Department for Transport

Rail Franchising Policy: Analysis of Historic Data

KPMG LLP

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1 Executive summary

1.1 Overview

This report uses the available data to consider whether there is any evidence about the impact of contract length and other aspects of contract design on the performance of franchise operators.

In UK heavy rail, we seek to assess the impact of contract design by comparing the performance of Train Operating Companies ('TOCs') in the same sector, over the same time period and, in many respects other than franchise length, on similar contracts. Beyond UK heavy rail we have looked at contracts for bus and light rail services in the UK and franchises for train operations in Stockholm and Melbourne. Here our focus has been on the policy drivers behind contract design rather than on comparative analysis of franchise outcomes.

The initial hypothesis was that, other things being equal and with simplistic assumptions, e.g. about writing down full asset value during a franchise life, etc, longer franchises should provide stronger incentives to invest up-front in improving performance and growing patronage. This is because with a longer contract, more up-front investments to yield a future stream of higher revenues might have a positive financial case. However, our comparative analysis of UK TOCs has provided no conclusive evidence of the impact of contract length on performance across the sample of operators that were studied.

Possible reasons for the lack of conclusive evidence about the relationship between franchise term and franchisee performance are:

- Franchisee bid assumptions for patronage growth or cost reduction proving not to be sustainable, meaning that some sample TOCs did not see out the full term of their contracts. Performance can also deteriorate as management seeks to cut costs to reduce financial losses. This effect may override any impact that franchise length might have on franchisee performance;
- Many of the investments or actions that will improve performance or customer satisfaction in the UK rail industry do not necessarily have a financial payback over the life of the franchise, even if it is a relatively long contract such as 15 years (and some investments may not generate a TOC financial return over any time period). Alternative mechanisms to bring about improved outcomes might include the Franchising Authority specifying investments in tender requirements. UK rail franchises tend to have a number of committed obligations to deliver specific improvements incorporated into the contract on signature. Often the nature of these committed obligations differs materially between contracts and are not related to franchise length;
- The different UK TOCs are highly individual businesses operating in different geographic locations with different fleets and inheriting assets of differening age and condition. They also experience different external events (performance shocks,

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changes to the local economy, Network Rail performance, etc) over the period of their contracts; and

- The ability of a management team to impact the results delivered may be related as much to its quality as to the term of a contract.

Each of these factors is likely to have impacted the outputs delivered by the sample of UK TOCs that we have compared and therefore conclusions from the data set should be treated with caution.

In our study sample were three of the five 15 year contracts let by OPRAF in 1996 and 1997, each of which included a commitment to replace existing fleets and introduce new rolling stock. Two of these, Connex South Eastern ('CSE') and Virgin Cross Country ('VXC') ran into severe financial difficulty by early 2002 and had been renegotiated by 2003. The third, LTS/ c2c, has proved to be financially robust and over the course of its franchise has seen significant improvements in terms of punctuality and customer satisfaction. It is important to note, however, that in the same London and South East (L&SE) TOC segment, South West Trains ('SWT') has seen similar longer-term performance improvements. SWT has operated under an initial franchise of seven years followed by one and three year short-term contracts and then a re-competed agreement.

Subsequent to the first round of UK franchising, the SRA let two long-term contracts in the regional TOC segment, Wales & Borders and Merseyrail - franchises of 15 and 25 years respectively (with performance-related 'break points'). These TOCs are both financially robust to date and have outperformed the regional sector in terms of punctuality and passenger satisfaction levels. Many factors might, however, explain these improvements, including significant investment led – and funded - by third parties. Merseyrail and Wales and Borders were both let at a time of significant SRA budgetary pressure and as such relatively little was specified in terms of TOC investment. Many of the improvements that have subsequently been delivered on these operations have been sponsored by the Franchising Authorities.

Within our UK TOC sample is another bespoke model, the Chiltern franchise. This was let in 2002 with a minimum term of 10 years and has the potential to be extended to up to 20 years if Government agrees to purchase a series of investments to be put forward by the franchisee. On the Chiltern franchise, outcomes for passengers, as measured by passenger satisfaction and delays, are well above the L&SE sector. Similar results were, however, achieved during Chiltern's earlier seven year contract, indicating that contract design in respect of term/ investment incentives may not be the only relevant issue. Whilst the TOC has proposed and delivered significant investments, the nature of its contract provides direct incentives for it to do so. Such a model may not be appropriate on parts of the network where the case for strategic investment is less strong, or where there are competing operators with different commercial interests.

We conclude therefore that whilst there might with very simplistic assumptions, e.g. about cost recovery during a franchise, be some theoretical basis to consider that longer franchises could provide stronger performance incentives, amongst the TOCs we have studied there is no strong evidence for or against a direct link between contract length and

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the outcomes delivered. In addition, the current ATW and Merseyrail franchises indicate that other factors – such as the relationship between passenger revenue and operating costs – are highly relevant. There is also some evidence that in time, costs and revenues can diverge widely from the bid position, (e.g. CSE and VXC). This would suggest that longer-term franchises, in the absence of mitigating measures, might lead to increased financial risk. There are also, however, examples of shorter franchises that have encountered financial problems (Anglia, Central and Northern Spirit/ ATN).

Recent international experience provides examples of alternative steps to promote financial robustness in establishing potentially long-term franchises. The Melbourne rail and tram franchises awarded in 2009 are each for an initial term of eight years with the ability for the franchisee to earn the right to negotiate a further seven year unpriced extension. Alternatively, the Franchising Authority can extend the initial term for a period of up to three years via a priced extension. The maximum possible term is therefore 15 years, with extension beyond eight years being at the discretion of the Franchising Authority. To promote financial stability, the contracts include steps to adjust franchise payments during the contract to allow for actual (rather than forecast) passenger revenues, with a rebasing undertaken in the third, sixth and ninth year of operations. Whilst the absolute level of revenue is rebased, growth rates from the bid are then retained for the next three years to provide incentives for the operator to grow passenger revenue whilst not retaining full revenue risk.

However the comparability of these franchises to the UK is limited. The Melbourne franchises are vertically integrated, with the franchisee also having a significant role in the delivery of a number of capital projects. The franchisees receive fixed shares of overall multi-modal ticket sales. As such delivering revenue growth is not necessarily the key objective of the franchisee and the Franchising Authority places a high priority on partnership working and establishing a stable operating environment. Furthermore, the alternative contractual mechanisms to promote long-term franchisee stability are as yet untested.

1.2 Role of this analysis

Franchise contracts have been used extensively for the delivery of public transport services in the UK and internationally. In some cases these arrangements appear to have delivered improvements in performance and reductions in cost. However they have also often proved unstable, with a high incidence of early termination or renegotiation.

In response, Government policy makers have varied the form and term of the contracts and the level of risk borne by the franchisees to promote both stability and performance improvement. Where contract incentives alone might not be sufficient, Government has also directly specified desired outcomes / investments.

The UK has used longer-term (up to 15 year) franchises with relatively high risk transfer (e.g. revenue) and incentives, shorter-term (e.g. seven year) contracts with lower risk and a variety of intermediate approaches. Different forms of input specification and output targets have also been prescribed and other incentives have varied. Other countries have also used a variety of approaches with no standard approach emerging.

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This experience suggests that there is no single ‘correct’ answer to the optimal form of franchise contract. However it also suggests that there is value in evidence-based analysis to learn from past experiences and to investigate whether franchise contracts could be modified to better meet government policy objectives.

The purpose of this paper is to provide data on the performance of a set of historic and current franchises and then to analyse this data to see if it can provide evidence as to how best to structure future franchise contracts. The data takes two forms:

- Outcomes (in terms of performance, financial robustness and other measures) of comparable (so far as possible) UK heavy rail franchise contracts, to investigate the extent to which outcomes are associated with particular aspects of contract structure, and
- A more qualitative description and assessment of light rail and bus contracts in the UK and of relevant contracts in other countries to investigate, for example, the reasons for particular contract structures.

1.3 Methodology and sources of information

In conducting this analysis, we have adopted two approaches. For UK heavy rail franchises we have, where available, analysed data to look for any evidence of the possible impact of contract form on franchisee performance. We have done this by comparing data on outcomes by franchise, where the franchisees provided similar services over a similar period, but differed in the form of their contracts. However, for the reasons already explained in Section 1.1 above, the extent to which the outcomes delivered by different TOCs are ever truly comparable should not be overstated.

For other contract arrangements in the UK and internationally, we have provided a description of franchise arrangements and outcomes, but have not attempted comparative analysis.

The performance of UK heavy rail franchises has been assessed in terms of:

- *Financial robustness*: the variance of the franchisee’s cost and revenue performance from bid, profitability and the incidence of contract termination or renegotiation;
- *Service quality*:
  - TOC-on-self delay minutes –delays caused by factors considered to be within the control of the TOC itself;
  - The Public Performance Measure (‘PPM’). This is an aggregate measure covering delays attributable to Network Rail, other TOCs, the TOC concerned and factors external to the railway; and
  - National Passenger Survey (‘NPS’) scores;
- *Growth:* passenger revenue and train kilometre growth; and

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- *Cost efficiency:* the cost per passenger kilometre and cost per train kilometre. These measures exclude track access charges and performance-related payments in order to better reflect those costs considered to be within the control of the franchisee.

We have also provided a more qualitative assessment of each franchisee in terms of the investment that was delivered. We have, where possible, attempted to identify where investment was: specified in the Invitation to Tender ('ITT'); committed at contract signature and / or TOC-led during the course of the franchise.

Performance information presented in this report relating to PPM and NPS is sourced from publicly available information supplied by DfT.

Financial information presented in this report is sourced from publicly available information. Information relating to franchise contracts which haven't been in operation for at least 3 years has drawn upon information provided by the SRA (DfT's predecessor as Franchising Authority) to KPMG in 2003.

In order to conduct the analysis in this report, we have referred to the following sources:

- Annual and quarterly National Rail Trends publications
- Office of the Rail Regulator and Strategic Rail Authority Annual Reports
- Transport Statistics Great Britain and Quarterly Bulletin of Transport Statistics publications
- TOC Accounts filed with Companies House
- Franchise ITT documentation
- Franchise Agreement 'Franchise Plan' sections provided by DfT
- National Passenger Survey publications
- Delay minute and Public Performance Measure data provided by DfT
- Independent Bus Review published by TfL in 2009

In addition, other specific information sources are quoted in the relevant sections of this report.

Information in respect of some of these outcome measures was not available on a consistent basis over time. Our response to data issues is described in each relevant section of the report.

Certain information has been redacted at the request of DfT as indicated in this report.

We consider a contract to be 'financially robust' if it is able to survive without a material change in the level of government support, other than that relating to a material change in services.

Franchisee performance is strongly affected by changes in the operating environment - e.g. macroeconomic trends. The most visible change in the course of the 'first round'

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franchises (as we have highlight on the relevant charts) was in response to Hatfield in late 2000. More generally, variations in outcomes might be attributable to franchise factors that are not directly or solely attributable to the franchisee, rather than to good or poor TOC performance. Such differences might include the impact of extended engineering work, the introduction of new rolling stock and changes in fares.

Where it is possible, we have taken steps to improve data comparability. This includes comparing franchisees serving similar passenger groups and franchisees over the same operating period. It should be noted, however, that the operating environment for any two franchisees can still vary significantly, even where both serve similar groups, e.g. London commuters or inter city passengers, over the same time period. In addition, some franchisees may inherit franchises that are already performing relatively well, and others may inherit operations that are performing poorly compared to the sector average. Again we have addressed this where possible by focussing our analysis on trends in franchise outcomes over time, comparing these to sector trends for all franchises serving the relevant passenger group (L & SE, inter city and regional).

1.4 Case studies

Table 1 identifies which UK rail franchises have been studied, along with the sector to which each belongs, the start date and the original franchise length. In some cases franchise length was variable and dependent on performance.

Table 1: UK rail franchises studied

Franchise	Start date	Original franchise length
London and South Eastern TOCs		
South West Trains	February 1996	7 years
LTS Rail/c2c	May 1996	15 years
Connex South Eastern	October 1996	15 years
Anglia	January 1997	7 years 3 months
Chiltern	March 2002	10/20 years
Inter city TOCs		
First Great Western	February 1996	10 years
GNER	April 1996	7 years
Virgin Cross Country	January 1997	15 years 3 months
Regional TOCs		
Northern Spirit/Arriva Trains Northern	March 1997	7 years
Central Trains	March 1997	7 years 1 month
Merseyrail	July 2003	7+5+5+5+3 years
Arriva Trains Wales	December 2003	5+5+5 years
Template Franchise Agreement		
National Express East Anglia	March 2004	7 + 3 years

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We have looked at two domestic contracts for transport services outside the heavy rail sector. For TfL buses we provide a summary of competitive tendering since 1985 and for the Docklands Light Railway ('DLR') we have described the operation of the franchise since it was originally announced in 1994 and let in 1997.

We have also looked at a sample of relevant international contracts. For the Melbourne heavy and light rail (tram) operations, we provide a description of franchising since the original tenders in 1999. This description includes the renegotiations of 2004 and the recent award of potentially long-term franchises in 2009. For Stockholm Metro, we have described the recent rounds of franchise tendering that took place in 2008.

1.5 Findings: heavy rail franchises

1.5.1 London and South East (L&SE) TOCs

Our analysis of the outcomes delivered by a sample of L&SE TOCs allows us to draw only very limited conclusions in respect of any link with contract design.

There is no clear evidence of a strong correlation between franchise term and financial robustness. The 15 year Connex South Eastern contract included some major investment programmes (most being funded by conventional means), but Government concerns over the franchisee's ability to manage its financial position led to the franchise being taken back in house. The LTS/ c2c 15 year franchise, however, has proved to be financially robust to date. Of the shorter franchises in the sample studied, Anglia was on a management contract for its final two years but SWT proved to be financially robust. A significant factor in financial robustness appears to be the aggressiveness of the original bid. In the first round, bids for UK TOCs became more aggressive as the franchising process progressed.

Across service quality metrics it is notable that LTS/ c2c and Chiltern perform well. However in drawing conclusions from c2c / Chiltern's strong performances, relevant points to note are:

- It is not just the franchises that still exist today that matter. The 15 year CSE franchise demonstrated declining service quality (delay minutes, PPM and NPS) until the franchisee was ultimately removed;
- Chiltern was a high performing TOC in the period from 1997 to 2001, before it was awarded a longer contract;
- The infrastructure of the LTS / c2c franchise area received significant investment in the period just prior to privatisation;
- In statistical terms, the sample size is very small, which means that it is not possible to isolate any statistically significant impact of franchise term on service quality;
- Since 2003, SWT has seen a similar long-term improvement in punctuality and satisfaction to c2c on what is a considerably more complex operation. In this period SWT has operated on one and three year management contracts and the franchise has

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been re-competed. The managing group has, however, been consistent over this period; and

- TOCs alone cannot deliver strong PPM or NPS results. The results are heavily impacted by Network Rail, as well as the performance of other TOCs and external factors.

Comparing cost efficiency metrics between TOCs is difficult as each of the businesses has different operating characteristics. Whilst operational factors, for example the introduction of new trains, or efficiencies, e.g. DOO, might appear to be better correlated with trends than many aspects of contract design, we have not carried out statistical analysis of the long list of events that could impact cost efficiency performance. Further analysis might investigate the extent to which the improved cost metrics on SWT after 2007 can be attributed to the competitive process.

In terms of investment, the following points are of note in relation to the 'first round' franchises:

- CSE had a major commitment to oversee Mark 1 fleet replacement during its 15 year term, but did not prove to be sufficiently financially robust to deliver this;
- SWT invested £25m in gating / fleet, financed on the TOC's Balance Sheet (Source: TOC Financial Statements), despite having a short franchise. This was, however, in the context of a benign financial environment; and
- LTS / c2c also made notable investments. A significant amount of the investments that were in excess of franchise commitments were via 'passenger dividends' – e.g. agreed when TOC ownership changed, or to compensate for the late delivery into service of rolling stock.

Chiltern's contract requires it to propose investments such as Evergreen 2 that are different in scale to those being developed by operators elsewhere, in order to secure extensions to its minimum franchise term. It should be noted that whilst Chiltern takes some shorter term risk on project costs and delivery, it does not take the risk on the additional revenue generated over the entire life of these investments, nor residual value risk. For example, on completion infrastructure assets might be transferred to Network Rail's Regulatory Asset Base ('RAB') at a pre-agreed price, with the TOC then paying higher access charges. Alternatively assets may receive a future franchisee usage guarantee or a commitment that a future franchisee will purchase assets at the Net Book Value ('NBV').

The Chiltern model in respect of track infrastructure may also not be considered appropriate for other parts of the network – for example where potential investments, with sufficient strategic priority, do not exist, or where the network has many competing users (and hence the incremental revenue as a result of an investment flows to more than one TOC). However, further investigations might seek to establish whether some of the mechanisms in the Chiltern contract, such as that in respect of "Schedule 4" assets, might potentially be useful elsewhere, to help TOCs play a more significant role in managing or financing investment projects, e.g. in stations/ car parks.

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1.5.2 Inter city TOCs

Only very limited evidence of any link between contract design / franchise length and performance is available from the sample of TOCs studied. The 15 year VXC contract included some major investments and service changes, many of which ultimately did take place, but the TOC did not prove to be financially robust and the cost to taxpayers beyond 2002 was significantly in excess of that forecast when the contract was let. (The TOC's franchise payments were reset annually after 2002).

As with the L&SE TOCs, further analysis indicates a clear correlation between financial robustness and the first round bid cycle. The two franchises that proved to be financially robust – FGW and GNER - were the first two let. VXC, which was let later in the process, had more ambitious targets in terms of revenue growth.

Against other measures, FGW appears to have performed better in terms of cost efficiency ratios whilst GNER delivered higher levels of customer satisfaction. In terms of PPM, the record of both of these TOCs is broadly comparable, although it should be noted that this metric is heavily influenced by factors outside TOC control. The fact that one franchise was initially seven years (GNER was extended for a further two years) and the other 10 years does not seem to have demonstrably impacted trends in outcomes.

In terms of investment, the most significant proposals were the timetable and rolling stock changes envisaged by VXC. Although these were ultimately delivered (with the exception of some of the service extensions which were wound back), the TOC was not sufficiently robust for these to be implemented under the original contractual / financial terms.

On FGW, a series of investments - over and above those contracted - were undertaken during the franchise. DfT has informed us that a number of these were tied to recovery plans agreed in 1998 and 2002. Some investments were also funded by the SRA's Rail Passenger Partnership scheme (e.g. Swindon platform four) or negotiated as a result of First operating Great Western Link services from 2004.

1.5.3 Regional TOCs

Our analysis of a sample of "first round" regional TOCs indicates that none of the bids proved to be financially robust. As all of the first round regional franchises were let on relatively short-term contracts, there is no data to see if longer franchises impacted outcomes.

Both of the later, longer regional franchises we have examined (Merseyrail and Wales & Borders) have to date proved to be financially robust. It should be noted, however, that both Wales & Borders and Merseyrail were let at what could now be considered the 'bottom' of the rail franchising market. Bids were not financially aggressive compared to 1997 and the SRA, due to financial constraints, specified relatively low levels of investment in these contracts. Bidders did not identify material levels of additional investment with a positive financial case.

In the case of Wales & Borders, both customer satisfaction and punctuality were either flat or deteriorated in the first two years of the franchise. Outcomes have since improved. The five year performance break is perceived to have been key, both by DfT and WAG Franchise Managers, in stimulating this improvement.

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In terms of investment, WAG considers that whatever has been delivered has primarily been driven by the Franchising Authority and not in response to incentives provided by a contract with a relatively long term. It should be noted, however, that the ratio of passenger revenue to operating costs on this franchise is low compared to the wider UK rail industry. Therefore financial business cases for TOC-funded investment, to be recovered through incremental passenger revenue, are likely to be relatively weaker than in the wider industry. In recognition of this, the contract initially signed by the SRA and Arriva was strongly geared towards ensuring the operation of the train service according to a new timetable.

Merseyrail has achieved a step change in operational performance and customer satisfaction, both immediately prior to and during the current franchise. It should be noted, however, that the Merseyrail network is largely self-contained, without the degree of complexity faced by other TOCs. In addition, the PTE has led and funded a significant investment programme, which bidders for the franchise were required to support.

1.5.4 Template Franchise Agreement

The first franchise to have been let under the Template Franchise Agreement was Greater Anglia ('GA'), which commenced in April 2004 and is operated by National Express. The franchise term was for a maximum of ten years, with the final three years dependant on achieving target levels of performance and other factors.

From the evidence we have reviewed it is not possible to determine if any aspect of the GA contract structure has had a causal impact on outputs for service quality, growth, cost efficiency or investment. In terms of financial robustness, the TOC made a profit before tax in four of the five years to 2009.

The GA franchise has seen a significant improvement in TOC-on-self delay minutes, but had to implement a recovery plan after this measure of delays initially increased by 26% in a year. The franchisee's NPS scores initially dropped a little but have recently been in line with the position at franchise commencement. The GA overall NPS score has been in the 71-79% band throughout the franchise. In the same time period, the equivalent L&SE sector NPS score has improved from 74% to 80%. The extent to which this is due to factors that the TOC can influence is not, however, clear. The trend in cost efficiency metrics has been flat. Growth in passenger revenues and patronage has been less than in the sector.

Overall, therefore, by some metrics there has been an improving trend. By others, GA has been out-performed by the L&SE sector. It is not possible from the data, however, to draw conclusions about the extent to which the outperformance of the TOC by the sector is due to factors within the franchisee's control.

1.6 Findings: other UK transport contracts

1.6.1 TfL buses

Bus routes in London are governed by contracts with several different operators, many of whom also run train services in the UK. Competitive tendering was initiated in 1985. The contracts were originally gross cost contracts, moved to net cost contracts from 1996 and

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then moved on to Quality Incentive Contracts ('QICs') in October 2000. Patronage has grown by over 80% since the mid 1990s, but there has also recently been a substantial increase in subsidy, from £40m in 1999/2000 to £653m in 2007/8.

TfL's bus model includes highly specified contracts which are broadly gross cost, with low revenue incentives. Contracts are typically for an initial term of five years, with a potential extension of two years provided performance meets defined contractual targets. The London bus specification and procurement process is considered to be of limited relevance to DfT's rail franchising process, as the models are so different. However, it is notable that whilst the QICs regime provides an example of how contract design can be used to improve service quality, the incentive regime has also coincided with a significant increase in costs to TfL.

1.6.2 Docklands Light Railway

The first contract for the operation and maintenance of the DLR commenced in 1997 and the franchise was re-let in March 2006.

The initial contract transferred revenue and cost risk to the franchisee. In the 2006 retender TfL decided to retain revenue risk, given the limited ability of the operator to manage the risk. This has been accompanied by the initiation of a more rigorous incentive/ penalty regime based on punctuality, reliability and the availability of passenger facilities.

1.7 Findings: overseas franchise contracts

1.7.1 Melbourne

The first Melbourne transport franchises were awarded in 1999. The original franchise arrangements had two train and two tram franchises, on terms of 10 to 15 years. The initial contracts followed a similar model for operations to the UK's "first round" rail franchises. The franchises were, however, vertically integrated. Track was maintained by the franchisees, against output-based criteria for track condition. Existing rolling stock was purchased by the franchisees and the tenders included significant new rolling stock commitments.

The initial franchises proved unsustainable due to bid assumptions on revenue growth and cost reduction that did not ultimately occur. The franchises were renegotiated in 2004, at which point the four franchises were consolidated to two (one tram and one train). In 2009 the franchises were retendered. Both incumbents lost the tender.

The broad approach to vertical integration has remained, but the level of risk borne by the franchisee has changed significantly. In 1999, franchisees had strong incentives to grow patronage above target benchmarks. There has since been a reduction in the degree of revenue (and cost) risk borne by the franchisees. In addition the initial approach to revenue allocation - related to actual passenger utilisation of different transport modes (bus, rail and tram) - has been replaced by fixed shares of a common revenue pot.

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The 2009 franchises offer an initial term of eight years, a right to extend by up to three years (at a defined price) and an alternative right to negotiate for up to seven years (an un-priced extension).

The earlier long-term franchises in Melbourne proved unsustainable. The 2009 tenders seek to reduce revenue risk in two ways. First, a cap and collar is placed on the farebox revenue forecast, with the State taking half of the benefit or cost when actual revenues diverge by more than 30% of the bid profit margin.

Second, the contracts allow for periodic resets of the farebox revenue parameters during the contract term. The revenue growth rates forecast by the franchisee will remain unchanged from the original bid. However this growth rate will be applied to the actual farebox revenue which was achieved immediately prior to the reset. As a result, the level of revenue risk borne by the franchisee will be significantly reduced. This is expected to make longer term franchises more sustainable, in response to an environment where providing revenue incentives to increase future franchise value is not considered to be the primary aim.

1.7.2 Stockholm Metro

The Stockholm Metro carries around 700,000 people per day. Half of its costs are covered by ticket sales and other revenues and the remainder by subsidy.

The current contract was awarded to MTR in 2008. The contract lasts for eight years, with an option for an additional six. It covers train operations, customer service and train maintenance. Whilst the structure of the current contract indicates a desire to move to relatively long-term franchise arrangements, it is premature to assess the impact on performance.

The approach to bid evaluation adopted in Stockholm was to explicitly and quantitatively trade price and quality, rather than to apply a quality threshold for bidders to meet. The procuring authority's approach to tender evaluation withstood recent legal challenge. We also understand that the contract was not awarded to the lowest cost bidder.

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2 Introduction

2.1 Background

The Department for Transport ('DfT') has commissioned a study to investigate how far the data available could allow conclusions to be drawn about the impact of contract design – and in particular contract term has had on operator performance. The study includes not only UK heavy rail franchises but also other relevant franchise structures, both in the UK and overseas. By way of background, we consider below:

- Why contract design may affect franchisee performance
- How the impact of contract design has been assessed in the course of this study
- The possible contribution of this assessment to future policy development

2.2 Impact of contract design on performance

Contractual arrangements for UK Train Operating Companies ('TOCs') have a significant impact on incentives to improve service quality and punctuality and to grow passenger kilometres and revenues. In some cases, inputs and outputs are explicitly specified (e.g. Committed Obligations) and in others the incentives come from the risk/ reward basis of a contract.

In most cases, TOC actions to improve service quality or growth require some degree of up-front investment. This may take the form of managerial and staff time and effort, for example in better management of the relationship with Network Rail or in developing performance initiatives. Alternatively they may require direct (physical) investment such as the refurbishment of rolling stock or enhancements to stations. In making this investment, a TOC will incur upfront costs and is likely to encounter the short-term disruption associated with implementing change.

This upfront investment – or cost of disruption – will be borne where it is expected to be repaid by a future stream of higher revenues or reduced costs. Other things being equal, we would expect longer franchises to make available longer lasting higher revenues or lower costs, thereby strengthening business cases and creating stronger incentives for TOCs to invest time, effort and money in improving outcomes.

It is important to note, however, that many investments will not have a positive financial business case within the life of a franchise, even where the franchise term is long (e.g. 15 years). Indeed some investments will never have a positive financial business case for an individual TOC, regardless of franchise length. In both of these cases – where a business case is not positive over a given franchise term, or where a positive financial business case does not exist over any time period - franchising authorities can specify certain inputs or set specific output targets in order to promote policy objectives.

Other features of contract design with properties that impact on business cases include the proportion of revenue benefits or cost savings retained by TOCs, the anticipated

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relationship being that the larger the proportion, the stronger the financial incentive to improve performance.

Stronger incentives for franchisees could mean that margins are more likely to be affected by TOC efforts to improve service delivery. However, at the outset of this report, it should be noted that the level of franchisee effort and its impact on margins is uncertain. In practice, it is hard to disaggregate between the degree of performance improvement and growth which is directly attributable to the efforts of a franchisee and improvements which are due to changes in factors external to the TOC. Furthermore, it is hard to distinguish between improvements that have been delivered in response to contract incentives and those brought about by the implementation of initiatives directly specified at the time of a tender.

2.3 Assessing the impact of different contractual arrangements on performance

Assessing the impact of contract term – and other features of contract design – on TOC performance requires comparing data from franchises operating under different commercial arrangements. Such a comparison is likely to be more meaningful and robust where:

- The TOCs concerned face similar operating environments. Changes in the operating environment – such as variations in GDP growth, or in levels of urban congestion – can have a major impact on performance; and
- The TOCs face similar contractual arrangements, but with variation in one or two key parameters. Where there are a large number of differences in the contractual arrangements for the TOCs being compared it may be hard to determine which of these factors has contributed to any variation in performance. However where there is a single difference – such as only contract term – then the comparison of performance outcomes against contractual arrangements is less difficult.

Given these issues, to allow as robust a comparison of TOC performance as we consider to be possible we have adopted the following approach:

- Firstly, we have grouped the franchises studied into three segments - London & South East (L&SE), Inter City and Regional. We consider this to be the greatest extent to which it is reasonably possible to compare ‘like with like’, given the limited number of franchises that have been let to date in the UK. However it is important to note that within these groupings, there remain key differences – e.g. the type of passengers being served by each TOC, the quality of rolling stock and other assets inherited by the franchisee, etc. As a result our segmentation has minimised the differences in the operating environments of the TOCs we are comparing, but by no means removed them altogether; and
- Secondly, our comparative analysis has focused on franchises let in the first contracting round in 1995-7. These contracts were therefore let at around the same time, with the first full year of operations usually being 1997/8. Although there were considerable variations in the operating environment over the period analysed – in particular the very major impact of Hatfield – by studying a common time period, we

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can analyse *comparative* performance to try to determine whether this was affected by different contract term and form.

The 1997 franchises all had broadly the same approach to risk transfer and the majority had seven year terms. However certain franchises - such as the Connex South Eastern (‘CSE’) L&SE TOC and the Virgin Cross Country (‘VXC’) inter city TOC - were 15 years in length. Our approach allows us to compare potential impacts of these different contract terms on the performance of franchisees on a ‘like for like’ basis to the greatest extent we consider practicable.

Within the three TOC segments analysed, there are three franchises which were re-let post 1997 under different contract models. These are Chiltern, in the L&SE segment, and Wales & Borders and Merseyrail in the regional segment. The current Chiltern contract began in 2002 and the Wales & Borders and Merseyrail contracts began in 2003. To assess the impact of these contracts, we have compared the performance of these TOCs either to sector average data or, in the cases of Chiltern and Merseyrail (Wales & Borders was created after an extensive re-mapping exercise), to the results achieved from 1997 – 2002, before the new contracts were in place.

Whilst the approach set out above might be considered to provide a reasonable (albeit imperfect) basis for assessing the impact of different types of contract on operating performance, it should be noted that the use of relatively old contracts may reduce the relevance of the analysis to franchisees operating under current contractual arrangements. For example, one might draw conclusions of the impact of long-term contracts on franchisee financial robustness through analysis of the franchises let in 1997. However subsequent modifications to risk sharing arrangements or growing maturity amongst the operator community may mean that these conclusions are not directly applicable to franchisees operating under current contract terms.

In recognition of this, as well as this comparative study of ‘first round’ UK franchises, we have analysed two further groups of contracts to help provide the best available information to DfT about how contractual terms might impact franchisee performance.

One group is franchises let more recently under the Template Franchise Agreement (‘TFA’). The TFA was introduced in 2004 and contains more tightly specified service patterns than the 1997 contract and different risk sharing arrangements – notably the ‘cap and collar’ around revenue risk. In determining whether the TFA has impacted key areas such as financial stability, a disadvantage is that data is only available for a shorter time period (making it harder to assess the impact of contract form on operational performance over time). Therefore, rather than undertake comparative analysis, we have reviewed a contract in some detail, to look for evidence of how particular features of the TFA have impacted franchisee behaviour/ franchise outputs.

Greater Anglia was the first franchise to be let under the TFA. Having operated for five years it may provide insight into the impact on operator behaviour of the new contract provisions. The DfT has informed us that this franchisee also currently receives 80% revenue support under the cap and collar arrangements. As the full effect of the recession is felt, it may be that a number of other TOCs will receive this level of support. We consider that looking for evidence of how operator behaviour, and ultimately the value for

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money delivered to the DfT, is impacted by these conditions is an important part of DfT's wider franchise review.

Our discussion of the Greater Anglia franchises let under the TFA is set out in Section 4 of this report.

The final area of investigation is an assessment of alternative franchising models, including those that operate overseas. In these cases, clearly it is difficult to draw a comparison of franchise performance in areas such as punctuality, service quality and revenue growth with UK heavy rail operators. However, this wider review can provide an insight into the policy thinking that has shaped different approaches to franchising in areas such as contract length and risk transfer.

The models that we have considered are:

- TfL's contracting models for the Docklands Light Railway and London buses. These are both gross cost contract models;
- The tram and train franchises let by the State of Victoria in Melbourne. These franchises were initially let in 1999 and are now in their third generation; and
- The recent Stockholm and Copenhagen concession competitions. These attracted significant interest amongst UK operators such as Serco, NedRailways and Arriva.

Our discussion of alternative models is set out in Section 5 of this report.

2.4 Contribution of assessment to policy development

The contractual arrangements for franchise operators in the UK – and elsewhere - seek to balance the provision of financial incentives for the franchisee to improve performance with steps to ensure operators are financially robust. There is no definitive answer to the correct balance. Operational performance and growth in passenger revenues are only partly under franchisee control. Incentives for operators to improve them are likely to have some effect but in some cases, direct specification by Franchising Authorities may provide the best route to delivering the policy outcomes desired.

In undertaking this study, we did not consider that a definitive answer would emerge from reviewing the historical link between contract structure (covering term and other aspects) and franchisee performance. There are many factors which can affect performance other than contract structure. Limiting the data set – by grouping franchisees into comparable franchise type, period and contract form as we do in Section 3 of the report - enables more consistent comparisons, but also reduces the data set.

Attributing variation in performance to particular causes is necessarily tentative. We have not attempted a full statistical analysis, but anticipate that it would be hard to demonstrate a statistically robust link between contract term and performance. Any relationships could show causation, or could simply be the result of a limited data set.

Despite these points, we think that there is value in the analysis that has been undertaken. It seeks to set out clearly and concisely what we know about the sample historic

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franchises, while being mindful of the limitations. By supplementing this with more qualitative analysis, both in the UK and internationally, we broaden the evidence base and provide insight into experiences in a number of different contractual environments.

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3 Comparative analysis

3.1 London & South Eastern TOCs

3.1.1 Introduction

In comparing the outcomes delivered by TOCs under different contractual arrangements in the London & South Eastern ('L&SE') segment we have considered the following five operators:

Figure 1: L&SE TOC sample

	Start date	Original franchise length	Original end date	Actual end date (if different)
South West Trains	Feb 96	7 yrs	Jan 03	Feb 07*
LTS Rail/ c2c	May 96	15 yrs	May 11	-
Connex South Eastern	Oct 96	15 yrs	Oct 11	Nov 03
Anglia	Jan 97	7 yrs 3 months	Mar 04**	-
Chiltern (1)	Jul 96	7 yrs	Jul 03	Mar 02
Chiltern (2)	Mar 02	12/20 yrs	2013/21	-

** This franchise operated on management contracts from 2003-2007.*

*** This franchise operated on a management contract for its last two years.*

South West Trains: South West Trains ('SWT') was the first franchise to be let by OPRAF in December 1995. The original contract was awarded to Stagecoach and ran for seven years. During the course of the franchise, the Strategic Rail Authority ('SRA') launched a competition for a 20 year franchise. Stagecoach was selected as preferred bidder but final terms could not be agreed following the collapse of Railtrack, which was a partner in the infrastructure works envisaged in the bid. The original franchise expired in January 2003 just as the Mark One replacement programme was due to commence. As a result the franchise was operated on short term arrangements for four years whilst the new trains were introduced. A new 10 year South Western franchise, with a performance break at year seven, was let in 2006. This was also awarded to Stagecoach and commenced in 2007.

LTS Rail/ c2c: The LTS/ c2c franchise was the first 15 year franchise to be let by OPRAF, in May 1996. The term reflected the fact that new rolling stock was to be procured during the course of the contract. Binding agreements for new rolling stock were required within 18 months, else the term would have reverted to seven years. (A seven year schedule of subsidy payments was explicitly set out as an alternative in the contract). The franchise was originally let to Prism Rail and transferred to National Express in

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summer 2000 when Prism disposed of its rail operations. The franchise was rebranded as c2c in 2002.

Connex South Eastern ('CSE'): CSE was a 15 year franchise let to Connex in August 1996. The contract contained significant replacement rolling stock commitments and an additional option – exercisable at the Franchising Authority's discretion – to extend the term by seven years from commencement if CTRL domestic services were incorporated.

Connex ran into financial difficulties in early 2002 and approached the SRA for additional subsidy. The SRA undertook a detailed investigation of Connex's financial and operational performance before taking the franchise back in-house in 2003. The franchise was re-let to Govia in late 2005.

Anglia: Anglia was a seven year franchise let by OPRAF to GB Railways in December 1996. Although broadly a commuter operation, Anglia did operate regional and inter city services. Anglia operated under its agreed subsidy profile until 31 March 2002, when due to financial difficulties, the operation was placed on a management contract until it became part of the enlarged Greater Anglia franchise on 31 March 2004. Anglia was operated by FirstGroup from summer 2003 following First's acquisition of GB Railways.

These four franchises were all let under a similar model of risk transfer and have a common operating period (1997 – 2003) over which performance can be compared. We also compare the results of these TOCs to average performance for the L&SE sector over the relevant period.

In addition to these "first round" franchises, we have looked at outcomes over the periods of the two franchising models that have been applied to **Chiltern** since privatisation. Chiltern was initially let in 1996 as a seven year franchise to M40 Trains, a company owned by the former BR management team and John Laing Plc. Laing then took a controlling stake in 1999. In 2001/02, Chiltern was re-let under a new contract, which had a minimum term of 10 years with the potential to be extended to up to 20 should Government agree to purchase a series of investments to be put forward by the TOC. M40 Trains successfully retained the franchise in the 2001/02 competition. In 2008, following the acquisition of John Laing Plc by Henderson Investments, the M40 Trains subsidiary containing the Chiltern franchise was sold to DB Schenke.

3.1.2 Financial robustness

The first indicator that we have analysed is financial robustness. Our investigation has drawn upon information provided by the SRA (DfT's predecessor as Franchising Authority) to KPMG in 2003, comparing the performance of each of the first round franchises to bid.

Comparison of 'first round' franchises

We have compared the robustness of the four 'first round' franchises over the period 1 April 1997 – 31 March 2003 by looking at Profit Before Tax ('PBT'). A commentary on trends in profitability has been provided by analysing variance against the bid financial

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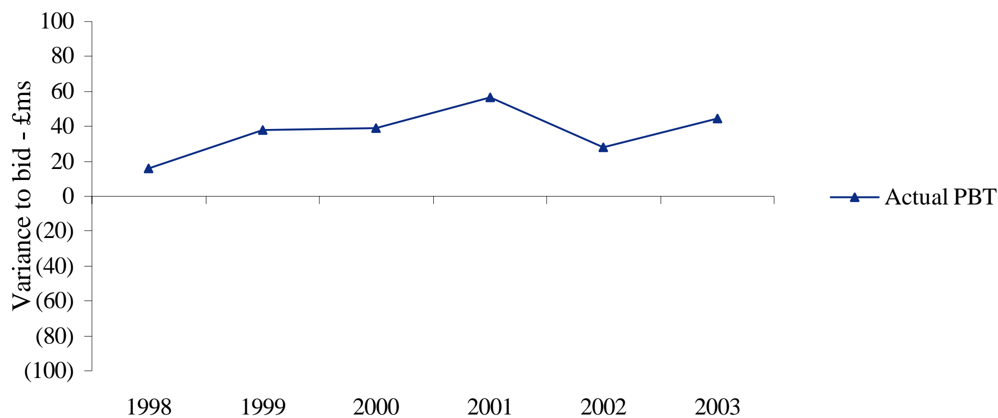
model both in terms of revenue and operating costs. (I.e. actual less bid passenger revenue and bid less actual operating costs).

Figure 2 shows that the first SWT franchise was financially robust throughout its original seven year duration. For the avoidance of doubt, the PBT values on the graph are outturn values, rather than the variance compared to bid PBT. Two distinct trends in financial performance are evident. Firstly, actual revenue was higher than bid. This positive variance was, however, almost entirely offset by operating costs also being higher than anticipated. These two factors therefore more or less balanced, meaning that profitability over the franchise was in line with the bid.

Figure 2: Financial variance to bid – South West Trains [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

The 15 year LTS/ c2c franchise was also financially robust during the period from 1997 to 2003. As at SWT, revenues were higher than bid – by an average of [**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] p.a.. In the early period of the franchise, operating costs were in line with or lower than bid. After 2000 costs were higher than bid.

Significant profits were made from 1999 to 2001. Research indicates that this is correlated with the late delivery into service of rolling stock. The franchise returned to a break even position in 2002 and 2003. Recent financial statements indicate that c2c remains financially robust 13 years into the franchise, recording PBT of £3.7m in the year to December 2008. .

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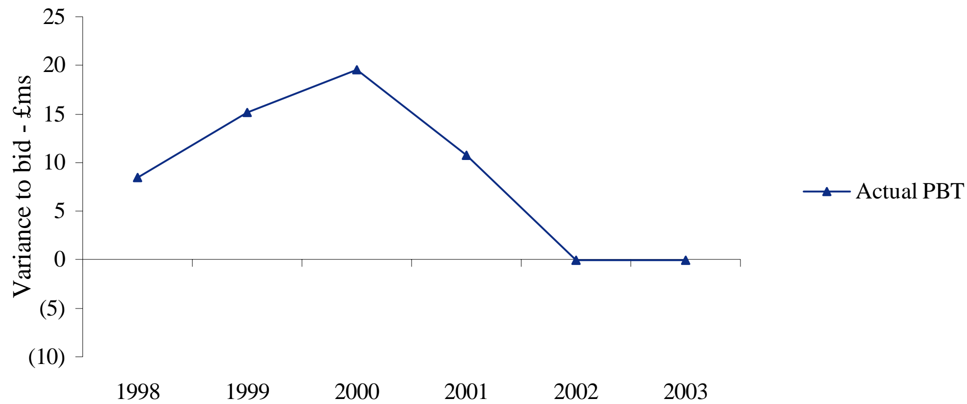
Figure 3: Financial variance to bid – LTS Rail/ c2c [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

The 15 year CSE franchise did not prove financially robust. Figure 4 shows that not only were costs higher than bid, but revenues were also lower. The franchisee made losses in 2002 and in 2003.

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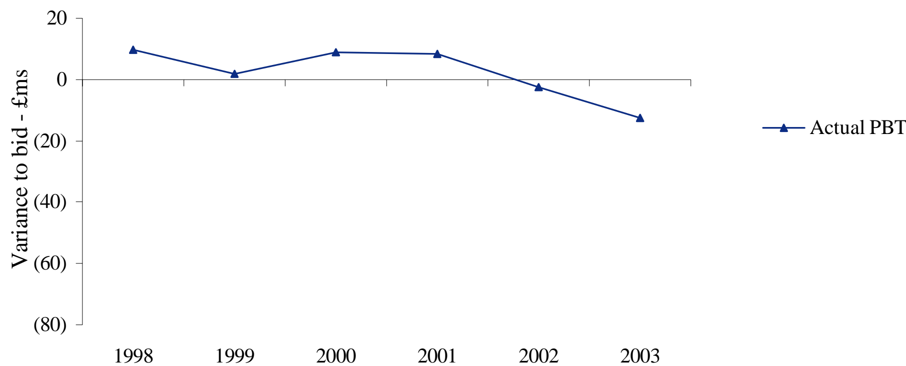
Figure 4: Financial variance to bid – Connex South Eastern [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

Notably, the 2003 loss would have been significantly higher had the SRA not provided £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] of additional subsidy to the TOC, in order to allow the Mark 1 replacement programme to progress. The SRA took the decision to take back the franchise in summer 2003, owing to concerns over financial management processes.

The 7 year Anglia franchise also did not prove to be financially robust. Although revenue was marginally ahead of bid, anticipated cost savings did not materialise and the operator made small losses from 2000 onwards. In 2002 the franchise was placed onto a management contract, after which the financial position improved. This was in the context, however, of the franchisee receiving around £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] subsidy per annum more than bid.

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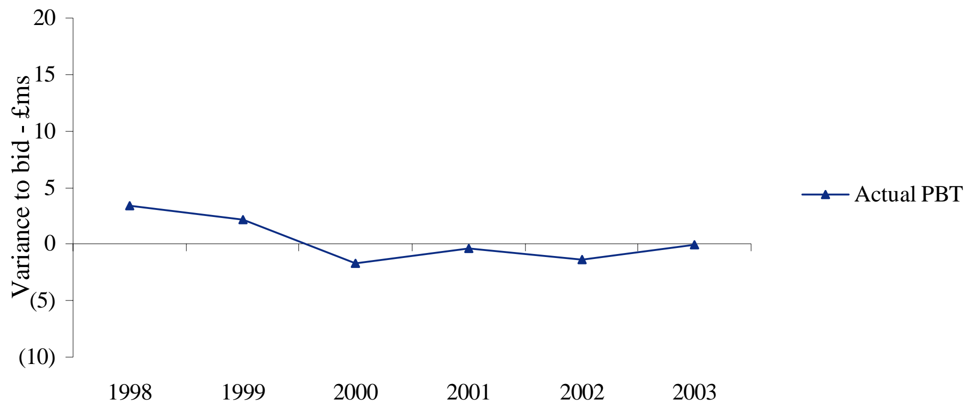
Figure 5: Financial variance to bid – Anglia [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

In summary, of the four L&SE TOCs studied, two proved to be financially robust and two did not. In each case, one was a seven year contract and the other a 15 year franchise. Our limited sample therefore provides no clear evidence of a relationship between franchise length and financial robustness.

In the case of Anglia and CSE, although these TOCs made a small profit on average, losses increased as the contract continued, with financial performance generally diverging more widely from the bid line through time.

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Further analysis indicates a clear correlation between financial robustness and bid aggressiveness. Bid aggressiveness increased as the 'first round' franchise letting process progressed, in terms of both forecast revenue growth and cost efficiencies. Figure 6 shows that the two franchises that proved to be financially robust – SWT and LTS/ c2c - were the sample franchises that were let first.

Figure 6: The bid cycle and financial outcomes – L&SE TOCs

	Date Signed	**Actual PBT Margin 1998-2003**
South West Trains	Feb 96	10%
LTS Rail/ c2c	May 96	14%
Connex South Eastern	Oct 96	0.8%
Anglia	Jan 97	0.6%

It would therefore appear that bid aggressiveness, particularly in relation to when in the bid cycle a contract was let, had a highly significant impact on the financial stability of the subsequent franchises.

Chiltern franchise

The current Chiltern franchise was let with 20 year financial projections. As part of our discussion of financial stability, we have analysed the performance of the Chiltern franchise against bid in the eight years to date to determine whether issues have arisen in forecasting financial performance over this relatively long time horizon.

Figure 7 below shows that Chiltern made profits in the first four years of its new contract. However losses were made in 2007 following the significant disruption caused by the collapse of a tunnel being constructed by Tesco at Gerrards Cross. The compensation payments for this flowed in 2008, returning the franchise to profit. However the franchise then made a loss in 2009.

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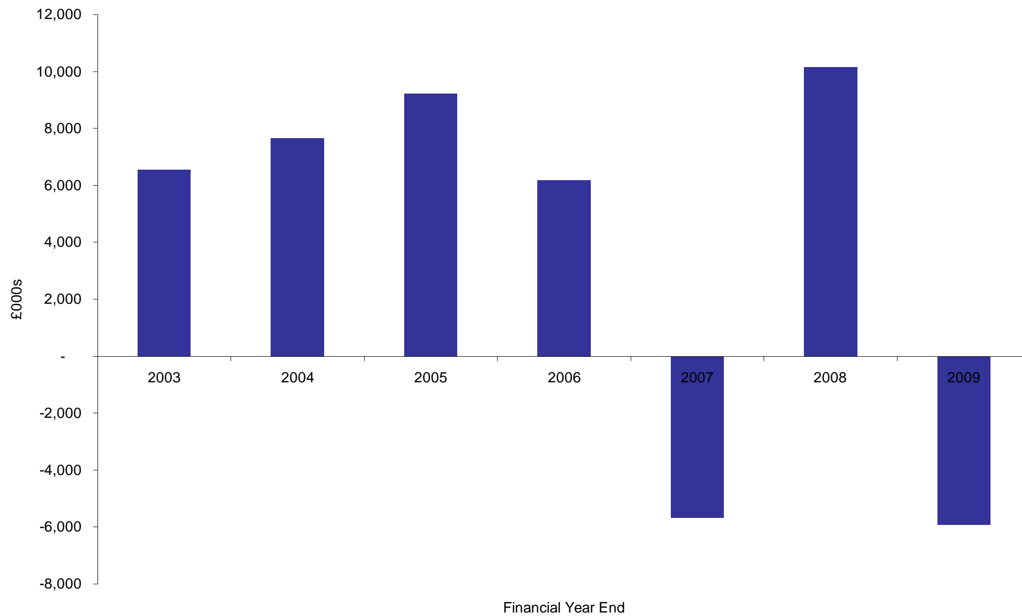
Figure 7: Chiltern – profit before tax



Source: TOC financial statements

This franchise does not therefore provide any clear evidence of a positive relationship between financial robustness and a longer franchise term, at this stage.

3.1.3 Service quality

To evaluate service quality we have assessed performance in terms of TOC-on-Self delay minutes, PPM and National Passenger Survey scores.

3.1.3.1 *TOC-on-Self Delay Minutes*

TOC-on-Self delay minutes data provides an insight into the performance of the sample TOCs in respect of delays caused by factors within their own control.

Comparison of 'first round' franchises

Our comparison of the first round franchises has been limited by the fact that delay minute data is only available for the period from 1 April 1999 onwards. Figure 8 shows the performance of each of the sample L&SE TOCs relative to performance in the year to March 2000 (i.e. as an index where delay minutes in the year 2000 = 100).

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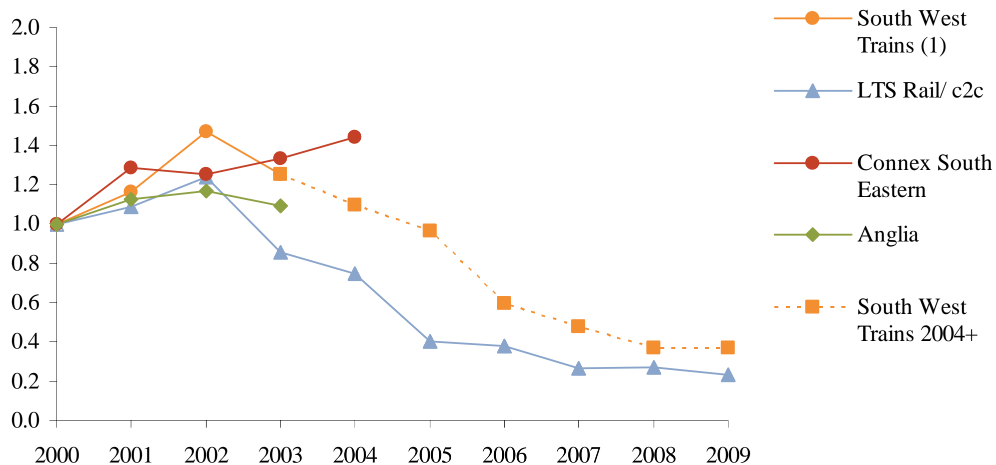
Figure 8: TOC-on-self delay minutes index – London & SE TOCs



All TOCs in the sample saw an increase in TOC-on-self delay minutes from 2000 to 2002.

The short period of data availability in relation to Anglia and CSE makes it difficult to draw meaningful conclusions in respect of these two TOCs.

An interesting comparison can, however, be made between SWT and LTS/ c2c. Between 2000 and 2009 (years 4 to 13 of its 15 year contract), LTS/ c2c achieved a reduction in TOC-on-self delay minutes of 77%. During the term of this franchise, Driver Only Operation ("DOO") has been introduced. The extent to which this has impacted on performance results, however, cannot be explicitly determined at this stage. Whilst DfT has informed us that DOO was not believed to have been specified in the original tender documentation, there are examples of when the DfT has mandated DOO, e.g. as part of franchise tender requirements. SWT also achieved a substantial overall reduction in TOC-on-Self delay minutes (of 63%) over the same period. In this period, it was operated under a number of different contract structures, with more and less direct influence by the DfT, albeit with a consistent owning group.

Chiltern

Analysis of Chiltern shows that TOC-on-Self delay minutes increased in 2001 in common with the "first round" franchises discussed above. Since the current franchise commenced in 2002, delay minutes have reduced by 38%. This improvement is not as large as that achieved on SWT or c2c over the same period, and has not been continuous – delay minutes were actually 111% of 2002 levels in the year to March 2006 (the year in which the Gerrards Cross tunnel collapse actually occurred).

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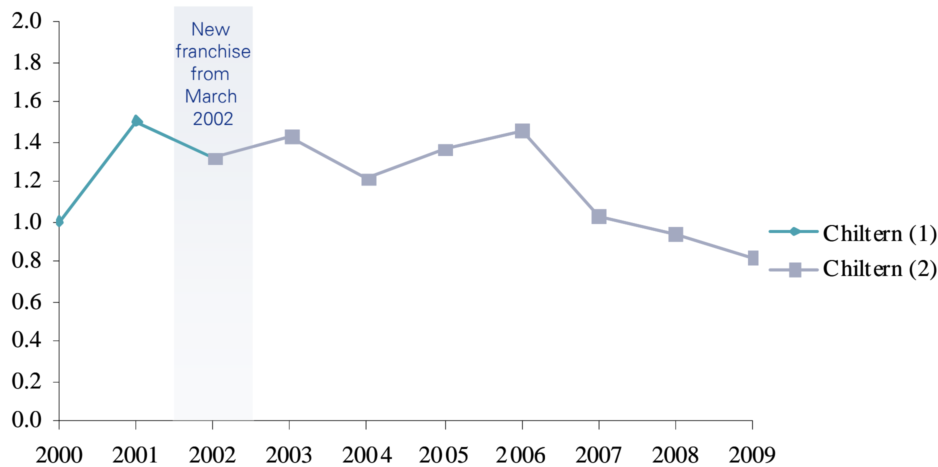
Figure 9: TOC-on-self delay minutes – Chiltern: 1999/00 = 100



3.1.3.2 *Public Performance Measure ('PPM')*

Whilst for the purposes of this report TOC-on-Self delay minutes provide the most important measure of TOC punctuality performance, since they tie directly to factors that the TOCs can influence, the public perception of service quality is also influenced by delays caused by Network Rail, other TOCs and external factors. All of these categories of delay are included in PPM, which measures actual train movements relative to a 'Plan for the Day'.

Comparison of 'first round' franchises

Figure 10 sets out the PPM results of the four "first round" L&SE sample TOCs and compares performance against the overall LS&E sector average.

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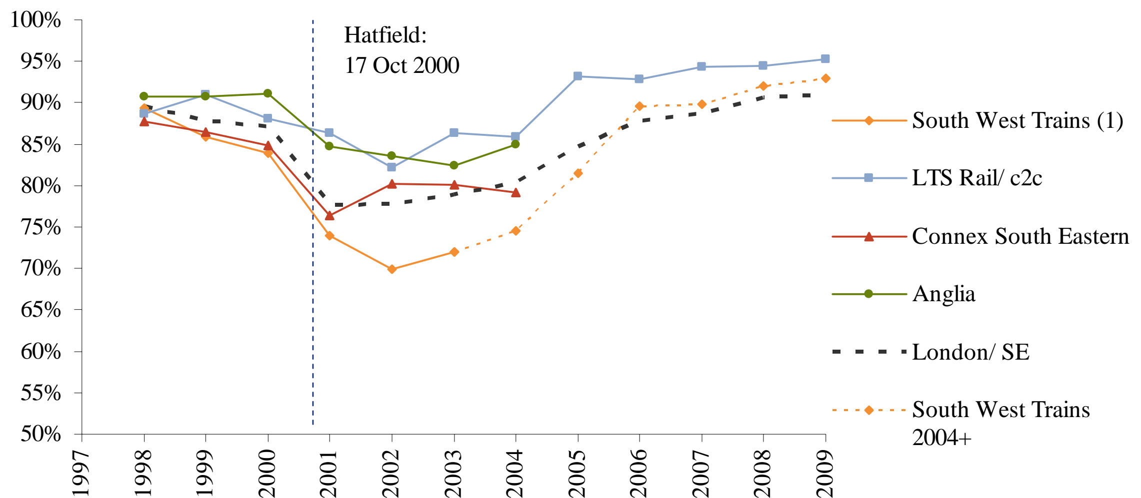
Figure 10: PPM – London and South East TOCs



The following points emerge from this comparison:

- In the period from 1998 to 2001, SWT and CSE followed a very similar trend. SWT's PPM then dipped considerably below CSE's from 2002 to 2004, in the final years of the first round SWT franchise;
- Following the dip in performance in 2002, SWT has also experienced a significant improvement in PPM. By 2008/9 PPM was 93%, outperforming the sector average by 2%, from a 2002 starting position that was 8% below it. This time period has seen the SWT franchise governed by a number of contracts that receive more and less direct influence from the DfT and all of which have mandated performance targets. A common managing group has, however, been in place over this period;
- Anglia, a seven year franchise, started with PPM above the sector average and was able to maintain this relative position throughout its contract; and
- LTS / c2c has over the 13 years in which its franchise has so far run seen an improvement in PPM from 89% to 95%, relative to a sector which has moved from 90% to 91%.

Chiltern

Figure 11 illustrates Chiltern's PPM performance both during the initial contract and the current agreement that commenced in 2002.

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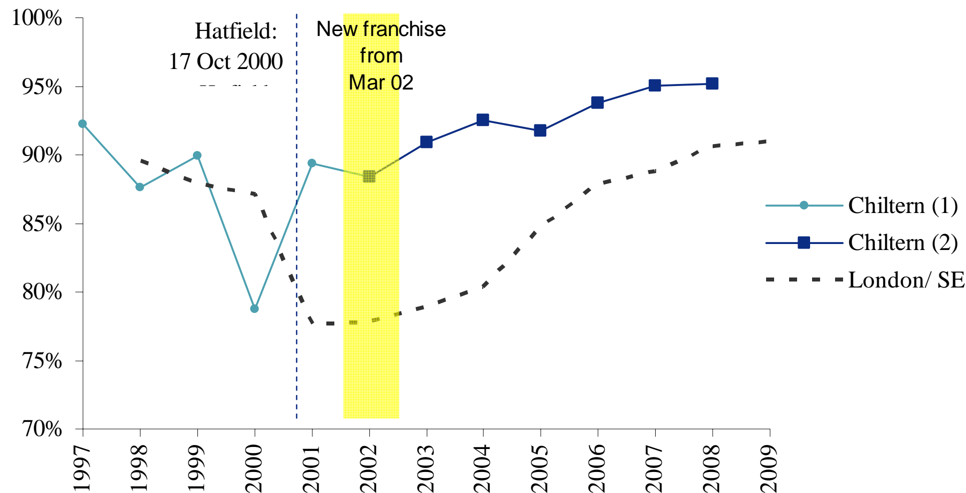
Figure 11: PPM – Chiltern TOCs vs. L&SE sector average



In the year to March 1998, Chiltern – governed by its 'first round' Franchise Agreement - had a PPM score of 87%, marginally below the sector average of 89%. By the time the new Franchise Agreement commenced in 2002, Chiltern's PPM had risen to 89%, significantly above the sector average which had fallen to 78% in the aftermath of Hatfield. There are clearly many factors that may influence this relationship, including that Chiltern may have been more insulated from Hatfield than TOCs operating on more complex parts of the Network.

Since 2002, Chiltern's PPM has risen from 89% to 95% whilst the sector average has recovered from 78% to 91%. As a complete proposition to passengers, which is influenced by Network Rail, the TOC and LU, etc, Chiltern has clearly sustained an excellent record of performance, albeit on a relatively simple operation. However given the high standards delivered before 2002, the fact that it represents just one example and the influence on PPM of non-TOC factors, it is not possible to directly distil a relationship between contract term, or any other individual aspect of contract design, and this result.

3.1.3.3 *National Passenger Survey (NPS) Scores*

The first wave of the NPS was undertaken in autumn 1999 and has occurred at six monthly intervals since then. The latest survey, conducted in spring 2009, represented wave 20.

Our analysis has focussed on overall customer satisfaction, and in particular the proportion of passengers indicating a 'satisfied' or 'good' overall response. It should be noted, therefore, that results will again be influenced both by factors within TOC control and outside of it.

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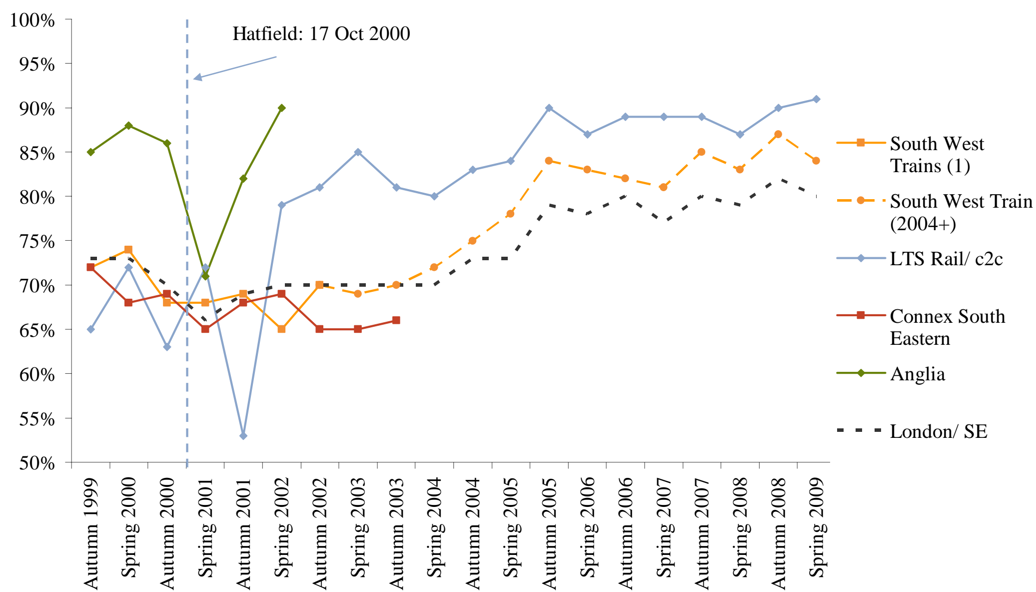
Comparison of 'first round' franchises

Since NPS was not introduced until either the third or fourth year of the "first round" franchises, there is a relatively short timescale over which to compare them. However the following points from Figure 12 below are notable:

- In the first wave of NPS in autumn 1999, the highest scoring franchise in our LSE sample was Anglia, which was two and a half years into a seven year franchise. The lowest scoring franchise in the sample was LTS/ c2c, which was three and a half years into a 15 year franchise;
- CSE and SWT had similar levels of satisfaction in the period from autumn 1999 to autumn 2002 (SWT's original 7 year contract ended in January 2003 and CSE was on a 15 year agreement). In the surveys conducted in this period, SWT performed better in four surveys and CSE in two;
- LTS/ c2c started off with low levels of satisfaction, recording a particularly poor result in autumn 2001. However, satisfaction increased significantly between 2002 and 2005. Clearly a number of external factors may have influenced this improved performance (e.g. the improved Network Rail performance in the period). The franchise also saw the introduction into service of an entire new fleet of rolling stock in the period. Since 2002, c2c's NPS result has consistently been at least 8% above the sector average; and
- This analysis does not tell us the cause of c2c's improved performance since 2002. However, SWT's trajectory of improvement in customer satisfaction since its initial contract ended in 2003 is similar to that of c2c, despite its different contract structure.

Figure 12: NPS overall % satisfied or good – L&SE TOCs



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Chiltern

Figure 13: NPS overall % satisfied or good – Chiltern vs. L&SE sector average

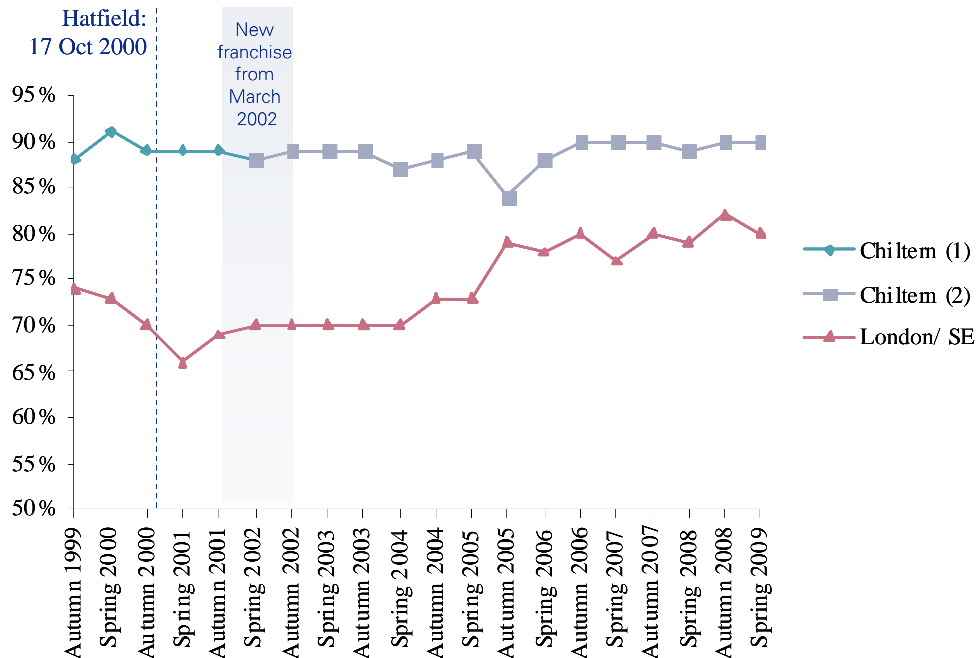

Figure 13 shows that Chiltern has consistently delivered passenger satisfaction in excess of the L&SE average over the period 1999 to 2009. However sector leading scores were also achieved in the initial 7 year contract that was due to run from 1997 to 2004, as well during the course of the potential 20 year contract signed in March 2002.

3.1.4 Growth

Between 1997 and 2004, passenger journeys on rail increased nationally by 26% and passenger revenue increased by 52%. From 2004 to 2009, the overall journey growth figure was again 26% and revenue growth was 54%.

Whilst comparison of relative journey or passenger revenue growth figures across our sample TOCs might be reasonably straightforward, these are measures where external factors beyond contract design are likely to be highly influential. These external factors will not necessarily have a consistent impact across the sample of TOCs studied; for example, certain routes may experience higher levels of economic development or housing growth over a given period.

Comparison of 'first round' franchises

The limited availability of passenger journey information by individual TOC means that our analysis focuses on revenue growth. Figure 14 shows that from 1997 to 2004, the highest revenue growth in the sample L&SE franchises was on Anglia, a seven year

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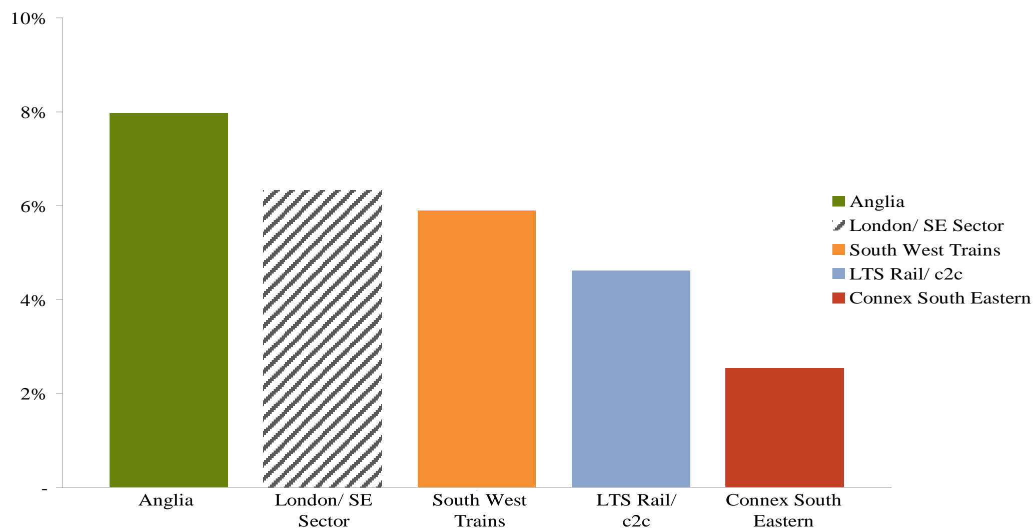
franchise. The other seven year franchise, SWT also achieved growth that was close to the L&SE sector average. The two 15 year franchises saw revenue growth that was notably lower than the sector average. However, as discussed above, the impact of external factors on these figures should not be underestimated.

Figure 14: LS&E passenger revenue growth % – 1997-2004



A better assessment might be to consider the performance of the 15 year franchises over a longer time frame, to see if there is any evidence to correlate longer contracts with longer term growth patterns in a franchise. Clearly, due to its collapse in 2003, such an analysis can not include CSE. However, Figure 15 compares the growth on LTS/ c2c over the first 13 years of its franchise against that of SWT over an equivalent period. This shows that over the longer timeframe, SWT still outperforms LTS/ c2c at a similar rate to that which occurred from 1997 to 2004.

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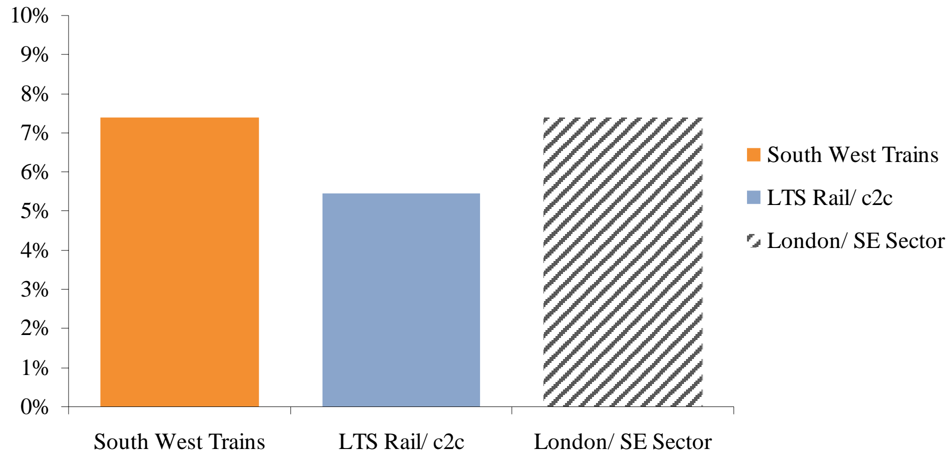
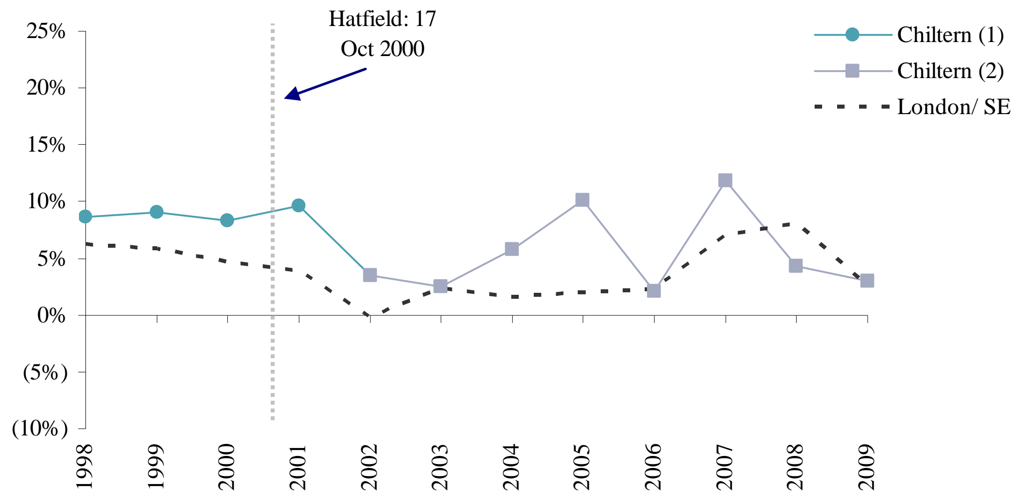
Figure 15: Passenger revenue growth % – 1997 - 2009



Chiltern

Figure 16 sets out journey growth on Chiltern from 1998 to 2009.

Figure 16: Passenger Journey Growth % - Chiltern TOCs vs. Sector



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In the course of both contracts, journey growth on Chiltern has exceeded the L&SE sector average during all but two years (one of which, 2006, coincided with the Gerrards Cross tunnel collapse). Growth from 1997 to 2002 was 46% (when the sector grew by 22%) and from 2002 to 2009 was 47% (when the sector grew by 29%).

Revenue growth on Chiltern averaged 13% p.a. (LS&E: 7.5%) during the first contract and 10% p.a. to date (LS&E 7.4%) during the second. Whilst this may be considered an impressive result, there are clearly many potential external as well as TOC-driven reasons for the growth. For example, Chiltern may have benefitted from disruption on the neighbouring West Coast Main Line during its upgrade.

3.1.5 Cost efficiency

Cost efficiency has been assessed by analysing cost per passenger kilometre and cost per train kilometre. Track access charges have been removed from the analysis in order to, at least partially, eliminate the distorting impact of regulatory reviews. Performance payments have also been removed. There are other non-TOC factors that will influence each TOC's cost base – e.g. energy prices, etc. It should be noted that each of the TOCs are individual businesses with different characteristics in terms of fleet type, train length, the number of stations operated, etc. Our analysis has therefore focussed on trends and not absolute figures.

In this analysis, a complete set of sector average data in respect of costs is only available from 1998 to 2003. Costs are in real prices – i.e. after adjusting for actual RPI inflation since March 1998.

Comparison of 'first round' franchises

Our analysis has been limited by the fact that passenger km data was not available for Anglia and CSE in 1998 or 1999. However Figure 17 illustrates some interesting points:

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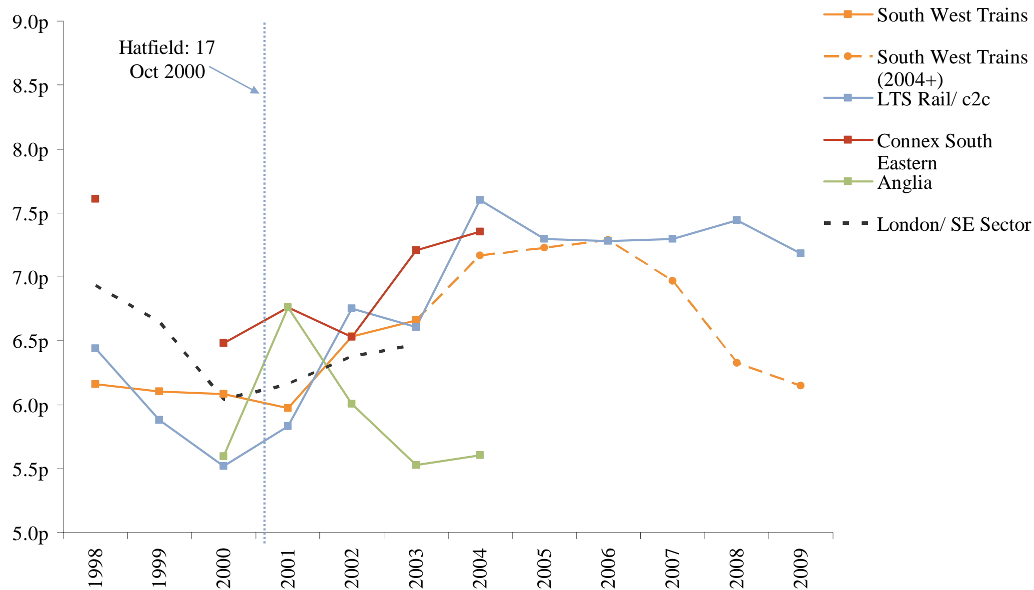
Figure 17: Real cost per passenger km– L&SE TOCs: (1998 price base)



- On the 15 year LTS/ c2c franchise, costs per passenger km increased from 2000 to 2004, correlated with the period in which new trains were introduced. Savings then occurred, potentially correlated with the introduction of DOO in 2004. Since 2004, real costs per passenger km have stayed broadly flat;
- A similar pattern occurred on SWT with costs per passenger km increasing over the period in which the Mark One fleet was replaced. During this period, the TOC was on management contracts of firstly one year and then three years. However, it is notable that cost per passenger km has fallen on SWT since 2007. Given that the new South Western franchise commenced in February 2007, this benefit could potentially be attributable to the competition process. However, further analysis would be needed to substantiate this; and
- Between 2002 and 2004, Anglia has the lowest cost per passenger km of the sample TOCs. One possible contributing factor is that Anglia's planned fleet replacement did not occur during the franchise.

A similar pattern emerges from analysing cost per train kilometre. Due to the absence of data, there is limited insight into CSE and Anglia. However, again the divergence in the trends of LTS/ c2c and SWT from 2007 to 2009 is notable. In each period for which data is available, Anglia has the lowest cost per train km of the sample TOCs.

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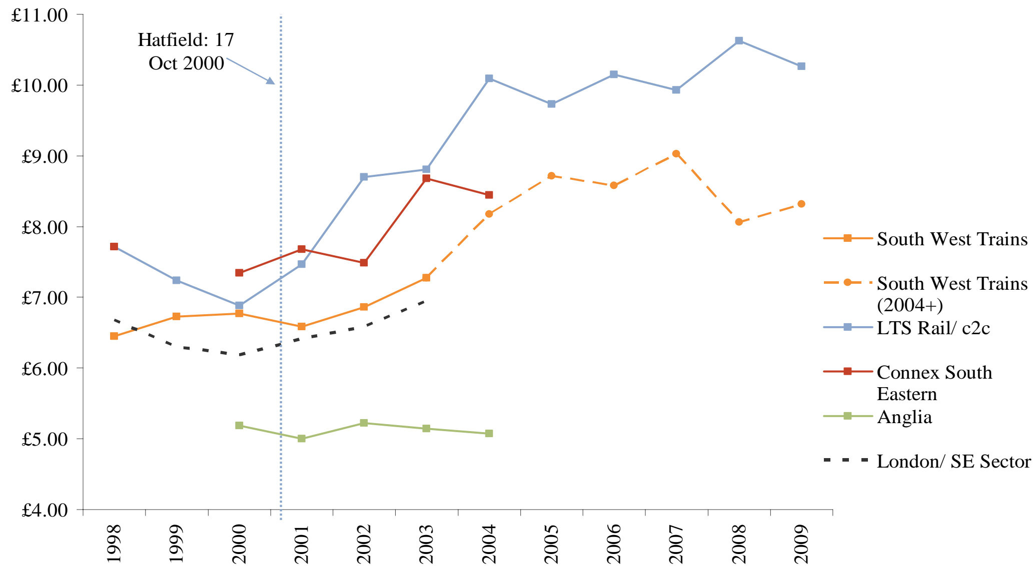
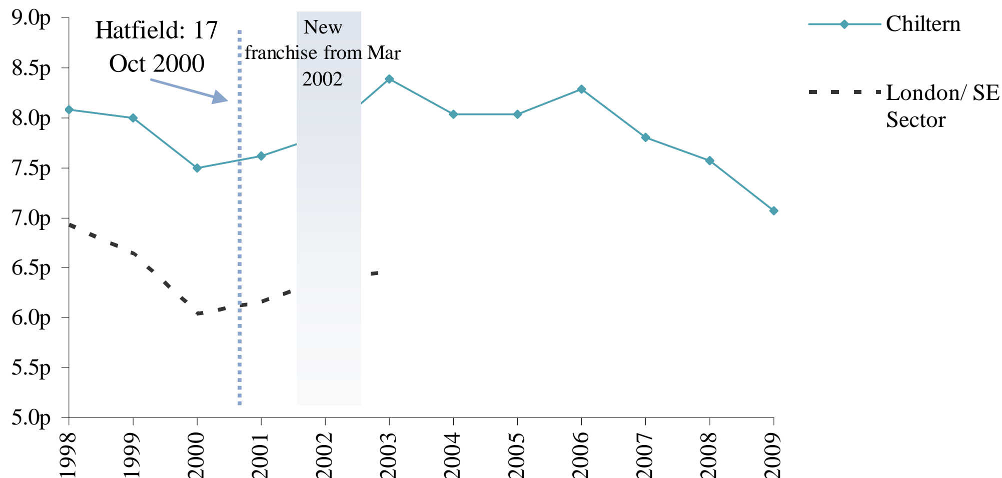
Figure 18: Real cost per train km – L&SE TOCs: (1998 price base)



Chiltern

Figure 19 shows that the cost per passenger km is higher on Chiltern than on the L&SE sector average. Movements in costs from 1997 to 2003, however, largely follow the sector trend. Like SWT, Chiltern has achieved a significant decrease in costs per passenger km from 2007 onwards, with passenger Kms increasing by 35% and costs by only 25%.

Figure 19: Cost per Passenger Km– Chiltern TOCs vs. Sector: (1998 price base)



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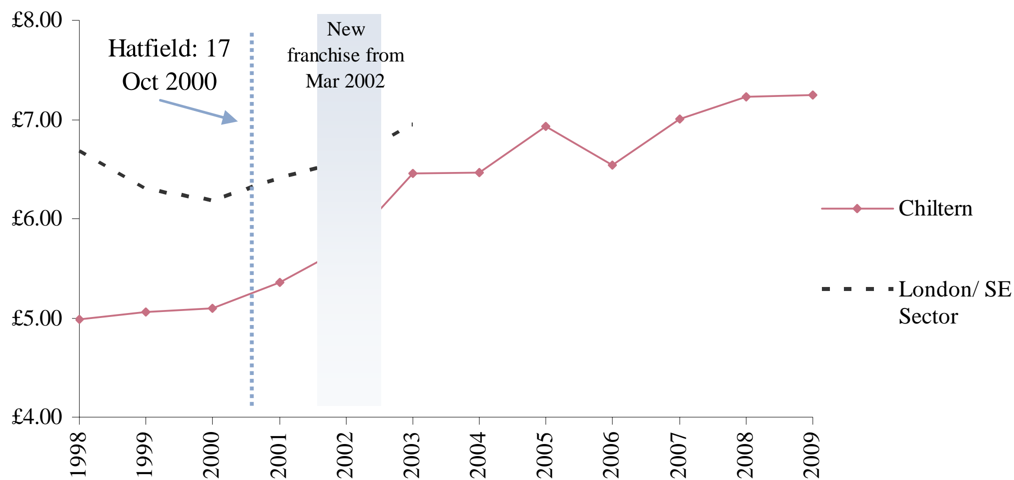
Again movements in costs per train km largely track the sector average where this data is available. In this case, the efficiencies that appear to have been achieved by SWT from 2007 to 2009 are not in evidence on Chiltern.

Figure 20: Cost per train km– Chiltern TOCs vs. Sector: (1998 price base)



3.1.6 Investment

In assessing the investment delivered during the course of each franchise, we have attempted to identify:

- What investment was specified in the ITT issued to prequalified bidders by OPRAF;
- What investment was formally contracted in the Franchise Plan;
- What investment was actually delivered; and
- How the investment delivered was funded and financed.

It should be noted that in many cases this information has proved difficult to source and has involved returning to British Railways Board Residuary ("BRB Residuary") archives. As part of our work, discussions have been held with Franchise Managers at the DfT. However in many cases Franchise Managers from the period under review are no longer employed by DfT. Where information was not available (as described below) the description of investments may not be complete.

3.1.6.1 *South West Trains*

The seven year term of the original SWT franchise was not dependant on the delivery of any particular investment.

The Invitation to Tender ("ITT") document did not specify any particular required TOC investment. Bidders were, however, required to provide a Franchise Plan setting out proposals to allow the bidder to meet and monitor station and other service quality

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standards and to operate a Passengers Charter (together with the proposed target performance levels). In addition, the ITT stated that extra resources might be required to keep loading factors within certain PIXC levels. The Franchise Agreement required critical capacity for 71,000 passengers, with 80% of the costs to be met by OPRAF if up to 73,500 of capacity was required, and 100% of costs to be met by OPRAF for capacity above this level.

The original version of the SWT Franchise Plan has not been available in conducting this study, only a version of the plan from later in the franchise. This version may include, for example, any extra passenger benefit packages that might have been introduced during the course of the franchise. However, it is clear that this, the first franchise let, had very few committed obligations. These included:

- £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] to improve passenger services (stations, interchange/ integration, customer info, station repainting, rolling stock improvements, security) over and above specifically contractually committed obligations;
- Procuring a new Hythe – Southampton Central bus service by Autumn 1999;
- Upgrading all customer information systems at stations to be capable of displaying and where possible announcing real time travel information by Feb 2002; and
- Improving the presentation of Clapham Junction.

Discussions with DfT indicate that these commitments were met. In addition, other investments made during the franchise include additional rolling stock reliability improvements, Class 442 and 159 fleet refurbishments and the addition of ticket barriers at 19 stations. From 1996 to 2004 the TOC funded £25m of new fixed assets (Source: Financial Statements).

In addition, 30 new four-car electric trains were ordered (the Class 458 fleet). These trains were owned by Porterbrook and delivery commenced in 1998. Their introduction was negotiated during Stagecoach Group's purchase of the ROSCO in 1996.

The 3 year management contract that ran from 2004 to 2007 contained a number of significant commitments, many of which had been developed as part of Stagecoach's 20 year bid. These included:

- The replacement of Mark 1 trains with a £645m fleet of new Desiros:
- Class 455 fleet refurbishment to improve reliability and passenger comfort;
- A station repainting programme at 75 stations; and
- The introduction of new automatic ticket machines.

These initiatives were funded by conventional means (ROSCOs and other leasing, DfT subsidy, etc).

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3.1.6.2 *LTS Rail / c2c*

The ITT for LTS rail / c2c envisaged a default franchise length of seven years, with bidders invited to justify a longer franchise period in their submissions. The final 15 year Franchise Agreement included a commitment to place binding orders for a new fleet within 18 months of contract signature. In the event that this did not occur, the franchise would have reverted back to a 7 year term. Ultimately, the entire fleet was replaced with Class 357 Electrostars between 1999 and 2002, owned by Porterbrook and Angel and leased to the TOC.

The ITT also described the potential opportunity to introduce Driver Only Operation ('DOO') as a result of slam door rolling stock replacement. The cost of associated upgrades to station lighting, cameras and monitors (described in the context of BR's anticipated use of Class 317 stock) would be financed by Railtrack and paid for by the TOC through higher access charges. We understand that a commitment to introduce DOO was included in the original bid by PRISM. Ultimately it was introduced in 2003/4 following the takeover of the franchise by National Express.

As with SWT, the ITT did not specify any particular required TOC investment. Bidders were again, however, required to provide a Franchise Plan. In addition, the ITT required bidders to provide sufficient capacity to accommodate an initial threshold level of demand of 27,500 passenger arrivals at Fenchurch Street within PIXC constraints. 80% of additional costs to be met by OPRAF if capacity for 33,000 arrivals was required and 100% of costs met by OPRAF for any further capacity above this level.

The version of the Franchise Plan we examined, which again included mark ups made during the course of the franchise, includes the following investment commitments:

- Procure the construction of West Ham Station, to be in use by December 1999 (the document does not set out how the investment was financed/ funded);
- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] p.a. on station improvements at a list of specified stations;
- To install and maintain ticket barriers at all stations by December 1999 (with 6 stations then delayed by drafting changes made in December 1999);
- To install CCTV on all station platforms and in all car parks where not already in place within 2 years and then maintain the equipment; and
- To make various improvements for disabled passengers over the first 12 months.

As part of the restructuring of a number of its franchises in 2000, Prism Rail committed to invest a further £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] in LTS/ c2c in areas to be agreed with the SRA. In 2002, National Express bought Prism's rail operations. At this time, the 'Umbrella Agreement' re-allocated the £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] investment package around NX's rail franchises, including some to Midland Mainline. £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] (including some external funding) remained to be spent on c2c, including £[**REDACTED ON GROUNDS OF COMMERCIAL**

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CONFIDENTIALITY] on station improvements (with £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] NR/ external funding) and a number of major security improvements.

In addition, Prism Rail also agreed in 2000 to fit CCTV in all of the new trains that were then on order. We are advised that this second 'passenger dividend package' was agreed in relation to the late introduction of the rolling stock.

From 1997 to 2008 the TOC funded £30m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

Connex South Eastern

CSE's Franchise Agreement was for 15 years with an option to extend for 7 years from the date of commencement of CTRL domestic services, should they have become part of the franchise. This could potentially have resulted in a 20 year contract.

The events of default in the contract include failure to sign agreements to replace the Class 411 fleet (a minimum of 120 vehicles) within 18 months of commencement. The new rolling stock was to be in service by the 2000 winter timetable change.

Unlike the neighbouring SWT and South Central contracts the Franchise Agreement required the operator to submit financial proposals for the replacement of Mark 1 rolling stock. The Class 423 replacement rolling stock was to be in revenue earning service by April 2005 and the Class 421 replacement rolling stock was to be in revenue earning service by April 2006.

The CSE Franchise Plan examined, which again included mark ups made during the course of the franchise, includes the following investment commitments:

- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] to improve station infrastructure by the end of year 3 and £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] by year 13;
- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on improvements at leased depots to accommodate Class 411 replacement rolling stock by the end of year 3 and £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on improvements at leased depots to accommodate Class 421/ 423 replacement rolling stock by the end of year 7;
- Incur expenditure of £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on improved station security measures and £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on car parks (security, facilities, capacity) within 3 years;

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- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on a new station ticketing system by the end of year 13, with £[**REDACTED AT THE REQUEST OF DfT**] incurred by year 7; and
- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on staff training (customer care, motivation, personal safety) by the end of year 2;

Ultimately the SRA took the franchise back in house in November 2003, by which time the orders for the replacement rolling stock were in discussion but we understand that the new trains had not been delivered into service. We have not been able to determine the extent to which the other franchise commitments had been delivered.

From 1997 to 2003 the TOC funded £35m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

Anglia

We understand from discussions with the DfT Franchise Management team that the fleet strategy agreed at the time of the bid was for 6-car Class 170 trains to operate on the route, thereby replacing the Class 86s. This strategy was never actually implemented on Anglia with the inherited fleet running until the franchise ended in 2004. During the management contract in the last two years of the franchise, Class 90 trials were undertaken.

Generally, the information available to us about the investment specified and delivered on Anglia is limited.

From 1997 to 2004 the TOC funded £2.6m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

Chiltern

The current Chiltern franchise can potentially run until December 2021, subject to the TOC developing investment proposals that result in the DfT agreeing extensions to the minimum franchise term. This minimum term was initially 10 years.

The Franchise Agreement contains a list of potential projects, such as route upgrades, station upgrades and electrifications and the TOC is tasked with bringing forward related proposals for investments. DfT then undertakes its own 30 year appraisal before evaluating the length of extension to the minimum term that is merited by the scheme. The schemes do not result in an adjustment to the subsidy/ premium profile of the franchise. In addition, the Franchise Plan contains commitments to spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] p.a. on stations and car parks.

Project Evergreen 2 extended the franchise term from 10 years to c.12 (Project Evergreen 1 having taken place prior to the current Franchise Agreement). Evergreen 2 involved

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line capacity enhancements between London and Bicester including additional signalling and the construction of two additional platforms at Marylebone Station. The capital value was approximately £70m and the investment was delivered via an SPV with a DBFT contract let to Carillion. The scheme was transferred to Network Rail at a pre-agreed price on completion.

Project Evergreen 3 is currently being evaluated by the DfT. It involves approximately £250m of investment to provide a new fast service between London and Oxford and other journey time improvements by:

- Constructing additional track between Bicester and the East-West rail route between Oxford and East Anglia;
- Double tracking the East-West rail route through Bicester to Oxford North Junction and reinstating the line between Oxford North and Oxford station; and
- Constructing a new station near the Water Eaton park and ride site.

Subject to DfT approval, the project will extend the franchise term to 20 years. It is anticipated that Evergreen 3 would be transferred to Network Rail's RAB in 2013 at a pre-agreed price.

In addition to the investments described above, the following enhancements have also been delivered since the commencement of the current franchise:

- 6 x additional Class 168 "Turbostar" DMUs built in 2004 and ROSCO-financed;
- Wembley Depot – a maintenance and train stabling facility; and
- Aylesbury Depot - extension of an existing facility.

A number of stations / car parks on the Chiltern route are TOC assets (as opposed to being owned by NR) and have a residual value to be paid out at the end of the franchise. Indeed from 2002 to 2009 the TOC funded £36m of new fixed assets (Source: Financial Statements). Chiltern has access to a bank facility in order to finance capital projects known as "Schedule 4" assets.

A direct agreement with DfT and the financier specifies that on expiry of the franchise, those assets that have been financed by the bank facility will be purchased by the incoming operator at the net book value using agreed depreciation rates. Any amounts received in excess of the draw down of the facility would then be passed on by the financier to Chiltern for the benefit of the exiting owner.

3.1.7 Conclusions

Our analysis of the outcomes delivered by a sample of L&SE TOCs allows us to draw only very limited conclusions in respect of any link with contract design.

There is no clear evidence of a strong correlation between franchise term and financial robustness. The 15 year CSE contract included some major investment programmes (most being funded by conventional means), but Government concerns over the franchisee's ability to manage its financial position led to the franchise being taken back in house.

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The LTS/ c2c 15 year franchise, however, has proved to be financially robust to date. Of the shorter franchises in the sample studied, Anglia was on a management contract for its final 2 years but SWT proved to be financially robust. A significant factor in financial robustness appears to be the aggressiveness of the original bid. In the first round, bids for UK TOCs became more aggressive as the franchising process progressed. This is illustrated further in our discussion of the regional TOCs in Section 3.3.

Across service quality metrics it is notable that the remaining TOCs with long franchises, c2c and Chiltern perform well. However in drawing conclusions from this the relevant points are:

- It is not just the franchises that still exist today that matter. The 15 year CSE franchise demonstrated declining service quality (delay minutes, PPM and NPS) until the franchisee was ultimately removed;
- Chiltern was a high performing TOC in the period from 1997 to 2001, before it was awarded a longer contract;
- The infrastructure of the LTS / c2c franchise area received significant investment in the period just prior to privatisation;
- In statistical terms, the sample size is very small, which means that it is not possible to isolate any statistically significant impact of franchise term on service quality;
- Since 2003, SWT has seen a similar long-term improvement in punctuality and satisfaction to c2c on what is a considerably more complex operation. In this period SWT has operated on one and three year management contracts and the franchise has been re-competed. The managing group has, however, been consistent over this period; and
- TOCs alone cannot deliver strong PPM or NPS results. The results are heavily impacted by Network Rail, as well as the performance of other TOCs and external factors.

Comparing cost efficiency metrics between TOCs is difficult as each of the businesses has different operating characteristics. Whilst operational factors, for example the introduction of new trains, or efficiencies, e.g. DOO, might appear to be better correlated with trends than many aspects of contract design, we have not carried out statistical analysis of the long list of events that could impact cost efficiency performance. Further analysis might investigate the extent to which the improved cost metrics on SWT after 2007 can be attributed to the competitive process.

In terms of investment, our work provides some interesting insights into the ‘first round’ franchises:

- CSE had the major commitment of overseeing Mark 1 replacement during its 15 year term, but did not prove to be sufficiently financially robust to deliver this;
- SWT invested £25m in gating / fleet (Source: TOC Financial Statements), financed on the TOC’s Balance Sheet, despite having a short franchise. However, this was in the context of a benign financial environment; and

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- LTS/ c2c also made notable investments. A significant amount of the investments that were in excess of franchise commitments were via ‘passenger dividends’ – e.g. agreed when TOC ownership changed, or to compensate for the late delivery into service of rolling stock.

Chiltern’s contract requires it to propose investments such as Evergreen 2 that are different in scale to those being developed by operators elsewhere, in order to secure extensions to its minimum franchise term. It should be noted that whilst Chiltern takes some shorter term risk on project costs and delivery, it does not take the risk on the additional revenue generated over the entire life of these investments, nor residual value risk. For example, on completion infrastructure assets might be transferred to Network Rail’s Regulatory Asset Base (‘RAB’) at a pre-agreed price, with the TOC then paying higher access charges. Alternatively assets may receive a future franchisee usage guarantee or a commitment that a future franchisee will purchase assets at the Net Book Value (‘NBV’).

The Chiltern model in respect of track infrastructure may also not be considered appropriate for other parts of the network – for example where potential investments, with sufficient strategic priority, do not exist, or where the network has many competing users (and hence the incremental revenue as a result of an investment flows to more than one TOC). However, further investigations might seek to establish whether some of the mechanisms in the Chiltern contract, such as that in respect of “Schedule 4” assets, might potentially be useful elsewhere, to help TOCs play a more significant role in managing or financing investment projects, e.g. in stations/ car parks.

3.2 Inter city TOCs

3.2.1 Introduction

In order to analyse the performance of Inter City operators with different contract structures, the following three sample TOCs have been considered:

Figure 21: Inter City TOC sample

	Start Date	Original Franchise Length	Original End Date	Actual End Date (If Different)
First Great Western	Feb 96	10 yrs	Mar 06	-
GNER	Apr 96	7 yrs	Apr 03	May 05
Virgin CrossCountry	Jan 97	15 yrs 3 months	Mar 12	Jul 02 / Nov 07*

** This franchise no longer operated on the subsidy profile set out in its original Franchise Agreement after July 2002. From July 2002 – November 2007 the franchise was operated according to the terms of the ‘Letter Agreement’*

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First Great Western: The original Great Western franchise was the second franchise to be let by OPRAF. The franchise was let to a consortium including a management buy out team, the venture capitalist 3i and First Bus. First Bus (which later became FirstGroup) then bought out the other shareholders early in the franchise. The franchise ran to the end of its term on 31 March 2006 without any major renegotiation of the original subsidy profile.

GNER: The original Inter City East Coast franchise was let to Great North Eastern Railway, a subsidiary of Sea Containers, as a seven year franchise in March 1996. In 2000, a competition for a 20 year franchise was launched. This competition was never successfully concluded. GNER was awarded a 2 year extension to the original franchise which as a result ran until May 2005. The second GNER franchise and the period of tenure of National Express East Coast have not been considered as part of this analysis.

Virgin CrossCountry: The original Cross Country franchise was awarded to Virgin in November 1996. It was let as a 15 year franchise. The Virgin bid included innovative proposals to alter the train service by running more frequent, but shorter, trains. However, even before these proposals were introduced, the franchise experienced severe financial difficulties. As a result, CrossCountry, along with the other Virgin franchise (West Coast, which was also 15 years), was operated under the 'Letter Agreement' from July 2002 following delays to Railtrack's main line upgrade (Source: DfT). This meant that the subsidy profile set out in the original Franchise Agreement no longer applied. The subsidy for the franchise was instead agreed each year as part of an annual review process. As part of the 'Letter Agreement', Government acquired the right to terminate the Cross Country franchise early. This was exercised and the New Cross Country franchise was awarded to Arriva in 2007.

This sample therefore includes a seven year franchise, a 10 year franchise and a contract initially intended to be 15 years. Comparison of outcomes delivered is possible over a common time horizon from 1997 to 2005. However, it should be noted that the sample size is small and clearly many other TOC-led and external factors, beyond franchise term, will have influenced the outcomes experienced by passengers.

3.2.2 Financial robustness

In respect of the inter city TOCs, our analysis of financial robustness has again drawn upon work that KPMG did for the SRA in 2003, which compared the performance of each of the first round franchises to bid.

Figure 22 shows that First Great Western ('FGW') was financially robust throughout the period of its franchise. In common with many of the L&SE TOCs the bid underestimated future revenues but overestimated the potential for cost savings. The revenue upside outweighed any cost issues meaning that the franchise was profitable in the period 1998 – 2003.

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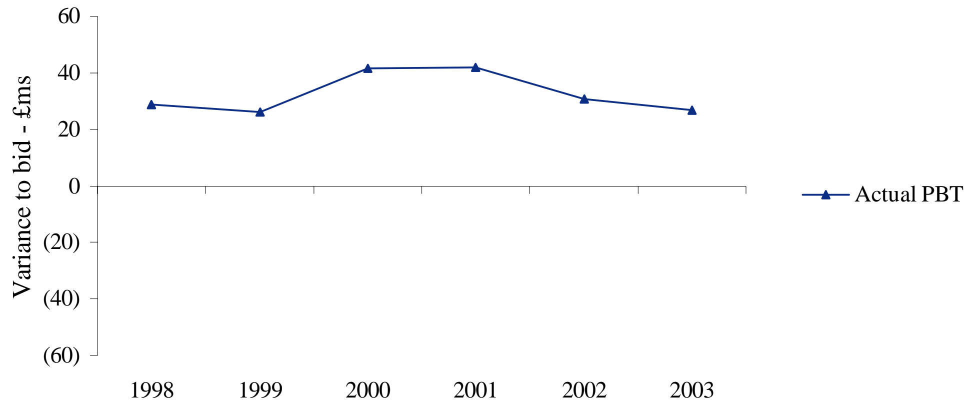
Figure 22: Financial variance to bid and PBT – First Great Western [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

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The financial performance of GNER follows a similar pattern to FGW. However, the degree to which revenue outperformed the original bid slowed significantly in 2001 following the Hatfield incident. In 2003 GNER received a significant payment from Network Rail through a combination of Schedule 8 and Hatfield-related compensation settlements. This contributed to a significant increase in profits that year.

Figure 23: Financial variance to bid and PBT – GNER [REDACTED]

Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

The 15 year Cross Country franchise was loss making from 1999 -2003. Costs exceeded bid forecasts and the positive revenue variance seen on FGW and GNER did not occur. The 2003 loss would have been substantially higher had VXC not received additional subsidy from the SRA as a result of the ‘Letter Agreement’.

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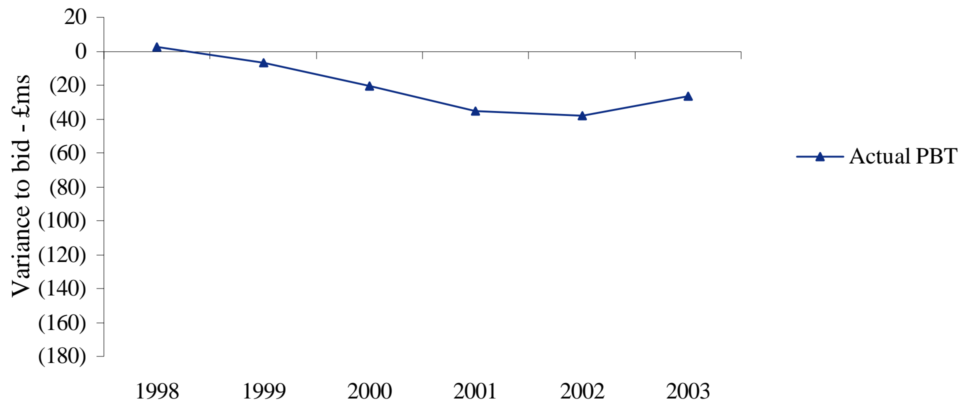
Figure 24: Financial variance to bid and PBT – Virgin CrossCountry [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

Therefore of the three inter city TOCs studied, two were financially robust and one was not. The TOC that did not prove to be financially robust was that with the longest original franchise term (in common with CSE in the LS&E sample TOCs). FGW and VXC appeared to experience increasing divergence from the bid cost and revenue projections over time. GNER did not follow this trend after 2000, although it should be noted that the TOC was significantly impacted by the Hatfield incident around this time.

As with the L&SE TOCs, further analysis indicates a clear correlation between financial robustness and the bid cycle. The two franchises that proved to be financially robust – FGW and GNER - were the first two let. VXC, which was let later in the process, had more ambitious targets in terms of revenue growth.

3.2.3 Service quality

To assess service quality, we have considered TOC-on-self delay minutes, PPM and National Passenger Survey scores.

3.2.3.1 *TOC-on-Self Delay Minutes*

Again our comparison of TOC-on-self delay minutes has been limited by the fact that delay minute data has only been available from 1 April 1999 onwards - the fourth year of the GNER and FGW franchises and the third year of the VXC franchise. Figure 25 shows the performance of each of the sample inter city TOCs relative to performance in the year to March 2000 (i.e. as an index where delay minutes in the year 2000 = 100).

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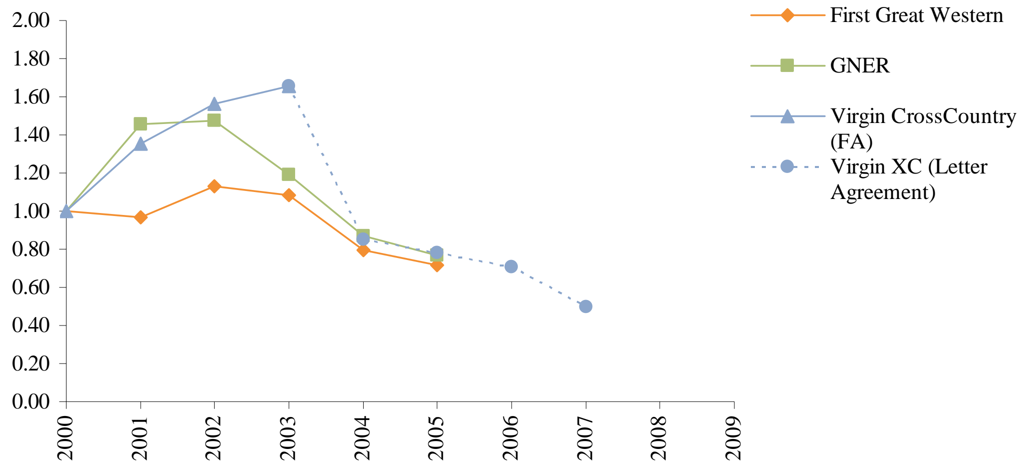
Figure 25: TOC-on-self delay minutes relative to 2000 – Inter City TOCs



The degree of improvement on the 2000 position achieved by each of these TOCs by 2004 and 2005 is broadly consistent. Prior to this, FGW had the strongest record with the 15 year VXC franchise the weakest. Many factors however may be responsible for these trends (including the impact of changes in timetables, etc).

3.2.3.2 *Public Performance Measure (PPM)*

Again it should be noted that PPM reflects the overall punctuality of rail services and is heavily influenced by the performance of Network Rail, other TOCs and other external factors.

Figure 26 sets out the PPM results for the three sample inter city TOCs and compares performance against the overall inter city average.

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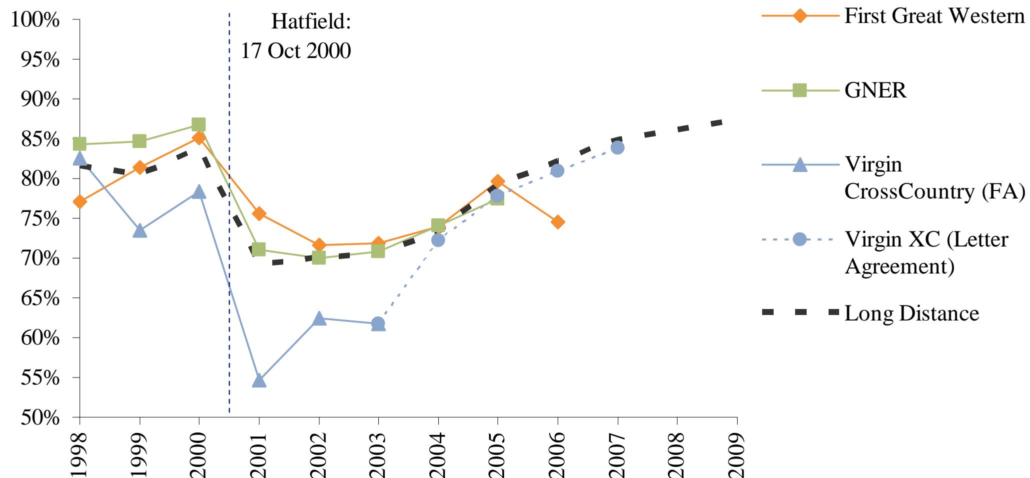
Figure 26: PPM – Inter City TOCs



In the first common full year of operation, GNER had PPM of 85%, VXC was at 83% (equal to the sector average) and FGW was at 77%. Subsequently, in the period prior to Hatfield, GNER and FGW saw improvements in PPM whilst performance on the 15 year VXC franchise deteriorated. Each of the TOCs was hit hard by Hatfield, as was the wider inter city sector. This reflects the significant impact of Network Rail performance on PPM. The fall in PPM on VXC immediately after the Hatfield incident was the greatest of the sample, but this may be expected given that it covers such an extensive proportion of the network and is the secondary operator along the majority of its routes.

Following Hatfield, GNER and FGW improved along a broadly similar trajectory which maps closely to the sector average. Virgin's PPM improved steeply from 2003 to 2005, by which time the franchise was operating under the 'Letter Agreement', rather than its original contract.

3.2.3.3 *National Passenger Survey (NPS) Scores*

Our analysis has again focussed on the NPS measure of overall customer satisfaction. It should be noted that results will be influenced both by factors within and outside of the control of the sample TOCs.

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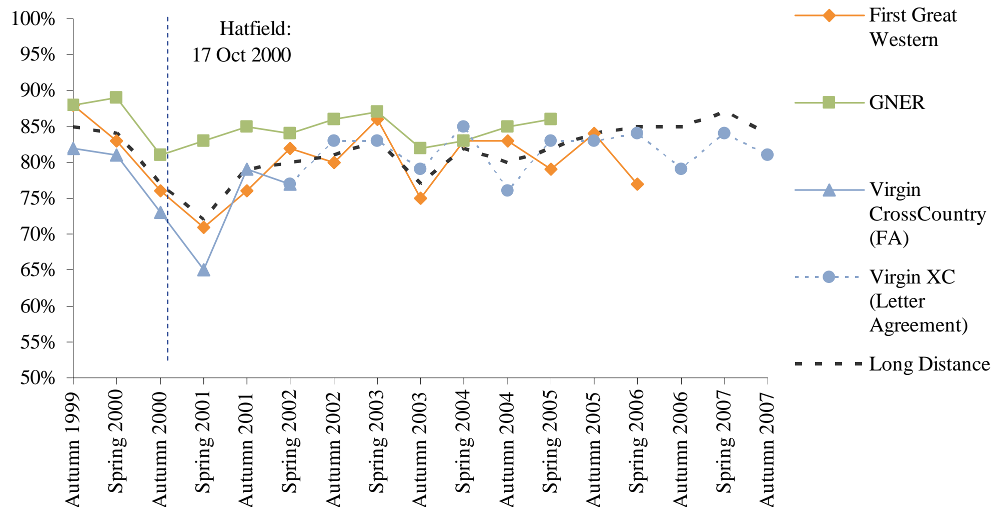
Figure 27: NPS – overall satisfaction % – inter city TOCs



The seven year GNER franchise was clearly the highest performing of the three sample TOCs, with satisfaction levels also consistently exceeding the inter city sector average. It can be noted from the investment section (Section 3.2.6) that GNER promised a number of franchise commitments in respect of customer service. The performance of FGW more or less tracked the sector from 1999 to 2006. VXC initially had the lowest satisfaction, although performance improved markedly from autumn 2001, soon after which the franchise moved onto the 'Letter Agreement.'

No clear evidence linking franchise length to improved satisfaction is therefore evident from this TOC sample. The shortest contract delivered the highest levels of customer satisfaction.

3.2.4 Growth

Figure 28 sets out the revenue growth achieved by each of the three sample inter city TOCs over their franchise terms. FGW achieved the highest level of growth, considerably outperforming what had been assumed in its 10 year bid. GNER also out-performed its bid expectations.

VXC underperformed its bid in the period before the 'Letter Agreement' came into force. However over a 10 year horizon, including the period under which it was operated under the 'Letter Agreement' revenue growth significantly exceeded that of GNER and FGW. A key factor is likely to have been the timetable changes in 2002/ 03 that increased train mileage by over 30% (even after some of the changes were unwound in summer 2003).

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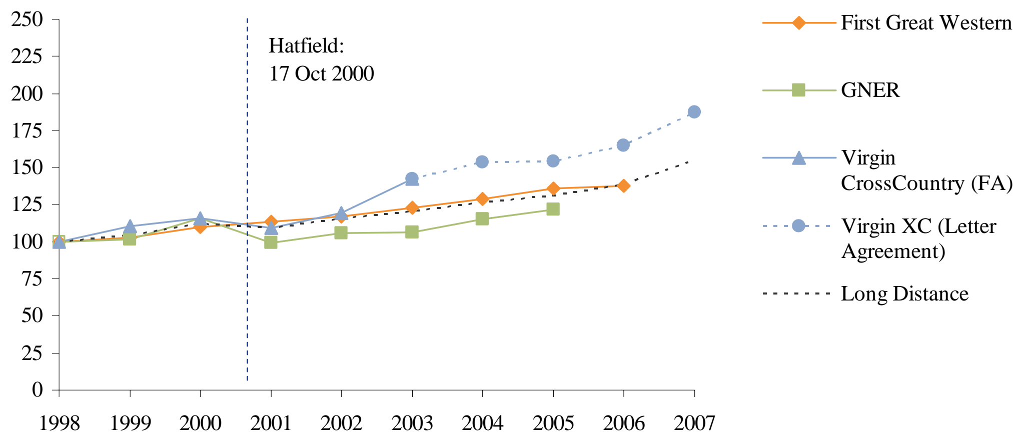
Figure 28: Outturn passenger revenue CAGR– inter city TOCs

	First full year revenue	Final/ latest full year revenue	Outturn revenue CAGR
First Great Western	£182m	£346m	7.4%
GNER	£285m	£426m	5.9%
Virgin CrossCountry	£124m	£148m	4.4%
Virgin XC (inc. mgmt. Contract)	£124m	£273m	9.1%

The high growth achieved by VXC from 2003 onwards is also reflected in trends in journey growth. Again increased journey growth is likely to have been heavily influenced by the timetable changes in 2002/03.

Figure 29: Passenger journey growth – inter city TOCs: (1998 =100)



3.2.5 Cost efficiency

Again our analysis in this area excludes track access and performance regime payments. Costs exclude the impact of RPI inflation since 1998. Sector information is unfortunately only available until 2003.

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Figure 30: Real cost per passenger km – inter city TOCs: (1998 price base)

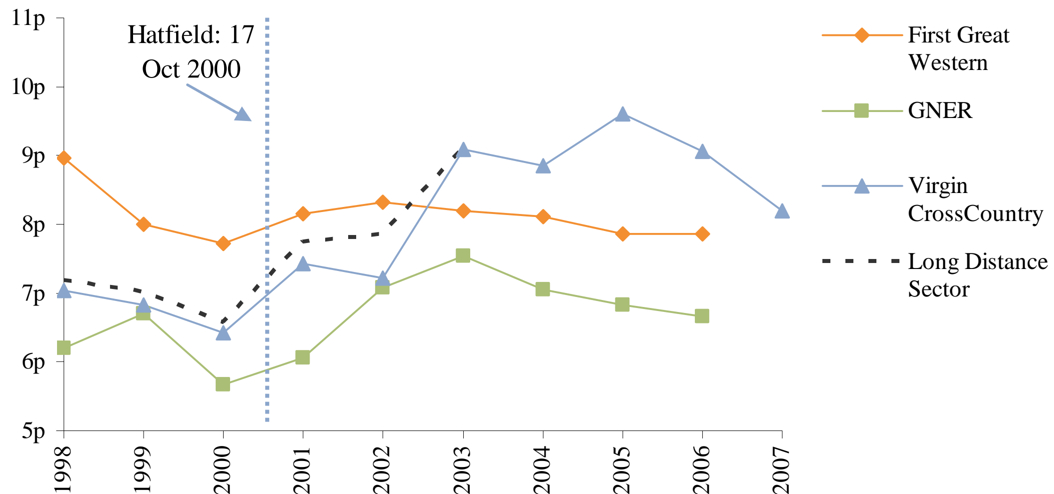

Figure 30 highlights the following trends:

- From 1998 to 2006, real cost per passenger kilometre on FGW fell from around 9.0p to 7.9p;
- From 1998 to 2005, real cost per passenger kilometre on GNER rose slightly from 6.2p to 6.8p; and
- Real cost per passenger kilometre rose steeply on VXC, particularly from 2002 to 2005. This is correlated both with period in which the franchise was operated on the ‘Letter Agreement’ and when the significant “Operation Princess” timetable changes were introduced. We believe that the Voyager and Super Voyager fleets were also in service by late 2002.

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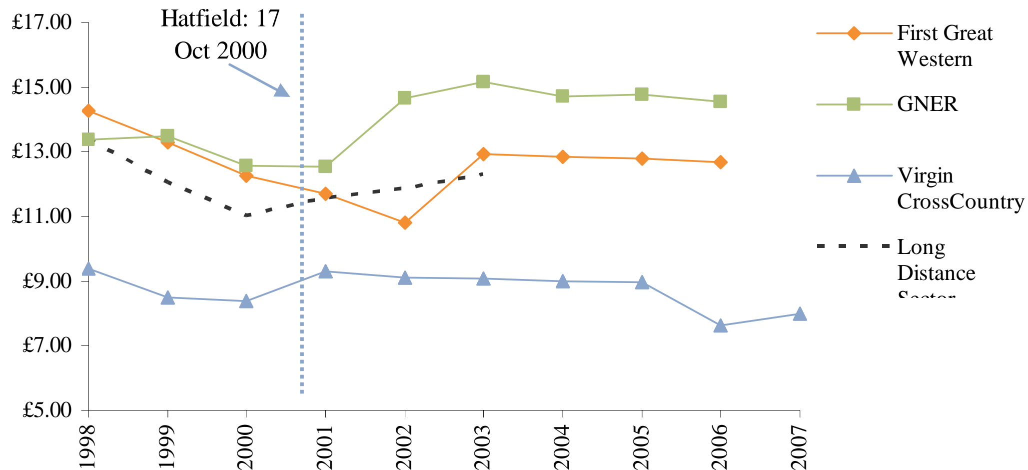
Figure 31: Real cost per train km – inter city TOCs (1998 price base)



Cost per train kilometre presents a slightly different picture. Again, FGW achieved a decrease in costs over its 10 year franchise with there being a small increase on GNER. Against this ratio, the performance of VXC looks considerably healthier with costs staying flat whilst train kilometres increased by 34% from 19.2m in 2002 to 27.2m by 2005. Had VXC not seen significant cost variances to bid (e.g. as shown in Figure 24 above), however, costs per train km would have been lower still. Had this been the case, a further reduction in real cost per train km would have occurred.

3.2.6 Investment

In trying to track the investment delivered by each sample inter city TOC, a similar approach to the L&SE TOC segment has been taken. Again issues of data availability mean that the outline below may not be a complete picture.

First Great Western

The ITT for the original FGW franchise had envisaged a default franchise length of seven years, with respondents invited to justify a longer franchise period in their bids. Ultimately the contract term was 10 years and 2 months.

The ITT did not specify any particular required TOC investment. As in other ITTs, bidders were instructed to provide a Franchise Plan setting out proposals to meet and monitor station and other service quality standards, as well as proposals for a Passengers Charter (together with target performance levels).

The original version of the FGW Franchise Plan has not been available in conducting this study. An available version of the plan from later in the franchise identifies inserted text and the date of insertion but does not show removed or replaced text. The FGW Franchise Plan examined includes the following commitments:

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- A step up in scheduled services from 132 per day at transfer to 164 by June 2001. The final step up, having been amended in Oct 1997, was to provide half hourly services to Bristol and Cardiff. The amendment is believed to have been as a result of enforcement action by OPRAF. A further increase was added in 2004 in respect of early morning Cardiff services;
- 40 new vehicles to be leased to provide the half hourly Bristol and Cardiff services. A further 30 new ROSCO-owned diesel vehicles of a quality standard similar to refurbished HSTs were required to be brought into service by December 2002 (edited December 2000);
- Refurbishment of the passenger areas of the HST fleet by April 1999, including the enhancement of cycle carrying facilities (by agreement with the relevant ROSCO) and to have a refurbished sleeper fleet in service by March 2000 (edited March 1998);
- Facilities improvements at Swindon, Reading and other stations by 2001 (edited in 2001). Provide numerous customer service facilities including waiting lounges at all stations, self service ticket machines at key stations and ensure that security measures (lighting, CCTV) are in place at all car parks by October 1999; and
- A passenger dividend package for annual season ticket holders (added in March 1998).

A “Recovery Plan” was inserted into the Franchise Plan in April 2002. It required the operator to spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on measures to improve performance, promote service recovery and provide passenger benefits. These included on-train customer hosts from January 2003 and extending the lease on two HSTs sets to provide a standby unit in London from 07.30-19.00 on weekdays.

Further additions include:

- July 2002 - arrangements in relation to platform four at Swindon station, a scheme part-funded by the SRA’s Rail Passenger Partnership (‘RPP’) scheme. (This was an SRA scheme where TOCs could bid for funding to match that secured from other sources, e.g. local authorities);
- March 2004 and March 2005 – arrangements in relation to works at Chippenham and Taunton Stations (further RPP schemes); and
- In March 2004, the TOC was required to lease four additional HST sets to increase the Paddington-Exeter and Paddington-Bedwyn service frequencies. It is not clear from the plan alone whether this solution was instigated by the SRA or, for example, offered by the TOC as a potential solution to an issue with a particular set of services. The plan does say, however, that it was “associated with the First Thames Trains Limited franchise award”. First purchased these HSTs from a ROSCO directly.

From 1996 to 2006 the TOC funded £14m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

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GNER

The term of the original ICEC franchise was seven years and was not dependant on the delivery of any specific investment. The ITT did not specify any particular required TOC investment. A mid life overhaul of the HST coaches was due to begin in 1996 and was the responsibility of Angel Leasing.

The first round GNER Franchise Plan examined, which again includes mark ups made during the course of the franchise, includes the following commitments:

- Passenger and engineering modification expenditure on the IC225 fleet by December 2001;
- A refurbishment of the HST fleet, or the same amount in additional lease costs over the franchise length, the refurbishment to be completed by August 1999;
- Station facilities expenditure, including first and standard class lounge construction or refurbishment at nine stations, ticket office/ travel centre refurbishment at three stations and a customer information centre at Kings Cross;
- Customer call centre enhancements;
- Station security improvements by December 2000; and
- Spend up to £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] to provide a business class service between Leeds and London from May 1998 and a "silver standard service" until at least December 1998.

After the 20 year East Coast franchise competition failed to result in a new franchise agreement, GNER's first franchise was extended for an additional 2 years. During this extension period, a high quality fleet refurbishment programme, funded via the ROSCOs / SRA subsidy, commenced.

From 1998 to 2005 the TOC funded £12m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

Virgin CrossCountry

In conducting our data analysis, the OPRAF ITT for the CrossCountry franchise has not been available. The franchise had a 15 year term, during which the rolling stock fleet would be replaced and a significant increase in service frequencies would occur (the "Operation Princess" timetable). These plans required some relatively minor, but geographically widespread, infrastructure works.

The VXC Franchise Plan examined, which again includes mark ups made during the course of the franchise, includes the following commitments:

- Incur additional lease charges in respect of refurbishing Mark 2 rolling stock by June 1999 and Mark 3 rolling stock by December 2000;
- To enter into unconditional agreements to replace (via a lease or operator purchase) the Mark 2 rolling stock by December 1998. At least 40 vehicles were to be in service

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by June 2002 with all non-tilting replacement rolling stock in service by November 2002 and the replacement completed by September 2003 (unless later dates were mutually agreed);

- Establish a central sales and reservations facility by May 1997;
- Provide real time travel information at 100 stations by January 1998;
- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on improving customer facilities at stations called at by VXC and West Coast services, but where neither is the station facility owner;
- Spend £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] on improving ticket sales outlets at stations called at by VXC and West Coast services (whether VXC/ VWC is Lead Retailer at the stations or not); and
- Employ additional customer service staff at Birmingham New Street throughout the franchise.

The new CrossCountry Voyager (Class 220/ 221) fleet entered service during 2002. The Operation Princess timetable commenced in December 2002 but after early reliability issues the service changes were partly unwound in summer 2003.

Discussions with DfT Franchise Managers indicate that when the franchise operated under the 'Letter Agreement' (from July 2002 until November 2007), investment commitments continued to be delivered. However, the cost of delivering these commitments was subject to annual negotiations with the SRA / DfT.

From 1997 to 2007 the TOC funded £4.4m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

3.2.7 Conclusions

Only very limited evidence of any link between contract design / franchise length and performance is available from the sample of TOCs studied. The 15 year VXC contract included some major investments and service changes, many of which ultimately did take place, but the TOC did not prove to be financially robust and the cost to taxpayers beyond 2002 was significantly in excess of that forecast when the contract was let. (The TOC's franchise payments were reset annually after 2002).

As with the L&SE TOCs, further analysis indicates a clear correlation between financial robustness and the first round bid cycle. The two franchises that proved to be financially robust – FGW and GNER - were the first two let. VXC, which was let later in the process, had more ambitious targets in terms of revenue growth.

Against other measures, FGW appears to have performed better in terms of cost efficiency ratios whilst GNER delivered higher levels of customer satisfaction. In terms of PPM, the record of both of these TOCs is broadly comparable, although it should be noted that this metric is heavily influenced by factors outside TOC control. The fact that

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one franchise was initially seven years (GNER was extended for a further two years) and the other 10 years does not seem to have demonstrably impacted trends in outcomes.

In terms of investment, the most significant proposals were the timetable and rolling stock changes envisaged by VXC. Although these were ultimately delivered (with the exception of some of the service extensions which were wound back), the TOC was not sufficiently robust for these to be implemented under the original contractual / financial terms.

On FGW, a series of investments - over and above those contracted - were undertaken during the franchise. DfT has informed us that a number of these were tied to recovery plans agreed in 1998 and 2002. Some investments were also funded by the SRA's Rail Passenger Partnership scheme (e.g. Swindon platform four) or negotiated as a result of First operating Great Western Link services from 2004.

3.3 Regional TOCs

3.3.1 Introduction

Our sample from the regional sector includes the following TOCs:

Figure 32: Regional TOC sample

	Start Date	Original Franchise Length	Original End Date	Actual End Date (If Different)
Northern Spirit/ Arriva Trains Northern	Mar 97	7 yrs	Mar 04	Dec 04*
Central Trains	Mar 97	7 yrs 1 month	Mar 04	Nov 07*
Merseyrail	Jul 03	25 yrs	Jul 28	-
Arriva Trains Wales	Dec 03	5+5+5 yrs	Dec 18	-

** These franchises only operated on their original Franchise Agreement subsidy profiles until 2001.*

Northern Spirit/ Arriva Trains Northern: This franchise was originally let in 1997 to Mersey Travel Limited ('MTL') as a seven year contract. In 2001, with MTL forecasting significant losses in its rail business, the franchise, (along with the original Mersey TOC), was sold to Arriva. Arriva then renegotiated the subsidy profile and operated the franchise under a management contract as Arriva Trains Northern until it was re-competed as part of an enlarged Northern franchise in 2004.

Central Trains: Central was let to National Express in February 1997 as a seven year franchise. Some routes were then transferred to Wales and Borders as part of a remapping exercise in October 2001. The franchise suffered significant financial losses and in late 2001, National Express and the SRA agreed to a revised subsidy profile for Central (along with National Express's Scotrail TOC), to commence from January 2002 until the original expiry date in March 2004. Central Trains was subsequently extended until 2007

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on a net cost basis, to allow for remapping into the West Midlands, East Midlands and New Cross Country franchises.

Because these franchises were only operated on their original terms for four years, our discussion of these TOCs is limited to financial robustness. Our comparative analysis in the Regional sector has focused on two longer term franchises (one 15 years and the other 25 years) which were let by the SRA in 2003. Since then, other regional franchises such as Northern, Scotrail and West Midlands have been let on considerably shorter franchise terms. The two franchises we have investigated are:

Wales and Borders: The Wales and Borders franchise is a 15-year contract with a potential break every five years. At this point, an "efficient operator" test considers the PPM, cancellations, TOC-on-Self delay minutes and average NPS scores of the operator. In the case of NPS, the operator is required to exceed sector benchmarks for a subset of questions and achieve a prescribed score in certain station-related categories. Subsidy for the franchise is provided by the Welsh Assembly Government ('WAG') with the exception of 3% of the support which funds services operating exclusively in England. The franchise is operated by Arriva Plc as Arriva Trains Wales ('ATW').

Merseyrail: The franchise is operated by a joint venture between Serco and Nedrailways. It is potentially a 25-year contract with performance reviews leading to a 7+5+5+5+3 arrangement. The reviews consider performance against PPM targets and NPS benchmarks, the financial viability of the operator, the delivery of franchise obligations to date and the ability of the operator to deliver its obligations and commitments for the remainder of the contract term. The franchise is managed by the Mersey Passenger Transport Executive, Merseytravel, rather than the DfT.

It should be noted that both Wales & Borders and Merseyrail were let at what could now be considered the 'bottom' of the rail franchising market. Bids were not financially aggressive compared to 1997 and the SRA, due to financial constraints, specified relatively low levels of investment in these contracts. Bidders did not identify material levels of additional investment with a positive financial case.

3.3.2 Financial robustness

Comparison of 'first round' franchises

The Northern Spirit franchise made significant losses in 2000 and 2001 with costs significantly higher than bid. Following the change of ownership, profits were made by Arriva. However by this point, as a result of a renegotiation with the SRA, the TOC was receiving around £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] p.a. more subsidy than bid.

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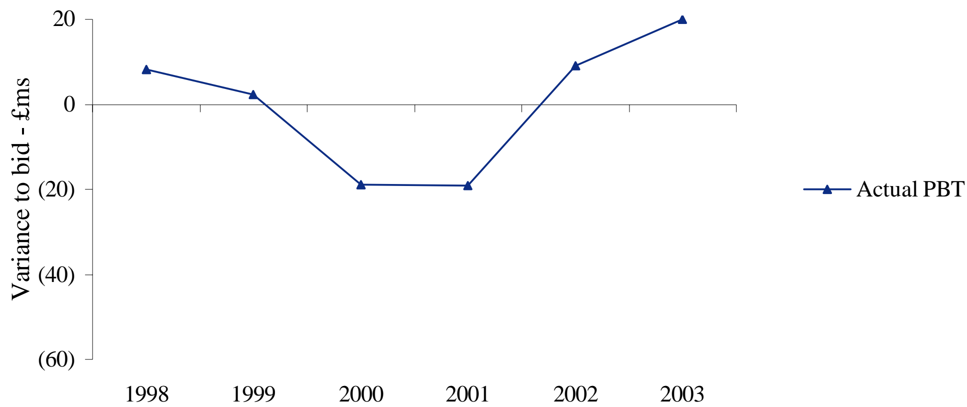
Figure 33: Financial variance to bid and PBT – Northern Spirit [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

On Central, revenues were ahead of bid from 1999-2002. However, because of larger, unfavourable variances in costs, the TOC made losses in 2000 and in 2001. Losses decreased from 2002 due to the renegotiated subsidy profile. In 2003 the TOC was receiving around £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] p.a. more subsidy than bid.

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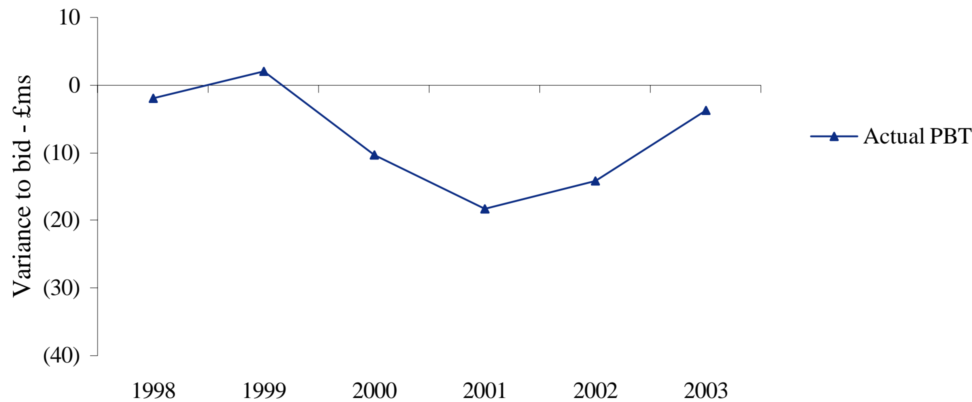
Figure 34: Financial variance to bid and PBT – Central Trains [REDACTED]



Source: Strategic Rail Authority

[PASSENGER REVENUE AND OPERATING COST VARIANCES HAVE BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

Figure 35 indicates that the issues of financial robustness on Northern Spirit and Central Trains were common across the regional TOC sector. These contracts were let towards the end of OPRAF's franchising process and the increasingly aggressive bid market assumed that the contracted levels of service could be delivered for the agreed subsidy profiles whilst making significant savings in staff and operating costs. These savings did not materialise and within 5 years of contract commencement, each of the regional franchises had been renegotiated.

Figure 35: Financial robustness and the bid cycle– wider regional sector

	Date signed	Order signed	Date restructured
Northern Spirit/ Arriva Trains Northern	7 Feb 97	21/25	1 April 2001
Central Trains	14 Feb 97	23/25	1 January 2002
Wales and West	16 Sep 96	10/25	1 April 2001
Merseyrail	19 Dec 96	18/25	1 April 2001
First North Western	4 Feb 97	19/25	1 April 2001
Scotrail	21 Feb 97	25/25	1 January 2002

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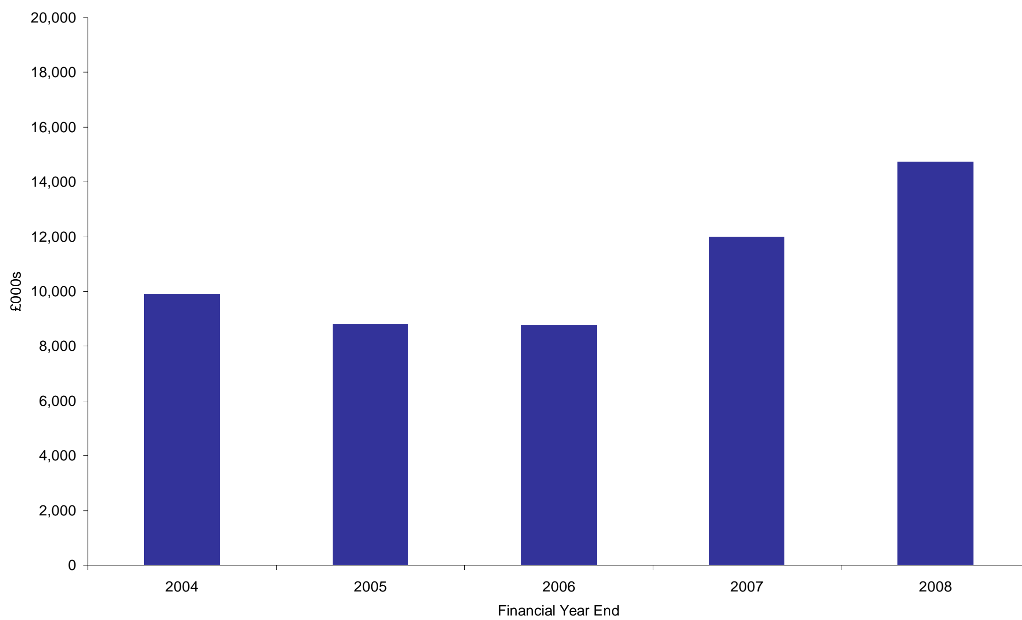
Since all of the original regional TOCs were let on either seven year or close to seven year contracts, it is not possible to assess how longer franchise terms might have impacted bid behaviour or franchise outputs.

Merseyrail and Wales and Borders

Since it commenced, ATW has earned a level of profit similar to that bid. We understand that additional services, funded by WAG or other parties, are being delivered by the franchisee. The additional subsidy paid to ATW is illustrated by Figure 37.

Figure 36: ATW – Profit before Tax



Source: TOC Financial Statements

Figure 37: Financial support relative to bid – ATW [REDACTED]

[THIS FIGURE HAS BEEN REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]

Source: Department for Transport

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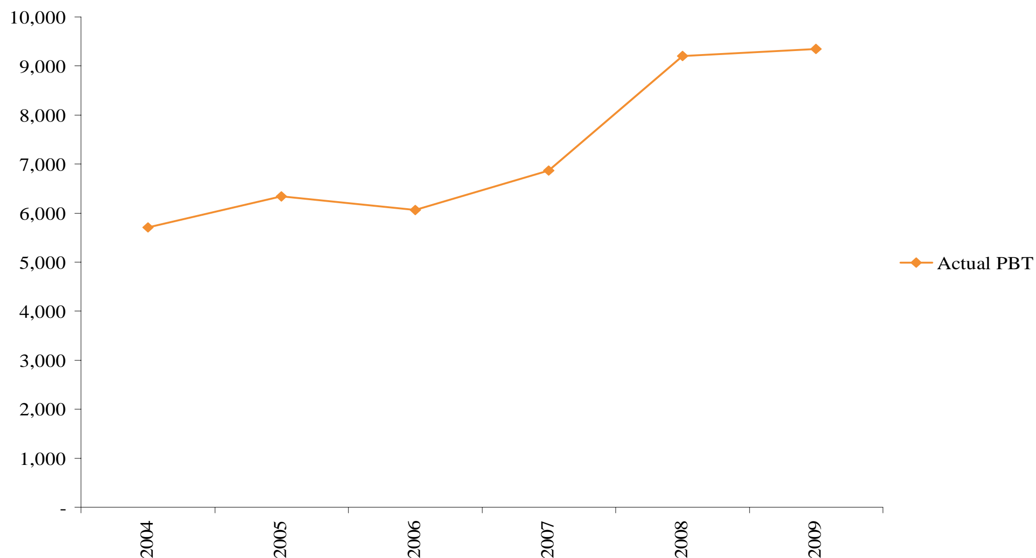
Figure 38 shows that Merseyrail has been financially robust throughout the franchise term.

Figure 38: Actual PBT – Merseyrail



Source: TOC Financial Statements

3.3.3 Service quality

3.3.3.1 *TOC-on-self delay minutes*

Given that the "first round" regional TOCs only survived on their original financial support profiles until 2001, Figure 39 shows the performance of ATW and Merseyrail only. Performance is relative to the year to March 2004, the first year of these two contracts. (I.e. as an index where delay minutes in the year 2004 = 1).

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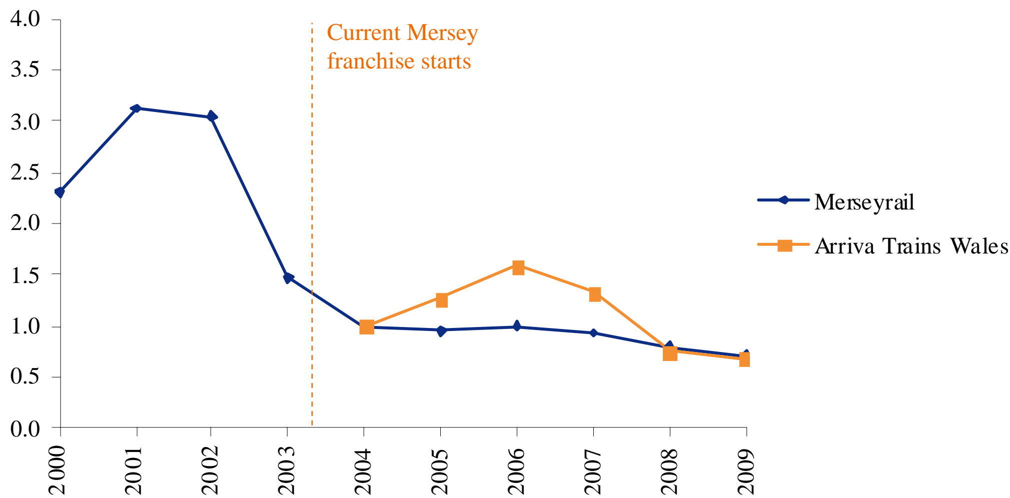
Figure 39: TOC-on-self delay minutes relative to 2004



TOC-on-self delay minutes for Arriva Trains Wales increased by 60% over the first two years of the franchise. A significant improvement then followed, which is believed to be attributable to investment (primarily non-TOC financed/ funded) and greater management focus.

Merseyrail's TOC-on-self delay minutes halved in 2003, the year before the new contract started. Merseytravel attribute this to a rolling stock overhaul and PTE-led endeavours to better manage industrial relations. Subsequently, Serco-Nedrailways has delivered a further, albeit more steady, improvement with TOC-on-self delay minutes falling by a further 30% from 2004 to 2009.

3.3.3.2 *Public Performance Measure (PPM)*

Again it should be noted that PPM reflects overall performance of rail services and is heavily influenced by the performance of Network Rail, other TOCs and other external factors.

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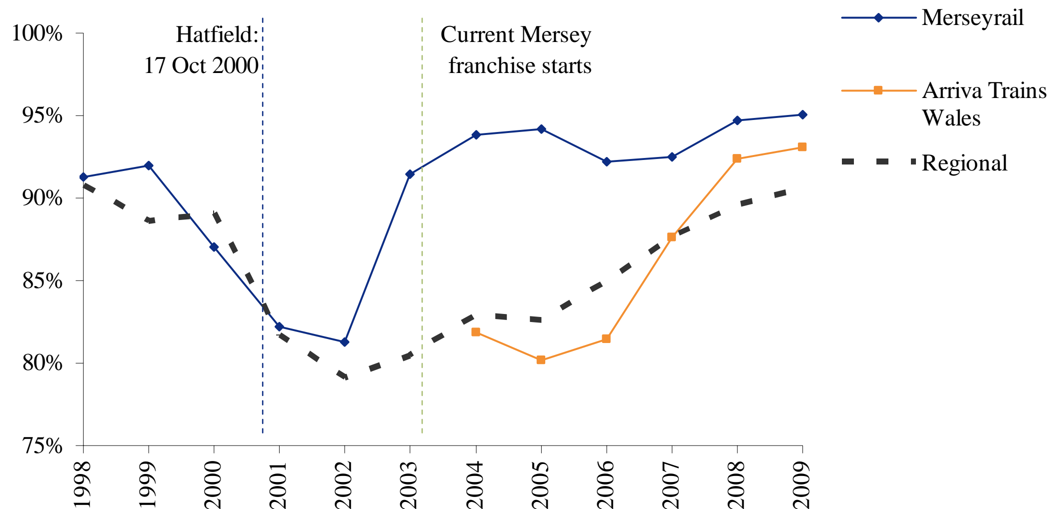
Figure 40: PPM – Merseyrail and Wales & Borders vs. sector



Both Merseyrail and Wakes and Borders are currently achieving PPM in excess of the sector average (other TOCs in the segment being Northern, Scotrail and West Midlands).

On Wales and Borders, whilst PPM was relatively static between 2004 and 2006, significant improvements in 2007 and 2008 brought the TOC above the sector trend. DfT franchise management has attributed this to a combination of investment impacts (many of which were not TOC-led) and ATW focussing on ensuring that extension performance criteria were met.

On Merseyrail, PPM again significantly improved in the year before the new contract was signed. Since Serco-Nedrailways has been operating the franchise, PPM has consistently been above the sector average. Whilst Mersey is a relatively self-contained network, the performance is vastly better than from 1998 - 2003. The extent to which this is influenced by improved Network Rail performance or other factors external to the TOC cannot be determined from this analysis.

3.3.3.3 *National Passenger Survey (NPS) Scores*

Our analysis has again focussed on the overall customer satisfaction NPS regime. It should be noted that results will be influenced both by factors within and outside the control of each sample TOC.

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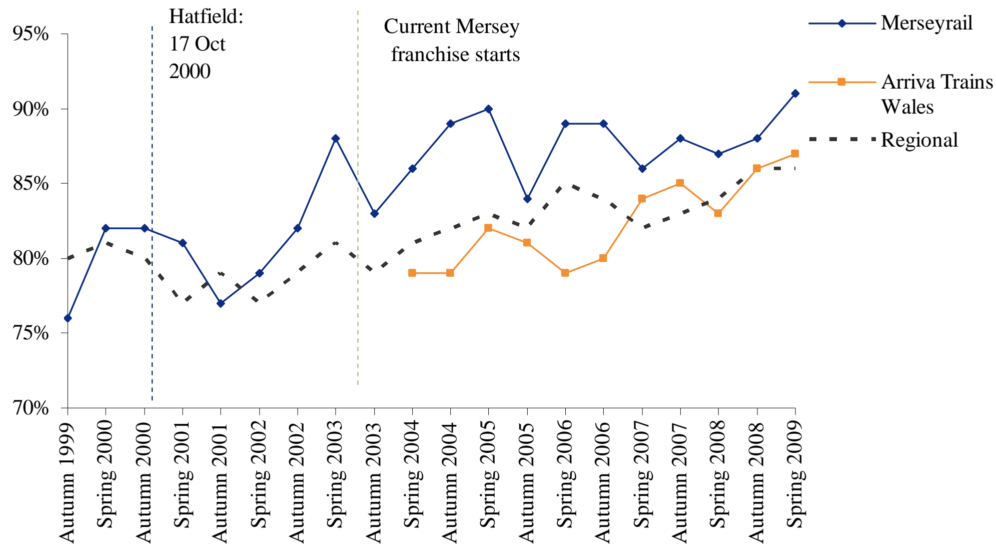
Figure 41: NPS overall % satisfied or Good – Mersey/ Wales & Borders



The results show only a marginal improvement for Wales and Borders from spring 2004 to autumn 2006 with the TOC consistently below the sector average. Subsequently, satisfaction has improved and the results in autumn 2008 and spring 2009 were broadly in line with the sector as a whole. This is consistent with the trend in TOC-on-self delay minutes and PPM.

On Merseyrail, as with TOC-on-self delay minutes and PPM, again there was a marked improvement in overall NPS scores just prior to the commencement of the current franchise. This has been maintained during the course of the new contract, with the TOC consistently outperforming the sector.

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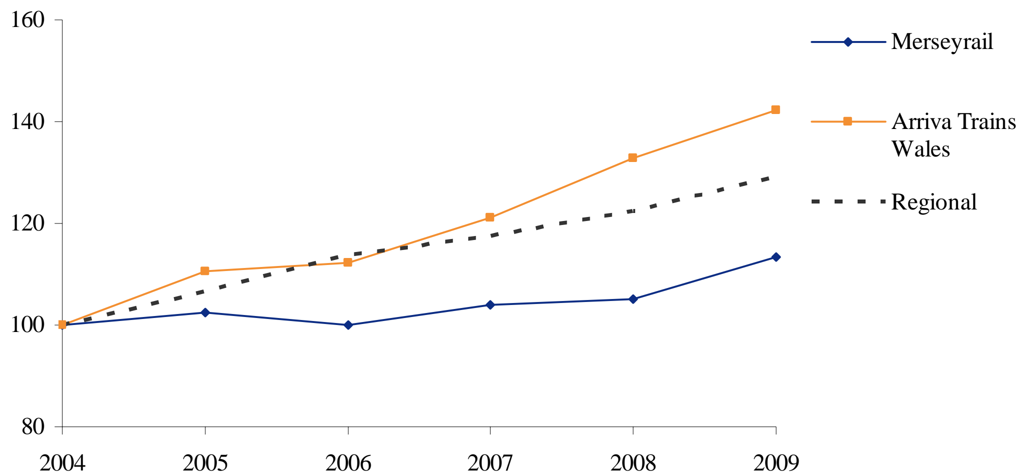
3.3.4 Growth

3.3.4.1 *Journey growth*

Figure 42: Passenger journey growth relative to 2004 (2004 = 100)



Journey growth on ATW was broadly in line with the sector until 2007. Since then, it has outperformed the sector – a result that can partly be attributed to the opening of the Ebbw Vale line in February 2008, which contributed 34% of the 2009 growth.

Merseyrail has underperformed the sector in terms of journey growth. However, as with the L&SE sector, it should be noted that its external environment (a local, self-contained network) is different to that of other regional TOCs.

In the 5 years since the franchises commenced, annual passenger revenue on ATW has increased by 58%. On Merseyrail it has increased by 60%. The high revenue growth on Merseyrail relative to the level of growth in passenger journeys may in part be due to a step change in revenue protection.

3.3.5 Cost efficiency

Again our analysis in this area excludes track access and performance regime payments. Costs are presented excluding the impact of RPI inflation since 1998. Sector information is unfortunately not available.

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Figure 43: Real cost per passenger km (1998 price base)

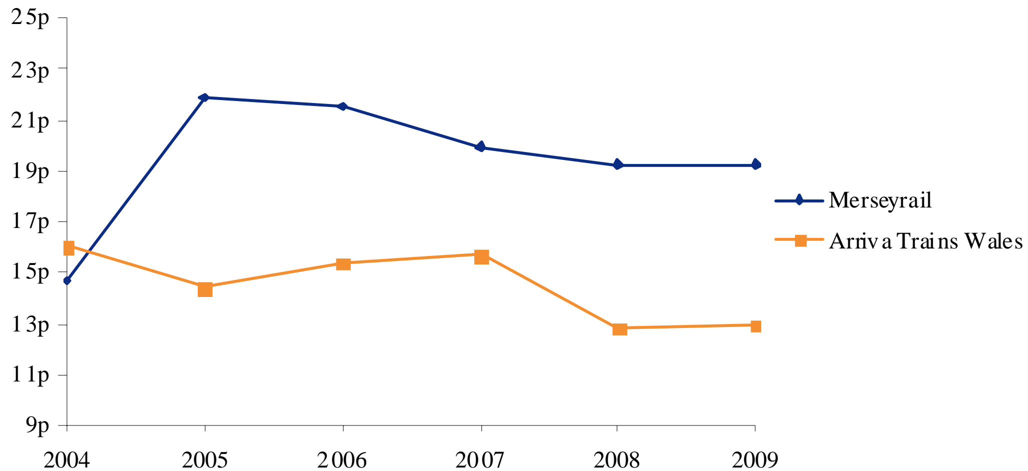
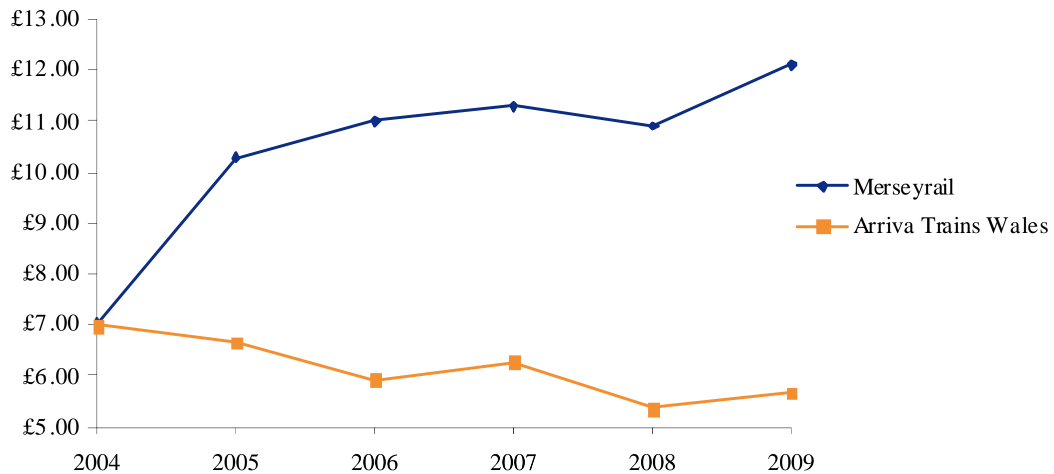


Figure 44: Real cost per train km – (1998 price base)



ATW has seen real reductions in both cost per train km and cost per passenger km. Real growth in operating costs (at about 20%) has been significantly exceeded by the growth in passenger and train Kms, each being close to 30%.

On Mersyrail, there was a significant increase in real cost per train km in 2005 with a further increase in 2009. Costs per passenger km followed the same trend in 2005 but have fallen or remained almost flat in each year since. Merseytravel re-invests any profit share payments that may be due to the PTE back into the franchise. The increase in costs may potentially therefore reflect additional staff and investment initiatives sponsored by the PTE.

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3.3.6 Investment

Wales & Borders

It is notable that the core proposition set out in the ITT for the Wales & Borders franchise in April 2002 did not include any specifically mandated infrastructure or rolling stock investments.

The original ATW Franchise Plan has not been available in conducting this study. A more recent version of the plan made available to us identifies inserted text and the date of insertion, but does not show removed or text. It includes the following commitments:

- Integrated ticketing schemes on 30 bus routes within 2 years;
- Continue to provide the following RPP-funded schemes:
  - Inform Cymru information system maintenance throughout the franchise;
  - Taff Corridor and Valley Lines service strengthening until Nov 2004/ May 2005; and
  - Vale of Glamorgan, Cardiff – Aberdare, Carmarthen – Milford Haven, Heart of Wales Winter Sundays and Royal Welsh Show additional RPP services
- Operate, maintain and renew (where not a commitment of another party) any items that have been upgraded as part of the Welsh Assembly Government's station improvement and modernisation programmes;
- Car park improvements at c. 18 stations;
- Replace three sets of Class 37 locomotives and mark 2 loco-hauled carriages with seven Class 150 units, by the Passenger Change Date in December 2004; and
- Participate in a trial of new train control and communications equipment on the Cambrian Lines, the investment being funded by NR/ WAG.

The opening of the Ebbw Vale line was an option in the bid that was not purchased by the SRA at the time the contract was signed. WAG then later funded the project. ATW services on the line are provided via a gross cost contract.

Discussions with DfT indicate that Arriva developed the scheme to consolidate maintenance of the Class 158 diesel fleet at Machynlleth Depot. This required approximately £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] of investment in cleaning and maintenance facilities. The franchisee procured the works and then transferred the assets to Network Rail at a pre-agreed price on completion.

WAG/ DfT Franchise Managers have indicated that small TOC-funded investments have taken place in ticket barriers/ revenue protection where these have been commercially viable. However, other investments, such as improvements at Swansea and Newport Stations, have been funded by WAG/ Network Rail.

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From 2004 to December 2007 the TOC funded £20m of new fixed assets (Source: Financial Statements). The extent to which this reflects the delivery of contractual commitments or the delivery of other investments is not known.

Merseyrail

In the tender documentation issued to bidders by Merseytravel/ the SRA, bidders were asked to respond with an 'enhanceable proposition' that essentially maintained service levels, set targets for operating performance and provided a series of options that the authority could decide whether to buy during the contract. Potential investments included:

- 25 station upgrade projects, as well as interchange and park & ride projects;
- The comprehensive upgrade of an additional five underground stations;
- Development of Allerton Interchange and Liverpool Central Station; and
- The stations and infrastructure Incremental Output Statement ("IOS") which included improvements at 59 stations and expenditure on track turn back facilities to boost operational flexibility.

Bidders were not asked to price the impact of these schemes but were required to co-operate with Merseytravel and state the improvements in NPS/ PPM that might result. In addition, bidders were "expected to share with Merseytravel any additional operating profit which it will generate following investment by Merseytravel."

Since the commencement of the contract, a key objective of a PTE-led investment programme has been to improve station security in order to increase off-peak patronage.

From 2004 to 2009 the TOC funded £7.7m of new fixed assets (Source: Financial Statements).

In addition, Merseyrail has undertaken a number of projects on behalf of Network Rail. Examples include:

- At Ormskirk, Merseyrail project managed and delivered the first National Stations Improvements Programme ("NSIP") project, apparently delivered on time and within budget. The refurbishment programme combined restoration and modernisation of the Grade 2 listed station and was completed in 2009; and
- At Liverpool Central, again as part of the NSIP programme, Merseytravel is in the closing stages of delivering a new Travel Centre / 'M to go' facility. 'M to go' combines ticket sales and travel information with a retail offering. Construction began in 2009 and the new facility was due to open in the first week of November 2009.

The Merseyrail fleet is due for renewal/ replacement in 2013. We understand that the TOC has no contractual obligations in respect of fleet replacement under the 2003 Franchise Agreement.

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3.3.7 Conclusions

Our analysis of a sample of “first round” regional TOCs indicates that none of the bids proved to be financially robust. As all of the first round regional franchises were let on relatively short-term contracts, there is no data to see if longer franchises impacted outcomes.

Both of the later, longer regional franchises we have examined (Merseyrail and Wales & Borders) have to date proved to be financially robust. It should be noted, however, that both Wales & Borders and Merseyrail were let at what could now be considered the ‘bottom’ of the rail franchising market. Bids were not financially aggressive compared to 1997 and the SRA, due to financial constraints, specified relatively low levels of investment in these contracts. Bidders did not identify material levels of additional investment with a positive financial case.

In the case of Wales & Borders, both customer satisfaction and punctuality were either flat or deteriorated in the first two years of the franchise. Outcomes have since improved. The five year performance break is perceived to have been key, both by DfT and WAG Franchise Managers, in stimulating this improvement.

In terms of investment, WAG considers that whatever has been delivered has primarily been driven by the Franchising Authority and not in response to incentives provided by a contract with a relatively long term. It should be noted, however, that the ratio of passenger revenue to operating costs on this franchise is low compared to the wider UK rail industry. Therefore financial business cases for TOC-funded investment, to be recovered through incremental passenger revenue, are likely to be relatively weaker than in the wider industry. In recognition of this, the contract initially signed by the SRA and Arriva was strongly geared towards ensuring the operation of the train service according to a new timetable.

Merseyrail has achieved a step change in operational performance and customer satisfaction, both immediately prior to and during the current franchise. It should be noted, however, that the Merseyrail network is largely self-contained, without the degree of complexity faced by other TOCs. In addition, the PTE has led and funded a significant investment programme, which bidders for the franchise were required to support.

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4 Template Franchise Agreement

The ‘first round’ of franchises were governed by bespoke contracts. Whilst these generally shared common principles, such as the transfer of revenue risk, there were variations in legal drafting and structure that led to potentially different interpretations of the contract by operators and the Franchising Authority - particularly around commitments. To simplify and clarify such matters, the Template Franchise Agreement (‘TFA’) and National Rail Franchise Terms (‘NRFT’) were introduced by the SRA in 2004. The template contract was developed following industry consultation.

The first franchise let using the TFA and NRFT was Greater Anglia (‘GA’), awarded to National Express. All franchises after GA have been awarded on the basis of the TFA and NRFT, which have seen relatively minor amendments over time - for example to cover the operation of services during the 2012 Olympics. However, in most material respects they remain largely unchanged and have been used by the DfT since it assumed the role of Franchising Authority.

4.1 National Express East Anglia

4.1.1 Introduction

The GA franchise was created by the re-mapping of three first round franchises. It includes all the services that were previously part of the Great Eastern and Anglia franchises and also the West Anglia service groups from the former West Anglia Great Northern (‘WAGN’) franchise, including Stansted Express. The remapping that saw GA created was intended to improve performance, by enabling a single operator to control all rail services operating out of London Liverpool Street Station. The SRA also expected the Greater Anglia operator to achieve savings by consolidating duplicate functions.

The competition for the new franchise included limited changes to the service specification on the Great Eastern Main Line and bidders were invited to propose alternative solutions that would meet the needs of passengers. The tender offered a seven year contract with a potential three year extension (giving a maximum franchise term of ten years) if performance targets were met.

The GA franchise was let to National Express in January 2004. The contracted outputs included an alternative tender timetable which increased train frequencies over the base case requirement on certain routes.

4.1.2 Financial robustness

The GA franchise has to date remained financially solvent and the franchisee has been profitable (by the PBT measure) in four of the five years of operation.

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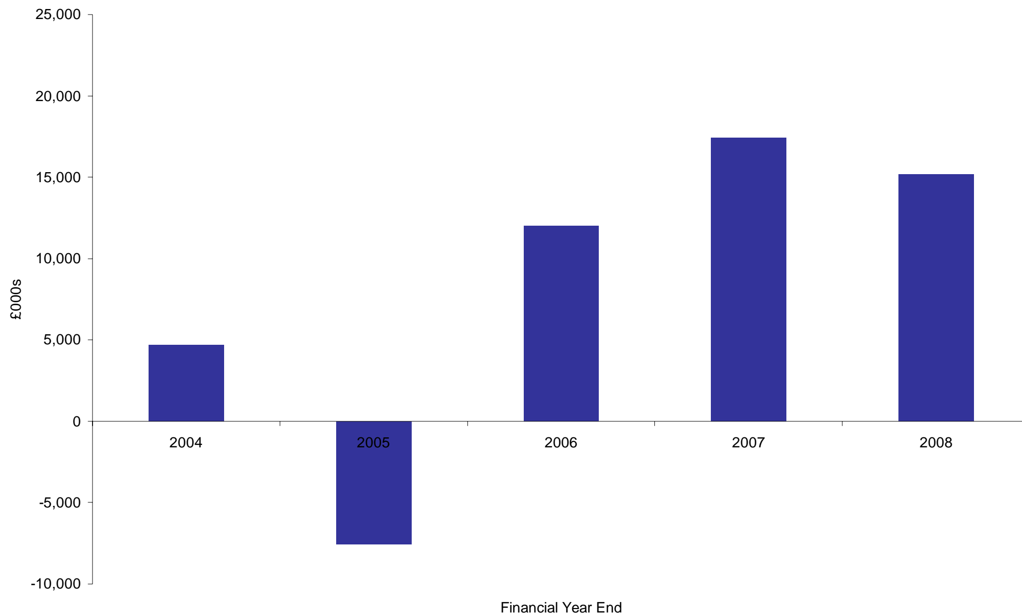
Figure 45: NXEA – Profit before Tax



Source: TOC Financial Statements

4.1.3 Service quality

GA's current levels of both TOC-on-Self delay minutes and PPM are better than they were upon commencement of the franchise. In the second year of the franchise, however, delay minutes increased by over 25% year-on-year. A recovery plan was introduced and performance has subsequently improved in each of the last three years.

Figure 46: NXEA – TOC-on-Self delay minutes and PPM

	2005	2006	2007	2008	2009
TOC-on-Self Delay Minutes	28,296	35,565	29,639	21,609	20,240
Indexed Delay Minutes	100%	125.7%	83.3%	72.9%	93.7%
PPM %	89%	87%	87%	90%	91%
Indexed Delay Minutes	100%	125.7%	83.3%	72.9%	93.7%

Source : DfT

The GA Franchise Agreement includes a moving annual average target for TOC-on-Self delay minutes and an annual PPM target. PPM will, however, be strongly influenced by factors outside of the franchisee's control (i.e. Network Rail, other TOCs and factors external to the railway).

The delay minute target starts at 32,290 minutes and progressively tightens to 29,090 minutes after year six of the franchise. The franchisee has achieved its target in each year of the franchise apart from 2006. The PPM target is 88% in years one to five and 88.6%

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in year six onwards. The PPM target has been met in each year of the franchise to date, although the extent to which the operator – as opposed to NR, other TOCs or external factors - is responsible for this is not explicitly known.

Since the first year of the franchise, L&SE sector PPM has improved from 85% to 91%, a proportionally larger improvement than that seen on GA (which has improved from 89% to 91%). Again, the extent to which the operator is responsible is not known.

Customer satisfaction has been broadly stable, between 71% and 77%, over the life of the franchise. In both the autumn 2004 and spring 2009 National Passenger Surveys ('NPSs'), the overall 'good' or 'satisfied' rating for the franchise was 77%.

Figure 47: NPS Overall % Satisfied or Good – One/ National Express East Anglia

		2005		2006		2007		2008		2009
	Autumn	Spring	Autumn	Spring	Autumn	Spring	Autumn	Spring	Autumn	Spring
Score	77%	71%	73%	71%	74%	71%	76%	76%	79%	77%

Source: National Rail Trends.

In the same time period, the overall equivalent level of satisfaction across the L&SE segment improved from 74% to 80%, an improvement when GA's overall score was the same in both surveys.

The GA Franchise Agreement does not include a target NPS score. However, it does include Passenger's Charter and Service Quality Management System ('SQMS') regimes. The Passenger's Charter offers price discounts, on a route-by-route basis, to season ticket holders of up to 5% if predetermined punctuality and reliability targets are not met. The SQMS regime sets targets for a number of Key Performance Indicators ('KPIs') against which the franchisee is assessed. The KPIs relate to the delivery of elements of customer service, such as train cleanliness. Incentive or penalty payments may be made if the franchisee exceeds or fails to achieve the KPI targets set.

As part of its bid National Express also committed to the following customer service initiatives:

- The establishment of a new customer service academy for training staff;
- To hold "meet the manger" sessions at stations; and
- To hold an annual customer forum in each year of the franchise.

4.1.4 Growth

The chart below shows passenger revenue and passenger journey growth. It compares these two metrics for GA to the wider L&SE sector.

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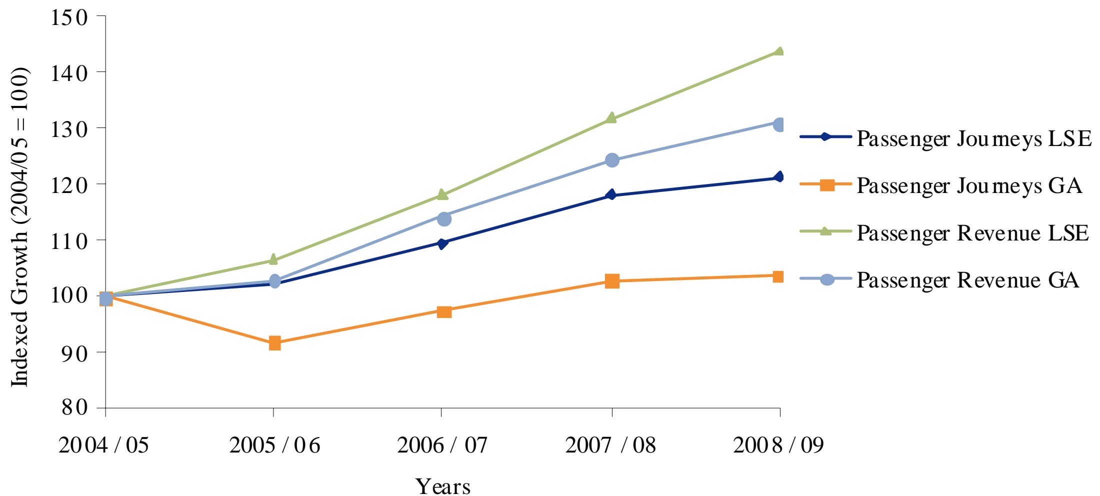
Figure 48: Indexed revenue and demand growth



L&SE operators have seen both revenue and journeys grow at a faster rate than GA throughout the term of the GA franchise to date.

4.1.5 Cost efficiency

To assess the cost efficiency of the GA franchisee, we have calculated the operating expenditure pre train kilometre and operating expenditure per passenger kilometre. This is summarised in the table below.

Figure 49: NXEA - Operating expenditure per train and passenger km

	2005	2006	2007	2008	2009
Opex per train km (£/km)	8.65	9.01	8.41	8.71	8.72
Opex per passemger km (p/km)	7.14	8.01	7.27	7.16	7.14

Notes: Source KPMG Analysis of DfT information and information from National Rail Trends. Operational expenditure has been adjusted for RPI inflation as published by ONS, the priced base is 2005. Operating expenditure excludes Network Rail charges and performance payments.

Operating costs per unit of output have remained stable over the five year time period.

4.1.6 Investment

The Greater Anglia franchise agreement includes provisions for the following investments:

- Rolling stock enhancements and refurbishments;
- Maintenance facility improvements at Clacton depot;
- Various building, security and environmental improvements at at least 55 stations;

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- For the duration of the franchise, an annual plan must be submitted to the Franchising Authority setting out how the franchisee proposes to invest an additional £[**REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY**] at stations and station car parks;
- Improvements in ticketing systems and technology, including the introduction of direct debit facilities for season ticket purchases;
- Systems and information technology improvements and integration;
- Acknowledgement of the importance of various third party investment schemes and commitments to cooperate with them; and
- Infrastructure schemes at Braintree and Cheshunt.

DfT has informed us that these investments have generally been delivered, with some minor adjustments (e.g. the Clacton depot improvements were transferred to Ilford).

4.1.7 Conclusions

From the evidence we have reviewed it is not possible to determine if any aspect of the GA contract structure has had a causal impact on outputs for service quality, growth, cost efficiency or investment. In terms of financial robustness, the TOC made a profit before tax in four of the five years to 2009.

The GA franchise has seen a significant improvement in TOC-on-self delay minutes, but had to implement a recovery plan after this measure of delays initially increased by 26% in a year. The franchisee's NPS scores initially dropped a little but have recently been in line with the position at franchise commencement. The GA overall NPS score has been in the 71-79% band throughout the franchise. In the same time period, the equivalent L&SE sector NPS score has improved from 74% to 80%. The extent to which this is due to factors that the TOC can influence is not, however, clear. The trend in cost efficiency metrics has been flat. Growth in passenger revenues and patronage has been less than in the sector.

Overall, therefore, by some metrics there has been an improving trend. By others, GA has been out-performed by the L&SE sector. It is not possible from the data, however, to draw conclusions about the extent to which the outperformance of the TOC by the sector is due to factors within the franchisee's control.

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5 Other franchise models

5.1 Transport for London – bus tendering

5.1.1 Overview

The London bus network is made up of 720 individual routes and there were 2,176 million passenger journeys made on it in 2007/08. The service is operated from 88 depots across London and resourced by about 8,300 buses operating 480 million route kilometres every year. Routes are operated via contractual arrangements between Transport for London (TfL) and third party private sector providers. The majority of buses and depots are directly owned by these private operators. TfL retains responsibility for the detailed planning of the network and operates several of the centralised functions, including bus stops, communication systems, network regulation and ticketing systems.

Bus patronage in London declined for most of the 1970s and 1980s, falling up to 20% over a 20 year period. Since 1993/94 passenger demand has increased year-on-year and is now over 80% higher than the mid '90s low.

The quality, scale and frequency of the service increased markedly in the period from 2001/02 to 2003/04. However, these increases in quality have come at a financial cost with the network subsidy paid by TfL increasing from a low of £40m in 1999/00 to £653m in 2007/08. Fares have also fallen in real terms (i.e. after adjusting for inflation) in the past eight years by 16%.

5.1.2 History of London bus service tendering

Competitive tendering for the operation of bus services in London commenced in July 1985, when the first small batch of routes was offered to the market. The introduction of tendering was driven by the desire to improve efficiency and the poor operating standards that existed at the time.

In preparation for privatisation, the main London Transport bus operating business was split into a series of wholly owned subsidiary companies. These were then allowed to bid, in competition with each other as well as against private operators, for the tendered routes. The initial tenders were offered on a gross cost basis, with the Authority taking revenue risk. A bus division was set up by London Transport to manage the tendering.

The subsidiary operating companies were privatised in 1994 and early 1995, and were sold either to management teams or trade buyers. In nearly all cases ownership of the buses and depots passed with the businesses. In conjunction with the privatisation process, those route contracts that had not been competed were supported by a negotiated block grant, net of revenues. A new forward tendering programme for routes was published, covering the entire network. Tenders now run in five to seven year cycles.

Post-privatisation, a number of different tendering approaches have been taken:

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- July 1985 to May 1996 – Gross cost contracts;
- June 1996 to July 1998 – Net cost contracts, with revenue risk transferred to operators to provide financial incentives for improved performance;
- August 1998 to September 2000 – A short return to gross cost contracts in the run up to the introduction of a new approach; and
- October 2000 to date – Quality Incentive Contracts ("QICs").

The London bus market is now dominated by large transport groups such as Arriva, First and Go-Ahead, many of whom also operate rail services in the UK. There are also a limited number of smaller operators, e.g. NSL Services (formerly NCP Challenger), Quality Line (Epsom Buses) and Hackney Community Transport ("HCT").

Whilst historically many new operators have entered the London market, it is becoming increasingly difficult for new entrants to break in due to the consolidation of the current owning groups and the requirement for depot ownership. The last newly established entrant was NCP Challenger in 2005. Since then, market entry has primarily been through acquisitions, e.g. Macquarie's purchase of Stagecoach's London bus operations in 2006 and NedRailways' purchase of National Express's London bus operations in May 2009.

5.1.3 Tender process and specification

TfL retains a list of pre-qualified bidders, all of whom are notified when a route is due for retender and asked whether they wish to express interest in bidding. Any pre-qualified party that expresses an interest is sent the tender documentation.

Many routes may be tendered in a single tranche but each will be bid, priced and evaluated individually. The template tender document for the QIC contract specifies a base case proposition that includes:

- The service frequency to be operated, by quarter hour period of the day, for each part of the route;
- The exact routing of the service, including the bus stops and stands to be used;
- The specification of the bus, including: age; capacity; maximum length and height; disability features; doors; emission standards and passenger comfort items;
- Punctuality standards, as measured by Excess Waiting Time ('EWT'), including triggers for penalty or bonus payments;
- Service quality standards (the Customer Experience Performance Regime - 'CEPR');
- The Contract Price Adjustment process which indexes the bid price each year by a weighted portfolio of inflation indices;
- Ticketing, communication and information systems support; and
- Safety and maintenance standards.

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The level of TfL base case specification has steadily increased in recent years and operators have commented that they perceive it as prescriptive. Operators can propose an alternative tender and vary elements of the specification. However in practice there are very few examples of TfL accepting an alternative offer from the operators and for this reason few alternatives tend to be offered.

5.1.4 Bid evaluation

TfL evaluates bids from a cost, quality and deliverability perspective. The evaluation process is less formally defined than the equivalent framework used by the DfT for rail franchises.

Bidders submit a contract price as part of their financial submission, in a template format prescribed by TfL. It is this single number that is used as the basis for the financial decision. Operators may offer combination bid discounts on where multiple routes are being competed simultaneously.

The lowest cost bid does not always win; the evaluation also considers deliverability, the level of operational risk, etc. Deliverability is assessed by evaluating:

- Proposed performance targets,
- Staff and resource requirements,
- The depot from which the route will be operated and proposed maintenance activities,
- The age and quality of the proposed vehicles,
- The number of buses used to meet peak demand; and
- The provision of spare vehicles to cover maintenance and breakdown.

Recently there has been a high retention rate for incumbent operators, with about 80% of incumbents retained.

5.1.5 Mobilisation

The mobilisation period between contract award and the commencement of operations is usually 9-12 months. This period is designed to be sufficient to enable the procurement of new buses and the recruitment and training of staff.

5.1.6 Contract term

TfL offers each contract for up to seven years, structured as an initial five year term with a potential two year extension. TfL management believes that competition during the tender process is the primary driver of taxpayer value, and therefore that contract length should be limited to less than ten years.

Operators automatically qualify for the offer of the two year extension if performance meets or exceeds the threshold criteria set out in the contract. Operators are free to accept or reject the offer of an extension.

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Between January 2005 and March 2009 around seventy five percent of contractees have been offered extensions, with ninety five percent accepting. This high rate of acceptance suggests that operators consider the structure of the extension to be either financially or strategically attractive.

5.1.7 Risk transfer

Under London bus contracts, TfL retains 100% of farebox revenue risk. Most non-farebox revenue, such as property income at the major bus stations and advertising at bus shelters, is also retained by TfL. The only significant income item for which risk rests with operators is on bus advertising.

Operators are responsible for cost risk, but are partially protected by indexation adjustments governed by the Contract Price Adjustment (CPA) mechanism. The mechanism is based on a weighted average of annual earnings, RPI and fuel indexation and also includes a proportion that is fixed in nominal terms. The objective of the CPA is to reflect key industry cost drivers without providing operators with total cost protection. The CPA weighting is shown in the table below.

Figure 50: Operating costs CPA weightings

Operating cost category	Contract price adjustment %
Driver wages and on-costs	62 percent (linked to national AEI)
Other labour and staff costs	
Fuel	7 percent (linked to DERV average retail price – DBERR energy trends)
Insurance and claims	16 percent (Linked to RPI)
Maintenance materials	
Other operating costs	
Vehicle depreciation (and profit margin)	15 percent (nominally fixed)
Total	**100 percent**

Source: TfL

5.1.8 Service quality and incentive regimes

QIC contracts were first introduced in 2000. Each contains a contract-specific Minimum Performance Standard (“MPS”) that takes into account the operating conditions and characteristics of the route and past performance levels. The MPS will normally remain fixed for the life of the contract, unless circumstances change significantly.

Operators are provided with incentives to deliver the scheduled mileage on each contract, with deductions made for mileage not operated for reasons within the operator’s control. Some lost mileage is classified as “non-deductible” - most notably that caused by severe traffic congestion.

Bonus and penalty payments are calculated by an annual comparison of the actual reliability of the route to the MPS. Payments and deductions are based on graduated scales. Bonus payments are made at a rate of 1.5% of the contract price for each step

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achieved above the standard and are capped at fifteen percent of the contract price. Deductions are made at a rate of 1% of the contract price for every step below the standard and are capped at 10% of the contract price.

QICs bonus and penalty payments remained relatively stable at between £55-£65 million and £2-£2.5 million respectively in the four years to 2007/08. However, in 2008/09, the level of bonus payments fell. TfL Management has informed us that it expects this downward trend to continue as minimum performance standards have been tightened.

The improvement in EWT (in minutes) that has occurred since the introduction of QICs is as follows:

Figure 51: Improvement in Excess Waiting Times ("EWT")

Year	1994 / 05	1995 / 96	1996 / 97	1997 / 98	1998 / 99	1999 / 00	2000 / 01
Excess Waiting Time	1.8	1.7	1.8	1.8	2.0	2.1	2.2
Year	**2001 / 02**	**2002 / 03**	**2003 / 04**	**2004 / 05**	**2005 / 06**	**2006 / 07**	**2007 / 08**
Excess Waiting Time	2.0	1.8	1.4	1.1	1.1	1.1	1.1

Source: TfL – London Travel Report 2008

In an effort to maintain operator incentives to continue to deliver a high quality service, a new contract, QIC 2, is now being piloted. The first pilot commenced in October 2008 and included mystery traveller surveys to assess driving performance. The pilots have recently been extended for six months, with the scope expanded to incorporate an assessment of vehicle condition and cleanliness, monitored by vehicle inspections undertaken at bus stands.

In developing the QIC 2 pilot schemes, TfL has negotiated with operators. Performance payments or deductions are determined by assessing operators against network-wide standards. Payments are based on the degree of out-performance/ underperformance against these standards.

The QIC 2 pilot schemes will shortly be assessed by TfL, at which point it will decide whether to make the arrangements permanent.

5.1.9 Investment

The majority of significant investment, particularly in respect of infrastructure and systems, is specified, funded and managed by TfL and the highways authorities (normally the London Boroughs). Operator investment is generally limited to the procurement of new buses at the start of the contact. Operators use a range of financing models to fund bus investment, the most common of which is direct ownership. The average life of a bus is 15 years, roughly double the length of a TfL bus contract. It has become standard practice for the operators to take a commercial view on the residual value of a new bus at the end of the first contract term and depreciate the bus over two contract terms. If an

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operator fails to retain a London contract the buses are sold, sub-leased or cascaded to operations elsewhere in the UK.

5.1.10 Relevance to the DfT

The London bus specification and procurement process is considered to be of limited relevance to the DfT's rail franchising process as the models are so different. However, there are some relevant points arising from TfL's experiences:

- Competition during the bid phase is the primary driver of taxpayer value, and contact lengths should therefore not be greater than ten years;
- The level of specification undertaken by TfL has progressively increased with the aim of improving service quality. Due in part to the current high levels of specification, there are limited examples of bus operator innovation or investment;
- The trade-off between price and quality during bid evaluation is not formalised and relies on a degree of management judgment. This has increased TfL's level of flexibility;
- Bus bids are simpler than rail franchise bids, with commensurate reductions in transaction costs (although there are still some costs);
- Bus and rail contacts both use contract extensions to incentivise improved performance and reward operators that achieve performance targets; and
- The 'QIC 1' contract has been associated with the successful delivery of improved operational performance. Initial findings from QIC 2 suggest that contract design can also be used to improve service quality. However, significantly, both of these incentive regimes have led to increased costs for TfL.

5.2 Docklands Light Railway

5.2.1 Overview

The Docklands Light Railway ('DLR') network comprises 34 km of railway with 40 stations. The system carries 67 million passengers a year and journey numbers are expected to grow considerably in the coming years as a result of extensions to the network. Work to upgrade the system to accommodate three-car trains is also underway and the first of these will enter service in 2010.

When originally constructed in 1987, the DLR was a wholly-owned subsidiary of London Regional Transport. Thus the public sector had responsibility for the operation of services as well as for the maintenance of track, signalling infrastructure and rolling stock. In 1994, in line with prevailing government policy, the decision was taken to let the operation and maintenance of the DLR network as a franchise. This franchise is now let and managed by Docklands Light Railway Limited (DLRL), a subsidiary of TfL.

5.2.2 Franchising history

The original DLR franchise commenced in 1997. The winning bidder was a management buy out backed by Serco. Subsequently Serco fully bought out the management and took

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over the ownership of the franchisee. The first contract included infrastructure and rolling stock maintenance. Revenue and cost risks were transferred to the franchisee.

The original franchise expired in March 2006. Prior to the re-let, the allocation of risk to the operator was reconsidered. It was decided that, given that TfL held most of the levers that impact patronage, it would be more appropriate for it to retain revenue risk. This decision was also influenced by several major Mayoral policy decisions, (e.g. with respect to concessionary fares), which had required TfL to make multi-million pound compensation payments to operators such as DLR and Croydon Tramlink. The compensation mechanisms had proved difficult to operate.

An ITT for the second DLR contract was issued to four bidders and two bidders were taken forward to a 'competitive dialogue' / BAFO phase. Following this process, Serco was awarded the second round contract.

5.2.3 Tender specification

The ITT issued by DLRL specified the service headways that must be provided and bidders were responsible for determining the most appropriate timetable to meet those requirements.

DLRL also set performance and facility availability targets that required improved service quality over the franchise term. The targets cover:

- Base service departures;
- Service reliability;
- Facilities (lifts, escalators, ticket machines and information displays); and
- Performance in quarterly customer satisfaction surveys.

Each of these targets has associated financial rewards or penalties.

Other aspects of service quality were specified by DLRL. For example, a target score for cleaning is specified in the contract and a bonus is paid if the franchisee outperforms the target.

5.2.4 Franchise term

The core term of the franchise is 7 years, with DLRL (only) having the right to the term for 2 years if it so wishes. The extension was priced in the bid.

5.2.5 Risk transfer

Whilst DLRL retains revenue risk, the franchisee nonetheless receives a payment of 10p per passenger as a revenue incentive. This payment was introduced into the second franchise contract, when revenue risk returned to the public sector, as an incentive for the franchisee to grow patronage and undertake revenue protection. When there are possessions on the Jubilee Line, however, extra DLR services do not tend to run,

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indicating that the additional payments may not cover the incremental costs. DLRL therefore also retains some staff to plan and market the service.

The franchisee retains cost risk and the core payment to the franchisee is indexed by RPI.

The performance regime is based around four factors:

- Departures – no. of departures compared to the service schedule;
- Reliability – arrival time at destination (within 3 minutes of schedule) and delivery of intermediate stopping pattern;
- Journey time – % of services that arrive at the destination within the contracted time; and
- Absence of service – if there is no train for a period of more than 20 minutes and the reason is within the franchisee's control then there is an additional penalty of **£[REDACTED ON GROUNDS OF COMMERCIAL CONFIDENTIALITY]**.

During the second round of franchising, the quantum of penalties / bonuses was also significantly increased, reflecting the removal of revenue risk from the franchisee. Payments were set at a level where they were not merely the "icing on the cake" and the operator needed to meet the targets to achieve its desired return. Performance has dipped recently and the operator has seen its returns fall.

5.2.6 Service quality

Cleaning is measured through customer satisfaction using a survey approach similar to NPS. The franchisee has a target score and receives a bonus for outperformance. Cleaning is not explicitly audited and it is believed that the franchisee has recently cut cleaning levels as it feels that the key drivers of passenger satisfaction are performance-related and not significantly influenced by this factor.

5.2.7 Operator investment

The operator has a limited role in respect of investment. Major projects, such as the extension to three car operation, are specified and funded by TfL.

5.2.8 Contract management

The structure of the DLR contract requires DLRL to have a much larger contract management team than that at the DfT for its rail franchises - especially when the size of the operation is considered. DLRL leads the analysis of market demand for extra services and as a result it has to retain operational and analytical capability in-house. In addition, DLRL has to develop longer-term policies and strategies in areas such as the rolling stock maintenance cycle, since the length of the contract does not incentivise the franchisee to consider whole life cost implications.

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5.2.9 Relevance to the DfT

- Single source negotiations – DLRL faces similar issues to the DfT when it enters single source negotiations with the franchisee. It is felt that these single source negotiations do not maximise value for money so, if possible, any action that requires such interaction is delayed until the franchise is next re-let. In some cases, however, such as arrangements in respect of the London Olympics, these negotiations cannot be avoided; and
- Contract management - a predominantly gross cost contract such as this requires a large range of in-house skills, e.g. in relation to service planning and marketing.

5.3 State of Victoria, Australia

5.3.1 Overview

The Melbourne tram and train system is one of the largest urban transit systems in the world. The train system has 371 route km and 209 stations and the tram system has 242 route km and 1,740 tram stops. The system carries 131m passengers per annum.

The Government decided to privatise the system in 1997 in order to improve efficiency and service delivery. Given that the system was heavily loss making and that continued operations would require not only financial support but also detailed oversight from Government, a franchising approach was selected.

These franchises, first let in 1999, are now in their third generation. Each franchise is a vertically integrated business with the franchisee responsible for service delivery and the maintenance of infrastructure and rolling stock assets. The franchisee also works in partnership with the State to deliver projects.

An understanding of the Melbourne experience is considered be of value as part of this study as Victoria initially followed a similar model to the UK but has since revised its approach to issues such as risk transfer and the length of contracts. The DfT is currently considering its approach to such issues.

5.3.2 Franchising history

When the franchises were initially let, there were two tram franchises and two train franchises. Two of the franchises (one train and one tram) were let to National Express. The remaining train franchise was let to Connex and the remaining tram franchise to Yarra Trams (a partnership between Transdev and Transfield Services Ltd).

However, within three years of privatisation, the Melbourne system was in financial crisis. National Express had walked away from its contracts, foregoing a significant termination payment. Yarra Trams and Connex were also facing severe financial difficulties. Key factors in this financial instability were:

- Assumptions by the bidders in relation to patronage growth and cost reduction (by far the most significant influencing factor) that did not ultimately occur; and

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- Flaws in, and disputes over, the contractual arrangements. The most notable of these were the output-based infrastructure maintenance regime and disputes over the allocation of revenue between different lines.

In 2004 the initial contracts were terminated and the franchises consolidated to form one metropolitan train franchise and one tram franchise. Short-term contracts (5 years with a priced option period of a further 18 months) were then negotiated on a single source basis with the remaining incumbent operators, Connex and Yarra. This second generation of the arrangements introduced more balanced risk sharing, including revenue downside protection for the operators and an upside profit sharing arrangements with the State.

These new agreements ran until 2009. The franchisees entered into revenue share early in the contracts as the system experienced significant demand growth from 2004 and, influenced by the initial round of bids, Connex and Yarra had been conservative in their projections.

5.3.3 2009 franchise proposition

Following a lengthy competition process, in June 2009 the State of Victoria awarded its train franchise to MTR and its tram franchise to Keolis. These new franchises were due to commence on 30 November 2009. Discussed below are those features of the competition process and the contract considered to be most relevant to this study.

At the outset it should be noted that the key aspiration of the State was to move from an adversarial contractual relationship with the franchisee to a philosophy of partnership. It was considered that this was the type of arrangement most likely to deliver the infrastructure and other improvements necessary to improve the public transport network.

5.3.3.1 *Tender specification*

The ITT document specified a base case proposition. This included:

- The service pattern to be operated by the franchisee in terms of a base timetable (including changes to this timetable within the next 12 months – this was set at the beginning of the franchise due to the time required to take these through the consultation and approval process);
- The punctuality standards demanded by the Operational Performance Regime (‘OPR’) over the term of the franchise;
- The service quality standards demanded by the Customer Experience Performance Regime (‘CEPR’) over the term of the franchise;
- The mechanisms around revenue and other risk transfer;
- Inputs in respect of infrastructure maintenance; and
- The major investment projects that were anticipated over the franchise term.

This specification related to the eight year initial term and the three year priced extension (see 5.3.3 below).

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The level of specification around service levels and quality has remained fairly constant since the first round of franchising in 1999, but has increased/decreased in certain specific areas. For example, infrastructure maintenance has moved from an output-based specification in 1999 to a more input-based specification in the current and new franchises, with substantially more involvement by the State in maintenance spend prioritisation/scheduling. This intends to mitigate issues with the 1999 regime around measuring and addressing asset condition deterioration. In contrast, due to the impact of significant patronage growth on the train network particularly, service patterns are now defined by an agreed timetable, rather than a PSR. Changes to the timetable can, however, be made via a discussion-based approach between the franchisee and the State. The net result is arguably therefore more flexible than a PSR.

In addition the State has progressively taken back more risk since 1999. For example it has:

- Provided protection against the introduction of an emissions trading scheme;
- Mitigated revenue risk through a tighter revenue share / support combined with a new revenue reset mechanism;
- Limited operators' maximum monthly exposure in respect of performance penalties; and
- Retained rolling stock cost risk.

This reflects:

- Movements in acceptable levels of risk transfer between 1999 to current practice, reflecting a more mature market which is also influenced by the level of risk taken under, for example, PPP and other contracting approaches;
- Areas of concern from the private sector about the structure and risk profile of the previous franchise arrangements, particularly the difficulty in estimating patronage and therefore farebox revenue for the full contract term; and
- The current situation on Melbourne's public transport network, and the impact of the significant increase in patronage on the level of on-time performance and therefore the impact on margin from the OPR regime.

This has served to reduce margins by about 1-1.5% in the new franchises.

Bidders had the flexibility to include priced options in their submissions. However in reality, very few options that were offered were actually taken forward by the State. It tended to be that new bidders included options that had previously been discussed by the State with the incumbent operators and that had previously been found to not be attractive.

5.3.3.2 *Bid evaluation*

The recent Melbourne franchises were awarded on the basis of a number of operational, financial and legal criteria:

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Contracts were not necessarily to be awarded to the lowest cost bidder. However, during the evaluation, the approach to making trade offs between price and quality in respect of the different evaluation criteria was not formalised. Bidder selection was determined by the judgement of an evaluation panel which weighed up this trade off. In the recent competition the State selected the bid which gave it the highest short, medium and long term benefit for the lowest cost - i.e. the highest quantitative plus qualitative value for money outcome.

The State had a combined budget for train and tram franchises. The bids came in within the budget, but if they hadn't then the State would have been required to de-scope some projects and reduce quality.

5.3.3.3 *Mobilisation*

The new franchisees have around 3 months to transition with formal transition having been due to end (and franchise commencement occur) on 1 December 2009. Transition involves formally changing over from the existing franchisee to the new franchisee and from the existing franchise arrangements to the new franchise arrangements and includes a range of operational, asset, contractual, employee and financial processes. The part of the transition that relates to re-branding and updating rolling stock will take place during the term of the new franchise.

On franchise commencement there will also be a revenue reset to take account of (and therefore shield the new franchisee from) any difference between the level of farebox revenue at franchise commencement estimated at bid stage and the actual level of farebox revenue at franchise commencement. This works as a 100% reset.

5.3.3.4 *Franchise term*

The State offered a franchise term of up to fifteen years to encourage a long-term partnership between the State and the franchisee. The franchise term is structured as follows:

- An initial term of eight years;
- A unilateral right for the State to extend the Initial Term for a period of up to three years via a priced extension;
- The franchisee may earn the right to negotiate an extension of the franchise by a further period of seven years, subject to meeting specified performance criteria and certain minimum requirements, via an unpriced extension; and
- A successfully negotiated unpriced extension will supplant the priced extension, so that the maximum period of the franchise term will be fifteen years.

The State also retains the right, in certain circumstances, to terminate the franchise at any point during the franchise term. The performance criteria relating to the right to negotiate an unpriced extension comprise two fixed criteria and three flexible criteria. The two fixed criteria are:

- The successful achievement of the reliability benchmark; and

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- The successful achievement of the CEPR benchmark.

The three flexible criteria will be defined by the State on an annual basis during the course of the franchise as part of the business planning process. The criteria will reflect operational issues relevant at the time. These may reflect performance in relation to:

- Operations, for example fare evasion reductions, timetable development;
- Customer experience, for example customer information, crowding management; and
- Infrastructure maintenance and projects, for example station upgrades, track quality improvement.

The franchisee must meet the required average score in four out of five performance criteria in four out of the first six years in order to secure the right to negotiate for an unpriced extension.

The negotiations for an unpriced extension will be subject to the principles specified in the Franchise Agreement, which include a requirement that the franchisee negotiates costs and risks on an open-book basis. The State will seek to achieve value for money outcomes and acceptable contractual, commercial and financial terms as part of its negotiations with the franchisee, but will not be obliged to accept the outcomes of any negotiation. If the negotiation between the State and the franchisee does not result in the parties reaching an agreement, then either the State will exercise its right to a priced extension for a period of up to three years, or the franchise will expire at the end of the initial term.

These arrangements provide the State with maximum flexibility. If the State finds that the franchisee is meeting the required contract extension criteria, and it is working successfully with the franchisee and its projects are being delivered, then it might consider that there is relatively little benefit in disrupting this relationship with a franchise competition. Therefore, it would seek to reach agreement with the well performing incumbent operator for a further seven years.

The possibility that the potential seven year extension would incentivise operators to invest in the franchise or develop innovative investment proposals beyond those currently envisaged was not a critical consideration in including this mechanism in the contract, although the bidding community reacted very positively to the concept (even though it is unclear what, if any, financial value they placed on it).

5.3.3.5 *Risk transfer*

Given the franchisee's ability to influence farebox revenue through marketing, operational performance and the management of fare evasion, non-farebox revenue risk is transferred to the franchisee.

The allocation of public transport farebox revenue will be fixed and allocated to each of the franchisees and the bus operators in the following proportions during the course of the new contracts:

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- Tram franchisee – 30%;
- Train franchisee – 40%; and
- Bus operators (with the bus proportion retained by the State) – 30%.

A risk sharing mechanism will protect the franchisee from any unforeseen volatility in revenue and ensure the State and the franchisee share in the benefits of significant farebox growth. This mechanism will operate as follows:

- The franchisee is required, at the time of the bid, to develop a real expected farebox revenue forecast for each financial year of the initial term and priced extension (11 years in total);
- A cap and collar will be set around the franchisee's real expected farebox revenue forecast equal to 30% of the franchise margin; and
- The cap will be applied on a semi-annual basis and the State will share 50% of upside benefit above the cap and 50% of downside risk below the collar.

In addition to the cap and collar, at the commencement of the franchise and the end of year two and seven months, year five and seven months and year eight and seven months, the State will undertake a reset of the farebox revenue parameters. The reset will involve:

- The State undertaking a full adjustment of the franchise sum, reflecting the difference between the franchisee's forecast line and actual farebox revenue;
- The franchisee's forecast growth trends will not be amended at the time of each re-set but will remain in line with the franchisee's original forecast; and
- The forecast growth will be applied to the actual farebox revenue which was achieved immediately prior to the reset.

The State is responsible for setting public transport fares in Victoria. Fares will be increased in line with Australian CPI on 1 January each year, based on the CPI data for the preceding September.

Under this approach to revenue risk transfer is that whilst the franchisee is left with a relatively strong marginal incentive (50% of revenue) to maximise the farebox, the level of revenue risk transferred remains manageable.

The cap and collar offers downside protection to the operator whilst also allowing the State to share in any upside. The benefits of combining this mechanism with a reset include:

- If there was an error in the early part of the bid then this would not be compounded across the franchise term; and
- It allows the level of support / share in the cap and collar to be limited to 50%. If the reset did not operate, these would need to be higher, as in the UK, and marginal incentives would be blunted.

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It is important to note that by applying bid growth rates to calculate future revenues at the time of the reset a single source negotiation between the State and the franchisee around revenue forecasts is avoided.

Franchisees are expected to take the bulk of the cost risk but there are a number of cost areas where the State has adopted specific risk-sharing arrangements. They include:

- Costs associated with certain insurances;
- The impact of the introduction of the Federal Government's Carbon Pollution Reduction Scheme; and
- Leave liabilities and long service leave payments.

5.3.3.6 *Service quality*

There are two fixed criteria – the performance (i.e. punctuality etc) regime and the customer experience (CEPR targets).

The punctuality regime exposure is now capped at AUS $1m per month for the train operator and AUS$500k per month for the tram operator. This is against average monthly bid profits of $3.5m AUS and $1.5m AUS respectively. These caps are at less than the historic penalty levels.

The new CEPR regime was brought in with the new Franchise Agreement, and covers the "softer" type of service requirements for both rolling stock and infrastructure, for example litter removal, graffiti removal, station lighting, etc. There is an associated financial incentive/penalty regime with this time an annual cap of AUS $1m for the train operator and AUS$500k for the tram operator.

Public procurement rules have driven certain elements of the contract in respect of service quality. For example, there must be clear performance criteria which can be demonstrated to have been met in order to allow the State to enter into a single source negotiation in respect of the unpriced extension.

5.3.3.7 *Operator investment*

The majority of investment, particularly in respect of infrastructure, is determined by the State and has been included in the franchise specification. The contract includes a 'Projects Agreement' which governs how large scale investments will be undertaken. Generally, the State is an 'intelligent client' and has a strong view as to how it wants the network to develop over time. The State does, however, seek a collaborative approach to delivering this investment. There is a regular forum called the Network Development Partnership (NDP), which includes senior representatives of the State and the franchisee. The NDP's role is to consider service planning, investment decisions (including the short but also long term) and other operational challenges, and is the ultimate body responsible for developing the strategic operational plan for the network/franchise. An informal (non-contractual) NDP was introduced in the last 2 to 3 yrs of the last train franchise, with much success during the challenging times of 10% plus per annum patronage growth. This approach has now been replicated contractually across both new franchises.

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The franchisee can undertake smaller scale investments provided it gives the State certain guarantees, e.g. over intellectual property. The Projects Agreement sets out processes for operator-initiated investment. There are no set mechanisms, however, to encourage operator investment in projects that accrue benefits beyond the end of the franchise. However, there is scope in the Projects Agreement to agree a deal to share costs depending on the payback period. Alternatively the operator could approach the state for complete funding.

5.3.4 Relevance to the DfT

The Melbourne experience is of interest to the DfT since the contracts were initially based around the UK model but subsequently have been amended in respect of contract length and risk transfer. However, in drawing on any lessons, it is important that the Melbourne context is well understood. The Melbourne franchises are vertically integrated businesses. Therefore the franchisee has responsibilities over and above those of UK TOCs, e.g. maintenance of the infrastructure and rolling stock. In this context, it is perhaps not surprising that the latest generation of contracts have placed a strong emphasis on partnership working and maintaining a stable operating environment.

Given the issues that the DfT is currently considering around franchising, the following points are of note:

- The level of specification undertaken by the State has in the latest round of franchising increased in some areas and decreased in others, reflecting movements in the level of acceptable risk transfer and other market developments between 1999 and 2009;
- The current proposition offers the franchisees a potential 15 year term. However, this is at the discretion of the State and is in place to provide the ability to continue with a franchisee that is considered to be working;
- At the time of contract award the potential seven year extension is unpriced. The DfT informed us that it believes that it is unlikely that such an arrangement would be permissible under UK procurement rules; and
- The revenue reset mechanism offers an alternative approach to providing greater financial stability. However, it should be emphasised that farebox revenue is a smaller element of each of the Melbourne franchisee’s finances than is the case with UK TOCs – particularly commuter and inter city operations. As well as growing farebox revenue, the operator has responsibility for controlling infrastructure and rolling stock costs. Therefore having regular revenue resets is potentially less likely to introduce perverse incentives in franchisee behaviour than might be the case in the UK system, where businesses have a higher operational gearing.

5.4 Stockholm Metro

5.4.1 Overview

The Stockholm Metro system is owned by the Stockholm County Council through AB Storstockholms Lokaltrafik (SL). The metro system includes three different lines, the

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oldest of which opened in 1950. The infrastructure (i.e. track, depots, rolling stock and stations) are owned by SL.

Metro operations were initially procured between 1994 and 1996. In this period, SL Tunnelbanan AB, a subsidiary of SL, won all tenders and indeed for the final competition, line 1, was the only bidder. CGEA (today Veolia) and BK tåg/VIA Transport (today Keolis) also competed in the other two tenders.

In 1999, 60% of the shares in SL Tunnelbanan AB were sold to CGEA (Veolia), who also took over the operation of the metro. At the end of 2002, SL sold the remaining stocks in Connex Tunnelbanan AB to Connex Transport AB. The agreements under which Veolia operated were the original contracts signed between 1994-1996 with many addendums and amendments.

5.4.2 Franchising

A second round procurement was undertaken in 2008 and the bidders who competed for the contract were a consortium of Arriva and Keolis, a consortium of ISS TraffiCare and Svesnka, MTR Corporation Ltd, S-Bahn Berlin, a consortium between EurailCo S.A. and DSB and Veolia. MTR won the competition.

In the new contract the franchisee is responsible for operation, customer service, cleaning and snow clearance. The contract also includes maintenance of the fleet, which until then was undertaken by a joint venture between SL and the incumbent operator (Veolia). MTR plans partner with Norwegian firm Mantena for rolling stock maintenance.

The contract is for an initial term of 8 years, with an option for an additional 6. Under the contract, demand risk is retained by SL. MTR receives a commission for ticket sales as an incentive to increase patronage.

The new franchise involves less specification than the previous contract and is more output-based.

5.4.3 Evaluation

Bids were evaluated on quality and price. In the final evaluation, the scores were assigned a quantitative value, with the total price adjusted for deviations in the quality score between bidders.. The resulting quality adjustments across all metrics was added to the tender price in deciding the final tender price. The bid with the lowest total price + comparative price for quality was considered to be the most economically advantageous offer.

Since the evaluation, Veolia has appealed to the Administrative Court of Appeal, the County Administrative Court and finally to the Supreme Administrative Court as it believed the weights between quality and price to be in conflict with public procurement and EU law. The Supreme Administrative Court, however, backed SL's process and confirmed MTR as the winner of the competition.

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5.4.4 Service quality

In the contract SL will pay MTR a fixed price each year, and the contract also contains financial incentives based on the number of trains run, cleanliness, punctuality and customer satisfaction. Customer satisfaction is measured by specific indices and includes passenger survey results.

In terms of punctuality, the following criteria are measured:

- The traffic solution's sensitivity to disturbances. SL performed a simulation of the tenderer's traffic solution applicable from the year 2010. In the simulation, the traffic solution of each bid was subjected to different types and degrees of disturbance, e.g. traffic congestion or an event that caused single-track traffic;
- Strategies, planning and optimisation of maintenance resources (rented maintenance reserve, workshop equipment, replacement units as well as manning and supply of spare parts);
- Methodology for, and ability to carry out improvements/rationalisations relating to, vehicle maintenance; and
- Strategy and concrete development plan for vehicle maintenance during the term of the agreement.

5.4.5 Relevance to the DfT

Stockholm provides an example of an alternative bid evaluation approach where price and quality are explicitly and quantitatively traded.

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