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Towards public ownership

TUC Summary Analysis: based on research by Transport for Quality of Life for the Action for Rail campaign

Introduction

This TUC Summary Analysis is based on research by Transport for Quality of Life for the TUC/rail unions' Action for Rail campaign.

Over the next five years 11 rail franchises will come up for renewal: Northern, Transpennine, Greater Anglia, West Coast, London Midland, East Midlands, South Eastern, Wales and the Borders, Great Western, South Western and Cross Country.

This analysis considers in turn the different types of savings from running these franchises under a single publicly owned railway company.

Section 1: Franchises up for renewal 2015/16 – 2019/20 and savings

Over the next five years 11 rail franchises will come up for renewal. The following types of savings directly derive from cutting out the administrative costs of the franchising process itself:

- **Savings in DfT internal staff and administration costs** from not running franchise competitions. These costs were put by the National Audit Office¹ at approximately **£3m per year**. During the next five years² removing these costs would amount to **£9m total savings**.
- **Savings in DfT contractor costs** from not running franchise competitions. These were put by the National Audit Office³ at **£2.5m per franchise competition**. During the next five years⁴ removing these costs would amount to **£20m total savings**.
- **Savings from train operating company (TOC) bidding costs** that otherwise would be added to their cost base, and therefore the railway cost base. These are about **£40m per franchise competition**. During the next five years⁵ removing these costs would amount to **£320m total savings**.

The Association of Train Operating Companies (ATOC) highlighted the costs that the bidding process add to the system in a document in which it recommended a 50 per cent cut in the number of franchise competitions: 'In the longer term, by halving the number of franchise competitions run, total bidders' costs of about £15-20m per franchise let (which inevitably have to be

1 National Audit Office 2008 The Department of Transport: Letting rail franchises p.13 Table 6, 2007/8 DfT staff and administration cost of specifying and procuring franchises was £2.957m

2 No saving is presumed for the three franchise competitions that will be underway by the time the next government takes office.

3 National Audit Office 2008 op. cit. p.14 Table 7

4 No saving is presumed for franchise competitions already underway.

5 No saving is presumed for franchise competitions already underway.

factored into future bid costs) would be saved'.⁶ Subsequent to this document, ATOC's estimate of the total cost of bidding for a franchise (which it has a vested interest in claiming is modest) has been shown to be unrealistically low, at least for the largest franchises. The failure of the West Coast franchise process in 2012 appears to have cost the DfT £55m⁷ in reimbursement of bidders' costs. Train companies who were bidding for the Great Western franchise when the DfT cancelled it in 2013 complained their combined costs totalled £40m⁸ (although in this case, it appears that these companies were not reimbursed, because the invitation to tender included a clause allowing for cancellation of the competition).

The next five years corresponds to a backlog in franchise awards, so the saving from not running franchise competitions during this period is large. Table 1 provides a calendar of when franchises are set to expire and savings can be achieved. It shows that by May 2020 there could be **£349m total saving**.

Table 1: One-off savings from removing the direct costs of letting and bidding for franchises, showing when these become available⁹

Financial Year	Franchises expiring	DfT internal saving (£m)	DfT contractor saving (£m)	System saving of TOC costs (£m)	Running total of savings (£m)
2015/16	Northern, Transpennine	0.0	0.0	0.0	0.0
2016/17	Greater Anglia	0.0	0.0	0.0	0.0
2017/18	West Coast, London Midland, East Midlands	3.0	7.5	120.0	130.5
2018/19	South Eastern, Wales & Borders, Great Western	3.0	7.5	120.0	261.0
2019/20	South Western, Cross Country	3.0	5.0	80.0	349.0

⁶ Association of Train Operating Companies 2010 Franchise reform and better value for money in rail p.7

⁷ Daily Telegraph 2014 Rail franchise turmoil looms 20.04.2014

⁸ Daily Telegraph 2013 Train firms furious over £40m wasted on Great Western rail franchise bid costs 31.01.2013

⁹ No saving is presumed for the three franchise competitions that will be underway by the time the next government takes office.

Beyond May 2020, savings would average **£66.75m per year**¹⁰, as compared with a ‘business as usual’ scenario in which there were on average 1.5 franchise awards per year¹¹.

By running these franchises in the public sector, further savings would also become available through capturing the previous profit leakage to shareholders of train operating companies¹². It is reasonable to assume that a publicly owned train operator taking over the operation on a like-for-like basis will inherit the same cost base and revenue base and so will be able to pay the same level of dividends¹³ that was paid out to the TOC shareholder, but instead pay it to the government as its sole shareholder.

Table 2 provides a calendar of when each franchise is set to become available for take-over with a running total of the increasing amount of annual dividend income that will become available to government. It shows that by May 2020 there could be an ongoing annual saving of **£154m per year**.

Table 2: Annual dividend income available from reclaiming franchises as they expire

Financial Year	Franchises expiring	Annual dividend income ¹⁴ of expiring franchises (£ millions per year)	Cumulative ongoing savings becoming available (£ millions per year)
2015/16	Northern, Transpennine	53	53
2016/17	Greater Anglia	13	66
2017/18	West Coast, London Midland, East Midlands	45	111
2018/19	South Eastern, Wales & Borders, Great Western	25	136
2019/20	South Western, Cross Country	18	154

In practice there is potential to reduce the cost base through combining operations within a single national operator, which enables removal of duplicate functions - further illustrating the benefits of re-integrating the railway.

10 This figure comprises £60m per year of saved TOC bidding costs, £3.75m per year of saved DfT contractor costs, and £3m per year in DfT saved internal staff costs.

11 This average considers just the number of franchises let by DfT.

12 The following analysis draws on the latest seven years of accounts for the train operating companies, using the FAME database.

13 This number is the same as the declared net profits: the FAME database data shows that, averaged over a number of years, all net profits are paid out by TOCs as dividends.

14 Seven year average from FAME data.

Section 2: Eliminating wastage through integration

Savings are available both from integration of train operations (and replacement of a proportion of TOC subcontractors by in-house capacity) and from integration of infrastructure management (and replacement of some infrastructure subcontractors with in-house capacity). The discussion below considers these types of savings in order.

- **De-duplication of TOC senior management**

Functions that are presently duplicated in multiple train operating companies can be combined and reduced as successive companies are rolled into the public operator. To be conservative Transport for Quality of Life has assumed in their calculations that there are no savings to be made by combining functions directly concerned with operating trains. However, the senior management teams of private train operating companies will become surplus to requirements as TOCs come into a single command structure. This cost can be saved completely since a senior management team can cover a larger company. Transport for Quality of Life estimates the resulting saving from published directoral salaries, adding an allowance for the cost of other senior management staff.

- **De-duplication of TOC marketing**

There is duplication of marketing functions across TOCs. Although a larger train operator covering more routes would merit a larger marketing budget, there is scope to remove duplicate web sites and ticket sales mechanisms and run the marketing operation from a single department. Train companies do not make their marketing spend known, so Transport for Quality of Life calculates potential savings on the conservative assumption that marketing functions are only 1 per cent of sales and that just one quarter of that is unnecessary duplication.

Table 3 shows the size of savings from removing TOC duplicate functions and when they can be achieved. It shows that by May 2020 there would be an ongoing annual saving of **£37.6m per year**.

Table 3: Annual savings available from de-duplicating functions repeated in separate train operators¹⁵

Financial Year	Franchises expiring	Spend on duplicated management (£m per yr)	Running total management saving (£m per yr)	Spend on duplicated marketing (£m per yr)	Running total marketing saving (£m per yr)
2015/16	Northern, Transpennine	4.2	4.2	2.3	2.3
2016/17	Greater Anglia	2.1	6.3	1.7	4.0
2017/18	West Coast, London Midland, East Midlands	5.1	11.4	4.1	8.1
2018/19	South Eastern, Wales & Borders, Great Western	5.8	17.2	5.3	13.4
2019/20	South Western, Cross Country	3.4	20.6	3.5	17.0

London Overground, Merseyrail¹⁶ and Scotrail¹⁷ franchises are excluded from the calculations because responsibility for letting these franchises is devolved, so achieving these savings is not directly within the control of the Department of Transport.¹⁸

- **Reduction of profit leakage through TOC subcontractors**

Another source of savings is profit leakage from private subcontractors that work for train operating companies. This has been estimated at £76m per year.¹⁹ It would not be possible for a re-integrated public rail operator to instantly recapture the profits made by these subcontractors. However, over a period of years it is reasonable to assume that a proportion of these service company functions could be brought in house (which might bring economies of scale as well as capturing dividend payments to shareholders). A

¹⁵ Management de-duplication savings are based on FAME data for directoral remuneration for the franchises in question, plus £1m p.a. to cover other senior staff that transfer when franchises change hands. No additional savings have been added to allow for the lower level of senior salaries in the public sector than in private sector companies, although some further saving probably could be obtained in this regard. Marketing de-duplication savings are based on a saving of 0.25 per cent of sales (taken as turnover) on a presumed marketing spend of 1 per cent of sales.

¹⁶ Merseyrail franchise is due to run until 2028.

¹⁷ A new Scotrail franchise has been contracted by Transport Scotland to start in April 2015.

¹⁸ Chiltern Railways has also been excluded, because this franchise does not terminate until Dec 2021. However, continually escalating premium payments are due to Government under the franchise agreement and although the company has made a small profit in the latest accounting year it has suffered much larger losses in each of the previous five years. Experience of similar circumstances with other franchises indicates that the company may choose to return the franchise to the Government before term even if this were to incur a penalty payment.

¹⁹ Just Economics 2011 A fare return: ensuring the UK's railways deliver true value for money Report for RMT

conservative estimate would be that by May 2020 a third of these functions could be in house, with an ongoing annual saving of **£25m per year**.

- **Reduction of costs incurred by TOC interfaces**

A potentially larger saving in train operating costs comes from removal of friction at interfaces. The McNulty Rail Value for Money Study²⁰ estimated that the costs of interfaces to train operating companies could be 5 per cent of their costs, which Rebuilding Rail calculated as £290m per year.

An example of interface costs is ‘delay attribution’, which in Britain involves 300-500 staff at Network Rail and the different rail companies arguing about liability for delays and compensation, on the basis of a delay attribution guide 90 pages long.²¹ An academic analysis²² of the UK rail industry after privatisation found real-terms back-room costs of TOCs had risen 83 per cent over the twelve years in question (56 per cent after normalising per train kilometre).

During the transition to a single public rail operator residual interfaces with remaining private operators are liable to have a disproportionate effect, through preventing thorough integration and requiring retention of systems to handle interface issues. On this basis, a cautious estimate is that half of TOC interface costs could be removed during the next five years (even though proportionately more franchises would have been absorbed into the national public operator). This would amount to an ongoing annual saving by May 2020 of **£145m per year**.

Further source of savings arises from bringing together train operations and infrastructure operations within a single public sector railway organisation (See *Rebuilding Rail* report²³ for discussion of how such a company could be constituted) and bringing in house a proportion of infrastructure activities that are presently outsourced.

- **Reduction of interface costs incurred by Network Rail**

There is a cost of friction at interfaces incurred by Network Rail. A benchmarking study²⁴ for Network Rail put interface costs for rail renewals work (between Network Rail, its subcontractors and TOCs) at £70m per year above those of other countries with more integrated structures. This calculation took into account only renewals (i.e. it excluded all maintenance

20 McNulty R 2011 Realising the potential of GB Rail: final independent report of the rail value for money study, detailed report p.91, p.99

21 Oxera 2010 Review of rail cross-industry interfaces, incentives and structures p.9

22 Merkert R (2010) Changes in transaction costs over time – the case of franchised train operating firms in Britain Research in Transportation Economics 29, 52-59

23 Transport for Quality of Life 2012 Rebuilding Rail

<http://www.transportforqualityoflife.com/policyresearch/publictransport/>

24 BSL 2008 Rail infrastructure cost benchmarking p.36

and enhancement works) and considered only the international efficiency ‘gap’²⁵ relative to other railway infrastructure managers. Stripping out interfaces by forming a unified infrastructure and train operating company would benefit maintenance and enhancements as well as renewals work. Transport for Quality of Life therefore considers that, at a conservative estimate, integration could achieve an ongoing annual saving by 2020 of **£70m per year**.

- **Profit leakage through Network Rail subcontractors**

Profit-taking by subcontractors to Network Rail has been estimated at £200m per year for renewals and enhancements.²⁶ This figure appears a modest estimate in light of Network Rail’s levels of capital expenditure on renewals and enhancements, which were £2,760m and £2,046m respectively in 2012/13.²⁷ A cautious view would be that by 2020 Network Rail could bring at least half of its renewals in house and some enhancement projects. By 2019/20 this could result in an ongoing annual saving of **£100m per year**.

The Rail Value for Money Study did not consider radical options to reintegrate the railway, so the savings identified in this section are additional to those that the industry has worked towards since publication of that report’s recommendations.

Section 3: Savings could fund cheaper fares

This section considers how and when the savings identified in this analysis could be used to fund reductions in fares. Some of the types of excess spending due to privatisation can be reclaimed more easily and quickly than others. Transport for Quality of Life has taken a step-by-step approach, calculating the level of savings achievable in each financial year and what must be done to turn those into cash for the Treasury/DfT.

Table 4 tabulates when savings in ongoing annual expenditure will become available.

²⁵ i.e. it assumes that the UK can not do any better than the average international comparator.

²⁶ Jupe R 2009 *New Labour, public-private partnerships and rail transport policy* Economic Affairs 29, 1, pp20-26

²⁷ Office of Rail Regulation 2014 *GB rail industry financial information 2012-13*

Table 4: Savings in ongoing annual costs that will continue indefinitely and could support a fare cut

Item saved	2015/16 £m/yr	2016/17 £m/yr	2017/18 £m/yr	2018/19 £m/yr	2019/20 £m/yr
DfT contractor costs for franchise competitions ²⁸	nil	nil	3.75	3.75	3.75
TOC bidding costs (an indirect gain) ²⁹	nil	nil	22.25	44.50	66.75
Dividends paid to private TOC shareholders	53	66	111	136	154
De-duplication of TOC management & marketing ³⁰	6.5	10.3	19.5	30.5	37.6
Interface 'friction' for TOCs ³¹	nil	10	40	90	145
TOC subcontractor profits (brought in-house) ³²	5	10	15	20	25
Network Rail interface 'friction' ³³	5	5	30	50	70
Dividends paid to Network Rail subcontractors ³⁴	10	20	40	70	100
Totals (rounded)	80	121	282	445	602

28 DfT internal costs are not included since these resources are likely to be needed during this period for activities associated with re-designing railway governance structures. Costs shown are those that represent the stable rate of saving in the long term. Much larger one-off savings arise during 2015/16-2019/20 (see Table 1) due to the forthcoming spate of refranchising, but these are excluded because a sudden fare hike would be required at the end of that period.

29 Savings in TOC bidding costs will be obtained gradually from a publicly owned rail operator that, having taken over franchises without bidding, is able to generate a greater surplus due to not having to recoup bidding costs (TOCs that bid to obtain franchises have to charge to their bidding costs to their companies in some form, so this cost is real, albeit indirect). The figures shown represent a gradual ratcheting up to the average ongoing annual level of competition costs. This could be reclaimed by DfT as a specified portion of the dividend paid to it as owner of the national rail operator.

30 This item would show up as increased surpluses for the unified publicly owned rail operator and therefore could be reclaimed as additional dividend paid to the government as shareholder.

31 This item assumes that half of the total estimated TOC interface costs are eliminated through recombination of TOCs into a unified operator by 2019/20. The saving is ramped up slowly because residual interfaces are liable to have a disproportionate effect through preventing thorough integration and requiring retention of systems to handle interface issues.

32 This presumes one third of private subcontractor services to TOCs are brought in-house by 2019/20. This item would also require to be reclaimed to government as part of an agreed dividend payment schedule.

33 This item presumes that the infrastructure operator progressively removes its subcontractor interfaces for renewals by progressively bringing those in house and also benefits from the removal of TOC interfaces.

34 This item presumes that by 2019/20 Network Rail has achieved half the possible savings in renewals and enhancement by bringing at least half of its renewals in house and some enhancement projects.

Transport for Quality of Life has taken the view that only savings that will continue year after year indefinitely are suitable for earmarking to pay for fare cuts (i.e. fare cuts should be sustainable, not just for one year). Savings on bidding costs are therefore capped at the level at which they will average out in the long term. The calculations in this analysis show that one-off savings during the five years under consideration will exceed this. These could be used for a temporary fare reduction, but only at the expense of a sudden fare rise at a later date. It is the view of Transport for Quality of Life that one-off savings should be used for one-off rail investments in routes, stations or rolling stock. Savings from purchasing direct rather than via rolling stock companies, although potentially large, are not included because these were calculated relative to the probable future rising trajectory for extra expenditure on rolling stock and therefore cannot be seen as savings against the *status quo ante* (which is the case for the other items).

It will be necessary to find a mechanism to ensure that the savings shown become accessible for the Treasury and Department for Transport to use on fare reductions. For items that pertain to the rail operator the simplest mechanism would be to agree a schedule of dividend payments from the public operator to the government as its sole share holder that increases by the sums concerned as it takes over successive franchises and realises savings. For the items that pertain to infrastructure management the government should agree in advance with the integrated rail company that its infrastructure grant will reduce by these amounts.

Fare income for the entire railway in 2012/13 was £7.7bn.³⁵ Applying a £602m annual saving (see Table 4) to all fares would therefore provide a ticket price reduction of 8 per cent. This is very large relative to the latest fare rise of 2.2 per cent that resulted in noisy complaints by passenger groups.³⁶

Furthermore, fare income from regulated fares was £2.7bn.³⁷ Applying a £602m annual saving to only regulated fares would therefore provide a price cut of 22 per cent.

These fare cuts represent the amount that could be funded after a five year programme to rebuild a unified railway. The fare cuts could be sustained in perpetuity because the cost savings that would be funding these figures are sustainable indefinitely. Future price rises in fares therefore would only need to reflect inflationary pressures.

An additional or alternative measure might be to institute family-friendly fares so that children travel free with parents or so that all children travel free. The

35 Office of Rail Regulation 2014 GB rail industry financial information 2012-13 p.13

36 Guardian 2015 David Cameron defends rail fare rises amid concerns over rip-off Britain 02.01.2015

37 Office of Rail Regulation op. cit. Figure 7

House of Commons Library³⁸ have calculated that the minimum cost of a free rail travel for under sixteens would be 0.5 per cent of fare revenue, on the basis that children presently account for 1 per cent of rail journeys and pay half fare, which would amount to a cost of slightly under £40m when applied to present fare revenues. However, this estimate is accompanied by a warning that it takes no account of demand increase as a result of free travel or the costs that will result from increased overcrowding. If the rail company is public rather than private, then it can be argued that the extra demand generated by free fares need not carry an extra cost of reimbursement in the same way as the government has had to reimburse private bus operators for extra bus journeys generated by concessionary free bus travel for retired people. The only actual revenue loss that would require reimbursement to keep rail finances on an even keel would be the loss of present child revenue. But this argument only holds good to the point at which extra demand exacerbates overcrowding and requires extra rolling stock or services, both of which are potentially costly. ‘Elasticities’ of demand to fare prices are well researched^{39,40} and show that cutting fares in half would be expected to cause an increase in rail use of 30-45 per cent, but these studies can not be extended to the case of zero price travel, for which the evidence⁴¹ shows that demand rises can be large and continue to build up over long periods. Full potential costs of a universal ‘all children travel free’ policy are therefore hard to predict. However, overcrowding issues could be alleviated by restricting child concessions to outside peak hours and the increase in patronage could be kept within bounds by choosing a fare reduction rather than totally free travel.

Taking these factors into account, Transport for Quality of Life concludes that a £20m budget would reimburse the railway for lost revenue from cutting present child fares in half (i.e. to quarter fares) and would be expected to cause a rise in total rail trips of under 0.5 per cent, for which overcrowding problems could be minimised by restricting the quarter-fares to off peak. It would also be relatively low risk to set an additional similar budget to implement a family-friendly fares policy under which children can travel free with their parents off-peak, because this is not actually free travel but in effect a cost reduction on

³⁸ House of Commons Library Social and General Statistics Section, 2011, *Free bus and rail travel for young people* SGS1107-234

³⁹ Suburban rail, where commuters may have little choice, has an elasticity of approximately minus 0.6, whereas inter-urban rail has a higher elasticity of minus 0.9 because a higher proportion of travellers can feasibly choose whether to make the journey or whether to make journey by other means. So, for inter-urban rail a 10 per cent fare decrease would be expected to result in 9 per cent increase in rail patronage. These figures are based on studies of adults. The limited data available shows children may be somewhat more price sensitive (i.e. a higher elasticity) which might be expected given that children generally have very restricted financial resources.

⁴⁰ Wardman M and Shires J D 2002 *Review of fares elasticities in Great Britain* Working Paper 573, Institute of Transport Studies, University of Leeds p.6

⁴¹ Fearnley N 2013 *Free fares policies: impact on public transport mode share and other transport policy goals* International Journal of Transportation 1, 1, pp.75-90

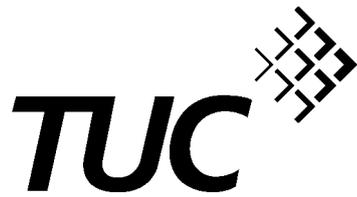
the family fare⁴². This approach would carry the advantage that, in both cases, the extra travel generated by the concessions will generate some compensatory fare revenue from children making more trips and more families travelling.

A possible programme of fare cuts that could be achieved during the next five years, fully funded by ongoing annual savings from rail reform, is shown in Table 5. It should be noted that in order to provide a simple illustration of the level of fare cuts that could be made, the figures have been calculated as if available savings were applied across the whole railway, but in practice that is almost certainly not the most practical or economical approach. It would probably be preferable to apply fare cuts just to the parts of the railway which are being operated by a public operator by the time the price change is introduced. This approach would provide a helpful pilot process to check that the consumer responses match predictions from elasticity theory and would avoid spending some of the savings on reimbursement of the remaining private operators and the administrative costs that process would incur.

Table 5: A timetable of possible fare cuts during the next term of government, fully funded by savings achieved by structural rail reforms as they progress.

Fare cut	2015/16 £m/yr	2016/17 £m/yr	2017/18 £m/yr	2018/19 £m/yr	2019/20 £m/yr
Cash-flow reduction by year end from Table 4	80	121	282	445	602
50% cut in child off-peak fares to ¼-fare	20	20	20	20	20
Free child travel with parents off-peak	20	20	20	20	20
10% cut to regulated fares	-	-	270	270	270
3% cut to all fares	-	-	-	-	230
Remaining annual cash-flow saving	40	81	(38)	135	62

⁴² The cost would also depend on how the reduction would be designed to interact with the present £30 family railcard.



Trades Union Congress
Congress House
Great Russell Street
London WC1B 3LS

www.tuc.org.uk

Sharon Sukhram:
0207 467 1273
ssukhram@tuc.org.uk

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