

Rail Delivery Group



National Rail



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Rail Delivery Group response to: Transport Committee inquiry Intercity East Coast rail franchise

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The Rail Delivery Group (RDG) brings together passenger train operators, freight train operators and Network Rail, together with the rail supply industry. The rail industry – a partnership of the public and private sectors - is working with a plan *In Partnership for Britain's Prosperity*¹ to change, improve and secure prosperity in Britain now and in the future¹. The RDG provides services to enable its members to succeed in transforming and delivering a successful railway to the benefit of customers, the taxpayer and the UK's economy. In addition, the RDG provides support and gives a voice to passenger and freight operators, as well as delivering important national ticketing, information and reservation services for passengers and staff.

The RDG is working in partnership with the Rail Supply Group – which was established in 2014 to strengthen the capability and competitiveness of the UK rail supply chain – to better coordinate shared objectives and further strengthen the rail industry's voice.

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¹ *In Partnership for Britain's Prosperity*, RDG (October 2017):
https://www.raildeliverygroup.com/files/Publications/2017-10_in_partnership_for_britains_prosperity.pdf.

1 Overview

The RDG welcomes the opportunity to respond to the Transport Committee's inquiry on the Intercity East Coast rail franchise.

The rail franchising model has evolved over the last 20 years to deliver significant value for customers, taxpayers and the economy. Britain's economy runs on rail. During the past 20 years, passenger journeys have doubled and they are set to double again by 2043. Every year, goods worth billions of pounds are moved by freight trains on one of the safest railways in Europe. The approach to passenger services in the UK is enabled through competition for the market, enabling the private sector to be a trusted partner in delivering these benefits.

While there are successes to acknowledge, the RDG and its members believe that the franchising model must evolve to make it sustainable for the long-term to enable the maximum benefits for taxpayers, customers, communities and employees to be achieved.

The East Coast Rail Franchise has been operated by Stagecoach and Virgin since 2015 as Virgin Trains East Coast (VTEC). It operates between London and Scotland, providing fast, frequent services and connecting London with communities in Yorkshire, the North East of England and Scotland. 3,124 employees enable the transportation of 21.5 million passengers every year, covering a network geography of 936 miles.

2 Response to Questions

Q1: The reasons for the failure of the current franchise agreement, lessons learnt from previous failures of franchises on the East Coast Mainline and the steps the Department for Transport needs to take to guard against future failures;

The current franchise agreement underpinning the VTEC rail franchise will need to be curtailed as the operator has not been able to achieve its original growth projections. These growth projections were set in 2014, determined in part by key parameters set by the Department for Transport (DfT), during the competition period for this East Coast rail franchise. It is now evident that the expected revenues from this rail line have not been realised, and as a result, the private operator has needed to inject additional monies into this business for it to meet its contractual and financial commitments to the Government via franchise premium payments. This, to date, is near £200 million, a demonstration of the bond mechanism, which is built into franchises to protect taxpayers from fluctuations in revenue, working.

There is a difference between the forecasted revenue and actual revenue received. The expected revenue line has not been achieved due to a dampening of rail demand relative to the original growth assumptions, which has been impacting many rail services over the past 18 months. There is a higher percentage of discretionary travel on this route; currently, 9.2% of all VTEC journeys come from seasons tickets; this contrasts with 15.2% season tickets of all long-distance sector journeys. This railway franchise is exposed in the short-term to changes in passenger demand as it is more reliant on discretionary leisure travel market compared to other rail franchises, and this - in turn - can make revenue more volatile.

There have been two prior cases where the businesses running the East Coast rail franchise has not been sustainable. Firstly, the rail franchise operated by Sea Containers, operating as GNER, was curtailed due to issues with the parent company not being able to fulfil its financial obligations. The second was National Express East Coast which did not achieve its targets, due to lower than expected revenues following the financial crisis. This resulted in the early termination of a rail franchise in 2009.

As a result of these challenges, an additional financial 'stress test' - the financial robustness test - was introduced by the DfT to limit the risk of repetition of this issue; although this still has not prevented the current issues from arising on the East Coast franchise.

Risk transfer is an important feature of the franchising model, but this must be proportionate and sustainable to deliver good value for customers and taxpayers to maximise innovation, customer focus and efficiency from the private sector. The DfT and other client bodies have evolved their approach to the dealing with the balance of financial risk within rail franchises. For example, in the most recent franchise competition for the South Eastern rail franchise, a forecast risk mechanism has been introduced to support the sustainability of rail franchises; the impact of this mechanism will not be known until full implementation, but the principle of partial revenue risk share between the franchisee and the client body is welcomed. Further steps need to be taken to ensure that the benefits of having competition for the market is sustained; moreover, consideration should be given to the introduction of reset mechanisms. If used cautiously but at important intervals in contract life, there could be the ability for the client body and deliver partner to have greater confidence in the long-term stability of the contractual relationships. The reason that the forecast risk mechanism and resets are important is because it is very difficult to forecast revenues accurately over the life of the franchise as the East Coast experience shows, since these are driven in part by fluctuating external economic and social factors. Unlike many other businesses, there is little that franchisees can do to respond to changing market conditions because they have fairly set cost bases and are still required to deliver the often very tight specifications in the franchise contract.

Q2: The management of infrastructure works on the East Coast Mainline, including the relationships between the Department's aspirations for the franchise, the operators' obligations in the franchise agreement and planned Network Rail infrastructure works;

At the time of the franchise bid for the East Coast, projections of passenger and revenue growth were based - in part- on the delivery of improvements to the railway infrastructure from 2019, in turn enabling faster and more frequent journeys, as well as the introduction of new high-speed trains. When VTEC was bidding for the rail franchise, the franchise was asked to be ready to implement a full train service requirement no later than May 2020. There were five schemes being delivered by Network Rail (NR) that would enable this: Kings Cross station remodelling, grade separation at Werrington, fourth track between Huntington and Woodwalton, additional platform at Doncaster and North East freight loops. These schemes were not fully scoped at bid stage and were subsequently reviewed by NR as these projects matured. We recognise that as these schemes have matured and their delivery dates being different from those assumed by Virgin/Stagecoach at the time of bid, is another reason why it will not be possible for Virgin/Stagecoach to meet all its future financial commitments. When the bidders were given the outline of the infrastructure capability for the period of the franchise, and whilst there was still ambiguity around the potential infrastructure plans, the bidder had to consider the risk and bid against the infrastructure capability picture presented.

There is currently a disconnect within the railway between the targets and obligations set out by the client body at the start of a competition process to operate passenger services, and the current 5-year regulatory cycle which determines the outputs that the government is due to buy from the infrastructure partner. To ensure greater certainty from all parties involved in the delivery of rail services, RDG would advocate that greater use is made of the flexibility built into the franchise agreements to respond to changing infrastructure capabilities. As such, the franchisee should not be held to a revenue line that is dependent on assumptions about infrastructure capability that are not fully known at the time of bidding. This can be resolved by utilising resets.

Q3: The Department's contingency plans, particularly the steps it is taking to minimise risk to passengers and taxpayers;

The decision on how to take forward this franchise, including options that will deliver the best value for money for the taxpayer, is a matter for the Government. The Secretary of State for Transport recently set out two options: an Operator of last resort or a management contract with the incumbent.

Under Section 30 of the Railways Act 1993, the Secretary of State has a duty to ensure that customers continue to be served. In 2015, the DfT appointed a partnership comprising of Arup, SNC-Lavalin Transport Advisory and Ernst & Young to support the Secretary of State with regard to his duties under aforementioned Section 30 of the Railways Act.

Q4: The readiness of the Department to act as an operator of last resort;

It is the RDG's understanding that, should it be necessary for the Operator of last resort to be called upon to discharge its duties, the Department would be in a position to do so. It is also worth noting that a significant amount of people and resources would transfer across from the existing operation under TUPE regulations.

The industry is well-placed and experienced at supporting the movement of rail services from one business to another, and this would be no different, whether it is a management contract delivered by Virgin/Stagecoach or a management team led by the Operator of last resort.

Q5: The feasibility of the Department's proposal to establish a public/private East Coast Partnership, to be operational by 2020;

The Secretary of State for Transport has set out key objectives for the rail franchise which will follow the interim arrangements on the East Coast. This has been set out under the auspices of the East Coast Partnership. The current high-level aspirations for the East Coast Partnership are set out in the 'Connecting people: a strategic vision for rail' published by the DfT in November 2017.

This East Coast Partnership is planned to be a longer-term proposition, compared to current franchises. The RDG is supporting the DfT in considering options for this partnership, and we would caution against short-term thinking to ensure that the next iteration of rail franchises allows for the evolution of balance of risk; is focused on delivering for the customer; has sufficient flexibility to enable appropriate responses to changing market conditions; and allows local managers and stakeholders to have a greater role in the delivery of rail services.

In addition, we would support:

- **contractual alignment**, meaning that NR's and train operating companies' (TOCs') commitments are consistent, with alignment between franchise contracts and regulatory targets/outputs; and
- **working together in partnership**, meaning increased collaborative working between track and train. This should be passenger-led and should not import excessive infrastructure cost risk on franchisees. It is important that other users' needs (including freight's) are reflected sufficiently in any formal partnership between NR and TOCs.
- **Market-led** – the contractual approach for the delivery of passenger services should reflect the market it is there to serve; with more revenue risk for long-distance markets to drive innovation, but not unlimited; with less revenue risk exposure or gross cost concessions on urban routes where revenue is mostly driven by economic factors. Where appropriate, the model could encompass more open access.

- **Level of specification** – should match the market characteristics; but where needed, government should focus on setting the outcome.
- **Contractual length** – should match the objectives for that market and operating context, and extensions should reward success.
- **Franchises size** – a managed transition to more, smaller, franchises would make risk more manageable, help maintain stable markets, and be consistent with further devolution of rail passenger services.

The RDG is pressing for a broader dialogue on the future of the franchising model; indeed, we are discussing with a broad range of stakeholders our proposals for the future sustainability of the partnership railway.

Q6: the wider implications for rail franchising of the failure of the East Coast franchise, including for the competitiveness of the system

Whilst recognising the challenges that have arisen as a result of the current East Coast franchise, this should not be used as an opportunity to diminish the advantages afforded by the competition for the market and enabled by the rail franchising system. It is important that when considering how to make the passenger services contracts more sustainable that, whilst the length of some contracts may increase, there is still incentive on the client body to put passenger services to the market regularly as this will ultimately drive value and innovation. Competitive environments drive innovation, efficiency and increase value for the taxpayer.

It is also important that franchise specifications match the capacity of the railway system. The client body could warrant that the base track access requirements (capacity) are in place prior to the competition, thus enabling the bidders to focus on innovating on additional capacity to deliver the outcomes.

The System Operator is a distinct yet connected part of Network Rail. It plans changes to the network as a whole and can be used to accelerate reform in this area and, also, advise on how the strategic capacity aspects of the railway are best utilised in the round.

We will also encourage greater collaborative working between the operator and the infrastructure manager in the pre-bid stage. We recognise the need to maximise the benefits of greater collaborative working between partners as early in the franchise bidding process as possible.

The partnership between the client body, the prospective operator and the infrastructure manager, should be clear on the potential enhancements that are to take place on the railway, and that the risk for that enhancement delivery is clearly understood and appropriately apportioned in the context of the risk/reward balance in the operating contract.

Reset mechanisms should be introduced. If used at important intervals in contract life, the client body and delivery partner would have greater confidence in the long-term stability of the contractual relationships.

In addition:

- full use should be made of **the existing contractual levers** to deliver the best outcomes for customers;
- the contractual framework should encourage **collaborative behaviour**, and agility from client and delivery partner;

- whole industry costs could be reduced by providing **market certainty**, with client bodies having to provide a two-year (at least) procurement programme; and
- **bid costs** should be proportional to the type and nature of contract being procured, and reduced from current levels.

END OF NOTE