Are the railway franchises on the right track? [1]

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If C P Snow was with us now, he would recognise civil servants and business people as two cultures divided by a common language, namely money. Awarding franchises to whomever forecasts, or pretends to forecast, the highest growth in passenger traffic has finally been shown to be as daft as it is. How the then Transport Secretary, Justine Greening, a chartered accountant who holds an MBA from one of the world?s most prestigious business schools, failed to recognise the fallacy is beyond words.

The taxpayer cost of this fiasco is reckoned to be £40M and that is before all the consultants involved in the two consequential investigations climb aboard the gravy train (sorry).

No other country uses this system. No surprise there. It makes it most likely that the winners will go bust. Recognising that much brings on consequential guesswork to establish the size of the bond that would then be called in. The franchise system also ensures that UK rail travel will remain more expensive than elsewhere in Europe.

The fiasco is re-igniting the debate between those who think the railways should be re-nationalised and those who want a return to the pre-nationalisation structure where large rail companies were responsible for their own track. Clearly the advocates of the former policy have forgotten how dreadful British Rail was. The mini-monopolies of the earlier system were not much better. John Major?s government envisaged that competition between different train operators using the same tracks would increase quality and reduce cost. The former has worked to some extent. Rush hours and Network Rail failures apart, the travel experience is better but it certainly has not reduced the price. The franchise process ensures that prices cannot be reduced because the train companies are desperate to service the cost of the franchise.

All these systems use Discounted Cash Flow whereby one forecasts the profits from the immediate years as well as one can, based on a good appreciation of what the near future holds in store. The ?out years? are all rolled into a single number called ?Residual Value? and placed far away in a box on the extreme right of the Excel sheet where the calculations are done. In theory, forecasts are made of passenger numbers, inflation etc and discounted to a single Residual Value. It is all quite complex and naïve recipients of the results tend to look at the immediate years and not worry about the number beyond as being too complex and too far off.

Using this inattention, the scam is to put the balancing number needed to secure the contract into the Residual Value box and derive the forecasts from that. It is hard to imagine Atkins, the transport consultant involved, being party to anything this trivial but the essence of the scam is making the out year forecasts fit the Residual Value required as distinct from deriving the values from the forecasts. An outsider, even one as illustrious at Atkins, would have difficulty in distinguishing the two processes, especially when, as seems to have been the case, inflation has not been properly accounted for.

But the issue is not what went wrong so much as what should be done in future. In essence a train operator should only bid for what they can control and leave the unknowns to government. Franchising should therefore not be based on a single number but on a table showing year by year tolls for the use of the infrastructure as a function of passengers carried. This should not be by train, as road tolls operate, because that would encourage over-crowding but by passenger mile which would encourage more trains. Where more than one operator uses the same track, some control would also be required to ensure capacity exists. The passenger mile fees should be on a diminishing curve so that additional passengers are more profitable for the operator and/or more price discountable. And the bids should be at present values leaving the actual future year payments to be adjusted by inflation, defined as the inflation then relevant to train operating costs.

None of that is complex although compressing it to a single paragraph may make it seem so. The underlying principles here are that the operator should only pay for what it can control and has an incentive both to improve the travel experience and to reduce costs to passengers.

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