclusivity. Determining in advance the degree of exposure which each franchisee might face could assist in the saleability of franchises by defining the risk

while at the same time creating a significant but controlled opportunity for competition. This would provide firm evidence about what competition would materialise and its practical consequences, rather than relying simply on the theoretical studies conducted so far. The ingredients of such an approach could be the following:

- a) Establish which rail markets in each franchise are contestable. This might depend on considerations such as whether in each franchise the minimum service specification left sufficient capacity for a competing service, the overall size of the market and whether the revenue in that market exceeded direct operating and variable costs by a given amount.
- b) Agree on a definition of the market for this purpose. This would involve identification of the key flows falling within (a) above and deciding whether it would be appropriate to segment the market in some way, e.g. between peak and off peak.
- c) Decide on the share of revenue on those flows which should be open to competition. The appropriate share would be for discussion, and might vary between franchisees, but if less than 20% of contestable markets were open to competition that might provide too small an opportunity to attract any new entrant. Also for consideration is the means by which the market share opened up to competition is translated into capacity which Railtrack is free to sell. A variety of approaches are possible and the Regulator would welcome views on this. Since this approach would be relevant in the absence of a technical solution towards charging, open access operators would pay a negotiated charge in line with the Government's proposal.
- d) In accordance with the financial arrangements described in para 3.2 above, the potential contribution above variable costs should be netted off the control total which the Franchising Director will be asked to underwrite. There are a number of possible mechanisms for doing this, on which the Regulator would welcome views. However, having a known share of the market open to competition determined in advance ought to assist in the process of setting the target contribution from that source, which would mitigate the effects of competition on the Franchising Director's financial position. It could also provide a mechanism for enabling Railtrack to share in both the risks and rewards of opening up the rail network to competition.

- e) Para 4.2 below proposes that administered rights of exclusivity should be reviewed by the Regulator periodically, perhaps at the same time as the overall charging regime. If the approach outlined here were adopted, it might similarly to be subject to periodic review.
- 3.31 Like the other options considered, means would have to be found of resolving potential drawbacks. The processes summarised in para 3.30 (a) to (c) above would have to be turned into detailed procedures. Ways would have to be found of avoiding a substantial administrative burden, since this option still contains elements of the case by case approach. Like access deficit charges, this approach might also imply continued reliance on income forecasting models.

### **Conclusions on Charging for Open Access Operators**

- 3.32 The different approaches towards access charges described above could all be argued to be consistent with the criterion, set out in para 2.9 (b), that they should not discriminate unduly between operators competing in the same market. If the charging regime itself provides a technical and automatic basis for moderating competition, less weight may need to be given to some of the principles set out in para 2.9, though others (e.g. fares and service co-operation) would be relevant in any circumstances. All the principles would remain relevant in looking at franchises on a case by case basis if competition is moderated administratively, whether or not predetermined limits are set for contestable markets.
- 3.33 Any degree of competition might be expected to have the effect of reducing the elements of monopoly profit within the industry and of worsening the industry's overall net revenue position, other things being equal. Of course other things ought not to be equal because competition should improve the industry's cost performance, encourage the development of new markets and generate extra demand. But the costs, which will affect the subsidy budget, are likely to be felt more immediately than the benefits, even though the benefits may be crucial to the longer term development of the industry.
- 3.34 The analysis above has likened the financial position and motivation of the Franchising Director to that of British Rail, seeking to maximise the opportunities for cross-subsidy in order to reduce the call on subsidy. But the Franchising Director is not British Rail. As an agent of Government he has responsibilities for achieving the wider purposes of the Railways Act, as well as keeping control over his financial position. One of the wider purposes of the Act is the promotion of competition. However, the analysis of the options above does not suggest at this stage one obvious method of approach by which to strike the right balance between the Franchising Director's financial concerns and the benefits of competition. The Regulator would therefore welcome views before deciding how to proceed.

## 4. *Access Rights*

---

- 4.1 Unless competition is moderated automatically through some form of charging mechanism, rights of exclusivity will need to be sought by operators in access agreements approved by the Regulator. Consideration needs to be given to how such rights should be defined. The Regulator's preference is that rights of exclusivity should be identified by exception, and not the opportunities to compete. Otherwise new patterns of service not currently provided by BR could be unintentionally excluded. The Regulator would in any case expect to be provided with evidence that the exclusive rights conferred were the minimum needed to achieve the Government's policy objectives, and he is likely to be satisfied much more easily if the exclusive rights are defined and limited. Consideration also needs to be given to how extensive the protection of particular markets might be. Such protection could be limited to certain times of day or days of the week for example.
- 4.2 The Regulator has a preference for time limited exclusivity, not necessarily coterminus with a franchise. It would provide incentives to procure more appropriate rolling stock (see para 3.9 above); it would create opportunities for synchronised termination of exclusivity to facilitate the introduction of greater competition; and it would apply a form of competitive pressure on those with longer franchises, to keep them on their toes. One possibility would be to synchronise a review of exclusive rights with the periodic review of charges in access agreements.
- 4.3 The Regulator will welcome comments on these points.

### **Information Requirements**

- 4.4 Where any administered rights of exclusivity are proposed, the Regulator will expect to be provided with evidence that the rights sought are proportionate to the risks in the case of each franchise. It is suggested that this may require some analysis of the markets served by each franchise, the income earned and the potential level of exposure, distinguishing where possible the relative impact of frequency changes and of the types of rolling stock available to the incumbent. The Regulator would expect to see, accompanying each proposal, the opinion of the Franchising Director's financial advisers on the impact on saleability or sale proceeds of the exclusive rights proposed. The Regulator will expect to see some proposals put to a proper market test by seeking franchise bids on an exclusive and a non-exclusive basis.

- 4.5 Respondents are invited to make more detailed proposals as to how they would seek to satisfy these broad information requirements of the Regulator.

### **Procedures**

- 4.6 It is for the Franchising Director to make proposals to the Regulator as to the approach he would like to see followed on moderation of competition on a franchise-specific basis. The Regulator does not expect that he will normally be prepared to entertain proposals which do not have the Franchising Director's support. However, the process by which proposals are put to the Regulator must be carried out in such a way as not to fetter the Regulator's discretion in approving access agreements, particularly since the Regulator will have to determine the terms of such an agreement if the parties cannot agree between themselves.
- 4.7 This suggests that a TOU, having agreed a proposition with the Franchising Director, will need to engage Railtrack in debate to see whether there are terms which they could jointly agree to put to the Regulator, or whether the TOU will wish to seek a s17 direction. It is doubtful whether the Regulator could properly take part in those negotiations. The parties will know, however, that the Regulator will consider each proposal on its merits, having regard to his statutory duties, and to the principles outlined in para 2.9 above.
- 4.8 As the Regulator has made clear in his guidance on the approval of access agreements, he expects to consult other interested parties on proposals for exclusive rights. This will include certain British Rail TOUs, whether or not they are incorporated, as well as the British Railways Board itself.
- 4.9 It could be argued that any rights of exclusivity ought to be delayed until as close as possible to the invitations to tender for franchises. BR has de facto exclusivity at present and the Regulator will consult the Franchising Director and other interested parties before granting any open access rights. An interregnum of this kind might provide some opportunity to see what practical evidence there is of competition emerging.
- 4.10 However, there are drawbacks. The main source of competition is likely to emerge from within existing train operators. So long as they remain in BR ownership the Board is likely to restrict their ability to compete against other parts of BR. Moreover, in order to develop and market business plans franchise candidates will find it helpful to have a broad understanding of the on-rail competitive environment for the future. The Regulator expects that he will wish to exercise his functions in such a way as to

facilitate and not hinder the franchising programme. Subject to the views of respondents therefore, the Regulator is minded to decide on the extent of moderation of competition as part of the process of approving regulated access agreements as soon as he has all the information available to enable him to do so. The exception to this will be those franchises where exclusivity is to be market tested in the bidding process. In those cases, the Regulator expects that exclusive rights will only be granted if they are a necessary term of the successful bid.

- 4.11 For some of the first six franchises, it is likely that the debate on moderation of competition will not be concluded within the time envisaged for vesting and approval of the first regulated access agreements. Those agreements will therefore have to contain provisions which would allow for the inclusion of arrangements to moderate competition at a later date.

## 5. *CONCLUSIONS*

---

- 5.1 Promotion of competition is one of the most difficult aspects of the restructuring of the railway, involving as it does the reconciling of apparently incompatible objectives. The Regulator's decisions in this area will determine the competitive environment and the opportunities for the railway industry to flourish and develop for many years to come. Before embarking on policies which, once started, will be difficult to alter, the Regulator wants to establish as clear an understanding as possible with all the interested parties and, so far as possible, proceed on a basis which commands their support.
- 5.2 This consultation document is intended to promote that dialogue and is being distributed to all those whom the Regulator believes to be directly interested as well as being made publicly available. On some aspects, this document expresses a firm preliminary view. On others, notably the role of the access charging regime, the document is less firm in its conclusions. But the Regulator will find comments on all the points raised equally welcome.