

## **Rail industry overview**

### **Historical background**

1. The first locomotive-hauled railway for the transport of passengers and goods was the Stockton and Darlington Railway, which opened in 1825. The Liverpool and Manchester Railway opened in 1830. The first trunk lines from London opened in the 1830s and the railway system developed rapidly thereafter. Originally the railways were operated by many separate companies, but consolidation occurred from the 1840s onwards, culminating in the Railways Act 1921 which amalgamated virtually all the railways in Great Britain into four companies, the Great Western Railway, the London Midland and Scottish Railway, the London and North Eastern Railway and the Southern Railway.

2. On 1 January 1948 these four railway companies were nationalized. They jointly became known as the Railway Executive, a part of the British Transport Commission (BTC).

3. The Transport Act 1962 abolished the BTC and established BRB to provide railway services in Great Britain. Against a background of declining traffic levels and increasing payroll costs, losses were experienced which necessitated capital reconstructions in 1962 and 1968. These capital reconstructions took place against the background of the Beeching Reports which recommended closure of approximately one-third of the existing route network and the development of improved services between major centres of population.

4. The Transport Act 1968 included provisions to separate services that were considered socially necessary but were not self-supporting from the commercial system and provided revenue support on an individual basis for certain of those unremunerative services.

5. The Railways Act 1974 established new methods of supporting BRB's passenger services. The individual grants for unremunerative services were replaced by the Public Service Obligation grant. The Secretary of State for Transport also placed an obligation on BRB that it should continue to operate its passenger system so as to provide a public service broadly comparable with that then provided.

6. A major reorganization of BRB was completed on 1 April 1992. This included transferring the responsibilities of the six geographically-based regions (Anglia, Eastern, London Midland, Scottish, Southern and Western) to a business management structure based on the type of rail service being provided. Accordingly, BRB's three passenger rail divisions-InterCity, Regional Railways and Network SouthEast-became responsible for all aspects of their services, including both infrastructure and rolling stock. Within the businesses, responsibility for performance was delegated to profit centres in order to bring management decision-making closer to the customer.

### **The new industry structure**

7. In July 1992 the Government published a White Paper *New Opportunities for the Railways* which set out its proposals for the privatization of BRB. The key elements of the White Paper were:

- (a) BRB's track and infrastructure would become the responsibility of Railtrack (to become a public company);
- (b) passenger services would be managed and operated by the private sector through a system of franchising;

- (c) rights of access to the railway would be provided for private operators without a franchise;
- (d) a Rail Regulator would be appointed to oversee access rights to stations, depots, track and infrastructure;
- (e) rail freight and parcel operations would be transferred entirely to the private sector; and
- (f) the private sector would have the right to purchase or lease stations.

8. In order to implement this policy the Railways Act was passed in November 1993. This Act created the powers to transfer to others the ownership and the activities of BRB. As a result of the Railways Act several new bodies were created and the operations of BRB restructured in anticipation of privatization.

9. As far as passenger rail services are concerned the key elements of the restructured rail industry are as follows:

- (a) The infrastructure of the railways is operated by Railtrack, which also owns most of the stations and depots. With the exception of a small number of major stations (also known as 'independent stations'), almost all of Railtrack's stations are leased to one or other of the TOCs, usually the one with the greatest existing use of the station. The independent stations are Birmingham New Street, London Charing Cross, Edinburgh Waverley, London Euston, Gatwick Airport, Glasgow Central, London King's Cross, Leeds, London Liverpool Street, London Bridge, Manchester Piccadilly, London Paddington, London Victoria and London Waterloo (excluding Waterloo International).
- (b) Passenger rail services are now operated by TOCs, which are owned by various franchisees.
- (c) TOCs acquire access to the rail track by means of an access agreement with Railtrack, which is regulated by the Rail Regulator.
- (d) TOCs obtain the right to use stations and depots either by leasing them from Railtrack or by means of a regulated access agreement with another TOC or, in the case of St Pancras, under a regulated access agreement with L&CR.
- (e) Substantially all of the domestic passenger rolling stock previously owned or leased directly by BRB was transferred to new ROSCOs. The TOCs lease their rolling stock from the ROSCOs or third parties.

10. In the period prior to privatization a considerable reorganization took place within BRB in order to prepare for privatization. In particular:

- (a) The infrastructure—the ownership of the rail track, signalling infrastructure, depots and many of the stations—was transferred to Railtrack. Railtrack Group plc, its parent, was privatized in May 1996 and its shares are listed on the London Stock Exchange.
- (b) Twenty-five TOCs were set up. Each TOC<sup>1</sup> entered into:
  - (i) leases with Railtrack in respect of stations and depots;
  - (ii) a track access agreement with Railtrack;
  - (iii) a station access agreement with one of Railtrack, the TOC which holds the lease from Railtrack, or an independent third party for those stations which are not leased by the TOC concerned but to which it requires access;

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<sup>1</sup>Cross Country and Island Line are slightly different in that they do not have the full range of Railtrack agreements.

- (iv) station access agreements with other TOCs in relation to stations which the TOC leases from Railtrack but to which another TOC requires access;
- (v) similar arrangements to lease or gain access to depots; and
- (vi) leasing arrangements with the ROSCOs for rolling stock. ROSCOs undertake maintenance on their rolling stock either by means of contracts with privately-owned maintenance companies or through contracts with TOCs which operate maintenance depots (themselves leased from Railtrack).

## **Franchising Director and Rail Regulator**

11. The Railways Act created two new statutory offices:

*(a)* the Franchising Director; and

*(b)* the Rail Regulator.

## **Franchising Director**

12. The Franchising Director's principal responsibilities under the Railways Act include negotiating and awarding passenger rail franchises on the basis of competitive tendering and monitoring the performance of the franchisees. The Franchising Director's principal objectives given to him by the Secretary of State for Transport in March 1994 were to ensure that passenger rail services were provided under franchise agreements as soon as reasonably practicable and to secure an overall improvement in the quality of passenger rail and station services. The second of these objectives is a continuing one. Under the franchise agreements the Franchising Director may receive payments from franchise operators on profitable franchises and is responsible for making subsidy payments to other franchise operators.

13. His duties are essentially fourfold:

*(a)* to designate passenger services as eligible for franchising;

*(b)* to award the franchises, normally on the basis of competitive tendering to be conducted by him;

*(c)* to ensure that the initial franchise assets are vested in the franchise operator and that the franchise operator is a wholly-owned subsidiary of the franchisee; and

*(d)* to ensure that there is no disruption to services when a franchise agreement comes to an end.

The Franchising Director has a duty to ensure that any payments he makes will economically and efficiently achieve his objectives.

14. He also has various duties in relation to fares. He must make sure the franchise agreement contains such provisions as are necessary for ensuring that fares charged by a franchise operator are reasonable if it appears to him that the interests of persons who use or are likely to use franchised services so require. This entails imposing limits on increases in certain fares. The Franchising Director is also given an enforcement role, to secure compliance with the terms of franchise agreements. This allows him to make both provisional and final orders and, where appropriate, to impose financial penalties on franchise operators. Other duties and powers relate to closures, transfer of the business of insolvent TOCs and reporting to the Secretary of State for the Environment, Transport and the Regions. The Franchising Director is also required to fulfil any objectives, instructions and guidance given to him from time to time by the Secretary of State.

## **Rail Regulator**

15. The Rail Regulator's functions under the Railways Act are to grant licences to operators of railway assets such as TOCs, to enforce the licences, to supervise the granting of rights of access to tracks, stations and depots, and to undertake certain responsibilities under competition legislation. He must exercise his functions in the manner he considers best calculated to:

- (a)* protect the interests of users of railway services;
- (b)* promote the use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent that he considers economically practicable;
- (c)* promote efficiency and economy on the part of persons providing railway services;
- (d)* promote competition in the provision of railway services;
- (e)* promote measures designed to facilitate the making by passengers of journeys which involve use of the services of more than one passenger service operator;
- (f)* impose on the operators of railway services the minimum restrictions which are consistent with the performance of his functions; and
- (g)* enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance.

16. The Rail Regulator also has a duty to exercise his functions in the manner which he considers is best calculated to protect:

- (a)* the interests of users and potential users of services for the carriage of passengers by railway provided by a private sector operator otherwise than under a franchise agreement, in respect of:
  - (i)* the prices charged for travel by means of those services; and
  - (ii)* the quality of the service provided,in cases where the circumstances appear to be such as to give rise to a monopoly situation in the passenger transport market; and
- (b)* the interests of persons providing services for the carriage of passengers or goods by railway in their use of any railway facilities which are for the time being vested in a private sector operator, in respect of:
  - (i)* the prices charged for such use; and
  - (ii)* the quality of the service provided.

17. The Rail Regulator has further duties to:

- (a)* take into account the need to protect all persons from dangers arising from the operation of railways, taking into account, in particular, any advice given to him by the Health and Safety Executive;
- (b)* have regard to the effect on the environment of activities connected with the provision of railway services;
- (c)* act in a manner which he considers will not render it unduly difficult for persons who are holders of network licences to finance any activities or proposed activities in relation to which the regulator has functions under the Railways Act;

(d) have regard to the financial position of the Franchising Director in discharging his functions under the Railways Act; and

(e) have regard to the interests of persons who are disabled.

18. Under the Railways Act licences are required for the operation of certain railway assets. There are four main types of licence:

(a) train operator's licence, which may be a passenger or a non-passenger licence;

(b) station licence;

(c) light maintenance depot licence; and

(d) network licence.

19. Licences may be granted by the Rail Regulator subject to the terms of the General Authority issued by the Secretary of State. Prior to privatization TOCs had been granted by the Secretary of State the licences that they needed to operate, which are typically a train operator's licence, station licence and light maintenance depot licence. However, a change in ownership of the TOC represents a 'change of control' for licence purposes and the franchisee has to satisfy the Rail Regulator that the relevant licences should be allowed to remain in force. The licensed operator, the TOC, remains the same regardless of any change of control of the franchise.

20. There are several legally binding arrangements which passenger operators are required to enter into as conditions of their licences and which have effect from the date the licence comes into force. These arrangements cover:

(a) third party liability insurance;

(b) claims allocation and handling;

(c) through-ticketing and other network benefits;

(d) handling of complaints; and

(e) provision of British Transport Police services.

### **The Rail Regulator's policy on competition**

21. The Rail Regulator's policy in relation to competition has been defined following consultation and taking into account guidance given by the Secretary of State for Transport in 1994. The guidance states that it is 'the policy of the Government that competition on routes to be franchised should be moderated to the extent necessary to ensure the successful launch of the first generation of franchises'. The Rail Regulator has also taken the view that, as the railway industry is still at an early stage of a period of fundamental restructuring, it would be difficult to predict with confidence the effects of allowing uncontrolled competition. His policy therefore is that no significant new entry in competition to services operated under the first generation of franchises should be allowed before 31 March 1999, and that substantial restrictions should remain for at least a further three years after that date, that is until 31 March 2002. These restrictions (achieved by Railtrack being constrained from selling additional access rights on flows which are protected from competition) will be reviewed in 2001.

22. In the first stage of the regime for moderating competition operators were able to nominate a list of point-to-point flows (subject to a flow being material, which is generally defined as representing more

than 0.2 per cent of the operator's total fare box revenue), on which new entry for scheduled passenger services is not permitted without the operator's agreement. In advance of the second stage operators will be able to nominate a revised list to be used as the basis for restrictions on new entry during the second stage. During this stage new entry will be permitted on nominated flows up to a ceiling of 20 per cent of those flows by revenue. Flows that face pre-existing competition will count towards this ceiling but there will be no restrictions on new entry for scheduled passenger services on such already competitive flows. New entry will be unrestricted on any flows not so nominated.

23. For the purposes of the above regime pre-existing competition does not include competition between neighbouring rail franchises on different routes.

24. The Rail Regulator may remove protection from competition with respect to flows where two TOCs operate services but both are in the same ownership.

## **The franchising process**

25. Under the Railways Act it is the Franchising Director who has responsibility for the provision of passenger rail services. By means of a franchising process the Franchising Director awards the right to operate passenger rail services over particular routes to a franchisee for a fixed term, typically seven years, with a possibility for longer franchises to be awarded, for example in order to secure investment in rolling stock which would otherwise not be made.

26. In bidding for a franchise prospective franchisees are required to indicate what level of subsidy they would require from the Franchising Director in order to undertake the operation of the TOC's services or alternatively what level of fee they are prepared to pay to the Franchising Director. It was expected that there would be some TOCs where the franchisees would be able to operate at a profit and therefore would be in a position to make payments to the Franchising Director. However, there were other TOCs where it was anticipated that franchisees would be able to operate only if they received a subsidy from the Franchising Director. One of the key elements of any franchise bid is therefore the amount of payment offered or subsidy sought from the Franchising Director. Typically bidders for franchises indicate levels of payment or subsidy which vary over the period of the franchise term.

27. Persons successfully tendering for a franchise enter into a franchise agreement with the Franchising Director and acquire the whole of the issued share capital of the relevant TOC. The TOC, which will continue to operate its passenger services, will already have in place its licences to operate railway assets, the key contracts which will govern its access to the railway system, its leases of rolling stocks and its relationships with other industry participants. For this reason it is the TOC and not the franchisee which is the franchise operator (although it will be under the ownership and control of the franchisee).

28. On the award of a franchise the franchisee, in acquiring the TOC, obtains the benefits of the existing access agreements for track, stations and depots.

## **The franchise agreement**

29. The franchise agreement governs the relationship between the Franchising Director, the franchisee and the franchise operator. Under it the franchisee undertakes to the Franchising Director to secure the provision of specified passenger services by the franchise operator for the term of the franchise. It provides for certain payments to be made either by the Franchising Director to the franchise operator or vice versa. The level of payments determined during the bidding process is determined for the franchise taken as a whole. The key elements of the franchise agreement include the following:

- (a) *The PSR*. This details the minimum services which the franchisee is required to provide. This will typically include the minimum number of trains on each service, first and last train times,

frequency and maximum journey times. On commuter services there is also a requirement to maintain peak train loadings below specified limits. The PSR is not a timetable but sets out the minimum service standards to be provided by means of the franchisee's timetable. Further information on the PSR is set out in paragraphs 30 and 31.

- (b) *Prices.* The franchise agreement imposes controls on the prices to be charged for particular categories of tickets. Some fares remain unregulated but season tickets and key leisure fares are regulated. The fares that are regulated vary from franchise to franchise. Further information on fares is given in paragraphs 32 to 35.
- (c) *Financial regime.* This is the level of subsidy payments to be made by or to the Franchising Director. Payments made by the Franchising Director are made out of Government funds and payments by TOCs go into Government funds.
- (d) *Performance bonds.* The franchise operator is required to provide and maintain a performance bond, which counts as part of the initial capital requirement, and a season ticket bond. The performance bond could be used to offset costs incurred by the Franchising Director in the event of premature termination of the franchise. The season ticket bond represents outstanding service obligations due to those who have purchased such tickets.
- (e) *Duration.* Most of the first round of franchises were awarded on the basis of a bid for a minimum duration of seven years but with the opportunity for bidders to submit proposals for longer terms.
- (f) *Inter-operator arrangements.* Franchise operators are required to participate in a number of inter-TOC arrangements which are designed to ensure that certain network-wide benefits are preserved, for example through interavailable fares and young persons', senior citizens' and disabled persons' railcards.
- (g) *Continuity of service.* At the end of a franchise the Franchising Director has to ensure that he is in a position to re-award the franchise and ensure continuity of service. To this end certain assets must remain within the TOC and be transferred to any successor operator.

## **Minimum service standards**

30. The franchise operator's obligations relating to the quality of the rail service it provides are derived from three sources:

- (a) a schedule to the franchise agreement which sets out the PSR for the TOC as required by the Franchising Director;<sup>1</sup>
- (b) additional commitments to specific service enhancements over and above the PSR which the franchisee included in its tender and to which it is committed as a result of their inclusion in the franchise plan which is attached to the franchise agreement; and
- (c) the requirement on operators to survey customer satisfaction with specified quality attributes and the requirement which can be imposed on them to take remedial action if customer satisfaction falls below benchmark levels on any attribute.

31. The details of the PSR vary from franchise to franchise and include matters such as:

- (a) frequency of trains;
- (b) stations to be served;

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<sup>1</sup>For those agreements to which a PTE is a party, the PSR in relation to services in the area of the PTE's responsibility is laid down by the PTE.

- (c) maximum journey times;
- (d) first and last trains;
- (e) weekend services;
- (f) through services; and
- (g) load factors and/or peak train capacity.

Performance of the franchise operator against the PSR is monitored by OPRAF which has established three stages of intervention in the case of shortfall, culminating in default of the franchise agreement.

## **Fare regulation**

32. Under the Railways Act, if the Franchising Director considers that the interests of persons using franchised services so require he must include in the franchise agreement a provision for securing that the price of fares is reasonable. The Franchising Director's current general policy on fare regulation is as follows:

The Franchising Director has concluded that this duty should be exercised by constraining unrestricted standard-class return fares and certain single fares for short distance journeys, 'Saver' fares (which do not include 'Super Saver' fares) on other journeys and certain standard class season ticket fares including all those for weekly season tickets. ...For the three years from 1 January 1996, increases in capped fares will not be permitted to be more than the RPI from the 1995 base price. For the four years from 1 January 1999, the price cap for such fares will be RPI minus one. Unless the Franchising Director decides otherwise, the price cap from 1 January 2003 will continue to be RPI minus one. ...There will be some limited scope for individual fares to exceed the cap where these are balanced by other controlled fares being held below cap levels.<sup>1</sup>

33. For each flow of over about 80 km where a Saver fare existed as at June 1995, the Franchising Director requires a return fare with the following characteristics to be available at a price capped by reference to the price of that Saver fare as at June 1995. Such a fare must be:

- (a) valid for at least one month;
- (b) valid on any day of the week; and
- (c) valid at any time of day, except that it need not be valid before 10.30 (Mondays to Fridays) or for journeys from Greater London and certain major stations near London between 1500 and 1900 (Mondays to Fridays).

34. For other journeys (that is, where a Saver fare is not available), the Franchising Director requires a return fare which is valid at all times of the day to be available, at a price capped by reference to the price of the unrestricted open (or one-day) return fare as at June 1995.

35. The effect of the Franchising Director's price regulation policy is to restrict increases in key rail fares initially to the RPI and subsequently to keep them below increases in the RPI.

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<sup>1</sup>Source: OPRAF Passenger Rail Overview, June 1996.

## **Passenger's Charter**

36. In the tendering process potential franchisees were required to submit their proposed charters containing provisions no less favourable than the existing BRB charter. The charter proposed by the winning bidder was then annexed to the franchise agreement and the franchise operator is required to use reasonable endeavours to comply with it during the franchise term.

## **ATOC schemes**

37. The Association of Train Operating Companies (ATOC) is an unincorporated body established to facilitate the development of various arrangements between the TOCs covering matters such as ticketing and settlement, discount cards and telephone enquiry bureaux. These arrangements or schemes have been put in place to enable TOCs to offer network-wide products to passengers and to make it possible for the individual TOCs to continue to provide certain facilities to passengers which existed prior to privatization.

38. Of the seven ATOC schemes, one of the most significant is the Ticketing and Settlement Agreement (TSA) which came into effect on 23 July 1995. The TSA deals with fare-setting, fare distribution, through fares and interavailability, the retailing of fares, methods of payment and the settlement of amounts owing to and from TOCs dealt with under the TSA. The TSA provides for three types of fares: permanent fares, temporary promotional fares and special fares:

- (a) *Permanent fares.* These fares are set on three occasions each year during the 'fare-setting round'. The individual passenger TOCs notify the fares which they have created to Rail Settlement Plan Limited (RSP). All proposed fares that are notified to RSP in the fare-setting round are disclosed to all passenger TOCs to enable them, if they wish, to respond to other passenger operators' pricing decisions and to address any anomalies that may have arisen.
- (b) *Temporary promotional fares.* These do not have to be notified as part of the fare-setting round and may be notified to RSP at any time. Such fares may be created for no more than 12 weeks and may not replace a fare with the same or substantially similar rights and restrictions. This is to prevent passenger operators relying exclusively on temporary fares and thereby taking advantage of the more limited retailing obligations which apply to them.
- (c) *Special fares.* The TSA also enables passenger operators to create special fares. They include, for example, fares for rail-inclusive tours and group travel.

## ***Interavailability***

39. On some flows there may be more than one operator which carries passengers over the same track. Interavailability allows a passenger holding a ticket at a specified fare to use any operator's service to reach the destination. On each flow to which compulsory interavailability applies (currently virtually all flows), a lead operator is designated. This is the operator with the greatest commercial interest in a particular flow and/or the best understanding of the market which the flow serves. The lead operator is entitled to decide on the interavailable fare over the flow and in such a case other TOCs which run trains on the flow are required to sell and honour tickets at these fares. Such interavailability does not extend to fares with an advance-purchase train-specific requirement or special fares.

40. Passenger operators other than the lead operator may also create their own dedicated or jointly agreed fares for the flow. These exist alongside the lead operator's fares and therefore there is some price competition notwithstanding the existence of compulsory interavailability.

41. On flows where compulsory interavailability does not apply and there is no lead operator any passenger operator which operates over more than 50 per cent of the route mileage on the flow may create through fares for the whole flow. These require the passenger to travel on its trains for the part of the flow over which it runs. For the remainder of the flow the fare must be honoured on the trains of any TOCs.

## ***Income allocation***

42. How the income is allocated depends on the type of fare it came from. The creator of a dedicated fare, for example (which entitles a passenger to travel on that passenger operator's trains only), is entitled to 100 per cent of the price of the fare. In the case of a jointly agreed fare, the carriers are entitled to the proportion of the price of the fare which has been agreed between them. In the case of an interavailable fare created by the lead operator on a flow to which compulsory interavailability applies, or a through fare created by a major flow operator, the principle is that the income should be allocated between operators in relation to the actual number of passengers travelling on each passenger operator's services in respect of that fare. Where no express agreement exists, this is usually implemented by allocating revenue in accordance with allocation factors produced by the ORCATS model (a suite of computer programs developed by BRB). The ORCATS allocation factors are based on the timetable and assumptions as to passenger behaviour derived from historical survey evidence.

43. The Rail Regulator and the Franchising Director both require passenger operators to settle revenues arising from the sale of fares, reservations and discount cards on behalf of other passenger operators through an approved settlement system. The current system is that each year is divided into 13 accounting periods of four weeks each and settlement occurs at the end of each of the settlement periods.

44. The other six ATOC schemes include arrangements relating to:

- (a)* London Transport;
- (b)* railcards;
- (c)* international travel;
- (d)* travel trade sales;
- (e)* telephone enquiry bureaux; and
- (f)* staff travel.

## **Timetabling**

45. Each TOC's timetable is conditioned by a combination of:

- (a)* its PSR commitments to the Franchising Director under the franchise agreement;
- (b)* the additional service commitments it has given to the Franchising Director under its franchise plan; and
- (c)* the arrangements for access to the tracks and stations that it has reached with Railtrack and other TOCs.