Franchising Policy Statement

November 2002

BRITAIN'S RAILWAY, PROPERLY DELIVERED

STRATEGIC RAIL AUTHORITY

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Objectives

1 To deliver a safe, more reliable service of consistently high quality for rail passengers.

2 To provide clarity of service specification so that industry partners work together for passengers.

3 To deliver a value for money service for passengers and taxpayers.

4 To secure accountable, viable operators who are passionate about delivering for their customers.

Richard Bowker, Chairman, Strategic Rail Authority

Introduction

This document is the SRA's franchising policy for the passenger rail industry in Great Britain. It describes the experience of franchises to date, summarises the SRA's analysis of the successes and failures and describes the changes we wish to make and how they will be effected. It sets out what it is that the SRA wants from those providing passenger train services under franchise agreements. It defines a new form of public private partnership with the franchisees focused on delivering reliable performance, meeting passenger needs and containing short and long term costs.

In formulating this policy the SRA has undertaken preliminary consultation with train operators, Passenger Transport Executives and the Rail Regulator, although it is recognised that more detailed discussion will be required on a number of the policies set out here.

The reason for change

A passenger franchise is the mechanism by which the SRA secures rail passenger services.

When the railway was privatised, the franchising of each of the passenger Train Operating Companies (TOCs) was seen as a series of business disposals for a fixed term, predicated on the concept of a genuine business opportunity to be exploited. Although it was accepted that most franchises would require some level of subsidy, the broad principle was that the bidder requiring the least subsidy was regarded as offering best value for money and therefore won the franchise. While this approach could be said to have the merit of awarding franchises to those with the greatest appetite for business risk, with the benefit of hindsight this has not delivered the outcomes contemplated at the time of privatisation.

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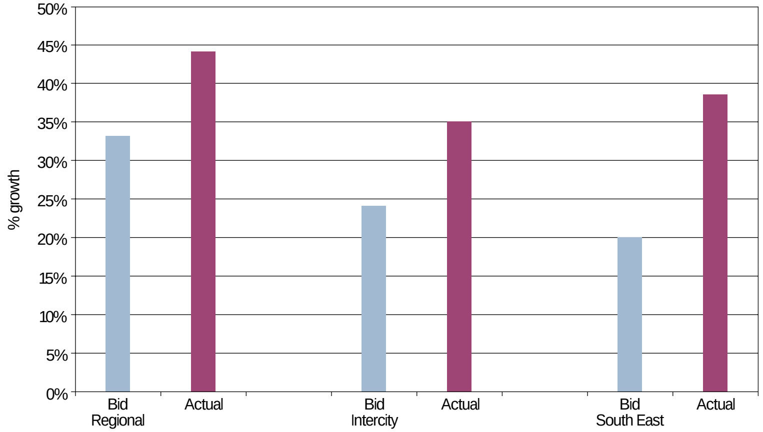
The reason for change

Franchising has been successful in securing:

- passenger growth – it has contributed to one-third more passengers using the railway today compared with the last year of British Rail, with revenue growth outstripping economic growth over that period (see table below);
- the private sector's commitment to huge levels of investment, particularly in rolling stock. New trains worth over £4bn have been ordered since 1997; and
- stronger marketing of passenger rail services.

Revenue growth, bid and actual, by sector



Source: SRA, KPMG analysis

Franchising has been less successful in a number of areas:

- after an early improvement post-franchising, service performance and overall reliability has worsened. In part this is a reflection of the fact that the network is now operating at capacity on many strategic locations and routes;
- it has not proved possible through the first round of franchise agreements to incentivise a universal improvement in quality of service;
- franchisees have been unable to withstand the financial shock of a number of external factors which have combined to undermine revenue growth;
- the costs of operating the current franchises have escalated and are substantially higher than bid levels. In combination with a levelling off of revenue, this has led to several franchises not remaining viable and the SRA providing financial support above those levels envisaged in the original franchise agreements (see graph on page 6). The extent to which risk, in relation to costs and revenue, has in reality transferred to the private sector is therefore questionable; and
- there is also a view within the industry that the creation of so many privatised entities has exhausted the supply of high quality managers that the industry needs to be successful.

We need to build on the successes and address the failures to deliver our objectives.

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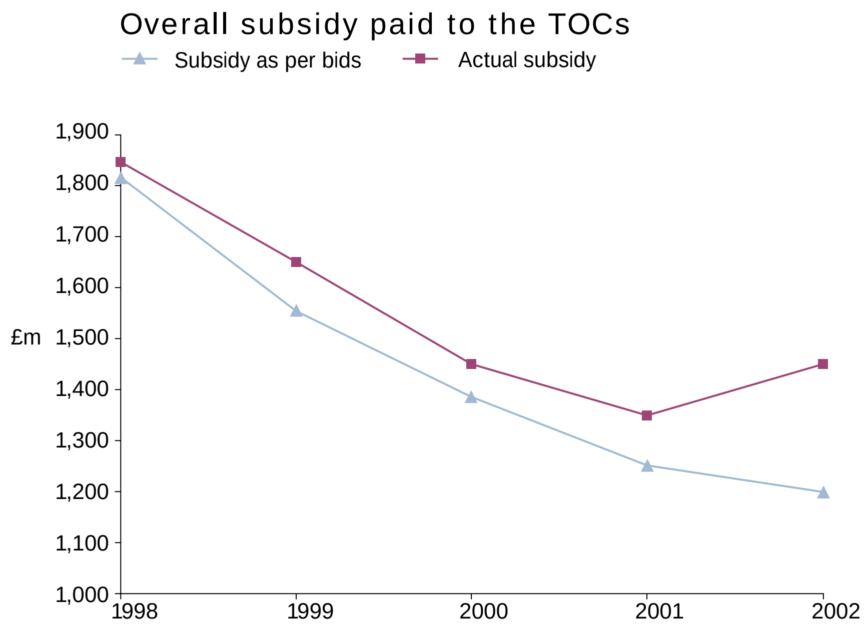

Source: SRA, KPMG analysis

The way forward

The way forward needs to focus on the practicalities of delivering consistently high quality services to passengers through the private sector. The new contract needs to direct private sector management's energy towards reliable performance, to meeting passenger needs and to containing short and long term costs. However, it is not the SRA's intention to interfere in day-to-day running of the franchises, nor does it wish to stifle private sector flair by 'micro managing'.

The way forward also needs to:

- address the financial fragility of the TOCs holding first round franchises. Bids must be deliverable, and risks must be allocated according to what a well managed and reasonably profitable franchisee can bear over the whole life of the franchise;

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- recognise that we now have an overcrowded network which faces a major programme of renewals and issues which require industry-wide rather than individual TOC solutions;
- accept that we have finite resources and a budget that must be prioritised. This requires consideration of alternatives to an ever increasing number of services in each and every franchise;
- encourage and make it possible for new entrants to come into the market and create competition for the franchises; and
- encourage and reward efficiency. The SRA is looking at benchmarks to enable efficiency comparisons to be made, both internationally and between operators in Great Britain, and to identify and encourage best practice. The SRA will encourage arrangements between franchisees and their key suppliers that incentivise performance. SRA support to the industry may be conditional on appropriate performance-related arrangements.

The new franchising arrangements cannot solve all of the problems and challenges facing the rail industry, but they can provide a large measure of clarity, certainty and predictability for passengers, industry participants, the wider stakeholder community and investors. Moreover, the approach must create and sustain a market capable of delivering the required level of service efficiently, at a price which is value for money, while enabling well performing franchisees to secure a reasonable level of profit on a sustainable basis.

The nature of the new contractual relationship

The SRA is firmly of the view that it should specify service levels and quality standards and the private sector should be charged with delivery. This is the essence of a successful relationship between the public and private sectors.

This differs from the model from the first round of franchising, which sought to create a set of business opportunities, subject to regulation, with obligations not to let services fall below specified base levels. However, the opportunity for further unilateral franchisee expansion of services has largely been exhausted. Further, some of the protected services are of dubious economic value, particularly now that network capacity is constrained.

Accordingly, the SRA sees the new franchise agreement as a contract with a more precise specification of the franchise proposition in terms of the service to be run, the performance standards to be met and the rewards for achievement. The agreement will clearly identify the criteria and rewards for a successful franchise. However, it will also effectively penalise poor performance with a set of known financial and other consequences, including the real possibility of terminating an under-performing franchise.

The key areas of change

1 Operating obligation
2 Service reliability
3 Passenger journey quality
4 Cost risk
5 Revenue risk
6 Franchise term
7 Variation mechanisms
8 Incentivising long term improvement
9 Remedies
10 Investor issues
11 Programme

A number of aspects of the current franchise agreement require change. The principal ones are set out below. The SRA envisages that some of these changes can be introduced straight away in the new franchises. Others will be reviewed over a longer timescale following wider collaborative industry input.

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1 Operating obligation

To deliver a better, more reliable service for rail passengers the SRA will define a clear operating obligation. From the outset, the operating obligation in the new franchise agreements will be expressed in terms of the timetable effective at the time of franchise commencement and the required train formation. The franchisee will be obliged to operate in accordance with the timetable established for its services.

The SRA wants to see forward planning of timetables, based on a collaborative industry effort, as foreshadowed in its consultation document on capacity utilisation. This approach is designed to ensure best overall value for money from a constrained network.

Franchise bidders will be encouraged to propose passenger focused improvements to the service pattern in their bids. If the improvements are consistent with value for money criteria and the capacity utilisation policy they will be included in the franchise agreement either as commitments or as options. This will enable the SRA to optimise service delivery and maximise value for money across the network through the introduction of changes to service patterns.

Timetables are developed in the rail industry through an annual conferencing round and this will continue. The SRA will require franchisees to exercise their rights under track access agreements and bid in the timetable development process in a way that is consistent with SRA strategies, including those set out as a result of the application of the capacity utilisation policy.

The SRA considers that the greater clarity of specification of rights provided for in the Rail Regulator's model clauses for track access agreements is consistent with this new approach to the operating obligation in the franchises.

Furthermore, the Rail Regulator's criteria for track access rights reinforce this approach since they require applicants:

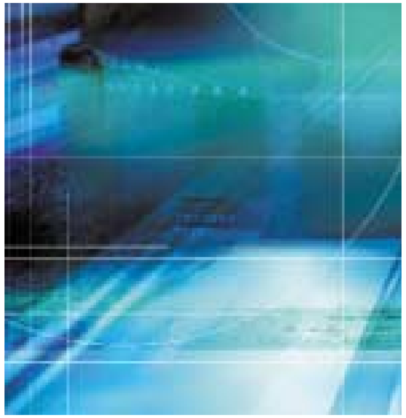
a) to seek rights which are exercisable in practice given the operating constraints of the railway;

b) to intend and be in a position to use the rights to deliver services; and

c) not to seek rights whose use would necessarily conflict with the use of rights in other access agreements.

These complementary policy initiatives will assist the SRA and the franchisee in giving effect to the Rail Regulator's new model clauses.

Where additions to or omissions from specified services require adjustment to franchise payments, these adjustments will be made by reference to the original bid, and any substantive change in service levels requested by a franchisee will require SRA approval.



2 Service reliability

The SRA believes that meeting the objectives of the policy (in particular to deliver a better, more reliable service for rail passengers) requires a revised approach to incentivising improved operational performance. The current incentive arrangements are:

- remote from the costs of improving performance – since the incentives are related to revenue losses and do not take account of franchisees' costs; and
- complex and are capable of being simplified.

The SRA believes therefore that the new franchise agreement must contain a stronger, more understandable and more transparent performance regime. This could involve:

- tariffs for failure events within the franchisee's control;
- tariff levels being set by reference to the cost of preventing failure; and
- incentives to recover services as quickly as possible following failure.

The SRA and the Rail Regulator are discussing the implications of this policy to ensure that the regimes in the new franchise agreement and the access contract complement each other and work effectively. These discussions are taking place in the context of the work which the Rail Regulator is doing to clarify the relationship between operators and Network Rail, e.g. through the development of local output commitments. The objective is to align the regimes, taking into account the desire to ensure accurate information on delays, to recover services following failure as quickly as possible, and to ensure that operators are not financially harmed as a result of poor performance by others.

3 Passenger journey quality

Passengers are not only interested in service reliability, but also in the quality of their journey. Therefore, in addition to the service performance regime as set out above, the new franchise agreement will contain a number of journey quality Key Performance Indicators (KPIs). The formulation of the relevant KPIs will focus on those things that research shows are important to passengers and where achievement of the required standards will improve the passenger's total journey experience.

The KPIs will include items such as train cleanliness, station cleanliness, passenger information provision, availability of ticket selling facilities and security. The list of KPIs, however, may vary depending upon the particular requirements of the franchises.

The SRA will ensure that:

- there is a complete specification of standards;
- the service commitments and improvements promised in the bids are reflected in KPIs in the franchise agreement;
- the KPI regime is workable and easily understood;
- the financial consequences of non-performance by the franchisee will incentivise delivery of the service, i.e. *payment will be by results*; and
- both company staff and passengers understand the standards to be expected from the rail service.

The SRA's proposal will require the establishment by the franchisee of a separate service quality management function, responsible for specified levels of audit of compliance with KPIs, as well as ensuring SRA rights to join those audits or initiate its own.

The National Passenger Survey will still be used as a measure of customer satisfaction. It is intended that customer satisfaction with train cleanliness, station cleanliness, passenger information provision, availability of ticket selling facilities and security will improve as a consequence of including incentivised KPIs in the new agreement.

4 Cost risk

The SRA believes franchisees are in the best position to control and manage cost risk.

However, the new franchise agreement will deliver greater transparency of, and focus on, franchisees' costs. This will be achieved by:

- having agreed financial and operational models incorporated in the franchise agreement;
- applying more appropriate indices to different elements of franchise costs (currently franchise subsidy/premium payments are inflated by RPI which has turned out to be a poor tracker of underlying cost inflation in the industry);
- encouraging franchisees to seek more cost and performance linked arrangements with their suppliers;
- better monitoring and reporting of costs against the business case of the successful bidder;
- provision of information to expedite implementation of changes during the term of the franchise; and
- appropriate intervention rights for the SRA if costs are trending in a way that threatens franchise viability.

The SRA will retain the risk of changes in Network Rail costs arising from the Rail Regulator's access charges reviews and certain cost changes arising out of a change of law.

The Rail Regulator's new model clauses for track access agreements ensure that the franchisee's costs and losses for breach of an access agreement by Network Rail will be paid by Network Rail. The clarity of this new regime will enable the franchisee to exercise greater control over its costs.

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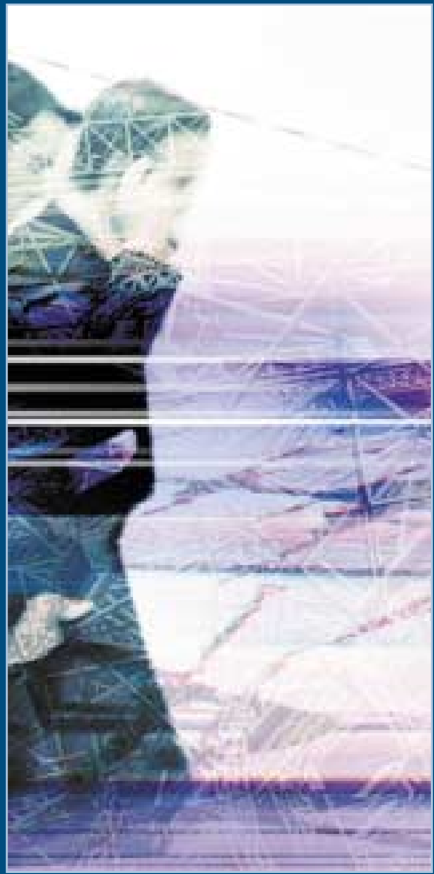
5 Revenue risk

The SRA believes that the market for rail services is likely to continue to expand (especially as the economy strengthens) and it wishes to capture private sector skills in optimising future revenue growth. The SRA believes that the franchisee is in the best position to manage revenue risk although, in the medium to long term, better value may be obtained if the SRA takes some part of the risk through an appropriate sharing mechanism.

The SRA plans to contain the level of revenue risk in the franchises through:

- a general approach of adopting shorter franchise terms (see section 6);
- more closely specified service patterns;



- agreed mechanisms for variation should specific circumstances (e.g. the outcome of the capacity utilisation study) impose a change on the franchisee; and
- where appropriate, revenue sharing arrangements in the later years of a franchise.

The SRA may also apply (e.g. where there is significant market uncertainty) a sharing mechanism from the outset if revenues materially exceed those projected in the bid.

The level of reward will be commensurate with the risks assumed by the franchisee.

The diagram on page 16 shows a possible revenue risk allocation.

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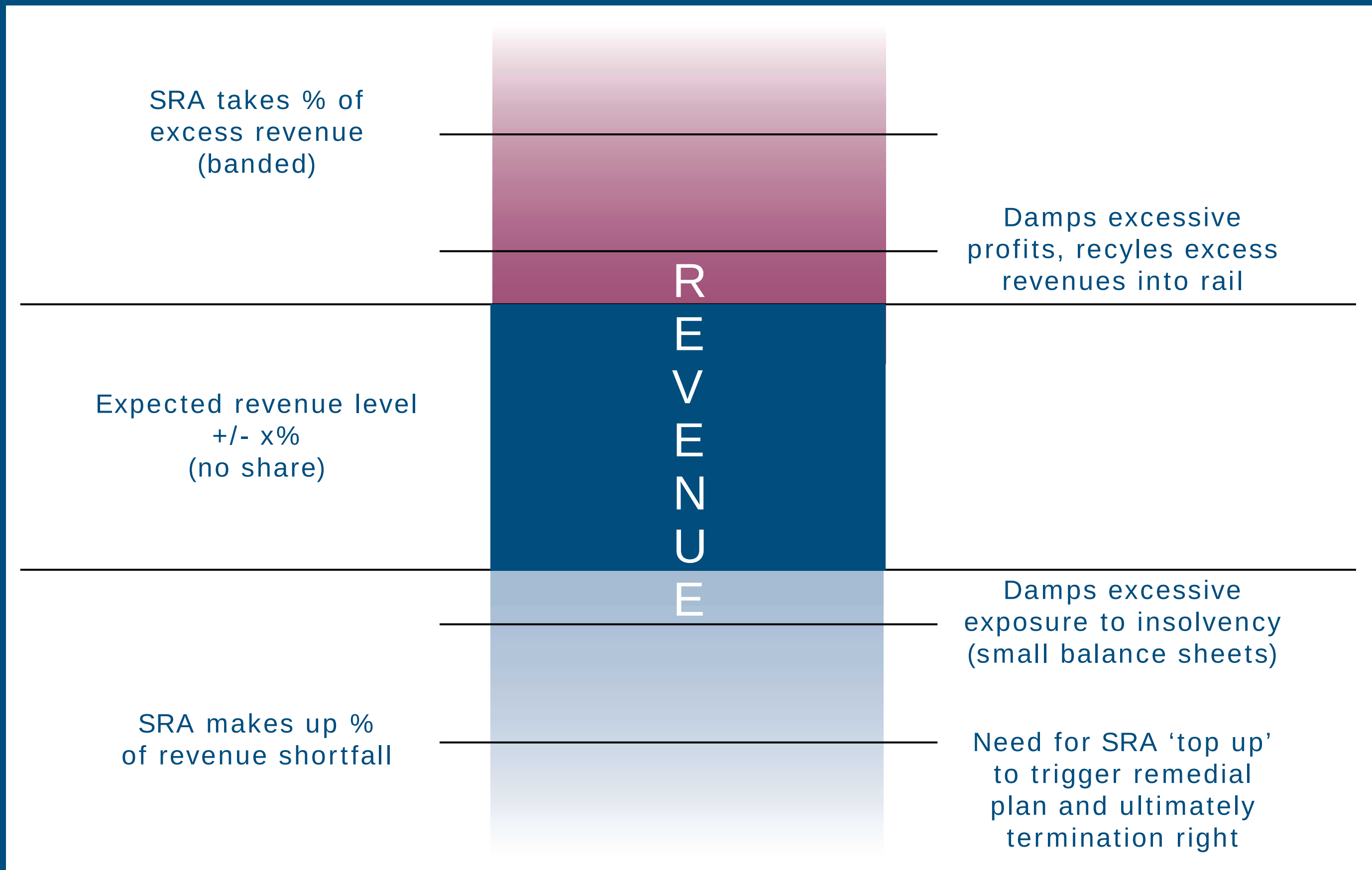


6 Franchise term

The franchise term cannot be considered in isolation from all the other elements of the agreement, in particular the need to ensure that the risk allocation under the agreement is sustainable throughout its term. It needs to reflect:

- the risk of inaccurate forecasting by franchise bidders of future revenues and cost increases as the term extends;
- the financial vulnerability of franchises to any significant variance from bid levels; and
- the extent of planned changes to the network.

The franchise term of each individual franchise will:

- be dependent on the characteristics of, and in particular the risks associated with, the individual franchise (such as the relative volatility of its revenue, major infrastructure works and significant changes to the rolling stock fleet); and
- take into account the need to establish a manageable programme for franchise expiry and re-letting, so as to ensure the availability and best application of industry resource, as well as to facilitate an orderly and properly competitive market.

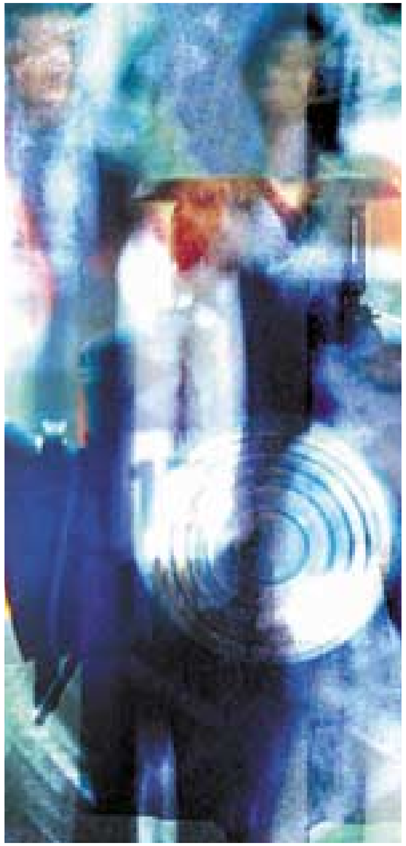
Having considered these and other factors (including EU procurement rules), the SRA has determined that franchise terms should generally be between 5 to 8 years.

If franchisees:

- deliver successfully against established performance targets and KPIs; and
- deliver committed management actions,

then there will be the opportunity for the franchise term to continue for a number of years, on a basis acceptable to the SRA.

The Rail Regulator's criteria and procedures for the approval of track access agreements make it clear that the term of the franchise agreement will be an important consideration in determining the appropriate duration of an access agreement. The SRA believes that franchises and access agreements should as far as possible be co-terminous, subject to appropriate arrangements to secure continuity of operation.

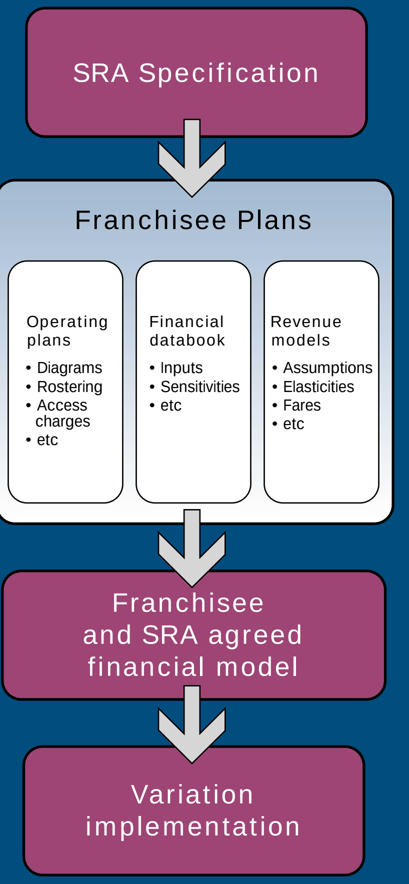


7 Variation mechanisms

Any variations to the new franchise agreement will be made against a background of a more closely specified service requirement at the outset and greater transparency as to costs and revenues. The SRA believes this will enable it to develop and implement a more straightforward and structured variation mechanism. This is particularly important in the context of future changes brought about by the application of capacity utilisation and route utilisation strategies and in response to major projects.

The mechanism will be based in future on franchise business models developed in each case to an SRA specification and submitted, in line with the SRA's requirements, with the bid as part of the process of franchise award. These are summarised in the diagram here.

Basing the financial impacts of variations on the agreed models, the defined reference points, will increase the level of certainty for all parties and reduce the level of effort associated with the evaluation and implementaion of individual changes. This provision will avoid any tendency towards 'ossification' of service specification and provide a more dynamic, market responsive and cost effective railway service in future years.



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8 Incentivising long term improvement

The SRA recognises that:

- a fixed term contract may dampen (and in certain circumstances may remove) the incentive for any franchisee to take actions (in relation to costs or revenues or both) which, although having demonstrable benefit to the industry in the long term, confer limited commercial advantage to the franchisee during the life of the franchise; and
- actions that may deliver net benefits to the rail industry as a whole may be detrimental to an individual franchisee within the term of its franchise agreement.

The SRA therefore intends to introduce mechanisms that will identify contributions that franchisees can make to wider scale and/or longer term initiatives, and reward franchisees who both commit to and deliver agreed specific actions to achieve those initiatives. These initiatives might involve specific schemes in terms of providing physical assets or enhancements to assets, or they may be schemes that focus on driving down long term costs. These improvements may be agreed at the outset of the franchise, held as options exercisable after franchise award or may be developed during the franchise term.

The SRA will evaluate the value for money and affordability of such schemes over an appropriate life not necessarily constrained by the term of the franchise.

It is envisaged that the franchisee will be rewarded for participation in these schemes by a proportion of the net benefit (notwithstanding that some or all of the benefits accrue after the franchise expiry date). The proportion of the net benefit will recognise the risk that the franchisee has taken in developing and implementing the scheme.

Incentivisation of projects that have a payback longer than the franchise term should mean that the passenger will continue to see projects that deliver benefits as franchises progress towards the end of their agreed term.

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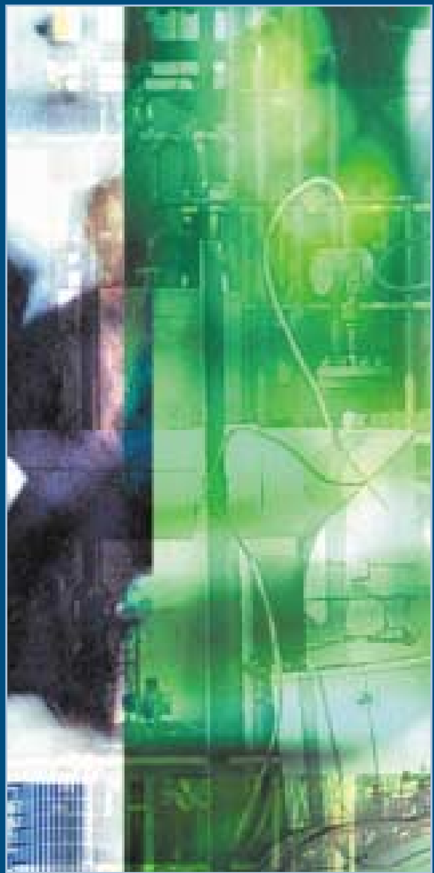

9 Remedies

The agreement will provide a range of remedies that, in the first instance, incentivise performance through a graduated system of payments from the franchisee according to the degree of shortfall in the level and quality of passenger service delivery. But the agreement will also recognise that some instances of failure cannot be addressed effectively by payments alone.

There will, therefore, be a progressive range of further remedies to enable the SRA to respond proportionately to such failures. This will include requiring the franchisee to develop and implement remedial programmes to address poor passenger service or financial performance, with further sanctions where this is not implemented or is not effective.

Ultimately, there will be provisions to facilitate a managed exit by the SRA of a franchisee which has either not delivered acceptable performance through these remedial measures, or has no reasonable prospect of being able to do so.

The SRA has considered extended financial bond requirements (including liquidity maintenance regimes) as a means of ensuring franchisee commitment to its obligations but has reservations concerning the value for money of such mechanisms.

10 Investor issues

General outlook

The SRA believes that through this policy and the new franchise programme franchisees will be selected on the basis of robust and deliverable propositions, providing a much greater degree of consistency and predictability for potential investors.

Rolling stock

The SRA will actively support rolling stock lease terms which extend beyond the end of the franchise term. However, there must be a balance between risk and reward. The provisions of such leases must demonstrate value for money, and support from the SRA for such leases will be linked to asset performance and asset condition.

In addition, franchisees and the investing community will be invited to consider innovative ways in which the payments for the leasing of rolling stock can have a stronger focus on usage rather than time, such that the cost base of the industry is less fixed and more variable.

Infrastructure

With respect to fixed assets, the SRA will also provide support to enable improvements to be made to the network which will benefit successive franchisees, provided that the value for money and affordability criteria can be satisfied.

11 Programme

There is a strategic objective to achieve a re-letting and replacement programme that smoothes out the replacement of franchises such that there is a continuous steady state replacement of 2 to 3 franchises a year. This will have the advantage of:

- avoiding bidder fatigue;
- enabling better value for money through increased competition for individual franchises;
- allowing the SRA and franchisees to learn progressively from experience and to incorporate improvements in the new form of contract; and
- smoothing the resource need at the SRA and ensuring policy consistency between negotiations on each franchise.

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A long term programme is being developed and will be published after extensive consultation with existing franchisees. The SRA expects to publish this programme before the end of the year.

The short term programme will be announced immediately following the publication of this policy.

Facilitating the programme

The SRA recognises that franchise bidding processes involve the industry in significant costs and tie up resources. The SRA will therefore help to reduce the level of unproductive costs in the industry through revisions to the way in which it approaches the franchise re-letting process, as follows:

- the SRA will provide clarity as to the service obligation and the franchise proposition;
- the SRA will invite bids on the basis of more transparent documentation, containing a clear risk allocation, enabling the evaluation of bids and negotiation of agreements to be conducted more expeditiously; and
- the time allowed for bidding will be extended in the first instance and more information will be provided. The bidders will have **one** opportunity to put in a comprehensive, best value bid. Bidders will be short-listed and following final selection of the preferred bidder the transaction will be expected to close without delay.

Evaluation of bids will take account of what is realistically deliverable, rather than focusing primarily on lowest cost and the maximum amount of risk which a bidder is prepared to take. Other key determinants will be value for money and affordability.

Single operators at London termini

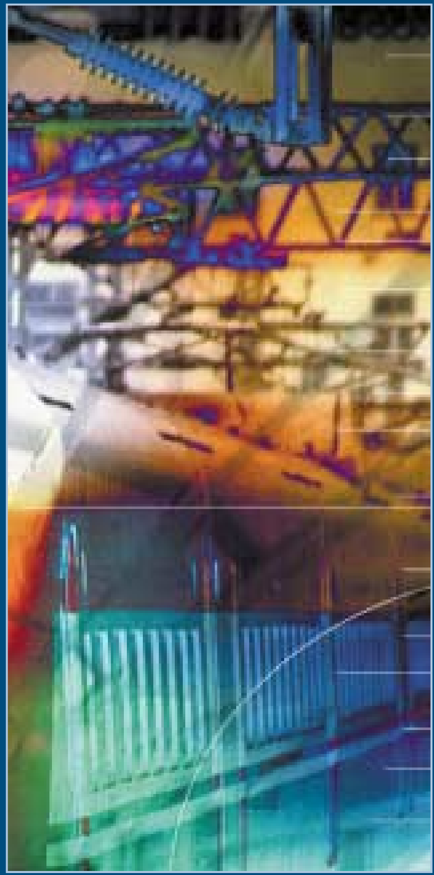
Following a positive response to its consultation document, the SRA is pursuing the objective of having a single franchisee at the major London termini. A single operator will facilitate optimum use of capacity, provide a simplified, more understandable and impartial day-to-day interface with the passenger and improve recovery from service disruption.

With this in mind, the SRA intends to implement the following:

- to serve Liverpool Street – creation of Greater Anglia (out of the West Anglia element of the West Anglia Great Northern franchise, the First Great Eastern franchise and the Anglia franchise);
- to serve Paddington – creation of Greater Western (out of the First Great Western franchise, the Wessex franchise and the Thames franchise); and
- to serve Waterloo – a South West franchise encompassing domestic services into Waterloo.

The timing of these changes will be driven by the different circumstances of each case.

Opportunities for single operator operation at Kings Cross and Euston will be pursued (subject to appropriate consultation) when issues relating to the West Coast Main Line, Thameslink 2000, and the Channel Tunnel Rail Link have been resolved.



Conclusion

This is a Policy Statement for rail passengers and the companies that serve them. It is intended to clarify and improve the relationship between those who depend on rail services and those that provide them.

The challenge now is to create a framework that enables the Train Operating Companies to deliver for their customers, to a high standard, day-in, day-out.

That challenge extends to helping passengers feel like valued customers, while providing value for taxpayers at large. There is no bigger challenge for the passenger rail industry. Passengers are our lifeblood.

Every franchise is different; this is not an homogeneous industry. But this is not the place for the detail of each and every contractual specification. This Policy Statement frames and specifies the nature of the single most important relationship that the rail industry needs to nurture – the one with its customers.

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