Rail Partners

Harnessing the commercial expertise of the private sector

The importance of incentives to drive revenue growth and recovery

2022

1. Overview

The private sector can grow revenue faster than the public sector alone with the right incentives

Since privatisation, the expertise, capability, determination and agility of the private sector has played a vital role in transforming Britain's railway finances; driving more than a doubling in passenger numbers and growing revenue at more than twice the rate of GDP, turning a £2 billion annual operating loss into an operating surplus in many of the years before the pandemic.

However, the dramatic fall in passenger numbers and revenues, caused by the COVID-19 pandemic, has halted that growth. The industry is facing a cumulative shortfall of around £20 billion in fares revenue by 2025, with the gap currently being plugged by taxpayers. Revenues are presently around 80% of pre-pandemic levels but this still leaves a shortfall of around £2.5 billion per annum. This is unsustainable and cannot be bridged by cost savings alone. We need to reharness all the innovation and expertise of the private sector to plug the gap as quickly as possible and return to a financially sustainable railway.

The Williams-Shapps Plan for Rail rightly notes the importance of building revenue incentives into future contracts "…to grow passenger numbers, foster a culture of innovation and introduce efficiencies that deliver real benefits for passengers"[1]. Independent owning groups support this and believe the right suite of incentives and levers for passenger operators, within a framework set by GBR, will ensure that private sector capabilities and experience are fully utilised not only to deliver for passengers but drive down costs and increase revenue to reduce the current financial burden on the taxpayer.

Our analysis shows that for operators on revenue risk,[2] revenues returned to around 87% of pre-pandemic levels in April 2022 (Period 1),[3] compared to 78% for DfT contracted operators in long-distance markets[4] with no commercial revenue incentives and with limited or no commercial freedom. This 9% shortfall equates to over £300m of lost revenue per annum across these 5 operators and nearly £1bn over a 3 year HMT spending review period.

In order to drive faster revenue recovery and unlock hundreds of millions of pounds in potential revenue, we recommend based on our analysis, that:

- **Current National Rail Contracts (NRCs) should have dormant revenue growth incentives switched on** and operators provided with the commercial freedom to respond to those incentives to bring back revenue faster;
- **Future Passenger Service Contracts (PSCs) should include revenue growth incentives and the commercial freedom** to respond to those incentives, as indicated in the white paper.[5] We have previously outlined what commercial freedom could be given to operators, including operator input on timetabling to drive performance and patronage, control over yield managed fares to grow revenue (with greater freedom on timetabling and fares for long-distance operators), and the ability to deliver local marketing campaigns to boost promotions – all within an overall framework set by GBR.
- **At the appropriate time, Passenger Service Contracts (PSCs) should feature some transfer of revenue risk and reward in the long-distance market** to fully harness the commercial expertise and entrepreneurial spirit of the private sector, as indicated in the white paper.[6]

[1] Williams-Shapps, Plan for Rail, "Revenue incentives will be built into contracts to grow passenger numbers, foster a culture of innovation and introduce efficiencies that deliver real benefits for passengers." p55
[2] MerseyRail, Grand Central and Hull Trains. It should be noted that unlike other contracted operators, none of these operators received additional financial support during the pandemic.
[3] Normalised to take into account the difference in number of days between period 1, 2022/23 and period 1, 2018/19.
[4] LNER, Avanti West Coast, East Midlands Railway, Great Western Railway and Cross Country.
[5] See footnote 1.
[6] Williams-Shapps, Plan for Rail, "Where and when it represents value for money and is financially sustainable, operators will have more commercial freedom, particularly on long-distance routes." p7.

2. Track record

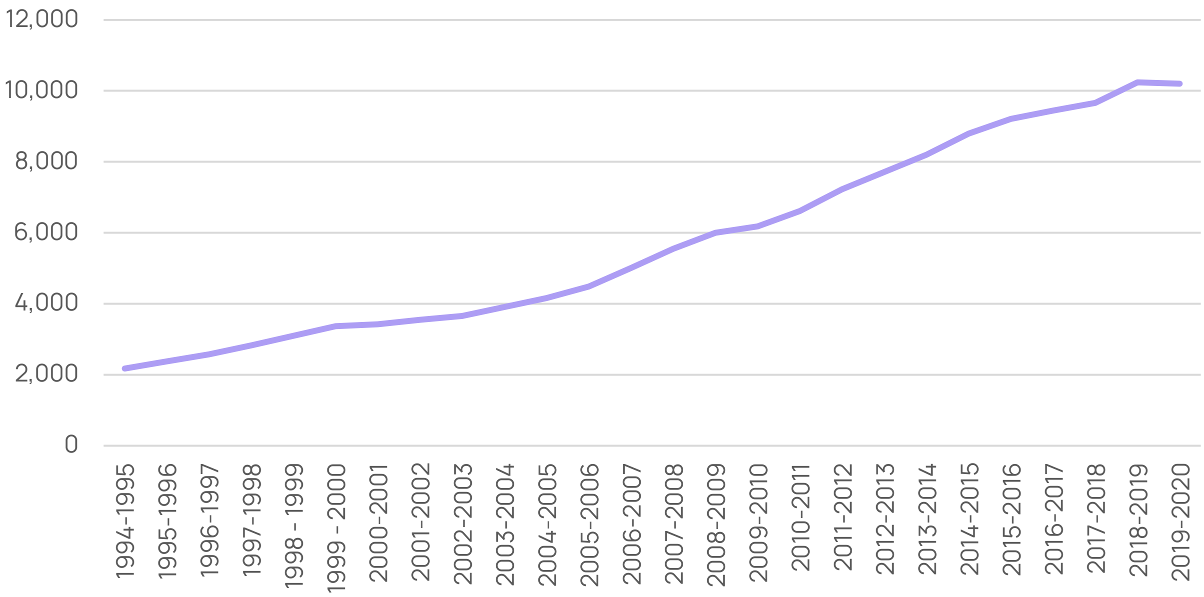
Historically, revenue incentives have driven strong passenger and revenue growth

The Williams-Shapps Plan for Rail states that our country succeeds when the public and private sectors work effectively together, and that our railway must therefore combine the best of the public and private sectors in the future.[7]

As evidenced in Figure 1 and noted above, since privatisation in 1994, private sector train operators have delivered strong revenue growth, significantly above what could be explained by exogenous (economic) factors alone. Owning groups and their train operators, responding to commercial incentives, have used their innovation, in-depth knowledge of their markets together with the development of partnerships with stakeholders to increase passenger numbers and drive revenue growth.

Owning groups support the establishment of GBR as a guiding mind, bringing track and train together, having responsibility for the whole-industry profit and loss and taking revenue risk in many contracts. However, working within this overall industry framework, owning groups and their train operators must once again be incentivised through their contracts to maximise revenues by using their strengths: ability to innovate throughout the life of the contract, entrepreneurial mindset, and commercial and delivery expertise. This is entirely consistent with the Plan for Rail and particularly pertinent in the context of the current industry financial position with significantly increased levels of taxpayer support.

Figure 1: Total franchised passenger revenue since privitisation (£ million)



[7] Williams-Shapps, Plan for Rail, "Our country succeeds when its public and private sectors work in tandem." p76

Figure 1: Data from Office and Rail and Road : Passenger rail usage, Passenger revenue by sector Table 1211

3. Current rail trends

Operators on revenue risk are increasing revenues faster than operators not on revenue risk

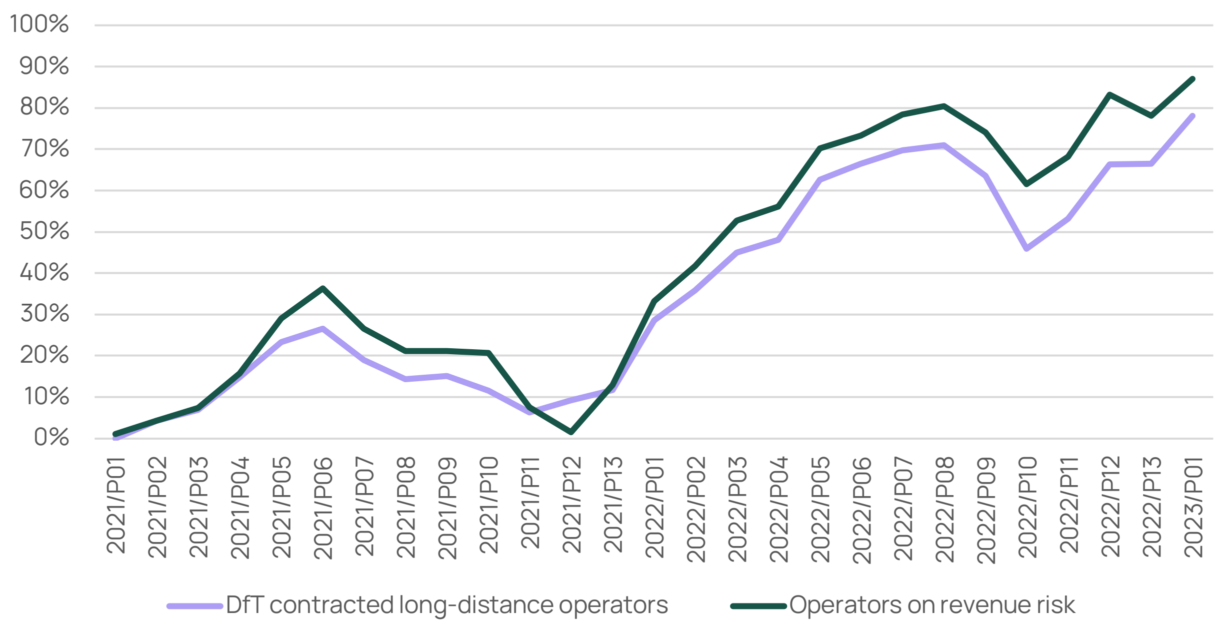
In March 2020 most franchised train operators were placed onto Emergency Measures Agreements (EMAs), then Emergency Recovery Measures Agreements (ERMAs) and are subsequently being transferred to National Rail Contracts (NRCs). Under EMAs, EMRAs and NRCs, most cost risk and all revenue risk of train operations transferred to government and revenue growth incentives are currently not utilised. The whole premise of private sector involvement in rail, as in other sectors, is to harness its commercial expertise and foster innovation to deliver better outcomes for customers and taxpayers.

The most recent figures show that rail revenue is just over 80% of pre-pandemic levels. As we emerge from the pandemic, passenger revenues are gradually recovering but we believe this could be accelerated if private sector train operators were given some commercial freedom. This freedom would be positioned within an overall industry framework created by DfT/GBR and would provide operators with revenue incentives and associated levers to encourage innovative use of that commercial freedom.

Figure 2 shows that operators on revenue risk[8] have increased their revenues at a faster rate when compared collectively to DfT contracted long-distance operators. By April 2022, the three operators on revenue risk had grown collective revenues to 87% of pre-pandemic levels compared with DfT contracted long-distance operators at 78% of pre-pandemic revenues.

These are high-level comparisons and TOCs have achieved differing degrees of revenue recovery across the different markets they serve. Leisure markets have recovered to greater than pre-pandemic levels whilst business and commuter markets are generally still well below pre-pandemic revenue levels. However, it is unlikely that

Figure 2: Revenue risk operator vs long distance EMRA/NRC operator revenue as % of 2019



[8] Data from Hull Trains, Grand Central and Merseyrail

differences in recovery rates in different markets explain the significant gap shown in Figure 2, a difference that peaked in period 12, 2022 at 17%.

Figure 2 shows that for the period examined, those operators on revenue risk have consistently seen revenues above DfT contracted long-distance operators relative to pre-pandemic levels. Although the gap is narrowing, this pattern would indicate that those operators on revenue risk and with greater commercial freedom act more quickly in implementing initiatives to grow passenger numbers and revenue – *see case studies*.

It should be noted that although LNER is a public sector operator and hence does not have strong corporate financial incentives, it has also fared well against other long-distance operators in growing back revenues. We believe there are two reasons for this. First, it has had to respond to the competition faced by Grand Central, Hull Trains and Lumo. Second, we understand that LNER has been afforded greater latitude by DfT when compared to DfT private sector contracted operators. LNER was the first DfT TOC allowed to resume marketing and promotional activities in May 2021, and also one of the earliest to reinstate near pre-Covid service levels – allowing greater scope for recovery.

We provide four case studies to demonstrate how operators on revenue risk have been agile to attract passengers back to their railways and grow back revenues strongly.

Case study: Merseyrail (Abellio/Serco) working with local partners

Merseyrail were able to optimise revenue recovery with agile campaigns that aligned spend and activity with national trends.

For example, post-lockdown(s), Merseyrail promoted outdoor days to encourage leisure journeys when restrictions limited indoor activity – working with local partners to promote outdoor venues and events. For returning commuters, a 'flexi-ticket' was developed consisting of 3 return tickets for use within 7 days. Further, from May 2022, in response to the high levels of demand, Merseyrail has been operating a 15-minute frequency service to capitalise on revenue potential.

For all campaigns, Merseyrail has adopted a 'base budget', which is committed, with an upper spend limit agreed which can be used via adjustable channels (i.e. digital or radio). The strength of this approach was highlighted by benchmarking in late 2021 which showed that Merseyrail leisure revenue was 7% above similar TOCs.

Case study: Grand Central (Arriva) Extended Booking Horizon

Grand Central stopped operating services three times during COVID as it was not commercially viable to continue. Driven by the pressing need to earn revenue as quickly as possible, Grand Central worked on extending advance booking horizons from the pre-Covid industry standard of 12 weeks before departure (T-12) to 6 months (T-26): the maximum window that online retail systems can currently manage.

This change went live March 2021, 23 days before Grand Central resumed passenger services. This enabled Grand Central to double the amount of its inventory available for sale and along with the industry's 'Book with Confidence' policy, customers were able to confidently book advance purchase fares and make reservations up to 6 months in advance. This was a key factor in Grand Central's strong recovery of leisure demand throughout Q2-3 2021.

This commercially-driven change came at a time when the industry was struggling to maintain T-8 on most routes – with CrossCountry at T-6 and LNER at T-8 (although LNER have subsequently extended to T-26). Grand Central bookings beyond T-12 now typically making up 8% of all bookings. While Network Rail goes live with its 'Personalised Journey Information programme' later this summer, which will enable all operators to open future trains for sale without a finalised timetable and potentially extend T-12, Grand Central achieved that milestone 15 months ago.

Case study: Hull Trains (First) getting customers back on track

The open access operator Hull Trains recently demonstrated its agility and commercial capability when launching the 'Hull Leisure Return' discount promotion.

Prices to travel on Hull Trains services between Hull and Doncaster, and other East Yorkshire stations to Hull, were reduced by over 50% of the current price. Hull Trains also worked collaboratively on promotions with local businesses to advertise the campaign and highlight to customers the benefits of rail travel.

This example demonstrates how Hull Trains was able to use its commercial flexibility, agility and in-depth local knowledge and relationships with local stakeholders to find ways of driving revenue growth, before those operators on ERMAs and NRCs were able to do so through the centrally coordinated Great British Rail Sale.

Case study: Lumo (First) a new offering

As Lumo is a new open access operator which started operating in October 2021, it has not been included in the overall data analysis. Lumo has started in the difficult post-pandemic market; offering good quality, high speed services at low fares, designed to attract new customers to rail from other modes. The standard class only model is just one of several innovations which would be unlikely to be developed through a centrally specified contract procurement.

Lumo has had a phased ramp up to its full 10 trains a day service which started on 1 April 2022. In the first 2 periods of operating this full service it has captured a 25% rail revenue market share on its main London – Edinburgh flow, much higher than its 15% share of the timetabled services. However, there is emerging evidence that this is a result of providing an attractive new proposition to compete with the dominant air market on this flow.

In March 2022 there was a clear improvement in the rail vs air market share on the London Edinburgh flow, with rail improving from 25% in March 2019 to 39% in March 2022. In contrast the rail vs air market share on the comparable London Glasgow flow remains virtually unchanged with rail at 23% (2019 24%).

4. Conclusion

Revenue incentives and more commercial freedom for private sector train operators will help accelerate revenue growth and reduce the taxpayer burden

Private sector train operators have demonstrated their capability to grow revenues if they have the incentives and levers to do so – based on past and current experience. Whilst the advantages of an overall strategic framework on simplifying fares, ticketing and retail from a customer perspective are recognised, an overly centralised approach within GBR to setting all fares and being responsible for yield management in all markets will not deliver the passenger and revenue growth that private sector train operators can support GBR in delivering. Overcentralisation will mean slower revenue growth and a higher burden on the taxpayer.

The Williams-Shapps Plan for Rail recognises and highlights that a reformed industry structure must avoid over-centralisation and enable private sector expertise to be harnessed. It states the importance of having revenue incentives in future contracts and allowing operators on long-distance routes greater commercial freedom with some transfer of revenue risk in the future. With the right contracts in place, the private sector will drive up revenues and drive down costs.

Our analysis shows that in period 1 (April 2022) operators on revenue risk achieved revenues of 87% of pre-pandemic levels compared with 78% for DfT contracted long-distance operators. This gap equates to over £300m of lost revenue per annum for these 5 operators and nearly £1bn over a 3 year HMT spending review period. The gap peaked at 17% period 12 (February/March 2022).

Based on the evidence presented in this paper, we believe it is imperative that the measures below are enacted to unlock hundreds of millions of pounds in potential revenue:

- **Current National Rail Contracts (NRCs) should have dormant revenue growth incentives switched on** and operators provided with the commercial freedom to respond to those incentives to bring back revenue faster;
- **Future Passenger Service Contracts (PSCs) should include revenue growth incentives and the commercial freedom** to respond to those incentives, as indicated in the white paper.[9] We have previously outlined what commercial freedom could be given to operators, including operator input on timetabling to drive performance and patronage, control over yield managed fares to grow revenue (with greater freedom on timetabling and fares for long-distance operators), and the ability to deliver local marketing campaigns to boost promotions – all within an overall framework set by GBR.
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