

# Ensuring a Sustainable Rail Industry

Options for developing franchised passenger services

# Contents

<b>Executive summary</b>	<b>3</b>
<b>1 Franchising: A model that has revolutionised the rail industry</b>	<b>5</b>
1.1 The rail industry has seen a period of sustained and unexpected growth	5
1.2 This growth has changed the role of the railway in the UK	6
1.3 Growth means that train companies today look very different to 1998	8
1.4 The franchising model has struggled to keep up with these changes	11
<b>2 Franchising: A model facing a period of turbulence</b>	<b>14</b>
2.1 The franchise model may appear to be healthy...	14
2.2 ...but passengers might disagree	16
2.3 A slowdown in growth would be critical for the franchise model	18
2.4 However, the franchise model may be compounding the slowdown...	20
2.5 ... means the industry is not able to work together to address the issues...	22
2.6 ... and may not support a holistic approach to demand management.	23
<b>3 A single network facing different challenges</b>	<b>24</b>
3.1 A network of different customers with different requirements	24
3.2 A network making different use of its core infrastructure	27
3.3 A network which needs different things from stations and trains	29
3.4 A network facing different competitive pressures	31
3.5 A network serving different stakeholders	33
3.6 A network at different stages of development	34
<b>4 Improving the effectiveness of the current franchising approach</b>	<b>35</b>
4.1 The Role of Franchises within the current industry structure	35
4.2 Theme One: Changing the variable from finance to quality	37
4.3 Theme Two: Changing the evaluation process	38
4.4 Theme Three: Creating a fairer financial structure for the industry	39
4.5 Theme Four: Create a better alignment of risks for the franchise model	41
<b>5 A long-term evolution of the franchising model</b>	<b>44</b>
5.1 A new role for operators in the National Rail and broader transport network	44
5.2 Building a new set of franchise models to innovate the rail industry	45
5.3 Creating a new market for train operations	46
5.4 Ensuring an integrated network operation	47
5.5 Ensuring an affordable railway	48
<b>6 Next steps: moving towards a more sustainable model</b>	<b>49</b>
<b>Appendix - Exemplar models for train operating companies</b>	<b>51</b>

# Executive summary

The franchise model developed for the UK passenger rail network was created at a time of stagnant revenue and falling passenger demand. It was intended to reduce the burden of the network on government finances. However, events of the past twenty years show that the rail network has followed a rather different trajectory, with improved external conditions and revived commercial management stimulating unprecedented growth.

As a result, the franchises themselves have changed considerably. What was originally 25 franchises all let centrally has become only 20 franchises - 15 let by the DfT. The average turnover of these 15 businesses has more than tripled, from £192m in 1998 to £744m in 2016. Over the same period, the ownership of the operating franchises has changed, whilst the risks of winning and losing a limited number of very large contracts has had profound impacts on the industry supply chain.

This growth could be seen as a strong endorsement of a system which has proven to be flexible, adaptable and transformed the finances of the railway. The continued re-letting of franchises, the strong interest international operators have in the UK and the success UK operators have had overseas support this.

However, the challenges of improving operating performance and meeting the capacity requirements placed on the network mean that many passengers may not agree. Moreover, the franchising model may be facing a period of significant risk and uncertainty which could ultimately make it unsustainable:

- Recent bids have been predicated on strong revenue growth. Such ambitious targets may prove challenging for operators - especially in the context of a slowdown in the rate of growth in rail demand over the last 18 months. If that does turn out to be the case the economics of the franchises means that the financial implications could be significant.
- Meanwhile the concentration of the industry in a small number of very large franchises creates risks for the supply chain. Whether an operator wins or loses any given franchise can have a disproportionate impact of the size of its overall business, making it difficult to ensure a sustainable investment strategy and plan accordingly.

Additionally, it is not clear that the current franchising model is best placed to support the wider development of the rail industry or reflect its role as a key catalyst of the UK's economy. Specifically:

- The current franchise model has struggled to create the right mechanism to support investment or encourage decision which are made on the basis of whole life costs. Whilst attempts to address this have been made - including through longer franchises - these have tended to import too much risk into the franchises themselves and risk creating an unsustainable model
- The current franchise model has also struggled to deliver optimal solutions for the development of key assets such as stations or support an industry wide strategy for rolling stock which minimises long term cost and supports innovation. A lack of integration with Network Rail - both in terms of incentives and planning horizons - has also created problems

- There is not a clear link between the current franchise model and the emerging industrial strategy or economic requirements from the railway. The railway is a vital economic asset for the UK's economy and is also a vibrant industry in its own right with a large and skilled supply chain. The process of awarding, managing and operating franchises needs to reflect this.

There are two essential pre-requisites to the effective reform of the franchise model:

- First, the Government must clarify the economic and financial role of the railway and the appropriate balance between taxpayer and fare payer to fund the railway
- Second, the DfT must lead a fundamental and bold review of fares to create a new system which removes the absurd complexity of current industry ticketing whilst ensuring that core rail products are more closely attuned to the needs of the modern workforce.

When this is achieved, then there are several areas where the franchise system could be improved and made more sustainable within the current industry structure. These could be based around four key themes:

- **Changing the variable from finance to quality**, asking bidders to offer a proposed service offer within a given affordability envelope rather than specifying requirements and asking bidders for financial quotes
- **Changing the evaluation process**, to give quality more weight, consider whole network costs and ensure an evaluation of the economic benefits of proposals.
- **Creating a fairer financial structure for the industry**, to ensure that there is acceptable certainty on future franchise payments, that any "windfalls" from ambitious bids are retained in the industry and ensuring that no franchise becomes too big to fail
- **Creating a better alignment of risks for the franchise model**, with a common set of objectives for network development, a consistent view on the nature of competition and greater flexibility to link with the national industrial strategy and longer term changes in travel patterns.

In the longer term, there may be benefits of rethinking the wider structure of rail franchises. A move from a single standardised model to a suite of smaller franchising models may provide much more flexibility in the network. This in turn might bring a greater set of skills into the industry, ensure the appropriate focus on capacity management and utilisation and provide a more effective way of integrating local rail networks into the local economy.

Such changes - whilst not without their challenges - could offer a new approach to maximising the value and ensuring the sustainability of the rail industry.

# 1. Franchising: A model that has revolutionised the rail industry

## 1.1 The rail industry has seen a period of sustained and unexpected growth

The franchising model developed in the mid-1990s for the UK passenger rail network was established in the context of a predictable and declining passenger trend. Ridership and revenue were falling and a combination of ever increasing car ownership and the growth of domestic air travel presented limited optimism for growth in passenger numbers or appetite for investment to enhance the railway - indeed the focus was on identifying ways to reduce the burden the railway imposed on the economy through a clear focus on cost reduction rather than revenue growth.

The twenty years since franchising was introduced have not panned out as anticipated. A combination of strong economic growth and increased road congestion have created a benign environment for the rail network. A change in national and local government policy to promote more sustainable modes of transport (most notably through the congestion charge in London but also seen through investment in local transport schemes and increases in city centre parking charges in most towns and cities across the UK) have created the foundations to enable strong growth. The innovative pricing, targeted marketing and enhanced customer services delivered by private train companies, coupled with increased Central and Local Government investment in new infrastructure, have capitalised on this environment and driven an unparalleled period of demand for rail growth (Figure 1) and increased rail's role in day to day travel patterns (Figure 2).

Figure 1: Passenger rail journeys since 1980

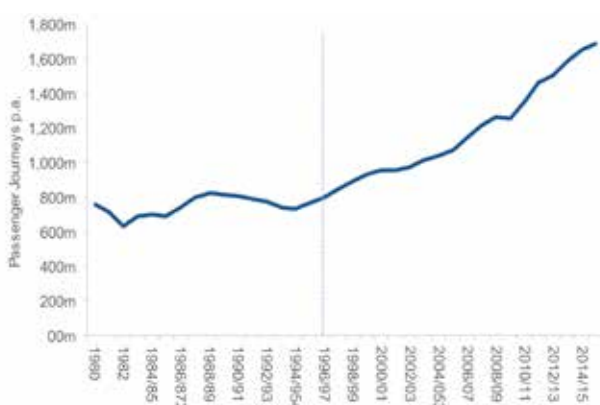
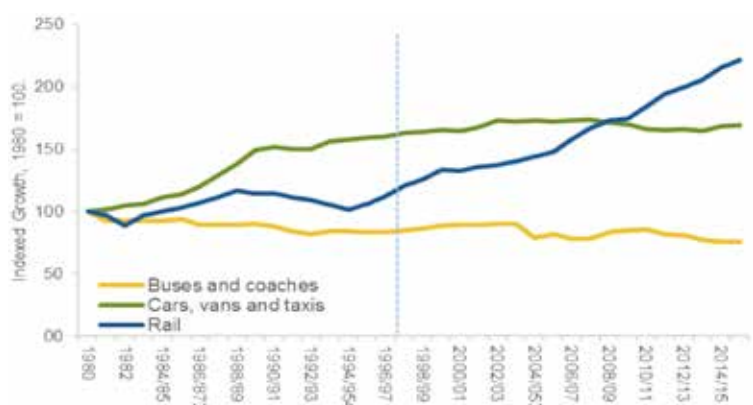


Figure 2: Indexed demand by mode of travel (1980 = 100)



## 1.2 This growth has changed the role of the railway in the UK

The growth in passenger numbers and revenue seen in the rail industry since privatisation has radically changed the place of the railway in the economic infrastructure of the UK.

The finances of train operators are transformed. From requiring £1.5bn of subsidy in 1998/99, rail operators made a net contribution of over £1bn 2014/15. Intercity operators paid a total premium of c. £600m to the Treasury in 2016, equivalent to 2.5% of the DfT's total operating budget. Previous analysis by Credo and CBT has suggested that the industry will pay between £2.1bn and £3.7bn in premia to the Government by 2019/20 (Figure 3).

The overall state of industry finances is more nuanced, due to the cost of maintaining and enhancing the infrastructure and the mechanism by which this cost is divided between the train operators and the Government. The industry still required £4.8bn of public funding in 2015/16, and with a total of £53bn having been invested by the government since 2000, the ongoing cost of the railway to the tax payer should not be underestimated. That said, franchising has helped to deliver a significant rebalancing of the financial burden for the railway, with farebox revenue contributing 74% of total industry costs in 2015/16.

The usage of and demands on the network have increased considerably. In London for example, the number of people commuting by rail each morning has almost doubled, from 620,000 in 1998/99 to 1.2 million in 2015/16, whilst the number of train kms operated by "commuter" train operating companies (TOCs) has increased by only 23%. As shown in Figure 4, the result has been that the number of passenger kms travelled per track km has increased by 76% between 2000/01 and 2015/16. On Intercity services, the number of passenger journeys has increased by 105% since 1998, whilst timetabled train kilometres have increased by only 35%. Even on regional services, demand has increased by 92%. This passenger growth has led to problems of overcrowding and the demand to operate more and longer services. This in turn places significant pressure on the rail infrastructure, and even allowing for the £10.5bn private investment in new rolling stock and £135bn of other infrastructure investment during this period, operating the railway during peak

Figure 3: Forecast contribution of rail funding to industry costs by 2020

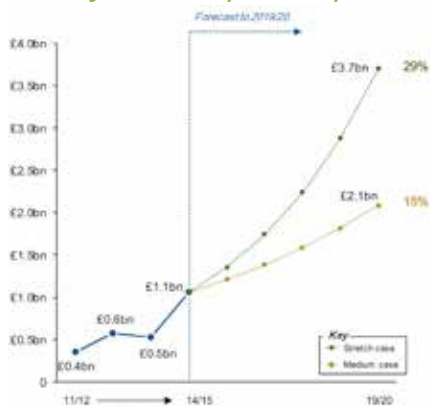
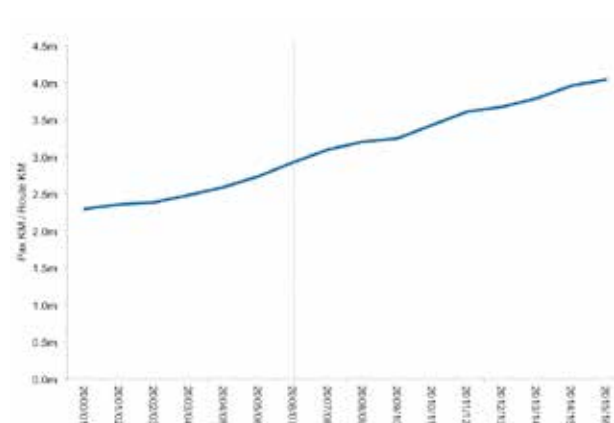


Figure 4: Passenger-km per track - km, 1995 - 2015



times is getting more and more challenging - especially given the imbalance in demand, which can be up to five times greater for each train in the peak than the off peak.

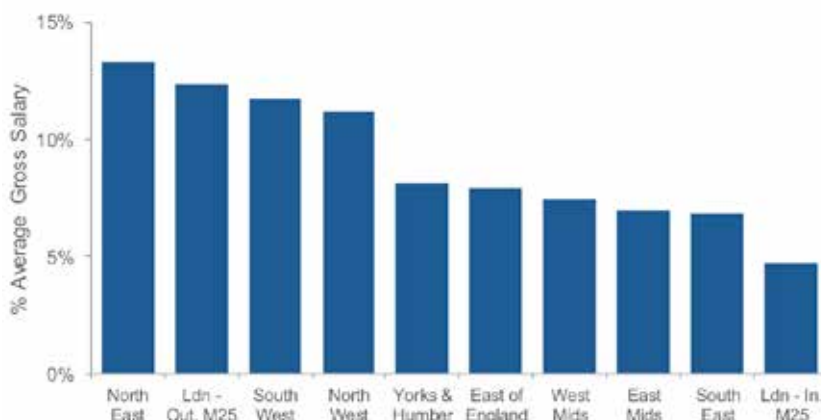
The economic importance of the industry has also changed dramatically. In 2002, 3.8% of the UK labour force used the railway to travel to work and we estimate that 4.6% of Great Britain's GVA was generated by people who rely on the rail network to travel to work. By 2015, this had increased by 50% to 5.9% of the labour force, and 7.1% of GVA - an increase of c. £40bn per annum of economic activity at current levels of GDP. These people and this economic activity is dependent on an increasingly overcrowded rail network. At the same time, a combination of demographic pressures and low interest rates have created a surge in house prices which has priced people out of the traditional suburbs and expanded the travel to work area - a trend which has been most extreme in London but been replicated across most major cities in the UK. The result is that:

- First, a fast and reliable form of mass transport into city centres is now more important than ever.
- Second, as people commute further, so rail tickets become a more significant demand on income; and
- Third, commuting becomes more important for lower paid and part time workers.

As shown in Figure 5, based on previous work undertaken by the Campaign for Better Transport, we estimate that the average annual season ticket costs c.9% of regional average gross earnings, and that this increases to over 13% in the North East. Given that the cost of annual season ticket is prohibitive for many people - especially those in temporary employment or on short term contracts - then for many people on lower wages the true cost of commuting by rail would be even higher than this.

This makes the state of the rail network - and a clear focus on the affordability of the network - ever more important. However, the capacity challenges which the network faces mean that there is limited scope to accommodate this additional demand - and a reduction in fares to make the railway more accessible for passengers may not be affordable to taxpayers if it necessitates a significant capital investment to accommodate this growth.

Figure 5: Annual Season Ticket Cost as % of Regional Wages





## 1.3 Growth means that train companies today look very different to 1998

### 1.3.1 Passenger franchises are over three times larger than they were in 1998

As the industry has grown since privatisation, the number of franchises has actually shrunk. In 1998, there were 25 franchises with an average turnover of £192m. In 2016, there were 20 franchises in total, 15 of which were let and managed by the DfT<sup>1</sup>. These 15 franchises have an average turnover of £744m. Moreover, the nature of the companies operating those franchises has now changed due to consolidation in the number of owning groups, of which five current groups are directly owned or backed by international state operators.

<sup>1</sup> This number excludes the Wales and Borders franchise which is being transitioned to a new franchise concession to be managed by Transport for Wales.

This concentration of a £10.0bn revenue industry (£12.4bn if Government subsidy payments are included) in a small number of franchises creates unsustainable pressures for transport operators. In 2016, Stagecoach, Firstgroup and Go-Ahead combined had a share in 9 of the rail industry's franchises (Figure 6). These franchises accounted for between c.25% and 65% of their respective total turnovers. This meant that a single franchise might comprise, average 12 - 20% of their total turnover. Losing a franchise therefore has a massive implication on the size of each business - and with only two or three franchises let annually, there is little scope to pick up other franchises to maintain the size of the business in the short term.

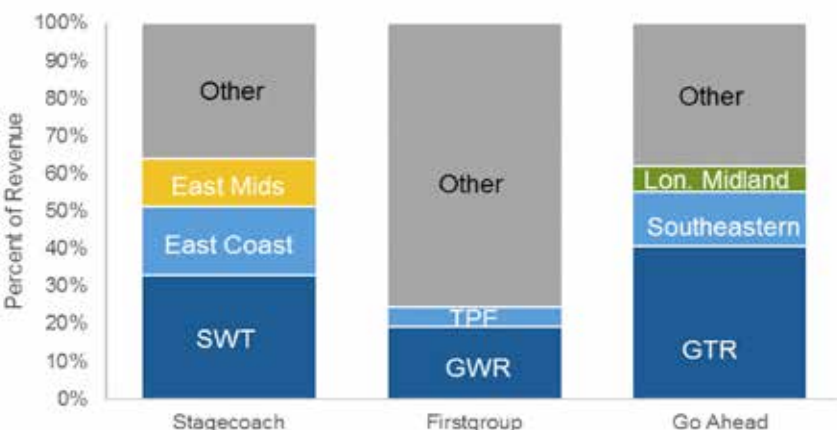
### 1.3.2 This increase in franchise size has magnified the risks of franchise bids

This creates a situation where franchises become "must wins" for specific operators and this may encourage overly ambitious bidding. But as these franchises become bigger the financial risks have also become larger.

Consider a scenario in which revenue underperforms by 1% per annum for a three-year period, growing at 4% instead of a predicted 5% growth rate in each year:

- For an average franchise in 1998, the revenue difference by 2000 would have been £6m - a significant shortfall, but one that could be covered within a large, diversified transport group
- Now consider the same calculation for a franchise in 2017. The average franchise revenue is £744m, and therefore the revenue shortfall in the same differential growth scenario would be £24m after three years. Such a substantial shortfall would be significantly harder for a transport group to cover - however large and diversified it might be.

Figure 6: Total operator revenues by revenue source





This risk is particularly acute due to two factors which limit an operator's ability to respond:

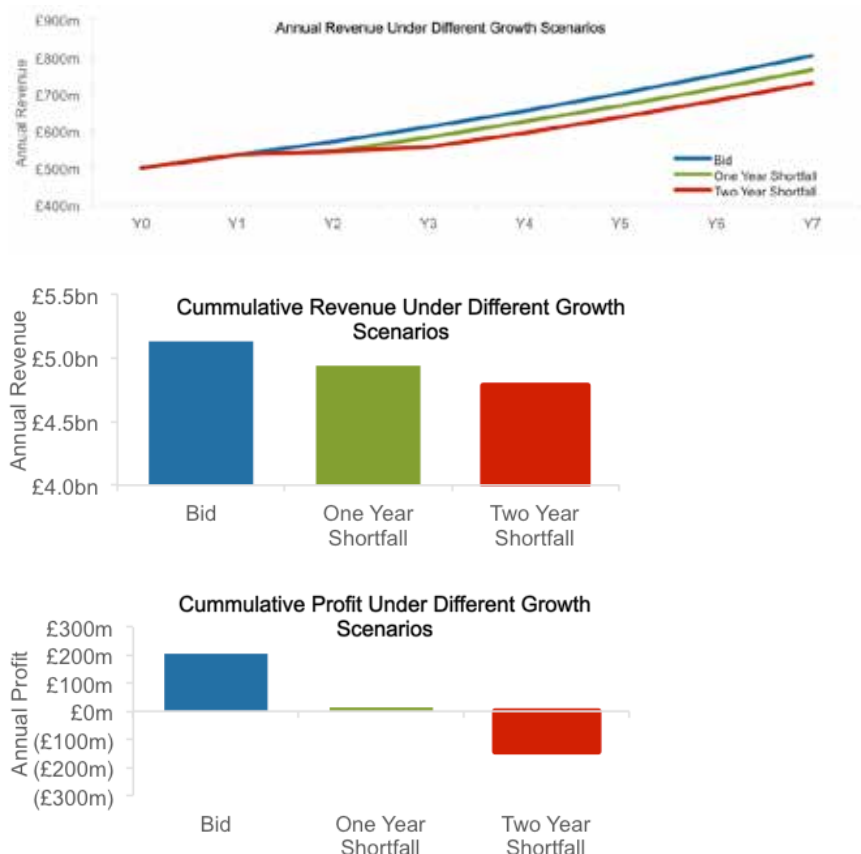
- First, a significant proportion of costs are fixed. This includes the proposed premium payment to the Department which is fixed at the time of bidding. In 2015/16, we estimate that on average 70-80% of TOC costs were fixed
- Second, the mathematical truism of compound growth means that one year of underperformance is retained throughout the franchise. For example, underperformance at the start of the franchise can be extremely serious as the franchisee falls behind the bid revenue line; even if it delivers bid growth thereafter, it does not re-capture the "lost year".

This means that franchises can become "can't wins" - especially for the large franchises approaching £1bn of passenger revenue - and the risk of winning at an undeliverable revenue line is too great for a publicly-listed company to support. The Department for Transport has offered some protection to bidders for the main external risks they face through GDP / economic support mechanisms. However, these mechanisms have struggled to find the delicate balance between protecting operators and ensuring that they retain appropriate incentive structures - a challenge made harder by the recent divergence between industry revenue growth and economic growth (see below).

## Case Study: The implications of revenue under- performance on an example TOC

Consider a scenario where a bidder bids a 7% growth rate on a £500m, 7-year franchise. If the revenue growth is only 2% in year 2, but 7% in every other year, then final-year revenue is £38m lower. If there are 2 years of underperformance, then final-year revenue is £78m lower. When considered across the life of the franchise, the cumulative revenue if there is one year of underperformance is £190m (3%) lower and with two years of underperformance becomes £350m (7%) lower (see Figure 7). On a bid with "typical" industry profit margins of 4% of expected revenue, such a revenue shortfall could quickly translate a significant operating loss. As franchise terms become longer, this risk is magnified further

Figure 7: Cumulative financial impacts of a period of revenue underperformance



## SECTION 1

### Franchising: A model that has revolutionised the rail industry

Stuck between these two competing pressures, existing operators find themselves facing Hobson's Choice. This has contributed to the retreat from the sector of some private companies (such as National Express Group) and potentially explains the perceived comparative advantage possessed by state-backed operators. Perhaps more damaging for the industry, it risks creating a model where operators may be bidding one approach but anticipating a different approach in reality, seeking cover in the change mechanism within any franchise.

#### 1.3.3 Larger franchises also present significant challenges to the supply chain

Whatever the bidding strategies owning groups develop, the sheer size of the current franchises present several additional challenges.

- First, the concentration of the industry into such a small number of businesses places great challenges on the sustainability of the operating supply chain and risks a "seismic shift" in company size when franchises change hands. Such risks could threaten long term investment decisions and planning among private sector companies when faced with such uncertainty over future revenue streams
- Second, the franchises risk becoming too large to support effective and focused franchise management from the central management team (of both the business and the tendering authority) - and it is not clear whether there are sufficient financial or operational economies of scale from such large businesses to compensate
- Third, the size of such businesses and the management challenges of operating them may serve as a disincentive to innovation and make the market less attractive - and potentially inaccessible - to new entrants who may lack the operating experience to take on the risks associated with such a large contract
- Fourth, as franchises get larger, so it is more difficult to ensure that there is appropriate local input (and control) over the businesses and it becomes harder to ensure a connection between local politicians and other local stakeholders and the railway which serves that community
- Fifth, as the size of the businesses become larger the implications of them failing become larger. This is true both for the shareholders in that business, but also for the DfT, which as operator of last resort would have to step in to ensure service continuity in the event of franchise failure.

## 1.4 The franchising model has struggled to keep up with these changes

The structure of the rail franchising model has been in a state of seemingly endless flux since it was first set up in 1998. Key strategic reviews of the franchising model (Figure 8) were linked to the development of the sSRA to replace OPRAF in 1999, the subsequent abolition of the SRA in 2006 and the root-and-branch analysis of the franchising process undertaken through the Brown Review, published in 2013.

Across each of these reviews, the intention has been to evolve the franchising model to create businesses well-aligned with the industry structure and with the correct duration and incentive structure to encourage both short term revenue growth and long term investment. As the franchising model has evolved the evaluation mechanism has evolved with it – most recently with a new bid scoring system designed to give due weighting to quality and financing issues, which was introduced after the Brown Review was published.

There have been some notable successes in the evolution of this model:

- Both the Essex Thameside and Chiltern franchises have twice been let under long term contracts, which has delivered investment in services and rolling stock and associated increases in passenger satisfaction. These arrangements were contracted under the original franchising model (with OPRAF letting an initial 15 year contract for the franchise which is now called Essex Thameside), the SRA “long franchise model” (used to let the second Chiltern franchise) and the “post Brown” model used to let Essex Thameside in 2014
- Similarly, the consolidation of operating responsibility into single-terminal franchises in 2004 (as seen on Great Western at London Paddington and Greater Anglia at London Liverpool Street) has delivered some benefits in capacity management and performance
- There has also been a clear improvement in the support mechanism offered to bidders in the event of external shocks. The current GDP and CLE support mechanisms (established in 2011) in place on East Coast and Greater Anglia offer a far more pragmatic solution than the revenue support mechanism used from 2005, which served only to reduce commercial incentives and appetite for innovation after the first four years of any franchise
- The model has also seen greater development of local ownership and devolution – most notably in the transfer of the London Overground Service to TfL and the Merseyrail franchise from the DfT to Merseytravel. While not necessarily a direct result of devolution, the 25-year contract agreed with Abellio-Serco to operate the services on Merseyside has led to growth in passenger journeys of c. 20m since the start of the franchise, migration in passenger satisfaction from five percentage points below the national average in 1999 to ten percentage points above the national average in 2016, and has seen the successful order of a new £700m fleet to be delivered by Stadler from 2020. While there is a desire to extend this devolution approach to other cities and regions across the country, progress has been relatively slow and even Transport for the North is not scheduled to assume responsibility for rail services in that region until 2023.

**SECTION 1**  
**Franchising: A model that has revolutionised the rail industry**

- The most recent changes will see a greater emphasis put on cooperation and integration between operations and infrastructure - with the recently published consultation document on Southeastern specifying the requirement for a clear alliance and potentially an “integrated operating team” with Network Rail to “ensure that trains run on time for passengers.” There is also a clear aim to open up the network to more third party funding, with an intention that the new franchise will “encourage additional private sector investment in infrastructure development, which could involve faster, more reliable journeys and new commercial, community and residential developments at stations”.

However, the pendulum has swung back and forth on several key issues, and the DfT and other franchising bodies have struggled to come up with a fully appropriate solution under any of the iterations of the model:

- First, the complex issue of incentivising long term investment in a short- to medium-term franchise has not been resolved. The DfT has experimented with long term franchises but found (for example with the ill-fated West Coast competition of 2011/2) that the risks and uncertainties for bidders were too great to allow a transparent franchising process. The DfT has also experimented with various forms of a residual value mechanism, but has not yet found a way for this to offer support of the scale necessary to fund long term investment. (For example, on South West Trains, the ITT stipulated bidders may propose up to seven assets/schemes where the RV mechanism may be used, with the total value not to exceed £120m at 2017/18 prices). Only investment in new rolling stock - often delivered through mandate by the DfT and underpinned by the involvement of a long-term leasing company with limited exposure to residual value risk - has really succeeded through the franchising model. Many issues related to capacity, especially at stations, have not been fully resolved and remain as risks that could inhibit growth over the next decade, despite the continued investment in new rolling stock committed in recent franchise bids
- Second, the model for joint working between NR and train operating companies has not been resolved. While much progress has been made from the confrontational structure of the initial franchising round, more recent attempts at “Alliancing” have either failed to deliver any real benefits, or not been able to establish the “deep” collaboration necessary for joint development of the network. Train operators have consistently highlighted

**Figure 8: Timeline of key changes to the franchising model**

GOVERNANCE	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	OPRAF formed		Mar: All franchises let		sSRA established	Arriva takes over the MTL franchises. National Express takes over Prism Rail	SRA and Network Rail established	Mar: Chiltern franchise awarded on 20 year franchise	July: Dutch Railways (NS) enter UK market through JV with Serco. Nov: Government takes over operation of Connex South Eastern franchise	New devolved Merseyrail concession started. “Cap and Collar” revenue support mechanism introduced.	Apr: Anglia services combined into “one railway” franchise, signalling consolidation of franchises serving single London terminals
FRANCHISE ISSUES											

the issues arising from a misalignment between the duration of operating franchises and the regulatory Control Periods of Network Rail, and the difficulties this causes for a consistent planning horizon in the network. The recent report by the Transport Select Committee identified this misalignment as a major barrier for better integration and planning across the network

- Third, the DfT has struggled to put the passenger at the centre of franchise design and award. The strength of focus on delivering a specified timetable means bid proposals tend to take a more operational focus. Further, reliance on a financial evaluation for markets in which short-term growth may not be directly linked to customer service makes it difficult to create a customer-centric culture within a franchise. Recent franchising awards have created a clearer financial incentive structure linked to NRPS scores, whilst Transport Focus continues to develop its role in providing input to the franchise specification and the ongoing oversight of franchise operation. However, the overall weighting attributed to NRPS scores and financial penalties associated with underperformance remain small. The DfT continues to work on this challenge - highlighted in the Southeastern Franchise Consultation Document as a desire that “the next operator ... engages fully with passengers and places them at the heart of their business and operations. It should also explore how the service provided can continue to improve.” However, it remains unclear how this commitment would be evaluated within the bid stage, nor how it would remain up to date and innovative during the execution of the franchise.

Thus, the franchising model faces a number of challenges. As the recent report from The House of Commons Transport Committee notes,

“While franchising has facilitated passenger growth and service improvements, it is clear it has not yielded all the competitive benefits initially envisaged by the Government in the early 1990s.”

The issues with the current model have led some commentators and politicians to champion the abolition of the franchise model altogether, and a return to nationalisation. The benefits franchising has delivered to the railway over the last twenty years since privatisation suggest that this would be an unusual and backward step. However, the widespread public sentiment for a retrospective change in ownership structure - combined with the ever more important role which the rail network plays in the UK economy - means that the next evolution of the franchise model must be one which supports sustainable investment and a clear customer focus across the industry.

Dec: Sea Containers relinquish control of the East Coast (GNER) franchise	Nov: MTR enters UK market through JV with Arriva to operate London Overground		Nov: DfT takes over operations of National Express East Coast	Apr: Arriva acquired by DB		Jan: Government proposes GDP-driven revenue support mechanism	Oct: West Coast procurement cancelled. Dec: Laidlaw Report Published	Jan: Brown Review Published	Oct: Transport Scotland let new Scotrail franchise. Nov: Passenger services directorate formed. Nov: NAO review of franchising process	Mar: CMA publish report citing benefits of greater competition		
2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
									Essex Thameside franchise re-let to National Express - first franchise award following the Brown review			Jan: Trenitalia buys c2c from National Express

# 2. Franchising: A model facing a period of turbulence

## 2.1 The franchise model may appear to be healthy...

At first glance, the state of the rail industry in the UK could be the envy of networks across the world. As noted in the previous chapter, the industry has seen sustained passenger growth, revenue is now c. 110% higher than 20 years ago and the industry is close to covering its operating costs - something not seen in any other rail network in Europe.

Throughout the numerous evolutions of the franchising model outlined above, the model has continued to deliver willing franchisees and strong income growth for the Government (Figure 9). Since the 2013 Brown Review, the DfT has signed seven contracts<sup>2</sup> with six different operators. Combined, these franchises will operate for c.60 years, serve c.8bn passenger journeys, raise £42bn of passenger revenue and deliver a combined premium of c. £11bn for the Treasury. Every franchise let over this period has seen a step-change in the premium offered to the Government (or corresponding reduction in the level of subsidy required) and all assume a rate of revenue growth for the new business higher than that achieved over the preceding contract.

Moreover, the UK market is now the hub for the European rail market and has attracted strong interest from all the major operators across Europe and increasingly from Asia as well. Some, such as Abellio (Netherlands) and MTR, have successfully entered the market by joint venture, whilst others (such as Deutsche Bahn) have successfully entered the market through acquisition. Most recently, Trenitalia completed a £70m acquisition of National Express's UK rail business, whilst Japan's JR East and Singapore's ComfortDelGro (through Metroline) both have passports to bid for UK franchises. In total, 36% of the UK rail industry (by revenue) is now run by international operators - working either alone or in joint venture - attracted to the commercial dynamism of the UK market. (Figure 10 )

<sup>2</sup> This section does not reflect the further changes which will occur once SWT transfers to the new First / MTR franchise, as that contract is still in the statutory standstill period at the time of writing for Wales.

Figure 9: Forecast aggregate franchise payments

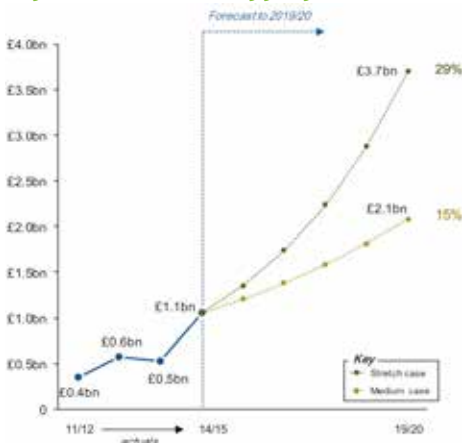
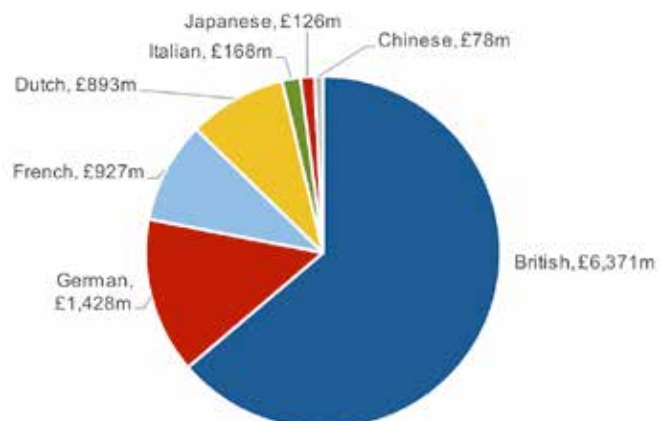


Figure 10: UK rail revenue by nationality of operator



In return, the UK market has proved to be a springboard for the growth of domestic transport operators into the European market. Arriva proved the potential of this model prior to its acquisition by DB, and more recently National Express and Go-Ahead have both established growing businesses in the German market.

With continued growth in passenger numbers, a successful bidding market and a two-way flow of companies and expertise between the UK and mainline Europe, one could assume that the franchise model set up in the UK in the mid-1990s (and now being exported to many of the major rail markets around the world) places the UK industry in a great position to meet the challenges of the next decade.

**Q. It is important to recognise that there is much to be admired about the UK rail network. How can the industry build on what has been achieved over the past twenty years?**

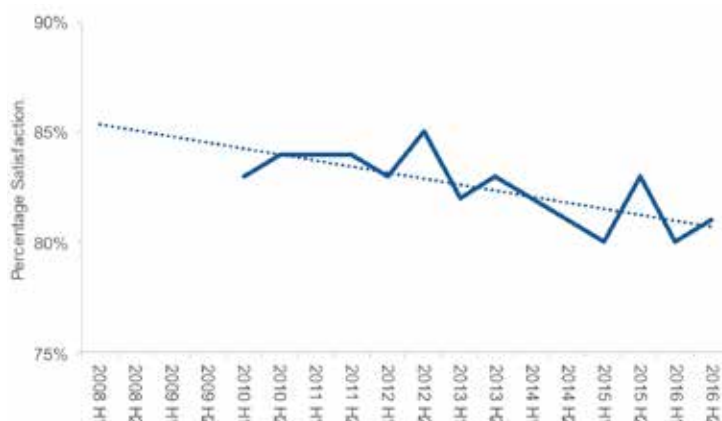
## 2.2 ...but passengers might disagree

Throughout the development of franchising, the DfT have sought to find ways to protect customer interests, incentivise operators to focus on passenger satisfaction and improve customers' perception of the railway. Despite these efforts and the financial success of franchising, the model is subject to some serious constraints and an increasingly alienated customer base:

- **Rail reliability and punctuality** is in retreat, with the percentage of trains arriving "on-time" falling from 91% to 89% over the past 4 years. The shift to a more instant compensation approach (Delay Repay) may offer some respite for customers that know how to claim, but can appear inaccessible to anyone not engaged with the system
- The national **fares structure** (itself a function of Government regulation, more so than the franchising system) becomes ever more confusing and less relevant to customers' work and travel patterns. There are numerous examples of this, but perhaps none more obvious than the traditional season ticket - a product designed to cater for traditional "9-to-5" commuting model which now applies to only c. 46% of the workforce
- The **payment and ticketing** system remains confusing and has failed to evolve to take advantage of new technology - the speed of technological development in other retail and customer service industries highlights the rail industry's relative inertia. The implementation of smart ticketing is a clear example of this - by 2015, TfL had managed to shift 38% of journeys of London Underground to PAYG and reduced cash payment from 15% of all journeys in 2004/05 to less than 3%. It has since evolved this further with the rapid take up of contactless payment card (CPC) technology, with more than 370m journeys made using CPC in the first 10 periods of 2016/17. The roll-out of modern ticketing on the rail network outside of London remains in its infancy.

The National Rail Passenger Survey is an indicator of how these factors have impacted passengers. Overall, passenger satisfaction has fallen from 84% in autumn 2011 to 81% in the autumn 2016 survey (Figure 11). More problematic, satisfaction is "propped up" by leisure travellers using the service outside the peak and often paying the lowest fares. When considering the regular commuter, satisfaction has fallen from 80% in Autumn 2012 to 74% in Autumn 2016.

Figure 11: Passenger satisfaction, 2008 - 2016





Equally challenging is the impact that rail user dissatisfaction has on wider perceptions of the industry. Most of Transport Focus's work and other research in the public domain reviews the attitude of users to the service they receive, rather than the impact which negative publicity has on deterring people from trying the network in the first place. However, one such survey - the 2015 Public Attitudes to Rail survey - found the majority of the population did not use the rail network (56% had not used rail for a short distance trip), and of those that did not use the service, only 61% of people thought short distance services were good. In particular, only 21% of non-users thought the cost of fares was 'good' or 'very good'.

**Q. As technology develops to support more remote working, video conferencing and (eventually) new modes of transport, so the rail industry will need to become more innovative and customer focused to remain relevant to its current and potential customers. How can the franchising model be developed to prioritise this long-term requirement over short term financial considerations?**

To date, the issues passengers have felt with the rail network have manifested themselves in falling satisfaction and press criticism. Historically, the industry has seen growth despite this. However, there are indications over the last 18 months that this situation may be changing. Despite relatively strong economic growth, overall passenger revenue has grown by only 3% (Figure 12).

It is too early to say whether this is a temporary correction to the surprising growth seen during the recession, or the start of a significant passenger response to the performance, capacity and customer service issues in the industry. However, it highlights the need for a suitable customer focus to be included as a core part of the franchising structure.

**Q. There is some evidence that customer dissatisfaction has reached a critical point and may be contributing to a reduction in industry growth rates. How can the franchising model be restructured to ensure a close link to customer requirements and to support sustainable long-term growth without putting undue burden on the taxpayer?**

Figure 12: Revenue growth, 1995/6 - 2016/17





### 2.3 A slowdown in growth would be critical for the franchise model

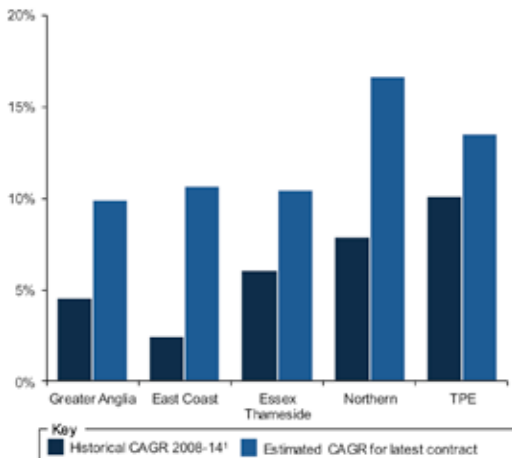
Owing to the current structure with a small number of very large contracts (as identified in Chapter 1), all recent franchise bids have seen ambitious bids from the winning bidder predicated on very significant revenue growth. Each of the last four franchise awards has seen a significant increase in the premium promised to, or subsidy required from, the Treasury. However, each has been based on revenue forecasts we estimate to be substantially higher than the growth seen historically on the franchise. (See Figure 13).

These aggressive revenue forecasts have been translated into commitments to pay the Government significant franchise premiums (or in the case of Northern manage with a significantly reduced subsidy) through the life of the franchise. In most instances, the amount promised to the Government dwarfs that set aside as likely profit for the operator. Profit margins included in bids are commercially confidential, but Oxera’s report “Ensuring value for money from rail franchise margins” estimates average profit margin to be 5% of revenue.

The real challenge comes if revenue growth slows below forecast. With the premium line and about half of the cost base fixed, profit margin falls away very quickly as revenue growth begins to slow. For example, consider a hypothetical £500m franchise, bid with a 7% real revenue CAGR, a £120m premium payment in year 1, a 4% margin and a commitment to hold costs steady.

In this scenario, the costs and the franchise premium are fixed. Therefore as the revenue falls the profit of the operator falls with it. A 1%pt underperformance in revenue growth against the plan could mean that the franchise makes no profit by year 5, and a 2%pt underperformance in revenue means that the business makes a loss by year 3. Underperformance by 4%pt would mean losses more than twice the original bid profit by year 5.

Figure 13: Comparison of historic and future revenue forecasts in recent bids

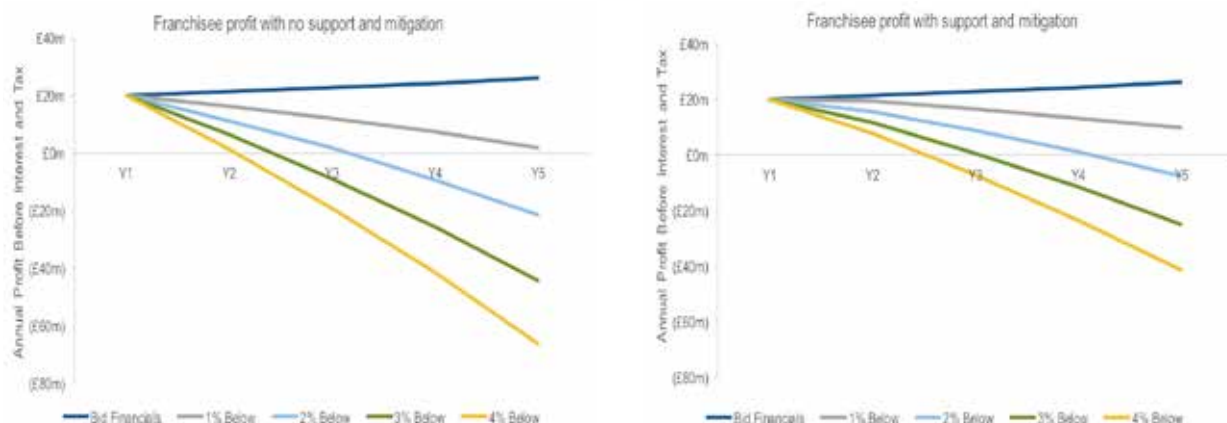


A real-life translation of this situation may not be quite so pronounced. There is scope to reduce some variable costs, and the GDP mechanism provided by the Government may provide some support. However, even if a quarter of the revenue shortfall was covered by the GDP support mechanism, with scope to reduce variable costs by 2% in a downturn, the returns to the franchisee are still highly sensitive to a reduction in revenue and at a 3% revenue underperformance, the franchise would still make a loss by year 3. (See Figure 14).

In a scenario of steady bids and growing revenue, the risks in this model may be tolerable. However, as noted above, the bids that have been submitted have been based on a significant step forward in revenue, whilst recent trends show a revenue line under serious threat. This trend will affect different operators in different ways - with the impact potentially being most immediate on the intercity franchises that rely on discretionary travel, but potentially being most acute in the medium-term on regional franchises that have based aggressive bids on significant and sustained passenger growth driven by mode-share gain from car linked to investment in new rolling stock. A continuation of this trend could put many franchises in serious financial difficulty, both threatening the future of the operators in the business and jeopardising the anticipated revenue stream to the Treasury.

**Q. If there is a slowdown in passenger growth, operators in the industry could run into financial difficulty. How can the industry ensure that a slowdown that puts pressure on payments promised to the Treasury does not result in further pressures being placed on the passenger in a way which creates an inevitable downward spiral for the industry?**

Figure 14: Indicative franchise commercials with different revenue outturns





## 2.4 However, the franchise model may be compounding the slowdown...

There is no current consensus on the cause of the observed slowdown in passenger growth on the rail network at a time when the traditional relationship to macroeconomic variables should be supporting a strong growth story. However, in so far as there is consistency as to the causes, this centres on four key themes:

- **Trust** - customers have lost trust in the railway and are therefore reluctant to use the network - it is struggling to attract new users. For example, Transport Focus's 2014 report "Rail Passenger Trust Survey," found that passengers have low trust in the service delivered by TOCs and feel TOCs do not currently act with passengers' best interests at heart
- **Complexity** - the complexity of fares and ticketing is unattractive - passengers cannot be sure they will be able to buy the right fares, or even that they can afford to use the railway at all
- **Flexibility** - the legacy fares and ticketing policy has not kept up with the changes to more flexible working practices, and therefore the rail network is struggling to remain relevant to passengers
- **Capacity** - the issues of crowding and capacity constraints - both on trains and at station car parks - may be limiting growth and suppressing demand.

The current franchising model does not lend itself to address any of these issues:

- First, the current model is not built around gaining customer **trust**. Whilst there has been some positive evolution of the franchise award process in this direction (most notably with the Customer Experience metrics included in the new Greater Anglia franchise) and a broader trend in the industry to bring a greater customer focus (seen with the recent move to a joint Oversight Board with clear Transport Focus representation on the Greater Western route), the emphasis on financial returns in franchise bidding does not prioritise customer service. That is not to say that the railway does not need a financial focus, or that customer service and long term financial returns are not linked. Investment in building trust is very likely to generate a long-term financial return. However, TOCs are tied in to short term premium lines which necessitates short-term thinking to generate revenue rather than long-term development of customer loyalty
- Second, changes to fares - both to address the issues of **complexity** and to implement a more **flexible** model - must be done in one of two ways. Either it must be accepted that to rebalance the structure some passengers will pay more and some will pay less to ensure it is financially neutral to the industry, or there must be a recognition that (in the short-term at least) changes to fares policy will be a net cost to the industry. The franchise model does not allow either option - major regulatory or policy changes are not enacted through the franchise process, whilst the award process does not make appropriate recognition for a solution that would cost the industry money. Therefore, the fare structure is locked in a cycle of self-reinforcement, while customers, operators and policy makers all get more dissatisfied with the status quo that is being reinforced

- Lastly, the challenges around crowding and **capacity** are likely to require industry wider solutions which have a long-term planning horizon. For example, a station car park will typically have a 10 to 15 year payback period which is likely to fall outside the time horizon of a 7 to 10 year franchise term. The DfT has sought to implement a residual value mechanism within franchise agreements to mitigate this risk on capital investments, and has used Section 54 agreements to underpin rolling stock investment. However, these offer only limited protection on long-term investment and only work if both parties agree the value and price of the proposed investment. Arguably, the franchise model has proven to be even less suitable in scenarios where the DfT is looking for a steward of operations through a period of major change - as the recent challenges on the GTR franchising clearly demonstrate.

The current conflicts in the franchise model can create businesses that fear their premium line, rather than focus on customers. Up to 40% of revenue is already committed to the Government and c. 14% is already committed to NR in any given year. Companies must generate short term revenue to remain afloat, meaning there is no mechanism to consider long-term passenger requirements or engage in an open and constructive dialogue with industry stakeholders about how to maximise the economic and social value of the network.

**Q. The industry requires greater innovation to improve customer satisfaction and develop new solutions for capacity and fares. How can the revenue risks and uncertainty associated with this be reconciled with a franchising award process linked to a strong financial evaluation and which promises significant income streams for the Treasury?**



## 2.5 ...means the industry is not able to work together to address the issues...

The challenges facing the franchise model do not just impact the train operators themselves, but also permeate the wider industry and therefore threaten to undermine many of the current attempts that Network Rail and the Rail Delivery Group are making to better position the railway to accommodate growth.

The key requirement to resolve between operators and NR is not necessarily one of structure, but rather the creation of strong relationships and the alignment of objectives. Under the current model, this is not always possible. Even when this does not occur, there remains a mismatch between timeframes given the difference in time periods between franchise duration and NR Control Periods.

**Q. The franchise letting process and incentive structure needs to be more closely aligned between NR and operators. How can this best be done, especially when operators may make stronger financial returns if they can negotiate contract change on NR's late delivery?**

This disconnect also extends to the wider supply chain. For firms fully engaged with the industry - such as rolling stock manufacturers - the cycle of franchise bids, each with their own individual franchise targets, makes it difficult to act in the best interests of the industry and the passenger. It also makes it difficult to consider the rolling stock requirements of the industry holistically - meaning that there are often competing and incompatible demands for the redeployment of existing trains, whilst decisions on the deployment of new fleets are made on a franchise by franchise basis without a view of the impacts on the whole life cost to the industry or the long-term sustainability of the supply chain.

For suppliers less familiar with the industry, the disadvantages of the franchise bidding process are even more acute. Third parties that have not traditionally worked in the industry - be it potential delivery partners, technology partners or investors - are reluctant to commit time to support a bid process when they have an uncertain chance of winning a contract for a business the 'client' does not currently operate, but nevertheless requires a firm financial commitment. Faced with such a challenge, many potential partners simply refuse to engage. At a time when the industry is focusing on ways to reduce demands on both the taxpayer and the fare-payer, the opportunity to leverage third party funding and innovation needs to be made as simple as possible. At present, the opposite is true.

**Q. The industry needs to establish partnerships with third parties to bring in new funds and support innovation. The franchise bidding process is not a realistic mechanism by which to do this. How can the industry allow and encourage greater innovation during the franchise period itself when companies can offer partners greater certainty?**

## 2.6 ... and may not support a holistic approach to demand management.

Recent franchise bids have been based around plans to maintain and enhance demand and revenue growth, reflecting an unwritten assumption that such growth would be beneficial for the passengers, the industry and the national economy.

There is some good logic behind this assumption - the railways have significant spare capacity across most of the day and the marginal cost of filling that capacity is low and therefore more passengers can translate to improved financial performance. Moreover additional demand for rail - whether it provides greater access to employment or helps deliver modal shift away from private cars - has significant societal benefits.

However, the business case for delivering greater growth on the railways varies significantly depending on when and where that growth is generated. Growth at off peak times in areas of spare capacity may have a high net contribution for the industry, but further growth in the peak and on crowded services may only worsen current crowding problems. The business case for investment in rail infrastructure requires demand across the whole day and a consistency of demand across the year. If operators are only able to stimulate "peak growth" on flows which are already heavily used, then passenger growth on the network could actually be highly undesirable.

When franchises are incentivised on short term revenue growth, they are likely to prioritise any revenue growth which they can accommodate within their available capacity (and specific crowding targets specified in their franchise agreement). But while this makes commercial sense for the operator, it may not make sense for the industry. Rather, an holistic approach to demand growth and demand management might take a longer term view and consider:

- How further growth could be encouraged in the shoulder peak periods and be able to weigh up the whole life business case for the fare reductions which would be required to drive such a shift in behaviour against the long term infrastructure cost of accommodating more peak demand;
- How a radical change in the fare strategy on the network could achieve the twin objectives of making the fare structure easier and more accessible for passengers, whilst also using greater variability in price to ensure a better alignment of supply and demand;
- The management of services and demand across wider regional networks to work with passengers (and developers and businesses) to focus demand on the services which had a greater level of capacity and were the easiest to expand in the long term;
- A long term travel management strategy which may actually reduce the demand for travel - for all journey purposes - in areas where better technology means people and businesses can be as effective remotely without the need for and associated costs of travel.

The development of such a strategy requires a long term planning horizon which encompasses all aspects of rail operation and is closely integrated with the wider economic strategy of the country. One would expect the Government to play a key role in leading the development of such a strategy and the franchising model is not the right mechanism to drive this change. But equally, the franchising model needs to have a common set of objectives which provide the right incentives to drive the "right kind of growth" and allow operators to help manage demand in areas where further growth may not be desirable.

**Q. The rail industry has limited scope to accommodate further growth and therefore needs to develop a more holistic approach to demand management. How can the franchising model evolve to ensure that operators have the right contractual freedom and financial incentives to support this process?**

# 3. A single network facing different challenges

## 3.1 A network of different customers with different requirements

One of the central tenets of the rail network at the time of privatisation was the need to maintain the feel of a single network for customers, and this has remained central to all Government policy over the last twenty years. Across all areas - especially in ticketing - there has been an assumption that the customer experience should be similar for any journey, irrespective of distance, and that all of the network should be able to accommodate and sell tickets for such a journey. This thinking has led to a common approach across the rail network on a wide range of issues from franchise models, customer service and ticketing.

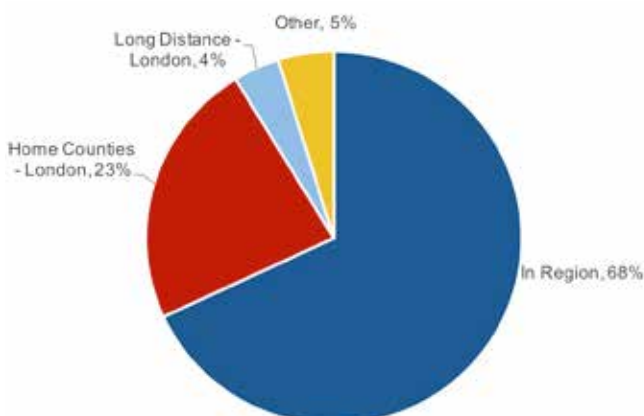
However, this single network is increasingly used in different ways by different customers. First, there is a clear regional focus on how customers use the rail network - in 2015/16, 68% of journeys on the network were made within a single Government office region, and a further 23% were from the home counties to London in the traditional commuting area (See Figure 15).

At the same time, the usage pattern differs radically across different rail businesses. This is seen most simply by comparing the average journey length and yield across the three classic TOC types of Long Distance, London & South East and Regional (see Figure 16). A more detailed analysis at a TOC-by-TOC level would highlight further differences between businesses, and even some material differences in the different business units within specific TOCs.

Different TOCs also play significantly different roles in the transport networks and economic fabric of the cities they serve. For example, in London, 35% of people commute to work by rail, underground or tram, but in Manchester that figure is only 4% and in Bristol it is only 2%. Similarly, the overall engagement in the network is different in different areas. For example, in the South East, the average person makes 36 trips per year by public transport other than local bus, compared with only 19 in the East Midlands and 16 in the South West. This is just one example of the differences in the role, quality and economic value of rail provision across the different regions in the UK<sup>3</sup>.

<sup>3</sup> For further analysis of variations in rail provision across the different regions in the UK, please see the CBT report 'Credo Benchmarking of Rail Services Across Great Britain'

Figure 15: Split of rail journeys by destination type





The different role that the rail network plays across different customer and geographic segments is one of the key driving forces behind the move to deliver greater devolution in strategic direction and control of the railway.

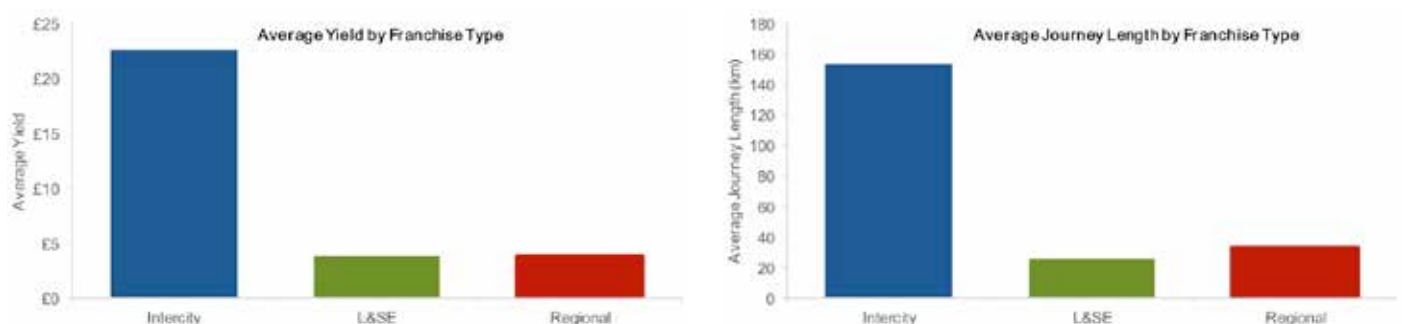
The argument made by Merseytravel in its case to take over local control of Merseyrail Electrics in 2002, was that only through local management and a team that ran the network in Liverpool could the network truly reflect the socio-economic opportunities and challenges, and ensure that the service provided was relevant and appropriate for the area. Being closer to the customer and key local stakeholders was an important element in helping Merseytravel work with Merseyrail to transform it from “Miseryrail.” The same argument was used by TfL in its case to first take over, and then expand, the LOROL network. Rail North and West Midlands Rail are further iterations of devolution, though the pace of involvement and responsibility has varied. However, even under rail devolution, the funding (i.e. subsidy) still comes from Central Government in the form of various grants, although that situation will change for TfL in 2018. Devolution is not yet a funding model, rather it is a form of franchising and a means of franchise management.

However, outside of the London Overground network which is run on a concession model, the increased focus on local management models has not been accompanied by the development of different franchise models to meet the specific needs of local markets.

Different TOCs play different roles in supporting the economic growth of the UK, and therefore the incentive structures placed on the TOCs should be different to reflect the separate ways by which they can maximise social value. For example, London commuter TOCs should be incentivised more on providing capacity and developing solutions which help address the housing crisis in the south east. A TOC providing rail services in to communities in rural Cumbria may have a very different role. Indeed, as rail services become more local, so their role within the local community will become more targeted.

**Q. Different customer segments have different requirements. How can this differentiation best be accommodated without losing the integrity of a single rail network?**

Figure 16: Different characteristics of different TOC types



### SECTION 3

#### A single network facing different challenges

Given the differences in customer segmentation and passenger requirements across the railway, one could even challenge the importance of a single national approach to the rail network. The potential damage which could be caused by fragmentation was one of the key risks identified at the time of privatisation, and as a result significant safeguards were put in place to ensure the inter-availability and interoperability of fares, tickets and information and the impartiality of retail systems and approaches. As a result, passengers can buy tickets for a journey between two stations hundreds of miles away as easily as they can from their local station to one just down the line.

The benefits of such an approach are self-evident, but there are significant downsides:

- The requirement to retail tickets which are valid for travel across the whole network is a challenge and a potential barrier to streamlining the retail process
- The need for interoperability of rail tickets means that any new ticketing solution must be accepted across the whole network - and this challenge has been a major impediment to the adoption of a more contemporary range of electronic ticketing (although the expansion of Oyster onto the national rail network demonstrates that this can be overcome)
- The requirement for a single national fare structure also contributes to the public confusion and perceived inaccessibility of rail ticketing.

Given these downsides, one must question whether the pre-requisite of national interoperability justifies the cost. Based on usage patterns, the case may not be that compelling.

- 37% of passenger journeys (22% of revenue) is derived from season ticket flows which (by definition) are based around passengers making the same journey between two specific stations
- 67% of total passenger journeys (54% of revenue) is based on travel within a single Government Office Region and therefore are "local" journeys where the national interoperability of the rail network may not be a priority
- A further 28% of journeys (32% of revenue) is derived from journeys to central London rather than across the national rail network as a whole.

By contrast, only 2% of industry journeys were made between regions (excluding London) which did not have a direct border.

Realistically, it may not be possible (even if it were desirable) to draw boundaries around the national rail network and adopt a fundamentally different approach in different parts of the country. However, it should be noted that for the vast majority of passengers, the current level of national integration is not necessary and could even be disadvantageous.

**Q. The interoperability of fares, ticketing and information across the entire national rail network has been regarded as a key requirement which must be maintained at all costs. How important is this requirement to the vast majority of customers, and is this actually stopping the development of a more efficient and innovative way to meet the needs of the majority of customers making regular short distance journeys?**

### 3.2 A network making different use of its core infrastructure

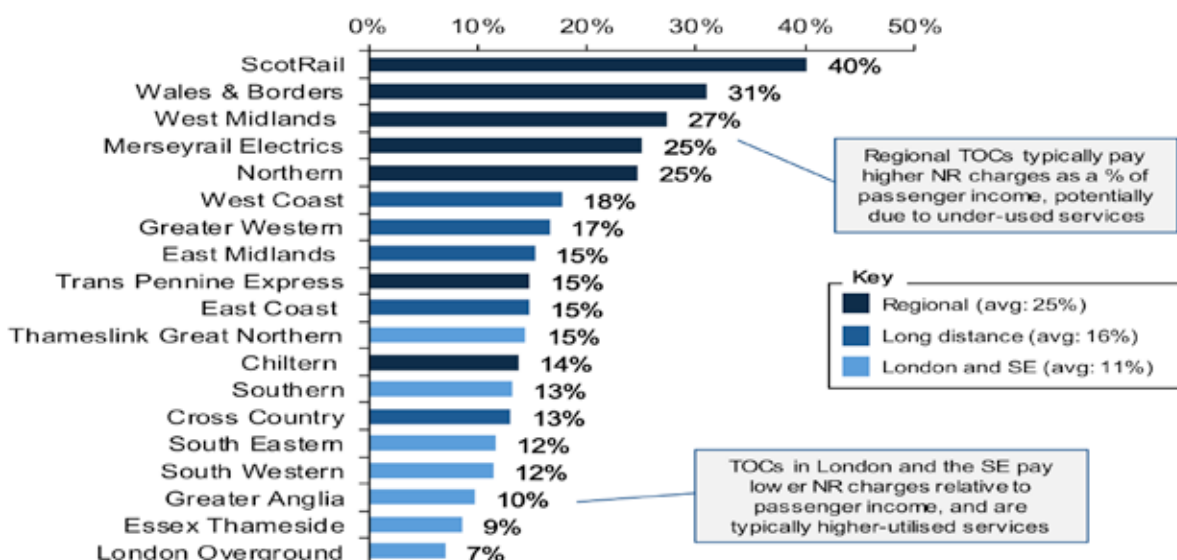
As well as having a different relationship with their local economy and customers, current TOCs have a fundamentally different relationship with Network Rail depending on the size, scale and focus of their businesses. This is seen most starkly in the importance of infrastructure costs within TOC business models - where NR costs range from 7% to 40% of the cost base across the different train operating companies (Figure 17).

This analysis of the cost base shows how NR cost comprises a relatively small percentage of the cost base for London and South East TOCs (averaging 11%), whereas it is over a quarter of the costs of most regional TOCs. Therefore the opportunity for, and importance of, delivering cost reduction through a closer alignment between operations and infrastructure clearly varies by franchise type.

Moreover, there is a fundamentally different alignment between NR and TOCs on different parts of the network. Previous work carried out for the McNulty review in 2011 found that 79% of the train services run across NR's Anglia route were operated by the c2c/Greater Anglia franchises, whereas at the other extreme, the train services operated across the London North Western route were split across 12 different franchises. In a scenario with such different operating models on different segments of the infrastructure, a single approach to managing that interface is unlikely to be effective.

As well as the differences in cost and access, different TOCs will also have different priorities from their interactions with NR and the operating requirement and the prioritisation of what the operators - as customers - need from NR as their client will also be different. In a perfect world, everything would get better. However, in an environment where the network is capacity-constrained and there needs to do the best with available resources, there will be inevitable trade-offs between reliability, time and speed. A one-size-fits-all performance model cannot reflect the priorities of several businesses. Whilst NR has recognised this to a certain extent, and devolution and Joint Control Boards are designed to ensure a common alignment of interests between operator and infrastructure maintainer in any given region, this assumes that the requirements of operators in a certain region are always aligned. However, this may not always be the case - especially in areas where operators with fundamentally different customer segments compete for track access and by extension the priorities of the funder and the network manager.

Figure 17: Percentage of TOC cost base paid to NR





## 3.3 A network which needs different things from stations and trains

Most of the discussion on industry structure and management has focused on the management of operations and track infrastructure. However, an industry wide solution should also include an optimal relationship for rolling stock and for stations. This is a further area where the requirements of different TOCs vary considerably.

### 3.3.1 Rolling Stock

As Operators face different operational, commercial and capacity challenges their requirements for a rolling stock solution will also change:

- For example, on a large regional franchise such as Northern, the optimal rolling stock solution could be highly customised to reduce the operating costs of the total network over the entire franchise (for example via a sustainable power supply or a lightweight tram-train which has lower maintenance requirements). Investment could also deliver significant passenger growth - but such growth will be seen as “high risk” during the bid process. Such radical solutions may have a 20- to 25-year payback period, beyond the life of a single franchise, and therefore would require commitments well beyond the scope of a traditional franchise (or even a Section 54 agreement) to deliver
- Conversely, solutions which offer the best long term capacity for the industry may not make sense for a franchise in its immediate time horizon. For example, the business case for longitudinal seating design to maximise capacity (as seen on London Overground) may not make sense at present, but could be compelling in 5 years’ time if growth continues. In a model where operators are considering revenue maximisation in a 5 to 7-year period, such an investment would not be advantageous through the life of a franchise and therefore a new train might be ordered with a traditional seating layout that will not ideally meet the requirements of the next franchisee.

The nature of the procurement process may also fail to capture the right benefits or long term planning considerations from the rolling stock manufacturers:

- In a scenario where potential franchisees are developing their rolling stock strategy during the tender process, and have a natural focus on the reduction in cost, this may limit the scope for innovation in customer centric rolling stock design and the ability of the rolling stock supply chain to engage positively in shaping the future rolling stock strategy for any given franchise
- This cost focus on the current franchise has also created a recent bias towards the introduction of new fleets rather than the refurbishment of existing fleets. This will deliver significant benefits to passengers in the short term - and can be delivered at lower costs over the immediate franchise than a refurbished solution. However, a potential over supply of new rolling stock over the next few years risks the short term sustainability of the refurbishment supply chain in the short term, and could have significant cost implications for the industry in the long term if it undermines the residual value of rolling stock assets with a lifespan of 25 years or more

The DfT or another contracting body can circumvent this problem by specifying its exact requirements for a long term rolling stock solution (something that TfL and Merseytravel have both done in recent rolling stock procurements) and that may well be the right decision for long term planning issues affecting a strategic national asset. However, this would have an immediate impact on the commercial business model of the operating company and force its thinking about the business decisions it should be making and the customer service it should be offering. Such detailed specifications begin to challenge the rationale of the current franchising approach, which seeks to transfer commercial decision making and risk and reward to the operator.

**Q. Long-term rolling stock policy and short-term commercial decisions may force different priorities. How can a franchising model ensure consistency across both areas to maximise the economic value which the industry delivers to the UK?**

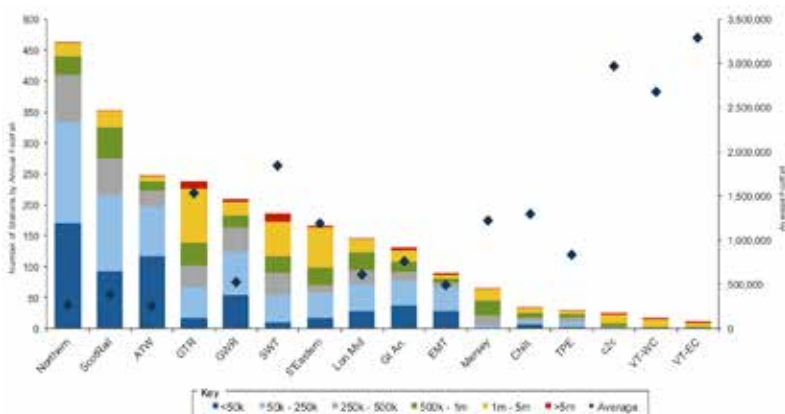
### 3.3.2 Stations

Whilst stations are the common structure by which passengers board trains for every rail business in the world, how customers use their station and the role the station plays in a community is different for every TOC. This is most clearly seen by the number of stations and the average footfall at the stations operated by different TOCs - ranging from Northern which operates 464 stations with an average footfall of 250,000, through to East Coast which operates 11 stations with an average footfall of 3.3m. (See Figure 18).

Reflecting this difference in station usage, the commercial and economic opportunity at stations is fundamentally different for different businesses.

- For rural services, the station has a role to play at the heart of the community and needs to be developed as such
- On commuter services, access and capacity are key whilst certain high footfall stations may have key development opportunities
- City centre stations are likely to be prime development opportunities, whilst intercity stations with high trip length and food footfall provide the type of commercial opportunities normally associated with airports.

Figure 18: Number and size of different stations across TOCs



### SECTION 3

#### A single network facing different challenges

Whilst the nature of the opportunities differs by station type, significant development potential exists across the whole network. Specialist skills, private funding and a long-term investment horizon will be required to capitalise on these opportunities. It is not clear that either TOCs - focused on operating train services with limited capital expenditure - are the right companies to develop this opportunity. Further, the current franchising model does not incentivise the creation of a long-term joint venture which could bring the requisite skills to supplement the TOCs' experience. It is also not clear that Network Rail - with a natural focus on the development of rail infrastructure rather than customer focused commercial buildings - is the logical organisation to more this forward. Rather, is this something that could be better done by specialist infrastructure investors with a longer-term time horizon, potentially developed through a more strategic partnership model linked to regional development - as was seen in the redevelopment of the area around St Pancras / Kings Cross and as TfL are currently exploring the redevelopment of underground stations such as South Kensington.

International experience provides some clear alternatives for station management. Other countries have demonstrated the possibility of specialists companies to develop opportunity around stations. For example, SBB in Switzerland has established SBB Real Estate to develop sites around the railway stations in that country and it is now working on about 100 sites - with the flagship project around Geneva delivering 120,000 m<sup>2</sup> of office and commercial space. The success of Jernhusen AB in Sweden, which owns 38 stations and manages an additional 200 in Sweden, also provides evidence of an alternative model which has supported the commercial development around stations whilst also maintaining a clear incentive to encourage train travel and maintain a welcoming station ambience. Alternatively, in less densely populated areas where the station could act as a hub both for public transport and the wider community, is this something which should be led by Local Authorities or Local Enterprise Partnerships to maximise the contribution stations make to their local communities and economies?

Developing a solution to station development is not just a commercial opportunity but also a capacity imperative. The industry is preparing for passenger-km to increase by 90% over the next 25 years. However, a significant majority of station car parks already operate at capacity, and overcrowding at major stations is beginning to cause serious issues to passenger flow during peak hours.

**Q. New approaches are required to capitalise on the commercial and economic opportunities at stations. This will require specialist skills and long term commercial models. How can such a requirement be included within the wider industry franchising model?**

## 3.4 A network facing different competitive pressures

The award of rail franchises is a competitive process, and as noted above that process has been highly effective in maximising promised returns to the Treasury (even if many of those returns are forecast to be achieved at various points in the future). However, once franchises have been awarded, operators face different competitive dynamics - both within the industry and from other modes of travel.

### 3.4.1 Rail-on-rail competition

There is relatively limited direct competition between franchised operators on point to point routes. On the top 1000 routes by revenue across the rail network, we estimate that one operator runs all direct services on at least 75-85% of these routes. Where there is rail competition, it tends to be limited and based around a choice between a fast, direct service and a slower, cheaper service running an alternative route. There can be more effective competition for a market in a competed catchment where passengers can drive to an alternative station (for example either Greater Anglia or GTR from East Bedfordshire and West Cambridgeshire). There can also be competition for allocated revenue (if not passengers) through the ORCATS allocation system. It is possible that the letting of franchises in a cycle, without consideration of their actual competition, creates sub-optimal decisions - either on the customer opportunities from competition or the management of capacity and risk arising from such competition.

Rail-on-rail competition could deliver benefits for passengers. Open Access Operators currently compete with Franchised TOCs on price, frequently offering lower fares for both 'Walk up' and Advance Purchase tickets, and have delivered service improvements and on-board innovations such as widening the range of ticketing options and introducing Wi-Fi and state-of-the-art information systems. Beyond Open Access Operators, where Franchise Agreements have been less restrictive on price (e.g. Chiltern Railways) on-rail competition may have contributed to innovative service improvements, leading to improved NRPS scores.

On-rail competition is already well-established in several European markets, such as Germany, Sweden and Italy where it has delivered significant benefits to passengers, including lower fares, increased service frequency and customer service improvements. The move towards on-rail competition in Europe is continuing, as on-rail competition is slated to be introduced in France, Spain, Belgium and Finland in the near future. Additional competition could bring better choice and benefits for UK customers - although it is not clear it this can be done without impacting the overall capacity of the network or while protecting passengers' ability to board the first available train.

Despite these benefits, a bigger challenge facing the industry is the asymmetry of views between the DfT's franchise model and the economic model of competition presented by the ORR and the CMA (with Open Access franchise models). Much has been written on the pros and cons of Open Access, and it is not something that we intend to revisit in this paper. However, in the context of developing new models for franchising, we would note that the introduction of competition may offer greater scope for innovation and immediate customer choice - but it is not clear that the combination of Open Access and franchised models is financially sustainable. Moreover, the introduction of Open Access services after a franchise has already been awarded could fundamentally change the commercial model for the franchised operator that submitted the bid. Even if the direct revenue loss could be covered via a provision in the franchise contract, the wider implications of unexpected competition on the bidder's commercial strategy (with a committed franchise premium to deliver) cannot be effectively "insured".

**Q. There is limited genuine competition between operators under the current structure, and Open Access can pose significant challenges to franchisees' ability to meet committed premia. How can the industry encourage competition in the fairest possible way for all parties?**

## SECTION 3

### A single network facing different challenges

#### 3.4.2 Non-rail competition

At present, UK rail has only a 6% market share of journeys over 5 miles, and a 14% market share of journeys between 25 and 50 miles. This suggests that the more significant competitive opportunity may come from attracting customer journeys from other modes. The scope for doing this will clearly vary by franchise.

For example, on a long-distance route that competes with air, there is clear scope for competition on price and service with airlines for an existing market. Rail's success in doing this has been a key factor contributing to an 8% reduction in domestic air travel within England between 2002 and 2015. Furthermore, air travel to and from London, where rail has a stronger competitive advantage than on regional flows, fell by 20% over the same period.

Likewise, on a regional service where c. 60% of people still drive to work in city centres (or indeed in Outer London, where 38% of people drive to work), an effective rail operator would strive to take share from people who would otherwise drive. Contrastingly, on a London commuter network where car's share is down to 36%, there is limited scope or need for an aggressive competitive strategy with other modes that could instead prove revenue abstractive. If the competitive opportunity is also at peak times where the network is full, any further growth may even have a negative business case if it requires investment in new stock or infrastructure which will not be used outside the peak.

**Q. There are radically different competitive dynamics and opportunities across different franchises. Is a "one size fits all" transfer of revenue risk to operators the best way to achieve this?**

#### 3.4.3 Competition from Not Travelling

In addition to the choices which people have around their mode of travel, the digital revolution is also causing people to reassess their overall need for travel.

The most immediate impact on rail demand has been the growth in remote working and working from home. In 2014, the ONS reported that 4.2m people (14% of the workforce) worked from home - and that this number had increased by 45% since 1998. Over half of these people were managers, senior officials or professionals - the type of professions one would expect to be the bedrock of commuting demand. This trend is forecast to continue. For example, Research by Lancaster University's Work Foundation, published in the report "Working anywhere: A winning formula for good work?", predicted that flexible working will be the main way of working for 70% of organisations by 2020. This trend threatens the continued growth of rail demand - both a curse for the continued revenue growth in the industry but also a potential blessing for an industry struggling to cope with severe overcrowding in the peak.

The impact of digitisation is also beginning to impact the demand for leisure and business travel. For example, online retail now accounts for over 20% of the non- food retail market - thereby reducing the role of travel to the high street or the city centre, whilst continual improvements in video conferencing is serving to reduce the need for business travel. Again, these trends could threaten the demand for rail travel, but the negative impacts on train company profits could well be outweighed by the social and environmental benefits of reduced demand for travel.

**Q. To what extent does the rail industry want to encourage people to consider alternatives to travelling, and in so far as it does want to encourage this, how can a franchisee with revenue risk possibly be incentivised to support this?**



### 3.5 A network serving different stakeholders

As well as competing in different markets, the franchises face different external pressures and need to meet the needs of different stakeholders.

This pressure has led to calls for greater local control of franchises and the increased call for the devolution of management of franchises to local management groups. There have been some obvious successes in a devolved model – most notably with the growth of the Merseyrail franchise since devolution in 2002. Whilst there are the green shoots of devolution in other areas, both through the increased regionalisation of NR's business model and the growth in power in Transport bodies in the North and West Midlands, franchising models that can meet the requirements of these regions have not been fully defined to date. For example, the treatment of revenue risk and the best way to integrate the rail network into the wider local transport network remains unclear, and a blended approach will look to incentivise the operator to grow rail demand, whilst also maximising the economic value of the broader transport network across the whole region. It is not clear whether the current franchise model – even the commercial model under which Merseyrail operates – could deliver this.

There is also an interesting contrast with the growth seen on London Overground compared with other rail franchises. Since it was let as a concession by TfL in 2007, LO passenger numbers have increased dramatically – showing a demand increase of c. 80% between 2011/12 and 2015/16 compared with an average of c. 30% for LSE TOCs. Clearly, the transformation of that franchise delivered through TfL's investment in new stations, new trains and the roll-out of Oyster ticketing, delivered a step change and enabled the growth in the network – and therefore it would be overly simplistic to link the LO operating model itself to revenue growth. However, what it does highlight is that the transfer of revenue risk to a private operator is not in itself a pre-requisite for growth – although it could be an important way to protect devolved authorities from any financial exposure should a franchise underperform against its revenue target.

The common concept of devolution will likely translate to different requirements in different regions, and much of the discussion to date has focused on how rail can work better in supporting travel to urban centres. However, the same solution may not be appropriate in more rural areas. For example, in the 2011 Census, 3% of people living in the West Midlands commuted to work by rail, compared with only 1% in Devon and Cornwall. Whilst both regions may be better placed to develop a local rail strategy than a centralised function in London, it is far from clear that they require a common model.

However, a devolved franchise will require effective local management. One of the reasons why the devolution of London Overground and Merseyrail has been successful is the clear direction provided by a strong and well-resourced public body. Not all regions have this at present – and even if they do, the geography of that authority may not be well aligned to the national rail network or the immediate travel to work area. Without this organisational capability and alignment devolution may not be successful.

**Q. There is an increasing view that greater local control and specification of rail services will improve the economic contribution and customer service of the rail industry. How can such a model be developed within the franchising system that offers sufficient flexibility to meet very different stakeholder needs across the country?**



## 3.6 A network at different stages of development

As the rail industry becomes more and more important to the economic growth of the country more capital spending has been committed and delivered to upgrade the network. The requirement to manage the network through major change - be it through the upgrade of lines as currently happening on Thameslink and is expected on the West Coast Partnership franchise, or the creation of new lines as will be seen on East West Rail - is a key challenge both to meet short term passenger requirements and to maintain the credibility of and public support for investment in the railway. Recent issues with major modernisation programmes suggest that further work is required across the industry to ensure the delivery of complex projects within agreed budgets and timescales, and the appropriate role of the franchisee could be considered as part of the scope for any such review.

Except for the current GTR franchise, the DfT has asked operators to retain revenue risk when it lets contracts - even when managing the network through periods of considerable change - and has relied on the industry compensation mechanisms to hold operators neutral for any revenue impacts. Even on GTR, the DfT specified the contract for and appointed a train operator who could manage the network through the change, rather than a programme manager who could ensure continuity of the network through change.

Given the challenges of delivering major upgrades on the network, it is not clear that this is the right approach. Franchises with a major change / delivery mechanism will require a different set of skills - and a much greater emphasis on project and programme management and integration - than a TOC on a business as usual activity. Further differentiation of the expectations of that contract and the skills of the contractor may lend themselves to a radically different contract structure on these franchises.

**Q. The franchise model needs to find a way to operate trains during periods of major change. How can the DfT share models that provide the right incentives and secure the right skills during this work?**

## 4. Improving the effectiveness of the current franchising approach

### 4.1 The Role of Franchises within the current industry structure

The train operating companies which deliver passenger services under franchise are just one part of the numerous stakeholders in the rail industry. It is not practical to consider changes to the franchising model without considering how TOCs interact with the wider industry.

In particular, there are eight key points which define the role of TOCs at present:

1. There is a three way separation of the industry between operation, infrastructure management and rolling stock ownership;
2. Network Rail maintains a monopoly position on the maintenance, renewal and enhancement of the rail infrastructure;
3. The network suffers from significant capacity constraints, and therefore the industry structure and strategy must look to ensure the best possible use of this capacity to meet the needs of passengers and freight;
4. There is a separation of operating responsibility between passenger services and the operation of freight services;
5. The industry regulator focuses on the economic efficiency of Network Rail and has limited oversight of the day to day business of train operation;
6. The requirement for a single integrated national rail network - with integrated, inter-available ticketing available across the whole network - remains a central operating requirement for the railway;
7. The Government retains a central role in defining the fare products which the industry offers and regulating the rates of increase of those fares;
8. There are a limited number of regional governmental bodies which have the requisite skills and experience to let passenger franchises, and where these do exist they do not necessarily align with Travel to Work areas of the division of the rail network.

## SECTION 4

### Improving the effectiveness of the current franchising approach

On a larger scale, the rail network itself is just one part of the wider transport infrastructure in the UK. This further defines the role of TOCs around two further key themes - specifically:

1. The process of letting rail services is seen as separate and distinct from the specification and procurement of other public transport services at both a local and a national level;
2. Bus, coach and rail are seen as potential competitors - especially in the long distance market - and therefore there must be some separation between these services to maintain a dynamic competitive market.

There are challenges around all ten of these points, and a wider review of the strategy for rail in the UK (may conclude that these points need reviewing. However, when viewed simply through the prism of the debate on the future of franchising, it is not clear whether potential issues with passenger franchising merit a wider review of industry structure, whether any radical changes would improve the overall health of the industry structure or what the timeline could be for delivering any major changes to the industry. The priority should therefore be to improve the sustainability of franchising within the current industry structure as a priority.

There are four key themes which would help deliver sustainability, and within these four themes ten potential changes that would improve the sustainability of the franchising model without requiring radical change to the industry structure.

## 4.2 Theme One: Changing the variable from finance to quality

At present, the franchise structure defines the service level the DfT wishes to procure on any given franchise, and then invites bidders to explain how they will deliver that service and what the cost (or premium) will be to the Government for delivering that level of service. Whilst there is some scope for variation in how that service will be delivered, and the “quality” of proposals bidders suggests to meet the overall objectives of the franchise, they are always expressed against what the Government wants to buy. This means that the major variable is the financial proposition to the Government.

In the future, especially as budgets come under further pressure, it may be advantageous to ‘flip the question’, and define what the Government can afford (be that in terms of the subsidy which it pays or the premium which it needs to receive) from the operator. Bidders could then be asked to define the service level they could provide within a given financial envelope - subject to some minimum operating requirements to protect key public services.

Such a change would have two key advantages over the current process:

- First, it would guarantee the affordability of the railway based on the available public funds (whilst recognising that what is affordable and what is desirable may be significantly different)
- Second, it would give operators much more licence to be creative in their bids within a given financial requirement, which could prove a mechanism to get better value from the skills of private operators and bring greater innovation to the industry.

## 4.3 Theme Two: Changing the evaluation process

The principle of maintaining the 'MEAT' concept of selecting the most economically advantageous tender for the railway, should be retained. However, the term "economically advantageous" covers a broad list of potential priorities - and recent evidence suggests that the priorities are based on the short term financial definition of economic rather than a more balanced definition reflecting economic growth. We have identified three potential changes in the evaluation criteria to reflect this:

### 4.3.1 Quality and Finance must be given equal weight

On the GA bid, DfT sought to give more emphasis to quality than financials - indicatively, quality was worth between 15 - 20% of the evaluation and financial performance up to 85% depending on the relative scores and ambition of the different bidders. Realistically, the nature of 'scoring in the round' (and the minimum compliance requirements on bids) means that all bidders scores are likely to range between c.40% and 70%, and therefore the scope to differentiate on quality is likely to be c. 5% of total marks.

This quality range is dwarfed by the scope for differing financial attitudes to influence scoring. For example, we estimate that on the GA bid, a 1% difference in the revenue CAGR across bids would have led to a 13% difference in the combined score between two otherwise identical, good quality bids. A 1% difference in the cost CAGR would have led to a 7% difference in scores. A 50% difference in quality (between 6/12.5 and 9/12.5) would have led to only a 4% difference in scores.

This is simply not enough to be a true differentiator and ensure that bidders focus on meeting the requirements of customers. We suggest that quality should instead form at least half of the evaluation criteria. Moreover, this should be based around the difference between a minimum-complaint bid and an extremely good bid with some outstanding elements (e.g. a range between 4 and 8 on the current scoring system), rather than a range between 0 and 10 that will never be representative of the spread from the average of 8 - 12 scored delivery plans prepared by competent operators delivering against a relatively tight specification.

### 4.3.2 Evaluation based on whole-network cost

At present, NR is involved in the bid process at arms-length and there is a very limited mechanism for decisions involving NR to be factored into a bid process. Therefore, if a bidder has an idea that would require additional NR investment it can be hard to include within a bid, whilst options which reduce the whole-life costing of the railway by saving funds to NR may receive quality points but are not included in the financial evaluation. Instead, NR charges are viewed as fixed and the bidder can then make plans to secure additional funds or delay service improvements off the back of NR delays. This is sub-optimal for the industry. Instead, in a new regulatory regime included within a subsequent control period, NR should have a chance to flex (with the ORR adjudicating if required) the infrastructure and access charge costs arising from each franchise bid. Differences in the infrastructure maintenance cost should then be included in any financial evaluation.

### 4.3.3 Formal evaluation of the economic benefits of proposals

If rail is a key asset for the UK economy there needs to be a more formal evaluation of the economic benefits of proposals developed by bidders. Initially during the franchise competitions, bidders had to submit an outline of the economic case for their proposals, but this concentrated on a tight "Webtag"-based evaluation of the transport economics which may not fully reflect the wider economic benefits of a proposal, not offer a formalised mechanism to translate economic benefits to evaluation criteria. This appears to be a missed opportunity - both to make sure that operators are aligned to maximising the economic value of the railway but also to recognise and credit innovation which could provide a boost to national or regional economies. A requirement for bidders to prepare a dedicated delivery plan - carrying a material number of marks - on the economic and social benefits of their proposals could have a key role to play in ensuring bids give appropriate focus to and are suitably rewarded for proposals which deliver significant economic benefit.

## 4.4 Theme Three: Creating a fairer financial structure for the industry

### 4.4.1 From bidder based franchise payments to Government specified licence fees:

The current mechanism suffers from the classic problem of prisoner's dilemma and encourages bidders to overbid. This has created the illusion of a financial windfall for the Government. However, it is largely based on a promise of "jam tomorrow". When revenue growth rates fail to materialise, passengers will suffer in order to meet the Government payment, and ultimately this will fail too. The Government will have failed to have got the payment which is wanted or the policy objectives which passengers need. The Government would be far better setting out an affordability target - how much money it needs from the bidder or how much it is prepared to subsidise depending on the franchise - and then bidders would indicate what they can deliver for this. This would offer financial certainty for the Government with additional opportunities generating extra investment for the passenger rather than the Treasury. This "licence" to operate could even be paid up-front at the start of the franchise, meaning that the financial returns are locked in and the franchisee is obligated to deliver on its objectives or default and lose its licence.

### 4.4.2 "Super-normal" profits should be hypothecated for the industry

This windfall from higher-than-expected franchise premia generated by the rail industry, should be retained by the industry. Whether it is used to support extra investment in infrastructure, a pan-industry focus on customer service, or to fund a more flexible and relevant fares structure, this funding could address some of the major challenges facing the industry. For example, we estimate that only 20% of the windfall would be sufficient to cover the costs of holding regulated fares flat in real terms for 5 years, introducing direct debit payment across all season tickets and introducing a new flexible season ticket for part time workers.

If the money is used in this way, the franchising process could generate real benefits for customers and the industry. If the contribution is used to fund other parts of the transport network - or is just seen as part of the public finances for UK PLC - the economic benefit that private operators are delivered will be lost to the public sector rather than given back to passengers.

### 4.4.3 No franchise should be too big to fail - for either the parent company or the network

Irrespective of industry, effective outsourcing to the private sector requires a realistic prospective that a company could be allowed to fail if it underperforms financially or operationally. The size and scale of current franchises limits this.

The DfT's principle recourse if there is failure is to call in the bonded Parent Company Support that operators must provide - amounts which are not in the public domain but are likely to range between £100 and £200m per franchise. This means that an operator would face a significant financial loss were it to hand back the franchise - albeit significantly smaller than the scale of a long-run revenue underperformance against an overly aggressive revenue bid as highlighted in Figure 14 on page 19.

## SECTION 4

### Improving the effectiveness of the current franchising approach

However, the receipt of a financial settlement from a defaulting bidder would not solve the issue of who would operate the service in the event of default. To a certain extent DfT has an insurance policy should this happen through the transfer of management to Directly Operated Railways (DOR), as happened when National Express pulled out of operating the East Coast service in 2009. However, it is not clear what capacity DOR would have to operate contracts and whether there is scope to take back more than one franchise in short succession. However, given operators are likely to be exposed to similar external risks at similar times, there must be a chance of multiple failure in short order, and therefore the practicalities of transferring multiple franchises to the public sector would be impossible.

This therefore raises the risks that, at present, bidders are relying on the fact that they will not be the first company to fail, and that the market simply cannot take more than one failure and therefore this will prompt a renegotiation for other operators that are "still standing".



## 4.5 Theme Four: Create a better alignment of risks for the franchise model

### 4.5.1 DfT should not look for bidders to propose policy change through franchising

In all recent ITTs, DfT has asked bidders to provide evidence of the simplification of fares structures or how bidders will deliver clarity regarding fares to passengers, which is intended to address some of the obvious inconsistency and unfairness in the fares structure across the industry. For example, the West Midlands Franchise ITT (published August 2016) asked for “Proposals to provide improved information or a simplified ticketing offer on flow where there are multiple ticket options available for passengers...in order for passengers to choose the most appropriate ticket for their journey.” However, the problem is that on each occasion, they have suggested, not mandated, that bidders deliver this, and required that any changes to be delivered without any supporting change in fares policy at the upper end.

The result of this is that any fare change requires a “leap of faith” that such fares would stimulate demand (often on crowded railways). For example, an illustrative three-day-a-week season ticket on some commuter routes would require a 66% growth in flexible season ticket holders to be revenue-neutral (see Figure 19).

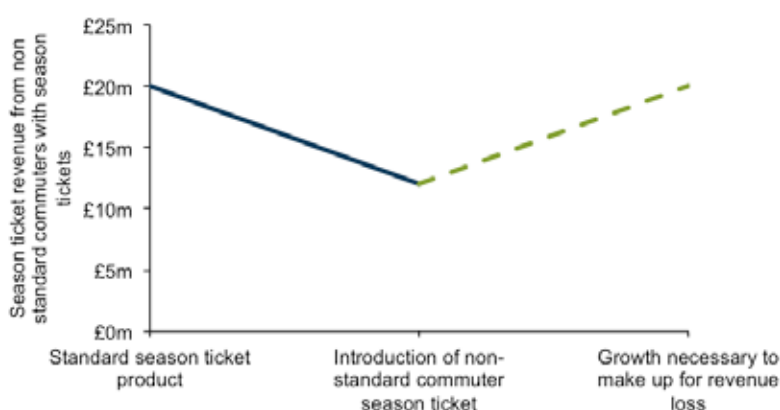
This is too big a risk to include within a bid without clear evidence from a field trial, and such a field trial is impossible within the bid process. Therefore, little progress is made - the financial risks are too great, the flexibility to do anything too limited and the quality marks insufficient to justify bidders taking the risk.

It is clear that franchise bidding is not the mechanism by which discrete changes in policy can be encouraged through the market. Put bluntly, if the DfT wants part-time season tickets, off-peak seasons, single-leg pricing or anything else to make the fares system simpler and fairer, it needs to mandate them in a bid process, or agree to hold any bidder harmless for the revenue implications of such a decision.

### 4.5.2 A common set of objectives for network development

Many franchises let recently have included a period of significant network enhancement - either through the delivery of a small package of network upgrades (such as the East Coast franchise) or a sustained transformation of the network through an Electrification programme (TPE). Bidders have been asked to link these improvements to a specific set of revenue forecasts, and this lends itself to the submission of an aggressive forecast which is contingent on the delivery upgrades.

Figure 19: Financial risks associated with a fare change



## SECTION 4

### Improving the effectiveness of the current franchising approach

There should not be a set of incentives which means that the operator benefits financially from a series of delays from Network Rail in delivering major enhancements or upgrades. Rather, there should be clear incentives in the franchise structure to encourage the operator to work with NR on delivery and ensure that all parties are incentivised to safeguard and benefit from the early delivery of major upgrades.

These incentives need to be aligned in a way which shifts from a simple transactional focus to a set of metrics which ensure that all parties have common objectives to ensure that schemes are delivered in a timely fashion. This should encompass not just scheme delivery, but also scheme origination, whereby the operating companies have a clear process for specifying and co-funding changes to the rail infrastructure where they feel that such changes would offer clear long term benefits for passengers underpinned by a strong business case.

#### 4.5.3 A consistent view on competition

The current “mixed competition” model of competition before and during the franchise period does not suit companies or passengers. In particular, the DfT cannot maintain a franchise-based view of competition - where companies compete for the contract rather than in the contract - at a time when the competition authority and regulator want to encourage in-contract competition. Whatever the solution, the current approach of Open Access operators providing competition at the margins whilst operating under different regulatory regimes and different cost bases does not appear a solid foundation for the future - especially when the potential operation of Open Access remains a “known unknown” during the franchise process<sup>4</sup>.

Realistically, under the current franchise model there is a very limited number of routes where competition is an option, and even then (on routes such as London - Birmingham, London - Cambridge or Liverpool - Manchester) the service propositions are so different that it supports competition through customer segmentation rather than customer service.

The case for rail-on-rail competition is not in itself compelling - especially on short distance services across a network which is capacity constrained and therefore need to ensure the best possible integration of services. Where it has been tried (most notably on train services from Gatwick), it has led to confusion among passengers and an inefficient allocation of capacity. Increased competition through restricting passengers' rights to use certain services (for example through dedicated fares) is also not consistent with making the rail network as accessible and attractive as possible for all operators.

#### 4.5.4 A clear link with the national industrial strategy

In addition to the clear economic benefits which the railway provides to other industries, the rail sector is a flourishing industry in its own right. The industry supply chain is currently going through a boom period - both in infrastructure development and in building new rolling stock. It is attracting new investment from multinational companies and providing a clear depth of exportable goods and services.

The current franchising process is somewhat divorced from this. There is no clear strategy in the prospectus of any franchise document of how the franchise could support the national industrial strategy and no commensurate requirement from bidders to demonstrate the role which they play in delivering this. This needs to change, and the DfT should consider three core options for future franchise models:

- First, there must be a clear requirement for bidders to demonstrate how the rail operation and the management of the supply chain will allow the specific TOC to support the industrial strategy, and material weight must be given to this in the evaluation process to this commitment. The exact approach here is likely to evolve and require some iteration as the new “industrial strategy” is developed

<sup>4</sup> For example, Alliance Rail Holdings launched a consultation into its plans for a London-Southampton open access rail service in November 2016, whilst the South Western franchise bids were assessed by the DfT

- Second, the DfT must retain the control and flexibility to alter the service level at short notice and within any given franchise to ensure that the railway supports the economic development of regions, and ensure that franchisees have appropriate incentives to support this in a timely and cost effective manner. This is a factor likely to become ever more important as changes linked to Brexit create new challenges and opportunities in developing the industrial base across the UK
- Third, in return for that control, the DfT must consider ways to protect the operator from the risks of economic downturn - both through traditional "macroeconomic" insurance to GDP and employment as it does at present, but also to specific regional changes caused by an evolving industrial base faces new challenges and demands from Brexit, automation and globalisation.

#### 4.5.5 Ensuring flexibility to deal with changing travel patterns

At the moment, the revenue based structure of the franchise award means that all operators are obliged to focus on growth at all times, irrespective of what that growth is in the wider good of the network, the passengers or the country. This is particularly true in the peak, when overcrowding issues mean that there could be a long run advantage in dis-incentivising travel.

In addition to network capacity issues, there are broader potential benefits from encouraging more remote working. Whilst technology has made travel time more productive, it is still "dead time" for many people and reducing the need for commuting could offer significant work life balance benefits, as well as opening up employment opportunities with people who find travelling difficult. Additionally, the environmental benefits of reducing the need for travel could be significant.

To a certain extent, train operators cannot hold back this trend, and therefore a growth in remote working could be a threat to the franchising model. But when considered holistically, the Government may be better off asking that train companies take an entirely different view - and actually support passengers with a fare structure which rewards remote working and therefore not travelling. Such an approach would require a radical change to the current evaluation process.

#### 4.5.6 A fare strategy which maximises economic value

In addition to having flexibility in service planning and delivery to maximise economic value, the DfT should also ensure that franchising implements fare strategies which maximise the economic value rather than the financial value of the railway. This is likely to include the development of new fare products which recognise the flexible nature of today's workforce, offer affordable commuting to part time workers and ensure that walk up long distance travel remains affordable - whilst at the same time ensuring that any resulting growth in demand can be properly accommodated on the network. These changes must be revolutionary - changing the system to deliver simplicity and trust - rather than simple additions of products or regulation to the current system.

The Government cannot award franchises with a clear focus on commercial performance and then criticise a lack of wider social and economic focus within the fares strategy. Whilst some operating companies could definitely do more on fares, the principal barrier to meaningful fares reform is an untenable approach to regulation which expects some fares to go down and change without giving licence to increase any fares or pay a lower premium. Whilst this remains the case, franchising structure will fail to deliver the real changes necessary to maximise the economic benefits of the railway.

## 5. A long-term evolution of the franchising model

### 5.1 A new role for operators in the National Rail and broader transport network

As outlined in section 4.1, the immediate priority must be on improving the effectiveness of franchising within the current industry structure. However, that short term focus on improving the current model should not prevent consideration of a new model for the longer term.

Any new model would require radical changes and could not be implemented overnight. In addition to the contractual and organisation changes it would require, it would also necessitate a careful review of the allocation of paths on the network to ensure that capacity was not compromised and the benefits of a seamless passenger experience were maintained.

Whilst the challenges of a new model should not be understated, the challenges of sustaining the current model may be greater. Simply sustaining the franchising model is unlikely to be sufficient to deliver the investment, customer focus and innovation required to address customer's dissatisfaction with the railway, meet the ever-growing capacity requirement and maximise the economic value of the railway.

Instead a new approach could be based around a new role for train operators - both within the National Rail network but also within the broader transport network. This new role would be based around a range of different franchise models, each with greater flexibility to deliver investment and meet the needs of different customer segments and local stakeholders. A collection of new franchises could also be sustainable enough to create and maintain a sustainable supply chain, whilst encouraging more flexible approaches to the delivery and enhancement of the network infrastructure.

The biggest risk of such a new approach is fragmentation across the industry - something which stakeholders have worked hard to avoid over the last twenty years. The success of any new model is therefore likely to be contingent on a central and independent body to oversee the operation of the system, ensuring that network capacity is maintained and specific route capacity is allocated according to market needs.

Even then, different franchising models may lead to different passenger experiences across parts of the rail network and threaten the commonality of experience currently offered by a single national rail network. The challenge is to ensure that improved, modernised and simplified experiences in different parts of the network are better aligned with customer requirements. Otherwise a single experience may be integrated but - by trying to be too many things to too many segments - it will fail to deliver in line with customer needs.

## 5.2 Building a new set of franchise models to innovate the rail industry

The analysis of the pressures and opportunities facing the different operating companies in the industry suggests that a “one size fits all” model – however well-structured and let – cannot solve all challenges. Rather, the franchise model needs to evolve into several sub-models more closely aligned with the needs of the different markets the industry serves, and the commercial and operational challenges it faces in each market.

We propose six outline models which could form the basis for the future of operations on the industry:

- **A competitive intercity model** – based around creating smaller franchises to compete for customers on intercity routes, this would retain the franchise concept but apply this to a package of slots and operating rights – combining “best of breed” best practice from the airline and utility model with the specific operating requirements of the railway in a way which would capture the benefits of competition identified by the Competition and Markets Authority, but doing so in a way which would not compromise capacity or customer service on the rail network
- **A commuter mixed concession model** – based around an availability payment model for providing the required capacity in the peak on core lines into London whilst continuing to transfer revenue to the private sector for delivering incremental growth and spreading demand off-peak
- **An “urban transport” model** – developed for cities outside London, designed to ensure the private sector operator is incentivised to promote integrated transport, modal shift and economic growth in addition to retaining a “traditional” commercial focus on costs and revenue – something which could provide a new model for integrated transport in the North East, for example
- **A “regional transport” concession** – an integrated model offering vertical integration across rail and horizontal integration across the management (and potentially delivery) of different modes of travel, scoped to deliver the best possible service within a pre-defined budget envelope – a model which could offer a mechanism for devolution in Devon and Cornwall, for example
- **A “project management” operation** – specifically designed to steward franchises through periods of significant change. Such a model would place the emphasis of programme management in the hands of specialist operators, who would then procure train services as part of an integrated package to deliver change in a timely and cost effective way. This would be a potential model to deliver the enabling works for HS2 or the ongoing transformation of the railway in the North of England.
- **A “design-build-operate” franchise** – capturing the benefits which integrated DBO contracts have seen in other markets to expedite the development of new infrastructure from delivery to initial operation – a model which could be used for the development of major schemes such as East West Railway or the reopening of local branch lines as feeders to the network

A potential framework for each franchise is included within the Appendix of this report. Further work is required to determine the specific details for each model – and to determine how these different models could be integrated to maximise the capacity of the network and maintain a seamless experience for passengers. Whilst there would be challenges to implementing any of these models, they could provide the basis for a new mechanism which would create a new market for train operators, provide a new approach to operating the railway and offer a new approach to ensuring the affordability of the railway.

### 5.3 Creating a new market for train operations

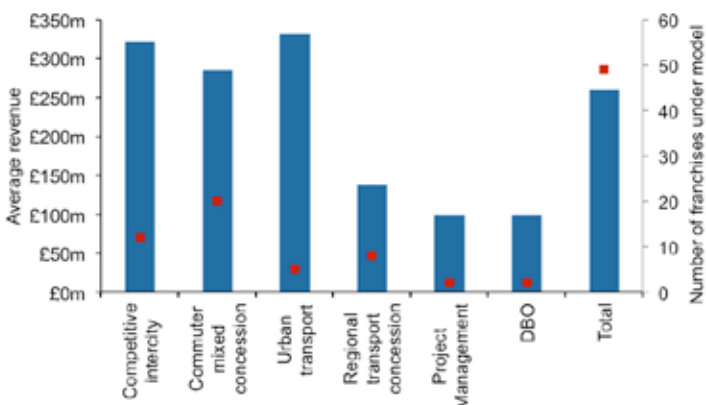
The development of six different types of franchise or concession model, each subdivided into a number of different franchises, would naturally reduce the size of a typical business unit that operates services. The exact number of businesses would depend on exactly how the network was divided and aligned with different devolved areas. However, an indicative assessment of the structure is shown in Figure 20 below. This implies that there would be 49 different operating contracts, with an average size of £260m, compared with today's 19 franchises with an average size of £650m.

This would make the business of bidding for, winning (and losing) contracts much more sustainable. For example, South West Trains, the largest franchise currently let under revenue risk with over £1bn of farebox revenue, would be divided into 10 smaller businesses, each with revenue between £80m - £120m. Rather than representing 33% of Stagecoach plc's total revenue, as SWT did, each franchise would represent 2-3%. Therefore, winning or losing individual parts of the business would not have the same transformative impact on the owning group as the decision on the SWT franchise will.

Smaller and more manageable risks of different types of contract may also serve to encourage new entrants to the market. Whether these are "commercial" operators looking to bring innovation to long distance services, "concession companies" with experience of running operating concessions for local authorities, or more operators with international experience, the additional competition in the bidding process could provide new ideas and greater innovation, as well as the potential customer and financial benefits that market economics suggests would occur in a competed market.

Such an approach will not be without challenges. The creation of smaller franchises creates the risk of a greater management overhead and the loss of important economies of scale. However, these costs are likely to be relatively minor and could be offset by the tighter management focus one could expect on smaller businesses. The bigger challenge is likely to be in ensuring that the creation of more businesses does not reduce capacity or compromise the operational efficiency of the railway. This is likely to require the development of new bodies with new skill sets to oversee the planning, capacity allocation and service recovery processes necessary to deliver integrated and effective network operation.

Figure 20: Indicative size and structure of new franchise models



## 5.4 Ensuring an integrated network operation

As noted in chapter 1, the industry has been going through a period of consolidation over the past 20 years in an attempt to deliver a more efficient operation and improved performance. However, continued integration and centralisation risks creating a number of “supersize structures” which may not be compatible with an operating base owned by the private sector and a railway which is closely aligned around the needs of distinct customer segments and regional stakeholders.

If this is the case, and there is a need to base the structure of the industry around a larger number of smaller but more focused businesses the driving question behind the organisation of the railway needs to change from the current focus of “how can the industry continue to consolidate to improve integration?” to a new challenge of “how can integration be delivered across a more fragmented operator base?”

When reshaped on this basis, the question highlights the need for an independent, customer-focused body to handle the system operation of the railway – to handle potential conflict in the planning process, operate the signalling and other parts of the network as required to operate the system and take the lead in making the operational trade-off required to run the railway.

Such an “integrated network operator” would be independent from the train operating companies, but rather provide a central “clearing house” for track access and operating rights. As the industry moves towards implementing a new philosophy built around a “digital railway”, the task of managing the traffic flow will change and support both a more centralised, informed and dynamic management approach.

The success of such an operator would depend on creating a clear commercial approach to managing the train service, with different services and network utilisation afforded different priorities based on the commercial and economic value of that service. The relative value could either be defined by the authority letting the contracts (in the case of the operating concessions), or by the relative prices that operators would be willing to pay in the competitive intercity model. The creation of such an internal market for capacity would also allow a much clearer commercial model to allocate paths to freight operators, as well as creating an internal market for track access for Network Rail (and other operators) to carry out maintenance and enhancement works on the network.

This network operator would have to be incentivised around the effective operation of the network rather than industry revenue. However, this does not mean that it would need to be publicly-owned. Rather it could be outsourced through a suitable commercial structure – in the same way as NATS, which is operated under a public-private partnership, with stakes held by airline employees and the government.

Taken further, this could provide the basis for a 25-year concession to deliver and manage the Digital Railway to deliver the required investment and then manage the service against this investment, in return for an ongoing performance-related management fee.



## 5.5 Ensuring an affordable railway

As identified above, the current franchising model is facing a period of turbulence, which is largely down to concerns about the capacity of the network, the amount which passengers are being asked to pay to access the network and the contribution which private operators are providing towards the total cost of the network.

To a certain extent, this turbulence cannot be resolved through changes to the industry structure, but rather through greater clarity on the role of the railway itself. The country needs to define what role it wants the railway to play in supporting the sustainable economic and demographic growth of the UK - and the whole Government - not just the DfT - needs to lead this debate.

The answer to this question will be fundamental to determining the balance for funding the railway between the tax payer and the fare payer, and will further dictate the level of ambition for the expansion and enhancement of the railway over the next twenty years.

The answer to this question will also play a key role in determining the economics of every rail franchise, both in terms of the level of premium and/or subsidy it can expect and the fare levels it should be demanding from its passengers. However, the models should be “balance agnostic” and function equally well with different levels of relative contribution drawn from the taxpayer and farebox.

That said, the success of any model is likely to be contingent on greater clarity in the public debate on the relative split of funding from the industry - and a clear understanding from all parties that a model requiring ever-growing payments from franchise operators, in an environment of a fixed cost base and limited scope to increase services, can only be sustained through a model which places a greater burden on farepayers.



## 6 Next steps: moving towards a more sustainable model

The railway supports 4.5m journeys every day. The country therefore cannot afford for the industry to stand still whilst it contemplates a period of structural reform. However, the number of reviews and reforms undertaken since privatisation (as highlighted in the timeline in Figure 8) indicate that previous attempts at reform have not necessarily delivered long term sustainable benefits - and that the structural reform of the railway cannot be considered in isolation from broader questions about what role the railway should have in the economic and social development of the country.

If the changes to the franchising model and the structure of specific franchises outlined above offer a way to a more sustainable operating model, they need to be developed as part of a broader period of policy review and strategic development for the industry. We suggest that there are 6 key steps which the Government and the industry need to move forward in order to deliver this:

### 1. Define the economic role of the railway in post-Brexit Britain

In addition to the financial implications, a clearer definition is required of the role which the railway should play in the economic infrastructure of the UK - and the funding requirements should be adjusted to reflect this. In a period of economic uncertainty that will accompany Brexit, some may feel that the railway has a key role to play in ensuring access to employment - and in particular in helping regional economies adjust to any structural risks and opportunities arising from Brexit. The Government needs to define what it expects from the railway in driving the growth agenda, and ensure that the franchise models can deliver this.

This should not only include the access which the railway can provide to employment and job opportunities, but also the role which the industry can plan in the wider industrial strategy and the opportunities for the key players in the supply chain to support the UK's renewed focus on an export-led growth strategy.

### 2. Define the financial role of the railway in post Brexit Britain:

Much of the friction at the moment between passengers and the rail industry is due to concerns about the level of fares and the level of investment. In the main, this is not driven by the specific operators, but the requirement to meet ever growing premium payments and ensure that operating the railway places ever smaller demands on the tax payer. In a period of sustained national budget pressures, such an objective may be unavoidable.

However, it should not be an objective delivered by stealth. If the country needs to spend less on its railway and ask passengers to meet a higher cost, then the Government should be explicit about what the taxpayer can afford and explain the implications of this to passengers and businesses. If the country does not feel that this is a reasonable or effective offer for passengers, additional funds will have to be allocated from the taxpayer.

### 3. Define a new approach to infrastructure enhancement

The development of a DBO based franchise model would offer one way of evolving the process for delivering major infrastructure enhancement on the UK rail network. However, it is not clear whether this change would be possible within NR's current approach or would be sufficient to bringing private finance and competition to the delivery of rail infrastructure. A clear strategy is required for how operators and other third parties can develop the rail network, and how NR can best facilitate this - both to support future franchise reform but also to provide the widest possible access to expertise and effectively leverage third party funding in the development of the network.

## SECTION 6

### Next steps: moving towards a more sustainable model

#### 4. Review the financial sustainability of franchises let since 2012

As noted in section 2.3, the growth in rail revenue has slowed considerably over the last eighteen months. As this slowdown has occurred despite strong economic growth, franchise support mechanisms (where they are provided) have not provided significant support to operators. Given the ongoing risks to revenue presented by factors such as Brexit and the threat of terrorism (both in terms of suppressing revenue growth and increasing inflationary cost pressures which the industry is facing), this lower growth scenario could become a sustained problem for franchisees. When considered against the backdrop of a cycle of high revenue growth bids which have been submitted since 2012, such a downturn could threaten the viability of a number of operators.

The DfT has contingency plans in place if a franchise falls into significant difficulty – but in the past such plans have only been enacted when a small number of franchises have been affected. 5 DfT controlled franchises (one third of the total) have been let on revenue risk between 2012 and the beginning of 2017. It would be highly challenging for the Government to implement sufficient contingency plans to cover the risk of multiple franchise failure without causing a major disruption to the industry.

The rail industry (and the needs of the passengers which they serve) are too important to the national economy to be jeopardised by some overly aggressive bids. Whilst rail companies should not have got to a point where they are “too big to fail”, the economic shock of a major disruption to the rail network is too big to consider at present.

Therefore the DfT needs to be confident that the current franchisees can withstand a potential slowdown in revenue growth. If that is not the case, it may have to consider some uncomfortable changes to existing franchise agreements, which ensure that passenger interests are maintained whilst the financial model for operators is made more sustainable.

#### 5. Create fit for purpose franchising bodies to work alongside DfT to let and manage franchises

Since the Laidlaw review in 2012, the DfT has implemented a new set of processes and has demonstrated that these processes can manage the current franchising process. However, as franchises become more diverse and the needs of the railway become more complex, so the governance and oversight requirements evolve.

In particular, a railway which is more closely linked to the economic markets it serves is likely to require greater local control, and this is likely to support the case for further devolution of responsibility and oversight to local levels.

Similarly, the level of Government oversight for competing, commercial long distance businesses will be very different from that required for a heavily subsidised public service, and so the possibility for a more market based regulatory model may create greater flexibility and scope for innovation on longer distance services.

Whilst the national government must therefore retain overall responsibility for the national railway, there may be scope to create different “client” models for franchise operators which provide for more effective management, more constructive partnership and a clearer representation of passenger interests.

#### 6. Implement a new suite of franchise models based around customer needs and network efficiency

When these policy positions have been clarified and the institutions governing the industry have been refreshed, it should be possible to evolve the franchise model to meet the needs of the passenger and the economy. The development of a more segmented approach to passenger operations, potentially built around five new types of franchise model, will then play a key role in ensuring a sustainable rail industry.

# Appendix – Exemplar models for train operating companies

A COMPETITIVE INTERCITY FRANCHISE MODEL	
EXAMPLE	INTERCITY EAST COAST
Overview	Rather than let a single franchise on the long intercity routes, DfT would act as an agent selling bundles of paths on the network to several different operators
	These operators would then compete for passengers in the same way that airlines do today, encouraging greater competition and customer service
	The DfT / Regulator would retain overall planning responsibility for the management of the network and therefore dictate the bundles in a way which maximises the capacity of the network
	Different bundles would potentially be sold at different prices, with premium bundles afforded greater priority in the planning and management of the network
Commercial Terms	Operators bid for the paths and receive a package of slots. No operator has a monopoly - indeed 3-4 operators would be likely
	The paths include the access charges paid to NR, and would come with certain obligations (e.g. around fares, capacity etc.)
	To retain a customer focus, “all-operator interoperable fares” could also be retained as a premium product, which would be sold alongside operator specific fares
Relationship with NR	NR, as infrastructure owner, would charge potential operators in the same way that Heathrow sells slots to airlines
	NR would be responsible for delivering against an SLA, and would not receive payment if it did not deliver
	Maintenance and enhancements would be booked within the slot allocation process and NR would lose the automatic right to decide when this would be carried out
	Management of the overall allocation of capacity of the network would sit with DfT / Regulator as licensee of the bundles of paths
Relations with Rolling Stock Solutions	There would be several operators on the route, and each would be responsible for sourcing their own rolling stock solution - either from ROSCOs, OEMS or through the existing IEP contract
	This would support more diversification in the market and potentially allow for a better internal market of rolling stock between TOCs
	It is anticipated that each would lease their rolling stock from a ROSCO or other third party, although there would not be a regulatory requirement for this
Requirements at Stations	The stations would be managed by a third party responsible for providing appropriate services and retail facilities. The concession for managing the stations would be let by DfT independent of the franchise process
	As with airports, station operators would charge a passenger handling fee for operators calling at the station, and make money from passenger spend at stations

**Appendix**  
**Exemplar models for**  
**train operating companies**

Fares and Ticketing Models	In a competitive marketplace with real competition, fares regulation would be unnecessary and TOCs could charge their own fares. DfT / Regulator could retain regulatory oversight if operators were not felt to be competing and / or on flows which overlap with traditional commuter flows
	The “all-operator” ticket could be retained or abolished as required. All operators would be required to sell “onward travel” tickets to other parts of the rail network at a fixed onward fee
Meeting customer needs	In a competitive marketplace, each TOC would have to meet the needs of a particular segment to attract customers. This may not necessarily be the same approach, and this could support the development of different operating models (full service, low cost etc.) in the same way as has been seen on airlines
Fulfilling social responsibility:	Different paths could be sold as bundles, with each operator obligated to take on some unprofitable services - or being given paths at a reduced cost if they did. This would be similar to the 4G licence auction where one of the packages carried an obligation to provide coverage to areas which did not have a commercial business case
Scale	We hypothesise an initial role out on the Midland Mainline built around 2 - 3 franchise packages, and this could then be extended to cover a further 4 packages on the East Coast Mainline as an alternative to the expansion of Open Access. If demonstrated successfully, such a model could then be used as the basis for the operating contracts on HS2 and the West Coast Mainline

## A BLENDED COMMUTER CONCESSION FOR LONDON

EXAMPLE	NEW APPROACH TO THE TSGN FRANCHISE
Overview	Replace the oversized London commuter franchises with a larger number of smaller concessions. These would be let along a line-by-line basis rather than a terminal basis, with the aim of creating 20 - 25 £260m businesses, rather than nine c. £700m businesses
	Common standards, peak ticketing and service levels would be dictated by the DfT / Regulator (and TfL if appropriate). Competition and innovation would be required for off-peak services
	In many respects, this would be more akin to the London Bus route model than the current rail franchise
Commercial Terms	Operators would receive two distinctly different payment mechanisms:
	During the peak periods, operators would be paid on an availability and performance mechanism, based on the number of services operated against the service level and a performance mechanism linked to customer satisfaction
	Off peak, the operator would retain revenue risk and be responsible for growing the market. This would be against a minimum service level specified in the franchise. This would create a natural incentive for operators to grow the off peak at the expense of the peak - which would meet the requirements of the industry
	Franchises would be let based on the most economically advantageous tender when considering both the peak and the off-peak pricing proposition
Relationship with NR	NR would continue to maintain the infrastructure as at present. No access charges would be charged in the peak - NR would receive a grant from DfT / Regulator and be managed on its delivery against these contracts
	A fully variable access charge model would be applied in the off-peak to cover the marginal costs of running additional services at these times rather than recover the full economic cost of the railway

Relations with Rolling Stock Solutions	DfT would specify the requirements and capacity configuration of rolling stock for each route. Operators would then contract with ROSCOs or other third parties for the supply of the stock
Requirements at Stations	All stations except London terminals along a route would be transferred to dedicated station management companies, which would bid for 25 year concessions to maintain the stations, manage the facilities and expand the stations (and car parks) to meet capacity requirements
	Station management funded through a combination of commercial income (including property development rights), station calls and the hypothecated revenue from station car parks
Fares and Ticketing Models	Single integrated ticketing model run across all franchises, based on an expansion of TfL Oyster / Contactless solutions
	Likely rewrite of the fares structure to create a newer and fairer model, including a new approach to season tickets and part-time commuting
	Through ticketing with intercity TOCs sold as a “bolt on”, to be bought through digital channels and retailed by the commercial intercity operators
	Concession companies to have discretion to offer reduced tickets at times where they have revenue risk without any fare regulation
Meeting customer needs	The remuneration structure for operators in the peak would be changed to be clearly linked to capacity, performance and customer satisfaction
	The split of peak and off-peak fares and the transfer of revenue risk would create a new approach designed to make the franchise affordable for passengers and make it easier to stimulate demand off peak
	Long-term station management companies would have a clearly aligned set of objectives to improve facilities at stations
Fulfilling social responsibility:	With the transfer of peak revenue risk from the operator to the DfT / Regulator the DfT can adopt a new approach to peak pricing which makes the railway more affordable in the shoulder peak and better manage demand in the off peak
	The complete break between peak and off-peak pricing will encourage the TOCs to trial more innovative pricing off-peak to make the network more attractive
	Specific accessibility requirements around stations can be built into the station concession company model
Scale	We hypothesise c.25 concessions, with an average of 3 concessions per London terminal divided along clear route and line basis with overall network management responsibility remaining with NR

## A GROWTH INCENTIVISED “URBAN TRANSPORT” CONCESSION FOR CITIES OUTSIDE LONDON

EXAMPLE	A NEW MODEL FOR THE NORTH EAST BUSINESS UNIT WITHIN NORTHERN
Overview	Developed for cities outside London, designed to ensure the private sector operator is incentivised to promote integrated transport, modal shift and economic growth in addition to retaining a “traditional” commercial focus on costs and revenue
Commercial Terms	Operators would work under a blended concession model, which includes incentives linked to performance and availability as well as ridership growth
	A 10p per passenger payment to the operator (as used on the DLR during the last concession) could provide a model to effectively link operator profit to growth in the network without making it the only metric

**Appendix**  
**Exemplar models for**  
**train operating companies**

	A small element of the remuneration structure could also be linked to wider growth in public transport usage - or even economic growth in the city. These linkages would not be sufficient to dictate the financial success of the whole operation, but could make the difference between breaking even and delivering a bid margin
Relationship with NR	Operators would require close alignment of incentives with the infrastructure manager - especially if concessions were to consider innovative opportunities to improve service levels or reduce costs
	This could be done through Oversight Boards as currently proposed or consideration of a more devolved and integrated structure. Whatever was decided, it is likely that the maintenance and enhancement of the infrastructure could be separated to allow for greater flexibility in the leveraging of private sector funding and expertise in the expansion of the network
Relations with Rolling Stock Solutions	These franchises are likely to offer the biggest scope for innovation for rolling stock manufacturers. Experience on London Overground demonstrates the role which new trains can have in transforming a franchising and driving growth. This model could provide a real opportunity for rolling stock providers to take revenue risk against the customer growth their products will deliver, and by so doing change the financing model for new trains
Requirements at Stations	Experience from London Overground suggests that improvement in the condition, staffing and management of stations in city centre networks could be an important factor to driving growth, whilst the cycle of greater footfall at the stations could then create a new commercial opportunity
	It would be for local transport bodies to decide whether they felt that a train operator was best placed to deliver this improvement, or whether there was merit in a specialist contract for the management and development of concession
Fares and Ticketing Models	Integrated, smart, multi-modal ticketing developed around travel to work areas is likely to be key to driving growth in these networks, and local transport bodies are best placed to define the strategy to reflect their local priorities and their local network
	Local Urban Transport concessions would be required to honour national rail tickets as an add-on (again, similar to Plus Bus), but this would be an add-on to a system built around the needs of a local area as opposed to retrofit the requirements of a local area to the national ticketing model
Meeting customer needs	The use of a blended contract linked to performance and ridership would allow for metrics specifically linked to customer satisfaction outcomes and customer facing outputs. It is likely that the performance based contracts developed by TfL for LO and DLR could provide a template for this
Fulfilling social responsibility:	The inclusion of a small remuneration element linked to the social and economic contribution of the franchise would offer an excellent way to connect the railway to its local responsibility. It would be for the local transport body to define the proportion of the contract value linked to this, and the metrics used to measure performance

## A REGIONAL TRANSPORT CONCESSION FOR REGIONAL TRANSPORT

### EXAMPLE

### NEW APPROACH TO REGIONAL NETWORK IN DEVON AND CORNWALL

#### Overview

Develop a regional, vertically integrated transport concession (potentially including operational responsibility for regional bus franchises), designed to provide "mobility as a service" to the residents of the region in a way that reflects the available budget and needs identified by the local stakeholders

Commercial Terms	The concession is let by the concessionaire based on the maximum available funds. Potential concessionaires are then required to set out a service level and infrastructure strategy to be delivered with the available funds (and any private funds that they can draw in). Concessions are then awarded based on the quality of the offer bidders can provide for the available funds
	The concessionaire budget is only released at key stage gates during the concession period once the concessionaire has delivered against promises
	It should be noted that an explicit change of mindset around competition on the network would be required in such a scenario, with bus and rail seen as compliments not competitors to ensure effective integration and planning across both networks
Relationship with NR	These contracts would be vertically integrated (potentially across all modes of transport) and therefore the maintenance of the infrastructure would transfer from NR to the concessionaire
	NR would retain responsibility for maintaining any “strategic” infrastructure where local services use the mainline, and the concessionaire would be required for negotiating an access agreement with NR for this infrastructure as part of the bid process
Relations with Rolling Stock Solutions	As with the urban transport model, rolling stock providers would have a new opportunity to take an element of revenue risk linked to the ability of their new trains to drive growth
Requirements at Stations	Responsibility for managing and developing stations would transfer to the concessionaire
	The concessionaire would be required to state during the bid stage the expected income received from station development (if any) and use these funds to contribute to the overall funding model for the contract
Fares and Ticketing Models	This would be as dictated by the letting body – they could specify the fares and ticketing strategy which they required within the available budget, or allow bidders to offer innovative fares strategies within the budget envelope specified by the bidder.
	The inclusion of rail within a broader regional transport concession could be a way to deliver greater integration within the transport network
Meeting customer needs	Again, the letting body would outline its priorities in the contract to meet customer needs. Delivery of specific customer satisfaction targets could be a pre-requisite to the release of funds promised to the concessionaire
Fulfilling social responsibility:	The letting body would outline its priorities within the affordability envelope and ask bidders to shape proposals accordingly. The inclusion of rail within a broader regional transport concession could be a way to deliver
Scale	We hypothesise c.8-10 franchises under this model, each mapped to a devolved authority across the UK – except in the large Urban areas where a different concession model could be used

## A “PROJECT MANAGEMENT” OPERATION TO DRIVE CHANGE

### EXAMPLE

A NEW APPROACH TO DELIVERING THE CHANGES ON GTR (AND A POTENTIAL MODEL FOR THE TRANSITION TO HS2)

### Overview

For a limited period during major works, the operational challenges of running services transform from a “business as usual” activity to part of a complex programme of work designed to deliver a step change in the capability of the network in the long-term whilst maintaining service continuity in short-term

**Appendix**  
**Exemplar models for**  
**train operating companies**

	In such a scenario, the right solution may not be to consider the day-to-day train operations as independent to the works, but rather part of the overall programme to be delivered, and therefore let a single integrated programme management contract to deliver the works alongside operating the service during the works
	Under this model, responsibility for management of the train service would be transferred to the programme manager of the overall upgrade programme and considered as part of that package of works with a contract and incentive structure to match. The programme manager would likely contract an established operator as a supplier to deliver the specified service
Commercial Terms	In this model, the commercial terms of train operation would be wrapped in to the commercial terms of the overall programme delivery - with payments made against a combination of delivery against milestones in the work and customer service and operational metrics for the maintenance of service levels during the work. The exact nature of the commercial terms would vary from programme to programme to reflect the different risks around the programme and the key requirements for service continuity agreed with local stakeholders
Relationship with NR	Within a change franchise, the programme manager would have overall responsibility for all aspects of the change, and this would extend to the enhancement and management of the infrastructure. The programme manager could either do this by managing NR work, or undertaking work on behalf of NR
	Under either scenario, the programme manager would have responsibility for ensuring alignment between operations and infrastructure under a single integrated structure, with the programme manager's contractual incentives closely aligned to the needs of the passenger during and after disruption
Relations with Rolling Stock Solutions	This would depend on whether the change involved the delivery of new trains - in which case the management of the rolling stock provider would also be part of the Programme Manager's responsibility. Otherwise, a short term leasing contract between the Programme Manager and a ROSCO is likely to be sufficient
Requirements at Stations	The programme manager would have responsibility for the management of service and enhancement works in stations, again through an incentive structure which rewarded both timely delivery and effective operation and customer service during the work
Fares and Ticketing Models	It would be up to the DfT to determine the fares and ticketing models to be used during a major change programme, and this would depend in part of whether revenue risk was transferred to the TOC
	The DfT could specify in the contract, for example, a 10% reduction in fares whilst the work is ongoing, with the programme manager taking the risk arising from any overrun to the scheduled period of work
	Moreover, given the Programme Manager's contractual incentives on customer satisfaction during the work which, the PM may be incentivised to reduce fares (or increase compensation) to boost satisfaction during times when works are particularly challenging for customers
Meeting customer needs	In any period of disruption, it will be difficult to meet the needs of customers and a programme management approach would not be a panacea. However, this revised approach could provide an incentive structure to suppliers to complete the work as quickly as possible, minimise the disruption to service and maintain customer satisfaction as much as possible



Fulfilling social responsibility:	Such a model could provide the mechanism to restore public confidence in how the rail network delivers major upgrades and ensures that the industry meets its obligations to customers and taxpayers. A broader approach to social responsibility - such as an approach to construction that meets the needs of local stakeholders, and minimises economic or environmental disruption - could also be contractualised within the delivery requirements and incentive structures, if required
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## A "DESIGN BUILD OPERATE MAINTAIN" FRANCHISE

EXAMPLE	EAST WEST RAIL
Overview	A single integrated "DBOM concessionaire" would be responsible for building and maintaining a new part of the railway, and then operating and promoting the services that run on that railway
	This could either be used for massive new projects, such as East West Rail, or for the reopening of branch lines intended to act as a feed to the main national rail network
	After a period of operation and maintenance, the asset would transfer back to NR as part of the national rail network and the franchise operation could be folded into one of the new "business as usual" models highlighted above
Commercial Terms	The DBOM concessionaire would be heavily incentivised against the timely delivery of the new infrastructure within an agreed budget. This could either be via a clear milestone based contract, or alternatively a payment model where the operator only receives payment once the service is in operation, meaning that they receive significant incentives to complete the work ahead of schedule and are exposed to significant financial penalties for late delivery
	The operator would receive annual payments for the maintenance and availability of the infrastructure, as well as a revenue payment for operating the services. This would come from both public funds and the passenger, with the exact balance depending on the business case for the infrastructure. There may also be scope to use private sector funding if, for example, the DBOM franchisee is serving a branch line developed to support new housing developments
	The operator would also be expected to take material revenue risk - at least for the first few years of operation - ensuring a clear incentive to market a high-quality and reliable service that attracts new passengers to the network
	At the end of the operating concession, the DBOM franchisee would be responsible for meeting the costs of any work required to bring the network to an acceptable standard to be handed over to NR or another infrastructure owner
	In many instances, the DBO responsibility has been combined with a financing responsibility, with private capital used to build the asset. This is then repaid over a 25 to 30-year period through user charges, public sector payments or a combination of these. This would make the model more akin to a PPP/PFI style contract and the economic case for these models is subject to considerable debate. However, such a financing model would be included within the DBO franchise if it were felt to offer a lower whole-life cost
Relationship with NR	NR's role as infrastructure developer and maintainer would be transferred to the DBOM franchisee, with NR having no responsibility for a clearly separated part of the network during the period of the franchise
	Some form of oversight or regulation would be required to ensure effective management of the interfaces where the DBOM network and the NR network met

**Appendix**  
**Exemplar models for**  
**train operating companies**

	However, at the end of the franchise, assets would transfer to NR, and therefore NR would have an oversight role and the right to demand improvements to the asset to ensure its safe inclusion in the national rail network in due course
Relations with Rolling Stock Solutions	The DBOM franchise would likely be long enough to support the financing of the rolling stock, and therefore the franchisee would contract with the rolling stock industry for the supply of an appropriate fleet. This could be financed as part of the overall concession finance or through a ROSCO as appropriate
Requirements at Stations	The DBOM franchisee would have responsibility for building, maintaining and operating all stations on the line, and would pay an access charge for use of any existing stations managed by a different TOC or station management company
Fares and Ticketing Models	This is likely to vary from franchise to franchise. For a major new piece of strategic infrastructure, such as East West Rail, some regulation of fare levels and fare structures is likely to be appropriate and ticketing will need to integrate with other local services
	Where the model is used to support the development of smaller branch lines, then the operator should be given more freedom and independence to develop fares and ticketing solutions which work best in the local market
Meeting customer needs	Operators would have long-term revenue risk from the growth which they could achieve on new networks, and this would encourage a customer centric approach to attracting and retaining customers
	Specific incentives could be included in contracts linked to customer satisfaction scores, although the requirement for this is likely to vary from contract to contract
Fulfilling social responsibility	The use of this long-term DBOM model could offer an effective way to expand the railway - and capture private funding to do so - meaning that the railway continues to meet its social responsibility and can support economic and housing growth in the country

# Tracks

Tracks is a dynamic Thought Leadership programme that reacts to contemporary issues in the transport sector. The annual programme comprises four themes, linked to current and evolving challenges. Ensuring a Sustainable Rail Industry is one theme within the 2016-17 programme.

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