Rail Value for Money Study: Research on VfM Assessment

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Introduction

Context

- Government subsidy of railways is considered too high
- Cost-benefit analysis is used to justify decisions on incremental spending, but it is unclear how VfM is optimised across the railway system overall

Project objectives

- Determine how the VfM concept is used in policy and investment decisions, and the appropriateness of this use
- Identify a framework for maximising VfM while controlling the overall level of Government subsidy

Key Issues

1. Insufficient understanding of Government's objectives

2. Lack of clarity as to what Government support for the GB rail industry buys

3. Mechanism for trading off alternative uses of funds does not necessarily maximise VfM

4. No plan for decreasing subsidy over time, nor a mechanism for its ongoing control

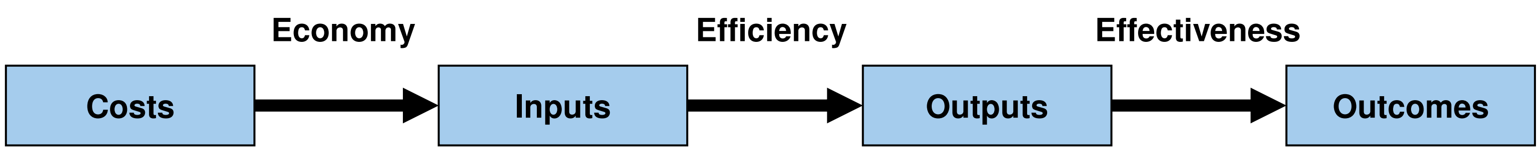
VfM is generally understood to mean economic, efficient, effective achievement of Government strategic objectives

- In general, Value for Money can be interpreted as getting as much as possible of “what you want” for a given spend or achieving desired outcomes more cheaply. The National Audit Office (NAO) defines good value for money as:

  “The optimal use of resources to achieve the intended outcomes”

  Here, “resources” need to be understood as public money.

- Across UK Government it is increasingly being accepted that VfM can be represented by “three E’s”:
  – Economy: how cheaply inputs are procured
  – Efficiency: the amount of output produced with given inputs
  – Effectiveness: the extent to which outputs deliver desired outcomes, or objectives – a key aspect of which is achieved by ensuring that money is spent on the right combination of outputs



- The VfM of Government support for the rail industry means Value for Money where
  – **Value** is the degree to which that support contributes to the achievement of Government objectives, and
  – **Money** is the cost of that Government support (the rail subsidy)

- In our interviews, we found DfT understanding to be consistent with the above definition

However, there is insufficient clarity around the Government's strategic objectives and their relative importance

- The reason any Government provides financial support for its national rail system is that the rail system contributes to one or more of the Government's stated objectives
- The previous UK Government set out its objectives for the transport system in terms of five Departmental Strategic Objectives (DSOs) for the Department for Transport

DfT DSOs (2010)
Sustain economic growth and improved productivity through reliable and efficient transport networks
Improve the environmental performance of transport
Strengthen the safety and security of transport
Enhance access to jobs, services and social networks, including the most disadvantaged
Improve quality of life

- The current UK Government has chosen to focus more on the priority actions required to achieve its strategic objectives, and these actions are set out in DfT's Business Plan for 2011-2015
- The strategic objectives of the current Government are thought by DfT to be similar to those of the previous Government, with a focus on economic growth and deficit reduction balanced against the environment, safety, etc.
  – However, the relative importance of the different objectives is not clear (and may have altered)
  – The focus on priority actions may even take us further away from the objective of subsidy reduction
- In any case, the strategic objectives need to be connected to operational criteria that practitioners can use to choose consistently between alternative uses of funds
- We understand that the DfT is reviewing its approach to decision-making, with output expected by summer 2011

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The rail subsidy buys services, infrastructure, and fare levels that the free market would not provide

- Government support for the rail industry facilitates the provision of desired increments over and above the implicit commercial railway for which the market would pay (the extent of which remains unknown)
- In addition, it could also be argued that as a result of Government support there may not be as strong a drive for efficiency as might otherwise be the case

What subsidy buys	Comments
▪ Non-commercial fare structure – Fares regulation – Peak pricing – Regional differences	▪Left to its own devices, the market would likely set fares, at least for some segments, higher than current levels ▪Support through subsidy enables Government to choose which, if any, fares to regulate and the degree to which the system is paid for by the farepayer rather than the taxpayer
▪ Non-commercial services – Regional services – Off-peak services – Certain peak services	▪The commercial railway that a free market would define would likely be substantially smaller than at present ▪The Government uses the rail subsidy to provide rail services in areas/market segments that might not otherwise be served
▪ Non-commercial infrastructure – Any incremental Infrastructure required for non-commercial services – Higher maintenance standards – More frequent renewal – Unused infrastructure	▪A commercial railway would define the minimum level of infrastructure required to provide the commercial services and dispense with the remainder ▪Any parts of the current network which support only non-commercial services are essentially being funded by the subsidy, as are parts of the network which are not currently being used ▪There are parts of the network that are being maintained and/or renewed to higher standards than those that would be required by a (minimum service) commercial railway

VfM assessments are undertaken but the overall contribution from subsidy to Government strategic objectives is not clear

- VfM in the rail industry is currently assessed in a range of ways, including:
  - DfT and NR have a well established Cost Benefit Analysis process for assessing proposed enhancements
  - At the time each franchise is re-let, franchise outputs are specified using CBA to determine the VfM of incremental changes to services, and the expected budget is set within the overall programme budget for franchises
  - Fares policies are assessed taking into account VfM for fare payers - note that fares policies which increase revenue often produce negative BCRs
  - ORR efficiency reviews of Network Rail (although these cover only the economy and efficiency components of VfM)
  - National Audit Office (NAO) periodically reviews the performance of both DfT and ORR in achieving VfM for the taxpayer. NAO reported positively on DfT's letting of recent rail franchises although there were some concerns about VfM from increases in rail capacity
- However, no overall assessment is made of the VfM of the rail subsidy as a whole
  - The focus of VfM assessment is on incremental changes, with no regular assessment of existing services and infrastructure
  - There is no defined process for consolidating the various VfM assessments of the individual programmes
- Furthermore, there is no comprehensive analysis of how much subsidy is consumed by individual services, infrastructure and fares policies - or how much of the subsidy is paying for benefits outside rail

Key Issues

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The mechanism for trade-off between alternative uses of funds does not necessarily maximise VfM

- The current process for allocating the transport budget is based on first establishing allocation between modes and individual programmes, then dividing funds within programmes
  - Within rail, funds for projects are separated from those for franchises
  - Within programmes there is a process for comparing alternative projects or new services against relevant objectives
- The initial allocation between programmes tends to gravitate towards incremental change on previous allocations, which would perpetuate any existing suboptimisation
  - There is little comparison between existing expenditure and new uses of funds
  - It is unclear whether VfM is optimised across modes and programmes
- Furthermore, current VfM assessment, being based on cost-benefit analysis, does not always fully reflect Government's strategic objectives
  - The cost-benefit analysis framework currently excludes consideration of some wider benefits (e.g. DfT acknowledges that the framework does not deal adequately with radial routes, as demonstrated by the outperformance of predicted patronage by the Jubilee line extension)
  - The recent move towards inclusion of wider economic benefits implies that some "wrong" decisions may have been made in the past (although we cannot say for sure that this change in approach is correct)
  - Valuable investments may be rejected or held up because they fail to meet a target BCR which does not reflect the real reason for the investment

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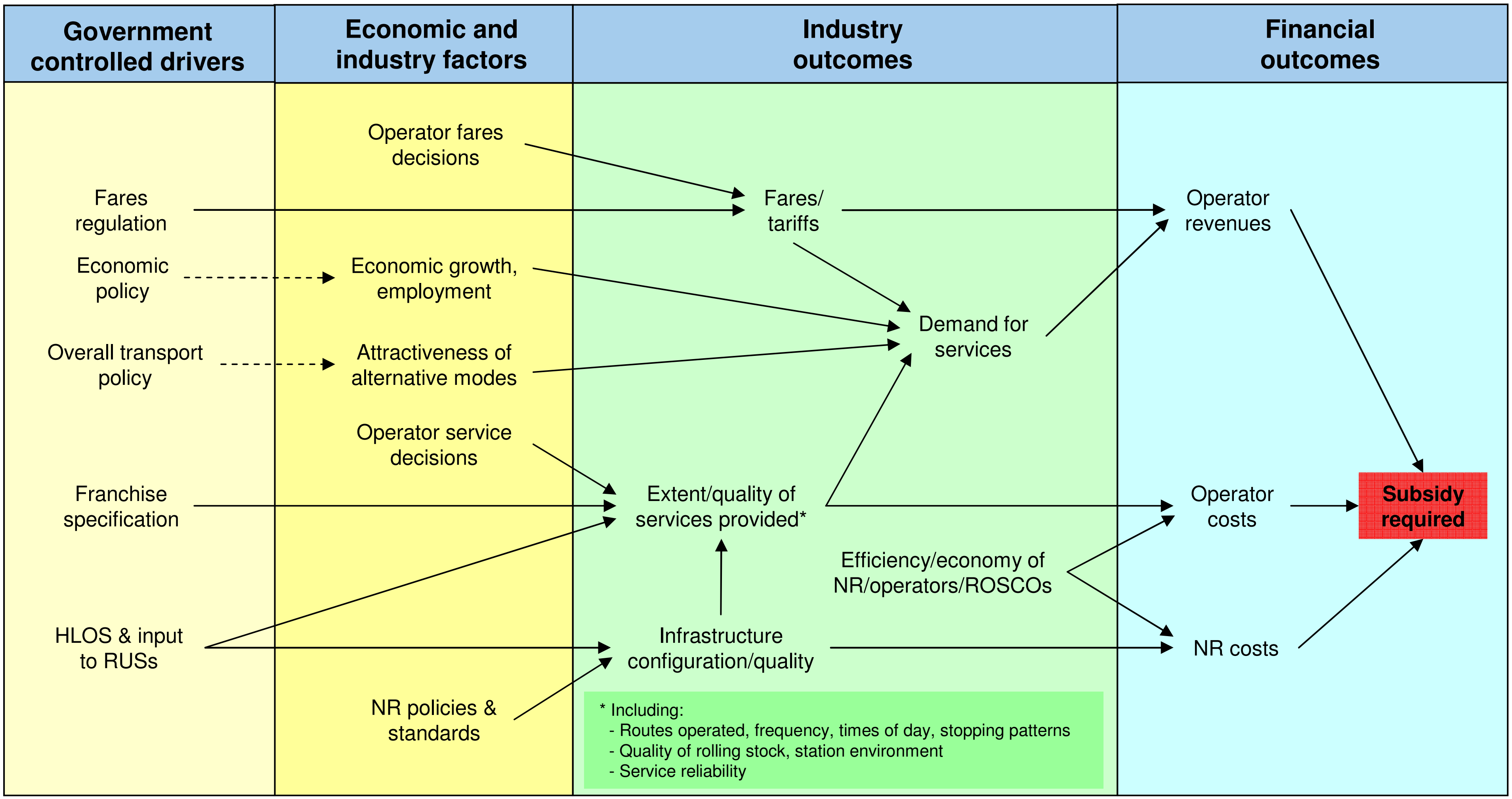
The current process for managing the rail subsidy is centred around the periodic determination of HLOS and SoFA

- On a five-year cycle around ORR's Periodic Review of NR funding, Government determines the Statement of Funds Available (SoFA) and, by iteration, its High Level Output Specification (HLOS)
  – From a baseline of maintaining the status quo, costs and revenues are projected, and specific interventions are assessed, in conjunction with TOCs, NR and ORR as to whether they support policy, generate revenue, and demonstrate VfM through their BCRs
  – The most recent HLOS was based on the (then) Government's stated policy of maintaining the current level of service and providing some capacity increases
  – The ORR, as independent economic regulator, determines whether the outputs sought by the Government from NR are affordable and deliverable within the funding that the Government is providing
- The manner in which the Government provides support for the rail industry is through
  – Direct grant to Network Rail for the provision of infrastructure
  – Subsidy (or premium) payments to (or from) TOCs for the provision of rail services
  – Various other smaller payments to the PTEs, TfL, Merseyside, and the freight industry
  – Separate funding is identified for major schemes such as HS2
- DfT manages the overall spend within the SoFA
  – NR funding and ongoing franchise support are relatively fixed, although outturn revenues can lead to subsidy adjustments
  – For the infrastructure elements of HLOS, NR identifies the most cost-effective means of delivery and is required to demonstrate VfM
  – HLOS rolling stock schemes are negotiated with the TOCs and are also required to demonstrate VfM

Application of SoFA
Cost of passenger services
Network Rail cost: O,M,R,E & financing
HLOS: infrastructure, rolling stock & financing
Less: Passenger & other revenue

The drivers of subsidy include the Government's tools for controlling it: fares, franchise specification and HLOS



Note: this is a simplified model - not all drivers and relationships are shown

There is no plan for how the subsidy can be reduced over time, and no mechanism for ongoing control

- The current process does not focus on reducing the subsidy
  - With HLOS and SoFA focusing on incremental changes to the status quo, there is currently no explicit long term plan for how the subsidy will be brought down over time while protecting those social objectives of greatest importance
  - Having such an explicit plan is crucial if the rest of the control system is to be made to respond to the overall objective of reducing costs
- We recognise that planning for a reduced subsidy is challenging given the need to maximise VfM at the same time
  - Some high VfM schemes might well increase the subsidy requirement
  - Some revenue generating schemes such as fare increases generate low VfM because of high disbenefits
  - Franchise revenue outturns and materialising cost risk events (for example, project implementation delays) impact ongoing subsidy requirements
- DfT applies some control of the subsidy on a year-to-year basis by managing the timing of HLOS interventions (e.g. new rolling stock)
  - However, this does not in itself provide the necessary control over long-term subsidy growth
- Moreover, the overall level of subsidy may be impacted by new schemes which are outside the SoFA (e.g. HS2) and fall outside controlled budgets

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Optimisation of VfM requires a control framework applied consistently across the industry

In order to optimise VfM across GB rail, a number of elements need to be in place:

- Clarity of strategic objectives, effectively communicated and connected to operational targets and criteria
- Clear articulation of the extent to which these objectives are being achieved by subsidy (i.e. industry-wide evaluation of VfM)
- Decision-making on use of Government funds explicitly to consider fundamental policy trade-offs across network and industry
- A plan for reduction in subsidy over time and a mechanism for ongoing monitoring and control

DfT's objectives need to be clearly defined and communicated

- Government's transport objectives (the "Value" part of VfM) need to be set out clearly, highlighting:
  - What changes the Coalition Priorities (as described in DfT's Business Plan 2011-2015) imply for the previous Departmental Strategic Objectives
  - The relative importance of different objectives
  - How the objectives are connected to operational targets, and therefore the criteria to be applied in practice for prioritisation and decision-making
- DfT should define VfM clearly, along the lines of the NAO definition
  - Emphasising that for the rail industry VfM is about maximising achievement of Government objectives at any given level of Government subsidy
- DfT's Appraisal Summary Table needs to be aligned with the updated Government policy objectives
- DfT should encourage industry parties to focus on delivering Government objectives efficiently
  - Focus on desired outcomes linked to Government's policy objectives, rather than the technocratic use of cost-benefit analysis (which is only one component of the VfM assessment)

The extent to which these objectives are being achieved by the subsidy needs to be clearly articulated

- In order to develop strategies for VfM improvement, it would be helpful to understand the existing profile of VfM through a one-off assessment of the use of all Government funds in the railway
- This could be done in three steps, as follows:
  - Analyse the principal uses of subsidy, by identifying and costing those elements of service provision, infrastructure provision and fares policy for which the market would not pay on a commercial basis, using a cost allocation approach
  - Where possible identify the costs which might be avoided if these services and other uses of subsidy were not provided. In practice, avoidable costs may be limited given the commercial interdependence between different services and network sections (e.g. London Outer vs London Inner)
  - Map the uses of subsidy to Government objectives, for example as shown below.

Use of subsidy	Allocated cost of this use	Avoidable cost of this use	Impact on Government Objectives			
			Objective A	Objective B	Objective C	Objective D
Provision of service on route X						
Accessibility of station platforms and vehicles						
Subsidised peak London fares						
etc						

Illustrative

Decision-making on use of Government funds should explicitly consider policy trade-offs across the network and industry

- The mapping of subsidy and value (outcomes) will create transparency and facilitate a genuine debate over the alternative uses of subsidy
- Decision-making should consider alternative uses of funds
  - Including not just new areas of expenditure but also existing spend
  - Comparing across modes and programmes
- Decision-making should be based on VfM assessment, regardless of the nature of the spend (for example investment project, maintenance activity, or fares subsidy)
- Assessment should include cost-benefit analysis, but focus on the underlying reason for the spend and how it contributes to Government objectives
  - For example, “reduced journey time for existing WCML users” as opposed to “£4m of social welfare benefits”

A strategy is required for reduction in subsidy over time and a mechanism for ongoing monitoring and maximisation of VfM

DfT needs a mechanism for maximising VfM while reducing the subsidy. We have identified three (not necessarily mutually exclusive) approaches by which this might be done:

1. **Single National VfM improvement plan**
   - Central Government determines a plan for VfM improvement based on an initial review of the use of all Government rail funds, and establishes an ongoing monitoring system
   - Other industry parties need to play an active role in building up and assessing options

2. **Local involvement and accountability**
   - Central Government determines local rail/transport budgets, possibly as a function of taxes raised with some adjustments for social policy considerations
   - Local authorities to have more say in how funds are applied
   - Local authorities develop their own VfM improvement plans - although a local area's future budget allocation could be influenced by national VfM assessments

3. **Market forces determine the commercial railway**
   - Central Government first invites bids for franchises, without constraints on fares or services offered, in order to establish just which parts of the railway are truly "commercial"
   - A second round of bids would then follow as the Government sought to re-introduce services which it wished to subsidise, supported by clear VfM considerations
   - This is perhaps easiest to envisage in a vertically-integrated industry although it is possible that the commercial relationships between TOCs and Network Rail could also be driven by market forces, with TOCs negotiating access agreements

Each approach taken individually has distinct advantages and also significant weaknesses

Advantages and Disadvantages of Alternative Approaches for Controlling VfM

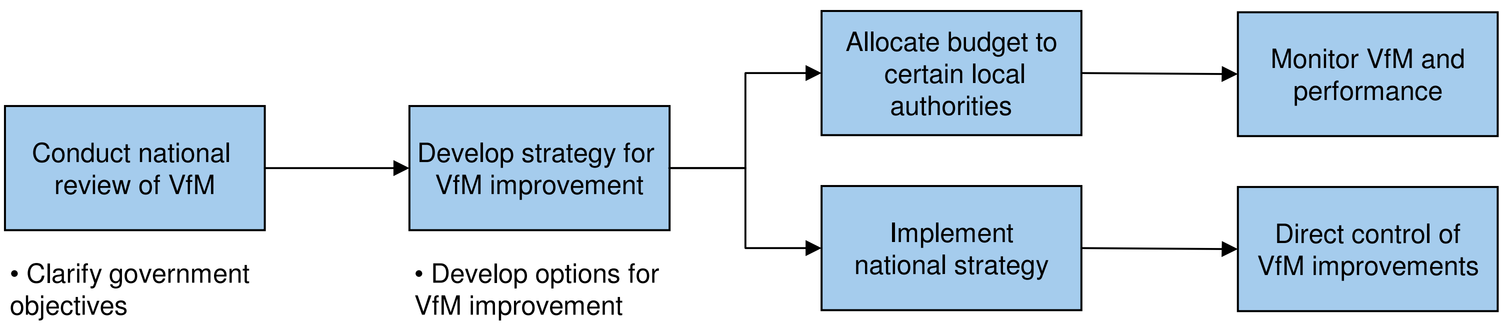
Approach	Advantages	Disadvantages
Single national VfM improvement plan	▪ Clear national VfM plan and audit trail ▪ Clear picture of how subsidy used and why ▪ Enables national debate about transport priorities	▪ Requires complex, labour intensive initial effort, for DfT and others (examining uses of current subsidy, identifying and prioritising options) ▪ Process likely to be politically sensitive
Local involvement and accountability	▪ Allows elected local bodies to prioritise what their constituents value the most highly ▪ Clear picture of which areas receive what subsidy ▪ Consistent with SoS desire to devolve responsibility to local level	▪ Makes funding of multi-area projects (even on single routes) more complex ▪ Arbitrary allocation of funds between local authorities may lead to significant VfM discrepancies (and likely political discord) ▪ Not all local authorities may plan and track VfM rigorously or consistently ▪ Harder to track national VfM of rail spend, especially if authorities have power to transfer budget between rail and other uses
Market forces determine commercial railway **(NOT RECOMMENDED)**	▪ May be the only way to discover the true extent of the commercial railway	▪ Likely that very little, if any, of railway is commercial in sense of paying for all costs (including costs shared with non-commercial railway) ▪ Difficult for operators to bid without knowing what complementary services would be available ▪ 2nd round of specification very complicated

It may be possible to combine the best elements of the national and local approaches

- A combination of the national and local approaches could result in a clear national plan for improving VfM and reducing subsidy while satisfying the desire to devolve responsibility to local authorities (at whatever level)
- The first step would be the analysis of current VfM and use of subsidy to inform development of broad options for VfM improvement through re-specifying services, infrastructure and fares policy
- Based on this analysis a national strategy would be formed for VfM improvement and eventual reduction in subsidy
  - Emerging thinking on franchising suggests that this could lead to the specification of a “core railway” (including peak service levels, first/last services, overall fares levels) which is necessary to satisfy Government objectives
  - Additional services and fares subsidies would be determined in consultation with local authorities
- Some local authorities would be identified which have the scale and degree of accountability required to manage a transport budget, absorb the associated risks, and demonstrate VfM
  - At the moment, this may only be practical in Scotland, Wales and London
  - The formation of Local Enterprise Partnerships may enable further devolution at some stage
- Budget would be allocated to those authorities along with a tailored process for monitoring VfM that would depend both on the scale and accountability of the authority and on the complexity of the local rail system
- Budget holding authorities would be required to report on their VfM plans and on progress against these plans
  - These reports would inform future budget allocation

A national strategy is required but should not result in creation of a new central planning industry

- The industry presently needs to be re-directed, but once the direction has been set there needs to be stability
  - Market players need clarity on the industry direction so that they have confidence to invest
  - Adjustments to the strategy can be made through the five-yearly planning cycle
- The implementation of the VfM improvement strategy will take many years
  - In particular, major changes to TOC outputs are most easily achieved at franchise re-let
- The process we envisage is shown below:



• Clarify government objectives

• Establish current use of subsidy

• Establish how objectives met

• Develop options for VfM improvement

• Facilitate debate around alternatives

• Identify “core railway”

• Develop long term plan for reduction in subsidy

• Identify suitable and capable local authorities

• Feed changes into HLOS process

• Implement franchise changes at re-let

At regular intervals:

• Review how VfM & subsidy objectives met

• Adjust plan where necessary, avoiding frequent shifts

Long term subsidy reduction will require management of the national plan and ongoing control against it

- The national plan for the rail subsidy must take into account the future needs of the railway, including capacity enhancements that demonstrate VfM, and incorporate an overall long term reduction in the rail subsidy
- The plan must be managed on an ongoing basis to incorporate changes such as
  - Any emerging new major programme requirements (as HS2 emerged in recent years)
  - Prioritisation of these against existing subsidy requirements
  - Any conscious Government decisions to increase or decrease the planned rail subsidy in the light of new information and/or spending reviews
- The plan must be made visible and established as the baseline against which all programme expenditure will be centrally monitored and controlled, in conjunction with VfM assessment
- Management against the plan should be firstly at the level of individual programmes (and local authorities), where
  - Expenditure and revenue impacts are managed against the allocated subsidy budget
  - All decisions are based on consideration of the long term impact on subsidy and VfM (for example, weighing up the long term impact of deferring expenditure)
- Overall control of the total rail subsidy needs to be a central function, where
  - Local area management of funding and VfM is monitored and controlled
  - The management of individual programmes is monitored and controlled
  - Decisions are taken to realign programmes deviating from the plan
  - Subsidy is periodically re-allocated between programmes and local areas following VfM-based trade-offs between alternative uses of funds

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In summary, we recommend that DfT should:

- Clarify the outcomes intended by Government, their relative importance, and how they are delivered in practice
- Undertake a comprehensive one-off analysis of how subsidy is currently used and how this contributes to Government's objectives
- Create a national plan for VfM improvement and long-term reduction in subsidy, based on the above analysis and with the following features:
  – Future needs of the railway to be taken into account
  – Future major spend decisions (including decisions to continue existing services or fares) to be tested using consistent VfM assessment and based on trade-offs between alternative uses of the funds
  – HLOS process and franchise re-lets used to implement major service changes
  – Adjustments made to the subsidy reduction plan as required but avoiding frequent major reviews of strategy
- Identify areas where local management of funding could improve VfM and devolve some responsibility for funding to local authorities in these areas, but link future funding to demonstration of VfM improvement
- Establish and implement a subsidy control process where individual programmes and local authorities manage their subsidy allocations but the overall subsidy is managed centrally against the national plan