Department for Transport

The Future of Rail Franchising

January 2010

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Foreword

The Government is about to commence the consultation exercises for three rail franchises that will be let over the coming year:

- Essex Thameside, covering South Essex and East London;
- Greater Anglia, covering East Anglia and North & East London;
- InterCity East Coast covering mainline services between London, West Yorkshire, North East England and Scotland.

Views will be invited on the key features of these franchises in order to help us to improve passenger services and value for money.

This paper has been written in order to provide information on developing policy options, with the hope it will provide background and context to these competitions.

It sets out the direction in which the Department is considering amending the current franchising process and discusses the key challenges that emerge as a result of the recent economic downturn, as well as our broader experience of letting and managing franchises.

We are also publishing the results of a Department commissioned report from consultants KPMG entitled *Franchise Policy Analysis* that have been used to inform our thinking in this area. The evidence included here should be considered alongside the emerging conclusions set out in this document.

This paper is a statement of work in progress. The Department has not made any final conclusions on this issues addressed in this document. In particular there are lessons to be learned from the experience of the failure of the National Express East Coast franchise. Further changes to franchise evaluation and contract structure that are still being carefully considered, since the interactions between different proposals need to assessed together. These include a revised system for bid evaluation, and potential changes to the current risk-sharing mechanisms.

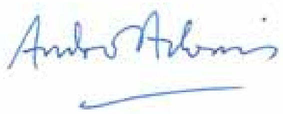
We intend to finalise any changes in the run-up to issuing the formal Invitations to Tender for the three franchises later this year. Over the coming months we will be holding discussions with Passenger Focus and partners in the rail industry to test the likely response to different options. We will take a final view based on passenger service quality, value for money, affordability and our wider transport objectives.

We also invite wider comments on the proposals noted here.

For the most part, the changes we set out in this document are evolutionary. As a system, franchising is largely delivering well for both passengers and taxpayers.

However, a greater emphasis on encouraging operator-led improvements and removing current barriers to investment will help rail meet passenger expectations in the coming years, while still delivering good value. The franchising system as a whole needs to create the right framework to deliver long term passenger needs, consider the allocation of responsibility and incentive for investment and deliver for both fare payers and taxpayers.

Alongside these considerations of franchising the Government will shortly commence a wider study into the overall costs of the rail network. This study is due to report in 2011 and may drive subsequent alterations to franchising policy.



Rt Hon Andrew Adonis
Secretary of State for Transport

January 2010

1. Introduction

1.1 Rail franchise agreements are the contracts which the Department holds with train operating companies for the provision of passenger train services.[1] These contracts are awarded by the Department following open competition. Whilst key elements of the service provided to passengers are mandated as part of the contract, other features are left to the commercial judgment of bidders and operators. Operators are responsible for the day-to-day management of train services.

1.2 There are currently 15 rail franchises managed by the DfT. Others have been devolved to Scotland, Wales, London and Merseyside and are managed locally. Some franchises pay a premium to the Government, while others require subsidy. However, within each franchise (even a premium paying franchise) there will be services, routes or other outputs that are not commercially viable and would not operate commercially if they were not specified by Government.

1.3 Overall, the Department paid £3.8bn in subsidy to the railway last year including grants paid to Network Rail to operate, renew and maintain the national rail infrastructure. All franchises, including premium paying franchises, benefit from the grant paid to Network Rail.

1.4 Since taking direct responsibility for franchising in 2005, the Department has held nine franchise competitions. The NAO report on franchising published in October 2008 reported that:

> *‘ The Department’s approach to rail franchising produces generally well thought through service specifications and generates keen bidding competition. This approach has resulted in better value for money for the taxpayer on the eight franchises let since the Department took over from the SRA’*

[1] Appendix A details the franchises that DfT manages, the operator, franchise length and appropriate break points.

1.5 Reliability is today over 90%[2], and passenger satisfaction is at the highest level since the National Passenger Survey (NPS) began in 1999, with 81%[3] of passengers satisfied or highly satisfied with their journey.

1.6 The franchising system has to deliver in a range of situations and needs to be robust enough to respond to changing economic circumstances. Franchisees must manage their businesses in order to reflect changing societal and policy trends.

1.7 The recent economic downturn has tested the performance of the current franchising system in exceptional circumstances. The issue of how financial risk is predicted and managed has been highlighted by the default of National Express East Coast (NXEC) and the subsequent termination of that franchise. The operation of the services operated by NXEC has passed smoothly to the interim public sector operator, East Coast. However the effects of this recession have been considerable for the rail sector, especially where franchisees were previously basing their plans for the business on significant passenger growth as a result of ongoing economic growth.

1.8 Before letting the next round of franchises, the Department is therefore examining the management of risk, alongside the other key features of franchising. This paper highlights proposals that the Department is considering, although further work remains to be done before the Invitations to Tender for the Greater Anglia, Essex Thameside and InterCity East Coast are issued to bidders later this year.

1.9 Importantly, the Department is not seeking to develop a single approach for all franchises. The operational challenges vary between franchises, as does the scope for investment, new stock or major service change. For all these reasons, each franchise has to be considered separately and will have important elements targeted at the specific tasks facing the franchisee.

1.10 Current franchises have been let for an average of around eight years, although some have been shorter to reflect circumstances in specific areas. For example, the South Central franchise has a term of just under six years, reflecting the major changes to service patterns that will be required when the Thameslink Programme is complete in 2015.

1.11 Because of the potential benefit of continuity, the Department has assessed the case for moving towards longer franchises of at least ten years, with options for still longer franchises based on firm investment proposals. We have also examined how higher levels of operator-led

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[2] 91.3% PPM MAA Q2 2009/10 National Rail Trends January 2010
[3] National Passenger Survey Spring 2009

innovation and investment can be encouraged so that greater investment in passenger-facing facilities is carried out.

1.12 However, any changes need to be supported by a range of other measures, not least because longer franchises reduce the frequency of competition, which plays a key role in improving services, generating innovation and getting good value for the taxpayer. It is also important to ensure that, if longer franchises are in place, Government has the ability to remove poorly performing operators.

1.13 In making changes to the current franchising model, we aim to build on rail's success in recent years in improving the service provided to passengers, whilst making sure franchises are value for money and affordable for taxpayers.

1.14 Any changes also need to recognise that programmes such as the Super Express Train take some key decisions out of the hands of operators and reduce the amount of flexibility operators have to manage their services.

1.15 Alongside this paper, the Department is publishing a report independently written by KPMG, which has contributed to the high-level conclusions we set out here. This report looks at whether features of contract design such as length have had an impact on the performance of a number of past UK franchises in terms of service quality, reliability and financial performance.

1.16 A number of longer contracts have been let in the past, with varying degrees of success. Whilst Merseyrail (25 years), c2c (15 years) and Chiltern (20 years) have been successful, the 15 year franchises operated to Connex Southeastern, Virgin CrossCountry and Virgin West Coast[4] required renegotiation in some form or were terminated early.

1.17 However, some rail operators are strongly of the view that longer franchises bring important benefits of continuity, allowing managers to implement important changes across the business and develop effective relationships with passengers, stakeholders and Network Rail. The study also suggests that the financial robustness of an operator may have a more important effect on performance than contract structure – perhaps because investment in services or facilities is likely to suffer when a business faces financial pressures.

1.18 We are now consulting with stakeholders on the contents of the new Greater Anglia, Essex Thameside and InterCity East Coast franchises.

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[4] The West Coast Franchise was placed on a 'letter agreement' (management contract) by the SRA in 2002 and was only placed back on an amended and restated franchise agreement in December 2006.

As we consider the issues raised and prepare the Invitation to Tender documents, the Department will be discussing the proposals contained in this report with the wider rail industry.

1.19 Final conclusions will be included in the Invitations to Tender for each franchise, due to be published later this year.

2. Franchise Length

The Department proposes to set franchise terms of at least ten years for the next round of franchises.

Bidders will be free to propose a longer franchise term, based on additional investment. Any decision to enter into such a contract will depend upon value for money, affordability and alignment with overall transport objectives.

Appropriate break points will be considered to ensure operators deliver for passengers throughout their franchise.

2.1 The rail industry has a long planning horizon. New rolling stock takes around three years to procure and deliver. Infrastructure projects, such as the West Coast Main Line upgrade or the Thameslink Programme, can take several years to plan and up to a decade to implement. Even relatively small station improvements take time to deliver and take longer to provide a financial return

2.2 There is no single 'right' franchise length. Individual circumstances will vary and a range of factors can be considered when assessing the appropriate length of the contract. However, in general, there are good arguments for keeping well performing operators in place for reasonable periods of time. Longer franchises will allow operators to plan ahead in the medium or longer term. Investments in staff training, improvements to stations and trains and new and improved timetables are more likely to make financial and operational sense if the operator can reap the benefit of such investments.

2.3 Longer franchise contracts may also help bidders and operators identify investments that can pay back within a longer contract term, although it is unclear whether significant new investment would result solely because of a longer contract.

2.4 Also when things are going well, continuity and momentum will benefit the passenger, leaving railway staff to remain focused on the day-to-day job of delivering high-quality train services

2.5 For these reasons, the Department is considering setting longer contract terms:

- Franchises should normally operate for at least ten years.

- Bidders will be invited to propose a longer franchise term:

  - up to 15 years based on additional investment proposals that are value for money, affordable and meet our wider transport objectives

  - longer than 15 years where significant investment proposals are good value and also meet the conditions in European legislation. Our view is that a contract of up to 22 years might be justifiable in some cases, where the operator is directly investing themselves rather than leasing assets.

2.6 Whilst the franchise winner would be decided on the ten-year proposal, it would be for the bidders to decide whether it was appropriate to offer Government the option of a longer contract and what additional benefits this might deliver. Such an option should allow bidders the freedom to propose longer franchise options where they believe a case can be made. It would be up to bidders whether they provided such a proposal and up to Government to decide whether the benefits of this longer contract were worth buying and were affordable. Longer franchises may not be appropriate in all cases, and the bidders may believe it not appropriate to offer such options.

2.7 The Department would also retain the right to let shorter contracts where specific operational concerns justified this. There may be particular locations where major infrastructure projects are likely to have such a major impact on a franchisee’s business that it is not viable to offer a contract of ten years. This was the case with the recently let South Central franchise, where the Thameslink Programme will have a major impact on South Central services when the scheme is complete in 2015. As a result, a shorter contract of five years and ten months was offered, with a possible up to two-year extension. However, the intention is that contracts of less than ten years should be the exception.

2.8 The Department considers that the extra incentives for investment provided by longer franchises are unlikely to be sufficient to deliver all the improvements that are needed by passengers and the wider economy.

2.9 Discussions with the industry indicate that increasing franchise length alone would not lead to a significant change in the level of operator-funded investment within a franchise. This is because investment on the rail network in attributes such as stations will often generate relatively little financial return for operators. This is especially the case where revenues are low, or passengers have limited options to switch to other modes. There will therefore continue to be a need for Government to specify, fund and monitor the delivery of key investments. [5]

2.10 A change towards longer franchises cannot be made in isolation. The bigger issues raised by this change are discussed in the later sections of this document. One of the most direct questions raised by longer franchises is how to get good results for passengers and good value for taxpayers throughout the franchise term so as to avoid a peak of activity within the first few years of the franchise and no improvements subsequently.

2.11 We also need to ensure that poor operators can be removed if they fail to deliver during the life of the franchise. This makes the design of breakpoint mechanisms a key issue.

Performance breaks, early terminations and extensions

2.12 Under the current franchise agreement, any operator who does not deliver the terms of the agreement will be asked to prepare an improvement plan – which the Department must agree as appropriate to remedy the failure – which will often involve additional investment by the operator. Where the operator fails to deliver an obligation that they committed to as part of the bid, franchise payments can be adjusted by a pre-agreed amount to reflect this.

2.13 If the operator continues to fail to deliver, the Department can take various enforcement actions and may decide that they are in breach of their contract, and ultimately remove the franchise.

2.14 In addition, franchises let since 2004 have included performance breaks. If an operator fails to meet targets set out when the franchise was awarded, the Department has the right to seek early termination of the franchise at a pre-agreed date. This is typically been between two and three years before the full franchise term.

2.15 The targets against which the franchise is judged usually cover levels of cancellation, operator delay minutes and the operation of short trains, alongside other issues such as contractual default.

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[5] The need for Government-led investment is perhaps illustrated by two of the longer franchises on the UK network: Arriva Trains Wales (15 year) and Merseyrail (up to 25). Both of these are long contracts, but low-revenue businesses and therefore rely on public-sector funding to support investments.

2.16 Performance breaks become more important when longer franchises are considered. It is important that operators deliver a good quality of service consistently to passengers throughout the franchise term. As a result, any contract must include the ability to terminate that contract when an operator is not performing at, or near, the required level. Any such mechanism must be strong enough to ensure that the operator delivers throughout its term, but which also allows the franchise to be seen as a long term contract by investors.

2.17 The Department is considering a number of changes to the criteria used to assess performance, and it may be appropriate to increase the range of performance targets considered during such reviews. For example, it may be appropriate to include service quality measures within such targets.

2.18 Performance breaks are one of the tools available to the Department to ensure that train operators deliver for passengers throughout the term of the contract. Other measures are discussed elsewhere in the document.

3. Specification and delivery

Train operators will be contractually required to deliver services and other outputs that are important to the public – whether or not they are premium paying franchises.

Franchise specifications will be designed to allow maximum scope for innovative solutions whilst still delivering the Department's requirements.

Accreditation will continue to form the first stage of the franchise competition.

It will remain important to hold operators to account for promises upon which bids were won.

Operators will need to demonstrate that any changes to timetables do not materially increase journeys times for passengers without justification.

3.1 There are two different and distinct elements to the current franchise procurement process:

- specification; and
- contractualisation.

3.2 Specification refers to the minimum outputs that the Department requires to be delivered as part of the franchise bid (and subsequent contract). Contractualisation refers to the process whereby promises and commitments offered by bidders are included within the contract with Government. Only when such promises are included within the contract can the Department hold bidders to these promises. The Department therefore usually contractualises outputs that deliver more than we initially specify within an Invitation to Tender, reflecting the contents of the bid received.

Specification: getting the balance right

3.3 The Department's current approach to franchise specification involves a mix of requirements that operators are required to deliver. As the public funder of the railway, it is important that Government sets out the requirements that it wants to be provided and holds operators to account if these are not fulfilled.

3.4 However, it is important that the level of detail within the overall specification is appropriate and the correct balance is struck between the different requirements in the specification (train service, service quality, access requirements etc.). The specification must also allow the private sector to propose innovative ways in which these requirements can be delivered whilst still meeting the overall objectives for the franchise.

3.5 The current process involves the Department (in consultation with Network Rail) setting out a minimum level of train service that should be delivered by the operator. This is not usually a timetable, but a set of minimum frequencies, maximum journey times and stopping patterns. Some of these services will not cover their costs and, without being specified, they would not be provided by the franchisee.

3.6 The complexity of these requirements may vary depending on the route under consideration. For example, the East Midlands Franchise Specification (issued in 2006) set out at a high level the requirement for the mainline timetable. It was then for bidders to propose how they would construct a timetable to deliver this. In other areas the requirements might be more tightly defined, reflecting the congested nature of the infrastructure and the requirements of other operators.

3.7 Where the Department is seeking enhancements as part of the franchise competition above the current level of service, these are currently included within the base specification if these are believed to be affordable and provide value for money. Other potential enhancements may be included as priced options.

3.8 The specifications for recent franchises have included elements relating to:

- access to the network (car parks, cycle parking, multi-modal interchange);
- stations, stations facilities and station improvements;
- quality of service;
- national passenger survey targets;
- fares and ticketing;
- security and revenue protection;
- passenger information; and
- environmental impacts

3.9 Many of these will not provide a commercial return to the operator and are included within the specification because they have a wider benefit to rail passengers and society, which the Department is prepared to pay for. If such requirements are not specified – and subsequently contractualised – it is unlikely that they would be delivered.

3.10 Some of these also relate to network requirements – such as maintaining through-ticketing, the impartial retailing of other operator tickets and acceptance of products such as National Railcards, whilst others relate to measures to improve integration or the overall quality of service.

3.11 In some circumstances the Department also specifies outputs within a franchise that have a business case over a period longer than the franchise. Even with longer franchises, there will continue to be investments and enhancements that the Department will need to fund and therefore specify.

3.12 The Department does not necessarily believe that different levels of specification should apply if a train operator is a paying a premium to Government. It is important – whatever the financial status of a franchise – that the required services are delivered. Government may also be prepared to accept a lower level of premium by including specific requirements in order to achieve other wider policy objectives and a better service to the public. For example, an operator seeking to maximise profits on a premium paying franchise such as InterCity East Coast might reduce stops at smaller stations below a level that the Department believes to be appropriate for passengers. By specifying these stops, the Department effectively reduces the premium bidders will offer.

3.13 Journey times are an important element in attracting passengers to the network. Some passengers have expressed concerns at lengthened journeys times. Whilst it is important to run a punctual railway, it is also important the journey times are considered by rail operators. In future DfT will work with the existing regulated industry framework to require operators to identify, and justify, material journey time increases.

3.14 The Department has already included new National Passenger Survey targets within the recently let South Central franchise. These targets were set by the operators as part of their bids and are now contractualised with monetary requirements to make further investments if these are not achieved. Given the increasing levels of punctuality seen on the network and increasing passenger expectations with regard to service quality, we intend to continue with this approach for future franchises. However, we are also considering whether other service quality measures should be introduced that could be included in any franchise performance review linked to a break point within the contract (see Section 2).

Flexibility within bids

3.15 The requirements set out in a specification usually give operators the flexibility to propose alternative methods of delivery within their bids and to offer more than the minimum specification the Department has requested. However, in future franchise competitions the Department will review how the required outputs are specified within the ITT. Our aim is to allow bidders as much scope as possible to propose innovative methods of delivery whilst also ensuring the overall franchise objectives and broader Government policy aims are being delivered.

3.16 The Government is also proposing changes to the way that franchise bids are submitted to give bidders greater incentive to provide innovative proposals as part of the franchise competition. These are described further in Section 4.

Accreditation

3.17 It is important that the Government appoints good quality operators with an ability to deliver the commitments given as part of the bid. We also have a responsibility to reduce as far as possible the costs of bidding for franchises whilst also appointing operators that have clearly demonstrated some forethought as to the issues that need to be addressed.

3.18 The Department believes that the current accreditation process is an important step in the competition. It enables the Department to shortlist approximately three to five credible bidders that have a realistic chance of winning the competition. By shortlisting, overall industry bidding costs are reduced.

3.19 The accreditation of operators who are new to the UK market within recent competitions indicates that the current accreditation is not a barrier to entry for new operators.

3.20 However, the Department is proposing to simplify elements of the accreditation process to reduce the amount of information that must be supplied, whilst maintaining the core information requirements. In reaching this conclusion the Department has considered a number of other models, but has concluded that none of these could ensure that good quality and financially robust operators are invited to bid without adding further to industry bidding costs.

Ensuring delivery

3.21 Proposed enhancements included by bidders within their franchise bids allow them to gain additional deliverability points when their bids are assessed. As a result, such proposals help bidders win the bid.

3.22 It is therefore important that the Department ensures that the operator is contractually obliged to deliver these outputs to a required timescale – with financial or other contractual enforcement mechanisms put in place if delivery does not occur. Such mechanisms allow the Department to manage the contract. Otherwise, the proposals in a bid would have no contractual weight, when these are being paid for by the taxpayer in the subsidy/premiums line. Contractualisation is therefore are important part of the franchising process.

3.23 However, the Department does recognise that some flexibility is required in managing a contract. Things may change in the period between bidding and the required delivery date, actual implementation of a scheme may prove more costly or more difficult than planned or a supplier may not be able to deliver a required output within the set time.

3.24 The Department will always consider minor changes to franchise commitments where these are appropriate and can be justified. However, where such change involves the operator not spending money that was committed in the bid, the Department will always seek a commensurate proposal that improves the level of service offered to passengers. The Department does not believe it appropriate for bidders to be ‘let off’ such commitments.

4. Encouraging innovation and investment

The bidding process will be altered to place greater emphasis on innovation and alternative proposals.

Improvements to the existing investment mechanisms will be considered to encourage operators to develop and fund investments, especially toward the end of a franchise.

Funding and planning improvements

4.1 Franchising funds a range of investments: in better facilities, in cost-reduction measures and in less tangible benefits such as staff training, research and longer-term planning. Most franchise competitions also generate new ideas and new approaches.

4.2 Broadly, investment in franchises arises either through a Department decision to support such an intervention or through a bidder/operator decision that such an enhancement will have a positive impact on the financial performance of that company. Innovation can arise from either the Department or from bidders/operators, but the Department recognises that in many cases it is not best placed to develop innovative methods of delivery.

4.3 The Department is considering a package of changes to the franchise competition process to allow more innovative proposals to be suggested and also incentives to deliver the best possible quality for passengers, while controlling the cost to taxpayers.

Franchise bidding

4.4 Franchise competitions present the best opportunity for innovation and new investments. Competitions are the only point when the Department can make significant changes in what it wishes to fund on rail without a renegotiation of the franchise contract. Competitions also allow the Department to gain a competitive price for such changes.

4.5 Competitions are also the point when bidders carefully and thoroughly consider the business for which they are bidding and put forward new proposals as to how that business should be run, costs reduced and additional revenues generated. The bid is an important element in ensuring that costs are minimised and that the operation is as efficient as possible. Less frequent competitions that result from longer contracts will reduce the benefits to the passenger and taxpayer that arise from more frequent competitions.

4.6 The current franchising process was designed to deliver comparable bids that are consistent with the Department's requirements. It avoids bids being received that cost significantly more than an acceptable base, which would then reduce the funds available for other transport projects. However, this approach places relatively little emphasis on innovations and alternative proposals. We therefore intend to make alterations to how franchise bids are structured and assessed, in order to increase the weight given to innovation and to take greater account of value to the national railway in the longer term.

4.7 We also recognise that the current franchise replacement process places little value on priced options submitted as part of the bid. Currently, such plans are not included with the assessment of bids in quality or financial terms. As a result, the price for such options can be uncompetitive and plans not as robust as they would otherwise be. As a result, we propose to include an additional elements and enhancement package as part of the bid.

4.8 We also rarely receive individual bidder-generated options. We propose to include a separate plan to cover bidder specified enhancements and innovations and would assess this plan as part of the bid although the financial impact of this plan would not be included.

4.9 The changes being considered will build on features that the Department has included in recent competitions, but will also give the Department the ability to supplement the minimum level of outputs should these be affordable. The proposed revised structure of franchise bids is noted in the box below, whilst the outline details of how the bid would be assessed and contractualised is and shown in Table 4.1.

Minimum output specification

This is the minimum level of service, across a range of outputs, the Department would wish to see delivered by the franchise. These would be marked and assessed in the normal way.

Additional elements / enhancement package

Additional elements and enhancements specified by the Department that we may wish to buy depending on the cost of the overall franchise, including the minimum output specification. These elements would be marked as part of the suite of delivery plans provided by each bidder and a proportion of the cost of the combined package included in the financial cost of the franchise. The proportion of this cost would be set on a franchise by franchise basis. Any elements included in this package should have a high probability of being affordable.

Bidder specified enhancements and innovations

Bidder specified innovations and enhancements are those that are not included within either of the above packages but which accord with the overall franchise objectives and could involve elements that reduce overall franchise costs or improve services. The number of such options would be set by the Department. The submission of such options would be for the bidder to consider but such plans would be included in the overall Deliverability assessment. The reasonableness of the cost of these options would be assessed before it was purchased, but would not be included in the award decision. We would expect bidder proposals for options for longer contracts to be submitted as part of this plan.

Table 4.1 Proposed Franchise Bid Structure				
	Mandatory	**Scored as part of delivery plans**	**Included within financial evaluation**	**Included within franchise contract**
Minimum output specification	Yes	Yes	Yes	Yes
Additional elements and enhancement package	Yes	Yes	Yes – but only a proportion of package costs	Possibly depending on Ministerial decisions and Affordability
Bidder specified enhancements and innovations* ***including longer contract options**	No – but DfT will set maximum number of plans.	Yes	No	Possibly depending on Ministerial decisions and Affordability. May require subsequent public consultation

4.10 The franchise would then be awarded using the existing methodology, i.e. the lowest cost deliverable franchise bid. Once the winning bidder has been identified, it would then require Ministers to decide which of the enhancement packages were affordable and which, if any, they would seek to buy. At this stage, bidder specified innovations and enhancements would also be considered. Contracts would be defined based upon decisions made at this time.

4.11 In the event that two bids are close on price (within a pre-defined band), the deliverability score is a key deciding factor. One option being considered would be to widen the band upon which bids would be tied on price, with the decision to award then based on the deliverability assessment.

4.12 This would move away from the current position which awards broadly on price to the taxpayer once bidders have demonstrated sound plans to deliver the required services and objectives. The change of approach would place greater weight on the overall deliverability of the franchisee's plans, the level of output committed and any innovative proposals made.

However, the Department would need to ensure that the value of additional outputs provided exceeded the additional cost to the taxpayer.

Investing during the life of the franchise

4.13 Some types of investment generate only small increases in revenue – if any at all. However, there is likely to be a pool of potential investments that could cover their costs without government funding. The extent varies to which franchisees make such investments during the franchise.

4.14 Towards the end of a franchise term, there is less time to earn a return on any investment. This is why longer franchises could increase the potential pool of viable investments in the short to medium term. However, issues regarding investment toward the end of a longer franchise term would still remain. In addition, the current cap-and-collar contractual risk-sharing mechanisms can make it harder for operators to make a financial case for improvements when they are receiving support payments or making additional payments to Government.

4.15 The KPMG report '*Franchise Policy Analysis'* published alongside this document suggests that one of the strongest factors in deciding whether investments and service improvements are made is the financial health of the franchisee. This is not surprising, as additional funds to plan and install improvements will be hardest to find when the franchisee is struggling to make a profit.

4.16 The existing mechanisms in the franchise contract to support operator-led mid-term investment are not extensively used. Currently, new assets can be listed as Primary Franchise Assets if deemed appropriate by the Secretary of State, and then passed over to the subsequent franchisee at a price to be agreed with an incoming operator (although rights for the Secretary of State to 'de-designate' do exist under the franchise, these can be formally waived to provide operators with certainty).

4.17 Whilst this provides some measure of increased financial certainty, the staff time and research involved in investigating opportunities and presenting even a simple proposal to the Department appears to discourage some operators, especially if the long-term value of the investment is uncertain or hard to predict.

4.18 Alongside longer franchises, the Department is therefore considering whether contractual mechanisms could be changed to encourage more operators to plan and carry out improvements mid-term, accompanied by an agreed level of depreciation applicable to that asset so that it would be passed to the next operator at a predetermined price. We are also considering widening the definition of additional investments to place more categories of investment outside the normal cap-and-collar regime described in Section 6. However, the Department would need to ensure that any proposals add value to future franchise competitions.

4.19 The Department will also review its internal processes to ensure that, when outline investment proposals are received, these are considered within pre-agreed timescales.

Improving stations

4.20 The recent report *Better Rail Stations,*[6] prepared for the Secretary of State by Chris Green and Professor Sir Peter Hall, highlighted the complexity of managing the stations portfolio. Many of the issues raised in the report are for Network Rail to address as station landlord. However, the Department is keen to use franchising to deliver better facilities and services on stations. We will therefore consider the recommendations made in the report carefully in the run-up to issuing invitations to tender, including the issues raised about allocating responsibility and funding for station improvements. .

4.21 The Department will also consider providing taxpayer funding for better stations by directly specifying key improvements in franchise competitions where this is value for money and is affordable. Examples of direct specification include the requirement for over a thousand new car park spaces and 1500 secure cycle spaces on the South Central franchise. We will also ask for bidder proposals – on South Central the successful bidder proposed a package of station enhancements across the franchise area. This proposal was acceptable to Ministers and was therefore purchased as part of the franchise. Other franchises, for instance Chiltern, contain a contracted requirement to spend an allocated annual sum on stations.

[6] Chris Green and Professor Sir Peter Hall, November 2009, *Better Rail Stations*, Department for Transport.

5. Changes during the life of a franchise

Change mechanisms employed in franchise contracts will be made more robust and easier to use.

Mechanisms to encourage operators to identify sensible cost savings from service changes will be developed.

Changes required by Government

5.1 Throughout any franchise term, it is likely that some form of change will need to be implemented. Such changes could reflect a number of new and different policy objectives, such as:

- fares and ticketing (such as the implementation of Oyster Pay As You Go in London);
- infrastructure enhancements (such as station enhancements or longer platforms); or
- new or additional trains (such as the additional trains for London Midland).

5.2 It is especially likely that, when longer franchises are in operation, changes will need to be delivered. Over a longer franchise, it is unlikely that all the potential changes could be envisaged at the start of the franchise, and it would take too long to wait for a new competition to commence to incorporate such changes as part of a new competition.

5.3 It is therefore important that any franchise has in place appropriate methods by which such changes can be implemented – and costed – in a clear and consistent manner.

5.4 However, it has to be accepted that a price obtained in a single-tender negotiation is likely to produce a worse value outcome than one received through a competitive bidding process.

5.5 All recent franchise competitions have included a requirement for bidders to submit a financial model as part of the bid that is then used to cost changes through the life of the franchise, as well as assessing the contents of the bid. However, models submitted as part of their bids have been of varying quality.

5.6 Within the South Central franchise competition, a specific Modelling Change Plan had to be submitted by bidders and was scored as part of the overall deliverability assessment. This requirement reflected the particular issues associated with the rail network in that area and specifically changes associated with the Thameslink Programme.

5.7 The Department believes that the focus on this particular element of the agreement added significantly to the quality of this part of the contract. The detailed refinements to elements such as the Record of Assumptions and the requirement on bidders to submit examples of how changes would be modelled mean that changes to the franchise contract are likely to be easier to implement in future.

5.8 The Department is therefore proposing that the Modelling Change Plan included in the South Central competition should be included as standard for future franchise bids.

5.9 Where a change can be envisaged but funding has not yet been committed, the Department proposes that a price will be sought for that change under the additional elements and enhancement package and then contractualised as appropriate. This price will have been obtained under the competitive tension of the bid process and should therefore be lower than would be obtained under the normal change process.

5.10 However, it is recognised that in many cases the enhancements will not be envisaged at bid stage. It is also envisaged that including too many such options within a bid will increase bidding costs and the overall burden on bidders, especially when such options have a low chance of being delivered. We therefore need to limit the number of options requested to minimise bid costs.

Other changes during the franchise

5.11 There is also a steady flow of smaller changes to franchise agreements, often negotiated in response to issues raised by operators – this is part of the routine work of managing large contracts.

5.12 The guiding principle in any such changes is that franchisees should carry out all the commitments that were contractualised during the bid process, or, if commitments have become overtaken by events, franchisees can agree with the Department to deliver a benefit of equal value to the railway and passengers.

5.13 The Department does seek to work in partnership with franchisees, and this usually works well. But the Department also has to be prepared to use the contract to protect the benefits purchased by the taxpayer on behalf of passengers; our policy remains that we should not bail out operators who have misjudged bids. There are therefore cases where operator proposals to change commitments are turned down as inadequate.

5.14 It will be important, especially in the case of longer franchises, to ensure that the Department's original specification can be amended during the franchise term. We therefore want to ensure that operators have an incentive to propose changes to service levels to reflect levels of use. The Department is therefore considering amending the current franchise agreement so that' where operators propose sensible measures to reduce costs during their franchise term' they will be rewarded by receiving a proportion of these savings.

5.15 Under the current process there is no incentive for operators to make sensible changes to services that are no longer justified, since any savings are returned entirely to Government. This in turn drives sub-optimal decision making. It will be important that any such changes proposed by the operator are justified, and the Department will always consider such changes.

5.16 The Department is also looking to encourage a greater volume of operator-led investment proposals that can deliver change on a franchise. Mechanisms to encourage more innovation and investment have been discussed in Section 4.

6. Better managing risk and incentivising operators

Provisions will be strengthened to discourage operators from walking away when times are tough.

Franchise agreements will continue to give train operators revenue incentives to attract passengers and develop the business.

Alternative risk-sharing mechanisms will be considered, including linking franchise payments to external economic factors, such as GDP or Central London Employment.

Lessons learnt from recent events

6.1 The current franchising system includes a number of safeguards to ensure that the train operator will remain solvent and cannot walk away from the contract without a monetary penalty. As part of these contracts, owning groups may be required to give 'parental guarantees' to Government that they will stand behind losses incurred by the operator to a predetermined level. They must also provide performance bonds that are used to cover the Department's costs should the operator terminate the agreement.

6.2 Experience in the recent economic downturn has led us to conclude that these measures should be strengthened. It is therefore proposed to increase the level of the performance bond and require the bond to be paid in full. We will also re-examine how parental guarantee requirements are calculated, in the light of any amendments to the risk-sharing mechanisms.

6.3 The Department believes it is nevertheless sensible to place a clear limit on the level of exposure an owning group might have to a particular franchise. This is because many of the elements that influence revenue levels are not in the control of the train operator. Therefore, very onerous funding requirements will increase the cost of the franchise to Government and may also limit the field of potential bidding organisations.

Sharing risks

6.4 When signing a franchise contract, train operators accept risks regarding passenger revenue over the life of the franchise. In times of slowdown or a recession, passenger numbers may reduce and business travellers may opt for cheaper tickets, or choose not to travel at all. In periods of strong economic growth, passenger numbers and revenues may grow as a result of increases in commuting, greater disposable income and a greater need to travel. Such changes often only have a limited link to specific actions taken by train operators, especially where mode choice is limited.

6.5 The Department currently shares some of this wider economic risk with train operators. The current cap-and-collar mechanism provides some protection for operators from wider economic risk and shares some part of the revenues gains during periods of growth.

6.6 The Department also protects operators from changes in the Retail Price Index (RPI) by indexing an element of franchise payments to reflect these changes.

6.7 Revenue risk is an important incentive for operators to manage their business effectively and attract more passengers. Under such circumstances there will continue to be a risk that operators get into financial difficulty if revenues diverge strongly from what was predicted at bid. This risk is increased by longer franchises, as economic prediction becomes harder.

6.8 Recent experience also shows that the current cap-and-collar mechanism can limit incentives for operators that are receiving revenue support.

The revenue incentive

6.9 The Department believes that the current approach to franchising has delivered significant benefits to both the taxpayer and farepayer and that it is broadly the right model for the future.

6.10 Under a pure franchise model, operators keep the revenues that passengers pay to travel by rail. The profitability and success of franchises depends largely on how far revenues perform in line with the expectations at bid. Franchising therefore provides incentives for operators to increase passenger numbers and revenues as far as possible.

6.11 The alternative is a ‘concession’-type contract, where contractors are paid a fee for operating rail, with the money that the operator receives being largely unconnected to the revenues generated by passengers. Usually the public sector receives the revenue generated. Under a concession, the operator’s profitability and success are determined by its ability to achieve the output-based targets included in the contract, usually as a set of Key Performance Indicators (KPIs). It is up to the concessionaire to manage the business to achieve these KPI’s at the lowest cost.

6.12 Most rail contracts around the world, including those in the UK, are a mix of these approaches. However, the UK franchise system relies strongly on revenue incentives and competition between bidders at franchise award to deliver outcomes. The franchise includes a number of requirements and KPIs that must be delivered, but relies on the ability of the operator to generate revenue from its own actions to maintain and improve the service offered.

6.13 Rail companies usually do more than is called for by the strict letter of their franchise agreements and licences, or even by commercial imperatives. As well as improving their overall business, such actions can be used to justify proposals and ways of working in new contracts. Longer franchises build on this strength and allow good operators to develop long-term relationships with passengers and stakeholders, build revenues and invest to improve the network. The Department intends to keep and build on the current franchise model by leaving a large degree of revenue risk with operators.

Current contract mechanisms

6.14 The cap-and-collar risk-sharing mechanism has been included in all rail franchises since 2004. This mechanism shares risk between the Department and operator. It requires the Department to make additional payments to franchisees if revenues fall below a level agreed at the time of bid, the so called Target Revenue.

6.15 The Department meets part of the shortfall, and the operator must bear the rest; the level of the support varies depending on the level of target revenue shortfall, but up to 80% of the revenue shortfall may be paid by the Department. This mechanism starts after four years of the franchise being in operation; for the first four years the operator stands by itself.

6.16 If revenues out-perform predicted levels, the franchise pays some of the additional revenues to the Department. In some instances 80% of revenues above a defined level are paid to the Department.

6.17 The mechanism recognises that a significant portion of revenue growth or decline is not controlled by the franchisee. Rail revenues are intrinsically linked to general economic and employment patterns, as well as to the performance provided by the operator. However, the current approach means that the operators are insured for both wider economic impacts and also their own ability to operate the service, provide a good quality service to the public and subsequently grow revenue.

6.18 This mechanism does have benefits for taxpayers. In a sudden economic downturn, such has occurred in the last year, additional franchise payments to existing franchisees will tend to reduce the number of franchises that experience financial difficulties – as long as the franchise has been in place for at least four years.

6.19 The mechanism also means that the taxpayer benefits during periods of economic growth, especially where this growth is above that forecast during the bid. However, recent experience has demonstrated a number of problems with the current design.

6.20 When the operator is receiving 80% revenue support or paying 80% revenue share, incentives are inevitably weakened. It is also unlikely that, once an operator has entered revenue support, it will ever leave it, given the levels of year-on-year growth that might be needed to regain losses in early years.

Alternative mechanisms

6.21 A number of alternative mechanisms could be employed that would correct for the shortcomings in the existing system. Some of the suggested approaches are noted in Appendix B. This table details a number of potential risk-sharing mechanisms that have been suggested to us and details some of the pros and cons of each approach.

6.22 The original franchise agreements let in 1996/7 gave full revenue risk to the operator. No revenue support or cap-and-collar mechanisms were employed. This is the model under which the current c2c franchise has successfully operated for nearly 15 years.

6.23 However, it should be remembered that a number of the franchises let under this approach were renegotiated by the Strategic Rail Authority in the early years after privatisation, recognising that bids had been too optimistic. The Department does not believe that competitive bids would be received if all financial risks rested with the operator regardless of what risks these were.

6.24 A mechanism that rebases revenue at periodic intervals throughout the franchise has also been suggested. This would see the maintenance of growth rates forecast as part of the bid, but the revenue readjusted to reflect actual revenues at an agreed point (for example every three years). This mechanism could create a number of perverse incentives, with operators focusing on very short term revenue generating activity or holding back from sensible revenue-earning activities until after a ‘rebase’ has occurred. The Department does not propose to assess such a mechanism in detail.

6.25 Some operators have shown an interest in a more direct link between franchise payments and Gross Domestic Product (GDP) and / or employment. Such a mechanism would potentially remove the perverse incentive issues with the current cap-and-collar approach. And – if all the revenue effects of exogenous events could be included – such a mechanism would focus operators entirely on management actions that increase revenue, such as marketing, pricing, service improvements and revenue protection.

6.26 As with current risk sharing arrangements, the aim of GDP/CLE type indexation would be that operators would not receive benefits from wider economic growth, or suffer the impacts of a downturn outside their control. Franchise premiums or subsidy payments to an individual operator could go up or down in relation to such changes.

6.27 In reality, such a mechanism could only approximate for the real effects of economic and employment changes. It might therefore be sensible to design a mechanism that would insulate franchisees from only part of the exogenous risks – in order to avoid providing too much support, or extracting too much revenue in periods of growth. This would also mean that the operator would still be incentivised to take prudent actions to reduce costs in any downturn or grow revenue further in a period of growth.

6.28 We are therefore considering mechanisms that could meet around 80% of these impacts, based on historic trends between revenue and GDP etc. Such an approach would ensure that train operators are not in the exceptional position of being entirely protected from the effects of wider economic changes.

6.29 It may also be appropriate to combine such an approach with a cap-and-collar mechanism in order to protect operators, passengers and taxpayers from major structural changes to the economy, although any such mechanism would be capped at 50% in order to retain a degree of incentive for operators to act rationally. The point at which cap-and-collar would apply would also be significantly widened.

6.30 These are complex issues, and the uncertainty created by an entirely new system may outweigh potential benefits. It is also important to assess how such a mechanism would perform under a range of economic growth scenarios and not to design a system that would only cope with the current pressures. Any approach might also need to reflect the significant differences between the different train operating cost models. The resulting bid behaviour would also need careful consideration to ensure that one set of perverse incentives is not just replaced by another.

6.31 The Department is currently considering the potential effects on bidder and operator behaviour of different mechanisms, as well as the likely impact on the Departmental budget. Conclusions will be set out when the Invitations to Tender for the Greater Anglia, Essex Thameside and InterCity East Coast are published later this year. We will discuss emerging thoughts on this approach with the rail industry over the coming months. Overall, any risk-sharing mechanism must be affordable for the Department and deliver good value across the length of the franchise contract, as well as incentivising the right bidder and operator behaviour.

7. Next steps

7.1 Over the coming months, the Department will be discussing the issues highlighted in this document with key members of the railway industry, including train operator owning groups. The Department will also be carrying out further work to develop, test and refine the options proposed. We will also consider the value for money of these proposals.

7.2 This document does not constitute a formal consultation paper, as the proposed developments of contract structure and design are judged to be of a more technical interest to owning groups and operators. However, the Department would welcome comments from other interested parties on these proposals. The address for such responses is given below. We will consider all comments received on these issues, but it would be helpful if such responses were submitted before the end of April 2010.

7.3 The Department will consider any views as it refines its franchising proposition for the next franchise competitions. We intend to publish a further our conclusions later this summer, alongside a report on industry views.

7.4 Later this month the Department will launch the formal consultation for the next three franchise competitions: Essex Thameside, InterCity East Coast and Greater Anglia. The Invitations to Tender for these franchises will be published later this year and will include any revisions to the franchising process. These consultations will cover the issues of the widest interest to passengers and stakeholders, who are encouraged to comment on all aspects of the franchise proposition.

7.5 Responses should be addressed to:

Franchise Policy Team
Zone 5/28
Department for Transport
Great Minster House
76 Marsham Street
London
SW1P 4DR

Or by email to

franchisepolicy@dft.gsi.gov.uk

Appendix A: Current franchise contracts managed by the DfT

Table A1 Current franchise contracts managed by the DfT

Franchise	**Owning group**	**Start date**	**End date**	**Franchise length at award**	**Break point/extension**	**Other notes**
Southern	GoVia	Sept 2009	July 2015	5 years 10 Months	July 2014. Extension of up to 2 years to July 2017	Thameslink programme required shorter than average franchise
C2C	National Express	May 1996	May 2011	7 years (subsequently extended to 15)	15 year franchise dependent on rolling stock order by specified date.	
Transpennine Express	First / Keolis	Feb 2004	Feb 2012	8 years	5 year extension possible	
Virgin West Coast	Virgin	March 1997	March 2012	15 years		Franchise operated under letter agreement for a number of years
Northern	Serco / Ned	Dec 2004	Sept 2013	8 years 10 months	Sept 2011	
National Express East Anglia	National Express	April 2004	April 2014	10 years	April 2011	Breakpoint clause exercised
First Capital Connect	First Group	April 2006	April 2015	9 years	First break point April 2010; franchise can be terminated anytime after 2012 at SoS's request	Contract structure designed around Thameslink Programme

Franchise	Owning group	Start date	End date	Franchise length at award	Break point/extension	Other notes
Southeastern	GoVia	April 2006	April 2014	8 years	April 2012	
East Midlands Trains	Stagecoach	Nov 2007	April 2015	7 year 6 months	Nov 2013	
London Midland	GoVia	Nov 2007	Sept 2015	7 years 10 months	Nov 2013	
First Great Western	First Group	April 2006	April 2016	10 years	April 2013	
CrossCountry	Arriva	Nov 2007	April 2016	8 years 5 months	Nov 2013	
South West Trains (including Island Line)	Stagecoach	Feb 2007	March 2017	10 years 1 month	Feb 2014	
Chiltern Railways	DB Regio	March 2002	Dec 2021[7]	Up to 20 years, depending on investment	Extension to Dec 2021, depending on investment	

- East Coast is currently operated by Directly Operated Railways, a subsidiary of the Department for Transport;

Other franchised railways:

- Merseyrail – managed by Merseytravel;
- London Overground – managed by Transport for London;
- Scotrail – managed by Scottish Government.
- Arriva Trains Wales – let by the DfT but managed by Welsh Assembly Government.

[7] If Transport and Works Act application is unsuccessful franchise end date revised to Dec 2016

Appendix B: Possible risk-sharing models

Table B1 Possible risk-sharing models

Option	Description	Positive	Negative
Cap-and-collar (current approach)	Current approach: operators receive share of revenue shortfall below the target revenue proposed at bid, of 50% or 80%. They pay a similar proportion of revenue to DfT if revenues are above target. Support starts from year 4 only	Has encouraged ambitious bids. These bids have been positive for taxpayers in recent years when economy has grown. Franchise payments are predictable to some extent for DfT and operators – during first 4 years and whilst a franchisee is within the neutral band (within 2% of target revenue).	Support only available after year 4; significant shocks can occur in this period. Revenue incentive reduced if operator is in the 50% band and significantly reduced if in 80% band Once an operator falls 2% below the target revenue line they proposed at bid, they are likely to remain in support for the rest of the franchise

Option	Description	Positive	Negative
Revised cap-and-collar	Current approach, but only 50% share support offered; could apply from year 1	Revenue incentive of 50% when in support /share – keeps a stronger incentive than current 80% band May lead to bidders offering less ambitious revenue growth projections, increasing franchise robustness and reducing tendency to enter revenue support Franchise payments predictable to some extent.	More cautious bids could lead to operators' making very large profits in an unanticipated upturn, as a result of higher-than-necessary taxpayer support. This reduces funds available to transport as a whole. Revenue share no longer available at 80% - potentially worse for taxpayer (but depends on how the new system affects bids, and the actual economic outturn). Revenue support no longer available at 80% - potentially worse for operator (but depends on how the new system affects bids, and the actual economic outturn).
Revenue reset Mechanism – three-yearly	Every third year the target revenue in the franchise agreement is reset to actual revenue, although the growth profile as bid for subsequent years would still apply	Avoids target revenue and real revenues diverging, therefore maintains revenue incentive – although will be focused on the short term.	Will promote short-termism and potential perverse actions by operators as they approach the reset period Hard to anticipate market reaction – bidders will have to devise different bidding strategies.
GDP/CLE Links	Using a predefined GDP/CLE link within the calculation of franchise payments with payments adjusted up and down depending on GDP/employment numbers	Is intended to insulate operators from the revenue effects of an economic downturn or upturn during the life of the franchise. These factors are outside their control – although it should be recognised that any link-factor can only approximate the actual effects of exogenous events on an operator. Makes train operator profits largely dependent on the actions and initiatives of the operators (and not on how accurately they predicted wider growth at bid).	Relationship between GDP/CLE and revenue is not precise and may therefore over or under compensate some operators. This could have potentially perverse effects on operator incentives, increased risk of franchisee failure, unnecessary taxpayer cost and high profits for operators. Further reduces DfT 's ability to predict franchise payments compared to current system. Hard to anticipate market reaction.

Option	Description	Positive	Negative
GDP/CLE Links shock bands	Using a predefined GDP/CLE link within the calculation of franchise payments with payments adjusted up and down depending on GDP/employment numbers but only when these move outside predefined bands	Is intended to insulate operators from the revenue effects of major changes arising from economic cycle. Makes train operator revenues largely dependent on the actions and initiatives of operators (and not on how accurately they predicted wider growth at bid). Operators and DfT will have certainty about franchise payments whilst "in the band".	Relationship between GDP/CLE and revenue is not precise and may over or under compensate some operators. This could have potentially perverse effects on operator incentives, increased risk of franchisee failure, unnecessary taxpayer cost and high profits for operators. Outside "the band", franchise payments remain unpredictable. Hard to anticipate market reaction.
80% GDP/CLE link with cap-and-collar	Using a predefined GDP/CLE link within the calculation of franchise payments, with payments adjusted up and down depending on wider economic circumstances GDP/employment numbers – although only 80% of the impact – would be passed to the operator. A wider (94%–106%) cap-and-collar could also apply in case of major structural changes in the economy.	Removes the risk of extreme exogenous factor changes from the TOC that it has no control over Makes train operator revenues dependent on the actions and initiatives of operators Protects operator further for extreme structural changes Allows DfT gain in a severe upturn period Encourages operator to make sensible decisions during recessionary or growth periods as they are not entirely insulated.	Relationship between GDP/CLE and revenue is not precise and may over or under compensate some operators. This could have potentially perverse effects on operator incentives, increased risk of franchisee failure, unnecessary taxpayer cost and high profits for operators. Further reduces DfT 's ability to predict franchise payments compared to current system. Hard to anticipate market reaction – especially given mix of methods.

Note: 'revenue incentive' in this table is used to refer to the incentive an operator has under the franchising system to perform well for passengers, invest in service and facilities and maximise income. This is a significant issue when considering risk-sharing. However, there are other controls in the franchise agreement which work alongside revenue incentives (including mandatory contractual requirements, targets and incentives from performance breaks). The Department also mandates and purchases many investments and service features directly through the specification issued to bidders.