The Brown Review of the Rail Franchising Programme

Provided to the Department for Transport

December 2012

Presented to Parliament
by the Secretary of State for Transport
by Command of Her Majesty

January 2013

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Note on publication:

Richard Brown was commissioned by the Secretary of State for Transport to conduct a review into the Department for Transport's rail franchising programme. The findings of this independent review are being published as a command paper for the purpose of sharing this information with Parliament. The views and recommendations expressed in this report are those of the author and do not represent Government policy. Government will be responding to this report in due course. The information in this document is being published by the Secretary of State on an 'as is' basis, without any representation or endorsement made and without warranty of any kind whether express or implied.

Paragraphs 8.13 to 8.20 have been temporarily redacted from this version of the report as they contain specific recommendations about the three live procurements that are potentially market sensitive and on which the Department intends to make an announcement shortly. These currently redacted paragraphs will be published as a Command Paper, Cm8527 Supplement to the Brown Review of the Rail Franchising Programme, immediately after this announcement has been made.

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1 EXECUTIVE SUMMARY

1.1 The competition held by the Department for Transport (henceforth 'the Department') to award a new InterCity West Coast (ICWC) franchise in 2012 was intended to be the first in the most extensive programme of franchising since privatisation. As is now clear, significant errors were made by the Department during the competition, which not only caused the cancellation of that franchise award at considerable public expense but also called into question the remaining franchising programme and the Department's ability to conduct it.

1.2 On 3 October 2012, I was asked to explore the wider implications, building on the relevant findings of an independent study into what had occurred, conducted for the Secretary of State by Sam Laidlaw (the Laidlaw Inquiry)[1]. I have also considered a separate report by the National Audit Office (NAO)[2].

1.3 The Terms of Reference for my Review, which were revisited but not amended following the publication of the Laidlaw Inquiry report, are set out in Appendix A.

Key Conclusions

1.4 The complexity of rail franchising makes the possibility for tinkering endless. Having examined the position, I share the Government's view, as set out in the 2012 Command Paper "Reforming Our Railways: Putting the Customer First" (the 2012 Command Paper)[3], that the rail industry works, and that there is no credible case for major structural change. I am firmly convinced that to continue to make real progress, concerted effort is required on a significant, though manageable, number of key areas, from which lasting and tangible improvements will flow.

1.5 Since privatisation, Britain's railways are successfully carrying more passengers, more safely, on many more and newer trains, more of which arrive punctually and with greater levels of passenger satisfaction. Passenger numbers have grown by 92% since privatisation and Britain has enjoyed the fastest rate of growth amongst major European railways. Britain's railways are now the second safest in Europe; punctuality and passenger satisfaction are

1 https://www.gov.uk/government/publications/report-of-the-laidlaw-inquiry
2 http://www.nao.org.uk/publications/1213/intercity_west_coast_franchise.aspx
3 https://www.gov.uk/government/publications/reforming-our-railways

running at much improved levels. Franchising is an important component of the privatised industry structure, and it is highly unlikely that these successes could have been delivered if franchising was fundamentally flawed.

1.6 We have now had nearly 2 decades' experience of franchising, and therefore have a good idea as to what has worked and what still needs to be addressed. There have been a number of reviews over the years, the latest undertaken by this Government in 2010, summarised in the January 2011 paper "Reforming Rail Franchising: Government Response to Consultation and Policy Statement"[4]. It seems to me that most of the conclusions in that statement were the right ones, but it is somewhat surprising that their logic was only partially followed in the terms of the ICWC specification and the way the Department managed the procurement.

1.7 My Review seeks to restate the principles of franchising, and to address what specific changes are now needed to set a clear and appropriate framework for how passenger rail franchising should work. It concentrates on the core questions of how to structure franchises, ensure effective and transparent competition for them and then manage them once they are let, so as to achieve the right outcomes for both Government and passengers. This includes the key issues of appropriate risk allocation and incentives for franchisees, and change mechanisms to ensure franchises can adapt to new opportunities and challenges. I have tried to provide a blueprint for franchising for the next few years, taking account not just of the lessons from the ICWC competition but also from all of our experience of franchising to date.

1.8 It is very important that the franchising programme is restarted as soon as possible. This is vital to maintain the momentum towards greater cost efficiency generated by the recommendations of the May 2011 McNulty Rail Value for Money Study (the McNulty Report)[5]. It is equally vital to support the continuing major programme of investment in the industry, where franchisees are both delivery partners and 'customers' for major infrastructure improvement schemes. The temporary suspension of franchising has also had a very negative impact on the industry's supply chain, with many companies having to reassure their investors in its aftermath. Many downstream decisions hinge on new franchise awards, for instance investments in rolling stock upgrades and refurbishments, and these decisions are currently on

[4] http://webarchive.nationalarchives.gov.uk/20110130130056/http://www.dft.gov.uk/consultations/closed/2010-28/govresponse.pdf
[5] https://www.gov.uk/government/publications/realising-the-potential-of-gb-rail

hold. Many suppliers in this market are international companies, and there is a risk funds and resources previously earmarked for UK projects, could be diverted to other countries. The uncertainty for both the travelling public and for staff has been highly unsatisfactory.

1.9 However, it is equally important that as the programme is restarted, this is done at a pace that both the Department and the industry can sustain. It is clear that the key priority is for the Department to rapidly strengthen its franchising organisation, including bringing in a number of senior, commercially experienced people. There is a sharp asymmetry between the experience and capability of bidders and that of the Department's franchising teams. I support Sam Laidlaw's recommendations on organisation, and have made further recommendations and suggestions which build on them. Restarting the franchising programme must be done in a way which takes account of the speed with which the Department can build its capability and resources; it must be accepted that my recommendations on franchise structure are to be implemented on a phased basis, and that the earliest franchises to be let will only partially include them.

Structure of the Report

1.10 The chapters that follow are structured around a series of key questions:

- Chapter 2: Why franchise? Reviewing the experience of franchising to date and the objectives for it

- Chapter 3: What are the principles of franchising? Restating how to approach franchising to achieve these objectives

- Chapter 4: How should franchises be structured? Covering franchise term, scale and scope, risk allocation, capital requirements and incentives

- Chapter 5: How should franchises be procured? Proposing ways to strengthen and simplify the bidding and evaluation processes

- Chapter 6: How should franchises be managed? Proposing ways to realise the full benefits of franchises once contracted

- Chapter 7: How should the Government deliver franchising? Strengthening the franchising authority's organisation and capability

- Chapter 8: How should the franchising programme be restarted?

Key Recommendations

1.11 **The bidding process is not fundamentally flawed, but there is significant scope to improve it further**. The Government should be clear about what it is seeking to 'buy' in a franchise – value for money and a partnership approach to developing and managing the franchise – and state its specific objectives for each competition. The bidding process should focus on these objectives and be further simplified to reduce unnecessary requirements and help reduce bidding costs.

1.12 **The Department's organisation and franchising capability urgently needs to be strengthened**, as the Laidlaw Inquiry and NAO reports have shown. The capability and experience of the franchising authority should match that of the bidders' teams, in line with good procurement practice. Strengthened capability should be accompanied by improved clarity of scrutiny procedures and accountability at the most senior levels.

1.13 **Franchise term should be determined by the circumstances and size of each individual franchise**. I recommend that this should usually consist of a 7 to 10 year initial term with pre-contracted continuation, subject to agreed franchise criteria being met, for further terms of 3 to 5 years giving eventual terms of up to 15 years, but with intermediate break points. There may be circumstances where shorter or longer terms are appropriate, but a franchise term should not be less than 5 years. Residual value mechanisms should be more actively utilised to encourage franchisee investments in projects which have a commercial return beyond the franchise term.

1.14 **Franchisees should be responsible for risks they can manage and should not be expected to take external macroeconomic, or exogenous, revenue risk**; there should be a clear mechanism to adjust franchise premium/support payments for variations in Gross Domestic Product (GDP) and Central London Employment (CLE) growth rates. Not taking exogenous revenue risk will enable franchisees to bid lower profit margins, so giving better value to Government. Franchisees should, however, take clear responsibility for delivering the management initiatives that they promise and bear greater responsibility for costs, particularly infrastructure costs. There should be a simple profit share mechanism to ensure that Government shares in any significant financial outperformance by the franchise.

1.15 **Capital requirements should be set at a level to create financial robustness, deter default and protect Government up to a reasonable limit for loss of premium or increase in support in the event of any default**. They should be calculable up front so that bidders know the capital requirements prior to bid submission. The Government should not seek to insure the risk of default in full in the financial markets. Capital requirements should be in the form of bonds and parent company support. The level of parent support and bonding should be determined transparently by the level of the franchisee's endogenous revenue forecast. Close account needs to be taken of industry balance sheet capacity in setting the level of capital required, and the need to avoid deterring smaller owning groups.

1.16 **Evaluation should assess the financial robustness and deliverability of bids.** The Department should describe the criteria it will use for this assessment.

1.17 **Bids should also be explicitly scored on their proposals for improving service quality for passengers and their approach to management**. Their score should form part of the evaluation process. I recommend that a weight of 20-40% (which will vary depending on the nature of the franchise) should be attached to quality in the final evaluation. This should include bidders' proposals to invest in training and workforce development and engagement. National Passenger Survey (NPS) scores, which directly reflect what passengers say, should be more closely reflected in franchise commitments and subsequent monitoring of franchise performance.

1.18 In the same way that franchises allow train services to be managed by organisations close to the markets and communities served, so **the specification and oversight of franchises should be managed by authorities that are closest to their communities and local economies**. I therefore recommend that further franchises are devolved to local control, by which I mean, where appropriate, the relevant Passenger Transport Executives (PTEs) or Integrated Transport Authorities (ITAs), in the regions, and that further devolution of services within London is actively considered. In the case of the Northern and London Midland franchises this is likely to require some re-mapping to conform services more closely to PTE areas. I expect this to be a staged process, to allow the relevant authorities to gain experience and build their own capacity, whilst avoiding adding unnecessary costs.

1.19 **Improved flexibility and change mechanisms should be built into each Invitation to Tender (ITT) and Franchise Agreement**, with a greater focus on outcomes in franchise specification to give bidders more flexibility to bid more resource-efficient timetables and to facilitate Government-initiated changes (e.g. new electrification schemes). Franchise Agreements should also include gain-sharing mechanisms to encourage franchisees to come forward with proposals to further improve franchise financial performance, where this might require amended franchise specifications.

1.20 **Franchise management capability is as important as the franchise letting process, and should be staffed by commercially experienced individuals able to develop a partnership relationship with franchisees, in order to deliver continuing value for taxpayers and improve service to passengers. In addition to strengthening its own capability, the Department should look to publish guidance on its franchise management approach.**

1.21 Finally, and most importantly, **the franchising programme should be restarted**. In restructuring the programme, the Department will need to be mindful of what it and the market can resource, and seek to avoid 'bunching' franchises, which increases the vulnerability of the programme to peaks and troughs in the economic cycle.

Methodology

1.22 Over a period of 2 months (from mid October to mid December) I have canvassed views from a complete range of industry bodies – operators, suppliers, passenger groups, the unions, investors, the Office of Rail Regulation (ORR), Government and other authorities. I met a wide range of individuals, and received written contributions from many more, as set out at Appendix B.

1.23 I have also met Sam Laidlaw, whose final report was a serious indictment of specific failings in the Department's processes, organisational structure, and culture. Where appropriate, the Laidlaw recommendations are reiterated or revisited in the text that follows. I have built on the evidence and subsequent findings from

Laidlaw and the NAO, relying on data and evidence supplied for the most part by the Department.

1.24 I commissioned First Class Partnerships to provide commercial advice and PricewaterhouseCoopers LLP to act as financial advisers, with Norton Rose LLP providing legal advice and IBI Group programme management advice. I was supported by a secretariat seconded from the Department.

1.25 In my consideration of the issues, I have had full regard to the impact of EU laws and principles, and I have had the benefit of legal advice on this. In particular, I have had regard to EU rules and general principles on the procurement of services and the award of concession contracts, to the effect of the EU's rail liberalisation packages, and to EU Regulation 1370/2007 which governs the award of public service contracts in the rail and road transport sectors.

1.26 I have also been conscious that EU rules in this area are developing. In particular, there is soon to be a recasting of the 'first package' of EU railway directives that were adopted in 2001; there is contemplation of a new 'fourth package' of railway liberalisation that might extend liberalisation to domestic rail passenger services; and there is active consideration of new EU directives on service contracts and concession contracts, the terms of which are likely to affect the scope of the rules on the procurement of UK rail franchises and which are thought likely to come into force within the next couple of years. I have had to bear in mind that UK rail franchises are relatively long-term, and that my recommendations are designed to influence the future of rail franchising over the medium to long-term, and accordingly many of my recommendations have regard to these ongoing developments in EU law making.

Next Steps

1.27 The proposals in this report complement the findings and recommendations of the Laidlaw Inquiry by providing a series of principles and deliverables for the whole programme. The recommendations are designed to provide the basis for the recommencement of a sustainable franchising programme that is effective, efficient and economic and that delivers more for passengers.

1.28 The recommendations should be considered as a package; they are mutually reinforcing rather than standalone. Taken together, they will deliver a robust franchising framework with clear objectives, transparent and predictable processes, and a proportionate approach to the balance of risk and reward in these complex commercial partnerships.

1.29 They should also be regarded as an evolutionary package of change – as an end point rather than an obstacle to restarting the programme. Almost 1.5 billion journeys were made on Britain's railways last year. Passengers cannot wait whilst theoretical discussions are held about the structure of the railways. Restoring confidence to the market is an urgent requirement. The franchising programme should now be put on a firm footing with proper stewardship and be restarted quickly.

2 THE EVOLUTION AND OBJECTIVES OF FRANCHISING

2.1 There have been many reviews and studies of passenger rail franchising, including reports by the NAO[6] and Transport Select Committee[7], and more recently by KPMG for the Department in 2010[8], and by the Department itself following its consultation on refranchising conducted between July and October 2010[9]. There is therefore much material to build on.

2.2 What is most pertinent is to review the main themes running through our experience of franchising to date. These can then be taken into account in determining the core objectives of franchising. There are 5 key themes which I believe are particularly relevant and important to the current situation, and which I will consider in turn below:

- the exposure of many franchises to macroeconomic factors, in particular downturns in the economy

- concern that over the years bidders have in some cases been over-optimistic in their forecasts, resulting in subsequent problems of default or revenue support from Government

- a trend over time towards progressively tighter franchise specifications and less flexible franchise management

- a general trend towards fewer, larger franchises

- the ability of franchising to adapt successfully over the years to a number of major changes and shocks in the rail industry, but with many aspects of performance now substantially improved.

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6 http://www.nao.org.uk/publications/0708/letting_rail_franchises.aspx

7 http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtran/233/23302.htm

8 http://assets.dft.gov.uk/publications/pgr-rail-passenger-franchises-historicaldata-pdf/report.pdf

9 http://webarchive.nationalarchives.gov.uk/20110504011839/http://www.dft.gov.uk/consultations/closed/2010-28/

Exposure to Exogenous Revenue Risk

2.3 The first franchise was let in 1995, and over a period of just 2 years the first franchising authority, the Office of Passenger Rail Franchising (OPRAF), let 25 franchises. All of these franchises passed full revenue risk to the franchisee, including exogenous risk from variations in wider economic activity.

2.4 A number of these early franchises ran into financial difficulties in the early 2000s, after the Hatfield crash, the subsequent collapse of Railtrack, and the economic downturn in 2001. In a number of cases the Strategic Rail Authority (SRA), which took over responsibility for franchising in 2001, agreed revised franchise support/premia to ensure franchisees remained solvent.

2.5 In the next round of franchising starting in 2003, the SRA sought to protect franchisees from exogenous revenue risk to a large degree by introducing the 'cap and collar' mechanism. This committed Government to provide revenue support if revenue fell below predetermined levels after, usually, 4 years into the franchise, and allowed Government to share in any outperformance in revenue above predetermined levels. The majority of franchises with 'cap and collar' provisions have required revenue support in recent years after the 2008 recession. The mechanism has been effective in ensuring the viability of a number of franchises, but at the cost of unplanned revenue support payments from Government. This has created significant problems for Government in forecasting and managing public expenditure and a serious dilution of the incentives for franchisees to grow their businesses.

2.6 The problem of exogenous revenue risk was also recognised in the Government's 2010 Franchising Review[10]. In its January 2011 Statement[11] Government proposed to compensate franchises for GDP-driven variations in revenue. This was carried through into the ICWC franchise. However, the mechanism proposed provided only limited protection, being triggered in the event of a substantial change in forecast GDP (it included a 'nil band' of + or – 5% variation in forecast GDP, within which no compensation or clawback would apply). It appears that the ICWC bidders gave very little credit to the value of this compensation. The issue of exogenous revenue risk allocation therefore remains to be satisfactorily resolved.

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[10] http://webarchive.nationalarchives.gov.uk/20110504011839/http://www.dft.gov.uk/consultations/closed/2010-28/consultationdoc.pdf

[11] http://webarchive.nationalarchives.gov.uk/20110504011839/http://www.dft.gov.uk/consultations/closed/2010-28/govresponse.pdf

Revenue Forecasting

2.7 A common criticism of franchising has been that bidders have too often constructed over-optimistic revenue forecasts in order to win franchise competitions. This was certainly the case with some franchises let under 'cap and collar' because bidders knew they would enjoy a measure of protection from approximately year 4 of the franchise, and therefore had much less to lose by bidding aggressively in later years. Over-optimistic forecasting was also a concern with the 2 East Coast franchises which ended in default and, in some quarters, with the recent ICWC competition.

2.8 It is clearly important that franchise bids should aim to make improvements to services and financial performance, in order to return best value to Government and taxpayers, but it is equally important that bids should be deliverable and robust so that franchisees should not default and trigger large unplanned changes in support from or premia to Government. Designing franchise structures that discourage over-optimistic bidding or 'gaming' in later years, and that strike an appropriate balance between value for money for Government and deliverability, is clearly now an important consideration.

Tighter Franchise Specifications

2.9 A consistent criticism of franchising from operators has been that, over the years, franchise specifications have become progressively more prescriptive, and consequent franchise management by the franchising authority has become less flexible. This was also recognised in the Government's 2011 Statement, but some bidders viewed the subsequent ICWC specification as only slightly less prescriptive.

2.10 It is certainly the case that the first round of franchises awarded by OPRAF had relatively few specifications, beyond a committed minimum level of train service to be operated. There was much criticism of the early performance of some franchisees, leading the SRA in the next round of franchising to set much tighter specifications and engage in a degree of micromanagement to ensure operators delivered higher standards of service. This trend can particularly be seen following the Hatfield crash in how operational performance was managed and improved under the SRA.

2.11 There is clearly a difficult trade-off for franchising authorities, who are ultimately procuring a public service, between ensuring an appropriate level and quality of service for passengers, and giving significant flexibility to operators to evolve and adapt services to ensure best value for money for taxpayers. Where to strike the balance is likely to be different for different types of franchise, with more flexible specifications usually being considered more appropriate for inter-city type franchises, which are closer to being commercial enterprises with a measure of competition from motorways and airlines. Yet even for these franchises many of the cities and communities served view inter-city services as an important public service, requiring a measure of safeguarding in franchise specifications.

2.12 A more telling criticism of many franchise specifications is that they are too focused on prescribing inputs – for instance first and last train times, and ticket office opening hours – rather than outcomes, such as the levels of passenger satisfaction actually achieved.

Fewer, Larger Franchises

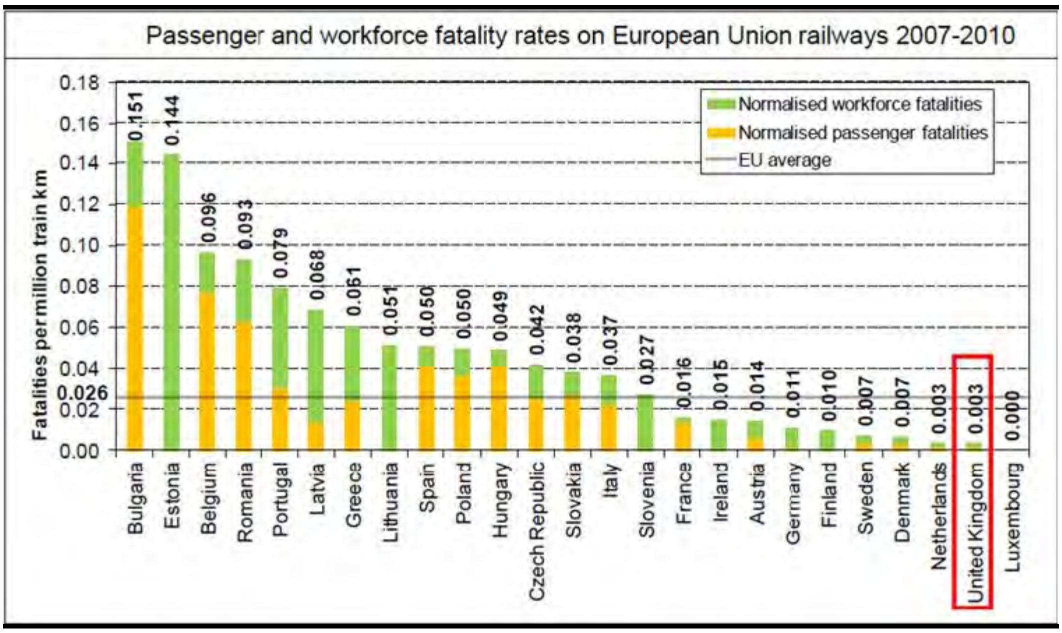
2.13 A factor which has received less attention, but which is important to the health of the franchising market, has been the trend towards fewer, larger franchises as a result of franchise mergers. OPRAF let 25 initial franchises, but this number will be reduced to just 17 if current plans to merge franchises proceed. A number of the mergers were initiated by the SRA, to ensure a single train operator at key London termini, but the trend has continued under the Department. At the same time the passenger rail sector has grown very substantially since privatisation, with passenger revenues having increased by 113% in real terms and passenger journeys by 92% between 1995 and 2011. Most franchises are now very substantial businesses, with revenues on average 3 times as large in real terms as in 1995.

2.14 This greatly increased size has 2 consequences. First, most franchise competitions are now major procurement exercises, with significantly increased complexity and risk. The ICWC franchise would have had a gross contract value of well over £20 billion over its core term, with aggregate premia to Government of £5.5bn in Net Present Value (NPV) terms. Bidders have generally increased their resources and capability to match the greater challenge, but the Department has not, as clearly revealed by the Laidlaw Inquiry. Second, each individual franchise competition is now more of a 'make or break' situation for individual bidders, since the prospects of winning more than one or two franchises are much reduced, as is the financial capacity of some bidders to hold more than this. With owning groups' eggs potentially in just one or two baskets, risk is increased as is the pressure to bid more aggressively to win one of the more limited number of franchises available.

Franchising Evolution

2.15 It is important to remember that the rail industry has undergone a number of major shocks and structural changes since privatisation, and it is now a very different industry. The Southall, Ladbroke Grove and Hatfield tragedies have led to a fundamental change in safety management, and the UK rail industry is now the second safest rail system in Europe according to the Rail Safety and Standards Board (RSSB), as shown in Figure 1. Franchises have also had to adapt to the demise of Railtrack, the creation of Network Rail and subsequent major changes in rail regulation, access charging, and the introduction of processes which introduced 5-year funding cycles for Government investment. There have been 3 different nationwide franchising authorities: OPRAF, the SRA and now the Department - and 4 franchises are now successfully devolved to national and regional authorities.

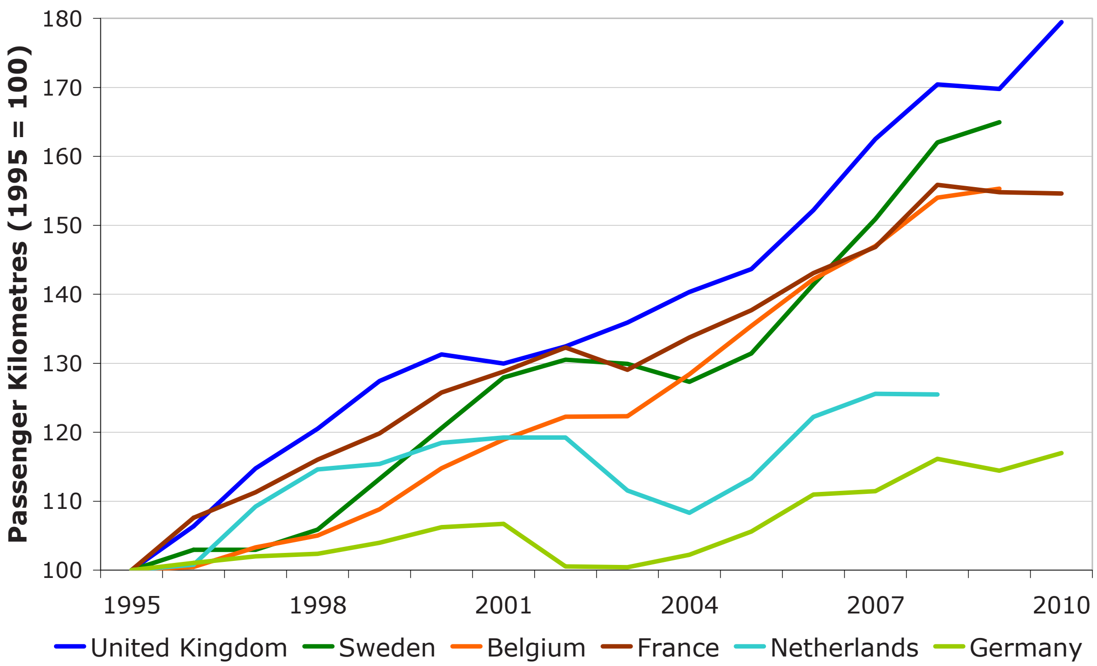
Figure 1: Passenger and Workforce Fatalities: EU Comparison



Source: RSSB, taken from http://www.rssb.co.uk/SPR/Documents/ASPR_2011-12_FullReport.pdf

2.16 Franchising has successfully adapted to all of these shocks and changes, and franchises have continued to deliver strong growth in passenger numbers, with only brief pauses during the post-Hatfield collapse in performance and the first few months of the 2008 recession. Passenger growth in Britain since privatisation has been faster than in all other major European rail systems, as underlined in Figure 2, and is in stark contrast to the situation before privatisation. Moreover punctuality as measured by Public Performance Measure (PPM) is at 92.8% (up from 79.2% in 2002-03) and, as reported in Passenger Focus's National Passenger Survey, passenger satisfaction is 83.2%, an increase of 9.7% since 2004 (when comparable records began). The UK compares favourably with other EU countries on a number of passenger satisfaction measures, notably satisfaction with punctuality and reliability, with 86.8% of UK respondents 'rather' or 'very' satisfied, compared with 52.3% in Germany and 54.0% in France. Further detail on these and other statistics is provided in Appendix C.

Figure 2: Passenger Kilometres – EU Comparison



Source: OECD

2.17 Whilst franchises are only one component of the rail industry structure, it is inconceivable that these gains could have been achieved, and changes successfully adapted to, if the franchising system was fundamentally broken. That said, there are still many shortcomings in the current system, some of which I have described above, which should be addressed in moving forward.

The Future of Franchising and Key Objectives

2.18 Clearly it is important that franchising maintains the much-improved levels of safety, punctuality and passenger satisfaction that have been achieved over the past few years, and makes progress in improving these further. It is also important to recognise the role of franchising in the debate about the structure of fares, which is the subject of a separate review by the Department and which is beyond the scope of this Review. There are 4 specific current challenges that need to be addressed in how franchise structures should evolve going forward:

- reducing unit costs and improving value for money for both taxpayers and passengers, as clearly highlighted in the McNulty Report

- helping deliver the unprecedented levels of investment now going into the industry, in most cases with franchisees acting as delivery partners and customers of Network Rail

- catering for the continued high levels of passenger growth expected for the foreseeable future, on routes and services which are operating increasingly close to capacity, and achieving efficiencies without sacrificing passenger satisfaction

- facilitating closer partnership working, including the development of alliancing between operators and individual Network Rail routes, to unlock further efficiency and performance improvements.

2.19 Clear, consistent objectives are essential so that Government, the industry, taxpayers and passengers can understand what is expected to be delivered by franchisees and can set the benchmarks for success. There have been a number of statements of objectives, in a range of public documents, which I will not rehearse here.

2.20 Drawing on these and on my discussions with interested parties during my Review, **I propose the following six objectives for franchising for Government to consider:**

- ensure value for money for Government in the delivery of passenger rail services by requiring potential franchisees to compete periodically *for* the market (as these are services which usually face limited competition *in* the market)

- harness private sector skills and innovation, to deliver value for money for taxpayers and improved services which increase passenger satisfaction

- ensure stability of services for passengers and communities served, through contractual commitments to core services and service improvements over the term of each franchise

- secure franchisees who will work in partnership with the Department and other rail industry parties (including rolling stock suppliers) to drive continuing growth in passenger numbers, help deliver the ongoing investment programme in the rail industry and drive further efficiencies in both their own and Network Rail's unit costs

- facilitate further devolution of decision-making and responsibility for specifying passenger rail services to regional authorities

- ensure passenger rail services are delivered and managed by organisations which are more closely attuned to local market needs, by designing franchises which cover well defined routes or geographic markets.

3 THE PRINCIPLES OF FRANCHISING

3.1 Before moving to my specific recommendations I believe it is useful to step back and restate the key principles which should apply in devising an effective franchising programme. I put these forward as a checklist or aide memoire to be borne closely in mind by those managing the programme going forward.

3.2 The principles set out below are based on my discussions with a range of industry parties and a review of published case studies, and reflect best practice from other public sector procurements and private sector outsourcing. They cover the requirements of encouraging a healthy franchising market, designing each franchise's financial and contractual architecture, and finally, organising the process of letting and then managing franchises.

3.3 **In order to have effective competition it is important to foster a healthy range of potential franchisees and ensure an active appetite for bidding.** There are currently 10 owning groups and others actively interested in bidding for franchises, but whilst this should provide a reasonably competitive market, experience suggests a trend towards consolidation. It is therefore important that the franchising programme continues to be attractive to new entrants. Three principal factors are likely to impact on this: the size and number of franchises on offer, the capital requirements for each franchise, and the ability to enter the market initially. More, smaller franchises will be more attractive to the market than fewer, larger franchises. Smaller franchises in particular are likely to be more attractive to new entrants. And most of the current owning groups would prefer a small portfolio of franchises, since this reduces the impact of failing to win a particular competition and spreads their risk.

3.4 **Peaks and troughs of activity in the refranchising programme should be avoided**, so that franchises are not all awarded at the same point in the economic cycle and therefore exposed to the same risks. A well spread programme of franchise renewals would also be a more efficient use of Department and bidders' resources, so reducing bidding costs.

3.5 **The level of capital requirement should be set at a level that allows owning groups to hold a small portfolio of franchises and encourages new entrants to the market.** Set too high, the capital requirement becomes a substantial barrier to entry. It also increases the likelihood that bidders will withdraw from a bidding process once they have won a single franchise, leading to a steadily diminishing pool of bidders towards the end of a refranchising programme. The capital requirement should also encourage joint ventures, as a way into the market for smaller entities or non-transport players, and continue to ensure that stock market listed and privately owned operators can compete against state backed or state owned enterprises, which have different risk capacity and cost of capital.

3.6 On the other hand, franchisees should be required to ensure sufficient capital and liquidity, to ensure there is cash within the franchise to meet obligations over the next 12 months, for the franchise to remain robust, and provide parent company support and bonds, at a level that helps avoid and deter default.

3.7 **Government should tolerate the idea that a franchisee may default**. It is neither sensible nor realistic to design franchise structures that seek to completely eliminate the risk of default. High capital requirements will be priced into bids, reducing the value returned to Government in premia or support. The trade off between value for money for Government, and capital requirements, should be balanced to encourage robustness and reduce the risk of default but not at the cost of seeking to eliminate it completely. Passengers remain protected through the Department's ability to handle default with an Operator of Last Resort on hand to take over operation.

3.8 **Each franchise should have a specific set of objectives which reflect the route specific needs and challenges of that franchise.** Clear objectives will assist bidders to focus on what Government is looking to procure, and ensure bids which offer the best value. These objectives should be consistent with the Department's published policy position, and with the domestic and EU legal frameworks for franchising.

3.9 **The proposition for each franchise must include appropriate risk transfer that reflects the fact that franchisees cannot manage exogenous revenue risks.** Only those risks which can be managed by a franchisee should be transferred to it, allowing franchisees to focus on those areas where they can best add value. Inappropriate risk transfer reduces value for money for Government as bidders add margins into their pricing for risks they cannot manage, thereby adding cost. The risk proposition should be tailored to each franchise, as there may be occasions where revenue risk transfer is not the best value for money option, e.g. when there are significant infrastructure works and disruption. In these instances, a management style contract may be a more appropriate contracting approach – learning from the lessons of the West Coast upgrade[12].

3.10 **Equally, the incentives for each franchise should be clear from the outset**. Transferring risk, provided it can be managed, is the most powerful incentive to franchisees. 100% marginal revenue risk transfer has proved to be a successful incentive to grow passenger revenue. There needs to be greater flexibility in franchise specification to allow more cost risk to be transferred and Franchise Agreements should facilitate alliancing with Network Rail (including allowing Government to share in benefits).

3.11 **Franchise Agreements need to be capable of accommodating significant change where required by Government, and should encourage changes proposed by the franchisees,** where it can be demonstrated there would be clear benefits in value for money for Government, for the wider rail network or for the quality of service for passengers. Such proposals need, of course, to be considered in light of affordability. Given the complexity of the rail industry, interactions between the different parts of it and the likely pace of change going forward, it is simply not practical or desirable to try to legislate for all possible situations and developments in the initial Franchise Agreement.

3.12 **The franchising authority and the franchisee need to develop a partnership relationship**. In such an approach, sustained collaboration brings improvements to both the financial and operational performance of the franchisee, enabling better realisation of value in the levels of premia or support delivered. Government is the owner of the entities being franchised, and therefore has an ongoing interest in facilitating franchisees in improving both their financial and operational performance.

3.13 **The procurement process must be focused and disciplined, have due regard to keeping bidding costs at a reasonable level, and concentrate on the essentials of price and quality in evaluation.** Improved discipline and transparency would also put the franchising authority in a much better position to engage with and respond to challenges to the process.

[12] http://www.nao.org.uk/publications/0607/west_coast_main_line_upgrade.aspx

3.14 **Wherever possible, the opportunity should be taken to simplify documentation and bidding requirements to avoid unnecessary complexity.** Each round of franchising has added cost and complexity, with the accretion of additional layers of detail whose purpose has often been superceded.

3.15 **The teams running the procurement need (at least) to match those of the bidders in terms of capability, commercial and procurement experience, and confidence**.

3.16 Equally, **ongoing oversight and management of franchises once let is at least as important as their procurement, in ensuring the desired results.** All experience of outsourcing, of which rail franchising is clearly one form, shows that ongoing oversight and management of a contract by the buyer is vital to ensuring the desired results. The calibre of the franchising authority's franchise managers is therefore a key element in the effectiveness of the franchising programme as a whole, and should match that of the franchisees.

3.17 Last, but not least, **the needs and expectations of passengers and franchise staff should be given greater weight and consideration in the whole approach to franchising.** Bidders should be required to table clear proposals on how they will meet passenger needs and improve passenger satisfaction, and how they will invest in and engage with staff.

4 STRUCTURING FRANCHISES

4.1 The ICWC competition proposed new approaches to franchise term, risk allocation, and capital requirements. This chapter explores the aims in relation to each of these, and makes recommendations for designing the financial and contractual structures of future franchises. Together these changes will establish more appropriate risk allocation, make bid evaluation more reliable and increase confidence that franchises will meet Government's objectives.

Franchise Term

4.2 The term, or duration, of franchises has been the subject of debate and modification over the course of passenger rail franchising. Most recently, Government sought to award longer franchises to encourage operators to make investments with a longer payback period. The argument for longer franchises is also that they provide continuity for staff and passengers, and a longer period for operators to pursue cost reduction initiatives. This was one of the conclusions of the McNulty Report.

4.3 On reflection some of these benefits can be seen to be overstated and could equally be achieved in other ways. Given that most asset lives in the industry are very much longer than 15 years, the types of investment that franchisees might make are relatively limited. Many of the franchise owning groups have a smaller balance sheet capacity and/or a higher cost of capital than the other key players in the industry, Network Rail and the rolling stock companies (ROSCOs), and so are less able to finance substantial investment. This was recognised by the SRA in its early days, when it tried to facilitate franchise owning groups in setting up Special Purpose Vehicles to finance large investment programmes in exchange for long franchises. It is also the case that for most businesses 7 to 10 years would be a more than adequate period to recoup the benefits of cost reduction initiatives.

4.4 Conversely, the major drawback of longer franchises is that they greatly increase risk (particularly in combination with larger franchises), as was seen with the ICWC competition. The uncertainties of forecasting, particularly of revenues, compound exponentially over time, reducing the confidence that can be placed in longer term forecasts, and driving both bidders and Government to take extra measures to compensate for risk. This was the main source of complexity in the proposal for an unspecified Subordinated Loan Facility (SLF) that caused so much difficulty for the ICWC competition. In turn, I understand that bidders' responses to this forecasting risk were to bid a higher profit margin, which was likely to lead to a reduction in value for money for Government.

4.5 **I therefore conclude that longer, 15 year fixed-term franchises without any break clauses are not sensible for the majority of franchises.** There may be instances where a longer franchise is justified – for instance for smaller franchises where revenues are relatively stable and no major change is foreseen in markets served or the pattern of service provided – but these should be the exceptions rather than the rule. The majority of parties that I have consulted consider that an initial franchise term of 7 to 10 years would strike an optimum balance between length and risk, as a general norm.

4.6 However, franchisee continuity remains a desirable objective for passengers, staff and wider stakeholders. If an operator is performing well it is in everyone's interests that it should be able to continue. Structuring franchises so that there is a pre-established continuation mechanism, subject to criteria specified in the ITT being achieved, is a relatively simple means of achieving this. This would also be a powerful incentive for the operator to continue to perform well throughout the initial franchise term; additional years of operation which do not have to be separately competed for via a refranchising competition are potentially of significant value to a franchisee.

4.7 **I recommend therefore that the normal franchise term should be in 2 parts**, subject to market sounding and specified when advertising the competition:

- **an initial term of between 7 and 10 years** – though, as noted above, this is not an absolute rule

- **a pre-contracted continuation, on the same basis as the initial term, for (indicatively) a further 3 to 5 years**. This continuation should be 'conditional-automatic', meaning that if agreed financial, operational performance and quality criteria are satisfied, the continuation must be granted by the Department. Even if those criteria are not satisfied, the Department could grant the continuation in its absolute discretion to avoid the risk of a franchisee deliberately failing the criteria so as to escape having to continue to perform the franchise services for the full term, for example for its own commercial reasons. In certain cases it may even be desirable to contract more than one continuation, as has been the case with Chiltern and Merseyrail.

4.8 There have previously been franchises which contained potential continuation periods. In those competitions, the Department traditionally evaluated bids by applying a weighting of 50% to the NPV of the premium/support offered for the period covered by the potential continuation. The most recent example of this was the competition for the Greater Anglia franchise.

4.9 The Department should continue with this approach – keeping the weighting under review for each franchise competition, depending upon the size and scale of the term under consideration.

4.10 The Department should in any event contract for an optional 26 reporting period extension (exercisable at the Department's option), to be exercised after either the initial term or any subsequent continuation, to give it flexibility in planning the franchising programme. This contrasts with the 7 period flexibility found in most current contracts (and builds on the ICWC proposal for 22 periods).

4.11 In all cases, the Department's decision in relation to franchise continuation and/or extension will be mandatory for the franchisee. In addition, if the franchisee fails to meet the continuation criteria, this might be taken into account in assessing the quality and deliverability of future franchise proposals from the franchisee or any member of its group.

Revenue Risk Allocation

4.12 There is a close relationship between general economic activity and demand for rail services. Exposure to exogenous variations in revenue has been a persistent issue for franchising. Franchisees are, quite properly, highly restricted in their ability to adjust to downturns in demand by cutting services or increasing fares, and are not therefore in a position to manage exogenous revenue risk as a normal business might.

4.13 The 'cap and collar' mechanism introduced by the SRA was an attempt to compensate operators for a substantial portion of exogenous revenue risk. However it produced 2 serious perverse incentives. First, it encouraged bidders to bid more optimistic revenue growth after year 4, when the 'cap and collar' regime came into play, knowing that they would be largely protected from failure to deliver. Second, once in revenue support, franchisees had little incentive to stimulate revenue because if they were receiving maximum support they only received circa 20p for each pound of additional revenue earned. Yet, over the years, franchises have played a major role in driving passenger revenue to historically high levels. It is very important that no mechanism dilutes franchisees' incentives to grow revenue.

4.14 As I noted in chapter 2, the issue of exogenous revenue risk allocation has to be resolved. The ICWC franchise proposal in practice provided only limited protection from macroeconomic risk, and bidders responded by bidding higher profit margins to provide a cushion against the exogenous revenue risk they were expected to take.

4.15 **I conclude that Government needs to address the issue squarely, and retain full exogenous revenue risk as far as practicable.** The mechanism I propose is as follows:

- **For each franchise the franchising authority agrees an appropriate mix of indices from national GDP, regional GDP and CLE, and the elasticity of demand to them.** The mix would be informed by the rail industry's Passenger Demand Forecasting Handbook (PDFH), which includes guidance on elasticity for different types of franchise. It should be subject to consultation for each franchise before being included in the relevant ITT.

- **The ITT should include base forecasts for GDP, regional GDP and/or CLE and the resulting exogenous revenue growth over the franchise term, which bidders would be required to adopt**. Bidders would then bid the endogenous revenue growth they propose to deliver from their own initiatives together with their proposed costings, profit margins and resulting premia or support payments.

- **After franchise award, the contracted premia or support payments would be adjusted each year, in light of actual changes in the indices compared to the base forecast.** Adjustments would be made upwards or downwards depending on whether the indices exceeded or fell short of the base forecasts.

- It will never be possible to tailor the indices of economic growth precisely to achieve complete accuracy in matching them to actual drivers of exogenous growth. GDP, regional GDP or CLE must be considered as the most practical proxy for the range of drivers. A pragmatic approach should be taken.

- **Assumptions on the elasticity of revenue to the indices should be consulted on and tailored for each franchise but should generally be conservative** (e.g. elasticities with respect to national GDP of 1.0 for rural operations, 1.2 for commuter operations and 1.4 for intercity operations or as indicated in PDFH), to further encourage responsible bids.

4.16 This mechanism would force bidders to focus principally on the endogenous growth they believed they could drive, reducing the scope for 'gaming' or over-optimistic bidding on the basis of exogenous revenue projections. It would also encourage them to focus more heavily on costs in order to continue to differentiate themselves from other bidders. Because they would no longer be taking exogenous revenue risk, bidders would also be encouraged to bid a lower profit margin because they would no longer need to provide such a cushion against economic downturns. Adjustments on an annual cycle, rather than monthly (as under cap and collar), would give greater certainty and predictability of out-turn to the Exchequer.

Capital Requirements

4.17 The current capital requirements for franchises take several forms. Their objective has been to establish appropriate financial robustness, to discourage franchisees from 'walking away' if they encounter problems in delivering their plans and to give the Department some protection in the event of any default. For future franchises the challenge is to establish an appropriate level of capital to achieve these objectives without creating inappropriate burdens on the industry.

4.18 In the ICWC competition, the proposal was to increase capital requirements significantly by requiring an SLF backed fully by a bond from a financial institution, partly because of the magnitude of risk that might be taken on by a bidder carrying the majority of general economic risk on a 15 year intercity franchise.

4.19 It is clear to me - from discussions with the industry and investors, analysis of the financial risk in the bids and the financial strength of the main industry participants - that the proposal for such large SLFs combined with very significant bonding from financial institutions is unrealistic and likely to be counter-productive. The industry does not have the capacity to provide the level of bonding across the whole of the franchising programme that this would have implied. Requiring it to do so would restrict competition for franchises and tie up capital which would be better employed in investing in the industry or by owning groups elsewhere in their transport activities. It should be unnecessary with appropriate risk allocation.

4.20 There is also doubt about the appetite of the banking and insurance markets to provide the bonding facilities that would be necessary at prices that would represent good value for money. Government does not normally seek external insurance for macroeconomic risks and needs to consider the reasons for doing so in this case.

4.21 As described by Laidlaw, the process for establishing the level of capital on ICWC was also deficient. The requirements should be clear to bidders when the ITT is issued. This will encourage them to concentrate on the implications for their financial exposure and serve as an effective discipline on the way they bid. This is key to establishing a fair and efficient procurement process.

4.22 **I recommend that the appropriate protections and discipline should be created by the following measures**, (in addition to the ongoing existing requirement for a season ticket bond) which are in three parts:

- **liquidity requirements** to ensure there is cash within the franchise to meet obligations over the next 12 months

- **an on-demand bond for each franchise** to cover the cost the Department would face in managing any re-let (which should be smaller than the existing Performance Bond and might better be termed a 're-let bond')

- **a default indemnity to the Department supported by the franchisee's parent company** and between a third and a half of which is bonded with a financial institution. This indemnity should be set at a pre-arranged percentage of the bidder's cumulative endogenous revenue growth.

4.23 My specific proposals are discussed in greater detail in Appendix D.

4.24 This package of capital requirements should be sufficient to establish appropriate financial robustness, deter default and help protect the Department's position in the event of any default, without dampening bidders' ambition. It will also ensure that bidders face guarantee and bonding costs which are proportionate to the endogenous revenue risk projected in their bids.

4.25 The combination of parent company support proportionate to the projected incremental revenue, with bonding to reinforce a portion of that support, seems to me an effective and practical way of ensuring that bidders have a proper incentive to make those projections realistic. This therefore also acts as an additional mechanism to assist effective verification of the projections. As a result of this, **I consider that the Department will no longer need to make revenue risk adjustments as part of the Financial Assessment.**

Profit Share

4.26 Given the uncertainty that remains in revenue projections over the duration of the franchise term **I believe there should also continue to be an arrangement under which Government shares in the franchisee's profits above an appropriate level**, such as when the franchisee's cumulative operating profit is 30 per cent above that projected in the bid. The exact level should form part of the calibration prior to the ITT being issued, but this should be simplified from the tiered ICWC proposal so that the share is a simple 50:50 calculation. Profit share will not only mitigate any problems arising from a franchisee making super-normal profits, but should also encourage alignment of incentives between franchisee and franchising authority to work in partnership.

Default

4.27 The small number of failures that have occurred have skewed the Government's appetite for risk. Out of the 47 franchises let since privatisation, only 3 have defaulted, and in each case the takeover by the Government's Operator of Last Resort worked smoothly. No frontline employees lost their jobs, no trains were cancelled, and passengers saw their tickets fully honoured.

4.28 **In my view, therefore, for franchising to function effectively and for the market to function competitively, Government should accept that there can be failure.** Value for money can still be achieved in such situations and passengers protected. The Department should be judged by how it deals with failure, should it occur, rather than attempting to over-prescribe, over-specify or create expensive and complex risk transfer mechanisms to avoid such a possibility. It is unrealistic to assume that there will never be failure by franchisees, or to try to design a system which removes this risk entirely.

Cross Default

4.29 Cross default is an event of default under many existing Franchise Agreements, which occurs if another Franchise Agreement held by the franchisee or any of its affiliates is terminated as a result of an event of default. In my view **this cross-default provision deters people from participating and investing in the franchising market and should not be necessary if there is a clear and appropriate requirement for parent company support and bonding**. This is particularly important for joint venture franchises and it represents a 'double jeopardy' situation for owning groups holding more than one franchise. The capital security provided for each franchise should stand alone and be sufficient.

Cost Risk

4.30 A surprising feature of existing rail franchises is that franchisees take relatively limited cost risk, the broad view within the industry being that some 80% of their cost base is fixed once the Franchise Agreement is set.

4.31 Following the McNulty Report, the rail industry has been set an efficiency improvement target of 30% by 2019. Franchise Agreements need to give greater freedom and incentives for franchisees to play their full part in achieving this.

4.32 A particular weakness of franchising to date has been that franchisees have not been exposed to the large majority of infrastructure cost risk, despite infrastructure accounting for broadly half the industry's cost base.

4.33 It is my view that franchisees need to have greater risk exposure to the true variable costs of the railway if serious inroads in efficiency are to be made and the McNulty target met. That risk should be balanced with appropriate incentives.

4.34 Helpful progress has recently been made on train leasing costs, in that ROSCOs are no longer obliged to offer the same price and terms to each bidder for a franchise. In addition, rolling stock leases do not always need to be committed for the full franchise term. Both of these relaxations allow greater flexibility for bidders and franchisees to negotiate better leasing deals.

4.35 But the biggest opportunity for further progress is on infrastructure costs. This issue needs to be addressed both in the way franchises are structured and bid for and in the way they are managed once let. I cover the latter issue in chapter 6. **In designing franchises and bidding requirements I recommend that**:

- **Franchise Agreements give sufficient freedom for franchisees to enter alliancing agreements with Network Rail after franchise award**.

- **Bidders are encouraged to include cost saving proposals in their bids**, building on initial alliancing discussions with Network Rail. It should be recognised that asking Network Rail to negotiate full alliances with each bidder at franchise award stage is inefficient and that savings are likely to be modest until an actual alliance has been at work for a significant period.

- **Bidders should be free to negotiate with Network Rail cost saving proposals arising from the franchisee taking over responsibility for the entirety of station maintenance**, for some or all of the stations covered by the franchise.

- **The Department should be engaging with Network Rail throughout the bidding process**, including testing alliance propositions in bids for deliverability.

4.36 The provision of a profit share mechanism, as described in paragraph 4.26 above, will ensure that Government shares in savings achieved by the franchisee from alliancing or other means, over and above its bid commitments.

Residual Value

4.37 It is important that operators have the right incentives to invest across the life of the franchise. There will be circumstances where an operator wishes to invest in a project to improve efficiency or enhance revenue which has a commercial return partly or wholly beyond the franchise term. This is more likely to be the case in the latter period of the franchise as the window for return shortens, and is just as much an issue for longer franchises in their last few years as it is for shorter franchises.

4.38 Current Franchise Agreements already give the Department the ability to offer residual value to operators on a case by case basis once the franchise has started, using several possible mechanisms. **To encourage the use and enhance the**

effectiveness of residual value provisions I recommend the Department issues guidance which explains the circumstances in which it will consider proposals and the mechanisms it would use to calculate residual value at franchise end. This would allow operators to understand Government's expectations and in turn give the market sight of the types of investments that could be considered.

Franchise Scale

4.39 It has been argued that there are benefits to be gained from merging some franchises for future competitions to gain economies of scale. However, in my view these benefits need to be balanced against the case for maintaining a good number and range of franchises with varying sizes and geographical types. This provides useful comparators and makes access to the market for newer entrants more feasible. There will be a case for some franchises to be reconfigured if market developments show this to be sensible, particularly in the context of devolution. However, the creation of a number of super franchises would make each one in its own right pose a substantial level of market risk both to the bidders and to the Department.

Management Contracts

4.40 A number of parties have suggested to me that management contracts, or operating concessions, should be considered as an alternative to franchising. The examples of London Overground (LOROL) and Merseyrail are most frequently quoted as successful operations where revenue risk is retained by the franchising authority and the operator is focused primarily on cost and service quality management.

4.41 With the exceptions I describe below, I do not consider management contracts or operating concessions to be appropriate alternatives for the majority of franchises. For such contracts to work the franchising or concessioning authority must have the capability to market services, sell tickets and collect revenue. This is the case for both LOROL and Merseyrail, where both Transport for London (TfL) and Merseytravel have the necessary capacity, with their own in-house marketing teams and ticketing and travelcard systems. This is not the case for the majority of rail franchises, where the only organisation able to market and sell is the franchisee itself. Moreover, leaving revenue risk with the franchisee has proved to be a powerful incentive to grow passenger revenue and patronage, which it would be foolish to lose.

4.42 There is a rather better case for management contracts where a franchisee is facing major and sustained disruption because of infrastructure works, and where revenue growth will be less important than maintaining services through the disruption. This situation requires the franchisee to be more of a delivery partner, working closely with Network Rail and others to minimise the impact of the disruption on passengers, and helping ensure on-time and within budget delivery of the investment programme. A management contract is likely to be a more suitable means of procuring an operator in this situation, with revenue risk only partially passed to the operator because of the difficulty of forecasting and retaining revenue through the disruption period. I note that the previous West Coast franchise was converted to a management contract for a period from 2002 to 2006, whilst the West Coast Main Line upgrade project was completed. The upcoming Thameslink, Southern, and Great Northern (TSGN) franchise is likely to be most suitable for such a management contract arrangement.

4.43 Likewise if further franchises are devolved to TfL or Passenger Transport Authorities outside London, as I recommend in chapter 5, there may be a case for further management contract type arrangements.

Summary

4.44 I believe that the package of adjustments to the structure of franchises that I have recommended in this chapter will allocate risk in an appropriate way, incentivise franchisees to focus on what they can best manage, and so deliver better value for Government.

4.45 The combination of shorter initial franchise terms, protection from exogenous revenue risk, and parent company support and bonding proportionate to endogenous revenue risk, will together greatly reduce the scope for bidders to ‘game’ franchise competitions by overbidding and allow the Department to dispense with the need to risk adjust bids for revenue risk.

4.46 The removal of the majority of exogenous macro-economic revenue risk should enable bidders to bid lower profit margins and should encourage them to focus more on the cost lines of their bid in order to differentiate themselves. Both of these outcomes would increase value for Government.

4.47 Overall the package should also make franchise payments more predictable. Whilst the GDP/CLE mechanism I propose would result in annual adjustments to premia/support payments, these adjustments would be more predictable than the large swings that have been experienced in the past when the ‘cap and collar’ mechanism has kicked in, or a franchise has defaulted.

4.48 I believe also that these structural adjustments will provide a sharper set of incentives for franchisees to deliver what Government is seeking, through incentivising revenue growth, incentivising performance, and forcing a greater focus on the cost lines in bids. I explore how some of these adjustments would work in further detail in chapter 6.

5 FRANCHISE PROCUREMENT

5.1 The Laidlaw Inquiry pointed to a systematic failure of the Department's procurement approach on the ICWC competition. My Review was tasked by the Secretary of State to look at how the Department should structure the bidding and evaluation processes including the evaluation of the risks of different bids.

5.2 What the Laidlaw Inquiry identified were numerous inadequacies in the ICWC competition, particularly in relation to inconsistent planning, an opaque procurement process, and the ways in which civil servants, lacking in commercial capabilities, acted outside their authorities or outside the agreed procurement framework.

5.3 In this chapter, I will look at the franchise competition life cycle and make recommendations on how the Department could simplify its approach at a number of stages, giving greater clarity to bidders and facilitating the more transparent risk transfer and capital requirement structure that I described in chapter 4.

Devolution

5.4 The first question to ask when planning a franchise competition is who should undertake the procurement. The principles of localism, devolution and integration underpin much of what Government is trying to achieve and this applies equally to the rail industry. Franchising of passenger rail services has already enabled the seamless devolution of parts of the railway including those operations now specified and procured by TfL, Transport Scotland, NEXUS and Merseytravel, with Wales and Borders also largely specified and managed by the Welsh Government.

5.5 The experience to date of all these franchises has been very positive. **I therefore recommend that Government should plan to devolve responsibility for further English franchises to the relevant authorities.** There is already active interest from the northern PTEs, and from Centro, the West Midlands PTE, to take responsibility for services in these areas. There may also be additional inner suburban services within London that could be devolved to TfL, as well as those which will pass to the new Crossrail operator. In the same way that franchises ensure rail services are managed by organisations close to their markets and communities, so the task of procuring and overseeing franchises should logically sit with those authorities closest to the communities and cities served.

5.6 Devolution of responsibility for further franchises will clearly require a phased approach, to give time for the acquiring authorities to develop experience and capability. In certain cases some remapping of franchise boundaries will be necessary, which will require careful planning to integrate this with the wider franchising programme. It is likely that in the first instance the Department will need to jointly procure the newly devolved franchises, with the relevant Transport Authorities. In doing this the Department should seek to utilise the existing capabilities of the devolved authorities as far as possible, for instance to lead consultation pre-ITT, helping relieve its own workload.

Specification

5.7 There have been many changes over the years in relation to how franchises are specified to achieve Government's objectives within its budgetary constraints. A key challenge lies in the trade-off between a tight specification which leaves little room for innovation by bidders but makes it easier for the franchising authority to evaluate bids; and a looser specification which invites innovation by bidders but which requires a greater degree of industry and commercial expertise to evaluate.

5.8 There have been some welcome moves towards output-based specification in recent competitions; this should now be taken further. Franchising should not just be about the best NPV, but also about improving long term franchise value through sustainable plans to increase patronage and improve passenger satisfaction throughout the life of the franchise. Inputs should be specified only for very specific purposes, for example to protect socially necessary and economically important services or realise the benefit of Government investment.

5.9 The train services the Department wants to procure are at the heart of the franchise specification. Whilst there will always be pressure from passengers and communities served to protect existing services, it is important that train service requirements are constructed in such a way as to give flexibility to bidders to offer more resource efficient ways of delivering them, for instance by allowing flexibility in the distribution of stops between different service groups operating on the same route.

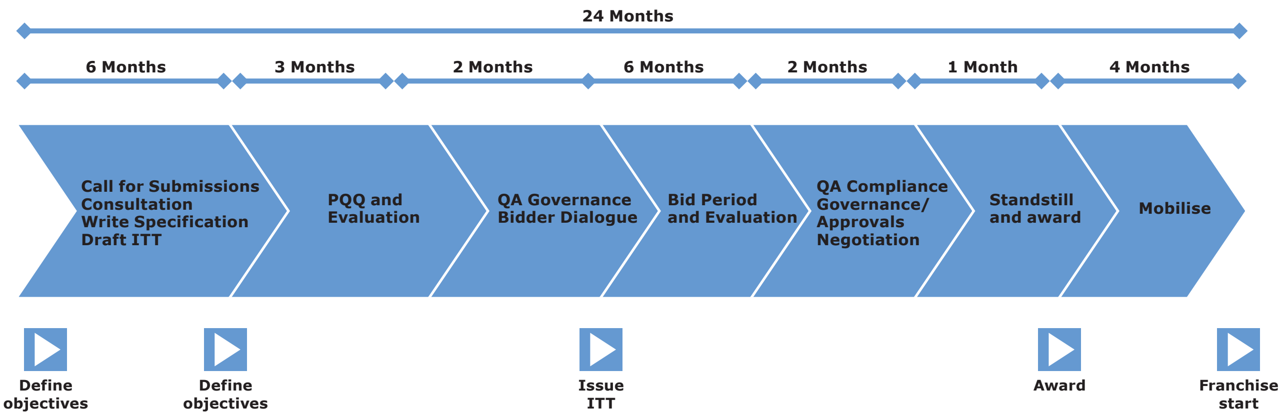
5.10 Likewise the specification of standards for crowding and passengers standing is a key issue for commuter franchises in London and other cities and some sections of intercity routes. **I recommend that the Department engage with the industry on a franchise by franchise basis to agree the framework for specifying Train Service Requirements, including a capacity plan, and crowding standards in such a way as to give flexibility to bidders, whilst also protecting minimum essential service levels for passengers.**

The Procurement Process

5.11 In strengthening its franchise procurement process the Department needs to give proper recognition to the size and complexity of the contracts it is awarding. **I recommend that the Department should plan franchise competitions to follow an indicative 24 month timescale,** as illustrated in Figure 3. This covers the whole procurement cycle from initial decision to re-tender a franchise, through stakeholder consultation, production of the franchise specification, to award of the franchise and the new franchisee taking over. It gives sufficient time for planning the individual procurement process, quality assurance and contingency, all of which were issues found by Laidlaw to be lacking in the ICWC procurement. It also provides a framework which will encourage early policy development to be carried out with rigour and to meet the procurement process timescales, picking up on one of the specific concerns of the NAO.

5.12 As the Department rebuilds its franchising capability this timescale might be shortened modestly, but I consider that in planning terms it is better to be cautious than over optimistic and 24 months is a pragmatic planning assumption. The timescale will also be capable of being shortened for the franchises which have already been the subject of much preparatory work, such as ICWC when it is re-tendered, and TSGN, or lengthened when contemplating remapping or devolution. Figure 3, below, sets out how such a timescale might work.

Figure 3: Elements of the Procurement Process



5.13 Many of the phases in Figure 3 are not new, but the timeline gives significantly more emphasis to initial consultation, working up an effective set of specifications, drafting the ITT and dialogue with the short-listed bidders to further refine the proposition. I believe it will streamline the process, make it more understandable for bidders and so improve the ability to offer better value for money for Government and for passengers in their final bids. It will also help the Department in how it structures and resources its franchising programme, which I address in greater detail in chapters 7 and 8.

5.14 The Department should regularly seek to inform the market about upcoming competitions through the issue of Prior Information Notices (PINs). This would be followed by engagement and consultation with stakeholders, passengers and the industry, culminating in the production of a draft ITT. By establishing the specification and commercial propositions at this stage of the process the Department can then confidently issue an Official Journal of the European Union Notice (the OJEU) to signal the start of the competition.

5.15 Following issue of the OJEU, interested parties will seek to pre-qualify. In my view the current pre-qualification process adds unnecessary duplication and costs when considered with the other steps bidders have to subsequently go through. **I therefore recommend that the Pre-Qualification Questionnaire (PQQ) should be purely backward looking**. By this I mean that it should be concerned with assessing the financial strength of the bidder and its technical ability to perform the contract, including as evidenced by its proven competence based on past performance (whether in the rail industry or on comparable large, public sector delivery contracts) to deliver the objectives of the franchise. To aid this simplification, I recommend that the Department removes the Vision section from the PQQ stage.

5.16 **Once the Department has short-listed its bidders for a franchise competition, I recommend that the Department opens the electronic data-site for that competition and makes available the draft ITT which it has already developed.** This will allow dialogue between bidders and the Department on specific areas such as the calibration of the GDP mechanism, the train service specification and the quality measures to be applied in the evaluation and in the contract. The Department should not be seeking to finalise the ITT without engaging meaningfully with bidders. This phase will allow the Department to not only test its proposition with the market, but will also provide Ministers with assurance that their policy outcomes are deliverable.

5.17 **I recommend streamlining the ITT, removing any elements relating to competence (already tested in the PQQ), any standard industry process descriptions, or evidence of compliance with statutory obligations which are tested by other bodies**. This should also reduce the number of delivery plans being sought from bidders, making them concise and focused on the hard evidence needed to differentiate between bidders' approaches and proposed outcomes. There should be no more than 8 such plans and they should be tailored to demonstrate how the bidder proposes to deliver the objectives of the franchise.

Running a Disciplined Competition

5.18 It is essential that when both the draft and final ITTs are issued, the Department also issues the template form of the expected Franchise Agreement. **I recommend that as each new Franchise Agreement is prepared it is reviewed to remove unnecessary details and process such as that covered by industry regulation or by legislation.**

5.19 As part of my Review, a number of industry parties have raised concerns about issues with late or missing data being provided to bidders on a number of competitions. This threatens the integrity of a bidding process. **I recommend that the Department takes steps to strengthen and clarify the Franchise Agreement, in relation to the requirements on an incumbent to provide timely, accurate and appropriate data.** The population of the data-site with specified incumbent data should be substantially complete at the time the Department announces the shortlist.

5.20 **The Department should also have sufficient, capable resource to actively manage the commercial dialogue with the bidders both pre and post-ITT publication.** It is not acceptable for clarification questions to go unanswered, or for bidders to be unclear about the basis on which the contract award decision will be made.

Bid Evaluation

5.21 Up until now the Department and its predecessor authorities have let franchises purely on the price offered by bidders, as measured in the NPV of the premia or franchise support payments offered. In theory quality is also evaluated by a 'funnel' mechanism, when NPVs of leading bids are sufficiently close together for quality scores to come into play. In practice, however, the winning NPV has always been far enough apart from the next placed bidder, so that the funnel has never been used and quality has never been a determining factor in selecting the winning bid. In this respect the Department is an outlier in the range of both public sector and private sector procurement approaches. In most major procurements, criteria other than price are also used in bid evaluation. Crossrail, for instance, has let its many construction contracts with price accounting for less than half of the evaluation weighting. After letting franchises purely on price it is not entirely surprising that there have often been criticisms of franchisees' subsequent service quality.

5.22 The comparison between bids and the assessment of Value for Money should continue to be based on the projected NPV of contracted premia or support payments. The Department should not accept any mark-up of the contract that affects the value of the risk transfer and there should be no adjustment for contractual risk.

5.23 The NPV should continue to be calculated using the Government's test discount rate applied in nominal terms to nominal cash flows (i.e. after allowing for projected inflation).

5.24 **I recommend that there should be an overt and direct weighting given to quality and deliverability in bid evaluation, replacing the current funnel mechanism.**

5.25 Quality should cover a range of attributes offered by bidders, and be articulated on a franchise by franchise basis linked to the specific objectives set for each franchise. These attributes could include proposals to maintain or improve individual passenger satisfaction scores, as measured by the NPS undertaken by Passenger Focus, proposals for investing in training, developing and engaging the franchise workforce, and proposals for non-commercial investment (for instance in station facilities). It should also include the bidders' approach to managing the franchise and developing partnerships and alliances with other industry parties, particularly Network Rail, and the Department itself. Different franchises will have different priorities and the weighting given to quality will vary. For instance intercity franchises already have greater incentive to deliver quality via passenger revenue earned, whereas regional franchises will have less farebox incentive to deliver quality, so are likely to need a higher weighting given to quality in bid evaluation. For each franchise competition, the Department should consult on the most appropriate basket of quality attributes before finalising the ITT.

5.26 **Deliverability should also be explicitly scored in bid evaluation.** This is an important verification of bid robustness in relation to bidders' plans. Together with the measures I have set out in chapter 4 to reduce bidding risk, by reducing the initial franchise term, not passing exogenous revenue risk to franchisees, and requiring proportionate parent company support, scoring deliverability is an important further means of reducing risk to Government in its choice of winning bidder. **As part of the evaluation of deliverability, the Department should test the credibility of the bidders' proposals including whether sufficient resource and capacity is being provided to support the level of revenue proposed.**

5.27 The Department's evaluation process already includes detailed scoring of a number of specific Delivery Plans produced by each bidder. However, because the funnel mechanism has never come into play, these scores are only used for a pass/fail test, a fail score leading to that bidder being ruled out of the competition. **I recommend that the required Delivery Plans are restructured and reduced in number, aligned with the quality attributes being sought and the need to test deliverability of the financial offer, and their scoring then used as the basis for the quality and deliverability score and in combination with the financial score determine the final award.** There would continue to be a pass/fail criteria for deliverability scores – so, if a bidder failed to demonstrate clearly how it was going to deliver its revenue and cost forecasts, it would not be considered further.

5.28 The proposed Financial Assessment confirms the affordability of the bid, the value for money of the bid, that the capital requirements have been met and that the financial strength of the parent has not deteriorated materially from PQQ. If bidders pass such an assessment, there should be a test of whether their proposals show an appropriate level of financial robustness so that the Department can satisfy itself that the bidders' proposals do not pose unacceptable probabilities of default.

5.29 This robustness test could be based on assessing a number of scenarios and financial variables, including economic growth[13], revenue elasticity, and incremental demand and costs.

5.30 To support a transparent process, the variables to be used should be set out in the ITT. The ITT should also specify what implied probability of default the Department would regard as acceptable and how this will be assessed. On the basis of this assessment, bids could be accepted or rejected.

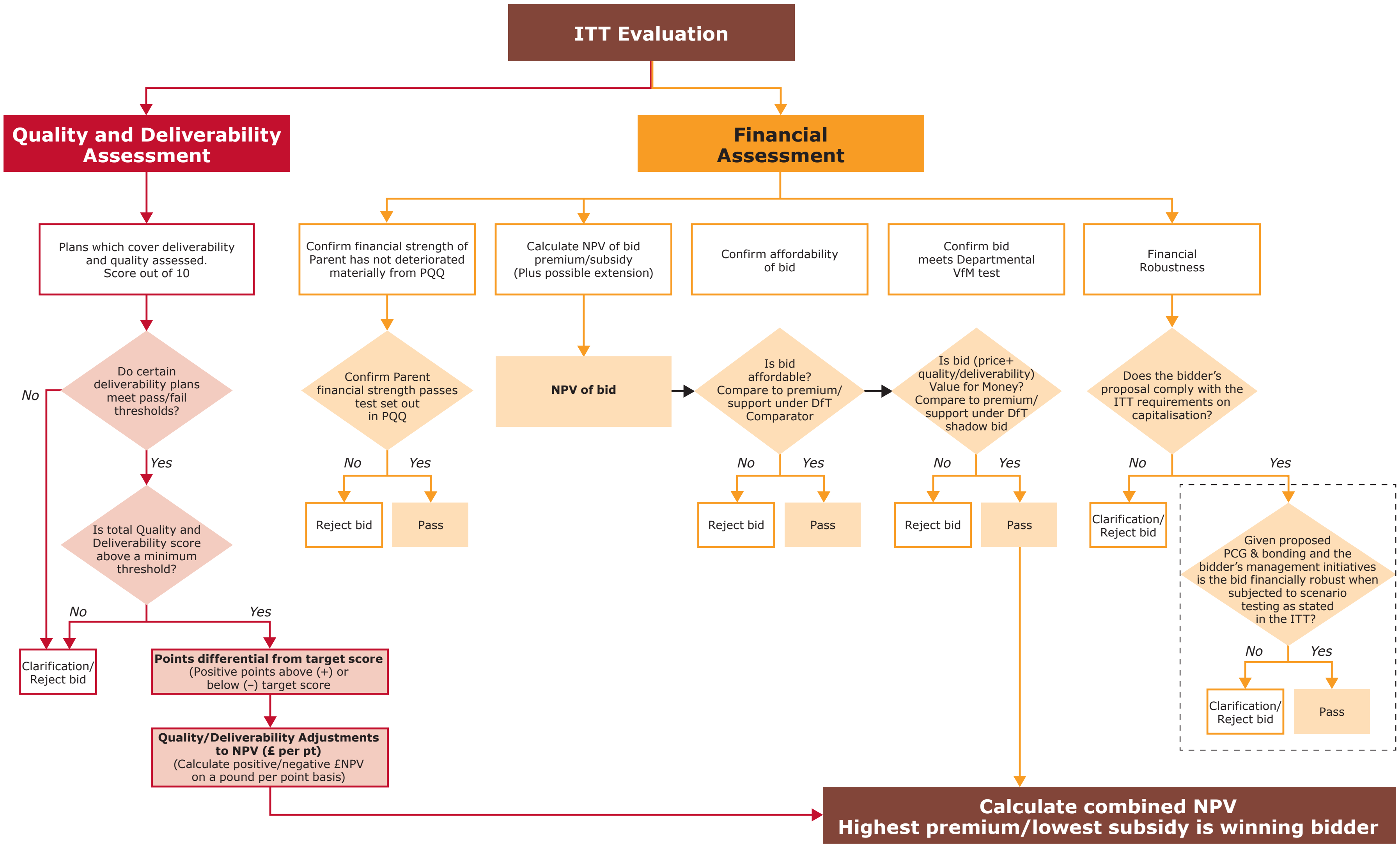
5.31 Following paragraph 4.25 I believe that the approach proposed on deliverability and financial robustness supports the Department no longer having to carry out a revenue risk adjustment as part of the Financial Assessment.

5.32 Together, the Quality and Deliverability, and Financial Assessments provide a means of ranking the bids. The Quality and Deliverability score should be converted into an NPV amount on a pound per point basis and then combined with the NPV of the bid from the Financial Assessment. Bidders will then be ranked on their combined NPVs.

5.33 The calibration of delivery plans and the overall weighting given to quality and deliverability need to be specified in the ITT, as do the quality attributes being sought and the methodology for assessment. I envisage the overall weighting given to quality and deliverability being in the range 20-40% of the final evaluation, depending on the franchise. Figure 4 illustrates how this revised evaluation process might work.

[13] Even though the Department retains exogenous revenue risk, the bidder may also propose management initiatives that assume levels of economic growth

Figure 4: Illustrative Evaluation Process



5.34 It is inevitable that procurement exercises of the size and scale of franchise competitions will involve judgement being applied. But this must be done transparently and on a basis that is supported by objective reasons and is non-discriminatory with the Department identifying explicitly where it sees judgement being applied so that bidders are aware of the approach to evaluation and award that the Department intends to take.

Securing Passenger Satisfaction

5.35 I noted in paragraph 3.17 that the needs and expectations of passengers could be given much greater attention in franchising. **I recommend that the NPS is used more widely both to set quality standards and objectives for bidders on a franchise by franchise basis, and to measure outcomes once franchises are let.** NPS scores directly reflect what passengers say and feel about their train service, on a range of detailed attributes, and the Survey has built up strong credibility as being objective and statistically robust. **To improve its usefulness further I recommend increasing NPS sample sizes, to give reliable measures of performance at service group level, not just at overall franchise level.** This will ensure NPS scores more closely reflect actual passenger experience, which is likely to vary significantly between service groups within the same franchise. To ensure franchisees are incentivised to maintain and improve NPS scores I recommend that attainment of contracted passenger satisfaction levels be a criteria in franchise extension and extending the mechanism included in the Southern franchise to other franchises, which requires the franchisee to invest in agreed 'passenger dividends' if it fails to achieve agreed NPS scores. The efforts already made in the industry to use mystery shopper and satisfaction audits should also be further developed.

Franchise Award

5.36 Franchise award needs to be managed within the construct of an improved governance process by the Department. The lessons from ICWC are that the Department needs to establish a clear governance and assurance framework for each individual competition and the Department's response to the Laidlaw Inquiry sets out its initial thoughts on how it will do that.

5.37 One specific area of governance and assurance that needs addressing is the anonymisation process that the Department has been employing on franchise competitions. How the Department sought to apply this was ultimately counter-productive, with senior officials and Ministers effectively precluded from the decision making process.

5.38 **I recommend that anonymity may be an appropriate mechanism for people who are carrying out detailed technical evaluations of the bid, but that once decisions are being considered by the appropriate, senior governance body, anonymity is not desirable.**

Negotiating the Franchise Agreement

5.39 The product at the end of the procurement process is a Franchise Agreement. These are necessarily complex documents, but the Department should be reviewing the Franchise Agreement each and every time it commences a competition to see where it can be simplified further. This exercise must commence with the start of the 24 month competition life-cycle.

5.40 The Department needs to ensure that it has sufficient external advisers to support the procurement process and the final negotiation stage of the competition which converts the winning bidder's proposals into contracted commitments. These are hugely valuable and complex contracts and the Department's negotiation lead needs to be credible with the bidders and commercially capable. I will provide further thoughts on the type of people needed in chapter 7.

Summary

5.41 In this chapter I have set out for the Department a number of recommendations which I believe will not only rectify problems seen on the ICWC competition, but support clearer and more robust procurement processes which promote active, mature engagement with the market. But to deliver such a process, the Department needs to address the organisational and resource issues which both the Laidlaw Inquiry and NAO have highlighted and I will provide further thoughts and recommendation in these issues in chapter 7.

6 FRANCHISE MANAGEMENT

6.1 The way that the franchising authority manages the franchise once let is as important as the way it is procured, in obtaining the best outcomes for Government as well as for passengers. A commercially experienced and confident franchise management capability, able to work in partnership with franchisees to agree appropriate changes and improvements to the franchise is essential. This is neither unique to rail franchising nor a new idea and was well described in the 2008 NAO report[14] into rail franchising, but it is something that rail franchising has struggled with.

6.2 This has been due in part to the fact that franchises are lengthy and complex contracts and it is inevitable that Government and bidders are not going to be able to anticipate all of the changes that are likely to happen. Moreover, protection of taxpayers' interests will always be a key priority for Government, and this may constrain its appetite or capacity for innovation.

6.3 This chapter suggests steps that can be taken during the term of the franchise, starting with specification, to create an enabling environment in which contracts can accommodate changes required by Government and those proposed by franchisees. It also looks at how franchisees need to be working in partnership, not only with the Department but with other parts of the industry to deliver better outcomes and improved efficiency.

Flexible Specification

6.4 In my view, the more detailed the specification, the less opportunity there is to harness franchisees' skills and abilities to innovate in pursuit of better outcomes. As set out in chapter 5, there should be scope in the procurement process for meaningful dialogue with the industry prior to the issue of an OJEU Notice to obtain industry input into how train services can be specified and where there can be greater flexibility in the specification for operators to bid efficient solutions. Once the winning bid is identified, elements such as train service requirements, capacity, and crowding proposals will need to be clearly contractualised. This enables the Department and franchisees not only to monitor delivery, but to provide a baseline for driving value through change.

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[14] http://www.nao.org.uk/publications/0708/letting_rail_franchises.aspx

6.5 In order to track and agree the financial impact of change proposals, it is necessary to have an agreed financial baseline against which changes are evaluated. This should logically be a financial model maintained by the franchisee, based on the original bid model and updated to reflect actual results. **I recommend that a single template financial model is maintained by the franchisee, and used to implement both the GDP/CLE adjustment mechanism and agreed change mechanisms.**

6.6 This approach needs to be shared and owned by both the Department and the rail industry and therefore **I am recommending that the Department develops this template model in collaboration with the Rail Delivery Group (RDG) and other interested parties.**

Government Initiated Change

6.7 During the life of the franchise itself, the principal tool used for amending the contract are change mechanisms. Over time, the change mechanisms have become more complex. The ICWC Franchise Agreement contained an even more sophisticated mechanism to deal with its looser intended contract structure which I believe could have driven greater transaction costs without clear associated benefits. It is important that Franchise Agreements are written in such a way that Government has the ability to make the changes that will inevitably be required over the life of the franchise.

6.8 Where Government is initiating change, it should be able to do so on a straightforward commercial basis. Following my discussions with industry and my Review of the ICWC franchise documentation, **I recommend that Government returns to a No Net Loss/No Net Gain mechanism as existed in contracts prior to 2004 and which still exists in the Chiltern franchise, for any changes it seeks to initiate.**

6.9 To assist Government initiated change on a No Net Loss/No Net Gain basis, it would be sensible for a franchisee to be required to provide an update of its bid financial model with its annual business plan to reflect the current position. This updated model would then form the basis for any changes that took effect in the following year. The updated financial model would also be used to make the GDP adjustments and franchise payments in line with my other recommendations on revenue risk transfer.

Flexibility in Contractualising Investment

6.10 For specific quality improvements and investments that have been included in the winning bid, existing Franchise Agreements include 'committed obligations', contractualising outputs designed to improve the quality of the service and the experience that passengers receive. Where outputs have been explicitly required by Government, these should continue to be contractualised as specified, e.g. smartcard technology.

6.11 Whilst franchisees should be encouraged to offer specific quality improvements and investments in bids, it should be recognised that better solutions may be identified during the term of the franchise, for instance from newer technology. Franchisees should therefore be enabled to implement these better solutions, rather than being narrowly held to the original scheme, so long as this is provided for in the original contract, for example as suggested in the next paragraph.

6.12 Therefore, **I recommend that the Department considers contractualising bidder proposed franchise investments in the same way as it sets out its High Level Output Specification (HLOS)**, the 5 yearly statement from Government about the major enhancements it wants to buy from the rail industry. These enhancements are described as 'specimen schemes'. These investments represent a baseline level of value that Government will buy – but provide the industry with the freedom to deliver different outcomes of equal or better value. Should the bidder find a more efficient or better way to deliver the commitment, it would then have the freedom to do so.

6.13 **I recommend that the Department and industry work together to establish how best compliance can be ensured, in an unobtrusive yet rigorous way**. One example might be the use of annual audits.

Partnership Working

6.14 Most important of all is a mature franchisee/franchise authority relationship which seeks to grow the value of the franchise to the benefit of both parties. Some of the mechanisms in the Franchise Agreements have been designed with the best of intentions but are then under-utilised. From my discussions with the industry, part of the issue is a lack of confidence amongst the franchisees that the Department will consider positively proposals for change or the use of residual value mechanisms.

6.15 To support better partnership working **I recommend that the Department issues a new guidance note – the Department's Approach to Franchise Management - covering all franchises and setting expectations for ongoing engagement**. This guidance would help current and prospective franchisees understand the Department's franchise management ethos and practices, including those set out in this chapter and chapter 4. Some specific areas that this guidance should include are:

- **Residual Value Mechanisms** –as discussed in chapter 4, and specifically addressing what criteria the Department would consider in applying them

- **General Consents** – building on the work already done by the Department and the legacy from the London 2012 Olympic and Paralympic Games, when the Department issued a General Consent to facilitate Special Event Timetables. There are other areas where the Department could set criteria and allow a more mature relationship with its suppliers e.g. in relation to non-material fares anomalies or minor modifications at stations

- **A 'Protected Proposals' provision** - which encourages franchisees to come forward with innovations and which should be renamed 'Franchise Improvement Proposals' to help send a better signal to franchisees. These are proposals from franchisees which will improve the profitability of the franchise and, where the operator innovates or wants to take more risk, for instance to address productivity issues, allows them to seek a greater reward than the standard change mechanism would provide.

Rebalancing the Focus on Whole Industry Costs

6.16 Franchise management should reflect the fact that franchises do not exist in a vacuum. The franchisee should be encouraged to work in partnership not only with the franchising authority but also the wide range of organisations that make up the rail industry. As the McNulty Report and the Government's 2012 Command Paper identified, there needs to be greater cost efficiency in the industry. Both recommended the facilitation of bespoke partnership working schemes, or 'alliances' between franchisees and Network Rail, as one way of achieving this.

6.17 I support Government's approach of facilitating and encouraging such alliances, recognising that differences across the network mean that no one particular model is appropriate. The recommendations in paragraph 4.35 explain how I think this should work in practice. In particular these models should provide appropriate incentives by allowing Network Rail and franchisees to take rewards in return for taking risk. The industry, including the Department, worked together to develop the Wessex Alliance between Network Rail and Stagecoach South West Trains. The aim should not just be to replicate this model, but to build upon it to drive out further opportunities.

6.18 The Department should keep under review how, as alliances develop between Network Rail and franchisees, the Franchise Agreement can continue to facilitate these arrangements. Adopting my recommendation on a simple profit share mechanism in new franchises will be one way of providing better alignment of incentives between Network Rail, the franchisee and the Secretary of State. This will reduce the need for complex gain share mechanisms as the Secretary of State can be satisfied that he will receive 50% of the franchisee's share in the short term, and see the full value of the alliance through reductions in Network Rail's settlement at subsequent Control Periods and better franchise value when it comes to be re-tendered.

6.19 **Government and relevant regulatory bodies, including the ORR, should be working collaboratively with the industry to identify opportunities for alliances, including how these can be extended, such as on multi-operator routes or on programmes of renewals and enhancements**.

6.20 Whilst alliances are one way of encouraging franchisees to share responsibility for industry costs, **I recommend that a full review of the track access charging regime is undertaken in advance of Control Period 6 (commencing 2019).** The purpose would be to ensure that the infrastructure costs to which franchisees are exposed much more closely reflect the true costs imposed on Network Rail by train operations. At the moment franchisees are effectively held harmless to infrastructure costs, their only real exposure being to wear and tear costs, which are a very small proportion of overall infrastructure costs.

6.21 Restructuring track access costs in this way will ensure that franchisees take a more substantial share of infrastructure cost risk, which will be particularly important for franchises operating on multi-user routes, where a deep alliance between a single franchise and Network Rail is not possible.

Summary

6.22 Franchises can only realise their potential value if there is an ongoing and constructive relationship between the franchisee and the franchising authority. The package of recommendations outlined in this chapter, together with those in chapters 4 and 5, are designed to ensure that improvements secured at franchise let can be built upon during the life of the franchise. In particular, they look to sharpen the incentives upon franchisees to focus on infrastructure costs and cost efficiency, and to bring forward additional proposals to improve the long term value of the franchise, during the franchise term rather than just during bidding.

6.23 The recommendations in this chapter all rely on clarity of roles and responsibilities, but will effectively count for nothing without a cadre of experienced, capable franchise managers within the franchising authority. In the next chapter, I explore the issues in relation to the Department's capacity for delivering franchising.

7 DELIVERING FRANCHISING

7.1 The previous chapters demonstrate the requirement for a capable, competent and confident franchising organisation. The Laidlaw Inquiry found that inadequate planning and preparation, poor organisational structures, a weak governance structure, stretched resources, and ineffective oversight within the Department all contributed to the failure of the ICWC award.

7.2 Addressing these issues is fundamental to executing an effective franchising programme. This chapter sets out recommendations in relation to organisational structure and leadership as well as setting out the capabilities required and recommendations for developing and maintaining these. Finally, this chapter discusses longer term structural options for the Government to consider.

Roles and Responsibilities

7.3 The Department's organisation, capability and resource committed to delivering the franchising programme must reflect the scale and complexity of each individual transaction as well as of the programme as a whole. It is worth reiterating the gross contract value of the ICWC franchise over its core term would have been well in excess of £20 billion – a huge contract by any standards. A number of other franchises are of similar scale, on average 3 times the size of those let by OPRAF. To ensure best value from such large contracts requires a sophisticated and properly resourced procurement organisation.

7.4 The Laidlaw Inquiry has reached the same conclusions as I that the Department's organisational structure during ICWC was not appropriate. The Department has also recognised this, and in its response to the Laidlaw Inquiry on 6 December 2012[15] set out some useful first steps.

7.5 **I support the Department's conclusion that it should immediately restructure its organisation so that one senior individual, which I will call the Franchising Director [16] is**

[15] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/16894/response-to-the-report-of-laidlaw-review.pdf
[16] Note: the civil service nomenclature is unhelpfully opaque. In referring to a Director of Franchising, I do not necessarily mean an SCS2 level Director, but use

responsible for specifying and procuring all rail franchises. I consider that the Department is also right to appoint senior figures, or 'SROs' (Senior Responsible Owners), reporting to this individual, for each franchise competition. As with standard project management practice, a dedicated project manager should also support each competition. These individuals need to be kept in their roles for the duration of each competition to ensure continuity of management.

7.6 **There also needs to be a greatly strengthened programme management capability.** Strong programme management is essential to ensure each franchise competition dovetails into the overall programme, including franchises being let by TfL and Transport Scotland. Programme management needs to have close regard to the resource capacity of the Department, and that of bidders, to run several competitions simultaneously, and the coordination of specialist resources which are shared across the teams running individual franchise competitions.

7.7 **The Franchising Director needs to be accountable for delivering the franchising programme as a whole, with the SROs responsible for the successful letting of each individual franchise.** The Franchising Director needs to act as the single "guiding mind" for franchising, able to anticipate potential problems and risks, ensure solutions are developed, or issues escalated when appropriate. Together with the SROs they would oversee each stage of franchising competitions, and steer each step through the necessary approvals processes within the Department. They should have the authority to bring in expert legal, financial or technical advice wherever necessary.

7.8 **Supporting team members need to be dedicated to the franchising programme rather than having it as "add ons" to a day job. And reporting lines, committee compositions and purposes – the foundations of proper programme management – all need to be clear and purposeful, as Laidlaw recommends.**

7.9 I believe **the resulting franchising team should be structured as a discrete organisational unit.** Delivering the franchising programme requires a disciplined process, close adherence to programme timescales and requires a rhythm or production line approach, repeating the same cycle of activity from initial industry and stakeholder consultation, through PQQ to bid

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the term in the sense of the Railways Act 1993, to mean a quasi Chief Executive figure responsible for all rail franchising.

evaluation and award, for each successive competition. The nature of this activity is rather different to the more traditional policy development role of the Department. There should be a mindset of 'continuous improvement', with lessons learned and experience gained from each cycle, used to improve the next one. Continuity of personnel and close liaison between the different franchise teams is essential to this.

7.10 I see the responsibilities of the franchising unit as embracing all those tasks which are repeated from one franchise competition to the next:

- industry and stakeholder consultation pre-ITT
- drafting of the specification and ITT
- ensuring timely filling of the data site for essential bidder information
- drafting the Franchise Agreement
- responding to bidders' questions
- evaluating bids
- negotiating the Franchise Agreement
- steering all of this through the necessary approvals processes
- handing over to the contract management function.

7.11 All of this would of course be undertaken within the wider policy framework determined elsewhere in the Department. An important further task for the Franchising Director will be to provide a point of pressure and push-back to ensure that the necessary policy issues are resolved within the timescales of the franchising programme.

Ensuring the Necessary Capabilities

7.12 However, process structure and governance is no substitute for commercial judgement. And as Laidlaw argued, "organisational structures and governance processes can only go so far in militating the actions of individuals"[17].

7.13 **The capability and experience of the people involved needs to be substantially strengthened.** The most senior

[17] Report of the Laidlaw Inquiry; page 57

individuals need to have the capacity and experience to simultaneously understand the detail and broad purpose of franchising. Most importantly they need to be able to command the respect of bidders and the wider industry, and have the confidence to engage at senior level when appropriate.

7.14 I have already observed that there is a sharp asymmetry between the capability and resources of bidders and that of the Department. **I therefore recommend that the Department brings in a range of experienced individuals, with senior level experience in areas such as procurement and commercial negotiation, finance and programme management.** These individuals should be drawn from the franchise sector itself, and from other sectors or Government Departments. They would bring in the necessary expertise to quickly enhance the Department's credibility and capacity. The Department has relied too much on the legacy of commercially experienced and industry knowledgeable people from the SRA. It has not been successful in refreshing its capability since then.

7.15 **The Department should draw up a capability plan which shows how to use this initial injection of outside experience and skills to develop and grow its own organisation so that as the programme progresses so does the Department.** However, I do see a continuing need for the Department to keep on top of its capability, and therefore recommend an ongoing programme of secondments in both directions between the industry and Department. This will require clear but more enlightened guidelines on potential conflicts of interest.

Scrutiny and Oversight

7.16 **I recommend consideration is given to setting up a small Franchising Advisory Board.** The purpose of such a Board would be to give support and guidance to the Department, as well as to help give reassurance to the bidders and wider industry on the probity of the strengthened process. I see such a Board as drawing expertise from a range of areas, which could include the rail industry, commercial procurement and programme delivery in other sectors. It could provide commercial oversight and audit functions to the franchising programme and also provide a level of assurance to the Secretary of State, the Permanent Secretary and the market that the Department had in place a sound advisory assurance and governance structure to support sensible and sustainable decisions. In the short term the Board could also act as a 'bridge' between the industry and the Department, helping to build more effective relationships.

Structural Options

7.17 In the medium term, **I recommend that the Department gives consideration as to where the newly strengthened franchising organisation is located.** There are three broad options for this.

7.18 The first, as now, locates the franchising unit within the main body of the Department. This is the simplest and quickest and most closely resembles the changes the Department is already making in response to Laidlaw.

7.19 The second option for Government is to set up the team as an Executive Agency. An Executive Agency is a part of Government that is treated as managerially and budgetarily separate in order to carry out executive functions. The Department already has a number of such agencies including Driver and Vehicle Licensing Agency (DVLA), Driving Standards Agency (DSA), Highways Agency and Vehicle and Operator Services Agency (VOSA). This would ensure a very clearly accountable organisation, and would separate the Department's strategy and policy setting role more clearly from the role of delivery. It would not require primary legislation as it would merely receive delegated authorities from the Department and continue to be accountable to the Secretary of State.

7.20 The third option would be a standalone organisation, similar to the original OPRAF model which successfully initiated the franchising process. This model has been suggested by several of the organisations I have spoken to, and would be seen as a way of depoliticising the franchising process as a result of a more detached relationship with central Government.

7.21 A further option which has been suggested is to pass responsibility for franchising to the ORR. However the skill sets required for franchising are very different to those of the ORR. As a regulator the ORR's mode of operation is more one of direction and enforcement, whilst the franchising task is more commercial and requires good negotiating skills. The ORR is already very fully engaged in the next periodic review, and will be subsequently heavily involved in safeguarding access for third party operators on alliances, in addition to its vital safety regulation role. There are no synergies to be obtained. I do not therefore recommend this option.

7.22 Each option has drawbacks. Within option one, it could prove difficult to attract and retain the necessary infusion of new, experienced people within a conventional civil service structure, particularly in a Department whose reputation has been heavily damaged by recent events. It could also be more challenging to enforce the necessary discipline in adhering to timescales and sign-off processes, located within a wider matrix organisation structure.

7.23 Creating an agency, as in option two, creates a new series of interfaces for the Department to manage and would require clear delineation of policy and strategy responsibilities. But it could prove easier to attract and retain the necessary injection of experienced people from the industry and elsewhere, into a new organisation with a clearly delineated mission, and able to establish its own culture and modus operandi. **I recommend that the Franchising Advisory Board structure also be considered if this option is adopted.**

7.24 Option three would require primary legislation to bring about, and could create tensions as a result of the division of budgetary responsibilities between the new Office and the Department. It also needs to be recognised that the Department is now much more closely engaged with the rail industry than it was when OPRAF was in place, with a whole range of processes such as Statement of Funds Available (SOFA), HLOS and major investment programmes directly sponsored by it. A separate OPRAF type organisation would therefore inevitably need to have continuing very close ties to the Department.

Franchise Management

7.25 The first priority is for the Department to immediately strengthen its capability and resource devoted to procuring franchises. However, it is also very important that the Department substantially upgrades its capability to manage franchises once let. Franchise managers likewise need to be commercially savvy and experienced individuals, able to engage confidently and negotiate with franchisees, using the range of change mechanisms to drive further improvements to franchise performance. The skill sets needed for this are very similar to those for procuring franchises, and there needs to be active feedback between the two to secure continuous improvement. **I therefore recommend the Department locates franchise management in the same organisation structure as franchise procurement, and works to similarly strengthen its capability in this area.**

8 RESTARTING THE FRANCHISING PROGRAMME

8.1 The suspension of the franchising programme has been a necessary but unwelcome consequence of the ICWC competition failure. In order to reassure passengers, the rail industry workforce, the supply chain, and the market, **I recommend that the franchising programme should be resumed as soon as is practicable**.

8.2 Resumption of the programme is necessary to enable Government to drive improved value from contracts, and to allow franchisees to support the major programme of investment in the industry planned for the coming years.

8.3 In this chapter, I consider how the Department can restart its franchising programme in the near term, and what actions it needs to take for existing and future competitions including the criteria the Department should be applying to the development of a detailed programme, when it should be published and resourcing considerations[18].

Franchising Powers

8.4 The first step **I recommend is that the Secretary of State should restate how he plans to exercise his franchising powers**. The Franchising Policy Statement published in line with Section 26(4A) of the Railways Act has not been reissued since March 2008. It states how Government intends to discharge its different duties and potential powers when securing passenger rail services and issuing an updated statement would be a first step in reassuring the market, passengers and other stakeholders. It could also include how the Secretary of State would consider devolving responsibility for rail services as appropriate.

8.5 Due to the pause in the franchising programme, the Department is likely to need to take steps to extend a number of existing contracts. In issuing a Section 26 Statement, the Secretary of State should identify the circumstances in which he will consider such extensions, having regard to the applicable EU and domestic law framework. The Department should also ensure it is sufficiently resourced to take forward any such negotiations.

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[18] A list of current franchises is included at Appendix E.

The Forward Programme of Franchises

8.6 I have not sought to produce a detailed programme for the procurement of franchises, as that is a matter for the Department to develop as it restarts the programme, building on the recommendations of the Laidlaw Inquiry and this Review. I am also conscious of the market sensitivity of signalling such a detailed programme, and indeed the market sensitivity of some of my recommendations in this chapter. The Department will need to consider how it manages the publication of my report in relation to specific competitions where the recommendation/announcement could be share price sensitive. My recommendations are necessarily around what steps I think the Department needs to take to get the programme re-started, the criteria the Department should be applying to the development of a detailed programme, when the programme should be published, and what internal resourcing issues they should consider.

8.7 The Department should not attempt a full programme re-start to a timeframe that it cannot resource. In particular, I am mindful that it will take a little time for the Department to grow its internal capacity, given the recommendations in chapter 7.

8.8 Equally important in developing a new programme is the need to take into consideration the capacity of the bidding market. Any timetable would also need to give consideration to the capacity of the market to resource multiple competitions. It is important to note that PINs have already been issued by TfL for competitions on the Docklands Light Railway (DLR) and Crossrail operations, and by Transport Scotland for the Scottish sleeper services. The Department should take soundings from the market and engage with other franchising authorities to ensure that the coming years do not lead to an unsustainable strain on capacity in the market, including on plans for competing the replacements for the Scotrail franchise and the London Overground concession.

8.9 The Department should be building a programme which seeks to smooth the profile of competitions, not only in relation to the number but also the size and type of contracts they are looking to let and in what sequence. The Department has a number of tools at its disposal to help with this, including as regards how it seeks to extend certain current contracts, and the terms of new franchises including potential continuation and extension periods.

8.10 An important assumption for the programme will be the number of contracts that can be let in any one year, **and I recommend this**

programme should stagger the competitions so that the Department is not seeking to award any more than 3 to 4 franchises in any one calendar year. As well as reducing the resourcing burden on the Department and industry, this will allow Government to spread the risk of the volume and mix of franchises let in any one part of the economic cycle.

8.11 As I set out in chapter 5, the Department must have in place a governance and assurance framework to support franchise competitions before it issues any further ITTs or commences any competitive process, and that this needs to be done before Easter 2013. **In light of that, I recommend that the Department publish a PIN outlining its proposed programme by the end of April 2013, allowing time to consider the required variables and consult with industry.** Having more opportunities to compete for the market and better line of sight of the pipeline, will allow a rhythm to be developed and confidence to be rebuilt.

8.12 In particular, the Department must build a resilient programme which reinforces the need for project discipline in the specification development as well as the procurement phases of the competition. A resilient programme must contain contingency to allow for unforeseen issues and delays to be dealt with effectively. **To aid the development of a resilient programme, I recommend that the Department moves towards the modular approach of a minimum 24 month cycle for each franchise competition, as set out in chapter 5, and takes the priority resourcing steps set out below.**

The Paused Competitions

[*Paragraphs 8.13 to 8.20 have been temporarily redacted from this version of the report as they contain specific recommendations about the three live procurements that are potentially market sensitive and on which the Department intends to make an announcement shortly. These currently redacted paragraphs will be published as a Command Paper, Cm8527 Supplement to the Brown Review of the Rail Franchising Programme, immediately after this announcement has been made.*]

Priorities

8.21 The market needs to understand the forward programme as soon as practicable – but it would be damaging to the industry and investor market if there were to be any false start on any of the paused competitions or the announcement of the wider programme as part of a PIN.

8.22 The Department needs to get the right resource in place, establish focused leadership of the franchising programme, fix the governance and assurance framework and deal with any emerging issues from the Laidlaw Inquiry, NAO Report and my recommendations. Based upon the principles of the programme approach I have recommended, including the limitation on the number of franchises, **I see a need for the Department to immediately put in place 4 credible project teams able to progress 4 franchise competitions simultaneously and supported by a bolstered programme office.** The Department should be focusing on having project teams in place who live with a franchise competition throughout that 24 month process, only rotating the resource once the competition is complete. The programme produced by April needs to be supported by a resource plan.

8.23 I will not pretend that these are quick tasks. Drawing my recommendations together, I see the following as the immediate priorities:

- early appointment of a credible leader to the crucial role of Franchising Director
- the Franchising Director taking on ownership within the Department for the implementation of my recommendations
- early announcement of appointments from outside the Department to strengthen its franchising teams and mobilisation of franchise project teams
- by February 2013, an announcement on its plans for the three paused franchise competitions
- by Easter 2013, a full implementation of my recommendations and the Department’s response to the Laidlaw Inquiry
- by the end of April 2013, publication of a PIN covering the whole programme.

8.24 The Department needs to get on with structuring and staffing a focused delivery unit for franchising, with capable and credible resource. There is a huge task for the Department in having a robust, resourced programme in place by the end of April. It requires energy and focus and the support of the industry if the Department is going to act on my recommendations and re-start the franchising programme.

GLOSSARY

CLE	Central London Employment
Control Period	5 year financial planning cycle for Network Rail
Data-site	Virtual data room containing, in electronic form, documents and information specifically relating to the franchise being bid for
DLR	Docklands Light Railway
DSA	Driving Standards Agency
DVLA	Driver and Vehicle Licensing Agency
EU	European Union
GDP	Gross Domestic Product
HLOS	High Level Output Specification
ICWC	InterCity West Coast
ITA	Integrated Transport Authority
ITT	Invitation to Tender
LOROL	London Overground Rail Operations Limited
NAO	National Audit Office
NPS	National Passenger Survey
NPV	Net Present Value
OJEU	Official Journal of the European Union
OPRAF	Office of Passenger Rail Franchising
ORR	Office of Rail Regulation
PAC	Public Accounts Committee
PDFH	Passenger Demand Forecasting Handbook

PIN	Prior Information Notice
PPM	Public Performance Measure
PQQ	Pre-Qualification Questionnaire
Premia/Support	Franchise payments either flow to Government (premia) or to a franchisee (support)
PTE	Passenger Transport Executive
RDG	Rail Delivery Group
ROSCO	Rolling Stock Company
RSSB	Rail Safety and Standards Board
SLF	Subordinated Loan Facility
SOFA	Statement of Funds Available
SRA	Strategic Rail Authority
SRO	Senior Responsible Owner
TfL	Transport for London
TOC	Train Operating Companies
VOSA	Vehicle and Operator Services Agency

APPENDIX A: REVIEW TERMS OF REFERENCE

1. The review should consider the implications for the remainder of the rail franchising programme of the position reached on the InterCity West Coast competition.

2. This review should take careful account of the points and lessons learned identified in the Laidlaw Inquiry and should also consider:

- How to structure risk transfer between the Department and rail franchisees in order to create optimum incentives in the long-term interests of passengers and taxpayers, and the ability to adapt to changing circumstances.

- How to structure the bidding and evaluation processes to ensure a robust and fair competition, including evaluation of the risk presented by different bids as a basis for decisions that take these risks appropriately into account.

- The timing of the remainder of the franchising programme, so that it can be resumed on a robust basis as soon as possible.

3. How the Department can take the learning points from the Laidlaw Inquiry and facilitate a clear and proportionate framework for franchising which balances Government's administrative and commercial judgements with the need for the market to have predictability, transparency and a proportionate application of legal rules.

4. The review should make recommendations on the basis of its findings.

5. The Terms of Reference may be refined further following the publication of the Laidlaw Inquiry. The review shall be completed by 31 December 2012 and published thereafter.

6. The review will be led by Richard Brown, Chairman, Eurostar.

7. The review team should include external expertise as well as expertise from within Whitehall, and some cross-membership as appropriate with the review of lessons learned.

APPENDIX B: REVIEW CONTRIBUTORS

1. The organisations and individuals listed below have met with either myself or a member of my Review team and / or made formal submissions to my Review. In addition, I received a number of contributions from individuals and members of the public.

Abellio Group
Angel Trains
Arriva
ASLEF
Association of Train Operating Companies
Bevan Brittan LLP
British Quality Foundation
Campaign for Better Transport
Carl Sargeant AM, Minister for Local Government and Communities
Crossrail Ltd
Derby and Derbyshire Rail Forum
Directly Operated Railways
Eversholt Rail
First Group
Go-Ahead Group
Govia
Keith Brown MSP, Minister for Transport and Veterans
Keolis UK
London Travelwatch
Maria Eagle MP, Shadow Secretary of State for Transport
Metro (West Yorkshire PTE)
MTR Corporation
National Express Group
Network Rail
Office of Rail Regulation
Oxera
Passenger Focus
Passenger Transport Executive Group
Passenger Transport Networks York
Rail Delivery Group
Rail Freight Group
Railfuture Policy Group
Railway Industry Association
RMT
Roland Berger
RSSB
Serco
Sir Roy McNulty

SNR Denton
South Hampshire Rail
South Yorkshire PTE
Stagecoach Group
The Trainline.com
Trades Union Congress
Transport for Greater Manchester
Transport for London
Transport Salaried Staffs’ Association
Transport Scotland
Unite
Virgin Group
Welsh Government

APPENDIX C: BENEFITS AND SUCCESSES OF FRANCHISING

1. In many ways Britain's rail industry has been transformed in the years since privatisation, and is barely recognisable from the time of privatisation.

2. The industry has undergone a number of significant structural and institutional changes[19], and it is certainly the case that franchising is still seen to have a number of shortcomings and criticisms, many of which are referred to in chapter 2. But it is also important to keep in mind the many successes and achievements of franchising. To only focus on the negatives in determining how to move forward would risk sacrificing the important progress made.

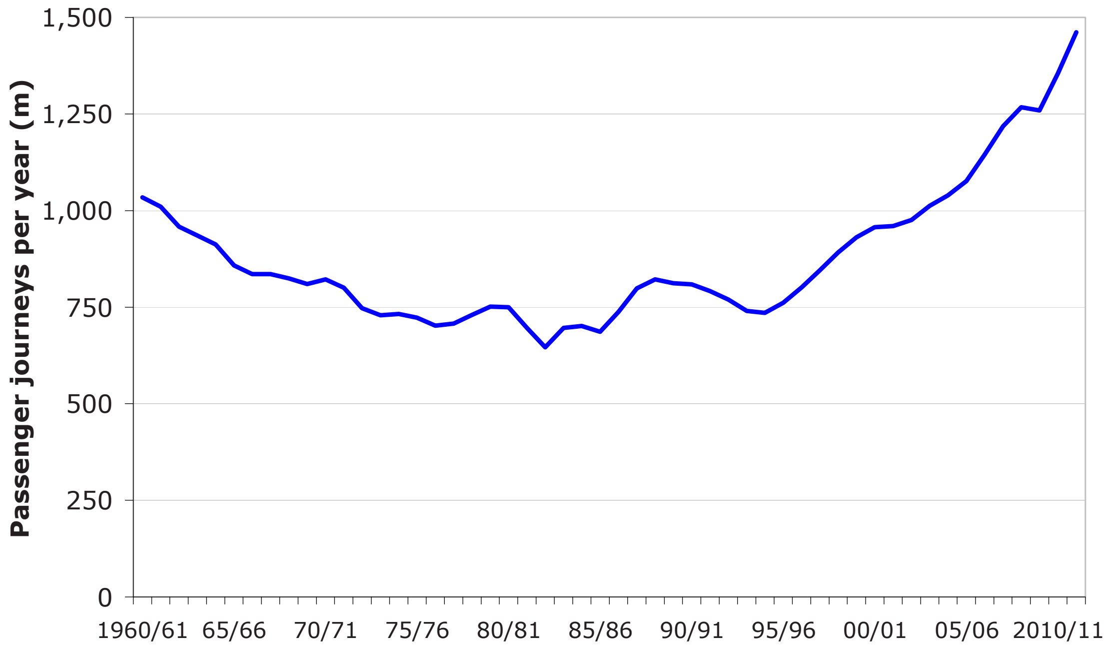
3. To summarise the analysis below:

- Britain's railways are carrying many more passengers, more safely, on many more trains, more of which arrive punctually and satisfy their customers.
- In comparison with other European countries, Britain has seen the fastest growth in passenger numbers since privatisation, is now the second safest network, and passengers are more satisfied with the frequency, speed and punctuality of their services than in many other countries.
- Passenger revenue has grown in real terms in every year since privatisation. Government support for the industry peaked in 2006/07 but has fallen significantly since then. The net amount of support payments to franchisees has also fallen in every year since 2006/07, despite the 2008 recession and increase in revenue support payments.
- Areas of clear passenger dissatisfaction are the ability to get a seat, arguably a problem of success given the large increases in passengers using the railway, and the level of fares.

[19] Appendix F provides a brief chronology of these changes.

Passenger Growth

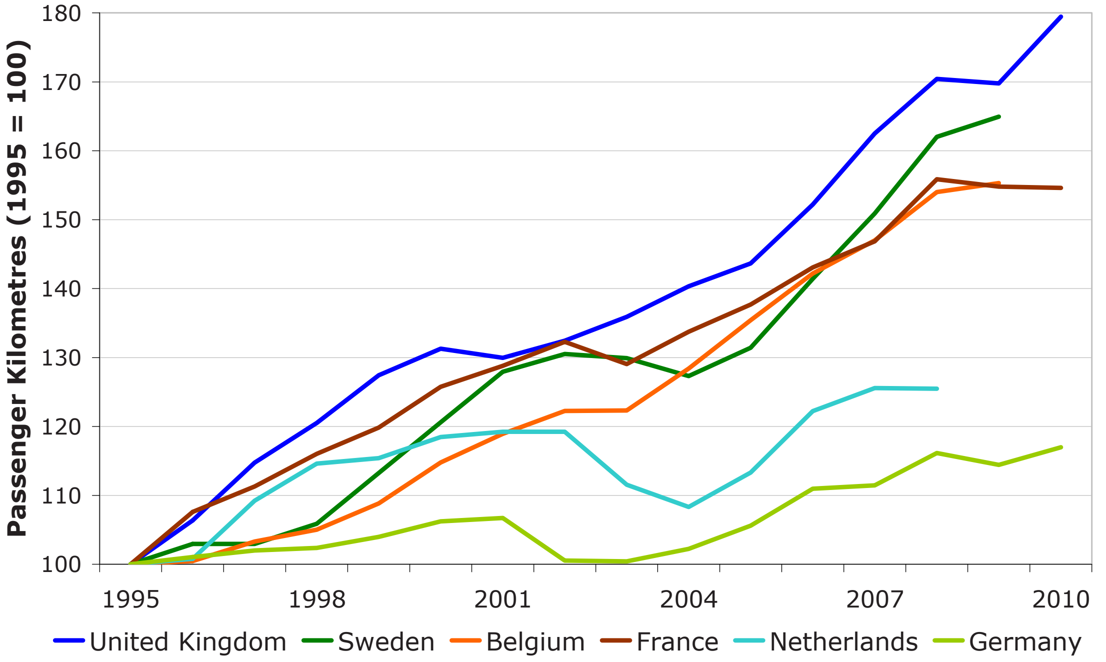
Figure 1: Passenger journeys: Great Britain annual data (millions)



Source: ORR. Passenger journeys are based on data collected from the LENNON ticketing database and, since 2010-11 Q1, quarterly data from each of the train operating companies (TOCs). Previously, non-LENNON data was collected annually from the TOCs.

4. Passenger journeys have increased by 92% since privatisation started in 1995. Passenger kilometres have increased by 91% over the same period. This is considerably ahead of growth in the UK economy as a whole, with GDP growing 43% between 1995 and 2011.

Figure 2: Passenger Kilometres – EU Comparison

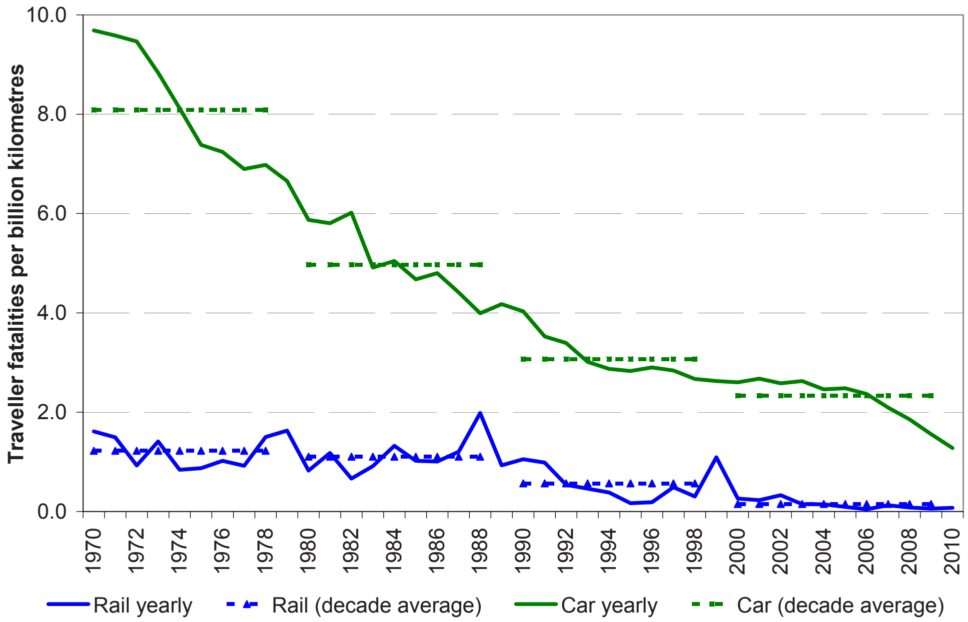


Source: OECD

5. Britain has enjoyed faster growth in passenger usage than any other major European network.

Safety

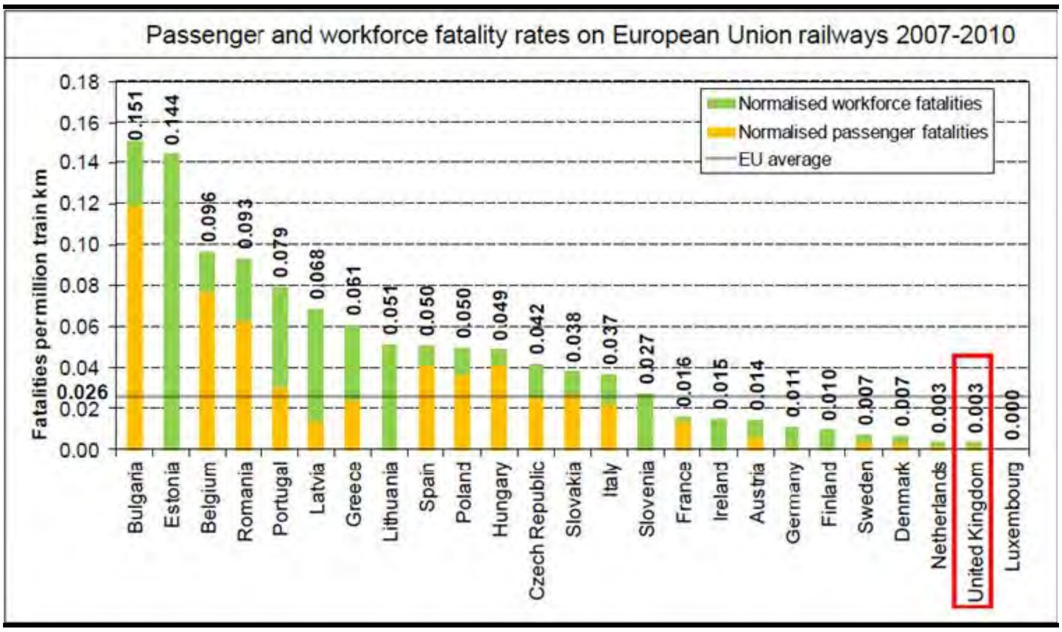
Figure 3: Safety of Rail Travel versus Car



Source: RSSB. The spikes in rail fatalities in 1988 and 1999 are Clapham Junction and Ladbroke Grove respectively.

6. Safety has improved substantially since the Southall, Ladbroke Grove and Hatfield crashes.

Figure 4: Passenger and Workforce Fatalities: EU Comparison

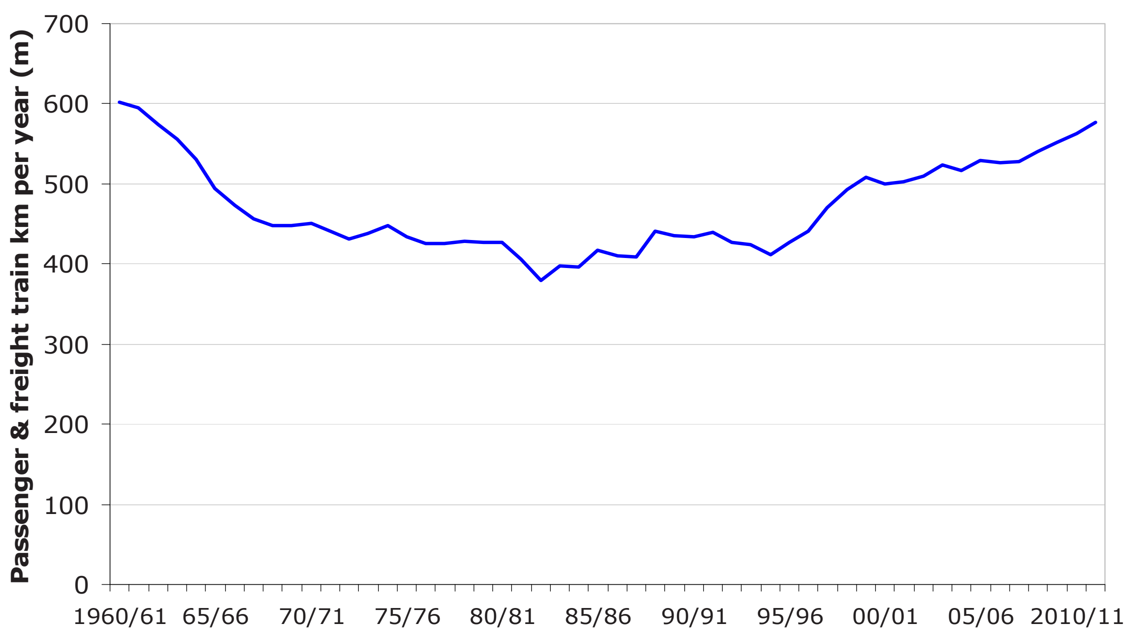


Source: RSSB, taken from http://www.rssb.co.uk/SPR/Documents/ASPR_2011-12_FullReport.pdf

7. The UK now has the second safest rail network in Europe, second only to Luxembourg – a very much smaller network.

Train Operators

Figure 5: Train Kilometres per year



Source: RSSB

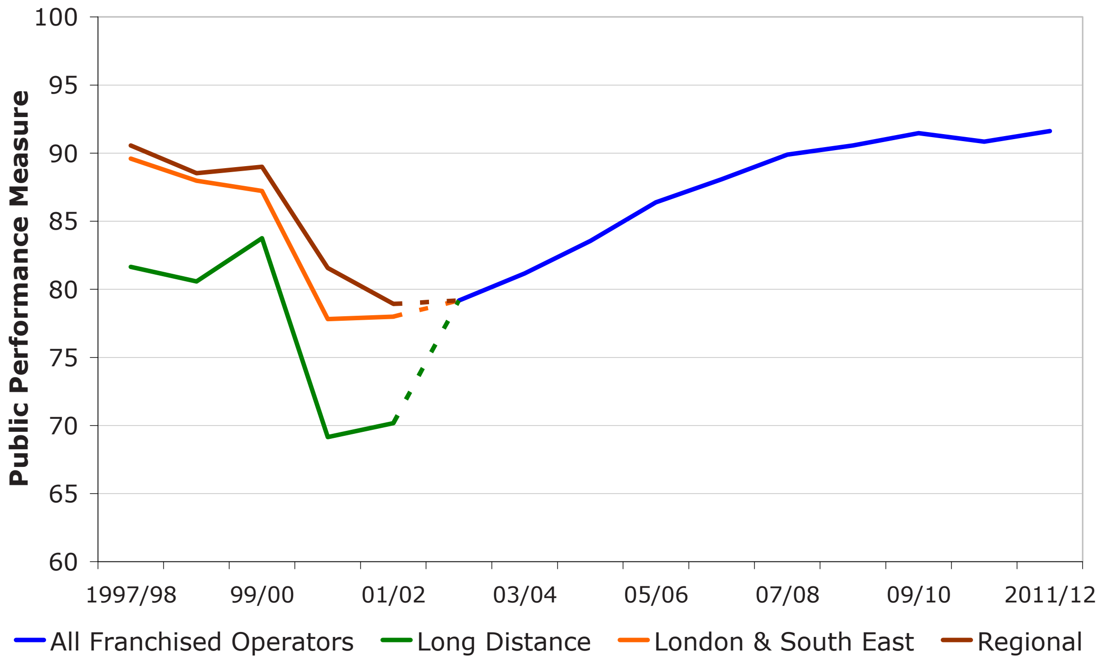
8. Many more trains are being run, with train kilometres increasing by 60% between 1994/5 and 2011/12. This is partly the result of increased frequencies on existing routes, and partly new services being introduced. Frequency has doubled for instance on the Midland Mainline between London and the East Midlands, trebled on Virgin's London-Manchester services to 3 trains hourly, and increased by 50% to 3 trains hourly London-Birmingham.

9. Extensive new services have been provided on the Chiltern network through to Stratford, Birmingham and beyond, through services to London reintroduced from a number of towns and cities which lost them in the Beeching era such as Lincoln and Corby, and new connectivity created such as Manchester Airport to Glasgow.

10. These are but a very selective sample from a long list of new and improved train services introduced over the last 15 years.

Punctuality and Passenger Satisfaction

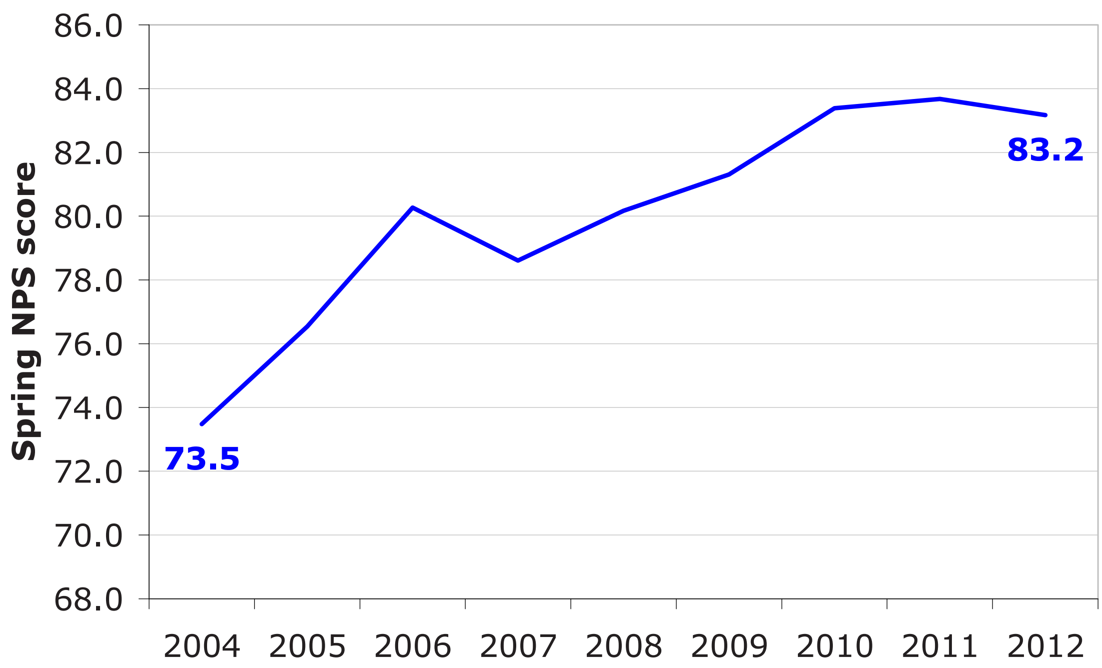
Figure 6: Punctuality



Source: ORR

11. Punctuality has improved substantially since the post-Hatfield low point of 2001. Overall it is now better than at any time in the last 15 years, despite many more trains being operated on the network, with many routes now close to capacity.

Figure 7: Passenger Satisfaction

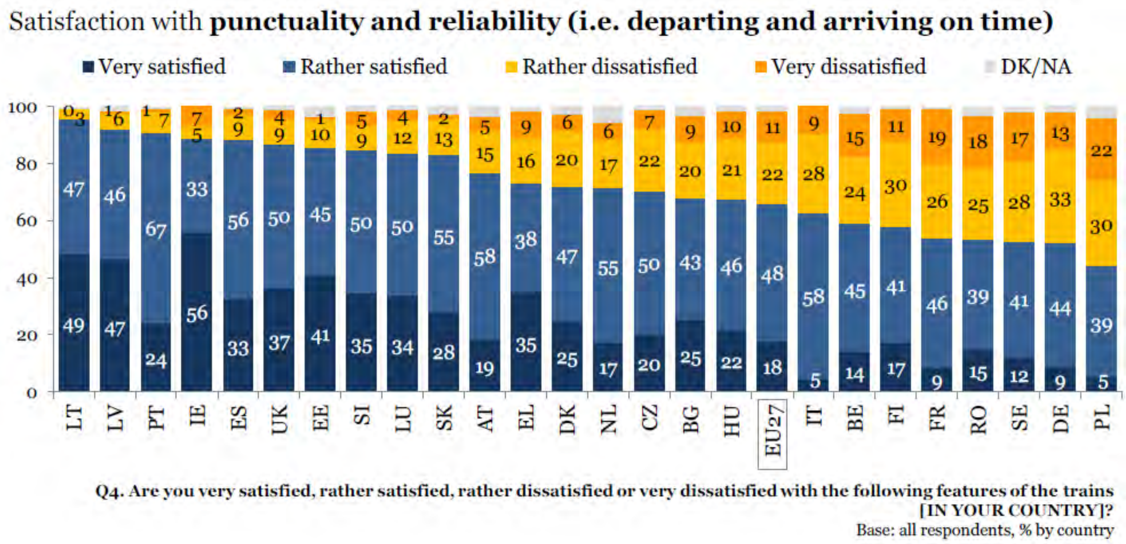


Source: Passenger Focus

12. Passenger satisfaction has improved markedly since the NPS survey was first introduced in 2004, although it has plateaued since 2010.

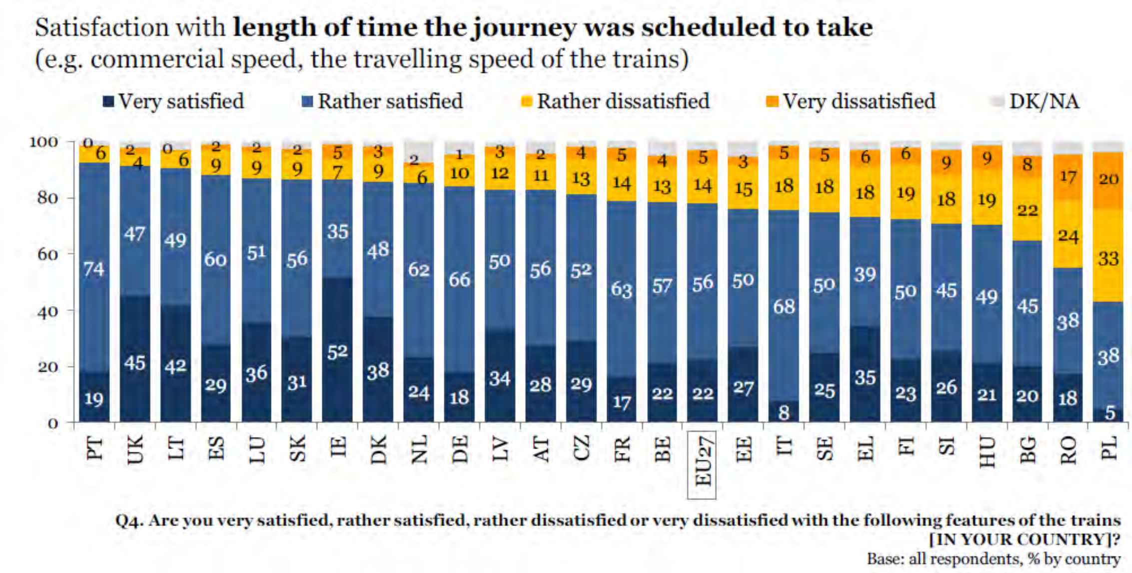
European Comparisons

Figure 8: Punctuality & Reliability



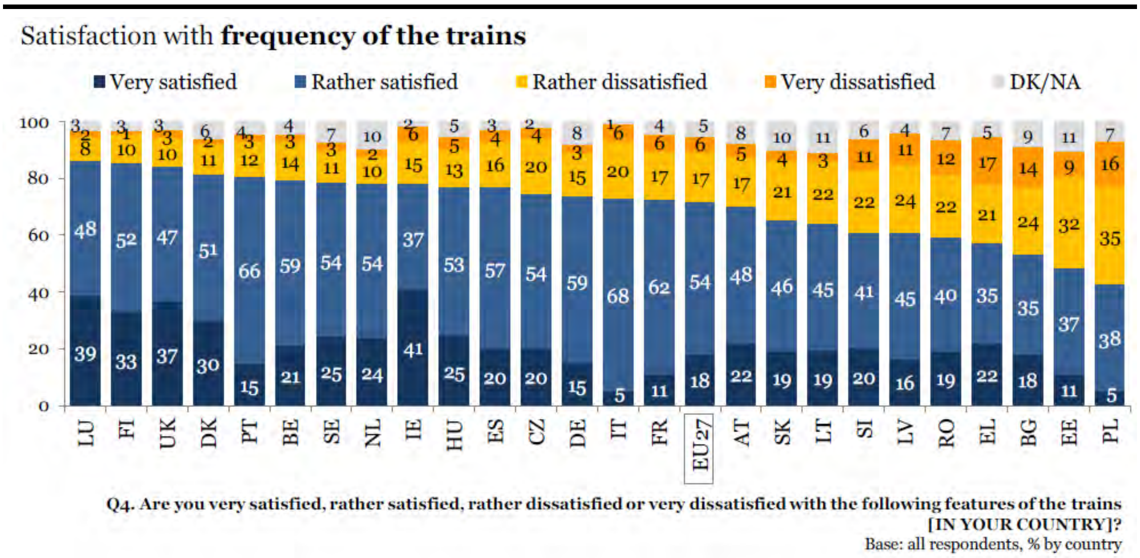
Source: Eurobarometer, taken from: http://ec.europa.eu/public_opinion/flash/fl_326_en.pdf

Figure 9: Scheduled Journey Time



Source: Eurobarometer, taken from:
http://ec.europa.eu/public_opinion/flash/fl_326_en.pdf

Figure 10: Frequency

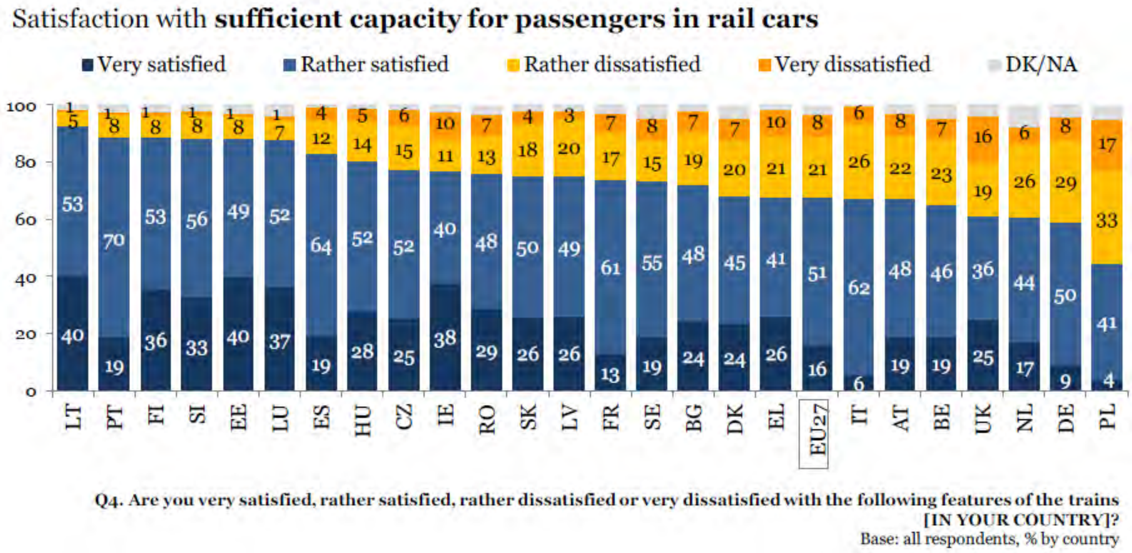


Source: Eurobarometer, taken from:
http://ec.europa.eu/public_opinion/flash/fl_326_en.pdf

13. UK rail passengers show surprisingly good levels of satisfaction with the punctuality, speed and frequency of their train services compared with most other European countries[20].

[20] It should be noted that the figures taken from Eurobarometer contain data which has been rounded.

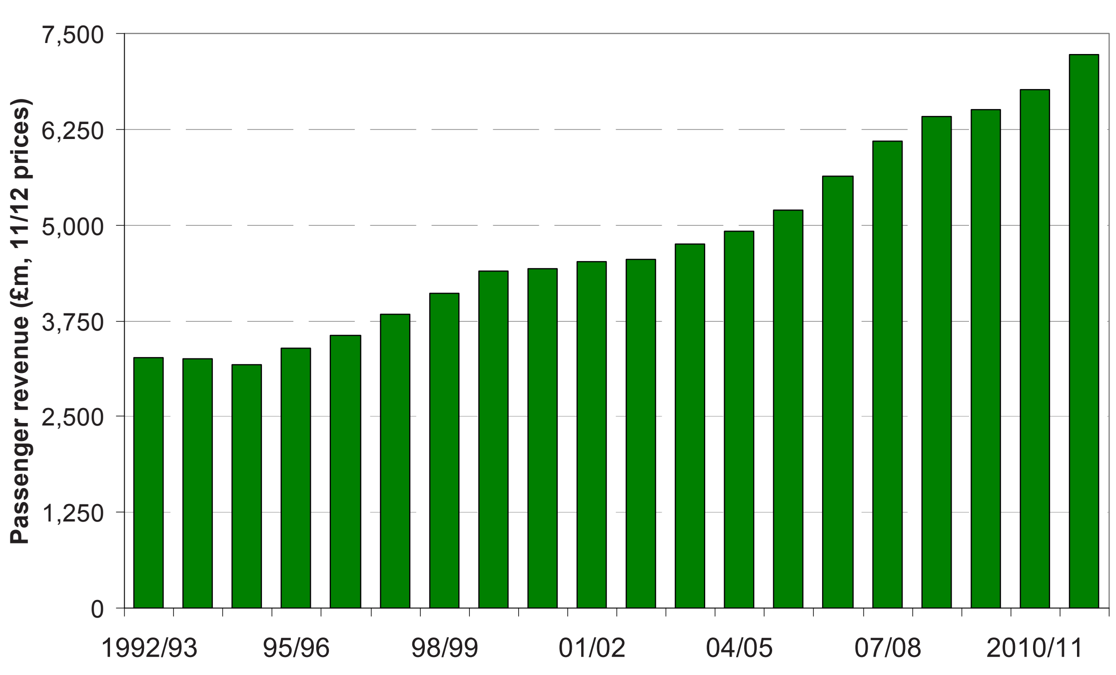
Figure 11: Capacity



Source: Eurobarometer, taken from:
http://ec.europa.eu/public_opinion/flash/fl_326_en.pdf

14. However, UK passengers are some of the least satisfied with the seating capacity of their trains.

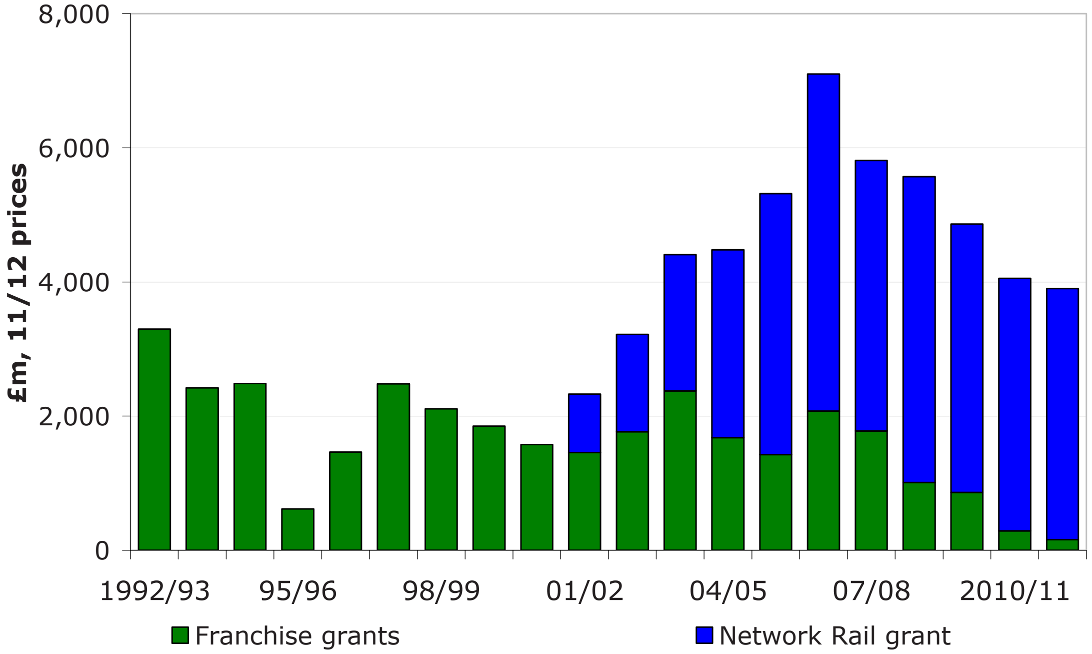
Figure 12: Passenger revenue



Source: ORR

15. Revenue earned from passenger has increased in real terms in every year since privatisation, even after the impact of the 2001 post-Hatfield meltdown in services, and of the 2008 recession.

Figure 13: Cost to Government



Source: ORR

16. Government financial support for the industry peaked in 2006/07, in the middle of Control Period 3. The financial settlement for CP3 included large increases in support for Network Rail, to allow them to catch up with the large backlog of renewals which had grown up under British Rail and Railtrack. Total financial support has fallen every year since 2006/07; support to franchisees has also fallen significantly, despite the 2008 recession and subsequent increase in revenue support payments to franchisees.

APPENDIX D: FRANCHISE CAPITAL REQUIREMENTS

1. The capital requirements in current franchises take several forms. The first, a bond in respect of the value of season tickets, is a sensible industry wide practice and raises no questions. The other major requirements, set by negotiation for each franchise, have hitherto taken the form of:

- A tripartite funding agreement between the franchisee, its parent company and the Department whereby the parent company commits to provide a loan facility to the franchisee if this is required to maintain liquidity, up to an amount that has been in the range of £20m to £100m.

- On-demand 'performance bonds' from a financial institution to protect the Department in the event of any default, which have been in the range £4m to £65m.

2. I consider that the proposal made for the ICWC competition for such large SLFs combined with very significant bonding from financial institutions was unrealistic and likely to be counter-productive. The industry does not have the capacity to provide the level of bonding across the whole of the franchising programme that this would have implied. It is worth repeating that requiring it to do so would restrict competition for franchises and tie up capital which would be better employed in investing in the industry or by owning groups elsewhere in their transport activities. It should be unnecessary with appropriate risk allocation.

3. As I set out in chapter 4, I recommend that the appropriate protections and discipline should be created by the following measures, which are in three parts:

- liquidity requirements to ensure there is cash within the franchise to meet obligations over the next 12 months

- an on-demand bond for each franchise to cover the cost the Department would face in managing any re-let (which should be smaller than the existing Performance Bond and might better be termed a 're-let bond')

- a default indemnity to the Department supported up to a certain proportion by parent company support, and backed in part by some further bonding from financial institutions.

Liquidity

4. The provisions requiring a certain level of liquidity in franchises should continue broadly in their current form but be simplified to focus on a defined ratio of prospective liquidity over the following 12 months, with parent company support as described below.

Season Tickets

5. The current approach to bonding season tickets should continue to apply to new franchises.

Re-let Security

6. There should be an obligation requiring the franchisee, on any default, to pay a fixed amount in respect of re-let costs, which should be specified in the ITT. The amount should be set depending upon the franchise but could be of the order of £10m to £20m.

7. That obligation should be backed by a re-let bond payable on demand in the event of any default and the Department should have no obligation to reimburse to the franchisee any amount in excess of the Department's actual costs.

Default Security

8. Franchisees should also be required to provide a default indemnity in respect of the negative financial impact caused to the Department if they default. This will cover, at least in part, any reduced premium offered or increased support required by a replacement franchisee.

9. The limit on the amount payable under this default indemnity should be specified in the ITT. This will ensure that bidders are aware of their potential obligation from the outset and are able to stand behind it. This limit should be determined for each franchise to reflect its scale and risk. I recommend this should be set at a pre-agreed percentage of the aggregate projected endogenous revenue from management initiatives. This is likely to be in the

range of 10-15% of endogenous revenue, depending on the size and risk of the franchise.

10. The absolute amount which can be claimed under the default indemnity will decline each year as revenue and franchise payments are delivered. The Department should therefore consider specifying in the ITT a floor, at least for the last 2-3 years of the franchise, to ensure that the financial commitment of the parent company does not reduce below an appropriate minimum level.

Parent Company Support

11. There should be (a) a tripartite funding agreement pursuant to which the parent company will be required to inject any funds into the operator that are required to maintain its liquidity at the level required under the Franchise Agreement, and (b) a parent company guarantee in respect of the franchisee's obligations under the default indemnity. The aggregate liability of the parent company under these provisions should be capped at the same level as the default indemnity.

12. There should also be a default bond from financial institutions to cover 33% - 50% of the outstanding amount of indemnity. The bond should cover a rolling 3 year period or the remainder of the contract, whichever is less, and be renewable annually.

Event of Default

13. Any breach in the liquidity ratio, or failure to maintain either bond before its expiry, or failure by the parent to comply with its support obligations, should be an event of default.

APPENDIX E: FRANCHISE TERMS

Franchise name	***Train Operating Company (Owning Group)***	**Start**	**End**[21]
InterCity West Coast	*Virgin Trains (Virgin Rail Group)*	December 2012	November 2014
Great Western	*First Great Western (FirstGroup)*	April 2006	March 2013
Essex Thameside	*C2C (National Express)*	May 1996	May 2013
Thameslink and Great Northern	*First Capital Connect (FirstGroup)*	April 2006	September 2013
Integrated Kent	*Southeastern (Govia)*	April 2006	March 2014
South Central	*Southern (Govia)*	September 2009	July 2015
InterCity East Coast[22]	*East Coast Main Line Company Limited*	November 2009	To be determined
Northern	*Northern (Serco-Abellio)*	December 2004	April 2014

[21] For further detail on the programme and end dates please see the Department's published timetable: https://www.gov.uk/government/organisations/department-for-transport/series/background-to-rail-passenger-franchises

[22] Operated by East Coast Main Line Company Limited and owned by Directly Operated Railways Ltd (a company established by Government) until a new franchise to operate services on the East Coast Main Line is let to the private sector.

Franchise name	***Train Operating Company (Owning Group)***	**Start**	**End**
Trans Pennine Express	*First Keolis TransPennine Express (First Keolis)*	February 2004	Between 1 Apr 2014 and 1 Apr 2015
East Midlands	*East Midlands Trains (Stagecoach)*	November 2007	April 2015
West Midlands	*London Midland (Govia)*	November 2007	September 2015
Cross Country	*CrossCountry (Arriva)*	November 2007	March 2016
South West	*South West Trains (Stagecoach)*	February 2007	February 2017
Chiltern	*Chiltern Railways (DB Regio)*	March 2002	December 2021
Wales and Borders[23]	*Arriva Trains Wales (Arriva)*	December 2003	October 2018

Source: DfT Rail Franchising Timetable as at 1 July 2012 (DfT Website)

[23] Management of the franchise is devolved to the Welsh Government, but DfT is the procuring authority.

APPENDIX F: CHRONOLOGY

1991 EU Directive 91/440 to “to facilitate the adoption of the Community railways to the needs of the Single Market and to increase their efficiency”

1992 White Paper which sets out the proposal to split infrastructure from operations, creating Railtrack to look after the former, and private sector franchises to run the latter

1993 Railways Act 1993

1995 First franchises awarded (South West Trains and Great Western)

1996 First privatised services start operating

1997 Southall Rail Crash

1999 Ladbroke Grove Rail Crash

1999 Shadow SRA created

2000 Hatfield Crash

2001 Railtrack put into railway administration

2001 SRA comes into existence under the Transport Act 2000

2001 SRA proposes creation of single terminal operators, reducing the number of franchises operating into London termini

2001 First EU Railway Package

2002 Potters Bar Crash

2002 Network Rail founded and takes over Railtrack’s functions

2003 SRA terminates Connex Southeastern Franchise

2004 The Future of Rail: White Paper

2004 Second EU Railway Package

2005 Railways Act 2005

2005 SRA wound up and responsibilities pass to Government

2006 Default by Sea Containers on InterCity East Coast Franchise

2006 Public Contracts Regulations 2006

2007 Third EU Railway Package

2009 Public Contracts (Amendment) Regulations 2009

2009 Default by National Express on InterCity East Coast Franchise

2010 Consultation on Coalition Government's proposals to reform franchising (Government response published in 2011)

2011 Publication of McNulty Report

2011 European Commission proposes revision of EU Directives on public procurement and the adoption of a Directive on concessions

2012 Cancellation of West Coast competition

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