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Taking the strain

RISK-SHARING IN UK RAIL FRANCHISING

The current rail franchise system in the UK has protected many franchisees from falling revenues during the recession, but at considerable cost to the taxpayer, and also blunting the franchisees' incentive to invest. The new Government has ordered a further review over the summer, postponing three imminent rail franchise competitions until late 2010. Drawing on Frontier's experience of designing incentive mechanisms in transport and other regulated industries, this bulletin examines the issues the review must address, and how it may give pointers to how other public-private partnerships may develop.

Like many other businesses, most of Britain's franchised train operating companies (TOCs) have seen customer revenues fall short of projections since the economic downturn began. However, unlike other businesses, the TOCs have the protection afforded by their contracts with the Department for Transport (DfT). Under their franchise agreements, if fare revenues fall short of predicted (and agreed) levels, the Government makes up a substantial part of the difference. This risk-sharing arrangement is symmetrical, so the Government gains a substantial part of any revenues above these predicted levels.



Insulating the operators from much of the revenue risk makes the franchise competitions keener, which should, overall, result in a lower level of subsidy to the railways. But as ever, the devil is in the detail, and the structure of the current scheme has had some perverse effects – unhelpful to citizens as both rail travellers and taxpayers. The pre-election review identified the problem, but provided only part of the solution.

PECULIAR ECONOMIES OF RAIL

Under the current scheme, if revenues are 2% or more below predictions, the Government makes up 50p of every £1 of shortfall. If revenues are 6% or more below, the government makes up 80p of every £1. In 2009-10, the fare revenues of three-quarters of TOCs were 6% or more below the levels agreed when they won their franchises.

In theory, this system both protects franchisees from unknowable economic events and (because it is symmetrical) protects the public purse from the risk that franchisees enjoy windfall profits. But it also has some perverse incentive effects. Outside a fairly narrow band of results, the franchisee receives only 20% of any extra revenue it generates through investment in a better service. Only within a very narrow band (+/- 2%) around predicted results does the franchisee gain the full revenue benefit from any investment in performance improvement. Such a system may work reasonably well in a period of stable and predictable growth, but has been tested beyond its limits by the uncertainties of the past few years.

Franchisees do face some revenue risks: for example, poor punctuality hurts franchisees' pockets through increased "Schedule 8" payments under the Track Access Contract with Network Rail. Other standards of service quality are embedded in the franchise, and the operators may be punished if the targets are not met. This includes the facility for DfT to impose a remedial action plan and ultimately to terminate the franchise. But many of the service quality measures are lightly monitored. The result is that TOCs are incentivised to cut costs rather than to increase revenues once the revenue sharing mechanism kicks in. Although such cost-cutting may help to drive up productivity, it can lead the system into a vicious spiral of lower revenue and higher subsidy.

FARES FARE

Fare collection offers a good example of this spiral. Up to 10%, it is estimated, of fare revenue (now about £6 billion a year) is lost to people travelling without a ticket or under-paying, either by reusing a ticket or buying one for only part of the journey.

The TOCs can reduce fare-dodging by employing ticket collectors and checkers, or by investing in electronic ticket barriers. At the beginning of a franchise, with a sufficiently long period over which to recoup the investment, there should be a strong incentive to make such investments. But once a TOC is outside the performance range over which it retains most of the revenue benefit, the incentive to invest fades rapidly. An operator with revenues more than 6%

below the contracted levels faces a huge hurdle in terms of acceptable rates of return for such investment.

Instead, the TOCs are heavily incentivised to cut spending on revenue protection. Once their revenues are more or less fixed, cost-cutting is the only way to improve financial performance. So it is not surprising that train operators now appear to be reducing the number of ticket checks and collections. (The incentive to do so must be particularly strong on those franchises coming to an end: for example, National Express has handed back the keys to the East Coast franchise, and is expecting its East Anglia franchise to be cut short.) And if the TOCs make less collection effort, while they enjoy the benefits of lower costs, the taxpayer suffers the cost of lower revenues.

NEVER SAY NEVER AGAIN

The DfT published a review of rail franchising in January 2010.¹ It highlighted the need to redesign the risk-sharing mechanism, proposing further investigation of separating the impact of economic factors on revenues from the impact of operator performance. Government would continue to share the economic risks, including both the effect of the cycle and such structural shifts in the economy as changes in city centre employment; but operators would carry more of the risks and rewards from performance and customer service standards.

However, the DfT review has come in for criticism from the Association of Train Operating Companies (ATOC), the train operators' association, for giving too little attention to operator investment and the length of franchises to be set for future competitions.

Much of the discussion since has focused on how long franchises should run for. Operators argue that they would invest more if they had longer to recoup their money. DfT's review in early 2010 recommended that bidders should be able to propose investments that they would make in return for being granted a longer franchise. However, it also recommended that such offers should not be taken into account in the financial evaluation of the bid. This would leave the system very little changed, since in past competitions bidders were asked to propose and loosely price specified add-on extras, which were negotiated once a bidder had been chosen.

Do longer franchises work better? The evidence is mixed. Chiltern Trains, which has a 20-year franchise, a substantial investment programme and no revenue-sharing arrangements, is rightly seen as a success. However, "never again" was the DfT's view after its experience with Virgin West Coast, which had a 15-year franchise, suffered poor financial performance during route modernisation and switched its franchise into a management contract which cost the taxpayer far more than was expected. Nonetheless, longer franchises are again being seen as a way of improving value for money. The review announced by the new Government, which is due to report in the autumn of 2010 (before the Comprehensive Spending Review) is expected to pay greater attention to franchise length.

This is partly because longer franchises would give time for more complicated risk-sharing mechanisms to work their way through, lessening the danger that windfall profits enjoyed through an economic upturn might not be evened out over the life of the franchise. Combining length with greater capitalisation of franchisees, and the requirement to post sureties, could help to prevent or at least deter franchisees from walking away in the bad times. Of course, bidders would seek some recompense, in terms of return, for higher capital requirements. So in its review, the Government needs to weigh the costs of running a more highly-capitalised railway operating system against the benefits of greater certainty of franchise persistence, and the effects of better investment incentives.

CONCLUSION

If the DfT can get a better balance in the next round of rail franchising, now due in 2011, it could both improve services and cut subsidies. But this will require a careful disentangling of risks and willingness to grant longer franchises over which the gains and losses can be evened out. That, in turn, will be a risk worth taking only if TOCs are adequately capitalised. The result should be a more stable system with greater potential for improved performance – though operators would seek a return on the increased capital at stake. On balance, we think that the changes would encourage more competitive bidding because the conditions will be attractive to good operators. The reduced upside exposure would be a difficult trade for any Government to make, and particularly one with immediate fiscal problems on the scale of the UK's; but the past has shown the dangers of milking all the financial benefits from franchises up-front.

Insulating private investors from economic factors beyond their control has obvious appeal in the wake of a downturn. But finding ways to ensure this does not wipe out incentives to improve operator performance is critical to ensuring that the Government gets value for money. Plainly, an effective mechanism for separating economic risk from operating performance could be applied to many other services for which demand is affected by economic growth. So finding a better economic risk-sharing model has applications well beyond the rail industry, to the whole range of public-private partnerships and contracts where the same dilemmas arise.

NOTES

1. *The Future of Rail Franchising*, Department for Transport, January 2010

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