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Rail franchising

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Transport Committee

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Summary

The premise behind franchising was that competition would increase efficiency, reduce the taxpayer subsidy, lower fares and improve services. While franchising has facilitated passenger growth and service improvements, it is clear that it has not yielded all the competitive benefits initially envisaged by the Government in the early 1990s. Many metrics of performance are plateauing and the passenger is not receiving value for money.

Franchising delivers the most benefits to passengers where there is robust competition between bidders to operate services. Direct awards and the recent fall in market interest demonstrates that genuine competition has been restricted to a limited number of franchises. The core policy objective of promoting competition is not being met and the potential benefits from this model are therefore not being maximised by the Department.

While not a complete alternative to franchising because of fragmentation risks, open access could provide opportunities for new entrants to the market to promote greater competition on intercity long distance routes. This model of passenger operation has been a success in Britain. Any expanded role on the network should occur in a measured way in order to fully understand future operational risks. Prior to any expansion, reform is urgently required to equalise the current track charging structures, which create an uneven playing field between open access and franchised operators. We recommend the Department and Office of Rail and Road work together, as part of the Periodic Review 2018, on a comprehensive set of reforms of track access charges in order to manage the differing requirements of open access operators and franchisees and ensure that operators, taxpayers and passengers get a fair deal. A specific proposal for a public service obligation levy should be put out to consultation by the Department over the next 12 months, so that a new regime can be introduced from April 2019.

The transfer of financial risk to the private sector was another central premise of rail franchising. It is clear that there has been a relatively low level of financial risk from operating a passenger rail franchise. Much of the financial risk in rail has always resulted from maintaining and enhancing the infrastructure and this is still the case. There are wider, whole-of-industry issues related to this, which go beyond the scope of this inquiry. These will be addressed in further detail in our forthcoming Rail Governance and Finance inquiry.

The current structure of franchises limits the ability of the private operator to deliver on the core policy objective of driving efficiencies and delivering benefits for passengers. Specifically, the general size of current franchises does not provide a clear enough market focus for the operator; and the relatively short length of franchises reduces the incentive of operators to both invest and drive down costs. While we acknowledge that there can be no single “template” of what a franchise should look like—as the rail network and passenger needs are diverse—there is merit broadly in procuring longer and smaller franchises. Immediate widespread reform is neither practical nor feasible. Where a franchise is due to expire the Government should, as a matter of routine, review the franchise contracts it lets so that they present less risk to the taxpayer, are not unnecessarily complex, and are focused on the market they serve.

It is clear that that the relationship between Network Rail and operators is not as coordinated as it should be. This is at the detriment of the passenger through higher fares and continued network underperformance. A number of reasons are to blame for this. In particular, the misalignment between the control periods and franchising schedules is a fundamental flaw of the current system and undermines further alignment between Network Rail and train operating companies. We have identified a number of wider issues during our inquiry; we intend to address those related to the regulatory incentives and governance structures in our Rail Governance and Finance inquiry expected to start in 2017.

The Department has an important role in managing the franchising programme which can influence the extent to which franchising can deliver for the passenger. We are encouraged by some of the work the Department has done to improve its franchising operations since 2012. But we remain concerned about a number of serious shortcomings with its capability and capacity. Certain functions of franchising may be better placed elsewhere. We recommend that the Department commission an independent review of its franchising functions. This should address the question of transferring franchise monitoring and enforcement functions to the ORR. The review should also set out a future strategic direction for franchising, including the way franchises are structured and planned for over the longer term and how open access fits into this picture.

The Department has failed to take responsibility for some of the failings in the handling of the Thameslink, Southern and Great Northern franchise. All parties are accountable for the disastrous outcomes on this franchise. While we do acknowledge that factors were beyond the control of the Department, including the significant and inevitable impact of the Thameslink programme enhancements, and industrial relations disputes; the Department does need to address issues such as inadequate planning, inaccurate assumptions and weak performance incentives. We have also exposed serious deficiencies in the Department's monitoring and enforcement of this franchise. This exposure led directly to the Department changing its policy on performance reporting which is a step in the right direction to holding serially underperforming operators like GTR to proper public account.

Additionally, the use of a management contract for this franchise, where the Department receives fares income and the operator receives a fee for running services, exposes the Department financially. The net revenue losses for the latest financial year, which amount to at least £38 million, will be met by public funds. We believe that serious lessons need to be learned from the GTR issue to prevent similar problems happening in the future when the awarding of a new franchise coincides with a major infrastructure improvement project, the introduction of new technology or the possibility of industrial relations problems.

If GTR is officially found to be in breach of its contract, the Department should consider restructuring the franchise and determine who is best placed to operate it. Ultimately any potential restructure should rectify the contractual shortcomings of the current franchise, realigning the incentives and focus of the operator back to the passenger and reducing the financial exposure of the taxpayer.

1 Introduction

1. This inquiry is one of five inter-related inquiries into the "future of rail". To date, we have published reports on Rail Technology and the Rail Passenger Experience. We are currently taking evidence on Rail Safety and our Rail Governance and Finance inquiry will start in 2017.[1]

2. The broad aims of this inquiry are to determine whether franchising is delivering on its core policy objectives and to examine challenges of the current system from structural, governance and Departmental perspectives.[2] Many other wider industry and governance issues are identified in this inquiry and will be addressed at further length in the Rail Governance and Finance inquiry.

Overview of franchising

3. Most passenger rail services in the UK are provided by franchised train operating companies (TOCs), which contract with the Department for Transport ("the Department" or "DfT" hereafter) to provide specified services for a fixed number of years.[3] Franchise agreement[4] specifications relate to: the timetabled train service; station upgrades; train upgrades; overall performance targets; passenger satisfaction targets; and fares and ticketing improvements. There is currently a mix of methods for franchise provision used by the Department for the 15 franchises it manages:

a) **'Traditional' competitive franchise**: Train companies bid for these franchises on the basis of the amount of funding they would require, or the premium they would be prepared to pay to run these services.

b) **Direct Award**: The Department negotiates directly with the incumbent operator with no competition for the franchise.

c) **Management contracts**: Differs from a typical franchise in that the Department receives the revenue from ticket sales and takes on the revenue risk and the company operates the services in return for a management fee. The most recent example is the Thameslink, Southern and Great Northern (TSGN) franchise.

Recent reviews of franchising

4. In 2012–13, following the problems with the re-let of the West Coast franchise, the Department published two independent reviews of its rail franchising functions:[5]

a) The Laidlaw Inquiry (published December 2012) examined what happened during the West Coast procurement and why, with the aim of establishing the lessons to be learned.

1 See Transport Committee page for details and information for all our inquiries.
2 Full terms of reference are available on our inquiry page.
3 For an overview of the fundamentals of franchising process, see the Department for Transport's latest Franchise Competition Guide; as well as the Campaign for Better Transport Passenger's Guide to Franchising.
4 Individual franchise agreements can be found on the GOV.UK website.
5 Department for Transport, West Coast Main Line: final report of the Laidlaw inquiry, December 2012; Department for Transport, The Brown review of the rail franchising programme, January 2013

b) The *Brown Review* (published January 2013) examined the wider rail franchising programme, looking in detail at whether changes were needed to the way risk was assessed and to the bidding and evaluation processes.

5. The DfT subsequently reviewed Government rail functions in February 2014 and the Passenger Services Directorate was formed within DfT in November 2014.[6]

6. In November 2015, the National Audit Office (NAO) published its report Reform of the Rail Franchising Programme which concluded that since 2012 "the Department has improved its management of rail franchising." However, it emphasised that "important risks" remained, particularly with respect to the infrastructure programme, and declining competition and market interest in franchising.[7]

7. In March 2016 the Competition and Markets Authority (CMA) published its final policy document on competition in rail passenger services.[8] The study found that greater competition, through expanded open access operations on long distance intercity routes, has the potential to deliver passenger benefits and to increase efficiency.[9]

Structure of this report

8. Our report initially assesses whether the Government is delivering on the three core policy objectives of franchising:[10]

a) Delivering for passengers and driving industry efficiencies (Chapter 2);

b) Promoting competition (Chapter 3); and

c) Reducing the taxpayer subsidy and transferring financial risk to the private sector (Chapter 4).

9. We conclude that the current model is not delivering fully on these core policy objectives. The latter part of the report examines why franchising is not maximising benefits for passengers and driving wider industry efficiencies; including the structural (Chapter 5) and governance failings (Chapter 6) of the current system, as well as the deficiencies on part of the Department in managing the franchising programme (Chapter 7).

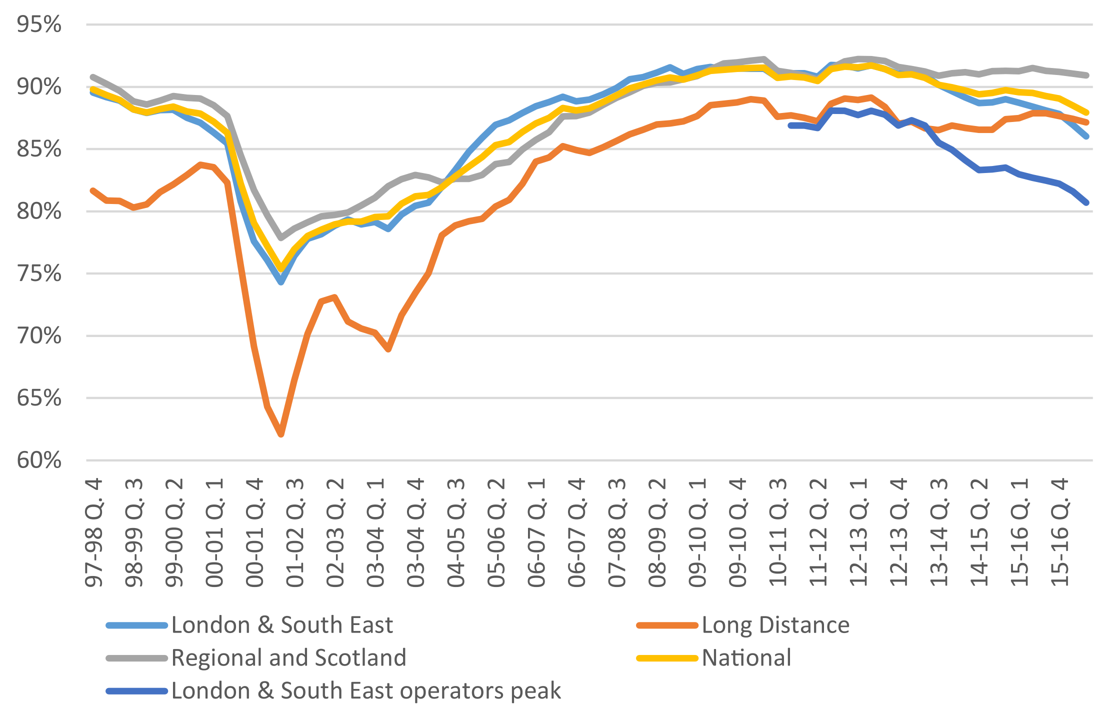
6 Department for Transport, Organisation review of rail: final report, February 2014
7 NAO, Reform of the rail franchising programme, November 2015
8 Competition and Markets Authority, Competition in passenger rail services in Great Britain, March 2016
9 Competition and Markets Authority (RFG0005)
10 Department for Transport, The Future of Rail Franchising, 2010; Department for Transport (RFG0003)

2 Is franchising delivering for the passenger?

10. Passenger rail in the UK has gone through a "renaissance" over the last two decades, as passenger numbers have doubled since 1997–98.[11] This has seen rail increase its modal share of all travel by 3.3% over that period.[12] Franchising has certainly played a key role facilitating this growth.[13] However, competition from franchising was expected to deliver improved services for passengers, lower fares and increased efficiency. In this section of the paper we briefly assess the progress of franchising against these objectives.

11. Britain's rail **performance and punctuality measure** (PPM), while much improved on results from the early 2000s, was at 89% for the first quarter of 2016–17 (see figure). This is below the highs realised in 2011–12 and performance has been flat for the past four years; though recent underperformance can be directly linked to areas of the network undergoing significant infrastructure change. While the national PPM appears relatively high, one of the key findings of our Rail Passenger Experience report is that this measure does not reflect the real passenger experience.[14]

Figure 1: Public performance measure (PPM) moving annual average (MMA) by sector



Source: ORR

11 Rail Delivery Group (RFG0019)

12 Rail Delivery Group, Rail's transformation in numbers, November 2016

13 Oxera Consulting quantified the impact of the change in the industry model as having increased the impact of the rail sector by 10–32% in 2014.

14 Transport Select Committee, The future of rail: Improving the rail passenger experience, Sixth Report of Session 2016–17, October 2016

12. **Passenger satisfaction** has been in steady decline since the National Rail Passenger Satisfaction Survey began in Spring 2011. Nationally, the percentage of passengers satisfied with their journey was 81% in autumn 2016; but has fallen in recent years, down from a high of 85% in autumn 2012.[15] Satisfaction is also falling on a number of core aspects of service, particularly punctuality/reliability and value for money.[16]

13. The **cost of peak and anytime rail tickets** in Britain are some of the highest in Europe; though they have been increasing at a slower rate than other high-income EU member states. It is also the case that when comparing similar long-distance journeys in the UK with those on the continent, advance purchase and off-peak tickets in the UK are often at an equivalent or lower rate than in other countries.[17] Between 1995 and 2016, fares increased in real terms by 23.5% and by a staggering 40.9% on long-distance routes.[18] The Government's policy is that regulated rail fares would not increase in real terms in this Parliament. The ORR has noted that last year's increase was less than inflation. Rail fares are set to rise by 2.3% in 2017.[19] This has seen cumulative premiums paid to Government by operators increase substantially in recent years (see Chapter 4); a result which has shifted the burden of paying for the railways from taxpayers to passengers.[20] Passenger share of total rail industry income has increased from 57% in 2010–11 to 71% in 2014–15.[21] The Government and industry both assert the importance of these fare rises in funding investment in the railways.[22] Irrespective of the ownership model of the railways, a balance has to be struck over the proportion of operating and capital investment costs that are met through the fare box and the proportion paid by the public purse.

14. Perhaps most importantly, the **efficiency of UK rail** lags considerably behind comparators in continental Europe. Past estimates from the McNulty report put the efficiency gap between the UK and continental comparators as high as 40%.[23] Much of the shortfall in industry efficiency is related to the rise in rail costs in the UK. As pointed out by Dr Andrew Smith of the Institute for Transport Studies, the cost increase since privatisation is "now more like 25% if we update it to today."[24]

15. **It is clear that franchising coincided with significant growth in passenger rail but has not yielded all the benefits for passengers envisaged when the Government made the case for privatisation in 1992. Many metrics of performance are plateauing against the backdrop of substantial growth in premiums paid to Government. Ultimately, it is the passenger who pays: rail fares have grown significantly in recent years. This is the result of a deliberate decision by successive governments to shift the burden of paying for the railways from taxpayers to passengers. We hope that the recommendations set out in this report will deliver better value for money for passengers.**

15 Transport Focus, National Rail Passenger Survey, Spring 2016 Main Report, p.7
16 Social Market Foundation (RFG0008)
17 European Commission, Study on the prices and quality of rail passenger services, April 2016
18 Office of Rail and Road, Rail Fares Index (January 2016), 14 April 2016
19 National Rail, About your rail fare, accessed 5th December 2016
20 For more information, see: Transport Select Committee, Rail 2020, Seventh Report of Session 2012–13, December 2012
21 Rail Delivery Group, Rail's transformation in numbers, November 2016
22 Rail Delivery Group, 2017 rail fares published, 2 December 2016; Railways: West Midlands: Written question – 59335
23 The McNulty review, completed in May 2011, examined the costs across the rail-industry and made a series of recommendations to improve efficiency and value for money in the industry.
24 Q2

3 Passenger rail competition

16. At the time of privatisation competition was seen as a means of delivering improved services, lower fares and driving industry efficiencies. This chapter briefly assesses the extent to which competition exists in passenger rail; then examines whether open access is a viable means of expanding competition on the network.

17. Passenger rail competition under the current franchising system takes two broad forms: competition "for the market" where operators bid for the right to run the service; or competition "in the market" at the point of delivery, where train operators compete to attract passengers for similar journeys (referred to as "on-rail competition" hereafter).

18. The current system of franchising creates competition "for the market". Even though operators face a degree of competition from other modes of transport, it mostly creates regional monopolies once the contract is let.[25] Because of this, there is currently only a small degree of on-rail competition,[26] which occurs in three ways:

a) **Overlapping franchises**: where two or more franchised TOCs operate and compete for passengers on a route. The extent of overlapping franchises has fallen in recent years, following a policy decision in 2001 by the Strategic Rail Authority, to reduce the number of franchises.[27]

b) **Parallel franchises**: where two or more franchised TOCs operate services between the same city pairs, although on different routes, and so compete for passengers travelling between those cities.[28]

c) **Open access operators** (OAOs): these are operators of passenger services authorised by the Office of Rail and Road (ORR) to access the network on certain routes but are not contracted with the Department through franchising.

Is there adequate competition for the market?

19. Franchising is predicated upon there being competition for the market, but the reality falls well short of that aspiration. In the six years leading up to 2012, the Department had let only two contracts. At least one of those was quite a short and small contract.[29] Direct awards, in which there is no competition between bidders, were used for 10 of 16 franchises in the three years following the West Coast franchise debacle in 2012 and are still in place for a third of all franchises.[30]

20. Franchising is also contingent upon an adequate level of market interest for franchise competitions. The general consensus is that a minimum of three bidders is preferable. In the past, there had consistently been three to four bidders[31] and it was not always

25 Office of Rail and Road (RFG0022)
26 Office of Rail and Road (RFG0022); Competition and Markets Authority (RFG0005)
27 Strategic Rail Authority, Passenger Rail Franchising, December 2001; See passenger franchise map.
28 For example, between London and Birmingham, Cambridge and Peterborough.
29 Q357
30 These include the West Coast, West Midlands, South Eastern, East Midlands and Great Western franchises.
31 Transport Focus (RFG0009)

the incumbent who won the contract.[32] Recently, however, the number of bidders for franchises has fallen, with only two bidders shortlisted for the South Western and West Midlands franchises.

21. There are different reasons for this decline in market interest for franchising. For example, barriers to market entry appear to be higher in the UK than in other European countries.[33] Hugh Clancy, Commercial Director of Rail at FirstGroup, also commented that the fall in market interest is partly because "there has been an [increased] transfer of risk from Government towards the franchisees, which are now very substantial businesses that have very large financial premiums that have to be paid […]"[34] Profit margins in the industry have also declined on average, from 3.6% in 1997–98 to 2.9% in 2014–15.[35] (see chapter 4 for more discussion)

22. The costs of bidding also present an obstacle for new entrants to the franchising market.[36] Witnesses told us that the cost of submitting what they termed "enormous"[37] bids to the Department, was between £5 and £10 million.[38] The Parent Company Guarantee,[39] which is a bond intended to protect the Department from the risk of franchise failure, is also substantial. For the TransPennine franchise, a Parent Company Guarantee in excess of £200 million was required in a mix of bonds and contingent loans. The c2c and East Coast franchises required support of £140 million and £232 million respectively.[40]

23. Some steps have been taken to reduce bidding costs, including the introduction of the pre-qualification questionnaire passport.[41] It was suggested that franchise bidding costs could be further cut by reducing the burdensome modelling requirements,[42] particularly around timetabling and revenue/crowding modelling. TfL emphasised that bidders for its London Overground concessions do not have to produce timetables or revenue projections. This removes the need for individual bidders to develop timetables in collaboration with Network Rail, which is an expensive and complex part of a franchise bidding process.[43]

24. There is a risk that market interest for franchise competitions could decline further. This is because a high proportion of franchise operators are owned by a small number[44] of foreign-owned companies which are "increasingly international in their outlook".[45] As further markets deregulate in Europe, according to Alstom, "the risk is that [existing] bidders will increasingly find other opportunities overseas that may be more financially

32 Q25
33 Competition and Markets Authority (RFG0005)
34 Q282
35 Rail Delivery Group, Rail's transformation in numbers, November 2016
36 RMT (RFG0006); Rail Delivery Group (RFG0019); Transport for London (RFG0025)
37 Alstom UKI (RFG0021)
38 Rail Delivery Group (RFG0019); FirstGroup (RFG0018)
39 The Department is protected from the risk of franchise failure by the provision of Parent Company Guarantee (PCG) which is normally achieved with a Bond.
40 Rail Delivery Group (RFG0019)
41 For more discussion, see: NAO, Reform of the rail franchising programme, November 2015
42 The models have to be submitted for a best practice review and supported by a letter from the financial advisor which together costs £200k for each bidder.
43 Transport for London (RFG0025)
44 Based on the experience of the last 20 years, it is likely there are fewer than 10 organisations capable of successfully bidding.
45 Campaign for Better Transport (RFG0013)

attractive."[46] The Department noted that East Japan Rail Company Ltd, partnering with Mitsui & Co Ltd, had recently entered the market and that it was expecting at least two further applications from new market entrants in the next 12 months.[47]

25. Joint ventures are a possible way of new entrants accessing the franchising market. There are five joint ventures operating at present.[48] Abellio, which entered the market in joint venture with Serco, has moved on to be a franchise operator in its own right. The company is also now partnering with JR-East and Mitsui in a bid for the West Midlands franchise.[49] However, other owner groups with a presence in the UK rail market may not always be willing to partner with new entrants where it could potentially erode their future competitive position.[50]

26. **Franchising delivers the most benefits to passengers where there is robust competition between bidders to operate services. The direct award dependency of the Department and recent fall in market interest demonstrates that genuine competition has been restricted to a limited number of franchises. This core policy objective is not being met and the potential benefits from this model are therefore not being maximised by the Department.** ***We recommend that the Department take steps to streamline bidding costs where possible; even if the effect of this on market interest is likely to be marginal. The Parent Company Guarantee is crucial in protecting the public purse and should not be removed or amended significantly. Wider reform is required, possibly through open access operators in appropriate areas, or creating smaller franchises, to attract new entrants into the market and promote competition in rail. Without change it is difficult to see how the current model will be sustainable in the longer term.***

Open access operators

27. There are currently just two OAOs in Britain, First Hull Trains and Grand Central Railway,[51] which represent less than 1% of the entire network but around 15% of the approximately 180 services a day on the East Coast Main Line.[52] Other OAOs are planning new services on both the West Coast and East Coast Main Lines. Open access was conceived as a way of filling marginal capacity on the network and providing services to places not adequately serviced by franchised operators.[53] Given the decline in market interest and relatively high barriers to entry for franchising, open access is seen as one way of attracting new entrants and promoting greater passenger rail competition.

Benefits and risks of open access

28. The core objectives of open access competition are to improve the quality and choice of rail services,[54] increase competition on fares and stimulate efficiency improvements.[55]

46 Alstom UKI (RFG0021)
47 Department for Transport (RFG0003)
48 Virgin West Coast, Virgin East Coast, London Midland, South Eastern and TSGN.
49 Transport Focus (RFG0009)
50 Transport for London (RFG0025)
51 TravelWatch NorthWest (RFG0017)
52 Lodge, T, Rail's second chance, 2014, Centre for Policy Studies
53 Competition and Markets Authority (RFG0005)
54 Department for Transport (RFG0003)
55 Competition and Markets Authority (RFG0005); Office of Rail and Road (RFG0022)

To date they have been relatively successful on these measures[56] and in the latest survey of passenger satisfaction, Grand Central and First Hull came first and second respectively.[57] Additionally, the ORR and Institute for Transport Studies (ITS) found that OAOs had costs 10 to 30% lower than those of franchised TOCs, taking into account the size of operation.[58] This is because they have greater operational flexibility, make greater use of outsourcing and have lower staffing costs. OAOs are also free from franchise specifications and have the flexibility to change their strategy more quickly according to changing demand and customer preferences.[59]

29. One of the main concerns with increasing the share of OAOs on the network is that splitting up the market into multiple operators might risk losing important economies of scale. The ITS concluded, however, that in general this was not the case, and that "OAOs have unit costs that are around the same as franchised inter-city TOCs."[60]

30. There are other considerations such as making best use of capacity, especially when train paths are limited.[61] Some witnesses commented that an increase in OAOs may further fragment an already complicated market and result in a potential loss of co-ordination between operators and Network Rail.[62] NECTAR (North East Combined Transport Activists' Roundtable) stated that passengers value frequently spaced and well connected services, which requires cooperation between train operators.[63] While this was achievable between a small number of operators, they argued that adding multiple operators along the same track mileage may undermine effective cooperation because of differing rules, fare levels and ticketing systems.[64]

31. In the context of declining market interest in franchising, Dr Andrea Coscelli, Acting Chief Executive of the CMA, felt that open access could provide opportunities for new entrants to the rail market beyond the current "very big binary type of [franchising] competition".[65] Rail Minister Paul Maynard, told us that he is "a great apostle of open access."[66]

32. Open access is likely to be aided by the pipeline of rail investments due for delivery over the next decade. HS2 has the potential to free up capacity for commuting and stopping services on the West Coast Main Line.[67] Investment in new rolling stock, signalling technology and electrification are also likely to increase the capability of the network to accommodate open-access entry.[68]

33. The ORR pointed out that the passenger rail market is far from homogenous, so the form of competition appropriate in differing market segments will vary.[69] There was a broad consensus that the benefits of OAOs are limited to intercity long distance routes

56 Department for Transport (RFG0003); Transport Focus (RFG0009)
57 Transport Focus, National Rail Passenger Survey – Spring 2016, June 2016
58 ORR (2011) The potential for increased on-rail competition – a consultation document.
59 Office of Rail and Road (RFG0022)
60 Institute for Transport Studies (RFG0011)
61 Campaign for Better Transport (RFG0013)
62 Railfuture (RFG0016)
63 NECTAR (RFG0026)
64 See paragraphs 5.160 to 5.207, CMA rail policy document.
65 Q37
66 Q380
67 Office of Rail and Road (RFG0022)
68 Office of Rail and Road (RFG0022)
69 Office of Rail and Road (RFG0022)

(East Coast, West Coast and Great Western main lines).[70] Other commuter operations are natural monopolies with captive markets, with passengers using high frequency "metro style" services, which limits the opportunity for on-rail competition.[71] Other regional franchises are subsidised and deliver important social objectives and have limited scope for on-rail competition.[72]

34. **Open access has been a success, albeit on a limited scale to date. The balance of evidence points to potential benefits in open access having an expanded role on long distance routes, beyond just filling marginal capacity or connecting unserved markets. Although it is not a complete substitution to franchising because of fragmentation risks. It is important to note that there are operational complexities that need to be addressed and we acknowledge that it will take time to test open access on a larger scale, to fully understand its feasibility, particularly in terms of operational risks.**

35. **In the context of declining market interest in franchising, open access may be an avenue for new and smaller entrants into the market. Additionally, given the lack of an operator of last resort, open access operators may be able to serve a role in franchise enforcement—possibly through the reallocation of capacity away from underperforming franchisees.**

Future reform for open access

36. The ORR is responsible for assessing open access applications against its statutory duties under Section 4 of the Railways Act 1993. The ORR recently granted rights to Great North Western Railway to run services from London to Blackpool on the West Coast Mainline from 2019. And in May 2016, it granted rights to FirstGroup to run services from London to Edinburgh on the East Coast Mainline, competing with the franchisee (Virgin Trains East Coast) from 2021. It is currently assessing a bid from Alliance Rail Holdings Ltd, under the branding of "Grand Southern", to run open access services from Southampton to London.[73]

37. The current framework for OAOs was designed for relatively small scale entry, providing services to under-served destinations. Because of this, OAOs currently only pay variable charges for use of the network.[74] However, when applied to areas of the network where capacity is scarce, or to applications that are large relative to franchise operations, the existing regulatory framework:

a) creates an uneven playing field between TOCs and OAOs, because the TOCs are required to pay fixed and capacity charges; and

b) imposes costs to taxpayers through lower franchise premiums, either at the point of bidding or through lower payments during the franchise term.[75]

70 Campaign for Better Transport (RFG0013); Office of Rail and Road (RFG0022); Institute for Transport Studies (RFG0011); Competition and Markets Authority (RFG0005)
71 Transport for London (RFG0025)
72 Office of Rail and Road (RFG0022); Transport for London (RFG0025)
73 Office of Rail and Road, Current track access applications, accessed 23 December 2017
74 For more info on track access charges, see: Office of Rail and Road website.
75 Office of Rail and Road (RFG0022); Department for Transport (RFG0003)

38. Dr Coscelli told us that "some fairly substantial changes"[76] would be required to address these shortcomings and enable an expanded open access model. The CMA concluded in their policy paper that "action is required now in order to address the issues in the current system and to put the necessary steps for reform in place."[77] FirstGroup called for a "long term open access charging methodology, with clear criteria to guide how competing calls for the available capacity will be resolved."[78]

39. The ORR has responsibility for overseeing changes to the framework for **network charges** via the Periodic Review.[79] The ORR said they wanted to ensure that costs are "more competitive" and that charges better reflect the full cost of usage which could help improve incentives for all train operators to support cost reduction.[80] The Minister indicated it was his intention to work with the ORR on reforming these charges.[81]

40. A **public service obligation (PSO) levy** would enable OAOs to contribute towards the costs of socially beneficial but commercially unviable parts of the network that might need subsidy from the taxpayer.[82] The design and implementation of a such a levy, which could be used to offset the decline in premiums, is a matter for the Government. It would likely require primary legislation.[83] We were concerned when Secretary of State Chris Grayling told us recently that he did not "immediately envisage change in the current arrangements."[84]

41. Franchised TOCs raised concerns regarding the uncertainty[85] that open access applications, such as those made on West Coast Main Line and the East Coast Main Line,[86] create in the franchise bidding process. Bidders for franchised services clearly want to be able to assess the potential impact of open access before they submit a bid. The Rail Delivery Group (RDG) argued that a lack of consistency will result in significant tension within the market and potentially fewer and lower bids for franchise competitions.[87] The CMA suggested that "uncertainty for franchised TOCs would be reduced by reserving a portion of track capacity for an open access operator in advance of issuing the Invitation to Tender for the franchise."[88]

42. **Reforms are needed if open access is to be expanded on the network.** ***We recommend that the Department and the ORR work together, as they develop the financial framework for the railways over Control Period 6 (2019–24), to present a comprehensive set of reforms to track access charges. These reforms need to manage the differing requirements of OAOs and franchisees and ensure that operators, taxpayers and passengers get a fair deal. A specific proposal for a PSO levy should be put out to consultation over the***

76 Q23
77 Competition and Markets Authority (RFG0005)
78 FirstGroup (RFG0018)
79 ORR, Periodic review 2018 (PR18), 2016
80 Office of Rail and Road (RFG0022)
81 Q380
82 Q380
83 Office of Rail and Road (RFG0022); Department for Transport (RFG0003); March 2016 Ministerial Statement
84 Oral Evidence: Departmental priorities and annual reports and accounts, HC 745, Q25
85 Q284; Q285; Competition and Markets Authority (RFG0005)
86 In 2016, ORR approved a number of applications to run additional services on the ECML.
87 Rail Delivery Group (RFG0019); Alstom UKI (RFG0021)
88 Competition and Markets Authority (RFG0005); For more info, see: Paragraphs 7.22 to 7.53, CMA rail policy document.

next 12 months, so that a new regime can be introduced from April 2019. We further recommend that timetabling spaces for open access services are determined upfront during franchise development prior to the publication of the Invitation to Tender. This will provide the certainty that industry needs to plan, particularly at the bidding stage of franchising but it will also help to encourage OAOs.

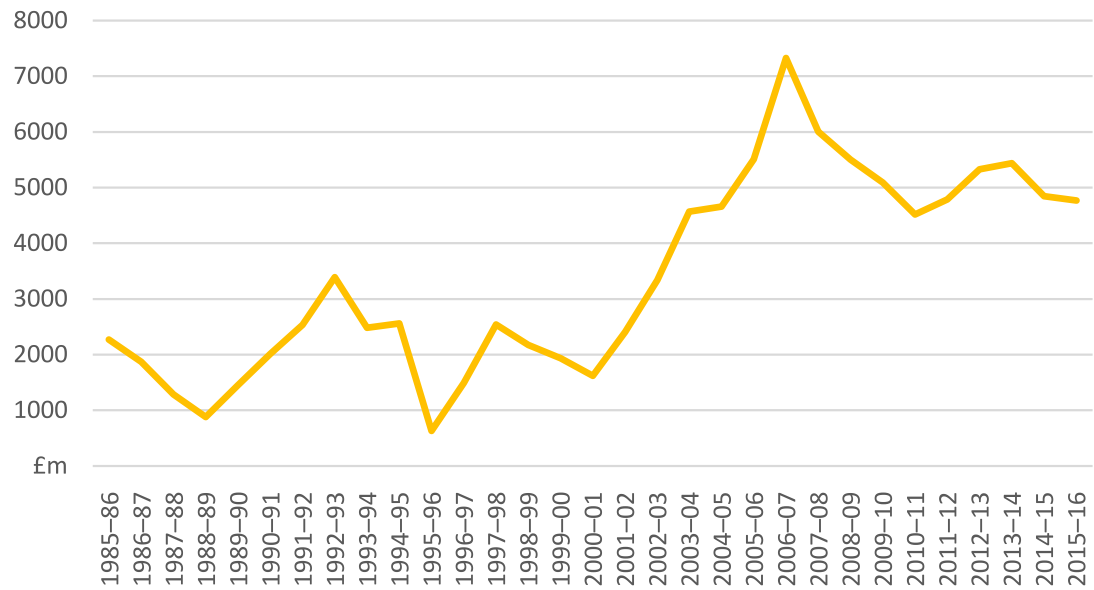
4 Taxpayer support and the transfer of risk to the private sector

Taxpayer support of the railway

43. A core objective of franchising was to reduce the taxpayer subsidy required to operate passenger services. The franchised railway now pays for itself in terms of running costs.[89] However, factors other than franchising have contributed significantly to this: input costs for operators, namely track access charges, are not reflective of the full cost of use;[90] and rail fares have risen significantly off the back of a policy decision[91] by successive governments to allow fares to rise above inflation for much of the past 12 years.

44. Franchised operators are consequently making a greater contribution to government through premiums. In 2015/16, TOCs made a £877 million net contribution to the government, more than double the £400 million paid in 2011/12.[92] Yet whole-of-industry government support for the railway remains significant, with the net total at £4.8 billion in 2015/16; still double the level recorded (in real terms) in 1985–86 (see figure).[93] The vast bulk of this subsidy is for infrastructure investment and maintenance.

Figure 2: Total government support at 2015–16 prices



Source: ORR

45. Private investment in passenger services also remains limited, with the Network Rail control period the main means by which investment in the network occurs.[94] However, some of those giving evidence acknowledged that rolling stock investment has improved

89 Campaign for Better Transport (RFG0013)
90 Office of Rail and Road (RFG0022)
91 Q279
92 Office of Rail and Road, 2015–16 Annual Rail Finance Statistics, 13 October 2016
93 Office of Rail and Road, 2015–16 Annual Rail Finance Statistics, 13 October 2016
94 Competition and Markets Authority (RFG0005); RMT (RFG0006)

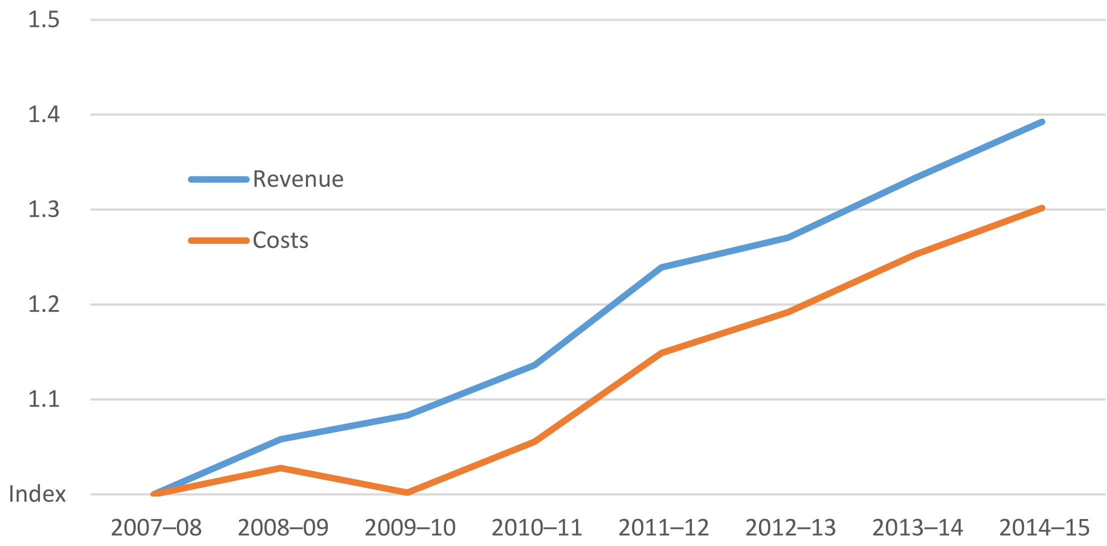
in recent franchises and according to the Rail Delivery Group (RDG) is up 55.3% to £622 million in 2015–16.[95] This is evident most recently in the £1.4 billion replacement of the entire fleet of trains for the East Anglia franchise, with 1,043 new carriages to be delivered by the end of 2020.[96] Although there is still some way to go improving rolling stock, with the average age of British passenger trains at 21 years.[97]

Financial risk in operating a franchise

46. Transferral of financial risk to the private sector (i.e. the franchised operator) was another central premise of rail franchising.[98] This was on the basis that there is a reasonable risk that revenues from operating rail passenger services may fall or costs may increase, thus undermining the profitability of an operator.

47. Using the accounts of nine train operating companies between 2007–08 and 2014–15, we can see that operator revenue increased by nearly 40%, offsetting the 30% rise in costs.[99] These companies collectively recorded profits in 88% of annual reporting periods between 2007–08 and 2014–15.

Figure 3: Operating revenues and costs, 2007–08 to 2014–15

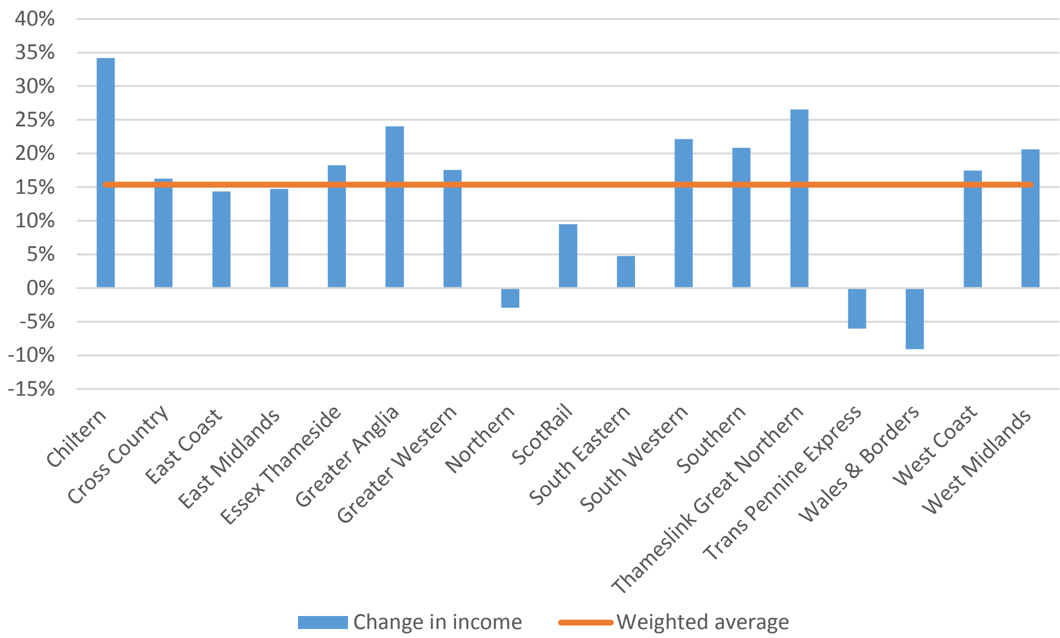


Source: Company accounts

48. Using wider data from the ORR, income increased for all but three operators between 2011–12 and 2014–15; the weighted average increase in operator income for that period is 15.4%.

95 Rail Delivery Group (RFG0019); Alstom UK&I (RFG0021); FirstGroup (RFG0018); Rail Delivery Group, Rail's transformation in numbers, November 2016
96 Q287
97 BBC News, Average age of British passenger trains is 21, 28 December 2016
98 Department for Transport, The Future of Rail Franchising, 2010
99 Revenues and costs cannot be measured accurately and consistently for all operators over time. This is because franchises have different financial years, differing franchise periods and varying availability of full accounts. The 9 franchises include Arriva Trains Wales, CrossCountry, East Midlands, London Midland, Northern, South Western, Southeastern, Transpennine and West Coast. These operators account for 53% of franchised passenger journeys.

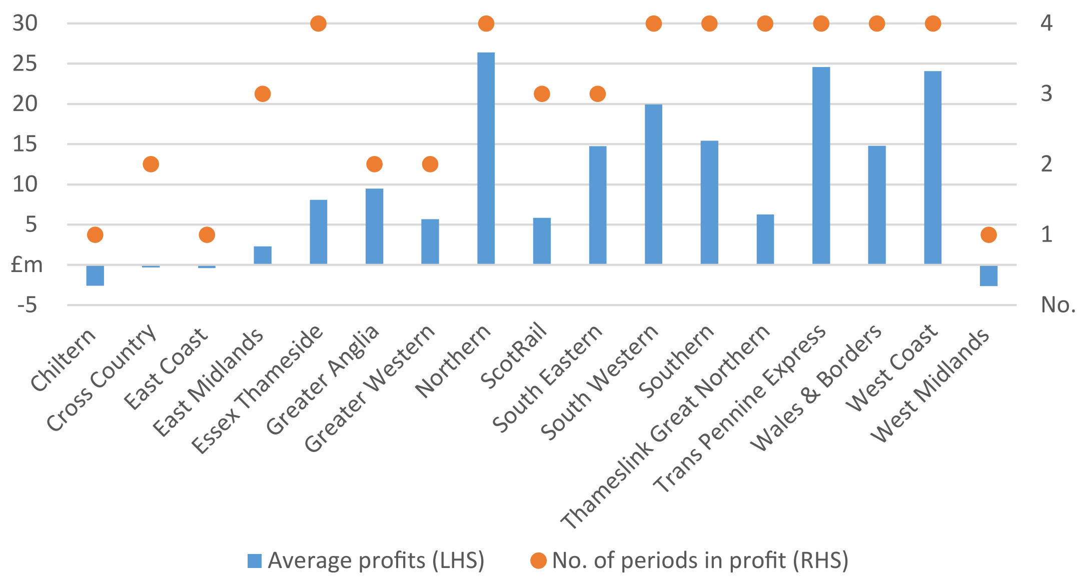
Figure 4: Train operator income, 2011–12 to 2014–15



Source: ORR, GB Rail Financial Statistics, 2011–12 to 2014–15

49. Additionally, almost all operators were profitable in 2014–15;[100] and between 2011–12 and 2014–15, operating profits were recorded in 75% of reporting periods across all franchises. Although operating margins have gone down, on average, from 3.6% in 1997–98 to 2.9% in 2014–15.[101]

Figure 5: Profitability, by operator, 2011–12 to 2014–15



Source: ORR, GB Rail Financial Statistics, 2011–12 to 2014–15

100 It should be noted that this is not an accounting profit in a statutory reporting sense due to statutory financial reporting adjustments for the treatment of deferred tax, pension costs, interest costs, dividends etc. For full methodology, see: ORR, GB Rail Financial Statistics 2011–12 to 2014–15, March 2016

101 Rail Delivery Group, Rail's transformation in numbers, November 2016; It should be noted that the dataset of the ORR and indeed that presented on profit margins by the RDG is different from the data collected nine train operating companies earlier in the report.

50. Although profitability and financial results vary from year to year, it is clear that a franchised operator is generally exposed to a relatively low level of financial risk. This is partly because rail passenger numbers continue to increase consistently. Fares have also been rising consistently following policy decisions[102] by successive governments to allow fares to rise above inflation for much of the past 12 years. The cost base of an operator is also largely predetermined through regulation and not exposed to large swings or volatility.[103] Much of the financial risk in rail still resides with Network Rail, a public sector body, which has responsibility for maintaining and enhancing the infrastructure. Operators are mostly remunerated for delays or cancellations resulting from the infrastructure failures via Network Rail compensation payments (Schedule 4 and 8 payments, see chapter 6). Operators are also not exposed to changes in track access charges during the life of a franchise.

51. Weighed against this are industry perceptions that the size and complexity of franchises are increasing the financial risk borne by franchisees.[104] Larger and more complex franchises require operators to take on higher value financial risks. This, combined with the falling profit margins, means that owner groups must now be highly capitalised to be able to absorb such risks. The DfT acknowledged that this could deter all but the biggest potential operators from bidding for franchises.[105]

52. **The transfer of financial risk to the private sector was a central premise of rail franchising, but historically there has been a relatively low level of financial risk from operating a passenger rail franchise. However, falling profit margins for passenger operators in recent years, and the increasing size and complexity of franchises, appears to be increasing risk to private operators. Much of the financial risk in rail has always resulted from maintaining and enhancing the infrastructure and this is still the case, with whole-of-industry Government support still substantial. There are wider issues related to this, which go beyond the scope of this inquiry. These will be addressed in further detail in our forthcoming Rail Governance and Finance inquiry.**

53. There have been recent circumstances in which a franchised operator might have been exposed to a substantial degree of financial risk, but the Department chose to insulate it. A number of witnesses saw the recent experience on the TSGN franchise as a failure by the Department to transfer sufficient risk to the operator.[106] In the case of TSGN, the Department took on all the revenue risk from the franchise because the risks from the infrastructure changes, from the Thameslink programme, were perceived to be too high for the private sector to take on. As a result, a management contract was used in which Govia Thameslink Railway (GTR) essentially receives a fixed annual fee, in the region of £1 billion, for delivering the service. Even accounting for the anticipated infrastructure delays, the prolonged industrial dispute, subsequent compensation claims[107] and the £20 million of taxpayer's money intended to get the franchise back on track, will see the Department receive considerably less revenue from this franchise than originally anticipated. GTR, which runs the TSGN franchise, has estimated that the likely net

102 Q279
103 For more info and statistics, see: ORR, Trends and comparisons for franchised operators, March 2016
104 Rail Delivery Group (RFG0019)
105 Department for Transport (RFG0003)
106 LondonTravelWatch (RFG0012); Campaign for Better Transport (RFG0013); RMT (RFG0006)
107 The Government recently announced 1 month's compensation for Southern passengers.

revenue fall since 1 April 2016 will be in the region of £38 million for this financial year.[108] This is, in effect, revenue, which could have been re-invested in rail services, lost to the public purse.

54. **With respect to the ongoing problems on the TSGN franchise, the ultimate financial risk remains with the taxpayer.** ***We recommend that in response to this report, the Department publish updates on the financial losses to the taxpayer from the TSGN franchise and set out the options available to recoup these losses.*** **Given the exposure of the taxpayer to the failings of this franchise, it is unacceptable for the Department to maintain its current 'arms-length' approach.** ***We recommend the Department intervene to ensure that all possible steps are being taken to stop the haemorrhaging of income. In response to this report, as well as setting out the steps the Department is taking, a full explanation should be given of the range of options considered in dealing with this franchise and why the current 'arms-length' approach was deemed suitable. If GTR is officially found to be in breach of its contract, we recommend the Department consider restructuring the franchise and determine who is best placed to operate it. Ultimately any potential restructure should rectify the contractual shortcomings of the current franchise, realigning the incentives and focus of the operator back to the passenger and reducing the financial exposure of the taxpayer.***

108 Committee correspondence with Paul Maynard, 17 November 2016.

5 Structure of franchising

55. It is clear that franchising is not yet maximising benefits for passengers, nor driving the efficiencies initially envisaged at the time of privatisation. One of the key problems has been the considerable rise in train operating costs that are linked to the structure of the franchises; indeed the ITS noted that "rail franchising has been associated with higher costs in contrast to reforms elsewhere."[109] The Government previously acknowledged that " … current incentives do not adequately reward franchisees for reducing costs."[110]

Size and complexity of franchises

56. Rail franchises in the UK are larger than elsewhere in Europe.[111] The number of franchises has reduced from 25 at privatisation to 15 now. The size and complexity of franchises has also increased.[112] This is most evident in the procurement of the TSGN franchise in 2014. This franchise covers around nearly 20% of the network and includes a variety of different commercial and commuter markets.[113] The Department's decision to combine HS2 services with the West Coast franchise, for an initial period of between three to five years from 2026, also creates a franchise that accounts for a significant proportion of the long distance network. (see Chapter 7 for more discussion)

57. There are potential benefits from having larger franchises, particularly regarding economies of scale.[114] However, the ability to exploit economies of scale with rail services is limited by the extent to which franchises have different operations and use different types of rolling stock.[115] Similarly, large franchises can often include very different types of rail services and do not, therefore, always provide a clear market focus.[116]

58. Other witnesses felt that the size of current DfT rail franchises did little to promote competition in the market.[117] This is related to the level of Parent Company Guarantee required of prospective operators in bidding (see Chapter 4). While this financial capital is an important lever in ensuring TOCs meet their financial obligations, "it is limiting the number of bidders to those who can raise the required level of capital."[118]

59. The ITS concluded that on the balance of the current evidence moving to smaller franchises could reduce costs and increase on-rail competition.[119] Transport Focus, Transport for London, the Rail Delivery Group (RDG) and CMA all concluded that smaller franchises would provide a lower cost option, with reduced exposure to financial risks, and may encourage new entrants into the market.[120]

60. There are important operational considerations from increasing the number of franchises on the network. NECTAR, in their submission raised a general point that, "as

109 Institute for Transport Studies (RFG0011)
110 Department for Transport, Reforming our Railways: Putting the Customer First, March 2012
111 Institute for Transport Studies (RFG0011)
112 Rail Delivery Group (RFG0019); Alstom UK&I (RFG0021)
113 Office of Rail and Road, Passenger rail usage, 2015–16
114 That is diminishing per unit costs as total output increases.
115 Institute for Transport Studies (RFG0011)
116 Q10
117 Transport for London (RFG0025)
118 Alstom UK&I (RFG0021)
119 Institute for Transport Studies (RFG0011)
120 Transport for London (RFG0025)

a rule of thumb, the greater the number of rail operators serving a particular section of railway, the greater the potential confusion and misinformation about levels of service, types of ticket, and quality of accommodation that can arise."[121]

61. There is also the consideration of a more congested franchising schedule. Currently, the Department has to manage 15 franchises. An increase in franchises would create a potentially higher resource burden on the Department and industry. This could be offset by the fact that the franchises procured would be more targeted in terms of the services specified. This may reduce the complexity of a franchise agreement and streamline the procurement process. A congested franchise schedule may also be managed through procuring longer franchises on certain parts of the network (see discussion below).

62. **There are potential benefits from operating smaller franchises, particularly in terms of providing a greater market focus for the operator. There is also less financial risk from taking on smaller franchises, which may enable new entrants into the franchising market. A wide restructuring of the current franchise system would, however, be prohibitively impractical because of the resource burden this would create for the Department and the restrictions from current franchise contracts.** ***We therefore recommend that, as franchises expire, the Department considers whether they can and should be restructured to align better with the specific market they serve.***

Length of franchises

63. The maximum length of rail franchises is mandated by European law and may be awarded for 15 years, with an extension for 7.5 years.[122] There had previously been cross-party political support for longer franchises.[123] In 2012 the Government stated that franchises "will be longer, giving operators more responsibility and more flexibility in the services they provide, as well as more incentives to invest."[124] However, the Brown Review recommended a more cautious approach to letting longer franchises, involving shorter initial franchises of between 7 and 10 years with the potential for extensions.[125] This is broadly the approach that has been pursued since.

64. A number of witnesses noted that, because of the shorter franchise terms, franchised TOCs have limited incentives to invest and to put pressure on Network Rail to increase efficiency.[126] The ITS also noted that "short franchises give limited incentives [to operators] to tackle the cost base [and] to invest in the network or rolling stock."[127] In the current environment operators look too much to the short term and are too risk averse. This limits the potential to shrink life cycle costs and embed innovation.[128]

65. Network Rail supports longer franchise terms as they provide for greater alignment of train operator incentives with Network Rail regulatory output targets (see Chapter 7), albeit on a five-yearly basis.[129]

121 NECTAR (RFG0026)
122 Articles 4.3 and 4.4 of Regulation 1370/2007/EC
123 Conservative Rail Review;
124 Department for Transport, Reforming our Railways: Putting the Customer First, March 2012
125 Department for Transport, The Brown Review of the Rail Franchising Programme, December 2012, p.26
126 Competition and Markets Authority (RFG0005); Social Market Foundation (RFG0008)
127 Institute for Transport Studies (RFG0011); ASLEF (RFG0014)
128 Institute for Transport Studies (RFG0011)
129 Network Rail, CP5 Performance Plan, p.28

66. One of the problems with having longer franchises is that it can be difficult to predict revenue and other risks with certainty over longer term horizons. This was a finding of the Brown Review and was emphasised by Paul Maynard who commented that a balance needed to be struck "between assessing revenue and other types of risk so that the Department could have reasonable confidence in what it was granting to the train operating company."[130] Yet, as shown recently, it can be difficult enough to predict revenue and passenger growth in the short term.

67. The Department should be seeking more innovative ways of contracting that would enable an appropriate risk share arrangement between the Department and the operator in the event of significant gaps developing between forecasts and performance outturns. It is also important to ensure that longer contracts are flexible and enable the Department to agree changes, particularly for major infrastructure enhancements. This was a key finding of the McNulty report[131] and as the RDG point out, inflexibility remains a problem area of the Department's current approach to contracting and in-franchise changes.[132]

68. **We believe that there are benefits from procuring longer franchises, particularly in terms of incentivising investment and efficiencies from an operator. However, a one-size-fits-all approach is inappropriate.** ***We recommend that the Department, upon the expiry of existing franchises, seeks to procure longer franchises where a franchise's operational risks are relatively low and historical performance has been strong. This would have the dual benefit of enabling operators to improve efficiencies and provide more space for the Department in a highly congested franchising schedule. It is important that the necessary enforcement levers against underperformance, as well change mechanisms for infrastructure works, are contracted for by the Department for franchises with longer terms. The Department should also find more innovative ways of contracting with operators to mitigate the unpredictability of financial risks over longer term horizons.***

130 Q379
131 McNulty, R, Realising the Potential of GB Rail, May 2011
132 Rail Delivery Group (RFG0019)

6 Franchising and Network Rail

69. Train operators, who pay for the right to use the tracks, are the client of Network Rail (NR). In addition to coordinating through franchise planning and day-to-day management, this relationship is formalised by a complex set of charges, incentives and outputs determined predominantly by the ORR every five years through its period review. These mechanisms are important in rectifying issues when infrastructure enhancements take place;[133] and are also used to hold both NR and the operator accountable in the case of poor performance from either party.

70. It is clear from the trajectory of costs and performance for both NR[134] and TOCs in recent years[135] that this relationship is not being optimised. This is to the detriment of passengers who pay higher fares and suffer from network underperformance. With infrastructure works presenting the biggest threat to rail passenger performance in the coming years, it is critical that this relationship is improved.[136]

71. This section of the report examines the core reasons why the relationship between NR and TOCs is not being optimised, and identifies some of the issues we intend to return to in our future Rail Governance and Finance inquiry.

Franchising and the control periods

72. Franchises are procured for a period of between 7 and 15 years in line with a schedule set out by the Department. There is no alignment with NR's programme of renewals and enhancements, which is managed in consistent five yearly cycles (Control Periods or 'CPs', set as part of the Periodic Review), with the current CP5 extending from 2014 to 2019. This was highlighted as a key failing of the current system.[137] The key problems stemming from this misalignment are identified below, most of which were identified in the Shaw Report on the future shape and financing of Network Rail published in March 2016.[138]

a) **Outputs and targets for NR and operators:** NR is required to meet a series of regulatory targets and outputs set by the ORR. Operationally, a TOCs' targets are set by the Department within the franchise agreements. Witnesses criticised the lack of alignment between the targets set by the ORR for NR and those set by the Department for operators.[139] For example, the current regime has inconsistent performance targets for NR and train operators.[140] NR have stated that misalignment worsens as franchises come to an end. This is because the regulatory outputs, as set in the Periodic Review, may be inconsistent with future franchise commitments, or with operators' commercial decisions.[141] NR, in

133 Transport for London (RFG0025)
134 Q300; Q302; Performance is monitored by the ORR and for the latest measures of performance, see the Network Rail Monitor.
135 Q10
136 Transport for London (RFG0025); Balfour Beatty (RFG0007)
137 Q306
138 Shaw, N, The future shape and financing of Network Rail, March 2016
139 Modern Railway, Peter Hendy interview, April 2016; Balfour Beatty (RFG0007)
140 Network Rail, Response to the ORR's 2018 period review of Network Rail – initial consultation, 10 August 2016
141 Network Rail, CP5 Performance Plan, December 2012

response to the ORR's initial consultation for the 2018 Periodic Review (PR18),[142] felt that "this area requires significant reform in PR18 to align our targets and priorities much more closely with those of local train operators, route-by-route."[143]

b) **Franchise planning and funding:** The determination of infrastructure improvements and the associated funding allocation, through the control period process, is separate from franchising and bid development. Tim Shoveller, Managing Director of Stagecoach, felt that improvements were required to address this disconnect.[144] In investigating the East Anglia franchise, it became clear that prospective franchisees were constrained in developing their bids because of uncommitted NR funding. Jamie Burles of Greater Anglia said that all franchise planning has to be conducted on the basis of no additional funding beyond the existing control period.[145] This lack of guaranteed funding for NR's infrastructure works presents the biggest risk to Greater Anglia in delivering journey time improvements. Balfour Beatty commented that a greater certainty of the work and funding that will come forward was required from NR. This was consistent with the conclusions of the Bowe Review and HMT productivity plan.[146] Balfour Beatty added that five-year control periods were too short to provide the certainty required by industry.[147]

c) **Franchise changeovers:** As franchises are let, operational outputs are specified by the Department, which may include changes to the previous timetable. NR, in their CP5 performance plan, said that there are risks from significant levels of timetable change that typically accompany multiple franchise changeovers.[148] Specifically, new timetables may provide for increased route utilisation and reduced journey times which, from NR's perspective, can reduce the available time for engineering access.[149] Responsibility for any subsequent underperformance of the infrastructure against the new timetable will then be allocated to NR—even though there may be restraints on their capacity to address problems because of a fixed resource allocation for the control period.

d) **Track access charges:** As it stands, charges are regulated on a five yearly cycle, which effectively only applies directly to NR. In practice, the price cycle for operators mirrors their respective franchise agreements because the franchise agreements enable changes to regulatory charges to be passed through to fares.[150] As such, franchised operators are not susceptible to changes to charges during a franchise period and "are largely indifferent to the charges and incentives regime

142 This will set NR's outputs for Control Period 6, 2019–24
143 Network Rail, Response to the ORR's 2018 period review of Network Rail – initial consultation, 10 August 2016
144 Q305
145 Balfour Beatty (RFG0007)
146 Department for Transport, Report of the Bowe Review, November 2015; HMT, Fixing the foundations: Creating a more prosperous nation, July 2015
147 Balfour Beatty (RFG0007)
148 Network Rail, CP5 Performance Plan, December 2012
149 Network Rail, CP5 Performance Plan, December 2012
150 FirstGroup (RFG0018)

of NR."[151] The inability of the ORR to apply updated track access charges during the course of a franchise is counterproductive to future efficiency gains in the industry.[152]

73. **The misalignment between the control period and franchising schedules is a fundamental flaw of the current system and undermines further operational alignment between Network Rail and train operating companies; and ultimately efficiency improvements that benefit the passenger.** We will examine possible options to rectify this problem, particularly in terms of adjusting franchising and regulatory timescales in further detail in our Rail Governance and Finance inquiry. This will include following up on key recommendations from the Shaw Report.

Incentives for performance and cooperation

74. Train operators and NR are answerable to the Department and ORR through incentives and targets specified in the franchise agreements and the NR licence respectively.

75. Paul Maynard acknowledged that there "is a lot of work to do in aligning the incentives between TOCs and NR."[153] Transport Focus also asserted that franchising, and the rail industry as a whole, has not yet created sufficient joint incentives and targets;[154] which, according to the ITS, has "led to a lack of focus on whole industry costs."[155]

76. It is widely accepted there is a lack of focus in these targets on the passenger. Chris Grayling, in a speech on 13 October 2016,[156] highlighted his intention to reform these incentives to focus on the passenger; possibly by measuring NR's operational performance in ways that reflect all delays to services (at all stations) and take account of the number of passengers on each service.[157]

Schedule 4 and 8 payments

77. Because of the different incentives and targets specified in NR and TOCs' contracts, a number of complex mechanisms have been introduced to bridge the gap and align the two organisations to improve operational performance and drive industry efficiencies.

78. One such mechanism is the Schedule 4 and 8 payments[158] in track access agreements which are designed to compensate train operators for planned and unplanned closures on and disruptions to the network. According to Transport for London, "there is relatively little incentive for [operators] to challenge the requirement for closures" because they are fully compensated by NR under these payments.[159] However, the operators made a firm

151 Cambridge Economic Policy Associates, Review of factors impacting the form and/or effectiveness of charges and incentives, September 2015, Report for the RDG
152 Office of Rail and Road (RFG0022)
153 Q385
154 Transport Focus (RFG0009)
155 Institute for Transport Studies (RFG0011)
156 The Rt Hon Chris Grayling MP, We put the travelling public first, 14 October 2016
157 Office of Rail and Road, 2018 periodic review of Network Rail (PR18) – Initial Consultation, May 2016; For more information on proposals, see : ORR, Working paper 4: Outputs Framework, July 2016
158 For more information, see Network Rail website.
159 Transport for London (RFG0025)

point, in their evidence to us, that there were no perverse incentives related to Schedule 8 payments and performance. Jamie Burles commented that "the fines payable for poor performance dwarf [Schedule 8] payments."[160]

79. TfL requires bidders for its rail services to assume that 100% of timetabled train mileage is operated and to submit a proposed rate per train mile that TfL can claw back for any mileage not operated due to a planned track closure. In this way, the operator has an additional incentive to challenge proposed track closures.[161] Transport for London identified two incidents on the Overground in which the operator—at TfL's instruction—challenged NR's proposed closures. On the Gospel Oak to Barking Line, it was able to reduce the closure period from eight to five months on works beginning June 2016; and on the line to Clapham Junction, it was able to reduce the number of weekend closures from 26 to six in December 2012.[162]

80. There are various other issues identified in the evidence associated with Schedule 8 payments. Balfour Beatty felt that while the rationale behind the payments is clear, they drain money from NR, a public sector organisation that is already has a significant debt at £41.6 billion in 2015–16.[163] In 2015/16, net payments of over £100 million were made from NR to operators under Schedule 8.[164] Schedule 8 payments also greatly increase the costs associated with, at times, unavoidable infrastructure repairs. It was highlighted that a £5000 cost to NR to repair cables resulting from an accident involving a lorry increased to £1 million because of Schedule 8 payments.[165] Schedule 8 payments can also have significant financial implications on NR for 'acts of nature' entirely out of their control.[166]

Route-level Efficiency Benefit Sharing (REBS) mechanism

81. Because the existing regulatory framework largely removes TOCs' exposure to changes in NR's costs, they have historically had little incentive to negotiate or facilitate NR cost reductions.[167] Joint performance targets have been proposed as a means of rectifying this.[168] Specifically, the Route-level Efficiency Benefit Sharing (REBS) mechanism[169] was developed by the ORR and introduced during CP5. This was designed to allow annual efficiency gains and losses in NR's costs to be shared with train operators. Specifically, participating train operators would receive a share of outperformance but would also make a contribution towards underperformance compared to the REBS baseline[170] for each route.[171]

82. Participation in this scheme is voluntary and to date, only GTR, First-Hull Trains and Virgin East Coast have signed up to the programme. This is because other franchised operators are "held captive" to the terms of their current franchise agreement. Additionally

160 Q308
161 Transport for London (RFG0025)
162 For more detail, see: Transport for London (RFG0025)
163 Network Rail, Annual report and accounts 2016, 2016
164 Network Rail, Regulatory Financial Statements, Year ended 31 March 2016
165 Balfour Beatty (RFG0007)
166 Balfour Beatty (RFG0007)
167 Department for Transport, Reforming our railways, 2012
168 Balfour Beatty (RFG0007); Transport Focus (RFG0009)
169 ORR, Guide to the route-level efficiency benefit sharing (REBS) mechanism in CP5, March 2016
170 REBS is based on ORR's efficient expenditure and income assumptions for England & Wales and Scotland.
171 Rail Delivery Group, Charges and Incentives User Guide, June 2014

the flow of finance from this programme is relatively insignificant compared to the total flow of revenue in the industry. For example, total REBS payments for participants amounted to £203,935 in 2014–15, compared to the £100m plus in Schedule 8 payments.

83. **The incentives for cooperation between the operator and Network Rail are not aligned sufficiently with outputs for the passenger. We are encouraged by the Secretary of State's recent comments on improving the focus the regulatory targets have on the passenger. However, the efforts to further align the incentives in Control Period 5, including the Route Efficiency Benefits Scheme, have been negligible. This is primarily the result of conflict between the control period and franchising schedules. This appears to be a fundamental failing of franchising and the wider regulatory framework and will be addressed at greater length in the Rail Governance and Financing inquiry in 2017.**

Joint working and alliancing

84. There was a consensus in the evidence that a joined-up approach to planning and management of the rail network is needed to improve outcomes for passengers.[172]

85. The Rail Delivery Group was established in May 2011 to bring together rail passenger operators and Network Rail with the clear aim of improving joint working.[173] More recently, the Department highlighted its efforts to enable this through the March 2016 Memorandum of Understanding signed with NR. This MoU sets out the new arrangements established to govern the infrastructure enhancement lifecycle. This includes the responsibility of Route Programme Boards, which include "operator representation, for ensuring delivery of the business case, mitigating programme risk and oversight of programme dependencies and interfaces."[174] A number of other arrangements are already in place to enable joint working, including through long-term performance plans and annual joint performance improvement plans between the operator and Network Rail. It was encouraging to hear that Greater Anglia has embedded Network Rail specialists in its teams to improve joint working.[175]

86. NR has also entered into working alliances with train operators in recent years "to achieve greater benefits for taxpayers and rail users through collaborative working arrangements."[176] Alliances can vary from coordination at a day-to-day management level to deeper commercial arrangements in which the disruption costs and benefits of renewal work come from the same budget.

87. It is generally accepted by industry[177] and NR that, in principle, alliancing is a positive way of incentivising greater alignment in infrastructure planning.[178] However, progress on alliancing appears relatively limited. In April 2012, NR entered into a "deep alliance"[179]

172 RMT (RFG0006); Transport Focus (RFG0009); Railfuture (RFG0016); TravelWatch NorthWest (RFG0017); Institute for Transport Studies (RFG0011)
173 Rail Delivery Group (RFG0019)
174 Department for Transport (RFG0003)
175 Q289
176 Alliancing Policy Statement
177 FirstGroup (RFG0019); Campaign for Better Transport (RFG0013); Institute for Transport Studies (RFG0011)
178 Balfour Beatty (RFG0007)
179 A "deep" alliance can be defined as one in which one of Network Rail's routes (or potentially part of a route) and a train operator share upside and/or downside risk against an agreed baseline for all or most of their activities.

with South West Trains putting in place a single joint management team responsible for infrastructure and train operations on NR's Wessex Route. In June 2015 that arrangement ended in order to meet the respective "internal needs"[180] of NR and the operator and to retain the separation of finances. This arrangement was always likely to be limited as the alliance did not supercede the contracts already in place between Government, Stagecoach (the owner group for South West) and NR. The only current substantive alliance is that on the NR Scotland Route, which begun in May 2015. Given recent troubles with Scotrail,[181] there are questions as to whether this has actually enabled tangible improvements on that part of the network.

88. One of the main limitations of the alliancing programme is that, where there are multiple operators on a NR route (e.g. on the London North Eastern & East Midlands routes),[182] NR is unable to establish deeper commercial relationships with a TOC. This is because it has an obligation to manage relationships with TOCs in a non-discriminatory manner. This was acknowledged by Jo Kaye, Executive Director for Network Strategy and Capacity Planning at NR, who commented that " … a deep alliance is not necessarily the complete option for all parts of the network".[183]

89. The Secretary of State, Chris Grayling, recently announced his intention to expand joint working on the network through integrated operating teams which will be introduced on the South Eastern and East Midlands franchises. He has proposed greater alignment of track and train, through joint ventures, as further franchises are renewed. The East-West Rail Link, which will link Oxford and Cambridge, is a new proposal which will see a private entity take responsibility for track and infrastructure, as well as operating train services.[184]

90. **It is clear that the alliancing programme, while a step toward greater alignment between the operator and Network Rail, has not achieved the desired benefits that were initially envisaged for this programme. We conclude that the programme is ultimately limited by the misalignment between franchises and Network Rail routes that prevents the establishment of deeper commercial arrangements. We do not yet know the details of the Government's recently announced plans for new alliances in the South East and East Midlands. In light of this we will return to this and other proposals, including the East-West Rail Link, in more depth in our Rail Governance and Financing inquiry; where we will also look at the wider success of governance structures and initiatives, including the Rail Delivery Group, to promote joint-working.**

180 Railway Gazette, South West Trains–Network Rail 'deep alliance' to end, 12 June 2015
181 Scotrail, ScotRail Performance Improvement Plan, October 2016
182 Network Rail, Our routes, accessed 11 November 2016
183 Q267
184 Written statement to Parliament, Rail reform: future of the rail network

7 Departmental capabilities

91. There are clearly a number of structural and governance issues that inhibit the franchising model from achieving all the benefits that it could potentially achieve for passengers. The Department also has a role is managing the franchising programme which can influence the extent to which franchising can deliver for the passenger.

92. The Department's franchising capability has, according to the RDG, strengthened since the Brown Review.[185] The NAO considers that "significant risks"[186] still remain in delivering the franchising programme. This section of the report assesses and draws conclusions about the Department's capabilities across the key phases of franchising, as set out in the diagram below. The broader planning and scheduling capabilities of the Department are also assessed.

Public consultation

93. The Department conducts formal public consultation prior to the Invitation to Tender (ITT) for a new franchise being issued to bidders. The consultation usually runs for 12 weeks. As part of this, a consultation document is published outlining proposals for the new franchise. A stakeholder briefing document is then published, which includes: analysis of public responses; and a review of the final franchise specification, explaining how the Department has taken account of stakeholder and public views in developing the franchise specification.[187]

94. Consultation response rates from individual passengers and members of the public vary drastically for different franchises—from more than 3,000 for TSGN to fewer than 100 for Essex Thameside and East Coast.[188] The Campaign for Better Transport told us that the wider public and rail users are not well engaged in franchising.[189] In particular, the size of the franchising consultation documents and the methods for engagement can be "very difficult" for the general reader to understand.[190]

95. In practice, rail user groups are the main way through which the passenger voice is represented during the consultation phase of franchising. It is clear that the Department has a well-established[191] relationship with Transport Focus which has increased the attention on passenger experience.[192] However, London TravelWatch was critical of the

185 Rail Delivery Group (RFG0019)
186 NAO, Reform of the rail franchising programme, November 2015
187 Campaign for Better Transport, Passenger's guide to franchising, 2015
188 Campaign for Better Transport (RFG0013)
189 Campaign for Better Transport (RFG0013)
190 Q78
191 Transport Focus (RFG0009)
192 Transport Focus (RFG0009)

Department for not engaging with them "in any way" in the preparation of the Essex Thameside and TSGN franchises. The East Anglia franchise also had the consultation and ITT preparation phases completed without any input from London TravelWatch.[193]

96. **The Department needs to find more innovative and streamlined ways of engaging with passengers and wider stakeholders when consulting on rail franchises. It is clear that consultation documents in the order of 60 to 70 pages and formal written responses are not the most effective in engaging with the wider public.** ***We recommend that the Department publish a rail franchising public engagement strategy. This does not have to be exhaustive. A short document and associated webpage would provide the public with a clearer view on how to engage with franchising. We also recommend that the Department engage with relevant rail user groups on a more substantive basis at the beginning of the consultation process.***

Franchise competition outcomes

97. Franchise competitions, pre-2013, were evaluated almost exclusively on price.[194] The Department now sets out in the franchise Invitation to Tender (ITT) the criteria for which franchise bids are evaluated, including: cost to Government; service quality; and deliverability.[195] As recommended by the Brown review, and given the requirements for different markets, scoring criteria reflects different franchise priorities and there is no "one size fits all" evaluation framework.[196]

98. Paul Maynard emphasised that "it is quality that drives the Department's aims in terms of franchising."[197] There is undoubtedly an increased emphasis on passenger experience[198] and on service quality[199] in recent franchise specifications. Yet across the industry it is assumed that cost remains the overarching factor determining the outcome of franchise competitions.[200] The RDG concluded that "other factors are only assessed when the cost gap between the top two bidders is small [and] … since the Brown review all franchises have been awarded on the basis of cost."[201]

99. Only DfT evaluation teams see full details of all bids. The relative scoring of the elements (e.g. price and service quality), within and between bids, is not seen externally.[202] Stephen Locke, from London TravelWatch, described the lack of transparency as a "black box"[203] and said that the "lack of transparency on these awards is a barrier to trust in the system."[204]

100. **We believe that the Department's commitment to transparency is undermined by the lack of information following a franchise award. Commercial sensitivities limit the amount and type of information that can be published.** ***Acknowledging this however,***

193 London TravelWatch (RFG0012)
194 Department for Transport (RFG0003)
195 Rail Delivery Group (RFG0019)
196 Transport for London (RFG0025)
197 Q342
198 Transport Focus (RFG0009)
199 Q280, 281; Q367; Alstom UK&I (RFG0021)
200 Q.71; Rail Delivery Group (RFG0019); FirstGroup (RFG0018); London TravelWatch (RFG0012)
201 Rail Delivery Group (RFG0019);
202 London TravelWatch (RFG0012)
203 Q73
204 London TravelWatch (RFG0012)

we recommend that the Department publish a scoring system, possibly in the form of a weighted index, following a franchise competition. This would omit commercially sensitive details but give the public and industry a better understanding of the basis, in terms of quality and price, on which a franchise has been awarded.

East Anglia competition and the Stansted Express

101. The Stansted Express is part of the East Anglia franchise and runs four times an hour with a typical journey from London Liverpool Street to Stansted Airport taking between 45 and 49 minutes, depending on the stopping pattern.[205] However, underinvestment on the West Anglia Main Line has seen journey times to the airport from central London decline by 10 minutes over the past decade. This has led to the share of Stansted's passengers using rail falling from around 30% in 2005 to around 22% currently.[206]

102. The franchise competition for East Anglia, which concluded in August 2016, presented an opportunity for the Department to ensure upgrades to the Stansted Express were prioritised. However, the winning franchise bid made no commitments to improving journey times to Stansted Airport from central London and included a requirement to add further stops on the Stansted Express.[207] Although it should be noted that the provision of a direct service from Norwich was specified in the franchise.[208]

103. It is clear that this outcome was, in a large part, reached because there was no reference or acknowledgment in the ITT of improving journey times to Stansted;[209] and there was no particular advantage to be gained for bidders from going beyond the ITT requirements.[210] This is in contrast with the Ministerial Foreword, as part of the February 2015 prospectus which stated that "a key aspiration is improved journey times [from Stansted Airport] into London and we expect that the new franchise can deliver on it."[211] This franchise outcome is also counter to recent Statements by the Secretary of State in October 2016 and the Rail Minister in November 2016 emphasising their commitment to greater rail access to Stansted Airport.[212]

104. We followed up on the issue of surface access to airports, with our report published in February 2016. This outcome demonstrates to us another failure from the Government in taking to take a clear lead on integrated transport planning which is, as we concluded, the major obstacle to better surface access to the UK's airports.[213]

105. **The experience from the East Anglia franchise competition shows that there is an obvious disconnect between franchising and the Government's wider transport policy objectives. As concluded in our previous report, integrated transport planning is crucial to improving surface access to airports. It is simply unacceptable that a service that provides significant economic and social benefits, within the context of constrained airport capacity in the South East, be entirely ignored in the bidding process.** ***We***

205 Department for Transport, East Anglia Prospectus, February 2015
206 Manchester Airports Group (RFG0023)
207 Committee correspondence with Manchester Airport Group.
208 Department for Transport, East Anglia – Stakeholder Briefing Document, September 2015
209 Department for Transport, Invitation to Tender – East Anglia, September 2015
210 Committee correspondence with Manchester Airport Group.
211 Department for Transport, East Anglia Prospectus, February 2015
212 House of Commons, Debate – Airport Capacity, 25 October 2016; House of Commons, Debate – West Anglia Taskforce Report, 8 November 2016
213 Transport Select Committee, Surface transport to airports, First Report of Session 2015–16, February 2016

recommend that the Department, Network Rail, Greater Anglia and Manchester Airport Group work together to develop plans for journey times improvements on the Stansted Express. Improvements would heavily and directly benefit MAG and as such it should consider making a funding contribution to the associated cost. The wider role of third-party investment in rail will be examined in our Rail Governance and Finance inquiry.

The franchise agreement and specification

106. TOCs contract with the Department to provide services, based on a set of specified terms, for a fixed number of years. These specifications are documented in the franchise agreement and relate to aspects including, but not limited to: level of train service; station upgrades; train upgrades; performance targets; passenger satisfaction; and fares and ticketing improvements.

107. A franchise agreement is typically a very large and complicated contract. They have grown in recent years because of the "pressure on the Department to try to control franchise outcomes."[214] Many aspects of the services in the franchise agreement are prescribed with very detailed granular outcomes, "often by someone sitting in Whitehall who is predicting what passengers will want in five or 10 years."[215] Paul Maynard asserted that the high degree of specification is needed to "make sure that we continue to drive quality", particularly on commuter networks.[216]

108. There was consensus in the evidence that the degree of specification within a franchise agreement is bespoke to an individual franchise.[217] For example, there is merit in tightly specifying commuter services or where the franchisee does not have a natural commercial incentive to improve its service offering.[218]

109. However, the Department itself commented that "detailed specification can sometimes be counter-productive",[219] particularly if the specification cannot change fast enough when circumstances change; or where the franchising authority is not best placed to determine what is best for passengers at a local level. The CMA also concluded that "detailed franchise specifications limit the ability and incentives of franchised TOCs to respond to changing customer preferences or to drive efficiencies during the life of a franchise."[220] With reference to Chiltern Railways, the CMA highlighted that "where franchise specification is less tight, franchisees delivered improvements to rolling stock, line speed and service in order to compete with other franchisees."[221] The RDG also concluded that "the more tightly specified the contract and the more regulation imposed, the more constraint there will be on innovation to improve services for passengers and to lower costs."[222]

214 Q39
215 Q13
216 Q342
217 Competition and Markets Authority (RFG0005); Department for Transport (RFG0003)
218 Department for Transport (RFG0003)
219 Department for Transport (RFG0003)
220 Competition and Markets Authority (RFG0005)
221 Competition and Markets Authority (RFG0005)
222 Rail Delivery Group (RFG0019)

110. Alstom recommended that franchise agreements should be focussed on franchise outcomes.[223] The Social Market Foundation (SMF) proposed that "new contracts should be centred on a single measure of overall satisfaction against which operators would be scored."[224] Such a measure might be a variation of the National Rail Passenger Survey which provides a network-wide picture of passengers' satisfaction with rail travel. However, Mike Hewitson of Transport Focus, felt that it was "a bit too blunt just to have a single overall satisfaction measure."[225]

111. ***We do not recommend moving to a single measure upon which to measure operator performance but we do recommend the Department streamline franchise specifications, taking an outcome-based approach. This would provide operators with more flexibility in delivering tailored services to passengers based on individual market requirements, which change over time. It would also reduce the burden on prospective operators in the bidding process and on the Department in developing the ITT and in the monitoring and enforcement of a franchise. However, it is also important, where an individual franchise warrants it (e.g. on largely urban, commuter-heavy franchises), that detailed commitments can be set out, related particularly to service quality provisions, in franchise agreements with the expectation that the TOC will be held to them.***

Franchise performance monitoring

112. Once a franchise is let, the Department has a role in monitoring the performance of an operator against its contractual performance obligations (such as cancellations, lateness and passenger satisfaction). Paul Maynard outlined his expectation that "from the day that they are let, [the DfT should] actively intervene, in a way which is proportionate, should there be a problem on the network."[226] For the Committee, the key point of scrutiny with respect to the Department's monitoring capabilities was transparency.

113. As established in our report on the Rail Passenger Experience,[227] GTR have had their Schedule 7.1 performance benchmarks[228] changed twice in November 2015 and February 2016; in the former case without any public notification. For example, the original cancellation benchmark in the contract was increased from 1.97% to 2.75% because of the remedial plan in February 2016.[229] Stephen Joseph OBE of the Campaign for Better Transport commented that "just letting GTR off the hook by amending their franchise requirements sends entirely the wrong signal about whose side the Department is really on."[230]

114. GTR also independently introduced revised timetables that resulted in the cancellations of 341 daily services between 11 July and 5 September 2016 implemented to improve reliability as a result of high levels of train crew sickness and a reduction in the uptake of overtime.[231] This was to the severe detriment of many thousands of passengers.

223 Alstom UK&I (RFG0021)
224 Social Market Foundation (RFG0008)
225 Q82
226 Q368
227 Transport Select Committee, The future of rail: Improving the rail passenger experience, Sixth Report of Session 2016–17, October 2016
228 See Schedule 7.1 of the TSGN franchise agreement.
229 Govia Thameslink Railway, Remedial Plan, 12 February 2016
230 Q91
231 Transport Select Committee, The future of rail: Improving the rail passenger experience, Sixth Report of Session 2016–17, October 2016

We tried to establish how the Department was holding GTR to account for these cancelled services. While we will not be able to establish this, with certainty, until the final force majeure claims are settled; it was clear that the revised timetable was not included in the measure of performance available to the public, the PPM.[232]

115. **Despite the Department's consistent claims of a commitment to transparency, our experience would suggest that transparency in franchising monitoring appears to be very poor. It has taken significant effort from this Committee to obtain basic information around GTR's performance benchmarks and timetabling which are not available publicly. Further, in allowing GTR to change their performance benchmarks and timetable, which effectively enabled them to avoid breach of contract, the Department has not actively intervened in a manner proportionate to the problems on the TSGN franchise. GTR have effectively been given a penalty holiday because of this industrial dispute.**

116. **The way the force majeure provisions are currently drafted in franchise agreements provides operators with far too much leeway when dealing with industrial disputes. We accept that part of the industrial action is outside the control of the operator. Yet the ability to respond to it, particularly in terms of managing longer term staffing levels, is very much within the control of the operator.** ***We recommend that in future contracts, terms are drafted in a way that has a clearer definition of what qualifies as force majeure and is commensurate to the degree of control of an operator has in dealing with an industrial dispute.***

Changes to performance reporting

117. After extensive investigations and pressure from the Committee, Rail Minister Paul Maynard, outlined the Department's intent to publish actual performance benchmarks for each rail franchise every four weeks.[233] This accepts one of the key recommendations from our Rail Passenger Experience report and will help in ensuring that "passengers can see what is going on in the franchises."[234] This commitment by the Minister is very much welcome and is an important step to more transparency in franchising.

118. It is important to note that this announcement is only the first step in the transparent publication of performance benchmarks. The Department can choose either to wait for a franchise to be renewed or introduce these new reporting measures through in-franchise contract changes.[235] Minister Paul Maynard indicated recently that Delay/Repay 15 changes would only be introduced where "a franchise competition is underway or is planned."[236] In other words, it would not be introducing changes through changes to existing contracts. It is therefore likely that we will not see the full publication of performance benchmarks until the Essex Thameside franchise expires in 2029.

119. Additionally, even if performance benchmarks are published, they may not provide the full picture of performance. This would particularly be the case in instances where

232 For the latest details of the force majeure claims, see Committee correspondence between Committee Chair Louise Ellman and Rail Minister Paul Maynard; Q258
233 Paul Maynard MP, Correspondence with the Transport Select Committee, 21 October 2016
234 Q346
235 Q347
236 Railways: Compensation: Written question – 52881

benchmarks are changed behind closed doors, or where operators are able to independently revise timetables to adjust performance results because of force majeure clauses. Thus, what is being published may not be fully reflective of an operator's actual performance.

120. **We welcome the Minister's commitment to make franchise performance reporting more transparent following our extensive investigations and ongoing pressure. It is a significant step forward and goes some way to increasing the accountability of operators to the public for poor performance.** ***We recommend that the Department outline, in detail and with a timeline, its plans to incorporate these reporting provisions into existing contracts. We also recommend that when the Government publishes the promised performance benchmarks, it does so in an easy to access format which is not hidden away separately on individual operator websites. The data must be centrally located on a dedicated and visible webpage that shows the performance of all operators and makes clear whether operators are failing to or are at risk of failing to deliver the services the Department has contracted them to provide. It must also be possible to track any agreed changes to the levels and quality of services and a clear rational for each such agreed change should be easy to find. This has implications for the transparency of the entire franchising process.***

Franchise enforcement

Performance penalties

121. Franchises contain performance and service quality targets. These are enforced by the Department using financial penalties when targets are missed. The financial penalties may not be sufficient to incentivise performance improvements from operators. For example, despite the severe operational failings of GTR, it paid only £2 million in penalties in its first year of operation (0.2% of its management fee of around £1 billion). In fact, we established that GTR earned a net payment (i.e. performance rewards were greater than the penalties) in its first year of operating the TSGN franchise. We also established that performance penalties, at least for the TSGN franchise, are capped with the breach level of performance. This means that once performance has exceeded the breach level, there is no incentive for the operator to improve or even maintain performance as the penalty will remain the same. The performance penalties for GTR are likely to be higher for this financial year but the extent of this is highly dependent on GTR's force majeure claims. If all such claims are approved, the financial penalties are likely to be negligible compared to the management fee.

122. Jamie Burles, Managing Director of Greater Anglia, asserted that, more broadly, penalties for poor performance had previously been more "reputational"[237] than financial in previous contracts. However, he noted that there is "a very significant financial penalty in the [new Greater Anglia] contract."[238] We are yet to see the new contract but will follow this up with the Department.

123. **We were concerned to see that GTR earned a net payment in the first year of operation on the TSGN franchise, with performance rewards greater than penalties. We are also disappointed that performance penalties on that franchise have been**

237 Q288
238 Q288

capped which disincentivises performance once it has deteriorated beyond the breach level. We conclude that by capping performance penalties the Department has not drawn up a contract in the public interest. ***We recommend that the Department learn lessons from this episode and that it overhaul its contracting approach to performance penalties to ensure that penalties are more proportionate to the revenue obtained from a franchise. As a starting point, it must no longer contract for a breach level cap on penalties in the way it did so on the TSGN franchise. There may be wider issues affecting other franchises but it is difficult for us to make any other specific recommendations as we have only seen performance penalties for the TSGN franchise.***

Revocation of a franchise

124. The Department enforces a franchise agreement principally through performance penalties. However, in the event of an operator repeatedly exceeding default performance benchmarks, the Department, contractually, has the ability to revoke a franchise from an operator—though it is not compelled to do so.

125. No franchise has ever been taken back by the Department because of poor performance.[239] However, Peter Wilkinson told us that "the Department is absolute in its commitment to remove a franchise if the conditions are such that that decision is merited."[240] The Government's enforcement policy has not been updated since 2008.[241] In the event of a franchise being taken back by the Government the operator of last resort is currently the Canadian engineering and construction firm SNC-Lavalin.[242]

126. **We are of the view that the Department does not have sufficient capacity to revoke a franchise from an operator, particularly of the size and complexity of TSGN. With a rather weak penalty regime, the Department appears to have very few levers with which to manage performance and enforce a contract. An out-of-date enforcement policy shows a complacency on part of the Department in terms of prioritising franchise enforcement.**

127. ***As an immediate priority, we recommend the Department update its enforcement policy by May 2017. In doing so and given the potentially high costs of running an operator of last resort, we recommend the Department consider new ways of enforcing the contractual terms of a franchise. For example, the Department should consider contracting for the reallocation of capacity to an alternative operator in the event of sustained poor performance or default. This could potentially mitigate the cost of running an operator of last resort and also provide a very genuine enforcement threat against poor performance.***

The commercial and enforcement functions of franchising

128. The Department is a commercial partner in a franchise agreement and has significant vested interests through premiums and subsidies. It also has an enforcement role in managing the contract.

239 Q183
240 Q376
241 Department for Transport, Enforcement Policy: Rail Franchise Agreements and Closures, July 2008
242 Q354

129. As established, the Department's enforcement capabilities are insufficient to provide a genuine threat to operators. Some witnesses also felt that there was a conflict between the commercial and enforcement roles of the Department, particularly as franchising is a "closed shop"[243] in terms of transparency. This is because the Department may, through different measures of enforcement, undermine the income it obtains through premiums.

130. At present the ORR has an important role to play in licensing the train operating company as a safe train operating company. It has no franchise enforcement powers.

131. ***We question whether it is effective for one of the commercial partners to a franchise (i.e. the Department) to also be the enforcement authority. In light of this, we recommend that the Government transfer enforcement and monitoring capabilities of franchising to the Office of Rail and Road or another independent body.*** **It should bring forward a consultation setting out the options for independent enforcement—including the ORR option or the creation of a new body. This consultation should also consider the costs of doing this and examine the implementation issues for the ORR in terms of the impact on its other functions and resources.**

Planning and scheduling franchise competitions

132. The Department has a key planning function by scheduling competitions in a way that is manageable and sustainable for it and industry. It also has a broader strategic function in terms of determining the structure and duration of franchises. These issues were discussed in Chapter 5.

133. In 2013, following the relaunch of the franchising programme, the Department introduced a franchising schedule to provide a "clear pipeline of all upcoming competitions."[244] Of the 15 franchises included on the DfT schedule, no fewer than seven are expected to be re-let between 2017 and 2019, "significantly stretching the capacity of bidding teams."[245] FirstGroup felt that the Department was "running to keep up"[246] and London TravelWatch had "grave doubts as to the DfT's ability to handle the large number of franchises to be let over the next two years."[247] ASLEF, with reference to the cuts in the DfT resource budget, added that "if the department was ill equipped to deal with the West Coast refranchise debacle in 2012, it's hard to see how it will be able to cope with the huge amount of competitions on a far reduced budget."[248] The RDG was also "less confident"[249] that the Department would be able to secure sufficient temporary resource, with the appropriate skills, to cope with the increased level of contract letting in the next two years.

134. Separately, Paul Maynard emphasised that "what is most needed on the part of the Department is as clear and predictable a schedule as possible, because the industry likes nothing less than uncertainty."[250] However, in 2016 alone there have been three revisions to the franchise schedule, which was most recently revised when the Intercity West Coast

243 Q96
244 Department for Transport (RFG0003)
245 Campaign for Better Transport (RFG0013)
246 FirstGroup (RFG0018)
247 LondonTravelWatch (RFG0012); Q85,86
248 ASLEF (RFG0014)
249 Rail Delivery Group (RFG0019)
250 Q356

Partnership was announced on 4 November 2016. This announcement took place the same month the ITT was due to be issued for the franchise. Even though the changes between schedules tend to be minor, constant changes create a "moving target" for the industry, which comes at a significant cost, particularly if prospective bidders are required to employ bidding teams on a full-time basis.

135. **The Department has only procured six competitive franchises since 2012. We do not believe the Department has sufficient capacity to procure the seven franchises that are scheduled between 2017 and 2019. One of those will be the complex Intercity West Coast Partnership. Recent experience with TSGN does not fill us with confidence that the Department can deliver this sort of complex franchise. Further, the West Coast Partnership will inevitably be a significant resource burden on the Department and has the potential to jeopardise other franchise competitions in that period.** ***Unless, within the timescale required, major changes advocated in this report are implemented and the Department is resourced to manage the procurements, we recommend the Department should consider direct awards for its highest performing franchises due for renewal between 2017 and 2019.*** **While not desirable, particularly in terms of limiting competition and creating further change in the franchising timetable, this proposal may mitigate the costs from mismanaged franchise procurement likely to result from a congested franchising schedule.**

Franchise competitions and infrastructure changes

136. The enhancements at London Bridge as part of the Thameslink programme are the main reason for the disruption on the TSGN franchise.[251] Paul Harwood, Strategy and Planning Director at Network Rail, added that having the franchising competition span when the major works were taking place made it "quite complicated to engage with the train operating company" and that "we would have wanted better and longer-term engagement with the train operating company around developing the plan when you have that much of an infrastructure challenge. We were not able to do that."[252]

137. The £800 million investment programme for Waterloo is due to reach its peak in terms of disruption in mid-2017.[253] However, the South Western franchise is, according to the Department's franchise schedule, due for changeover in August 2017. This presents a significant risk for the new franchisee in terms of sustaining performance in the initial franchise period. In the case of South Western, owner groups have confidence in the ability of industry to transfer a franchise from one company to another;[254] and told us that it is in the interests of all operators to make sure that the transition happens smoothly.[255] However, this transition is heavily dependent on the Department coordinating with Network Rail and the operator to ensure that the assumptions fed into the franchise are accurate and reliable. Paul Maynard and Peter Wilkinson, Managing Director of Passenger Services at the Department for Transport, both acknowledged that there were lessons to be learned from the misinformation during the TSGN franchise changeover and that "we do not repeat the same mistakes when we have to deal with Waterloo."[256]

251 Q129; Q261
252 Q261
253 Network Rail, Wessex Capacity Improvement Programme, accessed 22 December 2016
254 Q331
255 Q330
256 Q.333

138. **We welcome the commitment by all parties to a coordinated changeover of the South Western franchise in 2017. Yet the success of a franchise changeover depends on the assumptions and information provided by the Department. Given the gross inaccuracy of assumptions and planning for the TSGN franchise and the void in capability this represented, we believe that there is a performance risk to a new operator, and therefore passengers, from the South Western franchise changeover being scheduled in the middle of major infrastructure works at Waterloo. The practicalities and costs of delaying this franchise are likely to be significant and may outweigh the benefits of improved coordination in planning with the incumbent.** ***The current schedule for the South Western franchise competition should remain as planned. More broadly, we recommend that consistent operational management be maintained during any future major infrastructure works scheduled for major London terminals.***

Intercity West Coast Partnership

139. On 4 November 2016, the Government announced the Intercity West Coast Partnership, a new franchise that will be responsible for services on both the West Coast Main Line from 2019 and designing and running the initial HS2 services from 2026. The franchise will run for the first three to five years of operation of HS2 and is anticipated to be run on a partial revenue risk basis.[257]

140. The West Coast franchise, for which the ITT was due in November 2016, will now be extended by 12 months using a direct award until the commencement of the new franchise in 2019. This now means that the West Coast franchise would have been under direct award from December 2012 to April 2019 and with the same operator since the line was first privatised in 1997.

141. Paul Maynard in his announcement, outlined the potential benefits of this proposal, noting that partnership with HS2 Ltd was crucial "to design, launch and operate the passenger services on HS2 and manage the timetable recast of the West Coast Main Line."[258]

142. Many stakeholders have been concerned that HS2 was being developed as a wholly independent railway, unintegrated with the rest of the network. Roger Cobbe from Arriva UK Trains concluded that "this is a useful step towards better integration."[259] Paul Maynard also emphasised that "it would not have made sense to launch a franchise solely for the West Coast Main Line while taking no account of the needs of HS2."[260] Peter Wilkinson told us "the view we came to is that the right way to procure the franchise is to ensure that the franchise operator for the West Coast has a vested interest in the success of HS2."[261]

143. The TSGN franchise was also let on the basis of enhancing coordination and planning during the final stage of the Thameslink Programme. The eventual implementation of that franchise was shambolic and fraught with problems. Peter Wilkinson acknowledged that "[the DfT] would not embark on a franchise of that design, that construct and that

257 Department for Transport, West Coast Partnership franchise prospectus, 19 January 2017
258 Department for Transport, Rail franchising: InterCity West Coast and HS2, Written Statement to Parliament, 4 November 2016
259 Q325; Q326
260 Q359
261 Q360

nature again."[262] Yet there appears a serious risk that, because of the complexity and scale of services offered on the proposed Intercity West Coast Partnership, and the long term disruption to services form London Euston, there may be similar planning and coordination issues as those realised on the TSGN franchise.

144. The other major risk associated with this partnership is competition. What is being created is a very large single monopoly franchise, with very little or no on-rail competition on a key network route. Roger Cobbe, Policy Director at Arriva, questioned whether "we ought to ask whether there is scope to introduce more competition in the structure in the future."[263]

145. **While we acknowledge the potential benefits of having a single operator coordinating services on the West Coast Main Line and the new HS2 line, there are competition and planning risks associated with operating a franchise of this magnitude and complexity. And while this decision was informed by consultation from the now delayed West Coast franchise re-let, we are concerned that this specific decision has been made without any formal consultation; and that it was announced without any accompanying business case or evaluation for the public and stakeholders to consider.** ***We recommend that the Department publish the business case for this decision, clearly outlining the balance of benefits and risks from this decision.*** **We are pleased that the Government published further detail in the recent prospectus on how it intends to structure and operate this franchise in the future.**

Reviewing the franchising functions of the DfT

146. The franchising system was reformed following the Brown review in 2013.[264] It is clear that significant changes occurred within the Department in establishing the Passenger Services Directorate. The Department, in its submission, noted the work it has done, and is still doing, to streamline franchise procurement processes and to rearrange teams to have a better market focus.[265] A number of other witnesses commented that there had been progress by the Department in terms of its franchising capabilities, which is encouraging.[266] However, a number of serious deficiencies in capability have been identified in this inquiry, including:

- the breadth of the Department's consultation process;
- the transparency in reporting across all phases of franchising;
- the ability to attract new entrants into the market;
- the failure to contract in a way that protects the interests of the taxpayer;
- the complacency to contract without the necessary levers to incentivise performance from an operator and, if needed, enforce a contract; and
- the inability to plan strategically in terms of accounting for other franchise competitions and wider Government policy objectives.

262 Q376
263 Q325
264 RMT (RFG0006)
265 Department for Transport (RFG0003)
266 Transport Focus (RFG0009); FirstGroup (RFG0018); Alstom UK&I (RFG0021)

147. The Brown review recommended that, in the medium term, the Department review the best organisational location for rail franchising and franchise management, whether in the Department, in an agency or an arm's length body.[267] The previous Secretary of State concluded that the Department should retain its franchising functions.[268] Minister Paul Maynard told us that the Department is now "competent"[269] to the point where he has not considered implementing the recommendations of the Brown review. He also told us that the Department's track record since 2012 demonstrated that these capabilities were best retained in-house at present.[270]

148. **Despite the recent efforts of the Department to improve its franchising operations, there is extensive evidence pointing to serious deficiencies in its franchising capability and capacity. We are of the view that the Department's progress since 2012 is insufficient to warrant proceeding with the current structures and personnel in place. While we still believe the Department has an important role to play in franchising, we do believe certain functions of the franchising process may be better placed elsewhere.**

149. ***Because of this, we recommend that an independent and publicly available review of the Department's franchising functions be commissioned. In addition to reviewing the Department's capabilities and capacity, this can include consultation regarding the transfer of the monitoring and enforcement functions to the ORR. This should also outline the Department's strategic direction for franchising, including but not limited to the way it wishes to structure and plan for future franchises, and how it plans to manage the issue of open access.***

267 Department for Transport, The Brown Review of the Rail Franchising Programme, January 2016
268 Q377
269 Q378
270 Q365

Conclusions and recommendations

Is franchising delivering for the passenger?

1. It is clear that franchising coincided with significant growth in passenger rail but has not yielded all the benefits for passengers envisaged when the Government made the case for privatisation in 1992. Many metrics of performance are plateauing against the backdrop of substantial growth in premiums paid to Government. Ultimately, it is the passenger who pays: rail fares have grown significantly in recent years. This is the result of a deliberate decision by successive governments to shift the burden of paying for the railways from taxpayers to passengers. We hope that the recommendations set out in this report will deliver better value for money for passengers. (Paragraph 15)

Passenger rail competition

2. Franchising delivers the most benefits to passengers where there is robust competition between bidders to operate services. The direct award dependency of the Department and recent fall in market interest demonstrates that genuine competition has been restricted to a limited number of franchises. This core policy objective is not being met and the potential benefits from this model are therefore not being maximised by the Department. *We recommend that the Department take steps to streamline bidding costs where possible; even if the effect of this on market interest is likely to be marginal. The Parent Company Guarantee is crucial in protecting the public purse and should not be removed or amended significantly. Wider reform is required, possibly through open access operators in appropriate areas, or creating smaller franchises, to attract new entrants into the market and promote competition in rail. Without change it is difficult to see how the current model will be sustainable in the longer term.* (Paragraph 26)

3. Open access has been a success, albeit on a limited scale to date. The balance of evidence points to potential benefits in open access having an expanded role on long distance routes, beyond just filling marginal capacity or connecting unserved markets. Although it is not a complete substitution to franchising because of fragmentation risks. It is important to note that there are operational complexities that need to be addressed and we acknowledge that it will take time to test open access on a larger scale, to fully understand its feasibility, particularly in terms of operational risks. (Paragraph 34)

4. In the context of declining market interest in franchising, open access may be an avenue for new and smaller entrants into the market. Additionally, given the lack of an operator of last resort, open access operators may be able to serve a role in franchise enforcement—possibly through the reallocation of capacity away from underperforming franchisees. (Paragraph 35)

5. Reforms are needed if open access is to be expanded on the network. *We recommend that the Department and the ORR work together, as they develop the financial framework for the railways over Control Period 6 (2019–24), to present a comprehensive set of reforms to track access charges. These reforms need to manage the differing*

requirements of OAOs and franchisees and ensure that operators, taxpayers and passengers get a fair deal. A specific proposal for a PSO levy should be put out to consultation over the next 12 months, so that a new regime can be introduced from April 2019. We further recommend that timetabling spaces for open access services are determined upfront during franchise development prior to the publication of the Invitation to Tender. This will provide the certainty that industry needs to plan, particularly at the bidding stage of franchising but it will also help to encourage OAOs. (Paragraph 42)

Taxpayer support and the transfer of risk to the private sector

6. The transfer of financial risk to the private sector was a central premise of rail franchising, but historically there has been a relatively low level of financial risk from operating a passenger rail franchise. However, falling profit margins for passenger operators in recent years, and the increasing size and complexity of franchises, appears to be increasing risk to private operators. Much of the financial risk in rail has always resulted from maintaining and enhancing the infrastructure and this is still the case, with whole-of-industry Government support still substantial. There are wider issues related to this, which go beyond the scope of this inquiry. These will be addressed in further detail in our forthcoming Rail Governance and Finance inquiry. (Paragraph 52)

7. With respect to the ongoing problems on the TSGN franchise, the ultimate financial risk remains with the taxpayer. *We recommend that in response to this report, the Department publish updates on the financial losses to the taxpayer from the TSGN franchise and set out the options available to recoup these losses.* Given the exposure of the taxpayer to the failings of this franchise, it is unacceptable for the Department to maintain its current 'arms-length' approach. *We recommend the Department intervene to ensure that all possible steps are being taken to stop the haemorrhaging of income. In response to this report, as well as setting out the steps the Department is taking, a full explanation should be given of the range of options considered in dealing with this franchise and why the current 'arms-length' approach was deemed suitable. If GTR is officially found to be in breach of its contract, we recommend the Department consider restructuring the franchise and determine who is best placed to operate it. Ultimately any potential restructure should rectify the contractual shortcomings of the current franchise, realigning the incentives and focus of the operator back to the passenger and reducing the financial exposure of the taxpayer.* (Paragraph 54)

Structure of franchising

8. There are potential benefits from operating smaller franchises, particularly in terms of providing a greater market focus for the operator. There is also less financial risk from taking on smaller franchises, which may enable new entrants into the franchising market. A wide restructuring of the current franchise system would, however, be prohibitively impractical because of the resource burden this would create for the Department and the restrictions from current franchise contracts. *We therefore recommend that, as franchises expire, the Department considers whether they can and should be restructured to align better with the specific market they serve.* (Paragraph 62)

9. We believe that there are benefits from procuring longer franchises, particularly in terms of incentivising investment and efficiencies from an operator. However, a one-size-fits-all approach is inappropriate. *We recommend that the Department, upon the expiry of existing franchises, seeks to procure longer franchises where a franchise's operational risks are relatively low and historical performance has been strong. This would have the dual benefit of enabling operators to improve efficiencies and provide more space for the Department in a highly congested franchising schedule. It is important that the necessary enforcement levers against underperformance, as well change mechanisms for infrastructure works, are contracted for by the Department for franchises with longer terms. The Department should also find more innovative ways of contracting with operators to mitigate the unpredictability of financial risks over longer term horizons.* (Paragraph 68)

Franchising and Network Rail

10. The misalignment between the control period and franchising schedules is a fundamental flaw of the current system and undermines further operational alignment between Network Rail and train operating companies; and ultimately efficiency improvements that benefit the passenger. (Paragraph 73)

11. The incentives for cooperation between the operator and Network Rail are not aligned sufficiently with outputs for the passenger. We are encouraged by the Secretary of State's recent comments on improving the focus the regulatory targets have on the passenger. However, the efforts to further align the incentives in Control Period 5, including the Route Efficiency Benefits Scheme, have been negligible. This is primarily the result of conflict between the control period and franchising schedules. This appears to be a fundamental failing of franchising and the wider regulatory framework and will be addressed at greater length in the Rail Governance and Financing inquiry in 2017. (Paragraph 83)

12. It is clear that the alliancing programme, while a step toward greater alignment between the operator and Network Rail, has not achieved the desired benefits that were initially envisaged for this programme. We conclude that the programme is ultimately limited by the misalignment between franchises and Network Rail routes that prevents the establishment of deeper commercial arrangements. We do not yet know the details of the Government's recently announced plans for new alliances in the South East and East Midlands. In light of this we will return to this and other proposals, including the East-West Rail Link, in more depth in our Rail Governance and Financing inquiry; where we will also look at the wider success of governance structures and initiatives, including the Rail Delivery Group, to promote joint-working. (Paragraph 90)

Departmental capabilities

13. The Department needs to find more innovative and streamlined ways of engaging with passengers and wider stakeholders when consulting on rail franchises. It is clear that consultation documents in the order of 60 to 70 pages and formal written responses are not the most effective in engaging with the wider public. *We recommend that the Department publish a rail franchising public engagement strategy. This does*

not have to be exhaustive. A short document and associated webpage would provide the public with a clearer view on how to engage with franchising. We also recommend that the Department engage with relevant rail user groups on a more substantive basis at the beginning of the consultation process. (Paragraph 96)

14. We believe that the Department's commitment to transparency is undermined by the lack of information following a franchise award. Commercial sensitivities limit the amount and type of information that can be published. *Acknowledging this however, we recommend that the Department publish a scoring system, possibly in the form of a weighted index, following a franchise competition. This would omit commercially sensitive details but give the public and industry a better understanding of the basis, in terms of quality and price, on which a franchise has been awarded.* (Paragraph 100)

15. The experience from the East Anglia franchise competition shows that there is an obvious disconnect between franchising and the Government's wider transport policy objectives. As concluded in our previous report, integrated transport planning is crucial to improving surface access to airports. It is simply unacceptable that a service that provides significant economic and social benefits, within the context of constrained airport capacity in the South East, be entirely ignored in the bidding process. *We recommend that the Department, Network Rail, Greater Anglia and Manchester Airport Group work together to develop plans for journey times improvements on the Stansted Express. Improvements would heavily and directly benefit MAG and as such it should consider making a funding contribution to the associated cost. The wider role of third-party investment in rail will be examined in our Rail Governance and Finance inquiry.* (Paragraph 105)

16. *We do not recommend moving to a single measure upon which to measure operator performance but we do recommend the Department streamline franchise specifications, taking an outcome-based approach. This would provide operators with more flexibility in delivering tailored services to passengers based on individual market requirements, which change over time. It would also reduce the burden on prospective operators in the bidding process and on the Department in developing the ITT and in the monitoring and enforcement of a franchise. However, it is also important, where an individual franchise warrants it (e.g. on largely urban, commuter-heavy franchises), that detailed commitments can be set out, related particularly to service quality provisions, in franchise agreements with the expectation that the TOC will be held to them.* (Paragraph 111)

17. Despite the Department's consistent claims of a commitment to transparency, our experience would suggest that transparency in franchising monitoring appears to be very poor. It has taken significant effort from this Committee to obtain basic information around GTR's performance benchmarks and timetabling which are not available publicly. Further, in allowing GTR to change their performance benchmarks and timetable, which effectively enabled them to avoid breach of contract, the Department has not actively intervened in a manner proportionate to the problems on the TSGN franchise. GTR have effectively been given a penalty holiday because of this industrial dispute. (Paragraph 115)

18. The way the force majeure provisions are currently drafted in franchise agreements provides operators with far too much leeway when dealing with industrial disputes. We accept that part of the industrial action is outside the control of the operator. Yet the ability to respond to it, particularly in terms of managing longer term staffing levels, is very much within the control of the operator. *We recommend that in future contracts, terms are drafted in a way that has a clearer definition of what qualifies as force majeure and is commensurate to the degree of control of an operator has in dealing with an industrial dispute.* (Paragraph 116)

19. We welcome the Minister's commitment to make franchise performance reporting more transparent following our extensive investigations and ongoing pressure. It is a significant step forward and goes some way to increasing the accountability of operators to the public for poor performance. *We recommend that the Department outline, in detail and with a timeline, its plans to incorporate these reporting provisions into existing contracts. We also recommend that when the Government publishes the promised performance benchmarks, it does so in an easy to access format which is not hidden away separately on individual operator websites. The data must be centrally located on a dedicated and visible webpage that shows the performance of all operators and makes clear whether operators are failing to or are at risk of failing to deliver the services the Department has contracted them to provide. It must also be possible to track any agreed changes to the levels and quality of services and a clear rational for each such agreed change should be easy to find. This has implications for the transparency of the entire franchising process.* (Paragraph 120)

20. We were concerned to see that GTR earned a net payment in the first year of operation on the TSGN franchise, with performance rewards greater than penalties. We are also disappointed that performance penalties on that franchise have been capped which disincentivises performance once it has deteriorated beyond the breach level. We conclude that by capping performance penalties the Department has not drawn up a contract in the public interest. *We recommend that the Department learn lessons from this episode and that it overhaul its contracting approach to performance penalties to ensure that penalties are more proportionate to the revenue obtained from a franchise. As a starting point, it must no longer contract for a breach level cap on penalties in the way it did so on the TSGN franchise. There may be wider issues affecting other franchises but it is difficult for us to make any other specific recommendations as we have only seen performance penalties for the TSGN franchise.* (Paragraph 123)

21. We are of the view that the Department does not have sufficient capacity to revoke a franchise from an operator, particularly of the size and complexity of TSGN. With a rather weak penalty regime, the Department appears to have very few levers with which to manage performance and enforce a contract. An out-of-date enforcement policy shows a complacency on part of the Department in terms of prioritising franchise enforcement. (Paragraph 126)

22. *As an immediate priority, we recommend the Department update its enforcement policy by May 2017. In doing so and given the potentially high costs of running an operator of last resort, we recommend the Department consider new ways of enforcing the contractual terms of a franchise. For example, the Department should consider contracting for the reallocation of capacity to an alternative operator in the event*

of sustained poor performance or default. This could potentially mitigate the cost of running an operator of last resort and also provide a very genuine enforcement threat against poor performance. (Paragraph 127)

23. *We question whether it is effective for one of the commercial partners to a franchise (i.e. the Department) to also be the enforcement authority. In light of this, we recommend that the Government transfer enforcement and monitoring capabilities of franchising to the Office of Rail and Road or another independent body.* It should bring forward a consultation setting out the options for independent enforcement—including the ORR option or the creation of a new body. This consultation should also consider the costs of doing this and examine the implementation issues for the ORR in terms of the impact on its other functions and resources. (Paragraph 131)

24. The Department has only procured six competitive franchises since 2012. We do not believe the Department has sufficient capacity to procure the seven franchises that are scheduled between 2017 and 2019. One of those will be the complex Intercity West Coast Partnership. Recent experience with TSGN does not fill us with confidence that the Department can deliver this sort of complex franchise. Further, the West Coast Partnership will inevitably be a significant resource burden on the Department and has the potential to jeopardise other franchise competitions in that period. *Unless, within the timescale required, major changes advocated in this report are implemented and the Department is resourced to manage the procurements, we recommend the Department should consider direct awards for its highest performing franchises due for renewal between 2017 and 2019.* While not desirable, particularly in terms of limiting competition and creating further change in the franchising timetable, this proposal may mitigate the costs from mismanaged franchise procurement likely to result from a congested franchising schedule. (Paragraph 135)

25. We welcome the commitment by all parties to a coordinated changeover of the South Western franchise in 2017. Yet the success of a franchise changeover depends on the assumptions and information provided by the Department. Given the gross inaccuracy of assumptions and planning for the TSGN franchise and the void in capability this represented, we believe that there is a performance risk to a new operator, and therefore passengers, from the South Western franchise changeover being scheduled in the middle of major infrastructure works at Waterloo. The practicalities and costs of delaying this franchise are likely to be significant and may outweigh the benefits of improved coordination in planning with the incumbent. *The current schedule for the South Western franchise competition should remain as planned. More broadly, we recommend that consistent operational management be maintained during any future major infrastructure works scheduled for major London terminals.* (Paragraph 138)

26. While we acknowledge the potential benefits of having a single operator coordinating services on the West Coast Main Line and the new HS2 line, there are competition and planning risks associated with operating a franchise of this magnitude and complexity. And while this decision was informed by consultation from the now delayed West Coast franchise re-let, we are concerned that this specific decision has been made without any formal consultation; and that it was announced without any accompanying business case or evaluation for the public and stakeholders to consider. *We recommend that the Department publish the business case for this*

decision, clearly outlining the balance of benefits and risks from this decision. We are pleased that the Government published further detail in the recent prospectus on how it intends to structure and operate this franchise in the future. (Paragraph 145)

27. Despite the recent efforts of the Department to improve its franchising operations, there is extensive evidence pointing to serious deficiencies in its franchising capability and capacity. We are of the view that the Department's progress since 2012 is insufficient to warrant proceeding with the current structures and personnel in place. While we still believe the Department has an important role to play in franchising, we do believe certain functions of the franchising process may be better placed elsewhere. (Paragraph 148)

28. *Because of this, we recommend that an independent and publicly available review of the Department's franchising functions be commissioned. In addition to reviewing the Department's capabilities and capacity, this can include consultation regarding the transfer of the monitoring and enforcement functions to the ORR. This should also outline the Department's strategic direction for franchising, including but not limited to the way it wishes to structure and plan for future franchises, and how it plans to manage the issue of open access.* (Paragraph 149)

Formal Minutes

Monday 30 January 2017

Members present:

Mrs Louise Ellman, in the Chair

Clive Efford	Iain Stewart
Robert Flello	Graham Stringer
Mark Menzies	Martin Vickers
Huw Merriman	

Draft Report (*Rail franchising*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 149 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Ninth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 6 February at 4.00pm

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Monday 5 September 2016	*Question number*
Tony Lodge, Research Fellow, Centre for Policy Studies, **Nigel Keohane**, Director of Research, Social Market Foundation, and **Dr Andrew Smith**, Senior Lecturer, Leeds Institute of Transport Studies	Q1–29
Dr Andrea Coscelli, Acting Chief Executive, Competition and Markets Authority, and **Joanna Whittington**, Chief Executive, Office of Rail and Road	Q30–69
Monday 10 October 2016	
Mike Hewitson, Head of Policy and Issues, Transport Focus, **Stephen Joseph OBE**, Chief Executive, Campaign for Better Transport, and **Stephen Locke**, Chair, London TravelWatch	Q70–101
Gareth Powell, Director of Strategy and Contracted Services, Surface Transport, Transport for London, **Richard McClean**, Managing Director, Grand Central, **Elizabeth de Jong**, Director of Policy, The Rail Delivery Group, and **Charlie Hodgson**, Managing Director, Rail Development, Go-Ahead	Q102–144
Monday 24 October 2016	
Mick Cash, General Secretary, RMT, and **Mick Whelan**, General Secretary, ASLEF	Q145–217
Jo Kaye, Executive Director for Network Strategy and Capacity Planning, Network Rail, and **Paul Harwood**, Strategy and Planning Director (South), Network Rail	Q218–277
Monday 7 November 2016	
Roger Cobbe, Policy Director, Arriva UK Trains, **Hugh Clancy**, Commercial Director, First Rail, FirstGroup, **Tim Shoveller**, Managing Director, Stagecoach Rail, Stagecoach Group, and **Jamie Burles**, Managing Director, Greater Anglia	Q278–331
Paul Maynard MP, Parliamentary Under-Secretary of State for Transport, and **Peter Wilkinson**, Managing Director, Passenger Services, Department for Transport	Q332–387

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

RFG numbers are generated by the evidence processing system and so may not be complete.

1 Alstom UK&I (RFG0021)

2 ASLEF (RFG0014)

3 Balfour Beatty (RFG0007)

4 Campaign for Better Transport (RFG0013)

5 Competition and Markets Authority (RFG0005)

6 David Cooper-Smith (RFG0001)

7 Department for Transport (RFG0003)

8 FirstGroup plc (RFG0018)

9 Institute for Transport Studies (RFG0011)

10 London TravelWatch (RFG0012)

11 Manchester Airports Group (RFG0023)

12 Mr James Baker (RFG0024)

13 North East Combined Transport Activists' Roundtable (NECTAR) (RFG0026)

14 Office of Rail and Road (RFG0022)

15 Rail Delivery Group (RFG0019)

16 Railfuture (RFG0016)

17 RMT (RFG0006)

18 Social Market Foundation (RFG0008)

19 South West Transport Network/Railfuture/Bus Users UK (RFG0020)

20 The Cinderella Line Campaign – The Crofton Park Transport Users Group (RFG0004)

21 Transport Focus (RFG0009)

22 Transport for London (RFG0025)

23 TravelWatch NorthWest (RFG0017)

24 TravelWatch SouthWest CIC (RFG0015)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website.

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2015–16

First Report	Surface transport to airports	HC 516 (HC 995)
Second Report	Road traffic law enforcement	HC 518 (HC 132)
Third Report	Airport expansion in the South East	HC 784 (HC 564)
First Special Report	Investing in the railway: Network Rail Response to the Committee's Seventh Report of Session 2014–15	HC 347
Second Special Report	Motoring of the future: Government Response to the Committee's Eighth Report of Session 2014–15	HC 349
Third Special Report	Smaller airports: Government Response to the Committee's Ninth Report of Session 2014–15	HC 350
Fourth Special Report	Strategic river crossings: Government Response to the Committee's Tenth Report of Session 2014–15	HC 348
Fifth Special Report	Strategic river crossings: Greater London Authority Response to the Committee's Tenth Report of Session 2014–15	HC 558
Sixth Special Report	Surface transport to airports: Government Response to the Committee's First Report of Session 2015–16	HC 995

Session 2016–17

First Report	Operation Stack	HC 65 (HC 602)
Second Report	All lane running	HC 63 (HC 654)
Third Report	Volkswagen emissions scandal and vehicle type approval	HC 69 (HC 699)
Fourth Report	Skills and workforce planning in the road haulage sector	HC 68 (HC 740)
Fifth Report	All lane running: Government response	HC 654 (HC 858)
Sixth Report	The future of rail: Improving the rail passenger experience	HC 64 (HC 905)

Seventh Report	Rail technology: signalling and traffic management	HC 67 (HC 910)
Eighth Report	Bus Services Bill	HC 611 (HC 918)
First Special Report	Road traffic law enforcement: Government Response to the Committee's Second Report of Session 2015–16	HC 132 (HC 518)
Second Special Report	Airport expansion in the South East: Government response to the Committee's Third Report of Session 2015–16	HC 564
Third Special Report	Operation Stack: Government response to the Committee's First Report of Session 2016–17	HC 602
Fourth Special Report	Volkswagen emissions scandal and vehicle type approval: Government response to the Committee's Third Report of Session 2016–17	HC 699
Fifth Special Report	Skills and workforce planning in the road haulage sector: Government response to the Committee's Fourth Report of Session 2016–17	HC 740
Sixth Special Report	All lane running: Government Response to the Committee's Fifth Report of Session 2016–17	HC 858
Seventh Special Report	The future of rail: Improving the rail passenger experience: Government Response to the Committee's Sixth Report of Session 2016–17	HC 905
Eighth Special Report	Bus Services Bill: Government Response to the Committee's Eighth Report of Session 2016–17	HC 918
Ninth Special Report	Rail technology: signalling and traffic management: Government response to the Committee's Seventh Report of Session 2016–17	HC 910