



Independent Pricing and Regulatory Tribunal

Improving CityRail's accountability and incentives through stronger governance arrangements

Transport — Draft Report
October 2008



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The Tribunal members for this review are:

Dr Michael Keating, AC, Chairman

Mr James Cox, Chief Executive Officer and Full Time Member

Ms Sibylle Krieger, Part Time Member

Inquiries regarding this document should be directed to a staff member:

Fiona Towers (02) 9290 8420

Aaron Murray (02) 9290 8440

Independent Pricing and Regulatory Tribunal of New South Wales

PO Box Q290, QVB Post Office NSW 1230

Level 8, 1 Market Street, Sydney NSW 2000

T (02) 9290 8400 F (02) 9290 2061

www.ipart.nsw.gov.au

Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by 5 November 2008.

We would prefer to receive them by email <ipart@ipart.nsw.gov.au>.

You can also send comments by fax to (02) 9290 2061, or by mail to:

Review of CityRail regulatory framework
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

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If you would like further information on making a submission, IPART's submission policy is available on our website.

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1 Introduction and executive summary

In recent years, the Independent Pricing and Regulatory Tribunal of NSW (IPART) has expressed concern that the economic regulatory framework for CityRail is not effective. In particular, IPART has noted that CityRail's costs are increasing at an unsustainable rate, and there are insufficient incentives for CityRail to rein in these costs by improving its efficiency. In response to these concerns, the NSW Government asked IPART to investigate and recommend an economic regulatory framework that will create effective incentives for CityRail to provide its services at efficient cost levels while maintaining appropriate service standards (see Appendix A for the terms of reference).

One of the key elements of CityRail's regulatory framework is the approach IPART uses to set fares. IPART has considered its fare setting approach and made draft decisions to revise key aspects of this approach. IPART has used the revised approach in making its draft determination on CityRail fares from 2009. The revised approach will make an important contribution to encouraging CityRail to be more disciplined in its spending, and to improve its financial performance. In particular, IPART has identified the efficient costs of providing CityRail services over the next four years, and a transition path for CityRail to move from its existing to efficient cost levels. (Box 1.1 provides an overview of the key changes to the approach to fare setting, and the benefits of these changes.)

But the incentive properties of this revised approach to fare setting would be enhanced if complementary changes to RailCorp's current institutional and governance arrangements were also adopted. IPART's investigation found that while the current institutional and governance arrangements provide the appropriate overarching framework they are not sufficiently specific, detailed or transparent to enable the Government to set strategic direction and required performance standards, evaluate CityRail's performance, hold it accountable for this performance, or create effective incentives for it to improve its performance. This lack of transparency and accountability is contributing to confusion regarding the separate roles of government and CityRail management with the Government being held responsible for issues which are beyond its control such as the day to day operations of CityRail. The lack of transparency and accountability also undermines IPART's ability to use its fare determinations to create effective incentives for CityRail to improve its performance. Instead the governance framework proposed here, which builds clearer agreements that specify performance standards, will better allow the Government to set and monitor CityRail's strategic direction and performance.

IPART considers it critical that these institutional and governance arrangements are reformed, to ensure that the Government clearly specifies the levels of service and financial performance it expects CityRail to deliver for a specific amount of funding, and can hold CityRail's management accountable if these performance levels are not met. In effect, the Government should adopt a purchaser provider model that will enable it to effectively control CityRail's strategic direction and performance, while leaving CityRail to manage the day-to-day operation of its business and be held accountable for its performance. Providing the Government with enhanced strategic control should remove the need for reactive Government intervention in CityRail's operational affairs. This model will also support and complement IPART's revised approach to setting fares, and ensure that CityRail's economic regulatory framework is robust, comprehensive and effective.

Box 1.1 Overview of the key changes to the approach to fare setting

IPART's draft decisions on the approach to fare setting represent major revisions to the approach used in the past. The revised approach is more rigorous and robust, and provides significantly more scope to create effective incentives for CityRail to improve its economic efficiency. However, it is important to note that the effectiveness of any incentives IPART aims to create through this approach will be enhanced by the Government making changes to the institutional and governance arrangements for CityRail, so all elements of the economic regulatory framework are consistent and aligned.

IPART's draft decisions on the approach to fare setting include:

- ▼ Introducing a multi-year determination period. For the next determination, IPART will set CityRail's fares for a period of four years, from 1 January 2008 to 31 December 2012.
- ▼ Using the building block approach to determine CityRail's annual revenue requirement over the determination period.
- ▼ Establishing the shares of the revenue requirement to be recovered from CityRail passengers and from taxpayers by estimating the value of the external benefits generated by CityRail services, and considering potential impacts on fare affordability and patronage levels.
- ▼ Converting the portion of CityRail's revenue requirement to be recovered from passengers into fares by setting the maximum fare for each CityRail ticket type.

IPART considers its revised approach has clear advantages over alternative options. In particular, it takes account of the full economic costs of providing CityRail services and the external benefits of these services in a rigorous and transparent way.

1.1 Adopt a purchaser provider model

Under a purchaser provider model, the Government would clearly specify in service and funding contracts with RailCorp the quantity and quality of passenger rail services it will ‘purchase’, and the specific funding it will provide for the provision of these services. It would also specify key financial performance outcomes it expects CityRail to deliver. Such a model would enhance the Government’s and Minister of Transport’s role in setting RailCorp’s strategic direction and determining public transport policy.

Under a purchaser provider model the Government would continue to set strategic policy decisions such as the quantity and quality of services CityRail is to provide, where and when these services should be provided, the purchase of rolling stock, capital investments and any specific policies or practices it requires of CityRail. Government, once it has specified its requirements for CityRail services and performance levels by modifying its current agreements, would then be able to withdraw from involvement in, and taking responsibility for day to day operations of CityRail. In practice, implementing these reforms will be a gradual process. Once the framework is implemented and RailCorp has exercised its managerial autonomy Government’s role should focus on the strategic policy and holding RailCorp accountable.

By setting these strategic policy objectives in detail, the Government will directly control what matters most to it and the travelling public - an improved level of performance from CityRail. It also creates clearer lines of responsibility and accountability. Government is responsible and accountable for what it can control - its strategic policy decisions. Then RailCorp is responsible and accountable for ensuring that CityRail’s performance meets the objectives set by Government. If CityRail’s performance fails to meet these objectives, RailCorp’s management should be held responsible by the Government and the public.

Given the existing legislative framework for RailCorp, IPART considers that the most effective way to implement a purchaser provider model is to improve the existing governance instruments - RailCorp’s Statement of Corporate Intent, the Rail Performance Agreement between RailCorp and the Minister for Transport, and the funding agreement between RailCorp and the Ministry of Transport. It will also be important to increase the transparency of these instruments and improve public reporting of CityRail’s performance. IPART has identified and recommended a range of improvements to these three instruments that will enable them to form the nucleus of an effective purchaser provider model. IPART believes its recommended approach will enable the NSW Government and taxpayers to obtain the benefits of a more effective service contract for the provision of vital public transport services, while retaining public ownership of the service provider.

Rail safety is a vital, non-negotiable aspect of service. IPART has not reviewed rail safety regulation which is the responsibility of the Independent Transport Safety and Reliability Regulator. ITSRR has its own reporting and performance framework for

safety regulation. RailCorp is legally obliged to meet safety requirements under the *Rail Safety Act 2002*. However, in its draft fare determination, IPART has determined CityRail's revenue requirements for the next four years based on CityRail operating its rail network safely and at the levels determined by the safety regulations.

1.2 Improve the Statement of Corporate Intent

IPART has identified key improvements to the Statement of Corporate Intent (SCI) to enable the Government to play a greater and more effective role in guiding CityRail's strategic direction and priorities, and to create effective incentives for CityRail to improve its financial performance while maintaining service standards. The improvements involve the Government more clearly defining its objectives for CityRail, and clearly specifying the financial performance targets it expects CityRail to meet.

The current SCI includes the objectives for RailCorp set out in the Transport Administration Act, but does not provide any further explanation or interpretation of these objectives, or any specific objectives for CityRail. For example, the SCI notes that RailCorp's objectives include providing railway passenger services in an "efficient" manner, and operating "at least as efficiently as any comparable business", but does not define what is meant by operational efficiency or set out the targets CityRail needs to meet to achieve levels of efficiency comparable with other rail passenger service providers. IPART considers that the SCI should include a more detailed explanation of the Government's objectives for CityRail (as distinct from other parts of RailCorp). It should also indicate the Government's priorities to ensure RailCorp management operates CityRail consistent with these priorities.

In addition, to drive improvements in CityRail's level of efficiency, the SCI should include measurable financial performance targets. IPART considers the SCI should be a multi-year document that aligns with IPART's fare determination period, and transparently sets out the level of financial performance that the Government, as shareholder, expects RailCorp to deliver and to which RailCorp's management can be held accountable. More specifically, the SCI should include:

- ▼ Separate financial performance targets for CityRail. IPART considers that to create strong incentives to improve CityRail's performance, it is important that any inefficiencies in the CityRail business cannot be transferred to the CountryLink business.
- ▼ Long-term financial performance goals for CityRail that are measurable, and consistent with the Government's objectives for public transport including the service targets set out in the improved Rail Performance Agreement (discussed below). IPART considers that the inclusion of long-term financial goals is likely to encourage better financial planning and better integration of operating and capital expenditure.

- ▼ Shorter term financial targets for CityRail, including measurable efficiency targets. These targets should be consistent with the efficient operating costs determined by IPART as part of its fare determination, and with the funding being provided to RailCorp to allow it to transition to efficient benchmark levels (as set out in the improved funding agreement, discussed below). The targets should become increasingly ambitious over time, to put pressure on RailCorp management to move CityRail to a cost structure similar to comparable operators in Australia, while maintaining safety and service standards.

1.3 Improve the Rail Performance Agreement so it becomes an effective service agreement

IPART considers that the existing Rail Performance Agreement (RPA) should be improved so that it becomes an effective service agreement between the Minister of Transport and RailCorp. This would involve the Government, as the purchaser of passenger rail services for the greater Sydney area, clearly specifying:

- ▼ the quantity of service it requires CityRail to provide
- ▼ the quality of service it requires CityRail to provide
- ▼ any other government policy requirements of CityRail (such as a requirement to employ guards on trains).

The current RPA lacks this level of detail, which makes it difficult for the Government to hold CityRail accountable for its service performance. It also makes it difficult for IPART to accurately estimate CityRail's efficient costs, because the costs of providing passenger rail services depend on the quantity and quality of those services.

In determining the detail, the Government will need to consider its own objectives and priorities for CityRail and public transport (as set out in the improved SCI), and the cost of meeting these objectives.

IPART considers that the RPA should be a multi-year agreement that aligns with the fare determination period. It should focus on the aspects of service quality that are most important to passengers, and set clear performance targets for each of those aspects. This will ensure that CityRail does not respond to incentives for improved efficiency created by the SCI and fare determination by allowing key aspects of service quality to deteriorate.

1.4 Improve the funding agreement

Because CityRail's farebox revenue covers only a proportion of its revenue requirement, RailCorp receives significant government funding to provide CityRail services. This funding is currently provided through a funding agreement between the Director-General of the Ministry of Transport and RailCorp.

IPART considers that the existing funding agreement needs to be improved, so that it becomes an effective funding 'contract'. IPART also considers that this funding agreement needs to be consistent with and complement both the service agreement and IPART's fare determination, to ensure appropriate accountability and create strong incentives for CityRail to increase its efficiency while maintaining service standards.

The funding agreement should be a multi-year document that aligns with IPART's fare determination and the improved SCI and RPA, and clearly sets out the funding the Government will provide towards the costs of providing the quantity and quality of services specified in the service agreement. More specifically, the funding agreement should:

- ▼ Clearly establish ex ante whether RailCorp or the Government bears the cost or benefit if revenue or costs rise or fall unexpectedly. As part of this, the level of government funding for CityRail should be 'capped', and the 'parameters for compensation' in the event of lower than expected farebox revenue should be established ex-ante.
- ▼ Provide a clear and transparent breakdown of the different elements of government funding being provided to RailCorp to provide CityRail services.
- ▼ Reflect IPART's recommendations on CityRail's revenue requirement and forecast farebox revenue, and the expected levels of financial performance set out in the SCI.
- ▼ Be updated when the funding for CityRail is altered.

1.5 Improve transparency and public reporting

Transparency of information, including the contractual requirements between Government as purchaser and RailCorp as provider, is a key element in providing RailCorp with incentives to improve its efficiency. CityRail is a monopoly passenger rail provider and is not subject to competitive pressure to maintain and improve service quality. Public reporting of performance against targets acts as substitute for competitive pressure, counterbalancing any tendency to let the quality of services decline in the absence of competition.

The economic incentives resulting from IPART undertaking a more rigorous process of determining fares will be more effective in encouraging efficient operations if a cap is placed on the level of government subsidy and financial performance is actively monitored and reported on.

IPART recommends that the SCI, RPA and the funding agreement are made publicly available at the time the instruments are executed and whenever they are updated.

1.6 Draft recommendations

- 1 That the Government adopt a purchaser provider model by improving existing statements and agreements - the Statement of Corporate Intent, Rail Performance Agreement and the funding agreement. 17

Improve the Statement of Corporate Intent

- 2 That the Government clearly explain its objectives and priorities for CityRail in the Statement of Corporate Intent (SCI). 21
- 3 That the Government, as shareholder, clearly explain in the SCI the financial performance outcomes it expects from CityRail (and CountryLink). This should include: 22
- long-term financial performance goals that are measurable and consistent with the Government’s objectives for public transport, including the service targets set out in the improved Rail Performance Agreement (RPA) 22
 - shorter term financial performance targets, including measurable efficiency targets that are consistent with the efficient operating costs determined by IPART as part of its fare determination and the funding being provided to allow CityRail to transition to efficient benchmark levels. 22
- 4 That the SCI be a multi-year document that aligns with the fare determination period, and the periods covered by the improved RPA and funding agreement. 23
- 5 That the SCI be finalised and signed before it is scheduled to come into effect. 23
- 6 That NSW Treasury (as financial shareholder) and the Minister for Transport and Ministry of Transport (as purchaser of passenger rail services) drive the development of the SCI. 23
- 7 That the Government monitor and evaluate CityRail’s performance against the objectives and targets in the SCI, and take account of its actual performance in developing future SCIs. 24

Improve the RPA so it becomes an effective service agreement

- 8 That the improved RPA clearly specify the quantity of service to be provided by CityRail by setting measurable performance targets for the following indicators: 27
- minimum frequency of services by line, in various time bands (am/pm peak, between peaks, evening), by direction (to/from CBD), on weekdays and weekends/public holidays, and the times of first and last services 27
 - peak and off peak train service kilometres and carriage service kilometres 27
 - peak and off peak total patronage (passenger journeys). 27

9	That the RPA clearly specify the quality of service to be provided by CityRail by setting measurable performance targets for the following indicators:	33
	– on-time running, skipped stops, and cancelled services:	33
	a. in peak and off peak periods	33
	b. for each line of the CityRail network	33
	– total delay minutes in peak and off peak periods	33
	– average timetabled train speed, as a proxy for journey time	33
	– peak period crowding for each line of the CityRail network	33
	– offences against persons, derived from the Bureau of Crime Statistics and Research quarterly reports	33
	– an index of customer perception of safety, based on the results of the ITSRR’s annual passenger surveys	33
	– an index of customer satisfaction with information provision, based on the results of ITSRR’s annual surveys	33
	– an index of customer satisfaction with cleanliness of trains, based on the results of the ITSRR’s annual surveys	33
	– percentage of fleet less than 10 years old, as a proxy for passenger comfort.	33
10	That the Ministry of Transport in consultation with the ITSRR and RailCorp:	33
	– consider the feasibility of measuring on-time running at major centres, as well as the CBD, for future RPAs	33
	– consider developing a more sophisticated indicator for journey delays that takes into account the number of passengers affected for inclusion in future RPAs	33
	– consider developing an improved indicator for journey time for inclusion in future RPAs	33
	– review the definition of the morning and afternoon peak periods included in the RPA with a view to aligning this definition with the periods of peak use of the system and IPART’s fare determination.	33
11	That the Ministry of Transport regularly review the indicators and targets for service quality included in the RPA to assess whether the passenger rail services the Government is purchasing are consistent with its public transport strategy and in line with passengers’ priorities.	33
12	That the Government specify in the RPA government policies and requirements of CityRail which are over and above what would be implemented by an operator aiming to deliver cost efficient services that simply comply with the various government-specified benchmarks.	34
13	That the Ministry of Transport provide explicit guidance to RailCorp about the quantity and quality of service the Government expects CityRail to provide (similar to a request for tender) at the start of negotiations on the content of the RPA.	34

- 14 That the RPA be a multi-year document that aligns with the fare determination period and the periods covered by the improved SCI and funding agreement. 35
- 15 That the RPA is finalised and signed before it is scheduled to come into effect. 35
- 16 That the Government monitor and evaluate CityRail's performance against the targets in the RPA, and take account of its actual performance in developing future RPAs. 36
- 17 That the RPA include a requirement for RailCorp to report regularly to the Minister for Transport on CityRail's performance against all indicators and targets included in the improved RPA. 36

Improve the funding agreement

- 18 That the funding agreement clearly specify which parties bear the costs and benefits of cost overruns and variations in farebox revenue, consistent with the incentives IPART is aiming to create through its approach to fare setting 42
- 19 That the funding agreement establish ex-ante the extent to which RailCorp will be compensated if farebox revenue is lower than assumed in setting fares, due to lower than forecast patronage. 42
- 20 That the funding agreement clearly differentiate between the funding being provided for CityRail, CountryLink and other non-passenger services. 44
- 21 That the funding agreement clearly show the different components of funding for CityRail services, such as the funding associated with the efficient costs of providing the services specified in the RPA, the funding temporarily being provided to allow RailCorp to transition towards efficient operating benchmarks determined by IPART, and the funding associated with meeting government policy requirements, etc. 44
- 22 That the funding agreement be determined with reference to the SCI, RPA and IPART's fare determination, and be consistent with the incentives and targets created by these documents. 44
- 23 That the funding agreement be a multi-year agreement that aligns with the fare determination period and the periods covered by the improved SCI and RPA. 45
- 24 That the funding agreement be signed before it is scheduled to come into effect and expressly updated when any element of the funding provided to RailCorp is altered. 45

Improve transparency and public reporting

- 25 That the key governance instruments for RailCorp and CityRail – the SCI, the RPA and the funding agreement – are made publicly available at the time the instruments are executed and whenever they are updated. 47

26 That RailCorp publish on its website CityRail’s performance against all targets in the RPA, and produce a quarterly overview report for the public with commentary on where and why this performance has not met the targets.	48
27 That annual CityRail passenger surveys continue to be undertaken and results publicly reported.	48
28 That the ITSRR or the Ministry of Transport continue to produce a public annual report on CityRail’s performance against the targets in the RPA.	48
29 That CityRail’s performance against these targets be publicly reported on and feed back into the development of future SCIs.	48
30 IPART will publish an annual report on CityRail’s fares and actual services levels.	48

1.7 Structure of this report

The following chapters explain IPART’s draft findings and recommendations on improving the institutional and governance arrangements for RailCorp and CityRail in detail:

- ▼ Chapter 2 explains why stronger institutional and governance arrangements will enhance the economic regulatory framework for CityRail. It also provides an overview of IPART’s recommended approach for strengthening these arrangements by adopting a purchaser provider model, and for implementing this model by improving the existing SCI, RPA and funding agreement, and improving the transparency of these instruments and public reporting of CityRail’s performance.
- ▼ Chapters 3 to 5 explain IPART’s recommended improvements to the SCI, RPA and funding agreement.
- ▼ Chapter 6 discusses IPART’s recommendations for improving transparency and public reporting of CityRail’s performance.

Please note that IPART’s revised approach to fare setting, which is a key element of the overall economic regulatory framework, is not discussed in detail in this report. IPART is empowered to make decisions on this approach, and these decisions are discussed and explained in its report on its draft determination for CityRail fares from 2009, which is due to be released by 3 October 2008.

Also note that IPART invites stakeholder comments on the draft recommendations discussed in this report, and will consider these comments before it makes its final report and recommendations to the Government. Details on how to make a submission can be found on page iii at the front of the report. Submissions must be received by IPART by 5 November 2008.

2 Strengthen CityRail's governance arrangements by adopting a purchaser provider model

The broad economic regulatory framework for CityRail includes the institutional and governance arrangements between the Government and RailCorp. These arrangements include the key instruments through which the Government guides CityRail's strategic direction and priorities, and sets out the financial and service performance outcomes it expects CityRail to deliver.

IPART has reviewed the current institutional and governance arrangements to assess their effectiveness in creating incentives for CityRail to provide its services at efficient cost levels while maintaining service standards. IPART found that the arrangements are not sufficiently clear, detailed or specific enough to enable the Government to hold RailCorp accountable for CityRail's financial or service performance. This lack of accountability, combined with a lack of transparency, means the Government cannot create effective incentives for CityRail to improve its performance. It is also contributing to the Government being held responsible for issues which are beyond its control such as the day to day operations of CityRail. In addition, the lack of detail and transparency about the quantity and quality of services CityRail is to deliver, and the funding it is to receive in return, undermines IPART's attempts to create incentives for efficiency improvement through its fare determinations.

To ensure that CityRail has a robust, comprehensive and effective economic regulatory framework, and strong incentives to improve its efficiency, IPART believes the Government should strengthen the institutional and governance arrangements by adopting a purchaser provider model. Under this model, the Government would clearly specify the quantity and quality of services it will 'purchase' and detail the funding it will provide in formal agreements. It would also clearly specify the financial performance targets it expects CityRail to meet. This enhances the Government's and the Minister of Transport's role in setting RailCorp's strategic direction and determining public transport policy. The Government would continue to make key decisions on CityRail services - the quantity, quality and location of services, purchase of rolling stock, capital investments and any specific policies or practices it requires of CityRail. IPART's recommended reforms would provide the Government with greater control over what matters to it and the travelling public - an improved level of performance from CityRail.

With a well specified agreement the management and Board of RailCorp should have the autonomy in managing and operating CityRail in line with the Government's objectives. Under this model Government can hold CityRail

accountable for its performance. The Government would step away from involvement in or taking responsibility for CityRail's day to day operations. Stronger incentives for CityRail to improve efficiency will be created by aligning RailCorp's service and funding contracts with IPART's fare determinations, and will complement and strengthen the incentives IPART creates through its fare determinations.

The sections below set out the characteristics of effective institutional and governance arrangements for CityRail, explain why the current arrangements are not effective, and outline IPART's recommended approach for strengthening the current arrangements by adopting a purchaser provider model.

2.1 The characteristics of 'effective' institutional and governance arrangements for CityRail

As part of its review, IPART analysed the experience in other jurisdictions and industries to identify how CityRail's economic regulatory framework, including its institutional and governance arrangements, could be used to provide it with incentives to provide its services more efficiently. For example, it examined the frameworks for other rail passenger service providers (including those in Melbourne and England) and for other natural monopoly infrastructure service providers (such as energy and water utilities).

IPART concluded that, for a monopoly service provider such as CityRail, effective institutional and governance arrangements should provide for:

- ▼ the Government to set the strategic direction for public transport in general and for CityRail specifically, in line with Government policies and priorities
- ▼ the Government to specify the financial and service performance outcomes it expects CityRail to deliver
- ▼ the management and board of RailCorp to have autonomy in managing and operating CityRail in line with the Government's direction and, at the same time, for the Government to hold RailCorp fully accountable for CityRail's financial and service performance
- ▼ consistency with IPART's fare determinations and the incentives created by these determinations, so all the elements of the broad economic regulatory framework are aligned and complement each other
- ▼ full transparency in relation to the Government's expectations of CityRail, and CityRail's performance against these expectations.

Effective institutional and governance arrangements are especially important for monopoly service providers such as CityRail, which are not exposed to the disciplines of a competitive market. For example, in these circumstances, effective checks and balances to ensure accountability and transparency are critical for creating effective incentives.

2.2 CityRail's current institutional and governance arrangements are not effective

The current institutional and governance arrangements are intended to allow RailCorp to manage its day-to-day operations independently of the Government, while making strategic decisions in consultation with Government. These arrangements include the Transport Administration Act, the State Owned Corporations Act, plus three key instruments:

- ▼ the Statement of Corporate Intent (an over-arching or umbrella document) agreed between RailCorp's board, voting shareholders and the Minister for Transport
- ▼ the Rail Performance Agreement between RailCorp and the Minister for Transport, and
- ▼ the funding agreement between RailCorp and the Ministry of Transport.¹

IPART assessed these instruments against the characteristics of effective governance arrangements outlined above, and concluded that they do not clearly explain the strategic direction the Government expects CityRail to pursue, or enable the Government to hold RailCorp accountable for CityRail's financial and service performance. Nor do they provide for consistency with IPART's fare determinations, or transparency about the Government's expectations of CityRail and CityRail's performance against these expectations.

2.2.1 Current arrangements do not clearly explain the strategic direction for CityRail

The Government has multiple objectives for RailCorp, set out in the Transport Administration Act. It also has objectives for CityRail as a key provider of public transport services in the Sydney region, specified in a range of plans and policy statements.²

The Statement of Corporate Intent (SCI) for 2006/07 states that it reflects and supports the Government's objectives for RailCorp set out in the Transport Administration Act, and indicates how RailCorp's "key results areas" align with the objectives of the State Plan. However, the SCI doesn't indicate which objectives specifically relate to CityRail (as opposed to other parts of RailCorp's business). Nor does it further define or interpret these objectives, or indicate how RailCorp should prioritise them. This is problematic because many of the objectives are expressed in broad terms - for example, to deliver "safe" and "reliable" services in an "efficient" manner.

¹ There are a number of other mechanisms that guide RailCorp management such as NSW Government Procurement Policy and the Total Asset Management Policy issued by NSW Treasury.

² For example, the Premier's Urban Transport Statement, the State Plan, the Transport Strategy for Sydney (part of the Metropolitan Strategy), and the State Infrastructure Strategy.

These shortcomings mean that the SCI doesn't ensure that RailCorp and other stakeholders clearly understand the Government's objectives and priorities for CityRail. One of the consequences of this is that it is difficult for the Government to evaluate CityRail's performance against the objectives, or hold it accountable if it makes decisions that are inconsistent with the Government's priorities.

2.2.2 Current arrangements do not enable the Government to hold RailCorp accountable for CityRail's financial and service performance

IPART identified a number of issues with the current institutional and governance arrangements that limit the Government's ability to hold RailCorp fully accountable for CityRail's financial and service performance. In particular, the key instruments:

- ▼ do not consistently distinguish between CityRail and the other parts of RailCorp's business (such as CountryLink)
- ▼ do not clearly set out detailed, measurable financial performance targets for CityRail (or CountryLink)
- ▼ do not clearly define the quantity and quality of rail passenger services CityRail is to provide
- ▼ do not set out in sufficient detail the funding amounts the Government will provide to CityRail for specific purposes.

For example, the SCI includes several high-level financial targets for RailCorp as a whole, but does not include detailed, measurable performance targets that relate specifically to CityRail. As a result, the Government can't properly assess CityRail's financial performance or hold RailCorp accountable for this performance. Nor can it use the SCI to create incentives for RailCorp to improve CityRail's performance, either by setting stretch targets, or by establishing a system of rewards and penalties.

In addition, the Rail Performance Agreement (RPA) does not create a sufficiently formal relationship between the Government as the 'purchaser' of passenger rail services in the greater Sydney region, and CityRail as the 'provider' of those services. In particular, the RPA does not specify the quantum of services to be provided in total and by each train-line. And while it includes some service performance indicators and targets, these targets do not cover all the aspects of service quality that are important to passengers.

Further, the current funding agreement is extremely broad, and does not clearly and transparently show the individual components of funding, such as the costs of providing efficient CityRail services, the cost of meeting Government policy requirements (and the subsequent CSO funding), or the funding being provided to allow CityRail to transition to efficient benchmark levels. For example, it shows only the total amount of funding to be provided to RailCorp per year for four broad purposes, including 'services' and 'capital'.

2.2.3 Current arrangements do not provide for consistency with IPART's fare determinations

The current funding agreement does not relate the funding provided to CityRail to IPART's fare determination and, in particular, to the forecast revenue requirement and farebox revenue that underpin IPART's determination.

IPART, as the independent regulator is best placed to determine CityRail's total revenue requirements. IPART undertakes this role in many other industries that it regulates (eg, water, electricity, and gas). IPART's independence, consultative approach, professional expertise, analysis and decision-making ensures that CityRail's revenue requirement is based on efficient operating and maintenance costs, an appropriate allowance for both depreciation and return on the capital that CityRail's has invested. The share of revenue to be funded via passengers is determined by IPART having regard to a robust estimate of the external benefits of CityRail services, and impacts on patronage and affordability. The remaining share comes via the Government funding agreement.

To create effective incentives for CityRail to improve its efficiency, the funding provided by the Government should be consistent with the revenue requirement determined by IPART minus forecast farebox revenue. In addition, the funding agreement should specify Government determined level of concession funding associated with its CSO policies.

The current funding agreement does not clearly articulate how the costs and rewards of any unanticipated changes in costs or farebox revenue are shared between RailCorp, the Ministry of Transport, and NSW Treasury as shareholder. The clear allocation of responsibility for such variations between passengers, RailCorp and Government is fundamentally important to the incentives that are created, and is an important element of IPART's revised approach to fare setting. IPART considers it particularly important that all 'parameters for compensation' are established ex-ante.

Further, the funding agreement notes that in the event that RailCorp's funding is insufficient, the Director-General agrees to negotiate in good faith with RailCorp and make submissions to Treasury. While IPART recognises that unforeseen and rare events may impose additional costs on RailCorp in providing CityRail services, the ready provision of additional funding is not likely to encourage it to be more disciplined in its spending, and will undermine any incentives for efficiency improvements IPART tries to create through its fare determinations.

2.2.4 Current arrangements do not provide full transparency

IPART also found that the key governance instruments are not publicly available, or are not made available until after they have expired.³ As a result, the financial and service performance the Government expects from CityRail, and the extent to which RailCorp is subsidised by taxpayers for the provision of CityRail services, is not transparent. This lack of transparency compounds RailCorp's lack of accountability and poor incentives to improve CityRail's performance.

In addition, CityRail is not required to publicly report its performance against the Government's expectations. This means there is no transparency and public scrutiny of the true cost of providing CityRail's current services, and of expanding the CityRail network and improving service levels. Nor is there transparency about how much of this cost is properly borne by taxpayers, and how much is due to inefficiency.

2.3 The Government should strengthen the current arrangements by adopting a purchaser provider model

IPART considers that to strengthen the institutional and governance arrangements and create effective incentives for CityRail, the Government should adopt a purchaser provider model. Experience over the past 20 to 30 years indicates that the purchaser provider model is an effective regulatory approach for improving the efficiency of monopoly infrastructure service providers, including passenger rail service providers. This model is also consistent with the approach the Government has taken to improve efficiency levels in the NSW bus industry, NSW TAFE and NSW Health, where a significant portion of operating costs are funded through government subsidies.

IPART considers that the adoption of a purchaser provider model for CityRail would involve the Government setting out in transparent agreements with RailCorp:

- ▼ The quantity and quality of passenger rail services to be provided.
- ▼ Any policies CityRail is required to adhere to in providing those services (eg, staffing at low patronage stations).
- ▼ The financial and service performance indicators against which CityRail's performance will be assessed, and the performance targets it is expected to meet.
- ▼ The amounts of funding that will be provided for the provision of the services defined in the service agreement, and how unanticipated cost and revenue variations will be shared by RailCorp and the Government on an ex-ante basis.

³ The RPA and the funding agreement are not publicly available, and the most recent SCI that is available is for year ending 30 June 2007.

The purchaser provider model sometimes involves the introduction of competitive franchising, whereby private and public entities bid via a competitive tendering process to provide public services on behalf of government.⁴ However, IPART does not consider that this is necessary to obtain the benefits of the model, and is not advocating this approach. It notes that in Europe, there has recently been a move towards the use of transparent service contracts for the provision of public services that are directly awarded (rather than competitively tendered).⁵

Given the existing legislative framework for RailCorp, IPART considers that the most pragmatic way for the Government to implement an effective purchaser provider model for CityRail is by building on and improving the existing governance instruments – the SCI, the RPA and the funding agreement – and by increasing the transparency of these instruments and CityRail's performance.

Importantly, the Ministry of Transport as 'purchaser' will need to build and retain appropriate expertise in passenger rail services so that it can be an informed purchaser.

Chapters 3 to 6 explain IPART's specific recommendations for improving each instrument and increasing transparency. IPART considers that the effective implementation of these recommendations will provide significant benefits for Government, RailCorp and CityRail passengers, and ultimately for NSW taxpayers.

Recommendation

- 1 That the Government adopt a purchaser provider model by improving existing statements and agreements - the Statement of Corporate Intent, Rail Performance Agreement and the funding agreement.

2.3.1 Benefits for the Government

The implementation of IPART's recommendations will enhance the Government's and the Minister of Transport's role in setting RailCorp's strategic direction and determining public transport policy. Under the purchaser provider model Government can clearly articulate its objectives and priorities it expects CityRail to pursue and the policies it expects CityRail to adhere to, and explicitly considers the funding implications of these decisions. It will also ensure that the Government clearly specifies the quantity and quality of service it expects CityRail to provide in return for an explicit level of funding, and the financial performance outcomes it expects CityRail to achieve. Government, once it has specified its requirements for CityRail services and performance levels by modifying its current agreements, would then be able to withdraw from involvement in, and taking responsibility for day to

4 For example, competitive franchising is used in the provision of passenger rail services in Melbourne and United Kingdom.

5 Regulation no. 1370/2007 of the European Parliament aims to ensure that the terms on which the public service is provided and the compensation (or funding) provided in return for the service are set out in advance in a transparent service contract.

day operations of CityRail. In practice, implementing these reforms will be a gradual process. Once the framework is implemented and RailCorp has exercised its managerial autonomy Government's role should focus on the strategic policy and holding RailCorp accountable.

However, once the reforms to the framework are implemented Government would allow RailCorp to manage its daily CityRail operations without ad hoc intervention. This should ensure CityRail is held accountable for delivering the required rail services. For example, in the event of a major disruption to CityRail services on one day, Government would not intervene and would allow CityRail to take responsibility for its performance. Government involvement in CityRail's day to day operations would undermine RailCorp's accountability for its service and diminish the incentive effect of the recommended arrangements.

Importantly, this will enable the Government to evaluate CityRail's performance and hold it accountable if its performance falls short of the Government's expectations. It will also enable the Government to create effective incentives for CityRail to improve its performance, and support the incentives IPART aims to create through its fare determinations.

Thus implementation of IPART's recommendations will give the Government more effective control over CityRail's overall direction and performance targets, while leaving RailCorp's management to decide how best to manage the CityRail business to deliver on and be accountable for meeting those targets.

2.3.2 Benefits for RailCorp

The implementation of IPART's recommendations will benefit RailCorp by ensuring that it fully understands the Government's objectives and priorities for CityRail, and the service and financial performance outcomes it expects CityRail to deliver. And as noted above, this improved understanding, together with improved accountability, should allow the Government to provide RailCorp with greater autonomy over operational matters. In addition, implementation of the recommendations should result in greater revenue certainty for RailCorp, which will facilitate better planning and better integration of operating and capital expenditures, which in turn will promote the supply of services at least cost.⁶

⁶ This is consistent with the view expressed by Sydney Ferries who noted that a service contract would "provide a sufficient level of certainty with respect to funding (for both operational and capital expenditures) into the future so that longer term planning can be undertaken with greater confidence." Walker, B. 2007, *Report of the Special Commission of Inquiry into Sydney Ferries Corporation*, 31 October, p 125.

2.3.3 Benefits for CityRail passengers

Implementation of the recommendations will benefit CityRail passengers by driving improved levels of performance from CityRail. Passengers will also benefit from making transparent the quality of service they should expect, and CityRail's performance in delivering this quality. In addition, by encouraging CityRail to improve its financial performance, and rein in its costs to efficient levels, the recommendations will help ensure the long-term sustainability of CityRail services.

2.3.4 Benefits for NSW taxpayers

By contributing to the establishment of a robust, comprehensive economic regulatory framework for CityRail, and complementing IPART's revised approach to fare setting, IPART's recommendations for strengthening CityRail's institutional and governance arrangements will help ensure that CityRail faces effective incentives to improve its cost efficiency. Ultimately, this should lead to improvements in CityRail's level of cost efficiency that will benefit all NSW taxpayers.

3 Improve the Statement of Corporate Intent

As a State Owned Corporation, RailCorp must have a Statement of Corporate Intent (SCI).⁷ This document is one of the key instruments through which the Government aims to ensure that RailCorp's strategic direction and priorities are in line with the Government's objectives and priorities, and that its performance meets the Government's expectations.

IPART recognises that the content of the SCI, and the timetable and procedure for developing this document, are specified in legislation. However, IPART considers that the SCI and its development procedure should be improved so that, together with an improved RPA and funding agreement, it can form the nucleus of an effective purchaser provider model for CityRail. The key improvements are as follows:

- ▼ The SCI should clearly articulate the Government's objectives for CityRail.
- ▼ The SCI should transparently set out the measurable financial performance targets the Government expects CityRail to meet, and to which it will hold RailCorp's management accountable. These targets should include efficiency improvement targets, and should be consistent with any efficiency targets implied by IPART's fare determination.
- ▼ The SCI should be a multi-year document that aligns with IPART's fare determination period and the period covered by the improved RPA and funding agreement. In addition, it should be finalised and signed by all parties before the period to which it begins, to allow RailCorp to determine and plan how best to meet the targets and respond to the incentives included in the SCI.
- ▼ The Government, not RailCorp, should drive the development of the SCI, so it reflects the level of performance the Government expects from CityRail and is prepared to fund rather than the performance RailCorp believes it can deliver.
- ▼ The Government should monitor and evaluate CityRail's performance in pursuing the objectives and achieving the financial performance targets set out in the SCI.

⁷ *Transport Administration Act, 1988*, section 17C and *State Owned Corporations Act 1989*, section 21.

IPART considers that these improvements will enable the Government to exercise more effective control over CityRail's strategic direction and financial performance, and create strong incentives for RailCorp to improve CityRail's financial performance. Each improvement and IPART's specific recommendations are discussed below.

3.1 The SCI should clearly articulate the Government's objectives for CityRail and the relative priority of these objectives

As Chapter 2 discussed, the most recent publicly available SCI repeats the Government's objectives for RailCorp set out in the Transport Administration Act, and indicates how its key results areas align with the objectives of the State Plan. However, IPART considers that it doesn't provide clear and unambiguous guidance about the Government's objectives and priorities for CityRail in particular.

In IPART's view, the improved SCI should clearly articulate the Government's objectives for CityRail (as opposed to other parts of RailCorp's business, including CountryLink). This greater clarity will assist RailCorp in better managing any tension that exists between commercial and non-commercial goals (such as operating efficiency versus social responsibility goals), and improve the likelihood that it achieves the Government's objectives and does so at the least cost to the community.

Recommendation

- 2 That the Government clearly explain its objectives and priorities for CityRail in the Statement of Corporate Intent (SCI).

3.2 The SCI should transparently set out the measurable financial performance targets the Government expects CityRail to meet

While the 2006/07 SCI includes several very high-level financial targets for RailCorp as a whole, it does not include detailed, measurable financial performance targets for CityRail in particular. Therefore it does not enable the Government, as shareholder, to monitor and evaluate CityRail's financial performance, hold RailCorp's management accountable for this performance, or create incentives for RailCorp to improve this performance.

LEK Consulting's assessment of CityRail's costs, which IPART commissioned as part of its 2009 fare review, provided clear evidence that CityRail is not operating as efficiently as comparable Australian and international rail passenger service providers.⁸ To create effective incentives for efficiency savings, the SCI must contain measurable, detailed financial performance targets, including efficiency savings targets.

⁸ LEK, *Cost Review of CityRail's Regular Passenger Services*, report to IPART June 2008.

In IPART's view, the improved SCI should:

- ▼ Define what the Government means by operational efficiency and responsible asset management.
- ▼ Set out specific financial performance targets for CityRail. IPART considers that to create strong incentives to improve CityRail's performance, it is important that RailCorp cannot transfer inefficiencies in the CityRail business to the CountryLink business. This may also require a separate funding agreement for CityRail (discussed in Chapter 5).
- ▼ Set out long-term financial performance goals for CityRail that are measurable and consistent with the Government's objectives for public transport, including the service targets set out in the improved Rail Performance Agreement (discussed in Chapter 4). IPART considers that the inclusion of long-term financial goals is likely to encourage better financial planning and better integration of operating and capital expenditure.
- ▼ Set out shorter term financial performance targets for CityRail, including measurable efficiency targets. These targets should be consistent with the efficient operating cost benchmarks determined by IPART, (the independent regulator) as part of its fare determination, and the funding being provided to RailCorp (as set out in the improved funding agreement) to allow transition to efficient benchmark levels. The targets should become increasingly ambitious over time, to put pressure on RailCorp management to move CityRail to a cost structure similar to comparable operators in Australia.

Recommendation

- 3 That the Government, as shareholder, clearly explain in the SCI the financial performance outcomes it expects from CityRail (and CountryLink). This should include:
 - long-term financial performance goals that are measurable and consistent with the Government's objectives for public transport, including the service targets set out in the improved Rail Performance Agreement (RPA)
 - shorter term financial performance targets, including measurable efficiency targets that are consistent with the efficient operating costs determined by IPART as part of its fare determination and the funding being provided to allow CityRail to transition to efficient benchmark levels.

3.3 The SCI should be a multi-year document that aligns with the fare determination period

Currently, the SCI is an annual document that is prepared each financial year. The Transport Administration Act requires that it be completed and signed-off within three months of the start of the financial year. This is not conducive to the Government using the financial performance targets included in the SCI to create incentives for RailCorp to improve CityRail's level of cost efficiency.

IPART considers that to create effective incentives, the SCI should be a multi-year document that aligns with the fare determination period (and the periods covered by the improved RPA and funding agreement, discussed in Chapters 4 and 5). This will facilitate consistency between the financial performance targets included in the SCI and the efficient operating costs determined by IPART, and help to ensure that all elements of the economic regulatory framework are aligned.

IPART also considers that the financial performance targets included in the SCI need to be agreed in advance, to give RailCorp time to determine and plan how best it can meet the targets and respond to the incentives they create.

Recommendation

- 4 That the SCI be a multi-year document that aligns with the fare determination period, and the periods covered by the improved RPA and funding agreement.
- 5 That the SCI be finalised and signed before it is scheduled to come into effect.

3.4 The Government should drive the development of the SCI

The Transport Administration Act requires RailCorp to submit a draft SCI that includes financial performance benchmarks to its voting shareholders and portfolio Minister. This process implies that RailCorp drives the content of the SCI, by indicating the financial performance levels it is able to meet, rather than the Government setting the financial performance targets it requires, and creating incentives for improved efficiency.

IPART considers it important that NSW Treasury (as financial shareholder) and the Minister for Transport and MoT (as the purchaser of rail passenger services) drive this process, and determine the level of financial performance they expect from RailCorp.

Recommendation

- 6 That NSW Treasury (as financial shareholder) and the Minister for Transport and Ministry of Transport (as purchaser of passenger rail services) drive the development of the SCI.

3.5 The Government should monitor and evaluate CityRail's performance against the objectives and targets in the SCI

To gain maximum benefit from improvements to the SCI, and from the efficiency incentives resulting from IPART's more rigorous process for determining fares, the Minister for Transport, MoT and NSW Treasury need to monitor and evaluate CityRail's performance in meeting the objectives and financial service targets included in the SCI.

In the private sector, businesses are exposed to continuous shareholder and debt market scrutiny, and know that they will be penalised for poor management performance (eg, via falling share values, takeovers, receivership, insolvency or bankruptcy). This creates powerful incentives for good financial performance, including cost efficiency.

However, in the public sector, these conditions do not exist, and alternative ways must be found to provide this kind of scrutiny and create these incentives. IPART considers that rigorous financial monitoring of CityRail's performance by NSW Treasury as shareholder (and protector of the Government's financial exposure) and the Minister for Transport and MoT as purchaser of rail services is the most effective way. This monitoring is critical in order to:

- ▼ drive transparency and accountability in RailCorp, and minimise the costs of foregone efficiency
- ▼ limit RailCorp's managerial discretion to pursue objectives other than those specified by the Government
- ▼ align the incentives of the broader economic regulatory framework with those of fare regulation, and
- ▼ ensure that the SCI is an effective instrument in guiding the financial and management accountabilities of RailCorp.

In addition, CityRail's actual financial performance against the targets should feed back into the development of future SCIs, so that targets reflect actual achievements and stretch targets can be set.

To facilitate this monitoring, RailCorp should be required to report regularly to the Minister for Transport on CityRail's performance against the objectives, indicators and targets included in the improved SCI.

Recommendation

- 7 That the Government monitor and evaluate CityRail's performance against the objectives and targets in the SCI, and take account of its actual performance in developing future SCIs.

4 Improve the RPA so it becomes an effective service agreement

The Transport Administration Act requires that the SCI include a Rail Performance Agreement (RPA) between the Minister for Transport and RailCorp, and that the RPA include performance benchmarks for the rail services and rail infrastructure facilities provided by RailCorp. The current RPA describes qualitative outcomes for RailCorp, such as “RailCorp is to deliver clean, safe, secure and reliable railway passenger services” and includes a small number of quantitative targets for service performance.

The current RPA should be improved so that it becomes an effective service ‘contract’ between the Minister of Transport and RailCorp. In particular, IPART considers that:

- ▼ the RPA should clearly specify performance targets for both the quantity and quality of service the Government requires CityRail to provide
- ▼ the RPA should clearly specify any other government policy requirements of CityRail (such as a requirement to employ guards on trains)
- ▼ the Government should drive the development of the RPA, so it reflects the level of performance the Government expects from CityRail rather than the performance RailCorp believes it can deliver
- ▼ the RPA should be a multi-year document that aligns with the fare determination period, and with the periods covered by the improved SCI and funding agreement
- ▼ the Government should monitor and evaluate CityRail’s performance in meeting the service quantity and quality targets set out in the RPA.

IPART considers that these improvements will ensure that RailCorp can be held accountable for CityRail’s service performance, and does not respond to incentives for improved efficiency by allowing service standards to deteriorate. It will also enable IPART to more accurately estimate CityRail’s efficient costs, as these costs depend heavily on the quantity and quality of services provided. In addition, IPART considers that an effective service agreement is likely to be the most successful way to incorporate service standards into the regulatory approach.

However, IPART notes that for service quantity and quality targets to work effectively, they need to be ambitious yet achievable. In setting these targets, the Government will need to take account of the constraints of the CityRail system which are, in broad terms, reflected in CityRail’s recent performance. It will also need to

take account CityRail's legal requirements under the *Rail Safety Act 2002* to meet safety standards, and the complex interrelationships between various aspects of service quality, safety and network capacity.

In addition, the Government will need to consider the cost implications of the service quantity and quality targets it sets, and ensure that these targets are consistent with the improved funding agreement and IPART's fare determination.

Given the importance of targets being achievable, IPART considers that targets should be set only for service quantity and quality indicators for which a time series of data is available. In 2004, IPART commissioned LEK Consulting to develop a set of key performance indicators for RailCorp. These indicators, which cover a range of areas including service quantity and quality, were developed in consultation with RailCorp, MoT and the Independent Transport Safety and Reliability Regulator (ITSRR). Since 2004, RailCorp has been collecting data on these indicators, or developing systems to collect the required data if it was not previously collected. IPART has based its recommendations on the aspects of service quantity and quality for which targets should be set on these indicators.

4.1 The RPA should clearly specify the quantity of service the Government requires CityRail to provide

To be an effective service agreement, the improved RPA needs to clearly specify the quantity of service CityRail is to provide. This quantity is a fundamental part of any service contract, and directly affects CityRail's costs and its passengers' experience (through service coverage, hours of service and train frequency).

Currently, CityRail's timetable appears to be the main document that sets out, implicitly, the Government's expectations of when and where CityRail provides passenger rail services. IPART considers that the RPA should specify the quantity of service to be provided by CityRail in terms of the minimum frequency of services:

- ▼ by line
- ▼ in various time bands (am/pm peak, between peaks, evening)
- ▼ by direction (to/from CBD)
- ▼ on weekdays and weekends/public holidays, and
- ▼ the times of first and last services each day.

This will enable the Government to effectively guide the strategic direction of CityRail's operations.

IPART also considers that the RPA should set out target levels for train service kilometres, and carriage service kilometres⁹ (which provides information about service capacity). Monitoring CityRail's performance against these targets will enable the Government to determine whether CityRail's quantity of service is increasing or decreasing. In addition, IPART considers that the RPA should set out targets for total patronage (or passenger journeys).

The targets for train service kilometres, carriage service kilometres and total patronage should be broken down into peak and off peak targets, as the costs and complexity of increasing services in peak periods are greater than in off peak periods. IPART understands this information may not currently be collected for peak and off peak but considers CityRail systems should be developed to report this level of detail.

IPART recognises that there are complex considerations and multiple constraints on timetabling passenger rail services, and that MoT will need to build and retain resources and expertise in this area to undertake this role.

Recommendation

- 8 That the improved RPA clearly specify the quantity of service to be provided by CityRail by setting measurable performance targets for the following indicators:
- minimum frequency of services by line, in various time bands (am/pm peak, between peaks, evening), by direction (to/from CBD), on weekdays and weekends/public holidays, and the times of first and last services
 - peak and off peak train service kilometres and carriage service kilometres¹⁰
 - peak and off peak total patronage (passenger journeys).

4.2 The RPA should clearly specify the quality of service the Government requires CityRail to provide

To be effective the improved RPA also needs to specify the quality of service CityRail is to provide. However, as for many other essential services, the quality of passenger rail services has many aspects, and no one single indicator can adequately reflect all these aspects. IPART considers that the RPA should identify indicators for the aspects of service quality that are most important to passengers, and set a clear performance target for each of these indicators. Rail safety is a vital, non-negotiable

⁹ The KPIs recommended by LEK in 2004 noted that actual train service kilometres were not available at that time, and that timetabled service kilometres should be used until actuals were available. IPART understands that actuals are not yet available but would be a preferable measure to timetabled service kilometres. The LEK KPI for Carriage kilometres did not refer to service kilometres but total carriage kilometres (the distinction being that service kms excludes non-revenue services). Carriage service kilometres is a preferable measure of services to the public and, provided historical data are available, carriage service kilometres should be used in place of carriage kms. Actual carriage service kilometres are preferable to timetabled carriage service kilometres, when they are available.

¹⁰ Ibid.

aspect of service however IPART has not recommended requirements for rail safety be included in the RPA as RailCorp is legally obliged to meet safety requirements of the *Rail Safety Act 2002*. Therefore, the quality of service specified in the RPA should reflect RailCorp's statutory obligations in regards to safety.

IPART notes that the ITSRR and RailCorp have undertaken surveys to understand which aspects of service quality are important to CityRail passengers (see Appendix B). Taking into account this analysis, and the service quality indicators developed by LEK Consulting (discussed above), IPART considers that the RPA should focus on indicators for the following aspects of service quality:

- ▼ reliability
- ▼ journey time and delays
- ▼ crowding on trains
- ▼ passenger safety and security
- ▼ provision of information to passengers
- ▼ cleanliness of trains
- ▼ passenger comfort.

In addition, the Government should consider improving the initial indicators for some of these aspects of quality for future RPAs, and regularly review the indicators and targets included in the RPA to ensure they remain consistent with the Government's objectives and passengers' priorities.

4.2.1 Reliability

One aspect of service quality that is important to all stakeholders is reliability. The current RPA specifies several indicators (and targets) for the reliability of CityRail services, including the (average) peak period on-time running for the network as a whole,¹¹ and the number of cancelled/skipped stops for the network as a whole. However, because CityRail's network and services are so diverse, these highly aggregated indicators do not provide an adequate picture of the reliability of CityRail services. Therefore, IPART considers that the RPA should set targets for average on-time running and the number of skipped stops and cancelled services for each train line, and for peak and off peak periods. IPART understands that information about cancelled services for off peak periods and by line may not be currently collected, but considers systems should be put in place to collect this data.

¹¹ However, the RPA does require that RailCorp report on-time running by individual suburban and intercity lines.

4.2.2 Journey time and delays

IPART notes that different aspects of service quality are important to different passengers. Journey time is likely to be more important to long-distance passengers than inner city residents. Journey delays are likely to matter more to passengers who need to reach their destination by a specific time.

IPART was not able to identify an indicator for journey time for which a time series of data is available. However, it considers that average speed of trains as scheduled in the timetable should be used as a proxy for this indicator.

An indicator for journey delays should also be included in the RPA. In the first instance, this indicator should be based on LEK's measure of delay: total minutes of delay during peak periods per month (excluding events outside CityRail's control). IPART considers that a target should be set for this indicator, and for total minutes of delay during off-peak periods.

4.2.3 Crowding on trains

The level of crowding on trains during peak periods is another important aspect of service quality. The current RPA includes an indicator related to this aspect – the percentage of peak CityRail suburban trains at a load factor above 135 per cent¹² – and sets a target of 5 per cent of peak hour trains by 2008.

However, as crowding on trains varies significantly across the lines of the network, IPART considers this network-wide measure provides little insight.¹³ Passengers are likely to view CityRail's reported performance against this indicator with scepticism if it bears little relationship to their own experience. In view of this, IPART considers that the RPA should set a target for the percentage of trains in peak periods with a load factor above 135 per cent for each train line.

IPART notes that these targets will need to reflect the constraints of the system as well as planned system improvements. Where peak period patronage on a line is growing, and there is limited capacity to increase the number of services on that line within the system's safety constraints, the target needs to reflect this. Differential targets for different train lines will signal the need to address crowding issues on lines with higher targets. As projects addressing these issues are implemented, the targets should be adjusted downwards.

¹² When the LEK KPIs were developed, the crowding standard defined the crowding measure as 'percentage of peak service above 135 per cent loading standard (without an alternative service within 15 minutes). The RPA does not include the clause 'without an alternative service within 15 minutes' and IPART considers that it is desirable and appropriate for this clause to be excluded.

¹³ For example, in 2007, average load factors on the Western, Main North and Illawarra lines were 130 per cent, and maximum load factors on these lines were 180, 160 and 170 per cent respectively. In the same period, on the Eastern suburbs line, the average load factor was 50 per cent and the maximum load factor was 140 per cent. Source: RailCorp, *Review of Peak Train Loads, September 2007, Issue Paper 7/2007*, p 5.

4.2.4 Passenger security

The current RPA requires CityRail to report on one performance indicator related to passenger safety and security – the average monthly number ‘Offences against the person’¹⁴ occurring on or adjacent to railway property per million passenger journeys based on Bureau of Crime Statistics and Research (BOCSAR) quarterly reports – but does not set a target. IPART considers that the improved RPA should continue to include this indicator, and should set a target for it. In addition, as safety is also a matter of perception, the RPA should include an indicator and target for passengers’ perceived safety, based on the results of the ITSRR annual surveys.

IPART notes that the current RPA also includes some indicators that broadly relate to safety and security, including the percentage availability of PA systems on trains, CCTV and help points. However, it considers that these indicators are measures of inputs and provide little insight into passenger safety.

4.2.5 Provision of information to passengers

The current RPA requires CityRail to report on one performance indicator related to the provision of information to passengers – the percentage availability of PA systems on trains – but does not set a target. IPART considers that this indicator has limited value from a customer perspective, as it says little about the adequacy of information provided to passengers. IPART considers that a more customer-focussed indicator – an index of customer satisfaction with information provision, based on the results the ITSRR’s annual surveys – and a target should be included in the RPA.

4.2.6 Cleanliness of trains

The current RPA requires CityRail to report on the numbers of seats repaired, windows replaced, graffiti hits removed, and square metres of graffiti painted out to rectify damage caused by vandalism, but does not include indicators related to the cleanliness of trains. Again, IPART considers that a customer-focussed indicator – an index of customer satisfaction with the cleanliness of trains, based on the results ITSRR’s annual surveys – and a target should be included in the RPA.

4.2.7 Passenger comfort

The current RPA does not include any indicators related to passenger comfort. IPART considers that this is an important aspect of service quality for many passengers. LEK developed a proxy indicator for passenger comfort – the percentage of fleet less than 10 years old. IPART considers this is a reasonable proxy, as more

¹⁴ Offences against the person includes assault, robbery, sexual offences and stealing from a person which occur on or next to railway property. Statistics reflect incidents reported to and recorded by NSW Police.

modern carriages are air conditioned and more comfortable than older carriages. Therefore, in the first instance, this indicator and a target should be included in the improved RPA.

In addition, IPART considers that the target for this indicator should become increasingly ambitious over time, in line with Government policies and RailCorp commitments over the period (for example, the scheduled delivery of PPP rolling stock).

4.2.8 Improving on the initial indicators for future RPAs

IPART understands that information about some of the recommended indicators may not currently be collected at the level of detail recommended by IPART (for example delays, cancellations, skipped stops may not be available by line for peak and off peak periods) but considers CityRail systems should be developed to report at this level of detail.

IPART considers that MoT, in consultation with ITSRR and RailCorp, should work on improving some of the initial indicators discussed above for future RPAs. For example, in relation to service reliability, the Blue Mountains Transport Users Association suggested that on-time running should be measured at more points – the beginning, middle and end of the trip. NCOSS observed that the metropolitan plan focuses on employment opportunities outside the CBD and, over time, the targets for on-time running should reflect this. IPART sees merit in these arguments for wider measuring of on-time running, but considers that their practical and cost implications should be further investigated.

In relation to the indicators for journey time and delays, MoT should consider developing an improved measure of journey time, and a more sophisticated measure of journey delays which takes account of the number of passengers impacted for inclusion in future RPAs.

In addition, the current RPA defines morning peak period services as those arriving in Sydney CBD (Central) between 6 am and 9 am, and afternoon peak period services as those departing Sydney CBD (Central) between 4pm and 6pm. ITSRR has noted that this definition does not match the times of maximum passenger demand.¹⁵ The Auditor-General has made similar observations and recommended that RailCorp review and if necessary redefine peak period services.¹⁶ IPART agrees with this view, and considers that MoT should review the definition of the morning and afternoon peak periods in the RPA with a view to making these definitions align more closely with the periods of peak use of the system.

¹⁵ ITSRR, *Annual Reliability Report, 2005-06*, p 152. This report refers to a March 2006 survey of train loads, which indicated that a number of trains operating outside the peak periods had loads in excess of the crowding standard and that there were no trains with loads in excess of the crowding standard in the first hour of the peak periods.

¹⁶ NSW Auditor-General, *Managing disruptions to CityRail Passenger Services*, 2005, p 22.

IPART understands that RailCorp is reviewing its collection of performance and other data with a view to improving the data and increasing the efficiency of data collection. For example, RailCorp has recently joined the CoMET/Nova group of urban rail networks, which facilitates international benchmarking of rail networks performance against key indicators. However CoMET/Nova confidentiality agreements are likely to prevent RailCorp from reporting against these measures publicly¹⁷ and consequently these measures will not achieve IPART's aim of greater public transparency and accountability for CityRail performance. IPART understands that CityRail's Customer Service Improvement Program will include recommendations to collect new service performance information. In due course, it may be appropriate to consider replacing some of the indicators IPART has recommended be included in the RPA with these alternative measures, provided the measures focus on passenger outcomes and once it is clear the data collection is reliable and a time series of data is available. IPART considers availability of historical information is important as it informs the setting of challenging but achievable targets and provides the government and public with quantitative information about trends in CityRail's performance.

4.2.9 Periodically reviewing the service quality indicators to ensure they continue to reflect the Governments' objectives and passengers' priorities

Over time, the Government's objectives for CityRail and passengers' priorities may change. For example in the 2004 ITSRR survey, most of the train users surveyed nominated punctuality of train services as their highest priority,¹⁸ but in the 2008 survey most nominated frequency of services as their top priority.

Given this, IPART considers that regular reviews of the service quality indicators and targets included in the RPA are appropriate. As part of its annual review of the SCI and RPA, MoT should review the indicators and targets to assess whether the passenger rail services the Government is purchasing are consistent with its public transport strategy and in line with passengers' priorities.

¹⁷ Auditor-General's Report to Parliament 2007, volume 4, p 120.

¹⁸ When asked to nominate the highest priority out of punctuality, train frequency and journey time. See ITSRR, *Survey of CityRail Customers*, 2008, p 29.

Recommendation

- 9 That the RPA clearly specify the quality of service to be provided by CityRail by setting measurable performance targets for the following indicators:
 - on-time running, skipped stops, and cancelled services:
 - a. in peak and off peak periods
 - b. for each line of the CityRail network
 - total delay minutes in peak and off peak periods
 - average timetabled train speed, as a proxy for journey time
 - peak period crowding for each line of the CityRail network
 - offences against persons, derived from the Bureau of Crime Statistics and Research quarterly reports
 - an index of customer perception of safety, based on the results of the ITSRR’s annual passenger surveys
 - an index of customer satisfaction with information provision, based on the results of ITSRR’s annual surveys
 - an index of customer satisfaction with cleanliness of trains, based on the results of the ITSRR’s annual surveys
 - percentage of fleet less than 10 years old, as a proxy for passenger comfort.
- 10 That the Ministry of Transport in consultation with the ITSRR and RailCorp:
 - consider the feasibility of measuring on-time running at major centres, as well as the CBD, for future RPAs
 - consider developing a more sophisticated indicator for journey delays that takes into account the number of passengers affected for inclusion in future RPAs
 - consider developing an improved indicator for journey time for inclusion in future RPAs
 - review the definition of the morning and afternoon peak periods included in the RPA with a view to aligning this definition with the periods of peak use of the system and IPART’s fare determination.
- 11 That the Ministry of Transport regularly review the indicators and targets for service quality included in the RPA to assess whether the passenger rail services the Government is purchasing are consistent with its public transport strategy and in line with passengers’ priorities.

4.3 The RPA should clearly specify any other Government policy requirements

In addition to clearly specifying the quantity and quality of service CityRail is to provide, IPART considers it is important that the Government also transparently sets out in the RPA any specific requirement it has for RailCorp to provide CityRail services in a particular way. For example, LEK's 2008 analysis of CityRail's efficient costs identified potential for CityRail to make savings while delivering the same level of service. LEK found that other similar rail operators can provide similar levels of service at lower cost by reducing the presence of guards on trains and staffing at stations with low patronage and investing additional capital expenditure in CCTV systems. If CityRail is not able to realise this potential because it is government policy to have guards on trains and staff all stations, this should be specified in the RPA and reported against.

IPART considers that the Government should specify in the RPA all government policies and requirements of CityRail which are over and above what would be required of an operator aiming to deliver cost-efficient services that comply with the various government-specified benchmarks.

Recommendation

12 That the Government specify in the RPA government policies and requirements of CityRail which are over and above what would be implemented by an operator aiming to deliver cost efficient services that simply comply with the various government-specified benchmarks.

4.4 The Government should drive the development of the RPA

As Chapter 3 discussed, the Transport Administration Act requires RailCorp to submit a draft SCI, including an RPA, which includes financial and service performance benchmarks to its voting shareholders and portfolio Minister. This process implies that RailCorp is to drive the development of the SCI and RPA, by indicating the levels of performance it can meet, rather than the Government establishing the levels of performance that it expects and requires to achieve its objectives for CityRail and public transport.

However, IPART considers it important that the Minister for Transport and MoT, as the purchaser of rail service, and NSW Treasury, as financial shareholder, drive the development of the RPA. For example, MoT should provide explicit guidance to RailCorp about the quantity and quality of service the Government expects CityRail to provide at the start of negotiations on the content of the RPA. This guidance should be similar to the information provided in a request for tender.

13 That the Ministry of Transport provide explicit guidance to RailCorp about the quantity and quality of service the Government expects CityRail to provide (similar to a request for tender) at the start of negotiations on the content of the RPA.

4.5 The RPA should be a multi-year document that aligns with the fare determination period

The current RPA covers the period 1 July 2006 to 30 June 2011. IPART considers that to create effective incentives, and facilitate consistency between the different elements of the economic regulatory framework for CityRail, the RPA should be a multi-year document that aligns with the fare determination period, and the periods covered by the improved SCI and the funding agreement.

IPART also considers that the RPA should be finalised and signed before it is scheduled to come into effect.

Recommendation

14 That the RPA be a multi-year document that aligns with the fare determination period and the periods covered by the improved SCI and funding agreement.

15 That the RPA is finalised and signed before it is scheduled to come into effect.

4.6 The Government should monitor and evaluate CityRail's performance in meeting the service quantity and quality targets in the RPA

As for the SCI, to gain maximum benefit from the improvements to the RPA, and from the efficiency incentives resulting from IPART's more rigorous process for determining fares, the Minister for Transport and MoT need to monitor and evaluate CityRail's performance in meeting the targets included in the RPA.

IPART considers that rigorous monitoring of CityRail's service performance by MoT as the purchaser of rail services is critical to ensure transparency and accountability in RailCorp, and to enable MoT (on behalf of the Minister for Transport) to be an informed purchaser. To facilitate this monitoring, the requirement in the current RPA that RailCorp provide regular reports to the Minister for Transport on CityRail's performance against service benchmarks should require RailCorp to report on CityRail's performance against all the indicators and targets included in the improved RPA.

This report should be in a simple and meaningful format, which highlights whether results are good, bad or indifferent. It should include commentary on meeting of targets, explanations for any failure to meet targets and inform the Minister of CityRail's strategies and programs to address any shortfalls in performance and any emerging issues. MoT will need to retain appropriate expertise in passenger rail services to be an informed participant in discussions on performance and strategies to address poor performance.

4 Improve the RPA so it becomes an effective service agreement

Recommendation

- 16 That the Government monitor and evaluate CityRail's performance against the targets in the RPA, and take account of its actual performance in developing future RPAs.
- 17 That the RPA include a requirement for RailCorp to report regularly to the Minister for Transport on CityRail's performance against all indicators and targets included in the improved RPA.

5 Improve the funding agreement

As CityRail's farebox revenue covers only a proportion of its revenue requirement, RailCorp receives significant funding from the Government. This funding is provided through a funding agreement with the Director-General of MoT, as a contribution to enable RailCorp to provide CityRail services, offer fare concessions in line with government policy, and undertake capital works as detailed and agreed in the SCI and RPA.

However, as Chapter 2 indicated, the current funding agreement has significant shortcomings. For example, it does not clearly explain how any unforeseen costs and changes in revenues are allocated between RailCorp and the Government as shareholder. As a result, there is no effective 'cap' on the funding provided to CityRail, and thus no incentive for it to 'live within its budget'.

In addition, the funding agreement does not relate the amount of funding the Government will provide to CityRail to IPART's fare determination, particularly the forecasts of CityRail's revenue requirement and farebox revenue that underpin the determination¹⁹.

IPART, as the independent regulator is best placed to determine CityRail's total revenue requirements. IPART undertakes this role in many other industries that it regulates (eg, water, electricity, and gas). IPART's independence, consultative approach, professional expertise, analysis and decision-making ensures that CityRail's revenue requirements is based on efficient operating and maintenance costs, an appropriate allowance for both depreciation and return on the capital that CityRail's has invested. The share of revenue to be funded via passengers is determined by IPART having regard to a robust estimate of the external benefits of CityRail services, and impacts on patronage and affordability. The remaining share comes via the Government funding agreement.

¹⁹ In its draft fare determination IPART uses a building block approach to determine CityRail's annual revenue requirement. This includes efficient operating costs, a return of capital or depreciation and a return on capital. The return on capital compensates CityRail's shareholder (the NSW Government) for committing capital to the business and bearing the risks associated with the business. IPART notes that under the *Transport Administration Act 1988*, RailCorp is not required to pay a dividend to its shareholder - the NSW Government. The funding agreement should recognise that no dividends are to be paid and any implications for CityRail's cashflows.

To create effective incentives for CityRail to improve its efficiency, the funding provided by the Government should be consistent with the revenue requirement determined by IPART minus forecast farebox revenue. In addition, the funding agreement should specify Government determined level of concession funding associated with its CSO policies.

Further, the current funding agreement is extremely broad. It does not differentiate between the funding provided for CityRail and that provided for other parts of RailCorp's business (such as CountryLink). Nor does it clearly and transparently show the individual components of the funding, such as the funds provided towards efficient operating costs, and towards the costs of meeting government policy requirements.

The manner in which funding is provided to RailCorp for the provision of CityRail services has major implications for the accountability of RailCorp and the incentives it faces. It also has implications for the effectiveness of IPART's revised approach to fare setting and the improved SCI and RPA. To drive better accountability, and to ensure that the incentives created are effective and consistent, IPART believes the current funding agreement should be improved. In particular, IPART considers that the improved funding agreement should:

- ▼ Clearly allocate any unforeseen costs and changes in revenue between RailCorp and the Government in a way that is consistent with the incentives IPART is aiming to create through its revised approach to fare setting. As part of this, the level of government funding for CityRail should be 'capped' to reflect IPART's fare determination. The 'parameters for compensation' in the event that CityRail's farebox revenue is less than forecast should also be established ex-ante.
- ▼ Clearly and transparently set out the funding to be provided for the provision of CityRail services at the quantity and quality specified in the service contract (ie, the improved RPA), including a breakdown of the different components of this funding.
- ▼ Be consistent with the other elements of the regulatory economic framework for CityRail (ie, IPART's fare determination and the improved SCI and RPA).
- ▼ Be a multi-year document that aligns with the fare determination period and the periods covered by the improved SCI and RPA, and which is updated when funding is altered.

5.1 Clearly specify the consequences of cost overruns and revenue shortfalls

Clearly specifying where and when the Government or RailCorp bear the cost or benefit of unexpected changes in CityRail costs or fare revenue is fundamentally important to the incentives that are created for CityRail. IPART considers it important that the incentives under the broader governance framework match the incentives IPART is trying to create through its approach to fare setting.

5.1.1 Cost overruns

Under an incentive approach to economic regulation the risk that the actual costs of the service provider may be different to the forecast costs used in determining prices is borne by the service provider (rather than customers). This recognises that the service provider is typically best placed to manage cost variations, and creates incentives for it to keep its costs at or below the level used in determining prices.

Since the creation of effective incentives for CityRail to reduce costs to efficient levels is one of the main aims of this review of the regulatory framework, IPART considers it is crucial that RailCorp bears the consequences of changes in its costs so as to create these incentives. To do this, CityRail's revenue requirement, based on the efficient costs of providing CityRail services, must be determined ex-ante and its revenue must be 'capped' in line with this revenue requirement for the determination period.

In making its draft fare determination, IPART has determined CityRail's revenue requirement, and the appropriate share of this revenue to be recovered from passengers and from the Government (based on the value of the external benefits of CityRail services, patronage affects and affordability). It then determined CityRail fares so that the revenue CityRail receives from this source is capped in line with the share of the revenue requirement to be recovered from passengers over the determination period.

However, IPART is not able to control the amount of revenue CityRail will receive from the Government. Therefore, the incentives for improved efficiency it is aiming to create through its more rigorous approach to fare setting will be more effective if the funding agreement caps the amount of funding the Government will provide for CityRail services over the determination period consistent with the share of the revenue requirement IPART has determined should be recovered from the Government. Under such an agreement, the Government would not provide additional funding for CityRail services if RailCorp management was not able to control the growth in CityRail's costs and move these costs towards efficient levels.

IPART notes that this approach is consistent with funding agreements for service provision in other jurisdictions.²⁰

If unusual unforeseeable circumstances or events impose additional costs on RailCorp in providing CityRail services, it may be appropriate for the Government to provide additional funding to RailCorp. However, it is important that additional funding is only provided for events that are outside RailCorp management's control, and these events are transparent and clearly defined. IPART notes that under the funding contract between the Victorian Government and Connex (the Melbourne rail passenger service provider), additional funding is only provided in a limited number of circumstances to ensure that the responsibility for cost overruns are not transferred from the service provider to the purchaser.

One possible option to enhance management accountability is to link a proportion of CEO and senior management pay to achievement of specific objectives and performance indicators (reflecting the targets and indicators in the RPA and the funding agreement). This would provide a greater range of risks and rewards for senior management performance than is currently available. Introducing pay at risk would reinforce the importance of allowing RailCorp the freedom and responsibility to achieve Government outcomes and targets set in the RPA and funding agreement, without Government involvement in its day to day operations. Ultimately, if despite appropriate managerial autonomy RailCorp management has a record of failure to meet performance standards and control CityRail's costs then Government should change management.

5.1.2 Sharing the costs and rewards of variations in fare revenue

It may also be appropriate to set out in the agreement any arrangements to provide additional funding to RailCorp if actual demand for CityRail services over the determination period differs from the demand forecasts used in determining fares.

Under IPART's approach to fare setting a price cap or maximum price for each individual CityRail ticketing product has been set. The prices faced by customers will not change over the determination period, regardless of changes in demand. This creates an incentive for CityRail to increase its patronage, because if demand is higher than the forecast used in determining fares CityRail will receive more farebox revenue than assumed in the determination. However, there is also a risk that demand will be lower than forecast, in which case CityRail will receive less farebox revenue.

However, given that CityRail receives the majority of its revenue in the form of Government funding, the Government needs to consider whether it is appropriate for CityRail to bear the all the costs and rewards of unanticipated variations in

²⁰ Bus service tenders, such as London Buses and TransAdelaide transfer the cost risk to operators. In addition, the European Conference of Ministers of Transport recommends that governments focus the service provider on minimising costs by transferring cost risk. European Conference of Ministers of Transport (ECMT) Railway reform and charges for the use of infrastructure, 2005, p 64.

farebox revenue, or whether the Government should share some of these. This will depend on a number of factors including the incentive properties the Government wants to create and the nature of CityRail demand.

Because the Government has a clear policy objective to increase patronage of CityRail (and other public transport) services, IPART considers it appropriate for CityRail to bear the upside risk of fluctuating demand, as this creates incentives for it to grow patronage. For example, if CityRail receives a fixed level of Government funding, and is able to keep any increases in farebox revenue as a result of higher than forecast demand, it has an incentive to grow patronage. However, if the amount of Government funding is reduced to offset any increases in farebox revenue, this incentive is removed. Therefore, IPART considers that the funding agreement should state that CityRail is able to keep any additional farebox revenue as a result of higher than forecast patronage. This additional funding could be held in a 'reserve' or 'off-set' account to be used in times of lower than forecast patronage.

However, it may not be appropriate for CityRail to bear all of the revenue loss from reduced demand. Arguably RailCorp can exert only limited influence over demand for CityRail services through the quality of service it delivers.²¹ In addition, RailCorp may not be in a position to easily absorb reduced farebox revenue. Lower patronage and lower revenue than forecast may force RailCorp management to cut back on essential capital expenditure or reduce CityRail services. IPART does not consider this to be desirable.

For these reasons, IPART considers it appropriate for the Government to provide additional funding to RailCorp when CityRail's farebox revenue is lower than the forecast used in determining fares. However, this additional funding should be provided net of any funding in the reserve account (discussed above) and should be made transparently through an updated funding contract.

IPART notes that such an arrangement is consistent with funding agreements for service provision in other jurisdictions. For example, in designing the contract between Connex and the Victorian Government, both parties took the view that neither the Government nor Connex was uniquely able to manage farebox revenue risk. The result was a sharing of the risk through an arrangement set up ex-ante. The arrangements include a farebox revenue risk-sharing mechanism whereby franchisees are offered a measure of 'downside' protection in the form of a payment mechanism which is triggered when the farebox revenue falls below a threshold

²¹ Demand for CityRail services depends on a number of factors including employment growth (particularly in the CBD); passenger's alternate transport options (including impacts of road congestion) and the relative price of these options; CityRail service quality (reliability, frequency, cleanliness etc); and the price of CityRail services.

level. This sharing of revenue risk is consistent with the majority of other purchaser-provider contract arrangements where government bears some or all revenue risk.²²

If the Government decides to specify arrangements for unexpected variations in farebox revenue IPART considers it important that it:

- ▼ Specify the 'parameters for compensation' ex-ante, to provide certainty to both RailCorp and Government. This will involve specifying the extent to which RailCorp will be compensated if CityRail's farebox revenue is lower than assumed in determining fares, due to lower than forecast patronage. In IPART's view, this should be less than 100 per cent of the shortfall in farebox revenue, as RailCorp management does have some influence over the level of demand through the quality of the service CityRail delivers. There needs to be at least some element of funding 'at risk' to provide incentives for service performance. The funding agreement between the Victorian Government and Connex notes that the Government will make up 50 per cent of the shortfall in revenue through an additional contribution.
- ▼ Clearly specify additional funding that is provided as part of the arrangement. That is, this additional funding should not be provided by increasing the funding associated with the efficient operating costs of providing CityRail services. Rather the funding agreement should be updated to reflect any revenue sharing payment. Separating funding for items over which management has significant control (such as the costs associated with operational matters) from funding for those over which it exercises less control (such as the level of farebox revenue) will contribute to the accountability of RailCorp.

Recommendation

- 18 That the funding agreement clearly specify which parties bear the costs and benefits of cost overruns and variations in farebox revenue, consistent with the incentives IPART is aiming to create through its approach to fare setting.
- 19 That the funding agreement establish ex-ante the extent to which RailCorp will be compensated if farebox revenue is lower than assumed in setting fares, due to lower than forecast patronage.

²² Bus service tenders, such as London Buses and TransAdelaide, transfer the cost risk to operators but the revenue risk is retained by government, although an operator may be given financial incentives to increase patronage (that is, there is no downside revenue risk). In addition, the European Conference of Ministers of Transport recommends that governments seek to adopt 'gross cost contracting', involving an entity bidding on the basis of the total costs with the government bearing most or all revenue risk. The aim is to focus the service provider on minimising costs by transferring cost risk. See European Conference of Ministers of Transport (ECMT), *Railway reform and charges for the use of infrastructure*, 2005, p 64.

5.2 Clearly and transparently set out the funding for CityRail services at the quantity and quality specified in the service contract

IPART considers it important that the funding agreement provide a clear and detailed breakdown of the funding the Government will provide to RailCorp for the provision of CityRail services. This will ensure that the true costs of providing these services, including the costs of complying with government policy and the costs associated with RailCorp operating at costs above efficient operating benchmarks, are transparent and open to public scrutiny. In turn, this greater transparency will increase RailCorp's accountability and strengthen its incentives to reduce CityRail's operating costs to match those of comparable operators.

First, the funding agreement should differentiate between the funding provided for CityRail services, CountryLink services, and other non-passenger services. This will also ensure that any inefficiencies associated with the CityRail side of the business are not transferred to the CountryLink business.

Second, the funding agreement should breakdown the total funding amount provided for CityRail services into the separate components of this funding. The current funding agreement shows the separate funding amounts being provided for several items, including services, purchasing new rolling-stock and providing concession fares in line with government policy. However, IPART considers it important that the funding agreement further breaks down the total funding amount, so that it separately shows the funding for items over which management has significant control (such as operating costs) and for items over which management has less control (such as additional funding to compensate for lower than expected farebox revenue and the costs associated with offering concessions).

In particular, IPART considers the funding agreement should separately show the following components:

- ▼ The funding provided to cover the Government's share of CityRail's revenue requirement, consistent with IPART's fare determination. This would typically be the largest component of funding. For example, in making its draft fare determination for 2009, IPART determined that the Government should provide around 70 per cent of CityRail's revenue requirement.
- ▼ The funding that is temporarily being provided to allow RailCorp to transition towards efficient operating benchmarks determined by IPART. This is in recognition of the fact that the actual costs of providing CityRail services in the short-term will be above the efficient benchmark levels. This funding should diminish over time and should be consistent with the financial performance benchmarks determined by NSW Treasury and set out in the improved SCI. IPART considers it important that funding to compensate RailCorp for its inefficiency should be made transparent.

- ▼ The funding associated with meeting NSW Government policy requirements, as set out in the SCI (for example, the provision of concession fares).²³ This will ensure that taxpayers and wider community have an understanding of the costs of these policies.
- ▼ The funding provided as part of a cost or revenue variations.
- ▼ The funding provided for efficient capital investment.

Recommendation

- 20 That the funding agreement clearly differentiate between the funding being provided for CityRail, CountryLink and other non-passenger services.
- 21 That the funding agreement clearly show the different components of funding for CityRail services, such as the funding associated with the efficient costs of providing the services specified in the RPA, the funding temporarily being provided to allow RailCorp to transition towards efficient operating benchmarks determined by IPART, and the funding associated with meeting government policy requirements, etc.

5.3 Be consistent with the other elements of the economic regulatory framework

As discussed elsewhere in this report, it is important that all elements of the broad economic regulatory framework for CityRail are consistent and aligned. The funding amounts set out in the improved funding agreement need to be determined with reference to:

- ▼ The improved RPA, which sets out the quantity and quality of CityRail services to be provided.
- ▼ IPART's fare determination, which sets out the CityRail's revenue requirement based on the efficient costs of providing the services, the share of efficient costs that should be recovered from passengers and government and the forecast level of farebox revenue.
- ▼ The improved SCI, which sets out financial performance targets including the level of transitional payments that will be provided to RailCorp as it brings CityRail's cost structure into line with that of efficient operators.

Recommendation

- 22 That the funding agreement be determined with reference to the SCI, RPA and IPART's fare determination, and be consistent with the incentives and targets created by these documents.

²³ The NSW Government provides subsidised or concession travel to a wide range of people within specified target groups. These include school and tertiary students, jobseekers, apprentices and trainees, the vision impaired, certain ex-members of the Defence Forces, pensioners, NSW Seniors Card holders and war widow/ers.

5.4 Be a multi-year agreement

IPART considers that the funding agreement should be a multi-year agreement. The period it covers should align with the fare determination period and with the periods covered by the improved SCI and RPA. This will:

- ▼ provide greater revenue certainty for RailCorp, which will assist it in better integrating operating and capital expenditure
- ▼ ensure that RailCorp has time to develop and implement plans for efficiency savings
- ▼ allow CityRail's efficiency levels to be observed over a period in which reasonable efficiencies can be achieved
- ▼ provide NSW Treasury and MoT with a better indication of how levels of funding are likely to alter over time.

IPART also considers that the funding agreement should be signed before it is scheduled to come into effect, to allow RailCorp time to determine and plan how best it can meet the targets set out in the SCI and RPA, and respond to the incentives created by the regulatory framework. The funding agreement should also be expressly updated when any element of the funding provided to RailCorp is altered, to ensure full transparency.

Recommendation

- 23 That the funding agreement be a multi-year agreement that aligns with the fare determination period and the periods covered by the improved SCI and RPA.
- 24 That the funding agreement be signed before it is scheduled to come into effect and expressly updated when any element of the funding provided to RailCorp is altered.

6 Improve transparency and public reporting

Under the current institutional and governance arrangements, the objectives and financial and service targets CityRail is required to meet, and the funding provided for CityRail services are not transparent. In addition, CityRail's performance against these objectives and targets is not publicly reported.

For example, the key governance instruments for CityRail are either not publicly available, or are not made available until after they have expired.²⁴ As a result, CityRail's passengers and other stakeholders do not know what level of performance they should expect from CityRail, and the extent to which taxpayers are subsidising the cost of providing CityRail services. This lack of transparency compounds RailCorp's lack of accountability and poor incentives to improve CityRail's performance. In addition, CityRail's performance against the Government's expectations doesn't appear to be rigorously monitored, and is not publicly reported on.

IPART believes that transparency of information is central to accountability and a foundation of good regulation. Therefore, in addition to improving the SCI, RPA and funding agreement (as discussed in the preceding chapters), the Government should:

- ▼ make the key governance instruments publicly available
- ▼ improve public reporting of CityRail's performance against the objectives and targets specified in these instruments.

6.1 Make key governance instruments publicly available

Transparency of information – including transparency of the contractual requirements between Government as purchaser and RailCorp as provider – is important for providing RailCorp with effective incentives to improve its financial and service performance. As Chapter 3 discussed, because CityRail is a monopoly passenger rail provider it is not subject to competitive pressure to maintain and improve its performance, alternative ways must be found to provide this kind of pressure and ensure it has appropriate incentives. One way is to ensure rigorous monitoring of CityRail's performance by NSW Treasury as shareholder and the

²⁴ The RPA and the funding agreement are not publicly available, and the most recent SCI that is available is for year ending 30 June 2007.

Minister for Transport and MoT as purchaser of rail services (see Chapters 3 and 4). Another important way is to ensure that the objectives and targets CityRail is expected to meet (and its performance against these objectives and targets) are open to public scrutiny.

Under the recommended institutional and governance framework, RailCorp will be given the autonomy to manage CityRail to achieve the Government's specified objectives and performance targets. In return for this operational autonomy, RailCorp needs to be accountable to the Government and other stakeholders for delivering on those objectives and targets. In particular, the travelling public should know the quantity and quality of service they can legitimately expect (and whether CityRail is delivering this quantity and quality of service).

Recommendation

25 That the key governance instruments for RailCorp and CityRail – the SCI, the RPA and the funding agreement – are made publicly available at the time the instruments are executed and whenever they are updated.

6.2 Improve public reporting of CityRail's performance

Requiring RailCorp to report to the public, as well as the Government, on its success in achieving the financial and service targets for CityRail included in the SCI and RPA will have several benefits. First, it will signal to the public that responsibility for delivering on these targets lies with RailCorp management (not the Government). Second, it will allow the public to form an informed view on the trends and adequacy of CityRail's performance. Third, it will increase RailCorp's accountability for CityRail's performance, and provide added incentive for it to focus on improving this performance to meet or exceed its targets.

As discussed in Chapters 3 and 4, RailCorp should continue to be required to report to the Minister for Transport, as purchaser of CityRail services, on CityRail's performance against the objectives and targets included in the improved SCI and RPA. This reporting will enable early identification of areas of poor performance, and sharpen RailCorp's focus on developing strategies and programs to enable it to meet its targets for these areas in future reporting periods.

In addition, public reporting of CityRail's performance against targets in the RPA should be improved. IPART considers that the forms of public reporting of CityRail performance already in place – publication of performance information on CityRail website, and the ITSRR's annual passenger surveys and reliability report – should continue. However, this reporting should be against the expanded range of targets in the improved RPA. It should highlight good and poor results, and include commentary, analysis of trends, and strategies to address shortfalls in performance relative to targets. In addition, CityRail's service levels should be benchmarked against those achieved by passenger rail systems in other jurisdictions, to encourage performance comparable with world standards.

Recommendation

- 26 That RailCorp publish on its website CityRail's performance against all targets in the RPA, and produce a quarterly overview report for the public with commentary on where and why this performance has not met the targets.
- 27 That annual CityRail passenger surveys continue to be undertaken and results publicly reported.
- 28 That the ITSRR or the Ministry of Transport continue to produce a public annual report on CityRail's performance against the targets in the RPA.
- 29 That CityRail's performance against these targets be publicly reported on and feed back into the development of future SCIs.

In addition, to ensure that CityRail is not achieving operating cost savings at the expense of service quality, IPART has made a draft decision to require RailCorp to provide it with information on CityRail's performance over the previous financial year against the performance targets set in the RPA by 30 October each year. (See IPART draft report and fare determination, Chapter 3.)

IPART will publish annually a CityRail prices and services report that will highlight CityRail's service performance, based on the information provided by RailCorp and publicly available information. IPART will publish this report in December of each year as part of annual approach for monitoring CityRail's compliance with the fare determination.

IPART considers this is necessary as part of the revised regulatory framework for RailCorp.

Recommendation

- 30 IPART will publish an annual report on CityRail's fares and actual services levels.



Appendices

A Terms of reference

Review of CityRail regulatory framework

I, Morris Iemma, Premier of New South Wales, under Section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992* ('the Act'), refer to the Independent Pricing and Regulatory Tribunal (Tribunal) for investigation and report the following matter:

The Tribunal is to recommend a regulatory framework which will provide CityRail with the incentives to provide efficient passenger rail services.

In conducting this review, the Tribunal is to consider the matters listed under Section 15 of the Act, in particular the need for greater efficiency and reliability in the supply of services so as to reduce costs and improve quality, safety and reliability for the benefit of consumers and taxpayers.

Other issues the Tribunal is to consider in undertaking this review are:

1. the appropriate regulatory period for the Tribunal's fare decisions;
2. the efficient costs of providing CityRail's services and the scope for greater efficiency in the supply of these services;
3. NSW Government policy on passenger rail services and public transport, including the future investment in CityRail set out in the *Urban Transport Statement*, and the *State Plan*;
4. an appropriate range for the allocation of costs between government and users, taking into consideration the positive environmental, economic and social benefits for the community generated by CityRail's services;
5. how service standards can be incorporated into the regulatory approach;
6. appropriate fares for CityRail which take into account the cost of providing CityRail's services, the capacity of users to pay and current and future government policy on public transport fares; and
7. if necessary, transitional arrangements from the current form of regulation to the new regulatory approach.

A draft report is to be publicly released by 12 September 2008, with a final report due by 12 December 2008.

The Tribunal is conducting this review in conjunction with the 2008 determination of fares for CityRail services, conducted in accordance with the Tribunal's standing

reference under Section 11 of the Act. This reference under Section 12A of the Act is in addition to, and does not replace, the Tribunal's standing reference under Section 11 of the Act.

B Aspects of service quality important to CityRail passengers

B.1 ITSRR surveys

ITSRR has conducted annual surveys of CityRail passengers since 2004, asking people to rank the importance and quality of 37 separate aspects of CityRail service. These surveys provide a guide to what people think is important about CityRail services.

Table B.1 sets out the 15 aspects of service considered by passengers to be most important, on average, in each year the survey has been undertaken. There is a high level of consistency over the years, with personal safety in the evenings on stations and in trains consistently being ranked most important. In general, train punctuality, and information about arrivals, departures and delays are considered to be the next most important aspects of service, followed by train frequency.

Table B.1 Results of ITSRR passenger surveys – aspects of service – average importance ranking

	Importance ranking					
	2004	2005	2006	2007	2008	
Personal safety on stations in the evenings	1	1	1	1	1	
Personal safety in train carriages, evenings	2	2	2	2	2	
Station information about arrival/departure times	4	4	3	3	3	
Punctuality of trains	3	5	6	4	4	
Frequency of trains	6	3	7	6	5	
Quality of information about delays and cancellations	5	6	5	5	6	
Removal of litter from the train	13	14	8	9	7	
Clarity of announcements on platform	8	8	4	7	8	
Timeliness of delay/cancellation announcements	10	9	9	8	9	
Staff effectiveness dealing with security problems	11	10	11	10	10	
Delays and cancellations	7	7	12	13	11	
Facilities for calling for help	9	11	10	11	12	
Personal safety on stations non-peak, daytime	12	13	13	14	13	
Removal of dirt and grime from the train					14	
Clarity of announcements on trains		15	14	15	15	
Personal safety on stations, peak	14	12		12		
Staff visibility on platforms, evenings	15		15			
<i>Aspect of service with highest % of expectations not met</i>		<i>delays & cancellations (56%)</i>	<i>punctuality (59%)</i>	<i>crowding (50%)</i>	<i>crowding (55%)</i>	<i>crowding (55%)</i>

Note: ITSRR surveys 37 aspects of service. Aspects included in this table were those ranked most important on average by customers surveyed each year. The aspect of service with lowest levels of satisfaction that year is also included.

Source: ITSRR Surveys of CityRail Customers 2004, 2005, 2006, 2007 and 2008.

B.2 Douglas and Karpouzis' research

Based on the results of the ITSRR surveys in 2004 and 2005 where respondents were asked to rate various attributes of CityRail services, Douglas and Karpouzis²⁵ have modelled the relative weightings given to various aspects of CityRail's service. Their work suggests that the four most highly valued aspects of service are:

- ▼ reliability
- ▼ time spent on the train
- ▼ service frequency, and
- ▼ seat availability.

Train reliability was found to be as important as all aspects of *station* quality aggregated and was more important than all aspects of *train* quality aggregated.²⁶

This work suggests that the adequacy of the service provided (a combination of timetable measures, operational performance and crowding) might be the most important dimensions of rail service standard.

B.2.1 Complaints

ITSRR's Annual Transport Reliability Report 2006-07 identifies CityRail complaints by topic. The number of complaints fell by 7 per cent between 2005/06 and 2006/07. The most common topics of complaint in 2006/07 were:

- ▼ On time running (18 per cent).
- ▼ Service (includes crowding) (15 per cent).
- ▼ Cleanliness and facilities (14 per cent).
- ▼ About staff (13 per cent).
- ▼ Safety and security (12 per cent).
- ▼ Information (10 per cent).
- ▼ Ticketing (9 per cent).

The complaint categories are broad and not clearly defined and so are open to interpretation.

²⁵ Neil Douglas and George Karpouzis (2006), *Valuing Rail Service Quality Attributes through Rating Surveys*, 29th Australasian Transport Research Forum.

²⁶ Station quality includes ease of platform boarding and alighting, weather protection, platform seating, platform surface, subways and overbridges, station buildings, lifts and escalators, signage, station announcements, information, lighting, cleanliness, graffiti, toilets, staff, car park, car drop off, taxi, bus, bicycle, telephone, retail and ticketing. Train quality attributes include train outside, ease of boarding and alighting, seat comfort, smoothness, quietness, air conditioning, lighting, cleanliness, graffiti, train announcements and layout.

