

## **ATOC Response to DfT Consultation on Future of Franchising**

Franchise reform is a big opportunity for Government to get a better deal for both passenger and taxpayer alike. Although the language and direction of travel in the DfT January document is encouraging, it falls far short of what is needed.

Many commentators agree with ATOC that the current system is too tightly prescribed and managed. A better balance between the public and private sector roles needs to be found which does not treat TOCs essentially as management contractors. The tightness of the Department's grip can work against the interests of passengers, for example, where TOCs find that the time it takes to secure DfT approval for timetable changes (which may take many months) slows them down from offering better services to passengers.

Taxpayers would benefit from franchise reform as well and we believe that reform should be a major focus of the McNulty Review into value for money on the railways. We have estimated that the proposals for reform in six areas which we set out in our report of October 2009, promoting among other things longer, more output-based franchises, could reduce TOC and NR costs by as much as £350-600m per annum by 2014, split roughly evenly between TOC and NR costs. This amounts to a 5% reduction approximately in the total costs (before revenue) of providing rail services. In a time of financial stringency, a prize of this size is simply too big to ignore and we are very disappointed that the DfT has not reacted to our proposals more positively.

We also see no recognition of the value that a competitive bid process to find the best inputs to deliver the Department's outputs (eg. passenger satisfaction, capacity and reduced crowding) might bring. Under such an approach, bidders would identify their own blend of changes to timetables, rolling stock, revenue protection and staffing to achieve outputs. The bid competition at the moment is very much focussed on costing up the Department's inputs rather than testing to see if a better set of inputs can be identified. The forthcoming Greater Anglia bid, for example, is an opportunity to see if bidders can identify better ways of delivering outputs, such as speeding up the London-Norwich route off peak, using different rolling stock for the routes and finding better ways of protecting revenue.

In a number of ways, the DfT approach runs the very real risk of hardening the status quo and encouraging even more detailed DfT involvement. It also will lead to a substantial cost increase as a result of the requirement for increased performance bonding, very much the opposite direction to which the industry should be heading.

Preparation is already underway for the reletting of the next two franchises (ie. Essex Thameside and Greater Anglia). There is still time to let these along the lines we have proposed before issuing the ITTs, and we hope that the Government does not choose to maintain the status quo simply because of the apparent constraints of the procurement timetable.

We have concerns in six key areas.

### **Specification**

We are very disappointed that DfT shows no sign of stepping back from the detail of rail timetables (eg para 3.12 of the consultation document). This approach hardwires cost by fossilizing out of date timetables, making it harder for TOCs to respond to changing market pressures such as the continued growth of traffic into regional centres. It also makes it

nearly impossible for TOCs to negotiate better rolling stock leases, as the August 2008 Competition Commission report pointed out.

We completely accept that there need to be some key service specifications by DfT for all franchises. These might include first and last trains, minimum service frequencies at smaller stations and minimum journey times between key station pairs. The level of detail must acknowledge upfront that not all franchises are same: less detail is needed for TOCs such as East Coast, for example, which generates premia for DfT, than for Northern which requires significant subsidy. The Department's document is particularly silent on this point.

In a separate paper, we have provided worked examples of how our approach might be applied to the Essex Thameside and East Coast routes, but we are particularly unhappy with the way in which these examples have been interpreted by officials. As the first part of that paper indicates, our purpose is to identify the *minimum* specification needed for social reasons rather than *actual* level of service a franchise would most likely provide in practice once the power of the customer through the farebox is added in. ATOC is certainly not proposing that there should be major service reductions on these routes. With these two TOCs between them generating over £1.75m of revenue **every day**, there is ample awareness of the opportunity to provide an attractive service with good frequencies, service quality and journey times, to ensure that passengers keep on coming back to rail as their preferred mode of travel.

We have also proposed an innovative reform to franchising, to tie an element of franchise payment to improvements in passenger satisfaction within a structure that offers financial rewards if plans are exceeded and penalties if they are not. This mechanism would be in addition to the current structure under which, in the limit, a franchisee could ultimately be replaced for significant and repeated failure to deliver satisfactory performance. We see no response to the idea of judging franchises against passenger, rather than DfT, feedback in the Department's document.

### **Franchise length**

Although we were encouraged by the way in which the DfT January document opens the door to longer franchises, we were dismayed by the proposal to evaluate bids on the basis of the subsidy/premium sought over a 10, rather than a 15-20, year period (para 4.10). This makes it highly unlikely that bidders would risk significant bid resources (for example, in assessing opportunities for long-term cost reduction initiatives, such as improving labour productivity) in putting together a 15-20 year plan, because they would know that only the 10 year view would count. This approach is surprising because in the past SRA successfully evaluated bids on a 15-20 year perspective (Merseyrail, Wales and Borders, Chiltern (in 2000/01) and OPRAF let a series of others including c2c before that. None of these awards were criticised by the NAO: the restriction to a 10 year bid is therefore a retrograde step.

We have also found the DfT position somewhat hard to follow because it seems to have changed from the January document, and we understand that the option of extending a 10 year franchise, if a bidder puts forward good ideas, to a longer period is now actively being considered. This is potentially positive, but we need to know more detail to have any confidence this would work in practice. It is very much better from both a taxpayer and a passenger perspective for a 15-20 year franchise to be bid as such right at the outset rather than being 'retrofitted' in to a structure designed for a 10 year term.

## **Performance bonding**

ATOC's members think that the proposal to increase the performance bonding requirement is a wholly disproportionate reaction to the East Coast situation (para 6.2). Of the approximately 45 franchise lettings and extensions since privatisation, only three (Connex South Eastern, GNER and NXEC) have got to the stage in which calling on the bond was even an option and, so far as we know, it has only been invoked once. The reputational consequences to management and shareholders of any failure to perform are in practice considerable and are often over-looked. The franchisee has a very substantial incentive to make the bid work: this, together with the fact that roughly three quarters of franchises now have liquidity and financial ratio requirements as well as bonding, means that the financial costs of any franchise problem are already very substantial.

ATOC is therefore dismayed that, at a time when the industry's costs are under close scrutiny, the DfT is proposing both to double (roughly) the bonding requirement and to insist that it is fully paid up rather than being provided by insurance-backed bonds as is common today. This might require franchisees as a group to commit funds by way of bonds amounting approximately to an extra £1bn, costing the Department something in the range of £50-75m per annum extra (at a cost of borrowing between 5 and 7.5%), since the cost of this will inevitably be fed into bids.

## **Quality and innovation**

ATOC's proposal that franchise evaluation should include a significant weighting on quality in addition to the bid-line has not been addressed sufficiently. Our approach would encourage greater provision of those quality aspects, such as better stations, cycle spaces and retailing technology that the farebox provides insufficient return for, as well as providing a more balanced approach to franchise bidding by ensuring that the sole focus is not just the bid-line.

Other countries manage to achieve this balance. Examples are the recent award of the Oresund Bridge services in Denmark and Sweden (won by a DSB-FirstGroup consortium) and the Stockholm Metro contract (won by MTRC). In the latter case, one of the unsuccessful bidders (Veolia) appealed against the award on the basis that the weighting given to quality was inconsistent with EU procurement law, but the appeal was unsuccessful.

This approach could be applied to the UK by DfT using the significant amount of information it already gets from bidders on quality to create a blended score that includes an assessment of price as well as areas such as station condition, rolling stock and station cleanliness, and staff training.

## **Greater responsibilities for TOCs**

Our proposals for TOCs to take on more responsibility for station and depot spend have been ignored (eg para 2.09). We believe that in excess of £250m can be saved in CP4 as a result of this, because TOCs have lower overheads than NR and better incentives to get project scopes right. Examples, such as Chiltern, Southern and LOROL, show what can be done.

The value of greater TOC involvement in rolling stock investment is also not acknowledged. It is important to remember that many of the new fleets ordered since privatisation, such as the Turbostar, the Electrostar, the Pendolinos, Voyagers and the Desiros, were specified and

ordered by TOCs rather than DfT. They are all working successfully and are a big success with passengers. The Turbostar diesel train is now very widely used, based on an initial order by Chiltern Railways. The success of this has led to follow on orders by about six franchises and the development of a 'greener' successor, the Class 172. All of these were achieved by TOCs working with manufacturers and ROSCOs rather than by central planning by the DfT and show what can be done in a commercial environment, as pertained in the initial OPRAF franchises, in which getting new trains was key to expanding frequencies and improving services to passengers.

### **Sharing of risk and reward**

The Department's proposals on new risk-share mechanisms (paras 6.21-6.31), involving a mechanism based on changes in GDP/CLE, are welcome. These are generally on sensible lines, but the substance must now be fleshed out. We know DfT has a summary report from KPMG which they have promised to share with us, but until we see it it is difficult to know how effective it might be.

We also welcome the indication that the Department will move to a 50/50 support system in future, possibly even within the first four years of a franchise, in place of today's 80/20 structure which has proved to have major limitations from an incentive perspective.

DfT have confirmed they want to take forward the proposal (para 5.14) to give a franchisee an incentive to propose reductions in costs during the franchise, by allowing them to keep a share of those reductions. This is another potentially useful step, since it removes the current absurd situation where a TOC that puts forward a cost saving initiative effectively gains nothing from it, since under the franchise agreement all of the benefits flow back to Government. However, we need to see further detail to be confident that it will work.

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