Transport Perspectives

SPECIAL EDITION: RAIL

UK Passenger Rail and the Franchising Model

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In July 2013, the Association of Train Operating Companies (ATOC) published its paper "Growth and Prosperity: *how franchising helped transform the railway into a British success story.*" KPMG assisted ATOC in this work, helping collate the wealth of publicly available industry data to analyze the performance of UK rail operations since privatization from both a taxpayer and a passenger perspective.

Obviously we will never know precisely how UK rail operations would have performed had they remained in public ownership under the control of British Rail. However, analysis of the available data does point to something of a renaissance in UK rail in the period since 1997/8. In 2012, ridership, punctuality and passenger satisfaction were all at record levels with direct Government support to train operators falling. Whilst precise levels of causation cannot be determined, the weight of evidence suggests that the incentives created by franchising, both at the bidding stage and once contracts have been awarded, has had a material role in driving these results.

Financial performance

To assess the financial impact of franchising we examined the surplus from train operations. This is revenues generated by the train operating companies (TOCs) less those costs that they directly control – staff, rolling stock and other operating costs. This gives a measure of the financial performance of the railways before any charges are made for network infrastructure costs, before any subsidy is received from Government and before any payments are made to the TOCs' shareholders.

Table 1 (overleaf) shows that in real terms the financial surplus from the UK's train operations has increased substantially under the franchise model. It has more than tripled from £0.6bn to £2.0bn – the type of improvement in financial performance that was hoped for at the time of privatization.

Table 2 (overleaf) shows how this additional financial surplus has been distributed. In 1997/8, in 2012 prices, the TOCs received £2.8bn in subsidy from Government and paid £3.2bn in infrastructure charges – a net outflow to third parties of £0.4bn. This meant that of the £0.6bn surplus from operations,

£0.2bn was retained as profits for shareholders. By 2012, this net outflow to Government / Network Rail had increased to £1.7bn. The TOCs have benefitted from a reduction in infrastructure charges from £3.2bn to £1.8bn in part because Government has chosen to pay some of Network Rail's revenue through grant rather than via train operators. However, this has been more than outweighed by the fall in Government subsidy from £2.8bn to £0.1bn meaning that net outflows to third parties have increased from £0.4bn to £1.7bn.

Table 2 further shows that over the period 1997/98, the growth in TOC profits has been comparatively modest rising from £0.2bn to £0.3bn. The competitive nature of the franchise bid process has kept margins low and as a result, the TOCs have kept less than 10 percent of the £1.4bn improvement in the financial surplus from train operations that has occurred under their stewardship. The majority of the upside has flowed back to Government via reduced subsidies. Successive Government's have chosen to re-invest this in the railway via increased grants to Network Rail.

Table 1: Surplus from train operations

Aggregate Profit and Loss Account (all TOCs) – 2012 prices			
£bn	**1997-98**	**2011-12**	**Change**
Total TOC revenue	**4.6**	**7.9**	**+3.3**
Total TOC-owned costs	**(4.0)**	**(5.9)**	**(1.9)**
Surplus from train operations	**0.6**	**2.0**	**+1.4**

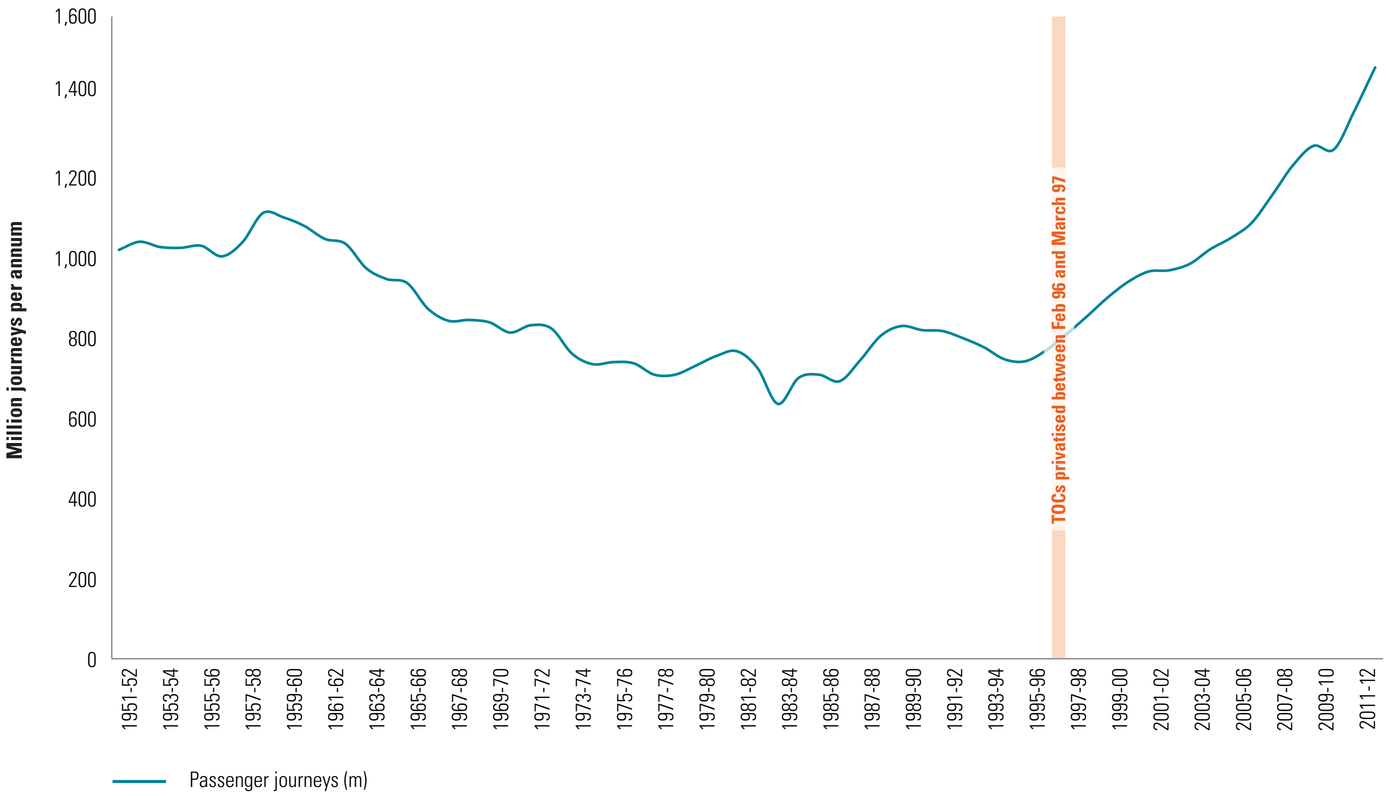
Source: ATOC analysis of TOC accounts, ORR and GB Rail Financial Information 2011-12

Table 2: Allocation of contribution from above track operations

2012 prices			
£bn	**1997-98**	**2011-12**	**Change**
Above track contribution	**0.6**	**2.0**	**+1.4**
Government Subsidy	2.8	0.1	(2.7)
Network Rail Charges	(3.2)	(1.8)	+1.4
Net outflows to third parties	**0.4**	**1.7**	**+1.3**
TOC Profits	**0.2**	**0.3**	**+0.1**

Source: ATOC analysis of TOC accounts, ORR and GB Rail Financial Information 2011-12

Graph 1: Growth in passenger journeys



Source: National Rail Trends

The key driver of the improvement in the finances of the UK's train operations has been in revenue growth. Graph 1 shows that between 1997-98 and 2011-12, passenger journeys have grown at a compound annual growth rate (CAGR) of 4 percent. In the 15 years prior to privatization, the CAGR of passenger journeys was less than half this rate at 1.7 percent.

The source of this increase in the rate of journey growth has been a subject of much discussion. Certainly it cannot conclusively be attributed to the move to franchising and private operations. However, analysis of public information suggests that it cannot readily be explained away by reference to the classic exogenous drivers of demand either. For example,

- Between 1997/98 and 2011/12, passengers journeys grew at more than double the rate of the economy - GDP grew by 33 percent, while passenger journeys increased by 73 percent. In the equivalent period before privatization rail patronage grew at half the rate of the economy. From 1982/83 to 1996/97 GDP grew 53 percent while passenger journeys grew by just 27 percent[1].
- Whilst population growth has been a driver, the number of passenger journeys being taken by each person in the UK has increased under franchising. Journeys per capita rose from 14.9 in 1997-98 to 22.4 in 2010-11[2]. The result is that the market share of rail has increased.
- Rail has not enjoyed any significant price advantage. A comparison of data from The Automobile Association and National Rail Trends shows that despite increases in fuel prices, the overall cost of motoring has grown at a rate broadly comparable to the cost of rail travel since privatization.[3]

Many opponents of privatization attribute the step change in the rate of passenger growth to the fact that Government's overall spending on rail has increased – despite TOC subsidies coming down significantly. This increase in funding has flowed through to Network Rail, either through direct grants or access charges, and has been used to support its major capital programme.

1 National Rail trends, ONS-GDP Q4 2012 dataset
2 National Rail Trends; ONS Mid-year population estimates
3 National Rail Trends; AA motoring annual motoring cost reports (data represents a car of 1,101-1,401cc price of £10k-£17k)

Increased Government's investment in the railway has undoubtedly played a part in the growth story as passengers have benefited from higher punctuality and safety as Network Rail's maintenance activity has been improved.

However, again the increase in journey growth does not necessarily directly follow on from the increase in expenditure on infrastructure. Notably:

- Graph 2 shows that the upturn in journey growth began between 1997-2001 in a period where overall Government support for rail actually declined; and
- Of the money spent on UK rail infrastructure since privatization, only 15 percent has been spent on enhancing the network. The vast majority has been spent addressing a backlog in maintenance and renewals activity on the "steady state" network.

Since the significant increase in passenger numbers since privatization therefore cannot be readily explained away either by exogenous factors or by government investment, this implies that TOC innovations in areas such as marketing, revenue protection, passenger information, ticketing, retailing and service quality have also been an important part of the growth story.

Passenger benefits

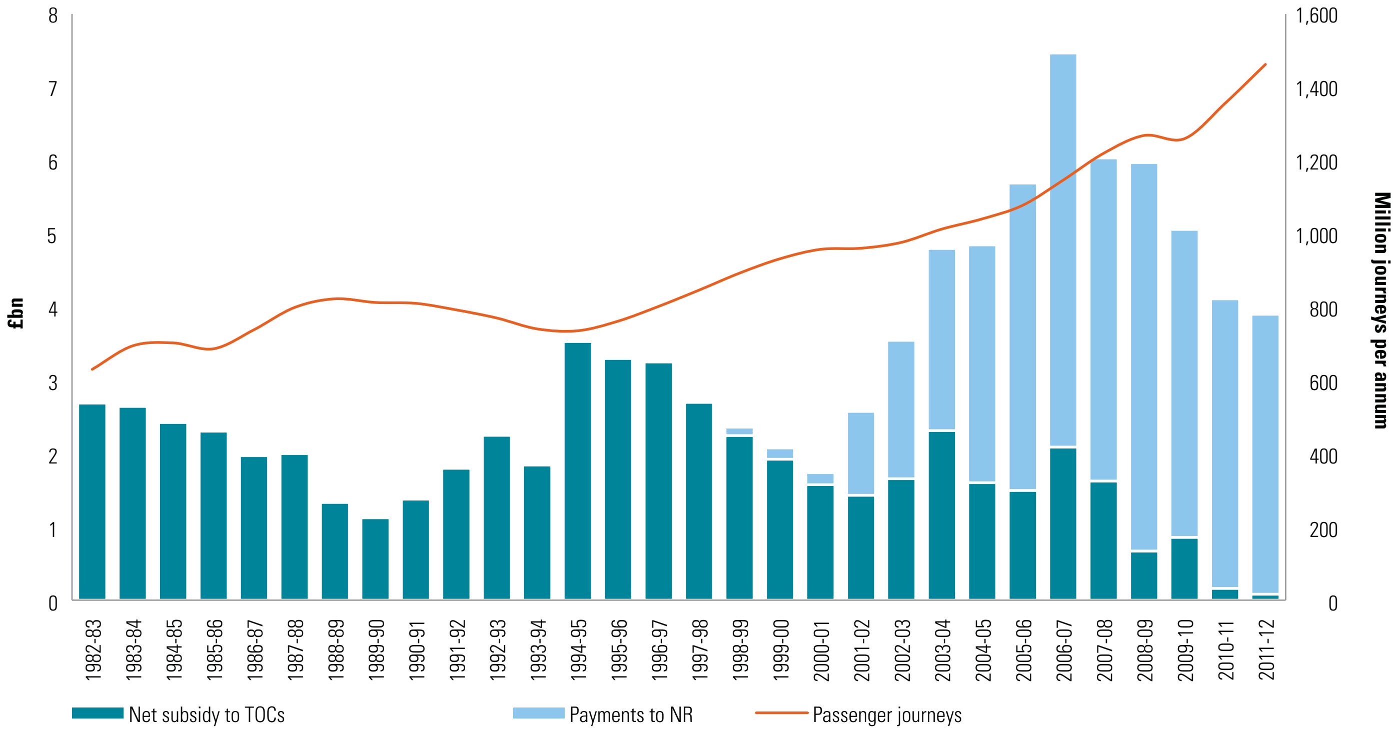
To meet the increase in demand highlighted in Graph 1, the UK rail network is now being operated more intensively than it was at privatization. Frequencies have been increased – for example there are now 47 trains per day from Manchester to London, compared to 17 in 1994[4]. Furthermore, there has been a 19 percent increase in overall fleet size and the average age of rolling stock has come down[5].

Much of this increase in capacity has been specified by Government during franchise competitions. However, the TOCs have generally been effective delivery agents for Government. Indeed, despite more intensive operation of the network, industry data for rail year 2012 indicates that the outputs experienced by passengers were at record levels in a number of key areas.

In 2012, 91.6 percent of trains in the UK arrived 'on time' as defined by the Public Performance Measure (PPM)[6]. This has been steadily increasing ever since the Hatfield crash in October 2000 and now exceeds the PPM calculated for 1997-98, the earliest available data. Publicly available information also demonstrates that safety has improved in recent years with the rate of passenger injuries declining by 50 percent since 2002/3[7].

4 ATOC analysis
5 OPRAF Passenger Rail Industry Overview, Long Term Passenger Rolling Stock Strategy for the Rail Industry, ATOC analysis
6 National Rail Trends. PPM was first published in June 2000 but was calculated back to 1997-98
7 Measured by fatalities and weighted injuries. Source: National Rail Trends, RSSB

Graph 2: Government support to the rail industry



Source: ATOC Rail Industry financial trends since privatization, British Rail annual reports 1982-1997

Passenger satisfaction has grown in parallel to this. Overall satisfaction as measured by the National Passenger Survey (NPS), rose from 76 percent in 1999 (when the Survey was introduced) to 85 percent in 2012[8]. When combined with the growth in passenger journeys, this equates to over 500 million more 'good' or 'satisfactory' journeys on the UK's railways in 2012 as compared to 1999.

The value of franchising

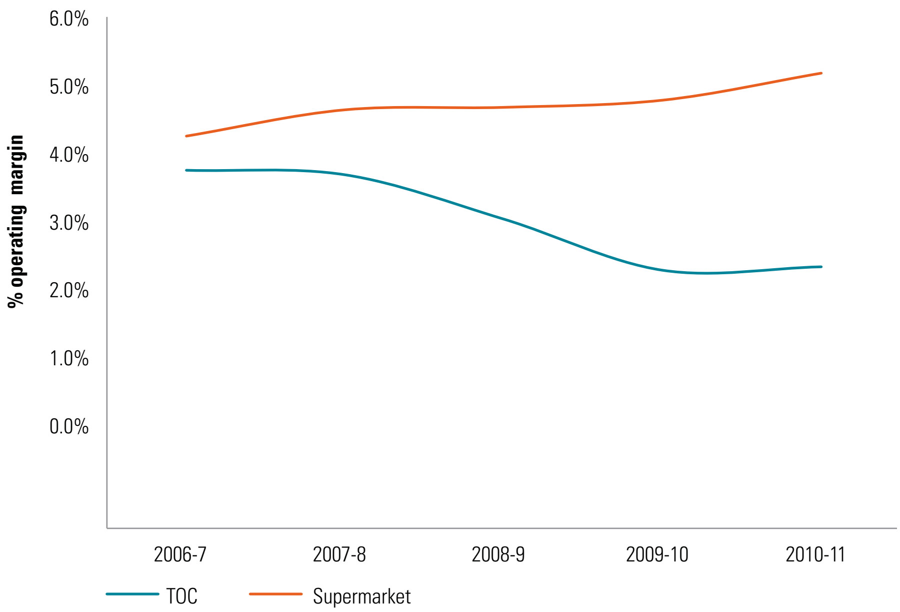
Whilst it is not possible to prove what would have happened to the UK's railways if they remained in Government's hands, experience is that the franchising model can bring beneficial effects for both taxpayers and customers.

Each bid competition brings a fresh focus on the needs of customers and other stakeholders. UK rail franchises attract interest from the leading transport players from around the world. This helps to drive product innovation and sharing of best practice.

At the same time, the competitive bid process, combined with the prolonged impact of the recession, has kept TOC margins low. Average industry margins in 2011 were at 3 percent – lower than those of the major supermarket chains.

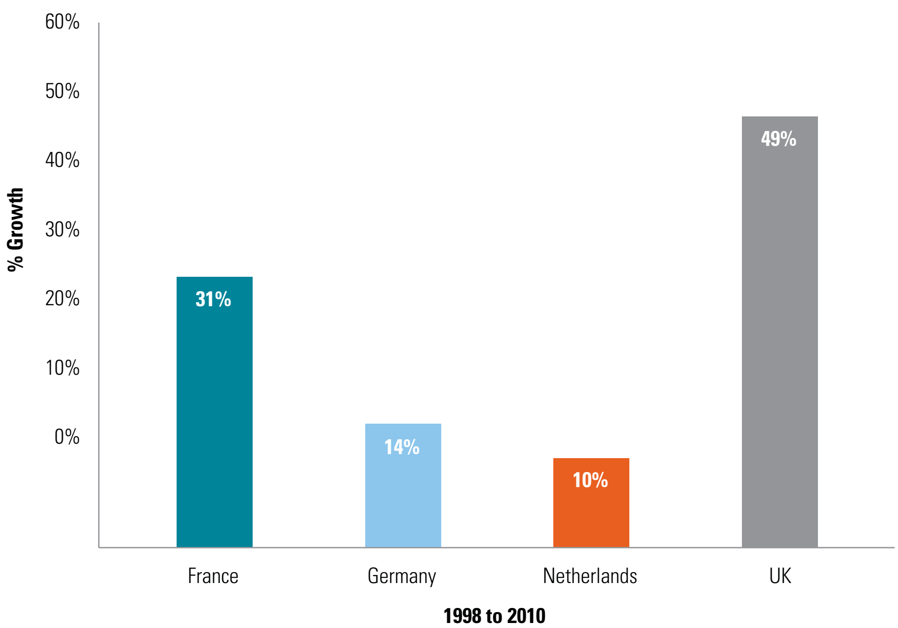
Once a franchise is awarded, TOC management teams are incentivized to deliver customer satisfaction and grow passenger journeys in order to meet the business plans set out in the bids. Graph 4 shows that under this incentive structure UK journey growth has significantly outstripped that of the state-run comparators in Europe during the period since privatization.

Graph 3: Industry margins



Source: Statutory accounts
Note: Supermarket figures are an average for Tesco PLC, J, Sainsbury PLC and WM Morrision Supermarkets PLC

Graph 4: Journey growth, UK and European networks



Source: UIC railisa database

8 National Passenger Survey (Autumn 1999)

Conclusion

The UK's current industry structure depends on effective partnership between Network Rail, Government and the TOCs. Under the franchising system, direct support from Government to the UK's train operators has fallen markedly, principally due to record passenger growth. At the same time passengers are benefitting from safer and more punctual services and levels of satisfaction have improved continuously.

No one can attribute these outcomes precisely to any of the industry parties, nor can anyone know how the railway would have performed had it remained under public ownership. However, there is a weight of evidence to suggest that the incentives created by the franchising system have delivered benefits to passengers at levels of profitability that offer value for money to taxpayers.

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