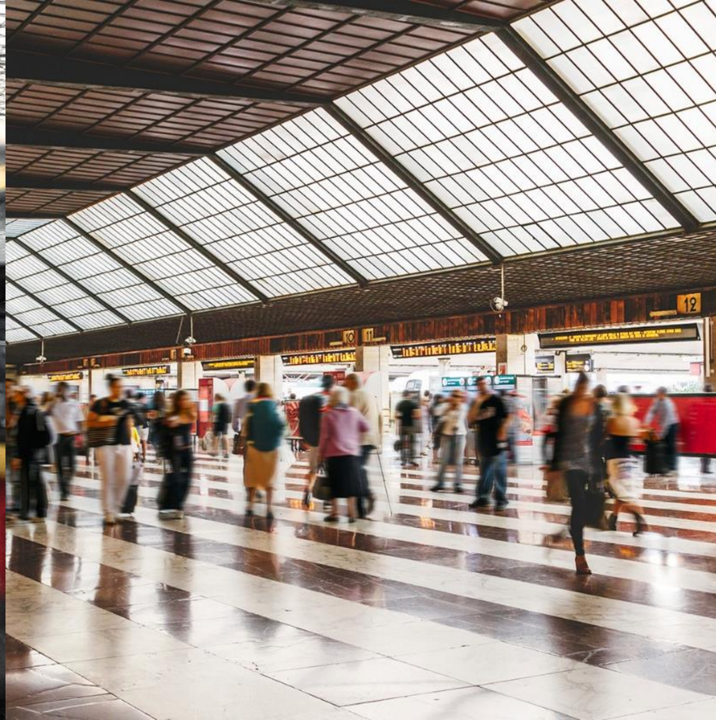

Future Rail Funding: Passenger Opportunities

Prepared for the Campaign for Better Transport

5th November 2015

Executive summary

1. The financial position of the railway has been improving over the last three years	• Aggregate franchise payments made by Train Operating Companies (TOCs) have increased from £0.4bn in 2011/12 to £1.1bn in 2014/15. This change has been driven by increasing passenger revenue, which grew by 6.5% per annum over the period. As a result, Commuter and Intercity TOCs both generate premiums for the DfT, with Intercity TOCs contributing over £3 per journey in 2014/15.	Pages 6 – 8
2. Continued revenue growth is expected to generate a significant surplus for the DfT compared with its "baseline forecast" forecast	• If the DfT is projecting revenue and franchise payments in line with the "comparator" cases it has published in recent franchise invitations to tender, it may be basis its future projections for industry growth on relatively conservative forecasts that project passenger growth lower than recent trends. • Successful franchise bids appear to be taking a rather more optimistic view on the rate of passenger growth and improving levels of cost management.	Pages 10 – 13
3. Under the current structure, this will result an increasing 'rail tax' on passengers, with an ever growing percentage of fare box income transferring directly to the Government. This will limit the value of the rail network to customers and the role it can play in supporting economic growth	• Given the high proportion of fixed cost involved in delivering rail services, much of this incremental income earned by Train Operating Companies will flow through to surplus. The franchising process means that this in turn is committed by TOCs to the government in the form of franchise payments. • These industry funding structures mean that additional net payments to the Government will be funded by passengers, and will effectively amount to a "rail tax" on passengers – especially those travelling at peak times. • This "tax" is being imposed against a backdrop of falling passenger satisfaction and passenger concerns about the affordability of the railway – especially for commuters. At the same time, there is also a growing appreciation that an accessible and effective rail network is a pre-requisite for sustained economic growth.	Pages 14 – 16
4. To combat passengers' concerns, the industry should look to fund initiatives that target increased commuter satisfaction	• The DfT has set out a high level vision to address these concerns through a fairer, more flexible fares structure. These initiatives would improve transparency, and would directly address the needs of modern commuters. However, the DfT has faced concerns about the affordability of these proposals. • Our analysis shows that there is likely to be ample funding to deliver these proposed initiatives and make the railway more accessible, whilst at the same time ensuring that the operation of the rail network does not place an unsustainable burden on public finances.	Pages 17 – 18

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- Past performance
- Finances to 2020
- Implications and opportunities

Introduction

- The new Government is grappling with two major issues which will define its domestic policy agenda for the duration of this parliament: the need to reduce public expenditure, and the requirement to improve economic performance in the face of a potential global slowdown. These two objectives are often viewed as contradictory – with a reduction in public spending and investment perceived as a major risk to economic growth
- Nowhere are these competing objectives more apparent than in the rail industry:
  - A strong, reliable, and growing rail network is needed to drive economic growth – from the South-East, where rail commuters are responsible for generating about 10% of the nation's GDP, to the North of England, where a rejuvenated rail network is at the heart of proposals to create a "Northern Powerhouse"
  - At the same time, the UK rail industry is seen by many as an unsustainable drain on public resources, with a seemingly limitless requirement for funding. Exponents of this view argue that funding levels are determined by what Network Rail needs to spend, rather than by what the country can afford. High profile delays in project delivery, and resultant performance and capacity constraints have raised serious concerns about the value for money offered by the rail industry
  - Previous work carried out by Credo for the CBT has highlighted significant regional variation in the UK rail network, which may exacerbate the challenge of achieving 'balanced' growth nationally
- This debate comes at a time of material fiscal constraint. With the Comprehensive Spending Review under way, Government Departments have been tasked with achieving 25% budget reductions, and against this backdrop the future funding of the rail industry will be subject to considerable challenge
- However, there is a danger that this funding pressure will translate into higher fares or will delay much needed service improvements for customers. There is also a risk around passenger satisfaction – measured by both TOC specific surveys and anecdotal media commentary, satisfaction with the railway appears to be declining. Customers are increasingly dissatisfied with services which, based purely on their relationships with the TOCs, they are being heavily taxed to use
- This trade-off of lower funding and better service expectations may appear to be impossible to manage, but recent evidence suggests otherwise:
  - Rather than being a drain on resources, the franchised rail operators in England and Wales returned over £1bn to the Government in 2014/15 – a figure which has more than doubled over the last parliament
  - If the current round of franchise bids are any indication of underlying market sentiment and future growth expectations, franchise payments could grow considerably over the next five years, with operators committing to farebox growth and tighter cost management. This may take the industry to overall profitability by 2020
- Given this projected dividend from rail industry finances, we argue that the focus of the debate should shift, asking instead how the rail industry can better support economic growth. Under current projections, commuters may be levied with a highly progressive 'rail tax' equivalent to up to 5% of income by 2020

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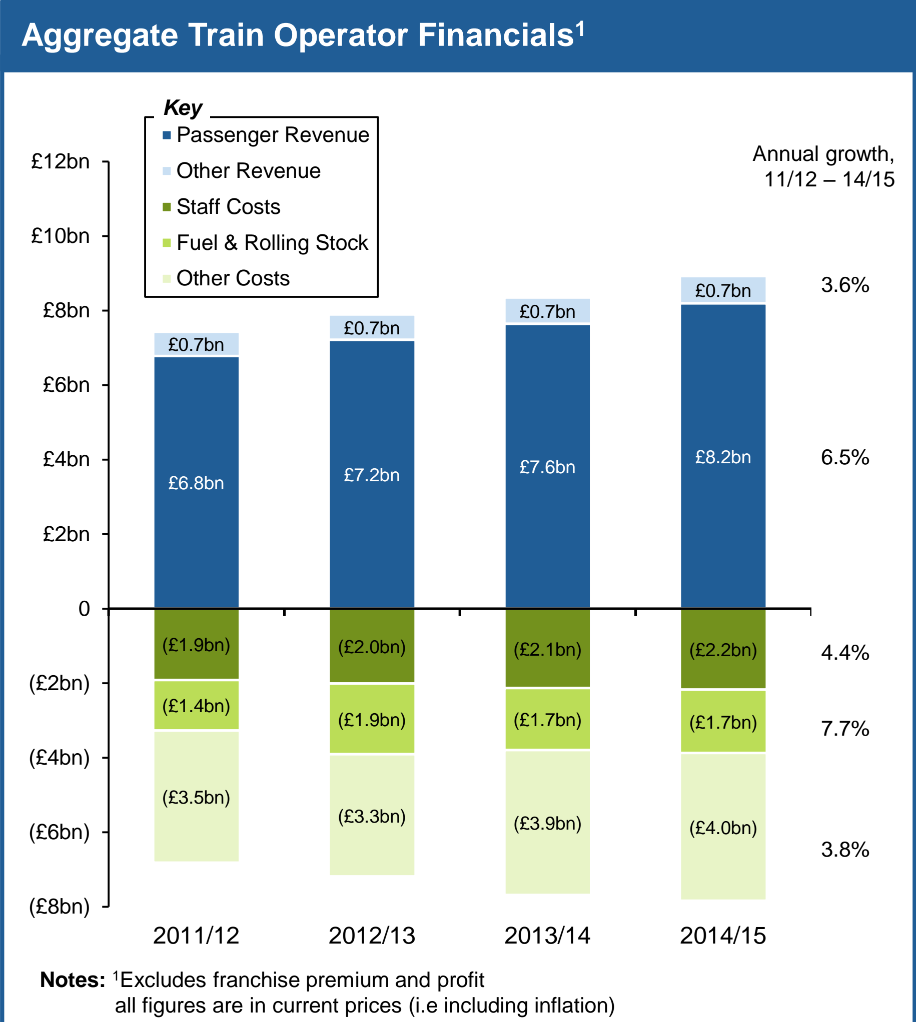
CREDO

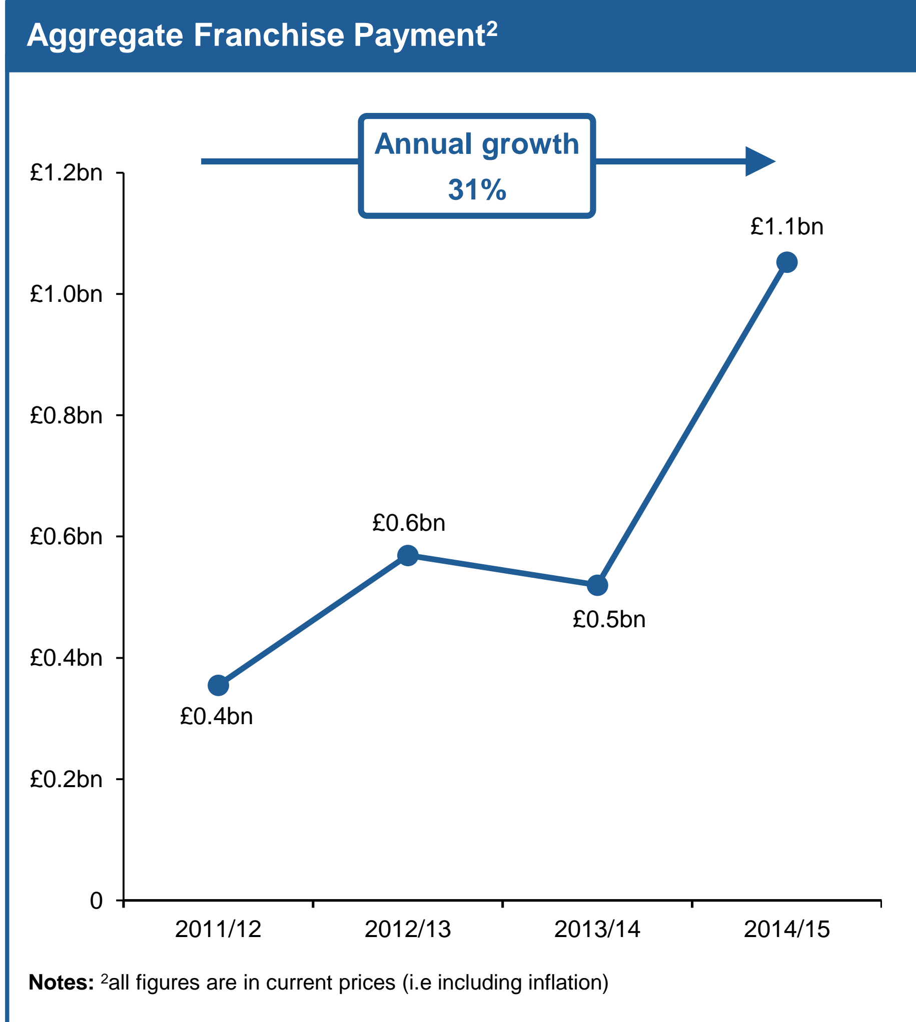
In 2014/15, Train Operating Companies (TOCs) in England and Wales made a £1.1bn net contribution to the government – more than double the amount paid four years ago

Aggregate Train Operator Financials[1]



Notes: [1]Excludes franchise premium and profit
all figures are in current prices (i.e including inflation)

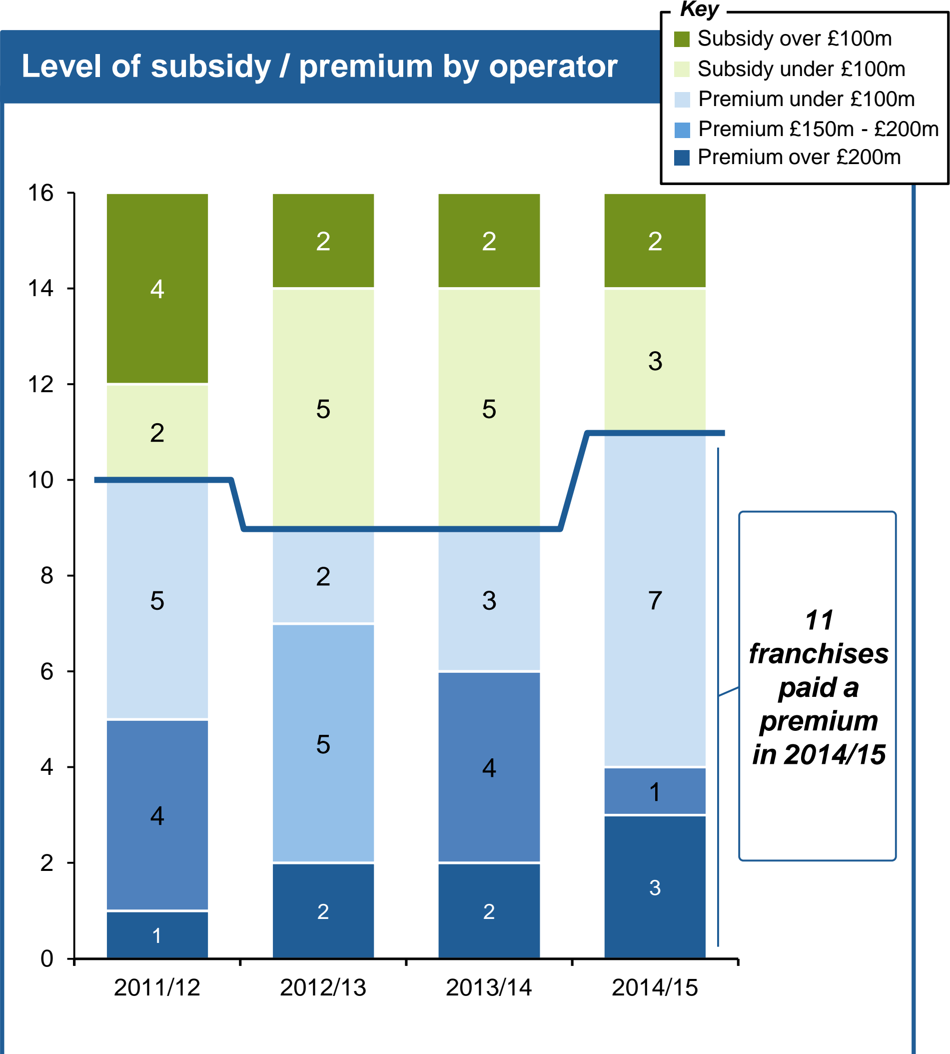
Aggregate Franchise Payment[2]

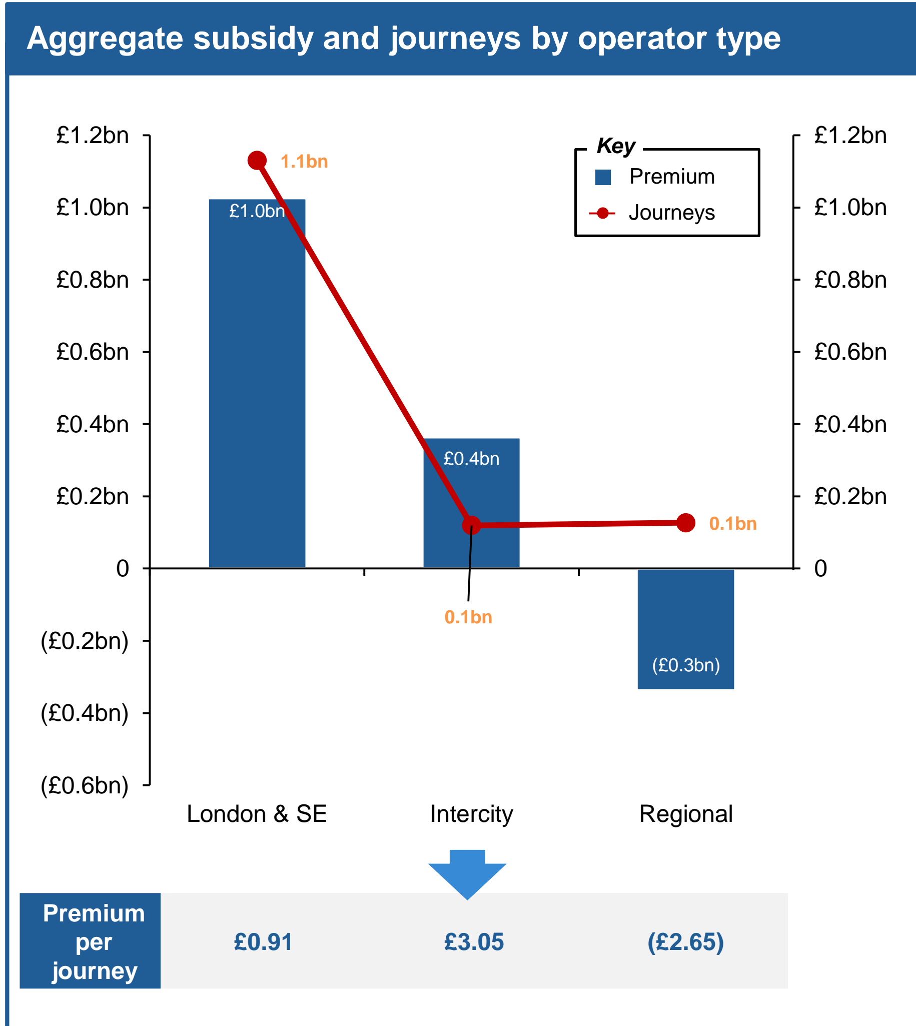


Notes: [2]all figures are in current prices (i.e including inflation)

Notes: Excludes ScotRail, London Overground, and Merseyrail

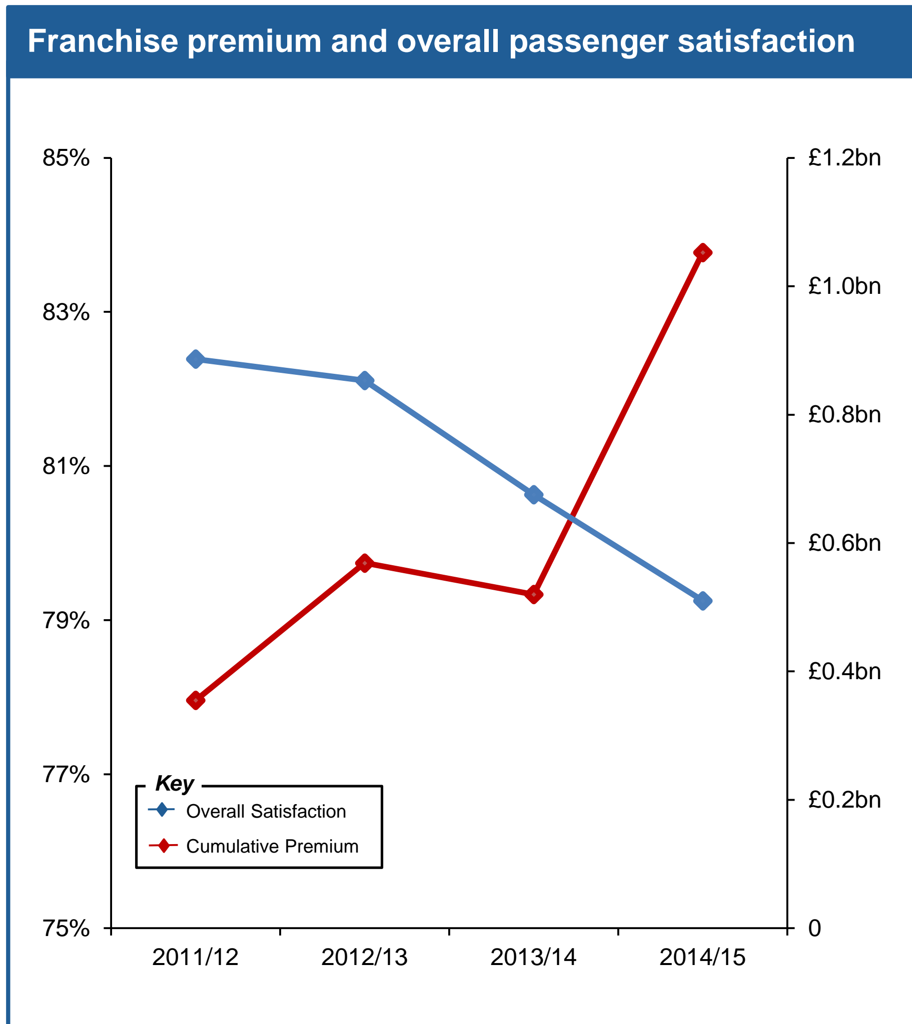
11 of the 16 franchises in England and Wales paid a premium in 2014/15, with Intercity Operators contributing an average premium of £3.05 per journey





Notes: Excludes ScotRail, London Overground, and Merseyrail

This increase in premium has coincided with a marked decrease in customer satisfaction and public confidence in the railway



Commentary on satisfaction

- Passenger satisfaction has declined significantly over the last three years, as can be seen by National Passenger Survey data to the left
- Market commentary appears to be aligned around the underlying drivers of deteriorating passenger satisfaction: fare increases, low levels of trust, and increasing expectations around service reliability
  - *"Rail passengers' satisfaction is driven by getting trains on time. Many are being let down – fare increases, billions in government investment, and promises of improvement don't seem to be delivering change on the ground."*

    Chief Executive of Passenger Focus (Jan 15)
  - *"Customers do not currently feel that TOCs are 'on their side', acting with their interests at heart."*

    Passengers' relationship with the rail industry, Passenger Focus (Aug 14)
- Another feature of declining passenger satisfaction is the poor performance of London and the South East, where value for money concerns are more pronounced than in the rest of the country
  - *"Travellers in London and the South East remain most frustrated with their trains, with less than half thinking tickets are value for money, and just one in three impressed with how delays were handled."*

    Rail misery hits five year high, The Telegraph (Jan 15)
  - 40% of passengers were satisfied with value for money in the NPS Spring 2015 survey, compared to satisfaction rates of 59% for long-distance Train Operating Companies (TOCs) and 58% for regional TOCs

Declining satisfaction is driven by service reliability and value for money, with the south east the most dissatisfied region

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Passenger demand is forecast to continue to grow in real terms over the next 5 years. Credo has modelled three scenarios which reflect this continued growth

All real terms annual growth figures

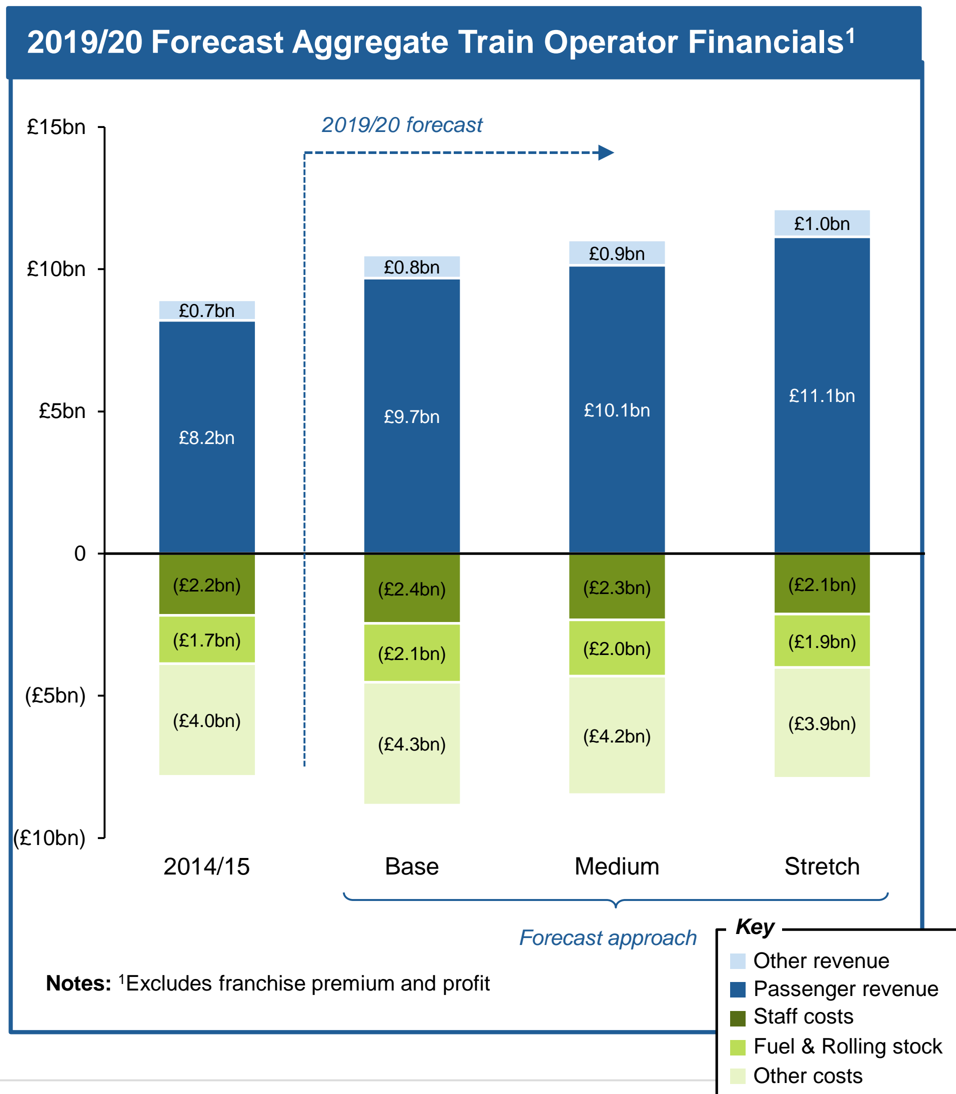
Area	Base Case	Medium Case	Stretch Case	Past performance
Commentary	• A stable and continued growth in demand with some cost inflation, intended to reflect the “comparator” cases published in recent franchise ‘Invitation to Tenders’	• A continuation of recent trends, with steady underlying growth maintained by the continued economic recovery, intended to reflect the recent performance of the railway	• A market driven case informed by recent successful franchise bids, which have seen bidders anticipate an acceleration of passenger growth combined with tighter management of costs	• Past data on rail operators’ financial performance to provide context for the three cases
Passenger revenue growth	• 3% p.a. for commuter TOCs • 4% p.a. for intercity TOCs • 5% p.a. for regional TOCs	• 4% p.a. for commuter TOCs • 5% p.a. for intercity TOCs • 5% p.a. for regional TOCs	• 6% p.a. for commuter TOCs • 7% p.a. for intercity TOCs • 7% p.a. regional TOCs	• Range of 5 year rolling average for real annual revenue growth[1] • Commuter: 2.1% → 6.3% • Intercity: 4.0% → 5.3% • Regional: 4.1% → 5.0%
Other revenue	• 2% increase p.a.	• 4% increase p.a.	• 6% increase p.a.	• n/a
Staff cost growth	• 3% p.a. - commuter TOCs • 3% p.a. - intercity TOCs • 1% p.a. - regional TOCs	• 2% p.a. - commuter TOCs • 2% p.a. - intercity TOCs • No change for regional TOCs	• (1%) p.a. - commuter TOCs • 1% p.a. - intercity TOCs • No change - regional TOCs	• 1-3% real increase from 11/12 to 13/14
Fuel & Rolling Stock	• 4% increase p.a. to reflect continued investment in rolling stock	• 3% increase p.a. to reflect continued investment in rolling stock offset be some efficiency	• 2% increase p.a. to reflect continued investment in rolling stock offset be some efficiency	• Material variation by TOC from 11/12 to 13/14 • 0% real increase (intercity) → 11% real increase (commuter)
Other Costs	• Between 2 and 3% increase per annum	• Between 1 and 2% increase per annum	• Between -1% and 1% increase per annum	• From 11/12 to 13/14, real change p.a.: • Commuter: (1.1%); Intercity: 6.5%; Regional: 5.0%
Summary	• We anticipate that this is a “do nothing” scenario which may be consistent with DfT and Treasury modelling	• We anticipate that this “upside” scenario may be more optimistic than DfT and Treasury modelling	• We anticipate that this may become an “outturn” scenario which operators believe they can deliver with the proposed network improvements	

Notes: [1]The stretch case forecast is not inconsistent with historical trends when they are adjusted for differences in GDP growth

CREDO

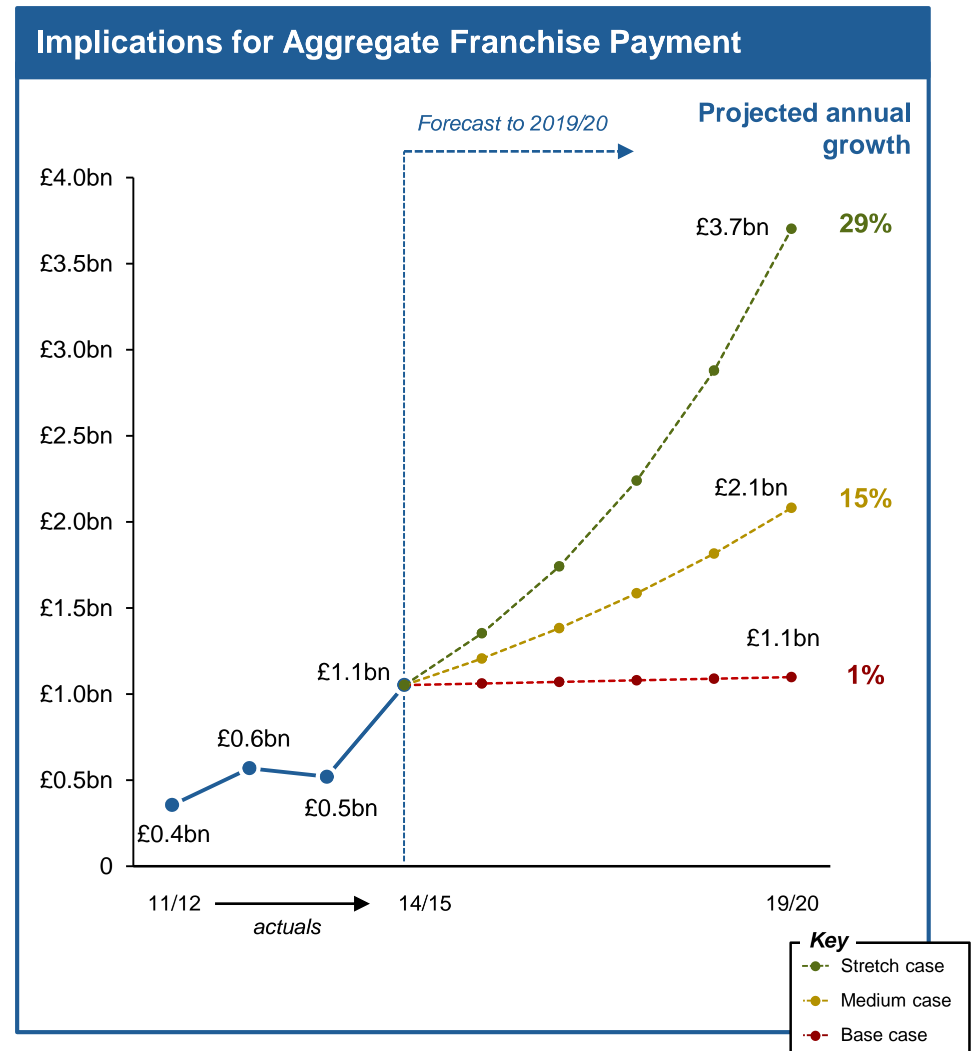
As a result of these increases, we forecast a stretch case that could see franchise payments rise to over £3.5bn p.a. in 2019/20 – £2.6bn more than today

2019/20 Forecast Aggregate Train Operator Financials[1]

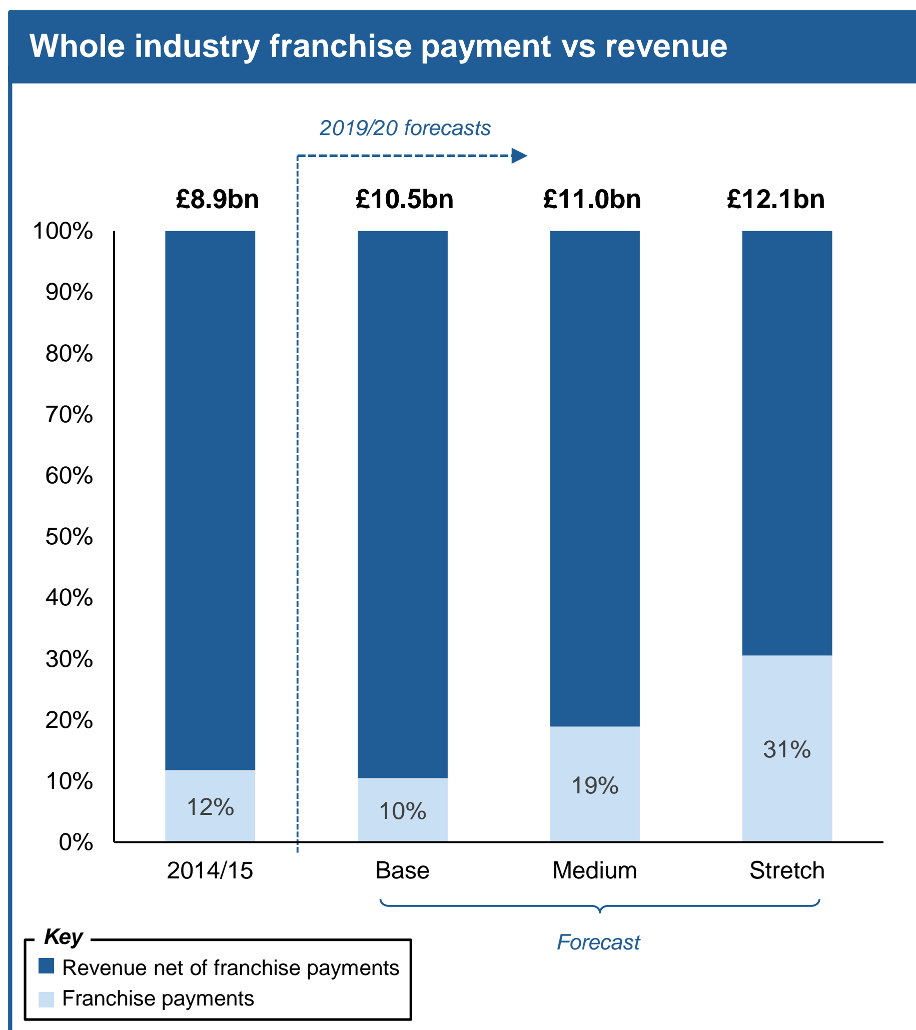


Notes: [1]Excludes franchise premium and profit

Implications for Aggregate Franchise Payment



In the stretch case, this results in a third of Train Operator revenue being given to the Government…



Increasing franchise payments

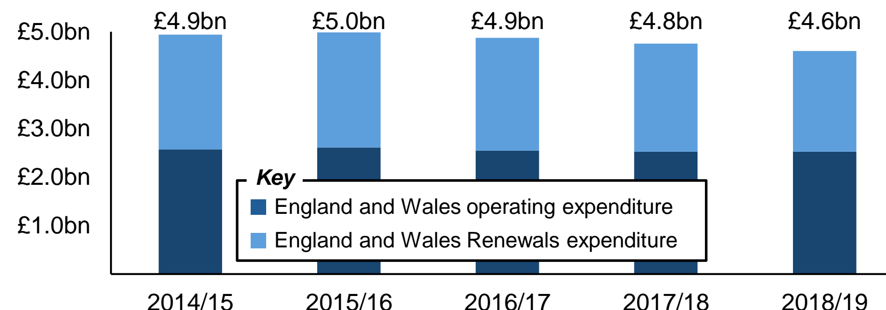
- Real franchise payments are increasing in the medium and stretch cases faster than overall revenue growth
  - The nature of the cost base of the railway – where a significant proportion of costs are fixed – mean that the majority of this incremental revenue will flow through to new surplus for the industry.
  - The structure of the franchise bid process means that Operators will commit to transfer the majority of this surplus to the Government
- Currently c.12% of industry revenue is paid back to the government via premiums
  - By 2019/20, this could increase to almost 20% in the medium case and over 30% in the stretch case.
- In this stretch case, this would mean that over 30p in every pound received by rail operators was transferred to the Government as premium. This would be 6 – 7 times the profit margins made by the operators of the service.

…which could mean that the railway returns an overall profit to the UK government by 2019/20[1]

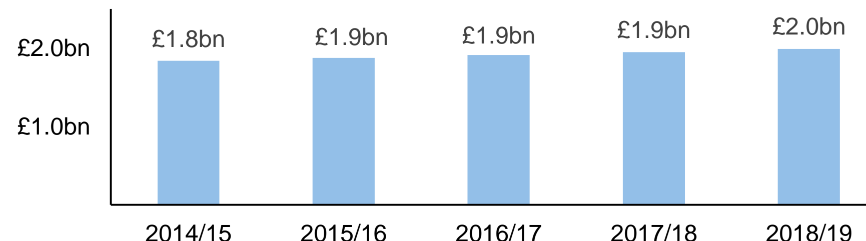
Moving from deficit to surplus

- The majority of public funding for the rail network in the UK is provided to Network Rail. The Office of Rail and Road (ORR) has determined Network Rail's revenue requirement through to 2018/19 through its settlement for the current Control Period (CP5).
- Based on the amount of work which is required to maintain and "renew" the rail network during CP5, the ORR have identified a cumulative funding requirement[1] of £24.2bn (excluding enhancements), across operating expenditure(£12.8bn) and renewals (£11.4bn)
- Train Operators in England and Wales currently contribute c.£1.8bn per annum to Network Rail through access charges, performance costs and other payments for use of the infrastructure, and we assume a modest increase during CP5 (generating a cumulative contribution of c.£9.6bn)
- The remaining funding requirement (c.£14.6bn) needs to be met from public sources – although some of this can be funded from the premium which the DfT receives from train operators
- We forecast that in the "base case" scenario, the railway would still require a public funding contribution of £2.6bn by 2018/19 to cover this operating and renewal cost.
- However, if franchise premiums are greater than this base case, so the public funding requirement falls.
  - The **medium case** scenario shows a £0.8bn deficit in 2018/19 – equivalent to a 60% reduction on current subsidy levels
  - The **stretch case** shows the railway in surplus by 2018/19, generating c.£0.3bn for the government – a material turnaround from the £2.1bn modelled subsidy in 2015/16

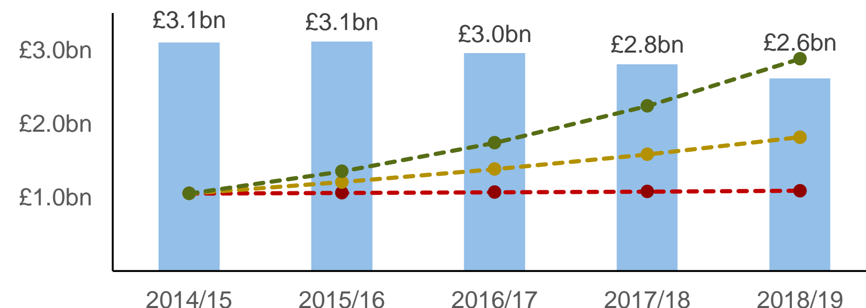
Comparison of Network Rail Funding Requirement



England and Wales modelled TOC access charges[1]



Net funding position[1], CP5



CREDO

Notes: [1]14-15 prices, estimated
Source: ORR Periodic Review 2013: Final determination

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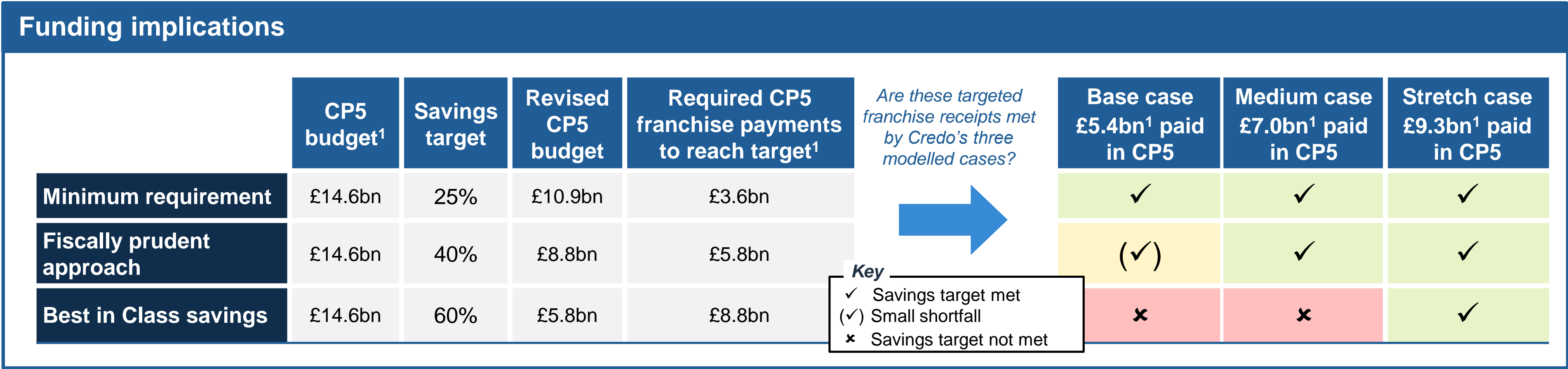
The Treasury has asked each government department to set out a budget identifying at least 25% savings in real terms by 2019/20

The Comprehensive Spending Review

- As part of the government's 2015 Spending Review, HM Treasury requires that each government department identifies material savings over the coming parliament
  - *"HM Treasury is inviting government departments to set out plans for reductions to their Resource budgets. In line with the approach taken in 2010, HM Treasury is asking departments to model two scenarios, of 25% and 40% savings in real terms, by 2019-20"*

A country that lives within its means; Spending Review 2015

- It is not clear that Network Rail's funding will be covered by the corporate spending review, but were the DfT to meet savings targets, it would follow that the actual outturn spending in CP5[1] would need to be between £3.6bn and £5.8bn lower than is currently anticipated. Assuming that this saving needed to be achieved across maintenance and enhancement work, then a 25% saving would imply £10.9bn of public funding in CP5.
- If this is to be delivered without a corresponding loss in output, then there may be a view that this had to be covered through service reductions or increases in fares. However, our analysis shows that the forecast increase in franchise premium will be sufficient to cover a 25% reduction in public funding – even in a likely base case.
- Assuming that the railway does indeed continue to grow and franchise premium continue to increase as a result, so there will be a greater surplus which could either be used fund further potential reductions in the Network Rail settlement.
  - However, they also provide an opportunity to fund initiatives to make the rail network more affordable and accessible for passengers


Funding implications

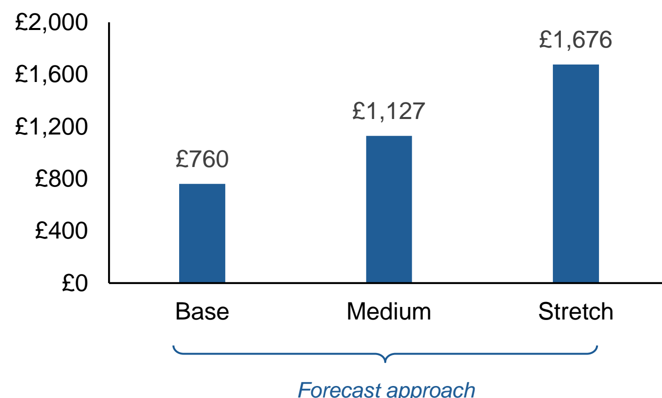
	CP5 budget[1]	Savings target	Revised CP5 budget	Required CP5 franchise payments to reach target[1]	Base case £5.4bn[1] paid in CP5	Medium case £7.0bn[1] paid in CP5	Stretch case £9.3bn[1] paid in CP5
Minimum requirement	£14.6bn	25%	£10.9bn	£3.6bn	✓	✓	✓
Fiscally prudent approach	£14.6bn	40%	£8.8bn	£5.8bn	(✓)	✓	✓
Best in Class savings	£14.6bn	60%	£5.8bn	£8.8bn	×	×	✓

Notes: [1]Including renewal capex but excluding enhancement
[2]Expressed in 14-15 prices

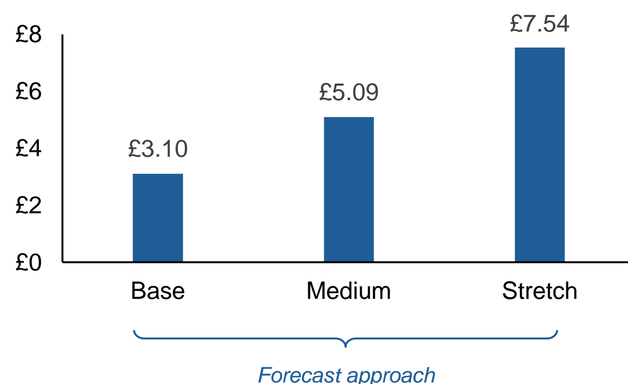
Source: Spending review 2015; ORR Periodic Review 2013: Final determination

This continued growth in premium payments will impose a significant "rail tax" on customers

19/20 forecast premium per season ticket; Commuter TOCs



19/20 forecast premium per journey; Intercity TOCs



The "Rail tax" on passengers

- From projections of revenue and passenger growth, it is possible to determine the future premium per season ticket for Commuter TOCs
  - In effect, this is the average money transfer between each commuter season ticket holder and the government
  - For a commuter earning c.£50k gross annually, this could be equivalent to an incremental 2-5% income tax per annum by 19/20 – which in turn could make the railway unaffordable to many, limiting access to jobs and hindering the economic recovery
- For intercity TOCs, where season tickets are less common, a more relevant calculation is average premium paid per journey
  - Again, this shows the average amount charged for each ticket that is a direct transfer from the passenger to the government and suggests that there could be an effective tax of £7.50 per journey by 2019/20
- As satisfaction with value for money is already one of the lowest scoring categories in the National Passenger Survey, it is worth exploring the potential impact on passenger satisfaction of this shift in rail funding
  - We explore this relationship further on the following slide

The stretch case could result in payments from season tickets to the government equivalent to an income tax of up to 5% by 2019/20

Notes: [1]That purchase a season ticket on a commuter TOC
Source: Credo analysis

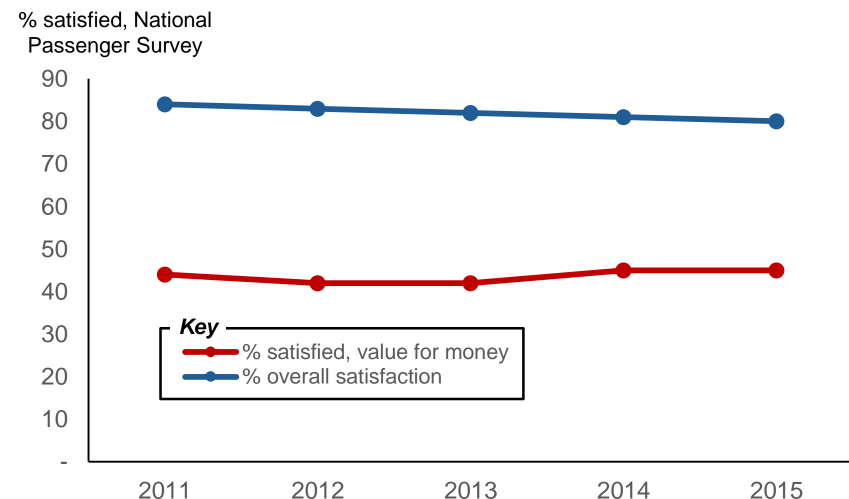
This increasing ‘rail tax’ may be resented if it is not reinvested in passenger facing initiatives

Opportunities for using additional DfT funds

- Despite the recent growth in usage of the rail network, passenger satisfaction has been declining. One area of poor performance is value for money of the rail network, where lass than half of passengers are satisfied
- As the cost of rail travel increases, so does the risk that the network will become unaffordable – especially for lower paid workers in peak times
- Stakeholders have identified this as a risk, and there has been considerable debate around competing policy objectives:
  - The DfT has identified some key policy objectives in its fares and ticketing review which were intended to reduce the impact of fare increases on passengers
  - There has also been considerable debate about the level of absolute fare increases, both in terms of the level of real increases and the appropriate inflation benchmark.
  - Other transport bodies – most notably TfL – have extended free travel for children to make the network more affordable for families
- There has been a shift in fares policy from RPI+1 to RPI+0 until 19/20
  - However, previous work by Credo for the CBT has suggests that CPI would be a more appropriate index for fare increases
- Yet concerns about affordability of these initiatives have limited roll out on the National Rail network to date

To avoid further declines in passenger satisfaction, the DfT could reinvest a proportion of any unanticipated surplus

Value for money and overall satisfaction over time



Fares and Ticketing Review; suggested improvements

Reduce impact of fare increases on passengers	• Cap annual fare increases at 2% (from its current 5% maximum) • Improve single leg ticket pricing for long distance off peak travel • Trail more flexible season tickets, especially those that serve commuters travelling fewer than 5 days a week

Source: Rail Fares and Ticketing: Next Steps

Given these risks, the DfT may want to invest some of the incremental funds generated by the railway during CP5 in initiatives that target improved passenger satisfaction

Indicative

The cost of passenger facing initiatives

- Based on our indicative analysis, we estimate that the DfT could use incremental income to underwrite the introduction of four key policy changes to fares and ticketing – changes which may well have a positive business case but which carry too much risk to implement in the current franchise model.
- The total downside cost of this would be less than £1bn – and therefore could be funded in the "medium" case, even allowing for a 40% reduction in rail funding.
- This assumes that these initiatives do not generate any incremental revenue for the industry and are purely abstractive. If they do generate additional funds, this will create additional income for the industry which could then be re-invested in further innovation.

The additional income streams which the Government will receive from the success of the UK Rail Industry can be reinvested to support the transformation of fares and ticketing policy

Potential passenger facing initiatives

Initiative	Description	Estd. cost (in 2019/20)
3-day a week season ticket	• Part time workers are disproportionately penalised by rail fare structures at present, with season tickets offered only on a 7-day-a-week basis • This initiative would offer flexible season tickets, valid across 3 pre-specified days a week • Credo has modelled both the abstractive and revenue generative impact of this initiative	**£200m**
CPI fare increases	• Currently a subset of fares cannot rise by more than RPI until 2020 • Credo has taken a high-level view on the cost of regulating those fare increases at CPI (which should depress regulated fare increases by 0.8 percentage points • This should both reduce ticket prices while increasing use of the railway	**£140m**
Single leg pricing	• Fair single leg off-peak travel is a policy objective which remains unimplemented • Credo has estimated the financial risk posed by such a scheme	**£270m**
Free travel for under 11s	• Transport for London would like to make transport free for under 11s, but current charges exist for 5-10s, which is limiting leisure use of the railway • Credo has therefore modelled the foregone yield by making transport free for all under 11s across England and Wales	**£210m**

Notes: [1]2014-15 prices
Source: Credo analysis

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