National Audit Office

Report
by the Comptroller
and Auditor General

Department for Transport

Reform of the rail franchising programme

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Department for Transport

Reform of the rail franchising programme

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This study examines whether the Department for Transport is managing its rail franchising programme effectively to drive value for money.

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Contents

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Key facts

£8.5bn

total train operating company revenue in England and Wales, in 2013-14

£1.2bn

total net payments to the Department from train operating companies in 2014-15

82%

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.

Part One

The Department's reform of rail franchising

1.1 In the mid-1990s the government privatised the UK's railways and let franchises for passenger rail services to private sector companies for a specified length of time following a competitive procurement process. Following the abolition of the Strategic Rail Authority in 2006, the Department for Transport (the Department) has been responsible for awarding and overseeing rail franchises in England and Wales.[4] **Figure 1** sets out the roles and responsibilities of the main organisations in the UK rail system.

Figure 1

Functions and responsibilities of the main organisations in the rail system

Organisation	Functions and responsibilities
Department for Transport	Sets overall rail policy and strategic objectives.
	Lets and manages passenger rail franchises; pays subsidies to loss-making rail franchises and receives premia payments from profit-making franchises.
	Acts as 'operator of last resort' to step in to keep rail services running in the event of operator failure.
	Provides grant funding and oversees Network Rail.
	Develops and sponsors major rail projects such as Crossrail and High Speed 2.
Network Rail	Owns, operates and maintains the UK's railway infrastructure.
	Carries out upgrades and improvement projects.
	Charges franchise operators to access the railway to run services.
Train Operating Companies	Operate passenger rail services.
	Pay Network Rail to access track to run services.
	Lease trains from owners usually Rolling Stock Leasing Companies (ROSCOs).
Office of Rail and Road	Regulates the efficiency of Network Rail's spending on maintaining and improving infrastructure.
	Grants licences to train operating companies to run passenger rail services.
	Monitors and enforces compliance with health and safety law on the railway.
	Considers applications from train operating companies to run 'open access' services to use up available capacity on the rail network.

Source: National Audit Office

4 Under the Railways Act 2005.

1.2 The Department is currently responsible for 15 franchises in England and Wales. Devolved transport authorities such as Transport Scotland and Transport for London are responsible for awarding some contracts such as ScotRail and the London Overground. In 2013-14, train operating companies raised around £8.5 billion in revenues and in 2014-15 returned around £1.2 billion (net) to the Department. Appendix Four sets out the flows of money in the rail system.

The Department's responses to problems in 2012

1.3 In October 2012, the Department cancelled its provisional decision to award the InterCity West Coast franchise to First Group. It had discovered errors in the procurement process, including the bid evaluation tool and inconsistent information provided to bidders, while preparing to defend itself against legal proceedings from one of the bidders. The Department consequently paused three other franchise competitions: Essex Thameside, Great Western and Thameslink, Southern and Great Northern.

1.4 As we reported in 2012, the collapse of the competition resulted in significant additional costs to the taxpayer to compensate bidders for the costs they had incurred. It also damaged the Department's credibility with train operators. Appendix Three sets out the sequence of events since the competition was cancelled.

1.5 The Department has now largely addressed the recommendations in the reports by us, the Committee of Public Accounts, and Sam Laidlaw (then a Departmental non-executive director). The reports highlighted significant weaknesses in the way the Department had managed the franchise competition which, while not the direct cause of the collapse of the competition, were contributory factors (Appendix Three).

The Department's capability and capacity

1.6 The NAO and Laidlaw reviews identified shortcomings in the Department's commercial and programme management capacity and capability. In its report on the West Coast failure, the Committee of Public Accounts concluded that the Department's "...attempt to make cost savings by cutting corners on the [West Coast] competition resulted in significant additional costs…",[5] and said the Department should put in place the right internal resources and external support.

1.7 The Department has taken steps to improve its capability. It has strengthened leadership and accountability by appointing a new Managing Director of Passenger Services to be the Senior Responsible Owner (SRO) for the franchising programme as a whole, and for each franchise competition. The new SRO has significant industry experience and is well respected by the market. Individual franchise competitions have a discrete project team of around nine members, headed by a senior civil servant as project director.

5 HC Committee of Public Accounts, *Department for Transport: Lessons from cancelling the InterCity West Coast franchise competition*, Thirty-first Report of Session 2012-13, HC 813, February 2013.

1.8 The Department has also made organisational changes (**Figure 2** overleaf) to address problems in the InterCity West Coast competition which were due to the competition being staffed by people from various divisions of the Department. It has established a Passenger Services directorate within the Rail Executive, which is responsible for franchise letting and franchise management. The new directorate has a clear corporate structure including its own finance, procurement, and assurance teams and its own programme office. The Department is also supported by external technical, legal and financial advisers. Within Passenger Services, the franchise letting and franchise management teams have been brought together. This aims to give operators a single point of contact, improve knowledge-sharing and strengthen the link between letting franchises and managing them.

1.9 The Department has also increased its capacity to run the rail franchising programme. Passenger Services had a target headcount of 259 as at the end of September 2015. At this point, there were 32 posts (12%) vacant in total, compared to 29 vacancies (11%) in August. 34 posts (13%) were filled by interim staff, one fewer than in August. The Department has recruited a number of staff from the rail industry, including former employees of train operating companies and advisory firms.

1.10 Recruiting additional staff and retaining current staff will be a challenge as there is increasing demand for expertise from other organisations, including train operating companies and Network Rail, as well as other parts of the Rail Executive within the Department. To help manage this issue, the Department negotiated with HM Treasury to offer additional allowances above the usual civil service pay limits for specialists.

The Department restarted its franchising programme in 2013

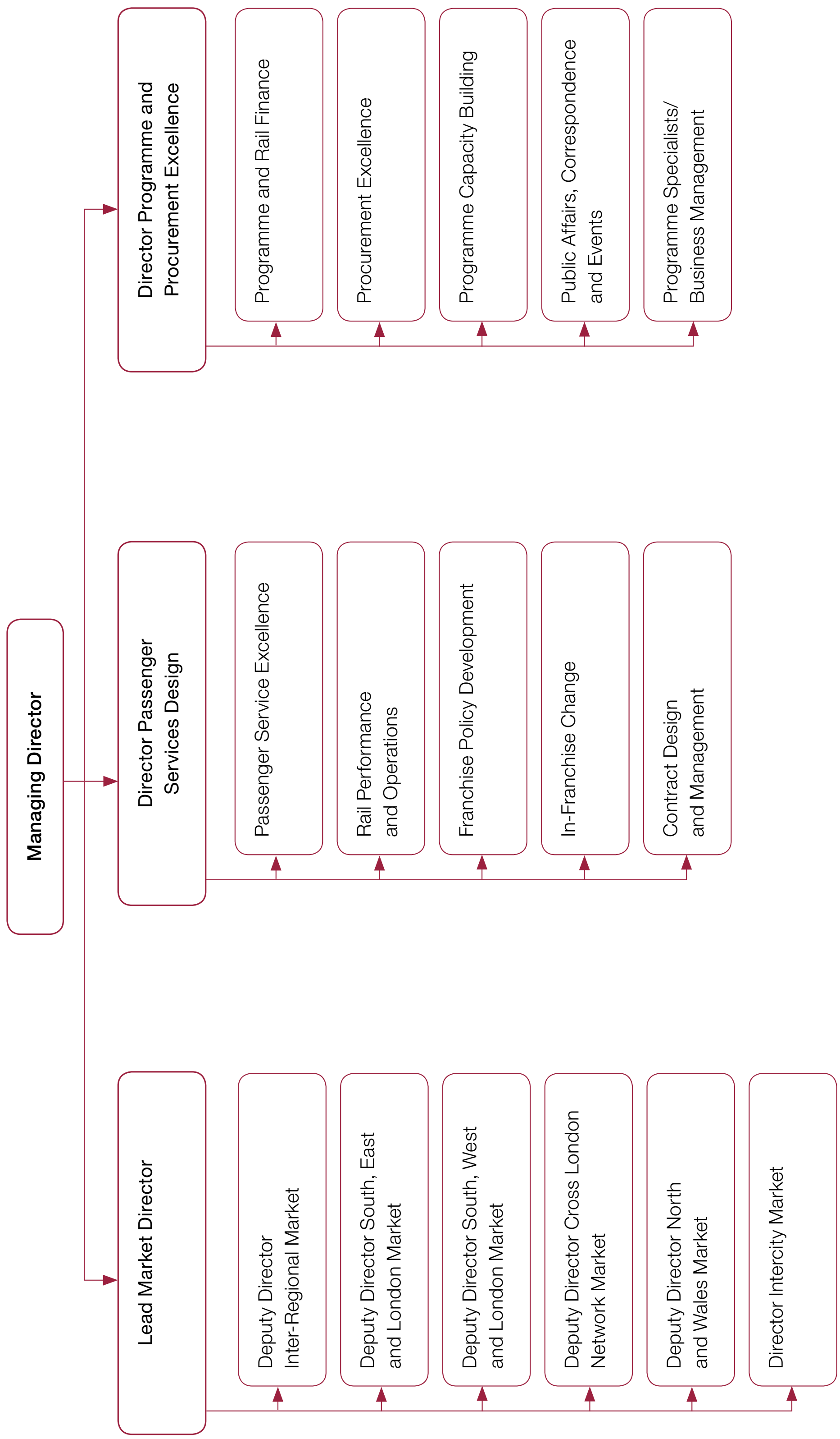
1.11 The government paused its live franchise competitions in 2012 and commissioned Richard Brown (appointed as a non-executive director of the Department in 2013) to carry out a further review of rail franchising, which looked at the Department's franchising approach. Published in January 2013, the Brown Review made recommendations on:

- scheduling franchise competitions;
- improving services for passengers; and
- improving the programme's commercial approach, including ensuring that risk is allocated appropriately between the Department and operators.

The Department has based its reform of rail franchising largely on Brown's recommendations.

1.12 In March 2013, the Department restarted the franchising programme. It resumed the competitions for the Thameslink, Southern and Great Northern and Essex Thameside franchises. The InterCity East Coast franchise competition, which began in October 2013, was the first the Department carried out from start to finish under its revised objectives and processes.

Figure 2
Passenger Services organisation chart



Source: Department for Transport

1.13 The Department has demonstrated that it is committed to continuously improving its franchising programme. This includes embedding a structured approach to learning lessons and responding to feedback from operators and stakeholders. This is particularly important for rail franchising, because the cycle of reletting will begin again as current franchises approach their end. For example:

- The Department holds 'lessons learned' workshops after each franchise competition.
- The Department holds 'bidder days' to give bidders the opportunity to feed back their experiences of the procurement process and make suggestions for improving it. Examples of the Department implementing changes as a result of feedback include the launch of the 'PQQ (Pre-Qualification Questionnaire) Passport' which is intended to increase the numbers of new entrants and reduce bidding costs and a review of the amount of parent company support a bidder requires (see paragraph 3.23).
- The Department is reviewing the complexity and quantity of information it requires from bidders in its financial models in an attempt to reduce bidder costs and reduce the risk of errors in bids.

Progress against the programme schedule

1.14 The Brown review recommended that the Department should limit the number of franchises it awards in any one year and provide operators with a clear programme of competitions to allow them to plan effectively. The Department's previous approach was characterised by peaks and troughs of demand. A programme in which franchise competitions are staggered also helps the Department to manage its resources. The Department has published such a programme, which it updates periodically to reflect delays, changes or risks. This has been well received by operators and has helped to build confidence in the programme.

1.15 In order to establish the staggered programme schedule, the Department decided to issue a series of direct awards (single tender actions) of varying duration to incumbent operating companies. This avoided having to run more franchise competitions at one time than the market or the Department could manage. The Department's management of direct awards is discussed in more detail in Part Two of this report.

1.16 The Department reviews and adjusts its programme schedule periodically. The main adjustments it has made to the programme so far have been to:

- delay the TransPennine Express and Northern franchise competitions by two months from December 2014 to February 2015;
- bring forward the start of the competition for the South Western franchise by two years from September 2017 to November 2015;
- put back the competition for the Great Western franchise for at least three and a half years;
- put back the start of the InterCity West Coast competition by a total of 10 months from August 2015 to June 2016; and
- put back the competition for the East Midlands franchise by four months from March 2016 to July 2016.

1.17 The specific causes and consequences of these adjustments are discussed in more detail in Part Four of this report, which looks at the Department's management of programme interdependencies. **Figure 3** shows the current programme schedule.

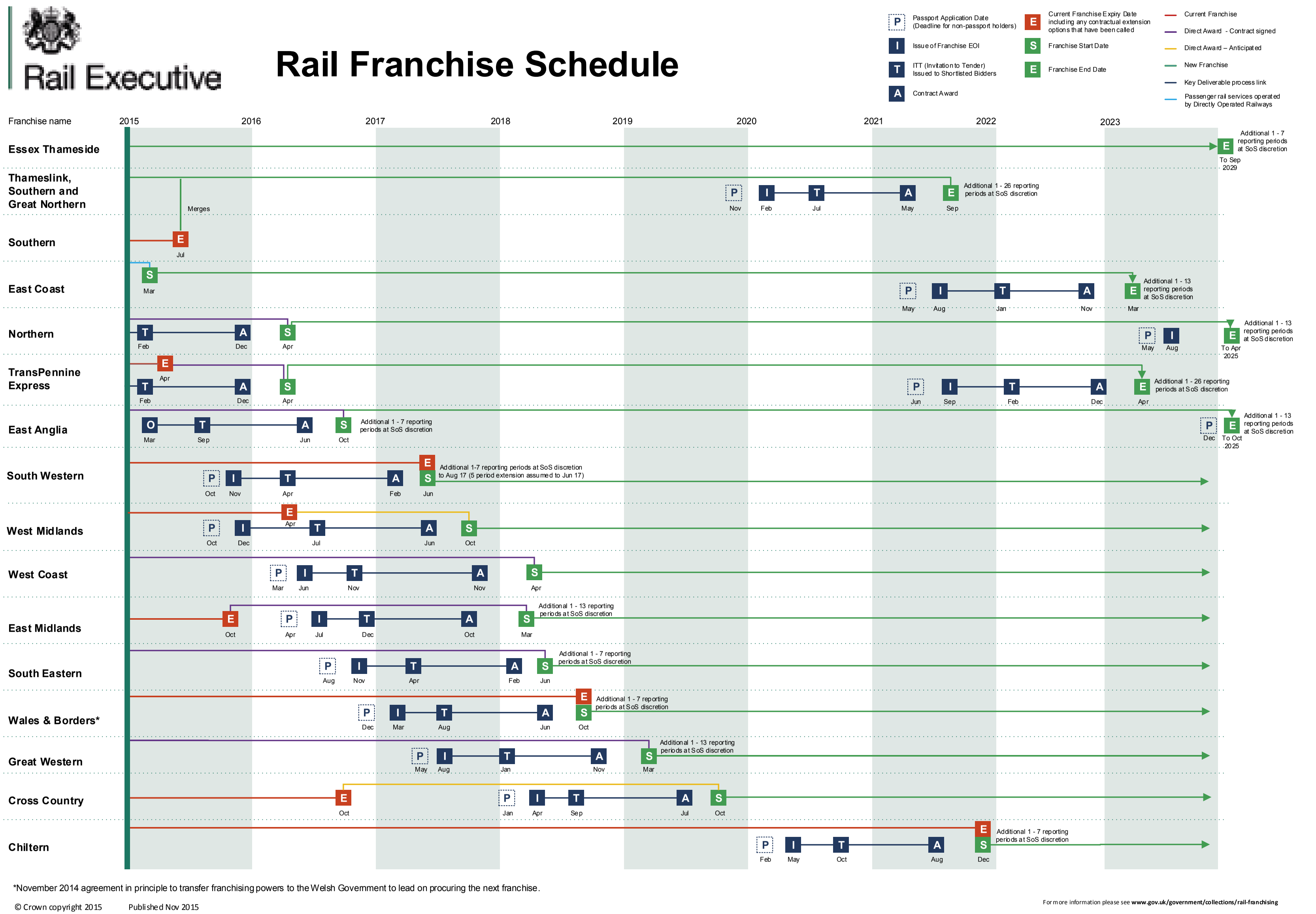
1.18 As a result of these changes the Department is now planning to begin the South Western, InterCity West Coast, West Midlands and East Midlands franchise competitions during an eight month period, and to award all four franchises between February and November 2017. This remains in line with the Brown Review, which recommended around three or four franchise awards in any one calendar year. The changes have been communicated early to operators to give them time to plan their resources. However, the schedule for 2016 and 2017 is tight and the Department's resources could be stretched. There is a risk that the Department will receive fewer expressions of interest than it might have, had the schedule remained more staggered.

1.19 The rest of this report examines three key aspects of the Department's programme management:

- its use of single-tender contracts known as direct awards;
- its commercial approach to getting value for money from the rail operator market; and
- its management of interdependencies between franchises and other plans affecting the rail network.

Figure 3

The rail franchising schedule as at November 2015



Source: Department for Transport

Part Two

Direct awards

2.1 This part examines the Department for Transport's (the Department's) use of non-competitive single-tender contracts for some franchises. It introduced these when it rescheduled the franchising programme after the failure of the InterCity West Coast competition. In particular we look at:

- the Department's rationale for using the direct awards; and
- the Department's approach to getting value for money in the absence of competition.

The Department's rationale for the direct awards

2.2 The Department paused its franchise programme following the cancellation of the InterCity West Coast competition. By the time it restarted the programme in 2013, this pause had added to congestion in the existing schedule of competitions and the Department could not further extend existing contracts. In line with the Brown recommendations, the Department tried to limit the number of competitions it ran in each year. This was to avoid overburdening the market and allow the Department and the operator market to plan resources effectively.

2.3 The Department therefore took the pragmatic decision to use single-tender contracts to let short-term 'direct awards' to incumbent operators. In doing so it had to weight the benefits of a manageable, staggered programme of competitions against risks to value for money such as:

- the absence of competition that would help drive down the price of bids or drive up service quality – as we explain in Part Three, effective competition is one of the Department's main ways of achieving value for money; and
- additional costs and demands on resources for the Department. While the resource requirement for a direct award is not as high as for a franchise competition (a direct award takes around 14 months from start to finish, compared to around 24 months for a franchise competition, and the team is smaller) it means the Department has to carry out two franchise procurements in relatively quick succession.

2.4 The Department is aware of the risks to value for money created by direct awards and has tried to limit their number and duration where possible. It has not used a direct award for five of the 15 franchises. Also, although the Department originally intended to use a direct award on the South Western franchise, this was with the aim of the incumbent operator and Network Rail working together in a close alliance across one of Network Rail's spending control periods, rather than to help stagger the programme. In the event, the Department cancelled the direct award process in July 2015 when it failed to reach agreement with the incumbent operator.

2.5 The Department has also tried to minimise the duration of the direct awards, and therefore the length of time a franchise runs without competition. Most last between two and three years. The exceptions are South Eastern, which will run for three and a half years, InterCity West Coast, which will run for three years and nine months, and Great Western, which could run for a total of six and a half years over two direct awards.

2.6 There is ongoing uncertainty about the detailed plans for Euston Station as part of the High Speed 2 programme. In November 2015, the Department decided to push back the competition for the InterCity West Coast franchise by a further six months to June 2016, in order to align the InterCity West Coast franchise with High Speed 2. As a result, the Department has had to extend its existing direct award contract with the incumbent operator. The Department has no further options to extend the current contract. If the Department needs to put the competition back again it will either have to issue another direct award, or appoint the government-owned Directly Operated Railways (DOR) to run the franchise temporarily.

2.7 The Department gave the first direct award for Great Western as part of the redesign of the franchise programme schedule. The contract ran from October 2013 to September 2015. The second direct award was agreed in March 2015 and is scheduled to run from September 2015 until April 2019, with an option to extend it for up to 12 months to April 2020. The Department decided to do the second direct award because it judged that work to electrify the route, and the introduction of new trains, created too much uncertainty to carry out an effective competition. It also wanted to use the incumbent's knowledge of the route to help with Network Rail's electrification programme and the introduction of a new fleet of Intercity Express trains. However, this means that if the full direct award term is used, the Great Western franchise could operate for six and a half years without the benefit of competition to determine the price.

2.8 The Department has completed ten direct award negotiations and has two more to complete (West Midlands and Cross Country).[6] The Department has now completed five franchise competitions on the routes that have been run under direct awards.

Getting value for money from direct awards

2.9 To protect value for money in the absence of competition, the Department brought in staff with strong commercial skills and extensive experience in the rail industry to work on direct award negotiations. The Department used two main approaches during the negotiations. First, the Department sought to introduce an element of competitive tension in its negotiations by retaining the option to transfer the service to another provider or run a full franchise competition if it could not reach agreement on the terms of a direct award. The Department kept Directly Operated Railways (DOR), the publicly-owned rail operator that ran the InterCity East Coast franchise from 2009 to 2015, mobilised throughout negotiations. Operators told us that they considered this to be a genuine risk to them securing the contract. In June 2015, the Department demonstrated that it was prepared to use one of the alternative options when it decided to halt negotiations with South West Trains and bring forward a franchise competition for the South Western franchise.

6 The 12 Direct Awards cover 11 franchises. There have been two Direct Awards for the Great Western franchise: one which ran from 2013 to 2015 and a second which will run until at least 2019, which the Department signed in order to facilitate Network Rail's infrastructure programme and the introduction of new Intercity Express trains.

2.10 The Department's second approach was to develop benchmarks or comparators that provided an indication of the level of premium or subsidy and level of service that the Department would regard as acceptable. It used these as the basis for negotiations with incumbents. The Department used two models:

- a 'top-down' model based on the Department's central long-term forecasts, which simply projected the performance of the current franchise into the future; and
- a 'bottom-up' model that included assumptions about what the incumbent might offer in response to the Department's specification.

2.11 For the early direct awards the Department used a conservative approach to judge whether it was getting value for money, which was not designed for the purpose. The Department used its top-down model both as a forecast of future premia (payments from the operators of profit-making franchises, to the Department) or subsidies and also as a tool on which to base its departmental budgets. Because the model was used as a budgeting tool, the Department built in contingency to manage the risk that it would break the budget, which resulted in a conservative benchmark. From April 2014, the Department replaced this conservative benchmark with a more ambitious benchmark to use in negotiations. While we cannot directly evaluate the effect of this changed approach because the premia or subsidies from different franchises are not directly comparable, this change should have resulted in improved value for money.

2.12 The contracted premia that the Department has achieved for direct awards are significantly lower than it has achieved from competitions, when compared to the comparator models used for each franchise:

- For the three franchise competitions completed so far, the overall contracted level of premium during the core years of the franchise is 82% higher than the figure shown in the Department's comparator models (see paragraphs 3.3 and 3.4).
- Across the direct awards negotiated so far, the overall contracted level of net premium is 32% higher than the Department's comparator models.

These figures suggest that competition is important for improving returns to the taxpayer. However, there are other factors at play. For example, direct awards are relatively short, meaning that there is less incentive for operators to invest in measures to improve returns. Also, the franchises where competition has taken place have different characteristics from those where the Department has used direct awards.

Part Three

The Department’s commercial approach

3.1 Because passenger rail services are, on the whole, provided by the private sector, achieving value for money from the rail franchising programme depends largely on the success of the Department for Transport’s (the Department’s) commercial approach.

3.2 The Department’s mantra for the programme is to ‘buy the right thing, in the right way’. The Department puts a great deal of effort into designing the specification to achieve value for money, and buying what has been bid. This part looks at the contracted premia that the successful bidders have agreed to pay the Department on the three franchises awarded so far and at three important aspects of its commercial approach:

- allocating risks to the party best placed to manage them;
- getting value for money during the franchise; and
- generating market interest and maintaining strong competition at the procurement stage.

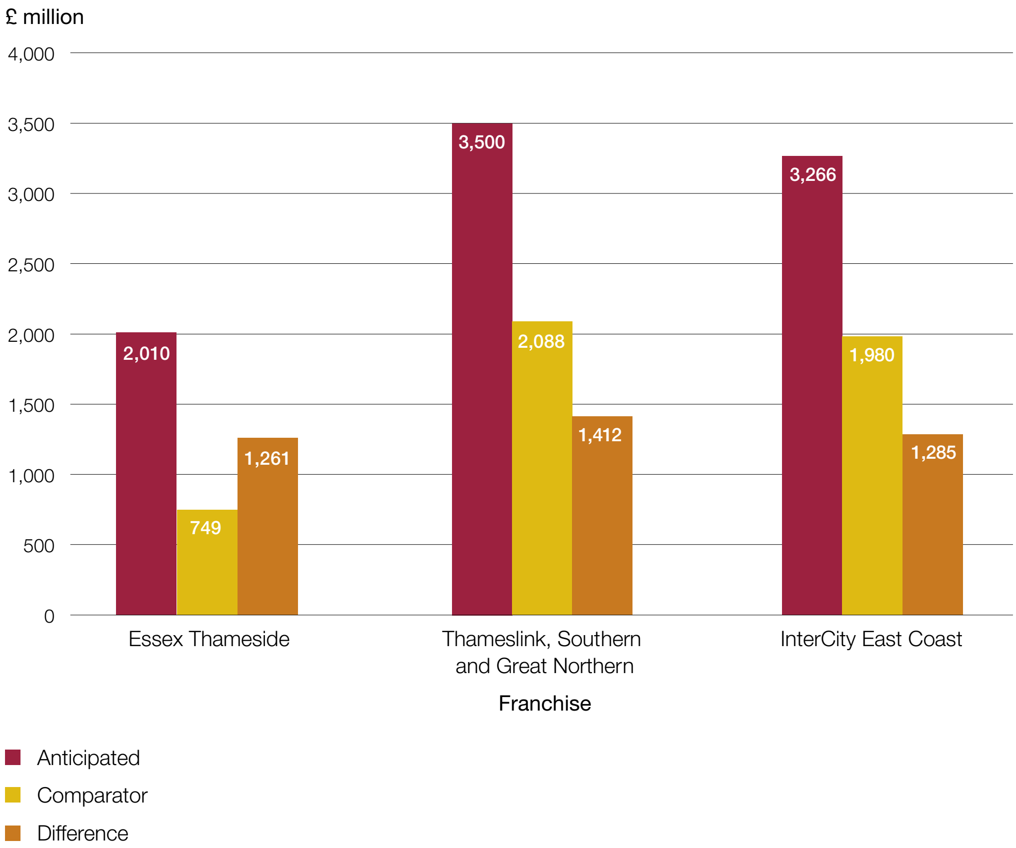
Contracted premia for the franchises awarded so far

3.3 The three franchise agreements awarded so far require operators to pay the Department over the life of the contracts, 82% more than it estimated it would have received had the previous franchises continued (**Figure 4** overleaf).[7] This does not necessarily mean that similar levels of returns will be achieved in all future competitions. Operators’ actual payments to the Department may change if, for example, infrastructure works result in disruption and reduced revenue, or if revenues exceed projections.

7 This is based on the Department’s own internal comparator model, which forecasts the likely payments from the franchise if the existing franchise continued. This does not include the Department’s assessment of what bidders might offer.

Figure 4
Anticipated versus comparator premia

Total financial premium for three franchises using anticipated and comparator projections



Notes

1 The comparator premia uses the Department's long term forecast model, which projects current performance into the future for the duration of the new franchise.

2 Figures are in nominal terms at the time the franchises were awarded.

Source: National Audit Office analysis of Department for Transport information

3.4 A number of factors contribute to these results. For example, passenger demand, which is linked to revenues and therefore franchise premia, has been increasing for many years. In addition, the three franchises awarded so far all include commitments to increase the number of seats through new, higher-capacity and more frequent trains. The Department expects these will allow more people to travel and increase fare revenue for operators.[8] The Department expects there to be 3,100 additional seats in the morning peak into London on the InterCity East Coast franchise, 10,000 extra on Thameslink, Southern and Great Northern and 25,000 more on Essex Thameside.

8 The Thameslink, Southern and Great Northern, and InterCity East Coast franchises are benefiting from new trains that the Department has procured through the Thameslink and InterCity Express Programmes.

Guarding against overbidding and supplier failure

3.5 There is a risk that the Department's focus on competitive tension in procurements could encourage bids that overestimate passenger demand and revenues, or underestimate costs. This could lead to operators being unable to continue to run the franchise, which happened with the InterCity East Coast franchise in both 2006 and 2009.

3.6 The Department protects itself from the risk of overbidding by assessing the financial robustness of each bid during the evaluation process and securing financial guarantees from the parent companies of operators. In the 2012 InterCity West coast competition, the Department was unclear about how to calculate the level of parent company support it would require from bidders and was inconsistent in the way it applied the model used to calculate this. While it remains to be seen whether the current approach will be effective, the Department has improved the clarity of the process. **Box 1** sets out the Department's current process.

3.7 There can be no guarantee that an operator will not fail, but the Department's approach protects it from excessive risk of supplier failure and ensures that operators have some capital at stake. As we noted in our July 2015 position paper on managing provider failure, the failure of a provider is not necessarily something that should be avoided at all costs. It can be the necessary price of innovation or come from effective competition, keenly priced contracts and robust contract management. However, supplier failure must be managed effectively.[9] The Department recognises this tension and the risk that it will have to step in if the operator can no longer run a franchise. In 2009, we reported on the Department's handling of the termination of the InterCity East Coast franchise and found that the Department had taken appropriate action and managed costs effectively.

Box 1
The Department's process for testing the financial robustness of bids

The Department carries out risk adjustments to elements of a bid which it feels present a significant risk of a materially different financial outcome to that proposed by the bidder.

The Department requires bidders to provide underwritten guarantees of financial support from their parent companies. This aims to protect the taxpayer from the risk of lower premia or higher subsidies than had been contracted. This support is also intended to discourage bidders from submitting overambitious bids. Bidders are required to commit a minimum level of financial support, but can increase this if they feel it would improve the financial robustness of their bids. Bidders are not allowed to offer additional finance during the competition.

The Department tests whether the risk-adjusted bids and levels of parent company support result in the bid remaining within a defined set of financial ratios for the duration of the franchise. The Department then assesses the overall risk of default of each bid. Bids that are judged 'high' risk are disqualified.

Source: National Audit Office summary of the Department's published tender documents

9 National Audit Office (2015), *Principles Paper: Managing provider failure*, 14 July 2015.

Steps to improve passenger experience

3.8 The Department has a number of objectives for its rail franchises:

- **Meeting demand for the network:** tackle capacity constraints, grow new markets and support wider housing and economic development plans.
- **Growing an efficient railway:** improve efficiency, spread demand, reduce costs and increase the long-term value of the railway.
- **Providing a world-class passenger experience:** increase standards in customer service, train performance and station facilities, and 'modal integration' between different forms of transport.
- **Improving safety and environmental outcomes:** maintaining rail as a safe, resilient and green mode of transport; promoting environmental sustainability; and improving safety and security.
- **Improving social inclusion, accessibility and modal integration**.

3.9 Of these objectives, the Department is particularly focused on improving passenger experience, and the franchise specifications reflect this. Passenger experience can be divided into two broad categories:

- **Punctual, reliable services with sufficient capacity.**

  Transport Focus surveys show that train punctuality and reliability have the biggest impact on overall passenger satisfaction. The Department requires bidders to demonstrate how they will meet these objectives, including specifying the train fleet that they propose to use and how trains will be configured to meet demand.

- **Other aspects of passengers' experience.**

  The Department introduced these objectives in response to the Brown Review. They include the quality of customer service and visibility of staff at stations, the look and feel of stations and trains, and the availability of Wi-Fi connections and power points on trains.

3.10 The Department varies the extent to which it incentivises different aspects of passenger experience depending on local factors.[10] It carries out its own research into passenger priorities and consults with Transport Focus, the industry body that represents passenger interests, on the passenger service elements of franchise specifications and bid evaluations.

3.11 The Department has set customer performance targets in its franchise agreements which, as recommended by the Brown Review, are partly based on National Rail Passenger Surveys run by Transport Focus. Operators told us that they are concerned about being found in breach of contract as a result of people's opinions, which they consider to be an unreliable measure. Attempts to measure the impact of franchise incentives are complicated by wider changes in the operating environment. For example, important investments in rail infrastructure and new trains, such as the InterCity Express and Thameslink programmes, are expected to increase capacity and improve punctuality, and reduce overcrowding on some of the busiest routes.

3.12 The Department has recently started to assess the impact of the strengthened focus on passenger experience, but does not currently plan to look in detail at the costs of specific measures alongside benefits. Measures to improve service quality, such as increasing staff numbers may come at a cost. This could reduce premia received or increase subsidies paid by the Department.

Risk allocation

3.13 In line with the recommendations of the Brown review, the Department seeks to allocate risks to the party best placed to manage them. If the Department tried to transfer risks to operators that they could not reasonably control, bidders would likely respond by increasing contingency in their franchise bids, leading to reduced premia or increased subsidies.

10 For example, the quality score for the InterCity East Coast franchise has a low weighting relative to the level of premium that bidders offer, because of the high level of discretionary travel and the close relationship between customer experience and demand. East Coast operators therefore have a natural incentive to improve the passenger experience, to attract more passengers and more revenue. On commuter routes such as East Anglia, on the other hand, where passengers have fewer options for their journeys, customer experience is given a higher weighting, in order to protect passengers from the operator being encouraged to cut costs to maximise revenue.

3.14 The Department has replaced its previous 'cap and collar' approach – which created perverse incentives if revenue fell below expectations – with contractual measures that are in line with recommendations from the Brown Review. For example:

- For most franchises, operators bear the risk if revenues do not meet forecasts for reasons that are within their control, such as the reliability of the train service or marketing. The main exception is the current Thameslink, Southern and Great Northern franchise.[11]
- The Department has developed approaches to share the impact of risks to revenue that are outside operators' control. These are based on factors that drive passenger demand on different franchises.
- On the InterCity East Coast franchise, where there is a lot of discretionary travel, the Department is using a formula linked to GDP. If GDP falls below an agreed baseline, the operator is protected from lower revenues due to reductions in passenger numbers attributable to lower GDP. If GDP exceeds the baseline, the Department stands to gain most of the increased revenues.
- For commuter franchises in and out of London the Department has been considering using forecasts of London job growth as the main indicator. In the invitation to tender for the East Anglia franchise, the Department has used both GDP and London job growth.

Getting value for money during the franchise

3.15 The Department's procurement approach – to buy what is bid – has provided clarity and consistency. It is also understandable that the Department takes steps to reduce the risk of legal challenge, given the inconsistencies in the procurement approach discovered after the collapse of the InterCity West Coast competition in 2012.

3.16 The Brown Review recommended that the Department and the franchisee develop a partnership relationship to bring about ongoing improvements in operators' financial and operational performance. The operators we spoke to felt the Department was not performing as strongly in this area as they would expect. Operators told us that there are high numbers of committed obligations that are written into contracts, that they must meet if they are to avoid breaching the contract. This approach can bring about rigidity in the contract management approach and reduce innovation and efficiency.

11 For the Thameslink franchise, the Department opted for a management contract with fixed premium regardless of revenues because of the level of uncertainty related to Network Rail's infrastructure work on the route – particularly the rebuilding of London Bridge Station. We discussed this in our 2013 Thameslink report.

3.17 The Department is aware of operators' views and is taking steps to develop its approach to contract management and its commercial capability. For example, it has begun reviews of the franchise agreement and the contractualisation process, in consultation with operators. This is looking at, for example, developing contractual obligations based on the results of an operator's activities (outputs or outcomes) rather than what the operator does (inputs). If managed properly, this has the potential to promote more innovation and reduce inefficiency.

3.18 The Brown Review emphasised the importance of franchise management, requiring commercially experienced individuals. Operators told us, however, that the Department's approach to contract management varies and has not noticeably improved since 2013. The Department is aware of this. In April 2015, it appointed an industry professional to a new role of Head of Franchise Contract Management. It is currently taking steps to strengthen its commercial capability.

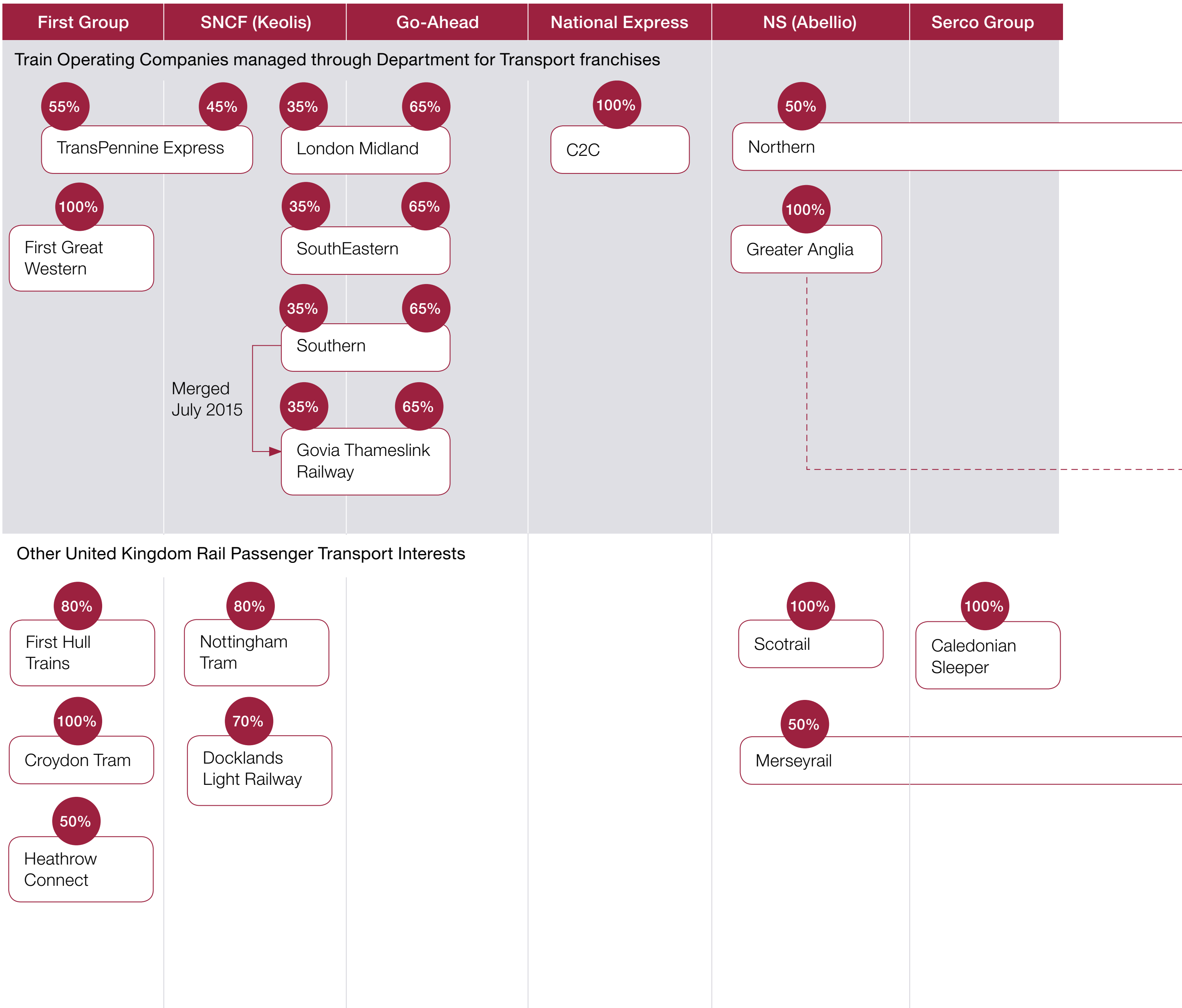
Market interest and competition

3.19 The Department's strategy for achieving value for money from rail franchises depends on receiving good quality competitive bids. The Department has increased the quantity and quality of its early market engagement. However, a range of factors including the timing of competitions, the burden on resources of bidding and the attractiveness of the franchise specification, all influence operators' willingness to enter competitions. In addition, by publishing the schedule of competitions, the Department has provided operators with the opportunity to consider their bidding strategies in advance, and to select which competitions they will bid for.

3.20 The Department's 15 franchises are currently run by companies set up by nine transport owning groups. Some owning groups bid on their own to operate franchises. Others create joint ventures and pool resources to bid and run franchises. **Figure 5** overleaf sets out the current make up of the rail passenger franchise market by owning group and franchise. There are some contracts to run passenger rail services let by other transport authorities including Transport Scotland and Transport for London. The timing of these could also have an impact on interest in competitions run by the Department.

Figure 5
Map of the UK passenger rail market by owning group[1]

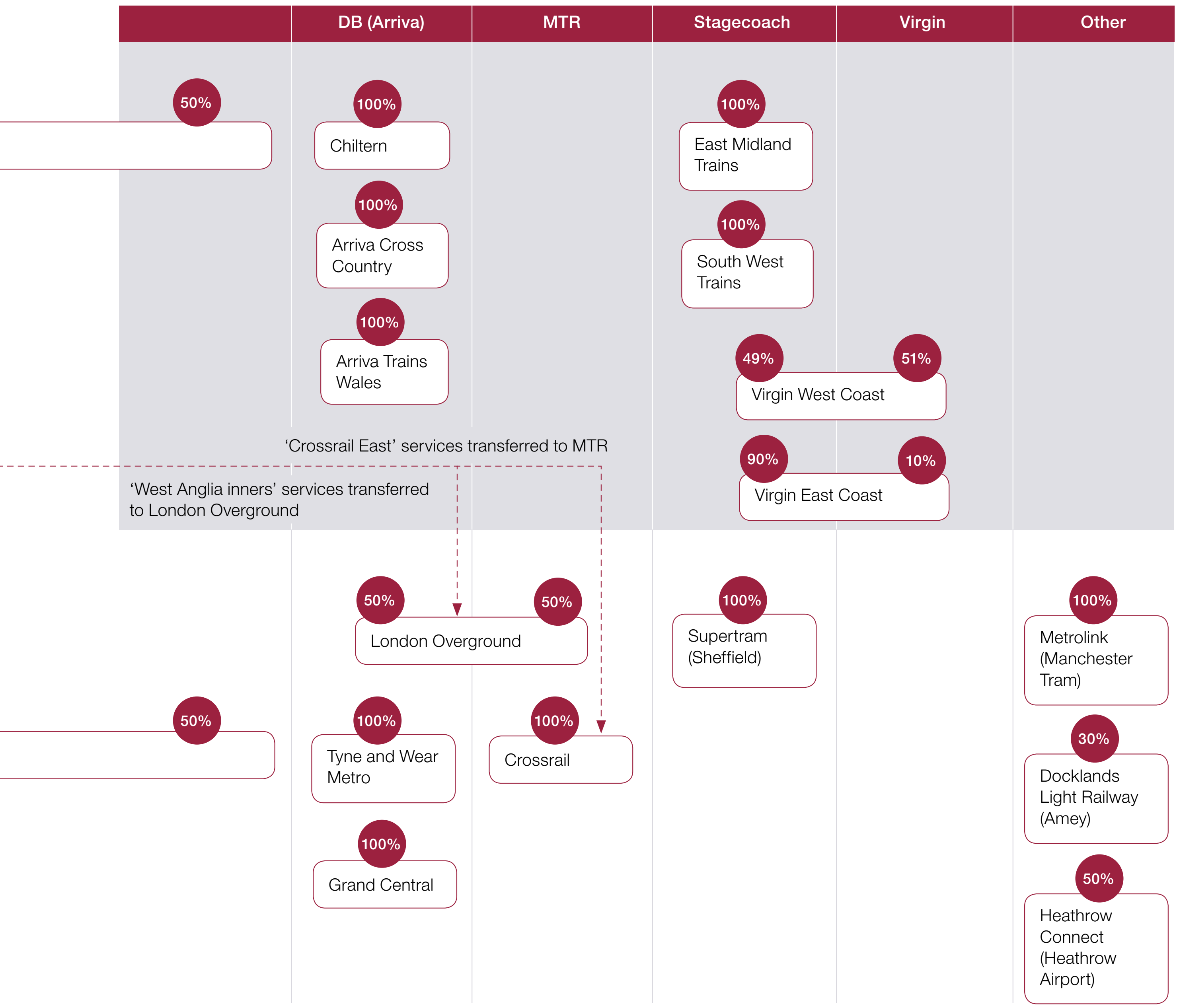
Franchise Mapping by Owning Group



Note

1 Includes franchises not let and managed by the Department.

Source: Department for Transport


DB (Arriva)
MTR
Stagecoach
Virgin
Other
50%
100%
Chiltern
100%
Arriva Cross Country
100%
Arriva Trains Wales
100%
East Midland Trains
100%
South West Trains
49%
51%
Virgin West Coast
90%
10%
Virgin East Coast
'Crossrail East' services transferred to MTR
'West Anglia inners' services transferred to London Overground
50%
50%
London Overground
100%
Supertram (Sheffield)
100%
Metrolink (Manchester Tram)
50%
100%
Tyne and Wear Metro
100%
Crossrail
30%
Docklands Light Railway (Amey)
100%
Grand Central
50%
Heathrow Connect (Heathrow Airport)

Competition in the current franchising programme

3.21 The number of bids the Department has received under the current franchising programme is lower than the historic trend. For each of the first three competitions (taking the InterCity East Coast competition to be the first) the Department has received three bids, which is the minimum the Department considers is necessary to ensure good quality bids. The previous ten competitions received four bids on average. The Department considers that this is partly due to its publication of the schedule, which allows owning groups to plan which competitions to bid for.

3.22 The Department has analysed the state of the market and identified a number of potential reasons for the decreasing levels of competition. For example:

- there are increasing opportunities for transport owning groups in other countries – particularly in Europe. A number of operators told us that barriers to entry, including the cost of bidding in these markets tend to be lower than in the UK;
- owning groups have interest in other transport modes, including buses. According to the Department's analysis, the cost of bidding for rail franchises is high compared with bus operations, while profits are lower; and
- bidders are required to provide financial guarantees from parent companies for each competition. Some operators are concerned that, as they win franchises and have more capital at risk in the UK rail market, owning groups could be discouraged from approving bids for future UK franchises.

3.23 The Department is taking steps to reduce the cost of bids and barriers to entry to the UK market, including:

- reviewing the number and size of franchises on the network;
- reviewing the level of parent company support required from operators; and
- a 'PQQ passport' which the Department launched in September to reduce the administrative burden and cost of bidding, and to encourage new entrants to the UK market. Rather than having to complete a pre-qualification questionnaire (PQQ) each time they want to bid for a franchise, bidders who have demonstrated managerial competence and a strong track record will be awarded a 'PQQ passport'. This will allow them to express an interest in a franchise without having to repeat a managerial competency test. Views from existing operators varied about the impact this would have on bid costs.

3.24 It remains to be seen how successful these measures will be. We have not seen any plans showing how the Department will adjust its approach to procurement to help drive a better deal, if levels of interest fall below those required to ensure intense competition, high-quality bids and value for money. These plans could involve introducing more negotiation and dialogue with bidders between the bid evaluation and award of the contract.

Part Four

How the Department manages interdependencies

4.1 To deliver UK passenger rail services, the franchise programme must be aligned with work to maintain and improve rail infrastructure, and with the provision of trains ('rolling stock'). The Department for Transport (the Department), operators, Network Rail and the Office of Rail and Road (ORR), work together to manage the interdependencies between the different parts of the rail system. This part examines how the Department manages:

- interdependencies between franchises;
- interdependencies between its franchising programme and plans to enhance infrastructure and introduce new trains; and
- the relationship between the roles of the Department and ORR in promoting competition for passenger services.

Managing interdependencies between franchises

4.2 While franchises are, on the whole, designed to serve discrete parts of the rail network, some franchises run services on the same sections of track and serve the same stations. If the tender specifications for these are not aligned, they could result in franchises that do not fit together in a way that benefits the passenger, inefficient management of infrastructure improvements and avoidable costly changes during the life of franchises.

4.3 The Department is running the Northern and TransPennine Express competitions concurrently. The invitations to tender, issued in February 2015, emphasised the importance of joint working between successful franchisees, and specified that the successful bidder for TransPennine Express will be required to represent both franchises in the facilitation of Network Rail's infrastructure improvement programme. The Department had intended to develop the specifications for the InterCity West Coast and West Midlands franchises together. However, in November 2015 the Department decided to push back the InterCity West Coast competition by six months (paragraph 2.6). The Department will now run the two competitions at different times, but will look to align the specifications as much as possible; for example, it plans to publish an overview and vision for the InterCity West Coast franchise to complement the prospectus for the West Midlands franchise in December 2015.

Managing interdependencies with infrastructure and rolling stock projects

4.4 The Department has to make assumptions about infrastructure work and the introduction of new rolling stock when designing franchise specifications. Changes to infrastructure specifications, construction and maintenance schedules or rolling stock plans are likely to require alterations to train services. These could increase costs to operators or reduce their revenues, and could also reduce the level of service for passengers. Changes during the life of a franchise can be costly if not managed effectively, because the price of change is not driven down by competition.

4.5 The costs of such changes fall mainly to the Department. Franchise agreements include mechanisms to control the costs:

- contractual clauses known as Secretary of State Risk Assumptions (SoSRAs) explain that the Department bears the risk of additional costs related to specific infrastructure or rolling stock projects; and
- there is a mechanism designed to deal with changes to the Department's assumptions. This includes an agreed basis for discussions about the cost of change, and clauses that specify that the Department has open access to information about operators' costs and revenues. This should enable the Department to reduce the risk that operators profit excessively from changes.

4.6 The Department's underlying assumptions about some franchises have already changed since the new franchise programme was launched, partly because some franchise competitions began before detailed infrastructure requirements had been finalised (for example, **Box 2**). Further change is likely, since the programme is being rolled out during a period of major improvement works to infrastructure and replacement of rolling stock. There is currently considerable uncertainty and volatility around Network Rail's infrastructure improvement programme. In addition, work on High Speed 2 is scheduled to begin during the next phase of franchises. This volume of activity on the rail network creates complex interdependencies with rail franchises which need to be managed.

The Department's approach to managing uncertainty

4.7 In this environment, the Department has to make difficult trade-offs. As set out in Part One, the Department is focused on maintaining the competition schedule, but going ahead when there are particularly high levels of uncertainty could result in costly and complicated changes during the life of the franchise. However, the option to put back competitions is complicated further where the existing franchise is coming to its end because an alternative means of maintaining rail services, such as a direct award, may be required.

Box 2

Uncertainty about Network Rail's infrastructure improvement programme

At the time that the 2014–2019 programme was agreed, planning for many improvement projects was at an early stage of development, with 52% of planned spending on improvement being on projects which had still to demonstrate their feasibility.

In June 2015, the Secretary of State announced that Network Rail's programme of improvement works for 2014–2019 would be reset as a result of delays and cost increases. He announced that electrification work on the TransPennine Express franchise and the Midland Main Line would be paused but that the electrification programme on the Great Western Main Line would continue.

Following its reclassification as a public sector body, new constraints were placed on Network Rail's ability to borrow, which limits its flexibility to absorb cost increases, which have occurred as plans became more certain.

The recently appointed Chair of Network Rail, Sir Peter Hendy is carrying out a review which will look at how the upgrade of the railway should be taken forward and is expected to be published in the autumn. The Department has contributed to this review by providing Sir Peter with a list of the projects that it sees as priorities to facilitate delivery of its projects, including franchise competitions.

On 30 September 2015, the Secretary of State announced that the electrification of the TransPennine and Midland Main Line routes would be 'un-paused', but there remains significant uncertainty about costs, schedule, and funding.

Source: Committee of Public Accounts Memorandum, *Planning and delivery of the 2014–2019 Rail Investment programme*

4.8 The Department has shown it is prepared to change the programme schedule when there is uncertainty about infrastructure assumptions:

- In October 2014, two months before the Department was due to issue the invitation to tender, it decided to delay the Northern and TransPennine Express franchise competitions by two months because of uncertainty about the specification of Network Rail's electrification of the northern section of the TransPennine route. While this had relatively little impact on the overall schedule, the late change resulted in increased costs for bidders and the Department.

- In July 2015 the Department put back the start of the InterCity West Coast franchise competition from August 2015 to December 2015, because of uncertainty about plans for redeveloping Euston station as part of the High Speed 2 programme and the level of disruption this would cause for trains entering and leaving the station. This has made it challenging for the Department to decide how best to allocate risk between itself and the operator. The uncertainty about the detailed plans for Euston Station is ongoing. In November 2015, the Department decided to push back the competition for the InterCity West Coast franchise by a further six months to June 2016, in order to align the InterCity West Coast franchise with High Speed 2.

4.9 The Department has also managed uncertainty by tailoring its approach to individual franchises. In the Northern and TransPennine Express franchise invitations to tender, in order to run a consistent competition and to evaluate bids on the same basis, the Department required bidders to present proposals based on the assumption that electrification works and other infrastructure enhancements would not be completed during the term of the franchise. The Department was also clear that this could change during the franchise.

4.10 The Department considers a range of options on how best to allocate risk and what form of contract to use where uncertainty exists, and has tailored its approaches to franchises:

- The Department issued a management contract on the Thameslink, Southern and Great Northern franchise. Under this form of contract the Department is taking revenue risk to protect the operator from uncertainty and disruption resulting from the renovation of London Bridge station and to focus the operator on supporting the delivery of infrastructure works, rather than maximising revenue.
- On the Great Western franchise the Department has let two successive direct awards to the incumbent operator and is relying on managing contractual change during the life of the franchise to protect value for money. Because of the uncertainties about the electrification programme, the Department has been working with the operator and Network Rail to consider multiple contract changes concurrently, to develop a more efficient approach to managing infrastructure change and the impact on passenger services, operator costs and revenues.

4.11 The Department has begun to develop a more integrated approach to anticipating and managing interdependencies, including improving the alignment of Network Rail and franchise operators' performance incentives, but this approach is not yet embedded throughout the Department. It created the Integrated Delivery Directorate, headed by a Director within the Rail Executive, which works with teams on high risk projects to map and mitigate interdependency risks. Decisions on significant changes to programmes are discussed at the Integration and Change Board, which is attended by the Managing Director of Passenger Services and senior staff from around the Rail Executive. We have seen examples of this increased focus on integration benefiting the franchising programme:

- The Integrated Delivery Directorate supported decisions on the timing of the Great Western franchise competition by producing an assessment of Network Rail's infrastructure plans for the route and the timing of the introduction of new InterCity Express trains.
- The Passenger Services Team in the Department is currently working with the Integrated Delivery Directorate in light of plans for the redevelopment of Euston as part of the High Speed Rail Programme. The Department plans to work with the rail industry and HS2 Limited to manage the uncertainties this presents for the InterCity West Coast and West Midlands franchises.

Promoting competition for passenger services

4.12 Under the 1993 Railways Act, operating companies can apply to ORR to use capacity on the network which is not being used by other operators. The regulator recently approved an application from an operator to run services on the West Coast Main Line between London and Blackpool and is currently considering four applications to run services on the East Coast Main Line.

4.13 There can be a tension between protecting returns to the taxpayer from franchises and promoting competition and choices for passengers on the network. The regulator has to weigh up, based on its analysis of evidence presented by all parties, whether the proposed benefits to passengers from introducing additional competition on the East Coast Main Line are sufficient to justify the forecast shifts of revenue from the franchisee to the open access operator. We understand that it is unlikely that a decision will be reached this year.

4.14 Under the InterCity East Coast franchise agreement, the Department decided to share the risk of lost revenue due to additional competition from open access operators with the operator, partly because it felt that leaving this risk with operators would result in lower bids. The Department carries most of the risk so it could receive significantly lower than expected premia in the event of additional competition. There is also a risk that the operator may not be able to continue running the franchise.

4.15 The Competition and Markets Authority is looking at open competition on the railways and has identified a range of options to improve it. The Authority stated that it does not envisage any changes would take place before 2023 at the earliest, when the current phase of the franchising programme is complete.

Appendix One

Our audit approach

1 This study examined whether the Department for Transport (the Department) is managing its rail franchising programme effectively to drive value for money. Our key areas of review were:

- the Department's reform of rail franchising following the collapse of the InterCity West Coast contract award in 2012;
- the direct awards, short-term single tender actions which the Department used in order to create a manageable staggered programme of competitions;
- the Department's commercial approach; and
- the Department's management of interdependencies between rail franchising and other aspects of the rail system.

2 Our audit approach is summarised in **Figure 6**. Our evidence base is described in Appendix Two.

Figure 6
Our audit approach

The objective of government

Through franchising, the Department aims to encourage a flourishing, competitive passenger rail market which secures high-performing, value-for-money services for passengers and taxpayers while improving cost effectiveness.

How this will be achieved

The Department relaunched its rail franchising programme in 2013, following the collapse of the InterCity West Coast contract award.

Our evaluative criteria

The Department has clear, achievable objectives that include a focus on value for money.

The Department has designed the programme to meet its objectives.

The Department has got the programme on to a stable footing and is managing it effectively.

Our evidence

(see Appendix Two for details)

We assessed the Department's objectives by:

- carrying out interviews with the Department and key stakeholders; and
- reviewing Departmental documents, published materials and other sources on the programme, including third-party evaluations.

We identified whether the programme design meets the objectives by:

- interviews with the Department and key stakeholders;
- reviewing Departmental documents, published materials and other sources; and
- applying the NAO audit framework on letting and managing complex contracts.

We evaluated the management of the programme to date by:

- interviews with the Department and key stakeholders;
- reviewing Departmental documents, published materials and other sources;
- analysis of performance and revenue data on the three franchises let to date; and
- applying the NAO audit framework on letting and managing complex contracts.

Our conclusions

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 the Department may have missed opportunities to maximise value for money in the early direct awards.

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.

Appendix Two

Our evidence base

1 Our conclusions on whether the Department for Transport (the Department) is managing its rail franchising programme effectively, to drive value for money, were reached following our analysis of evidence collected between June and September 2015.

2 Our audit approach is outlined in Appendix One.

We examined whether the Department had clear objectives for the new rail franchising programme, including a focus on value for money.

- We undertook **interviews** with stakeholders, including: the Department (staff from the Passenger Services and wider Rail Executive functions); train operating companies and owner groups; Passenger Focus (the passenger representative organisation); the Office of Rail and Road (the regulator), and the Rail Delivery Group (industry body representing train operating companies).
- We reviewed **documentary evidence** on the objectives for the franchising programme, from the Department and other sources. We also reviewed the recommendations made following the collapse of the InterCity West Coast contract award in 2012, in the Brown and Laidlaw reports and in our own reports. We examined how these recommendations had been addressed in the objectives for the programme.

We examined whether the Department had designed the programme to meet its objectives.

- We discussed the design of the programme with key stakeholders as part of our **interviews**.
- We **reviewed key documents** that the Department published on the design of the programme, to assess how the objectives had been translated into the design.
- We **reviewed documents on individual franchises**, such as the Invitations to Tender for the franchises awarded to date and the franchise contracts, to assess how overall programme objectives were incorporated into the individual franchise agreements.

We examined whether the Department had got the programme on to a stable footing and was managing the programme effectively.

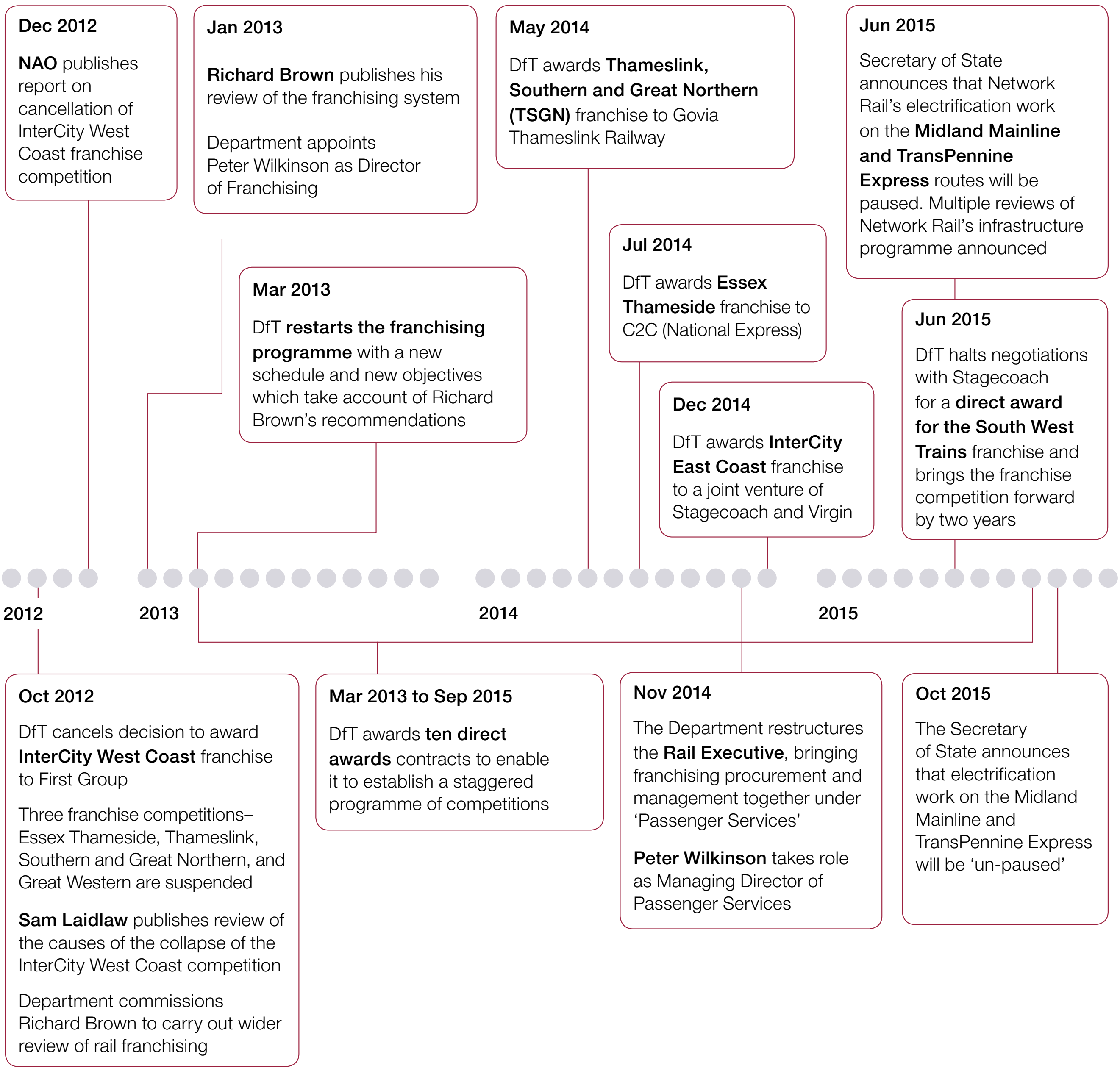
- We discussed stakeholders' experiences of the new programme as part of our interviews with them.
- We used the NAO audit framework on letting and managing complex contracts to help frame our approach.
- We analysed Departmental data on the three franchises let to date (Thameslink, Southern and Great Northern; InterCity East Coast; and Essex Thameside), including the Department's expectations for revenue from these franchises against the agreed levels in the contract.

Appendix Three

Events and actions following the InterCity West Coast franchise competition decision

Figure 7

Events and actions following the InterCity West Coast franchise competition decision



Source: National Audit Office

The Department's response to the NAO and Laidlaw reports

Area requiring improvement	The Department's response
Greater clarity of objectives and transparency of information	
The NAO report was particularly critical about the lack of clarity about the objectives and the way the Department calculated how much committed financial support it would require from bidders.	The Department has set clear objectives for the programme, and objectives for individual franchise competitions reflect these broad objectives. The Department has also improved the transparency of information. It has published, for example, a map of its procurement process, clear, detailed guides about how it will run franchise competitions, as well as procurement documents such as invitations to tender, and template financial models and franchise agreements. Following the restart of the programme, the Department has provided bidders with greater clarity and consistency about its requirements for parent company support.
More realistic timetables for franchising projects	
The NAO report identified that the Department had set itself an unrealistic timetable, in part due to the delay in issuing the invitation to tender without extending the award date.	For franchise competitions the Department typically allows around 15 months from issue of the Official Journal of the European Union notice to award of the franchise, which is a reasonable timetable, in line with past experience. Under the current programme the Department has tried to protect these time frames, even when it has had to delay issuing an invitation to tender, to avoid one of the factors which let to difficulties in the 2012 InterCity West Coast process. For example, when the Department delayed issuing the invitation to tender for the TransPennine Express and Northern franchises by two months, it also put back all of the competition milestones by two months.
Governance and assurance	
The NAO report identified weaknesses in governance, assurance and oversight, which resulted in a lack of effective challenge to decisions.	With the restart of the franchising programme, the Department has established a governance structure for Passenger Services to discuss progress, risks, budgets and schedules across the programme. It has also established the Procurement Assurance Board, which reviews franchise competitions at key milestones to assure that the appropriate procurement processes have been followed. As before, the Department requires its Board Investment and Commercial Committee (BICC), HM Treasury and the Secretary of State to approve the main procurement milestones. The Department has developed a clearer and more robust assurance process. For example, the outputs from the financial models used in bid evaluations are reviewed and independently audited by external consultants.

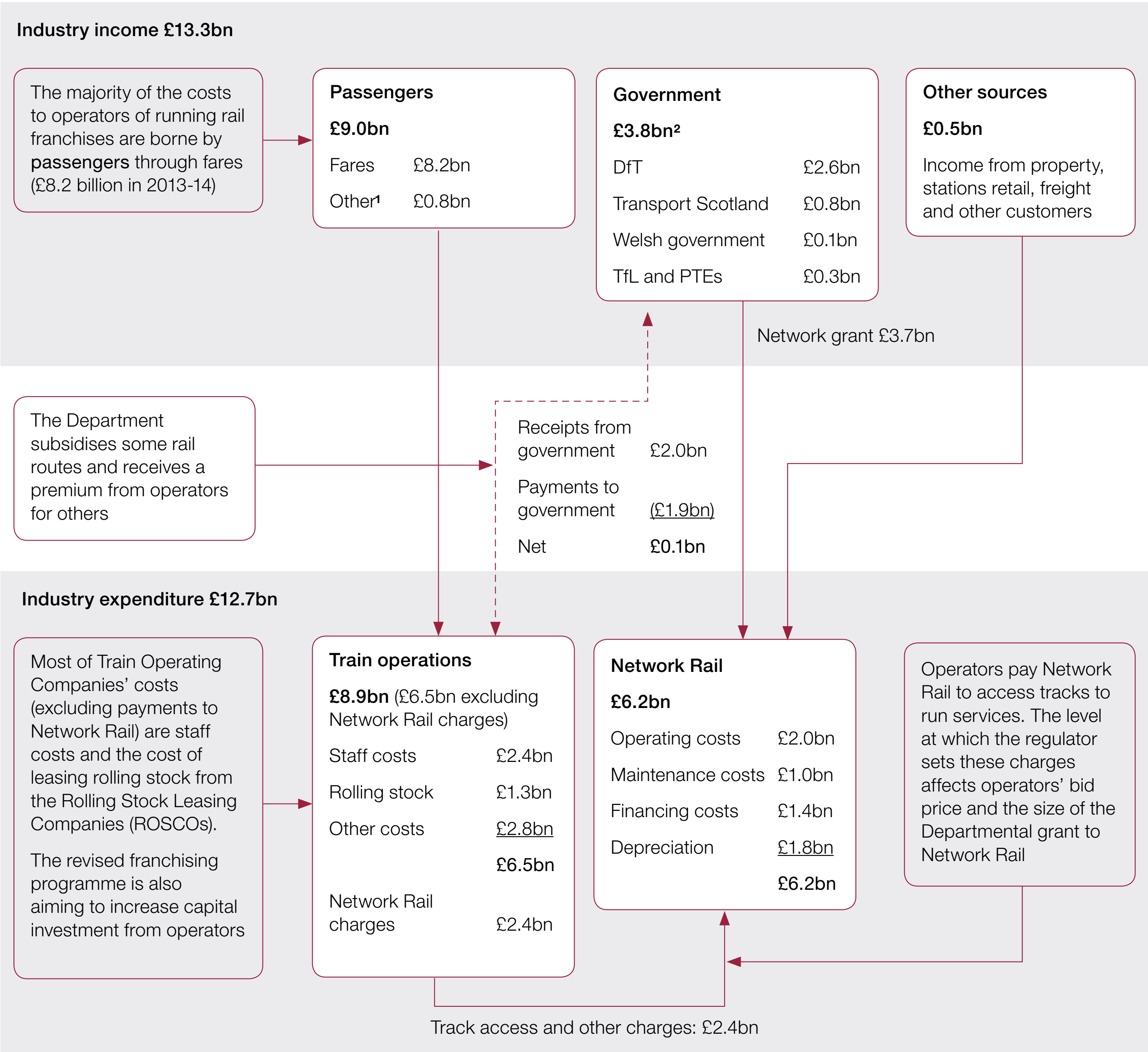
Source: National Audit Office

Appendix Four

Flows of money in the UK rail system 2013-14

Figure 8 overleaf.

Figure 8
Flows of money in the UK rail system 2013-14



Notes

1 Car parking, on-train catering and other train operator income.

2 Excludes net effect of taxation paid by Network Rail and operators.

Source: Office of Rail and Road and National Audit Office

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