



OFFICE OF RAIL REGULATION

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Dr Siân Phipps
Clerk, Enterprise and Business Committee
National Assembly for Wales
Cardiff Bay,
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Dear Dr Phipps,

Wales and Borders Franchise: ORR's submission

1. As the economic and safety regulator for the railways, the Office Of Rail Regulation has a duty under the Railways Act 2005 ("2005 Act") to have regard to any notified strategies and policies of the National Assembly of Wales and the ability of the National Assembly of Wales to carry out its functions. As such we welcome this opportunity to contribute to the Enterprise and Business Committee's consideration of the future of the Wales and Border's Franchise.

2. ORR's areas of direct responsibility with regard to all train operating companies include:

- issuing licences to operators of passenger and freight services, stations, light maintenance depots and mainline network;
- we are the health and safety authority for the whole of the railway, including all passenger train operators;
- approval of track access contracts between operators and Network Rail;
- ensuring that franchisees meet their obligations to provide timely information to passengers during periods of disruption; and

- we are the competition and consumer authority for the railways, including for passenger rail markets.

3. Future Wales and Borders Rail Franchise-holders will continue to be subject to ORR's regulation in each of these areas. Further details are available on the ORR website, and also in a dedicated guide to regulation that we have produced for any company considering starting up as a franchised train operator¹. We routinely work with franchise bidders to advise them of the regulatory requirements involved in being a passenger train operator, and we would expect to do this for bidders of the Wales and Borders Rail Franchise.

4. Although ORR does not have a formal role in relation to letting franchises, as the economic regulator of Network Rail we do have a strong interest in franchises being structured in a way that aligns the interests of franchise holders with the rest of the industry.

5. In particular, ORR believes that it is important that franchisees play their part in delivering efficiencies across the industry. We want to encourage franchisees to work with Network Rail to reduce the cost of providing network infrastructure. This is not least because the McNulty study of rail industry costs identified that approximately £0.5bn – £0.6bn of the total projected industry savings (£2.7bn - £3.8bn) were for franchisees to deliver.

6. To help inform the Committee's deliberations, the rest of this submission describes some of the longer-term trends that ORR sees driving the efficient delivery of network infrastructure over the next few years, and goes on to discuss the potential implications for franchised train operators.

Evolving models for delivering rail services

7. The organisation of the railway is experiencing a period of rapid change. A variety of related forces are at work that will reshape the industry over the next generation. In infrastructure delivery, Network Rail is moving away from a centralised command-and-control approach as it devolves responsibility to ten operational route areas across Britain, including a Wales route. At the same time, HS1 has demonstrated that it is possible to attract pension funds to invest in certain parts of the railway, and HS2 will add significant new capacity to some of the country's busiest routes. In the South West rail route, the alliance between Network Rail and South West Trains has

¹ Starting mainline rail operations: a guide to the regulatory process, July 2013, <http://www.rail-reg.gov.uk/upload/pdf/starting-mainline-operations.pdf>

developed a model of integration between infrastructure and service providers that may have relevance elsewhere.

8. Political devolution of decision-making to Wales, Scotland and regions of the UK is also altering the way that railway services are specified and procured in different areas. Integrated metropolitan transport authorities in London, Merseyside and elsewhere take their own approaches, and Scotland is working to develop its own model of integrated transport including rail. The devolution of franchising is currently being considered by the Silk Commission on Devolution in Wales. As the next generation of franchises for the operation of rail services is specified, including the Wales and Borders Rail Franchise, there will be an opportunity to take advantage of this transformation and align incentives for efficiency and customer service across the industry.

Evolving models infrastructure delivery

9. The way that rail infrastructure is provided is undergoing a period of rapid change. As well as Network Rail reorganising to devolve operational control to local routes, the concession to own and operate the HS1 route was successfully let to a private sector consortium. This may pave the way for the possibility of other rail infrastructure concessions in the future, and there is potential value in having comparative performance information from devolved and concessioned routes that may be owned and operated independently. Network Rail has considered the feasibility and business case for the letting of concessions to third-parties to run parts of the network infrastructure, and this may be one approach to developing alternative models of investment and operation.

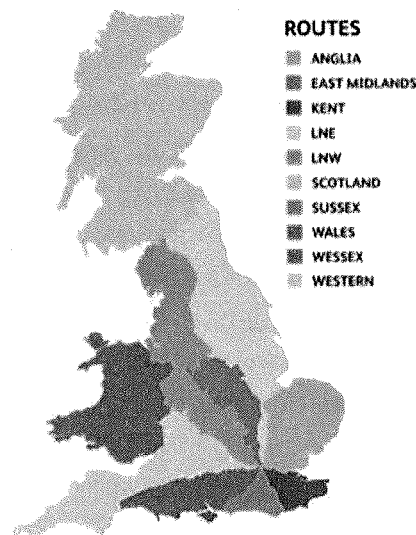
10. Infrastructure alliances are in various stages of development, including between South West Trains and Network Rail in the Wessex region, promoting closer working and the innovation of new approaches to operating, maintaining and upgrading the network in that area by putting track and train under a single entity. The governments in both Wales and Scotland continue to work closely with Network Rail, developing close joined-up working between service operators and infrastructure providers to create a more integrated approach to providing transport services in those countries. In England, integrated metropolitan transport authorities, such as those in London and Merseyside, administer their local networks in a joined-up manner. Elsewhere across the network, the 2011 Localism Act further encourages the consideration of nationally-planned rail services at a more local level.

11. ORR welcomes the industry's move away from a one-size-fits all approach towards different models of network delivery that suit the features of countries, regions and customers that each serves. ORR will continue to adapt its regulatory approach in line with the industry's evolution, including by taking a more comparative approach to regulation wherever possible, as other economic regulators do in water and energy. This innovation of new approaches is an important trend towards rail becoming a more dynamic and financially self-sustaining industry. The development of more disaggregated comparative information about route performance, including Wales specific information, would have the substantial benefit that it would allow the regulator to increasingly get out of the detail. We want to allow infrastructure providers greater scope for flexibility and innovation and to be increasingly held accountable for this by their customers in the first instance, and less by the regulator and government.

Operational devolution of infrastructure

12. Across the mainline network, Network Rail is doing many of the right things to get closer to its customers. The devolution of decision-making to each of its ten routes is an important step (Figure 1). Devolution should allow Network Rail route directors much more discretion in how they provide infrastructure services to the train companies; to assess how best to raise performance and improve efficiency in their own areas. Importantly it creates a kind of market for management within Network Rail, with the opportunity to draw comparisons and lessons from different approaches, and ultimately to benchmark comparative performance.

Figure 1: The ten operational routes within Network Rail



13. ORR is already using information generated by Network Rail to develop separate regulatory accounts at the route level, and intends to build on this with published route level performance data. PR13 included route-level scrutiny of Network Rail's Strategic Business Plan, and in due course ORR may pursue greater route-level accountability with disaggregated revenues reflecting disaggregated charges. This will make it clearer what customers and taxpayers are paying for in the different parts of the network, what they are getting in return, and how these contribute to the whole industry's costs. ORR will ensure that devolved and/or concessioned routes are operated in a transparent and non-discriminatory way.

14. There is potential for the routes to be powerfully incentivised to strike commercial deals with their customers, and in the process to make sure they make the best returns from the scarce network capacity they have at their disposal by providing what customers want and improving their own efficiency.

15. By moving infrastructure management closer to its customers, train companies should have greater ability to act more commercially with Network Rail. Similar to the current alliances, they may broker different options for the delivery and use of infrastructure services, pressing the routes to improve efficiency, and considering their own use of the network to identify ways in which they can reduce the infrastructure costs they pay.

Empowering train and freight operators

16. The next round of substantial efficiency savings from the railway can only be realised if we take a whole-sector approach, aligning incentives for Network Rail and the service operators to work together.

17. Rail customers would be better served if train operating companies (TOCs) and freight operating companies (FOCs) were able to have a more normal customer/client relationship with Network Rail, where the majority of Network Rail's costs are met from income generated by selling their services to the operating companies. This could allow remaining public funding to be more transparent and targeted in return for providing specific services which would otherwise be uneconomic to run.

18. We expect to see further evolution in industry structure, including deeper alliances between Network Rail and TOCs in some areas, including Scotland; the potential for more network concessions; the development of alliancing between Network Rail and its supply chain; and more bespoke arrangements in track access contracts.

19. For this to happen successfully it is essential that the environment in which TOCs operate becomes much more flexible and based on a more conventional commercial relationship between operators and Network Rail. Their incentives to drive efficient and cheaper use of the infrastructure should be more strongly aligned with Network Rail's. Network Rail should likewise become more responsive to the commercial needs of operators and through them their final customers, both passengers and freight. This means:

- giving FOCs, TOCs and passengers a stronger ability to identify improvements and enhancements to the Network and the way it is used;
- more effective annual Joint Performance Improvement Plans (JPIPs) to empower the ability of TOCs to drive better network performance with Network Rail, backed by regulation; and
- looking again at the way government funding flows through the industry.

20. TOCs should also be able to retain a share of the benefits of efficiency savings achieved by Network Rail. ORR also considers that TOCs should expect to bear more of the true cost of their use of the infrastructure rather than this being channelled through the Network Grant in a way that currently makes the true costs imposed on train operators opaque. As discussed in the previous section, the experience to date is that where operating companies are exposed to the true costs, then they work very effectively to reduce those costs while maintaining performance.

21. Growth in rail travel, and passenger revenues, could allow government subsidy to become more focussed on services that the market will not provide but that society values. This would allow government to step back from detailed specification of some services. It would allow TOCs to take a much more flexible role to determine and deliver what passengers want and to take a greater role in driving efficiency.

Strengthening the franchising model

22. The future of train franchising is critically important to the performance and efficiency of the railway as a whole. The granting of future franchises creates an opportunity to drive significant efficiencies across the whole railway sector, but this depends on franchises being structured and let in a way that allows and incentivises them to work for greater efficiency in partnership with Network Rail.

23. The incentives that TOCs currently have to work together with Network Rail to achieve efficiency savings are weak. The current £4bn Network Grant received by Network Rail from the governments covers a large part of the costs of the infrastructure that TOCs use, and so TOCs are currently insulated from the true costs of using the network.

24. This means that TOCs are not strongly aligned with Network Rail to find efficiencies and manage down the costs that they currently impose on the network. The industry could be put a more commercial footing through a move towards more cost reflective charging, and exposing franchised train operators to more of Network Rail's costs through its charges.

25. ORR has argued, in light of the Brown Review of franchising, to make franchise agreements more flexible to allow franchised passenger TOCs to share the financial benefit from working with Network Rail to deliver innovation and efficiency throughout the life of the franchise agreement. We also argued that a more transparent change mechanism should be included to deal with specification changes throughout their life.

26. To achieve this requires changes in the new TOC franchise agreements. If TOCs are to work with Network Rail to achieve the efficiencies which will reduce the size of the subsidy to Network Rail, this would require:


(i) franchise specifications that are sufficiently flexible, to allow and encourage TOCs to make innovations that result in efficiency savings during the lifetime of a franchise, not only when the franchise is let. This is particularly important if franchises are to be longer.

(ii) a franchise change mechanism to allow for changes to franchises to deal with beneficial changes to specifications during the franchise term. This should be transparent and predictable. There may be a role for independent regulation.

(iii) TOCs to retain the benefits of savings achieved through route-level efficiency benefit sharing (RBES) and alliance arrangements in CP5. This will encourage Network Rail and TOCs to work together to identify further savings by allowing TOCs to keep some of these savings. ORR believes that collaboration at the route level is likely to achieve such savings. The current franchises do not allow such benefit sharing.

(iv) TOCs to have an interest in the cost of the infrastructure that they use so that they are incentivised to help improve its efficiency. This means they should not be held neutral to changes in the access charges they pay as they are under the current franchises, nor when these change at the time of a price review. TOCs should increasingly expect to meet the true costs of the infrastructure that they use, rather than funding in respect of those costs being channelled directly from government to Network Rail. Any move towards more cost reflective charges for TOCs would need to be implemented in stages so as not to create additional risk for taxpayers through reduction in franchise premiums, and to avoid grievous commercial shocks to operating companies.²

With kind regards,

A handwritten signature in black ink, appearing to be 'D. Brown', written in a cursive style.

Daniel Brown
Director of Strategy and Policy

² ORR's submission to the Brown Review on franchising, December 2012 <http://www.rail-reg.gov.uk/server/show/nav.1324>