Train Operators
Working Together
ATOC

Franchise Reform

a better railway for passengers and for taxpayers

October 2009

The Association of Train Operating Companies (ATOC) is the national voice for train companies in Britain.

ATOC's mission is to work for passenger rail operators in serving customers and supporting a prosperous railway. We do this in three main ways:

> Running services which are mission-critical to passenger operators, such as National Rail Enquiries and the Rail Settlement Plan

> Managing major commercial arrangements where a collective approach delivers benefits for passengers, including railcards and promotional fares

> Striving to create a positive business environment for train companies, by building strong relationships within the rail industry, the broader business community and key policy makers.

Foreword

Passenger rail has boomed since privatisation. People have flocked back to trains in numbers not seen since the Second World War, with journeys up by 60 per cent since 1996. Train companies have been at the forefront of a sea-change in rail travel, generating record levels of investment, customer satisfaction and punctuality.

Train companies are passionate about doing more to improve the quality of rail travel. But we believe that it will become increasingly hard to deliver further benefits to passengers and taxpayers if the rules by which train companies are allowed to operate are not reformed.

The innovation, flair and commercial acumen of private sector operators are being hampered by unnecessary red tape which prevents a speedy response to changes in the economy, focuses too much on specifying operational requirements rather than the outcomes which passengers want, and deters long term investment.

What we need is a system which frees up train companies to do more for passengers. Where the government can reap the rewards of greater stability and smaller costs. And where train companies are motivated to become major investors in the rail renaissance.

We believe the way forward is not in radical change, but in focused reform of the existing approach to franchising in six areas. This report is aimed primarily at guiding policymakers in making the most of the next round of franchises: if adopted, it will allow train companies to work more effectively with private and public sector partners to deliver a better railway, fit for the 21st century and to the benefit of us all.

Michael Roberts
Chief Executive,
Association of Train Operating Companies
October 2009

Executive Summary

Train companies believe that an effective response to the challenges facing the railways should, among other things, include further evolution in a franchising system which has underpinned many positive developments in rail since privatisation.

This paper sets out proposals for smarter franchises which, as a package, would help increase investment, cut taxpayer subsidy, promote stability and free up train companies (TOCs) to give passengers the service that they want. ATOC believes that reform should focus on six areas.

1. Allow train companies greater flexibility to give passengers what they want

Too many franchises are over-regulated and micro-managed by the Department for Transport (DfT), which specifies timetables, frequency of trains, rolling stock and even the number of ticket vending machines.

DfT should continue monitoring franchises closely, but by concentrating less on inputs and more on setting outputs for TOCs to deliver in the most effective way, covering areas such as passenger satisfaction and capacity provided in peak hours.

Such an approach is consistent with advice on Government procurement, has been used before in delivering rail improvements, and is appropriate for a market made up of major players with a track record in delivery.

Allowing TOCs more opportunity to innovate would help them to deliver better services to passengers faster, offer scope to cut the overall cost to taxpayers of providing rail services – and potentially cut by one third the £24m spent by DfT Rail and National Networks (2007/08) on consultants.

2. Adopt longer franchises as the norm

Longer franchises are already used successfully in Britain: the three TOCs with the highest scores on performance and passenger satisfaction today have franchises of 15 years or more.

Longer franchises may not always be suitable, but we think the norm for franchises should be 15 years, and possibly 20 years in some cases, as allowed under EU law – backed up by mechanisms which exist to protect passengers and taxpayers where a TOC fails to meet its commitments.

Longer franchises would help in three ways. They would foster more TOC managerial focus on improving services for passengers, rather than looking ahead to the next bid. They would facilitate more private sector investment, by giving operators more time to benefit from their outlay – and strengthen TOCs' commitment to the long-term development of the network by giving them a greater stake in the railways.

3. Focus more on awarding franchises on the basis of quality, not just price

In line with official advice and overseas practice in rail franchising, we want to see DfT showing more commitment to the principles of best value procurement than appears to be the case at present.

This would mean DfT giving more weight, when considering bids, to proposals which commit to higher service quality at an acceptable price to Government, and not just the size of premium or subsidy due to be paid.

While the DfT's approach in recent years has helped drive down the cost to taxpayers of procuring rail services, we think our proposals would do more for passengers in terms of encouraging and rewarding ideas from TOCs for better services; and would ultimately benefit taxpayers by improving the quality of bids for franchises.

4. Structure franchises to improve financial stability

The worst recession since the 1930s has led to revenue growth significantly below projections made in franchise bids. A lack of flexibility means operators pay the same costs at a time when revenue is falling.

ATOC believes better risk–sharing is vital to promote stability in the industry. We identify seven options, including an earlier start to revenue support in a franchise, linking franchise payments to GDP and making a greater (but still limited) proportion of Network Rail charges variable.

Such options would allow TOCs to focus more on delivering long-term service improvements, to the benefit of passengers. By reducing the systemic risk in any future recessions of having to re-let franchises, taxpayers also stand to gain by enabling the DfT to plan ahead financially for the long term with greater confidence.

5. Enable train companies to take on greater responsibility for stations, depots and rolling stock

We believe that the expertise and structure of TOCs, combined with their closeness to the market and to operations, would enable them in many cases to deliver station and rolling stock improvements more quickly and cost-effectively than under current industry arrangements.

On stations and depots, experience suggests that were TOCs to take on more of a role from Network Rail in delivering improvements, then their approach on scoping projects, lower overheads and more streamlined processes could save as much as £250m-£500m from Network Rail's prospective spend in this area.

Such a move would also help Network Rail focus more on the vital job of managing and enhancing the network – very much the areas of its core expertise – ultimately to the benefit of passengers and taxpayers alike.

On rolling stock, despite the trend in recent years which has seen DfT progressively take over the role of procurer, TOCs have a positive record built up before then of working with ROSCOs to lead the ordering of £4.5billion worth of new trains. Giving TOCs the responsibility of managing procurement would lead in our view to faster delivery of rolling stock and better cost efficiency in the commissioning of new trains.

6. Sustain a mix of small and large franchises

Retaining a mix of small and large franchises has advantages. Changes in franchise boundaries can be costly and having a number of smaller franchises can help make the UK market more attractive to bidders than a market dominated by larger franchises might otherwise be.

There has been a general move towards larger franchises, but we think it essential that the DfT continues to assess the costs associated with changes to boundaries – and that there should be no automatic presumption in favour of further merging of franchises.

Introduction

The rail industry today is performing well against many important measures. Passenger satisfaction continues to improve and is up by 5% since 2000, to 81%. Train performance now exceeds 90%, its highest ever level. There are almost 60% more journeys than in 1996, and the industry is operating 30% more train-miles than then.

Train operators have played a large part in this record of success together with Network Rail and other partners, for example, by making a substantial contribution to reducing delay minutes and investing £4.5billion in new trains since 1995. Operators are very much at the front-line in helping to deliver further improvements under the High Level Output Specification set by government and underpinned by the major investment programme for the next five years in Control Period 4 (CP4).

Franchising has been a key part of the industry architecture which has made possible these developments. Despite current economic conditions, the basic model through which government (centrally, regionally or locally) procures rail services and the private sector delivers them remains sound, and continues to be used in many European countries.

But there remain many challenges. There must be continued focus on improving customer service and providing additional capacity, not least to encourage modal shift away from cars and air travel. All this needs be done in the context of considerable pressure on public finances, placing renewed emphasis in the industry on improving its cost efficiency and developing opportunities to attract additional private sector investment.

Tackling these challenges effectively will depend on many things: sustained investment, improved delivery of major projects, strategic decisions about the balance of funding for rail between taxpayers and passengers, and wider transport policy including the relative pricing of different modes. Radical overhaul of the institutional framework for rail would not be helpful: but we do believe that a move towards smarter franchising has a vital role to play in the future success of the railways.

Franchising has evolved over three phases since privatisation (as OPRAF, the SRA and now DfT have led the process). We believe that further evolution through a package of focused reforms which gives train operators, on the right terms, greater responsibility and a greater stake in the industry is in the best interests of the country.

By strengthening the role of the most commercial and customer-facing part of the industry – but still within a framework determined and overseen by government - such reforms would improve the scope for greater customer satisfaction, faster and more cost-effective delivery of improvements, and increased private investment. This paper sets out six areas of reform which as a package could help drive this:

1. The DfT should set a limited number of important high level outputs for each franchise and then give maximum scope for TOCs to find the best way of delivering them.
2. Longer franchises should be the norm, although there remains a role for shorter franchises in some cases. Longer franchises should retain the early-termination mechanisms that are in use today in case the TOC is failing to deliver (for example, on performance).
3. In assessing bids, DfT should show a stronger commitment to best value procurement and give greater weight to proposals which demonstrate ability to deliver service quality rather than simply lowest price.
4. Franchises should be structured to provide improved financial stability, which is key to ensuring that TOCs can take a long-term view on improving the service even during significant financial downturns.
5. TOCs should take on more responsibility for stations and depots, which will improve quality and cost efficiency, as well as speeding up delivery, in these important areas.
6. Ensure the franchise map sustains a mix of large and small franchises.

The time is now right to move towards smarter franchises for two reasons. First, the rail industry has matured since privatisation in the 1990s. Train operating companies today are owned by major public transport players, many with extensive international operations and fully committed to the delivery of quality services. Second, there is currently a window of opportunity to adopt a new approach in time for the next round of franchises – a window which has been widened by recent developments with the East Coast Main Line franchise. We hope the ideas in this paper will help enable policy makers to make best use of that opportunity in the interests of passengers and taxpayers alike.[1]

> "a move towards smarter franchising has a vital role to play in the future success of the railways."

[1] This paper is aimed primarily at policy makers in England and Wales, but it may also be relevant to policy in Scotland, where transport provision, including rail strategy, projects and franchising, is of course a devolved responsibility.

1. Move to franchises which are more output-based

Too many franchises today are over-regulated, adding to administration costs and slowing down delivery of improvements. A more output-based approach would speed things up, encourage innovation in more cost-effective ways of delivering what passengers want and facilitate cuts in DfT overheads. It is consistent with Office of Government Commerce (OGC) advice on complex procurements where innovation and the ability to respond in a complex market are key to delivering outcomes.

OGC's advice is that specifications should provide '…sufficient detail to allow the market to respond to requirements whilst leaving room for innovation where appropriate. Output, or outcome based specifications should normally be used…'.[2]

It is not always appreciated just how much detail about inputs the Department gets involved in in a franchise let today. Typically, DfT will:

- specify in considerable detail most of the features of the timetable to be run, such as frequencies, stopping patterns, capacity provision in the peak and even down to individual train timings,
- either decide which rolling stock to use or leave little practical choice in the matter,
- control fares which determine about 40% of TOC revenue[3], and
- identify a wide range of other features, such as Secure Stations, car parking, cycle spaces, ticket gates as well as retailing requirements such as smartcard acceptance and the numbers of ticket vending machines that they want costed into the franchise.

[2] An Introduction to Public Procurement pages 8-9: http://www.ogc.gov.uk/documents/Introduction_to_Public_Procurement.pdf and Driving Innovation through Public Procurement: http://www.ogc.gov.uk/documents/OGC09-0679_InnovationBrochure.pdf
[3] The influence of the public sector is higher again once the effect of the London areas fares process, through which fares are jointly set by TfL and TOCs, is allowed for.

The issue is not a question of whether the DfT should specify what it requires of franchisees, but how it seeks to do so. It is time to get rid of unnecessary detail in franchises and give TOCs the freedom to put in place more improvements faster through an output-based approach common in other areas of public procurement. We say this for three reasons.

First, an output-based model has been shown to be effective. Prior to 2003 when such an approach featured more strongly in franchising policy, it resulted in improvements such as:

- A near-doubling of train frequencies on many long distance routes, notably on the East Coast Main Line (particularly to Leeds), the Midland Main Line and the London-Norwich route
- Timetables that delivered step changes in performance, such as the complete recast of services into Waterloo in 2004, the standard pattern timetable for Wales in 2005 and clock-face timetables for the Snow Hill and Cross City lines in Birmingham in 2003
- More and better rolling stock, particularly the new build Pendolino and the First TransPennine Express fleets. In addition, the Turbostar, which has become the most widely used regional diesel train, was first built to allow the doubling of frequencies on the Midland Main Line
- Significant improvement on c2c, a long franchise let in 1996. What was formerly a very poorly performing railway has been transformed with a complete new fleet of trains, substantial upgrading of stations, a new brand identity and a dramatic improvement in performance
- Major transformation in customer service through services such as National Rail Enquiries (which now includes a website, an iPhone app and automated voice-recognition software for phone calls) and the roll-out of Ticket Vending Machines, which allow ticket queues to be shortened and make it easier to buy tickets through call centres and the internet.

Similar improvements are, of course, being made under the existing input-based model: the difference is that when TOCs propose improvements under the input-based model, it often takes a long time for DfT to agree to them.

Second, with many franchises relying less on subsidy and more on farebox revenue, the economic rationale for such tight input control is not clear. Revenue in 2008/09 exceeded £6bn per annum, up 180% from the level seen in British Rail's last year. Even with a period of lower passenger growth, it is quite possible that half of the TOCs will be paying premia by the end of CP4 and indeed a few may be earning enough passenger revenue to cover completely both their own costs and their allocated share of the direct grant that Network Rail receives from DfT and Transport Scotland (known as "Network Grant"). In other words, if this last group of TOCs could operate on a standalone basis, they would not need any taxpayer support at all. The need for detailed DfT prescription in the detail of these franchises is especially unclear.[4]

Third, industry relationships are mature enough to manage successfully an output-based approach. TOCs and Network Rail work increasingly well together to manage performance and plan timetables which get the most from the available capacity on today's busy rail routes. The TOCs themselves are now owned by major public transport players fully committed to delivering a quality service to the specification that customers and funders expect. They have significant managerial resources to call upon, often together with experience of bus, rail and other public transport interests right around the world. The core business of franchise owners is successfully to deliver and improve public transport and they have an established track record of providing better services by investing in buses and trains, motivating staff and driving up customer service delivery.

> "It is time to get rid of unnecessary detail in franchises and give TOCs the freedom to put in place improvements faster"

[4] The premia earned from these franchises are of course used to reduce the overall DfT subsidy budget and we would envisage this continuing (unless there is a move to a fully open access approach on main line routes). And we fully accept the need for some outputs to be set for these franchises, such as on first and last trains, and that therefore the internal 'cross-subsidy' needed within a 'commercial' franchise needs to remain. But the key point is that the DfT does not need to go into so much detail on this kind of franchise as it does with one which requires ongoing subsidy.

How a more output-based approach would work

The output-based franchise would be a natural development of the Department's approach to the High Level Output Specification (HLOS) process, which sets a top level view of the outputs that it seeks from the railway as a whole. It effectively would be a translation of the HLOS to a TOC level. We suggest the following should be included in the top-level outputs required of a franchise:

- Passengers' overall perception of how good the service is[5]
- On commuter routes, the capacity to be provided in the peak hour and peak three hours
- Performance achieved (ie. PPM)
- The numbers of hours in the day service should be provided for, including the times of first and last trains
- A carbon reduction target (or a similar measure of sustainability), which might usefully focus on the net change in carbon emissions following mode shift achieved during a franchise[6]
- For some franchises, minimum service frequencies on routes and/or mandatory calls at stations where revenues alone are not enough to cover the costs involved. This might also be coupled with a minimum number of train-miles operated since a requirement on this would naturally lead to a franchisee designing a timetable that tried to use the train-mileage to increase the number of passengers carried.

Under this approach TOCs, working with NR, would identify service patterns that best met market demands above the minima set out in the contract. They would also work with ROSCOs and manufacturers to find the best rolling stock solutions. With outputs for overall customer satisfaction, there will also be a direct commercial lever to drive up quality across the franchise as a whole including in areas such as station facilities, personal security, train cleanliness, staff responsiveness and car parking provision.

The franchise competition would be about finding the best way of delivering these outputs rather than almost entirely being about costing of the Department's chosen inputs as at present. An example of the advantages of this approach is the new Class 185 train fleet ordered for the First TransPennine franchise. This was not a requirement under the tender but FirstGroup, the successful bidder, proposed new trains as a way of providing a better passenger experience, to increase revenue and to reduce the cost of operating the franchise.

The approach would not mean franchisees simply adding trains to the timetable on an unstructured basis, simply to capture a bigger share of existing revenue rather than to grow the overall market. TOCs would still need to participate in RUSs and the industry's capacity allocation processes to gain track access rights, with final decisions being taken by ORR. The process in particular includes a demanding assessment of future performance and of the fit between the service plan with the timetables of other operators, particularly important as the country builds up a regular interval core timetable across the main routes (the main exception now being the East Coast Main Line, the new timetable for which is due in December 2011).[7]

An important feature of this approach is that it would avoid the need for DfT to become involved in the cumbersome process of consulting on, amending (or derogating) Service Level Commitments. This would facilitate application of the principles of Better Regulation[8] to the franchise management process. This would also allow the Department to deploy scarce experienced staff resources to longer term areas such as CP5 and High Speed Rail development, thus reducing the Department's reliance on expensive consultants. DfT's consultancy bill for Rail and National Networks reached £24m in 2007/08 alone. The greater the detail the Department works in, inevitably the greater the staff resources needed.

It is essential to understand, however, that a more output-based approach does not amount to complete 'deregulation' of the franchises. The railways are a key public service and the Department devotes very considerable financial resources to rail (£5.4bn last year): it is entirely right that DfT monitors franchises to ensure outputs are delivered and value for money is achieved. But we believe that our approach would free up TOCs to offer a better service and permit a significant reduction – perhaps a third - in the overall running costs of DfT Rail including consultancy costs.

[5] This might be assessed through a measure of the overall experience of rail journeys taken on each TOC, measured by a purpose-designed survey featuring a more targeted list of questions and carried out to a higher statistical confidence level than Passenger Focus's National Passenger Survey.
[6] In other words, not simply the carbon reduction from train operations per se.
[7] The changed approach we envisage is timely. The industry access planning process is currently being reviewed by a cross-industry working group set up under the auspices of the Industry Steering Group on the Network Code. In addition, ORR is currently beginning a review of its approach to access applications including those for open access services. There is therefore an opportunity to align the franchising and access planning processes more closely together from the outset.
[8] Cabinet Office, Better Regulation Commission 'Principles of Better Regulation', 2000.

In summary, output-based franchising would benefit passengers by allowing speedier improvement to rail services, as well as greater industry focus on delivering the improvements which matter most to passengers. It would also serve taxpayers by increasing the opportunity, through the bidding process, for the private sector to innovate in identifying cost-effective ways of delivering improvements as well as reducing the specific costs to DfT of managing franchises.

2. Adopt longer franchises as the norm

Longer franchises will not only facilitate increased capital investment, but also allow TOCs to make the kind of long term improvements in services and customer delivery that customers rightly expect. A long franchise would particularly encourage improvements that yield a payback outside a seven year franchise term, such as spending on stations, car parking, rolling stock (especially refurbishment), depots and customer service. Moreover, today's franchise lengths are simply not long enough to progress major management initiatives such as business process re-engineering and change initiatives designed to deliver better service and long term cost efficiencies.

Franchises of 15 years' duration should be the norm in future, with longer terms if substantial investment is required. There is, of course, a balance to be struck on franchise length and there is no single answer that suits all circumstances. Benefits in terms of greater management stability and scope to facilitate investment need to be set against factors such as the risks arising from:

- long-term revenue forecasting
- the commercial implications of major infrastructure schemes
- future HLOSs that DfT might propose downstream, and
- the reduced number of opportunities to market test the franchise.

The question of how to ensure that a franchise continues to deliver over a longer term is also an important one: we would not support longer franchises if we thought they would lead to a decline in customer service.

"Franchises of 15 years' duration should be the norm in future"

Nevertheless, we believe that 15 years is the right length, where the following features are incorporated into the franchise design:

- Retention of existing mechanisms to deal with poor delivery against clearly defined targets[9]. These include the ability to demand a remedial plan when it becomes apparent that targets will be missed and, following due process, to terminate a franchise early if major problems arise. Terminating a franchise is no more difficult for a longer franchise than for a shorter one
- Holding a mid-term review, to allow an assessment of performance and the wider environment in which the franchise is being operated. The review should lead to automatic continuation of the franchise if previously-agreed key outputs have been achieved. This is preferable to a situation where franchise extension is discretionary on the part of DfT, since the character of the arrangement is then in practice a series of short-term franchises rather than a long term one
- Adoption of measures which enable better sharing of risk between the operator and government (see section 4), such as an indexation of franchise payments at the mid-point to confirm the franchise on the long-term development path agreed at the start.

[9] The existing template franchise agreement has targets for service cancellation, capacity and delay. It contains thresholds which, if exceeded, require a remedial plan: further thresholds exist at which an event of default is reached. After an event of default, the franchise may be terminated. There are a number of other defined default events which may lead to termination.

It is sometimes argued that EU legislation prohibits the award of long franchises. The recent Public Service Regulation[10] allows the award of long franchises of up to 15 years, which can be increased by up to 50% if there is significant investment at the same time. Our proposal would therefore be fully compliant with European Law.[11] The forthcoming relet of the East Coast would be a good place to start with long franchises and the programme could then be rolled out for the c2c, West Coast and Northern franchises as experience builds up.

Franchises of this length – albeit all with slightly different structures – are already used in a number of cases such as Arriva Trains Wales (15 years), c2c (15 years), Chiltern (now on a 20 year franchise) and Merseyrail (25 years). It is worth noting that, at the moment, the three franchises (c2c, Chiltern and Merseyrail Electrics) that have the highest performance measured in terms of PPM and the highest passenger satisfaction are all long franchises. Arriva Trains Wales also successfully introduced a regular interval timetable and has developed, in partnership with a range of funders, a significant station improvement programme.

There are good arguments for having a long-term franchise in place during major route upgrades, such as those for Thameslink, West Coast and Great Western, to help manage the disruption during the work. First Capital Connect is already closely involved in procuring new trains for Thameslink yet its franchise will end before the project is completed. It is, however, particularly difficult to forecast revenue during major works: the revenue of TOCs using the West Coast Main Line was particularly badly affected by the route upgrade between 2003 until 2008 when the new Very High Frequency timetable began and the detailed interactions between the calibrations of the revenue support, Schedule 4 and Network Change mechanisms might be revisited to ensure that the risks involved here are better understood and improved means to manage them are found if necessary.

> "The forthcoming relet of the East Coast would be a good place to start with long franchises"

We recognise that there are some particular circumstances in which short franchises might still be appropriate, such as where local and regional bodies particularly value regular market testing of outputs as a means of managing costs (or are concerned about the budgetary implications of mechanisms such as revenue share). But even in such situations, our view is that an output-based approach could still be valuable. Although transfer of rail responsibilities to local and regional bodies has catalysed welcome public funding for improvements there is a tendency to have overly detailed input specifications. This then overlooks the value that the private sector can bring by finding a better set of inputs to deliver the required output and by using a partnering approach to do so.

Franchise length is therefore 'horses for courses': although 15 year franchises should be the norm, shorter franchises with different risk and investment structures might be let where this better suits local and regional needs. Nevertheless, we believe that longer franchises (including those where major upgrades are planned) would benefit passengers and taxpayers by:

- providing greater stability and thus more TOC managerial focus on improving services for passengers, encouraging staff development and building long term stakeholder relationships, rather than looking ahead to the next bid
- facilitating increased private sector investment, particularly in stations, retail facilities and rolling stock. It would also encourage such investment to take place steadily throughout the franchise rather than only at the beginning
- supporting TOCs' development as equal partners alongside NR with a real stake in planning and implementing long-term network development (very important, for example, for major technology projects such as ERTMS).

[10] Regulation EU 1370/2007.
[11] Provided that franchises are awarded in accordance with the PSO Regulation, the question of state aid clearance also does not arise since the Regulation is expressly designed to provide certainty for rail undertakings on what constitutes state aid. Contracts awarded in line with the Regulation do not need to be notified for potential state aid clearance. State aid issues are also a concern should franchises be extended or modified. Two cases at the European Court of Justice in 2003 based on contracts in Denmark and Germany established that any change to a franchise including any increase in payments could only be made if it were done pursuant to a clause under the original contract.

3. Promote best value procurement by favouring bids which aim to deliver on quality, not just price

In awarding franchises, DfT should show more commitment to the principles of best value procurement than appears to be the case at present. Bidders' experience suggests that the prime driver in recent years has been to secure the best outcome in terms of the size of premium or subsidy for a franchise, rather than to go for bids which commit to higher quality service at an acceptable price to Government.

How the Franchise Bidding Process Works

The DfT specifies the services it wants to buy and the way it would like a franchise to develop over time. Typically, this is through a new 'Service Level Commitment' (SLC) which replaces an initial SLC at franchise start. The new SLC is typically a highly detailed specification for the timetable to be introduced a year or two after the franchise has commenced and the DfT issues an 'Invitation to Tender' (ITT) summarising what it is seeking.

Bidders are invited to cost the ITT (including the two SLCs) and submit a series of plans setting out how they will deliver what the Department seeks.

The subsidy or premium that they require is the key part of the bid and is often referred to as the 'bidline' (in CP4, due to the very heavy level of direct grants by DfT to NR, many franchises are premium paying). Although DfT reviews bid deliverability[13], this is essentially about whether a bid meets the minimum standard that the DfT expects. Only when the difference in bidlines is very small is account taken of differences in deliverability above the minimum standard. One key issue with the process is therefore whether it gives sufficient weight to proposals which seek to offer higher service quality rather than simply the price bid to win the franchise.

To reach a bidline, bidders form a view on likely revenue growth, possible cost savings, the cost of meeting the DfT's capital requirements (see below) and the value of the mechanisms that share risk such as the performance regime, the possessions regime, the Network Code mechanism and revenue sharing/support arrangements.

Most commentators believe that bidding for franchises in recent years has been very competitive.[13] In effect, franchises typically take the revenue growth they expect and pledge to use it to reduce subsidy levels. Thus, contrary to the belief of many commentators, when TOCs increase fares their earnings are hardly affected because their bids have already assumed the extra income that fares rises bring and channel this back to DfT in reduced subsidies.

Similarly, although it is often argued that features such as revenue support are too generous to TOCs, it is important to bear in mind that the franchise bidding process means that the benefits of them are costed during bidding and have allowed bidders to reduce further the subsidy line that they bid for. So once again the advantages that they offer have already in effect been passed back to taxpayers through better bidlines.

There are opportunities at a more detailed level to reduce the cost of the franchise process to the taxpayer. The current requirement for the TOC to hold substantial cash balances, which amounts to about £1bn across the industry at present, makes the owner groups' capital structure inefficient and imposes costs of its own. Owner groups fully recognise the need to assure DfT of their support for franchises but believe that alternative mechanisms such as Parent Company Guarantees might also be used to do this.

[12] This is a measure of the franchisee's ability to make the improvements to the service (such as timetables) that the ITT proposes rather than the viability of the high-level revenue and cost assumptions in the bid.
[13] Professor Chris Nash and Andrew Smith, "Passenger Rail Franchising - British Experience" in Competitive Tendering for Passenger Rail Services , OECD/ECMT, Paris 2007.

The benefit of this approach – recognised not least in the October 2008 NAO report - has been to drive down the cost to the taxpayer of procuring passenger rail services, in line with DfT policy set out in the 2007 Rail White Paper to return the balance between taxpayer and farepayer funding of the railways closer to historic levels (from 50:50 to 25:75). This has been pursued within the context of both continuing high levels of infrastructure investment and relatively modest profit margins among rail businesses as a whole (typically a maximum of 5% of turnover).[14] The chart on the following page, taken from the NAO report, illustrates the planned decline in the level of support for franchises.

The downside is twofold. Bidders who might want to offer more than the minimum sought by DfT – such as more station refurbishments, extra rolling stock or commitments on Corporate Social Responsibility – are less likely to do so as they know they will get insufficient credit for them in the award of any franchise. In the DfT approach, the delivery plan scores are taken into account only if financial terms are close: and the merits of alternative service plans (such as Stagecoach's proposal for a better Midland Main Line timetable in the recent franchise competition) are only examined should the bidder that put them forward emerge during the DfT's internal evaluation as the front runner against the base specification.

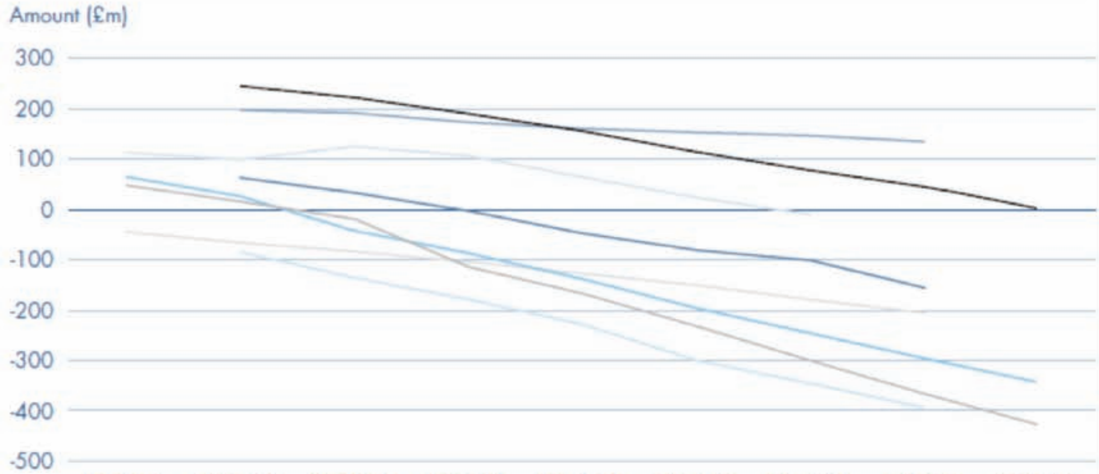
The other issue is that such a price-oriented approach is likely to have played a part in stimulating strong competition between bids in recent years. This is not to suggest that either DfT or owner groups have taken an unrealistic approach: but it could have led to individual bids which, although ultimately successful in winning a franchise, may be susceptible to strain in the event of economic downturn, particularly of the scale experienced since summer 2008.

We think that while such an approach may lead to short term financial gain to the DfT budget, it is likely to sell taxpayers and passengers short over the longer term. It is failing to maximize the appetite of the private sector to bring forward ideas on enhancing the overall quality of rail travel; and by undermining the commercial robustness of bids, it risks storing up problems for the taxpayer in the future. As the CBI noted in its October 2006 briefing "Innovation and Public Procurement" '…both the OGC and NAO specifically state that procurement decisions should not be made on the lowest initial price, but on value for money on the basis of "whole lifetime costs and quality to meet user requirements"…'.

Indeed, the Government's own guidance on this point is that "value for money is securing the best mix of quality and effectiveness for the least outlay over the life of the goods and services bought. It is not about minimizing upfront prices. Whether in conventional procurement, market testing, private finance or some other form of public private partnership, value for money will involve an appropriate allocation of risk."[15]

[14] Combination of farebox other income and subsidy payments, as reported in TOC statutory accounts.
[15] Managing Public Money, HM Treasury, 2007.

Planned payment trend for recent franchises (negative amounts are premia)



	2007-08 £	2008-09 £	2009-10 £	2010-11 £	2011-12 £	2012-13 £	2013-14 £	2014-15 £	2015-16 £
Southeastern	114	100	126	108	65	25	–9		
Stagecoach South West Trains	64	25	–41	–86	–140	–198	–248	–£296	–343
First Great Western	47	15	–20	–111	–168	–233	–302	–£364	–428
First Capital Connect	–44	–65	–83	–103	–126	–150	–178	–£205	
East Midlands Trains		64	34	–2	–46	–80	–100	–£155	
London Midland		198	193	174	162	154	148	£136	
CrossCountry		245	222	190	156	114	78	£44	6
NX East Coast		–85	–133	–179	–229	–301	–346	–£395	

Source: Department for Transport

NOTE

Subsidies for the franchises or predecessor franchises in 2006-07 total £811million. The data shows planned payment values at contract signature date. All amounts in real terms for the base year and month shown for each franchise: Southeastern – February 2005; Stagecoach South West Trains – January 2006; First Great Western – October 2005; First Capital Connect – October 2005; East Midlands – January 2007; London Midland – January 2007; CrossCountry – February 2007; NX East Coast – January 2007.

Source: National Audit Office report 'The Department for Transport - Letting Rail Franchises 2005-2007', published 2008

> "We propose a system where quality is weighted at least as highly as price in final bid award."

We therefore propose a system where quality is weighted at least as highly as price in final bid award. We recognise that the output-based approach requires a change in the relationship between the franchising authority and franchisee from client-supplier to partnership. This is not unique in government; other departments have used such an approach in complex procurements. It is also an approach which has been adopted elsewhere in Europe (see box).

Franchising in mainland Europe

Franchising of rail passenger services by competitive tender is now established in many countries in mainland Europe. To date such competitions have typically been smaller than in Britain and have only been for services requiring public support[16], but both factors tend to reduce risk on a single contract for both the operator and client body, and encourage portfolio ownership. Bid submission requirements are much simpler and consequently bidding costs are much lower.

Matters such as contract length, mobilisation period and revenue risk typically differ according to the circumstances of the franchise (e.g. offering a 15 year franchise where new trains are required) and are often decided after consultation with prospective bidders to achieve best value rather than the UK approach of focusing almost everything on price. It is normal practice to award on the basis of a combination (indicated clearly in the ITT) of price and quality and in most cases bidders' innovative options are welcomed and may be selected. This may include, for example, better train performance, improved customer service and better information displays on trains. Typically, the price bid counts for about 40-60% of the final score.

Significant franchises that have been let under this approach are First-DSB's win of the joint Danish/Swedish Oresund contract, Arriva's retention of local services in Jutland, Denmark and Arriva's award of regional services in Berlin/Brandenburg in Germany.

We believe that an approach to awarding franchises which puts more emphasis on providing quality rather than delivering lowest price works for customers in stimulating yet better service, while ultimately benefiting taxpayers by improving the commercial robustness of franchise bids.

4. Further strengthen the financial stability of franchises

Financially-stable franchises are desirable as they allow operators to plan and deliver improvement on a continuous basis, not just in a short spurt at the start of the franchise, and because they promote continued management attention on running improved services rather than short term measures to avoid franchise failure if things should go badly wrong.

There have clearly been times since privatisation when some franchises have not gone to plan. Since 1996, a number of franchises have been unable to live within the levels of support they bid for and have had to be terminated early, renegotiated or even, in the case of Connex, taken back.

Greater focus on procuring best value, as outlined above, can help reduce the risk of failure by doing more to encourage commercially robust bids in the first place. We think more can also reasonably be done by reforming the risk-sharing mechanisms in the franchise agreements themselves, to help ease the pressure which can seriously affect even well-run operators of soundly-planned franchises due to developments which are either completely unforeseen or outside their control.

When franchises do run into problems, owner groups put significant management effort into turning things around, including the injection of capital where needed. In the worst case, where the franchise economics cannot be improved, this can lead to significant losses amounting to tens of millions of pounds. Franchising, which includes a cap and collar structure on new contracts, is far from being the 'heads the franchisees win, tails the Government loses' situation sometimes depicted.

The most severe recession that the country has experienced since the 1930s has meant that TOCs have had to work hard, particularly on scrutinising costs, to maintain profitability. The downturn has very much been exacerbated by the inability of the franchises to take actions that other businesses can take, such as better matching of output with demand and slowing of non-essential capital spend (TOCs have very limited capital spend of their own). The industry structure of course concentrates much of the industry's revenue risk with TOCs rather than perhaps sharing some of it with Network Rail.[17]

[16] And not, for example, intercity operations: the UK remains unique in the EU in franchising intercity operations.
[17] A clear comparison can be drawn here with aviation. The current global downturn in traffic (of about 10% per annum) has put pressure on airports to cut landing charges and also on aircraft lessors to offer better terms (ie. write down values faster), in order to keep airlines flying. BAA is said to have offered better terms to airlines at Stansted (which its regulatory structure permits it to do) and lessors have had to offer better leasing terms to airlines to keep their aircraft flying.

A better approach

The way forward is to promote better sharing of risk while still incentivising TOCs to provide better services for passengers as the key to growing their businesses. The fundamental principle that the franchisee takes risks which it is best placed to manage should remain. Increased stability of tenure from long franchises should not mean certainty of tenure: where TOCs can grow the market and manage costs successfully, they should be able to earn returns commensurate with the risks incurred (including those from revenue shortfalls), but where they fail through poor management their franchises should be terminated. The issue is the level of risk to which long-term franchises in particular should be subject.

There are various options to consider and we envisage that a final structure would need to be designed carefully to combine mechanisms drawn from this list (see also the Appendix for further thoughts on how two of these arrangements might work):

- Allowing revenue support to begin earlier in the franchise (recalling that revenue share starts immediately and not after four years), so that the revenue share and support mechanisms are symmetrical.
- Indexation of franchise payments according to the rate of change (up or down) of GDP over the previous 12 months. This is in effect a variation of revenue support particularly focused on providing a better structure to handle major economic downturns, a risk that the franchisee cannot control.

> "Increased stability of tenure from long franchises should not mean certainty of tenure"

- Indexation of franchise payments at the mid-point of a long franchise to reflect the revenue then being earned by the franchise. In order to ensure that there is a sufficient incentive to undertake long term improvements (which, as noted above, is a key part of our proposal), there might be a formula under which only a proportion of the difference between actual and expected revenues would be used to adjust the franchise payments. This makes the review unlike a standard regulatory review in which income is essentially rebased entirely at each review point. Similarly on costs, there might be a partial reset mechanism to reflect a proportion of changes in areas such as energy prices.
- Review the target level of revenue for the operation of the share/support structure periodically, so as to improve the incentives to develop and market the railway on a shorter term basis. Under today's model once a franchisee is in the highest band of revenue share or support, 80% of the extra revenue it earns from marketing and other actions to grow the business in effect goes back to the DfT through reduced revenue support. This can often make such initiatives unprofitable to the franchisee – a perverse situation, given the policy goal of attracting more people to use rail. It also has the effect of locking franchisees into needing continued support.
- Reviewing the share/support structure so that it never goes higher than a 50/50 split between DfT and the franchisee (rather than the 80/20 today). This would mean that the franchisee only receives 50% of any decreased revenue in the form of increased support during a downturn, rather than 80% as today.
- Harmonising the indexation process in the agreements. At present, fares, access charges and franchise payments are indexed according to three different formulae based on indexes published on three different dates in the year. Given recent rapid within-year changes in RPI, this can create additional risk exposure (particularly where the result is a mismatch between revenue increases and cost indices) and we think that a single date should be used and applied to all three, and
- Creating a closer link between the access charges that NR receives and the revenue that the train companies earn. The strength of the existing link might be improved in the next Control Period so that NR was more exposed to the ups and downs of the passenger business. The intention would be to expose only a small element of NR's income from access charges. This would not materially affect NR's ability to sustain investment at steady levels over time, but (because NR's level of spending is very substantial) relatively small changes in its income could make a significant difference to the economics of a franchise.

These options need to be looked at further and assessed alongside their implications for the Department's future budget. We envisage them applying to new franchises rather than current ones, so the immediate budgetary implications during CP4 would be very limited. These options would involve greater variability in the Department's budget as it would have greater exposure to the economic cycle. Against this, however, should be set some reductions in the levels of support actually needed as bidders priced in the benefits of these structures, together with a significant reduction in the systemic risk that the DfT could face of a number of franchises running into difficulties simultaneously in any future recession.

In summary, a better risk-sharing structure would allow TOCs to focus more on delivering long-term service improvements and reduce the systemic risk in any future economic downturns of having to relet a large number of franchises at once in poor market conditions. The latter also ultimately benefits the taxpayer by enabling the DfT to plan ahead financially for the long term with greater confidence.

5. Drive efficiency by asking TOCs to take on more

The efficient delivery of improvements to the infrastructure and the train fleet is critical to the success of the industry. Whilst Network Rail is well equipped to deliver improvements to the track related assets we believe that there are significant opportunities for TOCs to do more:

- They could take on greater responsibility for stations and depots, and
- They could take back the role that they used to play on large rolling stock procurements.

Since TOCs are closest to the market, this reform would facilitate provision of the kind of improvements to station facilities such as car parking, security, ticket retailing and waiting rooms that are important to passengers. Experience suggests that they would be able to do this more cost-effectively and faster than NR, because they have lower overheads and less cumbersome internal processes. In addition, Network Rail has a big job to do to manage and enhance the network, in which lies its core expertise and on which it could focus more through such reform.

Stations and depots

The way forward should be to give TOCs the option to take on full repairing leases for stations and depots rather than the complex structure of split responsibilities that we have today. A number of TOCs have already made moves in this direction in respect of depots, notably Chiltern, Southern and SWT. An additional benefit of this is that such a change can even be made within existing franchise agreements, by agreement with NR, rather than waiting until franchise relet (since it would essentially just require a three way agreement between NR, ORR and the TOC).

This is an important area because there are significant gains to be secured from ensuring that projects are built efficiently and properly scoped from the outset. Over CP4, some £1.25bn will be spent on franchised stations between TOCs and NR (out of overall stations expenditure of £3bn) so it is important to get this right. TOCs have lower overheads than NR and can generally move much more quickly as well, since they have simpler management processes. We will shortly be working with NR and ORR on an assessment of the potential efficiency gain if TOCs took on station and depot work, but initial estimates from owner groups suggest it could be as much as 15-20% from reducing overhead costs alone.

In addition, there are further savings from ensuring that scopes are right (taking station rebuilding as an example, in terms of the design of key features such as footbridges or booking halls). Experience of applying value engineering to NR's project plans (as Chiltern has done) suggests that scope can be as important as unit costs. It is therefore quite possible that as much as £250-500m could be saved from NR's prospective spend in CP4 and channelled back into providing better facilities, such as car parking, retail and waiting areas, and in improving conditions through repainting and refreshing of stations.

The short franchise is a limitation to taking on stations and depot work. It has led to the creation of today's complicated split, unique in the property industry, under which responsibility for most building work lies with the landlord (ie. NR) and 'shopfitting' lies with the tenant (ie. the TOC). Property specialists advise that this structure is only found in rail and is completely different from other kinds of property leases, such as shopping centres and normal commercial premises leasing. The split is also a contrast with other European railways, such as Denmark and France, where station responsibilities have been allocated to the train operators rather than with the infrastructure provider.

Commercially, an important consequence of today's structure is that NR is very largely divorced from the revenue implications of its actions and also has so many other things to do – not least to look after the 17 major stations that it has retained - that medium-sized and smaller stations are at risk of not getting the attention they deserve. Although in CP4 NR has identified separate budgets by franchise for most station renewal work, the overall budget for station spend remains unclear (ie. including maintenance and enhancement) and there is concern that resources are disproportionately focused on the very large stations.

Naturally, if responsibilities were shifted, similar safeguards to those put in place for NR will be needed to ensure that asset management is carried out on a long term basis rather than stopping as a franchise nears its end and that capital spend is adequately remunerated if it is funded by borrowing. The box illustrates one way in which this might be done.

How responsibility for stations and depots might be structured

The following is an option for discussion on how the change in station and depot responsibilities might be structured:

- NR to continue to retain the freehold.
- TOCs who are going to be the facility owner (for the purpose of the station and depot access arrangements) would be granted full repairing leases of, say, 99 years duration the benefit of which would transfer at franchise change.
- All maintenance and renewal obligations to be carried out by TOCs.
- Franchise bids to require specified levels of output in terms of station condition and TOCs to cost this in bidding.
- Once a franchise is let, ORR would regulate station and depot spend to ensure an appropriate level of renewal and maintenance is carried out even if franchise budgets are squeezed. This might be backed by creating ring-fenced sinking funds for a proportion of the renewal work, to ensure that capital spend is buffered against the ups and downs of passenger revenue.
- Progress on station improvements (eg. car parking provision, customer information systems) to continue to be monitored by DfT where necessary, possibly tied to incentive payments for efficient and timely delivery.
- Where renewal or enhancement spend is very large, DfT and TOCs to have the option of financing it through a bespoke structure rather than through a one-off increase in franchise support payments. This has already happened at a number of depots today, notably with Southern, SWT and CrossCountry/Virgin Trains. Financing for non-routine spending on stations and depots would be 'ring fenced' and given either a Section 54 undertaking or be irrevocably designated as primary franchise assets under the mechanism that exists in all franchise agreements but which is seldom used. The effect of either of these would be to require an incoming franchisee to take over responsibility for the financing, factoring the amortisation of it in the franchise bid.

Rolling stock

In addition, TOCs ought to take back their responsibilities for procuring new and refurbished trains that the DfT has, in effect, progressively taken over. As the Competition Commission recommended in August 2008[18], the DfT should place much greater reliance on normal commercial negotiations between TOCs and ROSCOs to determine matters such as:

- When rolling stock is refurbished
- Which stock should operate on which route
- When new trains should be acquired, and
- What the specification of those trains should be, noting that key technical elements of design are increasingly being determined by European Technical Standards for Interoperability (TSIs).

Train operators demonstrably have the skills and experience to do this since they successfully worked with the ROSCOs to create a rolling stock market post-privatisation up until 2003 and have led the £4.5bn of train orders seen in the past 15 years. One of the key elements of this is the experience that TOCs have built up in getting new trains commissioned into service, ensuring that the safety validation process works smoothly and that new depot arrangements deliver the high levels of performance that today's railway demands. But this experience has been set aside, with the Department becoming increasingly concerned that TOCs might not take the right approach from a long term, whole-life perspective. It has therefore felt that it must step in itself, creating in effect an additional commercial interface on rolling stock – that between itself and the future franchise. This imposes additional costs, not least because the performance and commercial risks associated with getting new trains into service are considerable.

[18] http://www.competition-commission.org.uk/inquiries/ref2007/roscos/index.htm

What is needed instead is for the DfT to make better use of the mechanisms put in place at privatisation to create a competitive supply chain for rolling stock, whilst offering a sensible level of support for rolling stock lease payments, either through a Section 54 undertaking or a long franchise. The TOCs should manage procurement, dealing with manufacturers and financiers (including the ROSCOs) to support the necessary investment. This might also include, over time, franchisees taking on some of the investment directly on their own balance sheet, supported by either Section 54 undertakings or irrevocable Primary Franchise Asset designation.

If the current initiative to replace HSTs had been structured as a long term franchise either for the East Coast or Great Western to involve fleet replacement from the outset (which the Great Western ITT specifically ruled out), an owner group could have taken it on as an integral part of the franchise, including the significant commercial risks involved. Procuring rolling stock through the franchise would have allowed the franchisee to use its direct experience of what passengers want from trains and to manage the risks involved with getting the new trains commissioned. Franchisees are also in a good position in each case to consider where the appropriate balance lies between taking an existing train design or creating a new one. An important part of risk management during procurement, given the small size of the UK rolling stock market on an international scale, is to consider what kind of trains manufacturers are supplying in other markets and keep the level of 'UK customisation' to a sensible minimum.

"If TOCs took on more responsibility for stations, depots and rolling stock they would be able to deliver spending efficiencies and faster delivery of capacity"

In summary, if TOCs took on more responsibility for stations, depots and rolling stock they would be able to deliver spending efficiencies and faster delivery of capacity, particularly on rolling stock for the benefit of passengers. This is going to be increasingly important as demand recovers from the recession and the Government's budget is squeezed.

6. Sustain a mix of franchise sizes

Changes to franchise boundaries are commonly proposed at franchise ends in order to improve performance or operational synergies. Different policies have been applied over the years, so that today there is a mix of franchises:

- some of which are still very much based on the routes of the 25 former BR profit centres which formed the basis of the original franchises (such as NXEC, CrossCountry, Chiltern, First Scotrail, VT and c2c)
- new market-led franchises such as FTPE (provides services formerly operated by North Eastern, North Western and Cross Country Franchises)
- geographically and operationally-led franchises (such as ATW, First Great Western, EMT and NXEA), which have brought together intercity, regional and local services across particular geographies, and
- local concessions (such as Merseyrail and LOROL) which operate suburban railways as part of a broader integrated transport network.

The general move has been towards larger franchises, driven by operational rather than market considerations, which bring together premium-paying with heavily subsidised services. We believe that there should be no automatic presumption that further franchises should be merged together in the pursuit of potential economies of scale, as was done to create First Great Western in 2006 and National Express East Anglia in 2004. Smaller franchises have some advantages: they are arguably easier to manage and to build an 'espirit de corps' amongst the staff. For quoted companies, the risk involved in losing the turnover and earnings from a small franchise is more manageable than for a large franchise. Retaining some smaller franchises offers potential portfolio benefits to owner groups which might reduce the 'cliff-edge' effect that owner groups have when faced with the loss of a potentially major contributor to their headline financial numbers. It might also encourage new entrants to the franchising market.

If further changes are contemplated, DfT needs to pay much closer attention to the pros and cons of changes in boundaries. They often increase the complexity of the network that passengers experience and their cost is often underestimated. Where franchises are split, there can often be extra staffing costs and rolling stock costs as more trains and depots are needed. When franchises (or parts of them) are merged, there is strong pressure to harmonise pay and conditions upwards to the highest-paying 'donor' TOC.

In summary, there are some advantages to retaining a mix of small and large franchises, because changes in franchise boundaries can be costly and because having a number of smaller franchises can help make the UK market more attractive to bidders than a market dominated by larger franchises might otherwise be.

Conclusion

The changed franchise approach would help facilitate improvement in rail services by ensuring that those closest to the market, TOCs, have a greater role in developing rail services that passengers want to see. Today's franchise agreements are very tightly specified and leave the locus for developing each route very largely with the DfT rather than the rail industry.

Longer franchises would help catalyse continued improvements in customer service and allow the TOC to take a stronger role in investment, particularly on stations, depots and rolling stock. If this were coupled with output-based franchises, DfT administration costs could be reduce by about a third. These would also allow TOCs to introduce changes, such as rolling stock replacement, more quickly than the current DfT-led approach.

Transferring station and depot responsibility to TOCs could lead to savings worth up to £500m in CP4 and also would lead to much more rapid improvement.

Longer franchises would need to be coupled with enhanced mechanisms to manage the risks involved. These might include indexing franchise payments to GDP and adjusting a proportion of the franchise payments to the actual revenues being earned at the mid-point of a long franchise. The precise levels and mechanisms should be set on a franchise-by-franchise basis to ensure that the franchise retained a significant element of risk in it, something we regard as a fundamental principle of franchising.

Appendix

Mechanisms to create more stable franchises

This appendix provides more details of two of the mechanisms we propose to create more stable franchise.

A GDP index

One possibility is a system in which franchise payments are scaled pro-rata to changes in GDP over the prior year. Since passenger demand and GDP for most franchises are thought to be quite closely correlated (at least over the long term), this would increase the chance a franchise could withstand a serious recession (a risk that the TOC cannot control). This might be designed to provide proportionately more support the larger the fall in GDP so that it acts as a stabilising mechanism in serious recessions. Indeed it might only come into operation once the rate of GDP fell below a certain level. In effect, it would be a form of revenue support that is scaled to actual economic conditions rather than the original revenue forecasts.

The level of the support might be structured to increase the chance that the franchise remains stable in severe economic conditions whilst retaining a significant incentive to market and grow the business during smaller downturns.

A hypothetical example might be as follows, although the precise ratios to be set in each franchise agreement would reflect the revenue/cost balance in each franchise.

Year on year fall in GDP (%)	% increase in franchise support payments for that year (if from DfT to TOC)
1	1
2	3
5	10

Summary of Current Revenue Share/Support Structure

- There is a target revenue for each year of the franchise: share and support mechanisms are related to this
- Support normally begins after four years (although shorter periods have been conceded in negotiation) and is initially 50/50, meaning that 50% of the shortfall against target revenue is paid by DfT and the balance is absorbed by the franchisee. The mechanism kicks in once revenue falls below 98% of target revenue and increases to an 80/20 split when revenue falls below 94% of target revenue. These percentages are common to all franchise agreements. The mechanism is not intended to provide a permanent stabiliser for a franchise that is unable to meet its bidline over the long term because it does not provide full compensation for revenue loss.
- Share, however, applies from the start. It is initially 50/50 but moves to 80/20 once revenue rises above specified a percentage of target revenue. The percentages vary from franchise to franchise.
- Once franchisees are in support or share, the incentive to expand revenue through measures such as service development, marketing and revenue protection is blunted because a high proportion of the extra revenue earned in effect flows back to DfT.
- In addition, TOCs are required to provide performance bonds equivalent to a proportion of annual costs (which is bespoke to each franchise) and to maintain liquidity based on the ratio of 1.05: 1 revenue to operating costs, to give DfT confidence that the TOC will fulfill its obligations.

Making NR charges more variable

NR's access charges might be reviewed in CP5 with the objective of creating a stronger revenue incentive mechanism than the combined revenue and volume incentive found in CP4. NR would share in the risk of growth in the passenger business as a whole.[19] The current position is that, apart from a very small element of charge (the volume incentive, which as a result of growth in CP3 will increase NR's income by about 1% per annum in CP4 onwards), NR is essentially paid the same regardless of whether rail volumes are rising or falling. The variable charges that NR makes are designed to be entirely cost reflective over the long term so any decline in them as a result of declines in vehicle-miles operated should be matched by corresponding declines in NR's costs as less renewal work needs to be carried out.

Our proposal would have other benefits as well. Exposing NR to a greater degree of demand risk would, we think, help make it more responsive to passenger and TOC growth aspirations and, indeed, the same system might even be considered for freight operators as well. We argued during the CP4 review for some increased sensitivity of NR's revenues to passenger demand. The proposal would provide a natural cushioning of risk because of NR's balance sheet strength and substantial investment spend.

As an illustration of the approach, if passenger revenue had been expected to grow by 10% but in fact only stayed flat in nominal terms, the lost revenue in any given year would amount to about £550m. This is a very extreme difference: one option, consistent with risk sharing with DfT and leaving significant risk with TOCs, might be to share, say, about 20% of this (£100m) with NR. This would amount to no more than 2% of NR's total spend per annum on renewal and enhancement in CP4. The scale of these numbers illustrates that only a very small proportion of NR's total spend would make a very significant difference to franchise stability.

[19] If this were done, it is for consideration whether these changes ought to be compensated under the Clause 18.1/Schedule 9 process. There is a significant co-ordination problem since the normal approach would be that all franchises let between now and 2014 would reverse out this change if it were introduced at the start of CP5. One way forward might be for franchises let under the new process outlined in this paper to be let with a provision that Clause 18.1/Schedule 9 might be waived if a revenue-sharing mechanism with NR was created.

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