

Agenda

Advancing economics in business

The age of the train

The GB passenger rail sector is ranked highly among those of EU Member States, and is set to improve further. Current projections suggest that, in the 2020s, Britain's railways may be returning money to taxpayers, and that net government subsidy could decrease to zero. In such a scenario, how would the industry be organised, and what would need to change from its current structure?

A recent study by the European Commission¹ placed the railways of Great Britain fourth among those of 25 EU Member States in terms of the success of the passenger sector.² Moreover, the study suggested that, in the last two decades, Britain's privatised, vertically separated model has shown the most improvement of all the railways studied. Some of the more interesting statistics in the study are given in Table 1, which compares the UK network with three of Europe's other large rail networks—in Germany, France and Italy.

The Commission's analysis highlighted, as key elements of this success, high levels of passenger satisfaction and punctuality, and strong growth in usage.

However, while the study provides welcome news for the sector in Britain, further improvements are still to be expected. The GB Rail Value for Money study,³ led by Sir Roy McNulty, found plenty of scope for obtaining value from the sector in years to come—identifying a

Table 1 European Commission rail comparison

Description	UK	Germany	France	Italy
Scale of operation (route miles)	9,826 (4th)	23,487 (1st)	19,288 (2nd)	10,271 (3rd)
Train km ('000)	508m (2nd)	396m (3rd)	675m (1st)	266m (4th)
Intensity of infrastructure (passenger km/km of track)	2nd	6th	4th	3rd
Passenger km growth (1995–2008)	71%	19%	8%	10%
Government subsidy (2009) (€ billion)	5.1	13.5	10.9	8.1
Railway employees (2008)	90,000	178,000	160,000	94,000
Punctuality (2011)	91.5%	80%	90.8%	93.3%
Increase in the cost of rail prices (2000–11)	34%	16%	10%	25%
Reduction in public subsidy (2000–08)	–23%	–20%	+48%	+28%
Passenger satisfaction with punctuality/reliability	87%	53%	55%	63%
Passenger satisfaction with train frequency	84%	74%	73%	73%
Passenger satisfaction with information	80%	50%	48%	69%
Overall comparison	1st	7th	10th	23rd

Source: Network Rail (2013), 'Most Comprehensive European Rail Comparison Study Published', news release, April 1st, based on European Commission (2013), op. cit.

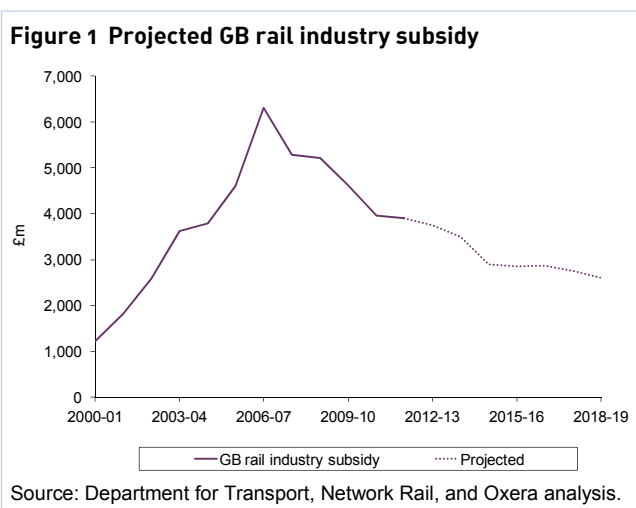
variety of structural characteristics inhibiting the realisation of cost efficiencies. The industry is now working to address these structural characteristics and to deliver the efficiencies expected of it.

Furthermore, the UK Department for Transport (DfT) has just announced⁴ that its rail franchising programme is to restart—albeit slowly. This follows its decision in late 2012 to cancel the West Coast and Great Western franchise competitions due to errors in its bid evaluation procedures.⁵ To the extent that this delay has prevented the efficiencies and innovations from the franchising process being passed on in lower subsidy requirements, the recent restart should put matters back on track (excusing the pun).

The overall position—of strong patronage (and, therefore, revenue growth), and an expectation that costs will fall over time—is changing. Subsidy in the sector was £3.9 billion for the financial year 2011/12, but, as Figure 1 below demonstrates, this has been declining since 2007 and could reach zero at some point in the future.

If a zero *net* subsidy⁶ were to be achieved, it would very much depend on the government deciding to keep the outputs it buys from the industry (in terms of passenger services) the same, or similar to those of today. Substantial elements of the GB rail industry will require continued subsidy to support operations and necessary infrastructure work. As long as there is a welfare case for this subsidy to continue, it would be worthwhile for the government to support services.

However, which elements of the network will still require subsidy is, surprisingly, unclear. The way in which subsidy is paid to the industry is mixed—some is paid to Network Rail in a block grant (£3.7 billion in 2011/12), while the rest is formed primarily of subsidies paid to franchised train operators—although this resulted in the operators paying the government £133m



in 2012.⁷ While operating subsidy per passenger mile is greater for 'regional' services, many suburban and other commuter services often require substantial capital expenditure to keep capacity in line with demand.⁸

What would a zero-subsidy railway look like?

Assuming, for now, that rail outputs are kept at current levels, and net subsidy declines to zero, what might change in the industry?

- **Franchising**—currently, passenger services are (with some exceptions) provided by operators under contract to the DfT and other client bodies. Franchising is likely to continue along the path towards a zero-subsidy railway, perpetuating areas of geographical monopoly, from which monopoly rents could continue to be extracted. Without the extraction of such rents, a zero-net-subsidy state may not be achievable. If it were attained, however, franchising would be needed only if there was no other way of securing public service obligations (PSOs—eg, minimum levels of service at intermediate stations).

Otherwise, alternative options would be for services to be provided on an open-access basis, subject to PSOs, or for packages of paths to be auctioned (in the same way as spectrum is sold in the telecoms sector), again subject to PSOs. This would be a very different model from the current, highly specified franchise arrangements, in which bidders are required to deliver services according to detailed timetables. A likely outcome under such a scenario would be an increased number of operators providing services across smaller geographic areas. This would reverse the recent policy of merging franchises to maximise profitability and reduce subsidy requirements.

- **More focused subsidy**—even in a zero-net-subsidy world, many services would still require support from client bodies specifying them. However, the uncertainty about the drivers of subsidy would need to be resolved in order for socially necessary—but commercially unviable—services to be identified, and provided under contract. As railway services form part of a network, it might prove impossible in certain circumstances to disentangle which parts of a service do or do not require subsidy. In this case, packages of services might still need to be tendered. However, subsidy becomes much more focused in this model, and it may prove attractive to devolve the specification and funding of these services to local bodies. These new client bodies could, for example, invite tenderers to offer the best package of local services (outputs) for a given level of funding,

as opposed to requiring bids just to maintain existing service patterns. There would be a risk of commercially viable services requiring subsidy again over time (for example, due to a fuel price shock). This has been a feature of the bus market, and reflects market dynamics.

- **Fares regulation**—at present, season-ticket prices and some other fares are regulated as part of the franchise agreement. However, the current form and coverage of regulation dates back to privatisation, and does not reflect traditional rationale for regulation (protecting consumers against market power; enabling inter-available fares to be readily available; etc). In a zero-net-subsidy railway, the case for fares regulation in its current form—which arguably places considerable emphasis on transferring monopoly rent from franchisees to the taxpayer—seems to be considerably weakened. Instead, a more market-oriented approach to fares regulation, in which the Office of Rail Regulation (ORR) determines the existence of significant market power, and limits fare changes accordingly, would seem considerably more in keeping with models seen in the postal and telecoms sectors in the context of liberalised retail markets.
- **Alliancing**—a major change since the McNulty study has been the introduction of various levels of alliance between Network Rail and train operators, including arrangements between South West Trains and Network Rail’s Wessex route. In a zero-net-subsidy railway context, such arrangements (between a Network Rail route and the local passenger operator) may be less likely to occur, owing to increases in the numbers of operators. In a zero-net-subsidy scenario, it may transpire that there are more passenger operators than at present, due to a potential increase in the number of opportunities to provide services.
- **More power to operators**—passenger train operators in Great Britain are currently held financially neutral to changes in Network Rail’s track access charges. In a zero-net-subsidy railway, if operators were able to flex the timetable (and, to some extent, with appropriate safeguards, the PSO) in response to demand changes, there would be greater scope for them to take on the (limited) risk that their access charges might change at a regulatory review (a risk to which freight operators are currently already exposed in Great Britain). There is arguably a case that this should happen now,⁹ but in a more market-driven railway it would almost certainly be

necessary. Otherwise, operators would have limited incentives to keep down the costs of the infrastructure they are being provided with.

- **Ongoing role for government**—government would still have a role to play in the sector. This could resemble the strategic role it currently takes: setting high-level outputs for the industry, consistent with its transport and wider policy goals. In particular, government would need to ensure that key projects are undertaken (eg, introducing smart-ticketing platforms, making major capacity enhancements), which might otherwise not take place in a purely market environment. More widely, its role would be to continue to underpin the external benefits of rail for society as a whole.
- **Passengers**—the above points matter only if they make a (positive) difference to passengers. If changes in the way services are delivered mean that operators are more customer-focused, innovative and efficient, and can respond to change much more quickly, passengers are likely to benefit and feel that the offering is good value for money. Moreover, passengers (and their representatives) may well take on a wider role in franchise specification and monitoring, especially in a zero-net-subsidy scenario. As experience with customer engagement in the utilities sector is demonstrating, having customers informing the business plan, and helping to facilitate and monitor delivery, has the potential to transform how these industries operate.

In summary

The likelihood is that governments (national or regional) in Great Britain will continue to buy increases in outputs from the rail industry, rather than allow net subsidy to decline to zero. However, at current rates of progress, this notion is not inconceivable, and in any case provides a useful thought experiment about the railways of the future and, more importantly, the railways of today. Where subsidy is not required—which may well already be the case for significant parts of the GB rail network—there would seem to be a strong argument for much less government specification of services. Where subsidy is required, this could become much more targeted.

Passenger rail usage is at levels not seen in Great Britain for many decades, and is fundamentally a success story—the question now is how to develop policy that reflects this.

¹ European Commission (2013), 'Commission Staff Working Document Impact Assessment, accompanying the Documents: Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1370/2007 concerning the Opening of the Market for Domestic Passenger Transport Services by Rail; Proposal for a Directive of the European Parliament and of the Council amending Directive 2012/34/EU of the European Parliament and of the Council of 21 November 2012 establishing a Single European Railway Area, as regards the Opening of the Market for Domestic Passenger Transport Services by Rail and the Governance of the Railway Infrastructure', SWD(2013) 10.

² Based on passenger satisfaction calculated using detailed rail surveys on quality of services, frequency, punctuality and reliability, information provision, and cleanliness.

³ Department for Transport (2011), 'Realising the Potential of GB Rail, Final Independent Report of the Rail Value for Money Study', May.

⁴ Department for Transport (2013), 'Rail Franchise Schedule', March 26th, available at: <https://www.gov.uk/government/publications/rail-franchise-schedule>.

⁵ Department for Transport (2012), 'West Coast Main Line Franchise Competition Cancelled', announcement, October 3rd.

⁶ A zero net subsidy refers to a position where the GB rail network is not receiving any subsidy in net terms from funders. However, in this case some rail services would still require subsidy, but this would be offset by surpluses generated elsewhere in the network.

⁷ Office of Rail Regulation (2012), 'National Rail Trends', August 23rd.

⁸ For detailed information and statistics on government funding for GB rail, see Office of Rail Regulation (2013), 'GB Rail Industry Financial Information 2011-12', April.

⁹ Oxera (2010), 'Review of Rail Cross-Industry Interfaces, Incentives, and Structures', September 30th, available at www.oxera.com.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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