

A Review of Melbourne's Rail Franchising Reforms

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Abstract

This paper reviews Melbourne's rail franchising to identify lessons learned. The first franchising model sought cost efficiencies following much unionised influence on management. Despite some successes, it failed due to "optimism bias" of revenue growth and cost cutting potential, and flawed contract and revenue sharing arrangements. A revised model involving negotiated sustainable funding, partnership approaches and simplified revenue sharing emerged. Overall Melbourne's rail franchising is considered a "qualified" success and demonstrates many cost efficiencies. All governments need to consider the potential risks of commercialisation and to heed the hard learned lessons from cities like Melbourne.

Introduction

The effective governance of urban railways is a major concern of all governments. However there has been much debate and a range of practices worldwide. Whilst the traditional model is direct government management, commercialisation to re-invigorate management and reduce costs is increasing. Reforms have ranged from corporatisation to full privatisation although the latter in urban railways is rare.

Melbourne is one of the few cities where urban rail and tram services have been franchised to private sector operators. These reforms have undergone many changes over the last decade. In July 2009 the incumbent operators have been replaced in the latest tender. This is an opportune time to review the Melbourne experience and ask if it was worthwhile.

The First Rail Franchising Model

The first phase of franchising commenced in 1999 and resulted from the election of a conservative government in 1992. Prior to this, a labour government had managed to halt a long term decline in ridership through investment. However labour and off-vehicle ticketing reforms had failed due to significant strike action. The productive efficiency of public transport was poor. For example, one of the first measures taken by the new government was the removal of ticket collectors from restaurant trams where no ticket revenue was collected (Allsop 2007).

A major election priority of the new government was cost efficiency. Between 1992 and 1997, staff levels of the government rail agencies were reduced from 18,000 to 8,400 with an estimated annual operating cost saving of A\$250 million. (Department of Infrastructure

2005). During this period, modest improvements in service and ridership were achieved. To continue reforms, a franchising model was implemented with the aim of improving service quality, growing ridership, minimising costs and transferring risks to the private sector while ensuring safety standards are maintained.

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The final model included:

- Vertical integration whereby rail operations and track management are integrated to ensure effective management. (This contrasted to the UK franchising model with separate track and rail operations);
- Peer competition where rail and tram services are each split into two separate companies (four in total). This was to encourage the poorer performing operator to improve. It also reduced the risk of an incumbent contractor failing since an alternative operator was available;
- A 10–15 year contract to ensure financial stability. The contract included base fixed payments plus a variable payment based on farebox revenue (split between all operators according to a ridership formula);
- Contract payment with a system of incentives and penalties based on performance monitoring; and
- To protect public interest, the integrated

multi-modal ticketing system was retained and fare rises pegged to inflation. Minimum service levels were also prescribed based on existing service levels. In addition, an A\$1.1 billion investment program involving new and refurbished rolling stock was included.

The outcomes of the competitive tendering process were impressive. Costs savings of some A\$1.8 billion were announced, including substantial reduction in government operating subsidies to almost zero by the end of the franchise period. Average cost cutting was 24% compared to public sector operation (Greig 2002). In addition, ridership growth of 40–84% over 10–15 years was expected. As one author puts it: “in short the government made a financial gain, shed most of the operating cost, revenue and investment risks and provided for better services” (Greig 2002, p8). UK based National Express Group won a rail and a tram franchise (plus a country rail contract) while Connex and TransDev won the remaining rail and tram operation respectively.

In 2003 a financial crisis emerged. This was caused by:

- Overly optimistic revenue growth and cost cutting expectations: bidders didn't seem to have considered the substantial historical reductions in costs since 1992. In addition, Melbourne is a low density, car dependent city and bidders seem to have expected European style ridership growth;
- A new labour government which was previously opposed to privatisation was elected;
- Contractual flaws: while some innovative contract measures worked, others were

difficult to implement in practice, e.g. the infrastructure maintenance regime; and

- Revenue sharing: the formula for splitting farebox revenue was complex and prone to disputes. Delays in the introduction of a planned magnetic swipe ticketing system compounded this problem.

The crisis called for a review of the franchising process and new interim operating arrangements.

The major result of the franchising review was the settlement of some disputes, including an additional A\$110 million of payments to operators (Greig 2002). At the same time, the government commenced negotiation for new interim operating arrangements with a view to create stability until a review of next steps could be undertaken. The government sought an increase in operator performance bonds as well as the operators' consent to participate in the review. In December 2002, National Express could not agree and withdrew from its contracts. This led to a forfeiture of its performance bonds to the value of A\$135 million (Department of Infrastructure 2005) and a financial write off for National Express estimated at A\$300 million. A new franchising model was required.

The Second Rail Franchising Model

An immediate response to the withdrawal of National Express was to merge the contracts under the remaining operators, i.e. TransDev to operate all tram services while Connex operate the trains (*Figure 1*). New model contracts were signed in 2004 operating for a 4–5 year period. The refranchising process considered the options of reinstating

government ownership and retendering the remaining contracts. The evaluation process used a “public sector benchmark” (financial model representing likely costs under public ownership) and “open book” negotiation with the remaining incumbent operators. This was a due diligence process which avoided competitive tendering and sought to ensure value for money. The objectives of the second franchise model emphasised “stable and sustainable relationships with franchisees”, “financial sustainability” as well as “value for money” outcomes (Auditor General Victoria 2005). In essence, a partnership model was sought which reduced the risk of future failures and emphasised stability.

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The major feature of the second rail franchising model is merging the 4 contracts into one rail contract and one tram contract, operated by the 2 incumbents. Revenue sharing was fixed between both parties to ensure revenue stability. In addition a single agency, Metlink, coordinated the functions of revenue collection and apportionment, ticketing and marketing for the operators and the government. Maintenance contracts and investment in new infrastructure were based on a collaborative approach where plans and costs were agreed with the government. In general all the other elements of the first franchising model were retained, including vertical integration and the fixed, variable and performance incentive/penalty form of the contract payments.

Figure 1: Tram and train services operated by TransDev and Connex respectively



- 4 new tram super stops were constructed, 4 stations improved and 1 tram line extended;
- Overall customer satisfaction index increased from 61% to 68%; and
- Patronage growth of 3% p.a. was achieved (about twice that during public operation).

Stanley and Hensher (2003) gave the first franchising model a “supplementary pass” due to the limited success against expectations and its lack of financial sustainability. They also suggested that bidders might have used a strategy termed “regulatory capture” whereby an artificially low cost bid is submitted to win the tender which is then later renegotiated under threats of service disruption. No evidence of this is available. However the additional A\$110 million payment in 2002 certainly wasn’t envisaged in the original agreements.

Assessing the Performance

Although the first franchise model failed due to the lack of financial sustainability, there were some positive aspects of its performance (Department of Infrastructure 2005):

- Rail punctuality/reliability improved by an average 35%;
- Service levels increased by about 10% but this is said by some to be less than in the period prior to franchising (Stanley and Hensher 2003);
- There was considerable industrial peace (hardly any strikes);
- Some A\$1.1 billion of new and A\$143 million of refurbished rolling stock was delivered on time and budget;

The processes used in generating the second franchising model were reviewed by the independent Victorian Auditor General (Auditor General Victoria 2005). This concluded that the second franchising model represented “reasonable value for money”. Mees (2005) has suggested that this process was a further example of the regulator being “captured” by the private operator, suggesting that it was in both the government’s and the operators’ interests to increase costs regardless of public interest. He cited the 10% fare increase which followed and a purported A\$1 billion in additional subsidies as examples of this (Mees 2005). However it is difficult to disentangle the increase in subsidies resulting from refranchising from service development costs which also took place during this time. Certainly the independent auditor’s finding

that refranchising was “value for money” does not match claims of a financial subsidy blowout. A range of other authors claim a “break even” outcome (Allsop 2007) or “modest” cost reductions (Williams et al. 2005).

In June 2008, a benchmarking study of urban rail system costs compared the Connex operation with CityRail in Sydney (LEK 2008). The comparison is of interest because the CityRail is comparable in scale to Melbourne's rail system but is a traditional government-run rail system with heavy union influence. It is without the commercial reforms implemented in Melbourne. The study found that:

- Connex had annual rolling stock costs of A\$ 62 million p.a. which was 40% less than CityRail at A\$ 88 million p.a. (2006/7);
- Connex had crewing costs which were some 17–29% less than CityRail;
- Connex's operating costs per station were 43% better than CityRail;
- Connex's overhead costs per employee were less than half of CityRail's; and
- Connex's employees per service kilometre (2006/7) were less than half of CityRail's.

Overall these findings suggest that Melbourne has realised substantial cost efficiencies compared to Sydney's government-run railway. This benchmarking occurred after the second franchising model was implemented, suggesting the adjusted franchising model is achieving substantial cost efficiencies.

A limited performance review of the post refranchising model (Williams et al. 2005) found:

- An increase in rail service cancellations and a decline in punctuality;

- A decline in passenger satisfaction index;
- Continued patronage growth;
- Minimal industrial disputes; and
- Delivery of several infrastructure projects on time and budget.

Williams et al. (2005) viewed the franchising as a whole as a “qualified success” while Allsop (2007) rated it a “reasonable success”. While there is a strong lobby from the left wing for a return to government control, this is very unlikely since almost all political parties would not want to return to the problems of the past.

Some have seen the patronage growth and associated overcrowding on the heavy rail system as “problems” of success rather than failure (Allsop 2007). More recently the overcrowding problem has become acute, leading to longer station dwell times, affecting reliability and time performance and stressing the rail operations as line capacity is limited.

It is difficult to associate any of these factors directly with rail franchising. Tram reliability has been impacted by increasing traffic congestion (Melbourne trams operate in mixed traffic) while increased dwell times have affected time performance of all rail lines. Indeed, ridership growth, while considerable, is largely influenced by population growth, increases in fuel prices and traffic congestion. None of these factors is related to franchising. It is difficult to see if public or private sector models could better adapt to these challenges.

Lessons Learned

A great deal has been learned from the Melbourne rail franchising process which is

useful for all authorities considering alternative governance models. These include the following (based largely on Williams et al. 2005) :

- There is a need to move away from cost saving as a major goal and to emphasise financial soundness and sustainability;
- In general the whole debate on contracting and regulation in passenger transport recognises the need for better partnership models as opposed to contracts which create barriers and are adversarial;
- When farebox revenue needs to be split between private operators, it is important to define simple incontestable models. These should be agreed and signed off before contracts are awarded;
- Performance based contract models can work but there is difficulty in measuring infrastructure condition;
- Government needs to make more careful assessment of risks and who is best able to handle them. In general, the contractors are better at cost related risks but have less control over revenue risks; and
- Long contract periods have higher revenue risks.

In addition, there is a need to address the emerging pressures for expansion of urban rail infrastructure and the increased pace of change in the development of urban public transport system. In Melbourne's case, substantial recent patronage growth has resulted in plans for an underground Metro system (State of Victoria 2008). Such a system was not envisaged in 2002. Hence governance models require a high degree of flexibility for all participants to adapt to changes. A partnership model is the only way flexibility of this kind can be managed.

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For the private sector, there are also lessons, notably with regard to managing "optimism bias" in bid development. As Stanley and Hensher (2003) have suggested, "if it looks too good to be true, then it probably is".

Conclusions and Next Steps

This paper has reviewed the performance of rail franchising in Melbourne to identify lessons learned. The first franchising model sought cost efficiencies following much unionised influence on management. Despite some successes, it failed due to "optimism bias" of revenue growth and cost cutting potential, flawed contract and complex revenue sharing arrangements. A revised model involving negotiated sustainable funding, partnership approach and simplified revenue sharing emerged. Overall Melbourne's rail franchising is considered a "qualified" success and demonstrates many cost efficiencies.

In 2009 the government decided to have a full competitive tender for new contracts. The new contract period is 8 years with an option to extend for a further 7 years (based on good performance). When the tender results were announced in July 2009, both the incumbent operators lost. The new contractor for rail is Metro Train Melbourne, a joint venture of the Hong Kong Mass Transit Railway Corporation and Australian engineering companies John Holland and United Group.

For tram, the winning consortium comprises the French Keolis group and the Australian rail engineering company Downer EDI. The rationale for the tender results has not been announced to date. However a continued support for rail franchising remains for all major political parties.

Overall the Melbourne rail franchising reforms provide some important lessons for authorities examining new governance models. Partnership approaches are to be preferred to overly complex contractual arrangements. Authorities should aim to

achieve sustainability in financial arrangements rather than set cost cutting as a singular objective. Performance based contracting has much to offer but arrangements need to be transparent as well as flexible to respond to the ever changing conditions which can arise. Commercialisation of traditional government-run rail services has its benefits. However all governments need to be aware that there are substantial risks associated with reforms and that heeding the lessons of cities like Melbourne is a wise means of developing informed policy.

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