A new structure for success on Britain's railway

An ATOC position paper on industry structural reform

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ATOC

Association *of* Train Operating Companies

Introduction

The challenge facing the rail industry is to cut costs while continuing to improve services for passengers. The McNulty Review into value for money has identified savings of up to £1bn a year above the efficiency targets already set for Network Rail, and the Office of Rail Regulation (ORR) estimates that rail infrastructure costs are up to 40% higher than in Europe.

The key to better value for money is a more commercial railway that releases the full potential of the private sector and puts the passenger at its heart. This means a new, 'horses for courses', approach in which franchises are designed around the commercial and operational realities of each route, with government intervening and specifying to lesser or greater extents, as appropriate.

There have been positive steps already. The Government's policy of longer, less prescriptive franchises creates the potential to build on the success of operators in increasing patronage and driving revenue growth by attracting more private sector investment and reducing their own costs, particularly in areas where significant efficiency improvements are not possible within a short contract. Network Rail (NR)'s plans to create devolved business units should also help the operation of trains and track to work more closely together.

But the scale of cost efficiencies identified requires a real step change which can only be achieved through more fundamental reform of the railways, engendering an even stronger commercial relationship between train operator and infrastructure provider and allowing train operators to play a much bigger part in prioritising infrastructure expenditure in line with customer needs.

The next stage of structural reform

NR's announced organisational reforms are welcome and the regional business units it is setting up should bring decisions closer to passengers and freight users. But we do not think that NR's reforms yet go far enough. Further structural change is needed which:

- creates around 10 independent infrastructure companies, separately licensed and regulated by ORR, from NR's current operations. These would be based largely on NR's current nine routes to ensure a good fit with train operations and should be rolled out by 2014
- retains essential network-wide functions in a lean systems body, but underpinned by new and stronger licence obligations to ensure they are governed and operated by the industry as a whole
- introduces new franchising and regulatory arrangements, incentivising train operators and regional infrastructure businesses to form alliances and commercial agreements to improve services and value for money, while allowing the taxpayer to share the benefits of outperformance.

Taken together, these would stimulate an early start in delivering a more cost-efficient and customer-focused industry.

Transforming Network Rail into separate regional companies

The free-standing infrastructure businesses (infracos) would:

- operate signal boxes and lines (though there may be opportunities for these functions over time to be managed by TOCs, to the extent possible under EU law, in order to further align operations with the passenger)
- have full budget autonomy and authority to progress renewal and enhancement schemes without the need to go through NR's centralised approval processes
- be responsible for their own track access contracts with operators and earn revenue from access charges, levied as today on principles set by ORR, and
- be licensed and regulated by ORR so that their efficiency, development plans and RABs would be scrutinised at periodic reviews, with costs benchmarked against other infracos.

This is a substantial reform, yet it brings several advantages over the status quo by:

- enabling local managers to progress more quickly and effectively those initiatives (including investment projects) that matter most to passengers and, with greater input from train operators, apply clear commercial pressure on infrastructure costs
- significantly improving the relationship between track and train operations, since their businesses would have much clearer common incentives to improve performance, patronage and revenues
- providing much better accountability, since managers could be held directly to account by regional funders, stakeholders and elected representatives
- providing a clear challenge to the size of central overheads
- creating clear comparability between regional businesses, thereby allowing relative performance to be benchmarked more effectively, with the prospect of some competition between businesses to further drive cost-efficiencies.

The priority should be to establish the infracos under NR ownership and, by the start of CP5, put them under separate ownership to achieve the maximum benefits of cost comparability and contestability. Given NR's size, each infraco would be a significant, FTSE-250 sized business with good economies of scale. The larger ones would be comparable in scale to continental EU operations such as ProRail (Netherlands), Trafikverket (Sweden) and Banestyrelsen (Denmark) and would, once a track record had been established, be attractive to potential investors.

The infracos would be based on the current NR routes, but with some remapping (e.g. to create infracos for Wales and the North of England) to promote closer integration with TOC operating areas and better relationships with regional stakeholders.

To achieve the full benefits of this reform, there also need to be changes in two other areas:

- first, in the way the industry's important central functions (particularly those discharged by NR) are governed, so that decisions are made on a collective, whole-industry basis wherever possible
- second, regulation of NR and DfT's franchise policy must adapt to encourage commercially-focused partnerships to develop between infracos and TOCs. The amount of detailed central regulation to which both are subject should consequently be focused on outcomes and reduced.

Reforming central functions

With system operations largely pushed down to infracos, there will still be important functions which need to be provided at a network-wide level, some of which are currently carried out by NR. These include some aspects of strategic planning and timetable production, major network initiatives such as improvements in signalling, development of national standards and provision of some items of civil engineering plant.

We believe these functions should migrate to a new and lean central systems body whose executive would retain the best of the current significant skilled resources in the industry, including NR, devoted to such tasks. The key difference here is that governance of most of these network-wide functions should be exercised through the industry as a whole, rather than just by NR (although NR would form part of the governance arrangements for as long as it owned infracos). This would allow the executive to operate more obviously as a service provider to its infraco and train operator clients in the industry.

This approach already works well in areas such as ATOC's management on behalf of its members of through-ticketing, revenue settlement and the National Rail Enquiry Service. Other models could include National Air Traffic Services (NATS) and the American Association of Railroads. While such governance could not apply to all of the functions carried out by the systems body (such as capacity allocation, which EU law requires must be fully separated from train operations), we think it could be extended to other areas, such as wider provision of passenger information and industry research.

We believe that this approach would be cost-effective (by introducing a clear commercial pressure to improve efficiency), have clear authority where needed and would help achieve buy-in from the whole industry to outcomes. All infracos and train operators would be required by licence to co-operate to deliver these network-wide functions and would agree how best to do this on commercial lines, again whilst fully respecting the limits that EU law sets on the influence of train operators and regulatory requirements for transparency, fairness and non-discrimination.

Facilitating commercial partnerships and joint working

Central, devolved and local government will continue to exercise an important role as client and funder of many rail services. However, closer alignment between train operators and infracos, based on stronger shared commercial interests and more extensive partnership working, is key to successful industry reform. This alignment could take several forms:

- informal partnerships (of the kind that has led to successful adoption of single integrated control centres on some routes) where the two work together voluntarily without a contractual agreement
- commercial agreements on specific issues (e.g. contractual deals to deliver minor network enhancements, or agreements on cost and revenue sharing to increase capacity and revenue)
- more formal alliancing arrangements, such as establishing joint venture companies (e.g. for a major enhancement or investment project) which shares the revenues and costs of the JV project.

Such partnerships are possible across the whole network and offer the prospect of early agreements to drive value for money. An operator spanning more than one infraco would have agreements with each, tailored to the issues most important in that region: e.g. a commercial agreement with one for minor enhancements to improve performance, and a separate agreement with another to share costs and revenues to grow the market on a particular set of services. Secondary operators, including freight companies, should also be able to participate in these partnerships if they wish to.

It is important that the move to closer alignment is voluntary rather than mandatory, as this is more likely to generate the full commitment needed from both parties to make partnerships work best.

Nevertheless, DfT and ORR policy needs to change in some respects to provide the early spark which will facilitate different players coming together more readily than before:

- DfT should activate the efficiency benefit sharing mechanism agreed in principle at the last periodic review and ORR should agree to implement it on a regional basis
- DfT and ORR should agree arrangements for all future franchises (starting with West Coast) to facilitate commercial partnerships, e.g. by giving TOCs a more formal role in decision-making on the scope of NR's infrastructure projects or by increasing TOCs' ability to make appropriate changes to timetables during engineering work without recourse to government. In return, the taxpayer might share in the benefits of outperforming franchises through a profit-share mechanism (as we have put forward in our proposals for a GDP or CLE-based revenue risk sharing approach in future franchises).

Pursuing further, evolutionary structural reform

There are two further structural reforms that would build on closer alignment between infracos and TOCs and which need to remain firmly on the industry structure agenda – vertical integration to merge train and track operations within a single company; and long term operating concessions for some franchises. These have the potential to offer still further efficiency improvements.

Vertical integration

Under vertical integration (VI), passenger train operation and track provision would be brought together within a single holding company. VI would work best where there is already significant geographic alignment between a dominant franchised train operator and a Network Rail region, such as Greater Anglia, South West Trains, Kent, Merseyrail and Scotland.

VI is the most likely option to drive fundamental changes in asset management policies and practices since integration of infrastructure decisions with the commercial approach of train companies would lead to a much sharper market focus. But the structure needs to have two important safeguards:

- the interests of freight and secondary operators should continue to be protected by ORR to ensure no abuse of national or regional monopoly positions, in line with EU law. Any benefit sharing structures created should also be open to these operators
- the existing system of ORR regulation should continue to apply to ensure that adequate long-term investment in renewals took place to protect asset condition.

The vertically integrated company might be sold or concessioned through a competitive tender, on the basis of the track record of the infraco and on the train operator service commitments and subsidy requirements of the DfT.[1] Another option is for the market to determine the commercial opportunities and pace of evolutionary change, with separate franchising of the train operation and separate sale or concessioning (on the model of High Speed 1) of the infrastructure company, with the opportunity for one to acquire the other.

Long-term train operating concessions

For some passenger train services (as distinct from infrastructure), reform might take the form of concessions, as an alternative to franchises. Under a concession structure, the opportunity to run train services on a long term basis might be offered via auction. The essential difference compared to today is that the concession would primarily be commercial in approach and regulated by ORR rather than DfT, just as open access operators are at the moment. Although DfT's role would be much more limited than today it would retain important functions, such as funding non-commercial but socially necessary services (or station calls), contributing to future capacity enhancements to the extent that the farebox gains are insufficient, and regulating commuter fares where the operator has appreciable market power.

This approach would be particularly appropriate for premium-paying intercity train operations, which generate substantial passenger revenue in direct competition with car and air, yet which do not have the level of market dominance (other than potentially on some commuter services) that justifies the heavy regulation of timetables, fares and quality to which they are currently subject.

This model might be applied to current franchises, such as East Coast, West Coast and Cross Country. The common feature is that these franchises are strongly commercially driven: e.g. by the end of CP4, the East Coast franchise may be able to operate without any subsidy even were it to be charged its full infrastructure costs (some are currently paid direct by DfT).

Train operation concessions could be offered along the lines of the recent successful auction of HS1, by setting up a company with a set of access rights to the network which parties bid for. The access rights would be time-limited, in line with ORR policy and EU law, with arrangements to apply for the rights to be extended to the end of the concession and to determine the financial value of this. The winning bidder would continue to be free to enter into the commercial agreements with infracos that it thought appropriate.

The advantages of the concession approach, apart from providing up-front benefit to taxpayers through the sale proceeds, are that it increases further the commercial nature of the business. The operator's success will depend solely on attracting passengers and controlling costs,

[1] To the extent that the company would be subject to public service obligations (PSOs), then EU law limits the length of the contract that applies the PSO to 15 years (or 22.5 years if significant investment is involved). The same limitation would apply to the long term train operating concession. However, there is no equivalent limit under the PSO Regulation on the length of an infrastructure concession per se.

including infrastructure, in competition with other modes. Combined with the ability to plan and invest on a long-term year basis, this could transform what TOCs can do for passengers in terms of innovation, increased investment and improved services.

Implementation and timescales

The initial step to create regional infrastructure business units has begun, but needs to progress at a sustained pace. NR should be set a goal to establish all the infracos as separate businesses by the start of the next regulatory control period. The settlement for CP5 would then become the first one fully determined on regional lines. The industry's management processes have improved since the initial years of privatisation, such that this can be done while maintaining the pace of operational performance improvement and ensuring that safety remains paramount.

In addition, the Anglia NR region should be vested into a separate infraco, with its own accounts, governance structure, RAB and charges regulation in time for the Greater Anglia franchise competition in 2013. This would allow Greater Anglia to be a pilot for vertical integration. Separating out the East Coast NR region should also have high priority to allow bidders for the East Coast franchise (due to be let in 2012) to plan how best to build value from the new relationships. The complexity of the route and numbers of operators involved make it less suitable for vertical integration, but the franchise could potentially be sold as a long concession.

The West Coast franchise competition is underway and will be complete before decisions are taken on longer term structural issues. But government should not waste the chance to incorporate key elements of the franchise reform package into the ITT, including greater service flexibility and responsibility for maintaining stations. The franchise should also be designed from the outset to allow the new franchisee to enter into commercial agreements with relevant infracos once established, rather than rely on today's cumbersome franchise change mechanism. A new profit-sharing mechanism could be considered to ensure the taxpayer shares in the benefits of those agreements.

If these priorities are met, then the franchising programme from 2013 can progressively implement and take advantage of new industry structures.

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