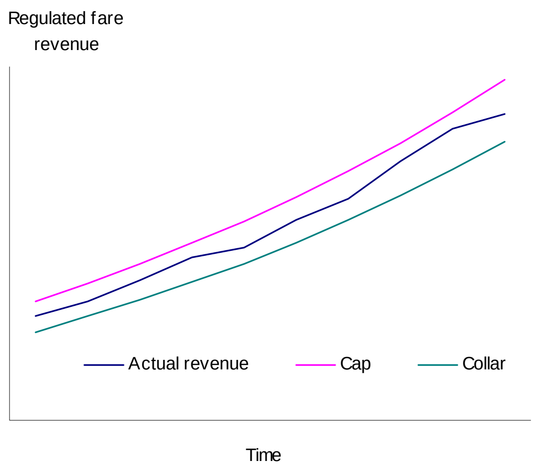
Why have fares increased so much?

Prices of Southeastern's regulated fares increased very sharply in January, some by up to 12.8%, an extraordinary 8 percentage points (pp) more than the 12-month change in the All-items Retail Price Index to July 2009 which is used as a basis for increases.

We knew that Southeastern were subject to an 'RPI + 3pp' formula for regulated fares and were led to expect[1] that the (weighted) average of regulated fares would increase by that amount. Yet it is now clear that 'RPI + 3pp' is generally about the minimum increase for individual regulated fares this year, so the weighted average regulated fare rise this year will be considerably in excess of this.

So what's been going on? The SRTA Committee has had several contacts with Southeastern management who have provided some clarification. Our current understanding of the position is as follows.[2]

Chart 1
Stylised 'cap and collar' arrangements



Regulated fare revenue is constrained to grow in a corridor bordered by a cap and collar. If actual revenues exceed the cap, the excess is paid to the government in the form of a reduced subsidy. If revenues fall below the collar, the government is obliged to increase the subsidy.

Revenue is regulated not fares as such

The regulated fare regime that applies to Southeastern and other Train Operating Companies (TOCs) is very highly regimented. The TOCs are permitted to earn revenues within a regulated 'farebox' which is contained by a cap and collar arrangement (See Chart 1). If regulated fare revenue exceeds the cap, the excess is, in effect, taxed at 100% and is used by the Department for Transport (DfT) to reduce the passenger subsidy paid. If regulated fare revenues fall below the collar, the DfT is obliged to increase the subsidy.

So the emphasis of the regulated fare regime is not on fares per se but on revenues (the product of fares and the number of tickets sold (volume)). Should revenues threaten to fall below the collar, then the TOCs are permitted by the DfT to increase fares (subject to no individual fare being increased by more than a further 5pp) to restore regulated revenue to the 'RPI + 3pp' annual growth targeted for the

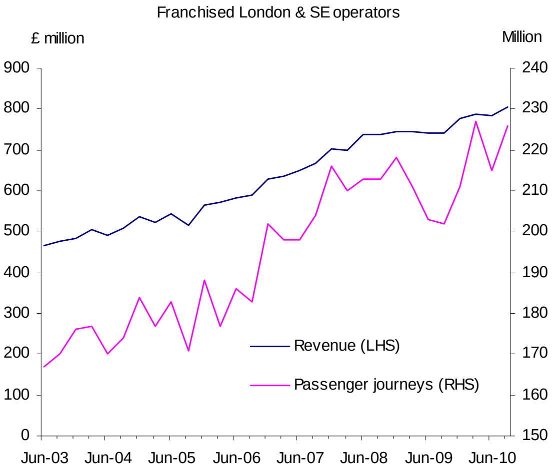
[1] For example this is how the Office of Rail Regulation ambiguously describes the regime in its National Rail Trends Yearbook 2009-10.

> "Fares regulation for franchised operators is based on the July 'all items' RPI+1% (except for Southeastern and services in the West Yorkshire PTE area which allow for rises of RPI+3%). Open access operators are not bound by fares regulation. The regulatory regime is fixed by the Department for Transport." [SRTA underlining]

[2] A useful description of DfT's approach to regulated fares from January 2004 is attached as an appendix to this paper.

regulated farebox.. The farebox calculation is not linked to the actual level of passenger journeys.

Chart 2
Passenger journeys and revenue



Source: Office of Rail Regulation, *National Rail Trends, Rail Usage, January 2011*.

Data are for franchised London and SE operators and include all services (i.e. both regulated and unregulated fares).

The recession led to a fall in train usage overall and thus to a marked slowdown in revenues (Chart 2). So fares are being increased, not just to compensate for inflation but for an unexpected drop in traffic. The logic of this remarkable arrangement – what other private companies have their earnings underwritten during an economic downturn? – is that were revenues to fall off not because of a decline in economic activity (which the TOCs cannot be held responsible for) but because of the impact of a rapid rise in fares, the TOCs would be able further to increase fares to compensate for the price-induced decline in revenue!

The arrangement is also symmetrical. Were traffic and regulated revenue grow faster than expected because of a strong economic recovery the 'RPI + x' formula will be moderated to put actual revenues back on target (See Chart 3). Rail travellers, who experienced what appeared to be a steady growth in rush-hour passenger numbers and overcrowding during much of the 2000s until the onset of the recession, yet also saw their fares being regularly increased each year, may be highly sceptical. We do not have access to Southeastern's numbers to verify the symmetry. However, there is some indirect evidence in that regulated fares for London and South Eastern operators collectively were roughly the same in real terms in January 2010 as they had been in January 1998, although the 'RPI +x' formula applied throughout that period. In fact, they fell in real terms between January 1998 and January 2003 before rising 8.9% between January 2003 and January 2010 (Chart 4).

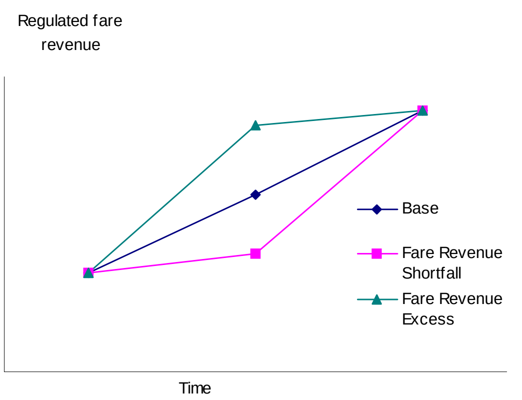
In theory, rail traffic and revenues could also expand, not because of a general strengthening of the economy but because of the efforts of Southeastern to improve its service to passengers. However, rather than being rewarded for this, Southeastern would find its ability to increase fares thwarted by the farebox mechanism. The current (dis-) incentive structure seems to leave a lot to be desired for both train users operators!

Position of DfT: A conflict of interests?

You might ask, isn't the DfT conflicted? On the one hand it has a responsibility to rail users to ensure they are not exploited by, in effect, a monopoly supplier of train services. On the other, they have responsibilities towards taxpayers to ensure that the level of subsidies paid reflects government policy. Unfortunately for rail users, it is pretty clear which group has priority within the DfT as successive governments have been committed to reduce the subsidy to rail transport.

In FY2008-09, the latest year for which data on subsidies are available, Southeastern received £35.6 million of a total of £254.7 million net amount paid to all operators. This represented a subsidy of 0.9p per passenger kilometre. The highest subsidy paid was £224 million to First ScotRail (or 8.6p per passenger km). On the other hand National Express East Coast *paid* the DfT £184.9 million t (a negative subsidy of *minus* 3.9p per passenger km). So there is considerable cross-subsidisation between TOCs, with generally lesser-used services in the remoter parts of the country receiving funding from more populous regions / busier routes.

Chart 3
Stylised regulation of the 'farebox'

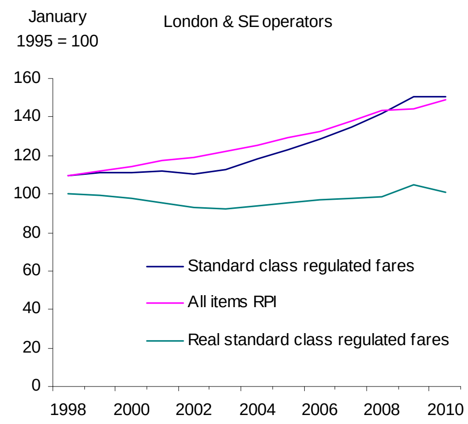


In the "Base" case, the regulated farebox grows at RPI + 3pp per year.

In the "Fare Reveune Shortfall" case actual regulated fares revenues grow only by 2% in year 1. Fares are raised in year 2 by an amount that restores revenues in year 2 to the base case level in year 2 (subject to no individual fare rising by more than an additional 5pp).

In the "Fare Revenue Excess" case, actual regulated fares revenue in year 1 grows by more than RPI + 3pp. Fare increases in the following year are constrained to produce a level of revenue equal to the base case in year

Chart 4
Trend in regulated fares



Source: Office of Rail Regulation, National Rail Trends Yearbook 2009-10

Remaining uncertainties

There are several details which remain unclear. For example, the regulated farebox was expanded with the introduction of High Speed 1 (HS1) and there are suspicions that a slower than expected take-up of HS1 is one reason for the very sharp rise in Southeastern fares generally. The farebox is not divided into service sectors, it is just an aggregation of all income. It also appears that the RPI formula which applied to TfL area services operated by Southeastern was more favourable (RPI +2pp) than that which applied to other Southeastern services. In effect, users of Mainline services have been required to subsidise users of TfL Metro services.

Sevenoaks Rail Travellers Association
10 June 2011

Extract from *Fares Review Conclusions*, Strategic Rail Authority, June 2003.

Appendix C: How fares regulation will work from January 2004

Each train operator's franchise agreement with the SRA provides for the regulation of certain fares. The SRA will regulate fares in two categories, known as 'Protected Fares' and 'Commuter Fares'.

Protected Fares

- The following fares are 'Protected Fares':
  – Saver returns (an off-peak walk-up leisure fare available for most long-distance journeys) for all journeys where a saver existed in February 2003;
  – standard returns (the full-fare return ticket, valid at both peak and off-peak times), for journeys where a Saver did not exist in February 2003 (typically journeys under 50 miles, or wholly within the old Network SouthEast area), other than those which are included in a Commuter Fares basket;
  – weekly season tickets, wherever a weekly season ticket existed in February 2003, other than those which are included in a Commuter Fares basket.
- Each operator will have one Protected Fares basket, which will contain (before the simplification explained below) every Protected Fare set by that operator.
- Each fare in a Protected Fares basket will be weighted by the revenue received by that operator from the sale of that fare in the financial year to 31 March 2003. The total value of the fares basket is the sum of each fare multiplied by the weighting for that fare.
- To simplify the basket, fares with the lowest revenue weighting will be excluded from the fares basket, up to the value of 5% of the gross value of the fares basket. The basket will therefore include at least 95% of the revenue received from Protected Fares. However, all Protected Fares must continue to be made available for sale, whether or not they are in the Protected Fares basket.
- The train operator must make sure that the total value of its fares basket does not exceed the 'cap' placed on that basket. The cap is equal to the total value of the fares basket calculated using February 2003 fares, increased by RPI+1% on 1 January 2004 and each year after that for three years.
- Individual fares within fares baskets may not go up more than 5% above the basic policy (in other words, RPI+1%+5%=RPI+6%) in any one year.
- Fares regulation also protects certain conditions attached to these fares. In the case of Savers, these are required to be valid for no less than a month, and to be valid all day Saturday and Sunday and from no later than 10:30 on any other day. They need not be valid for any journey beginning between 15:00 and 19:00 on Mondays to Fridays from London area stations or (when travelling away from London) stations between London and Reading, Watford, Luton or Stevenage, inclusive.

Commuter fares

- Commuter fare regulation will apply to the following fares used by commuters in the London area:

  – season tickets (weekly, quarterly, annual) to, from and within the London Travelcard zones;

  – standard singles and returns for journeys wholly within the London Travelcard zones;

  – standard singles and standard returns to any station in the Travelcard zones from a defined London suburban area, roughly 35-50 miles from London. The boundary stations for this area are: Shoeburyness, Southend Victoria, Southminster, Marks Tey (exc. Sudbury branch), Audley End (not origin Stansted Airport), Ashwell & Morden, Arlesey, Harlington, Bletchley, (excluding Bedford branch), Aylesbury, Haddenham & Thame Parkway, Twyford (incl. Henley branch), Earley, Fleet, Alton, Whitley, Christ's Hospital, Brighton (exc. coastway), Windsor & Eton Riverside, East Grinstead, Crowborough, Wadhurst, Paddock Wood (incl. Strood-Paddock Wood) Maidstone East, Canterbury East, Margate.
- Each train operator serving London will have one Commuter Fares basket. This fares basket will contain every regulated commuter fare from which that operator takes any share of the revenue. This will include both fares for which the operator is 'lead operator' and sets the fare, and fares where another train company sets the fare, but the operator in question receives a share of the revenue.
- Each fare within a basket is weighted by the revenue received by that operator from the sale of that fare in the financial year to 31 March 2003. The total value of a fares basket is the sum of all the weighted fares which it contains.
- To simplify the basket, fares with very low revenue will be excluded. The basket will be constructed so that it includes 95% of the revenue received from Commuter Fares, with no more than 5% of the gross value of the basket excluded. However, all Commuter Fares must continue to be made available for sale, whether or not they are in the Commuter Fares basket.
- Each year, the train operator must ensure that the total value of its fares basket does not exceed the 'cap' placed on that basket. The cap is equal to the total value of that basket in February 2003, increased by RPI+1% on 1 January 2004 and each year after that for the next three years.
- Individual fares within fares baskets may not go up more than 5% above the basic policy (in other words, RPI+1%+5%=RPI+6%) in any one year.
- Commuter fares around Cardiff and Edinburgh are also subject to fares basket regulation. These baskets contain the standard singles, standard returns, and season tickets for journeys wholly within the defined commuter area. The weighting and annual increase in the cap will operate in the same way as for London area Commuter Fares baskets.

Unregulated fares

- Fares which are neither a protected fare nor included in a fares basket are unregulated, and train operators are free to determine these fares according to market forces. Unregulated fares include:
  – all first class fares;
  – all 'advance purchase' fares;
  – tickets (other than Travelcards) which include through travel to destinations served by bus services, light rail services or London Underground;
  – tickets which include a non-rail element such as entrance to a museum, theme park or other attraction;
  – Saver tickets, for journeys where there was no Saver fare in 2003;
  – Weekly season tickets, for journeys where there was no weekly season fare in 2003.
- Although a particular fare may be unregulated, in certain cases the regulated fare acts as a ceiling – for example, an unregulated Supersaver fare cannot logically exceed the price of the regulated and less restrictive Saver fare.

Fares regulation in Passenger Transport Executive (PTE) areas

- In five PTE areas (West Midlands, Strathclyde, Tyne & Wear, Merseyside and South Yorkshire) fares are currently specified directly by the PTE, and fares are not regulated (although this may change when franchises concerned are replaced). In two PTE areas (Greater Manchester and West Yorkshire), fares are set by the relevant train operator in the normal way, and key commuter fares are regulated by a version of the fares basket mechanism. All standard singles and returns for journeys wholly within the Greater Manchester and West Yorkshire PTE area are included in a fares basket, which is capped in a similar way to the fares baskets described earlier.

Important points about fares regulation

- **Individual fares within fares baskets.** Because fares regulation works by applying a 'cap' on the total value of fares baskets, there may be increases in individual fares that are greater than (or less than) the permitted increase in the basket as a whole. However, individual fares within fares baskets may not go up more than 5% above the basic policy in any one year.
- **Year-on-year increases.** The annual permitted increase in regulated fares (RPI+1%) is a cumulative increase in the 'cap' placed on fares baskets based on the value of that basket in 2003. It is not a maximum permitted increase in actual fares from one year to another. Operators do not have to increase their fares by the maximum permissible amount in any given year, and some choose not to do so, leaving the actual value of their fares basket below the maximum level permitted by the cap in that year. This gap between the actual value of the basket and the maximum permitted by regulation is usually called 'headroom'. The following year, such an operator can use up this headroom as well as taking advantage of the annual RPI+1%, and so legitimately increase the value of its fares basket from one year to the next by more than RPI+1%. The operator would comply with fares regulation because the actual value of the basket would still not exceed the maximum permitted value.

- **Fares anomalies.** Fares have not been set according to a standard fare per mile for many years. British Rail abandoned this principle in favour of a more commercial approach, setting fares for each journey according to what the market would bear. With such a large network, it is inevitable that some anomalies exist where a combination of short-distance tickets is cheaper than a through ticket covering the entire journey. It is also possible that such anomalies arise where the lead operator setting the short-distance fares is a different operator from that setting the long-distance fare. However, such anomalies do not contravene fares regulation, and passengers are entitled to benefit from them, providing that they can legitimately use that combination of tickets for the journey they are making under the terms of the National Rail Conditions of Carriage. The SRA will consider applications from operators to adjust the regulation of particular fares if this is necessary to correct an anomaly that has arisen from (for example) an error inherited from British Rail.
- **Fares increases and investment.** The SRA may allow increases above the base level (RPI+1%) in specific cases where this is needed to fund additional investment. Operators who want to use this method of financing improvements to services need to provide a robust business case to the SRA in support of their proposals.