A NEW MODEL FOR RAILWAY

In January 2012, BAA formally put Edinburgh Airport up for sale. A fierce bidding war is expected for a profitable and sought after asset. Issued a week later, the Invitation to Tender for the Intercity West Coast Franchise highlighting the need for the new operator to invest in some poor, unprofitable railway stations.

The disconnect is jarring. Airports and stations provide the same service – they allow passengers to board a mode of transport. But while one asset is highly coveted by the private sector, the other requires public subsidy, fails to deliver the requisite customer service and is not leveraging strong commercial opportunities. Previous reports such as the 2009 "Better Rail Stations" review suggest failure to spread best practice is costing the industry over £45m per annum, whilst external benchmarking against airports suggests the missed opportunity might be higher.

This was not lost on Sir Roy McNulty, who concluded in his Value for Money study that "The complexity of the contractual matrix in which stations operate can lead to sub-optimal investment…Split responsibilities for station development can lead to delays, avoidable cost increases, and potentially missed opportunities."

The present system, by which stations are owned by Network Rail, operated by TOCs and funded by a long term charge reflecting capital expenditure needs reform. The charge does not necessarily reflect station usage **[see Figure 1]** or the quality of the service offered.

In addition, the current structure:

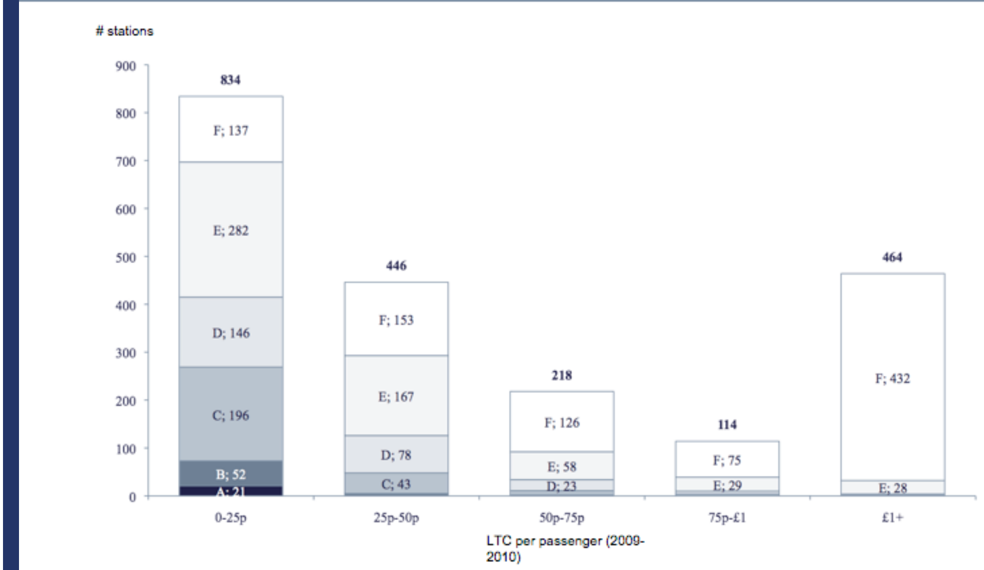
- Creates a sub-optimal process for planning and delivering investment in stations
- Lacks specialist expertise in promoting an integrated commercial offer
- Does not provide suitable incentive structures for ensuring quality and cost effective operation
- Is regulated under a model which is insufficiently granular and not fit for purpose

A new approach is required, in a model which empowers TOCs (and local communities) to specify service levels, reshapes the payment incentive and legislative structure to reward service quality, investment and innovation and leverages specialist skills to deliver upgrades and develop commercial facilities.

We propose that Dedicated Station Management Companies (SMCs) would offer one such solution. In our model:

- The SMC would take ownership of all stations, with long term responsibility for investment, maintenance and management of all stations. The SMC (backed by infrastructure grade finance) would deliver improvements more effectively and take long term investment decisions;
- The TOC would be a customer of the SMC, procuring a service for its passengers in the same way that an airline does from the airport. Payment would be made on a usage basis (in the same way that airlines pay aeronautical fees to airports) establishing a clear financial link to service quality;
- The SMC would receive all ticket retail commission and have the right to develop commercial retail and car parking at each station;
- It is possible that at many stations, this revenue would exceed the cost of running the station, and the SMC would therefore pay the TOC for these rights.
  [See Figure 2, the new station delivery model].

Figure 1: Long Term Charge Per Passenger



STATIONS IN THE UK

Combining this model with some changes to the regulatory strategy would address all of the weaknesses in the current system:

Planning and Delivering Investment

Longer franchises and clearer asset transfer are intended to encourage TOCs to invest. However, even assuming that this is achieved, it is not clear that TOCs would have the incentives or the skill set to deliver station upgrades. However, a specialist Station Management Company - which would continue to manage stations across multiple franchises - would.

Moreover, it could probably do it more cheaply - a recent study for New York University identified an average weighted cost of capital for Railroad operators of 8.88%, more than four percentage points higher than the 4.78% for banks.

Incentive Structures

TOCs and SMCs can establish new incentive structures to reward quality of service and investment. For example:

- Commission on ticket sales could become variable and linked to service quality. For example SMCs at a well-run station could, for example, receive 12% commission on regular ticket sales, whilst sales made at a poorly run station with no facilities would only receive 5%.
- Similarly, usage charges could be linked to output achieved and not the value of the asset base. This would encourage a true partnership between TOCs and the SMCs, specifying which services TOCs are prepared to pay for at which station.

Specialist Expertise

In the 2009 Review "Better Railway Stations", Green and Hall noted that "The importance of retail and catering is often underestimated within the industry." At airports such revenue is key: At BAA's airports in 2010 average retail spend per passenger was £5.11. Passengers will spend longer at an airport than a railway station. However if rail could achieve 10% of this, it would translate to £544m of retail spend, and with a 10% revenue share arrangement – similar to airports - £54m of new profit.

An SMC would be suitably incentivised and qualified to develop such retail facilities, and by so doing could develop the funding mechanism for new investment.

Categorisation Structures

With a new approach to station ownership must come better categorisation and regulation of stations. The current model is insufficiently granular. Each station will require its own retail and commercial plan reflecting its service profile, usage pattern and location which an SMC would develop.

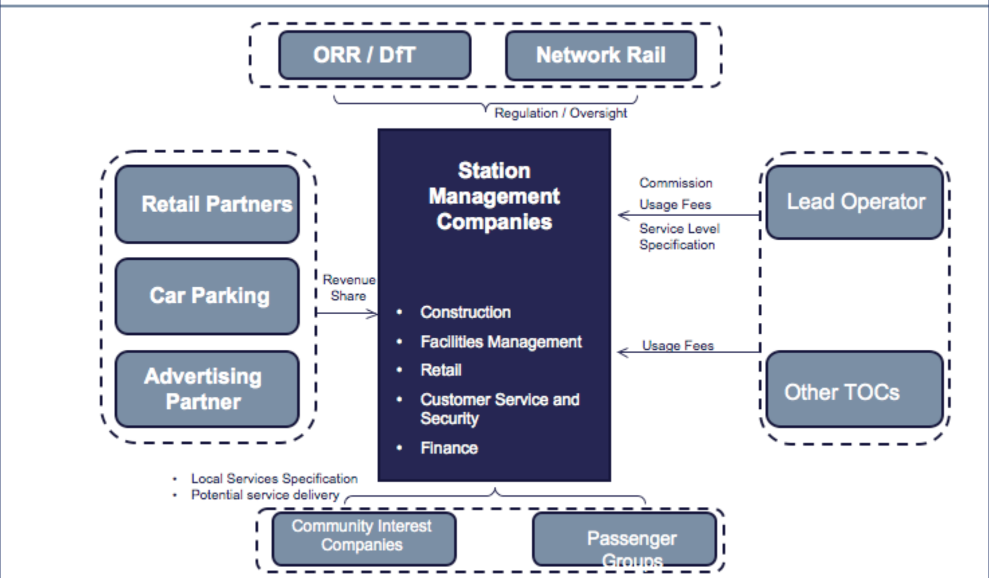
As McNulty noted "passenger security is not necessarily enhanced by the presence of a person in a ticket office." Passenger security and investment across the network could be improved though the investment in remote station control rooms instead of ticket offices, with staff reduction plans contingent on a certain percentage of passengers using TVMs / Internet ticketing or successful transferring of ticket retail to local shops or Community Interest Companies.

Delivering this model

The forthcoming tender for the Great Western franchise is the ideal test bed for a new station delivery model. As lead operator of over 200 stations (many of which require significant upgrade) the benefits of a new model would be significant.

In the consultation document on that franchise, the DfT has stated that: "Bidders will be expected to have considered how best to enhance the quality of the station portfolio in their proposals". In doing so, prospective bidders would be well advised to consider a Station Management Company.

Figure 2: Station management company relationships



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