Rail Value for Money Study - Research Project on unit costs and franchising: RVfM 10002

Final Report

24th January 2011

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EXECUTIVE SUMMARY

Executive summary (1)

Overview

- The Colin Buchanan Consortium has been commissioned by the Rail VfM study team to consider potential mechanisms to reduce unit costs in rail franchising. Our approach has been to consider the barriers that prevent unit cost reduction in the current system and review the potential actions an “unconstrained Train Operating Company (TOC)” would take to reduce unit costs. Building on this analysis of barriers, we have developed a range of mechanisms that could be put in place to enable and incentivise TOCs to reduce unit costs and improve value for money (VfM) (noting that in practice significant constraints must remain to protect the interests of taxpayers and customers).

Our analysis

- The unit cost of delivering rail services has remained high and continues to exhibit upward pressure (see Booz & Co – Cost of Railway Outputs, prepared for the Rail VfM Study). This is variously attributed to a range of factors key which include:
  - Detailed government specification with little room for flex or an effective process for so doing
  - TOCs having little scope/incentive to tackle unit costs and perverse incentives to cut costs in areas relevant to revenue (marketing etc.) when in revenue support
  - Short franchises and related issues around investment payback and risk management
  - No alignment of incentives with government or Network Rail to reduce industry costs for which TOCs are held largely harmless through Not Net Loss/No Net Gain (NNL/NNG) regimes
  - Significant reputational/revenue risks for TOCs in addressing staff costs and outmoded working practices
- Our analysis of an unconstrained TOC has found that a TOC could deliver cost savings through a mix of:
  - Internal savings – wage restraint, outsourcing etc.
  - Industry wide savings – Reduced cost of industry-wide overheads; increased liquidity of rolling stock market
  - Network rail collaboration / risk sharing – Reduced access charges through better working relationships
- The overall value of these savings could be up to 12% in NPV terms for a typical 15 year franchise.

Executive summary (2)

Key findings and recommendations to reduce unit costs and improve VfM

- A longer franchise (see mechanism B1) delivering an output based specification (see mechanism A1)
- Removal of current revenue risk sharing mechanisms (mechanism B3) to be replaced by a regulatory-style review by the Office of Rail Regulation (ORR) every 5 years, whereby TOCs' efficient level of costs, revenue and franchise payments are reset for exogenous factors (e.g. GDP) with risk then remaining with the TOC until the next review (see mechanism A2). The TOC would retain the benefit of its own initiatives throughout the life of the franchise. If this proposal is adopted, formulaic adjustment of franchise payments for the impact of macroeconomic variables would not be appropriate (mechanism B4)
- To integrate decision-making better at the top level, franchise management and enforcement, including franchise reviews to be done by ORR (see mechanism A4)
- Upfront payment for new franchises (see mechanism B2) to ensure the TOC has "skin in the game" and incentivise it to treat the franchise as a business to manage and grow, not merely a government contract, enabling a reduction in the requirements for performance bonds/liquidity maintenance/parent company guarantees (mechanism B6), which we believe are generally less efficient
- Economic regulation of fares by ORR within policy constraints set by DfT (see mechanism A7)
- Removal/reduction of "Secretary of State" risk assumptions (see mechanism B5)
- New planning approach for investments which have a socio-economic rather than a financial business case (see mechanism A8)
- Risk sharing in respect of industrial relations impacts in the case of cost reduction initiatives (see mechanism B8)
- Franchises incentivised to work with Network Rail (NR) as key supplier to reduce its costs and not held harmless for changes in those costs as is now the case (see mechanism C2) – other VfM study workstreams are developing the detail on this but we believe this is a key mechanism to reduce unit costs
- Other measures to incentivise NR-TOC collaboration (see mechanism C4) or to improve transparency, such as routing all NR revenue through TOCs as access/lease payments (see mechanism C1) and Regional/route virtual P&L accounts (see mechanism C3)
- Measures to improve the liquidity of the rolling stock market including the introduction of rolling stock auctions at regular intervals (see mechanism D2)
- TOCs to take a greater role (through full repairing leases) in managing stations (see mechanism E1)

Executive summary (3)

Key findings and recommendations to reduce unit costs and improve VfM

- The above represents a **core package** of mechanisms which we believe is key to enabling TOCs to reduce unit costs and improve VfM. These mechanisms are in many cases mutually reinforcing (e.g. long term franchises require 5 year reviews; upfront payments enable a reduction in bonding) so cannot be cherry-picked without creating inconsistency and reducing their individual effectiveness. The application of these mechanisms would, however, vary according to the characteristics of each franchise, for example if a highly subsidised TOC was tendered on a gross cost basis, an upfront payment might not be appropriate in which case a parent company guarantee might still be required and the nature of the five yearly review might be different.
- Other mechanisms we also believe could deliver additional unit costs savings, but require further detailed consideration and are outside of our scope, include:
  - More freedom of action on Intercity routes (see mechanism A5)
  - Delegation of part of rail budgets to regional level (see mechanism A6) and letting franchises on a gross cost basis (see mechanism A9), which have been shown in Europe to facilitate cost reductions
  - Joint decision-making arrangements at local and national level on issues which affect more than one TOC (see mechanism D1)
  - ORR review of possible arrangements for bringing private capital or more extensive benchmarking of performance into NR's managed stations and commercial property portfolio (see mechanism E2).
- The following are generally desirable but not critical and are being considered by another workstream of the VfM Study.
  - All NR payments to be routed through TOCs as access / lease payments (see mechanism C1)
  - Regional/route virtual P&Ls (see mechanism C3)
  - Other measures to incentivise NR-TOC collaboration (see mechanism C4)
  - Wider use of local rail service provision arrangements (see mechanism C6)
  - Joint decision-making at local and national level (see mechanism D1)
- C5 (Vertical integration) has not been looked at in detail but is not a recommendation of this study.

Executive summary (4)

- One of the effects of our proposals is to attempt to de-politicise some aspects of the rail industry such as the detail of service specifications and fares ,which we believe should be commercial decisions. The DfT must continue its key role of ensuring the taxpayer receives good value for the money it spends on rail, but this does not mean it has to specify (and therefore politicise) in detail the service to be provided by the TOC. Recent research by PwC and the Institute for Public Policy research (IPPR) (Appendix 6) has indicated that voters are shrewd enough to work out who to “blame” when things go wrong based on which body has actual responsibility. If these findings are correct, they support the case for devolution of decisions to both operators and regional/local tiers. (However it must be recognised that if politicians don’t want to be blamed when things go wrong, they must ensure the appropriate parties get credit when things go well.)
- We have not specifically assessed the transaction cost of different mechanisms in our analysis. The Arup/Oxera report for the Rail VfM Study and the analysis undertaken by Nash and Smith for this report has shown that transaction costs are not currently a significant issue in value for money considerations for franchised rail operations. We believe that longer franchises, a reduction in DfT responsibilities, clearer criteria for accepting output changes and a tight remit to ORR in its franchise monitoring role will all keep transaction costs sustainable and should, if well implemented, reduce expenditure by the public sector on oversight of the industry.

INTRODUCTION

Study objectives and approach

Objectives of research project on unit costs and franchising

- The aim of the study is to review the perceived barriers to reducing costs and raising efficiency in the franchises managed by DfT and make recommendations on whether and how the specification, procurement and management of franchises could be used to improve the incentives and outcomes to facilitate such changes.
- In addition, and following on from its scoping study and initial analysis, the VfM study team is testing the proposition that reformed industry structures, which more closely align TOCs and their infrastructure manager provide a greater incentive to tackle unit costs. This research project is intended to provide a stronger evidence base for that work. This research project is also intended to work collaboratively with other research projects awarded by the Study team.

Our approach

- Our approach in completing this study has been to take a holistic approach looking at all of the franchise related mechanisms to implement cost savings identified to date by the review. We have been clear to identify which of these mechanisms derive from our work and which are being covered elsewhere in the review. In identifying appropriate solutions we have sought to develop mechanisms based on an understanding of what works elsewhere.
- It is also important to recognise where these mechanisms can be applied, reflecting both the franchising timetable and the suitability of the mechanisms for different franchises. We have therefore sought to identify for each mechanism the applicability to upcoming franchise competitions (Greater Anglia – short and long and West Coast) and the applicability to different TOC types.
- Reflecting our terms of reference we have structured the study in two :
    - Part 1: TOC barriers analysis
    - Part 2: Proposed mechanisms for encouraging TOCs to deliver better VfM

Context: Rail franchising reform

- The rail franchising system has been in operation since 1994 with a range of different approaches taken, to varying degrees of success. The Government has also set out its view and options in "Reforming Rail Franchising". We are aware that some submissions to the Rail VfM Study (e.g. First Economics) have advocated a move away from franchising towards a fully privatised railway for certain routes.
- We believe the original reasons for having franchises remain valid:
  - The socio-economic benefits of rail and the amount spent in subsidy, justify government involvement in specifying services to some degree
  - Notwithstanding government intervention, it is better to have competition among operators than no competition – the regulatory approach has only been used for asset intensive natural monopolies where tendering contracts would be difficult
  - Competition for the market (through tendering franchises) is a valid substitute where competition in the market is inherently limited
  - There is a market of willing franchise operators all capable of providing innovative bids. Competition is desirable because testing the market should promote innovation and efficiency
  - One of the benefits of a bidding process is that the party which will have to implement the bid has generated the proposals – a regulatory solution is second best
- In our proposed mechanisms we support the implementation of a regulatory review approach for longer franchises, however the review is a fine tuning mechanism for the basic franchising approach, to reflect changes in circumstances during the life of a franchise, whilst retaining the fundamental benefits of longer franchises. Unlike a regulated industry, the franchise could still be terminated for under-performance.
- Linked to this point is the reform of the rail franchising generally, we believe that modest incremental reform will bring limited improvements in unit cost reduction and not meet the objectives of the Rail VfM Study. Our proposals, therefore, represent a more holistic and significant change within the context of the current system of franchising for rail passenger operations. We do not believe the benefits of vertical integration would be generally justified but we do recommend a number of steps towards better integration of decision-making.

Context: Current State Assessment

- The current GB rail system has delivered many successes in terms of passenger growth, improvements in customer satisfaction and getting a ‘grip’ on performance.
- However, the unit cost of delivering rail services has remained high and continues to exhibit upward pressure (see Booz & Co – Cost of Railway Outputs prepared for the Rail VfM Study). This is attributed to (and we concur with this general analysis):
    - Detailed government specification with little room for flex or an effective process for so doing
    - Bidders concentrating on revenue growth strategies for which they have high risk coverage, rather than cost reduction for which they are on risk
    - TOCs having little scope/incentive to tackle unit costs and perverse incentives to cut costs in areas relevant to revenue (marketing etc.) when in revenue support
    - Short franchises and related issues around investment payback and risk management
    - The absence of incentives for stable franchises to put downward pressure on costs
    - No alignment of incentives with government or Network Rail to reduce industry costs for which TOCs are held largely harmless through NNL/NNG regimes or when the franchise is re-bid
    - An inefficient rolling stock market
    - Significant reputational/revenue risks for TOCs in addressing staff costs and outmoded working practices
    - High and “sticky” industry-wide costs such as pensions and British Transport Police (BTP), with no single decision-maker incentivised to keep them affordable in the context of passenger revenue.
- We would add that post-Hatfield, GB rail saw an extraordinary focus on safety and performance, with cost management taking a back seat. As performance reverts to steady state the time is right for more balanced business management and a relatively greater focus on cost management without compromising the improvements which have been made.

PART 1: TOC BARRIERS
ANALYSIS

Academic Review: European and International Learnings (1)

- To learn the lessons of rail franchising in Europe and more widely we commissioned work by Dr Andrew Smith and Professor Chris Nash from Institute of Transport Studies at Leeds.
- Their work reviews the academic literature in relation to European and International rail service procurement (see appendix 5 for full report).
- The relevant findings are summarised below and referenced to our recommendations in part 2.

Academic Findings	How developed in this report
Costs tackled more effectively abroad than in the UK - competitive tendering in the Netherland, Germany and Sweden has reduced costs by 20-30%. Key factors include: approach to labour where in Europe there is scope for new entrants coming in with revised terms and conditions, rolling stock and fuel	Barrier Analysis including “Unconstrained TOC” Model B1: Longer Franchises
Cost performance shows constant returns to operational scale (1.02), but strong returns to density (1.44) – key implication is that having fewer, larger franchises would not reduce costs. The stronger returns to density suggest bigger gains are possible through combining over lapping franchises	Franchise re-mapping not proposed in this study, but relevant to other workstreams in the Rail VfM study
No evidence of benefits of longer franchises in rail sector (noting sample problems). Wider literature in franchising supports benefits of longer franchises.	B1: Longer Franchises A2: Franchise reviews of franchise outputs/payments by ORR

Academic Review: European and International Learnings (2)

Academic Findings	How developed in this report
Gross contracts appear to work in subsidy-heavy environments – analysis supports case for devolving specification of services to regional authorities.	C6: Wider use of local rail service provision arrangements C9: Franchise to be let on gross cost basis
Transaction costs marginal to cost of a vertically separated structure – issues lie with alignment of incentives	C1-C5: Network Rail Interfaces (largely but not exclusively the responsibility of other workstreams) – in this report for relevance. Vertical Integration (C5) not recommended
Mechanisms required to bring benefits of holistic approach to rail (e.g. Better integrated timetabling)	Dealt with in System Authority & Industry Structure Workstreams in Rail VfM Study
Open Access Operation is often abstractive (and therefore needs to be regulated in public interest) but may offer VfM where large service enhancement	Not core to proposals and analysis, remains at high level – (A5: More Freedom of action on Intercity routes)
Network Rail deemed only accountable to ORR and does not take the TOCs seriously enough as customers – giving greater role to TOCs in negotiating with NR over costs and capability of network may lead to cost savings.	C1: Route all Network Rail charges through TOCs C2: Removal of NNLNNG protection for NR access charges

The "Unconstrained TOC"

- A Shadow TOC board was brought together comprising former TOC Managers including a Managing Director, Commercial Director, Traincrew Manager, Station and Operations Managers with PwC providing the role of Financial Director. All members also had previous franchise bidding experience.
- Drawing on experience and analysis of other workstreams, the shadow executive identified the likely executive actions to improve the value-for-money performance of a TOC in an unconstrained environment, but assuming that the headline timetable outputs are unchanged.
- Using the Greater Anglia draft long form report as a base, VfM improvement actions were brainstormed in the manner of a TOC business planning session with all features of the business considered (with specific issues recorded).
- Target savings (as a percentage of current costs) were identified. Where operating costs were identified with making the saving or mitigating costs/risk associated with the saving then these were added back.
- Each saving and action was then considered in the context of current franchise contracts and notes made in relation to the change to existing industry contracts shown.
- There are no savings shown for reduced cost of capital, reduced profit margin etc. which are discussed elsewhere. No analysis of revenues (fares or other) was undertaken as part of this exercise.
- Further detail of approach, methodology and assumptions are provided in Appendix 2.

It should be noted that the outcome of this exercise is intended to be illustrative of the general scale of efficiency savings available if the mechanisms recommended were applied. This does not mean these specific cost reductions should be applied by every TOC as our work was not at the level of detail required to support such a recommendation. For example, if a TOC was successful in growing revenue, it might actually need to increase some costs in total at the same time as achieving unit cost reductions.

"Unconstrained TOC" – Potential Savings Sources

- The key savings from an unconstrained TOC are to be found across three key areas as shown below, with the management actions. We have also identified what changes would facilitate these savings and build on these further in part 2.

Savings Type	Management Action	Facilitated By
Internal Savings	• Outsourcing of non-core activities to achieve efficiencies e.g. Train presentation • Wage restraint – Wages increase only at Average Earnings Index (AEI) • Management pay - contract change to increase role of incentives in package against lower base pay • Match resources to workload – sickness managed down to industry average, driver productivity up through local negotiation of, for example, cover ratios & increased part time and split shift; significant rationalisation in ticket office staff - facilitated by technology • Introduce technology – Smartcards introduced to support ticket office staff reductions • Reduction in low value activity: Reduction in management and franchise reporting activities, reduced prescription in standards, more efficient approach to management of staff redundancies	• Longer Franchises (see mechanism B2) • Output Specification (see mechanism A1) • IR action protection (see mechanism B9) • Five yearly review (see mechanism A2) • Devolved Powers (see mechanism A6)

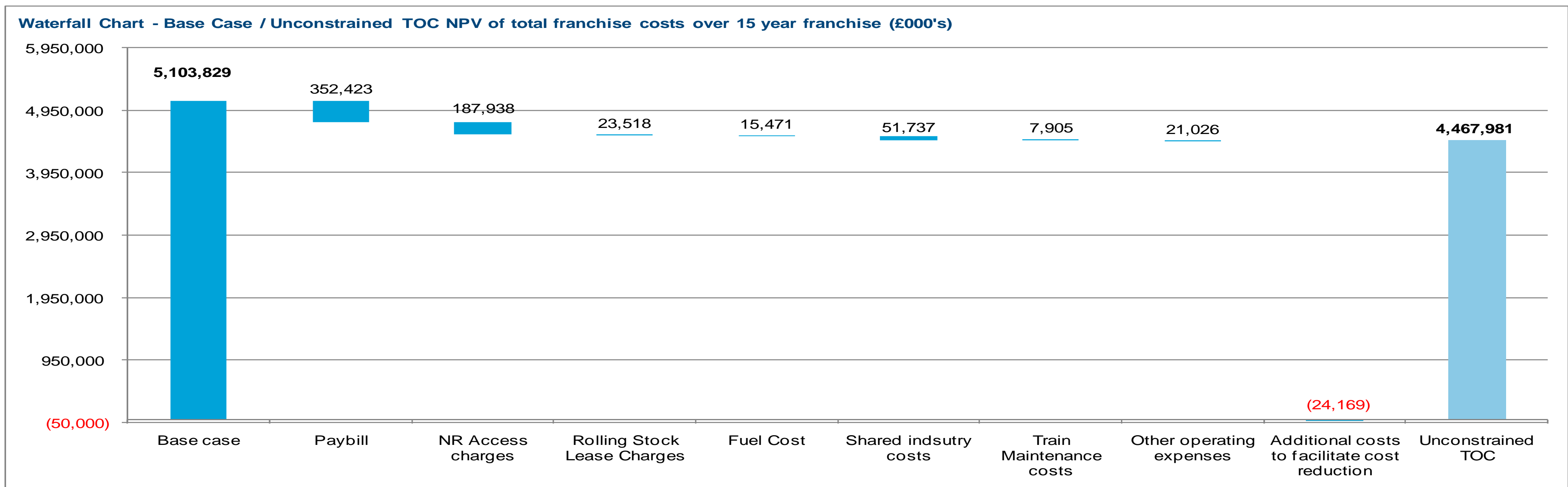
"Unconstrained TOC" – Potential Savings Sources

- The key savings from an unconstrained TOC are to be found across three key areas as shown below, with the management actions.

Savings Type	Management Action	Facilitated By
Industry Wide Savings	• Reduced industry wide costs through reduction of activities back to 'core' role • British Transport Police contract efficiencies with greater use of regional forces • Pension Costs - Cap employer contribution growth and benefits in future; up-rate employee contribution in defined benefits schemes • Rolling Stock market liquidity – Maximise gains from any rolling stock market efficiencies	• Industry Leadership (see mechanism D1) • Rolling Stock Auction or other mechanisms to improve market liquidity (see mechanism D2)
Network Rail Collaboration/Risk-Sharing	• Reduced Access Charges through better operations maintenance and renewals practice, incentivised through removal of NNLNNG • Staff levels to be reduced to reflect all time performance high achieved in recent years and industry focus on increased efficiency • More relevant role of revenue sharing in NR incentives • Energy saving through best practice efficiency measures	• New Alignment Model with NR (as developed by other VfM study workstream) (see mechanism C1,C3 & C4) • Removal of NNL/NNG (see mechanism C2) • Full repairing station leases (see mechanism E1)

"Unconstrained TOC" – Results

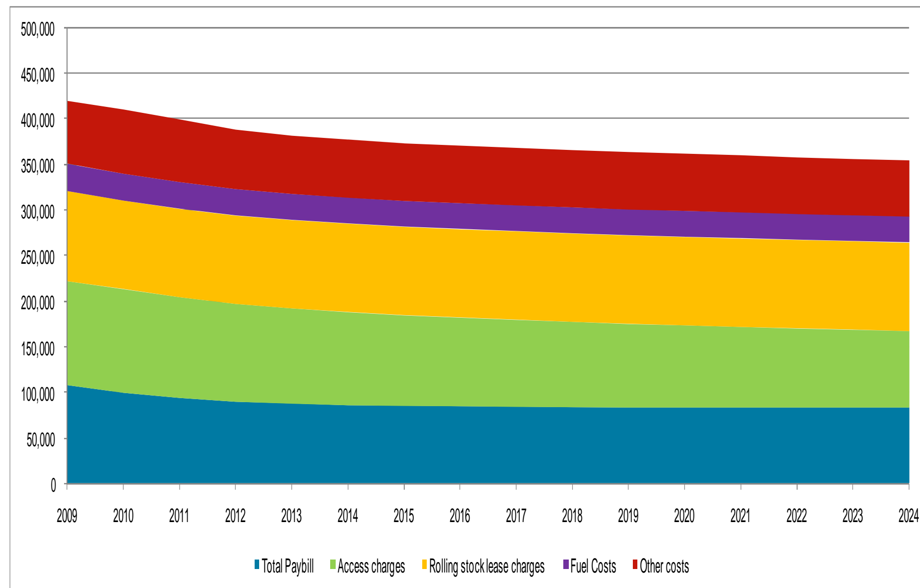
- This section presents the results of the "Unconstrained TOC" analysis. The headline of this analysis is that an "Unconstrained TOC" could reduce the overall level of costs (over a 15 year franchise) compared to the base case by up to 12% in NPV terms. This analysis is based on delivering existing output levels, however this would include switching retail channel from ticket offices to ticket vending machines (TVM).
- The breakdown of this reduction is shown in the waterfall diagram below. The key drivers of efficiency savings are improvements in train crew productivity, reductions in ticket office booking staff, HQ and management staff. Further savings are delivered through reductions in access charges and shared industry costs (ATOC and BTP). Additional costs are included where additional equipment costs, training costs etc. are incurred.



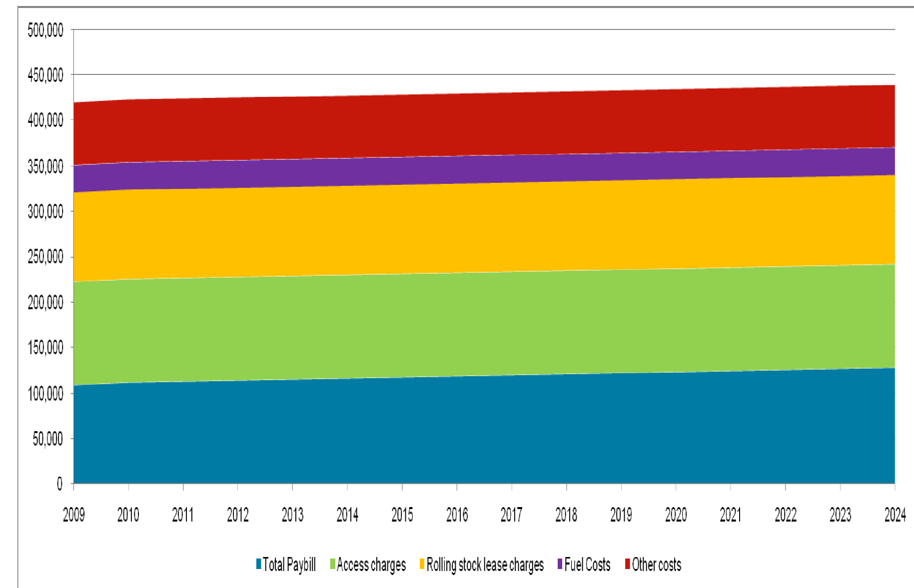
"Unconstrained TOC" - Profile of cost savings

The diagrams below illustrate the cost profiles of the base and unconstrained TOCs. The cost reduction profile for the unconstrained TOC illustrates that there are significant savings in the early years of the franchise, reflecting the longer nature of the franchise and the incentives for management to make early savings (and investments) to generate long-term payback. The cost profile of the base case TOC reflects a rise in TOC costs over the life of the franchise driven largely by increases in wages above AEI. The detailed assumptions underlying the analysis and the actions require to deliver these savings is given in appendix 2.

Unconstrained TOC cost profile

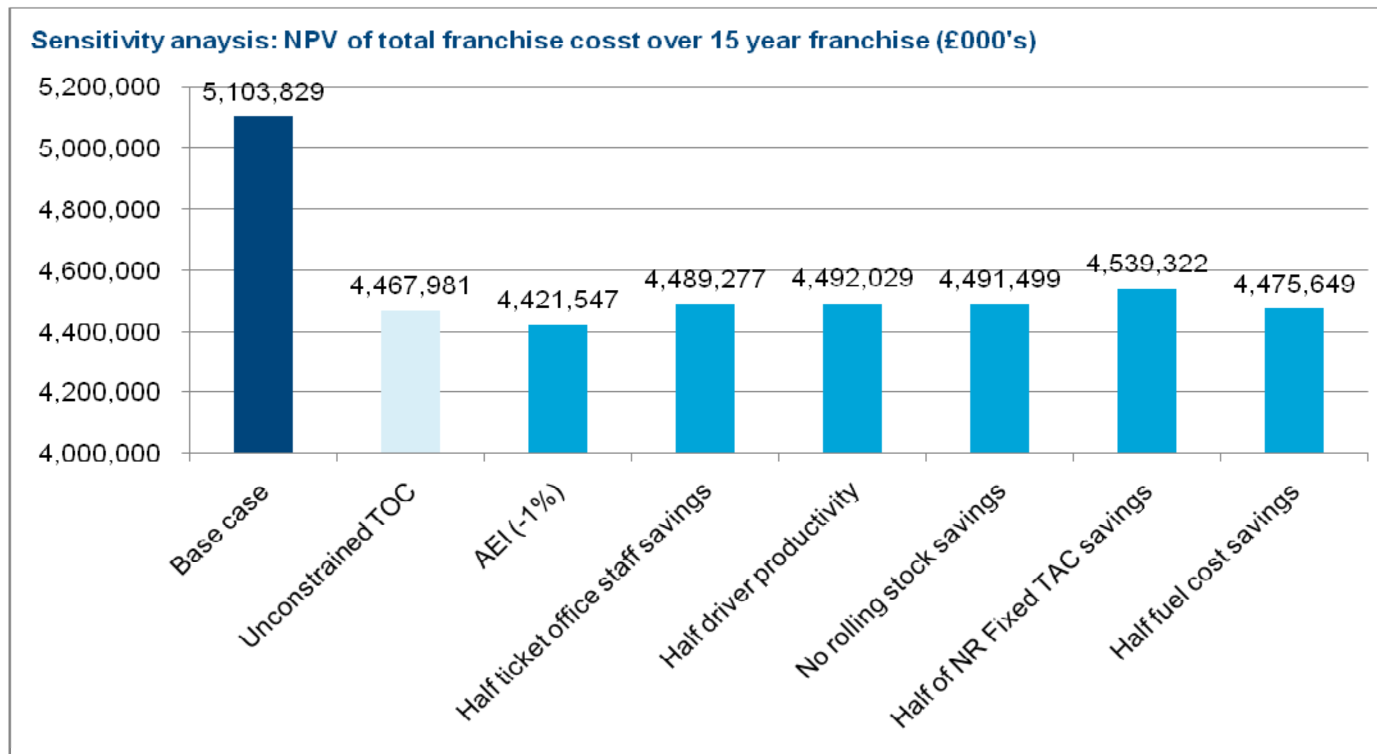


Base case TOC cost profile



“Unconstrained TOC” – Sensitivity analysis

The diagram below presents a range of sensitivities to our analysis of an unconstrained TOC, showing the impact on the NPV of total costs under various scenarios. The results of the sensitivity emphasise that a package of costs saving measures would be required to deliver the indicative savings of the unconstrained TOC.



PART 2: PROPOSED MECHANISMS FOR ENCOURAGING TOCS TO DELIVER BETTER VFM

Introduction

- The starting point for our work in part 2 was to review the mechanisms identified in other workstreams of the VfM study and previous work developed by others. To develop our understanding we held:
  - A Project team workshop on mechanisms based on the team's rail, other sector and international experience
  - Meetings with ATOC, Network Rail, ORR and the PPP Arbiter plus PwC specialists in pensions and regulation
  - Discussions with Rail VfM project leads and DfT franchising experts
- For each of the mechanisms identified and analysed we have examined:
  - The VfM improvement the mechanism will give
  - The pros and cons of the mechanism
- For mechanisms that are core to our proposals (e.g. 5 yearly reviews of franchises) we have carried out further analysis in order for the implications of the mechanism to be fully understood. Where the mechanism(s) is not core to our proposals, is out of scope to our terms of reference or is being developed in detail by others, we have not developed the analysis further.
- We have considered a number of mechanisms (namely mechanisms A7, C1-6, D1-2) that have been covered in other workstreams /proposed by industry and made corresponding recommendations.
- In addition, we have also considered other mechanisms, which we also believe could deliver additional unit costs savings (namely mechanisms A5, A6 and A9), but require further detailed consideration.
- For each mechanism we have identified whether it can be applied or not (identified by √ or X) to upcoming franchise competitions (Greater Anglia (GA) Short, West Coast and GA Long) i.e. whether the mechanism can practically be implemented in time given the tender process timetable, on the assumption this was part of a GB-wide implementation – we have not considered whether the mechanism would be right for that franchise in isolation. We have also identified whether the mechanism is potentially applicable to different TOC types (Intercity, London & SE and Regional) based on their general characteristics. Generally we believe that a significant proportion of the core package could be applied to West Coast subject to adjustments given the lack of time for institutional change to take place.

Mechanisms for delivering better VfM

The mechanisms we have identified for delivering better VfM and unit cost savings are given in the table below and are split into two groups. The first group relates directly to the franchise agreement and tendering process and have generally been analysed in detail. The second group of other VfM study mechanisms, summarises other mechanisms that are being considered elsewhere in the VfM study or are mechanisms that we have developed but are not directly related to the franchise agreement. Each mechanism is categorised as either: recommended, not recommended or as a related issue with scope for further analysis. From this complete list we have identified (overleaf) a **core package** of the most important mechanisms that we believe would lead to an improvement in VfM but need to be considered together because they interact with each other.

	Recommended	Not Recommended	Related issue with scope for further analysis
Franchise Agreement and tendering process related mechanisms			
A: Franchise specification, tendering and regulatory arrangements	A1, A2, A3, A4, A7, A8		A5, A6, A9
B: Franchise terms	B1, B2, B3, B5, B6, B8	B4, B7	
Other VfM Study mechanisms			
C: Network rail interface	C2	C5	C1, C3, C4, C6
D: Industry wide arrangements	D2		D1
E: Stations	E1		E2

Summary of key findings and recommendations to reduce unit costs and improve VfM

- A longer franchise (see mechanism B1) delivering an output based specification (see mechanism A1)
- Removal of current revenue risk sharing mechanisms (mechanism B3) to be replaced by a regulatory-style review by ORR every 5 years, whereby TOCs' efficient level of costs, revenue and franchise payments are reset for exogenous factors (e.g. GDP) with risk then remaining with the TOC until the next review (see mechanism A2). The TOC would retain the benefit of its own initiatives throughout the life of the franchise. If this proposal is adopted, formulaic adjustment of franchise payments for the impact of macroeconomic variables would not be appropriate (mechanism B4)
- To integrate decision-making better at the top level, franchise management and enforcement, including franchise reviews to be done by ORR (see mechanism A4)
- Upfront payment for new franchises (see mechanism B2) to ensure the TOC has "skin in the game" and incentivise it to treat the franchise as a business to manage and grow, not merely a government contract, enabling a reduction in the requirements for performance bonds/liquidity maintenance/parent company guarantees (mechanism B6), which we believe are generally less efficient
- Economic regulation of fares by ORR within policy constraints set by DfT (see mechanism A7)
- Removal/reduction of "Secretary of State" risk assumptions (see mechanism B5)
- New planning approach for investments which have a socio-economic rather than a financial business case (see mechanism A8)
- Risk sharing in respect of industrial relations impacts in the case of cost reduction initiatives (see mechanism B8)
- Franchises incentivised to work with Network Rail (NR) as key supplier to reduce its costs and not held harmless for changes in those costs as is now the case (see mechanism C2) – other VfM study workstreams are developing the detail on this but we believe this is a key mechanism to reduce unit costs.
- Other measures to incentivise NR-TOC collaboration (see mechanism C4) or to improve transparency, such as routing all NR revenue through TOCs as access/lease payments (see mechanism C1) and Regional/route virtual P&L accounts (see mechanism C3)
- Measures to improve the liquidity of the rolling stock market including the introduction of rolling stock auctions at regular intervals (see mechanism D2)
- TOCs to take a greater role (through full repairing leases) in managing stations (see mechanism E1)

A1: DfT to specify franchisees on output basis (or even outcome specification where possible)

- DfT specifies what it wants to buy as part of HLOS and franchise specific iterations within control periods e.g. no. of passenger or train kms, crowding levels and minimum service quality/levels. TOC determines timetable and other aspects of services on annual basis. There may be limits to the risk imposed on the TOC for example it might not be good value for the TOC to have to bear crowding risk beyond the general capacity of the infrastructure though the TOC should have responsibility for instigating smaller scale capacity improvements.
- ITT is based on existing timetable and other outputs with changes by TOC permitted which improve overall VfM subject to DfT-specified constraints ("service change criteria") as part of bid and during the life of the franchise. Passengers are protected by ORR approval process based on evaluation against predetermined service change criteria.

VfM improvement

- Freedom for TOCs to identify and implement market development/ revenue growth/cost reduction/capacity utilisation initiatives at any time and keep the benefit subject to predetermined "service change criteria"
- Reduced transaction costs (re. changes during the life of the franchise) because of clarity of requirements / certainty of outcome. Service change criteria remove the need for 1-1 negotiations between DfT and TOC which have been perceived by TOCs as a disincentive even to positive changes because they do not get the full benefit of their efforts

The pros and cons of this mechanism are presented on p29.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
?	√	√	√	√	?

A1: DfT to specify franchisees on output basis (or even outcome specification where possible)

Pros

- Gives operators flexibility to optimise delivery of DfT's requirements but protects passengers from major adverse change
- Clear service change criteria give TOCs clarity over which proposal will be accepted
- TOCs able to respond to market requirements
- Easier for TOCs to undertake investments which require changes to services

Cons

- Challenge of defining output/outcome based specification in first place and determining appropriate change evaluation criteria – but these could be refined over time and at reviews
- More difficult to compare bids (but the outputs are the same for all bids)
- There may be an incumbency advantage when assessing options / opportunities
- Service planning is dependent on proprietary knowledge not visible to the industry which may lead to discontinuity at franchise change (though many staff transfer across)
- Longer term planning in relation to the timetable would be less visible NR and the industry

A1: DfT to specify franchisees on output basis – example of bid/change process

Constraints set by DfT at bid stage:

Bid must be based on existing timetable but the operator may make changes which increase overall VfM (measured through DfT's Benefit:Cost Ratio (BCR)) e.g. by changing the timetable or by diverting carriages to crowded routes

Where there is an adverse impact on any passenger group it must be no greater than the specified limits and is only allowed to facilitate a greater improvement elsewhere ("the greatest good of the greatest number"). This needs to be supported by demonstration of how impacts on any "losers" are mitigated

A similar process would operate at each annual timetable round and at 5 year reviews with changes approved by ORR

Further analysis of franchise specification issues is presented at Appendix 3.

Example of specified limits to adverse changes:

- first/last trains cannot change by more than 15 mins or changes must not affect more than X pax per annum
- No reduction in vehicle kms
- No. of services on a route cannot reduce by more than [X]%
- No of services for a station cannot reduce by more than [X]%
- Impact on crowding must be managed so that there is no worsening due to the change (whether by capacity provision or yield management)
- Key connections must not be impaired by more than [X] minutes [for Y% of services per day]
- No more than [X]% of direct services (or those used by no more than Y pax p.a.) on a route can be changed to indirect

Changes would be assessed against the initial timetable so these limits are cumulative through the 5 year period. A TOC could propose changes which exceed such parameters but they would need to be negotiated with DfT rather than simply approved by ORR. The assessment of VfM would take account of services provided by other operators, so a TOC can remove trains if the equivalent service is provided by another operator.

A2: 5 Yearly reviews of franchise outputs and payments both undertaken by ORR – "Franchise Review"

- The potential disadvantages of longer franchises (in terms of inability to accommodate changing requirements and increased risk as outturn revenues and costs deviate from bid assumptions over time) would be balanced by five yearly reviews (or at longer intervals where appropriate) which would involve a process similar to High Level Output Specification (HLOS) and Statement of Funds Available (SoFA) to reset outputs and franchise payments. This would be a regulatory-style process overseen by the ORR rather than a single tender negotiation.
- Regulatory review mechanisms are currently used in regulated utilities, network rail, airports and other infrastructure sectors and are generally held every five years. Review mechanisms are used across private finance initiatives (PFIs), where in accommodation type transactions (e.g. Hospitals, schools, prisons etc.) there are reviews of annually recurring costs, such as soft facilities management, every five to ten years. The reviews cover benchmarking and market testing, where the services provided are contestable.
- The output from the franchise review process would be a determination of franchise premium/(subsidy) to be paid by the TOC over the next franchise period, along with the outputs the TOC will deliver.
- Further details of the approach and analysis of how it would deal with a range of scenarios is contained at appendix 1.

VfM improvement

- Flexibility to allow changes to outputs
- More robust risk allocation because cost and revenue risks would be transferred to the private sector but exogenous risks would only be transferred for five years
- Review could allow TOC to carry forward the benefits of outperformance and of certain investments so that incentives are maintained throughout the life of the franchise.

The pros and cons of this mechanism are presented on p32.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	√	√	√	√	√

A2: 5 Yearly reviews of franchise outputs and payments both undertaken by ORR – "Franchise Review"

Pros

- Allows DfT to flex outputs, whilst receiving benefits of longer franchise
- Relatively efficient transfer of risk
- Allows removal of revenue risk sharing, as franchise review process mitigates risks which TOC cannot manage
- Incentivises TOCs to develop ideas to deliver better value for money
- Creates a structure for general VfM improvement through benchmarking of TOC costs
- Enables comparison of performance between TOCs
- Transaction costs should be lower than for current system

Cons

- Regulatory game playing is possible but this risk can be mitigated and should still be an improvement over current arrangements
- Regulatory regime needs to enable TOCs to receive long term benefit of their actions/ investments and avoid risk that investors see franchises as a 5-year bet
- TOCs may price "regulatory risk" into their bids – especially where they perceive a risk that ORR may assess them as "inefficient" and require further cost reductions.
- Fixed point reviews may not be appropriate for all TOCs

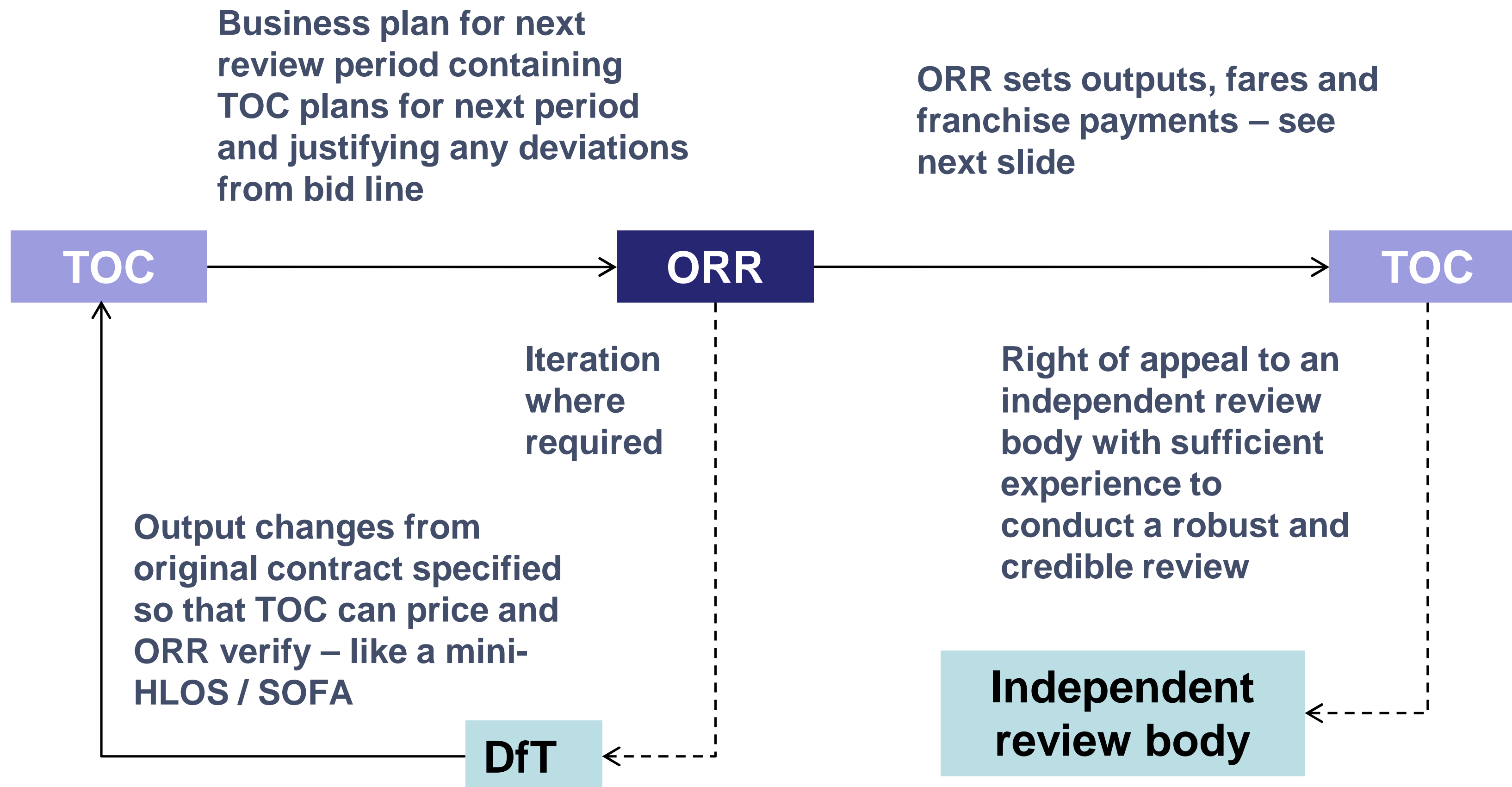
A2: Comparison of 5 yearly franchise review and regulated utilities periodic review

- Regulatory review approach has worked tolerably well for Network Rail and in water, airports, telecommunications etc. however there are important differences:
  - Demand for utilities tends to be inelastic and very stable – it is very difficult for water companies to sell more water and indeed they don't even try. Energy companies tend to compete only for market share, not to persuade customers to use more. Airports are one sector where there are similarities in that they are incentivised to grow passenger revenues, due to the non-aeronautical revenues they generate from shopping etc. Utilities also face relatively elastic demand profiles. Consequently, utilities have their revenue regulated by reference to economic and efficient costs. In contrast, it is a policy objective to encourage franchises to try to sell more journeys to change modal share and it is not proposed to regulate their entire revenue. The focus is more on cost-efficiency.
  - Utilities have their revenue re-set at each periodic review. Longer franchises are proposed in order to allow TOCs to receive the benefit of investments and difficult restructuring decisions so it would undermine this principle to reset TOCs' revenue in the same way. Hence, revenue would be reset at each periodic review only to the extent that it was driven by exogenous factors (e.g. GDP/CLE or efficiency targets) and even these should be only partly compensated because of the risk of errors e.g. the difficulty of isolating different factors, the fact that the periodic review will occur at an arbitrary point in an economic cycle, and also because it is reasonable for the TOC to bear some economic risk.
  - Utilities are regulated by reference to their comparators and rewarded if they exceed the industry norm. This approach could be applied to franchises but if applied across the board might dis-incentivise knowledge sharing and would be ineffective if none of the franchises was efficient. An industry-wide efficiency target based on the application of specifically-identified best practice would be a valid driver of regulated costs for all TOCs and might encourage collaboration and knowledge sharing in a common cause. It should also encourage bidders to make the right efficiency assumptions at the outset and to implement without action by the regulator so that in an ideal world, the actual review is not the main driver of change. Some TOCs have argued that the review should happen only if triggered by one party or another but, having considered this suggestion, we remain of the view that some form of external oversight is necessary to bring about the changes which have been identified by the other workstreams in the Rail VfM Study.
- Therefore, whilst franchise reviews are similar in nature to regulated utilities reviews, the issues which need to be regulated are different and cover:
  - Outputs (social/monopoly ones but not commercial services)
  - Selected Fares (but not total revenue as for utilities and Network Rail)
  - Efficiency (but not total costs as for utilities and Network Rail)
  - Franchise payments (akin to revenue but does not apply to most utilities) – partly a function of the other three

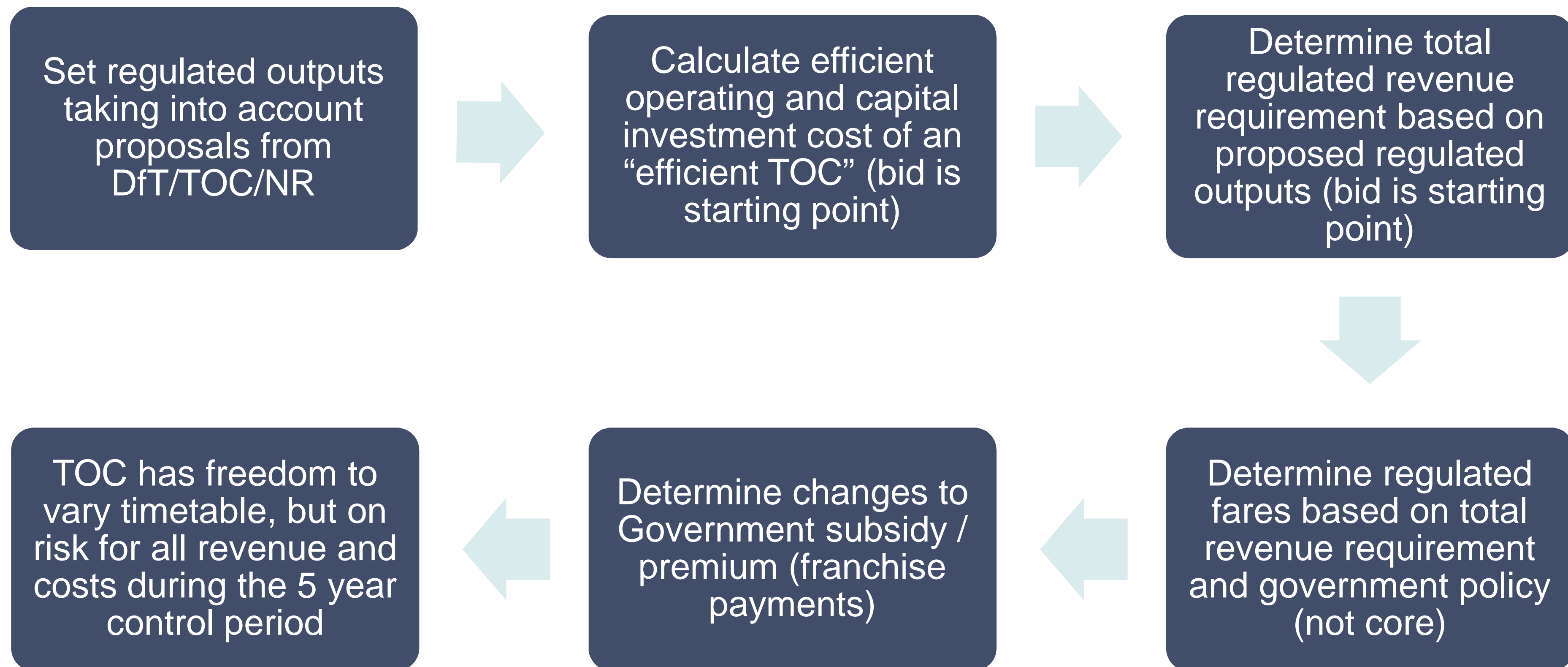
A2: Proposed principles for franchise review

- ORR to regulate TOCs through the franchise agreement as a third party arbitrator , governed by the franchise agreement (not under licence as NR)
- The starting point of ORR's analysis of costs and revenues would always be the franchise bid as this is market tested i.e. the review process is looking at deviations from the bid line, with a high bar for moving away from it supported by evidence. This means that where the TOC is seeking additional subsidy due to a change its costs or revenues it would have to clearly justify why there should be a deviation from its bid. It also means that in assessing bids, DfT would have regard to the ORR's view of efficiency and would not award a franchise based on a bid that did not appear to be efficient.
- A key element of our proposals is the need for the ORR to consider the costs of an "efficient TOC" at each review to ensure a continual focus on efficiency throughout the life of the franchise. In doing this ORR could make reference to other TOCs' costs and to evidence of efficient practice in other countries and businesses.
- ORR would determine the efficient level of revenue, taking account of exogenous factors such as employment levels (i.e. TOC would only have these risks for <5 years)
- TOC would therefore be on risk for its own revenue growth initiatives and cost efficiencies
- TOC would also be on risk for the success of any service developments (e.g. changes to timetable it inherited)
- TOC would be able to retain the benefits of investment across review periods (for the life of the franchise) though there might be some categories of cost-free timetable change where it should keep the benefits only until the next review in order to avoid a windfall benefit
- Franchisees could make proposals to enhance the VfM and profitability of the franchise and DfT would make proposals to enhance outputs and VfM.
- Need to learn the lessons of Tubelines: TOCs need an effective and transparent dialogue with ORR about what levels of performance will be expected at next 5 year review, although the shorter time period between reviews (i.e. 5 years instead of 7.5 years) and building on the experience of the HLOS/SOFA process, would help mitigate any risk. If TOCs were regulated to different franchise-specific review timetables, there would be a continuously evolving body of precedent which would enable them to reduce the element of surprise in review decisions.

A2: Overview of 5 year franchise review process

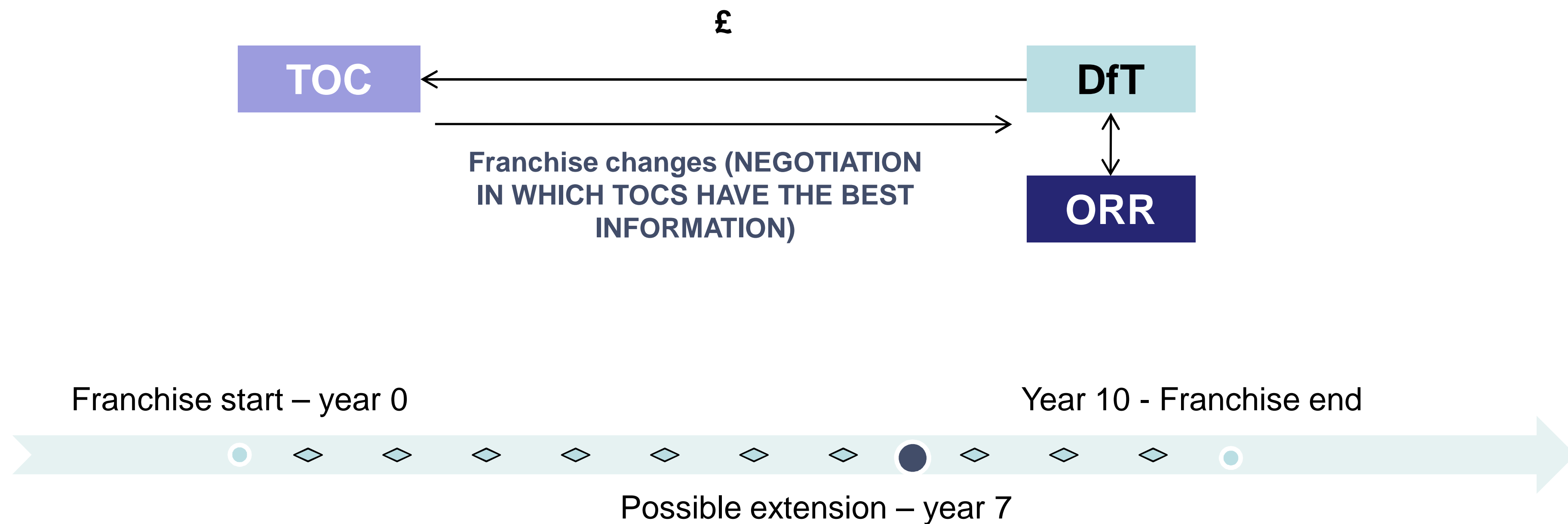


A2: Indicative process for ORR franchise review



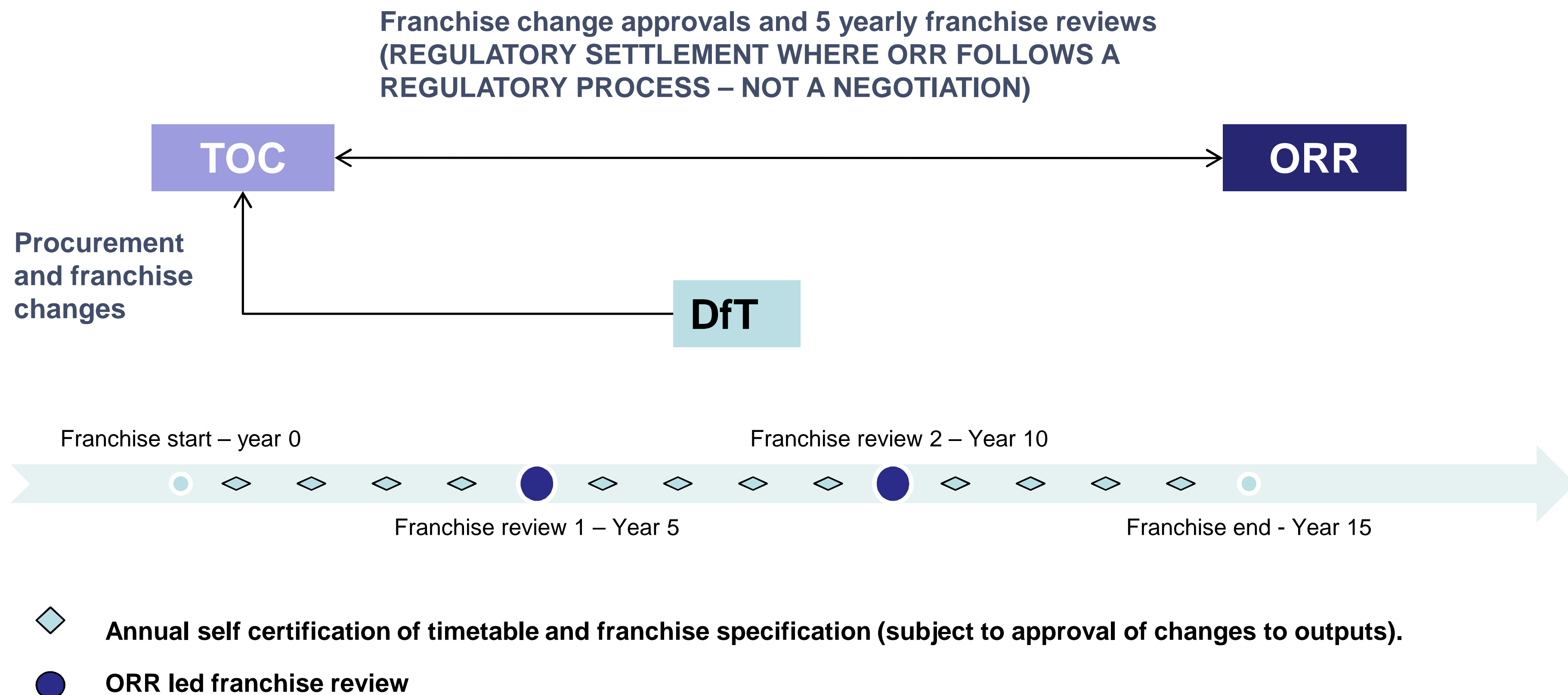
A2: DfT / TOC / ORR relationships during franchise management: *Current franchise model*

Current approach for changes to the specification of the franchise during its life is characterised by a single tender commercial negotiation, from which it is challenging for DfT to obtain VfM due to information asymmetry and differing skills and incentives between the parties. Previous work by PwC for Strategic Rail Authority (SRA) indicated that single party negotiation/tender was a significant driver of increases in subsidy. Process can result in significant management distraction for both parties, for relatively small gain. Many good ideas are never proposed because this process acts as a disincentive even if the TOC is able to keep some of the benefit (which is not/has not always been the case).



A2: DfT / TOC / ORR relationships during franchise management: *New franchise model*

New process for franchise management would be for a lighter touch between review periods, with TOCs free to proposes changes and retain the benefit, subject to approval based on predetermined criteria (see mechanism A1). TOCs will report to ORR on output delivery and compliance, which ORR would monitor.



A2: Timetable for franchise review (1)

- We have considered three alternative approaches to review timing:
  - Approach A- All franchises reviewed at the same time as NR every five years – this has not been considered in detail as the workload would probably be unmanageable and it would make bidding timetables very inflexible – a bidder would not willingly accept the risk of a review 2-3 years after franchise start.
  - Approach B - The normal timing for franchise reviews would be every five years and in line with the Network Rail periodic reviews, however to avoid having to let many franchises simultaneously, franchises commencing within three years before an industry five year review point would not be reviewed until the following review i.e. up to eight years later. Franchises let during the first and second years of a five year review period would be reviewed at the first following review point. This option reduces the workload but does not solve the problem.
  - Approach C – HLOS/SOFA would be a rolling iterative model such that franchises would be reviewed at a high level at the same time as NR, perhaps focusing on common issues such as pay rates or industry-wide costs, but then in detail at franchise tendering and at five year points from the start date of the franchise. Implementation of the results of the high level review might be delayed until the next review date for each franchise.
  - We believe Approach C would be the best approach but Approach B might be required as an interim measure (when it would be applying to only a few franchises) and aspects of it might be included in the final approach adopted.
- We originally selected five years as the term to align franchises with NR. If approach C were adopted it would also mean that individual franchises could have review periods of longer (or shorter) than a year, where the risks indicated this was appropriate, or could have reviews set to align with major changes in the franchise or with specific other related franchises.

A2: Timetable for franchise review (2)

- The outline ORR timetable for the periodic review of NR consists of four phases of planning covering: long term options, next control period options, formal review and implementation. We would expect the franchise review process to work alongside these existing process, with the franchising inputs being part of the HLOS/SOFA process i.e. the government would specify the outputs (reflect changes for franchises since the original specification or last franchise review) it requires from franchising and the available funding to deliver these outputs.
- In keeping with other regulated sectors, the ORR would set out in advance (2-3 years before) the key parameters of the franchise review (including government inputs) and would require the TOC to update the detailed business plan submitted with its bid to incorporate these requirements.
- Early engagement between ORR and TOCs will be critical to ensure the lessons of the Tubelines PPP are learnt and applied e.g. that the ORR does not have efficiency expectations that TOCs are not organised to meet.
- ORR will review the TOC's business plan and deliver a draft determination of the franchise review that would allow stakeholders the opportunity to comment. Finally the ORR would deliver a final determination of the franchise review that would cover the outputs and franchise payments for the next period.
- There would be an opportunity for the TOC to appeal the ORR's decision and take it to an independent review body.

A3: Franchise bid evaluation to focus more on quality of management/corporate backing

DfT to revise its procurement process to help fulfil the objectives set for the industry and those specific to the franchise. Move to less emphasis on deliverability of bidders' specific proposals and more emphasis on strength of the parent company, management team and track record at the bid stage. This should include assessment of its vision for the business and managing collaborative relationships with government (as Melbourne Metropolitan Train Franchise) and delivering cost reductions whilst developing a business. Reduce requirement for bidders to produce detailed delivery plans in favour of an overall business plan. This change is important because of the move to output specification and longer franchises which mean DfT-specified proposals will be less applicable. See next page for scope of bid evaluation.

VfM improvement

- Reduction in transaction costs as fewer delivery plans will need to be produced/evaluated
- Winning bidders will have demonstrated a track record in reducing costs and will have demonstrated an ability to work with others to do so – increasing the likelihood of actually delivering VfM
- Evaluation of socio-economic investment proposals separated from selection of best manager of the commercial business

Pros

- Evaluation consistent with selecting a company to operate a business rather than manage a contract and consistent with the approach in recent port concessions
- Bidders spend more time on designing a financially effective bid which delivers VfM and meets passengers' needs and hiring the best management, not writing delivery plans to a DfT specification
- DfT spends less time evaluating

Cons

- Potential for challenge if process not clearly defined
- Depends on certain other changes being introduced e.g. upfront payments, reduced specification and 5 yearly reviews
- Increased time and resources on DfT bid evaluation in early re-lets until all parties understand DfT's requirements and the process

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	√

A3: Scope of bid evaluation

- We have reviewed the DfT's franchise evaluation process charts available at: http://webarchive.nationalarchives.gov.uk/+/http://www.dft.gov.uk/pgr/rail/passenger/franchises/franchiseprocess.pdf
- The effect of the recommendations on the previous page would be as follows:
- Delivery Plans which a bidder has to produce as part of its bid would be focussed on outputs (e.g. increase in passenger journeys/km or reduction in crowding) and would therefore need to be more innovative than at present (now focussed on delivery of DfT-specified requirements(Chart 2)). Quality of proposed management and their overall vision and plan for the business (rather than quality of the individual delivery plans as drafted) would therefore need to be a key factor in assessing the robustness of the bid since initiatives are not certain to be successful and management need to be resourceful and still able to develop the business if the specific plans envisaged do not work.
- Delivery plans related to investments or other initiatives which do not drive the core franchise outputs but have a mainly socio-economic business case would carry less weight (as long as effective measures where in place in the event of non-delivery). Many such outputs would be covered by the separate process described in mechanism A8.
- When risk adjustments are overlayed on bidders proposals, the effect of the outcome of the five yearly review would be considered (Box 1.14 on Chart 1).
- In the final decision (Box 5.12 on Chart 5), quality of management should be a relevant factor since in the event of bids being close, a good quality management team can have an impact across all areas of the franchise
- Financial risk still needs to be assessed (Chart 4) and no change to this chart is proposed but in practice, the requirement for upfront payments should mean that bids are more likely to be robust so this is less likely to be a differentiating factor between bids.
- The net effect of these changes should mean that bid price is a more significant factor because fewer adjustments are made and fewer bids are eliminated for other reasons – this is important if unit cost is to be reduced and VfM improved.

A4: Management and enforcement of franchises to be done by ORR

DfT would draft the specification and run the tender process but the management of franchises and franchise reviews would be done by a franchising team in ORR. Provision would need to be made to allow Ministers to provide guidance to ORR at franchise reviews. ORR would also need to be involved in the procurement of franchises to ensure it is effective in its management role (to address a current concern about different parts of DfT not being close enough to each other). See next page for details of roles and responsibilities in franchising process.

VfM improvement

- Greater objectivity of ORR should improve decision making in the industry.
- ORR able to take whole industry view. Alignment of franchise management with regulation of NR would improve decision making around costs and co-ordination of industry-wide initiatives

Pros

- Would enable decisions to be taken based on a whole industry view by ORR
- ORR should bring independence and greater objectivity to role (as other utilities regulators)
- Removes risk that decisions are seen as politically driven (i.e. removes uncertainty)
- Helps market confidence re. investing in long term franchises
- DfT input retained in similar role to HLOS/SOFA (might be more detailed for highly subsidised franchises)

Cons

- The need to ensure ORR is involved in the procurement process may increase transaction costs
- Reduced political accountability
- Reduced DfT workload may lead to resourcing and skills issues
- Involvement in “management” reduces ORR independence in carrying out reviews
- For regional franchises, DfT/others are the buyers so might need to be included in management

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
?	√	√	√	√	?

A4: Roles and responsibilities of DfT and ORR in franchising process

Area/Issue	DfT	ORR
Franchise agreement	• Run tender process and select winner • Detailed drafting and negotiation	• Provide template (as for access contracts) • Be consulted on individual agreements (too cumbersome to require them to approve)
Outputs	• Specify at bid stage • Request output changes at review	• Determine outputs and cost at review
Monitoring/delivery of outputs	• Receive monthly/annual report from ORR (small team)	• Monitor and enforce compliance
Capital projects funded by DfT	• Remains the client, as for NR	• Monitor and enforce delivery
Financial robustness	• Evaluate at bid stage	• Evaluate at franchise review stage and have in mind during franchise review
Cashflow	• Receive upfront payment and make/receive franchise payments	• Determine franchise payments after first franchise review
Fares (subject to mechanism A7)	• Set policy	• Approve detailed framework proposed by TOCs • Specify increase in regulated fares

A5: More freedom of action on Intercity routes

Intercity (IC) TOCs are closest to full profitability and least constrained by social role which means that franchising approaches which minimise Government involvement and regulation can be considered . There are many options for separating IC TOCs from template reform of rail generally and franchising specifically. Some re-mapping would be required to separate London-South Wales from the more social components of the Greater Western Franchise. They require detailed evaluation, and may be too great a distraction to an already challenging reform programme, especially as West Coast is close to being tendered. They are:

- Capacity auction on IC routes
- Create overlapping franchises on IC routes so increasing the amount of competition
- Reduce the scope of the franchise (no. of paths) to allow for more open access
- Create Open Access-style concessions with fewer network responsibilities (e.g. removing Station Management)
- Full privatisation (see First Economics Paper: An Alternative to Franchising 15 September 2010)

VfM improvement

- Reduced franchise payments and improved services which better serve passenger needs (through increased competition)

Pros

- Competitive market should result in greater choice and benefits for passengers
- Greater franchise premiums (or upfront payment) for DfT
- Some market appetite for such a change

Cons

- Difficult to create efficient parcels of paths.
- May be difficult to impose minimum service standards (e.g. first/last trains)
- Difficult to prevent ORCATS raid type behaviour
- Reduces economies/ synergies of single operator e.g. harder to manage performance
- Less clarity for passengers (need to protect inter-available fares)
- TOCs will not finance infrastructure improvements

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	√	X	√	X	X

A6: Delegation of part of rail budgets to regional level (Related issue not in scope)

Outputs which affect only a local area/region to be determined by an Integrated Transport Authority or other regional franchise specification body which is responsible for the relevant budget. DfT could provide technical franchising role for authorities. Where no such body exists (or there are significant cross-boundary issues), DfT could consult a committee of local authority representatives on VfM options. In all cases, saved budget to be available for other (transport) uses by the Authorities. In some cases, local specifications could be contracted on a gross cost basis e.g. if highly integrated with other modes – link to mechanism A9.

A potential variant of this approach would be that the baseline DfT proposal could be adjusted plus or minus according to local views, with the consequences to be accepted and managed locally with financial cost or saving going to the local authority(ies).

VfM improvement

- Enables decisions to be made by people they affect in order to improve VfM (local stakeholders may be happy with reduced outputs if funds can be spent on other public services or reduced tax)

Pros

- Enables local decision making with those closest to the local area making decisions on funding
- Requires those who request services to understand cost of providing those services, thereby improving the consideration of VfM
- Encourages local decision makers to consider the alternatives

Cons

- Maybe difficult to identify an appropriate local authority to make decisions
- Informal or cross boundary advisory body may require legislation or where the ITA does not cover a suitable area – may need to be an informal advisory body
- Slow decision making on use of funds
- May only work with shorter routes in single authority control
- Delegated funding can reduce overall VfM through poor or excess service specification by local bodies, but this is constrained if they have to find funding.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
?	X	√	X	√	√

A7: Economic regulation of fares by ORR within constraints set by DfT

Individual fares and structures would be set by TOCs within a framework approved by ORR. ORR would determine the annual increase to regulated fares after consultation with Ministers, taking account of matters such as the DfT's Rail budget , TOCs' financial position, general inflation, passenger expectations. Fares framework and fare types would remain national with local variations. DfT could still decide on subsidy policy but this should be done on an outcome basis i.e. by reference to support for certain types of passenger or journey not by specifying the detail e,g. type of fare. We have not analysed this in detail as it is the subject of another workstream.

VfM improvement

- Scope to optimise passenger revenue
- Facilitates demand management and therefore better utilisation of capacity
- Subsidy targeted on the right journeys/customers rather than historic fare definitions

Pros

- Gives TOCs flexibility to balance supply and demand to optimise use of resources
- Encourages simplification and evolution of fare structures to make them more user friendly and effective and keep them market-focused
- Enables TOCs/ORR to address the historic inequities in fares e.g. fares for journeys of the same distance can be significantly different
- Distances Government from actual fare levels set
- Makes fare setting more transparent based on industry costs

Cons

- Reduced political control over fares whilst democratic accountability remains
- Risk of profiteering if regulation is not effective

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
?	?	√	√ (as no TOC is pure intercity)	√	√

A8: New planning approach for socio-economic investments

A range of initiatives to encourage TOC investments (NR investments are outside the scope of our work) but in principle investment to be based on commercial decision by TOCs.

(i) Part of the rail budget could be allocated to deliver additional investment where this is justified by socio-economic benefit. TOCs could bid for such investment sums. Investments no longer specified in franchise agreement

(ii) Sometimes investment cannot be justified because payback period is longer than remaining franchise length. Consider s54 undertakings or contracted/regulated residual values based on predetermined objective criteria related to VfM/benefits – possible role for ORR

(iii) ORR could oblige other TOCs to contribute to investments/ share benefits where there are multiple beneficiaries e.g. at stations

VfM improvement

- Investment optimisation – would improve prioritisation of investment based on maximum VfM
- Franchise awards no longer need to be influenced by who has the best list of ways to spend DfT budgets

Pros

- Clear allocation of responsibility for investment decisions with clear criteria for decision
- Investment requiring government support will be prioritised on basis of economic benefit
- Consistent with longer franchise (B1) and greater flexibility for TOCs
- Clear evaluation criteria will enable TOCs to focus on which schemes to promote
- Enables investments to be undertaken where there are multiple beneficiaries

Cons

- May result in investment allocation in areas where greatest return (i.e. greatest number of passengers) so other measures may be required to safeguard regional investment

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	Maybe not needed	√	Minimal	√	√

A9: Franchises to be let on gross cost basis – i.e. DfT/ Authority takes revenue risk

Let contracts on a gross cost basis for the following reasons:

(1) Several regional franchises are in receipt of substantial subsidies so the TOC is less well placed to make decisions about value for money

(2)(Evidence from studies of franchising in other countries suggests that gross cost contracts are effective in delivering cost savings and hence VfM in heavily subsidised railways.

(3) Passenger Transport Executives or other authorities determine other services and fares and there is a significant potential benefit from better integration of all aspects of service delivery as in London, including ticket retailing.

Gross cost has been used successfully for London Overground Rail Operations Ltd. (LOROL) and London Bus contracts but requires an effective transport authority to deal with a wide variety of issues which affect revenue. This recommendation is likely to be more effective in delivering VfM improvements if decision-making is delegated to the regional level (see mechanism A6).

VfM improvement

- Bidders focus on operating services efficiently and compete to drive cost out of the business
- The winning TOC cannot rely on revenue growth to deliver profits – it must deliver its cost reduction plans
- Procurers of services can get a clearer picture of the costs of providing specific services

Pros

- Generates focus on costs, the key driver of value in heavily subsidised franchises
- TOC has to deliver cost savings to deliver bid targets
- Management can focus on delivering prescribed services efficiently, it does not have to identify business development opportunities
- May be appropriate where high integration with other modes

Cons

- Has to be carefully contracted – TOC has no automatic incentive to maintain standards of service or collect revenue. Can be addressed through incentive mechanisms
- Can be difficult and costly to vary the service specification, in particular if TOC is operating efficiently
- DfT / Authority has to take responsibility for service development

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	X	?	X	X	√

B1: Longer franchises

In line with the current thinking, DfT would specify and let longer franchises of up to 20 years for Intercity franchises; 15-20 for London & South East and Regional, except in exceptional cases, such as London Overground where key levers are retained by franchising authority. As explained in A2 these franchises would be subject to a 5 yearly review process. We understand that under EU law franchises longer than 20 years need to be justified by the need to pay for investments Railways Infrastructure (Access and Management) Regulations -(RI(AM)R 2005:
http://www.legislation.gov.uk/uksi/2005/3049/contents/made ;
RI(AM)R (as amended) 2009:
http://www.legislation.gov.uk/uksi/2009/1122/contents/made).

VfM improvement

- Greater premium / (less subsidy) to DfT for longer franchise as longer term decision-making should lead to faster business growth
- TOCs able to take longer term view on costs and able to take difficult decisions to achieve long-run cost savings and improvements to VfM

Pros

- Greater incentive for TOCs to identify and implement initiatives for market development/ revenue growth/cost reduction/capacity utilisation.
- Greater incentive for TOCs to spend time collaborating to manage industry-wide issues/costs
- Improved real business decision-making

Cons

- Need for regular reviews which could have all the disadvantages of single tender negotiations – avoided by a robust review process - see A2.
- Greater risk to private sector which may not be able to bear it – mitigated by reviews and upfront payments plus changes to evaluation process
- Less frequent competition

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	√	√	√	√	√

B2: Upfront payments

Bidders would offer an upfront capital sum to “buy” the business for the franchise period rather than bidding an increasing profile of franchise payments. This would be consistent with the approach in other transport concessions, such as in the ports sector. (Escalating) annual premium payments could be fixed at the outset with the capital sum bid in addition to this. This approach could be used to manage the size of the upfront payment to acceptable levels and avoid constraining competition by excluding bidders. The early termination of East Coast illustrated a problem which arises when bids are evaluated and franchises awarded based on assumptions about future revenue. It appears to the market there are no prizes for financial prudence and yet the winning bidder may not be fully on the hook for the franchise payments they have committed. In the private sector, there is a presumption against deferred consideration for sales of businesses because of uncertainty over the value and the risk of non payment. This mechanism is closely linked to B6 and would allow a reduction in the overall cost of performance bonds/liquidity requirements and parent company guarantees.

Could apply to subsidised or premium paying franchises though for high subsidy franchises the upfront payment might be fixed and the subsidy would be bid for. This proposal might be less appropriate for any franchise awarded on a gross cost basis.

An illustration of upfront payments under a downside revenue scenario is given at appendix 4.

VfM improvement

- Improved financial robustness of franchise
- Improved risk allocation and management

The pros and cons of this mechanism are presented on p52.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	?

B2: Upfront payments

Pros

- Upfront payment to DfT on letting of franchise, rather than premium in later years
- The upfront payment incentivises the TOC to work hard to achieve its business plan rather than handing back the franchise
- Any potential additional cost of the private sector earning a return on its investment should be more than offset by reduced risk to DfT and greater incentive to grow business
- The level of return currently earned by TOCs possibly means they can afford some upfront investment without an increase in cost if our other recommendations are adopted
- Discourages over-optimistic bidding so bids received will be more realistic and deliverable, reducing the challenge of DfT evaluating financial robustness and deliverability. If TOC hands back the franchise, DfT still has the cash
- More reliable budgeting for DfT and can smooth premium/(subsidy) payment and DfT has cash, instead of it being tied up in bonds/liquidity reserve/parent company guarantee
- Could attract new sources of private equity to rail industry

Cons

- Upfront payments could discourage some bidders, although likely to be outweighed by benefits of longer franchise
- Requires other liberalisations (e.g. less specification) to allow TOCs to effectively manage their investments and risks
- Upfront payment may be costed as additional risk in bid, resulting in more expensive bids from DfT’s perspective.

B2: Overall impact of upfront payments on financial robustness

This proposal complements the proposals for longer franchises, output specification, regulatory reviews and the removal of revenue share/support and to a lesser extent some of the other recommendations. Taken together we believe there is a significant improvement in the inherent financial robustness which would be delivered by the bidding process which should then make bid evaluation more reliable. VfM is also improved as cashflows are used more efficiently The overall rationale for this is:

- Regulatory reviews give greater certainty and better incentives than revenue share/support or GDP-linked formulae
- Upfront cash is more certain for DfT (and can be spent)
- In the event of the TOC underperforming, the upfront payment is a sunk cost for the TOC. The DfT's right to franchise payments ranks ahead of the return on the TOC's investment so DfT is cushioned from downside and TOC incentivised to drive recovery. See illustration of upfront payments at appendix 4. This creates an incentive for more prudent bidding. Excessive prudence should not lead to an excessive windfall for the TOC because any upside in revenue from exogenous factors is recouped at 5 year review
- In contrast, parent co. guarantees and liquidity maintenance provide less protection because they are less flexible and do not cover 100% of franchise payments
- This should not lead to the TOC charging an unjustifiable risk premium because the true cost of risk is the same for DfT and TOC (since the underlying cashflows they are exposed to are the same)

B2: Upfront payments – example of Pricing structure on a recent port terminal concession tender

Concept

- Operating concession for 25 years; harbour authority responsible for infrastructure and regulation
- Fixed concession fee for 25 years
- Variable concession fee (fixed amount per unit handled)
- Bidders required to pay for NBV of assets acquired
- Business was loss making so bidders could bid a discount to the fixed fee in years 1-3 to allow time for turnaround
- If bidders perceived positive value, they could bid a premium to NBV of assets and no discount to the fixed fee
- Regulated cap on tariffs
- Bidder selection based on quality of operator and proposals plus level of financial offer

Rationale

- Incentivise improvements to efficiency and revenue generation
- Share risk in business performance between Authority and operator, reflecting that some volume risks outside its control
- Optimise cost of capital (Authority pays for infrastructure; operator pays for business but does not have to finance the entire value from the beginning)
- Achieve book value for existing assets
- Note that the economics of generating extra passenger revenue means it might not be sensible to introduce a variable concession fee for passenger charges. The variable track access fee plays a similar role.

B2: Will upfront payments be expensive for DfT? - Comparison of short and long franchises with and without upfront payment

Input to calculation	A: Without upfront payment, short franchise	B: With upfront payment, long franchise
Cost of investment	Minimal payments for franchise assets taken over, assumed equivalent amount recovered at end of franchise; TOC may include in calculation bid costs on won and lost bids	As A, plus upfront payment, not recouped at end of franchise. Upfront payment would be lower than in a normal M&A deal due to fixed term of franchise and obligation to make franchise payments (or inherently loss-making nature of some franchises)
Parent Company Guarantee	May be treated as cost of investment but also earn deposit interest. For accounting purposes likely to treated as a contingent liability i.e. not on balance sheet.	Not included as replaced by upfront payment. For accounting purposes, upfront payment would be recognised on the franchisee's balance sheet
Capex specified by DfT e.g. station improvements, PIS etc	Assumed there is minimal revenue generation in franchise term from such investments but TOC may treat as part of cost of investment in the franchise. Sometimes the profile of franchise payments and exogenous revenue growth means the private sector funds such capex in the short term. In reality this is low risk taxpayer funded social investment which should not attract a private sector equity rate of return.	Capital investment more likely to be aimed at generating revenue though may still be part funded by DfT
Private sector return	Normally a margin on turnover, fare revenue or operating cost unrelated to investment – leads to a high effective equity IRR, which appears low because of the inclusion of DfT-specified capex in the calculation.	Private sector would assess required WACC. Transaction would be part financed by debt. Private sector would also provide for repayments of debt and equity given fixed term franchise. No rationale for TOC to earn additional margin on turnover/cost. (note that if no upfront payment, approach in A will continue)
Risk transfer	Most risks nominally transferred to private sector but in practice often revert to DfT	Greater risk transferred, including for example significant risks around achieving cost reduction. Less likely to revert because TOC has upfront payment at stake.
Ability to bear risk	Liquidity maintenance intended to provide buffer but in practice this cash cannot be used to solve a problem	Upfront investment provides a cushion for absorbing risk – private sector debt/equity repayments and return on investment can be reduced before risk reverts to DfT – so lower risk of franchise insolvency

B3: Remove or reduce scope of revenue share/support arrangements

Remove revenue sharing/support because (i) this has had adverse impacts on incentives to invest to grow revenue, (ii) it has incentivised TOCs to make cost savings which might have an adverse revenue impact and (iii) whilst encouraging bidders to submit relatively bullish bids, the consequences have undermined risk transfer as DfT has ended up retaining significant revenue risk for several franchises. As an alternative approach, the franchise review process can be designed to address concerns over actual revenues being significantly ahead or behind forecasts for matters outside a TOC's control (See Mechanism A2)

VfM improvement

- Potentially increased revenue as TOC is incentivised to outperform its revenue projections as it will get to retain the upside
- Cost reduction decisions which are good VfM rather than simply cash savings (e.g. not taking out revenue protection staff)

Pros

- Five year reviews are arguably less likely to cause perverse incentives
- More effective risk transfer and greater financial robustness
- Increased certainty for DfT budget with no requirement for revenue support payments

Cons

- May increase (perception of) risk to bidders and reduce premium/(increase subsidy) bid – but arguably this would reflect a fair assessment of the risk
- DfT would not benefit immediately from upside where revenues are ahead of projections – but would still benefit at re-franchising and to some extent at reviews

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	√

B4: Adjust Franchise Payments for GDP/CLE (NOT RECOMMENDED unless many of our other recommendations are not adopted as might be the case for GA Short)

This mechanism has been widely discussed as a way to mitigate concerns about risk allocation and financial robustness, as it is argued that TOCs cannot manage the macroeconomic impact on fare revenue. However, the five year review (see – mechanism A2) is designed to address the same issue in a more efficient way.

VfM improvement

- Helps to ensure financial robustness, reducing the need for re-tendering with associated costs, however needs to be balanced alongside negative VfM consequences of removing revenue risk incentives on TOCs.

Pros

- Provides TOCs with assurances over macro-economic drivers of revenue which are outside their control.

Cons

- Other businesses have macro-economic risk and most other recommendations seek to make TOCs more like other businesses so even if this proposal were favoured, it is inconsistent with the general approach of our recommendations
- This protection might encourage aggressive bidding on the basis that TOCs are well protected on the downside
- Less appropriate if TOCs have greater control over costs or service changes or other arrangements such as five yearly reviews put in place (might be more appropriate if current system continued)
- Whilst models exist, the elasticity of demand to GDP/CLE is not known with certainty either generally or for specific franchises – the recommended review process potentially uses better data by resetting revenue going forward based on outturn rather than attempting to devise a forward looking formula

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	X	X	X	X	X

B5: Removal/reduction of Secretary of State risk assumptions

Bidders have sought to pass risk back to DfT (e.g. consequences of major schemes). In some cases this is believed to have disincentivised TOCs to manage and mitigate problems.

TOCs should be expected to take full business risk, subject to having the means to manage them. Other proposed changes give them this ability.

Examples include Oyster implementation, gating at Waterloo, introduction of new rolling stock, impact of major enhancements where a TOC with a longer franchise and an output specification could be expected to take more risk rather than passing it back to DfT.

We note that this is consistent with the direction of travel on the Secretary of State risk assumptions on the South Central franchise.

VfM improvement

- Reduces risk of TOCs negotiating increases to franchise payments during the franchise term for risks that they should be managing as a normal part of their business
- Placing risks with party best place to manage them will improve overall VfM

Pros

- TOCs will be better incentivised to work with NR on major schemes rather than as a passive by-stander
- Limits scope to claim for other problems under this protection

Cons

- Some risks may genuinely be inappropriate to be transferred to TOCs so this may not be achieved in full

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
May not be able to take full risk	√	√	√	√	√

B6: Reduction of performance bond/liquidity requirements/parent company guarantee

There is a cost associated with the performance bonds and liquidity maintenance obligations in the TFA – interest margin on cash tied up plus credit risk premium reflected in bond fee or interest. It is not clear (although we have not reviewed any data) whether these arrangements have prevented any franchise defaults (although in some cases they have compensated DfT for re-tendering and takeover costs).

If bidders paid an upfront capital amount (see mechanism B2) the cash would be available to DfT instead of being tied up as security. Liquidity requirements would not be required as owning groups would be incentivised to protect their initial investment.

No change is proposed to season ticket bonds which are necessary to protect customers' money.

VfM improvement

- Saving in funding costs with no adverse impact on financial robustness
- Improvement in risk allocation

Pros

- Removal of bond/liquidity/parent company guarantee requirements will reduce funding costs
- Replacement with upfront cash payment will improve DfT budget position and incentivise the TOC to deliver its franchise commitments – means that cash for guarantee is actually available for use rather than being tied up
- Upfront payment (see mechanism B2) preferable to parent company guarantees due to improved risk transfer and incentives

Cons

- Upfront franchise payment may deter some bidders
- If requirements are reduced without upfront payments being introduced there could be a worsening of financial robustness depending on other factors such as evaluation/franchise reviews. Guarantees may therefore still be required if some franchises are let on a gross cost basis.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	?

B7: Cost reduction metric specified in franchise - POTENTIAL for GA (short) but otherwise not recommended

This mechanism would specify a maximum tolerable inflation of franchise controlled costs over the life of the franchise. As part of the franchise specification , DfT would develop a unit cost target. Cost would exclude all NR and ROSCO's and the unit would probably be something like vehicle miles. DfT specify how much the cost could increase or decrease by the end of the franchise. This would be inflation (calculated as it is currently) plus or minus the level specified. Where cost exceeded the prescribed level DfT would recover the excess from the TOC. Generally speaking, the five year regulatory review is a more tried and tested way of achieving the goal of cost regulation so we do not recommend this approach unless there is a reason why five year reviews cannot be introduced (in time). The approach may be applicable for GA short if there are specific short term cost reduction objectives but for longer franchises there is a risk in divorcing cost regulation from revenues.

VfM improvement

- Cost reductions contractualised with TOC
- TOC incentivised to achieve specific cost reductions

Pros

- Unit costs of the railway are maintained at a level specified by DfT
- Opportunity to benchmark best in class on operating costs
- TOC would not be off the hook for delivering cost reductions if revenue grows ahead of expectation
- Financial penalties could compensate DfT for failure to achieve reductions.

Cons

- Adverse impact on TOC’s ability to manage the business holistically
- If costs in a particular year (e.g. final) are in focus, there is an incentive to massage accounts.
- Micro management of TOC costs by DfT – contractual description of each cost saving required
- Requires DfT to take view on acceptable TOC costs
- Financial penalties would result in TOC facing double risk with a random possibility that revenue windfalls would offset

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
Option to be evaluated – may offer VfM	To first franchise review	X	X	X	X

B8: Risk sharing in respect of industrial relations impacts in the case of cost reduction initiatives

Our analysis of TOC barriers and an unconstrained TOC in part 1, identified industrial relations risk protection as a key potential enabler of unit costs savings (e.g. Driver only operation or other staff reductions). Where TOCs face full risk then the business case for such savings can be negative. Industrial relations (IR) protection was previously introduced by the SRA and South West Trains sought the SRA's IR protection for its 2002 Guards dispute, when the RMT refused to accept an increase of 7.6% over 18 months. Leading to a period of industrial peace and negotiated settlements based on management proposals since.

Protection, which would come in the short term from the DfT (to be repaid from future savings), could be in the form of suspension of breach/default provisions. DfT might also consider partially underwriting revenue losses though the effect on incentives needs to be considered.

VfM improvement

- TOC risks reduced in tackling staff costs, would enable the TOC to seek reductions in unit costs and improved VfM.

Pros

- Provides incentives for TOCs to tackle staff costs
- Improves business case for TOC staff cost measures.
- Clear message to the industry that industrial action risk shall not form a barrier to achieving efficient TOC performance
- Clear message to Unions that the Government is serious about tackling the cost of the industry

Cons

- Difficulty in differentiating between "good" and "bad" disputes/IR performance
- Potentially unquantified risk to government (unless capped)
- This measure does not work by itself – it enables TOCs to deliver savings, and it needs to be supported by other mechanisms set out in this report that incentivise TOCs to make the difficult decisions.
- Recommendation is inconsistent with the general principle in recommendation B5 (Secretary of State risk assumptions) so DfT would want to scrutinise the business case on a TOC by TOC case.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	√

C1: All NR revenue to be routed through TOCs as access / lease payments

Reversion to the financial structure of the industry at privatisation, under which TOCs were seen as the paying customers of NR. This was changed for reasons of Government accounting. It is assumed that this issue no longer applies with the current Government.

The original access charges did not reflect a detailed cost allocation exercise so there is scope for a more accurate allocation to be developed. There is no “correct” allocation as this depends on assumptions made, however any reasonable allocation is likely to improve data and therefore improve the VfM of decisions made.

VfM improvement

- Better decision making due to greater transparency and accountability
- Supports other changes which might promote better incentives for TOC and NR to work together

Pros

- Pre-cursor to allowing TOCs and NR to align and for each party to influence each other to deliver VfM for Rail
- Gives a whole system picture of industry costs.

Cons

- Would need allocation of infra costs for each TOC – NR would incur a cost for doing this. (See recommendation C3)

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	√	√	√	√	√

C2: Removal/reduction of no net loss/no net gain protection for NR charges - replacement with ORR-determined allocation of cost changes

Instead of TOCs having full indemnity under s.18.1 of the franchise agreement for any changes in NR charges as now, the ORR would need to consider affordability and VfM from a customer (i.e. TOC) perspective when setting access charges and adjusting franchise payments, as happens with other regulated utilities.

If ORR deemed it necessary to fund an investment which customers could not afford, this would have to be done through subsidy or borrowing.

TOC bidders would need to make (or be given) an assumption about NR's long term rate of efficiency improvement. There might be cases where changes to this rate would lead to a windfall or unfair burden on TOCs in which case ORR would need to determine whether such changes too should be funded through subsidy, adjusted franchise payments or borrowing.

VfM improvement

- Gives TOCs a strong incentive to help reduce NR costs
- Incentivises TOCs and NR to work together to generate revenue (no need for an artificial passenger revenue incentive for NR)
- Optimisation of infrastructure investment decisions to take account of whole system VfM

Pros

- Ensures NR charges take account of VfM from a passenger and TOC perspective
- Enhances the incentives for TOC-NR co-operation and for decisions to be taken on a whole system basis

Cons

- Whilst desirable in principle, this will be difficult and complex in practice and may place an unbearable level of risk (including a significant possibility of windfall profits) on TOCs. TOCs will be very dependent on ORR decisions. More detailed consideration, e.g. of how ORR would make such decisions is therefore required outside the scope of this report and is being completed in other VfM study workstreams.
- Might deter TOC investors if risk is seen as too great, however investors are used to accepting regulatory risk – ORR would regulate the overall position of the TOC, not just the NR charges so the ability of the TOC to bear the charges would be well understood
- Might make TOC more risk averse in dealing with NR, potentially frustrating some initiatives to avoid bearing cost/risk
- Requires better allocation of costs to franchises than currently exists

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	√	√	√	√	√

C3: Regional/route virtual P&Ls (Related issue not in scope)

Presentation of industry financial data in a way which gives all parties the information required to make the right decisions on a whole industry basis. This is purely about collation and presentation of data and does not change contracts or cashflows (other than to require disclosure of data)

VfM improvement

- TOCs and NR have relevant information to make decisions around growing revenues and reducing costs
- Optimisation of investment decisions

Pros

- Encourages TOCs and NR to work together to make decisions that reflect whole system costs
- Enables benefits of vertical integration with limited transition costs

Cons

- How could benefits be reflected in franchise bids?

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
?	√	√	?	√	√

C4: Other measures to incentivise NR-TOC collaboration (Related issue not in scope)

The Joint Performance Improvement Plan (JPIP) process is widely regarded in the industry as a success and a prototype for industry alignment, Joint Network Availability Plans (JNAP) offers the next step to secure infrastructure investment efficiency.

This approach is consistent with C1, C2 and C3 and facilitates greater collaboration between NR and TOCs.

VfM improvement

- Increased revenue
- Reduced NR costs
- Optimisation of investment decisions

Pros

- Builds on existing industry processes
- Facilitates working together both between NR and TOCs and between TOCs

Cons

- May not provide for radical cost reduction on its own without other incentives

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	√

C5: Vertical integration (Not recommended)

Network to be re-integrated at regional level with long term (15-20 year) concessions let by DfT. A system operator would provide system level co-ordination. ORR's role would be to ensure business plans are consistent with the funding available. NOT RECOMMENDED AS A GENERAL APPROACH.

VfM improvement

- Increased revenue incentives
- Clarity of whole system costs should facilitate cost reductions
- Facilitates optimisation of investment decisions
- Improved transparency over relative cost of providing different types of rail services

Pros

- Improves and aligns decision making and control over costs
- Potentially some opportunities in specific areas (e.g. Mersey) to test implementation or undertake trials

Cons

- Cost of change might outweigh benefits
- Not clear who would bid for the franchises - bidders would require considerably greater capital backing than currently
- Challenge of contracting the return condition of the infrastructure
- Other mechanisms proposed might achieve many of the same benefits with less risk.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	X	X	X	X	X

C6: Wider use of local rail service provision arrangements

This approach adopts an aspect of the structure of the railfreight industry seen in some countries i.e. the use of short line and long haul operations to seek to drive out local rail costs and picks up some of original principles of SRA's Community Rail.

It could take several forms:

- Sub-contracting local operations/infra to low cost operators
- TOCs taking over infrastructure in some rural areas

VfM improvement

- Tailored response to local needs
- Reduced franchise and NR costs for provision of some regional rail services

Pros

- Adapts rail provision to local circumstances through local decision-making
- Encourages/ enables providers to look at the most efficient way of providing services
- Good model already in place on Stourbridge Line
- Could work in conjunction with mechanism A6 (local decision making) and as a pilot for mechanism C5 (vertical integration)

Cons

- Risk to through services (but could be co-ordinated through timetable)
- Potential standards issues where local and mainline services meet
- Least effective where civil infrastructure retains residual catastrophic risks (e.g. Isle of Wight)

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	X	√	X	√	√

D1: Joint decision making at national and local level on issues which affect more than one franchise (Related issue not in scope)

Where issues affect multiple TOCs a joint decision making process is required for making cross industry decisions and sharing costs and benefits. This might be achieved by giving ATOC specific responsibilities – this is being covered by another workstream.

VfM improvement

- Cost reduction, by allowing cross TOC improves to be implemented
- Improvements to ticketing e.g. Smartcard role out
- More timely adoption of new technology including IT systems
- Reduction in safety costs
- Improvements to network benefits generally

Pros

- Achieve effective cost/VfM control of industry wide overheads such as pensions and BTP (and regulators!) – see below for discussion of rail pensions issues
- Economies of scale through developing joint solutions to industry problems

Cons

- Potential for game playing amongst participants

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
√	√	√	√	√	√

D1: Illustration of cross industry issue – railway pensions

Overview

- On privatisation of the railways, employees who were members of the Railways Pension Scheme (RPS) were provided in legislation with protection on their future pension benefits. The protection reduces when the individual voluntarily moves employer.
- New employees may be provided benefits different from those with protected status, although industrial relations pressures have resulted in individuals continuing to be given access to the RPS.
- The RPS is unusual relative to most private sector defined benefit pension schemes in that the cost of benefits is shared between the members and the company (40:60). Most schemes are financed with fixed costs to the members and the balance of the costs being met by the sponsoring company.
- The protection afforded members makes it impossible to change the benefits without obtaining their consent. The one potential lever here is that of members' contributions (their share of the costs) reaching levels at which change in benefits become preferable to the individual paying the required level of contributions.

Current position

- Since privatisation pension costs have increased. In 2008, the Railways Pension Commission stated that the main difficulties in funding the RPS were:
  - Improvement in the levels of benefits as a result of legislation, collective bargaining and regulatory intervention;
  - Improvement in life expectancy; and
  - A reduction in anticipated investment income.

D1: Illustration of cross industry issue – railway pensions

Incentives on rail franchises

- The incentive to address pension deficits is not the same for franchise holders in the rail industry as for many private sector employers. While in typical private sector pension schemes, the employer will ultimately have to meet the pension deficit out of the business' earnings, an owner of the rail franchise is only responsible for the contributions payable to the RPS during the term of the franchise. At the end of the franchise any deficit will flip over to the next franchisee who have the ability to factor the deficit into its bid.
  - Actuarial valuations to establish the contribution rates are undertaken every three years with any deficits being spread.
  - To maximise its profit a franchisee should seek to minimise cash being directed towards pensions. Given the shared cost basis of the RPS minimising cash is also in the interest of members.
  - Some sections of the RPS are funded on more optimistic actuarial assumptions than we typically see being used for actuarial valuations of pension schemes outside the rail industry. This points to pressure to keep contributions down.
- The treatment of pensions in the franchise procurement process has fallen behind those in similar processes in other monopoly infrastructure services (water and sewerage, gas and electricity distribution) as well as those used in out-sourcing local government and NHS services. The current approach to procurement allows (if not encourages) the holder to avoid addressing the true economic costs of the pensions and risks. This leads to:
  - overall employment cost and risk being understated, storing up a legacy for future franchise periods; and
  - an inappropriate allocation of costs being borne by different generations of consumers by back end loading of cost and risk onto future consumers.
  - DfT (and taxpayers) bearing the ultimate cost but being in no position to manage that cost.

Impact of longer franchises

- More pressure on the franchisees to address the funding of the RPS (and to work together to do so) as they face greater risk of rising contributions over their ownership term and thus reduced profits; and
- A potential fall in the profitability of rail franchises as more cash is spent addressing these deficits; and
- A fall in the bid price for franchises recognising the greater risk associated with the longer term funding of the RPS, reflecting the true cost.

D2: Five yearly/annual rolling stock auctions and other measures to make the market more liquid - subject to other workstream consideration

- There are a number of constraints which mean that the market for rolling stock does not operate effectively:
  - Specific fleets/types are specified in franchise agreements
  - Leases have to be signed for the entire franchise period and s54 agreements mean the commitment of the DfT is often for longer
  - Franchises are too short to allow TOCs flexibility in changing fleets
  - TOCs do not invest in new trains because (a) they are committed to leases on their existing fleets and (b) they do not have efficient means to match the cost of the fleet to the revenue it will generate (which increases over the life of the fleet)
- The effect of this is that rolling stock usage is set in stone and cascades generally happen only at the instigation of DfT. When they do happen, e.g. as a result of the purchase of new fleets by DfT, there is little scope for operators to find innovative uses for the outgoing fleets – the cascade is planned by DfT.
- Consistent with the move to more output specification, we propose:
  - Franchise agreements should not specify particular rolling stock and TOCs should not be required to sign leases for the entire franchise – bidders should simply have to demonstrate that they have a robust means of delivering the service
  - There should be an annual “auction process” to facilitate cascades – see below for illustrative process
  - When major fleets become available e.g. to be replaced by the new Thameslink fleet, TOCs should be able to bid for the old stock (with bids on the basis of least cost/best VfM to the taxpayer)
  - S54 agreements and leases need to be made flexible to allow fleets to move as long as the payments are secure and the usage of the trains is approved by DfT

D2: Five yearly/annual rolling stock auctions and other measures to make the market more liquid - subject to other workstream consideration

This would involve TOCs declaring any surplus stock they have and any stock they would like to replace and bidding for stock offered by other TOCs at set periodic dates (say, every 2.5 years plus other major project-driven dates). It is a way of addressing allocation and utilisation of rolling stock on a national basis whilst leaving decisions to TOCs as far as possible. Regular auction mechanism would provide market based approach for allocation. There is a precedent for this type of solution in other illiquid markets, i.e. collating and co-ordinating dispersed supply and demand. One example is the trading in shares in employee owned companies, which sometimes takes place on only one day per annum to make it easier to match potential buyers and sellers.

This approach would need Rolling Stock Operating Company (ROSCO) support, but the process could be underpinned by sub-leasing rather than by trying to introduce new leases.

VfM improvement

- Improved utilisation of rolling stock
- Better matching of capacity with demand
- Revenue growth achieved by reducing crowding

Pros

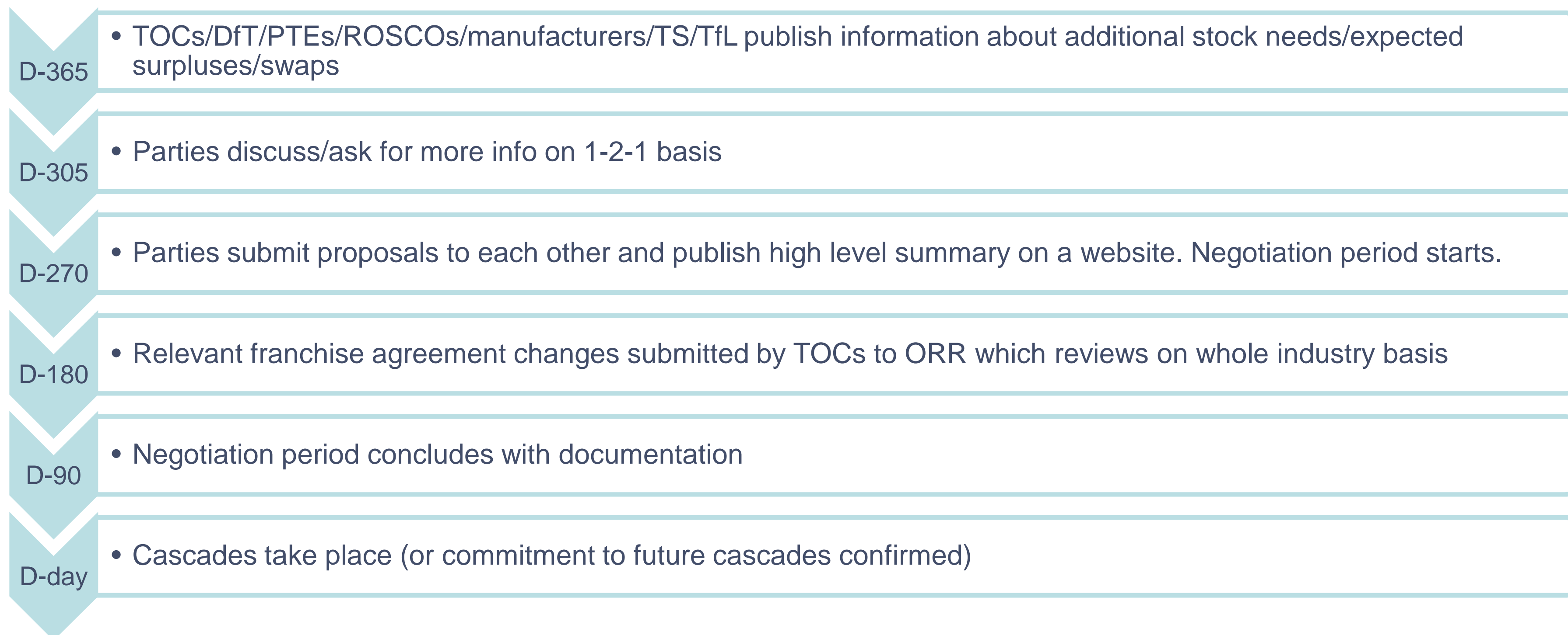
- Improve rolling stock utilisation and promote investment (by facilitating cascades)
- Help improve liquidity (at the margins) of rolling stock market
- Improve ROSCO pricing as stock with high lease/maintenance cost would have no demand once TOCs could source alternatives
- Customer (TOC) market power could be enhanced
- Address some of the criticisms of the Competition Commission review of the rolling stock market

Cons

- Surplus stock might not match requirements – but this would enable investment needs to be identified
- Potentially complex mechanism
- Would need to get buy in from ROSCOs and code of practice to minimise profiteering
- At the margins some trading does already take place, however we believe a range of options (including those considered by other workstreams should be considered

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
X	√	√	√	√	√

D2: Illustration of rolling stock auction process



- Above timeline is for existing stock. A similar long term process needs to run say 3 years ahead to facilitate ordering of new stock
- Differing lease lengths will be an issue – maybe stock declared available would need to be accompanied by a new lease offer from the ROSCO
- There may be some swaps where a TOC agrees to subsidise a cascade as it is receiving a greater benefit e.g. if it has unused stock which is expensive to maintain.

D2: Examples of deals that could be facilitated through rolling stock auction process

1. TOC A swaps vehicles with TOC B as for historical reasons each has vehicles more suited to the other's operations
2. Same as 1, involving 3 or more TOCs
3. TOC A gets additional vehicles for capacity because the cost saving made by TOC B which used them before enables B to lease some new trains.
4. DfT declares part of current stock available for use by other TOCs as a result of DfT sponsored procurement of new trains. Cascaded to TOCs which show best business case (i.e. lowest incremental franchise payments) by taking risk on crowding relief effect. Some of these TOCs will thereby cascade other stock into the process.
5. TOC A is proposing new better timetable and has a deal to buy new stock. As part of franchise specification change, some services will be reduced to make room for new services. Surplus old stock transferred to TOC B.
6. TOC A has wide seasonal variations in demand and subleases surplus cars to another TOC with opposite variations or to an open access charter operator

E1: Increased TOC responsibility for stations (full repairing lease)

The terms of the standard lease and Station Code would be changed to align the legal arrangements for stations with normal practice (e.g. the retail sector) with a full repairing lease.

NR to keep Managed Stations and possibly expand to cover development and heritage sites, subject to E2.

VfM improvement

- Improved revenue due to more attractive stations and more investment
- Station investment funds more effectively targeted (though NR does consult TOCs)
- Reduced station operating costs

Pros

- Greater incentives for TOCs to effectively manage their station portfolio
- Easier and quicker to make investments to respond to customer needs
- May be easier to introduce cost saving measures e.g. redesign of access to allow for gating
- NR can bring financial strength to bear on high development potential sites where railway interface is complex

Cons

- Could reduce early realisation of development profits while system is embedded
- May lead to an increase in handback/dilapidation issues.

Applicability to upcoming lets			Applicability to TOC-types		
GA short	West Coast	GA long	Inter City	London &SE	Regional
?	√	√	√	√	√

E2: ORR should examine transfer of station ownership to a listed JV(s) in which NR has a minority stake

ORR should examine NR Managed Stations portfolio (potentially augmented as argued in E1) and consider transfer to a new commercial organisation focussed on their development. This would build on their recent innovations such as the Kier JV for TOC operated stations. A full range of commercial options would need to be considered, including full listed JV, minority stake etc. Could be trialled on a regional basis. The rationale is that NR, as a company limited by guarantee whose main aim is provision of national rail infrastructure, is inherently less suited to maximising property development profits than a dividend/gains-driven developer. We recognise however that NR needs to be involved so that the interests of the railway are safeguarded. This proposal is supported by DTZ's identification of a potentially greater level of development opportunities than have historically been realised by NR.

The aim would be to get a stronger focus on realising the development potential of the stations portfolio, which could manifest itself as either a lump sum profit share or annual income.

NR has argued that the Kier JV shows that they are already implementing an effective commercial approach. Review of the effectiveness of this JV and the JVs implemented for London termini is outside the scope of our report

VfM improvement

- Increased development profits to reduce other network charges under the NR single till
- Scope for private financing of major schemes e.g. Birmingham, Reading

Pros

- Brings private equity back into railway infrastructure in the part of the industry where there is most scope for improved incentives to lead to better VfM and improved passenger service
- Incentivise realisation of development opportunities by making incentives consistent with the rest of the real estate sector
- Other proposals for NR do not address incentives with regard to stations.
- Provides focus for the real estate aspects of station development and allows NR to focus on operational aspects of infrastructure (including Managed Stations)

Cons

- Risks may arise from separating stations from other infrastructure e.g. safety and access considerations
- NR approach of developing stations on a case by case basis depending on the nature of the project may produce better results

CONCLUSIONS

Conclusions (1) - Recommendations: Mechanisms critical to achieving VfM and unit cost reductions

We have identified a core package of mechanisms which we believe is key to enabling TOCs to reduce unit costs and improve VfM. These mechanisms are in many cases mutually reinforcing (e.g. long term franchises require 5 year reviews; upfront payments enable a reduction in bonding) so cannot be cherry-picked without reducing their individual effectiveness.

Franchising specification, tendering ad regulatory arrangements

- A1: DfT to specify franchisees on output basis (or even outcome specification where possible)
- A2: 5 Yearly reviews of franchise outputs and payments both undertaken by ORR
- A3: Franchise bid evaluation to focus more on quality of management/ corporate backing
- A4: Management and enforcement of franchises to be done by ORR
- A7: Economic regulation of fares by ORR within constraints set by DfT
- A8: New investment planning approach

A5 (More freedom of action on Intercity Routes), A6 (Delegation of part of rail budgets to regional level) and) and A9 (letting franchises on a gross cost basis), are not in our core package but are desirable in that they could make an additional contribution to VfM/cost reduction and would benefit from further analysis.

Franchise terms

- B1: Longer Franchises
- B2: Upfront payments for franchises
- B3: Remove or reduce scope of revenue share / support arrangements
- B5: Removal / reduction of Secretary of State risk assumptions
- B6: Reduction of performance bond / liquidity requirement / parent company guarantees
- B8: Risk sharing in respect of industrial relations impacts in the case of cost reduction initiatives

B4 (Adjustment for GDP/CLE) and B7 (Cost reduction metrics in franchise) are not recommended as they are inconsistent with the mechanisms identified above.

Conclusions (2) - Recommendations: Mechanisms critical to achieving VfM and unit cost reductions

Network Rail interface and Industry wide arrangements

- C2: Removal of NNLNNG protection for NR access charges - replacement with ORR-determined allocation of cost changes
- D2: Five yearly/annual rolling stock auctions and other measures to make the market more liquid

The following are generally desirable but not critical and are being considered by another workstream of the VfM Study.

- C1: All NR payments to be routed through TOCs as access / lease payments
- C3: Regional/route virtual P&Ls
- C4: Other measures to incentivise NR-TOC collaboration
- C6: Wider use of local rail service provision arrangements
- D1: Joint decision-making at local and national level

C5 (Vertical integration) has not been looked at in detail but is not a recommendation of this study.

Stations

- E1: Increased TOC responsibility for stations (full repairing lease)

We believe E2 (Transfer of station ownership to a listed JV(s) in which NR has a minority stake) should also be in the package but the recommendation requires further detailed review (and ORR is best placed to do this) so we have not included it as a firm recommendation.

Conclusions (3) - Applicability of our findings to different TOC types

- We agree with the conclusion presented in the interim VfM study report that not all solutions will be appropriate for all types of TOC. We have therefore identified in this report which mechanisms might be appropriate to which TOCs.
- Our core recommendations of longer franchises (B1) with franchise reviews (A2) and upfront payments (B2), using an output specification (A1) are applicable across all types of franchises. In addition the following would also be applicable across the board if introduced at all:
  - A3: Franchise bid evaluation to focus more on quality of management/ corporate backing
  - A4: Management and enforcement of franchises to be done by ORR
  - A7: Economic regulation of fares by ORR with constraints set by DfT
  - A8: New planning approach for socio-economic investments
  - B3: Remove or reduce scope of revenue share / support arrangements
  - B5: Removal / reduction of Secretary of State risk assumptions
  - B6: Reduction of performance bond / liquidity requirement / parent company guarantees
  - B8: Risk sharing in respect of industrial relations impacts in the case of cost reduction initiatives
  - D2: Five yearly/annual rolling stock auctions and other measures to make the market more liquid
  - E1: Increased TOC responsibility for stations (full repairing lease)

  C1-C4 and E2: Changes related to the NR interface may need to be consistent across the board though there would be variants for example where TOCs share major routes. E2 (Transfer of stations) could be done on a regional basis.
- The application of particular mechanisms would, however, vary across franchise types, for example whilst the principle of upfront payments could be applied to regional franchises, the size and nature of the payments would be very different to that of an Intercity TOC where premiums are forecast. In particular, we believe there is potential for further analysis and debate on:
  - **Regional** - The delegation of rail budgets to a regional level (A6) and the use of gross cost contracts (A9), both of which could improve VfM and reduce unit costs. Local service provision arrangements (C6) are also more applicable here though could also be used by other TOCs
  - **Intercity** - More freedom of action on Intercity Routes (A5)

Conclusions (4)

Applicability of our findings to forthcoming franchise competitions

- Following the Secretary of State's announcement on 7th December 2010 regarding the timetable for future rail franchises we were asked to consider how our findings could be applied to franchises due to be let in the next two years, which includes West Coast and Greater Anglia (short).

West Coast

- For the West Coast franchise we believe the following mechanisms could be incorporated in the tender documentation
  - A1, A2, A3 and A8
  - B1, B2, B3, B5, B6 and B8
  - C2 and C6
- Variations to the proposals might be required, for example the five yearly review might need to be carried out by a private arbitrator until such time as ORR was formerly given the relevant powers.
- Other changes could be included during the life of the franchise if agreed in principle at the outset, for example changes in public sector responsibilities and processes (i.e. A4) or some of the NR related changes (such as C3).

Greater Anglia – Short

- Given the short run nature of this franchise, a number of our recommendations are not relevant (e.g. Franchise reviews) and it will be difficult to include others as the franchise would not be long enough for the incentives to have an effect. For this franchise, the current approach of more detailed specification may therefore be appropriate, with a requirement for specific cost reductions. However the franchise term could be used to implement some changes of responsibilities, such as with regard to stations, to facilitate the tender for GA long and test approaches to be used on other franchises.

Appendices

1. Franchise review scenario analysis
2. Assumptions for unconstrained TOC
3. Analysis of key franchise specification issues
4. Upfront payments illustration
5. Review of European Franchise evidence
6. Research by PwC and IPPR on political accountability

Appendix 1: Franchise review mechanism scenarios

Franchise review mechanism: Scenario analysis

- To help understand how the franchise review mechanism could work we have developed a range of scenarios covering:
  - S1: Revenues
  - S2: Costs
  - S3: Outputs
- Under each of these scenarios we look at the risks that the scenario presents, how the franchise review mechanism would apply to each scenario and how the franchise mechanism would be applied under the scenario.
- In each case we look at what would happen at the first review point (assumed to be after 5 year but this could vary). We have not complicated the analysis by looking at what would happen at the second review point. In practice the same exercise would be repeated and similar adjustment(s) could be made.
- We also present graphically the implications of each scenario for: revenues, costs and franchise payments (subsidy / premium) over time and the implied adjustments to each of these components.
- In all illustrations we have assumed that the TOC has bid a declining profile of subsidy payments
- To further clarify how the review mechanism would work where there are several of these scenarios occurring at the same time (as is likely in reality), we have modelled the implications based on the illustrative modelling undertaken for the unconstrained TOC.

S1: Scenario analysis - revenue

(a) A TOC bids revenue line X and at year 5 X minus 5% is achieved thanks to CLE growth being below expectations

(b) A TOC bids revenue line X and at year 5 X minus 5% is achieved but the cause is inadequate revenue performance relative to wider TOC community in equivalent sector

(c) A TOC bids revenue line X and at year 5 X plus 5% is achieved thanks to CLE, but some costs of managing growth fall to TOC (e.g. Additional staff resources to deal with additional growth)

(d) A TOC bids revenue line X and at year 5 X plus 1% is achieved as a result of additional TOC- specified investment

S1(a) A TOC bids revenue line X and at year 5 X minus 5% is achieved thanks to CLE growth being below expectations

Risk

- Excessive short-termist cost reduction to compensate for loss of revenue
- Insolvency of TOC (in context of many at risk)

How franchise review mechanism assists

- TOC has revenue risk - so cost reduction should be less severe (than that practiced by TOCs with revenue support in operation)
- Resetting franchise payments at 5 yearly review mitigates insolvency risk

How franchise review mechanism is applied

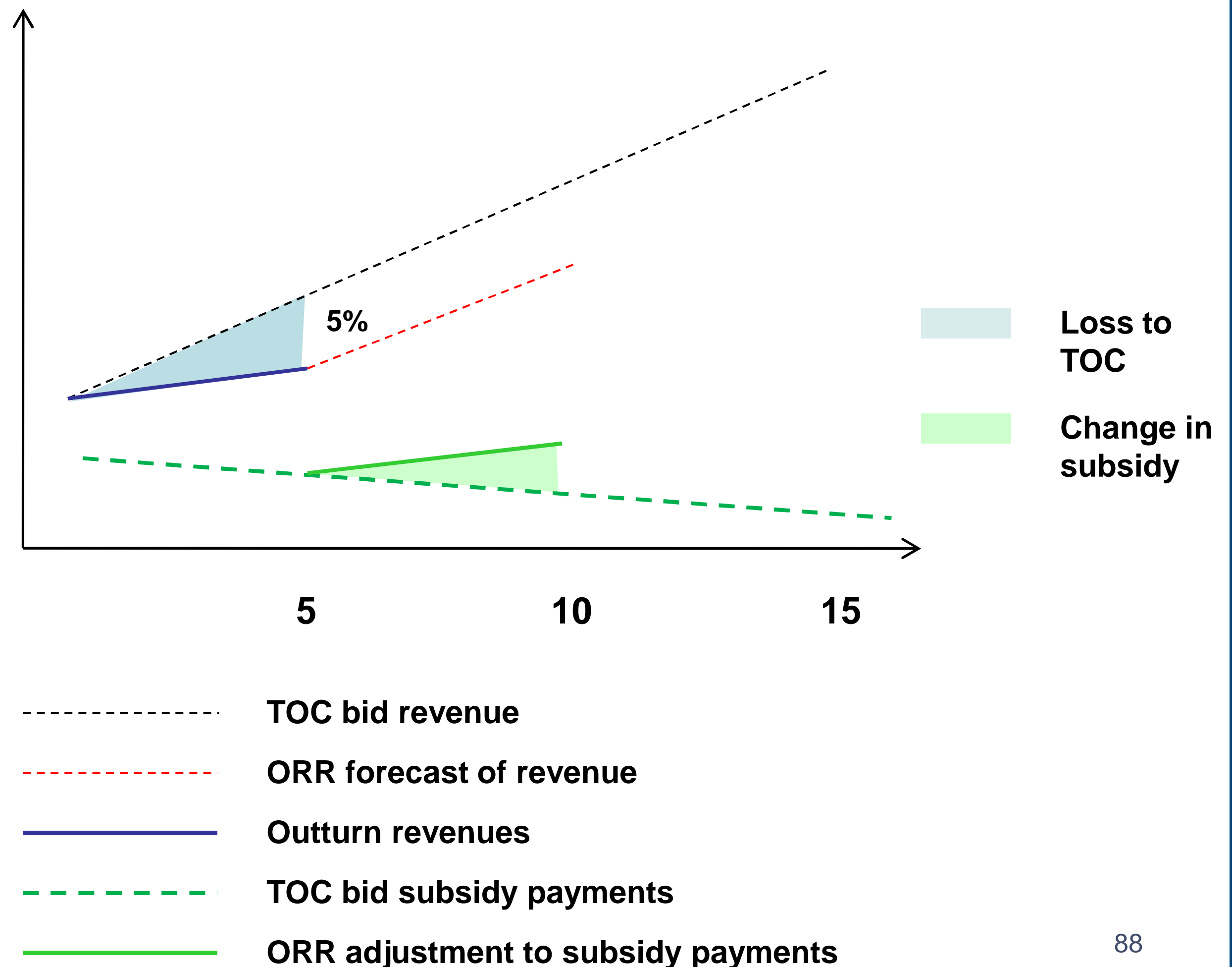
- ORR would adjust revenue for CLE, i.e. if base revenue was £100m, bid franchise payments would be increased by £5m (plus indexation/other growth factors) at year one of next review period.
- This requires the CLE assumption and the corresponding revenue elasticity to have been stated by the DfT in the bidding instructions, albeit bidders can assume what they like in their bids – the adjustment is based on the standard DfT assumption.
- Bidders therefore take all CLE risk for the first 5 year period and thereafter take risk on their deviation from the standard DfT assumption.

S1(a) A TOC bids revenue line X and at year 5 X minus 5% is achieved thanks to CLE growth being below expectations

No compensation to TOC for short-falls in revenues in year 1 to 5 (i.e. full revenue risk) due to CLE being below expectation in bid.

Revenue reset at end of year 5 (for effect of the CLE shortfalls) so franchise payments adjusted for shortfall for years 6 to 10, due to CLE. ORR to adjust revenues bid taking into account latest available information on CLE.

TOC is then at risk for revenue outturn in years 6 to 10.



S1(b) A TOC bids revenue line X and at year 5 X minus 5% is achieved but the cause is inadequate revenue performance relative to wider TOC community in equivalent sector

Risk

- Short-termist cost reduction to compensate for loss of revenue
- Insolvency of TOC

How franchise review mechanism assists

- TOC has revenue risk - so cost reduction should be less severe than that practiced by TOCs with revenue support in operation
- Ensures that risks of poor performance are retained by the TOC, with no compensation for under performance

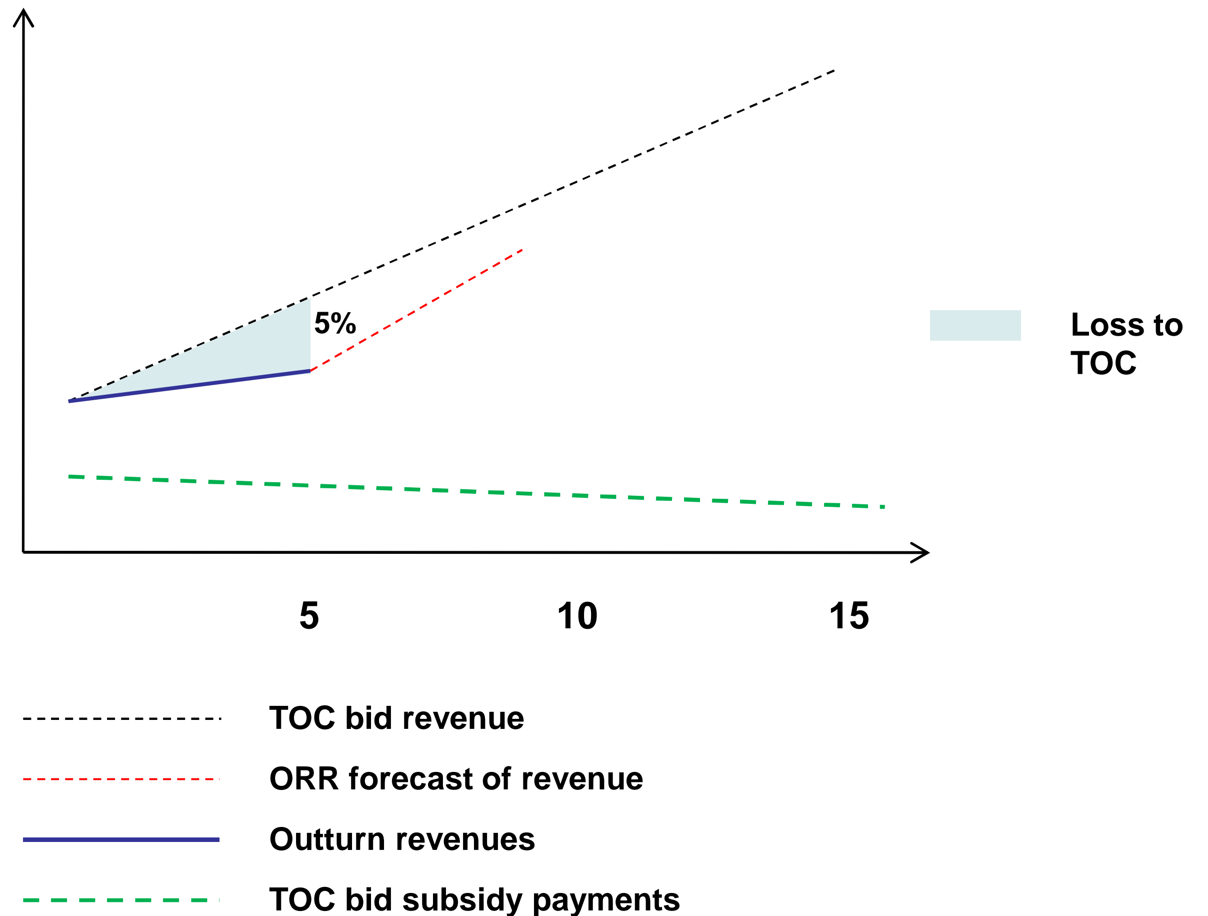
How franchise review mechanism is applied

- No adjustment to franchise payments
- Scenarios S1(a) and S1(b) could happen together and an adjustment would be made for S1(a) and not S1(b)
- Not clear whether the problem is the TOC being poor at revenue generation or the franchise being different from its comparators, but in either case the TOC has taken the risk based on information about the franchise

S1(b) A TOC bids revenue line X and at year 5 X minus 5% is achieved but the cause is inadequate revenue performance relative to wider TOC community in equivalent sector

No compensation to TOC for short-falls in revenues in year 1 to 5, as these are due to poor TOC performance.

No adjustment for short-fall in franchise payments in years 5-10, as performance short fall is controllable there would be no adjustment for performance in years 6 to 10.



S1(c) A TOC bids revenue line X and at year 5 X plus 5% is achieved thanks to CLE, but some costs of managing growth fall to TOC (e.g. Additional staff resources to deal with additional growth)

Risk

- Excessive overcrowding/cost of extra capacity not covered by extra revenue
- Windfall profit to TOC
- TOC cannot generate extra non-CLE revenue due to crowding so will suffer at periodic review

How franchise review mechanism assists

- TOC has an overcrowding metric - so TOC will be obliged to spend some of its extra revenue on mitigation (extra carriages, extra staff)
- Overcrowding metric needs to be constrained to mitigate risk to TOC (e.g. relief if growth is >x%)
- Windfall profit limited due to overcrowding metric
- TOC can propose timetable/service change to move resources from less crowded routes
- TOC able to adjust fares to redistribute demand
- Resetting franchise payments at 5 yearly review means effect of 3rd risk identified above (i.e. Windfall profit) is not an immediate problem as TOC keeps significant CLE- driven revenue without having to spend on marketing. ORR can allow for extra spending to boost capacity

How franchise review mechanism is applied

- ORR would adjust revenue for CLE, i.e. if base revenue was £100m, bid franchise payments would be decreased by £5m net of direct cost (plus indexation/other growth factors), less any allowance for cost of providing extra capacity consistent with “efficient TOC” cost, at year one of next review period, subject to HLOS / SOFA outcomes.

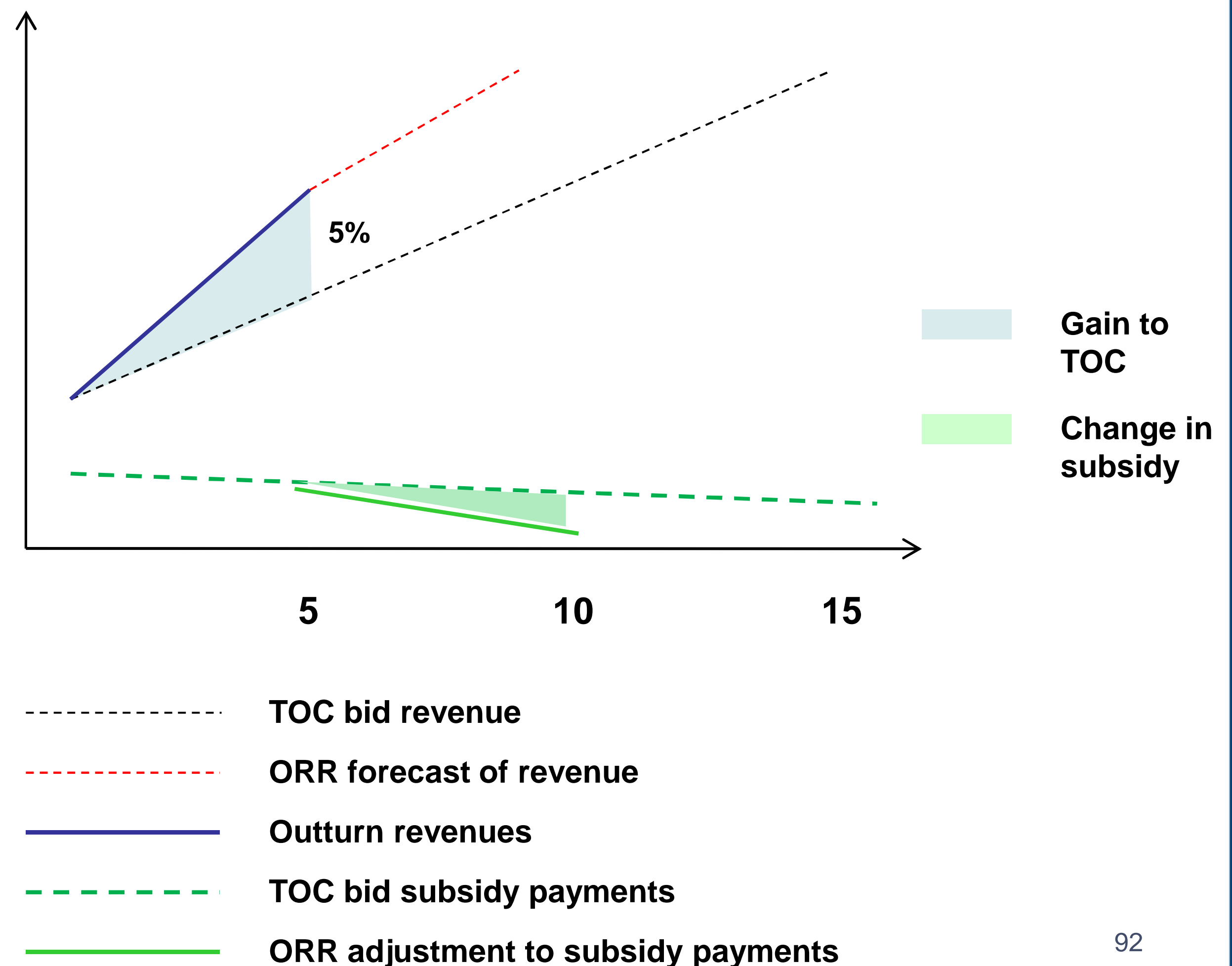
S1(c) A TOC bids revenue line X and at year 5 X plus 5% is achieved thanks to CLE, but some costs of managing growth fall to TOC (e.g. Additional staff resources to deal with additional growth)

TOC retains benefit of outperformance of revenue in years 1-5.

Revenue reset in year 5 (for effect of the CLE increase) and franchise payments adjusted for CLE for years 6 to 10. TOC is then at risk for performance in this period.

Costs of managing additional performance growth would be considered separately in ORR review of cost.

NB: Under scenario where TOC is struggling to manage growth, increases in fares may act as more efficient mechanism.



S1(d) A TOC bids revenue line X and at year 5 X plus 1% is achieved as a result of additional TOC- specified investment

Risk

- Limited or no investment made by TOC due to concerns regarding claw back at franchise review
- Loss of investment benefits of longer franchise
- Government required to take a greater role in decision making
- Sub-optimal revenue growth

How franchise review mechanism assists

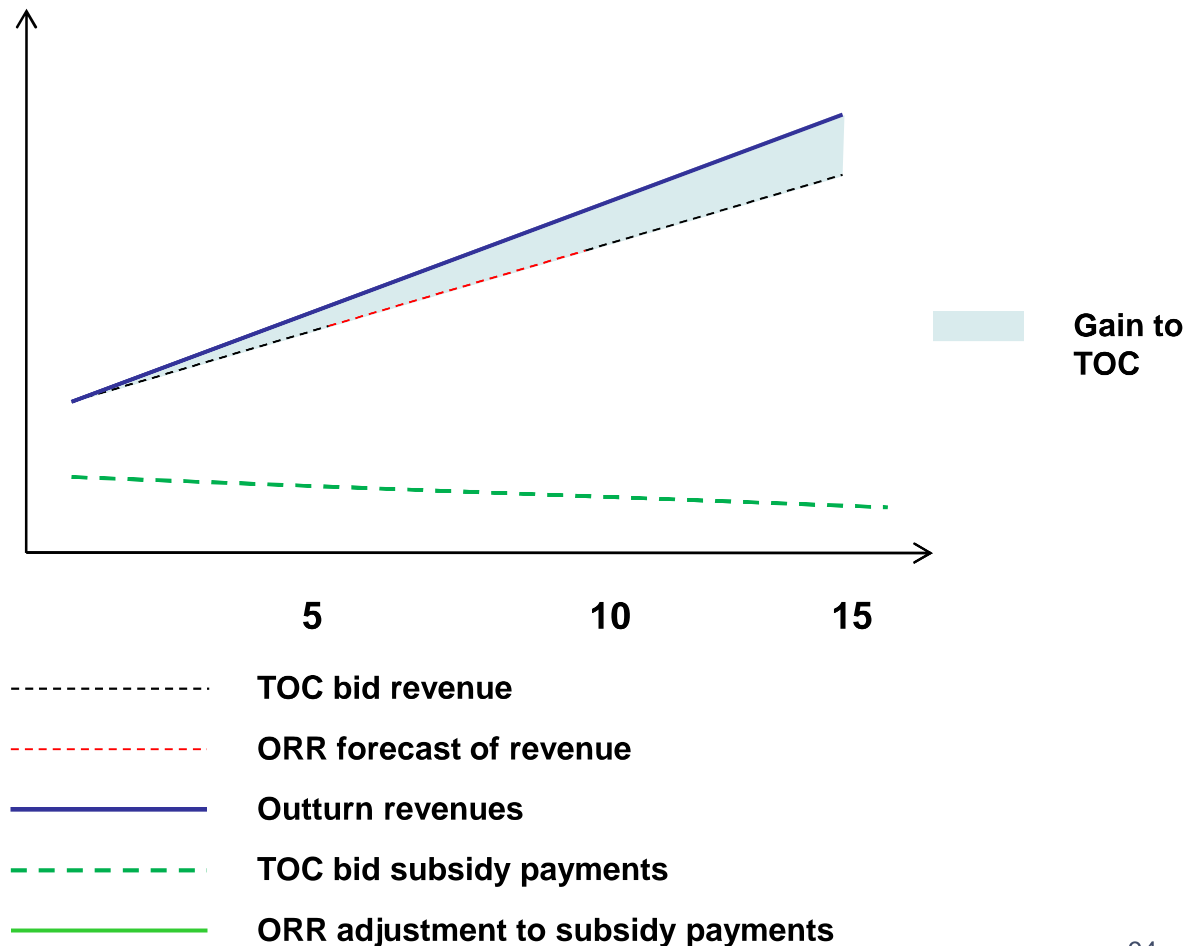
- ORR will be required to track franchise investments across review periods and ensure that the TOC receives all the benefit of such investments

How franchise review mechanism is applied

- ORR would only adjust franchise payments by revenue that is as a result of exogenous factors (CLE/GDP), such that investments are fully recognised i.e. if base revenue was £100m and the additional investment resulted in base revenue of £1m there would be no adjustment in franchise payments for the additional revenue.

S1(d) A TOC bids revenue line X and at year 5 X plus 1% is achieved as a result of additional TOC- specified investment

Principle of longer franchise is that TOC would retain benefits of outperformance due to its investments. Therefore ORR would not seek to capture additional revenue benefits across review periods where these can be attributed to a particular investment.



S2 Scenario analysis - Cost

a) A TOC bids cost line Y and at year 5 costs are 5% above the bid line due to poor TOC cost management
b) A TOC bids cost line Y and at year 5 costs are at Y ORR identifies further efficiency savings to be delivered in the next review period
c) A TOC bids cost line Y and at year 5 NR demands an increase in spending not contemplated in Y due to a change to standards (TOC perceives no value)
d) A TOC bids cost line Y and at year 5 NR demands an increase in spending not contemplated in Y due to a change in performance (say PPM or linespeed), marginal benefits to TOC, but not sought by TOC
e) A TOC bids cost line Y and makes an additional investment in year 3 that reduces its costs for the remainder of the franchise

S2(a) TOC bids cost line Y and at year 5 costs are 5% above the bid line due to poor TOC cost management

Risk

- TOC not achieving VfM objectives of franchising
- Request for additional funding
- Insolvency of TOC
- Longer term costs reduction targets franchise not met

How franchise review mechanism assists

- TOC is at risk for performance during years 1 to 5 and would not be compensated for ORR for any deviation from the cost bid line due to poor performance in delivering cost reductions.
- TOC costs reset at franchise review, with TOC set cost profile of an efficient TOC for next franchise period (i.e. TOC would be expected to achieve improved cost efficiency)
- Mechanism does not protect against insolvency but disclosure with ORR and availability of benchmark information should provide early warning to TOC that actions need to be taken.

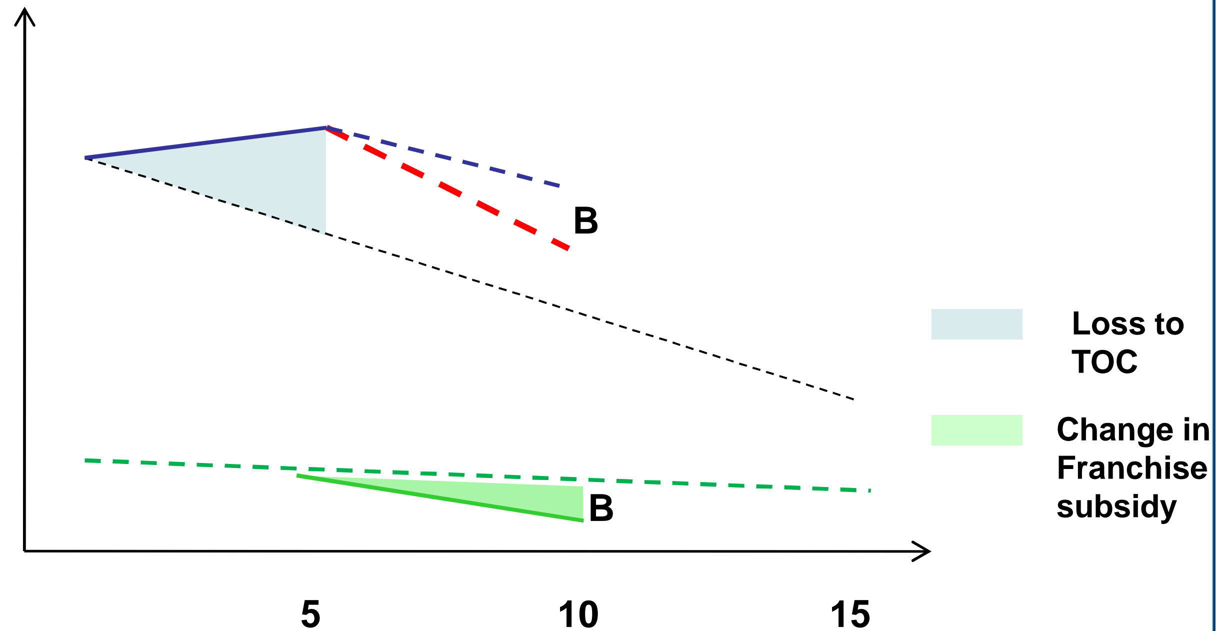
How franchise review mechanism is applied

- There would be no adjustment to franchise payments during years 1 to 5 – any losses to be borne by the franchisee
- ORR would assess the costs of an “efficient TOC” at the franchise review and the TOC would be on risk to deliver future cost savings consistent with the bid line and a degree of catch-up

S2(a) TOC bids cost line Y and at year 5 costs are 5% above the bid line due to poor TOC cost management

TOC remains responsible for all cost performance during the 5 years. After 5 years cost profile would be reset by ORR to reflect the costs of an “efficient TOC” in years 6 to 10 (which is likely to include a degree of catch-up), for which the TOC would be on risk for the delivery of costs.

ORR to revise franchise payments and reflect revised costs.



S2(b) A TOC bids cost line Y and at year 5 costs are at Y and ORR identifies further efficiency savings to be delivered in the next franchise review period

Risk

- TOC inaction due to good performance in years 1 – 5 limits efficiency savings in future periods
- Windfall gains to TOC
- Loss to government of potential efficiency savings not implemented by TOC

How franchise review mechanism assists

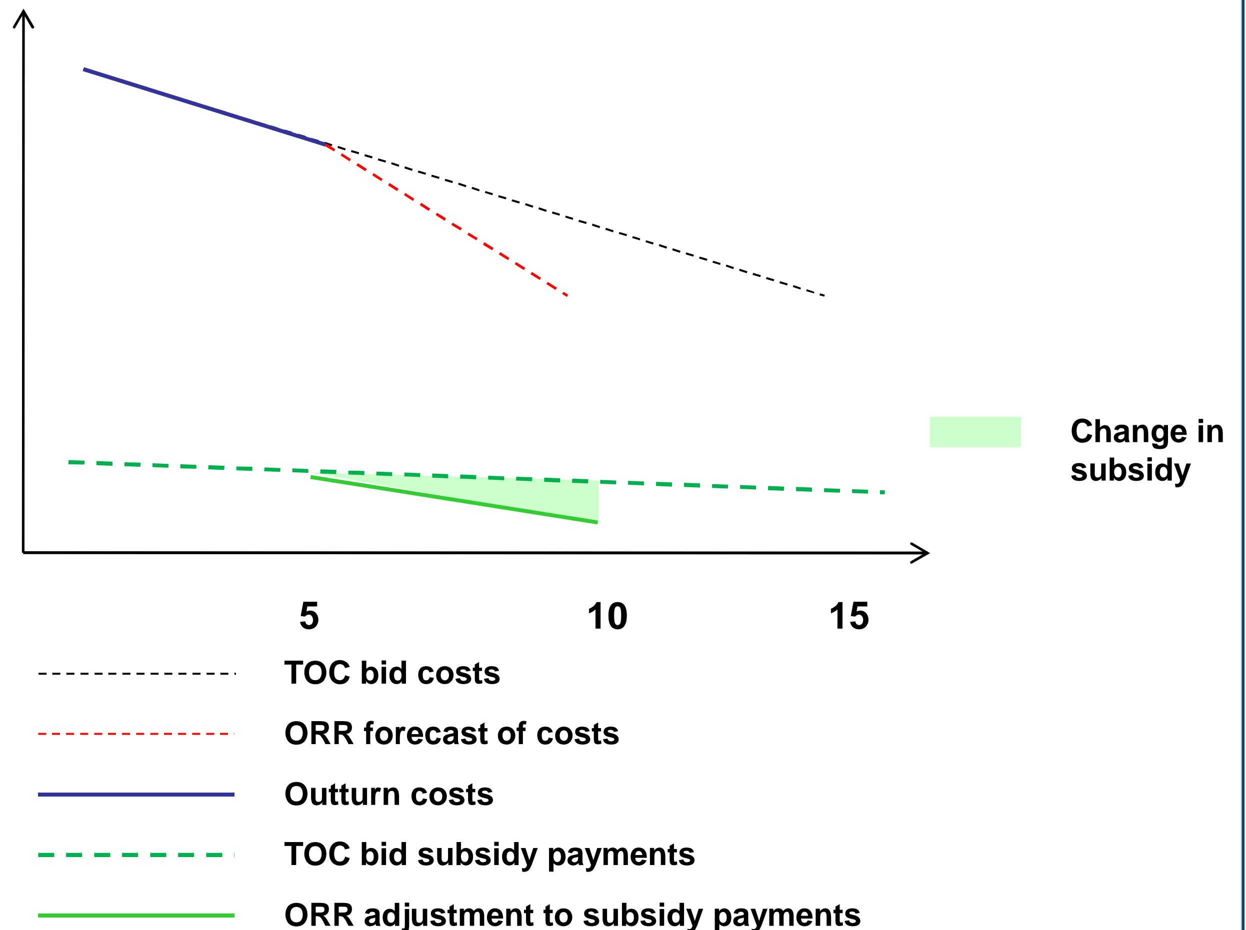
- TOCs are incentivised to deliver additional cost reductions during the 5 year period and are allowed to keep the gains from outperformance under the franchise review mechanism. N.B Where specific investment is made, to enable efficiency savings, the TOC would be allowed to retain the benefits beyond the review period – see S2(e).
- Franchise mechanism allows government to gain from efficiency improvements that were not identified at the bid stage (e.g. Technological developments) and could be implemented by the TOC to yield further cost reductions, whilst ensuring that the benefits of this are shared with government at the franchise reviews.
- In addition, the franchise review could also allow the government to capture additional value where it takes steps to enable the TOCs to deliver savings beyond those anticipated at the bid stage (e.g. unanticipated technological developments).

How franchise review mechanism is applied

- ORR would assess the costs of an "efficient TOC" taking into account available evidence (e.g. mechanisms successfully introduced by other TOC benchmarking) include these efficiencies in forecasts of costs for years 6-10 and adjustment to franchise payments as necessary.

S2(b) A TOC bids cost line Y and at year 5 costs are at Y and ORR identifies further efficiency savings to be delivered in the next franchise review period

If ORR identified further savings in year 6-10 (e.g. through the identification of generally available efficiency opportunity that had been implemented by comparator TOC) as part of its review of an “efficient TOC”, it would include these it its forecast of TOC costs and franchise payments. TOC would then be required to deliver against the revised cost line.



S2(c) A TOC bids cost line Y and at year 5 NR demands an increase in spending not contemplated in Y due to a change to standards (TOC perceives no value)

Risk

- TOC cannot absorb cost and goes insolvent
- TOC bidder risk premium is too high due to this type of risk
- NR cannot absorb cost if no increase in its regulated revenue
- Change in standards gives no benefit to anyone

How franchise review mechanism assists

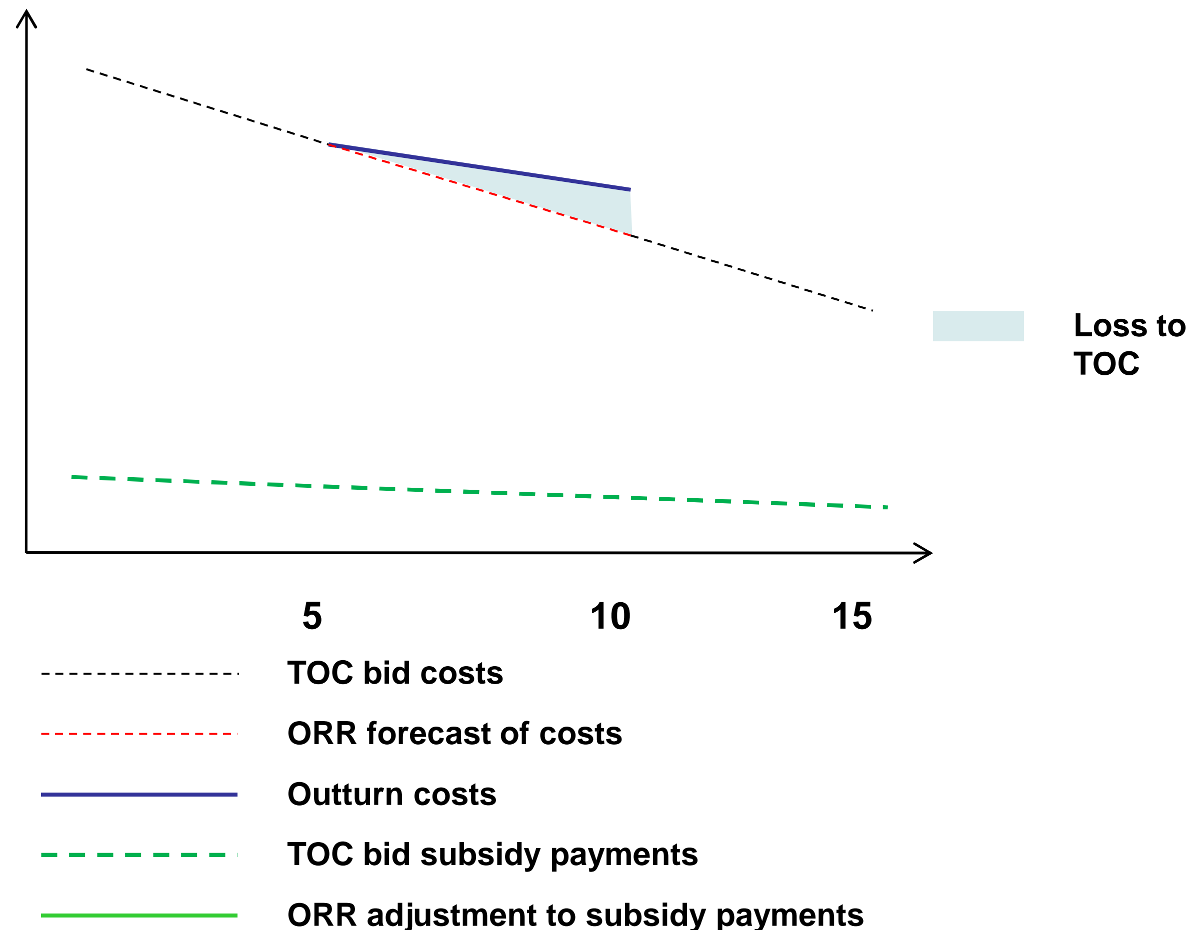
- ORR decides at 5 year review whether cost should be borne by TOC and reflected in a change to franchise payments or absorbed by NR (which may be partly a function of how effective NR has been in mitigating the cost increase). The cost has to be borne by someone! ORR can require NR to borrow to fund cost increase until next review.
- TOC bears part of the risk of efficient NR charges – reflecting ability of TOC to fund and manage business risks over the life of a longer franchise.

How franchise review mechanism is applied

- This is simply an industry risk of which the TOC must bear its fair share, just as other industries bear H&S compliance risk. TOC therefore has incentive to help NR reduce this cost and justifiably has risk of insolvency if it cannot bear the cost – will include risk premium in bid. Competition should limit the risk premium as long as adequate information available.
- An additional mechanism may be required to ensure coordination across TOCs for such a change, which limits the ability of a TOC to challenge the investment, when it is regarded as necessary for the industry.

S2(c) A TOC bids cost line Y and at year 5 NR demands an increase in spending not contemplated in Y due to a change to standards (TOC perceives no value)

This scenario would depend to on application of mechanism C2 (removal on NNLNNG protection for NR access charges). If TOCs had no protection then there would be no adjustment to the TOC cost line i.e. the TOC would not be compensated and would need to absorb any additional efficient NR charges.



S2(d) A TOC bids cost line Y and at year 5 NR demands an increase in spending not contemplated in Y due to a change in performance (say PPM or linespeed), marginal benefits to TOC, but not sought by TOC

Risk

- TOC cannot absorb cost and goes insolvent
- TOC bidder risk premium is too high
- NR cannot absorb cost if no increase in its regulated revenue
- Improvement gives minimal actual benefit to passengers
- Other TOCs can free ride on investment

How franchise review mechanism assists

- NR should only deliver linespeed/PPM improvement requested by DfT based on a business case – not make unilateral decisions
- ORR decides at 5 year review whether cost should be reflected in revenue (grant or charges) or absorbed by NR (which may be partly a function of how effective NR has been in mitigating the cost increase). The cost has to be borne by someone! ORR can require NR to borrow to fund cost increase until next review.
- TOC should contribute to cost of improved performance outputs – this would be a franchise specific decision as an inter-city TOC might be able to gain commercial benefit whereas a regional TOC might not. This could probably be a commercial discussion before cost could also be allocated by ORR as part of the 5 year review.
- TOC would be involved in Review and would need to develop plans to utilise improved output and this would inform ORR decision.

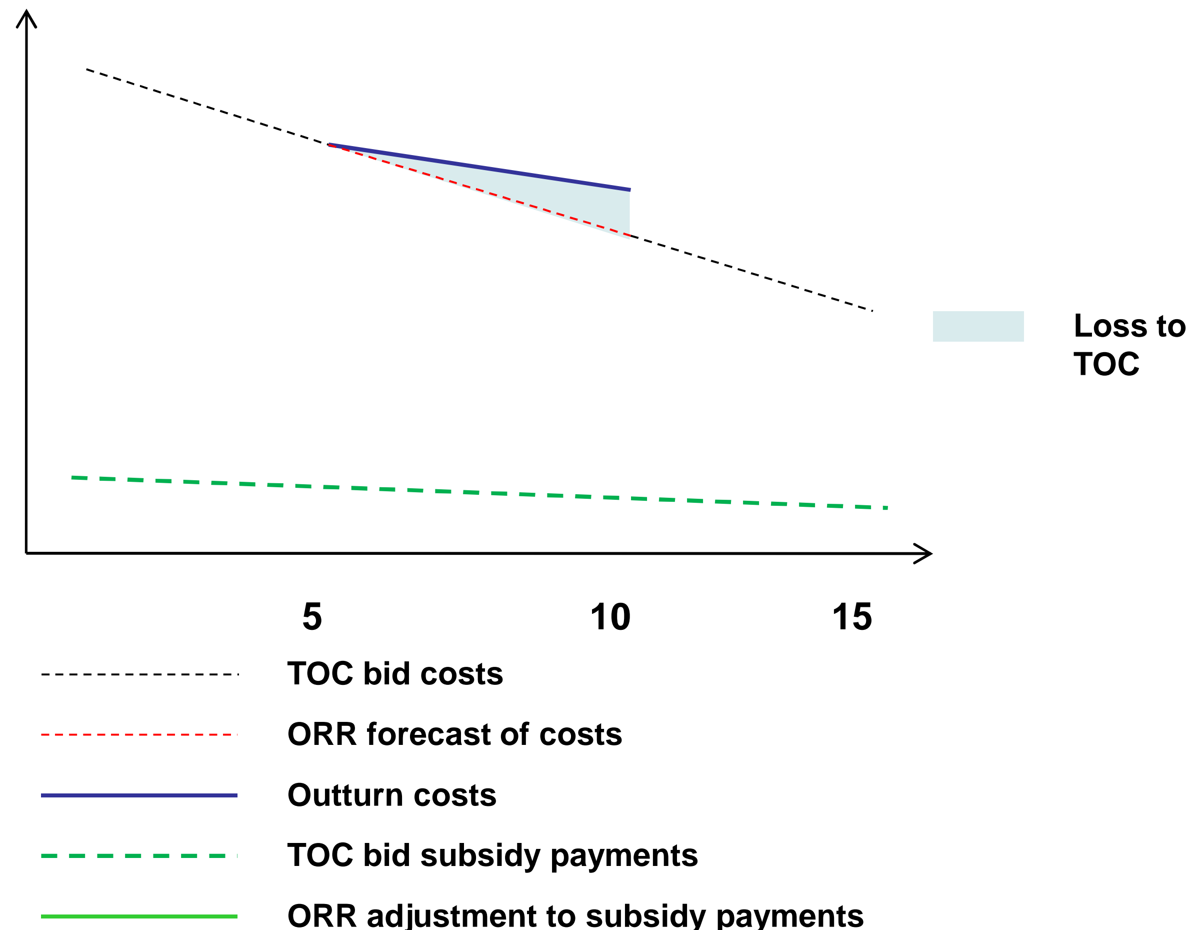
How franchise review mechanism is applied

- If cost of improvement was £5m pa, TOC would bear a proportion, which could be paid for by forecast incremental revenue net of operating costs and profit margin, determined by ORR.

S2(d) A TOC bids cost line Y and at year 5 NR demands an increase in spending not contemplated in Y due to a change in performance (say PPM or linespeed), marginal benefits to TOC, but not sought by TOC

Application of this scenario would depend to on application of mechanism C2 (removal on NNLNNG protection for NR access charges). If TOCs had no protection then there would be no adjustment to the cost line i.e. the TOC would not be compensated and would need to absorb any additional efficient NR charges for the benefits they obtain from the NR investment.

N.B. – ORR may also reflect the benefits to the TOC in its revenue forecasts.



S2(e) A TOC bids cost line Y and makes an additional investment in year 3 that reduces its costs for the remainder of the franchise

Risk

- Limited or no investment made by TOC due to concerns regarding claw back at franchise review
- Loss of investment benefits of longer franchise
- Government required to take a greater role in decision making
- Sub-optimal revenue growth

How franchise review mechanism assists

- The franchise review mechanism will recognise and protect investments that a TOC makes during the franchise and ensure that the benefits to the TOC of this investment are not clawed back at franchise reviews.
- The ORR will not make adjustments to franchise payments for investments which give costs reductions that are in addition to the bid line.

How franchise review mechanism is applied

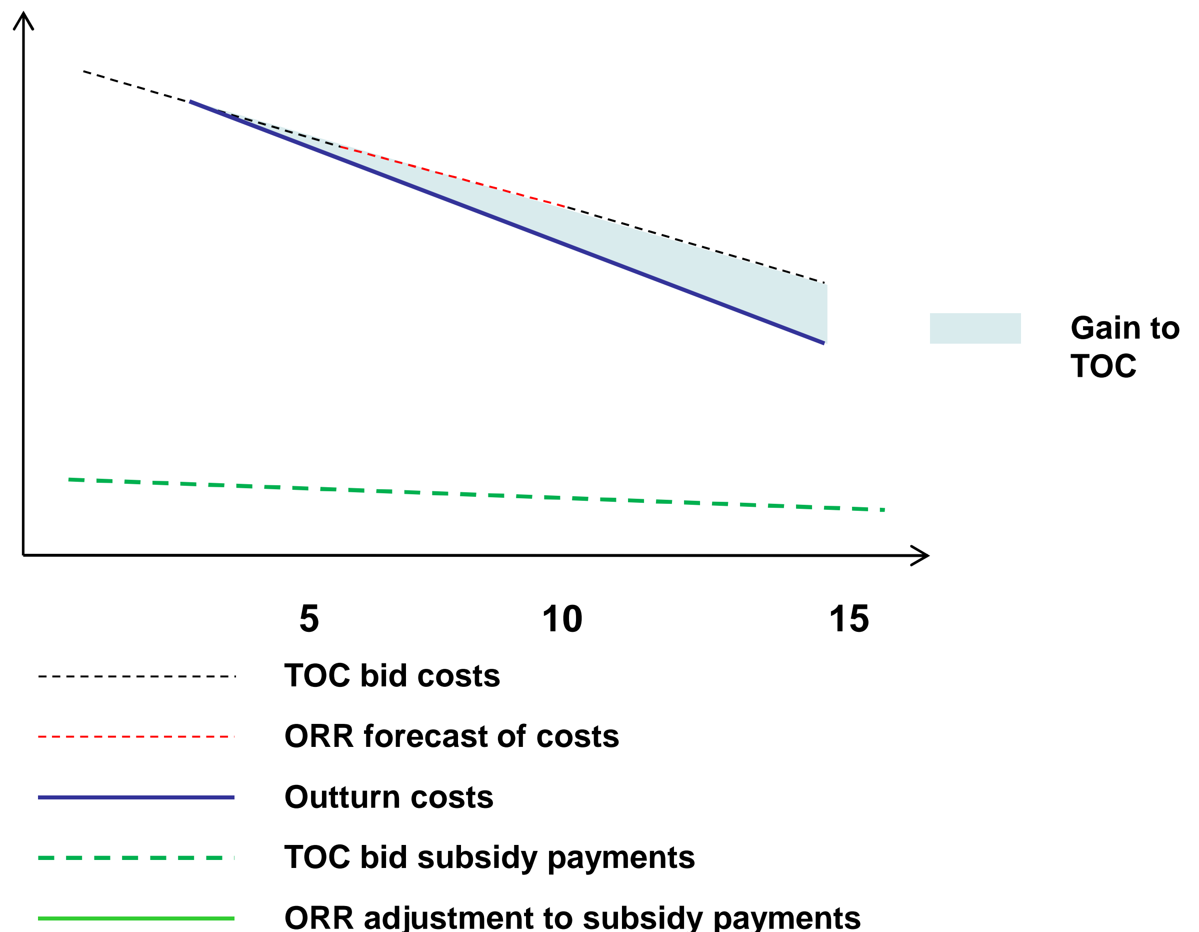
- ORR would not adjust its forecast of costs where the TOC has made an identified investment that will reduce costs. The TOC would keep the benefits of such investments throughout the life of the franchise.

S2(e) A TOC bids cost line Y and makes an additional investment in year 3 that reduces its costs for the remainder of the franchise

Assuming the additional investment was not included in the TOC bid line. i.e. the TOC took an initiative which does not change ORR's view of efficient costs.

This reflects a key principle that the TOC should retain the benefit of its investments across franchise reviews. i.e. TOC should keep benefits of investments in cost saving measures not in its bid which need to pay back over longer than a review period.

N.B. Approach is consistent with similar scenario for revenue - S1(d).



S3 Scenarios - Outputs

a) The DfT decides at the 5 year review that it would like to increase the number of lifts at stations, the revenue benefits to TOCs are there but are marginal and don't generate a business case

b) ORR notices that TOC A has failed to deliver passenger volumes to the levels in the contract; what happens next and who benefits from the enforcement

S3(a) The DfT decides at the 5 year review that it would like to increase the number of lifts at stations, the revenue benefits to TOCs are there but are marginal and don't generate a business case

Risk

- Cost overruns comes to government
- Delivery of required specification
- Realisation of accessibility benefits

How franchise review mechanism assists

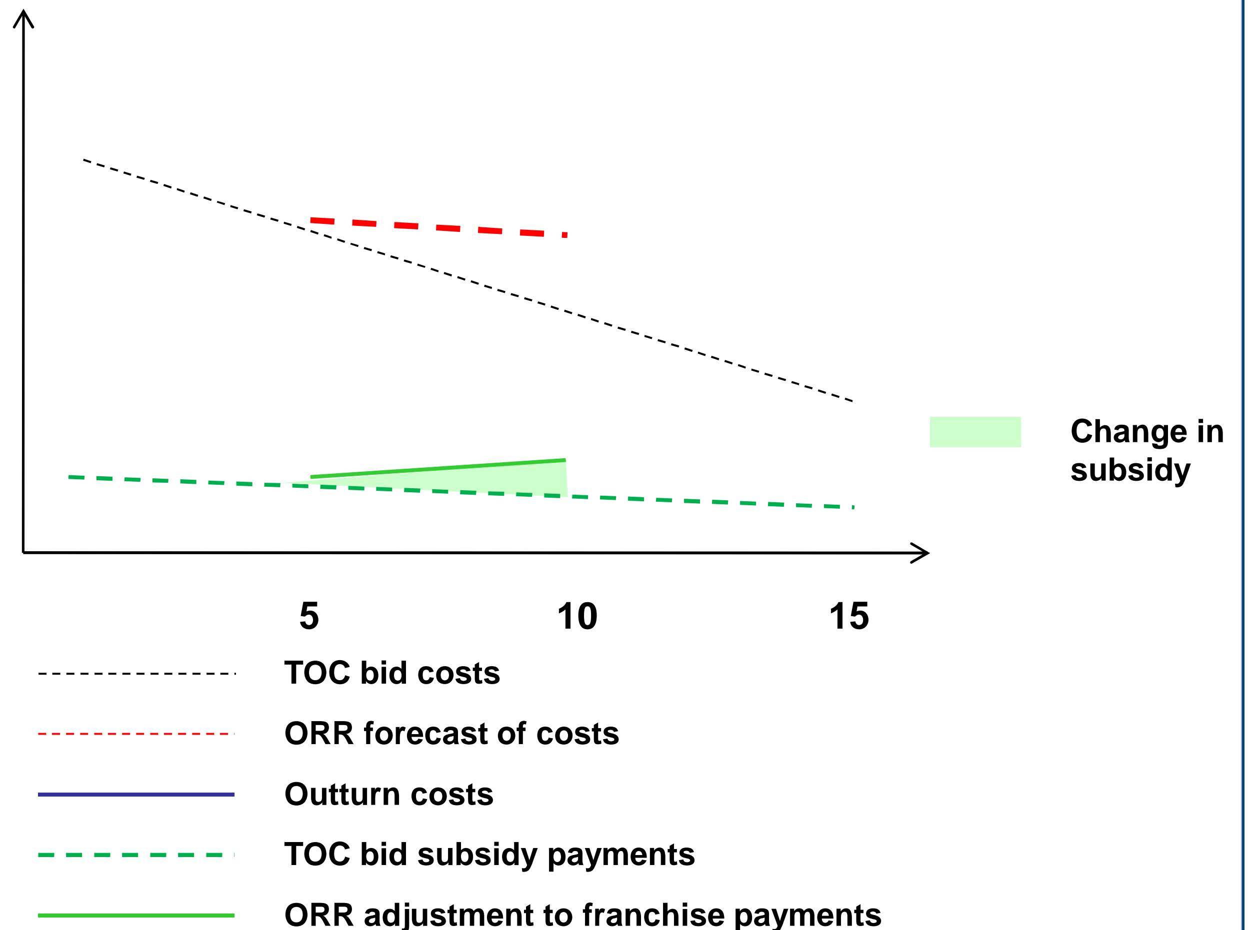
- Specification in output terms by DfT at 5 yearly review – priced by ORR based on submission by TOC and other data (e.g. previous similar projects by TOC or others). N.B. This assumes that DfT did not include in specification in output terms by DfT at franchise bid to be priced competitively by bidders, or waits until the next franchise competition to implement the change.
- Same approach would also apply where DfT wants to add services that would not be competitively provided by TOC.

How franchise review mechanism is applied

- DfT specified outputs priced by ORR and adjustment made to franchise payments

S3(a) The DfT decides at the 5 year review that it would like to increase the number of lifts at stations, the revenue benefits to TOCs are there but are marginal and don't generate a business case

ORR would forecast the additional costs arising as a result of the investment required by government and adjust the franchise payments accordingly.



S3(b) ORR notices that TOC A has failed to deliver passenger volumes to the levels in the contract; what happens next and who benefits from the enforcement

Risk

- Government is not getting the outputs it has paid for and is achieving poor VfM
- Windfall gains to TOC

How franchise review mechanism assists

- Regulatory review mechanism is not applicable and franchisee will be require application of contractual mechanisms by government – this could be at a franchise review or during the operation of the franchise

How franchise review mechanism is applied

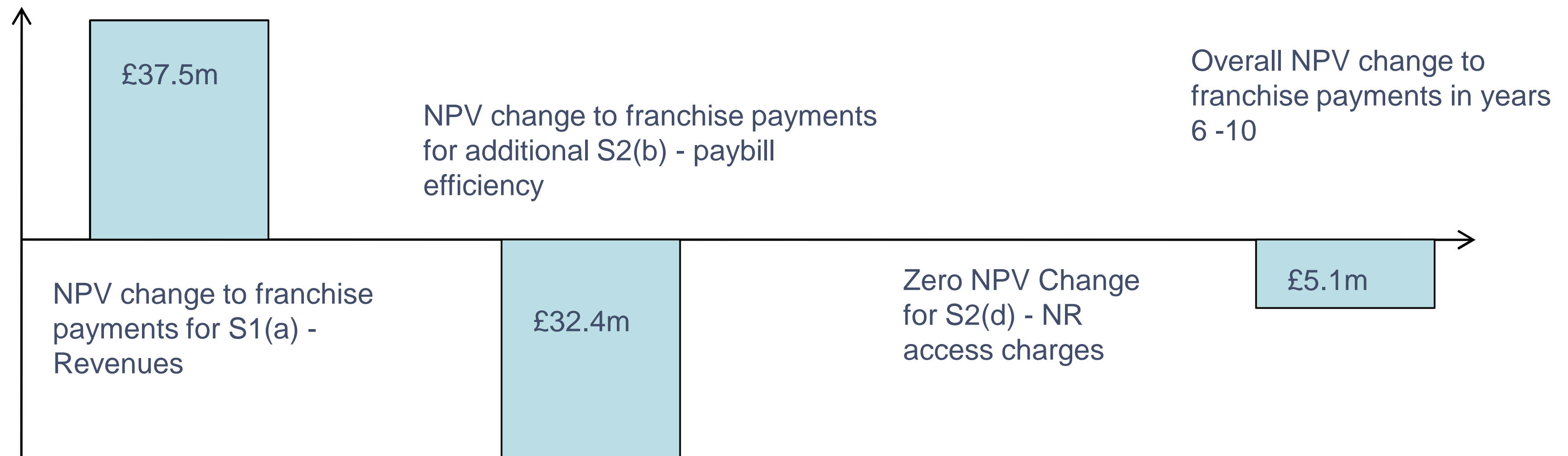
- ORR will monitor the franchise and inform the DfT if and how the TOC is in breach of the contract, with DfT to enforce the contract based on the provisions for breach and termination.

S4 Combined scenario analysis

- To understand the implications of several scenarios happening at once we have looked at the effects of three scenarios on the illustrative modelling for GA covering:
  - S1(a) where it is assumed the GA revenue line of minus 5% is achieved at year 5 thanks to CLE growth being below expectations. At the franchise review ORR assesses that over the next review period only 97.5% of the forecast revenue will be achieved.
  - S2(b) where it is assumed that and after 5 years GA's paybill costs are 5% below the bid line due to TOC management action. At the franchise review ORR identified further paybill efficiency savings (based on a review of comparator TOCs) in the next franchise review period of 5% beyond the bid line
  - S2(d) where it is assumed that GA's access charges are increased by 1% at year 5. At the franchise review the ORR assumes that access charges are as per bid line (i.e. ORR does not adjust franchise payments to reflect the higher NR charges as they represent efficient NR charges and the TOC remains at risk for these)
- The following slides present the impact on of the franchise review on franchise payments in years 6 to 10 of an illustrative GA TOC.

Illustration of combined scenario analysis on franchise payments for years 6-10

The diagram below shows the impact of the franchise review on franchise payments over years 6 – 10 of the franchise. Under the scenarios modelled, the fall in franchise payments due to additional payments reflecting the shortfall in CLE, is largely offset by the further reductions in franchise costs. Despite changes to access charges there would be no change in franchise payments.



NPV changes are the NPV at year 6 for the franchise payments over years 6-10

Appendix 2: Assumptions for unconstrained TOC

Appendix 2: Assumptions for unconstrained TOC

Purpose

- The workshop was undertaken to identify the likely executive actions to improve the value-for-money performance of a TOC in an unconstrained environment, in order to identify the constraints upon such action and the required mechanisms (particularly relating to the franchise agreement) to be able to undertake them. We recognise that the "unconstrained TOC" would not be a desirable animal but it was necessary to analyse it in order to identify the mechanisms which would enable its desirable features (e.g. focus on cost reduction) to be replicated in a constrained TOC.

Assumptions

- The timetable outputs will be broadly as now
- The TOC will seek to stay in business and secure profit for shareholders
- The value of farebox revenue improvement was neutralised for the purposes of this analysis so as to focus on cost and other revenue sources
- Actions shall be consistent with the McNulty Interim Report themes; e.g.:
  - Less control by government,
  - More incentives to TOCs (a higher cost of doing nothing)
  - Higher responsibility for property
  - Risk sharing with NR and (therefore no opportunity to pass on costs, and some opportunity to share in the task of their reduction)

Unconstrained TOC – Method and approach

Method

- A Shadow TOC board was brought together comprising former TOC Managers including a managing director, Commercial Director, Senior Traincrew Manager, Station and Operations Managers with PwC providing the role of Financial Director. All members have franchise bidding experience as well.
- Using the Greater Anglia draft long form report as a base, Value for Money improvement actions were brainstormed in the manner of a TOC business planning session with all features of the business considered (with specific issues recorded)
- Target savings (as a percentage of current costs) were identified. Where operating costs were identified with making the saving or mitigating costs/risk associated with the saving then these were added back.
- Each saving and action was then considered in the context of current franchise contracts and notes made in relation to the change to existing industry contracts shown.
- There are no savings shown for reduced cost of capital, reduced profit margin etc. which are discussed elsewhere. No analysis of revenues (fare or other) was undertaken as part of this exercise.
- This assumes a 15 year franchise starting in April 2010, building on a base of the long form report numbers for 2009-10.
- All reductions in cost are real terms reductions and there is no analysis of GA revenues

Base case

- No real terms increases in staff numbers
- Wages increase 1% above AEI
- All other costs: no real increases

Unconstrained TOC – Management Actions (1)

Management Structure and Reward

- The modelled assumption is that reductions of between 11% and 33% are achieved in the management and HQ staffing levels depending on role. Whilst there is opportunity to achieve such an outcome now, there was a strong presumption in favour of reward consistent with wider-market norms i.e. lower basic salaries, stronger incentives to out performance and higher risks to non-performance**.**

Safety, Quality, and Environmental Management Systems

- To reduce burden upon management (and hence supporting fewer staff numbers, and other costs) there is a commitment to reduced prescription (standards etc.) in the Franchise Agreement and associated documents..

PR, Communications (including Internal Communications)

- There is no further reduction in these areas for GA but some opportunity in other franchises

Training and Development

- Some training is undertaken by employees in advance and other training costs may be clawed back for non-completion of a basic term of employment. The benefits of this approach are then modelled in wider productivity assumptions, to avoid double counting.

Pensions

- The assumption is that employer/employee pension contribution increases (and benefits underpinned by these contributions) are unaffordable in the future. Therefore contributions are capped and benefits reduced or employees switch their contribution into defined benefits schemes

Access Agreements and Charges

- The future will see reduced electricity for traction (*EC4T)* and *VTU* charges as TOC respond to the structural incentives in these rates and, subject to more risk sharing with NR *Fixed charge* reductions as downward pressure bought on NR costs and redundant assets***.***

Environmental Management

- Significant non EC4T electricity savings in line with best practice

Unconstrained TOC – Management Actions (2)

Industry Costs

- There will be reduced ATOC expenditure and some further efficiencies from BTP

Station Staff, Ticket Sales, Security and Revenue protection

- Continued trend towards more technology (e.g. Customer information, CCTV/Gates/ticket vending machines etc.) will provide significant staff saving opportunities whilst retaining core staff at key locations

Station Asset Management including Enhancements

- Significant savings by localised and targeted contracting using asset/budget transfer from NR.

Call Centres, Customer Service Management

- Further benefits from the long term trend away from call centres to internet self-service

Fleet Leasing Costs; Fleet Improvement programmes and Mid-life refurbishment

- Some general assumptions are made in relation to a more liquid rolling stock market

Fleet Maintenance, Depot staffing and Supply chain

- More flexible working arrangements (with higher hourly wage rates) will underpin reductions in quantum of staff. Further benefits in spares contract costs as replacement better tailored to actual need (identified via diagnostics)

Train Presentation

- Assumption that all out-sourced except general supervision

Train Planning (Short/long term); Control, Service Recovery and Performance Management

- We anticipate continued improvements – and small savings - as seen on previous integration schemes. Staff numbers shrunk back to reflect all time performance high, and more relevant role of revenue sharing in NR incentives.

Traincrew rostering, terms and conditions, spare cover, including engineering costs

- General levels of productivity up across traincrew include – in this case – some marginal increments to driver only operation (DOO) network. In other franchises this may be more significant

General

- Salaries to run at AEI only for the period of the franchise

Appendix 3: Analysis of key franchise specification issues

Analysis of key franchise specification issues (1)

In this section we set out some of the key franchise specification issues that DfT commonly faces when specify franchises and how the proposed mechanisms under A1 would address these issues.

Issue 1: performance levels in certain areas is deemed important and fears exist in public mind (and hence government's) that provision will reduce to de minimis levels through new franchising management arrangements for managing franchises.

- Examples of these issues might comprise:
  - *'trains – crowding'*
  - *'information provision and during disruption*
  - *'poor punctuality'*
  - *'ticket office opening hours – and closures'*
  - *'ticket office queues / purchasing times etc'*
  - *'service changes; reductions in service'*
  - *'service changes that impact on particular journey (e.g. school trips or key journeys at key times) or individual stations especially when large in a % term (i.e. removing direct connections etc)'*
  - *'trains – changes, cleanliness and wrong type (i.e. changes to seat layout etc)*
- These issues would be managed by the general approach (recommendations A1 and A2) of starting with the current specification and allowing changes which improved overall value for money within certain upper and lower bounds. Also, no particular group could be deemed to have been harmed unduly without reasonable mitigation. The upper and lower limits of change would be a specified each five years as part of the HLOS-style review, with government setting the limits of change.
- Our key proposal is not to make it easy to worsen these things but to allow flexibility to vary/adapt/improve without needing a negotiation and also to allow the TOC to keep the profit generated by improvements whilst remaining on risk for any losses

Analysis of key franchise specification issues (2)

Issue 2: Stations are important to people's perception of the railway and may be subject to destructive cost-cutting where not underpinned by output specifications

- The requirements to perform general upkeep and maintenance should be managed through lease obligations as with any retail property. Improvements to stations which might not pay for themselves should be dealt with through the social fund proposal (recommendation A8) or through the HLOS process and five-yearly reviews (scenario 3(a) of the Franchise Review Process). Day to day issues such as cleaning standards can be covered by the approach in issue 1 above.
- Our general recommendations for stations are covered in E1 and E2.

Issue 3: Car parks are the first place many passengers come into contact with the railways. How can car park performance and capacity outcomes be protected from a profit seeking TOC?

- Parking charges are not currently regulated or heavily specified so no change is proposed. Some car drivers can easily switch to driving their whole journey so there is downward pressure on charges as the TOC does not want to lose the revenue from the fare.
- The TOC needs to be incentivised to create new capacity (e.g. by decking) where possible. Regulating charges would exacerbate capacity issues. There might be a case for regulation where there is no scope for increasing capacity (to prevent abuse of a monopoly) but the general issues of parking capacity in a town should be dealt with by local authorities not DfT – it is the local authority's role to plan for sufficient parking capacity and if charges are high this would help to bring other land into use for parking. Car parking standards (e.g. signage) could be dealt with as in issue 1 above.

Analysis of key franchise specification issues (3)

Issue 4: proper integration of rail with other modes has long been the aspiration of central and local government. How is this achieved in an outcome specified franchise

- Integration is a good example of an area where growing revenue based on improved service quality involves getting lots of small things right - a longer franchise makes it viable for the TOC to invest extra management time in such issues. Other aspects of integration such as provision of information might be covered by the approach in 1 above. Improvements which are not commercial or might require significant capital funding might be covered by recommendation A8.
- With a longer and more stable franchise, it is expected that a good management team would see investment in a broader integrated service offer as a commercial proposition. This might be the case for issues which require management effort but not much cash cost, such as co-ordination of timetables with buses – the payback on the management effort will last longer.

Issue 5: Key to delivering outcomes such as integration requires that there is engagement with stakeholders, an activity that is potentially time-consuming and therefore given low priority by TOCs

- We believe that engagement with stakeholder management will – as with integration – be more attractive to a longer franchise where TOCs get more benefit from proactive engagement. They will, for example, be more likely to be able to raise funds from local authorities – and they will naturally be able to build more effective relationships.
- Specification in this area should be kept to a minimum and possibly focus on facilitating co-ordination between NR and TOCs on a consistent basis in the first instance. Potentially TOCs could be bound by a Part C licence condition as NR (Dealing with Third Parties)

Analysis of key franchise specification issues (4)

Issue 6: Security is a major issue for certain passenger groups who may not – in aggregate and with their travel patterns – provide enough revenue incentive to cause a TOC to improve its performance in this area

- Security is currently managed through a secure station accreditation process with franchise agreements requiring a percentage of passengers to be covered by accredited stations. There are incentivises to improve security through passenger numbers (revenue) and potentially through a passenger satisfaction score (measured by NPS e.g.).
- On a commuter/regional franchise with lots of stations, these incentives might be inadequate to give a payback on the required investment so security may need to be treated as in Recommendation A8. However, given the importance of this issue to passengers, it might be appropriate to develop an output measure based on crime levels and possibly also fear of crime.
- There should be sufficient data available to calibrate a performance payment/deduction to a TOC which would provide adequate incentive to invest in staff/equipment or even in time spent managing relationships with BTP/local police/authorities.

Issue 7: Environmental issues are important to government and customers alike, but do not easily form part of a customer service proposition

- DfT has used output specification for the South Central franchise and we believe this approach could be further developed upon. At the very least this areas should be covered the same way as issue 1 above

Issue 8: Accessibility

- This area is widely covered by Legislation and Codes of Practice and operates effectively. Significant improvements beyond those envisaged in the Act can be secured through recommendation A8 as it is inherently social.

Issue 9: Network benefits such as provision of an ITSO Smartcard have traditionally been managed by DfT on behalf of the industry. How would these be managed in the future?

- We believe specifications should be output/outcome based. In the case of Smartcards, we believe a longer franchise with full revenue risk and the ability to keep the return on its investments would provide an incentive to invest in the appropriate forms of ticketing whether smartcards, mobile phone or others. The chief stumbling block with smartcards seems to have been integration between TfL and ITSO not a lack of appetite by operators to invest. The industry leadership workstream is addressing why a mature industry cannot achieve such outcomes in a coordinated manner for itself.

Appendix 4: Upfront payments illustration

Upfront payments illustration

- The illustration presented below assumes total franchise payments over a 15 year franchise of £75m real. Time value of money and return on investment are ignored for simplicity though the analysis would be robust if they were included.
- In Bid A, the TOC bids £30m of the £75m upfront and in Bid B there is no upfront payment. Net book value of franchise assets would be additional to this but has been ignored as the same in both bids.
- In the downside scenario, passenger revenue falls illustratively by 10% p.a. compared with the bid assumptions. In Bid A, with upfront payments, DfT is effectively held harmless and there is a strong incentive on the TOC to return to greater profitability to recoup its investment.
- In Bid B, in the same downside scenario, with no upfront payment – DfT may have to draw on the parent company guarantee. There is also a greater risk the TOC would wish to negotiate an exit to minimise the claim on its guarantee (which may be less than the full amount of franchise payments due)
- If revenue support applied, then franchise payments would be reduced for both Bids in the downside but our proposal is to not have revenue support – the review and upfront payments are an alternative way of improving robustness.
- At the 5 year review, the franchise payments would be increased to the extent that the revenue fall was due to exogenous factors. This gives the TOC an incentive to accept the losses in either case and to continue managing for the long term as it has the prospect of a return to profit. Without a review, either TOC would be incentivised to negotiate an exit or rescue. The review therefore supports the concept of upfront payment as the risk faced by the owning groups is (upside and downside) lower.
- It is possible that the upfront scenario would have led to a more prudent bid and therefore less money for DfT but any reduction would be bringing the bid closer to reality so the outturn should be no worse than without upfront payments. The review also has the effect of mitigating any excess of caution by bidders (as does the inherent competition in the bid process).

Upfront payments illustration – Bid A with upfront payments Bid B no upfront payments

Franchise bids

Bid A	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
Revenue	1125	0	75	75	75	75	75	75	75	75	75	75	75	75	75	75	75
Costs	975	0	65	65	65	65	65	65	65	65	65	65	65	65	65	65	65
Franchise payment	75	30	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3
TOC profit	75	-30	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7

Bid B	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
Revenue	1125	0	75	75	75	75	75	75	75	75	75	75	75	75	75	75	75
Costs	975	0	65	65	65	65	65	65	65	65	65	65	65	65	65	65	65
Franchise payment	75	0	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
TOC profit	75	0	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5

Downside Scenario – first 5 years

With upfront payment

	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		0	68	68	68	68	68
Costs		0	65	65	65	65	65
Franchise payments		30	3	3	3	3	3
TOC profit	-30	-30	0	0	0	0	0

Without upfront payment

	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		0	68	68	68	68	68
Costs		0	65	65	65	65	65
Franchise payments		0	5	5	5	5	5
TOC profit	-10	0	-2	-2	-2	-2	-2

Appendix 5: Review of European Franchise evidence – Andrew Smith and Chris Nash

Rail Value for Money Study: Research Project on Unit Cost Reduction and Franchising

Andrew Smith and Chris Nash

January 2011

1. Introduction

This note contains a summary review of the academic literature concerning the impact of competition in rail services on unit costs and levels of traffic. It draws on a previous European Transport Conference paper (Smith et. al., 2010a), which in turn draws on a joint Ove Arup and Institute for Transport Studies, University of Leeds study conducted for the Office of Rail Regulation in 2009 (Ove Arup and ITS, 2009a and 2009b). That study also involved the input of academic partners from around the world[1].

This note updates the previous paper noted above to take account of the most recent additions to the literature. It also briefly refers to some recent non-academic literature, though it is not intended to be an exhaustive review of the latter.

There exists a wide body of evidence on the impact of rail franchising in a range of contexts with a wide range of industry structures. The biggest challenge however is in understanding the reasons why some models have worked and others not as the contexts are very different and it is not always straightforward to apply lessons from another country to the British case. There are also weaknesses in the data that further hamper our ability to draw definite conclusions.

We understand that the overall aim of the current research project is to determine how changes to the specification, procurement and management of franchises could be used to strengthen incentives and bring about lower unit costs. Whilst the focus is on the franchises, wider questions about the structure of the industry, and in particular the role of open access and the extent to which franchisees and Network Rail might share cost and revenue risk are within scope. To that extent, the academic literature on the impact of vertical separation / integration on costs is clearly of interest, even if at this stage vertical integration lies at the most extreme point of possible outcomes. We also consider that a brief review of the literature on sector management within British Rail should be informative in the present context, given that the objective is to seek greater cost/risk sharing between the infrastructure and operations side of the business.

The rest of this note is structured as follows. Section 2 summarises the literature on the impact of rail franchising on unit costs across a range of countries (including Britain). Section 3 summarises the literature on the impact of open access competition. Section 4 considers the literature on vertical separation, including the experience of sector management under British Rail. Finally, section 5 seeks to summarise the key findings and draw out the lessons that may be learned from the above for the British case.

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[1] Jan-Eric Nilsson of the Swedish National Road and Transport Research Institute (VTI), Heike Link of the German Institute for Economic Research (DIW), Rico Merkert of Cranfield University and Lou Thompson of Thompson, Galenson and Associates.

2. The impact of passenger rail franchising on unit costs

This section aims to briefly summarise the findings from the academic literature on the impact of passenger rail franchising on unit costs.

The British cost story

In Britain, virtually all rail passenger services were franchised by means of competitive tendering over the period 1994-7. The outcome was that, after an initial decline, the cost of train operations started to rise from the time of the Hatfield accident (see Table 1), both in absolute terms and per train-km (see also Affuso et. al, 2003). Whilst the disruption following that accident may be part of the initial cause it cannot explain the trend long run (Smith et. al., 2010b). Part of the reason for this rise appears to lie in the costs of new rolling stock, and externally determined causes such as fuel prices and insurance (diesel prices doubled between 2000 and 2006, though these represent only about 5% of TOC costs). Partly it was associated with the bailing out of TOCs who had put in too ambitious bids. By 2001 around half of all TOCs had been placed on management contracts, which typically continued for a few years or had their franchises renegotiated. Smith et al. (2009) find strong evidence that this process weakened cost control, leading to a sharp deterioration in inefficiency.

Table 1 TOC cost rises

(£m, 2005/06 prices)	**1996/7**	**1999/2000**	**2005/06**	**2007/08**
All TOCs				
Staff costs	1,132	1,104	1,625	1,682
Rolling stock leasing costs	1,028	972	1,148	-
Other*	1,420	1,316	2,079	2,793
All	3,580	3,392	4,852	4,475
Average salary £	25,948	28,266	33,269	34,746
Headcount	43,638	39,049	48,842	48,407
Passenger train-km (m)	380.9	426.2	454.5	458.1
Passenger-km (bn)	31.8	38.3	43.2	49.3

* Note: A comparable breakdown for 2007/08 is not available. Note also that, as discussed in Smith et. al. (2010b), the post-2005/06 data is less reliable. However, whilst the scale of the cost reduction may therefore be in doubt, the direction of costs (downward) is still clear.

Sources: TOC Annual Accounts; National Rail Trends; Network Rail

However, a major issue seems to be the labour market, where wages rose fast, above the national average, and conditions were improved, including the widespread adoption of a 35 hour week (Smith et. al., 2010b). Between 2000 and 2008, TOC staff wages grew in real terms by 23%, as

compared with the real economy wide average earnings increase of only 9% over that period (see AECOM, FCP and ITS, 2010). At the time of privatisation, many training schemes were wound down, and the new private companies relied more on recruiting staff from their competitors than on training their own. It appears that the combination of rapidly rising output, shortages of skilled staff and relatively short franchises (combined with the performance penalties resulting from disruption) led to a situation in which the trade unions were able to achieve substantial gains by negotiating improvements with the more profitable TOCs, which the less profitable then had to match if they were to retain sufficient staff to meet their obligations. Labour productivity also fell over this period (2000 to 2008), although in 2008 it was still higher than at privatisation, in part reflecting increased traffic levels rather than necessarily improvements in working practices (see AECOM, FCP and ITS, 2010).

Nash and Smith (2010) also note that in the British franchising process, whoever wins the franchise takes over the existing company and staff (with the exception of senior management) at their existing wages and conditions, so – unlike in other European countries - there is no scope for a new entrant coming in with lower labour costs except for open access operators. Glaister (2006) points out the difference between the experience of franchising in rail and bus de-regulation in Britain, with wage rates falling sharply in the bus industry, in contrast to the passenger rail case. He argues that downward pressure on wages in the rail sector is reduced by the stronger commitment by government to the maintenance of rail services compared with bus, and also by the relative ease with which new bus drivers can be trained, relative to train drivers.

It could also be said that the cost rises in Britain were in part driven by improvements in quality. The average age of rolling stock in Britain fell from 20 years in 2002/03 to just 13 years in 2005/06 (see Nash and Smith, 2010). TOC-caused delays per train-km also fell substantially over this period (see Smith et. al., 2010b). Other explanatory factors concerning cost changes, and differences between operators, include franchise length and the extent to which the franchise is tightly specified or not (there being a contrast between the OPRAF contracts and those signed later by SRA and DfT). In Smith and Wheat (2010), franchise length was found not to have any statistically significant impact on costs. Affuso, Angeriz and Pollitt (2003) did find a positive relationship between longer franchises and efficiency (or strictly speaking, between efficiency and length of contract remaining). However, it should be noted that their study did not extend to the post-2000 period after which costs started to rise. Wheat and Smith (2010) indicates that OPRAF style contracts were slightly cheaper than DfT contracts (although this finding is not statistically significant).

Thus the period 2000 to 2006 saw very substantial unit cost growth, with this growth perhaps beginning to reverse or at least come to a halt post-2006 (see Smith et. al. 2010b; though the data quality is less certain over that period. Nevertheless it seems clear that costs have at least stopped rising.

Whilst there are some explanatory factors noted above, using econometric methods, Smith and Wheat (2009) find that, after accounting for wage rate growth as well as a wide range of other variables characterising the production technology, and taking into account the deterioration in inefficiency amongst TOCs on management or re-negotiated contracts, there remains a substantial unexplained, sector-wide cost growth element (see also Cowie, 2009). It should also be noted that much of the cost rises come in the “other” non-staff cost category (see Smith et. al., 2009), so the cost growth appears to be more than just a problem concerning staff productivity and wages (although it is possible that this is explained by more contracting out, for instance of maintenance).

Finally in respect of the British cost story, one possible explanation for the failure of franchising to deliver sustained unit cost reduction is that the TOCs inherited an already efficient operation following the substantial productivity gains achieved by British Rail (BR) as a result of sectorisation in

the 1980s (Cowie, 2002a). However, as noted in Smith et. al. (2009), the fact that BR costs started to rise again in the early 1990s after the cost falls in the 1980s, and that significant unit cost savings were made in the early post privatisation period, means that this argument is not proven (see Pollitt and Smith, 2002)).

The international evidence on BR's relative efficiency is also not conclusive. In some studies, BR appeared as amongst the most efficient operators, whereas in others BR is ranked as about average, or amongst the most inefficient operators. The comparisons are hampered by access to good quality data, and also different methodologies produce quite different results. Given that in all of the above-mentioned studies BR was being compared with other, state-owned European railways, and in general there is no strong evidence that BR was any more efficient than its international peers, it seems unlikely that BR was particularly efficient at the time of privatisation. It therefore could be argued that the sorts of savings achieved by other privatised utilities should have been possible in railways. It has to be acknowledged, however, that the evidence is not clear cut, and different views on BR's efficiency or not at the time of privatisation remain (see Smith et. al., 2010b).

Evidence on tendering elsewhere in Europe

The other European countries with most experience of franchising are Sweden and Germany, although some services are franchised in other countries, particularly Denmark and the Netherlands. Franchising by means of competitive tendering is now applied to all subsidised services in Sweden; in Germany it is up to the individual state to decide between this and negotiated contracts. Brenck and Peter (2007) conclude that German experience of competitive tendering has been very successful, with typically a 30% cost saving as well as improved services and more passengers. Other German evidence (Lalive and Schmutzler, 2008), focusing on the German state of Baden-Wurttemberg, also finds in favour of competitive tendering. For example, their results show that the competitively procured lines enjoyed stronger growth of frequency of service than those that were not procured competitively.

Results in Sweden (Alexandersson and Hulten, 2007a) and the Netherlands (Van Dijk, 2007, Van de Velde et. al., 2008) were similarly favourable. In Sweden, where regional services are tendered using gross cost contracts and inter-regional services are tendered using net cost contracts, Alexandersson and Hulten (2007b) highlight quite consistent associated cost decreases of approximately 20%. Indeed, for the Stockholm Commuter Trains regional tender let in 1998 the cost decrease was as much as 32% (though 7 years later this tender was associated with a 10% cost increase), whilst for the Northern Trains inter-regional tender let in 2002 the cost decrease was some 42%.

Nash and Nilsson (2009) contrast the approaches in Britain and Sweden. Swedish regional franchises are awarded by the regions and are on average smaller and shorter than British. They are gross cost contracts but with incentives regimes which are often complicated (and Jansson, 2009, examines one case and finds no evidence that they work, possibly because there are no incentives on the infrastructure manager, delays caused by which are outside the scheme). Nevertheless, they note that there has been a very strong growth in regional traffic in Sweden, although they could find no studies identifying the causes of this. On the other hand the approach to long distance franchises (which are only awarded for non commercial services in Sweden) is rather different. These are awarded by a national franchising body (Rikstrafik) and are net cost contracts. Thus there are different approaches for different types of franchise.

In most Swedish franchises the rolling stock, and often depots too, are leased to the operator by public sector bodies; there is greater variety in Germany.

The length of franchise varies from case to case. Sweden typically lets 3-5 year franchises for regional services and 5-7 year inter-regional franchises (though one-year franchises have also been used). The longest franchises let by competitive tender are for 10 years in Sweden and Germany, although there are examples of 15 year negotiated contracts. Netherlands has some examples of 15 year franchises, including the franchise to operate high speed services on the new high speed line from Amsterdam to Rotterdam and Brussels.

In many countries, franchising of regional services is undertaken by regional authorities. It is argued that these are closer to the needs of the population than are national bodies. They are also better placed to integrate rail franchising with bus services and with policy on land use and planning. Bosserhoff (2007) describes a number of case studies where regional decision making has led to benefits, and it has been argued that similar benefits exist where franchising has been devolved in Britain (PTEG, 2010). On the other hand, this may mean that a body is responsible for franchising which only undertakes one such exercise every ten years. In terms of the necessary expertise to procure and manage services under franchises, having a national specialist body would seem to have advantages even where the specification of the bid and the financing of the services is developed. (Nash and Nilsson, 2009)

The wider franchising literature argues that franchise length is one of the most important aspects of a franchise agreement. While franchisees typically seek long-term contracts with liberal renewal rights (principally as a means of protecting their investment and allowing them to make a return on it), franchising agencies see longer term contracts as imposing costs through limiting their ability to make changes and terminate non-productive franchisees. Recent US evidence on contract duration based on a large sample of franchise companies from a broad range of business sectors shows that contract duration "is positively and significantly related to the franchisee's physical and human capital investments" (Brickley et al, 2006). There is also evidence to show that larger, more experienced franchisors offer longer-term contracts than do newer franchisors as their experience reduces uncertainties about optimal contract design (Brickley et al, 2006; Vazquez, 2007).

Finally, it should be noted that Sweden, Germany and the Netherlands have, however, all experienced some problems with unrealistic bids, leading to bankruptcies or premature withdrawals from the market, and Alexandersson and Hulten (2007b) consider the reasons for this, concluding that strategic decisions to place unrealistic bids have played a part in Sweden. However, the problems have not been anywhere near as severe as those in the UK or Melbourne.

Evidence on tendering outside Europe

The joint Arup / ITS study for ORR in 2009 concluded that outside Europe the cases of Melbourne and Latin America are of particular interest in respect of drawing possible lessons for Britain.

There have been three phases of private sector participation in Melbourne. The first set of franchises, awarded in 1999, were net cost contracts for 12-15 years. They were vertically integrated with franchisees leasing the infrastructure and being responsible for enhancements, and taking control of the rolling stock. However, whilst large cost savings were expected, these did not materialise and franchise re-negotiation followed. Some of the problems were outside the control of operators, for example, the imposition of a fares tax and problems associated with the automated ticketing system (see Arup and ITS, 2009a). It has also been argued that major cuts in staff and costs had already been achieved in Melbourne prior to tendering, thus explaining why large cost savings did not result (see Kain (2009)).

As noted, franchisees were also responsible for track maintenance; there is a suggestion that the relatively short franchises led the franchisees to neglect the long term health of the infrastructure (Kain, 2007). Kain (2009) argues strongly that net cost contracts make it difficult to select the best bid, and add to risk of strategic bidding and failure. He argues for gross cost contracts and for stringent scrutiny to ensure that bids are realistic (in Melbourne he argues that the public authorities actually encouraged unrealistic revenue forecasts). The new franchise agreements include a mechanism for handling change with a 'cap and collar' whereby the government share 50% of the upside benefit and 50% of downside risk above and below defined tolerances of the revenue forecast. At regular intervals of about three years the level of the revenue forecast is also reset to match actual revenue figures although the trend line remains the same (see Arup and ITS, 2009a).

In Latin America, in general, the initial approach to concessioning of regional, suburban and metro systems was the creation of net cost, exclusive, vertically integrated concessions with fare levels and level of service specified by the government, but with passenger demand forecasting and cost control the responsibility of the concession. The concessions also had full control over the size and wage costs of their workforces. The concession periods were initially for 10-25 years. These were extended to 25-30 year periods to encourage concessionaires to finance new rolling stock. However, even with these lengths of concessions, private operators have been unable or unwilling to invest in the concession requirements for infrastructure and rolling stock renewal and modernisation (see Arup and ITS, 2009a).

Governments have also failed to deliver their committed investment. This created an effective default leading to concession renegotiation. In Argentina, the government default on its international debts during the crisis of 2000-02 resulted in the government's failure to honour investment commitments (see Arup and ITS, 2009a). However, the impact of privatisation has been to stimulate growth in passenger demand. In Argentina, the suburban rail networks in the Buenos Aires region experienced substantial growth in the years following the establishment of the concessions. This growth also reflected improved performance from the concessionaires' investment commitments (though there was a sharp decline in the few years after 2000, during the economic crisis, with growth resuming thereafter (see Arup and ITS, 2009a).

Also the economic crisis led to the government limiting concessionaires' scope for imposing fare increases and delaying support payments for investment which resulted in a loss of capacity and reduced quality of service. These factors resulted in government takeover of some of the concessions and a conversion of the remaining concessions into something resembling management contracts. Consequently all contracts are now mostly gross cost. Passenger demand is currently growing with the expansion of the Argentine economy.

Overall, given the economic turbulence affecting the economies of Latin America, the concession experience has been successful. Demand on concession railways has generally exceeded the growth in GDP and labour productivity and traffic volumes have grown rapidly. However, the concession experience in the major Latin American countries has been characterised by the underlying economic and political factors which has resulted in uncertainty and risk even with long concession of over 20 years. This uncertainty has led to the need to re-negotiate contracts, and government taking on more risk. The severity of the economic crisis in Latin America during this time limits the transferability of the results elsewhere.

Economies of scale and density: international evidence

To the extent that changes to franchise boundaries are envisaged in the British reforms, economies of scale and density are highly relevant. With respect to franchise size, Wheat and Smith (2010) find constant returns to scale (1.02), but strong returns to density (1.44). The policy implication here is that having fewer, larger franchises would not reduce unit costs (or conversely, unit costs would not rise in the case of having more, smaller franchises[2]). The strong returns to density suggest that bigger gains are possible through combining overlapping franchises, rather than just making franchises bigger. Thus there may be some savings from creating larger TOCs, where the merged TOC can exploit economies of density; which in turn is likely to depend on how easily rolling stock can be utilised across different service types. So much will depend on the circumstances. Cowie (2002b) reports diseconomies of scale at low traffic volumes and increasing returns to scale at higher traffic volumes, although there is some ambiguity concerning this result in his paper.

The above results for the British TOCs, of strong economies of density, combined with weak economies of scale, are broadly in line with the general literature on (vertically integrated) railways. For the US Class I railroads, this literature shows constant returns to scale and increasing returns to density. (e.g. Caves et al, 1985). The literature on European railways is more mixed, giving decreasing, constant and increasing returns to scale depending on the railway. Preston (1996) finds increasing returns to density alongside decreasing returns to scale for British Rail (though prior to privatisation and the creation of the TOCs, so this could relate to the infrastructure rather than the operations).

Summary of section 2

From the above section, we note that competitive tendering has been successful in getting costs down in some cases, most notably Germany and Sweden, whereas in Britain and Melbourne this did not occur. The concession arrangements in Latin America also appear to have driven improvements in labour productivity. It is not straightforward to identify precisely what it is about the particular models chosen that drives success or failure, and of course there are many context-specific factors that mean the findings cannot always be generalised. In section 5 we seek to draw out the key findings and in turn the lessons for Britain as far as possible from the literature.

3. Open access competition

There is already some limited experience of open access competition in European rail passenger markets (Nash, 2009), particularly in Germany and Britain. Not surprisingly such competition has always been in the more profitable intercity sector although not generally involving high speed trains. In Germany, open access for new entrants who wish to operate commercial services has been authorized by law since 1994. In Britain, entry is permitted provided this is deemed to be in the public interest, the test for this being that the new service predominantly generates additional traffic rather than diverting traffic from existing rail operators, who have already won the franchise to operate services on that route through competitive tendering, as explained above.

To date, actual experience has been that there has only been a very limited amount of new entry, even in Germany, and what has taken place has been mainly in niche markets; usually routes not otherwise served by through train services, but also sometimes involving special services such as

[2] Assuming variation in size close to the sample mean.

sleeping cars. There are a number of reasons for this, including the low profitability of many routes, relatively high infrastructure charges, the advantages of an integrated passenger network, and lack of capacity on key routes and at the busiest times of day. There have also been allegations of continued barriers to entry. In Germany, the main operator and the infrastructure manager remain part of the same group, which is also the main provider of services such as maintenance, cleaning and information, and it is alleged that this position has been used to try to prevent entry.

New entrants in both Germany and Britain have invariably offered through services between cities with no or limited existing links by through services, at lower fares than those charged by existing operators for journeys involving a change of train. In Germany, this has been achieved largely by running the services in conjunction with regional services, with which they share rolling stock (Seguret, 2009).

In Britain, of the three open access operators currently active two are part of larger organisations: First Group in the case of Hull Trains and DB in the case of Shropshire and Wrexham, and they share facilities with other train operating companies in their group. Only Grand Central is a small independent company. Open access operators in Britain benefit from not having to pay fixed access charges or to contribute to the premium that franchisees on profitable routes have to pay. They have been able to lease new or second hand rolling stock, and have also competed in terms of other quality dimensions including catering and on board services. Whilst they operate to destinations such as Hull and Sunderland, which are off the main line and not served by through inter city services (or only served once per day in the case of Hull), and their stopping patterns when on the main line are restricted by the regulator to give some protection to the franchisee, they do directly compete with the main line operator between some city pairs, such as London and Doncaster (Hull Trains) or York (Grand Central).

However, there are signs that more intense competition may emerge in Europe in the coming years, both on international and domestic routes, with the most interesting case being in Italy, where a new operator is seeking to challenge the position of Trenitalia by offering high frequency services on high speed routes.

Open access operations have clearly benefited consumers through lower fares and the availability of through services that otherwise would not exist, and studies in Britain have suggested that these benefits exceed the costs of operating the trains (Griffiths, 2009). On the other hand, criticisms of open access competition include that it often makes poorer use of scarce capacity, as open access operators often operate shorter trains than the incumbent and may reduce load factors on the incumbents' trains, that it leads to poorly integrated timetables and reduces the profitability of the incumbent. Thus it reduces any premium that can be paid by a franchise holder, and surplus available for cross subsidy of less profitable services or contribution to infrastructure costs.

On track competition has also occurred in Britain between different companies where services are franchised and franchises overlap. Indeed there has been much debate as to whether franchises should be deliberately designed to promote this type of competition between major cities. Typically this again has been competition between an inter city operator and a regional or commuter operator, with the latter offering slower, less comfortable services at lower fares. Key routes where this has happened are London to Birmingham, Peterborough, Cambridge and Ipswich. To the extent that such competition makes use of spare capacity in the lower cost operator to relieve long distance operators of medium distance traffic it may be socially beneficial.

There have been several attempts to model competition in the rail passenger market using the PRAISE software. PRAISE is a model designed to simulate the effect of competition between operators. It predicts the impact of changes in fares and services on the overall volume of rail travel

and on its share between operators, by simulating the decisions of a sample of individuals choosing between combinations of individual trains and ticket types, in the light of their preferences regarding departure time, values of time and levels of crowding. Subject to data availability, it also undertakes a cost-benefit analysis of the impact of the competition on operators, passengers and society at large.

The most relevant past studies in the current context are studies of open access competition on intercity lines in Britain and Sweden. Preston, Wardman and Whelan (1999) first used PRAISE to address the issue of competition in the market through open access operations, based on a case study of a busy intercity route in Britain, with approximately 2 million end-to-end passenger journeys per annum, linking two major cities with substantial commuting at either end. They look at four possible scenarios for duopolistic on-track competition: cream skimming, head-on competition. price war and service quality competition .They conclude that entry based on cream skimming and fare reductions may be profitable, but does not increase overall welfare, as the benefits to users do not offset the operating costs of the additional services. In practice, it is to be expected that such cream skimming might be forestalled by the incumbent who would provide its own additional services. In their case study they estimate that the incumbent can broadly double its service frequency and still break even on this particularly profitable route.

They find that head-on competition is not generally feasible except where the entrant is only charged for the marginal cost of infrastructure provision, but entry in this case results in a reduction of economic welfare for the reason stated above. By contrast competition from a lower quality cheaper service is feasible. In these circumstances, the entrant could capture a significant market niche, namely peak hour non-business travellers. With fares at 50% of those on the incumbent's franchise, the parallel entrant could capture 25% of the rail market.

The study did not consider costs in detail assuming entrant and incumbent have the same variable costs, and does not consider overcrowding. If competition drives down costs, by introducing a lower cost competitor, and thus also putting pressure on the costs of the incumbent, then the benefits are likely to be greater. However, in the British context it is assumed that any such cost reductions will already be produced by the need to compete for the franchise.

Similar work in Sweden (Preston, Holvad and Raje, 2002) modelled the effect of competitive scenarios for two lines, one a high frequency inter city service and one a low frequency inter city service. Two service options were examined – where an entrant matches the services of the incumbent (head-on competition) or only runs one train in each direction in peak periods (fringe competition). It was assumed the entrant matches the incumbent’s fares or offers reductions across all ticket types. The incumbent maintains initial fares or matches the entrant’s fare reductions. It is assumed tickets are not inter-available.

This work actually found that with lower track access charges, head on competition was commercially feasible on the busiest routes although it might be capacity constrained. Such competition was not desirable as it led to too many services at too high fares. On less busy routes, welfare was maximised when there were substantial fare reductions and modest service reductions. Any scenarios involving profitable fringe competition on the less busy lines were in peak periods and reduced welfare.

Where there is a shortage of track capacity, open access competition also raises the issue of how scarce capacity should be allocated between competitors. Use of the price mechanism, either by reservation charges that are high enough to choke off excess demand or by auctioning slots, has often been advocated. PRAISE has been used to estimate the opportunity cost of transferring slots from the incumbent to an entrant, and it has been shown that the revenue earned by the entrant

frequently greatly overstates the benefit of the additional services, as much of it simply transfers from the incumbent and the degree of benefit to the consumer necessary to provoke that transfer is small. Thus use of the price mechanism to allocate capacity without some form of regulation or combination of taxes and subsidies will not optimise the use of capacity (Johnson and Nash, 2008).

Summary of section 3

Three key conclusions emerge. Firstly, the extent of competition attracted will be very dependent on the level of track access charges, which greatly influence the scope for profitable entry. Secondly, if there are no constraints on entry, the most likely form of entry is 'cream skimming'; i.e. simply duplicating the most profitable services of the existing operator, and reducing their profits. Only on the busiest routes is it likely that head-on competition - high frequency duplicate services by two or more operators - can survive. Thirdly, it is likely that competition will generally lead to excessive levels of service and costs, for which the benefits to consumers will be more than offset by the losses of profitability to the existing operator. The loss of economies of density for the existing operator will exacerbate this tendency. The consequences of this loss of profitability may be a need for increased subsidies or the withdrawal of other services which were being cross subsidised from these profits.

It has also been argued that the existing approach to allocating capacity and producing timetables is not prescriptive enough and leads to seriously suboptimal results, and that a more centralised approach could give better use of capacity and higher traffic and revenue, following the Taktfahrplan principles developed in Switzerland (Tyler, 2009). An earlier modelling exercise found that rail revenue in Britain could be raised by some 6% on routes to London and 17% on other routes simply by better integrated timetabling, with no additional resources (Johnson et al, 2006) This of course is an issue relating not just to the efficiency of open access competition but also to the degree of prescription in service specifications in franchises.

4. The literature on vertical separation

The massive increases in infrastructure costs in Britain which followed the bankruptcy of Railtrack are often quoted as arguments against separation of infrastructure from operations, but a number of other factors appear to have been involved here, including weak regulation, mismanagement by Railtrack of its maintenance contracts and an inherited backlog of renewals (Nash et al, 2005). Complete separation in some other countries, such as Sweden, appears to have worked much better (Nilsson, 2002).

More formal econometric evidence on the impact of vertical separation is limited and inconsistent. Not surprisingly, there is clear evidence that the level of infrastructure investment affects both passenger and freight train operating costs (Cantos, 2001) although what is surprising is that whilst it appears to reduce freight train operating costs it increases those for passenger. So it is obvious that any vertical separation will have to provide incentives or regulation to ensure adequate infrastructure investment.

A number of US studies have also found costs involved in separating infrastructure from operations resulting from a loss of economies of scope (e.g. Bitzan, 2003), but these take evidence solely from vertically integrated freight railways and ask what would happen to train operating costs if infrastructure spending were reduced to zero and vice versa, rather than what would happen if

infrastructure spending were in the hands of another organisation. Four studies have attempted to examine the evidence of European railways post privatisation; whilst Friebel et al (2003) find no clear conclusion, two of the others (Rivera-Trujillo,2004; Growitsch and Wetzel, 2009) find that vertical separation raises costs, although in the latter case the result is very variable from one country to another. The final study, Cantos et. al. (2010) finds that vertical separation, combined with horizontal separation and the entry of new freight operators, has led to improvements in efficiency (though importantly in this context, Britain is excluded from this final study).

The most obvious explanation for this lies in the transactions costs involved (Merkert, 2007). Following Williamson (1985), Merkert postulates that high transactions costs arise from asset specificity, complexity and uncertainty in the relationship between infrastructure managers and train operators. Given the long term nature of railway assets, it is likely that infrastructure managers and train operating companies will require long run contracts, setting out procedures for the interaction of the two and with penalty clauses for poor performance, which in turn need to be monitored and disputes as to the causes of poor performance resolved. Bouf et al (2005) argue that the main areas in which conflicts between infrastructure managers and train operators may occur are the following:

- Network Changes, where investment plans have to be agreed and their cost shared amongst the interested parties (given the existence of joint costs, this leaves scope for attempts at free riding by different train operating companies)
- Access and timetable establishment (where different operators may be competing for the same paths; a particular source of dispute here seems to be the planning of track maintenance and renewals, where complete line closures are the most efficient approach for the infrastructure manager but very disruptive for operators)
- Delays and disruption (which may be caused by faults on the part of the infrastructure manager or one of the train operators; given their daily occurrence, monitoring and agreement on responsibility is necessarily expensive).

However, Merkert et. al. (2008) find that, whilst transactions costs are higher in vertically separated systems, the increase is a small proportion (less than 1%) of total costs. Thus the explanation for substantial economies of scope between infrastructure and operations must lie elsewhere, for instance in better alignment of incentives and increased pressure on the costs of the infrastructure manager. If we wish to introduce competition, whether on track or by franchising, there is an argument for some form of vertical separation. In the case of on-track competition, it is clear that if one of the train operators is also responsible for infrastructure, it will have an incentive to favour its own services, both in planning and in real-time operations. The key question then is whether an independent regulator can fully overcome this problem. In the case of franchises, the argument for separation is less strong, particularly where a geographical split of franchises into relatively self contained networks is possible. But in a complex network, with services to a wide variety of destinations sharing tracks over part of the route, it will be inevitable that vertically integrated franchises will run over each other's tracks, unless the network is franchised as a single entity, in which case it may be difficult to maintain a number of competing bidders, as the losers would have no chance of participating in the market until the time came for refranchising. Obviously growth of an international franchising market reduces this problem.

European Union legislation initially just required accounting separation, with non discriminatory infrastructure charges and slot allocation. However, there were many complaints that the timetabling process and other requirements regarding safety certification of vehicles, driver training and so forth were used by vertically integrated companies (House of Lords, 2005). Thus further legislation was introduced requiring at least that infrastructure charges and slot allocation should be

the responsibility of a body not engaged in train operation, that appeal should be available to a regulator independent of the infrastructure manager, and that specified harmonised procedures should be followed regarding safety certification. Nevertheless, there remains a suspicion that the most effective way of ensuring non discriminatory access is by complete separation of infrastructure from operations.

Different degrees of separation are also to be found (Nash 2008). In some European countries (e.g. Germany, Austria, Italy), infrastructure and operations remain separate subsidiaries of the same holding company (with disputes between them, investment plans etc handled at the holding company level), whilst in others (e.g. Sweden, Netherlands, Britain) they are completely separate organisations. Most remarkable is the case of France, where there is a completely separate state owned infrastructure manager (RFF) but it contracts all operations, maintenance and renewal work back to the dominant state owned operator, SNCF (thus permitting close integration of infrastructure and train operations at the day to day level). Obviously both these approaches may afford economies of scope but may also give the opportunity for discrimination.

It has been suggested in Britain that infrastructure may be leased to the franchisee, as happens in Latin America; with the change of government in 2010, an experiment with this approach on a franchise well segregated from the rest of the network has been suggested. In India, the first small move towards permitting new entry has come via allowing new container operators to provide their own terminals and wagons and run their own trains, but they must not only pay for track access but also hire drivers and locomotives from Indian Railways (Singh, 2007). All these arrangements try to reduce the costs of separation, but at the expense of opportunity and motivation for discrimination to favour the integrated operator. Of course, continued links between the infrastructure manager and the dominant operator only reduce transactions costs where there is a dominant operator, so the argument for such an approach is that there can be sufficient competition to force the operator to behave efficiently, whilst the dominant operator retains perhaps 90% of the market as in Germany (Kirchner, 2005).

In the British context, The House of Commons Transport Committee (2006) argued that franchise agreements insulate TOCs from changes in track access charges. In the Arup / ITS (2009a) study for ORR, interviews were held with several industry leaders, and the view was expressed that Network Rail is only accountable to ORR and does not take the TOCs seriously enough as customers. They accept that longer franchises will not automatically lead to a better relationship between the TOC and Network Rail. A range of solutions were proposed, from changes in behaviours, through new licence conditions on Network Rail, transfer of operations and maintenance responsibilities from Network Rail to TOCs, through to a geographical break- up of the infrastructure company.

It has been argued (e.g. Gourvish, 2002) that the introduction of sector management was a significant factor in the improvements in productivity achieved by British Rail in the 1980s. Under sector management, a passenger or freight business manager was responsible for specifying the infrastructure they required and for meeting the costs of it from revenue or subsidies. This required a way of allocating the costs of the infrastructure between the sec tors; the approach adopted was to designate one sector the ‘prime user’ of each section of track and other assets. The prime user met the costs that would be incurred had they been the sole user of that asset, and other sectors met the ‘avoidable’ costs of their use of the assets. Whilst there is some ambiguity about the allocation, and scope for game playing to shift the costs, where several sectors make substantial use of the same assets, it is argued that this approach led to increased clarity about financial performance of different sectors and strong incentives to find ways of economising on infrastructure costs whilst satisfying the need for appropriate levels of service. Such an approach might be possible without vertical integration, but would require long term contracts between train operators and the

infrastructure manager, with sufficient freedom of action for them to negotiate and appropriate infrastructure costing methods. Indeed, initially within British Rail, sector management was introduced even though the business sectors did not actually operate or maintain the infrastructure, although subsequently BR did move to complete vertical integration of the sectors.

Summary of section 4

The relative cost of separation versus integrated models is not necessarily clear cut a priori, since it depends on how the cost of internal co-ordination compares against the cost of contracting between different legal entities. There would perhaps be a suspicion however that costs would rise or at least that the ability of the companies to operate as a system would be impaired in some way. The evidence is not clear, partly due to data and methodological challenges, although on balance it does seem to suggest that vertical separation raises costs. Transaction costs likewise appear to be higher in separated systems, although this increase is rather trivial.

Ultimately of course, any higher costs of separation need to weighed against the fact that full, legal vertical separation is the cleanest way of achieving increased competition, which is also a key objective of national and European policy. However, the evidence shows that there are a range of institutional possibilities here that lie between full separation and an integrated model. The challenge in the British context is to seek to obtain some of the co-ordination, planning and joint cost-minimisation benefits via cost and revenue risk sharing arrangements between TOCs and Network Rail, without losing the benefits of on-track competition, and without unduly complicating the franchising process and thus diminishing the benefits of competition for the market. Sector management, as practiced by British Rail in the 1980s, may have lessons here.

5. Summary of key findings and lessons for Britain

Econometric evidence provides few prescriptions in terms of what works best in the case of franchises. There is no clear evidence that longer or shorter, larger or smaller franchises would be more efficient than what we currently have, although there is strong evidence of economies of traffic density, suggesting that when changing the franchise map, the avoidance of overlapping franchises should be an important consideration (although of course overlapping franchises may have a compensating benefit in terms of increasing competition).

British experience suggests that one key requirement for successful franchising is to ensure as far as possible that the finances of franchises are robust, but then to insist on refranchising as quickly as possible when a franchise does fail, rather than renegotiating of placing franchises on management contracts for significant periods of time. But even without this issue, it appears that franchising in Britain has been less effective in reducing costs than in Sweden or Germany. One difference may be that the predominance of gross cost contracts particularly in the former country encourages attention to costs. But the key difference appears to be in the workings of the labour market; in Sweden or Germany, new entrants are free to set their own wages and conditions, as in the bus industry in Britain and also in rail franchises in South America. Given that it is difficult to see how this could happen given the scale of franchises in Britain, this may argue in favour of allowing more open access competition as a key way of bringing pressure to bear in the labour market. However, experience of open access competition is limited. Whilst it suggests that open access competition can bring benefits for users, modelling suggests that it is not always beneficial in terms of value for money from the rail industry as a whole, and that regulated competition, as currently practiced in

Britain, rather than a complete free market, may be desirable. There is also evidence on the benefits of integrated timetabling.

In the two European countries outside Britain with the greatest experience of franchising, Sweden and Germany, regional services are franchised by regional authorities, and there is evidence that this leads to benefits in terms of better knowledge of the needs of users and closer integration with bus and other aspects of policy. Certainly in both countries regional services and traffic have expanded considerably under regional franchising, although it might be argued that some of the same expansion has occurred in Britain with less regionalisation.   Both countries deal with long distance services in a different way from short. In both countries, profitable long distance services are not franchised but simply up to commercial operators. Sweden does franchise unprofitable long distance services, but on net cost contracts, whereas regional services are predominantly franchised on relatively short, gross cost contracts which specify fares, services and rolling stock fairly precisely.

Whilst the evidence suggests that there are some costs associated with vertical separation, the pure transactions costs of this policy do not appear to be large. Economies of scope between infrastructure and operations may depend more on better alignment of incentives regarding the capacity and quality of the infrastructure and how it is maintained. Sector management, as practiced by British Rail in the 1980s, may offer a model for achieving better alignment of incentives in a vertically separated railway, where it is argued that substantial economies were achieved by placing business sectors in charge of determining the capability of infrastructure they needed and could afford. One way of achieving this might be for lead franchisees to have a greater role in negotiating with Network Rail about the cost and capability of the infrastructure required on the network over which they are the main operator, subject to the HLOS and the franchise specification, although obviously it would be necessary to ensure that the interests of other operators over the network in question were adequately protected, Any cost savings identified could be shared between the operator and Network Rail. In order to avoid increasing the risk to franchisees, this approach may require ORR to arbitrate where Network Rail and the operators cannot agree. A maximum level of access charges may also have to specified at the outset, with operators then having incentives to reduce these, rather than a “blank piece of paper” approach, in order to reduce risk to operators.

To sum up then, the literature does not point to a single solution that is appropriate in all circumstances. For heavily subsidised services, there seems to be a strong case for devolving specification of services to regional authorities, who determine fares and services in some detail and for the use of gross cost contracts. For long distance services, longer net cost contracts with much less detailed specification may be more appropriate. Selective open access competition may play a valuable role but needs to be regulated in the public interest. Finally, giving train operators a greater role in negotiating with Network Rail over costs and capability of the network they use may lead to cost savings.

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Appendix 6: Research by PwC and IPPR on political accountability

Who's accountable?

The challenge of giving power away in a centralised political culture

ippr

PRICEWATERHOUSECOOPERS

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Summary

All parties appear to support greater localism but given the tendency to hold ministers accountable for all aspects of public service performance is it really possible for government to 'let go' in our centralised political culture?

Ministers will understandably be reluctant to devolve powers if they are still held accountable for things if they go wrong. Conversely, however, they may be more inclined to devolve power where lines of accountability are clear and when they can be assured that once they've let go the public, the media and the opposition will accept that responsibility rests at the local level. The question therefore arises about how best to devolve power and accountability.

Original research by PwC and ippr suggests that although the public does hold the government in Westminster responsible for core parts of public service delivery, public perceptions of accountability – and hence credit and blame – will change if devolution is well communicated, clearly enacted, and if real powers are transferred to highly accountable bodies. When this isn't the case, responsibility tends to stay with Westminster, regardless of formal accountability structures.

Introduction: Localism in a centralised world

The task of modernising the British constitutional settlement is not yet complete: we must be prepared to give power away … devolving and decentralising power even further throughout our country.
Gordon Brown[1]

Our society has been undermined by an over-centralised state that saps responsibility and initiative from people. An essential step to tackling the great challenges of the day … is decentralising responsibility and power. Localism holds the key to economic, social and political progress in the future. We want nothing less than radical decentralisation to reach every corner of the country.
David Cameron[2]

We need to take control away from central government, where bureaucrats and ministers are in charge, and give it to local government, people and communities.
Nick Clegg[3]

Today all the main political parties claim to be in favour of decentralisation. Indeed it might be said that we are all localists now. But despite the apparent consensus that excessive centralism has had its day, there remain a number of barriers to achieving greater localism.[4]

These include a lack of agreement about which powers should be devolved, particularly when it comes to financial powers, and to what level, and to whom, since decentralisation concerns not only giving power away to local government, but also to civil society, communities and individuals themselves.

Added to this is the general scepticism within Whitehall – and amongst the public – about the capability of local government to competently exercise new powers. Frustratingly for local councils this scepticism persists despite the significant improvements that many, though by no means all, councils have made in the last decade.

Another major barrier rests with people themselves and their hostility to 'post-code lotteries' and a concern that decentralisation will lead to unacceptable variations in outcomes. Localism, it is argued, runs counter to the traditional UK account of social citizenship which rests on the notion that citizens are treated the same wherever they happen to live.

Perhaps the most important barrier to localism is a highly centralised political and media culture which tends to hold ministers responsible for all aspects of public service delivery. Ministers worry that while they may be able to devolve powers and functions downwards, it is difficult in our political culture to devolve accountability for exercising those functions.

1 Building Britain's Future June 2009
2 Control Shift: Returning power to local communities
3 Policy Briefing 7, Liberal Democrats
4 For a more detailed discussion see Lodge G 'Central-local relations: why it is so hard to let go' in (ed.) Brooks R Public Services at the Crossroads (London: ippr 2007)

When local problems arise national politicians are often judged responsible by the media, opposition parties and members of the public. There is a long tradition in Britain of holding ministers accountable. As long ago as 1904 the political commentator, Sidney Low, argued that when things go wrong in Britain we will always want ‘to hang the minister’. It seems that the constitutional doctrine of ministerial responsibility – the idea that ministers alone are accountable – is deeply ingrained in the national consciousness.

The other reason ministers tend to get blamed is because of the absence of strong accountability mechanisms at the local level – think of the low profile and visibility of local councillors – which ensures that responsibility is quickly passed back to the centre.

These two issues, a belief in the omnipotence of national politicians and the relative weakness of local accountability structures, are connected and have produced a vicious cycle of centralism: because ministers are held responsible for the performance of services at a local level they naturally seek to control those services, hence the proliferation of targets and the appetite to micro-mange from the centre. Such interventions both erode the role of local government at the local level and reinforce the accountability of central government ministers.

A highly centralised media, combined with a toxic adversarial model of politics, also serves to concentrate responsibility on Westminster. Columnist Simon Jenkins has argued that if a story is important enough for national coverage then the media assume that responsibility for dealing with it must also rest at the national level.[5]

Of course by asserting their control over local services it is only right that central government shares the burden of accountability. In a highly centralised political system such as the UK’s, responsibility very often does reside with national politicians. The challenge for localists however, is whether a political culture that has got so accustomed to holding national governments accountable for the quality of local services will be able to adjust to a world in which responsibility has moved elsewhere.

Understandably central government ministers will be reluctant to devolve powers if they are still held accountable for the decisions of other bodies, especially if they go wrong. This would amount to accountability without control, a politicians’ worst nightmare. As one leading opposition spokesperson told us:

> *… you will find that anyone who goes in for new localism on a grand scale will regret it. They will find that they are being blamed for things which they no longer have any control of*

5 Simon Jenkins Thatcher and Sons: a revolution in three acts

Is there a way out of this centralist bind? We argue that real localism depends on the ability to transfer powers *and* the accountability for exercising such powers to the local level. In other words, ministers may be more inclined to give up powers where lines of accountability are clear and when they can be assured that once they've let go, the public, the media and the opposition will accept that responsibility rests at the local level.

Yet despite the importance of this issue to the current debate about localism there has been very little research into who the public holds responsible for public service performance. The core assumptions have never been tested in a systematic and empirical way. This paper is intended to help fill that gap.

In order to understand this debate we need a much better understanding of who the public holds accountable for different types of public service delivery and why.

Methodology

To help inform policy thinking, PricewaterhouseCoopers LLP (PwC) and ippr commissioned a major new body of research[6] to understand the factors that impact on public perceptions of accountability across a range of service areas. This paper presents some initial findings from an opinion poll of 2709 members of the public, designed to understand who the public hold to account when things go wrong, as well as who they credit for when things go well, and how this varies according to a range of different factors.

The online survey set out to test two specific issues. Firstly, we wanted to test the degree to which the 'government in Westminster' is actually held responsible for the performance and delivery of core public services. To test this, we were interested in seeing how perceptions of responsibility varied across different public services – health, education, policing, transport and refuse collection – and by geographical level, so that we could compare who the public held accountable for a problem which arose in their local area or across the country as a whole.

Participants were therefore asked to consider various scenarios in which public services were seen to have deteriorated or improved across the whole country as well as at a local level.

The second issue we set out to test was the degree to which it is possible to shift accountability for public service performance from the Westminster government to other bodies. This goes to the heart of the debate about localism and accountability since it allows us to see whether it is possible to give power away *and* decentralise responsibility for exercising those powers within a centralised political culture. To test this we looked at a range of bodies, which included: devolved institutions; the Scottish Government; London Mayor; local authorities; quangos, using the example of the qualifications authorities; and private companies, where we looked at the impact of transport companies.

Given that identifying the difference made by the presence of devolved assemblies was a core part of this research, the majority of statistics reported here refer to England only – so that they can be fairly compared to those from Scotland where necessary.

6 We commissioned Brand Democracy, an independent research consultancy – **www.branddemocracy.co.uk** – to conduct an online poll with 1505 members of the public (GB-wide), alongside 'booster samples' of 505 adults in Scotland, and 654 adults in Greater London. The total number of people surveyed was 2,709. All samples are representative of the populations from which they were drawn in terms of age, gender, social economic grade, and region.

Section 1: Who's accountable?

Participants were asked to consider various scenarios in which public services were seen to have deteriorated across England as well as at a local level and then asked to say who they hold most responsible. In each case they were given a range of options to choose from.[7]

We used the following scenarios:

- Health: who would you hold most responsible if hospital waiting lists got longer across the country as a whole / in your local area?
- Crime: who would you hold most responsible if the police force across the country as a whole / in your local area became less effective at fighting crime?
- Education: who would you hold most responsible if school results across the country / in your local area got worse?
- Transport: who would you hold most responsible if transport across the country / in your local area got significantly worse?
- Refuse: who would you hold most responsible if rubbish bins in your local area were not emptied for a number of weeks?

Findings

The public 'default' is to hold Westminster most responsible for public service performance. For problems arising at a national level in the fields of health, education and policing, our survey revealed that the public held the 'government in Westminster' more accountable than any other option with which they were provided.

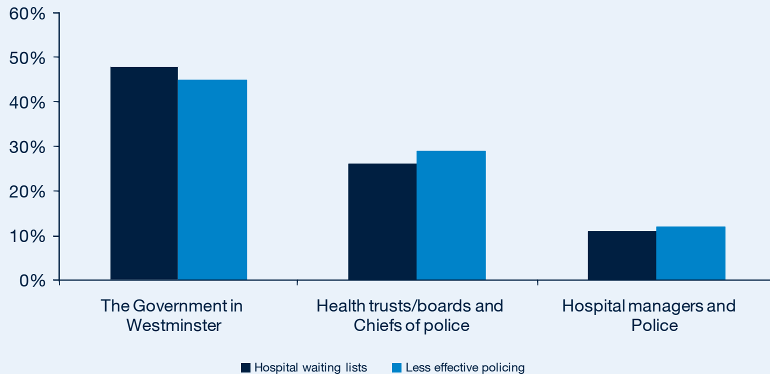
This was not the case for transport where most respondents believed that the transport companies were most responsible if the performance of public transport declined. We discuss each service area in turn below.

7 Core options included: Government in Westminster; Scottish Government / Welsh Assembly; MPs in your area; local councils in your area; staff; providers e.g. health trusts, schools etc; Mayor of London; managers in providers

Health and policing

When we asked respondents who they hold most responsible for failures in health and policing across England, the government in Westminster came top by some way. As shown in Figure 1, just fewer than 50% of respondents held Westminster most responsible, followed by the leaders of service delivery – health trusts (26%) and police chiefs (29%), with core providers being held much less responsible, hospital managers (11%) and the police (12%).

Figure 1: Health and policing across the country:



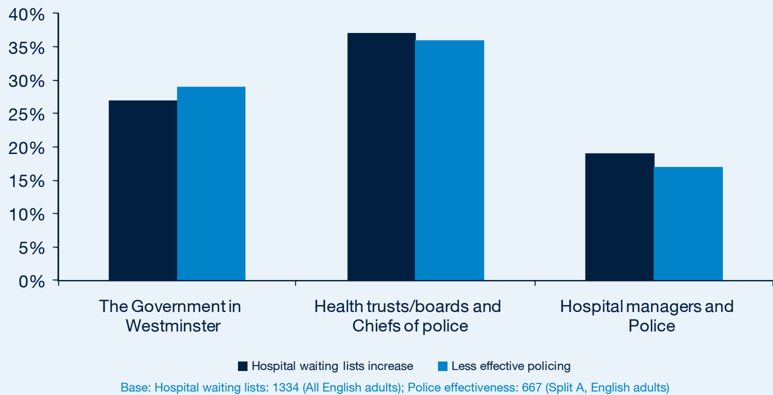
Base: Hospital waiting lists: 1334 (All English adults); Police effectiveness: 667 (Split A, English adults)

- If waiting lists got longer across England, 48% would hold the government in Westminster most responsible
- If police became less effective across England, 45% would hold the government in Westminster most responsible

At a local level, however, the public's position shifted with more respondents holding those in charge of service delivery – health trusts and police chiefs most responsible if services deteriorated, than those who blamed the government in Westminster.[8] This raises important questions about the accountability of health trusts and police chiefs. Many commentators have pointed out that local bodies are often insufficiently accountable to the public and have suggested ways of improving this, for example the Conservative Party wants to introduce directly elected police commissioners who would hold the police chief to account.[9]

But as Figure 2 suggests even when a problem arises with health and policing in a local area, respondents still felt that the *elected body* they hold most responsible is the Westminster government.

Figure 2: Health and policing at a local level



Base: Hospital waiting lists: 1334 (All English adults); Police effectiveness: 667 (Split A, English adults)

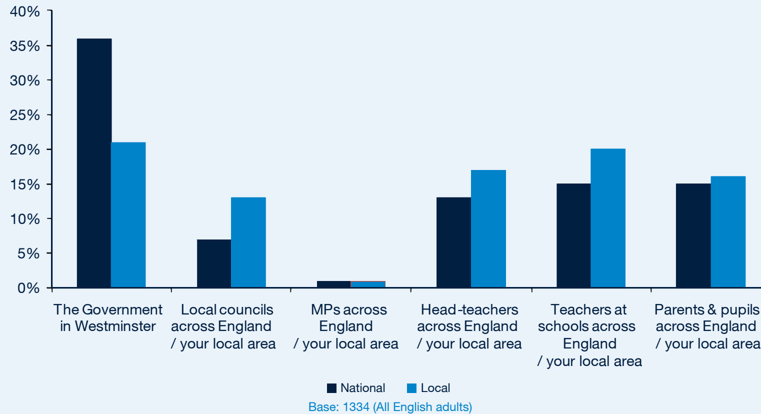
- 37% of respondents in England would hold the Health Trust most responsible if waiting lists got longer in their local area compared to 27% blaming the government in Westminster
- 36% of respondents in England would hold the police chief most responsible if policing became less effective in their local area compared to 29% holding Westminster to account

8 We also note that the pattern of accountability at the local level remained concentrated on the same three groups that were held responsible at the national level (those in charge of service delivery, government in Westminster and public service providers)

9 See for example R Muir and G Lodge *A New Beat: Options for more accountable policing* (ippr, 2008)

Figure 3: Blame for failure in education is more diffuse

If school exam results got worse across the country / your local area who would you hold most responsible?



Base: 1334 (All English adults)

- If school results got worse across England, 36% would hold the government in Westminster most responsible, compared to 15% for teachers, 15% for parents and 13% for head teachers
- If school results got worse in the local area in England, 21% would hold the government in Westminster most responsible, compared to 17% for teachers, 16% for parents and 20% for head teachers

Education

Responsibility for failure in education is more diffuse than it is for health and policing with teachers, head teachers and parents themselves being held responsible if school results were to get worse. Nonetheless it is still the government in Westminster that is held most responsible at both a local and a national level.

The fact that 16% of respondents believe that parents are most responsible for school results in the local area would seem to chime with recent calls, including from David Cameron, for parents and individuals to take greater responsibility for improving educational outcomes.

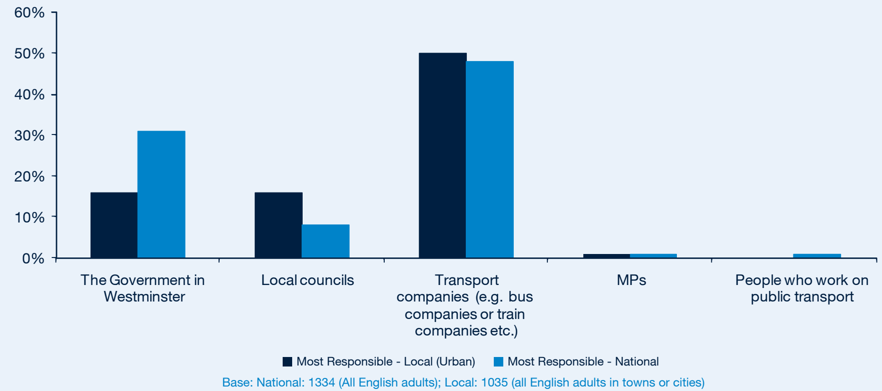
Transport

Unlike in health, policing and education, where the government in Westminster was consistently held most responsible for nation-wide problems, respondents were more likely to point the finger at private transport companies for problems with public transport. This also proved to be the case at the local level.

We discuss a possible explanation for why transport might be different below.

Figure 4: Transport at the national and local level

And which ONE of the following would you consider to be MOST responsible if public transport across England / across the city or town you live in got significantly worse?

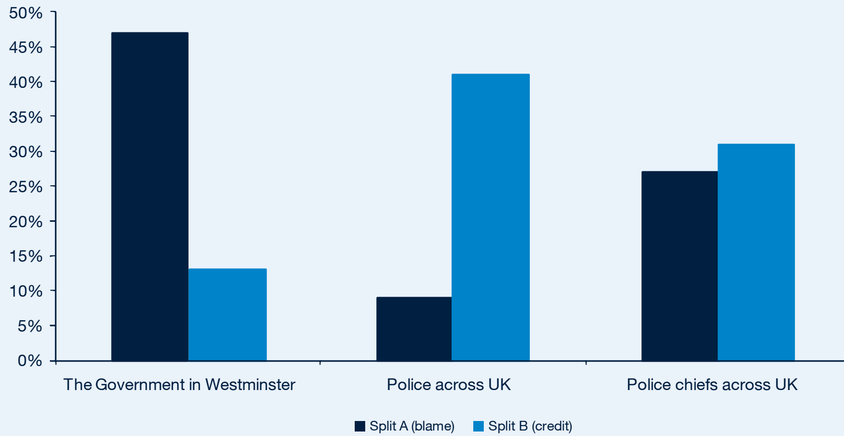


Base: National: 1334 (All English adults); Local: 1035 (all English adults in towns or cities)

- 48% of respondents in England said they would hold transport companies most responsible if public transport got worse across the country compared to 31% for Westminster
- At a local level 50% of respondents in England said they would hold transport companies most responsible in their city or town, compared with only 16% for the government in Westminster

Figure 5: Who's get the credit when things go right?

And which ONE of the following would you give the MOST credit to / hold most responsible if the police force across the United Kingdom became more effective / less effective at fighting crime?



Base: Split A: 782 (GB adults); Split B: 768 (GB adults)

Who takes the credit for things going well?

We were not only interested in who the public associates with things going wrong but also sought to see who they would reward for success. The findings across Britain do not necessarily make comfortable reading for politicians.

Our survey shows that while the government in Westminster is held accountable for things going wrong, it is not given the credit when things go right. For example, if policing gets worse, 47% of respondents hold the government in Westminster responsible. But if it gets better, 47% of respondents hold the government most responsible.

Summary

The public ‘default’ is to hold Westminster most responsible for public service performance, especially where the failure is seen to be country-wide

The profile for accountability varies by service. Health and policing have concentrated profiles on Westminster with the main delivery leaders/bodies taking most responsibility. Education, in contrast, has a more diffuse profile, with parents and teachers sharing accountability alongside the government. Where the involvement of private organisations is well understood, as in transport, these are held most responsible.

It also varies by geography where responsibility for failure varies according to whether a problem occurs in ‘my local area’ or ‘across the country’. At a local level delivery agents tend to be held most responsible, which raises important questions about how these bodies are made publicly accountable. But even when a problem arises ‘in my local area’, the government in Westminster is the *elected body* that most people hold most responsible.

Section 2: Giving power away – is it possible to shift responsibility?

The second thing we set out to test is the extent to which it is possible to shift accountability once power has been transferred to other bodies. We looked at the following bodies: the Scottish Government, the Mayor of London, local councils, quangos and private providers. Each is discussed in turn below.

Transferring risk to devolved institutions – Scottish Government and London Mayor

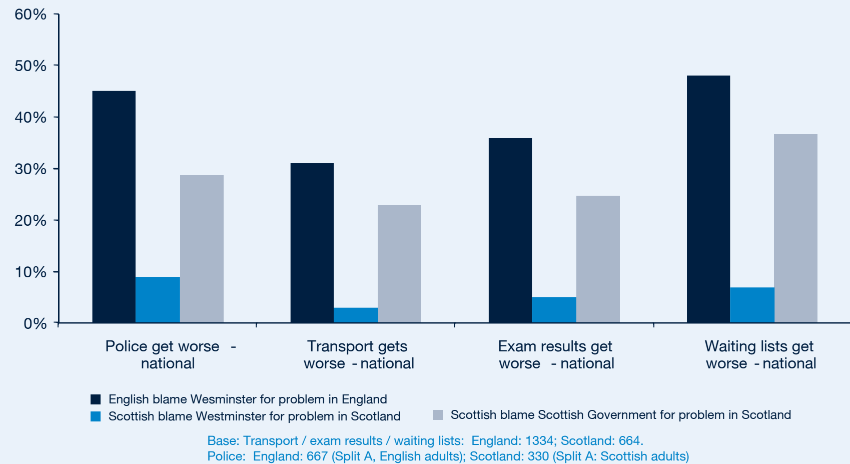
Our survey revealed clearly that devolution to an elected body needs to be wholesale and well publicised if perceptions of responsibility are to move from the default option of the government in Westminster to devolved bodies.

We looked at the impact of the Scottish Government and the Mayor of London to examine the degree to which these devolved institutions have changed public perceptions of accountability.

In Scotland – where the Scottish Government's powers are clearly defined and communicated and where Scottish Government ministers have a relatively high profile – the devolved Scottish government tends to be held to account rather than the government in Westminster.

For example, if waiting lists were to get longer across Scotland, only 7% of Scottish adults would hold the government in Westminster to account, while 37% would hold the Scottish government most to account.

Figure 6: Devolution of power to the Scottish Government



Indeed, as Figure 6 above indicates, Scottish respondents were much less likely to hold Westminster accountable for problems in Scotland. The good news for those who support decentralisation, therefore, is that this suggests that public perceptions can shift if real power is given away from the centre.

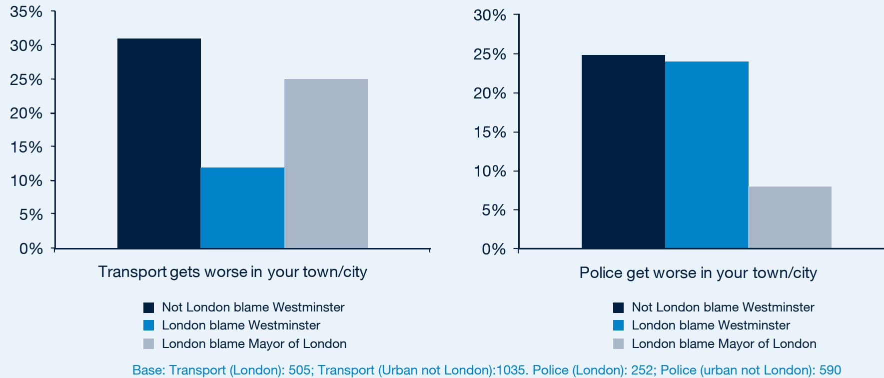
- 37% of Scots said the Scottish Government was most responsible for any rise in waiting lists in Scotland, compared to only 7% who held the government in Westminster most responsible

- 29% of Scots said the Scottish government was most responsible for any decline in police effectiveness across Scotland compared to 9% for the Westminster government
- 25% of Scots said that the Scottish government was most responsible if school results got worse across Scotland compared to 5% who hold the government in Westminster most responsible
- 23% of Scots would blame the Scottish government if transport got worse in Scotland compared to just 3% who would point towards the government in Westminster

10 The SSA survey was conducted before the Scottish Executive changed its name to the Scottish Government.

Figure 7: Public perceptions of Mayoral accountability

And which ONE of the following would you consider to be MOST responsible if public transport / police effectiveness across the city or town you live in got significantly worse?



Base: Transport (London): 505; Transport (Urban not London):1035. Police (London): 252; Police (urban not London): 590

Our survey does not provide longitudinal data but it is possible to compare our results with other research in this area to get a sense of how things have changed over time. The 2007 Scottish Social Attitudes survey, for instance, asked Scots who they thought exercised 'the most influence over how Scotland is run' and records that the proportion who believed it to be the Scottish Executive[10] rose from 13% in 2000 to 28% in 2007. Although we asked a different question, our own data and this evidence from the SSA would seem to suggest that over time the Scottish people appear to have got more used to their new institutional arrangements and have come to recognise the increased importance of the Scottish Government in Scottish public life.

In London, the results appear to confirm the Scottish experience. For instance, where the Mayor's role is clearly understood – as in public transport – it appears that he soaks up responsibility for failures from Westminster. But the same is not true of policing, where the distribution of responsibility is much less clear. If public transport got worse in London, 25% of Londoners would hold the Mayor responsible, whereas only 12% would hold the government in Westminster accountable. In contrast, if policing became less effective, only 7% of Londoners would hold the Mayor to account, while 24% would hold the Westminster government responsible.

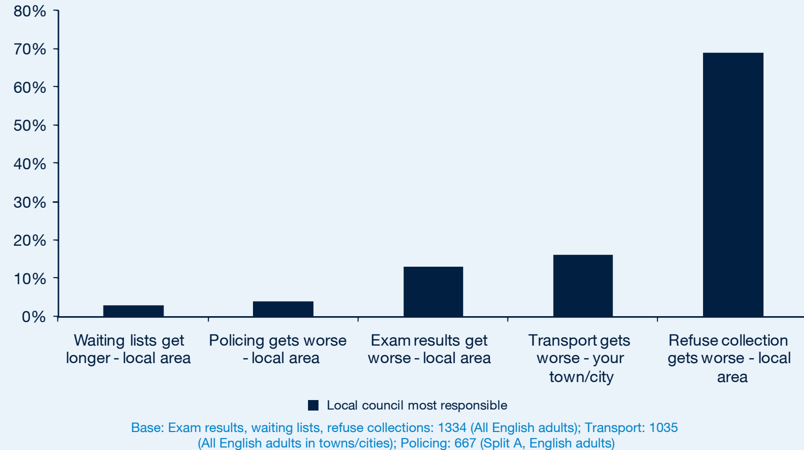
It appears that where the division of powers is much less clear, as in the case of policing in London, then respondents reverted to their default position and hold the government in Westminster to account. However, where powers are clear, it appears that a directly-elected mayor can make a big difference.

Transferring risk to devolved institutions – local authorities

Our survey shows that when something goes wrong in a local area, councils are very rarely felt to be the most responsible body. The one notable and unsurprising exception to this for the scenarios we tested, is refuse collection, where the great majority of the public hold the council most responsible. It is also the case that at a local level the same number of respondents held the local council and Westminster government most responsible if public transport got worse.

These results should not surprise us. Given the scaling back of local governments' powers over local services in the last thirty years why would the public hold them responsible for the performance of services they either do not control or control in a limited way? This, of course, assumes that respondents were aware of the division of powers between central and local government: though we note that respondents hold councils least responsible for health and policing at a local level but hold them most responsible for refuse collection which does seem to correspond to the actual division of powers.

Figure 8: Accountability of local councils across service areas



Base: Exam results, waiting lists, refuse collections: 1334 (All English adults); Transport: 1035 (All English adults in towns/cities); Policing: 667 (Split A, English adults)

To really understand the relationship between powers and attitudes towards responsibility at a local level we would need to see whether the pattern identified here changed if real powers were decentralised.

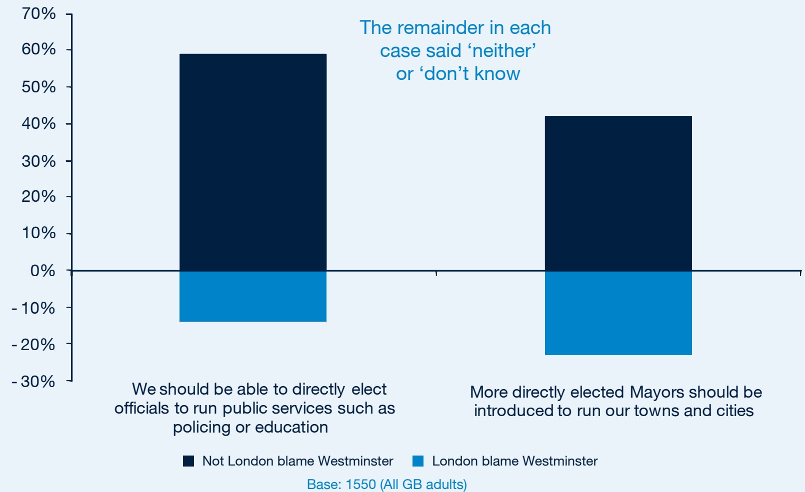
There are, however, reasons to be cautious about such a view. Whereas the Scottish Parliament and the London Mayoral model (for transport at least) appear capable of absorbing responsibility and therefore insulating the Westminster government from being held accountable for the decisions take by the devolved bodies, it is questionable whether governance arrangements in local government, as currently constituted, are sufficiently accountable for the transfer of power that some advocate.

As one leading Conservative front bench spokesperson told us:

> *I always argue that one of the problems with local government in England is that nobody takes local responsibility for anything, there is no local accountability. Everything that goes wrong at the local level is blamed on the national government.*

Figure 9: Support for directly elected officials

To what extent do you agree or disagree with each of the following statements?



Base: 1550 (All GB adults)

There is ample evidence to suggest why this may be the case: local authorities tend to have a low profile in their communities with very few members of the public being able to name their local politicians. For instance a recent Mori poll for NLGN found that 71% of the public could not name their council leader. Another obvious indicator is the low turnout in council elections.

It may be that local governance arrangements would need to change as a quid pro quo for greater powers. A number of policy proposals have been suggested to address the weak level of accountability at a local level. Two in particular stand-out: directly-elected mayors and directly-elected commissioners of public services, such as the idea of an elected police commissioner to hold the police to account. Both are intended to deliver more visible accountability by providing the public with a name and face to hold to account.

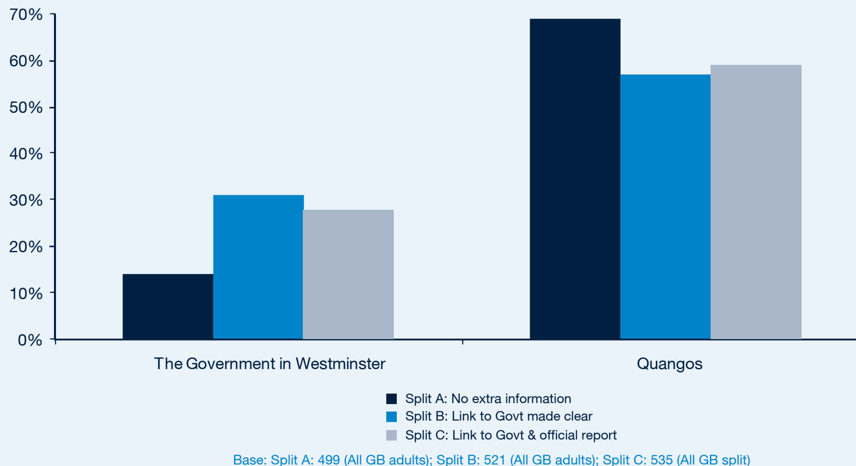
There is some evidence to suggest that directly elected mayors can deliver this accountability. 67% of Newham residents were able to identify Sir Robin Wales as their mayor in a recent survey.

Given the interest in the options we asked our respondents whether they supported their introduction. Figure 9 shows that both are popular, with over 40% supporting directly-elected mayors, and just under 60% backing the idea that the public should be able to directly elect people to run public services.

Quangos

Governments often set up quangos to perform specific and discrete functions. But is it possible to delegate accountability to these bodies or does the public still hold government responsible? The evidence from our poll is a little mixed but the main message appears to be that it is possible to transfer risk to quangos, but only if the public believe that such bodies are genuinely independent and responsible for their actions. If the public suspect that the government has interfered with the way they work then accountability for their performance moves back to Westminster.

To test the 'quango effect' we asked respondents a series of questions relating to a scenario involving a delivery failure within the education system. We divided respondents into three separate groups ('Splits'), each of which was given a different amount of information relating to the scenario. They were then asked to say who they felt was most responsible from a list which included an option for relevant quangos set up to deliver the service alongside seven other options such as "The Government in Westminster" and "local councils".



Responses by Split

- Split A were simply told that there had been a service delivery failure. The role of quangos was not mentioned
- In addition to what was described above, those in Split B were also informed about the government's role in creating quangos
- Respondents in Split C were given both pieces of information above, as well as being told that an official report had been published which held the relevant quangos most responsible

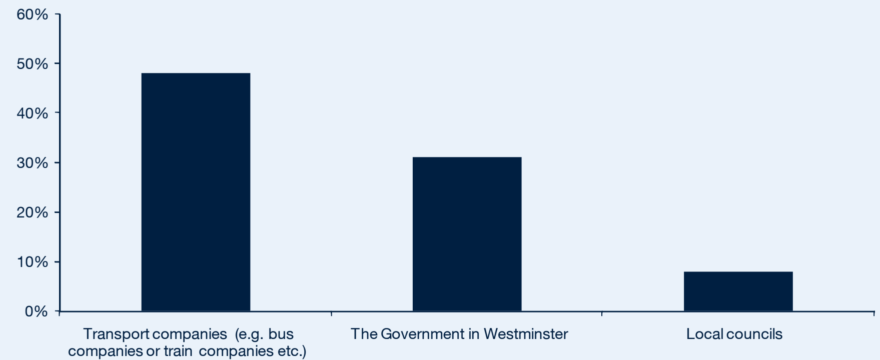
As Figure 10 shows, in this scenario the majority of respondents in Split A held the quangos most responsible (69%). But amongst respondents in Split B (who were asked to believe that the quangos "had been set up by the Government to be independent and manage the process,") perceptions of their responsibility begin to fall (by 10%) and the number holding the government in Westminster to account rises: in fact it more than doubles. Even when told in this scenario that an official Government report held the quangos responsible, respondents in Split C still shifted responsibility towards the Government and away from the quangos.

While a majority (56%) believed that an independent organisation ought to be responsible if something goes wrong, a larger majority (66%) felt that, because government has a role in setting the remit and resource for such organisations, they can never really be independent.

Private Providers

Private providers are held responsible when people interact with them day-to-day (as set out previously in public transport). Unlike health, crime and education, where the government in Westminster was consistently most held to account for nation-wide problems, respondents were more likely to hold private transport companies responsible for problems with public transport. Why might this be? Firstly the public has had time to get used to the privatised operators, and regularly interacts with them on a daily basis. And secondly because unlike in other public services where the role of private companies tends to be 'hidden' beneath a public service brand (such as the NHS), in transport the private operators have highly developed and publicly-recognised brands with which the public are familiar.

Figure 11: Giving power away - private transport companies



Summary

These findings demonstrate a number of things. Most importantly they show that it is possible to shift perceptions of accountability if devolution is well publicised and if real powers are transferred to highly visible and accountable bodies such as the Scottish Government, and the London Mayor (for transport policy at least). However, we can also observe that there is a lag in this transition, where it appears to take time for public perception of responsibility to catch up with the reality of devolved powers.

Giving power away to quangos can also work, but the independence is fragile and any government involvement moves accountability back to the government in Westminster. Private providers are held responsible when people interact with them day-to-day (as in public transport).

We can only speculate but the data also appears to suggest that members of the public have a good sense of how to allocate responsibility for the various scenarios to which they were asked to respond in our survey.

Determining who to hold responsible appears to depend on the extent to which a body has the powers to make a difference. In London they felt that the Mayor was more responsible for transport than policing which appears to reflect the balance of power between the Mayor and the Westminster government. At a local level they held councils responsible for refuse but not for health or policing.

Conclusion

This paper has sought to explore the degree to which it is possible to devolve responsibility for decisions within our highly centralised political culture. Although it shows that the public does tend to hold Westminster responsible for core parts of public service performance, it also shows that it is possible to give power away and transfer accountability to other bodies if certain important criteria are met.

In particular, public perceptions of accountability will change if decentralisation is well communicated, clearly enacted, and if real powers are transferred to highly accountable bodies. When this isn't the case – when lines of accountability are unclear, where the public does not know who is in charge, and where the division of power is murky – then the public reverts to holding the government in Westminster responsible for the performance of public services.

Contrary to what many assume, our research tends to suggest that when the public come to allocate responsibility they tend to so with a relatively good awareness of whether particular bodies have the powers to act in a particular area.

However, it also appears that it can take time for public perceptions of accountability to change once power has been transferred to a new body, as the experience with the Scottish Government appears to show. The public it seems need time to get used to understanding who is responsible for exercising powers at the devolved level.

This presents a challenge for politicians as it implies that there will be a period of time in which they will still be held responsible for the outcomes of decisions taken by a devolved body once they have let go. We believe politicians in Westminster need to hold their nerve if they are to rise to the challenge of giving power away in our centralised political culture.

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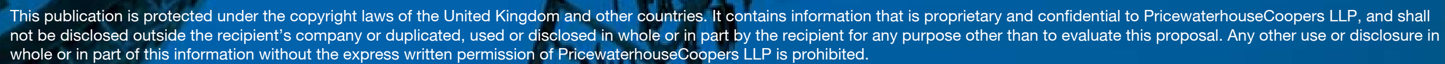

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