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The Costs and Benefits of Devolving Responsibility for Rail Services in London

Report for TfL London Rail

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Executive Summary

This report, by NERA Economic Consulting, considers the case for devolving responsibility for rail services in London to Transport for London (TfL). TfL has put forward a compelling case for adopting a different approach for rail services in London, and for being given the powers to provide the leadership that is required in London.

While TfL is responsible for other public transport in London (including London Underground, Docklands Light Railway, bus, tram and riverbus services, as well as managing the congestion charge and London bicycle hire scheme), its role in relation to National Rail services is limited. It lets and manages one rail concession, London Overground, and it will oversee Crossrail services. But the Department for Transport (DfT) lets and manages other rail franchises. TfL's powers are limited to being able to specify (and fund) increments or decrements to DfT's proposed service specifications.

As well as highlighting the rail industry's need for clear leadership, the McNulty review has suggested a possible wider role for train operating companies (TOCs). And DfT has decided that future franchises will be significantly longer and will give TOCs more commercial freedom. Consistent with McNulty's rejection of a "one size fits all" railway, it is not clear that these general proposals are best for London, where a dense system of inner suburban services is currently provided by 10 separate TOCs with different brands, different fares, different marketing material, different commercial strategies and operating to different time horizons. The commercial incentives faced by these TOCs are likely to be weaker than normal, given the relative insensitivity of commuter demand, and in any case there remains a strong need to co-ordinate services in order to make the best use of the congested infrastructure in and around London. Current policy developments therefore strengthen the arguments for adopting a different approach in London.

If TfL had greater powers in relation to London rail services, and responsibility for funding these services under a budget transferred from DfT, it could take measures to improve integration, both between different rail services and with other forms of public transport. TfL could also take on responsibility for marketing and branding, and establish unified fares and ticketing arrangements. Passengers would know what to expect when using rail services in London, which would play a more prominent role in an improved London-wide transport network.

Devolving responsibility for rail services would also allow TfL to implement a number of specific changes. One of these is that TfL would propose a switch to "gross cost" contracts, so that TOCs would no longer bear revenue risk on London rail services. This could free up estimated net savings of around £290 million over 20 years, much of which TfL could invest in bringing rail services and stations in London up to a set of common standards.

A switch to gross cost contracts should also ease the process of implementing such improvements, especially where changes would need to be introduced part way through franchises. TfL estimates the net cost of these improvements to be around £180 million over 20 years, which is reduced to around £130 million by the revenue benefits from extra station gates, yet they will deliver estimated passenger benefits of more than £350 million over the same period. After taking account of the extra marketing and administration that TfL will have to carry out (estimated net cost of £20-30 million over 20 years), the additional costs are still significantly lower than the potential gains from the transfer of revenue risk.

These changes could be implemented, without necessarily redrawing the current franchise map, by giving TfL the lead role (alongside DfT) in procuring and managing franchises for predominantly London TOCs. DfT would still be able to set specifications for longer distance services within these franchises, and TOCs might still bear revenue risk on such services. But for inner London services, bidders would simply specify a cost for providing the services and standards specified by TfL. The interests of longer distance passengers and freight customers would be protected, among other things, by DfT's specification of longer distance services, by the Office of Rail Regulation's role in overseeing the allocation of scarce capacity, and by two non-executive directors of TfL who have specific responsibility for representing the interests of people living, working and studying outside Greater London served by TfL's rail services.

An alternative approach would see the creation of further dedicated concessions, similar to London Overground, providing London services only. TfL would then have sole responsibility for procuring and managing these concessions. While this might cause more disruption initially, because of the need to adjust the franchise map, there would be longer term benefits from avoiding the potential interface problems that might arise in jointly managed franchises (though TfL believes these can be addressed). With a smaller number of dedicated London concessions, TfL might be able to introduce service improvements more quickly and more cost-effectively.

A further possible step, especially if TfL becomes responsible for dedicated London concessions, would be to devolve some responsibility for overseeing infrastructure enhancement projects in London. Recent experience has shown that the benefits from effective sponsorship of projects can lead to savings of 10-30% from adjusting the scope of the project to optimise value for money, and 5-20% from identifying areas where the specification can be reduced without a significant reduction in the benefits from the project.

1. Context

This report, by NERA Economic Consulting, considers the case for devolving responsibility for rail services in London to Transport for London (TfL). There are a number of different ways this could be achieved. We therefore highlight some of the key changes that TfL could introduce, if given greater responsibility for rail services in and around London.

1.1. Public Transport in London

Many cities, both in the UK and around the world, have local bodies with responsibility for a full range of public transport services in and around the city. This is almost the case in London, following the creation of TfL in 2000 as the integrated body responsible for London's transport system. Its main role is to implement the Mayor's Transport Strategy for London (see box) and manage transport services across London for which the Mayor has responsibility.

The Mayor's Transport Strategy for London

The Mayor's Transport Strategy, published in May 2010, adopts a vision that:

"*London's transport system should excel among those of world cities, providing access to opportunities for all its people and enterprises, achieving the highest environmental standards and leading the world in its approach to tackling urban transport challenges of the 21st century*".

It sets out six objectives for implementing this vision - that the strategy should:

- support economic development and population growth;
- enhance the quality of life for all Londoners;
- improve the safety and security of all Londoners;
- improve transport opportunities for all Londoners;
- reduce transport's contribution to climate change and improve its resilience; and
- support delivery of the London 2012 Olympic and Paralympic Games and its legacy.

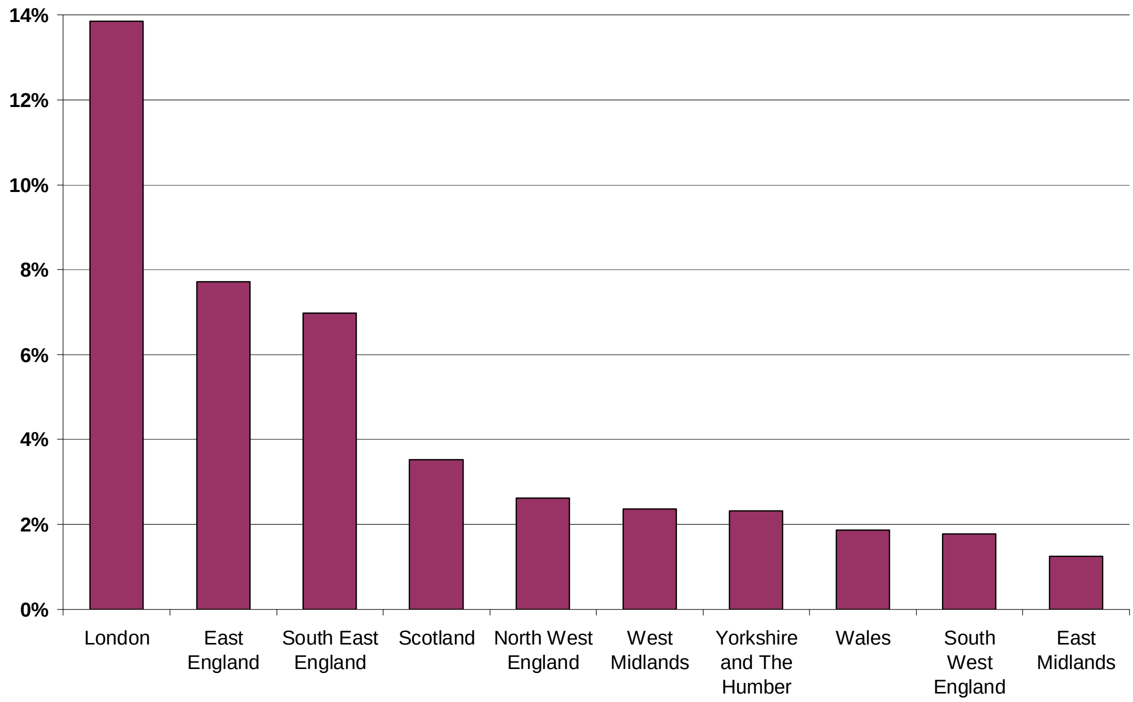
TfL is responsible for London Underground, Docklands Light Railway, bus, tram and riverbus services, and it also manages the congestion charge and London bicycle hire scheme. It has wide ranging powers and responsibilities in relation to all of these services. It provides funding, specifies services standards, and is responsible for the branding and marketing of these services.[1] London Underground services are provided by TfL itself, operating through fully-owned subsidiary companies. In other cases (such as London Buses, London Tramlink and the Docklands Light Railway), external service providers operate under a framework of contracts designed, awarded and managed by TfL subsidiaries.

[1] In addition, the Mayor of London is responsible for setting fares for these services.

1.2. Rail Services in London

National Rail services play a vital role in getting London employees to work. As shown in Figure 1.1, nearly 14 per cent of London residents use National Rail services as their usual method of travelling to work. And rail services also bring large numbers of other workers into London from locations in the South East and East of England. Less than 40 per cent of London residents use private motor vehicles as their usual method of travelling to work, compared with 70-80 per cent in the rest of the country.[2]

Figure 1.1
Normal Journey to Work: Share of Journeys by National Rail



Source: Labour Force Survey, Office for National Statistics, March 2011
Note: Region refers to place of residence, rather than location of employment. The figure for North East England is reported as "not available".

In comparison with other forms of public transport, TfL's role in relation to National Rail services is more limited. It awards and oversees a single rail concession, London Overground (LO), and it will play a similar role in relation to Crossrail services in future. However, LO accounts for a relatively small proportion of the rail services provided in London,[3] with only one route (Watford-Euston) serving any of the main terminus stations.

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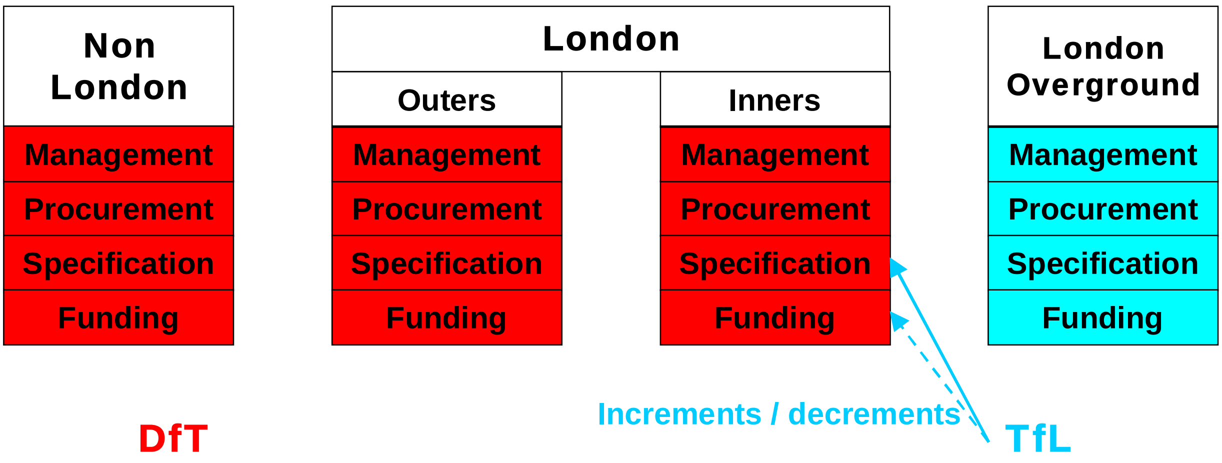
[2] Percentage using car, van, minibus or works van - source: Labour Force Survey, Office for National Statistics, March 2011.

[3] During 2009/10, LO's services accounted for 437 million passenger kms, compared with over 19,926 million passenger kms from five train operating companies with a high proportion of services within London (First Capital Connect, National Express East Anglia, SouthEastern, Southern and South West Trains). *Source: National Rail Trends*, July 2010.

Other rail services, including a great many commuter services that run wholly or largely within the London area, are provided by train operating companies (TOCs) under franchise contracts awarded and managed by the Department for Transport (DfT). This includes five TOCs (First Capital Connect, National Express East Anglia, SouthEastern, Southern and South West Trains) for which services within the London area represent a major part of their operation, and a further four (c2c, Chiltern, First Great Western and London Midland) for which London services form a smaller, but still important, part of a wider portfolio of services.

For DfT rail franchises, TfL can propose (and pay for) increments or decrements to DfT's proposed franchise specification. However, as shown in Figure 1.2, DfT retains responsibility for all aspects of the franchise, including the original specification, the procurement process and dealing with any problems (such as poor performance) that arise during the course of the franchise.

Figure 1.2
Summary of Current Franchising Framework



This system provides only limited flexibility for TfL, as:

- the process of proposing increments/decrements is best suited to minor changes to individual franchise specifications, rather than wider-ranging changes to services across several franchises (or even several modes);
- TfL does not control the budget for rail services in London, and so may be unable to fund service improvements if it cannot also implement cost savings in other areas;
- franchise contracts are let at different times, and trying to agree changes mid-contract can be an expensive and lengthy process under the current franchising framework.[4]

Furthermore, TfL is not able to implement more far-reaching changes, such as introducing common branding for National Rail services in London, or simplifying the structure of rail fares in London. Another possible option for TfL is to negotiate changes directly with

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[4] This applies especially in cases where the success of a proposed change depends on reaching agreement with all London TOCs.

individual TOCs, but this is not an effective way for it to implement changes across London as a whole (and can be expensive and time consuming even in simpler cases).

1.3. Wider Rail Industry Developments

The provision of rail services both in London and in other parts of Great Britain will change as a result of recent and ongoing policy reviews. DfT has already completed its review of franchising policy and has decided, among other things, that most franchises should last for 15-22½ years in future, and that service specifications should be simplified in order to provide franchise bidders with more flexibility in how they develop services.[5] The aim of both of these changes is to increase the effectiveness of the commercial incentives placed on TOCs. To support this, future risk-sharing mechanisms will be linked to macroeconomic changes, in contrast to the current "cap and collar" mechanism which treats all revenue changes in the same way, regardless of the cause.

Far-reaching changes may also result from the ongoing Rail Value for Money Study, headed by Sir Roy McNulty. Some common themes emerging from the study team's interim submission include the need for improved leadership and clear objectives, and an industry-wide focus on cost reduction.[6] To achieve this, the submission suggests, might require a restructuring of the industry, including both a closer alignment/partnership between Network Rail and TOCs and greater decentralisation within Network Rail. The study team will present well developed proposals to the Secretary of State in April 2011.

[5] Department for Transport, *Reforming Rail Franchising: Government response to consultation and policy statement*, January 2011.

[6] Rail Value for Money Study, *Interim Submission to the Secretary of State*, September 2010.

2. What Changes Might Devolution Bring?

2.1. Overview

There is not a single model for the devolution of rail powers in London. There are different degrees of devolution, and there is a range of different changes that TfL could seek to implement if given greater responsibility. As described in Section 1.2, moreover, TfL already has some powers, in that it can suggest changes to DfT's proposed service specifications for individual franchises. In addition, it can negotiate changes with individual TOCs, though this can prove difficult, time-consuming and expensive in cases where TfL is seeking to introduce changes across London (one recent example is the acceptance of Oyster Pay As You Go on National Rail services).

Some possible forms of devolution are described in Section 3. An important feature of these options is that the budget for funding rail services within London is transferred from DfT to TfL. At the same time, TfL will take the lead in specifying the services and standards that TOCs should provide within London. This might cover the London Overground, Crossrail, and other inner suburban services shown in Figure 2.1.

These changes will provide TfL with significantly greater flexibility to decide how best to use the funds available to provide the most effective rail services in London. If given sufficient control (including an active role in franchise management), these changes could allow TfL to extend the London Overground brand to a wider range of rail services in London, and to take responsibility for the branding and marketing of services currently provided by a number of separate companies with different brands, different marketing strategies and different commercial priorities.

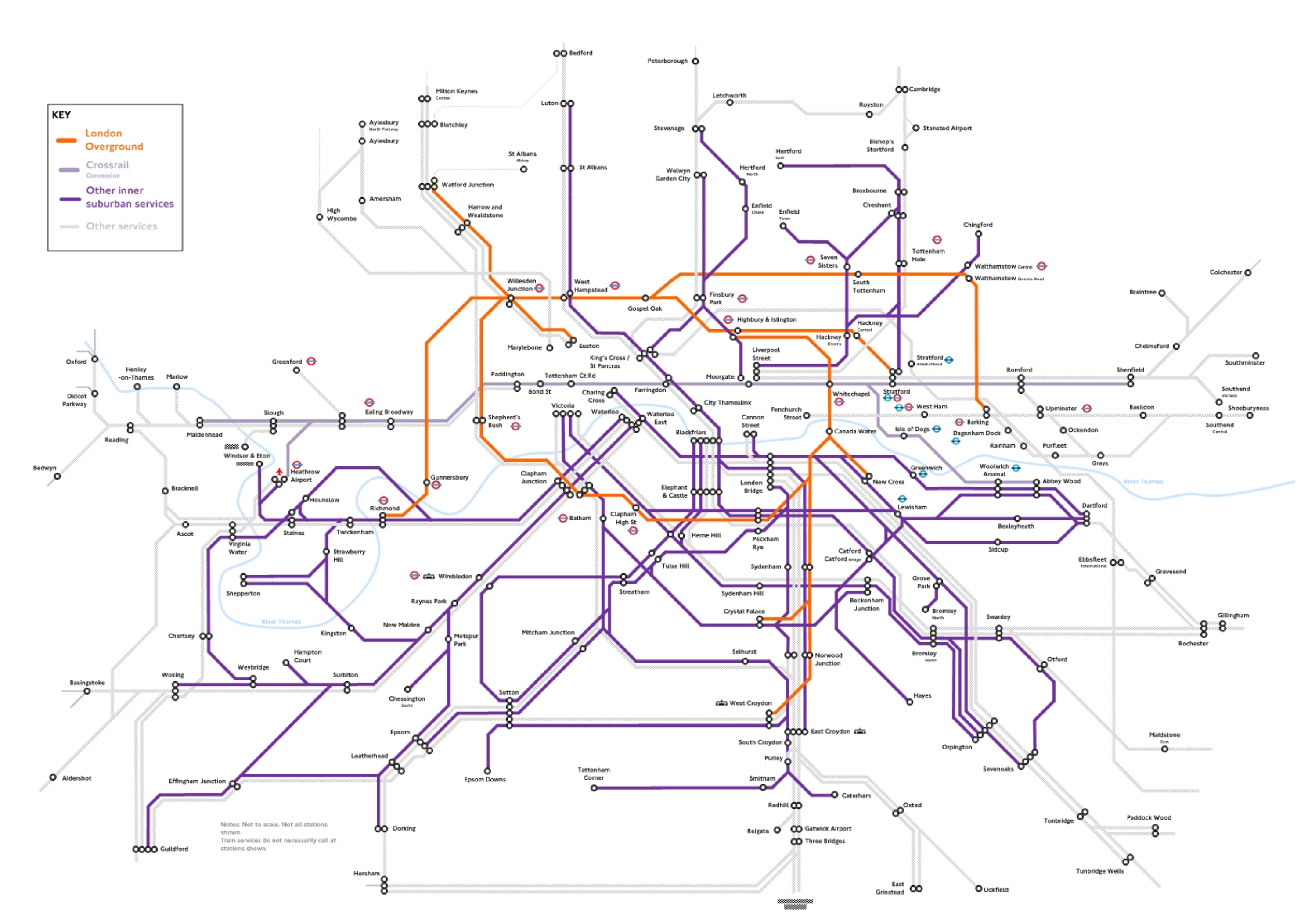
This would allow a closer integration of London rail services, based on:

§ a common, recognised brand for many rail services in London, stressing their role as part of an extensive interconnected network, rather than a series of separate lines, and highlighting for example opportunities for interchange both with other rail services and with other modes;

§ a common fares framework across London, reducing the risk that potential passengers will be discouraged by uncertainty about the level of fares, confusion arising from the complexity of the current fares structure, and a possible perception that fares are higher than they actually are. TfL would have more flexibility to offer a wider range of cross-modal fares within London;

§ practical steps to improve integration with other services, including better use of strategic interchanges, better planning of connections between services, and seeking potential cost savings in the provision of rail replacement buses.

Figure 2.1: Possible TfL Controlled Services



The benefits from such changes are difficult to predict (and to measure in practice). Some might result from changes that address specific concerns (for example about complexity, the ease of connections, ticket validity, etc) that could discourage the use of rail at present. Others might result simply from a general improvement in passengers' perception of the quality and interconnectedness of rail services in London.

Further longer term benefits might also arise from TfL's ability to plan the future provision of public transport services across all modes, whereas at present it has only a limited and mainly short-term influence over rail services. Such benefits are difficult to estimate, however. The following sections describe three more specific changes that TfL might introduce, for which the costs and benefits are easier to assess.

2.2. Transfer of Revenue Risk

An important difference between LO and rail franchises in the rest of the country is that LO bears only a very small amount of revenue risk. It has a predominantly "gross cost" contract, where it is paid for providing services specified by TfL and meeting quality standards also set out in the contract. Though it still bears performance risk (through contractual penalties and bonuses), its income is only very weakly affected by changes in the number of passengers carried, or the fares they pay. If given more responsibility, TfL would seek to introduce similar gross cost arrangements for other rail services in London.

Other TOCs bear revenue risk at present. In theory, this provides them with commercial incentives (in addition to other incentives in the franchise contract) to generate additional demand, which in turn will encourage them to deliver high levels of performance, market their services effectively, and so on. In the case of London services, however, commuters' demand is likely to be relatively unresponsive to such factors,[7] and to the extent that demand is affected at all, the response may be slow, very possibly stretching beyond the length of the current franchise contract. London TOCs' scope to respond to commercial incentives is also limited by the congested nature of much of London's rail infrastructure, meaning that timetables need to be carefully co-ordinated and in many cases there may be little scope to vary services in response to commercial incentives.

Instead, demand for rail services in London (and for commuter services in particular) is significantly affected by macroeconomic factors, notably changes in central London employment, which are clearly outside of TOCs' control. Figure 2.2 shows the close relationship between changes in central London employment and the number of passenger rail journeys in London and the South East over the last 14 years.

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7 This is illustrated by the fact that, within the rail industry's standard forecasting framework (the Passenger Demand Forecasting Handbook), the recommended fares elasticities and generalised journey time elasticities for commuters and passengers with season tickets are generally lower than those for leisure or other (non-business) passengers, often by quite a wide margin.

Figure 2.2
Changes in London & SE Rail Journeys and Central London Employment

Source: NERA, from National Rail Trends and Office for National Statistics data
Note: 2010-11 is change from Q1-Q2 2009/10 to Q1-Q2 2010/11

Macroeconomic conditions affect all TOCs, and the inability to control such risks has led to the "cap and collar" mechanism being included in most franchise agreements. Even though DfT has suggested that future revenue risk-sharing arrangements will be focused on macroeconomic risk, we believe in practice any such mechanism will still leave TOCs facing significant external risk.[8]

Even outside of London, TOCs are not necessarily well-placed to bear such risk. They operate time-limited franchises, with very few assets, so they tend to be thinly capitalised and they also have a limited ability to reduce costs if revenues are lower than expected. We would therefore expect TOCs to include a substantial risk premium in their franchise bids, which will increase the subsidies payable by DfT (and therefore taxpayers). DfT's costs may also increase if it has to "pick up the pieces" after a TOC either fails or surrenders its franchise because of financial difficulties.

Despite these disadvantages and likely additional costs, most TOCs will continue to bear revenue risk. The argument for this approach is that the benefits from providing TOCs with commercial incentives outweigh the disadvantages from increased risk exposure, and DfT is

[8] The impact of macroeconomic changes is difficult to predict with sufficient accuracy, both for rail services as a whole and especially for individual TOCs. So there is a serious risk that any risk-sharing mechanism based on the *expected* impact of macroeconomic changes will either over or under-compensate TOCs, perhaps quite significantly, thus leaving them still exposed to macroeconomic risk.

proposing a number of changes (such as longer franchise lengths and looser service specifications) that should increase the likely power of these incentives.

Within London, however, the argument for allocating revenue risk to TOCs is weaker, for the reasons noted above. If given greater responsibility for rail services, therefore, TfL would propose to introduce gross cost contracts and therefore take on the revenue risk that train operators currently bear. As a large organisation with a wide range of different activities and sources of income, TfL is better able to bear revenue risk than TOCs. It is also better able to manage revenue risk, as:

- it manages other forms of public transport (which is one source of revenue risk to TOCs); and
- TfL will also be able to adjust its allocation of funds, both between modes and between different types of expenditure, in the event of a shortfall in fares receipts.

In addition, the Mayor can determine the overall level and structure of fares applying across rail and other public transport services in London, which provides valuable flexibility to help deal with the impact of higher or lower passenger volumes.

Taking revenue risk away from London TOCs is likely to have two types of benefit:

- it should reduce the risk premium that TOCs factor into their franchise bids. While it is difficult to predict exactly how much impact this will have on bids, NERA analysis for TfL suggests that transferring revenue risks from TOCs to TfL could yield cost savings equivalent to around 1.5 per cent of fares revenues, even after taking account of the cost of TfL bearing revenue risk and also the increased regulation of revenue protection activities that will be necessary.[9] This leads to estimated savings of around £290 million over 20 years; and
- it will support TfL's other aspirations for London rail services, including introducing common branding and service standards. If TOCs retain revenue risk, in contrast, then they will be reluctant to hand over responsibility for branding and marketing to TfL. And the process of agreeing changes to services and standards should also be quicker and easier under gross cost contracts, as discussions between TfL and TOCs will be focused on any change in TOCs' costs, rather than more difficult questions of the likely direct and indirect or long-term effects on revenues.

The absence of revenue risk means that TfL concession contracts will need to include a detailed specification of the services (and standards) to be provided by TOCs. But this might be required even under DfT's approach, as a high degree of co-ordination will continue to be required in order to make the most efficient use of the congested network in and around London.[10]

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9 NERA Economic Consulting, *Gross Cost Contracts: Final Report for Transport for London – London Rail*, July 2007.

10 Whereas the DFT is proposing to increase franchise lengths, in order to strengthen the impact of longer-term commercial incentives, for London TOCs it may be more cost effective to adopt shorter length franchises in order to retain the benefits from more frequent competitive tendering. And we note that, in order to realise the potential benefits from transferring revenue risk away from TOCs, it will be important for TfL to ensure that other risks are not

2.3. Improved Standards Across London

Greater responsibility for rail services in London would allow TfL to introduce a major package of improvements. This would see a set of common standards applied to rail services and stations across London, supported by a single brand identity, unified marketing and a common, simplified fares structure.

Figure 2.3 shows a package of improvements, costed by TfL, based on increasing service frequencies and bringing all stations operated by predominantly London TOCs up to a common set of minimum standards.[11] This has an estimated net cost (ie after allowing for income from additional journeys generated by the improvements) of around £90 million over 20 years, and would generate estimated passenger benefits of more than £350 million over the same period.[12] Furthermore, by including additional station gates (which do not generate specific passenger benefits, but increase expected revenues due to lower fare evasion, and also contribute to other improvements such as enhancing station security) in the package, the estimated net cost is reduced to around £40 million over 20 years.

These estimates were calculated using TfL's standard business planning methodology (as used, for example, for London Underground services) and, in a number of cases, used deliberately conservative assumptions. In addition, they consider the specific, tangible improvements that make up the overall package, and do not make any allowance for the possible impact of a "step change" in the standard of rail services in London, or the introduction of a single recognisable brand with a simplified fares structure.

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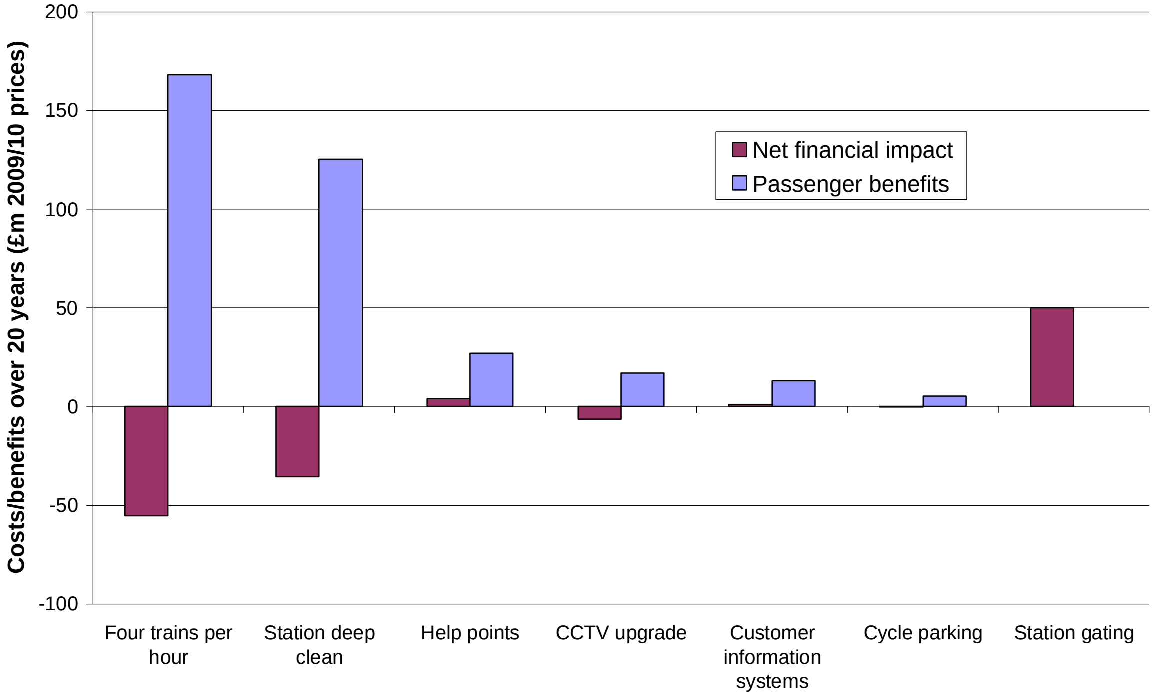
introduced and that TOCs are treated fairly (and perceived to be treated fairly) if services or standards are changed part way through a franchise.

11 The provision of four trains per hour would lead mainly to additional services at off-peak times, where existing frequencies can be poor and capacity is generally available to accommodate such additional services.

12 In addition to these specific improvements, TfL would also propose some changes to station staffing, including changes to ticket office opening hours and the use of roving staff after 1500 to provide better reassurance to passengers. The financial impacts discussed in Section 3 (and shown in Figure 3.2 below) include the net cost of these additional changes.

Figure 2.3
Net Cost and Passenger Benefits of Proposed Improvements



Source: TfL

There are several different ways in which devolving greater powers to TfL would support the implementation of these improvements:

- the savings generated by the switch to gross cost contracts can be used to fund the expected net cost of this package. The estimated net cost of these improvements, of around £40 million over 20 years, is substantially lower than the potential savings from transferring revenue risk as reported above. So the package is likely to remain affordable even if the savings from transferring revenue risk are lower in practice, for example because they are affected by prevailing market conditions or by other aspects of the new contracts (including the initial unfamiliarity with the new structure);
- with more devolved responsibility, and reflecting a combination of risk transfer and a closer and more direct relationship with TOCs, TfL believes it would be able to secure a lower cost for the implementation of these changes;
- TfL's role in setting service specifications, its closer relationship with TOCs, and the use of gross cost contracts would all make such improvements easier, quicker and cheaper to implement. TfL could take a strategic cross-London view when writing the specification for individual concessions, and any changes that needed to be implemented mid-contract would be easier because of TfL's direct relationship with the operators and because the agreement would not need to reflect the expected revenue impact of the proposed changes.

2.4. Improved Project Sponsorship

A further change that a more extensive devolution of powers might allow is for TfL to have a direct role in overseeing rail infrastructure enhancements in London. These would continue to be funded by DfT (reflecting the greater difficulty of separating infrastructure budgets, and also the likelihood that the proportions of London and non-London expenditure will vary significantly over time), but TfL would help to identify and plan possible enhancement projects in London and, if the project is agreed by DfT, TfL would be the "client" responsible for discussing emerging specifications and costs with Network Rail and other parties.

TfL has already succeeded in constraining potential cost increases in several projects, which demonstrates both the general benefits that can be gained from active and informed oversight of projects, and also its own capabilities for this role. Examples include the North London Railway Infrastructure Project, where extensive TfL involvement helped reduce the estimated cost very considerably, and work at Clapham Junction for the East London Line Extension, where TfL suggested alternative solutions to help avoid a large cost overrun.

To investigate the potential gains from effective sponsorship of a wider range of projects, TfL commissioned Jacobs Consultancy to review a number of specific rail infrastructure projects in London and elsewhere. Jacobs concluded, among other things, that:[13]

- there are benefits to be gained from strong project sponsorship. A sponsor with appropriate skills and experience, and independent from those managing the project, will be best placed to achieve efficiency and value for money through effective challenge and review. In contrast, inexperienced sponsors run an increased risk of cost escalation;
- investment is likely to be better focused and tailored to users' needs if organisations closest to the specific market are involved in project specification and development.

Jacobs concluded that the benefits from effective sponsorship of enhancements projects can lead to savings of 10-30% from adjusting the scope of the project to optimise value for money, and 5-20% from identifying areas where the specification can be reduced without a significant reduction in the benefits from the project.[14]

In addition to the benefits from specific cost savings generated through effective project sponsorship, the lessons learned from such oversight of Network Rail might be valuable to the Office of Rail Regulation (ORR) and to other project sponsors.

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[13] Jacobs Consultancy, *Transport for London: Value for Money Improvements to Rail Projects and Standards in London*, September 2010..

[14] Jacobs also found that effective sponsorship reduced project costs (by 5-30%) by removing costs that are properly part of Network Rail's renewals or maintenance budget. In economic terms, this does not represent an efficiency saving (since it relates to the funding of particular pieces of work, rather than the underlying cost of the work), though it could be argued that effective sponsorship can play a useful role in supporting the regulation of Network Rail, and in particular ensuring that it cannot reclaim the cost of activities for which funding has already been provided.

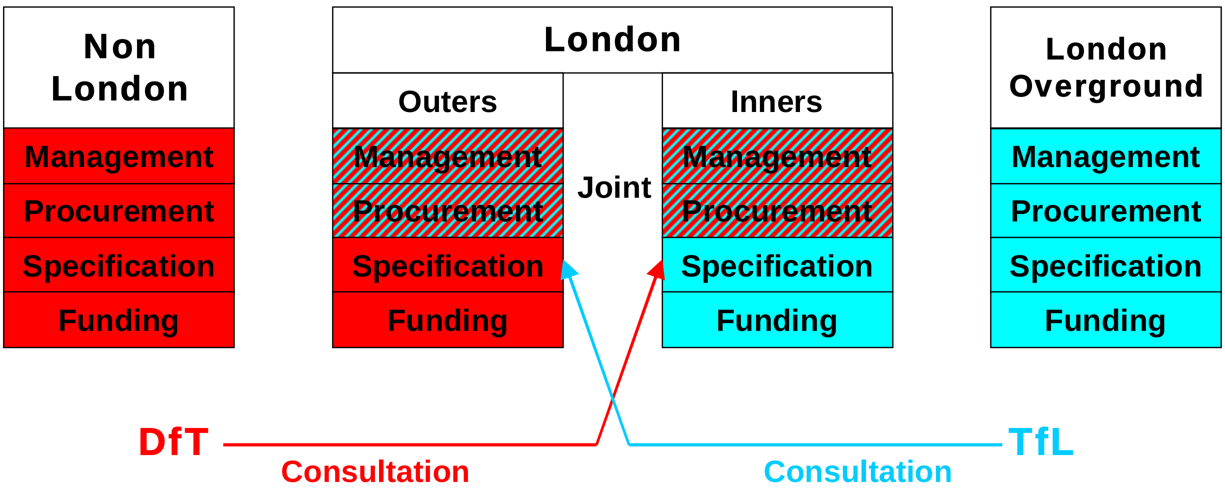
3. Options for Implementing Devolution

In order to implement the changes described above, at least some responsibility for franchised rail services in London would need to be devolved to TfL. The following sections give examples of the way devolution could be implemented, either retaining the current pattern of franchises with responsibility split between DfT and TfL, or else redrawing the franchise map in order to create new dedicated London rail concessions.

3.1. Joint TfL-DfT Contracts

Instead of the current framework, in which TfL can merely suggest increments and decrements to a franchise specification drawn up by DfT, Figure 3.1 shows an alternative model in which the services within predominantly London franchises are identified as either "inner" or "outer" services, and TfL assumes responsibility for specifying the inner services to be provided by the franchisee. TfL would also fund these services, from a budget for London rail services transferred from DfT.

Figure 3.1
Joint Franchises, TfL Lead for Inner London Services



Under this approach, the franchisee would bear revenue risk on outer London services (subject to any revenue risk-sharing mechanism applied by DfT), whereas inner London services would be subject to a gross cost arrangement, with the franchisee paid an agreed fee to provide the services and standards proposed by TfL. Procurement and management of the franchise contract would be carried out jointly by TfL and DfT.

These changes represent the minimum required in order to implement TfL's proposals. This would allow TfL to have a more direct involvement in specifying services and managing the franchise, allowing it to take a long-term integrated view of the most effective role for rail services in London, and also facilitate the transfer of revenue risk on inner London services from TOCs to TfL. A number of important practical steps would need to be completed, including:

§ agreement of the split of revenues and costs between outer services and inner services, in order that the budget for the latter can be transferred from DfT to TfL;

- close co-operation between DfT and TfL, to ensure that the service specifications for inner and outer London services are mutually compatible;
- considering any measures necessary to avoid game-playing opportunities for TOCs bearing revenue risk on some, but not all, services. Standard rail industry revenue allocation models would be used, but DfT and TfL would need to be alert for any changes proposed (such as retiming of fast services) by the TOC that were intended to manipulate the allocations from such models;
- agreement on a joint franchise procurement and management process, including monitoring arrangements, triggers for intervention, etc. We would expect TfL to take the lead in franchise management for inner London services, and DfT for other services. But agreement would be required before any enforcement action was taken, and formal legal powers might remain with DfT for both inner and outer London services.

Under a joint franchise model, it would be especially important for TfL to ensure that performance incentives and monitoring arrangements are adequate, otherwise TOCs might be unduly encouraged to prioritise outer London services, for example in times of operational disruption or if staff shortages mean that some services have to be cancelled.

TfL has examined the practical aspects of this approach, and believes that it can be implemented and that the likely risks (for example, game-playing by TOCs) can be addressed. Figure 3.2 summarises TfL's estimates of the overall financial impact. It would incur additional costs as it would take on responsibility for the branding and marketing of inner London services (though most of these would be offset by a reduction in TOCs' costs), and there would also be additional administration costs reflecting some loss of economies of scale as franchise procurement and monitoring responsibilities are shared between DfT and TfL. However, the estimated gains from the transfer of revenue risk are more than sufficient both to cover these additional costs and also to fund the service improvements described in Section 2.3.[15] Even if these gains were only half as large as expected, the overall financial impact would be roughly neutral. As reported in Section 2.3, TfL estimates that these improvements would also generate passenger benefits of more than £350 million over a period of 20 years.

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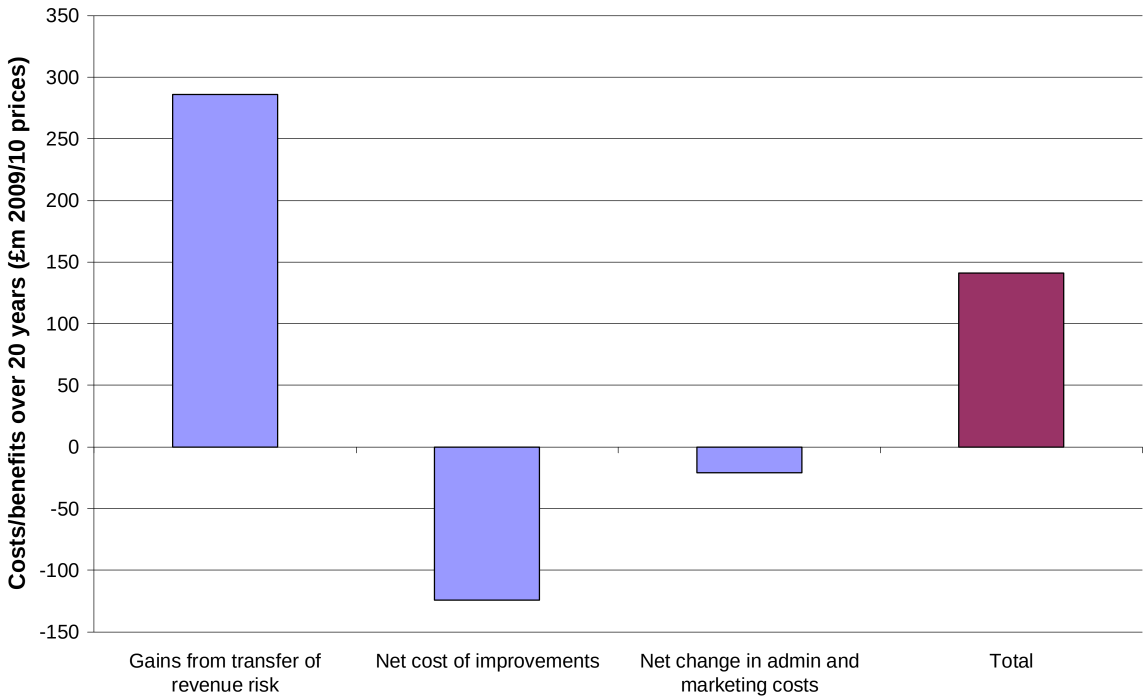
[15] These estimates do not show any additional cost for ongoing marketing and branding activities, and only include rebranding costs to the extent that TfL might refresh London Overground signage more frequently than rebranding would occur under DfT's new policy with longer franchises. In effect, TfL has assumed that the other additional costs it incurs will be offset by reductions in TOCs' concession bids, reflecting the cost savings from activities that they are no longer required to carry out. However, the estimated overall net financial impact remains positive even if this assumption is relaxed.

Figure 3.2
Net Financial Changes from Devolution

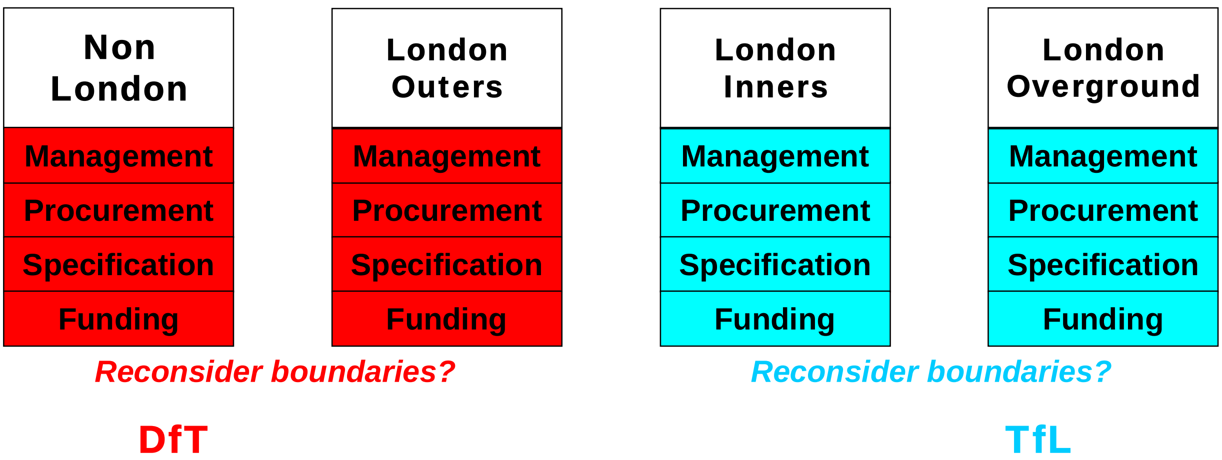


Source: TfL

3.2. London Rail Concession(s)

An alternative option, rather than retaining the existing pattern of franchises providing both inner London and longer distance services, would be to create dedicated inner London concessions for which TfL would be solely responsible (see Figure 3.3).

Figure 3.3
Dedicated London Rail Concessions



This would require significant preparatory work to redraw the franchise map, and implementation would need to be aligned with the expiry of relevant existing franchise contracts. As well as splitting existing franchises between inner London and other services, it may be appropriate to consider other changes to franchise boundaries, for example if any of the newly separated franchises are now too small to operate on an efficient basis, or if economies of scale can be realised by combining some of the inner London or outer London franchises.

Compared with the use of joint DfT-TfL contracts, this option:

- avoids the complications and possible overlaps that might arise from having both DfT and TfL involved in the procurement and management of a single contract;
- reduces the risk of game-playing, for example because a single TOC bears revenue risk on some of its services but not others;[16]
- but may lead to some loss of economies of scale and some additional transactions costs between TOCs, for example because light maintenance can be carried out at the same depot at present for both inner London and longer distance rolling stock, or because a single pool of train drivers can be used both sets of services.[17]

TfL's estimates of the financial impacts are very similar to those shown in Figure 3.2 above:

- administration costs would be slightly higher. This reflects the costs associated with changing the franchise map and drawing up new contracts for inner London services, which are only partially offset by avoiding the extra costs that arise when responsibilities are shared between DfT and TfL;
- but the estimated costs of TfL's proposed improvements would also be slightly lower, as TfL believes lower implementation costs could be achieved if these improvements are carried out by dedicated London TOCs answerable only to TfL (rather than both TfL and DfT).

As with the previous option, therefore, TfL's projections show that the savings from the transfer of revenue risk are more than sufficient to cover both the additional administration costs and also the net cost of a package of service improvements that would deliver significant passenger benefits.

3.3. London Rail Concession(s) Plus Project Sponsorship

A further step in the devolution of powers for rail services in London would see TfL take on some responsibility for overseeing infrastructure enhancement projects in London. As described in Section 2.4 above, this would not involve TfL either taking responsibility for funding National Rail infrastructure or becoming an infrastructure manager itself. Rather, it would play an active role in overseeing work carried out by Network Rail (or its contractors),

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[16] Instead, there may be an increase in cases of competition between TOCs. Longer-distance TOCs will often offer faster services and will have more freedom to set individual fares. As inner London TOCs will operate within the London-wide fares framework, they will not be able to engage in route-specific price competition, but they may be able to offer better integration with other rail services or other forms of public transport.

[17] Any loss of straightforward economies of scale, which simply reflect the size of the company, might be recovered through creating larger franchises dedicated to either inner London or longer distance services.

placing pressure on these parties to deliver the project within budget, and being closely involved in ongoing reviews to help identify changes that might reduce the risk of overspends or allow the project to be delivered more effectively.

This would not require a major change from the framework shown in Figure 3.3. In addition to specifying, procuring and managing contracts for the operation of inner London rail services, TfL would take on this additional oversight role.

Based on previous cases where TfL has intervened and the Jacobs Consultancy study described in Section 2.4, effective sponsorship could deliver potentially significant cost savings, which would more than cover the additional costs that TfL would incur in carrying out this role. In addition, as a body with wider powers and responsibilities than at present, TfL would be very well placed to provide clear leadership for rail services in London, thus helping to remedy one of the shortcomings identified in the interim report of the ongoing Rail Value for Money Study.

3.4. Protecting Non-London Services

Understandable concern has been expressed that TfL would use any additional powers to improve rail services for Londoners, at the expense of longer distance or freight services. In order to allay such concerns, TfL has appointed two board members (Charles Belcher and Sir Mike Hodgkinson) with a specific responsibility for representing the interests of people living, working and studying outside Greater London served by TfL's rail services.

This is in addition to the existing rail industry mechanisms designed to protect the interests of existing and potential users of the network. Foremost among these is ORR’s role in approving all track access contracts. As part of this process:

§ ORR will consult with actual and potential network users whose future aspirations might be constrained by a new or amended track access contract, and will also consult with DfT and other funders;

§ ORR will also take account of the Route Utilisation Strategies (RUSs) developed by Network Rail, to promote the most efficient use of congested infrastructure; and

§ ORR has described the criteria that it will use when considering access rights that might conflict with other potential uses. These include the relative benefits of different services to rail users, the impact on DfT funds, the benefits of timetable/planning stability for existing services, the likelihood of more efficient capacity utilisation as a result of a proposal, and the extent to which capacity might be increased.[18]

ORR has already addressed situations where there have been conflicting requests for access rights, and demonstrated its willingness both to give very serious and detailed consideration to such situations, and to learn the lessons from previous cases.[19]

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18 See paragraph 4.22 of Office of Rail Regulation, *Criteria and procedures for the approval of track access contracts*, November 2009.

19 See Office of Rail Regulation, *East Coast Main Line: Lessons Learned Report*, August 2010, and the extensive documentation relating to East Coast Main Line track access applications at http://www.rail-reg.gov.uk/server/show/ConWebDoc.9242.

Operators with access rights will then be protected by the legally enforceable rights set out in their track access contracts and, importantly, by the various provisions of the Network Code. These include, for example:

- detailed provisions about the timetabling process (Part D) and the decision criteria (Condition 4.6 of Part D) that Network Rail should apply during this process; and
- a requirement (in part H) for Network Rail to establish a Railway Operational Code covering, among other things, train regulation policies, emergency timetable procedures, and arrangements for dealing with track blockages, adverse weather, etc.

In relation to longer distance passenger services, moreover, these will also be protected by DfT's continued specification of the level of services to be provided by its franchisees. And TOCs themselves will have strong incentives to ensure that longer distance services are not disadvantaged, given their commercial importance and the greater sensitivity of demand as compared with London services.

Aside from the formal protections that will continue to be provided to all rail users, as they are at present, we also note TfL's own interest in protecting the interests of freight and longer distance services:

- long distance services are vital to London's economy. They play a major role in allowing non-London residents to work in London, in providing efficient transport connections between London and other business centres in the UK, and in making it easy for visitors and tourists to come to London; and
- promoting rail freight contributes to the Mayor's objective of reducing transport's contribution to climate change. One proposal set out in the Mayor's transport strategy is to "Encourage, and where appropriate specify, improved freight movement efficiency through, for example, greater consolidation, more off-peak freight movement and greater use of water and rail-based transport",[20] and this commitment has been demonstrated by the Mayor's recent intervention to protect continental gauge rail access from the High Speed 1 line to a freight yard at Barking.[21]

[20] Mayor's Transport Strategy, section 5.22.3.

[21] See *Modern Railways*, March 2011, p11.

4. Conclusions

The interim submission of the Rail Value for Money Study, led by Sir Roy McNulty, states that "the "one size fits all" railway is unlikely to represent value for money or provide the right incentives to reduce costs".[22] It also stresses the importance of good leadership, and the need for improved planning and decision-making.

TfL has put forward a compelling case for adopting a different approach for rail services in London, and for being given the powers to provide the leadership that is required in London. Among other things, this case reflects:

§ the benefits that can be delivered from London-wide responsibility for rail services, including better integration of the rail services currently provided by different companies, and improved integration with other forms of public transport;

§ the savings that can be achieved if London TOCs no longer bear revenue risk. London TOCs are significantly affected by macroeconomic risk, especially changes in central London employment, and the potential benefits from them retaining revenue risk are low, reflecting both the weak incentives associated with service standards and performance (especially for commuter traffic) and also the difficulty of responding effectively to incentives when capacity is already congested and services are therefore carefully planned;

§ the passenger benefits that can be delivered from a package of improvements to bring rail services and stations in London up to a common standard, and from marketing and branding rail services as an integral part of London's public transport network.

Some changes will be required in order to implement devolution. But the estimated financial benefits exceed the costs of implementing these changes, and in any case the structure of the rail industry may well need to change in order to accommodate the recommendations of both the McNulty review and the DfT's revised franchising policy. Indeed, the DfT's adoption of longer franchises strengthens the arguments for a different approach in London.

In addition to changes to rail franchises, further gains might be achieved, potentially quite significant ones, by giving TfL an enhanced role to oversee the efficient implementation of infrastructure enhancement projects in London.

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22 Rail Value for Money Study, *Interim Submission to the Secretary of State*, September 2010, section 6.2.

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