



Transport Perspectives

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KPMG LLP (UK)

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Transport in the 'Age of Austerity'

The new Secretary of State for Transport is confronted by a difficult balancing act. Reducing the deficit is the central priority of the Coalition and indeed £683 million, 4.7 percent of Department for Transport's (DfT) £14 billion annual budget, has already been earmarked to be cut. However, whilst further cuts are inevitable, investment in infrastructure remains critical to assure the future growth and competitiveness of the UK economy, as the Chancellor helpfully acknowledged in his emergency Budget statement.

KPMG is an active voice across all sectors of transport. We explore below ways of addressing the current fiscal constraints by raising revenue and delivering efficiencies. We also consider potential areas of policy reform — notably in respect of the national roads network.

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Rail

Since privatisation, the overall performance of the UK rail industry has improved significantly. Between 1996/7 and 2008/9, the number of passenger journeys has grown by 59 percent and there has been a 37 percent increase in the volume of freight that is moved by rail¹. Furthermore both train reliability and customer satisfaction (as measured by the National Passenger Survey), are at their highest recorded levels.

However, over this period, industry costs have risen faster than revenues with taxpayer support for the railway increasing from £2.5 billion in 1993/4 to £5.2 billion in 2008/9². In an environment where Departmental budgets may be cut by 25 percent, clearly any further increase in taxpayer support is unsustainable. Indeed the critical question facing the industry is whether cost efficiencies can be delivered and additional revenues generated such that the service level and capital programme currently being purchased by Government can be maintained.

- Do asset management and supply chain management in UK rail meet best practice when benchmarked against other industries?
- Can human resources structures and processes within the industry be improved?

Given the high quality of the outputs that are currently being delivered, KPMG would guard against any wholesale structuring of the UK rail industry. However, a 25 percent reduction in taxpayer funding implies a £1.3 billion cut in industry support — equivalent to 11 percent of total industry costs. To achieve such a saving, significant efficiencies will be required in each of the areas identified above. However, efficiencies of this scale may only be deliverable over the medium term. If a reduction in net taxpayer support is required more immediately, then it is likely that an increase in fares, or some reductions in service levels, will become an unavoidable part of the short term picture.

Value for Money Study

DfT and the Office of Rail Regulation (ORR) are in the course of undertaking a detailed Value for Money Study to identify where there is scope for cost reductions to deliver the same or better outputs and thus improve value for money. KPMG considers the key questions for the study to be:

- Can re-organising or changing incentives within the current industry structural framework lead to improved efficiency, for example with regards to Network Rail?
- Can revenues be increased through, for example, improving revenue protection and car parking and exploiting the potential of the railway property portfolio?

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¹ Rail Value for Money - Scoping Study Report, DfT/ORR, 31/3/2010, Page 12

² Rail Value for Money - Scoping Study Report, DfT/ORR, 31/3/2010, Page 6

Crossrail

The £16 billion Crossrail programme is the largest transport project that the Coalition will oversee. Whilst the strategic case for Crossrail improving connectivity to the most productive part of the UK economy is well understood, ministers have indicated that the current fiscal position demands a review of outputs and costs. The key question is whether this review will recommend changes that affect the scope of the project or just seek to be more efficient in procurement.

If significant savings are to be sought it is likely that these can only be realised by examining:

- The economic benefits of running the route out beyond Canary Wharf in the east and Heathrow in the west. It may be that parts of the route could be de-scoped in a way that delivers cost savings without undermining the business case of the project;

- Whether scheme implementation could be re-phased/delayed to save costs or re-profile the rate of expenditure; and
- Whether the signalling could be simplified in the short-term to a lower cost and more proven technology.

It is unlikely that any of the changes set out above will result in a dramatic saving to the cost of Crossrail since the bulk of the expenditure is in the central London tunnelling and stations. The decision to proceed with Crossrail therefore represents a welcome indication that the Government, notwithstanding its extraordinary fiscal pressures, will continue to invest in the UK's transport network.

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Bus

KPMG has recent experience of reviewing the procurement of bus services in the UK. In 2009, we undertook an independent study of Transport for London's (TfL) system of contracting for bus operations and we are currently advising DfT and the local Passenger Transport Executive (PTE) on a bus efficiency review in Greater Manchester.

In London, the net cost of supporting bus services has increased from about £40 million to over £650 million over the past decade³. However, our review of the TfL contracting model concluded that it was broadly fit for purpose. There is a competitive market for contracts which are operated on relatively tight margins. The increase in support has largely been a function of policy decisions in respect of fares and service quality that may need to be revisited given current fiscal constraints.

However, in the conurbations outside of London, the taxpayer funds around 40 percent of all industry revenues through concessionary fares, the Bus Service Operators Grant (BSOG) and amounts paid for tendered services. Because this subsidy flows through multiple routes, little of it is targeted. Our work in Greater Manchester indicates that this can lead to inefficiencies, most obviously from too much bus capacity on some routes, and also because opportunities from multi-operator ticketing are lost.

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A key issue for authorities and operators alike is how to ensure that any partnership arrangements that are developed to address these issues do not fall foul of competition rules. The recent initiative by Centro to organise bus services in Birmingham is reported to have taken months of meetings with the Office of Fair Trading for all parties to be comfortable that they were within the law. It remains to be seen whether such arrangements can deliver both better services for passengers and savings to the taxpayer.



³ *Independent strategic review of the provision of bus services in London*, KPMG, 16/07/2009, Page 2



Releasing some of the value locked up in the UK's national roads network could clearly make a significant contribution to reducing the deficit.

Roads

Lorry road user charging

A new source of revenue identified by the Coalition is lorry road user charging. The policy is directed at addressing the competitive distortion perceived to have arisen from lorry road user charges being introduced in a number of other European countries.

This means that UK hauliers operating abroad can pay both UK fuel duty and lorry road user charges. However, overseas hauliers entering the UK generally buy fuel outside of the UK so pay neither UK fuel duty nor any road user charges.

The procurement of a system of lorry road user charging was previously launched by Customs and Excise in 2003/4. It was proposed to levy a charge on all lorries on the UK's roads, both foreign and domestic. A rebate was then to be provided to those who had paid UK duty on their fuel. However, the procurement was abandoned due to:

- Rising overall project costs;
- Concerns with procuring bespoke technology that could become a 'white elephant'; and
- Fears that the proposed commercial structure, which involved separate contracts for design, administration and enforcement, had become too complex.

Technological advances mean that lorry road user charging schemes have now been implemented in Germany, Austria and Switzerland. It is understood that Government may introduce charging via a simple licence for operating heavy goods vehicles in the UK. This system would be easy to implement as there would be no roadside or satellite technology involved. However, the downside of such an approach is that the opportunity to take a first step towards the type of distance-based charging that would be consistent with a sustainability-focused transport agenda would be deferred.

The national roads network

Releasing some of the value locked up in the UK's national roads network could clearly make a significant contribution to reducing the deficit. A sale of the network, with Government making future payments to the new owner under a system of shadow tolls, has been proposed by some commentators. Whilst that would raise potentially significant sums and quickly, it is unclear what long-run efficiencies would be achieved and the servicing cost of the shadow tolls would be very high.

One alternative approach would involve a change in ownership. A regulated entity responsible for the operation, maintenance and enhancement of the road network in England could be established. A roads regulator would then also be created to determine budgets, returns, performance and safety targets. This structure would help maintain quality standards and drive efficiency in roads maintenance expenditure.

To raise money now, the Government could sell a proportion of the regulated entity to institutional investors. The remaining shares would be given to road users free of charge. However, if these shares were subsequently sold, a levy would be payable to Government. This would provide Government with a revenue stream over many years, helping to cut the deficit.

In the long term, road pricing in the UK will help to tackle congestion and the costs that it imposes on the economy.

A network of recharging points may for example prove to be problematic because few drivers will want to park their car for extensive periods in the middle of a journey to recharge their vehicle.



At present, opposition to road pricing is strong and the Coalition has ruled out charges for existing roads during the current Parliament. However, over time, the change in ownership described above might allow road pricing to be introduced in a way that is politically acceptable.

The regulated entity could put in place technology to allow distance based road pricing. A system of shadow tolls would operate until all technological problems are ironed out. A switch over to real tolls would then follow. This would be matched by a reduction in Fuel and Vehicle Excise Duty. By accompanying the introduction of charging with a reduction in other taxes on the motorist, these proposals could be 'cost neutral' to road users. The result would be the same amount of revenue raised in terms of excise duty and congestion charges but with there being more efficient usage of the road network due to better price signals to motorists. Future Governments and/or the regulator could retain flexibility to increase tolls over time both to fund improvements required to the network and to manage levels of congestion.

Greater efficiency in service delivery

Current conditions will bring pressure to examine the machinery of Government to identify where services can either be undertaken by the private sector or synergies delivered by merging activities.

An example within DfT is the area of vehicle licensing. Some of the activities of the Driver Vehicle and Licensing Agency (DVLA), the Vehicle Operator Service Agency (VOSA) and the Driver and Vehicle Agency (DVA) may be capable of being undertaken by the private sector. Furthermore, aspects of DVLA and VOSAs' vehicle work might efficiently be merged and there may be synergies from combining driver information with other government identity databases. On a case by case basis, DfT, and indeed the whole of Whitehall, will need to identify where potential efficiencies and synergies outweigh the management challenge of restructuring.

Establishing a national network for re-charging electric vehicles

One of the most eye-catching commitments in the Coalition agreement is to mandate a national network for electric and plug-in hybrid vehicles. The challenge for Government is establishing a network at a time when the model for charging electric vehicles (at home, at work, at public charging points) has not yet been shaped. The risk of supporting a network which is overtaken by emerging technology needs to be balanced against the Coalition's desire to position the UK as an early adopter of this new technology.

Network design must be mindful of the demands that vehicle charging will place on electricity generation. Smart metering could serve to limit the impact on peak generation requirements and indeed could play a role in 'balancing' network demand across the day.

KPMG understands that the Government is minded to promote the network by allowing electricity companies to recoup the cost through their Regulated Asset Bases. This would be a clever way of moving the cost from the taxpayer to the consumer, but begs the question whether electricity companies are best placed to determine the nature of the network. A network of recharging points may for example prove to be problematic because few drivers will want to park their car for extensive periods in the middle of a journey to recharge their vehicle. In addition, recharging at home may be an issue for those who do not have a garage and therefore can not readily access charge points.

We expect the DfT to want to continue to consult extensively with industry in this area as private sector innovation and indeed capital will be essential to getting the solution right. What is clear is that the feasibility of an extensive switch to electric-only cars is largely dependent on technological improvements.

Conclusion

The new Secretary of State has a significant challenge in delivering the necessary savings whilst maintaining a viable programme of infrastructure investment to maintain the UK's international competitiveness.

Getting to grips with large areas of expenditure will demand difficult policy choices and potentially reform in areas such as bus operations and rail infrastructure. At the same time, establishing new sources of revenue will require political boldness. Finding effective business case mechanisms to assess the economic benefit of capital expenditure has never been more critical.

The quality of the UK's transport infrastructure has a significant bearing on both economic competitiveness and our ability to meet carbon reduction targets.

The change of Government provides an opportunity to circulate fresh ideas before policy gets set in stone. KPMG intends through this and our ongoing programme of thought leadership to be fully part of this debate.

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