Train Operators Working Together ATOC

Franchise reform

and better value for money in rail

March 2010

The Association of Train Operating Companies (ATOC) is the national voice for train companies in Britain.

ATOC's mission is to work for passenger rail operators in serving customers and supporting a prosperous railway. We do this in three main ways:

> Running services which are mission-critical to passenger operators, such as National Rail Enquiries and the Rail Settlement Plan

> Managing major commercial arrangements where a collective approach delivers benefits for passengers, including railcards and promotional fares

> Striving to create a positive business environment for train companies, by building strong relationships within the rail industry, the broader business community and key policy makers.

Executive Summary

In October 2009, ATOC published proposals for a smarter approach to franchising, *Franchise Reform – a better railway for passengers and for taxpayers*. The report argued that giving train companies a greater stake in the railways through longer, more robust and more output-oriented franchises would increase the focus on better quality for passengers and speed up delivery of improvements.

The report also highlighted the opportunity for reform to give taxpayers a better deal for their money, by enabling train operators to deliver some rail projects at lower cost and by improving the prospects for attracting more finance into rail.

Since then, the Government has announced a value for money review of rail, to be chaired by Sir Roy McNulty, a final report from which is due in March 2011. The remit for the review is substantial and the review team has indicated that there are no "no-go" areas for their work.

This paper takes forward the proposals identified in *Franchise Reform* and indicates how longer franchises could help improve industry value for money and thereby support the work of the McNulty review. A smarter franchise system can help harness private sector disciplines to facilitate savings by TOCs, by Network Rail (NR) and in the management of the interface between them. In our view, this is a preferable route to other options open to Government, such as scaling back project commitments or funding those commitments through ever higher levels of Network Rail debt.

This paper seeks to give a sense of the scale of the opportunity that giving a greater role to train operators would generate. It provides a headline indication of the possible financial savings based on TOCs' experiences with franchises and NR schemes in recent years. Much more detailed work, largely on a franchise-by-franchise and scheme-by-scheme basis, is needed to assess the possible savings in detail. NR is already beginning to make significant progress on cost efficiency and deserves considerable credit for this. Our contention is that an appropriately designed long franchise structure would help this process to go further and faster.

The paper provides an indication of the kind of cost savings that we believe might be possible from actions taken over the next few years, by doing two things:

- It reviews the six areas of franchise reform identified in the ATOC report and their potential impact in terms of costs savings. It provides a reminder on each area of reform taken from the report's executive summary, followed by a brief commentary and figures where possible (which, in some cases, have been estimated since the report was published).
- The table below summarises the combined potential impact of action in these areas. The benefits flow through in various ways, such as lower costs incurred by TOCs in running operations or preparing bids; lower investment costs (both infrastructure and rolling stock related) through more rigorous scoping of projects and application of private finance disciplines; and lower DfT running costs in managing franchises and holding competitions.

It is important to be clear that not all of the efficiencies identified can be realised in the short term: for example, cost savings from efficiencies in the franchising process (some £60m in a typical five year period) will only come through as franchises are rebid. We believe that over time annual savings in operating costs of up to c. £250m are possible, and that potentially up to £1.7bn of the costs associated with investment projects might be saved by 2014 (the end of the current five-year rail investment period, CP4).

Whilst these reforms could be seen as a menu of separate initiatives, taken together they reinforce each other to deliver still greater efficiency. For example, the combination of longer franchises and the experience gained from doing more would give TOCs both the long-term interest in the network and the data to challenge Network Rail more effectively on the scope, standards and costs of the renewals and enhancement work it undertakes.

This paper provides very much a headline indication of the financial benefits of our proposed measures. It does not seek to identify all the scope for cost savings in the rail industry and further work would be needed to confirm the initial figures. But we hope the paper will give some sense of the scale of opportunity from creating a greater role for train operators.

Initiative	Annual operating account savings, once policy fully implemented	Savings on investment project costs over five years
Savings in train company's costs, arising from longer franchises	£150-£210m	
Additional revenue generated through better revenue share/ support mechanism	£30m	
DfT Consultancy Savings	£8m	
Total eventual annual savings	**£188-£248million**	
Savings on stations and depots		£250-£500m
Reduction in NR spending (in addition to stations and depot savings)		£600m-£1.1bn
Efficiency savings from TOC led rolling stock procurement		£20-£60m
Total Investment Cost Savings by 2014		**£870m-£1.7bn**
Typical Savings in bid costs from longer franchises		£60m over 5 years

Financial benefits of franchise reform

This paper comments on, and where, possible provides high level estimates of the potential cost saving from the proposals for franchise reform identified in the October 2009 ATOC report. Each section begins with the relevant text from the executive summary of the report.

1. Allow train companies greater flexibility to give passengers what they want

Too many franchises are over-regulated and micro-managed by the Department for Transport (DfT), which specifies timetables, frequency of trains, rolling stock and even the number of ticket vending machines.

DfT should continue monitoring franchises closely, but by concentrating less on inputs and more on setting outputs for TOCs to deliver in the most effective way, covering areas such as operational performance, passenger satisfaction, train and station cleanliness, and capacity provided in peak hours.

Such an approach is consistent with advice on Government procurement, has been used before in delivering rail improvements, and is appropriate for a market made up of major players with a track record in delivery.

Allowing TOCs more opportunity to innovate would help them to deliver better services to passengers faster, offer scope to cut the overall cost to taxpayers of providing rail services – and potentially cut by one third the £24m spent by DfT Rail and National Networks (2007/08) on consultants.

This approach seeks to offer better value for money and faster delivery of improvements. Franchise competitions today are essentially about costing a government specification of both timetables and rolling stock, and assume the specification is right for the market on that franchise. In effect, Government has replaced the market in determining what a franchisee should deliver.

Apart from the modest scope for reducing DfT Rail consultancy costs highlighted in the report, an output-based approach would encourage bidders to research the market and find timetable, rolling stock and service plans that generate more revenue than the government specification or which have more efficient rolling stock requirements (and hence cost less). Elements of this already happen on a selective basis (eg the Southern rolling stock plan, under which the winning bid proposed a better rolling stock plan than the DfT original plan). By market testing outputs and rolling stock plans in every case, efficiency can be increased. It is hard to be sure what benefit this might bring, since it is a number of years since this approach was last used.

2. Adopt longer franchises as the norm

Longer franchises are already used successfully in Britain: the three TOCs with the highest scores on performance and passenger satisfaction today have franchises of 15 years or more.

Longer franchises may not always be suitable, but we think the norm for franchises should be 15 years, and possibly 20 years in some cases, as allowed under EU law – backed up by mechanisms which exist to protect passengers and taxpayers where a TOC fails to meet its commitments.

Longer franchises would help in three ways. They would foster more TOC managerial focus on improving services for passengers, rather than looking ahead to the next bid. They would facilitate more private sector investment, by giving operators more time to benefit from their outlay – and strengthen TOCs' current commitment to the long-term development of the network by giving them a greater stake in the railways.

Experience of the few franchises which have been let for more than seven years (the current norm) gives a good indication of the potential value which longer franchises may be able to bring.

The line between London, Tilbury and Southend (c2c) has a 15 year franchise; it was let in 1996 when franchises were not tightly specified by government. This flexibility has enabled its management to focus on delivering to its customers, improving the station environment, introducing a wholly new fleet of trains and focusing on operational performance. This has transformed what was once known as the "misery line" into a TOC with some of the highest levels of customer satisfaction and punctuality, within the support profile of the original franchise bid. It is a model of what could be done more widely.

Longer franchises can help unlock more private investment since they provide a natural underwriting of residual values. They allow TOCs to plan and develop long term capacity improvements. Chiltern's successful Evergreen initiative, catalysed by this TOC's 20 year franchise, the longest so far let by DfT, illustrates the point. This initiative has already seen new rolling stock, additional signalling and expansion of Marylebone station lead to increases in train frequency and better journey times between London, Oxfordshire and the West Midlands. The final stage, agreed by Ministers in January, will see significant journey time reductions between London and Birmingham and a new direct route between London to Oxford.

Chiltern has delivered its projects to time and budget. In each case, it has designed, specified and tendered for them itself and then gone on to project manage their delivery. The work has either been financed through Chiltern itself or, in the case of the final two phases, mechanisms have been designed to allow the cost of the projects to be transferred to NR's Regulatory Asset Base and then amortised over time.

Where TOCs do not lead enhancement work themselves, a long-term stake in the network gives greater impetus to TOCs to challenge Network Rail on the efficiency of its scopes and costs. We see particular value in this for small and medium-sized schemes (eg capacity enhancements worth perhaps up to £500m in scale). These are very significant schemes at the level of an individual franchise, but are at risk of getting insufficient attention within NR's substantial project portfolio. TOCs want to see these carried out to a more market-based, rather than engineering-driven, specification and for them to be built on time.

We believe that more detailed TOC scrutiny of Network Rail's plans offers substantial cost-saving potential and, based on our experience, could help reduce NR spend by perhaps 2-3% on renewals and 5-10% on enhancements.

Over the current 5 year control period, this would amount to a saving of between £600m and £1.1bn, money that would otherwise have to be borrowed and repaid from rail budgets in future years. In our view, such savings might come about for two reasons.

First, due to their knowledge of the market they serve, train operators are well placed to develop "right-sized" infrastructure solutions and find the most efficient mix of rolling stock and infrastructure enhancement needed to address issues such as crowding and market growth. The example of Chiltern, which has tailored each addition to infrastructure capacity and rolling stock to demand growth, shows what can be done here.

Second, the use by TOCs of private finance to fund such schemes creates a strong incentive for cost control (as we have already seen in cases where such an approach has been adopted, eg for maintenance depots). Under the current mechanism, although in principle ORR can disallow NR expenditure that it believes was inefficiently incurred from being added to the RAB, in practice the money will have been spent and the debt raised to finance it by the time this decision is taken. The cost of the debt must be taken into account in the next regulatory review. Any cost overruns in reality are therefore paid for by funders over the long term rather than by shareholders, as is the case in a private finance contract.

Longer franchises would also facilitate delivery of long term restructuring initiatives of the TOC itself, such as measures to better match resources with the tasks needed on a modern railway. These are hard to realise in a short franchise as they can have long lead-times to realise the full benefits and one-off implementation costs.

In our view, over time, restructuring changes such as these might unlock efficiencies of perhaps 5-7% of franchise operating costs, equivalent to £150m-£210m per year, over and above the rigorous cost control that is part of each franchise bid in any case. Since the franchise bid process is very efficient, the benefit of this would flow back to Government through keener franchise bids.

We believe the benefits from gains on investment scope and operating cost reductions outweigh the risk from long-term cost growth that might arise from reducing the amount of market testing for a franchise. What is important is not so much how often this happens, as that the bidding process is structured to allow an in-depth review of the costs and strategic options for reducing them. A longer franchise naturally facilitates this.

In terms of timing, these benefits would flow from the franchise re-letting process, which (following the recent DfT announcement on the future of National Express East Anglia) runs as follows:

Inter City East Coast	2011
Essex Thameside	2011
Greater Anglia	2011
West Coast	2012
Northern	2013

These are substantial franchises in business terms and so it is possible that a quarter to a third of the savings could be achieved from these franchise competitions by 2014 (if the longer franchise approach was applied in all cases).

A further benefit is that longer franchises would lead to fewer competitions and the associated costs to bidders and the DfT would be removed. However, there is little scope to realise these savings in the short-term given the limited number of franchises due to be re-let before 2014. In the longer term, by halving the number of franchise competitions run, total bidders' costs of about £15-20million per franchise let (which inevitably have to be factored into future bid costs) would be saved. Similarly, it would be possible to save half of DfT's consultancy costs associated with the letting of franchises of between £1-2.5million per franchise (and some of the costs of DfT staffing) because franchises would be bid less frequently. [1]

[1] The DfT cost estimate is taken from the NAO October 2008 report, The Department for Transport, Letting Rail Franchises.

3. Focus more on awarding franchises on the basis of quality, not just price

In line with official advice and overseas practice in rail franchising, we want to see DfT showing more commitment to the principles of best value procurement than appears to be the case at present.

This would mean DfT giving more weight, when considering bids, to proposals which commit to higher service quality at a price which represents value for money to Government, and not just the size of premium or subsidy due to be paid.

While the DfT's approach in recent years has helped drive down the cost to taxpayers of procuring rail services, we think our proposals would do more for passengers in terms of encouraging and rewarding ideas from TOCs for better services; and would ultimately benefit taxpayers by improving the quality of bids for franchises.

Improving quality and customer service are vital to increasing rail use over the long-term and improving the value of the DfT's portfolio of franchises.

The main advantage of this would be to discourage bidding heavily oriented around price, i.e. bidders would differentiate themselves on quality, deliverability and customer service as well as price. This reform would encourage better customer service and higher quality, as well as ways of delivering these as efficiently as possible.

The current heavy focus on price risks encouraging franchises to over-commit financially and potentially leads to instability. Stability, by contrast, is important in terms of delivering improving service quality to passengers and to government; forced re-franchising is cost-inefficient in terms of the process (which has to be done quickly) and undermines the value of the franchise (i.e. the amount that the franchise will be let for in its next term).

A different approach would undoubtedly lead to changes in bidders' approaches to franchise bidding, but it is difficult to provide any kind of precise forecast of the impact of this.

4. Structure franchises to improve financial stability

The worst recession since the 1930s has led to revenue growth significantly below projections made in franchise bids. The lack of flexibility inherent to the current franchise model means operators pay the same costs at a time when revenue is falling.

ATOC believes better risk–sharing is vital both to promote stability in the industry and to build long-term value. We identify seven options, including an earlier start to revenue support in a franchise, linking franchise payments to GDP and making a greater (but still limited) proportion of Network Rail charges variable.

Such options would allow TOCs to focus more on delivering long-term service improvements, to the benefit of passengers. By reducing the systemic risk in any future recessions of having to re-let franchises, taxpayers also stand to gain by enabling the DfT to plan ahead financially for the long term with greater confidence.

Rail franchises are unlike any other businesses insofar as DfT or ORR regulation tightly prescribes what a TOC can do to manage its output in a downturn: it must continue to operate the same train service, many of its fares are controlled by DfT and one of its key supply costs (track access) is controlled by ORR and cannot be reduced.

In recognition of these tight controls, revenue risk is shared with government. A target for revenue is agreed at the start of the franchise and the government then shares in outperformance above the target or provides support where revenue falls short of the target. Both the share and support mechanisms, if they are used, have the effect of undermining the operators' incentive to grow revenue. This reduces the long-term value of the franchise.

We favour a mechanism by which revenue risk is shared on a more equitable basis between train companies and the Government. In particular, a better system is needed to handle economic downturns. The current approach carries with it the risk of a number of franchises running into difficulties at the same time during a recession, as operating margins (typically less than 5%) are not always large enough to absorb the implications of substantial downturns for long periods of time. If a number of franchises have to be re-let in poor economic conditions, it will be much harder to generate an active bidding market and relets would be on terms that are perhaps £100m worse per annum than they otherwise would be.

In our October document we argued that there are three main options for improvement:

- starting revenue support earlier
- a GDP or a Central London Employment index
- revenue sharing with NR.

We also argued that revenue should be split 50/50 between Government and TOCs rather than 80/20 today. These percentages should be applied to both upside and downside. A move to 50/50 sharing would improve the incentive that a TOC has to grow revenue at the margin by investing in measures such as marketing and revenue protection. Given the period of below-trend revenue and volume growth that we are seeing at present, a number of franchises may be in this situation over the next 2-3 years and will question the need for spending on initiatives that, in effect, ensure that up to 80% of extra revenue earned is handed straight over to government.

Tackling the revenue share/support structure should therefore be an urgent priority. One option is that after 18 months of revenue support, the TOC and DfT agree to consolidate some or all of the likely payments under the share/support regime within the base franchise payments and renegotiate the target revenue to apply in future, to more realistic levels. This would reset the incentive and ensure that TOCs are once again exposed to 100% of increases or decreases in revenue.

We believe these improved revenue share/support arrangements could be introduced into current agreements and could incentivise TOCs that are in revenue support to earn perhaps an additional 0.5% of revenue which equates to an additional £30million per year.

5. Enable train companies to take on greater responsibility for stations, depots and rolling stock

We believe that the expertise and structure of TOCs, combined with their closeness to the market and to operations, would enable them in many cases to deliver station and rolling stock improvements more quickly and cost-effectively than under current industry arrangements.

On stations and depots, experience suggests that were TOCs to take on more of a role from Network Rail in delivering improvements, then their approach on scoping projects, lower overheads and more streamlined processes could save as much as £250m-£500m from Network's Rail's prospective spend in this area.

Such a move would also help Network Rail focus more on the vital job of managing and enhancing the network – very much the areas of its core expertise – ultimately to the benefit of passengers and taxpayers alike.

On rolling stock, despite the trend in recent years which has seen DfT progressively take over the role of procurer, TOCs have a positive record built up before then of working with ROSCOs to lead the ordering of £4.5billion worth of new trains. Giving TOCs the responsibility of managing procurement would lead in our view to faster delivery of rolling stock and better cost efficiency in the commissioning of new trains.

As an example, during the last Southern franchise, £125m of enhancement was carried out to its main Brighton and Selhurst depots and their satellites. This work was delivered in a live railway environment and in good time for the introduction of its new fleet of trains. It was funded by private capital. The financier was made owner of the new assets who then granted a lease to Southern, while Network Rail remains the ultimate landlord. There was no disruption to Southern's services during the work, and the project's safety record was excellent. The only cost over-run related to the provision of some sidings additional to the original scope and these were delivered at half the cost that Network Rail would have delivered them.

Our earlier report published in October already identified the scope to save as much as £250m-£500m in prospective Network Rail spend on stations and depots over the period to 2014. This would be achieved through reduced overheads and by ensuring scopes are driven by business needs.

In addition, we believe TOC procurement of rolling stock would result in more cost effective specification of the design and size of new fleets. The recently announced delay in the completion of the Intercity Express Programme (IEP) illustrates the risks involved here. Rolling stock costs have increased considerably since DfT took effective control of procurement. Although much of this results from the depreciation of sterling and manufacturers rebuilding their margins, we still believe that there are significant efficiency opportunities here by:

- Ensuring that the scope of new train projects is not over-complicated by mixing up 'must have' features with 'nice to haves'. A franchisee with strong farebox incentives will look to ensure that 'nice to haves' are only included where there is a good business case. This includes associated depot changes and the value of procuring a long term maintenance contract from the manufacturer at the same time. The benefit of these needs to be looked at case by case rather than simply being assumed by the DfT from the outset.

- Reducing consultancy spend: professional fees for IEP are now up to £21m since the project began four and a half years ago and still no train has been ordered.

- Making more use of life extensions and refurbishments rather than buying new trains
- Balancing the fleet size with market demands. In some cases, this might mean ordering vehicles more slowly but in others, such as Pendolino and Class 185 trains, where the cost per vehicle of small follow-on orders is much higher than the original build, it may be better to order a full fleet right at the start.

These opportunities arise from TOCs' close understanding of passenger needs and railway operations. We believe that the competition for Inter City East Coast provides an excellent opportunity, in particular, to invite TOC solutions to HST replacement should IEP not proceed.

We believe that the capital cost of trains (including adviser fees) can be cut by 5-10%. Based on the need to order another 300-400 vehicles by 2014 and possibly about 500-1000 in the next control period simply to keep up with passenger growth, and a conservative average cost of £1.5m per vehicle, this equates to substantial savings of £20-60m by 2014 and a further £30-£159m between 2014 and 2019.

6. Sustain a mix of small and large franchises

Retaining a mix of small and large franchises has advantages. Changes in franchise boundaries can be costly and having a number of smaller franchises can help make the UK market more attractive to bidders than a market dominated by larger franchises might otherwise be.

There has been a general move towards larger franchises, but we think it essential that the DfT continues to assess the costs associated with changes to boundaries – and that there should be no automatic presumption in favour of further merging of franchises.

Retaining the existing franchise mix would obviate the need for restructuring of franchise boundaries which, making allowance for the risk of levelling-up of staff salaries from 'donor' TOCs as well as the consultancy fees needed to separate train diagrams, fleets and other resources, can easily cost tens of millions of pounds for each boundary change.

Having smaller franchises available may encourage new bidders, who can find the UK market difficult to enter because of the significant amount of knowledge of the industry's rules and processes that is needed to mount a successful bid. This is exacerbated by the large scale of contracts if won (turnover additions of many hundreds of millions of pounds per annum). A structure which had some smaller contracts (turnover of perhaps £100m or so, the norm in Germany and Denmark for example) might encourage new entrants and improve longer term efficiency.

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