Reforming Rail Franchising: Response from Railfuture

Summary

The review of franchise policy offers the opportunity to address the many challenges facing the passenger rail industry:

- The need to reduce overall emissions from transport;
- Encouraging modal shift away from the car;
- Promoting integration with other modes of transport, through better physical interchange, through fares and ticketing, including smartcards;
- Bringing about increased competition over more of the national network;
- Encouraging investment that will bring this about.

The consultation makes no provision for development of the railway to be linked to land use planning, and thereby leaves the provision of services that meet the changing needs of society very much to chance.

The consultation proposes to lengthen franchises, but does not convince that this can be achieved without undue risk to the taxpayer or operator, and without locking in patterns of service that fail to meet the shifting needs of the travelling public through the organic growth of the railway or by modal shift from car travel.

Introduction

The Coalition Government's consultation *Reforming Rail Franchising* (1) makes proposals to correct what it sees as the deficiencies in the existing system of franchising; namely that it is too prescriptive at the point of bidding and lacks flexibility once operational. Specifically, it proposes that franchises should be longer (in order to establish successful working relationships with industry partners) and more flexible (moving from highly detailed inputs to a focus on quality of outcomes for passengers). Prior to the election, the *Conservative Rail Review: Getting the Best for Passengers* (2) proposed that 15 to 20 year franchises should be the norm, to encourage investment in new capacity.

The previous Government published *The Future of Rail Franchising* (3) in January 2010. This document outlined developing policy options ahead of consultations for three franchises intended to be let during 2011. It proposed to set franchise terms of at least ten years, with bidders able to propose longer terms based on additional investment. Alternatives to franchising were briefly considered, and there was a detailed discussion of contract enforcement and risk sharing mechanisms.

The Competition Commission reported on its investigation into the rolling stock leasing market in 2009 (4). One of its findings was that limited franchise terms and prescriptive specifications were responsible for train operators paying high rolling stock leasing charges. It recommended that franchise terms should be in the range 10 – 15 years, and that invitations to tender (ITTs) should not be prescriptive such that the bidder was constrained to use the rolling stock already used by that franchise.

The House of Commons Transport Committee last considered franchising in 2006 (5). Among its many concerns was a belief that franchise specifications failed to reflect the findings of regional planning assessments and route utilisation strategies. This concern has failed to strike a chord with the present Government or its predecessor: nowhere is there any recognition that the design of a franchise should be based on development frameworks for the areas to be served. Indeed, the situation is even more confused at present, as the regional spatial strategies which laid out comprehensive plans for the development of the English regions have been abolished and there is little at present on which franchise specifications could be based. The regional planning assessments presumably remain. In the North East of England the disparities between RPA and RSS were considerable, and we do not consider that the former is a sound basis for formulating franchise specifications.

The McNulty rail value for money review (6) is currently under way. While firm conclusions will not be available until later in the year, it is pertinent that in the scoping study report dated May 2010, it is stated that *Franchising of train operations in other countries such as Germany and Sweden has reportedly led to cost reductions of between 20 to 40%, whereas train operating costs per train-km in Great Britain are still above their level in 1996-97*.

If substantiated, this finding alone makes reform of the franchising system vital.

What is franchising for?

In its response to the 2006 House of Commons Transport Committee inquiry *Passenger Rail Franchising* (5), ***rail****future northeast* suggested that the purpose of franchising is:

To enable Government to commission others to operate passenger rail services as part of the national rail network within a financial framework reflecting the wider economic needs of the area served as well as the direct costs and revenues accrued from operating the service.

Within that statement is to be included:

- *The need to achieve and then continuously to improve upon minimum standards of service*
- *The need to operate an initially agreed timetable and then continuously to develop the scope of the timetable to meet the changing and growing needs of the communities and passengers served*
- *The need to reflect Government policy initiatives to reduce climate change, increase public transport modal share and reduce road congestion*
- *The need to operate in an integrated way within the National Rail network and with Network Rail under the jurisdiction of the Office of Rail regulation*
- *The need to demonstrate responsible financial management which does not require unplanned support, which restricts the profits payable to shareholders and sets the return to Government at the minimum level necessary to exercise control.*

Specifically, maximising direct financial returns to Government should not be part of the franchising process. It is a conundrum that sweating the railway assets in Britain in the interests of efficiency has resulted in reduced flexibility, poorer performance and apparently higher costs. It commonly observed that in continental Europe stations seem to have more platform capacity, less intensively used, with a resultant predictability of platform availability and reduction in delays.

What objectives should motivate franchising policy?

Much of the Coalition Government's action is motivated by the need to reduce spending and the UK financial deficit. The Government also has obligations under the 2008 Climate Change Act to reduce the nation's carbon emissions. Given that domestic transport is responsible for 21% of the UK's emissions (7), the pressing need for a substantial reduction should be at the heart of the Department for Transport's policies.

A wide range of policy objectives will be met by encouraging modal shift away from the car towards more sustainable modes of transport. Experience teaches that (outside London) the current arrangements fall far short of this ideal, so we propose that franchise policy should have as its ultimate aim the ambition to increase the proportion of journeys made by rail. This is not the same as increasing patronage, particularly if such journeys are new and not replacing existing journeys made on the roads.

Modal shift will be encouraged by integration of the railway with other modes of public transport. This will require operators to collaborate with bus companies, local authorities and others in the provision of good physical interchanges at stations, convenient connections to destinations beyond the railway, and through ticketing in both directions.

Where significant competition exists, for example between Newcastle and York or Southampton and Portsmouth, the passenger benefits from lower fares and a better service. Judicious redrawing of the franchise map can introduce this competition to other areas of the network. As we discuss below (Q6), in the early days of franchising, some operators extended their services beyond their immediate boundaries. We believe that, subject to maintenance of robust timetables and avoiding deliberate abstraction of revenue from other operators, this should be encouraged.

Fares and ticketing are aspects of the present day railway that are unattractive to passengers. The complexity and inflexibility of the range of tickets available remain despite attempts at simplification. Smart cards are confined to London and the South East, and their introduction to other parts of the network is still a remote prospect. The present Government believes that alternatives to travel should be encouraged, but it acknowledges that season tickets promote travel every working day and proposes carnets as an alternative. Carnets are not popular with operators and have been withdrawn where they were previously on offer. Future franchise specifications across the country will need to make provision for these features, as has been done in the South East, if ticketing is to move forward.

The rail industry can make significant improvements in its own carbon footprint by increasing electrification, more efficient rolling stock, improved operating practices, and ensuring that its services are well promoted and patronised. Franchising should therefore be one of a coherent set of DfT and Network Rail equipment and investment policies, covering these issues.

Government would like the private sector to assume more of the commercial risk of providing passenger services. As Government is the operator of last resort it is questionable whether this risk is ever effectively transferred. The recent history of the Intercity East Coast franchise amply demonstrates this point.

Franchising policy should also be used to foster, develop and grow the railway cost effectively through the application of good practice and the support of an industry-wide research and development programme. This implies that franchise contracts have within them sufficient flexibility to enable operators to take advantage of lessons learned elsewhere.

What challenges does franchising policy need to meet?

Franchising policy has been considered rather narrowly as contracting with a private sector train operator to deliver passenger rail services as specified, together with the managing of stations, retailing of tickets and sundry other responsibilities. We would like to see the vision of franchise policy extended to meet the challenges that the industry must address if it is to provide services that are attractive to passengers and meet the Government's environmental goals. These include:

- Increasing capacity: passenger numbers have risen significantly in recent years, and services in many parts of the country are badly overcrowded;
- Rolling stock: while much of the fleet is quite recent, outside of South East England much of it is older. Plans to replace the HST fleet, the IEP programme, are on hold, and it is likely that the class 142 *Pacer* units will have their life extended rather than being replaced. Note that the (private sector) rolling stock leasing companies have indicated that they do not want to invest in new diesel traction;
- Electrification: Electric traction emits far less carbon dioxide than diesel;
- Integration across the network: “joined up” services across operator boundaries.

Many parts of Britain already enjoy fast links to London. Prosperity in the provincial regions of the country would best be promoted by fast links between its cities and city regions. We would like to see the franchise system deliver intercity services, not only to and from London, but also between Scotland, Newcastle, Leeds, Manchester and Liverpool (much faster than current Transpennine Express services), the Midlands, the South and South West.

As well as these rail links to other parts of Britain, we would like to see the franchise system deliver passenger rail services properly integrated with other modes of public transport. This would give public transport options to residents of rural areas.

The services specified in a franchise need to serve population centres as they currently exist today. If franchise durations are extended beyond existing terms, there will be an increasing need to consider population changes in the longer term. Proposed reform of the planning system mean that these changes will be decided at a considerably more local level. Logically, there should be local input into the specification of a franchise. The franchise review makes no such provision. Nor does it intend to restore to Integrated Transport Authorities the status of cosignatories to franchises serving their areas (ref 5, recommendation 8).

We strongly believe that the design and specification of franchises should reflect decisively the policies of those who influence the local development frameworks of those areas served by the railway. This will include local authorities, ITA's where they exist, and the new local enterprise partnerships. These bodies will be expected to collaborate in order to avoid the step change in services and fares that too often occurs at ITA boundaries.

Once a franchise is let, the operator will run services for its own commercial benefit. It is therefore critical that franchise specifications capture all the available wider economic benefits: operators will not improve services where they do not see a return.

Franchise Specification

Q1: Is the suggested model of specification practical and would it deliver good outcomes for passengers and taxpayers? What are the key unresolved issues? Are there alternative models that work better and what are these?

In answering this question, it must be recognised that passengers are both taxpayers and farepayers.

According to the National Audit Office (8), DfT's approach to franchising produces generally well thought through service specifications, generates keen bidding competition, and has achieved better value for money for the taxpayer since the Department took over from the SRA.

Alternatives to franchising were considered briefly in *The Future of Rail Franchising* (ref 3, p. 31). Apart from a pure franchise model, in which operators keep the revenues that passengers pay to travel by train, there is the concession contract. In this contract, DfT would set the specification and the fares, and take the revenue risk. The contractor is paid for operating the service. This arrangement is used for Merseyrail and the Tyne and Wear Metro. The conclusion is that the UK franchise system relies strongly on revenue incentives and competition between bidders at franchise award to deliver outcomes.

The concession system is used also for buses in London, while in other parts of the UK buses are run on a fully commercial basis supplemented where necessary by services supported by the local transport authority. It is notable that only in London has bus patronage increased in the years following bus deregulation.

The remaining alternatives to franchising are complete deregulation (in which the operator provides services which are profitable for it, sets fares and is responsible for all aspects of service quality), and a renationalised system (possibly through a Railways Agency) in which Central Government runs the service in its entirety.

Complete deregulation transfers risk to the operator but will certainly result in a wholesale withdrawal of very necessary services and will probably mean large increases in fares. Both these outcomes are totally unacceptable on environmental and social grounds. Deregulation plus support for socially necessary services would leave the private sector to benefit from profitable operations leaving the taxpayer to pick up the cost of loss-making services. This is a poor deal for the taxpayer. If risk cannot truly be transferred to the private sector, then we would suggest that the concession model is likely to prove better value for money.

Q2: What factors should be considered in determining franchise length?

As the franchise term lengthens, the risk to the bidder will increase and consequently the cost to the taxpayer will rise. There is a tension between the extent of freedom made available to bidders, the level of prescription in franchise agreements, the extent to which the private sector is willing to invest in franchises, the provision of marginal services (ranging from booking office opening hours to evening and weekend trains) and the value for money obtained by the passenger for the fare paid. Bidders will take more risk and possibly invest more of their own money if the present prescriptive requirements in franchises are relaxed. However, this will almost certainly result in the withdrawal of services and facilities that cannot be provided profitably.

An examination of the finances of franchises that have come to a natural end should give guidance as to whether the bargain struck at the outset was fair to both sides, or whether poor value for the taxpayer and excessive profits for the franchisee was the result. The consultation document (ref 1, p20) refers to the c2c franchise, one of the original 15 year franchises let in 1996, but states that this was due to the predictable revenue stream available to a commuter franchise and hints that the deal was unduly generous to the operator.

Once let, a franchise is not easily or cheaply modified. Long franchises, therefore, are not responsive to changes in circumstances and risk locking in unsuitable patterns of service.

Franchises can be knocked off course by unforeseen circumstances: the Hatfield derailment is the best example of this. Some franchises were suspended, being replaced by management contract arrangements. Several years elapsed before normality returned, and dealing with franchisees will have absorbed a considerable amount of SRA resources.

Franchises can also be affected by initiatives aimed at other parts of the network. For example, as part of the proposed Eureka timetable changes for the East Coast Mail Line, East Coast services to Glasgow will be drastically reduced. The intention had been to extend Cross Country services terminating at Edinburgh to Glasgow to compensate. However, it now appears (9) that the necessary changes to the Cross Country franchise will be too expensive. This episode illustrates the inflexibility and expense inherent in franchising passenger rail services and represents an obvious disbenefit of longer franchises.

There are several arguments in favour of longer franchises. These include the encouragement of private sector investment, particularly as the lead times for infrastructure and rolling stock projects may be lengthy, and the large costs to bidders and DfT in running franchise competitons. It is also true that relationships with stakeholders, including local authorities, rail partnerships and other interested parties take time to develop.

Inevitably, the optimum duration for a franchise will depend on the circumstances, and franchise policy must be sufficiently flexible to allow for this. Nevertheless, we believe that as a starting point, ten years duration is a sensible compromise, with longer periods possible against suitable investment proposals from bidders.

Q3: Would the proposal to supply an initial "affordability" figure for premium or subsidy help bidders submit realistic proposals?

If bidders know the level of premium or subsidy available then it seems likely that their bid will amount to this figure. If this bid is for the base case specification, then DfT runs the risk of second-guessing the market. It may be that bidders will bid in terms of services for a given amount of premium or subsidy, in which case assessment of the bids will be on the basis of what is offered rather than how much it will cost. This is likely to make objective assessments difficult: if one bidder offers more trains and another better stations then the comparison is bound to be subjective and may contravene competitive tendering rules.

Franchise procurement

Q4: What are the benefits and downsides to the procurement process outlined in the document?

The overriding consideration is that DfT must have an objective basis for assessing bids, and this will be impossible if there is not a base case in each of the bids submitted. If a base case bid is submitted and innovative enhancements are invited, DfT has the task of assessing these enhancements objectively . Bidders are naturally reluctant to share their ideas ahead of making their bids. This reluctance makes the competitive dialogue less meaningful, because DfT cannot ethically discuss one bidder's proposed enhancements with other bidders. The result may be that innovative enhancements may be lost if combined with an otherwise uneconomic bid.

Q5: How can we reduce the complexity of bidding, while still protecting taxpayers and passengers (especially given a greater focus on quality)?

Recent invitations to tender have comprised a set of standard provisions applicable to all franchises together with provisions specific to the franchise in question. This has found favour with the industry and should therefore continue.

As franchise terms are extended, then the complexity of the process put in place to protect tax payer and operator increases. As private sector operators have declined to take a significant share of risk, these complicated arrangements are unavoidable.

The consultation document admits that frequent market testing has delivered better value for money for the taxpayer, although this is presumably based on a system of bid assessment that values low cost above all else. It is not certain whether the value for money resulting from frequent market testing outweighs the cost to bidders and Government of such regular competition.

Contract design and management

Q6: What services, outcomes and commitments should be contracted?

Experience has shown that if an outcome is not laid down as a contractual obligation, then it is at risk when money becomes tight or profit-taking dominates. Examples include reductions in ticket office opening hours, or even their complete closure (South West Trains) and threatened withdrawal of restaurant facilities (National Express East Coast). There is serious consumer dissatisfaction with the scale of station car park charges, which have appreciated considerably in recent years. Towards the end of its franchise, National Express East Coast imposed charges for making seat reservations, unknown on the rest of the network. Thus it becomes tricky to pare down the list of outcomes, and commitments that should be contracted.

We believe that only minima should be specified, leaving the successful bidder free to enhance services and facilities, subject to track access. Even seven year franchise operators proved capable of introducing completely new services. For example, Northern Spirit used some of its 158 fleet to run direct services between Leeds and Glasgow (at the time the fastest growing cities in England and Scotland). Leeds to Glasgow is some 70 miles shorter via Settle than along the East Coast Main Line as is now being promoted by the DfT. Other examples include Rochdale to London (First North Western) and Chelmsford to Basingstoke (Anglia). These services were subsequently withdrawn at the insistence of the SRA.

A commitment to maintaining services if at all possible should be introduced. At times of severe weather or similar disruption, it can take operators too long to make alternative arrangements and communicate these to their passengers. There should be contingency arrangements in place to ensure that passengers are able to continue their journeys with the minimum possible delay. Franchises that operate stations used by other operators should be required to provide suitable and sufficient assistance to all passengers requiring it, not just their own.

The use of replacement bus services at times of planned engineering works should be discouraged if this can be avoided by ensuring that train crews have route knowledge of appropriate diversionary routes.

Recent franchise agreements have contained commitments to support community rail partnerships in the area of the operator. Rail partnerships are increasingly finding local authority support hard to come by, and train operator support is vital to to their continuing viability.

Q7: What is the best way to structure outcome measures based around passenger satisfaction levels?

In principle, the National Passenger Survey should identify the principal grievances of passengers. Even when it does, the record of train operators in rectifying the underlying causes is not good, for example the issue of cleanliness of onboard toilets. The problem with relying on this survey is that the gap between something happening and registering in the survey may be lengthy. Policy changes may be deliberately timed to avoid rousing the ire of passengers until the change has become established. Also the National Passenger Survey can really only identify a small handful of issues. Unless they are widespread across the network, local issues may not register.

More seriously, the accuracy of rail surveys has been questioned (10). Passengers expressed satisfaction with non-existent features such as Merseyrail toilets, CrossCountry stations and Overground on-train staff. Survey results failed to distinguish between commuter and long distance services in the provision of luggage space, and judgements on a range of issues from value for money of fares to cleanliness of trains were subjective. Until a survey can be devised that provides an accurate and quantitative measure of passenger satisfaction, then its use in assessing the performance of operators will not give fair results.

To some extent this is a matter of design. To get results that are representative of passengers in general requires a sufficient sample size. Survey questions could elicit what is important to passengers, and then probe those features. These issues will inevitably be operator dependent, but it is important to be guided by what passengers identify as faults with particular routes and services: if these are generalised then it becomes difficult to pin down those responsible. The use of guidance to respondents to ensure a greater consistency of response should be considered.

The use of opinion surveys by business is well developed, and it should be possible to find a means of assessing accurately the view of passengers so as to form true picture of an operator's performance.

As well as monitoring franchise contracts in terms of passenger satisfaction levels, there is a pressing need for a consumer watchdog with adequate teeth that it is able and willing to use. It is debatable whether the current arrangements meet this need.

Q8: What sanctions should be used to ensure operators deliver their commitments, including outcome measures?

A range of sanctions proportionate to the level of breach is necessary. At the most serious level, for example National Express East Coast, there certainly seemed to be a gambit of emphasising the cost of re-tendering the franchise in the hope that renegotiation might seem to be a cheaper option. DfT appeared not to have any sanction to enforce the contract entered into with National Express, which was able to allow its East Coast subsidiary to become insolvent once its original investment had been exausted.

It is reported that Cross Country Trains is in breach of a franchise commitment to install Wi Fi on its trains, and that DfT has not applied a sanction effective in hastening compliance (11).

These episodes illustrate the need for contracts that impose effective penalties appropriate for the level of breach.

It is important to realise that when sanctions are applied, it is seldom the passenger who benefits. Where the breach has had an adverse impact on passengers, then the sanctions applied must be for their benefit. In 2001, the SRA levied a penalty on Arriva Trains Northern because of persistent failures arising from a shortage of drivers. This was supposed to be invested in service improvements, but these were never delivered. Whether fare reductions or some other passenger benefit is secondary to the principle that the penalty should benefit those who have suffered the shortfall in service.

Q9: What level of performance bond and/or parental guarantees are appropriate?

The performance bond is defined as a penalty paid by a defaulting operator to defray the expense borne by DfT in reletting a franchise. It should therefore be relatively straightforward to set this at a level that protects the taxpayer.

It should also be straightforward to define a level of parental guarantee that makes default financially unattractive. The initial investment made by National Express in its subsidiary company National Express East Coast was clearly inadequate to deter National Express from defaulting when this investment was exhausted.

The danger is that these amounts of money, while easy to calculate, may deter bidders from making bids that are good value for money for the taxpayer or farepayer.

Revenue risk

Q10: Should the risk inherent in forecasting revenue over a longer period be shared between operators and government, and if so, how? What are the merits or drawbacks of review points? What are the merits or drawbacks of economic indexation compared to the existing revenue support/share or leaving revenue risk entirely with the operator?

Both the present franchise review (1) and its predecessor (3) contain a variety of proposals for sharing the risks and rewards of longer franchises. None of these provisions is an adequate substitute for a decent crystal ball! All have drawbacks, sufficiently obvious to be mentioned explicitly, and all run the risk of the operator making profits that are too high (poor value for money for taxpayer and/or passenger) or too low (in which case the operator may bail out).

We assume that the cap and collar provisions that feature in recent franchise contracts are designed to share risk in a way that encourages bidders to make more modest bids.

It is worth noting that an escalation mechanism is already imposed on passengers as a result of the RPI + 1 % fare regulation process. At the time of writing, it appears that this escalation is to be increased significantly.

Franchise investment

Q11: How can we add to incentive from longer franchises to remove the barriers to private sector investment?

The easy answer is to remove prescription from franchise specifications and regulation from fares. As discussed earlier, this will have an unacceptable effect on many services.

For premium paying franchises, the possibility of setting off some of the premium or fiscal performance above contract in return for investment to encourage or support the growth of the railway in the franchise area should be explored.

Q12: How can we encourage investments with long payback periods throughout the franchise term, not just at the start?

There is already a mechanism for DfT to designate an investment having a long payback period a key franchise asset, meaning that a subsequent operator will be expected to pay to take over the asset. The consultation document alludes to this mechanism (ref 1, p. 28, *Residual value*), but admits that it is seldom exercised.

One means might be to take passenger aspirations from something like the National Passenger Survey. If an independent mechanism could be devised for converting these aspirations into an investment programme (and if the money was there to invest), then operators could be encouraged to make use of the key franchise asset mechanism as a complement to shorter rather than longer franchises.

Cost control and efficiency

Q13: How can the government incentivise operators to control cost increases over the life of the franchise, and to improve cost efficiency?

There needs to be a clear distinction between the cost of delivering specified services (efficiency) and the ability to reduce costs by measures such as service reductions, e.g., reducing the hours of operation of booking offices. We believe that the existing arrangements give clear incentives to operators to control their costs (and indeed maximise their revenues) as this will feed directly into their profits.

A good example of an operator's initiative to maximise revenues is Northern Rail's Duo ticket. This provides a discount for two people travelling together off-peak (offering good value for money to the passenger) and increases patronage (a benefit to the environment). Northern Rail has very commendably experimented with ticket offers to try to fill seats on lightly loaded services, for example the over 55s offer on selected lines. Their franchise contract evidently provides ample incentive for this operator to take such initiatives. Other revenue raising avenues have been exploited by train operators that are not so laudable, for example car park charges in excess of those prevailing elsewhere in the locality.

The previous franchise review (3) proposed to encourage cost reductions by offering to share the proceeds with the operator. This was presented as a means of identifying services that fulfilled no useful purpose, and saving money by discontinuing them. The prospect was greeted with horror by campaign groups, who felt that it offered the opportunity for operators to reduce costly but socially necessary services. This dispute demonstrates clearly that better means for specifying services over the term of a franchise are required. We believe that making a better link between franchise specifications and local developments will lead to timetables that deliver socially and environmentally necessary services.

Conclusion

Reform of the passenger rail franchising offers the opportunity for Government to promote sustainable transport, encourage investment, tackle deficiencies in fares and ticketing, secure better value for farepayers and taxpayers, and align more closely the performance of train operators with the interests of passengers. The consultation document seeks to justify longer franchises, but does not establish that this can be achieved without serious financial risks to Government and operators and without locking in service patterns that may become inappropriate with the passage of time. A consequence of the proposals is that development of the railway will take place in isolation from any form of land use planning. Absent from the consultation is any form of integration with other modes of transport, including physical interchange, fares or ticketing. These deficiencies will limit the ability of the railway to contribute to meeting the transport needs of the population, attracting people out of their cars, and limiting emissions from transport.

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