National Audit Office

THE DEPARTMENT FOR TRANSPORT

Letting Rail Franchises 2005-2007

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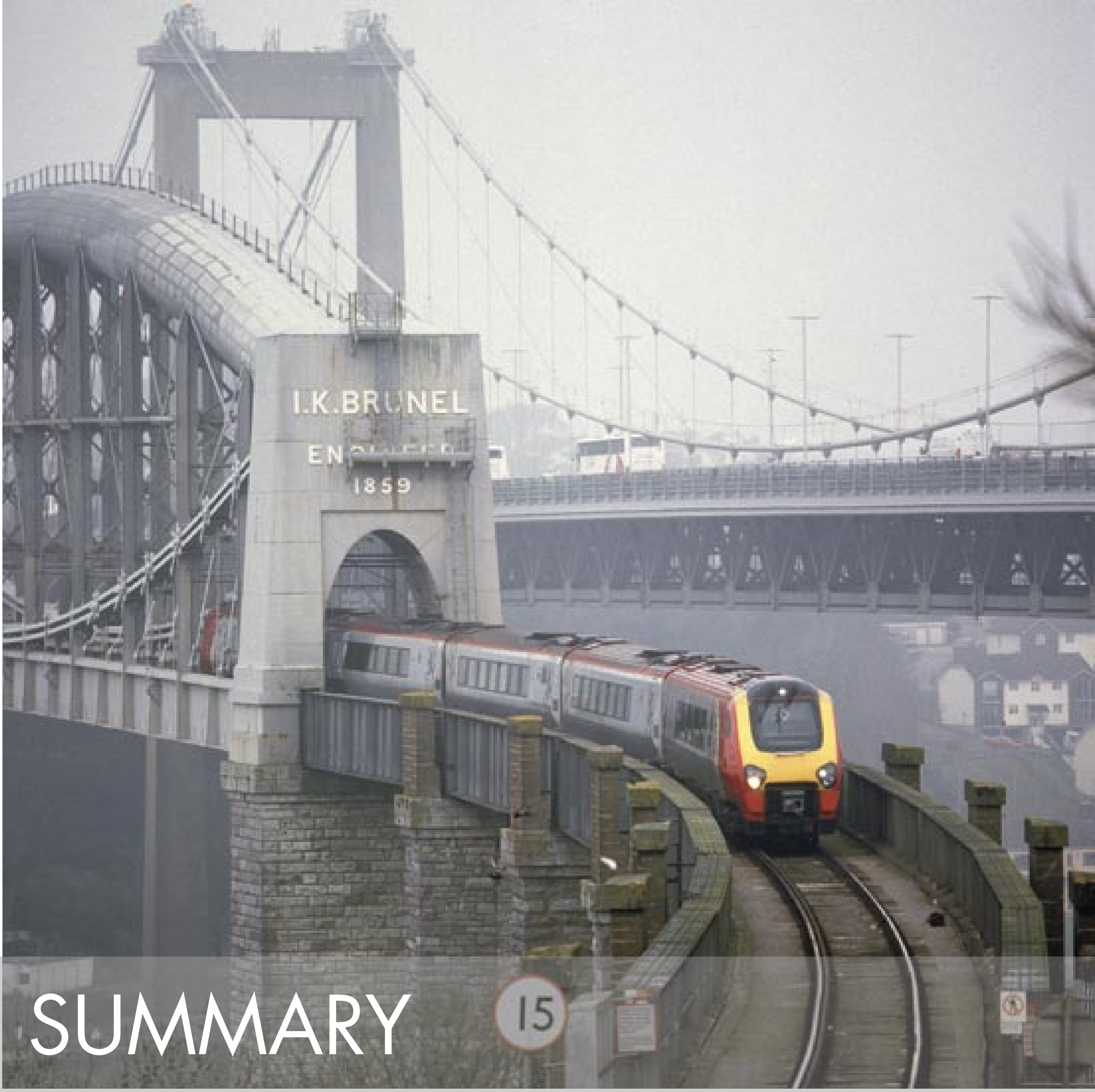

SUMMARY

1 Passenger rail services are provided by train operating companies under franchise agreements which generally run for 7–10 years. Responsibility for the operation and condition of the track rests with Network Rail. Strategic decisions on major investment, which also affect service to passengers, are the responsibility of the Department for Transport (the Department). Under the Railways Act 2005, the Department also took over responsibility for the oversight of passenger rail franchising following the abolition of the Strategic Rail Authority (SRA).

2 The Department's rail franchising objectives have broadly been to provide a safe, reliable and efficient service for passengers that is affordable and value for money. In under three years, since taking over from the SRA, the Department has re-let eight of the sixteen rail franchises that it manages **(see Figure 1)**. Rail passengers have experienced a change of train operator on six out of the eight franchises, along with changes to fares and services. The report examines the:

- franchise competitions (Part 1);
- impact on the taxpayer (Part 2);
- impact on the passenger (Part 3); and
- approach to managing rail franchises (Part 4).

Key findings

On the franchise competitions

3 Throughout planning, procurement and operation the Department has set specific objectives which reflect its overall priorities to control costs, live within the public funding available and improve railway performance. Although the Department's wider objective of improving the environmental impact of transport was not explicitly stated as an objective in any of the franchises examined, the Department has begun to include environmental issues in its assessment criteria and has added an explicit objective for the South Central franchise (to be let in 2009).

4 The Department's service specifications are generally well thought through, reflecting the objectives set. The Department assesses changes from the previously specified level of service in consultation with stakeholders. These changes are clearly linked to the specific objectives for each franchise and alterations are subject to cost benefit and affordability analysis.

5 Local bodies are consulted on specification but are not involved in bid evaluation and negotiation. The Department asks relevant local bodies, such as Passenger Transport Executives (PTE), for their views on the service specifications for each franchise. PTEs are not, however, closely involved during subsequent bid evaluation and negotiation.

1 Rail Franchises and Concessions in England and Wales in June 2008

Train operator	Franchise area or name	Parent(s)	Start Date	Expiry Year
c2c	London, Tilbury and Southend	National Express Group plc	May 1996	2011
Virgin Trains	West Coast Main Line	Virgin Group and Stagecoach Group	March 1997	2012
Chiltern	Chiltern	Deutsche Bahn	March 2002	2021
Southern	South Central	Govia Ltd	May 2003	2009
Merseyrail[3]	Merseyside Region	Serco Group & NED Railways	July 2003	2028
Arriva Trains Wales	Wales	Arriva plc	December 2003	2018
TransPennine Express	TransPennine	First/Keolis Transpennine Holding Ltd	February 2004	2012/ 2017[1]
National Express East Anglia	Greater Anglia	National Express Group plc	April 2004	2014
Northern Rail	Northern	Serco Group & Ned Railways	December 2004	2013
Southeastern	Integrated Kent Franchise	Govia Ltd	April 2006[2]	2014
First Capital Connect	Thameslink/Great Northern	FirstGroup plc	April 2006[2]	2015
First Great Western	Greater Western	FirstGroup plc	April 2006[2]	2016
Stagecoach South West Trains	South Western	Stagecoach Group plc	February 2007	2017
London Midland	West Midlands	Govia Ltd	November 2007	2015
East Midlands Trains	East Midlands	Stagecoach Group plc	November 2007	2015
CrossCountry	New Cross Country	Arriva plc	November 2007	2016
National Express East Coast (NX East Coast)	Inter City East Coast	National Express Group plc	December 2007	2015
London Overground[3]	London Region	MTR and Deutsche Bahn	November 2007[3]	2016

Source: National Audit Office analysis – the eight franchises in the outlined box were let by the Department. The table is dated June 2008 as the date when the Gatwick Express became part of the Southern franchise.

NOTES

1 Extension option. The other franchise expiry dates assume that any relevant extension is earned.

2 Franchises specified by SRA.

3 Merseytravel and Transport for London concessions.

6 The Department has been successful in stimulating keen competition for franchises. There were three or more bidders on seven out of the eight franchises awarded by the Department and two on the West Midlands franchise. All the winners of the franchises were established UK companies and there was limited interest from overseas companies. There is no sign that incumbency bestows any clear advantage when bidding for franchises.

7 The Department has been successful in letting franchises to the timescales initially established. The Department did not incur any delays, and all four franchises awarded in 2007 were procured by the dates initially envisaged.

On the impact on the taxpayer

8 The eight franchise agreements reduce the burden on taxpayers, replacing a direct subsidy of £811 million in 2006-07 with a projected £326 million payment to the Department in 2011-12 (Figure 2). Six franchises out of the eight received subsidies in 2006-07 averaging £130 million. The number subsidised falls to three franchises with an average subsidy of £128 million in 2011-12. The other five franchises potentially pay over £142 million of revenue premium, on average, with the highest premium being £229 million for the Inter City East Coast franchise. These savings help to fund the Department's proposed investment in passenger services.

2 The potential impact of the revenues set out in franchise contracts

Franchise	Direct subsidy or (premium) in 2006-07 actual £ million	Direct subsidy or (premium), per franchise contracts, in 2011-12 £ million
South Western	123	(140)
South Eastern	145	65
Thameslink/Great Northern	(14)	(126)
Greater Western	97	(168)
East Midlands	30	(46)
West Midlands	212	162
New Cross Country	231	156
Inter City East Coast	(13)	(229)
Total	**811**	**(326)**

Source: National Audit Office summary of Department data

NOTE

See note 1 to Figure 10 to clarify 2006-2007data. The saving in subsidy shown does not take into account the Department's investment plans published in July 2007.

9 Indirect grant support, to cover Network Rail's maintenance and renewal of infrastructure in these franchise areas, means that there will still be an overall taxpayer subsidy. The future amount of network grant to be set by the Office of Rail Regulation for the period 2009-2014 is not yet known. Assuming continuation of the current level of grant, this overall subsidy would be £926 million for these eight franchises in 2011-2012 (a reduction of 55 per cent).

10 The reduction in subsidy is dependent on a continued strong increase in the number of passenger journeys. If past trends continue, two thirds of the increase in revenue for all franchises in the period to 2013-14 will come from this source. The balance includes revenue from a variety of other sources such as reduced fare evasion, changes in the mix of fares paid by rail passengers and higher fares in real terms to the extent permitted by the Department's regulation of fares.

11 After the first four years of the franchises, the taxpayer shares demand risk with the train operators. Until then each train operating company bears nearly all financial risks associated with revenue and thereafter still bears the financial consequences if revenue falls two per cent below its projection. Beyond this point, the Department shares the financial consequences with the train operator, by varying the amount of subsidy paid or premium received by the Department. From the outset the taxpayer is also entitled to share in any extra revenue (see Figure 9 on page 17). **Reducing the train operators' risk in this way has resulted in better bids, based on higher revenues, with a firm financial commitment for four years.**

On the impact on the passenger

12 Many commuters face increased crowding at peak periods until planned investment delivers more carrying capacity. For example in the worst affected area, passengers being carried to and from London at peak times in 2006 (the latest date for which information is available) were on average 3.5 per cent in excess of the planned capacity required (up from 2.7 per cent in 2004). The morning peak had reached 4.8 per cent in excess of such capacity. In the short term, most train operators seek to respond to fast-growing passenger demand mainly through making better use of existing rolling stock (such as changing interior layouts and better train plans) and using ticket pricing to try to spread out peak demand. In addition six out of the eight new franchises have an obligation to introduce additional carriages quickly. The franchises we examined provided for an average seven per cent increase in fleet capacity.

13 The Department also plans to increase capacity in most franchise areas by negotiating changes in franchises to introduce 1,300 more carriages (see Figure 11). This will involve commercial negotiations between the Department and most train operators before the end of each franchise period. These negotiations will focus on the impact on the train operator's revenues after allowing for increased costs they incur for leasing extra carriages.

14 The Department has negotiated commitments to improve the quality, reliability, accessibility and security of passenger services, for example through station refurbishment and investment in rolling stock. Crowding and fare increases may offset some of the impact of these commitments on passenger satisfaction. There is to date, however, no established trend in passenger satisfaction on the recent franchises that are already in service and it is too early to assess those let in 2007. There have, however, been difficulties for one train operator (First Great Western) in meeting its first year plans and the Department has issued a formal notice requiring remedial action to reduce train cancellations.

15 Since June 2003, most commuter and other regulated fares have risen at one per cent above the retail price index, although some increases in non-regulated fares have been substantially higher. Some fare increases have been significant. For example, Stagecoach South West Trains raised some unregulated fares by 20 per cent in 2007. Incentives to travel outside peak and shoulder peak periods, however, have been maintained, or increased by special low fare offers, to ease crowding for commuters paying increased fares.

On the approach to managing rail franchises

16 The Department's arrangements for identifying and managing risks, including handling the failure of a train operator, are well planned and follow good practice. Appendix 3 sets out the key risks we have identified and the main mitigants. The right to impose a remedial plan was invoked, for example, when First Great Western breached its franchise agreement (see Figure 16, case example on page 23). A key risk for the Department is maintaining sufficient numbers of staff with relevant industry knowledge and commercial skills to manage delivery and negotiate mid-term changes to franchise contracts. The risk of reduced revenues following an economic downturn is partly mitigated by the Department using more conservative budgeting assumptions, regular updates of budgets and train operator contingency plans to reduce costs and adjust discretionary services. In an extreme case, the Department also has contingency plans ready to step in as operator of last resort.

17 The cost of managing franchises decreased from £7.3 million in 2004-05 to £5.7 million in 2007-08. The main reason was the reduction in the number of staff involved in franchise management. The relevant Department Directorate, Rail Service Delivery, had 72 staff in post in June 2008 whereas the equivalent parts of the SRA had over 100 staff in post in early 2004. The Department can operate with fewer staff as a result of an approach that allows train operators to 'self certify' that low risk obligations have been delivered. After reviewing experience with this approach in early 2007, the Department has strengthened its compliance activity by requiring more data checks.

Value for Money Assessment

18 The Department's approach to rail franchising produces generally well thought through service specifications and generates keen bidding competition. This approach has resulted in better value for money for the taxpayer on the eight franchises let since the Department took over from the SRA. The Department has been able to gain a commitment to some improvements in quality, reliability, accessibility, security and capacity at the same time as negotiating a sharp fall in subsidy. The combined contracted subsidy of £811 million in 2006-07 should turn into a payment to the Department of £326 million by 2011-12. The Department does, however, bear up to 80 per cent of shortfalls from contracted target revenues after four years and the bids assume continued high passenger growth. Slower growth would lead to subsidies falling by less than projected. Although there will be some service improvements passengers overall will pay more. Crowding will increase for many commuters until expected investment delivers more carrying capacity.

Recommendations

On letting franchises

Involving regional decision making bodies

1 Local decision making bodies (such as Passenger Transport Executives (PTEs)) have plans for other transport modes that need to be integrated into the long term planning of the rail network. Consultation generally works well at the specification stage, with options for increases or reductions in services. Local bodies, however, are not closely involved in bid evaluation and subsequent negotiations.

The Department should include additional local expertise when negotiating franchises, for example, by making use of short term secondments from relevant PTEs. These secondees would provide local knowledge to support the Department's evaluation of bid options.

Evaluating alternative options in bids

2 When interviewed, most companies admitted that they do not put as much effort into working up requested options as they do on meeting the base level specification. As a result, the alternative options are priced on a 'take it or leave it' basis and may not be fully specified.

In the technical evaluation, the Department should consider taking into account the value for money and affordability of options. This approach would provide bidders with greater incentives to develop options competitively. The number of such options should be limited to avoid an excessive increase in bid costs.

The impact on the taxpayer and the passenger

Transparency on financial support for franchises

3 Information on the extent to which fares cover the overall costs of passenger rail services, taking into account grant support to Network Rail, is not available. Increased visibility of the overall Government support to the railways would lead to better informed debate.

Information on the overall support, e.g. per passenger mile, that franchise services receive from the taxpayer should be made available. It should take into account additional support including grants paid directly to Network Rail.

Transparency on service quality standards

4 The Department seeks to achieve improvements in service quality (covering such aspects as train and station cleanliness, the provision of information and the attitude and helpfulness of staff) through agreeing measurable standards and setting targets to achieve year-by-year improvements on a baseline measured in the handover period. The targets and scores are not publicly available.

Service quality standards and the results of the train operator's quality audits should be more transparent. In particular, the Department should develop scores, based on existing franchise terms and conditions. The targets and scores should be made publicly available and more intelligible for passengers. To strengthen scrutiny by passenger groups, Passenger Focus should commission and make public the results of periodic "mystery shopping" (see Glossary) surveys.

The approach to managing franchises

Negotiating for extra capacity

5 The Department plans to provide additional passenger capacity through investing public funds itself or through Network Rail. The Government's July 2007 plans provide for 1,300 additional train carriages. Investment is also planned, for example, in lengthening railway station platforms. Securing this investment involves commercial negotiations about the cost of the additional rolling stock to train operators compared to the extra revenue they generate. If the Department does not adjust the contract revenue target, train operating companies may enjoy a windfall of extra revenue.

The Department should calculate the net incremental revenues that it expects the extra carriages to generate. It should then use this as a target in its commercial negotiations with train operators about contract revenues.

6 Adequate staffing is important given the strategic importance of rail franchising and the potential to reduce direct subsidies. The Department has difficulty in recruiting and retaining experienced and skilled staff particularly in its Rail Service Delivery Directorate. So there is a risk of insufficient capacity, or the wrong mix of skills, to operate effectively in future.

The Department should staff the National Networks Group adequately and not rely unduly on agency staff. This may require flexible recruitment practices to attract and retain staff of the right calibre with railway industry knowledge and commercial skills.

Background

The public and private bodies involved in rail franchising

i The **Department for Transport** (the Department) sets the overall framework and strategy for railways and provides public funding in England and Wales.[1] In Scotland, Transport Scotland has similar responsibilities. In Wales, the Welsh Assembly Government specifies, funds and manages the majority of the Arriva Trains Wales franchise. The Department took over these responsibilities from the Strategic Rail Authority (SRA) in October 2005, which was abolished by the Railways Act 2005. The Department's National Networks Group (NN Group) specifies, procures and oversees private Train Operating Companies' (TOCs) delivery of franchises. The Department has responsibility for 16 rail franchises in England and Wales but not for two rail concessions. The Merseyrail concession was awarded by Merseytravel PTE and the London Overground was specified and procured by Transport for London, which has rail responsibilities within London (Figure 1). In some cases the Department specifies and procures additional rolling stock, generally provided by rolling stock leasing companies and made available to TOCs.

ii **Network Rail**, a company limited by guarantee, owns and operates Britain's fixed rail infrastructure, including rail stations, which it mainly leases to train operators. It is responsible for the reliability of the network and leads on performance and industry planning. The Department provides grant funding and train operators pay Network Rail station access and track access charges.

iii The **Office of Rail Regulation** (ORR), is an independent statutory body led by a Board. ORR regulates Network Rail's stewardship of the network; secures compliance with relevant health and safety law; licenses operators of railway assets; and enforces competition law in the rail sector.

iv **Train Operating Companies** (TOCs) are special purpose companies, owned by one or more of eleven parent organisations (see Figure 1), which hold each rail franchise.

v **Rolling Stock Leasing Companies** (ROSCOs) own the majority of rolling stock that is then leased by the Train Operating Companies.

vi **Passenger Focus** is a statutory body funded by the Department to protect passengers' interests by ensuring that passengers' views are represented whenever decisions are taken that affect the rail network. It is responsible for the National Passenger Survey.

vii **Passenger Transport Executives** plan and develop public transport in six of England's major conurbations, receiving funding directly from the Department or indirectly via local Passenger Transport Authorities. They are consulted on franchise specifications.

The place of passenger rail franchising within the rail industry structure

viii Rail privatisation in the early 1990s separated the operation of rail services into two broad elements. The first consisted of the national fixed rail network, i.e the tracks, signalling, tunnels, bridges, stations and depots. The second was train operations. Passenger and freight train operating companies run trains on the tracks though, in most cases, they do not actually own the trains but lease them instead from one of three rolling stock leasing companies.

ix Responsibility for maintenance and renewal of the rail network lies with Network Rail though most stations are leased to the principal train operating company using them.

x Rail franchises confer the right to run, subject to the ORR's approval of access to the network, passenger services for a specified period on a specified part of the network. Train companies bid for franchises on the basis of the quality of service they intend to offer and the amount of funding they require (subsidy) or the premium they would be prepared to pay to run these services. Passenger service provision generally requires a net subsidy from government. Train operators can generate more revenue through attracting more passengers, raising unregulated fares and other commercial income.

The funding of passenger rail services

xi It is Government policy that passenger rail services are publicly specified, procured and, where necessary, funded, but are privately delivered by train operators.

xii In 2006-07, the passenger railway in England and Wales cost nearly £9 billion, with £4.8 billion funded from passenger revenues received by train operators, £0.8 billion from the Department's net subsidy support to train operators, £3.1 billion from Department grants to Network Rail (part of which meets train operators' track access charges), and £0.3 billion from Department grants to Passenger Transport Executives.

1 Some franchises also run services from England into Scotland.