The Transport Committee

The Transport Committee is appointed by the House of Commons to examine the expenditure, administration and policy of the Department for Transport and its associated public bodies.

Current membership

Mrs Gwyneth Dunwoody MP (Labour, Crewe) (Chairman)
Mr David Clelland MP (Labour, Tyne Bridge)
Mr Jeffrey M Donaldson MP (Democratic Unionist, Lagan Valley)
Clive Efford MP (Labour, Eltham)
Mrs Louise Ellman MP (Labour/Co-operative, Liverpool Riverside)
Mr Philip Hollobone MP (Conservative, Kettering)
Mr John Leech MP (Liberal Democrat, Manchester, Withington)
Mr Eric Martlew MP (Labour, Carlisle)
Mr Lee Scott MP (Conservative, Ilford North)
Mr Graham Stringer MP (Labour, Manchester Blackley)
Mr David Wilshire MP (Conservative, Spelthorne)

The following was also a Member of the committee during the period of the inquiry:

Mr Robert Goodwill MP (Conservative, Scarborough & Whitby)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/transcom.

Committee staff

The current staff of the Committee are Tom Healey (Clerk), Annette Toft (Second Clerk), Clare Maltby (Committee Specialist), Louise Butcher (Inquiry Manager), Tony Catinella (Committee Assistant), Ronnie Jefferson (Secretary), Henry Ayi-Hyde (Senior Office Clerk) and Laura Kibby (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Transport Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 6263; the Committee’s email address is transcom@parliament.uk
First Special Report

The Committee published its Fourteenth Report of Session 2005–06 on 5 November 2006. The response from the Department for Transport was received in the form of a memorandum dated 23 January 2007, and is published as an Appendix to this report.

Appendix

The Objectives of Passenger Rail Franchising

1. We agree wholeheartedly with the general objectives of improving passenger services and maximising the value for money achieved from Government subsidies. But we do not believe that the current system of passenger rail franchising can achieve those aims in the long term. (Paragraph 11)

The franchising process is designed to harness private sector commercial judgment and innovation to reduce the net cost and increase the value for money achieved from the Government’s overall support for passenger rail services.

Whilst we continue to keep our franchising processes under review, we believe that the current franchising system is delivering. Over 1 billion passenger journeys were made last year, 40% more than ten years ago. We now have the fastest growing railway amongst the major European states.

Performance has continued to improve, with almost 88% of trains running on time over the last 12 months. Customer satisfaction is at its highest since we began measuring it through the national passenger survey.

People are seeing newer trains and investment in stations. We have the youngest fleet of passenger rolling stock in Europe. We’re making changes so that more people can use smartcards. These improvements are being made under the current franchising system.

We believe the franchising process has contributed to all of the above, particularly the growth in rail patronage. During the inquiry, we discussed with the Committee the limited evidence we have available to quantify the specific contribution of passenger rail franchising but we are commissioning research to resolve this query.

2. The objectives of the passenger rail franchising system are a self-contradictory muddle, providing no coherent framework or vision for the development of passenger services for future generations. The result is a system that is worth less, and costs more than the sum of its parts. It is high time that the Government established a consistent and achievable set of objectives and a system capable of achieving them whilst providing good services and value for money to passengers and taxpayers. (Paragraph 15)
The Government disagrees with these conclusions.

The franchise regime has helped us secure record passenger levels, strong revenue growth, lower fare increases than under British Rail, massive investment in new trains, an increase in reliability and customer satisfaction, and a reduction in passenger complaints.

Following the Government’s wide-ranging review of rail policy issues, The Future of Rail White Paper (WP) was published in July 2004, which enacted a more effective industry framework whereby:

- Government sets the overall framework, with the Secretary of State determining strategy and the rail budget, and the Department for Transport letting franchises in England and Wales
- Network Rail supplies an efficient GB network, and takes the lead on performance
- Train Operating Companies (TOCs) provide services for their customers
- The Office of Rail Regulation (ORR) takes responsibility for economic and safety regulation.

Further, the Government is quite clear on the high level objectives it seeks to achieve through its franchise specification process:

- to set out the level of train service provision required (through a review of historic provision and forecast future demand) where market forces otherwise would not supply;
- to protect passengers from monopolistic actions in specific markets (for example, through the regulation of certain commuter fares);
- to ensure that the benefits of a national rail network for Great Britain are protected;
- to provide the ‘level playing field’, the prerequisite for a competition to award franchises successfully within the terms of procurement legislation and general best practice;
- to allow the specification to be varied over time to reflect changing market needs through innovation and commercial judgement.

The new industry structure has been delivering good services and value for money to passengers and taxpayers. Customer satisfaction is at its highest since we began measuring it through the National Passenger Survey – where 80% of passengers declare themselves satisfied or better with their overall journey. In addition, the Government has been promoting cost-control and cost-efficiency to the general benefit of both fare-payers and taxpayers.

3. The key objectives of our railways for the next decades must be to increase capacity, and facilitate growth in patronage through improvements in services to passengers. The only way to achieve this in the long term is to drop the dogmatic pursuit of competition where competition is not possible, and to make honest and tough choices about what the private and public sectors can and should do in future. We expect the
Government’s forthcoming long-term strategy for the railways to tackle these fundamental issues head on. It must contain a structure and a strategy capable of securing quality passenger rail services to meet demand over the next half a century.

The Government agrees that one of our key objectives for the next decade is to continue increasing capacity and facilitating growth in patronage on passenger rail franchises. However, the Government does not accept that it is engaged in “the dogmatic pursuit of competition where competition is not possible”.

We believe that competition between prospective TOCs to win franchises and maximise revenue has been and will continue to be important in stimulating growth in patronage and rail services. It is not, however, the primary mechanism for increasing capacity.

Capacity improvements are part of current contracts, but future growth will be addressed as part of the longer term framework for the railways we will publish in Summer 2007.

It should be highlighted that significant improvements in capacity have already been introduced in the last five years, helping to accommodate the recent increases in train travel. Greater passenger-carrying capacity has been introduced through new and larger fleets of trains, for example on Trans-Pennine routes, Chiltern Railways, South West Trains and Midland Mainline. Additional route capacity enabling more trains to operate has been introduced through infrastructure improvements, for example the upgrade of the West Coast Main Line, with further improvements expected in two years’ time when more track works and re-signalling has been completed. Other infrastructure capacity enhancements are being driven through a variety of Network Rail schemes ranging from small local track and signal improvements to major projects such as Kings Cross station.

The Government will set out its future plans on capacity and investment in Summer 2007 when the Secretary of State intends to publish a High-Level Output Specification (HLOS) for the passenger railway in England and Wales. This will cover the years from 2009/10 to 2013/14, specifying the capacity, reliability and safety improvements the Government wishes to secure and setting out the funds available for this. It will be accompanied by a strategy considering, *inter alia*, capacity issues in the longer term.

However, the Government disagrees with the assertion that “competition is not possible” within current passenger rail franchising arrangements.

Competition within the rail industry is achieved by the holding of vigorous competitions for new and replacement passenger franchises. The aggressive bidding that has characterised recent franchise replacement contests has ensured a good deal for the taxpayer, and there is no sign that the forthcoming round of franchise letting will be any less competitive.

In previous competitions, bidders have proposed many additional services and minor investment schemes, over and above what was set out in the Invitation to Tender (ITT), that have been contractualised into the franchise within an overall bid price which was affordable. For instance, on the Integrated Kent Franchise, Southeastern provided services which are additional to the base line DfT asked for in the ITT. This included a strengthened half-hourly service to Beckenham Junction to Victoria, an additional peak
service between Faversham and Cannon Street, two additional peak trains between Ashford and Charing Cross and some extra mid-evening and late evening trains to suburban and Kent destinations from London. On Thameslink/GN, in the security plan in its bid, First Capital Connect committed to fund additional British Transport Police resources (2 sergeants, 3 constables and 24 PCSOs), achieve “Secure Stations Scheme” accreditation at 12 additional stations and install 167 new CCTV cameras and 78 additional help points. None of these improvements was mandated in the DfT specification.

4. **Having re-designed franchise contracts to include ‘revenue risk-sharing mechanisms’, it is crucial that the Government resist any pressures to renegotiate franchise agreements if operators get into difficulties. If it were to bail out operators through renegotiation despite taking over most of the medium- and long-term revenue risks, the Government would have failed doubly.** (Paragraph 23)

The Government is in complete agreement that we should resist pressure to renegotiate franchise agreements with operators on the new style contracts and always have been. The Government has made it clear that rail operators that fall into financial difficulty should expect to surrender the franchise and not receive financial support. We’re not prepared to rescue a TOC that can’t deliver the service it contracted to deliver at the price it contracted to. To do otherwise could set the precedent that we are willing to bail out operators at extra cost to the taxpayer.

This is evidenced by our recent decision to put GNER on a temporary Management Agreement whilst we undertake a competition to procure a new operator to run services on the InterCity East Coast Mainline.

As the Transport Select Committee report references, however, there is a distinction to be drawn between TOCs which have the benefit of revenue risk sharing provisions in their contracts, and those which don’t have such provisions because they’re on older style contracts. We have said that we might, in certain cases (e.g. a slow-down in economic growth), look a little more sympathetically at requests for support from the latter group.

A guide to the railway franchise procurement process, which is published on our website at http://www.dft.gov.uk/stellent/groups/dft_railways/documents/page/dft_railways_611464-04.hcsp#P56_12834, notes:

The Department will consider (with no presumption that it will accept and subject to state aid rules) requests for additional support from franchisees who are not on new-style franchises, but would have received protection from the revenue-risk sharing mechanisms, or been able to make a *force majeure* claim if they had been on such a contract. This recognises that there may be exceptional circumstances, for example a large and widespread downturn in demand, where it might be wrong to penalise the franchisee and where wholesale use of the Operator of Last Resort mechanism would be impracticable and damaging to the market. However, these exceptional circumstances aside, the Department will insist that a franchisee which is unable to operate to the price it bid should surrender the franchise. The Department will therefore hold franchisees to the terms of their contracts. Where an event of default occurs which leads to termination, the Department also reserves the right to trigger the cross-default mechanism in franchise contracts, under
which termination of a franchisee may bring about a termination of other franchise agreements to which the franchisee or an affiliate company is a franchisee.

5. The transfer of risk to the private sector was a core objective of privatisation. But in the current system only a very limited proportion of risks are, in reality, borne by franchise operators. There are also significant inconsistencies about what risks are borne by operators, and which by the Government. The relative lack of risk transfer calls into question the fundamental assumptions and objectives of the franchising system. If risk is not transferred, there is little point in involving the private sector in the running of the railways. (Paragraph 25)

DfT has sought to learn from historical industry experience and enact a franchising policy that achieves an appropriate balance of risk, reward, and involvement between the public and private sectors.

Our aim is to place risk where it can be managed best. For instance, TOCs are not in a position to manage GDP-risk but, for the most part, they are able to manage operational expenditure. Consequently, there are provisions in the new franchise contracts, which provide comfort to the TOCs that they will not be held accountable for certain risks and extraneous events beyond their control. However, these are balanced against a change mechanism, which sets the parameters for negotiating changes during the life of the franchise (thus minimising the impact of single tender negotiations), and revenue share arrangements, which ensure that any windfall revenue gains are shared with Government.

Most importantly, we have made it clear that we expect contractual commitments to be met. TOCs carry cost risks and, to the extent that they are unable to manage these within the terms of their franchise agreement, they directly bear the financial implications. If necessary, we are prepared to use our Operator of Last Resort powers (as happened when Connex South Eastern was failing as a franchise), and we have robust plans in place to ensure the continued provision of train services to the public.

This is a very real risk, which TOCs take seriously. The industry is aware that our new accreditation process would make it difficult for any TOC to pre-qualify on a franchise competition who, as a result of its own business decisions, gets into serious financial difficulties so that it defaults on the franchise. Further, TOCs on the new style contracts would need to forfeit their performance bond, which is currently set at 5.5% of the aggregate forecast annual operating costs of the franchise and in recent franchise agreements the full amount is at risk from the date of signature.

The Process of awarding passenger rail franchises

6. We welcome the fact that the Department for Transport is taking steps to better integrate the franchising process with long term strategic plans, Regional Planning Assessments (RPA) and Route Utilisation Strategies (RUS). This is a move in the right direction. We are, however, concerned that the Government has failed to embrace the notion of RPAs, RUS and franchise specifications flowing from a wider strategic plan rather than the other way round. This approach is likely to result in perpetuation of the status quo rather than development based on a strategic vision for what is required and desirable for the future. (Paragraph 29)
Following the Future of Rail White Paper, the Department for Transport has moved towards greater co-ordination over the long term planning of the rail network.

Regional Planning Assessments (RPAs) enable regional strategies to be taken account of when assessing the needs of the railway in the medium and long term and, in turn, can inform future Regional Transport Strategies in terms of the appropriateness of rail in meeting regional transport objectives.

It is true that, up until now, the Regional Planning Assessments, Route Utilisation Strategies, and Franchise Specifications have not necessarily occurred in a linear progression. However, the programme of Regional Planning Assessments will be complete by Spring 2007 and these are informing our High-Level Output Specification and the long term strategy for rail. The RPAs will also inform subsequent Route Utilisation Strategies carried out by Network Rail. In terms of franchises, both the West Midlands RPA and RUS were able to inform the franchise specification for the West Midlands franchise.

As referenced under our response to TSC recommendation 3, this Summer, we will be publishing a High-Level Output Specification (HLOS), which will be a costed plan for the development of the railway over the next five years. It will be accompanied by a budget, independently verified by the ORR. Alongside the High Level Output Specification, we will set out a longer term framework for rail that takes into account all forms of transport so we know our present choices will have sustainable, long-term value.

Future franchise specifications will be undertaken with reference to the HLOS and some existing franchises will need to be reviewed to reflect the HLOS outcomes.

7. A broad-based consultation with passengers should be a statutory requirement, and we recommend that the Government include such provisions in its next railways bill. (Paragraph 34)

Before issuing Invitations to Tender on franchise competitions, the DfT undertakes comprehensive stakeholder consultation exercises with the rail industry and a very wide range of stakeholders. The list includes statutory organisations that set policy/strategy/provide funding for transport provision (e.g. Devolved Administrations, County/Unitary/Metropolitan Authorities; Regional Assemblies; Regional Development Agencies; TfL and Passenger Transport Executives) and Passenger Focus/London TravelWatch (for passenger views).

Consultation documents are sent to all affected Authorities/Agencies and MPs with one or more affected station in their constituency. We also post the documents on the DfT website and issue press releases. By this means the consultations are open to the general public. Indeed, we have had a large number of individual responses from members of the public.

During the consultation we invite all affected Authorities/Agencies to a series of consultation meetings, held at a number of venues around the country, to discuss the specification and any concerns/issues they have with it and to hopefully inform their responses to us. These meetings are generally well attended. We also have separate
meetings with Passenger Focus, the independent rail consumer organisation for Great Britain, and London TravelWatch.

Following the closure of the official consultation period, we evaluate all responses received and issue a Stakeholder Briefing Document. This outlines the responses received, key comments made and any resulting changes to the proposed specifications. Should the successful bidder propose any additional changes, we would expect the TOC to undertake a comprehensive consultation before introducing any new timetable.

All franchise consultations are carried out in accordance with the Cabinet Office Code of Practice on Written Consultation:

(http://www.cabinetoffice.gov.uk/regulation/consultation/index.asp). The Government considers these consultation arrangements to be sufficiently robust in considering the passenger’s view.

8. The removal, in the Railway Act 2005, of the statutory right of PTEs to co-sign franchise agreements was a mistake. We therefore recommend that the Government consult PTEs in order to determine what adverse consequences have resulted from it, and take steps to address them. We also recommend that franchise specifications should take account of regional and inter-regional economic strategies. (Paragraph 44)

As set out in the Transport and Rail White Papers the Government is keen to devolve greater decision making to local and regional bodies. However, local decision making can only be made on a level basis where the body making the decision is exposed to the financial implications of that decision. The present procurement arrangements and specifically the co-signing of franchises do not lead to financial accountability. Therefore, there was a need to change it.

The Government has no active plans to remove PTEs as co-signatories to existing franchise agreements, like Northern Rail, and there is discretion for PTEs to remain as co-signatories on future franchise agreements. However, the Secretary of State would not expect to exercise this discretion unless a PTE can provide evidence that their presence as a co-signatory added significant value to the management of the franchise and wider DfT objectives of improving performance and cost control.

PTEs have played a valuable role in specifying and monitoring franchise agreements for local services. They will need to stay closely involved in local rail services if they are to properly plan the best local transport solutions for their areas – but possibly not quite so ‘hands on’ as they have on the past.

We have consulted closely with the PTEs when drawing up the detailed guidance on how PTEs will be able to input into the franchising process in an appropriate and accountable

---

1 Since its formation on 24 July 2005, the aim of Passenger Focus (a non-Departmental Public Body sponsored by DfT) has been to “get the best deal for Britain’s rail passengers” through influencing decision making and providing advice, advocacy and empowerment to passengers. Consultations with DfT and the wider rail industry is a key activity for them in fulfilling their wide ranging statutory duties to investigate issues that affect passengers. They conduct research into what passengers want from the franchising process and provide this to the Department, industry and passengers.

2 In instances where our franchise consultation period is shorter than the statutory 12 weeks, we carry out a pre-consultation exercise with the same set of stakeholders, previously referenced, prior to issuing our consultation document.
way. The Railways Act 2005 also provides the flexibility to enable PTEs to be co-signatories to franchises where this can be deliver the most benefits. The Government would not expect to exercise this discretion unless a PTE can provide evidence that their presence as a co-signatory added significant value to the management of the franchise and wider DfT objectives of improving performance and cost control.

As part of our wide-ranging consultation process, we take into account regional and inter-regional economic strategies. The RPAs, which inform our franchise specifications, also take into account regional strategies and inform future Regional Transport Strategies.

9. The Government must ensure that real innovation contained in franchise bids is rewarded, even where it goes beyond the strict requirements of the franchise specification. (Paragraph 51)

The need to reward innovation in franchise bids needs to be balanced against the need to provide a “level playing field” in which all bids are assessed against the same base. Generally, the DfT seeks to enable the benefits of private sector innovation and commercial judgment to be applied during the procurement and subsequent franchise term. It is important, however, that we are clear about what innovation, realistically, can be expected of TOCs.

There is flexibility for bidders to be innovative through proposing additional services, as the DfT specifies minimum service levels and not timetables. There is also the opportunity for bidders to propose additional investment, for instance to rolling stock or minor station enhancements (e.g. Passenger Information Systems and CCTV).

In our response to Recommendation 3 above, we provided examples of some of the additional services and minor investment schemes that were contractualised with winning bidders. A good example of innovation is First Great Western’s commitment to reconfigure / refurbish its High Speed Trains.

10. A re-balancing of the importance of cost among the criteria for the evaluation of franchise bids is urgently required. We recommend that the Government develop ways of evaluating cost relative to proposals for innovation and franchise development over and above the basic franchise specification. The re-balanced evaluation criteria should also take into account less tangible costs and benefits such as wider environmental and socio-economic factors. This would serve to reward innovation and development whilst retaining cost as a criterion. (Paragraph 57)

11. We are concerned that the drive to extract premiums from some parts of the network will result in further above-inflation fare increases and a deterioration in customer service, investment and innovation. Where rail franchises are profitable, the structure of premium payments to the Government should provide incentives for franchises to invest and be more innovative. We recommend that future contracts include the possibility to make a proportion of the premium payments from a franchise available for re-investment directly into that franchise or into infrastructure used by the train operating company involved. Such reinvestment should be dependent on clear, specific and innovative investment proposals from the operator with a demonstrable benefit to passengers and the environment. (Paragraph 58)
Combined response for 10 and 11

Cost is just one element of our evaluation criterion. Prior to issuing invitations to tender, we take into account wider environmental and socio-economic factors when developing the franchise specifications we issue to bidders. Before formally evaluating, we ensure that all bids received are compliant with the base specification. We then proceed to evaluation – taking account of price, performance and deliverability.

It should be noted that we do not specify premiums or indeed subsidy. No tender will win a franchise competition if we are not satisfied the bidder can deliver the Franchise Services. The premiums we are paid bolster the rail budget, and provide funds for investments in rail enhancements in England and Wales. Our processes have incentivised Train Operating Companies to raise the quality of their services, and attract more passengers to use the railways. We have the fastest growing railway amongst the major European states.

With regard to reinvestment, we have been communicating to the rail industry that we warmly welcome TOC station investment proposals, which add value to the franchise, and which would transfer to successor TOCs at balance sheet value.

Lastly, it must be stressed that operators do not have complete freedom to increase fares and regulation is in place to cap some fare increases, including commuter fares. In 2006, commuter fares are on average 3% less in real terms than they were ten years ago, and the average price paid per kilometre has risen by just 2%, whilst GDP per head has gone up 26%.

12. We fear the re-franchising process is driven more by consultants and lawyers than by people with an in-depth understanding of the railways and what is required to run good passenger services, now and in the future. We urge the Government to revise its re-franchising procedure to focus clearly on the core requirements, weeding out unnecessary detail. Costs incurred by bidders will eventually be paid by taxpayers and passengers through increased fares, and subsidies or decreased premiums. It is therefore in the public interest to keep the costs of the re-franchising process at the lowest possible level. (Paragraph 63)

13. The Rail Division within the Department of Transport should be staffed so that, on the whole, it can manage the entire process of re-franchising without outsourcing significant parts of the work to external consultants. Consultants should be used only to deal with the occasional special or unusual aspect of a franchise specification and procurement. We recommend that the Department review its staffing requirements and establish clear guidelines for the use of consultants. We would expect such guidelines to be made publicly available with performance against them open to scrutiny. (Paragraph 64)

Combined response for 12 and 13

Due to the cyclical nature of franchise replacement projects, it would be difficult for both the public and private sector not to outsource some of this work. It must be stressed, however, that the specification of franchising is led by permanent DfT staff with an in-depth understanding and experience of the railways and procurement of major rail projects. Our staff have experience in both the public and private sectors in a range of

Despite this range of skills to draw from within DfT, it remains the case that the volume of work requires us to supplement our resources with external support. We believe this is far more prudent than recruiting additional permanent staff to be on stand-by during periods of inactivity over the medium to long-term.

The DfT is conscious of the need to reduce industry costs by focussing franchise bids on essential factors and requiring supporting evidence which is proportionate to the degree of improvement and innovation offered by bidders for the issue concerned. Consequently, the criteria and evaluation process is advised to bidders to enable them to best focus their resources in preparing their bids.

An overall bid size limit was first introduced for the South Western franchise competition and, following consultation with bidders, has been further reduced for the East Midlands, New Cross Country and West Midlands franchise competitions. We also ensure consistency of approach across franchise competitions so as to reduce the complexity of bidder responses, particularly when more than one Invitation to Tender is issued simultaneously.

14. The Government must consider, in cooperation with the OFT and the Competition Commission, the suggestion of incorporating competition considerations into the specification of franchises. It must also monitor the effects of the new process for referral to competition authorities only once a franchise has been awarded to ensure that the late referral does not limit the range of remedies available to the Competition Commission. It is vital that the Commission has the full range of structural remedies at its disposal to prevent abuses of dominant position by monopolist operators. (Paragraph 70)

The handover of an outgoing franchisee to a new franchisee is legally classified as a merger. The merger control regime is operated by the Office of Fair Trading (OFT) and the Competition Commission (CC). The OFT has a statutory duty to review the competition implications of any ‘qualifying merger’* and has a duty to refer a merger for further investigation and possible remedies to the Competition Commission if it considers that there is a significant prospect that the merger will result in a substantial lessening of competition.

A new process has recently been agreed between OFT, DfT, ORR and the rail industry. Bidders for franchises will no longer have to notify OFT of their intention to merge until preferred bidders stage, previously all pre-qualified bidders had to notify. These changes have been introduced to reduce the requirement for abortive work by OFT and the bidding community. A streamlined process for information gathering has also been agreed between the OFT, CC, DfT and ORR, which will reduce the burden on the franchisee from participating in any merger inquiry relating to franchise acquisition.

* For an acquisition to be a qualifying merger:

(a) two or more enterprises must cease to be distinct; and
(b) either:

i. the value of the turnover in the UK of any of enterprises ceasing to be distinct exceeds £70m; or

ii. as a result of the merger the enterprises ceasing to be distinct either supply or are supplied with at least one quarter of all the goods or services of a particular description within the UK or a substantial part of the UK.

15. The absence of new entrants into the passenger rail franchising market is a clear indication of unreasonably high barriers to entry. Whilst we agree with the Government’s policy to include past performance as a criterion for new franchise awards, we are deeply concerned that a small number of companies have come to dominate the franchising market. There is little evidence of the Department positively encouraging new entrants, and we recommend that steps be taken to bring new companies into the franchising market. (Paragraph 72)

The Department disagrees with the assertion that there are unreasonably high barriers for new entrants to the passenger rail franchising market. The letting of franchises is a competitive process conducted in accordance with Office of Government Commerce best procurement practice. We have attracted several new bidders who have successfully pre-qualified on recent franchise competitions.

We have also made efforts to positively encourage new bidders. Last January, the DfT issued a Prior Information Notice in the Official Journal of the European Union to indicate the rail franchise procurement activity planned for 2006. This was augmented with a Trade Day in April and a Press Day in June – the purpose of these was to communicate to the market the competitive processes that the Department uses in order to prepare the market for franchise procurement. The information supplied was augmented with the Franchise Procurement processes being accessible on the Department’s website. In accordance with Cabinet Office best practice guidance, the Head of Rail Procurement keeps his diary free for supplier surgeries every Friday morning in order to explore franchising issues with current and potential suppliers.

Our evaluation criteria and methodology is made clear to all bidders throughout the process. Transparency has been introduced into the accreditation process with the focus on business excellence and technical ability. The process filters those out who provide insufficient evidence that they are capable of providing the services required.

This process has already seen new partnerships and entities formed and whilst not always successful in progressing to the next stage, a full and comprehensive debrief is provided to all bidders in order that strengths and weaknesses are highlighted, thereby informing their future submissions.

As much as we welcome new entrants, we are under a duty to award a franchise to the bidder who returns the best overall tender in terms of price, reliability, and deliverability.
The management of passenger rail franchising system

16. We welcome the move towards a general set of base specifications that are used across all franchises, with a separate set of specifications setting out requirements that are franchise-specific. The base specifications should remain strictly limited to essential conditions. Franchise-specific conditions should be allowed to vary widely so that the tightness of service specifications can be tailored to the circumstances of individual franchises. Taxpayers are entitled to expect that heavily subsidised franchises have tighter specifications than ones that pay a premium. (Paragraph 78)

Noted.

17. The aim to attract private companies who are prepared to take commercial risks, provide innovation and adapt to market circumstances is fundamentally at odds with the need for the Department to guarantee the consistent delivery of a quality public service and value for money for taxpayers and passengers. On the one hand there is a need for loose and flexible franchise specifications with room for innovation and risk, and on the other hand there is a need for very tight specifications and targets. Franchise operators have very limited flexibility to innovate, and they assume only a relatively small part of the overall risk. This tension cannot be fully resolved within the current framework, but the Department could mitigate the problem to some extent by reassessing the gains and losses of its current approach with a view to achieving greater flexibility. (Paragraph 83)

The Government believes its current rail franchising policy balances the benefits of private sector innovation and commercial judgment with the need to (i) ensure the continued provision of train services to the public and (ii) deliver the best deal for both the passenger and taxpayer.

There is also sufficient flexibility within the current framework to allow for innovation by bidders over and above the base specification contained in our Invitations to Tender.

In our franchise competitions, we specify outputs that passengers tell us they want – safer stations, smart-cards, and better performance. When the public is paying, the Government has a right to set out what must be supplied for that money.

However, it is equally important to emphasise that our approach to specification does give operators the flexibility to run more services, where this is operationally practicable, since we specify minimum, not maximum, service levels.

18. We recommend that the Government move towards medium-length franchises of up to fifteen years with one or two in-built break-points where contracts may be terminated if performance is unacceptable. We believe longer franchises will enable greater stability, increase the willingness by TOCs to invest, and reduce the cost of re-franchising. The Government already deploys break clauses, and we think they are the key to having longer franchises without losing the ability to set incentives and targets for TOC performance. (Paragraph 90)

The Government has decided to let contracts of varying lengths. Current policy is that franchises will generally be let for periods of 8 to 10 years, as experience has shown that
there are challenges in forecasting cost / revenue any further ahead than that with any confidence. Also, Government takes the view that this is long enough to present an attractive business opportunity – thus encouraging a robust field of bidders – whilst allowing the taxpayer and passenger to benefit from the innovation and efficiencies associated with competitions taking place at regular intervals.

There might be a good case to let longer contracts in specific circumstances, for instance when a franchise will cover a period of operational instability or there is an identified need to allow a longer period for a return on an operator investment. However, these would need to be balanced against the risks of TOCs seeking financial support in the later years of their franchise life for items deemed to be out of their control.

Likewise, in some instances, it is appropriate to include “break clauses” to deal with the implications of major infrastructure projects (e.g. Thameslink Route Modernisation). There may also be justification for aligning contiguous franchises’ terms to enable a more holistic review of future service provision. Again, such exceptions would need to be carefully considered during the development of the procurement strategy and with reference to EU Directives.

19. With the creation of the two new Midlands and the Cross Country franchise, the number and sizes of franchises across the network is broadly sound. Any further re-mapping should be undertaken only if there are compelling operational reasons for doing so. (Paragraph 93)

Noted.

20. The Government must ensure, through franchising contracts, that franchise operators keep their costs tightly under control. (Paragraph 97)

The Government agrees.

We monitor TOCs’ financial and operational performance on a monthly basis and taking a quarterly review of the financial health of their owning groups. Review of these operational and financial obligations provides an early warning system for the DfT.

21. We did not receive any compelling evidence to determine whether vertical integration would improve passenger services. We believe that vertical integration across the entire network, and in conjunction with the current franchising model, would be a retrograde step. But we also believe that vertical integration may have some merit in self-contained regions, such as Merseyside. We therefore recommend that Network Rail and the Government, with advice from the ORR, design and carry out pilots of vertical integration on self-contained part of the network, where a sound case for such pilots can be made. It is essential that Network Rail supports such pilots. We look to the ORR and the Government to ensure that pilots are encouraged and given the best possible conditions of success. (Paragraph 106)

The Government agrees that vertical integration across the entire network would be a retrograde step. Overall, however, we continue to believe that “virtual integration” – through aligning the incentives of track and train companies and closer collaborative
working – is the optimal solution for the rail industry, as there are a number of drawbacks to combining ownership of track and train.

With regard to introducing pilots on self-contained networks, such as Merseyrail Electrics, the Government believes that the transfer of infrastructure responsibilities to train operators should be introduced only with the agreement of all the parties involved.

The DfT worked closely with Merseytravel, the Office of Rail Regulation, and Network Rail to facilitate such an arrangement on Merseyside. However, in the absence of any prospect of Network Rail agreeing to enter into a lease agreement with Merseytravel, we concluded that we were unable to support any more work on this proposal. This remains the Government’s position.

The Government believes that the good progress with “virtual integration” between Network Rail and Merseyrail Electrics is the best way forward. It will yield significant benefits for passengers and will facilitate the development of a truly joint team. Network Rail has:

- created a new operations and maintenance team to provide a more focussed and dedicated customer facing team to improve the interface with Merseyrail;
- arranged to co-locate with Merseyrail at Rail House, Liverpool, from the go-live date; and
- facilitated further integration of the control centre at Sandhills, with the next phase (integrating fault control) being delivered early in 2007.

Network Rail believes that the integration of the control centre will improve the response to incidents on the network and enhance performance. Merseyrail has been supportive of the changes so far and has actively helped to make some of them happen, e.g. accommodation for co-location at Rail House.

Network Rail and Merseyrail are also discussing their long term priorities for the route as an input to the development of Network Rail’s strategic business plan for the next five year control period from 2009.

**Open access**

22. Rail services need to be planned and coordinated. It is crucial that all decisions on access to the network cohere into a long-term strategy optimising the passenger benefit of the network. This is all the more true for part of the network where capacity is scarce. Whilst open access services can bring significant benefit to passengers on some routes, it is imperative that such access is not allowed to reduce the capacity and jeopardise the efficiency of the network as a whole. (Paragraph 114)

23. Where open access is granted to the network, the ORR must ensure that timetables are coordinated between open access and franchised operators so that passengers reap the full benefits of the services available. (Paragraph 115)

24. It is a very serious flaw that open access decisions appear to be made without due regard for overall network strategy and existing contractual obligations. We appreciate
the importance of the ORR acting as an independent regulator, but decisions about network access must never be made in a vacuum. We recommend that ORR and the Department for Transport establish clear lines of communication about network capacity and access, and the scope for extra paths to be allocated, be it to a franchise or an open access operator. (Paragraph 116)

25. Unlike many other and more predictable risks, the risk that a successful open access bid will reduce the ‘fare box’ and limit track access of an incumbent franchise falls entirely with the franchise operator. This makes little sense given the probable size of the risk premium that will be priced into franchised bids as a result. The risk of new open access operations should be shared between the Government and the franchise operator. We recommend such an arrangement because it would create an incentive for the Department to coordinate policy in this area more closely with the Office of Rail Regulation which grants open access rights, and to be more explicit about the open access potential in the course of the re-franchising process. (Paragraph 121)

**Combined response for 22–25**

The Government agrees that open access should not be allowed to reduce the capacity and jeopardise the efficiency of the network as a whole and that decisions on open access should be made with due regard for overall network strategy and existing contractual obligations.

As highlighted in the Future of Rail White Paper, the DfT’s position is “that operators should continue to be free to apply to run passenger services under open access rights” as “the possibility of purely commercial services supplementing those provided under franchise remains a valuable one” (para 4.4.9) but we think “access rights should not be granted for services which just poach passengers from other services and do not increase the overall market” (para 4.4.10).

The ORR is currently engaged in a consultation exercise with all operators, including potential open access operators, and with Network Rail in the area affected by the current competitions for the East Midlands, West Midlands and New Cross Country franchises, to establish the capacity available and whether the aspirations of those operators can be accommodated on the network alongside the services to be operated by the three new franchises. This is part of an effort to ensure that ORR are in full possession of the aspirations of all operators – franchised and otherwise – which will enable them to take decisions that have due regard for overall network strategy and existing contractual obligations. DfT is working closely with ORR throughout this process.

At present, it is DfT’s view that the East Midlands, West Midlands, and New Cross Country franchises will be able to obtain track access rights sufficient to enable them to fulfil the Service Level Commitments described in the Invitations to Tender.

In the cases of these three franchises, it is DfT’s view that there is only a small risk that a successful open access bid might have a significant impact on projected farebox revenue. Consequently, the DfT continues to believe that the market is best placed to consider the impact of future open access services, although ORR has a role to ensure that it approves new access rights in accordance with its statutory duties.