SRA
STRATEGIC RAIL AUTHORITY

Consultation

Future fares policy –
seeking your views

July 2002

Contents

Foreword

A coherent and transparent fares policy that balances the different needs of policy, users (both passengers and operators) and funders, including taxpayers is critical to any plan for the development of the national rail network. The level of fares affects many things that are central to our objectives – for example, the number of passengers, the level of overcrowding, the funds available for investment, and the subsidy required from the taxpayer.

In publishing this consultation document, we are asking for the views of passengers, potential passengers, train operators, and other rail industry stakeholders to help us with our review of SRA fares policy. In the document we share our initial thoughts on each aspect of fares policy, based on the research that we have done so far. However, nothing has yet been finalised, and this is a real chance to contribute to our review. We shall be tackling some difficult issues, and in devising a fares policy for the future we will have some tough decisions to make. Please read the document carefully before sending us your response – it explains how our existing fares policy works, sets out the key issues and some of the pros and cons of changing fares policy in certain ways. Our fares team will welcome constructive and well-reasoned responses having regard to the issues raised in the document.

We look forward to hearing from you.

Richard Bowker
Chairman

19 July 2002

Introduction

The SRA has a duty, set out in the Railways Act 1993, to ensure that rail fares are 'reasonable', and to fulfil this obligation the SRA regulates certain fares. In fact, about 44% of the £3.4billion of fares revenue generated each year comes from fares which we regulate through our franchise agreements with the train operators.

Our current fares policy has been in operation since the first franchises were let in 1996, and we now want to review this policy to see how it might be improved. The review will involve an independent study of how our fares policy has performed in meeting our objectives, and further work to look at different aspects of fares regulation, and what effects different policy options might have in the future. As part of the review, we are seeking the views of industry stakeholders, including train companies and passengers. This consultation document explains our current fares policy, sets out the issues and the options, and asks some specific questions on which we would welcome your views.

We realise that it would be easy for passengers to say they would like more regulation and lower fares, and for train companies to say they would like less regulation and higher fares. However, in devising a fares policy for the future, we will need to make some tough decisions:

- rail industry costs have risen. Along with the Rail Regulator, we are looking at how these costs can be contained or reduced, but how much of the industry's costs should be borne by taxpayers, and how much by passengers?
- the rail network urgently needs investment – £33.5 billion of public money has been committed to support and invest in the rail network over the period of the ten year plan, but more may be needed. Where should this come from?
- we want to get more people travelling by train – but we also want to reduce overcrowding
- government resources are limited – should we use these resources to subsidise fares through greater regulation, or would they be better spent on directly improving the network?

We are looking for responses that will help us make these decisions, and strike the right balance between the different needs and wishes of passengers, taxpayers and train companies. We want to devise a fares strategy for the future which best supports our duties and objectives, and which will help us produce a safer, better, bigger railway.

Why are we reviewing fares policy?

Since fares regulation was devised in 1996, there has been a change of government and with it a change of policy. The focus has shifted from consumer protection alone to both consumer protection and increasing the role played by the rail network in our national transport system. We are considering how our fares policy might best support our wider objectives under the government's 10-year plan for transport. These include the objectives:

- to increase rail use in Great Britain (measured in passenger kilometres) from 2000 levels by 50% by 2010, with investment in infrastructure and capacity, while at the same time securing improvements in punctuality and reliability;
- to reduce overcrowding to meet SRA standards (no passengers standing for journeys of more than 20 minutes and no more than 30% standing for shorter journeys) by 2010.

In addition, there are other factors which suggest that a review of fares policy is timely. Overcrowding has increased, and is now severe on many of the commuter routes into London and other cities. Passenger groups have expressed concern about some increases in fares, in particular full fares on certain long-distance routes. From an industry perspective, there are aspects of the current fares

regulation mechanism, including a conflict between national rail fares regulation and (for example) Travelcard pricing policy, which is placing a severe strain on operators' ability to set a logical fares structure. Our review is intended to address each of these issues, amongst others.

Our duties and objectives

As well as the obligation in the Railways Act to ensure that fares are 'reasonable' (a term which the Railways Act does not define), our fares policy needs to fit with the SRA's duties set out in the Transport Act 2000, and with the Directions and Guidance given to us by the Secretary of State. The duties and objectives most relevant to fares policy are summarised in appendix A. They include the duties to:

- protect the interests of users of railway services;
- impose on operators of railway services the minimum restrictions consistent with the performance of our functions;
- enable providers of rail services to plan their businesses with a reasonable degree of assurance.
- to encourage proposals that help make fares more easily understood by passengers and which use new technology such as smartcards;
- to take account of government policy in other areas such as social exclusion and employment.

We need to consider the issues raised in this consultation document in terms of how they affect all of our duties and objectives. You can see that most of them influence our fares policy in some way, and there is often a balance to be struck between conflicting objectives. For example:

- lower fares may attract more passengers, but we need to consider how this affects overcrowding;
- we need to protect rail users from excessive fares, but must not impose more regulation on operators than is strictly necessary to achieve this;
- we need to strike a balance between funding the network from passengers and funding from the taxpayer, as enforcing lower fares will almost certainly require greater subsidy;
- we need to ensure that our policy is clear and consistent, allowing operators to plan their business with a reasonable degree of assurance;
- improving the railway to achieve our objectives requires investment. Lower fares may reduce the funds available for investment, and conversely, fares revenue may provide a source of funding for investment.

Finally, it is important to realise that none of our duties and objectives are absolute. We are required to show that any action we take in furthering these objectives represents 'value for money', and is affordable, given the money that we have available, and the other competing calls upon those funds. The SRA is audited by the National Audit Office, and we may have to present evidence to Parliament's Public Accounts Committee to show that we have made proper and effective use of public money.

Our current fares policy

If you are unfamiliar with the way fares regulation works, there is a summary of our current fares policy in appendices B and C. We have not tried to regulate every fare, but have aimed to strike a balance between allowing competitive factors to determine fares (giving train companies the commercial freedom to offer new and innovative fares to passengers), while on the other hand, ensuring that passengers are protected from excessive pricing in areas where rail transport has a high degree of market power.

At present, we regulate two categories of fare - key fares used by commuters and long distance turn-up-and-go off-peak 'Saver' tickets - and at least one type of fare is regulated between any pair of stations. We regulate these fares in two different ways: in the London area and certain other urban areas, fares are regulated by means of 'fares baskets', where a price cap is applied to a group or 'basket' of fares, but operators have a degree of flexibility to adjust individual fares within each basket. Outside these areas, each individual regulated fare is subject to its own price cap, and these fares are known as 'protected' fares. In addition to regulating the price of fares, we also regulate certain ticket conditions – in particular the maximum travel restrictions which may be applied to Saver tickets.

In all cases, we have based the fares cap on the prices charged by British Rail in 1995, adjusted for inflation (as measured by the previous July's Retail Price Index or 'RPI') each year until 1998, then by 1% **less** than inflation each year from 1999 onwards. In the case of ten London commuter operators, we also adjust the cap by up to +/-2% to reflect the improvement or worsening in the performance of their train service each year.

What has happened to fares since franchising?

We have developed a 'fares index' to measure how different types of fare – both regulated and unregulated - have changed over time, and the results are shown in the tables and chart below[1].

Table 1: The average change in the price of rail fares, 1995-2002

1995 = 100	Jan 1995	Jan 1996	Jan 1997	Jan 1998	Jan 1999	Jan 2000	Jan 2001	Jan 2002	Average change in price 2001-2002	Expenditure weights 2002 (% of total)
RPI (all items)	100.0	102.9	105.8	109.3	111.9	114.1	117.2	118.7	1.3%	-
London and SE operators										
First class	100.0	103.2	105.2	109.2	113.1	115.4	118.8	118.7	-0.1%	2%
Standard class regulated	100.0	103.6	105.9	109.6	111.1	111.1	112.1	110.6	-1.3%	28%
Standard class unregulated	100.0	103.6	106.0	110.3	114.7	117.7	121.5	123.4	1.5%	20%
All standard class	100.0	103.6	105.9	109.9	112.4	113.6	115.7	115.6	-0.2%	48%
All tickets	100.0	103.6	105.9	109.8	112.5	113.7	115.8	115.7	-0.1%	50%
Long distance operators										
First class	100.0	101.9	104.7	109.5	121.8	136.7	145.8	156.8	7.5%	8%
Standard class regulated	100.0	101.2	103.7	107.2	111.1	111.2	109.0	113.0	3.7%	9%
Standard class unregulated	100.0	101.9	104.9	109.2	115.6	123.7	128.3	134.3	4.7%	17%
All standard class	100.0	101.7	104.6	108.6	114.4	120.1	122.3	127.6	4.3%	26%
All tickets	100.0	101.7	104.6	108.8	115.6	123.5	127.3	133.8	5.1%	35%
Regional operators										
First class	100.0	104.0	105.8	110.8	113.9	120.8	126.5	132.5	4.7%	1%
Standard class regulated	100.0	101.2	104.4	107.7	110.5	111.5	113.6	115.3	1.4%	7%
Standard class unregulated	100.0	101.4	104.6	108.0	112.4	115.3	118.8	121.5	2.2%	8%
All standard class	100.0	101.3	104.5	107.9	111.6	113.7	116.6	118.8	1.9%	15%
All tickets	100.0	101.4	104.6	108.0	111.6	113.9	116.9	119.3	2.0%	16%
All train operators										
First class	100.0	102.3	104.9	109.5	119.4	131.5	139.2	147.6	6.0%	11%
Standard class regulated	100.0	102.9	105.3	108.9	111.0	111.2	111.7	111.9	0.1%	44%
Standard class unregulated	100.0	102.5	105.3	109.4	114.6	119.7	123.7	127.3	2.8%	45%
All standard class	100.0	102.7	105.3	109.2	112.9	115.6	117.8	119.6	1.5%	89%
All tickets	100.0	102.6	105.2	109.2	113.5	117.2	120.1	122.5	2.0%	100%

[1] The SRA's fares index was first published in National Rail Trends on 6th June 2002. The index excludes fares which have a non-rail element (other than Transport for London). Results for 1995-1999 exclude First Class Travelcards. Results up to, and including, January 1998 are based on the the profile of tickets purchased in 1995-96. Thereafter, results are based on the profile of tickets purchased in the 'base' year of comparison. For example, the comparison between prices in January 1998 and January 1999 is based on the profile of tickets purchased in 1998 etc. For more information on the methodology, including how the post-1999 indices are weighted, please see the June 2002 edition of National Rail Trends which is available on the SRA's website, www.sra.gov.uk.

Table 1 shows the average change in the price of fares over the 7-year period between 1995 and 2002. Over this period standard class passengers faced an average increase of 19.6%, around 1% above the corresponding change in RPI of 18.7%. Passengers in London and South East area have faced the lowest overall increase of 15.7%, a decrease in real terms. This is likely to reflect the large number of regulated fares in this area. InterCity passengers have faced the highest average increases of 33.8%, although the increase faced by standard class InterCity passengers was lower at 26.7%.

Table 2: Year-on-year average increases in fares

All train operators	**1995 to 1996**	**1996 to 1997**	**1997 to 1998**	**1998 to 1999**	**1999 to 2000**	**2000 to 2001**	**2001 to 2002**
Maximum permitted increase in regulated fares:	**3.5%**	**2.2%**	**3.3%**	**2.5%**	**0.3%**	**2.3%**	**0.6%**
First class	2.3%	2.6%	4.4%	9.1%	10.1%	5.9%	6.0%
Standard class, travel anytime / buy anytime (e.g. Standard Open Return, Standard Day Return)							
Regulated fares	3.1%	2.2%	3.3%	0.9%	-0.1%	1.4%	-0.5%
Unregulated fares	2.2%	2.6%	3.7%	5.8%	6.3%	2.8%	4.3%
Total	2.5%	2.5%	3.6%	4.3%	4.3%	2.4%	2.9%
Standard class, travel restricted / buy anytime (e.g. Saver, Cheap Day Return)							
Regulated fares	0.8%	2.7%	3.3%	3.5%	0.5%	-1.4%	3.6%
Unregulated fares	2.7%	3.0%	4.5%	4.9%	3.1%	3.0%	2.1%
Total	2.1%	2.9%	4.1%	4.5%	2.3%	1.3%	2.8%
Other (including season tickets and 'book ahead' tickets)							
Regulated fares	3.5%	2.3%	3.5%	1.7%	0.1%	1.0%	-1.2%
Unregulated	2.3%	2.3%	2.9%	2.7%	3.8%	5.0%	1.3%
Total	3.2%	2.3%	3.4%	1.9%	1.1%	2.2%	-0.4%
All tickets total	**2.6%**	**2.6%**	**3.8%**	**3.9%**	**3.3%**	**2.4%**	**2.0%**

Table 2 shows the year-on-year increases in different categories of fare since franchising. The 'travel anytime, buy anytime' category includes fully flexible fares such as Standard Open Singles and Returns, and Standard Day Singles and Returns. The 'travel restricted, buy anytime' category includes off-peak tickets that can be bought on the day of travel, such as Savers and Cheap Day Returns. The 'other' category includes season tickets and all types of 'book ahead' tickets. The table shows that first class fares and fully-flexible 'travel anytime, buy anytime' standard class fares have on average seen the largest increases.

Chart 1: Estimated revenue earned from different ticket types, 1995/6 and 2002
(source: SRA's National Rail Trends and Fares Index)

Chart 1a – Financial year 1995-96

£2.637bn at 99/00 prices

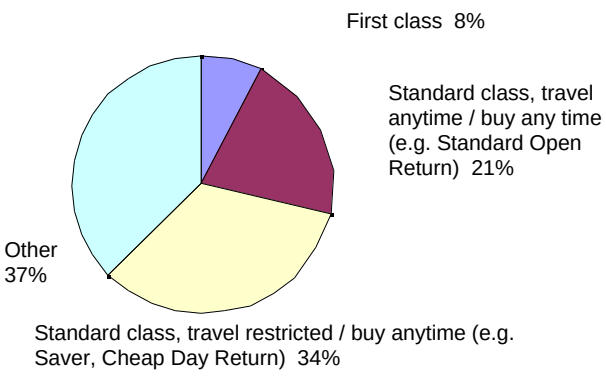
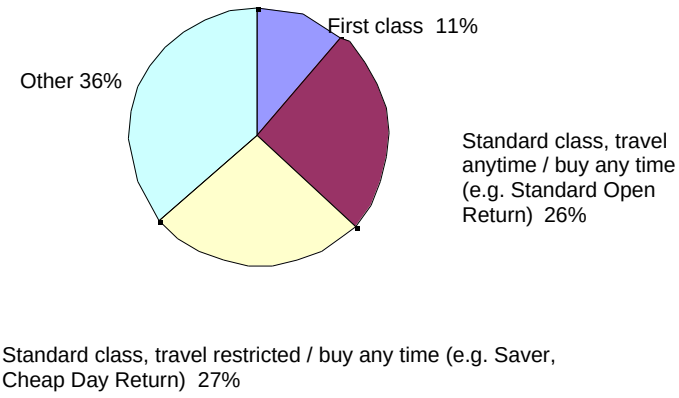


Chart 1b – Calendar year 2001

£3.330bn at 99/00 prices



Charts 1a and 1b show a breakdown of the revenue earned from different categories of fare in the 1995/6 financial year and in the calendar year 2001. Chart 1b is larger, because total revenue grew by about 25% in real terms from 1995/6 to 2001. You can see that tickets which can be bought at any time and used any time (for example Standard Open Returns or Standard Day Returns) make up a larger proportion of total revenue in 2002 than in 1995/6, partly because these tickets have increased in price over this period relative to other ticket categories. Remember that these charts show revenue - tickets in the 'buy anytime, travel restricted' category are cheaper than 'buy anytime, travel anytime' tickets, and so will still account for significantly more passenger journeys than unrestricted tickets. The charts show total revenue based on earnings for all operators, the relative importance of each type of fare will vary by operator. For example, first class fares will be more important in revenue terms for long-distance operators than for regional or London and South East operators.

Independent fares policy evaluation

We have also commissioned some independent research on how our fares policy has performed, where it has done well and where it might be improved. A summary of the conclusions of this research is attached as appendix D.

In the London and South East area, most commuter fares are regulated, but leisure fares are not. Fares regulation has kept the overall increase in commuter fares below inflation, and because of our 'RPI-1%' policy and the link with train service performance, many season ticket fares are now significantly lower in real terms than in 1995. This contrasts sharply with the policy applied in the nine years before 1995/6, when under British Rail there were significant real increases in commuter fares. On the other hand, these lower fares may have contributed to the overcrowding being experienced on many commuter routes. Although cheap day returns, the main off-peak leisure fare in the South East, are (with a handful of exceptions) unregulated, they have generally increased broadly in line with inflation. Demand for these fares is relatively sensitive to price, and operators typically price low to fill spare off-peak capacity. In part, the regulation of peak fares may also have limited operators' ability to increase off-peak fares.

On long-distance routes, the picture is more varied. Regulation has kept increases in Saver fares (the main long-distance turn-up-and-go leisure fare) below inflation, and has limited increases in travel restrictions (although some operators have increased restrictions closer to the maximum permitted where they were previously less restrictive than the maximum). Our research suggests that demand for this type of fare is less sensitive to price than had been thought. Savers would probably have increased significantly above inflation, and would have had additional travel restrictions placed on them, if they had not been regulated. On the other hand, the research also suggests that regulating the maximum Saver travel restriction has led to overcrowding on certain trains, as it has limited operators' ability to manage demand. Although the Saver is regulated, the cheaper but more restrictive Supersaver is not, and several operators have abolished this type of fare, making it necessary for people to trade up to Savers.

Long-distance full fare tickets such as Standard Open Singles and Returns, which are unregulated, have generally increased above inflation, and on certain routes this increase has been significant. However, it is not clear whether such increases will continue, or whether these fares are now at what train operators consider an appropriate level.

Long-distance 'book-ahead' tickets are also unregulated, but many such fares have reduced in real and sometimes absolute terms. For example, the cheapest return from London to Glasgow in 1995 was £34, but in 2002 it is just £29.

Privatisation was expected to encourage greater innovation and customer-focus in the setting of fares, although it was recognised that in some cases fares regulation could hold this back. The research concluded that the decision to leave 'book ahead' and similar fares unregulated has worked well, and has allowed a number of innovations to take place. In particular:

- there have been many innovations connected with 'book ahead' tickets. Sales of these tickets have increased significantly, and there is better use of trains at off-peak times. Tickets can now be bought on the internet, and sophisticated yield management systems are being developed;
- competing operator-specific fares have been introduced on a number of routes, for example London to Birmingham and London to Bath. These allow passengers to choose between a slower and cheaper or faster and more expensive journey;
- a wider range of first class tickets is now available on many long-distance routes, aimed at increasing first class travel at off-peak times;
- several operators have introduced reduced-rate tickets for small groups of four or more people, to attract passengers who would otherwise have travelled by car.

Opportunities to change fares regulation

Fares regulation is written into the franchise agreement between the SRA and each franchised train operator. We have an opportunity to change fares regulation when we enter into a new franchise agreement, but we can also change fares regulation under certain circumstances during the course of existing franchises.

In the case of franchises which have recently been replaced, the franchise agreement allows us to vary fares regulation at any time. In the case of existing franchises which have yet to be replaced, the franchise agreement allows us to vary fares regulation by negotiation now, or as we see fit after January 2003. However, any changes to our fares policy are unlikely to come into effect before 1 January 2004, because of the lead times involved in setting fares.

Although franchise agreements may give the SRA the right to change fares regulation, it is sometimes assumed that we can impose additional regulation on operators at no cost to the taxpayer. This is not the case. Whenever a change is made to fares regulation in an existing franchise agreement, we are obliged to make sure that the financial effect on the franchisee is neutral. This means that if we want to increase fares regulation or lower fare levels, we will need to increase the subsidy payments made to the franchisee to make sure that they are no worse off financially after the changes are made. Increasing the scope of fares regulation (which restricts operators' future commercial freedom, even if fares are regulated at their current levels) or lowering fares levels could be expensive, and this is where the issues of 'value for money' and affordability arise. In practice, the calculation of this compensation is complex, and it is likely to be both easier and cheaper to change fares regulation when franchises are replaced. Although the cost of increased fares regulation will still be factored in to the subsidy required by franchisees, it is likely to be minimised through the competitive process of bidding for a franchise.

Issues to consider

From an economic perspective, the most efficient allocation of goods and services takes place in a competitive market where demand and supply are allowed to determine the price without interference. Government intervention is unlikely to be justified unless there is some sort of 'market failure', where competitive forces alone do not lead to the optimum outcome. In the rail industry there are two situations which might justify the regulation of certain fares, both examples of 'market failure'.

These are situations:

- where train operators have a dominant position and are able to abuse this position; or
- where rail travel offers significant social benefits relative to other forms of transport, but these are not reflected in the relative market price [2].

Decisions on the scope and level of fares regulation will need to be based on these two situations, one implying a need to protect passengers whilst the other recognises the benefits to non-rail users of increasing the use of rail travel.

Protecting passengers

Train operators have to compete with other forms of transport such as coaches, airlines and private cars, none of which are subject to direct economic regulation. Airline competition exists for both business and leisure travel between London and Scotland, for example, and there is competition between rail and coach on routes such as London to Oxford. Competition from the private car exists almost everywhere. In markets where there is a reasonable level of competition, regulation may not be necessary or desirable[3].

However, rail has a significant share of certain markets, and in some of these markets a train operator may have a dominant position. Abusing a dominant position is prohibited by chapter II of the Competition Act 1998, and charging excessive or discriminatory prices may amount to such an abuse. The Rail Regulator has responsibility for the application of the Competition Act in connection with the railway industry, including in relation to fares. The Competition Act provides passengers with a level of protection from train operators abusing their dominant position. Regulating key fares in markets where operators may have a dominant position may also provide protection.

The most obvious example of a case where rail operators may have a dominant position is in the market for London commuter travel and similar commuter travel elsewhere. On these routes, passengers may have little choice in their mode of transport and there is often little or no spare capacity available which might allow other operators to enter the market. However, most fares used by commuters are already regulated. A wide range of commuter fares, including both season tickets and daily tickets, is regulated in the London area, and around Manchester, Leeds, Cardiff, and Edinburgh. Fares in and around Birmingham, Liverpool, Glasgow, Newcastle, and Sheffield are currently set directly by the local Passenger Transport Executive, and therefore do not need to be regulated. Away from the cities, weekly seasons and (for short journeys where there is no Saver ticket) unrestricted day returns are regulated, but all operators currently use a standard method of calculating monthly and longer period season ticket prices based on the weekly rate

Although commuter travel is the prime example, it is possible that rail operators may have significant power in other markets, depending on exactly how a 'market' is defined. One area where we know there has been some concern is with Standard Open Singles and Returns on long distance routes. These are fully-flexible tickets which are valid without restriction, including during the morning and afternoon weekday business peaks. Fewer than a fifth of inter-city journeys are made using Standard Open tickets (compared with about a third made with Savers) and the majority are bought for business

[2] If road travel were to cover all the social and environmental costs which it imposed, the case for subsiding rail would be reduced.

[3] In pronouncing on the National Express Group's proposals for Midland Mainline, Central Trains and ScotRail, the Monopolies and Mergers Commission (MMC) concluded that there was competition between rail and bus/coach. However, the competition was limited and applied mainly for the leisure market. The MMC also concluded that competition between car and rail was not sufficient to restrict increases in rail fares.

travel. Although some Standard Open fares have increased significantly in recent years, the fact that a particular type of fare has increased in price does not in itself demonstrate abuse of a dominant position. It could reflect a more general move towards market pricing. There could also be significant overcrowding on certain trains and operators may be pricing up these fares to manage demand and spread non-time critical traffic onto other trains. Nevertheless, if it could be shown that such increases were excessive in terms of the cost of the service being provided and the profits being made, this might be an argument for extending fares regulation to the fare types or markets concerned. Our review of fares policy will consider the reasons for these increases and the degree of market power exercised by train operators in various markets.

If we conclude that some long-distance Standard Open fares need to be regulated, we will also need to decide which ones and at what level. Should they be regulated in all cases or only on specific routes or in specific areas where it can be shown that the operator has a particularly high level of market power? We would need to decide whether to regulate these fares at the price the operator charges now, or at some historic (lower) price. Alternatively, a price could be set which brought fares for similar journeys into line, reconciling existing differences in different operators' pricing of similar routes. If regulation was extended to cover these fares, we would need to consider how operators would manage demand in the business peaks.

Saver tickets are currently regulated. Our research has suggested that demand for Savers is less sensitive to price than had been thought, indicating that operators may have a degree of market power in relation to these fares too. On the other hand, long-distance 'book ahead' fares and shorter-distance Cheap Day Returns have generally increased in line with inflation, and it is unlikely that operators possess much market power in these markets.

The increase in the number of passengers travelling on very cheap 'book ahead' tickets has been one of the success stories of the last few years. If passengers book ahead, operators can use 'yield management' techniques to make the best use of their available capacity, and in the process offer fares that are much cheaper than 'normal' rail fares. However, the need to plan in advance and commit to a particular service, although familiar to airline passengers, is a change from the traditional way of booking rail travel that many passengers are used to. By regulating the Saver, we have safeguarded reasonably-priced turn-up-and-go travel outside the business peaks, but we intend carrying out more research into the relative value passengers place on retaining flexibility as against paying cheaper fares.

As well as identifying the markets that need to be regulated, a decision will need to be made on which fares to regulate within that market. This is not always straightforward, as there may be several types of fare addressing a given market, or conversely, certain types of fare which address more than one market. However, even where a train operator has a dominant position in a particular market, it is not always necessary to regulate every single fare. Providing that the basic fare or fares in that market are regulated, the operator can be allowed to introduce unregulated 'value added' fares such as fares for superior accommodation (e.g. first class) or with added benefits (e.g. inclusive of car parking, food and drink, and so on) without undermining the effectiveness of the regulation.

Fares and quality

There is one further consideration in circumstances where operators have a high level of market power. A train operator in this situation has the ability to reduce the quality of the service, and so reduce the cost of providing it. A change in the quality of service, for example, in frequency, reliability, or the quality of the rolling stock, is the equivalent of a change in price. So where we think there is a need for price regulation, it may also be necessary to regulate quality. We have a number of measures in place to make sure that quality is maintained, built into our franchise agreements with operators. These include:

- the 'Passenger Service Requirement' (PSR). This sets out the minimum train service and maximum journey times an operator must provide;
- the performance regime. This provides operators with an incentive to maintain or, where cost effective, increase performance;
- a measure of overcrowding – passengers in excess of capacity (PIXC). Where passenger loadings exceed capacity we require operators to provide a plan to reduce this overcrowding where practical.
- customer satisfaction – passengers' satisfaction with other quality issues such as train cleaning and passenger information is monitored through the SRA's National Passenger Survey, and operators may be required to take action to put things right if satisfaction falls below a certain benchmark.

When deciding on the appropriate scope and level of fares regulation, we need to consider whether our fares regulation and quality control policies have proved successful. We also need to consider whether fares should reflect changes in the quality of service.

Increasing the use of rail travel

Rail travel offers many benefits over other forms of transport, and in principle, a switch from road to rail could reduce pollution, reduce road congestion, lower energy consumption, and as the safest form of travel, result in fewer deaths and injuries from road accidents. These are benefits to society as a whole and not just to rail users themselves. The government is keen to increase the role played by the rail network in the national transport system, and has set us the objective of increasing rail use (in terms of passenger kilometres) by 50% from 2000 by 2010. Although investment in infrastructure and capacity will attract more passengers and allow more passengers to be carried where capacity is currently constrained, our ability to regulate certain fares may also have a role to play in achieving this objective.

Protecting passengers from excessive fares increases in commuter markets is unlikely to generate a large increase in rail travel, precisely because rail already has such a large share of those markets that lower fares are unlikely to produce a major switch from other modes. On the other hand, using our ability to regulate fares in more price-sensitive off-peak markets (where the capacity exists to carry additional passengers) might be one way to encourage more people to travel by rail, contributing to the objective of a 50% increase in passenger miles. Proposals would need to be targeted at the fares used by the type of traveller most likely to switch modes. A general subsidy to fares may simply be a windfall gain to passengers already using rail services, and represent poor value for money.

Another idea for increasing the number of rail passengers is to introduce a national railcard, available to anyone and giving a discount on off-peak rail travel across the country. The railcard would encourage people to make more use of the rail network once they had invested in the railcard, in a similar way to the national railcards available in some other countries such as Switzerland. The idea has a number of arguments in its favour, but there are also a number of things that we will need to consider when comparing the 'national railcard' approach with other options for increasing rail travel. For example, unlike simply reducing fares, a railcard is designed to give a discount to regular rail users - the very people already using rail – and might not provide an incentive for existing car users to switch modes for one particular journey. Secondly, if a national railcard were available to anyone, it could not be targeted at those groups of people who are most price-sensitive and therefore most likely to make additional journeys or switch modes. We already protect the existing national railcards for young people, senior citizens, and people with disabilities, three groups of people who are likely to be more price-sensitive than others, as well as most in need of lower fares. We would need to be sure that supporting a national railcard, or a geographically-based version such as the London and South East 'Network Card' was good value for money.

If more fares are regulated, either directly or through the introduction of a new railcard, this will require additional subsidy, as operators will need to be compensated for the net loss in revenue. Although lower fares may increase the number of passengers, in most rail markets the additional revenue from new passengers does not cover the loss of revenue from existing rail passengers travelling at the lower fare. Proposals for lower fares will need to show that the benefits of (for example) reduced road congestion, reduced pollution and fewer road accidents are sufficient to justify the cost of the additional subsidy which will be needed. We would also need to show that spending this money on reducing fares is a better use of our resources than spending a similar amount of money on improving the train service.

A further factor in generating the increase in passenger numbers since privatisation has been the innovative and customer-focused fares introduced by many train operators. As long as operators continue to offer the regulated fares for sale at no more than the regulated 'cap', they are free to introduce other products to generate additional revenue and passengers by meeting particular passengers' needs. We need to consider whether there are situations where fares regulation prevents useful new types of fare being introduced. For example, we regulate traditional season tickets, when employment practices are moving towards more flexible patterns of work where people need to travel only on two, three or four days each week. We would welcome train operators' and passengers' views about how fares regulation might accommodate these and similar changes, and what we might do to encourage the creation of new ticket types which will generate a further switch to rail.

The balance between passengers and taxpayers

When the railways were privatised, both Railtrack and the train operators were expected to drive down costs. The benefits of this cost reduction were to be shared between the taxpayer and the passenger. The taxpayer would benefit from a steady reduction in the subsidies paid to train companies, and passengers would benefit from the annual 1% real reduction in regulated fares from 1999 onwards.

In practice, although some cost reductions have been realised, the basic cost of maintaining the rail network has risen significantly. An annual grant of over £800 million is now being made to Railtrack to offset this increase. The higher cost of providing the rail network is therefore being borne entirely by taxpayers.

Our Strategic Plan allows for this increase in Railtrack's costs without the need for an increase in fares or any change to fares regulation. However, the plan excludes the longer term cost increases which Railtrack may experience post-Hatfield, and it also excludes any costs arising from implementing recommendations on safety and recent European directives on railway interoperability. A decision will need to be made on whether and to what extent taxpayers or passengers provide the additional funding for these. As the expected cost reductions have not materialised, and as it is likely that additional network funding will be needed in the future, we need to consider whether or not the annual real reduction in regulated fares should be allowed to continue, or whether passengers as well as taxpayers should shoulder a share of the costs.

Funding investment

£33.5 billion of public funding has been earmarked to support and invest in the rail network over the period of the ten year plan. This is enough to fund the investment set out in our Strategic Plan without increasing fares, on the assumptions made in the plan. However, passengers may want to see even more investment than this. The Strategic Plan includes the development of a number of longer-term projects, but the implementation of these projects may need funding in due course. One source of funds for further investment in our rail network is revenue from fares. However, our existing fares policy is set to reduce revenue and so will not increase the money available for investment. Since 1999, regulated fares have been due to decrease indefinitely by 1% less than inflation each year, implying a

reduction of about 18% in real terms over the life of a 20-year franchise. This reduction might be welcomed by passengers, but the RPI-1% policy will cost in the region of £65m per annum by 2010 when compared with allowing increases in line with inflation. If used to finance investment, this sum would be sufficient to finance a capital project costing over £800m.

One option is to change our fares policy to provide an increased stream of revenue for re-investment across the whole network. Another option is to vary fares policy between geographic areas, routes or operators, to allow a real increase in regulated fares to reflect specific investment that has been, or is being, made in that particular part of the network. If this were to be done, we would need to decide what level of increase should be permitted under what circumstances. We would also need to decide whether increases should be permitted in advance to fund improvements, or only applied once improvements have been delivered.

Overcrowding

In a competitive market, supply and demand determine the price, quality and quantity of goods or services. If demand for a particular good outstrips supply, the price will rise. As result, consumers may choose to buy other goods, ration their consumption or continue to pay the new higher price. As the price rises, suppliers will switch resources to production of this good where they can do this cost-effectively. In this way, changes in price ensure the market returns to an efficient balance of supply and demand. However, an imbalance between supply and demand may arise if prices are regulated at levels which do not reflect costs.

Since privatisation, fares regulation has largely prevented commuter operators from raising fares as capacity became used up. In fact, many commuter fares have reduced in real terms, because of the 1% real reduction in regulated fares each year since 1999 and (in the case of the ten London commuter operators) the effect of the regime linking fares to performance. Passenger numbers have increased as central London employment has risen, leading to overcrowding on many routes into London, and in some cases the reduction in fares required by fares regulation may have made the overcrowding worse. Table 3 below shows how the number of passengers has increased in the morning peak on each London commuter operator, based on annual passenger counts undertaken for the SRA.

Table 3: Increase in passenger numbers in the morning peak[4], 1995 - 2000

Chiltern	25.0%
Connex South Eastern	14.1%
c2c	13.0%
Great Eastern	16.1%
Silverlink	34.6%

South Central	30.6%
South West Trains	29.6%
Thames Trains	45.5%
Thameslink	21.2%
WAGN	23.5%
Total	**22.2%**

Train operators have run more and longer trains, and have managed to raise capacity on London commuter routes by 9.4% between 1995 and 2000, but in spite of this the number of passengers in excess of capacity has doubled over the same period. In 1995, around 3% of passengers were standing over and above SRA acceptable levels (which allow for limited standing by passengers on shorter journeys), but in 2000 this figure reached 5%. Adding extra track capacity in urban areas can be difficult, and where it can be done, it takes time to get the additional capacity on stream.

Until now, the same permitted increase has been applied to both commuter fares and the long-distance off-peak Saver fares (essentially a leisure product), but commuter and leisure fares could be treated

[4] Trains arriving at London terminals between 07:00 and 09:59 Mondays-Fridays

differently. Another option is to allow different increases in regulated commuter fares on different routes or for different operators, so that greater increases could be applied on those routes where overcrowding is a problem. Allowing a greater increase in commuter fares might reduce levels of overcrowding and the additional revenue could fund investment in increased capacity.

A further possibility is to change regulation to require lower prices in the 'shoulder-peak' periods and higher prices at the height of the peak. This might spread passengers' journeys across a wider time period, easing overcrowding and reducing pressure on peak resources. We could encourage proposals for peak and shoulder-peak pricing by changing regulation in this way, or we could offer to change regulation if specific proposals were put to us by a particular operator. New technology such as smartcards may make systems like these easier to implement than they have been in the past.

Although commuter routes bear the brunt of overcrowding, it also occurs on certain long-distance trains, not only in the business peaks but also on certain trains on Friday evenings and Sunday afternoons. Our research has suggested that regulating the restrictions on Saver tickets has limited operators' ability to manage overcrowding. We would welcome responses about how this might be resolved.

The SRA is developing a strategy for how available network capacity should be used, which may be the subject of a separate consultation. However, it is clear that if our fares policy continues to reduce commuter fares in real terms, this is unlikely to help reduce the level of overcrowding.

Fares integration

An important consideration is how our fares policy interacts with the policies of other organisations such as Transport for London (TfL) in London and Passenger Transport Executives (PTEs) in other cities. In the London area, the SRA and TfL share the aim of improving fares integration between trains, bus and tube, to make it easier for people to travel in and around the capital. The popular range of Travelcard tickets is a prime example of how successful such integration can be. However, inconsistencies between SRA and TfL fares policy have had some unintended effects. In the longer term, these could undermine the attractiveness of integrated multi-modal tickets such as Travelcard, and have serious consequences for both revenue and subsidy requirements.

Travelcard fares are subject to a TfL pricing policy which at present requires them to be increased in line with inflation each year. National rail commuter fares are subject to our own fares policy, which since 1999 has required an annual real decrease of 1% in the total value of each train operator's fares basket. The ten London commuter operators are also subject to a regime linking fares with performance, and recent levels of performance have in most cases required an even bigger real decrease in the value of each fares basket. Table 4 below shows the maximum permitted increase in the total value of each of these operator's fares baskets, compared with inflation.

Table 4: Permitted increase in regulated fares, June 1995 to January 2002

Inflation (as used for fares regulation) 1995 to 2002:	**20.2%**
Permitted increase in regulated fares 1995 to 2002 under basic fares policy (RPI to 1998, RPI-1% from 1999):	15.6%
Chiltern	13.7%
Connex South Eastern (inner suburban basket)	9.7%
Connex South Eastern (outer suburban basket)	13.0%
c2c	10.0%
Great Eastern	14.4%
Silverlink	17.3%
South Central (inner suburban basket)	12.2%

South Central (outer suburban basket)	11.6%
South West Trains (inner suburban fares basket)	8.9%
South West Trains (outer suburban fares basket)	5.8%
Thames Trains	9.4%
Thameslink	11.2%
WAGN (West Anglia fares basket)	9.3%
WAGN (Great Northern fares basket)	12.8%

Travelcards are included within these fares baskets, and they make up a significant percentage of most of them – in some cases, up to 70%. The only way an operator can limit the increase in the value of the whole basket to the maximum permitted under fares regulation is to reduce non-Travelcard fares to balance the increase in Travelcards. Some of these decreases have had to be large, and in many cases the gap in price between a Travelcard and a normal national-rail-only ticket to London has widened significantly. As a result, users of non-Travelcard tickets see a disproportionate benefit from fares regulation, while Travelcard users see far less of the benefit

There are more serious effects. Integrated ticketing works in practice because the multi-modal Travelcard is priced at a reasonable premium above the basic national-rail-only fare to London. It is the preferred option for most passengers travelling beyond their national rail London terminal to a destination on the Underground, because it is normally the same price or cheaper than buying the national-rail-only fare to London plus a zone 1 Underground ticket. By creating a steadily widening gap between Travelcard and non-Travelcard fares to London, it is becoming increasingly difficult to maintain a logical relationship between these two types of fare. Ultimately, if Travelcards become more expensive than a national rail ticket to London plus a zone 1 Underground ticket, the benefits of integrated bus-Underground-rail ticketing will be lost.

The significant cuts in national-rail-only fares will be welcomed by those passengers who buy them, but there may be adverse effects for the industry and the taxpayer in the longer term. Fares regulation is intended to limit increases to 1% less than inflation, plus or minus any performance-related fares adjustment. However, the interaction of Travelcards and fares baskets described above has forced some operators to cut some non-Travelcard fares by up to 20% in a single year. If this in turn prompts a switch away from Travelcards to the non-Travelcard fare, the drop in revenue could be severe, and in the longer term, much greater subsidy may be needed.

This situation also makes it increasingly difficult to introduce further fares integration, and in general, if fares policy allows different fares increases for different operators, this makes it much more difficult to extend the use of simplified, consistent, zonal fares across all operators in a particular area. Our research suggests that operators are finding it increasingly difficult to set fares under these circumstances, and that it has become the fares regulation mechanism itself which is determining the setting of fares rather than commercial incentives or SRA objectives.

Social inclusion

The Government is committed to a policy of social inclusion for disadvantaged groups within the community, and the rail network has an important part to play. For example, the rail network can provide a means of travel to work or school, or for leisure purposes, for people without access to a car. Many people do not have a debit or credit card, or internet access, and through our regulation of ticket retailing we make sure that the cheapest 'book ahead' fares for long distance travel remain available at many local station ticket offices, where they can be paid for in cash.

Rail fares also have a material effect on the use of rail services by such groups. We regulate most commuter fares used for travel to work. We also make sure that the senior railcard, young person's

railcard and disabled person's railcard continue to be available. We could consider whether regulating certain types of fares would allow rail travel to become more accessible to poorer parts of the community, but we would need to be sure that regulation was the best way of achieving this goal. It is possible that other agencies will be better placed to tackle this issue, using more closely targeted solutions than adjusting the fares paid by all passengers, but we intend to examine the possibilities further.

Cost and value for money

The cost of any change in fares regulation is a vital consideration. If regulation is increased, we are obliged to compensate the train operators to ensure that they are no better or worse off after the change. In very simple terms, if it were decided to increase regulation to limit the price of a particular ticket to £100 when an operator intended to charge £160, the taxpayer would need to pay the equivalent of £60 for every passenger travelling at the regulated £100 fare. In fact, the cost could be significantly more than this, because if the lower fare increased the number of passengers, additional rolling stock or infrastructure might be needed, which we would also have to pay for. Although more passengers means more revenue (which would offset the cost of the fare reduction to the taxpayer) this is very unlikely to cover the loss of revenue caused by the fare reduction. If it did, operators would lower their prices for their own commercial benefit, without the need for regulation. When making our final decision about the level, scope and mechanism for fares regulation we will need to consider whether each policy option offers value for money and is affordable.

The scope of Regulation

In devising a fares policy for the future, the first major decision is about the scope of regulation, in other words the range of fares which should be regulated. We will need to consider:

- whether there are any groups of passengers who are not adequately protected by the current scope of fares regulation and general competition law. In particular, are there groups of passengers who are the dominant users of one particular fare who have little or no alternative to rail travel? If so, is it sufficient in practice to regulate another ticket (for example, Saver tickets) which these passengers could use but choose not to?
- whether there are tickets types which could be regulated to help the SRA achieve its passenger growth target of 50% by 2010;
- whether there are ticket types which could be regulated to increase social inclusion.

The options

The options that we could consider include:

- continuing to regulate the present range of fares;
- extending regulation to include long-distance Standard Open Singles and Returns on all or selected routes;
- extending regulation to include other ticket types such as Cheap Day Returns, on all or selected routes;
- reducing regulation to cover just commuter fares, where a high level of market power can be proven;
- increasing or reducing the regulation of ticket conditions, for example Saver restrictions.

Our view

We expect we will continue regulating most fares used by commuters, because of the significant level of market power exercised by operators in the London and South East area, and to a lesser extent major cities elsewhere. This includes both season tickets and full fare daily tickets. On the other hand, we think it unlikely that off-peak fares on commuter routes need to be regulated. Cheap day return fares for shorter-distance off-peak travel have generally increased in line with inflation. Initial studies have shown that demand for these tickets is quite sensitive to price, and operators have in general priced low to make the most of the available off-peak capacity.

The regulation of fares on long-distance and regional routes is a more difficult issue. Our research suggests that in many cases demand for turn-up-and-go off-peak tickets such as Savers is less responsive to increases in price than had been previously thought, and that the price of Saver tickets would have increased significantly had they not been regulated. It also suggests that Saver travel restrictions would have been increased beyond their current level if these had not also been regulated. However, regulating Saver tickets may also have led to overcrowding on certain services as it restricts operators' ability to manage demand.

Full fare open tickets for long distance journeys are currently unregulated and on average they have increased by more than inflation. We plan to do more research into the reasons for these increases. However, fewer than a fifth of inter-city journeys are made with these fares, and the majority are used by passengers travelling on business. We would not expect operators to set these fares at discounted levels, as they are premium fares, offering complete flexibility including travel during the weekday business peaks. They will need to be set at a level which allows operators to manage peak demand.

Low-priced advance-purchase fares are unregulated, but they have generally not increased above inflation. In fact, some of these fares are lower now than in 1995. We think that regulation of this type of ticket is unlikely to be necessary, and could prevent operators from introducing further customer-focused and innovative fares.

Questions for consultation (1):

Do you think the balance between fares that are regulated and fares which are not regulated is currently correct?

If you think that we should regulate a different range of fares, which fares should be regulated, and why?

If you think the range of regulated fares should be increased, which additional ticket types do you think should be regulated, and on which routes? Tell us why you think these fares should be regulated, and at what price level you think they should be set – for example, at the current prices or a particular historic price. How should the cost of increased regulation be paid for, and what benefits might justify this cost? What will be the effect on overcrowding?

If you think the range of regulated fares should be reduced, tell us which fares should cease to be regulated, and why. What are the likely effects of this reduction in regulation?

Is the regulation applied to ticket restrictions (for example, Savers) sufficient, and if not, would increasing regulation of ticket restrictions be good value for money?

The level of regulated fares

Once we have considered the range of fares which need to be regulated, we need to decide upon the level at which these fares will be set, and how we will allow this level to change each year with inflation. At present, all fares caps are based on the prices charged by British Rail in 1995, increased by inflation each year until 1998, then 1% less than inflation each year indefinitely.

Fares levels affect our objectives in a number of ways:

- lower fares generally mean more passengers, higher fares fewer passengers;
- lower fares may mean less money for investment, higher fares could permit greater investment;
- higher fares may reduce overcrowding, lower fares may make overcrowding worse;
- lower fares imply the need for higher subsidy, so a decision on the level of fares is in effect a decision on how the cost of our rail network is split between the passengers and taxpayers.

The options

Options that we could consider include:

- continuing to regulate all regulated fares at RPI-1%;
- changing the permitted increase to RPI for all regulated fares;
- changing the permitted increase to RPI+x% or RPI-x%
- changing the permitted increase to (for example) RPI for commuter fares, but maintaining RPI-1% for other fares such as Savers;
- varying the permitted increase on each route according to the level of overcrowding or spare capacity;
- allowing an increase over and above the basic policy where investment has delivered demonstrable improvements for passengers.

Our view

Since 1999, regulated fares have been capped at RPI-1%, leading to a decrease in regulated fares in real terms. Although this has contributed to the significant increase in passengers carried by the railway system since privatisation, it may also have contributed to overcrowding. We are not convinced that the subsidy required to lower regulated fares by 1% in real terms each year represents good value for money, or that it is the best use of the funding that we have available. We think that these decreases in fares are unlikely to be sustainable much longer, because of overcrowding, the need for additional investment, higher industry costs and (in the London area) the problems caused by inconsistency with TfL fares policy.

We are therefore considering changes to the level of regulation, including whether the same permitted increase should necessarily be applied to all regulated fares. We are considering whether we should vary the permitted increase by line of route, type of train service, or part of the country, to reflect levels of overcrowding or overall quality of service, or to target those services, areas and routes where lower fares are most likely to increase rail travel.

We are also considering whether real increases should be permitted in specific cases to help fund additional investment, and if so, whether this might be applied before the investment is made or only after demonstrable improvements have been delivered for passengers.

Questions for consultation (2):

How should the level of regulated fares be determined, and how should fares change each year with inflation?

If you think that an increase in fares should be permitted to fund investment, what circumstances might justify what scale of increase? Should an increase only be applied after the investment has taken place, or are there circumstances when it might be applied beforehand?

Should fares policy be used to ease overcrowding, and if so, how?

Should the same policy apply to all fares in all areas, or should different policies apply in different areas or to different fares to reflect capacity constraints, the need for investment, or the delivery of quality improvements?

What are the problems (if any) caused by differences in fares policy between the SRA, TfL and PTEs, and how might these be resolved?

The link between fares and performance

We have already mentioned the option of allowing fares to increase to reflect quality improvements on a discretionary basis. However, a key issue is whether fares should *automatically* be linked to the quality of the service provided, and in particular train service performance.

Linking fares to train performance is a way of compensating passengers when train service performance gets worse, and conversely, ensuring that passengers contribute to the costs when performance improves. It is particularly important on commuter routes. On routes where there is a lot of competition from other modes of transport, an operator has a commercial incentive to perform well, and perhaps to lower prices to retain passengers if performance declines. Commuters are often a captive market, and there is no such pressure on train operators to perform well to attract passengers, or lower fares to keep them if performance declines. Linking commuter fares to performance is one way to recreate this mechanism in a non-competitive or regulated market.

The attractions of a link between fares and performance need to be set against the problems which are likely to arise with any link between fares and performance:

- There is a long lead time involved in setting fares, so there will be a large time lag (about 5 months) between any fares change and the period of train service performance to which it relates.
- In the London area, Travelcards are subject to a London-wide pricing policy, with annual increases usually equal to inflation. A fares adjustment related to train performance will therefore have a disproportionate effect on people who use non-Travelcard tickets, because the effect of the fares adjustment will have to be borne largely by these fares.
- A link between fares and performance means allowing different fares increases for different operators. This makes it very difficult to introduce (for example) standard zonal fares for national rail services around inner London, as different operators' fares could not be kept in line with each other, or with bus and Underground fares. It can also make it difficult to maintain a logical fares structure where fares on a route are set by different operators and are therefore subject to different increases.

A link between fares and performance is not the only way to compensate passengers for poor punctuality and reliability, and the alternatives need to be considered. For example, compensation

provided through train operators' passenger's charters is more immediate and more closely related to the performance which passengers actually experience. On the other hand, it only works in one direction, because passengers are compensated for poor performance, but do not pay more when train performance improves. Passenger's charter compensation (in the form of season ticket discounts) is automatic for monthly and longer season ticket holders, but holders of daily or weekly tickets have to claim their compensation for specific delays.

If fares are to be linked to train service performance, we need to decide how. The existing system applies to ten London commuter operators, and it allows the cap on the relevant operator's fares basket to increase by up to 2% **more**, or up to 2% **less**, than the basic 'RPI-1%' policy, depending on whether that operator's train service performance has improved or worsened in the previous year relative to the year before that. The system is explained in more detail in appendix C.

For franchises which have not yet been replaced, there is also an adjustment made to subsidy payments which is calculated to offset the increase or decrease in revenue attributable to the performance-related adjustment on fares. This is because a separate performance regime already provides the necessary rewards or penalties for good or bad performance. The train operator is no worse or better off from the performance-related fares adjustment, but the SRA, and hence the taxpayer, bears the cost or enjoys the benefit of the fares adjustment. This subsidy adjustment is being discontinued when franchises are replaced, so that the changes in revenue provide an additional incentive on operators to improve performance.

There are a number of additional problems with the existing link between fares and performance:

- It is complex and often difficult for the public to understand.
- It is based on how train performance **changes** from one year to the next and not on the **absolute** level of performance achieved. A train operator which performs extremely badly in one year and moderately badly in the next will be permitted a greater fares increase, whereas an operator which enjoys excellent train performance in one year and merely good performance in the next year will be permitted a smaller increase in fares.
- The adjustment on fares is limited to a maximum of +/-2%, to avoid causing major fares increases or decreases in any one year. However, this maximum can cause problems. For example, a serious decline in performance might be sufficient to generate a fares adjustment of -15%, but as the maximum fares adjustment is –2%, fares would be reduced in the following year by just 2%. A gradual recovery in performance over the next few years could be sufficient to produce not just one, but several years of +2% adjustments on fares, leading to a real increase in fares. This situation could easily occur following the poor performance after the Hatfield accident. On the other hand, if this 2% limit was increased or removed, this could lead to unacceptably large swings in fares levels.

The options

Taking into account these drawbacks and the alternatives available, there are several options. We could:

- continue to link fares with performance through the existing regime;
- link fares with performance, but through an alternative regime, perhaps based on absolute levels of performance, with a linkage to resolve the 'cap' problem. Such a regime might cover the same range of regulated fares as the existing regime, or a different range;

- discontinue any automatic link between fares and train performance, use passenger's charters to compensate passengers for poor performance, and consider fares increases in specific cases where a particular quality improvement has been delivered.

If an automatic link between fares and performance is discontinued, some operators' passenger's charter compensation arrangements might be sufficient, but others might need to be improved. The taxpayer would have to pay for any improvements, as each operator would have to be held financially harmless for the change to their passenger's charter.

There is also a subsidy issue. Over the last few years, worsening performance has meant that the fares/performance link has reduced London commuter fares below the level which would have resulted from the basic 'RPI-1%' policy alone. The figures for each operator are shown in table 4. Subsidy has been increased to offset the effect of these lower commuter fares on operators' revenue. If the link between fares and performance is eliminated and fares are left at their reduced levels, this additional subsidy will have to be continued indefinitely. One option might be to return these fares (perhaps over the course of several years) to the levels that would have applied had there been no fares/performance link.

A further consideration is the level of incentive placed on operators to improve performance. Most train operators, whether or not subject to the fares/performance link, have a performance incentive regime written into their franchise agreements. Under their performance regime, operators make penalty payments for train performance below an agreed benchmark, and receive incentive payments for performance above the benchmark. It is SRA policy that when franchises are replaced, these payments will be doubled to further incentivise good performance. The fares/performance link doesn't provide any additional incentive for existing franchises, as subsidy is adjusted to ensure that operators are no worse off or better off than if it didn't apply. However, this subsidy adjustment is being discontinued when franchises are replaced, adding a further incentive for operators to improve performance. If the link between fares and performance is eliminated, we need to consider whether the performance regime incentives are sufficient, or need to be further increased when franchises are replaced, instead of the additional incentive provided by the link with fares. If incentives need to be further increased, the taxpayer rather than the passenger will pay for improved performance.

Our view

Our initial research has concluded that the existing automatic link between fares and performance has not worked well. We think that it is desirable either to alter the existing fares adjustment mechanism so that it is based on the absolute level of performance achieved, or to discontinue it in favour of an enhanced passenger's charter as a more direct way of compensating passengers for poor performance. If we alter the automatic fares adjustment, the problem of inconsistency between the fares increase for Travelcards and that for national rail tickets will still exist. There will also still be a significant time lag between the fares increase and the period of performance to which it relates. On the other hand, if we discontinue the automatic adjustment, existing passenger's charters may or may not be sufficient to compensate passengers for poor performance. The financial effects of altering or discontinuing the link between fares and performance will need to be taken into account, including the cost of any necessary enhancement to passenger's charters. If we discontinue this regime, we will also need to consider whether London area fares should remain at their present level, or if they should be adjusted back to the level that would have applied had there been no performance-related fares adjustment since 1995.

If an automatic link between fares and performance is discontinued, investment in improved performance could still be funded through an increase in fares. A 'one-off' increase could be agreed as

part of an investment plan, to be introduced only once a measurable improvement in performance had been delivered as a result of the investment.

Questions for consultation (3):

Should fares continue to be linked to train service performance through the FIAP regime? If so, how should we deal with the problems highlighted above?

Should fares be linked to performance through an alternative regime, perhaps based on absolute levels of performance with a linkage to solve the 'cap' problem? If yes, which services and ticket types should it cover and how might it work?

Should a link between fares and performance be discontinued? If yes, how should passengers be compensated for poor performance? Are the current passenger's charter arrangements sufficient for this on all operators, or would these have to be improved first? How should we handle the issue of fares levels which are currently depressed by poor performance and the fares/performance link? For replaced franchises, do you think performance incentive payments need to be increased to compensate for the effect of losing this link?

Are there other aspect of train service quality that should be linked to fares?

The way fares are regulated

Having decided which fares should be regulated and at what level, we need to consider the method of regulation. In general, the more defined and rigid this is, the greater the impact on the operators abilities to respond to the market, and the greater the cost to the taxpayer. On the other hand, the more loosely defined the regulatory regime, the greater the chance that some people will see increases or decreases in fares over and above the average. Once again, a balance needs to be struck between the needs of the passenger, the commercial freedom of the operator, and the cost to the taxpayer.

Fares baskets versus 'protected fares'

We regulate certain fares on an individual basis ('protected fares') and others by means of 'fares baskets'. Fares which are regulated on an individual basis are regulated rigidly, and are not allowed to increase above a specified 'cap'. However, fares which are regulated by means of fares baskets are regulated much less rigidly. They may increase by more than or less than the basket as a whole, providing the total value of the basket does not exceed the cap. Fares baskets give operators a degree of flexibility to price individual fares up or down, to resolve anomalies, or reflect capacity constraints. In terms of subsidy, regulation through fares baskets is likely to cost less than regulation of individual fares because of this degree of flexibility it gives to the operator. In deciding which method of regulation best meets our objectives, we need to consider the following:

- Regulating all fares individually would provide certainty, because no-one using a regulated fare would face above-average increases in their fare from one year to the next.
- On the other hand, regulating fares in a fares basket allows operators to maximise their revenue, and will therefore cost the taxpayer less.
- A basket allows operators to respond to market conditions. If individual fare levels are regulated the SRA has to second guess the market and set what it believes to be the market price. Operators are likely to have more information about market conditions than the SRA, making this a more efficient solution.

- A basket allows operators to maximise the number of passengers who travel on rail by raising prices in markets that are not responsive to changes in price and reducing prices in markets which are responsive to price. This type of pricing is efficient, but it could be seen as unfair.

The fares included within fares baskets

At present, an operator's fares basket contains every regulated fare from which that operator takes any share of the revenue. This includes fares set by other operators, and London Travelcards, where the price is set by agreement between Transport for London and the national rail train operators.

As explained earlier in the 'fares integration' paragraph, the inclusion of Travelcards can cause a particular problem, because of the difference between SRA and TfL fares policy. We could remove Travelcards, or even all fares set by other operators, from fares baskets, but we would need to consider the following issues:

- Including fares which are not within the control of the operator increases the risk which the operator faces. For example, an operator might have a basket in which only a small percentage of fares were under its own direct control. The only way in which it could keep the total basket value within the cap would be to make large changes in the fares which it controlled;

- On the other hand, removing these fares from the fares basket could result in the fares not being properly regulated. For example, the revenue from a popular fare might be split between several operators. If that fare was only included in the fares basket of the operator who set it, its weighting within the basket would only reflect its importance to the total revenue of that particular operator, and not necessarily the importance of that fare in terms of the number of people who bought it;

- If fares baskets only contain the fares which are set by that operator, the weightings of each fare within the basket will be higher than they otherwise would be, as each weighted fare would form a higher proportion of a smaller basket.

Fares basket weighting

At present, fares within a basket are weighted according to the revenue received by that operator from the sale of that fare in 1995. Fares for popular routes therefore count more towards the total value of the fares basket than fares that are bought by only a few passengers. However, travel patterns may have changed since 1995. There are two key issues:

- If travel patterns have changed significantly since 1995, the current weightings will no longer reflect the relative importance of different fares. Operators may be able to impose greater increases in fares on routes where demand has been strong and grown above the average. As a result an operator may be able to make additional profit.

- The number of fares included in each basket is very large, and to re-construct a fares basket annually would require a significant amount of work by both the SRA and the operators

Rail fares are not alone in being regulated by means of a weighted basket of prices, as a similar mechanism is used to regulate prices in a number of other regulated industries, for example, the water and telecoms industries. In both of these industries, basket weightings are updated each year. OFTEL concluded in March 2000 that British Telecom's basket should continue to be updated annually, using weights based on the previous year's consumption. We need to decide whether to update the rail industry's basket weightings, or to leave them set at the 1995 levels. We could update the basket weighting annually, or at some other regular interval, but we would need to make sure that the benefits

justified the work involved. A further option is to update fares basket weightings only when certain specific circumstances arise. How might these circumstances be defined?

Regulating individual fares within fares baskets

Most London commuter fares are regulated by means of fares baskets, where a cap is placed on the total value of a weighted group or 'basket' of fares. To prevent undue increases in particular fares, a cap is also placed on individual fares within each basket. The cap on each fare is increased by RPI+2% each year, which means that it is now 37.6% above 1995 prices, compared with the cap for the fares basket as a whole which is just 15.6% above the 1995 basket value. This now gives operators significant flexibility to price up certain fares as long as they balance their basket by pricing down others, and clearly, the gap between the cap for a fares basket and the cap for individual fares within that basket will continue to widen each year. Policy options include:

- continuing the existing pricing flexibility on individual fares within baskets
- relating the cap on individual fares more closely to the cap applying to the fares basket as a whole, for example by setting it as a fixed percentage above the cap.

Our view

Our initial research suggests that in the London area in particular, constraints imposed by the regulation mechanism itself may be determining fares more than commercial considerations or SRA objectives. This is because of the combination of the RPI-1% policy and further real reductions in fares due to the fares-performance link, acting upon fares baskets containing both Travelcard and non-Travelcard fares. A key issue is how to relieve this pressure on the fares structure, and restore some degree of flexibility for operators, whilst continuing to control increases in fares.

An issue that will need further work is whether fares baskets should continue to contain the existing range of ticket types, or whether multi-modal tickets such as Travelcards should be removed and regulated separately. We will also consider whether baskets should only contain fares that are set by the operator concerned.

Fares baskets may remain the preferred method of regulation in urban areas, but travel patterns may have changed after five years, and we realise that it may be necessary to revisit fares basket weightings. We need to do some more work to assess to what extent travel patterns have changed, but in principle we are considering the need to re-weight basket fares weightings, either as a 'one-off' or at intervals of so many years.

The cap on increases in individual fares within fares baskets is already significantly above the cap on fares baskets as a whole, and because it is cumulative, this gap will widen indefinitely to the point where it provides little protection for the individual passengers affected. We are considering relating the cap on individual fares more closely to the cap applying to the fares basket as a whole, for example by setting it as a fixed percentage above the cap.

Questions for consultation (4):

Should we continue to regulate fares through a mixture of fares baskets and individually protected fares, or should one or other mechanism be adopted for all regulated fares? What implications would any change have for passengers and operators?

What fares should be included in fares baskets – all fares from which the operator takes any share of the revenue (as now), or only the fares set by that operator? Should Travelcards and other multi-modal fares be excluded from fares baskets?

Should the weightings within fares baskets remain at the 1995 levels, be updated as a 'one-off', at regular intervals, or when certain circumstances arise?

Should the caps on individual fares within fares baskets be set closer to the overall basket cap to protect passengers from excessive rises in individual fares? If yes, what should the cap on individual fares within baskets be in relation to the basket cap?

Other interaction between different fares regulation regimes

The interaction between protected fares and fares regulated in a basket, and between regulated and unregulated fares, can sometimes cause problems. For example, tensions in the fares structure can arise at the boundary between an area where fares are set by a Passenger Transport Executive (PTE) and the surrounding area where fares are set by the train operator in line with SRA regulation. One result might be 'railheading', where if fares inside the PTE are significantly lower than those outside it, passengers may drive to the first station inside the PTE area instead of taking the train from their local station. Another possible result is the creation of fares anomalies, where a combination of tickets becomes cheaper than a through ticket, or alternatively, a short journey can be made more cheaply by buying a longer-distance ticket.

Questions for consultation (5):

What problems, if any, has the interaction of different fares regimes caused in practice? What do you think could be done to improve the way the different regimes interact?

Fares regulation processes

If you represent a train operator, we would like your feedback on the day to day working of our fares policy and fares regulation processes. There may be aspects of regulation which you think should be improved or which you think need to be clarified.

Questions for consultation (6):

If you represent a train operator, how well do you think the mechanics and processes involved in fares regulation work, and how might these be improved? Is sufficient guidance provided, and how might this be improved?

Fares structure

Fares regulation has been designed to limit increases in the price of fares, rather than determine the fares structure to be offered by train operators. However, we know there are concerns about the complexity of the fares structure available on many routes.

A degree of complexity is inevitable if operators are free to 'market price' by offering a wide range of products designed to attract the maximum revenue from each type of rail traveller. However, for passengers this means a wide choice of fares and a greater likelihood of finding one that exactly fits their requirements. For the operator, it allows revenue to be maximised, and this in turn minimises subsidy from the taxpayer. It is also likely to attract a larger number of passengers to rail travel. If

operators were compelled to offer only a limited range of ticket types, operators' revenue is likely to reduce, subsidy would need to be increased, and some passengers would lose out as certain types of ticket ceased to be available.

On the other hand, different operators can sometimes use different terminology for what is essentially the same or a similar product, or address the same segment of the market in slightly different ways. This can make the fares structure appear more complex than it needs to be. Passengers might benefit if fare descriptions, restrictions and conditions were co-ordinated between operators where possible. It is also important that passengers have access to comprehensive and accurate sources of information on fares, to make it easy for them to find the fare that best meets their own particular needs.

Our view

We can see the benefits of the customer-focused and innovative fares which many operators have introduced since privatisation, and we would not want to constrain this. However, passengers need accurate and comprehensive information on the fares which are available for their journey, and it might be easier to provide this information if there was greater co-ordination of fares descriptions and conditions between operators. The Association of Train Operating Companies (ATOC) may have a role to play in this process.

Questions for consultation (7):

Do you think that the complexity of the fares structure is a significant problem or not? Why?

How might we resolve the conflict between offering passengers a wide choice of fares and making the range of fares understandable? How might we resolve the conflict between simplifying fares and preserving operators' commercial freedom?

Should the SRA become involved directly, or should operators be allowed to address this issue for themselves?

How to respond

If you have a view on the questions asked in this document, or any other issue connected with the regulation of fares, we would like to hear from you.

Respond in writing to	Fares review
Address	Strategic Rail Authority 55 Victoria Street London SW1H 0EU
E-mail	FaresReview@sra.gov.uk
Fax	020 7654 6010
Telephone contact for queries	020 7654 6000
Deadline for responses	As soon as possible, but no later than 11 October 2002

We may make consultation responses public unless you specifically ask for it to be confidential.

Thank you for your help.

Appendix A: Our duties and objectives

The SRA has a number of duties and objectives relevant to fares policy.

Extract from section 28 of the Railways Act 1993, as amended by the Transport Act 2000:

"Subject to the other provisions of this Act, if it appears to the Authority that the interests of persons who use, or who are likely to use, franchised services so require, it shall ensure that the franchise agreement in question contains any such provision as it may consider necessary for the purpose of securing that any fares, or any fares of a class or description, which are to be charged are, in its opinion, reasonable in all the circumstances of the case."

The government's 10-year plan for transport sets a number of objectives for the SRA. These include the objectives to:

- increase rail use in Great Britain (measured in passenger kilometres) from 2000 levels by 50% by 2010, with investment in infrastructure and capacity, while at the same time securing improvements in punctuality and reliability;
- reduce overcrowding to meet SRA standards (no passengers standing for journeys of more than 20 minutes and no more than 30% standing for shorter journeys) by 2010;

The SRA's duties set out in the Transport Act 2000 includes the duty to:

- protect the interests of users of railway services;
- promote efficiency and economy on the part of persons providing railway services;
- promote measures designed to facilitate passenger journeys involving more than one operator (including, in particular, arrangements for the issue and use of through tickets);
- impose on operators of railway services the minimum restrictions consistent with the performance of the SRA's functions; and
- enable providers of rail services to plan their businesses with a reasonable degree of assurance.

The Directions and Guidance given to us by the Secretary of State requires the SRA to:

- keep the level of regulated and unregulated fares under review;
- encourage proposals that help make fares more easily understood by passengers and which use new technology such as smartcards;
- subject the existing range of regulated fares to an overall cap of inflation less 1%, but consider changes to the cap where (a) existing capacity is fully used and additional revenue earned from increasing capacity would not cover the costs involved, (b) significant quality improvement is proposed which might be paid for, in total or in part, through fares or (c) variations in peak and shoulder-peak prices might be effective in encouraging redistribution of peak demand and thus reduce overcrowding;
- keep the present link between London fares and train performance under review.
- take account of government policy in other areas such as social exclusion and employment.

Appendix B: How the national fares system works

Although the current review is limited to fares regulation, the following information may be useful as background.

One of the SRA's tasks is to ensure that although there are 26 different train operators, our rail system remains a national network. There are conditions in every train operator's franchise agreement and passenger licence which require them to participate in National Rail Enquiries, in National Rail Conditions of Carriage, and in an agreement called the Ticketing and Settlement Agreement (TSA). The TSA sets out how rail fares will be created, set, honoured, refunded and the revenue settled between operators, and it ensures that nationwide through- and inter-available ticketing continues to exist as it did under British Rail.

Through tickets

A 'through' ticket is a ticket for a journey which involves the use of two or more operators in succession, for example, a mainline operator followed by a branchline operator. The TSA ensures that fares are set for each through journey for which British Rail had a fare in 1995. In practice, this means that through fares remain available for travel from any national rail station to any other national rail station.

A choice of operator

An 'interavailable' ticket is one which gives passengers a choice of operators over the same section of route. For example, an inter-available ticket from London to Peterborough will be equally valid on trains run by GNER, WAGN or Hull Trains. Unless a ticket is specifically shown as valid only by the trains of particular operator, it is fully inter-available, and can be used (subject to any other conditions applying to that type of ticket) on the trains of any operator over the relevant route or any section of that route. The TSA ensures that there is at least one set of inter-available fares for each journey on the national rail network. The SRA can permit exceptions to this rule where we believe that competition will bring a greater benefit to passengers, but the only exception permitted so far has been made in respect of fares between Gatwick Airport and London, and certain other journeys passing through Gatwick.

A choice of route

The TSA ensures that where alternative routes exist, passengers continue to have a choice of route with most tickets. Tickets on which the routing is shown as 'any permitted', or on which no specific route is shown, are valid for travel via any of the permitted routes listed for that journey in a document called the National Routeing Guide. Tickets valid via a particular location (for example, 'route Chesterfield') are valid on any route shown in the National Routeing Guide which passes through that location. The National Routeing Guide forms part of the TSA, and any changes to the routes it contains must be approved by the SRA.

Who sets fares?

Fares for each journey (known as a 'flow') are set by the 'lead operator' for that flow. The lead operator is normally (generally speaking) the operator with the greatest commercial interest in that particular flow. The TSA requires other operators to honour these fares once they have been set by the lead operator.

Once the lead operator has set its inter-available fares, both lead operator and other operators are free to set 'dedicated' fares if they wish, for travel only on their own trains at fares lower than the inter-available ones.

Passenger Transport Executives (PTEs)

In seven urban areas outside London, local rail services are sponsored by local authority transport organisations known as Passenger Transport Authorities, through their executive arms, the Passenger Transport Executives. Two PTEs (Greater Manchester and West Yorkshire) allow the train operators to set fares in the normal way, and to receive the revenue from the sale of those fares. In the other PTE areas (West Midlands, Strathclyde, Tyne & Wear, Merseyside and South Yorkshire), rail fares are specified directly by the PTE, who receives the revenue from the sale of those fares and pays the train operator to run the trains.

Appendix C: How current fares regulation works

Each train operator's franchise agreement with the SRA provides for the regulation of certain fares. The SRA operates two types of fares regulation, known as 'protected fares' and regulation through 'fares baskets'.

Protected fares

- The following fares are 'protected':
  - saver returns (an off-peak walk-up leisure fare available for most long-distance journeys) for all journeys where a saver existed in 1995.
  - standard returns (the full-fare return ticket, valid at both peak and off-peak times), for journeys where a saver did not exist in 1995 (typically journeys under 50 miles, or wholly within the old Network SouthEast area. Does not apply where a standard return is included in a fares basket).
  - weekly season tickets, other than those which are included in a fares basket.

- Each of these fares is required to be made available for sale at a price equal to or lower than a 'cap'. The cap for each fare is equal to the 1995 price increased by inflation ('RPI') for each year from 1996-98 and by inflation less 1% ('RPI-1%') for 1999 and subsequent years.

- Fares regulation also protects certain conditions attached to these fares. For example, in the case of savers, these are required to be valid for no less than a month, and to be valid all day Saturday and Sunday and from no later than 10:30 on any other day. They need not be valid for any journey beginning between 15:00 and 19:00 on Mondays to Fridays from London area stations or (when travelling away from London) stations between London and Reading, Watford, Luton or Stevenage, inclusive.

Fares baskets

- Regulation through 'fares baskets' applies to the following fares used by commuters in the London area:
  - season tickets (weekly, quarterly and annual) to, from and within the London Travelcard zones;
  - standard singles and returns for journeys wholly within the London Travelcard zones;
  - standard singles and standard returns **into** the Travelcard zones from a defined London suburban area, roughly 35-50 miles from London. The boundary stations for this area are: Shoeburyness, Southend Victoria, Southminster, Marks Tey (exc. Sudbury branch), Audley End (not origin Stansted Airport), Ashwell & Morden, Arlesey, Harlington, Bletchley, (excl Bedford branch), Aylesbury, Haddenham & Thame Parkway, Twyford (incl. Henley branch), Earley, Fleet, Alton, Whitley, Christ's Hospital, Brighton (exc. coastway), Windsor & Eton Riverside, East Grinstead, Crowborough, Wadhurst, Paddock Wood (inc. Strood-Paddock Wood) Maidstone East, Canterbury East, Margate.

- Each train operator serving London has a fares basket, although some larger operators have an inner suburban and an outer suburban basket. Into a fares basket go every regulated fare from which that operator takes any share of the revenue. This will include both fares for which the operator is 'lead operator' and sets the fare, and fares where another train company sets the fare, but the operator in question receives a share of the revenue.

- Each fare within a basket is weighted by the revenue received by that operator from the sale of that fare in 1995 (or other nominated year). The total value of a fares basket is the sum of all the weighted fares which it contains.

- Each year, the train operator must ensure that the total value of its fares basket does not exceed the 'cap' placed on that basket. The cap is equal to the total value of that basket in 1995 (or other nominated year), increased by RPI for each year from 1996-98 and by RPI-1% for 1999 and each subsequent year. This cap now stands at 15.6% above 1995 prices.

- The basket mechanism gives operators flexibility to price up individual fares within the basket, as long as other fares are priced down to keep the total value of the basket within the 'cap'. However, to prevent undue increases in individual fares within a basket, there is a separate 'cap' on increases in each fare. This cap is equal to the 1995 price for that fare, increased by RPI+2% each year. The cap now stands at 37.6% above 1995 prices.

Fares Incentive Adjustment Payment ('FIAP') regime

- Ten London commuter operators are also subject to a regime sometimes referred to as 'FIAP' (Fares Incentive Adjustment Payment regime), which links fares increases to changes in train service performance. The relevant operators are:

    - WAGN Railway
    - First Great Eastern
    - c2c
    - Connex South Eastern
    - SouthCentral
    - South West Trains
    - Thames Trains
    - Chiltern Railways
    - Silverlink
    - Thameslink

  Under this regime, the annual increase in the cap on these TOCs' fares baskets may be greater than or less than the basic 'RPI-1%' policy, according to the improvement or worsening in train performance in the 12 months to the end of July in the previous year compared to the 12 months before that.

- The fares adjustment is calculated using a defined formula, based on the difference between performance incentive regime payments in the two years concerned. It is capped at a maximum of +2% and a minimum of –2%. For example, if an operator's train performance improved significantly from one year to another, and this generated the maximum +2% fares adjustment, then the cap on that operator's fares basket would be increased in the following year by RPI-1% +2% = RPI+1%. Conversely, if performance declined so as to generate the maximum negative fares adjustment of –2%, the cap would increase (or potentially, decrease) by RPI-1% -2% = RPI-3%.

- For existing franchises, the increase or decrease in revenue resulting from FIAP is offset by an adjustment in the franchise payments made by the sSRA to the TOC. The regime is therefore 'bottom line neutral', the operator receiving no immediate benefit from any increase, or disbenefit

from any decrease in fares due to the link with performance. However, for replaced franchises it is proposed that franchise payments will not be adjusted, and the TOCs will bear the full cost/benefit of the adjustment on fares.

- Commuter fares around Cardiff and Edinburgh are also subject to fares basket regulation. In urban areas where there is a Passenger Transport Executive (for example, Birmingham, Manchester, Glasgow, Liverpool, Sheffield, Leeds), either the PTE itself sets the fares, or a version of fares basket regulation applies. However, fares regulation in PTE areas is outside the scope of this consultation.

- Travelcard season fares are included in fares baskets, although Travelcards are subject to a separate policy agreed with TfL of increases equal to or greater than inflation. To ensure that the total value of their basket does not increase more than RPI-1% (plus/minus any FIAP adjustment), operators have had to implement lower increases or even reductions in the non-Travelcard fares which they control. With Travelcards forming sometimes 70% of a fares basket, significant increases or decreases to non-Travelcard fares are sometimes necessary to balance the total value of the basket.

Unregulated fares

- Fares which are neither a protected fare nor included in a fares basket are unregulated, and train operators are free to determine these fares according to market forces. Unregulated fares include:
  - all first class fares
  - all 'advance purchase' fares
  - tickets (other than Travelcards) which include through travel to destinations served by bus services, light rail services or London Underground
  - tickets which include a non-rail element such as entrance to a museum, theme park or other attraction
  - Saver tickets, for journeys where there wasn't a Saver fare in 1995
  - Weekly season tickets, for journeys where there wasn't a weekly season fare in 1995

- Although a particular fare may be unregulated, in certain cases the regulated fare acts as a ceiling – for example, the unregulated Supersaver fare cannot logically exceed the price of the regulated and less-restrictive Saver fare.

Fares regulation in Passenger Transport Executive (PTE) areas

- In five PTE areas (West Midlands, Strathclyde, Tyne & Wear, Merseyside and South Yorkshire) fares are specified directly by the PTE, and fares are not regulated. In two PTE areas (Greater Manchester and West Yorkshire), fares are set by the relevant train operator in the normal way, and key commuter fares are regulated by a version of the fares basket mechanism. All standard singles and returns for journeys wholly within the Greater Manchester and West Yorkshire PTE area are included in a fares basket, which is capped in a similar way to the fares baskets described earlier.

Important points about fares regulation

- The permitted annual increase in regulated fares (RPI-1%) is not a year-on-year increase, but a cumulative increase in the 'cap' based on the 1995 price. For protected fares, the cap is now 15.6% above the 1995 price, due to the effect of inflation. Operators do not have to increase their fares by the maximum permissible amount in any given year, and some choose not to do so. If, for example, an operator had chosen not to increase its fares at all between 1995 and 2001, it could have imposed a 15.6% increase in January 2002, and still been within the fares 'cap' and therefore compliant with fares regulation.

- Fares anomalies: Fares have not been set according to a standard fare per mile for many years. British Rail abandoned this principle in favour of a more commercial approach, setting fares for each journey according to what the market would bear. With such a large network, it is inevitable that some anomalies exist where a combination of short-distance tickets is cheaper than a through ticket covering the entire journey. It is also possible that such anomalies arise where the lead operator setting the short-distance fares is a different operator from that setting the long-distance fare. However, such anomalies do not contravene fares regulation, and passengers are entitled to benefit from them, providing that they can legitimately use that combination of tickets for the journey they are making under the terms of the National Rail Conditions of Carriage. We consider applications from operators to adjust the regulation of particular fares if this is necessary to correct an anomaly that has arisen from (for example) a error inherited from British Rail.

Appendix D: Executive summary of our fares policy evaluation study

This is a summary of the conclusions reached by an independent evaluation of SRA (formerly OPRAF) fares policy, carried out by National Economic Research Associates (NERA) in Spring 2002.

The Study

1. This report presents the results of an evaluation of national rail fares policy in Great Britain between 1995 and the present. The evaluation was conducted by NERA for the Strategic Rail Authority. The evaluation assesses the impacts of the policy, both in relation to government objectives at the time, and in regard to objectives with regard to current government policy towards the railways.

2. The evaluation was conducted using a combination of face-to-face interviews with key officials and train operators, a review of published material and unpublished files, assessment of evidence on how responsive demand for rail travel of different types is to fares, and an analysis of the detailed data on rail revenue and traffic held by the SRA.

The Rail Industry at Privatisation

3. In the years before privatisation British Rail's InterCity sector was required to cover costs, but Network SouthEast and Regional Railways were not. It follows that fare levels for many services could not be judged on whether or not they permitted cost recovery. For some years there had been a policy of increasing fares in real terms: between 1986 and 1994 season ticket rates per km rose by an average of 2.3 per cent per annum in real terms. British Rail was not set explicit objectives in regard to fare levels, but financial objectives for different business sectors fed through to fare levels.

4. A White Paper in 1992 heralded privatisation. Passenger train operations were to be franchised, with broad objectives in regard to service levels, service quality and fares being determined by government. While train operators would have freedom to set many fares, travellers on London commuter services would be protected against the levels of fare increase needed to achieve commercial viability without subsidy, and against the exercise of market power. The 1993 Railways Act gave the new Franchising Director the duty to ensure that fares were reasonable.

Determining the Policy

5. The new policy was announced in May 1995. Some fares would be regulated, and others not. For those that would be regulated, the (RPI-X) system would apply, with X set at zero for the first three years, and then with (RPI-1) for the following four years. For every journey at least one fare, known as "protected fares", would be regulated, as would weekly season tickets. In addition, an additional tier of regulation in the form of "fare baskets" would apply for commuting stations around London, Edinburgh and Cardiff. Within the baskets individual fares would be capped. Fares in the London commuting area would be adjusted on the basis of service performance.

6. The system announced differed in two important respects from the one initially proposed by the Franchising Director:

- it had originally been envisaged that regulated fare levels would be allowed to increase above the rate of inflation, broadly continuing the previous policy by British Rail; and

- it had originally been envisaged that only commuter fares, primarily in the London area, would be regulated through the national policy (while commuter fares in the other main conurbations would continue to be subject to local control from the PTEs). Competitive pressures both from other modes and within the rail industry were expected to be sufficient to control other fares on the rail system.

7. The changes were the result of policy decisions and pressures. The government was keen to reduce the unpopularity of rail privatisation and so wished passengers to benefit from the expected efficiency gains from privatisation by seeing fares fall in the longer term. It also wanted to avoid the risk of fares increases outside the main commuter areas. The Franchising Director, whose ultimate legal responsibility fares policy was, agreed once he was convinced that the government was prepared to underwrite the costs of this policy in greater subsidies for franchises, and in committing to the policy in the franchise contracts.

Details of the Policy

8. **Fares baskets** are used to regulate some commuter journeys. Fares baskets permit some flexibility, since individual fares can be adjusted to remove anomalies. Fares baskets are more complicated to monitor than protected fares, since compliance requires monitoring of all the fares in the basket, some of which will be set by another TOC. Our investigations also revealed some anomalies in the definition and monitoring of fares baskets.

9. **Protected fares** are easier to monitor than fares baskets, since it is only individual fares that need to be checked. In practice, the SRA monitors a sample of them. However, the regulation of individual fares provides a less flexible system of regulation, since opportunities for operators to introduce more customer-focused fares for the ticket types concerned are removed.

10. The **FIAP system** provides a mechanism to link fares for commuter services in the London area to performance. However, there are a number of problems with its operation: when TOCs perform badly, fares are reduced, but then the SRA compensates them for the loss of revenue giving the appearance that subsidies are increased for TOCs that perform badly (in fact the operator would have already been fined through the, separate, performance regime); there is a lag of 26 weeks between the measurement of a TOC's performance and the application of FIAP, so that the passengers who gain from lower fares are not necessarily those who experienced the poorer services (and *vice versa*); and the fact that fares cannot be adjusted by more than 2 per cent in any one year means that fare adjustments might not fully reflect the change in performance of a particular TOC.

11. TOCs operating services to London are required to comply with the **Travelcard** agreement. They must accept Travelcards, the multimodal tickets used in London, on their London

services. Travelcards are required to rise at or above inflation. This has caused some problems for some TOCs, whose fare baskets must rise below the rate of inflation, because Travelcard revenue can make up a high proportion of their fare basket revenue. As a result they have needed to reduce non Travelcard fares by large amounts.

Fare Setting and Elasticities of Demand

12. Evidence on fare elasticities of demand can be used to assess what would happen to fares in the absence of regulation. In the absence of regulation train operators would increase fares whose demand is inelastic at least to the point where demand is of unit elasticity, and beyond that point if the services concerned would still be subject to overcrowding.

13. At the time that the current regulations were being designed policy makers believed that season ticket demand was inelastic, and was particularly inelastic for season tickets to London. The evidence at the time also pointed to demand for ordinary tickets on the former Network SouthEast being demand inelastic for journeys under 60 miles, but elastic for some longer journeys in the sector. Demand for much Intercity travel was believed to be elastic, though OPRAF were probably aware that business travel was inelastic. Recent evidence suggests that leisure travel on intercity services may be less price elastic than was previously the case.

14. Regulation will have a relatively limited impact if it is applied to fares for which demand is elastic, but regulation of such fares will prevent increases that might have been made to ration scarce capacity. Levels of unregulated fares will also be influenced by regulated fares in circumstances where existence of regulated fares impacts on the "headroom" available to increase unregulated fares that lie below them.

Rail Fares from 1995 to 2001

15. The report includes very detailed analysis of changes in fares between 1995 and 2001 by different types of ticket and different groups of service.

16. Regulated season ticket fares in the London area have risen close to the permitted annual increase, which means they have decreased in real terms. Unregulated fares in the London area have also decreased in real terms since privatisation. The differential between the targeted increase in London Underground fares and the permitted increase for each London fares basket, rather than planning or market-driven objectives, has been a major determinant of the way in which commuter fares have been adjusted.

17. Full Intercity fares have risen by well above inflation. Cheap Day and SuperSaver tickets have also risen in real terms, and we expect that Saver tickets would also have done so if they had not been regulated. The regulation of Saver tickets has severely constrained the ability of TOCs to manage demand effectively at peak times.

18. Experience of fares on regional TOCs has varied. Cheap Day returns have increased broadly in line with inflation. Unregulated full fares have generally increased broadly in line with inflation, but there have been some exceptions where they have risen significantly in real terms. Fares in the Edinburgh basket have risen by the maximum amount permitted, and so would likely have risen faster in the absence of regulation. Fares in the Cardiff basket have risen at

slightly below the maximum permitted, which suggests that regulation had a relatively limited impact there.

The Counterfactual

19. On the basis of what we regard as the best evidence on elasticity values for different types of service we have assessed what would have happened in the counterfactual case where only London commuter fares would have been regulated, and at (RPI+2).

20. Under the counterfactual London commuting fares would have been 14 per cent higher than they are at present, while 5 to 8 per cent fewer journeys would have been made in the morning peak. Annual revenue to TOCs from the London fares baskets would have been £30 to £55 million higher, though they would have gained further revenue from increased purchase of off-peak tickets. It is likely that subsidy bids would have been lower had this different regime been announced in advance of the franchise bidding process. The remaining passengers would benefit from less crowded conditions, but there would have been significant increases in highway congestion.

21. In regard to Saver tickets on Intercity services, our counterfactual suggests that in the absence of regulation they would have risen by about 20 per cent in real terms, and demand for travel on these tickets would have fallen by about a quarter. Since some travellers would use other tickets, we believe overall Intercity traffic would have been reduced by around 3 per cent.

22. Table 1 provides a summary of counterfactual results by different service groups in terms of fare changes, decreases in rail journeys and increases in TOC revenues.

Table 1: Counterfactual Compared to Actual Fares Policy (2000/01)

	Fare increase	Estimated Actual Journeys (m)	Change in Journeys	Estimated Actual Revenue (£m)	Increase in revenue (£m)
London Fare Basket	14%	237	-7%	780	45
Protected full fares for London commuting TOCs	17%	41	-10%	160	8
Edinburgh and Cardiff fare baskets	13%	7	-10%	14	0
Intercity services (all fares except season tickets)	21%*	42	-4%	950	22
Protected full fares for regional TOCs	13%	14	-10%	31	0
Protected season tickets	13%	40	-10%	80	1
Other	0%	360	1%	1,300	13
Total, all fares and services	6%	740	-3%	3,320	90 (+3%)

*Note: we have assumed mid range elasticity values. These estimates are derived from unallocated revenue and journey data which will not correspond exactly with published journey and revenue data. * Saver tickets only.*

23. Fares regulation does interact with other policies; in particular it can restrict TOCs' ability to tackle overcrowding, which they might otherwise do by increasing fares to reduce passenger demand. Fare regulation can weaken incentives to invest and otherwise improve performance, though primarily this effect will be determined through the franchise process and other negotiations with the SRA. For, if TOCs were allowed to set higher fares, they would bid for lower funding requirements, so that funding can be stretched further. However, fare regulation may have resulted in increased capacity for crowded services, because TOCs have had to find means other than raising fares to deal with capacity problems.

Developments since 1995

24. Changes in the fares regulation policy since 1995 have been limited because the system was "hard-wired" into TOC franchise agreements. However, rail traffic grew much more strongly than had been anticipated at the time of privatisation, and the emphasis of rail policy has changed to give greater prominence to rail in dealing with the country's transport problems. There is now a greater emphasis on transport integration, and the 10 Year Plan has specific targets for further increases in travel by rail, with a headline target of 50 per cent growth between 2001 and 2011. The objectives of policy have therefore changed, though the emphasis in the original policy on reducing regulated fares in real terms is consistent with the new emphasis on rail traffic growth as an objective in itself.

Evaluation of the Policy

25. In evaluating the policy we have identified a set of appropriate criteria, related to: objectives at the time of privatisation; new objectives in current government transport policy; and implementation objectives.

26. Our assessment of performance in regard to all these criteria is summarised in Table 2.

Lessons for the Future

27. A number of findings have emerged from the time since fares policy was introduced which are relevant to determining future policy.

- TOCs are able and willing to increase some fares significantly. The SRA does need to protect some fares if it does not wish them to increase beyond certain levels.
- Regulation of some fares has succeeded in constraining other fares, but experience varies by market. However, demand characteristics of fares have been shown to change over time, a risk which should be considered when determining future fares policy.
- Regulation does constrain TOCs' ability to improve their fare structure, particularly if the pricing regime prevents real fare rises. It limits TOCs' ability to manage demand at peak times in order to encourage more efficient use of their services.

- The regulation of commuter fares does serve to alleviate severe traffic congestion, a key transport policy objective, though there may be a case for higher rail fares which are used to fund service improvements.

- The policy of not regulating pre-book tickets has resulted in many passenger benefits. We are sceptical of the value of any return to a nationally-imposed fare structure that would discourage fare innovation.

- The pricing regime for London commuting fares has been inconsistent with London Underground Limited price increases. Given the high level of ticket integration in London, this has created undesirable distortions in the fares structure and is ultimately unsustainable. The fares adjustment mechanism (FIAP) has had limited effectiveness, also in part due to its incompatibility with integration of London fares.

- Government rail policy has changed radically since the fares regulation policy was formulated. There is now a much greater emphasis on integration across modes, and on the increased role that rail can play in the overall transport system. It is clear that future fares regulation policy cannot be divorced from the SRA's overall objectives and the way in which fares regulation policy impacts on these objectives.

Table 2
Evaluation Results

Fares Policy Objective	Score	Comment
Objectives at the time of rail privatisation		
Reduce subsidy	*	The RPI-X fares policy regime is in conflict with this objective, though overall privatisation did succeed in reducing subsidy levels, at least in the short term.
Ensure reasonable fares	***	This policy has been largely successful, helped a great deal by the last minute decision to regulate Saver tickets, and the protected fare regime more generally.
	*	The exception has been full fares for Intercity services, which have risen in real terms by more than 3 per cent a year. At the time it was recognised that these fares would probably rise, but that was not necessarily considered to be "unreasonable".
Encourage efficiency	*	The regulation of Saver tickets (arguably without regulating SuperSaver tickets) has reduced the effectiveness of pricing signals to discourage passengers travelling at crowded times outside the main traditional afternoon peak on Intercity services.
	***	Absence of regulation on pre-book tickets has allowed capacity to be used much more efficiently on longer distance services.
Promote competition	**	The policies to encourage integration discourage competition. However, on-rail competition appears to have been successful in constraining and reducing fares for some longer distance services.
Light touch regulation	*	The regulation of many of the protected fares now seems to be unnecessary, and the London fares basket is extremely complex.
Objectives under current transport policy		
Integrated transport	**	Requirements to have inter-available tickets for almost all journeys, and the London Travelcard agreement have successfully promoted integration; inconsistency of RPI-X regime with London Transport's target fare rises has not. Other areas which have not been integrated have produced certain passenger benefits, notably lower fares. Of course, greater integration could be achieved with a nationalised industry, or a single operator.
Greater use of railways	***	Ensuring that regulated fares now rise below the rate of inflation has encouraged rail use, as has absence of regulation on pre-book tickets. However, it is not clear that the present policy encourages rail use where it is most economically and environmentally desirable.
Improve quality of service	*	Regulated low fares have severely limited TOCs' ability to control overcrowding, which is detrimental to punctuality targets and passenger comfort. Under FIAP, this has resulted in even lower fares, resulting in a vicious circle of deteriorating performance to which fares policy is a contributory factor.

continued ….

Fares Policy Objective	Score	Comment
Implementation objectives		
Appropriate risk	**	By regulating a ticket for every journey, the risk of large unexpected fare rises was largely eliminated for commuter and leisure travel. However, it was not eliminated for business travel on Intercity services.
Avoid loop holes and distortions	***	OPRAF largely managed to avoid regulatory loopholes, with perhaps an exception being certain parking charges.
	*	However, the combination of FIAP and the Travelcard agreement has meant that TOCs have little flexibility as to how their fares can be altered.
Flexibility	*	Fare regulation was formulated on the basis that it would be revised in a relatively short period, by 2002. However, conditions of passenger demand and expectation changed almost immediately and fares policy could not readily be modified to adapt to these changing circumstances.