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Is the government trying to protect HS2 from competition?

Last June, the Department of Transport announced three bidders for what it has termed the West Coast Partnership, so called because it will combine the current inter-city West Coast main line franchise with eventual HS2 services. The final winner of the bidding process will work with HS2 Limited to plan and run the first services on the high-speed line (to be constructed between London and Birmingham). According to the Government, combining HS2 with the current West Coast franchise operator is to ensure full integration of services and, as the Chairman of HS2 remarked, to ensure both parties are "working towards the same goal"[1]. But, is this goal really to suppress prospective competition? Indeed, the proposed franchise raises a number of competition concerns.

When the railways were re-privatised in the 1990s, a competitive element was built into the structure of rail services, primarily by breaking-up the service network into a number of franchised areas. Each of these was offered to a Train Operating Company (TOC) on a competitive tender basis, constituting competition *for* the market. In addition, there was a very small amount of planned-for on-rail competition on a few nominated routes, whereby a rail company could enter the market (through a so-called Open Access Agreement) by offering distinct new services to places poorly served by the incumbent franchisee. This latter form of obtuse competition was deliberately moderated to enable the early franchise system to bed-in, but with the original intention of allowing more entry in future years.

There were further elements of on-rail competition more by accident than design. Some passengers could choose between different franchise operators operating broadly parallel routes; for example Exeter could be reached from London either via Paddington or Waterloo. And there was some competition as a result of overlapping boundaries between the early franchised territories; the original franchised areas were based on BR profit centres, which happened to overlap. Consequently, on some major radial routes into London and other conurbations there was potential for inter-city and regional rail operators to compete directly, although competition in this instance was blunted because of product differentiation (between stopping and inter-city services). Nevertheless, both forms of on-rail competition appeared to have been effective. NERA in 1999 sampled a number of point-to-point flows benefitting from competing services, 19 in total, with Herfindahl's varying between 0.35 and 0.75, and found that there was significantly higher output (measured by service frequency) and significantly lower (unregulated) fares on the 19 routes by comparison with network-wide averages.

After nearly two decades this modest competitive element in the original post-privatisation rail service network has declined. The number of rail franchise areas has shrunk significantly, from 25 to 15 and, as a result, there is far less geographical overlap between franchised areas and thus less scope for on-rail competition. Nor has this situation been off-set by a material increase in the number of Open Access operations. There was also a serious interruption of the franchising process after a debacle with the award of the West Coast franchise in 2012. This led to negotiated Direct Awards to a number of existing franchisees when their contracts came up for renewal. At the beginning of 2017, Direct Awards were still in place for a third of all franchises. There has also been a fall in market interest in bidding for franchises so that the number of bidders for recent contracts has fallen, an outcome possibly due to amalgamations and takeovers of the TOCs. Thus, since the late 1990s, competition both 'for' and 'in' the rail market has declined quite significantly.

In an attempt to turn the tide, both the CMA and the House of Commons Transport Committee (Rail Franchising, Ninth Report Sess. 2016-17) suggested recently to the Government a need for more competition in the market. The CMA launched a Policy Project in early 2015 which concluded that the small amount (covering less than 1% of passenger miles) of on-rail competition that prevailed through Open Access Agreements (extant mostly on the East Coast route) had been very effective particularly in promoting innovative services. It therefore suggested for the immediate future increasing the number of such Agreements or, in future awards, splitting franchises. For

[1] https://www.gov.uk/government/news/government-announces-new-rail-franchise-for-inter-city-west-coast-with-the-introduction-of-high-speed-2-services

the longer term it suggested a system of multiple licensed operators as an alternative to franchising. It also noted that the potential for entry was greatest on three main inter-city routes, one of which was the West Coast route.

The Transport Committee in its February 2017 report endorsed much of this thinking, particularly with respect to increasing the extent of Open Access. It noted that: "[o]pen access is likely to be aided by the pipeline of rail investments due for delivery over the next decade" (para 32) and that "[i]nvestment in new rolling stock, signalling technology and electrification are also likely to increase the capability of the network to accommodate open-access entry" (para 67). Significantly, it went on to note that: "HS2 has the potential to free up capacity for [Open Access] commuting and stopping services on the West Coast Main Line" (para 68). The Government's announcement of the West Coast Partnership, in contrast, represented a further closing down of competition. "What is being created is a very large single monopoly franchise, with very little or no on-rail competition on a key network route" (House of Commons, para 144). It is to be noted also that the first announcement of the Partnership in the autumn of 2015 came during the course of the CMA Policy Project and after the CMA's release of its Interim Report for consultation in July, which signalled the CMAs views on the need for more competition.

There is, of course, a genuine public policy issue concerning the size of taxpayer support for the railways apparent in the tension between the size of the premiums aid (subsidy required) by franchise bidders and the degree of competition that they face and, in a way, this tension has been exacerbated by requiring entrants to pay track access charges based only on direct costs with no contribution to network overheads. But the CMA put forward suggestions (endorsed by the Transport Committee) to ease the dilemma, specifically proposing a form of a PSO levy on entrants.

It would appear therefore that the merging of HS2 with the West Coast franchise is a response to the competitive threat that a separate franchise for the West Coast route (and a possible increase in Open Entry) poses for the success of the controversial £60bn HS2 project (with its lacklustre economic return); the Government's Partnership proposals are an attempt to counter this threat. Strong evidence to support this argument lies within the contents of a Report commissioned by HS2 Ltd from consultants (Booz&Co, *Review of HS2 Demand Forecasts*) in 2012. This report analysed early forecasts of passenger demand using Eurostar and the high speed track built for it, HS1. Use of Eurostar has proved disappointing with usage flat-lining in recent years at around half of some earlier passenger forecasts. It was argued in the consultant's report that the principal reason for this was de-regulation of European aviation and the resulting low cost airline revolution. This aviation liberalisation led to a substitution of longer distance trips in Europe instead of travel to near-Europe. Whilst noting that aviation would not be a competitive threat in the HS2 context (it overlooked autonomous road vehicle technology), the report continued:

> Understanding competitive response will continue to be a key issue for HS2 demand forecasts. However, <u>HS2's main competitor will be other rail services, not aviation, and government policies on franchising and rail fare regulation would greatly influence the competitive environment in which HS2 would operate"</u> (emphasis added).

It would appear that both HS2 Ltd and the Government have taken this message to heart and by merging the forthcoming rail operation of HS2 with its most likely rail competitor, are seeking to close down a future competitive threat to HS2 services. The CMA has in the last couple of years investigated two rail franchise agreements that raised competition concerns; now it might wish to turn its attention to the pending merger that will create the West Coast Partnership.

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