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Signals to invest

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Encouraging train operating companies to invest in the physical network

Summary:

This paper explores the possibility of implementing a new mechanism of incentivisation for the private sector train operating companies to undertake some of the commitment to fund rail infrastructure improvements.

The train operating company would be encouraged to invest in the railway, in return for post-franchise payments for a defined period of time following the termination of their arrangement.

The level and length of this payment would be calculated based upon their level of investment, performance, and how long the company had retained the franchise.

Investment by train operators

There has recently been an increased level of debate as to how the structure of the railways operates and the manner in which franchises are provided. Whilst this paper does not look at the franchise mechanism itself it does pose the question as to how we could further incentivise train operating companies (TOCs) to invest in the system on which they operate.

Most franchises in Great Britain are awarded by the Department for Transport (DfT), following an invitation to tender. Companies that tender do so according to a number of service criteria and targets that are outlined by the DfT to be achieved during day-to-day operation.

However, as with most regulated industries the franchise model is not without its flaws. Some companies perform well, others do not. There have been instances of fare increases significantly above the rate of inflation, with questionable service provision and improvements taking place. There is also anecdotal evidence that the confusing terms and conditions and negotiations within the franchise system making performance achievement hard to measure and value hard to judge.

Part of the reason for such occurrences is a reduced willingness to improve an infrastructure asset which the TOC does not own.

As we have seen from the government's recent announcements in the Comprehensive Spending Review, the level of subsidy provided to the companies that operate these franchises is due to fall, and fares rise. This will not please rail users unless service levels continue to improve and investment continues to take place to upgrade Britain's ageing rail network.

The questions once again arise: are franchise companies willing to invest in the network, are they able to invest in the network, and are they willing to make these investments given the current length of the franchise agreements and that they do not receive the full market return for the investment that takes place?

There is a willingness among TOCs to invest in physical assets. Virgin, for example, has bid for the design, build and operate contract for the new Tampa to Orlando high speed line in Florida. Train operators in the UK have invested in station refurbishment, while alternative models (such as "adopt-a-station"

schemes) have been applied to harness alternative resources and community efforts.

Other solutions have been proposed which include lengthening franchises to encourage franchise operators to take a long term view of investment, or privatising the system allowing all decisions to be made on a cost/profit basis with ownership of the asset under private hands. However, privatisation holds the potential for the formation of an uncompetitive monopoly and brings into question how the asset is treated in terms of its national efficiency, importance and strategic value.

Ways in which such investment issues could be alleviated include creating regulatory frameworks which incentivise investment (effectively subsidising the TOC) and extending the term of franchises to extend the period under which a return is made.

As well as the financial issues explored in this paper, there may be other obstacles to bringing private investment into the physical rail network. These include issues of planning law, compulsory purchase mechanisms and regulatory and procurement processes, all of which would impact private sector efforts to build new railway infrastructure. This paper only considers the financial mechanisms by which investments could be encouraged.

Franchise reform

In March 2010 the Association of Train Operating Companies (ATOC) produced a report entitled "Franchise reform and better value for money in rail" with a number of recommendations that it felt would help improve the current franchise system.

Greater flexibility for train companies

- "Too many franchises are over-regulated and micro-managed by the Department for Transport (DfT), which specifies timetables, frequency of trains, rolling stock and even the number of ticket vending machines."

Longer franchises

- "Longer franchises are already used successfully in Britain: the three TOCs with the highest scores on performance and passenger satisfaction today have franchises of 15 years or more."

Award franchises on the basis of quality

- "In line with official advice and overseas practice in rail franchising, we want to see DfT showing more commitment to the principles of best value procurement than appears to be the case at present."

Ensure that operators are financially secure

- "The worst recession since the 1930s has led to revenue growth significantly below projections made in franchise bids. The lack of flexibility inherent to the current franchise model means operators pay the same costs at a time when revenue is falling."

Give train companies greater responsibility for stations, depots and rolling stock

- "The expertise and structure of TOCs, combined with their closeness to the market and to operations, would enable them in many cases to deliver station and rolling stock improvements more quickly and cost-effectively than under current industry arrangements."

Maintain a mix of franchise sizes

- "Retaining a mix of small and large franchises has advantages. Changes in franchise boundaries can be costly and having a number of smaller franchises can help make the UK market more attractive to bidders than a market dominated by larger franchises might otherwise be."

The National Audit Office has also reported upon the rail franchise regimes, in their report entitled "Letting Rail Franchises 2005-2007" released in October 2008. The report generally finds that the rail franchise system has delivered improved services and improved safety levels. However, it also makes recommendations with regards to the following:

Involving decision making bodies

- "The Department should include additional local expertise when negotiating franchises, for example, by making use of short term secondments from relevant PTEs. These secondees would provide local knowledge to support the Department's evaluation of bid options."

Evaluating alternative options in bids

- "In the technical evaluation, the Department should consider taking into account the value for money and affordability of options. This approach would provide bidders with greater incentives to develop options competitively. The number of such options should be limited to avoid an excessive increase in bid costs."

Transparency on financial support for franchises.

- "Information on the overall support, e.g. per passenger mile, that franchise services receive from the taxpayer should be made available. It should take into account additional support including grants paid directly to Network Rail."

Transparency on service quality standards

- "Service quality standards and the results of the train operator's quality audits should be more transparent. In particular, the Department should develop scores, based on existing franchise terms and conditions. The targets and scores should be made publicly available and more intelligible for passengers."

Negotiating for extra capacity

- "The Department should calculate the net incremental revenues that it expects the extra carriages to generate. It should then use this as a target in its commercial negotiations with train operators about contract revenues."

- "Adequate staffing is important given the strategic importance of rail franchising and the potential to reduce direct subsidies. The Department

has difficulty in recruiting and retaining experienced and skilled staff particularly in its Rail Service Delivery Directorate."

The Post Franchise Payment Mechanism

The following is a theoretical model which could be used to encourage TOCs to increase their investment in the physical infrastructure whilst maintaining the ownership of the asset under network rail.

The Post Franchise Payment Mechanism (PFPM) is untested and it would be necessary for further feasibility studies to takes place, with a view to a trial before widespread implementation.

How the model would work

Under this model, TOCs would be encouraged to invest via a payback mechanism which operated like a parachute payment or pension scheme.

The TOC would be encouraged to invest in the railway, in return for post-franchise payments for a defined period of time following the termination of their arrangement.

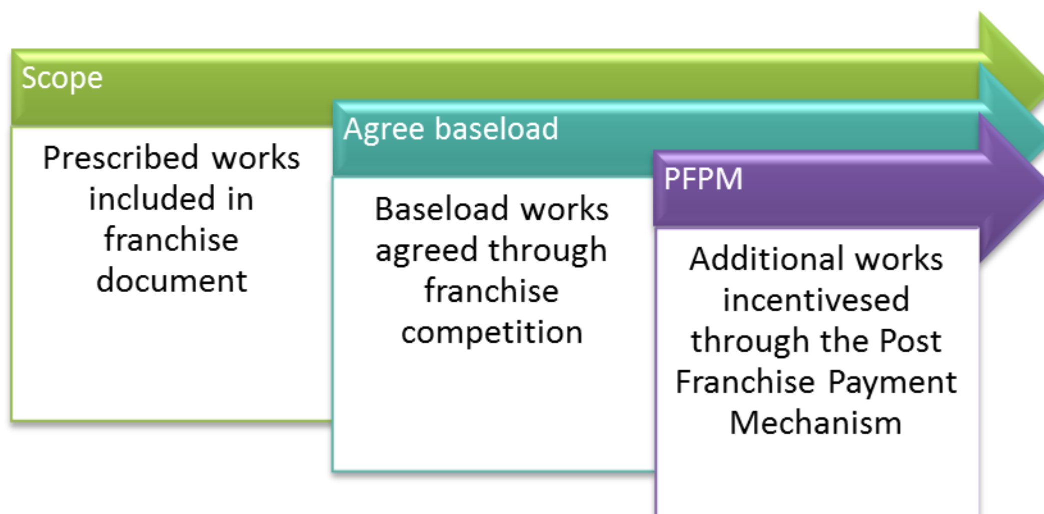
The level and length of this payment would be calculated based upon their level of investment, performance, and how long the TOC has operated the franchise.

Differentiating investment types

The rail network requires two types of investment, that which maintains the system and its safety with limited commercial value (until the point of failure), and that of improvement works.

The model we are proposing in this paper, works on the basis of guiding investment according to its revenue and performance potential. For this reason any project which potentially improves performance and/or revenue could possibly be considered part of the scheme.

It is for this reason that a 'baseload' of works required to maintain the operation of the railway (put forward by Network rail) should be included within the franchise after approval from DFT.



Works in addition to this can then be opened up to the mechanism suggested in this paper to promote investment.

How would such a system work?

When a TOC invests in the rail network, the regulator would agree under the scheme to pay a percentage (e.g. 10%) of the investment cost back to the company annually for the defined period of years (e.g. 4 years) following the termination of their franchise.

Using the example figures provided above, a train operator that invested £1bn in the electrification of the railways would then receive a payment each year for 4 years of £100m following the termination of their franchise.

Effectively the company is paying funds for improvements to the system which would otherwise have been government funded in their entirety, to improve their own revenues and performance. As an added incentive, a percentage of the initial investment costs are recovered following the termination of the franchise (in our example £400m or 40%).

Building flexibility and incentives into the PFPM

The period of time over which companies receive these payments following the termination of their franchise would be based upon the number of years they had successfully operated and reapplied, alongside the quality of the service they provide.

For example if you had successfully retendered and been re-awarded the franchise the company could be awarded an additional year of payments for the investments undertaken during their franchise. This effectively raises the level of capital the government provides towards a project) and hence incentivising investment.

Additional performance could also be incentivised with the top 3 performing TOCs could also have an additional year added annually. For example performance indicators that could be used include:

- Financial robustness – fares, costs, stress testing
- Service quality - delays, satisfaction, congestion
- Growth – revenue, journey
- Cost efficiency – investment types, procurement, administration
- Investment – stations, carriages, interiors

To limit the liability of the public sector it is suggested that such payments cannot rise above 75% of the cost of providing the infrastructure. This means that even in the best case scenario 25% of the cost of provision would always be met by the private sector.

The investment cycle

For such an incentive system to work it must consider the nature of the investment required on the rail network and the manner in which these investment commitments can be transferred from one TOC to another in the event of a loss of franchise.

For such a system to work there would need to be a clear understanding of:

- Those investments which are considered strategic for the network; and
- Investments that the TOCs could undertake given their own investment preferences and the financial conditions at that point in time.

The importance of making such a distinction is clear when franchises change hands. Investment projects could be transferred between parties and the subsequent payments adjusted to reflect the value of the work completed to date. However, it would need to be part of franchise agreements that any work undertaken that was seen as strategic to the railway is continued to completion. On the other hand, projects that were at the discretion of the TOC could be re-

evaluated and the funds redirected if the incoming TOC feels that alternative actions would be more effective.

Currently there is little incentive for investment to take place towards the end of a franchise period, and although the mechanism proposed in this paper would not fully address this issue it does improve the level of reward associated with a company having their franchise renewed.

Advantages of the mechanism:

- It would encourage companies to invest in the railway because they continue to receive some benefit of their investment once the franchise had ended;
- Companies would be incentivised to earn additional years of payment, and increase the level of post franchise payments by investing in physical assets;
- The mechanism would help to shift a significant amount of the responsibility and funding requirements onto the private sector;
- The mechanism would help to reduce the administration requirements that network rail has to undertake helping it meet its efficiency and cost saving targets; and
- The post franchise payments mechanism would support the exiting company meeting the costs of the tendering process.

Potential risks:

- The most important issue here is that of analysing in detail the cost of such a scheme. There would need to be detailed studies on how the post franchise payments were funded (would this be out of the current franchise fee or using ring fenced funds at the time of investment); and
- The scheme needs to incentivise the right forms of investment in relation to the railway and franchise that is being operated. For this reason the scheme would need to be flexible enough to deal with such eventualities, but in doing so may become complex and time consuming to administer.

Funding the PFPM

Funding for the PFPM would need to be secure for it to be successful. It is only by ensuring that companies have confidence in the scheme and its ability to pay

out the necessary contributions, that the private sector will be able to approach investors with confidence.

Currently the whole cost of the project would be undertaken by central government, so it is proposed that following a detailed plan of the investment works to be completed and approval for entry into the PFPM scheme, that the government set aside the funds to cover 75% of the cost of the improvements (the maximum amount that the TOC would be entitled to reclaim) into a trust.

These funds are locked into the scheme until the contribution is determined. If less than the 75% is claimed, the funds can be reassigned to other investment schemes.

In this case, the net result would be a saving to the taxpayer of 25% on what would normally be invested by the public sector. In practice, it would be unlikely that the full 75% would be reclaimable by the TOC. Therefore, the saving to the public sector would likely be even greater.

Applying the model

A top 3 performing TOC

For a TOC that is performing well, the Post Franchise Payments Mechanism would provide a number of post franchise payments in excess of that which would have be achieved if investment were to occur at a rate under which service quality remained constant.

The likelihood is that the company will retain its franchise for a number of years and so build up a number of investments under the scheme that would pay the maximum public contribution in terms of the payments they receive following the franchise termination. Under this model, the TOC would receive 75% of their investment costs.

An averagely-performing TOC

An averagely performing TOC would also receive payments under the scheme but is unlikely to be in the top 3 performers and so will be unable to receive additional years in this way. However, they can still earn such payments by retendering and successfully winning another term. This could raise their post franchise incentive payments from 40% up to the maximum proposed 75% over a number of years (10% increase for each successful re-tender).

This incentivises the franchise to invest over the longer term, with performance improvements and on-going projects being looked at favourably by the regulators, providing they can demonstrate that these will lead to service improvements.

In the event they lose the franchise, the payment mechanism would provide them with 40% of the cost of investment under our model and the new franchise operator would benefit from the investment made.

A poorly performing TOC

TOCs that are performing poorly would be unlikely to be reappointed, ruling out the possibility of increasing their payments post-franchise.

They would still receive repayments worth 40% of investments post-franchise, which would support the company in winding down, restructuring, or in applying for new franchises. In this case the government has still benefited from having to only pay 40% of the infrastructure costs, compared to the 60% contribution from the private sector.

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