National Audit Office

Report
by the Comptroller
and Auditor General

Department for Transport

Reform of the rail franchising programme

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Key facts

£8.5bn	£1.2bn	82%
total train operating company revenue in England and Wales, in 2013-14	total net payments to the Department from train operating companies in 2014-15	average overall increase in payments to the Department across the three franchises let to date, compared to the Department's forecast of what the previous agreements would have delivered

15	franchise competitions in the programme
3	franchises let to date through competitions
£3.3 billion	anticipated value of payments to be returned to the Department over the 8-year InterCity East Coast franchise
3,100	additional seats in the morning peak into London on the InterCity East Coast franchise, partly due to the introduction of new trains
£3.5 billion	anticipated value of payments to be returned to the Department over the 7-year Thameslink, Southern and Great Northern franchise
10,000	additional seats in the morning peak on the Thameslink, Southern and Great Northern franchise, partly due to the introduction of new trains
£2.0 billion	anticipated value of payments to be returned to the Department over the 15-year Essex Thameside franchise
25,000	additional seats in the morning peak into London on the Essex Thameside franchise

Summary

1 Since the privatisation of the railways in the mid-1990s it has been government policy for passenger rail services to be run by private sector companies on franchises that serve specified parts of the country for a specified length of time. Since the abolition of the Strategic Rail Authority in 2006, the Department for Transport (the Department) has been responsible for awarding rail franchises in England and Wales to the private sector, usually after a competitive procurement process.

2 In October 2012, the Department cancelled its competition for the InterCity West Coast franchise, having discovered errors in the procurement process, including its evaluation tool, while preparing to defend itself against legal proceedings from one of the bidders. The Department also paused three further franchise competitions. Subsequently, Sam Laidlaw led an inquiry into the events that led to the cancellation of the InterCity West Coast competition, and we and the Committee of Public Accounts published reports that drew out wider lessons for the Department to learn and apply to protect value for money. These reports highlighted a number of weaknesses in areas including:

- clarity of objectives and transparency of information;
- timetables for franchise competitions;
- senior level oversight, governance and assurance; and
- commercial and project management capacity and capability.

In addition, Richard Brown led a review that looked at franchising more widely.

3 In March 2013, the Department published a revised programme of 15 competitions to run passenger rail franchises staggered over an eight-year period. It also included 12 short-term, single tender actions ('direct awards') to maintain the provision of train services while facilitating the staggering of competitions. Since the launch of the programme the Department has awarded three franchises through competitions and has made ten direct awards.

Scope of this report

4 This report examines the Department's approach to passenger rail franchising since the collapse of the InterCity West Coast competition. This includes how it has responded to the main recommendations of the Laidlaw, Brown and NAO reports, and the effectiveness of its programme management.[1,2,3] We do not examine the merits of the franchising approach relative to other ways of delivering passenger rail services, nor do we look in detail at the franchises the Department has awarded so far under the current programme. We expect to look at the letting and management of passenger rail franchises in more detail when more have been awarded under the Department's revised arrangements.

5 We summarise our audit approach and evidence base in Appendices One and Two.

Key findings

The Department's management of the overall programme

6 **The Department has addressed the issues that contributed to the cancellation of the InterCity West Coast franchise competition in 2012 and has made progress in rebuilding its reputation within the rail industry.** In particular, the Department has established a Passenger Services team to focus on franchise letting and management; improved the transparency, consistency and clarity of information provided to bidders and the public; and strengthened the assurance and governance of franchising. To continue to improve the programme the Department has started to apply lessons learned from completed competitions and feedback from bidders.

7 **The Department has placed more emphasis on the experience of passengers, but it is too early in the life of the programme to see what impact this will have.** The Department has always required bidders to demonstrate how they will deliver punctual and reliable train services and limit crowding on trains. This includes specifying the train fleet that they propose to use and how trains will be configured to meet demand. In the current programme the Department is incentivising bidders to improve additional elements of the passenger experience, such as levels of customer service from staff on trains and at stations. The Department has recently started to look at contracted passenger service benefits on the franchises it has let so far, but does not currently plan to look in detail at the costs of specific measures alongside benefits.

1 *Report of the Laidlaw Inquiry*, Session 2012-13, HC 809, December 2012.
2 Department for Transport, *The Brown Review of the Rail Franchising Programme*, Cm 8526, January 2013.
3 Comptroller and Auditor General, *Lessons from cancelling the InterCity West Coast franchise competition*, Session 2012-13, HC 796, National Audit Office, December 2012.

8 **The competitively awarded franchises, if managed well, could increase returns to the taxpayer.** Overall, for the three completed franchise competitions, operators are contracted to pay the Department 82% more than the Department's estimate of what would have been paid under the terms of the previous franchises. This does not necessarily mean that it will achieve similar returns in all future competitions. To mitigate the risk that franchises fail because operators' bids are overambitious, the Department challenges bidders' assumptions about forecast costs and revenues. The Department also requires bidders to provide guarantees in the form of parent company support that returns to the taxpayer will be protected if costs turn out higher and revenues lower than forecast.

9 **The Department is only now beginning to address Richard Brown's recommendations to strengthen its franchise management capability.** The Brown Review recommended that the Department and the franchisee need to develop a partnership relationship to bring about ongoing improvements in financial and operational performance. Transport owning groups told us, however, that the large number of committed obligations in franchise contracts results in a rigid approach to contract management which can be inefficient and limit innovation. They also noted that the Department's capability to manage franchise contracts has not yet noticeably improved. The Department has appointed a Head of Franchise Contract Management and is reviewing its franchise management capacity and capability.

Direct awards

10 **The Department's decision to let 'direct awards' to incumbent operators was a sensible temporary measure.** Although competitive tension is an important driver of improved returns and service quality, the Department has contained risks to value for money from these non-competed contracts by limiting the number and duration of direct awards, with most lasting between two and three years. Richard Brown recommended that the Department limit the number of competitions that take place in any one year. The pause in letting franchises following the cancellation of the InterCity West Coast competition added to congestion in the existing schedule of competitions and options for temporarily extending existing contracts had largely been exhausted. The Department therefore had few alternatives.

11 **On the Great Western franchise, the Department will not benefit from the potential higher returns resulting from competition for up to six and a half years longer than originally planned.** There have been two direct awards for the Great Western franchise which could last as long as six and a half years in total. The second of these will last between three and a half and four and a half years. The Department awarded it because it judged that the work to electrify the route, and the introduction of new trains, would create too much uncertainty to carry out an effective competition.

12 The Department may have missed opportunities to get better value from direct awards because the benchmark it used in the early direct awards was too low. It was important for the Department to let the first direct awards quickly. The Department used the only benchmarking tool it had available, which had been designed to inform its overall budget and included contingency to protect it from the risk of overspending. From April 2014, the Department replaced this conservative benchmark with a more ambitious one to use in negotiations. For all the direct awards, the Department achieved leverage to help drive value for money by using the threat of bringing forward the open competition (which it did in the case of the South Western franchise) or bringing in the publicly-owned company 'Directly Operated Railways' to run the franchise, should the incumbent's proposals not meet the Department's expectations. The Department also used staff with strong commercial skills and experience to work on direct award negotiations.

Emerging risks to value for money

13 Uncertainty, delays and cost increases on major infrastructure works pose risks to value for money in rail franchising. The scale and complexity of planned infrastructure work has presented challenges for the franchising programme, and Network Rail's infrastructure improvement programme is costing more and taking longer than planned. In addition, there are major decisions pending about the construction schedule for High Speed 2. The Department must decide between a range of responses and judge how to protect value for money while keeping train services running. Its options include:

- **Delaying competitions until there is more certainty about infrastructure plans.**

  The Department did this with, for example, the TransPennine Express, InterCity West Coast and Great Western franchise competitions. Further decisions to postpone competitions could result in the Department having to extend contracts, issue direct awards or appoint the government-owned Directly Operated Railways (DOR) to run the franchise temporarily without the benefit of competition. This is particularly the case with the InterCity West Coast franchise. As a result of putting back the competition again, to align the franchising programme with High Speed 2, the Department has used up its contractual options to extend the current direct award.

- **Issuing a management contract that protects the operator from the risks to revenue.**

  The Department took this approach on the Thameslink, Southern and Great Northern franchise to enable the operator to focus on supporting the delivery of major infrastructure work, including the redevelopment of London Bridge Station, rather than maximising revenue where there are risks that services could be affected. This option could reduce returns to the taxpayer in the short term.

- **Managing change during the life of the contract.**

  The Department is doing this on the direct award for the Great Western franchise, where there is significant uncertainty about the timing of infrastructure work. The Department may need to weigh up the risk of costly changes during the life of a franchise against the risk that bidders include additional costs in their bids where there is uncertainty about key assumptions at the time of the competition.

The Department is trying to balance these issues for forthcoming competitions. The Department has also set up an Integrated Delivery Directorate to help identify and manage interdependencies between different franchises, infrastructure work and changes to trains.

14 **The resources of the Department and potential bidders could be stretched by high levels of activity planned for 2016 and 2017.** The Department produced a phased competition schedule to avoid overburdening the market and to encourage competition. In July 2015 the Department decided to end negotiations for a direct award for the South Western franchise as it was not satisfied that contracting with the incumbent operator offered value for money. The Department instead brought forward the South Western franchise competition. In addition, in November 2015, the Department decided to push back the InterCity West Coast competition by six months. This means that the Department is now planning to start competitions for the South Western, InterCity West Coast, West Midlands and East Midlands franchises over a period of eight months and award all four franchises between February and November 2017. This remains in line with the recommendations of the Brown Review.

15 **The Department may find it harder to get value for money in future competitions if market interest drops below the current level.** The three competitions that have started since the Department relaunched the programme each received three bids. By the Department's own measure, if it receives fewer than three bids this may reduce value for money. The Department is trying to encourage new entrants to the market, and maintain interest from existing operating companies. For example it is simplifying the pre-qualification process and reviewing the number and size of franchises in the network. It has not yet decided how it might adjust its procurement approach to protect value for money if market interest falls, for example by introducing more competitive negotiation and dialogue with bidders.

Conclusion on value for money

16 The Department has improved its management of its rail franchising programme, and is better placed to deliver value for money than it was in 2012, following the collapse of the InterCity West Coast competition. The results of early franchise competitions indicate that, if managed effectively, returns to the taxpayer could be higher than in the past. The Department's use of short-term direct awards was sensible but it may have missed opportunities to maximise value for money in the early direct awards.

17 More importantly, there are emerging risks to the value for money of future competitions. In particular, there is significant uncertainty about the infrastructure requirements for some franchises and there are risks to effective competition if market interest declines. The Department recognises these challenges and is taking steps to address them.

Recommendations

a The Department should capture the costs and benefits from the different approaches it has taken to managing uncertainty around, for example, the Thameslink, Southern and Great Northern, InterCity West Coast and Great Western franchises. It should use this to inform decision-making on franchises where there are challenging interdependencies with infrastructure improvement and the introduction of new rolling stock.

b The Department should develop alternatives to its current commercial approach so it is well placed to deliver value for money if market interest falls to a level where intense competition cannot be guaranteed. This could involve introducing more negotiation and dialogue with bidders to drive a better deal.

c The Department should assess the maturity of the programme, including its procurement and commercial capability, to establish whether it is ready to take a more flexible approach to managing franchises. The Brown Review recommended that the Department and operators establish a contractual relationship based on partnership but the Department has not yet started to do this.

d As part of the Department's analysis of the success of measures to incentivise improvements to the passenger experience, it should capture the costs of implementing such measures alongside the benefits. The Department will need to understand both the costs and the benefits to be able to assess the impact on both passengers and taxpayers.