

Rail regulation

Introduction

1. This appendix outlines the aspects of rail regulation relevant to the Scottish rail franchise and the resulting limits on the scope for the franchisee to take independent commercial action. All TOCs are regulated by the Rail Regulator, the SRA and the Health and Safety Commission/HSE. Rail services within the Strathclyde passenger transport area¹ (Strathclyde) are specified and marketed by the SPTE.

The Rail Regulator

2. The Rail Regulator is the independent economic regulator of the monopoly and dominant elements of the rail industry in Great Britain. In connection with TOCs, he is primarily responsible for granting licences (without which they cannot operate), for setting licence conditions and for enforcing some of them. The Rail Regulator is also responsible for approving or directing the terms of contracts granting access to stations, depots and track. Track access agreements establish rights regarding the number and frequency of trains that can be operated and the stops that they can make.

The Strategic Rail Authority

3. The SRA's role¹ is to provide strategic direction for the railways in Great Britain. It is subject to directions and guidance from the Department for Transport and its statutory obligations cover among other things, negotiating and awarding TOCs' franchises, including specifying the services to be provided by them, and monitoring their subsequent performance. The SRA's regulatory functions are focused on enforcing the TOCs' passenger and station licences. The role of the SRA in specifying services and the quality of service to be provided by the Scottish rail franchisee is in effect shared with the SPTE. Section 208 of the Transport Act 2000 enables the Scottish Executive to give directions and guidance to the SRA about passenger services which start and/or end in Scotland and are provided under a franchise agreement.²

The Strathclyde Passenger Transport Executive

4. The Strathclyde Passenger Transport Authority (SPTA) is one of seven passenger transport authorities established under the Transport Act 1968. It consists of members nominated by 12 local authorities and is responsible for public passenger transport policy in their areas, including the overall planning of the public transport network. The SPTE is a separate public body, funded via the SPTA by the local authorities and grants from the Scottish Executive. It is responsible for implementing the policies adopted by the SPTA. With regard to rail services, the SPTE has powers to:

¹The unitary local authority areas of the City of Glasgow, North Lanarkshire, East Dunbartonshire, West Dunbartonshire, Renfrewshire, East Renfrewshire, Inverclyde; most of South Lanarkshire, North Ayrshire, East Ayrshire, and South Ayrshire; and parts of Argyll and Bute.

²These are in addition to (and must be consistent with) the directions and guidance given by the Secretary of State for Transport.

- finance subsidized passenger rail services in its area and to contract with the local TOC to provide additional services;
- ensure that information about local transport services is available; and
- provide investment to refurbish and update all aspects of the local transport system.

The Scottish rail franchise

5. The process of re-tendering the Scottish rail franchise started in October 2002 and it is intended that the new franchise will start in October 2004. The tender documents provide a detailed specification of the services and the quality of service that the franchisee is expected to provide. The main elements include broadly maintaining current routes, levels of service and patterns of service and allowing for enhancements with possible additional support.
6. As described in paragraphs 3 and 4, the SPTE and the Scottish Executive, as well as the SRA, are involved in specifying, negotiating and awarding the Scottish rail franchise. Both the SRA and the SPTE will be parties to the agreement. The Scottish Executive funds the SRA and the SPTE to enable them to pay any subsidy required by the Scottish rail franchisee and must provide any finance needed to cover the cost of additional services required by its directions and guidance.
7. Subject to the guidance it receives, the SRA manages the bidding process, consults other parts of the industry where necessary, evaluates the bids, selects the preferred bidder and negotiates details of the franchise contract. Once the franchise is let, the SRA and SPTE are responsible for monitoring performance in their respective areas.

Level of service

8. Under the current franchise agreements the level of service provided by a TOC has to fulfil a passenger service requirement (PSR) specified by the SRA. The SRA has subsequently developed a new franchise model, which will be used for the Scottish rail franchise. It tightens the specification of the services to be operated by replacing the PSR with more detailed service level commitments.
9. The minimum level of service that must be provided by the Scottish rail franchisee³ is set out in two service level commitments: one specified by the SPTE for services within its area and another specified by the SRA (and indirectly the Scottish Executive) for the remaining part of the franchise (but including long-distance services passing through Strathclyde). Both draft service level commitments are based on the current timetable. The franchisee may only operate a service different from that specified in the service level commitments with the approval of the SRA or the SPTE (as appropriate).
10. The SRA (or the SPTE in its area) can specify its service level commitment on a timetable by timetable basis in such detail as it decides and may issue a new service level commitment each year if a new timetable requires one. For each service, the draft service level commitments include the service intervals at all times of day, the times of early and late services, maximum journey times, and stopping patterns. They also specify a minimum number of seats for certain services. The franchisee will be required to add any additional services subsequently specified by the SRA (or the SPTE).

³Strictly the level of service that it must seek train slots for in the annual Network Rail timetabling exercise.

11. To support future improvements in the level of service, 29 new trains (seven for the SPTE services and 22 for other services) have been procured with finance from the Scottish Executive and will come into operation over the next two years. The SRA told us that there were no plans to purchase further rolling stock and that the franchisee was very unlikely to acquire such rolling stock without being substantially funded by SPTE or the Scottish Executive.
12. The franchisee is required to prepare a train plan showing the proposed allocation of its train fleet to meet the service level commitments. SPTE rolling stock must be used for its services where possible and may only be used for SRA services with prior agreement. The franchisee has to use its reasonable endeavours to prepare a plan that meets target passenger demand and provides passengers with the reasonable expectation of a seat within 10 minutes of boarding.⁴

Quality of service

13. A train running regime provides financial rewards and penalties related to the franchisee's performance in areas such as punctuality, short train formations and timetable changes. Another performance regime is used to monitor the performance of the franchisee in respect of cancellations, capacity and service delivery. In this second instance, poor performance produces financial penalties and can lead to remedial plans, and then to breach and ultimately default under the franchise agreement.
14. Requirements for 39 detailed aspects of service quality are set out in the service quality incentive regime (SQUIRE) that is part of the franchise agreement. Performance under SQUIRE will be measured against a number of key performance indicators, including such factors as the condition of trains and stations, car parks, staffing, passenger information, ticket collection, cleaning, graffiti and litter. Rewards and penalties for success or failure to achieve service benchmarks will be calculated according to a points system. If the franchisee fails to achieve service benchmarks, it can be penalized until the failure is remedied. Persistent failure results in a remedial plan and can lead to a breach and ultimately default under the franchise agreement.

Scope for commercial action by franchisee to vary services

15. The SRA told us that the franchisee was given very little flexibility about the services it is expected to operate. Clearly, the franchisee's freedom of action in reducing services is very tightly constrained by the service level commitments. Although it might consider adding further services in certain limited circumstances (such as special events that were not contemplated when the franchise was awarded) it is normally constrained to operate only the services in the service level commitment. All significant aspects of service quality can only be reduced at the risk of incurring penalties. Consequently, unless genuine efficiency improvements can be made, the franchisee will find it difficult to increase its profits by economizing on the level or quality of its rail services.

Fares regulation

16. The franchise agreement will enable the SPTE to set and vary all fares within Strathclyde. Outside Strathclyde, regulated fares accounted for 39 per cent of ScotRail's revenue in 2002/03.

⁴There is a derogation from the 'standing rule' for the service on non-stop trains between Glasgow Central and Paisley Gilmour Street.

17. In June 2003, the SRA announced the results of a review of its fares regulation policy. This proposed that all regulated fares should be regulated by means of price caps on a simplified system of 'fares baskets' and that these price caps should increase at RPI +1 per cent a year for the three years from January 2004. The new policy does not, however, apply directly to the Scottish rail franchisee as its fares policy has to be agreed separately with the Scottish Executive which funds the franchise. Despite the SRA review, Scottish Ministers decided not to change the structure of fares regulation, other than to enable the SRA to make any future changes they request. The Scottish Executive intends to give further consideration to fares regulation and this may result in changes during the life of the next Scottish rail franchise.
18. Scottish Ministers decided to apply a price cap at RPI +1 per cent a year to the Scottish rail franchisee's fares with effect for three years from January 2004. This policy was set out in the invitation to tender: bidders were required to assume that all fares set by the SPTE would increase at RPI +1 per cent a year and that the price caps for regulated fares across the remainder of the franchise would increase at the same rate. If the Scottish Executive or the SPTE decide to amend this policy, any changes would be introduced using the change and variation mechanism in the franchise agreement which would adjust the subsidy to ensure that the franchisee suffered no gain or loss from the change.
19. We understand the level of control that the various regulators and funders will have is as follows:
 - (a) SPTE will continue to specify all types of fares for journeys within the Strathclyde PTE area and on certain services extending up to 25 miles over its boundary. Under the current franchise it also takes the associated revenue risk. It is expected that the new franchisee will take at least some of this revenue risk (see paragraph 23).
 - (b) The SRA (and indirectly the Scottish Executive) will continue to set price caps for regulated fares for the other services covered by the Scottish rail franchise. Outside Strathclyde and the Edinburgh region (see below) the regulated fares are saver return fares⁵ and weekly season tickets for flows where such fares existed in June 2003. Where no saver ticket existed the standard day return fare is regulated. Although the SRA is reviewing its overall policy on whether saver fares should continue to be regulated after about 2006, any change will be determined by the Scottish Executive.
 - (c) Certain fares within a region extending roughly 20 miles around Edinburgh⁶ will be regulated separately in a commuter fares basket. The fares covered are weekly, monthly, quarterly and annual season tickets; unrestricted singles; and unrestricted returns. The increase in the fare basket is capped at RPI +1 per cent a year and increases in individual fares are limited to RPI +4 per cent a year. The SRA intends to retain a right to specify the fare on an individual flow.

Scope for commercial action on fares by the franchisee

20. The franchisee will retain some flexibility over non-regulated fares outside Strathclyde. These fares include all first class fares; standard single and open return

⁵In each case where a type of fare is said to be regulated, this applies to standard class fares only and covers both the adult and child tickets. No first class fares are regulated.

⁶The region is bounded by, and includes, Kirkcaldy, Glenrothes with Thornton, North Berwick, Addiewell, Bathgate, Falkirk High and Falkirk Grahamston.

fares; cheap day return fares (except in the area covered by the Edinburgh region commuter fares basket); low-price advanced-purchase return fares (such as supersaver or apex tickets); and any new types of fare developed by the franchisee.

21. These fares will, however, be constrained to varying extents by the effect of the controls on regulated fares and the need to keep a reasonable relationship between regulated and unregulated fares. Considering the types of fare that might be subject to commercially motivated increases:
 - (a) significant increases in the standard class 'turn-up-and-go' single and open return fares or cheap day returns would probably result in most passengers using regulated saver tickets whenever possible;
 - (b) significant increases in first class fares would probably persuade many passengers to travel standard class, fly or drive; and
 - (c) increases in low-price advanced-purchase return fares would defeat their purpose as yield management tools designed to fill unused seats.
22. It therefore seems likely that the scope for substantial increases in non-regulated fares is very limited. FirstGroup told us that it had assumed in its bid that all fares, both regulated and unregulated, would increase by RPI +1 per cent each year.

Revenue risk

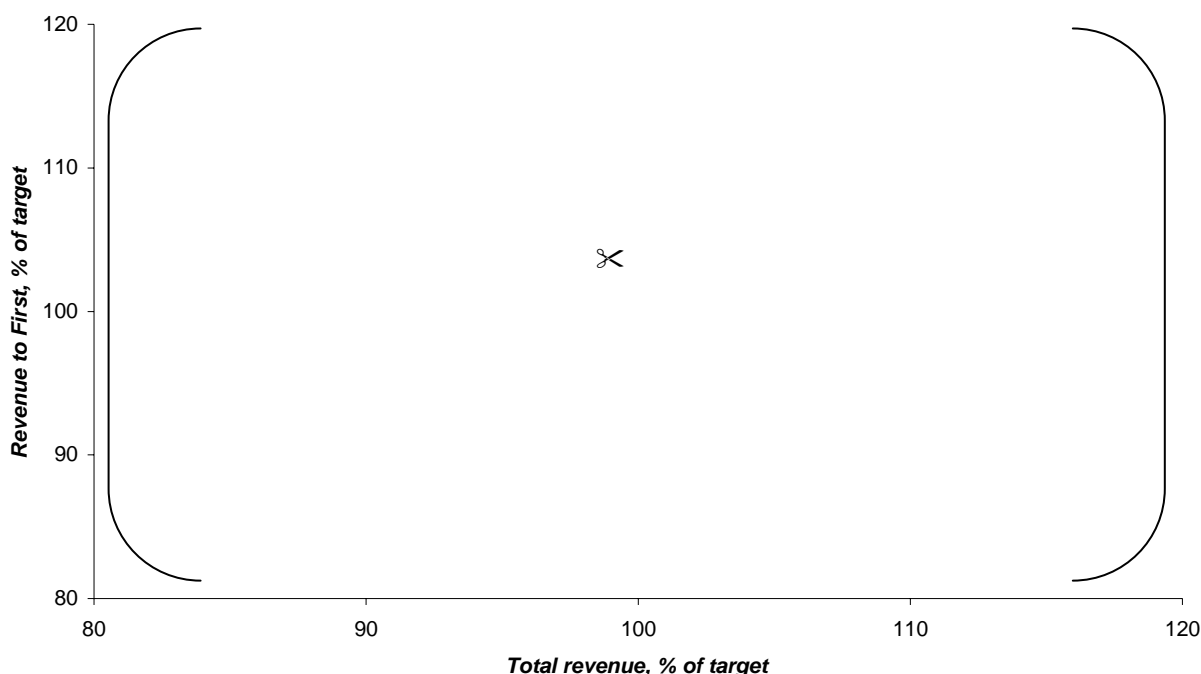
23. The original invitation to tender asked bidders for the Scottish rail franchise to bid on two alternative revenue risk bases: a base case in which the franchisee takes the revenue risk across the whole franchise and a mandatory variant in which the franchisee takes no revenue risk and the SRA and the Scottish Executive cover the revenue risk across the whole franchise. In either case, the SPTE would have had the right to set fares in its area and the SRA would have set price caps for regulated fares.
24. In December 2003, the SRA asked bidders to make an additional bid on a third basis. They were invited to amend their base case submissions to incorporate a revenue share and support mechanism, referred to as a 'cap and collar', similar to that being negotiated for some other franchises. Under this option, the bidder was required to bid (a) a target level of revenue; (b) two threshold levels of revenue above this target; and (c) percentages for sharing additional revenue between the two thresholds and above the higher threshold. If revenue falls beneath a first revenue support threshold, set at 98 per cent of the target, the SRA provides revenue support. The bidder had to bid for a second, lower revenue-support threshold. If revenue falls between the two revenue-support thresholds the SRA provides revenue support at a rate of 50 per cent. Below the second revenue-support threshold, the SRA provides revenue support at a rate of 80 per cent.
25. The levels and shares actually bid by FirstGroup for the cap and collar are set out below:
 - (a) *Revenue share*: If revenue in a year falls between [] and [] per cent of target, the SRA will receive from FirstGroup [] the amount by which actual revenue exceeds [] per cent of target revenue. If actual revenue exceeds [] per cent of target, the SRA will (in addition to the amount due at [] per cent of target) receive [] per cent of the amount by which actual revenue exceeds [] per cent of target revenue.

(b) *Revenue support.* The SRA will provide revenue support to FirstGroup on the following basis, but only from the end of the fourth year of the franchise period. If actual revenue is between [X] and [X] per cent of target, the SRA will pay FirstGroup [X] the shortfall below [X] per cent of target revenue. If actual revenue is less than [X] per cent of target, the SRA will (in addition to the amount due at [X] per cent of target) pay [X] per cent of the shortfall below that level. Similar revenue support can only apply in the first four years if the shortfall is directly attributable to force majeure (other than industrial action).

26. Figure 1 illustrates the effect of FirstGroup's proposals on its revenue under the cap and collar.

FIGURE 1

FirstGroup's revenue as a percentage of target revenue



Source: FirstGroup.

27. The Scottish Executive has yet to make a final decision on the approach to revenue risk. It has, however, decided that there should be a consistent approach across the whole franchise area and that the mandatory variant under which the franchisee would carry no revenue risk should be dropped. In March 2004, bidders were asked to submit final prices for the two options in which the franchisee would either carry all, or most of, the revenue risk. A final choice between the base case and the cap-and-collar option is yet to be made.