

Agenda

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Chuffing hell: is the British model of rail franchising dead?

The recent cancellation of the InterCity West Coast rail franchise competition by the UK Department for Transport might imply a radical rethink, and raises fundamental questions about the ‘British model’ of running railways. However, while there may be some economic deficiencies in the current approach, there are plenty of lessons from incentive regulation that can be implemented within the current arrangements

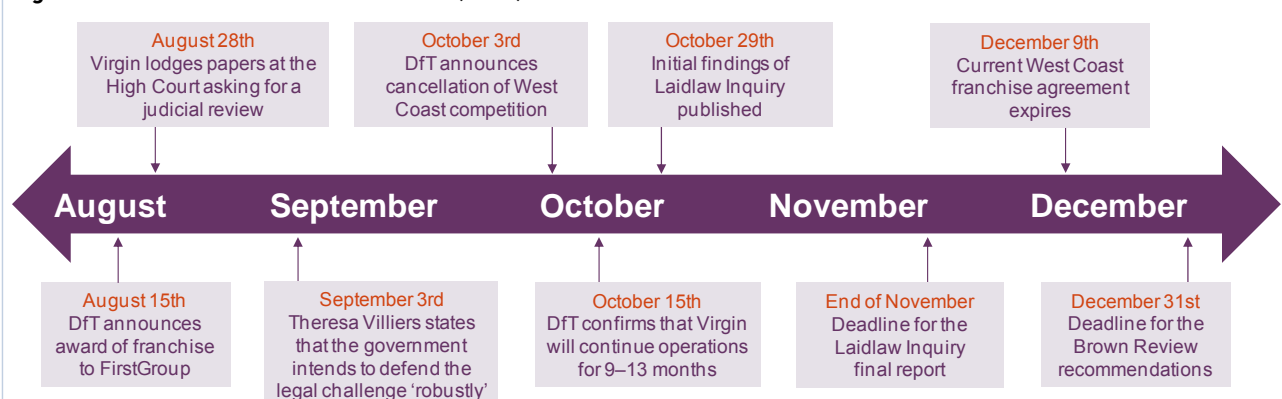
In October, the UK Department for Transport (DfT) announced that, following the discovery of ‘significant technical flaws’ in the bidding process, the competition for the InterCity West Coast rail franchise was to be cancelled at a cost of £40m to the taxpayer.¹ The announcement followed a decision in August by Virgin Trains, the incumbent operator, to seek a judicial review of the DfT’s decision to award the 13-year franchise to FirstGroup.

Following the cancellation, Virgin is now set to continue operations on the West Coast line for an additional nine to 13 months after its current franchise agreement expires in December (see Figure 1 below). During this time a competition will be run for a further interim franchise agreement of an, as yet, unspecified length of time. Elsewhere, three other competitions (for the

Great Western, Essex Thameside and Thameslink franchises) have been put on hold pending the conclusion of two independent reviews into rail franchising.

The first of these reviews has already reported its initial findings on what went wrong in the specific case of the West Coast franchising process (see box overleaf), and is expected to deliver its final recommendations by the end of November. The second, to be overseen by Eurostar chairman, Richard Brown CBE, will examine the implications of the cancellation for the DfT’s wider rail franchising programme, with particular focus on whether there is a need to alter risk assessment and bid evaluation processes. Its recommendations are due by the end of the year.

Figure 1 Recent GB rail franchise events (2012)



Source: DfT (2012), ‘New Operator for West Coast Rail Passengers’, press release, August 15th; Virgin Trains (2012), ‘Virgin Trains Limited Commences Court Proceedings in Respect of West Coast Main Line Franchise Award’, press release, August 28th; DfT (2012), ‘Rail Franchising’, written statement by Theresa Villiers MP (then Minister of State for Transport), September 3rd; DfT (2012), ‘West Coast Main Line Franchise Competition Cancelled’, press release, October 3rd; DfT (2012), ‘Department for Transport to Negotiate with Virgin on Temporary Operation of West Coast Rail Services’, press release, October 15th; DfT (2012), ‘The Laidlaw Inquiry: Initial Findings Report’, October 27th; DfT (2012), ‘Letter from the Secretary of State to Sam Laidlaw’, October 15th; DfT (2012), ‘Letter from the Secretary of State to Richard Brown’, October 15th.

A shorter (and rather different) version of this article appeared as Meaney, A. (2012), ‘Comment: Pause, Reflect and be Thankful’, *Passenger Transport*, 45, November 16th.

This article focuses on the rationale for franchising, highlights issues with the approach to rail franchising implemented for GB passenger services, and draws on incentive regulation practice for some easy-to-implement resolutions.

Why franchise?

In circumstances where the competitive market that economists and policy-makers strive for (owing to its properties of efficient allocation of resources, incentives to innovate, etc) is infeasible, or delivers outcomes that are undesirable in the relevant policy context, one alternative is to set up competition *for* (as opposed to *in*) a market.

One such example is passenger rail franchising, in which the right to operate is auctioned, subject to extensive contractual requirements. Importantly, the intention (as with franchising in other contexts) is that competition between bidders will deliver more efficient, higher-quality services, and achieve a reasonable degree of risk transfer away from the public sector during the contract term. However, the precise form of franchise can vary, with one potential option being a more 'horses for courses' approach—for example, a more detailed specification twinned with greater degrees of subsidy in some cases, and much less specification being offered to the franchisee where

a premium is paid for the right to provide services in other cases.

Passenger rail transport services are increasingly being procured under contract, with the entry into effect of Regulation 1370/2007 relevant in a European context. The Regulation requires that passenger rail services are either competitively tendered, or that outcomes from services being directly awarded (for example, to a state-owned provider) mimic those of a competitive tender.

So franchising—or some variant thereof—is perhaps here to stay for GB passenger rail. The relevant question is therefore whether recent events have been a one-off, or a symptom of a more fundamental problem that must be remedied. And if the latter, what does this mean for the future?

Process or principle?

The box below setting out the draft conclusions of the Laidlaw Inquiry suggests that there were specific issues with the franchising process for the West Coast line. However, from an economic perspective—and going back to Oxera's work for the McNulty Review of rail value for money study in 2010²—there seem to be more fundamental issues with the businesses being offered.

Initial findings of the Laidlaw Inquiry

Sam Laidlaw, Chief Executive of Centrica and a non-executive board member of the DfT, has published the initial findings of his inquiry into the DfT's handling of the West Coast competition. These findings focus on the calculation of the subordinated loan facility (SLF) required to be provided by bidders at the parent level. The SLF is a form of bank-guaranteed risk capital that is forfeited by the operator if it defaults on the franchise agreement. The size of the SLF is dependent on the DfT's evaluation of the level of risk associated with franchise bids—ie, the 'riskier' the bid, the larger the SLF requirement.

However, the initial findings of the Laidlaw Inquiry suggest that, in the case of the Intercity West Coast franchise, there were significant issues with the calculation of the SLF.

- **Transparency and information.** There was a lack of transparency regarding the DfT's approach to calculating the size of any SLF requirement, as it did not share with bidders the model that it intended to use in the calculation. Without access to the model, bidders did not have sufficient information to accurately predict the size of the SLF.
- **Non-compliance with guidance.** The final SLF requirements were not calculated in accordance with the DfT's own SLF guidance, and instead appear to

'reflect a view taken by the DfT as to the appropriate numbers'.

- **Inconsistent treatment of bidders.** The SLF requirements for FirstGroup and Virgin were calculated in an inconsistent manner, due to the influence of extraneous factors (including a desire that there should be a minimum level of SLF imposed on all bids, and the—converse—fear that setting too high an SLF could result in a bidder leaving the competition) such that the final requirements did not adequately reflect the relative risk of the bids.
- **Modelling errors.** It has been noted above that the final SLFs were not calculated using the DfT's guidance. However, even if they had been, they would have been significantly lower than necessary due to errors made in the DfT's modelling. These errors resulted in the DfT calculating the SLF requirements in real terms but treating them as if they were in nominal terms.

The initial findings highlight several potential factors which could have contributed to these mistakes, including inadequate planning for financial risk evaluation, budgeting challenges, the structure of the DfT (ie, the lack of continuity in roles), and inadequate quality assurance processes. The final report will provide a greater focus on what lessons can be learned to avoid the same issues arising in the future.

Source: DfT (2012), 'The Laidlaw Inquiry: Initial Findings Report', October 27th.

The West Coast franchise was the first to be offered under a new longer term. Previous franchises—with some exceptions—have been just over half the proposed length, and the move was intended to enable operators to take a longer-term view of the underlying business, such that they will have stronger incentives to invest in it.³

However, the successful bidder takes revenue risk for the entire period (typically around 15 years), at a time when GB passenger rail revenues are proving highly unpredictable. Standard industry models suggest that revenues should have been moribund since 2008, but National Rail Trends suggests that they have, in fact, risen by 6.4% on average (on a compound annual basis, in nominal terms).⁴ Much of this stronger-than-expected growth is thought to have arisen from car users transferring to rail over this period, but there is genuine concern that this effect (rail's market share increasing) is unpredictable: it could continue unabated, stop, or even reverse altogether.

Most businesses can cope with revenue volatility by changing their cost base. In a rail context, this effectively means changing the number of services operated, since this is the main driver of costs (access charges, train-leasing costs, staffing). However, the timetable is highly specified—in the West Coast case, bidders had to set out in detail the timetable they intended to operate in each of the next 13 years, together with train and crew deployment. Bidders were allowed to vary services by only 'approximately 10% (or 1 stop where the total is fewer than 10)', but no reduction in the total number of stops per week was permitted,⁵ and within the franchise any changes had to be consulted on extensively. Effectively, there was very little scope for bidders to change their cost base in response to a negative shock to revenue (eg, from an economic downturn).

Previously, the combination of volatile revenues and relatively fixed costs was mitigated to some extent by an insurance policy within the franchise agreement—the 'cap and collar' arrangement. This provided support (or required increased payments to the franchising authority) if revenues moved outside an agreed percentage (or 'deadband'), and proved important to operators that had made bids before the economic downturn struck.⁶ But under the West Coast franchise agreement, bidders would be protected by a 'GDP mechanism', which effectively provided protection only if one input to a revenue model—GDP—fell outside of a deadband around government projections. This ignores the competing car market, and other factors outside of franchisee control, considerably reducing the insurance available to bidders.

In effect, bidders were offering to operate rail services for 15 years under a tightly specified contract, providing limited protection against downside revenue shocks, while earning a profit margin that might be wiped out in the event of such shocks. This would appear to be at odds with the original rationale for longer franchise periods, namely that they would give the successful bidder confidence to invest. Effectively, the franchising authority is offering franchisees a risky business, plus a 'put option' in financial terms, in which the franchisee would default in adverse revenue circumstances.⁷ This option is valuable, and may well be exercised, given the underlying volatility in earnings.

Crucially, the focus of bidders will be on the degree of risk to take on the bid revenues—and, by implication, the riskiest bid will succeed (subject to the winning bidder being able to raise the capital for the associated SLF⁸). This, in particular, places the current franchising process a long way from one that is likely to secure the efficiency, service quality and innovation benefits of competition for the market.

So is the 'British model' dead?

The issues highlighted above might suggest that an entirely different approach to providing passenger rail services should be considered. However, there are a number of minor changes to risk allocation and bid evaluation in the current set-up that could help to achieve the original aspiration of getting franchisees to invest in the context of longer franchises.

- With a couple of exceptions, risk has been allocated in the same way across all GB franchise types—whether they are serving the central London commuter market, rural branch lines, or long-distance intercity travel. While bidders should probably be exposed to a reasonable degree of traffic (ie, demand) risk in each franchise (consistent with a recent report⁹ by Oxera and RBconsult, which drew this conclusion in the context of toll road schemes), it would seem sensible to give them more scope to flex services (and, therefore, the cost base) with the market in the context of a long-distance franchise requiring no subsidy. This flexibility would be consistent with allocating the operators of such services relatively more revenue risk. In contrast, operators of commuter services, or services requiring high relative degrees of subsidy, would seem to need to operate against a more fixed service pattern, which in turn suggests that lower relative risk exposure should become a feature of the franchise agreement.
- Noting that even with intercity services, lower risk exposure than in the current arrangements is likely to be beneficial. The lower risk exposure could take a number of forms:

- *review points in the context of 15-year franchises*—reviewing each franchise every five years would bring a number of benefits. First, the review would allow initial bids to be reassessed, and could enable a ‘*bonus–malus*’ arrangement to be implemented to reward accurate revenue forecasting. Second, it would enable timetable compliance over the full 15 years to become less of a burden on bidders—they would instead be required to plan the timetable (and, therefore, their cost base) in detail only up to the first review. This would allow the timetable to be flexed with the economic and policy environment, although this flexibility would come at a cost to other elements of the value chain, which would price the uncertainty associated with a move away from more contractual certainty. Lastly, this approach should underpin investment by bidders, as long as they believe that the review process will be conducted fairly, retaining a well-designed allocation of risk;
- *an explicit revenue-sharing mechanism*—if organising and delivering such reviews proves too difficult to implement, an alternative arrangement in which genuine uncontrollable factors were shared, while both parties retain a degree of risk (and, therefore, incentives to grow revenues), should be possible to develop;
- *return to shorter franchises*—if none of the above were deemed workable or desirable, shorter franchises could once again become the model of choice, although this would require disregarding the desire to incentivise train operating companies to invest.

- Currently, bids are scored on the basis of the net present value of subsidy or premium payments over the life of the franchise, and an evaluation of the deliverability of the bid. The quality of the offering to the passenger—except in the case of performance against the timetable and requirements to improve passenger satisfaction scores—is afforded limited weight in evaluation. Moreover, innovation is limited by a lack of time to respond to the Invitation To Tender, and strict specification and evaluation criteria. Placing more weight on these criteria might reflect the principles of franchising more accurately.

These suggested changes assume that the tenor of franchising policy remains broadly the same. However, a question remains in what is effectively a ‘third phase’ of passenger franchising: what does government want from the private sector? One option is a continuation of the status quo, with bidders being required to bid keenly, take on significant degrees of risk, and deliver against the franchise agreement. Another option would be to develop partnerships with service providers, which would share risk and long-term policy objectives, and develop and revise service specifications. These options are likely to result in quite different types of franchises being offered to the market.

Conclusions

The apparent pitfalls in GB passenger rail franchising do not necessarily require substantial effort (or legislation) to overcome—more effective risk allocation, and a refocusing of procurement on the original rationale behind franchising, should make each franchise more valuable, more likely to last the full term, and more investable.

¹ The £40m will reimburse the companies for the cost of their bids. DfT (2012), ‘West Coast Main Line Franchise Competition Cancelled’, October 3rd.

² Oxera and Arup (2010), ‘Review of Rail Cross-industry Interfaces, Incentives, and Structures: Options to Reduce Industry Net Cost’, prepared for VfM Review team, September 30th.

³ HM Government (2010), ‘The Coalition: our Programme for Government’, p. 31.

⁴ Source: Office of Rail Regulation, and Oxera calculations.

⁵ DfT (2012), ‘Intercity West Coast Franchise Invitation to Tender’, January 20th, p. 22.

⁶ Note that the cap and collar mechanism came with its own perverse incentives, which is why it was replaced. Essentially, if the economic downturn were sufficiently severe, 80% of revenue shortfalls would be met by the DfT, considerably reducing operator incentives to grow revenue during the remainder of the franchise.

⁷ This is the right, but not the obligation, to sell the franchise revenue stream back to the franchising authority under predetermined arrangements, if prospects decline sufficiently.

⁸ For the SLF mechanism to work effectively, bids need to be developed with the size of SLF associated with a bid in mind; the SLF needs to be calculated against an unbiased comparator model; and the franchising environment needs to price risk effectively. The mere involvement of private capital markets will not necessarily deliver the comfort that such a mechanism is designed to provide.

⁹ Oxera and RBconsult (2012), ‘Disincentivising Overbidding for Toll Road Concessions’, prepared for the Australian Department of Infrastructure and Transport, April.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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