

A Review of Passenger Rail Franchising in Britain: 1996/1997–2011/2012

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Workshop on Tendering Transport Services

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Outline

Update of a paper in Research in Transportation Economics in 2008.

- Brief History of Franchising.
- Key Trends.
- Key Issues: Competition, Objectives, Overoptimistic bids.
- Franchising Futures.
- Conclusions

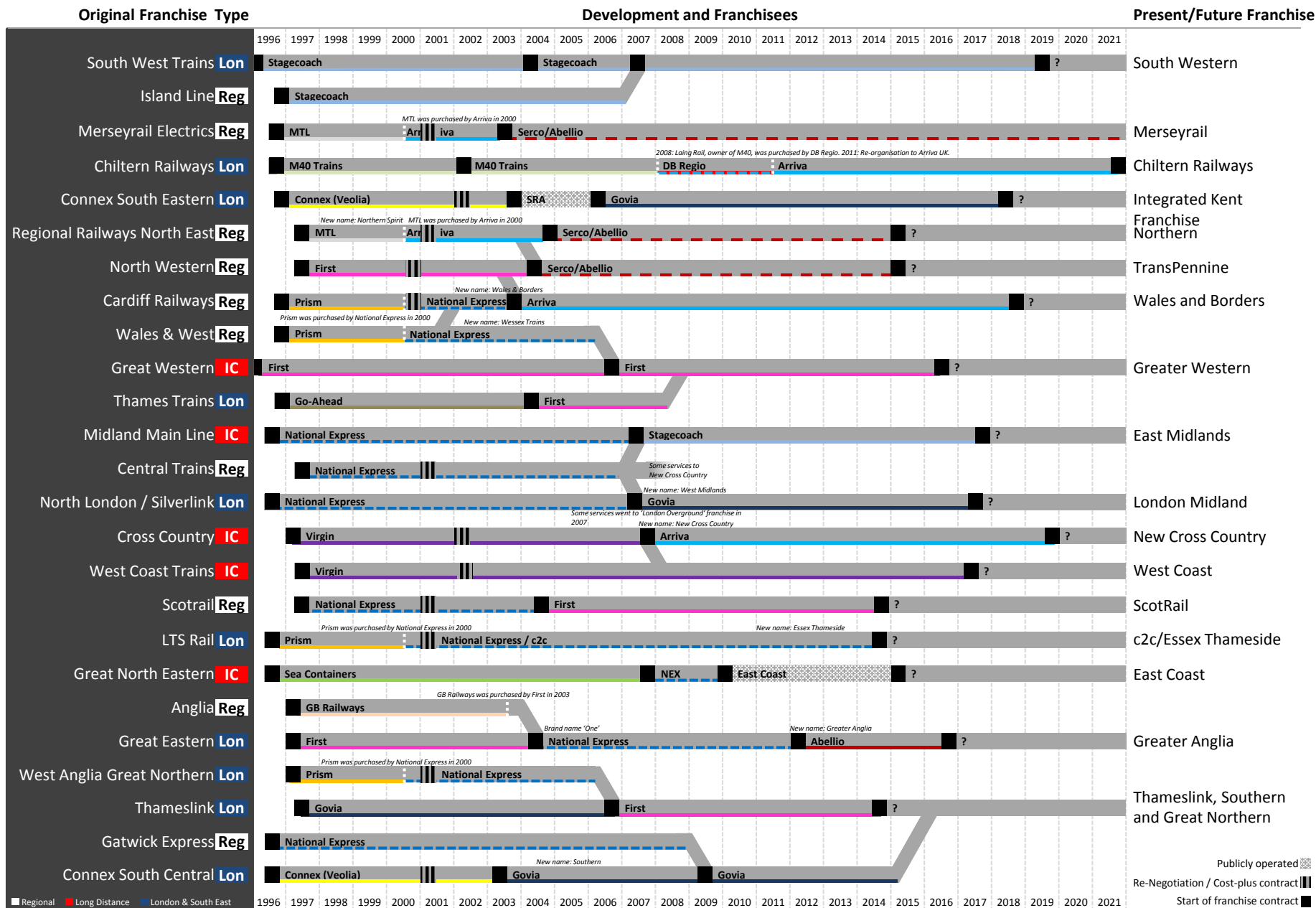
A Very Brief History of Rail Franchising in Britain

- First phase. 1996/7 – c2000. Associated with OPRAF. 25 TOCs franchised.
- Second phase. c2001-2004. Associated with SRA. 9 TOCs (re)-franchised.
- Third phase. 2005-12. Associated with DfT. 13 TOCs (re)-franchised.

2012. 'Failure' of West Coast Franchise and instigation of the Laidlaw Enquiry and Brown Review.

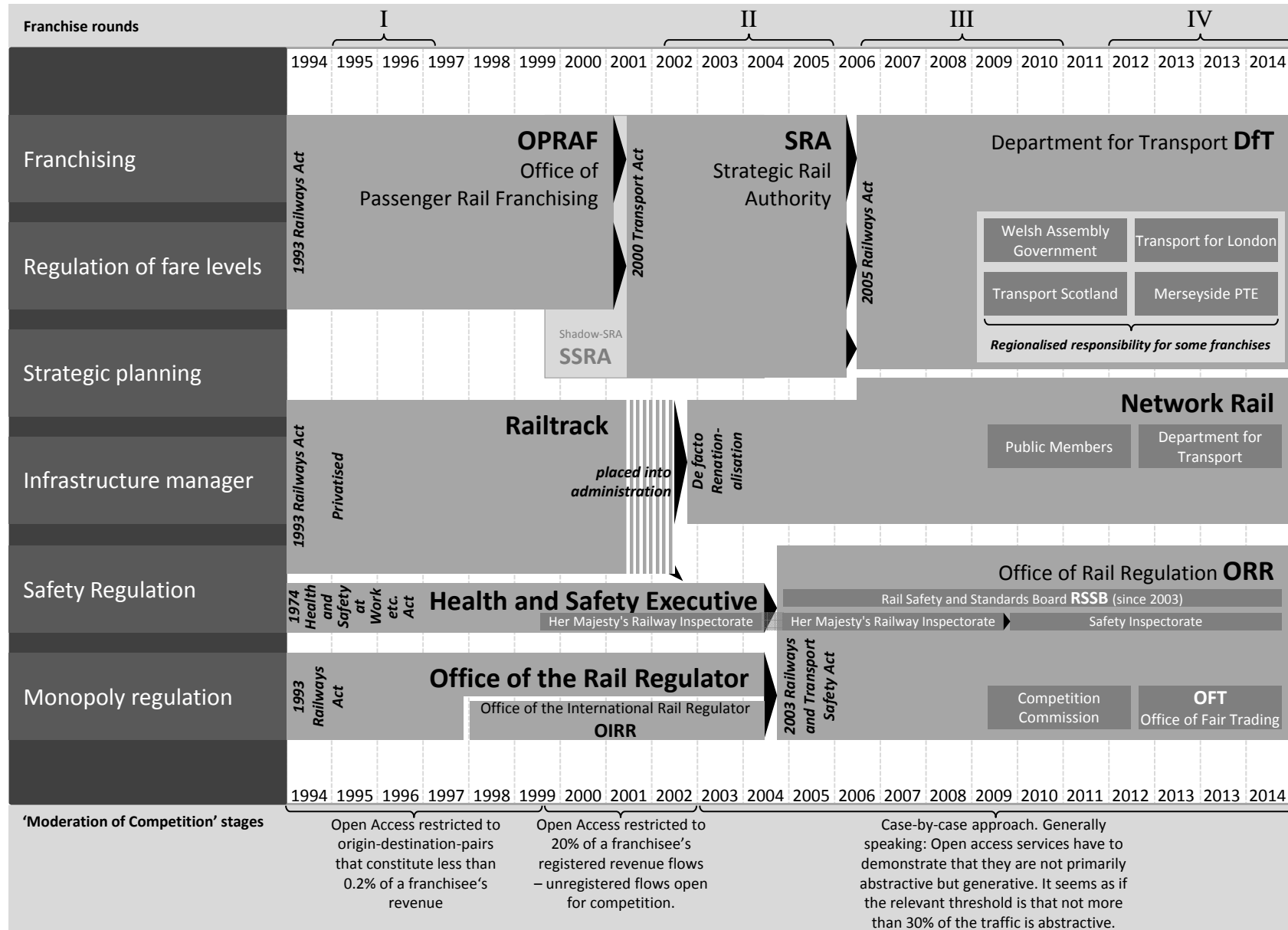
- Fourth phase. 2014-

Development of the British Rail Franchises



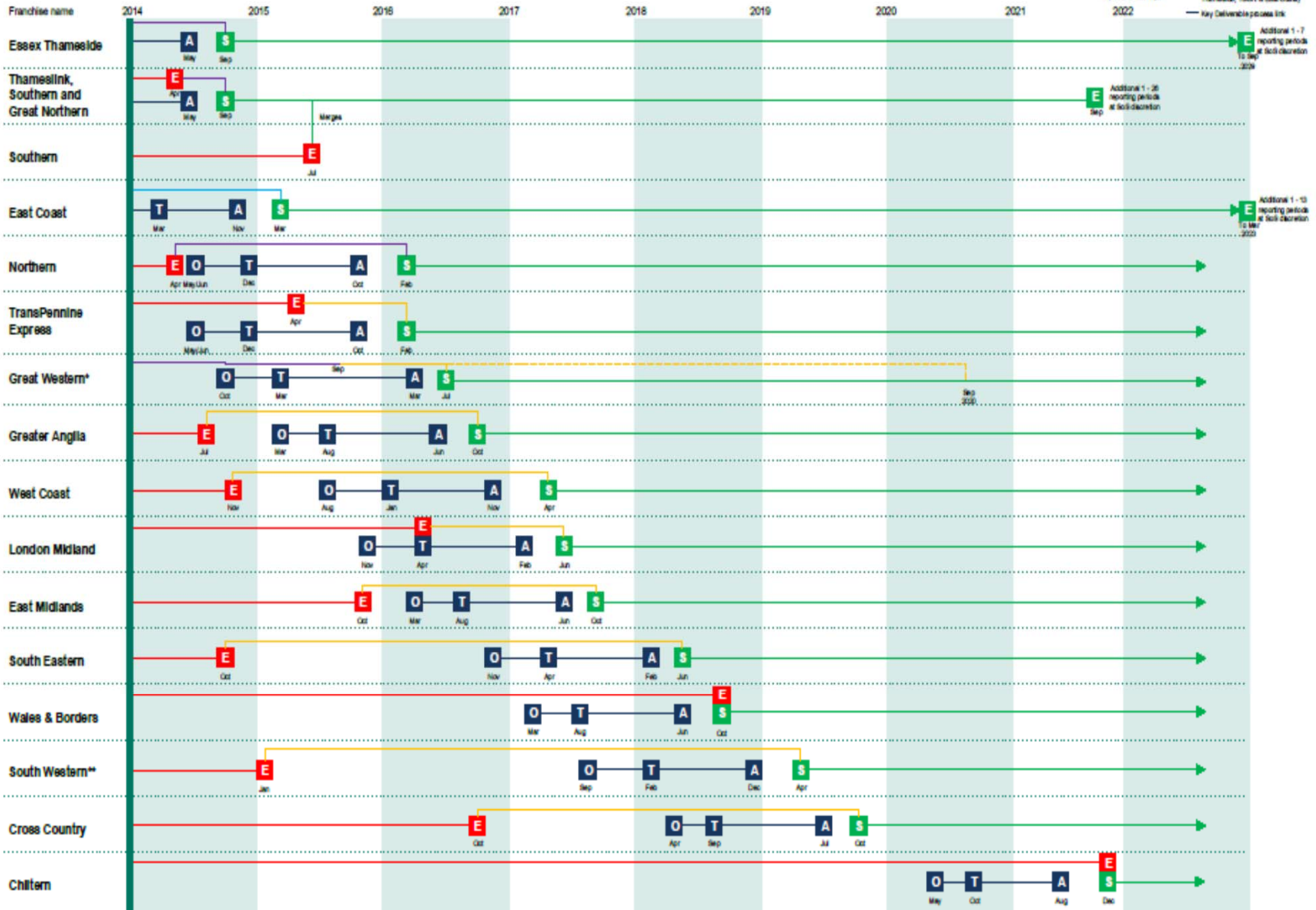
Source: Schneider, 2013, after DfT 2013, Knowles 2004, Müller 2011, Nash/Smith 2007

British Rail Regulation 1993 -



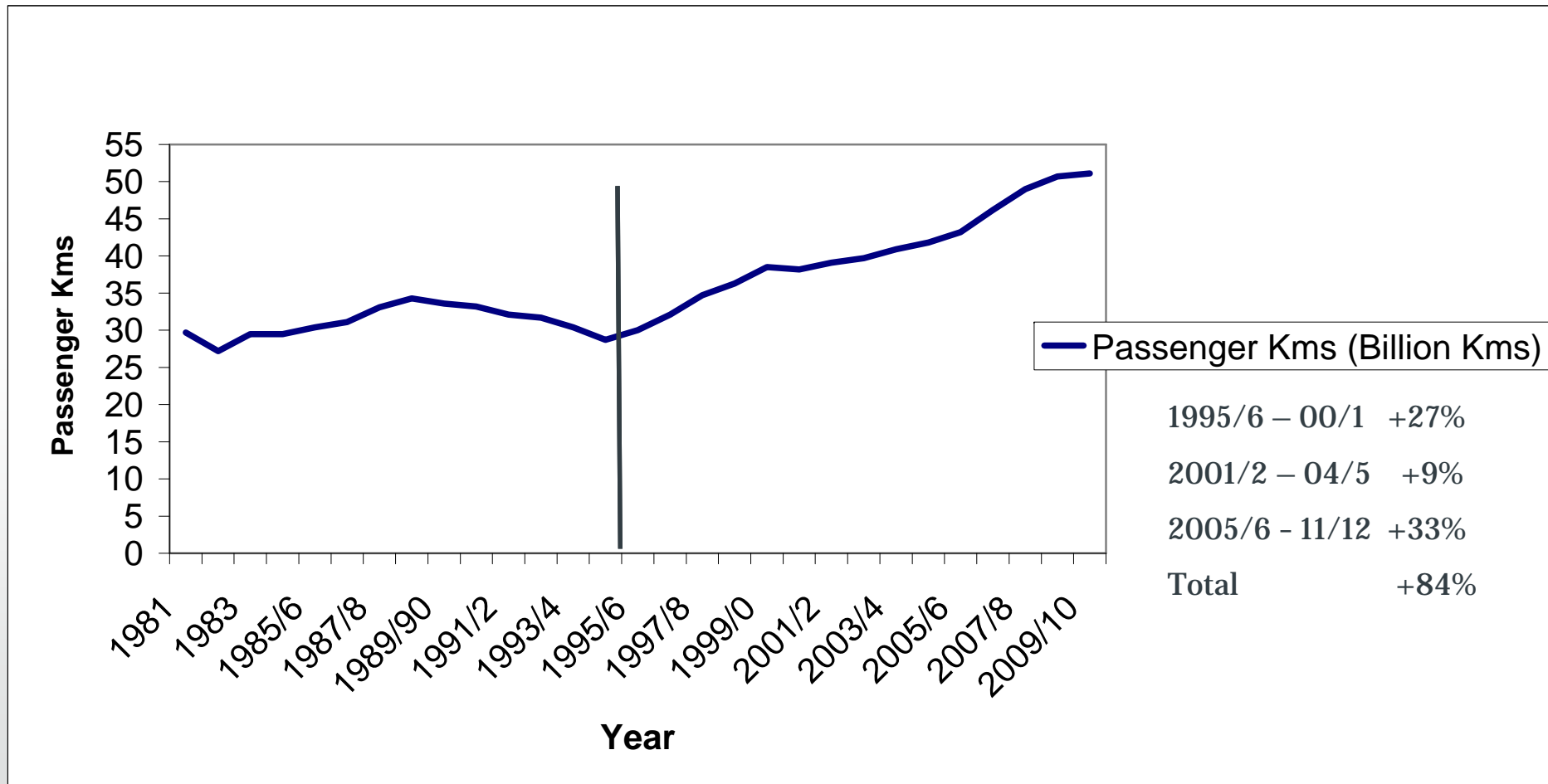


- E** Current Franchise Expiry Date (including any contractual extension options that have been called)
- O** OJEU (Official Journal of the European Union) Notice Published, followed by Pre-Qualification Process
- T** ITT (Invitation to Tender) issued to Shortlisted Bidders
- A** Contract Award
- S** Franchise Start Date
- E** Franchise End Date
- Passenger rail service operated by Directly Operated Railways
- Current Franchise
- Contract Award - Contract signed
- Contract Award - Anticipated
- Contract Award alternative option being considered
- New Franchise, Duration to be determined (except for Great Western, TSOA & Scot Coast)
- Key Deliverable process link

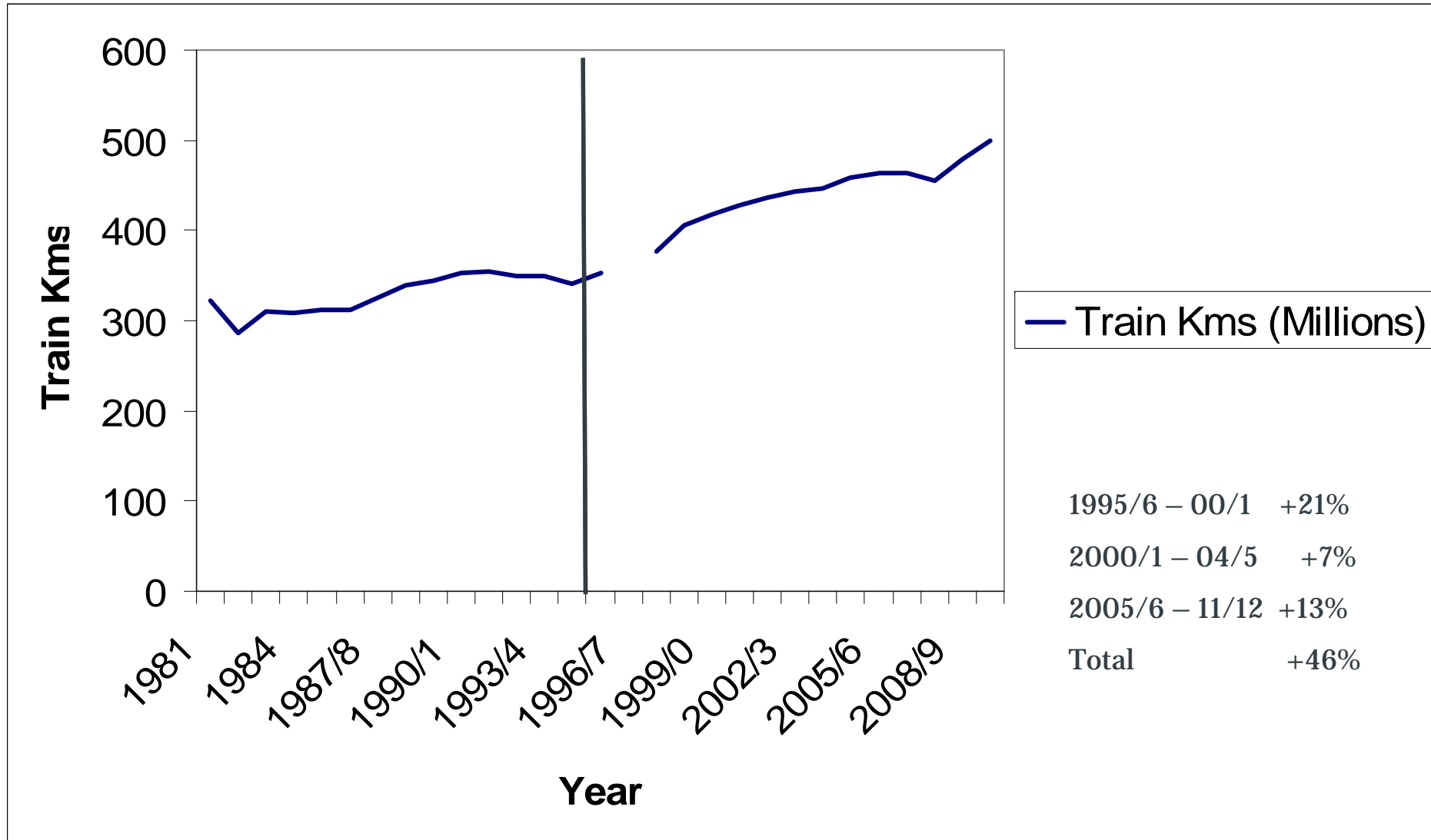


* See 6 March 2014 project PIN notice for further details on dates.
 ** See 4 January 2014 project PIN notice for further detail.

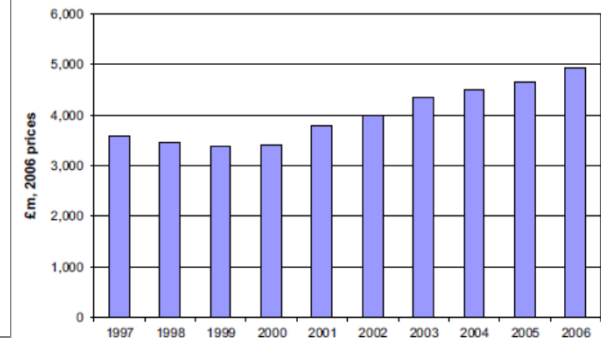
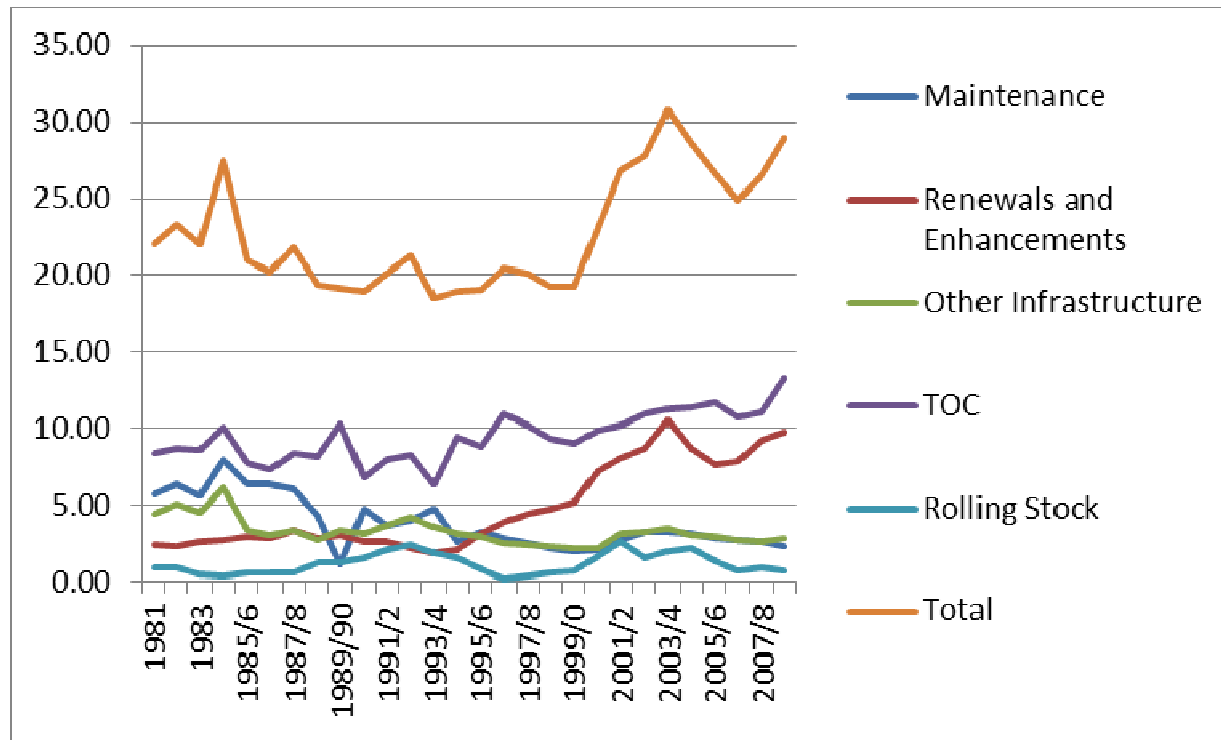
Trends: Passenger Kms



Trends: Train Kms



Trends: Unit Costs

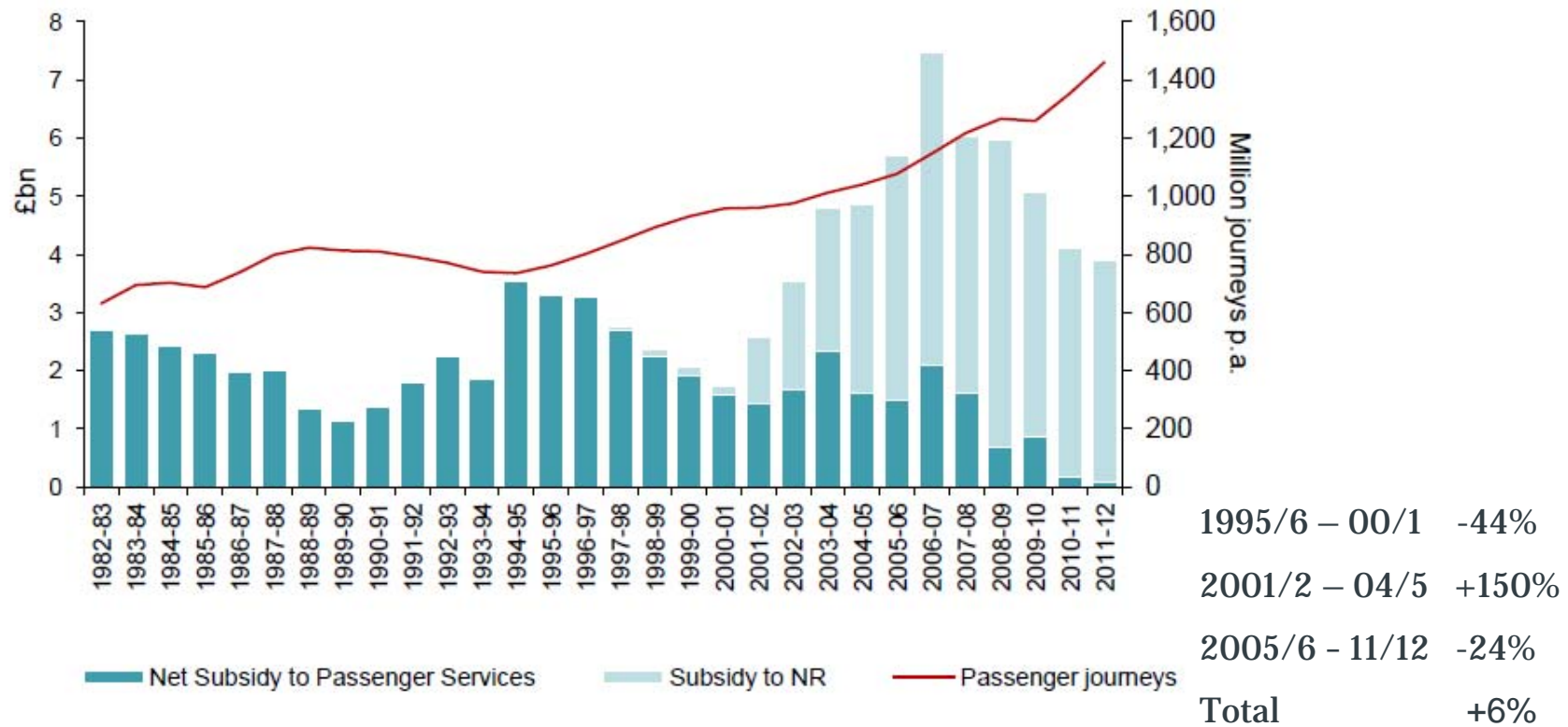


Source: Robins, 2012. Unit costs in £ per train km, 2008 prices.

Main growth in Renewals and Enhancements, but also increases in TOC costs since 2000.

Trends: Government Support

Annual rail subsidy and journey growth (2012 prices)



Estimated Welfare Effects (£ B)

	Overall	Increase in Infrastructure Costs	Net Effect
1995/6 – 2000/1	-2.2	+4.6	+2.4
2001/2 – 2004/5	-18.7	+16.9	-1.8
2005/6 – 2008/9	-13.8	+17.0	+3.2
Total	-34.7	+38.5	+3.8

Based on Robins (2012) and Preston and Robins (2013). If each franchise had bidding costs of £22.5M then the net benefits of £3.8B are offset by transaction costs of £1.1B.

Issue (I) Level of Competition and the Winning Bid

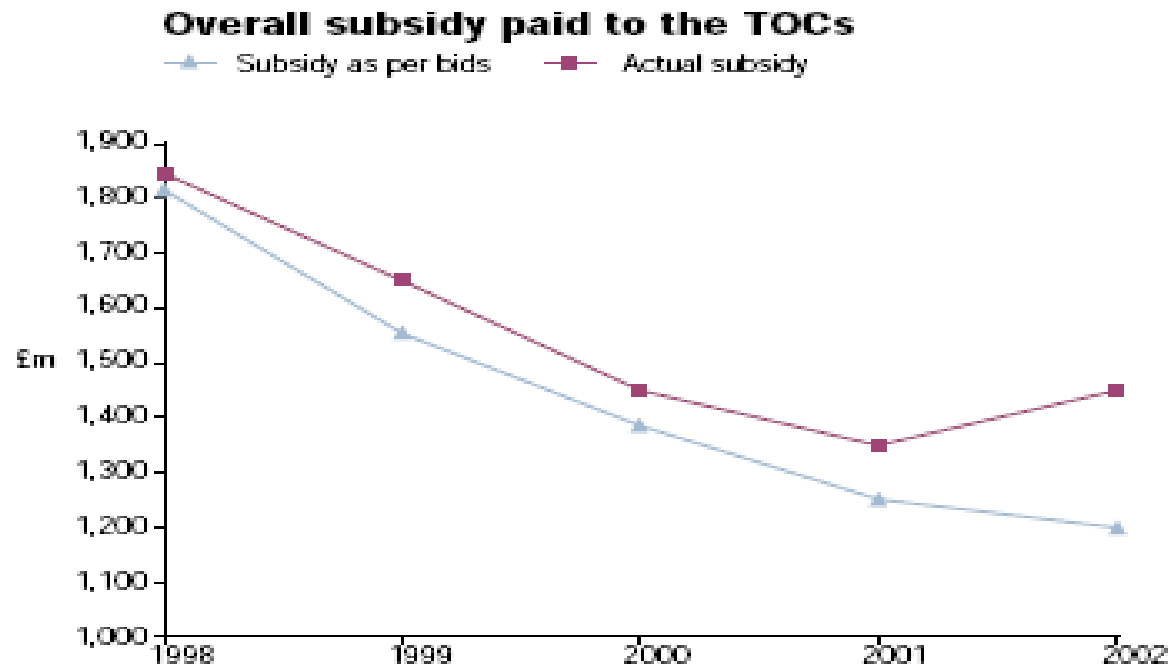
Franchising has been competitive, but competition declining over time:

- First phase: 5.4 bids per franchise
- Second phase: 4.2 bids per franchise
- Third phase: 3.8 bids per franchise.

Current pool of 10 active bidders. High bidding costs (£5M per bidder in 2006, £10M in 2012).

Are rail franchises a common value or a private value auction? Assuming no uncertainty and/or no risk aversion contracting-out will ensure optimal effort. But where there is uncertainty (e.g. open access) and risk aversion, effort will be sub-optimal.¹²

Issue (I) Level of Competition and the Winning Bid



Source: SRA, KPMG analysis

Only 3 out of 47 franchises have failed.

However, 13 franchises re-negotiated after Hatfield 2000.

Evidence of the winner's curse?

Issue (II) Objectives

What is franchising trying to achieve?

- (i) To harness private sector commercial judgement and innovation to reduce the net cost and increase the value for money achieved from the Government's overall support for passenger rail services.
- (ii) To improve passenger services, commensurate with funding available.
- (iii) To set the level of service needed and to vary specifications to reflect changing market needs and accommodate future passenger growth.
- (iv) To protect passengers from the power of unregulated monopolies.
- (v) To maximise the benefits of the network as a whole.
- (vi) To fit rail within Government's wider public transport objectives.



**Maximise net social benefit subject to a budget
constraint?**

Issue (II) Objectives

Brown Review:

- (i) Ensure value for money by competition for the market.
- (ii) Harness private sector skills and innovation.
- (iii) Ensure stability of service.
- (iv) Secure franchisees who will work in partnership.
- (v) Facilitate further devolution of decision making.
- (vi) Ensure services are delivered and managed by organisations which are attuned to local market needs.

Issue (II) Objectives (continued)

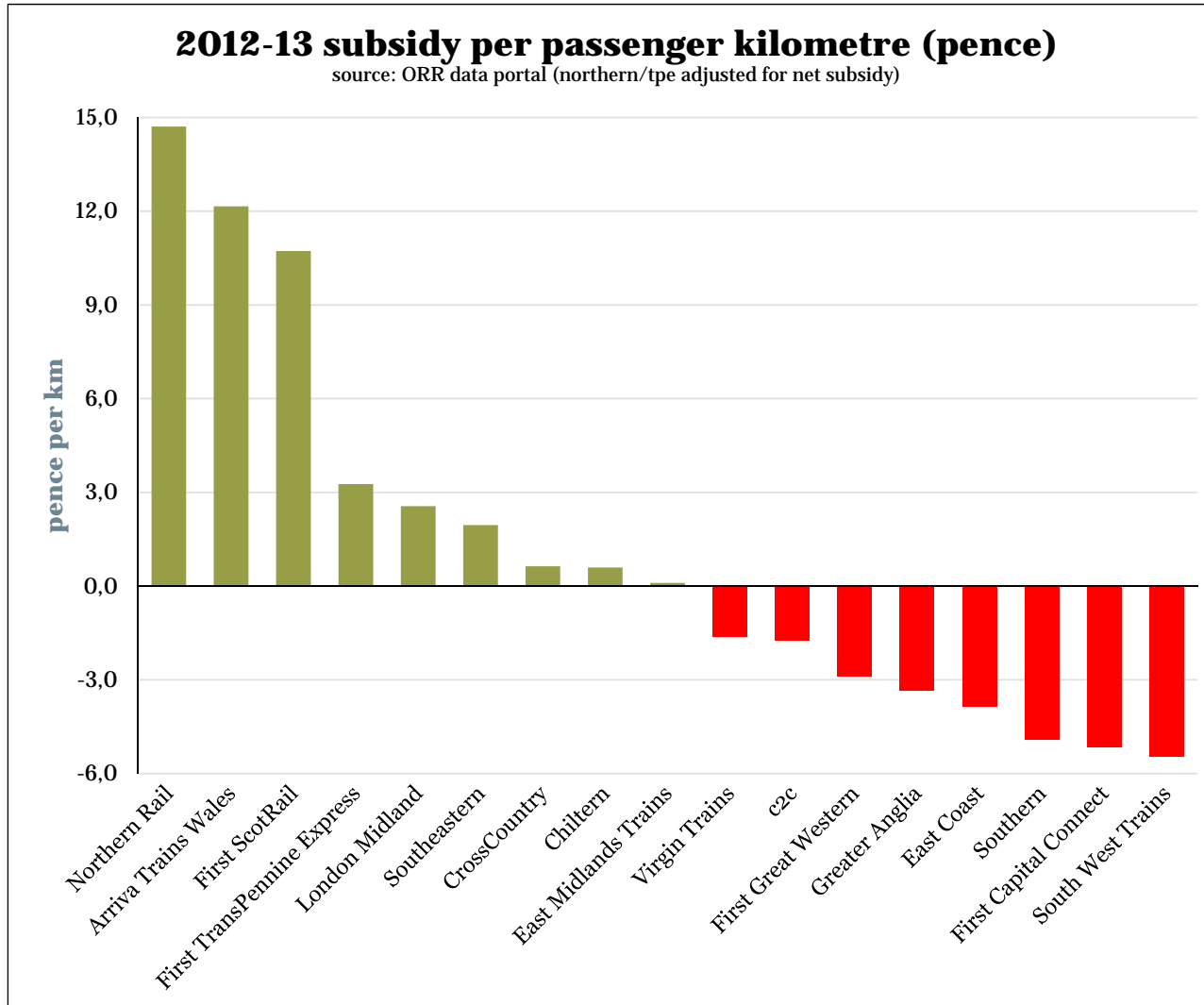
Change in:	Fares	Train Miles	Subsidy	Welfare
Profit Max - 50% variable	+17%	-8%	-7%	-22%
Constrained Welfare Max - 50% variable	-1%	+8%	0	0
Unconstrained Welfare Max - 50% variable	-93%	+71%	+521%	+86%
Profit Max - 100% variable	+24%	-47%	-89%	-35%
Constrained Welfare Max - 100% variable	-36%	-30%	0	+25%
Unconstrained Welfare Max - 100% variable	-88%	+12%	+374%	+53%

BCR of revenue support (£1.2 b per year) \approx 4.

BCR of revenue and direct support (£4.6b per year) \approx 1.1

Issue (II) Objectives (cont.)

Social v Commercial



Issue (III)

Overoptimistic Bids

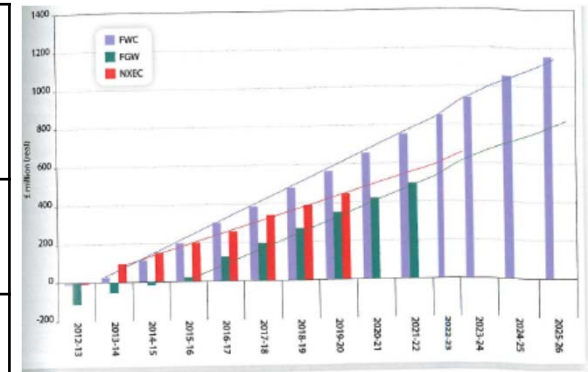
The East Coast Franchise

	Date Started	Expected Duration	PVNP 1 st year (£m)	PVNP Final year (£m)
GNER	April 1996	7 years	65 ¹	0
GNER	May 2005	10 years	(50)	(219)
National Express	Dec. 2007	7 ¼ years	7	(311)

PVNP = Present Value of Net Payments. Figures in brackets denote premia paid.

¹Out-turn.

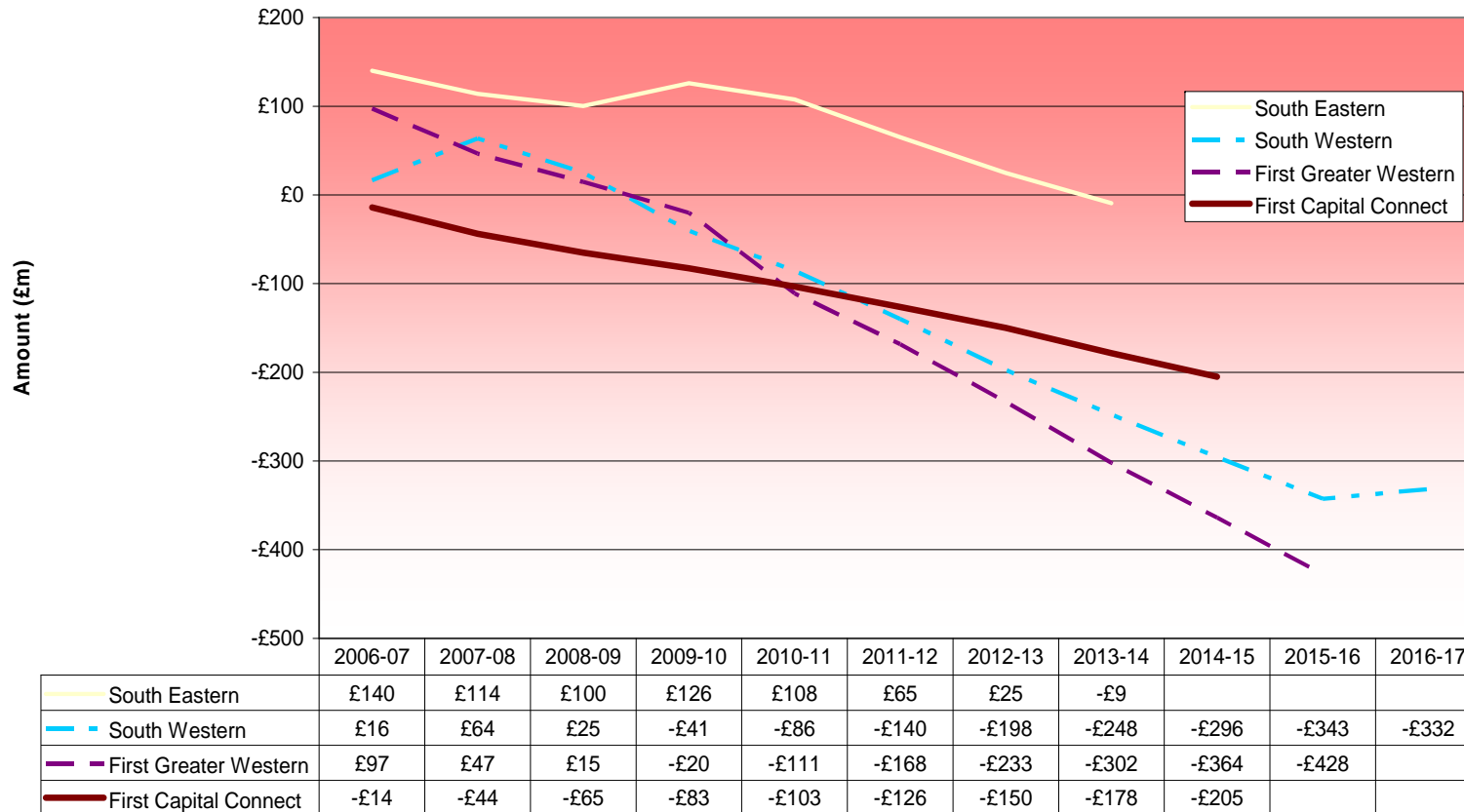
Source: Preston and Root (1999) and www.dft.gov.uk



Comparison of FWC (purple) and NXEC (red) bids.

Source: Modern Railways, 2012.

Issue (III) Overoptimistic Bids



	Date Started	Expected Duration	PVNP 1 st year (£m)	PVNP Final year (£m)
Greater Anglia	April 2004	10 years	(19)	(116)
South Western	Feb 2007	10 years	16	(235)
Southeastern	April 2006	8 years	135	(11)
Great Western	April 2006	10 years	95	(313)
Capital Connect	April 2006	9 years	(14)	(156)
TOTAL			163	(1050)

Issue (III) Overoptimistic Bids (cont.)

Cap and collar regime intended to promote efficient bidding given concern that post Hatfield bidders would be overly risk averse:

- 50% of any fares revenues in excess of 102% of the TOC's original forecasts are shared with DfT;
- DfT makes a contribution equivalent to 50% of any revenue shortfall below 98% of the TOC's original forecast
- For any short fall below 96%, DfT's contribution increases to 80%.

However, seems to have led to strategic behaviour, although extreme gaming behaviour should be detected at the bid evaluation stage.

Issue (III)

Overoptimistic Bids

(cont.)

West Coast franchise replaced the cap and collar regime but with bidders required to have in place a subordinated loan facility (SLF) to be drawn upon in case of default.

21/01/12 ITT issued

15/08/12 Intention to award to First Group

03/10/12 Cancellation of franchise and suspension of programme.

Laidlaw Enquiry highlighted (i) lack of transparency with SLF process (ii) technical mistakes in the calculation of the SLF (iii) contributory factors relating to lack of planning resource.

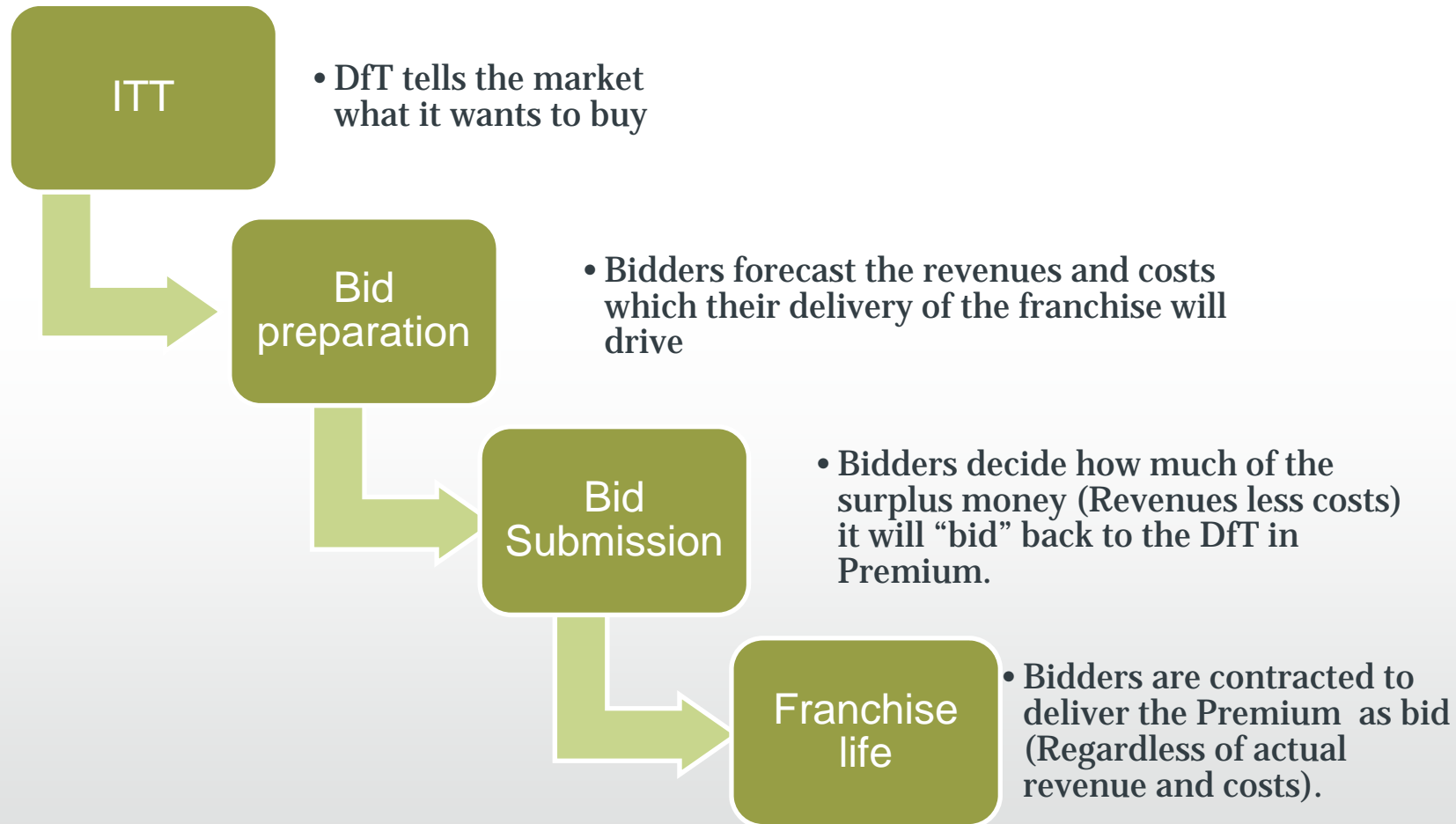
Brown Review: Key Themes

1. Exposure to macro-economic factors.
2. Overoptimistic bids.
3. Trend towards tighter franchise specifications and less flexible management.
4. Trend towards fewer, larger franchises.
5. Reduced ability of franchises to adapt.
6. Asymmetry between the experience and capability of bidders and that of the DfT franchising team.

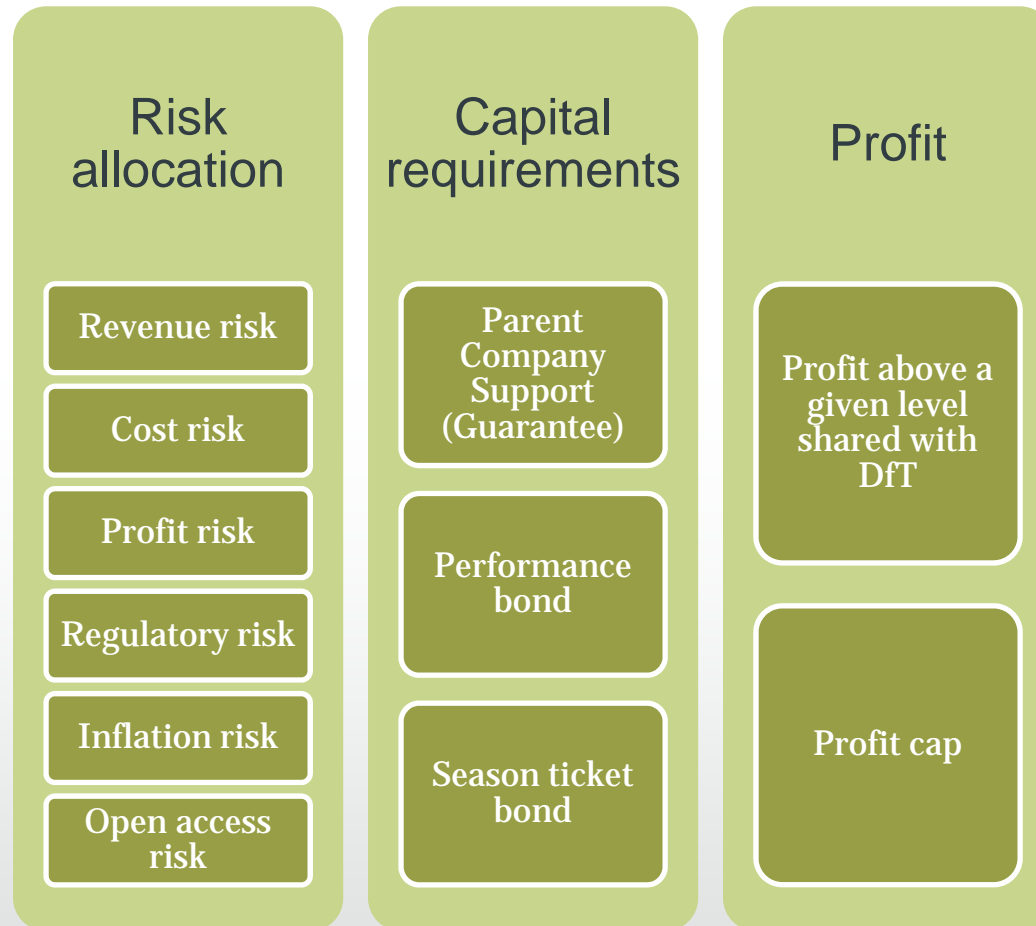
Alternative Contract Specifications

- ‘Commercial’ franchises (long distance services): longer length, looser specification, remain net subsidy.
- ‘Social’ franchises (short distance commuter and regional services): shorter length, tighter specification, gross cost.
- Experimentation with vertical re-integration, micro-franchises, Vickrey auctions and contracting out of planning function.
- Brown favours 7 to 10 years franchises, with a 3 to 5 years continuation mechanism. Management contracts where major upheavals. Concessions where authority has marketing capabilities. Against cross default provisions.
- Some calls for re-nationalisation via DOR.

Franchising Futures – process

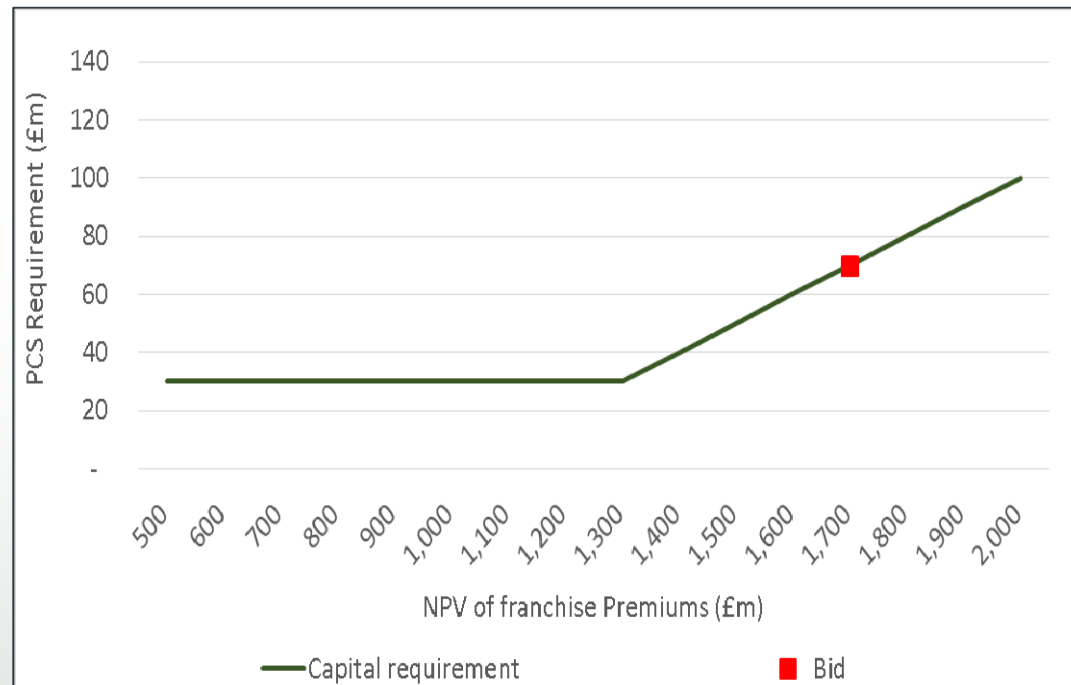


Franchising Futures – Key components



Franchising Futures: Parent Company Support (PCS)

The PCS requirement will be proportional to bid “ambition” above a certain level.



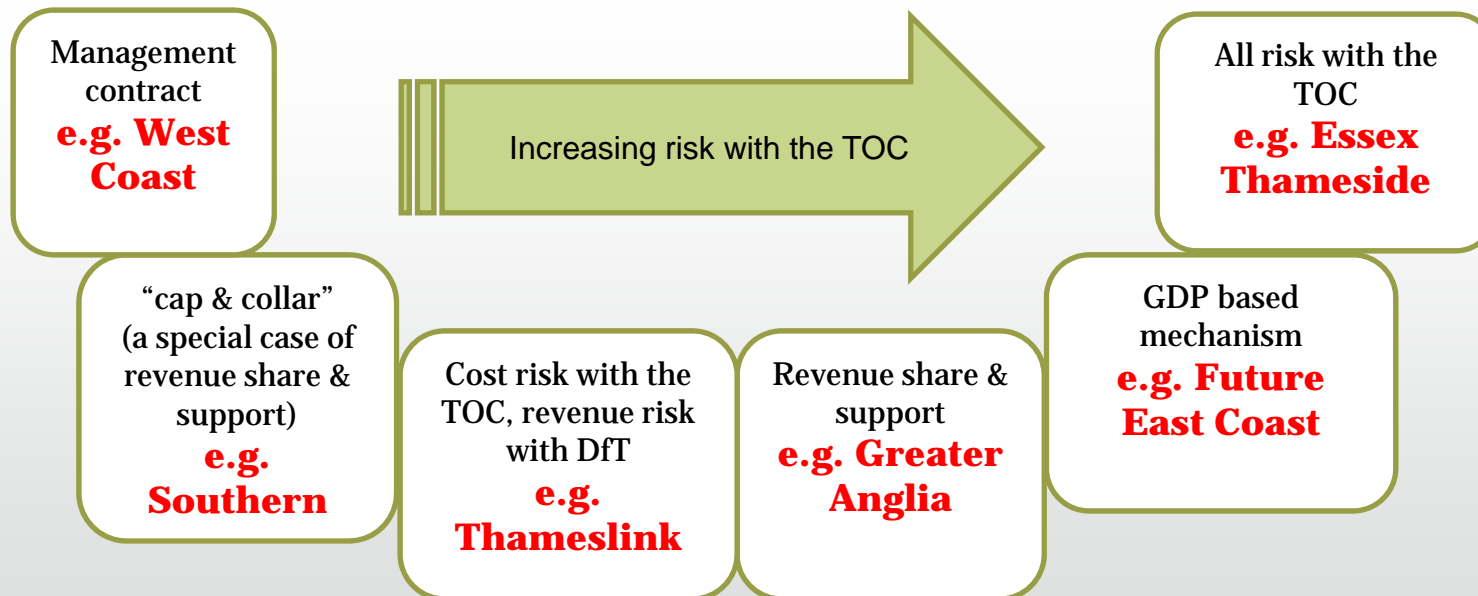
In this example, a bidder would be required to provide a minimum PCS of £30m, with bids above £1bn requiring additional PCS at a rate of £100k for every additional £1m bid.

Financial Futures: Risk Allocation

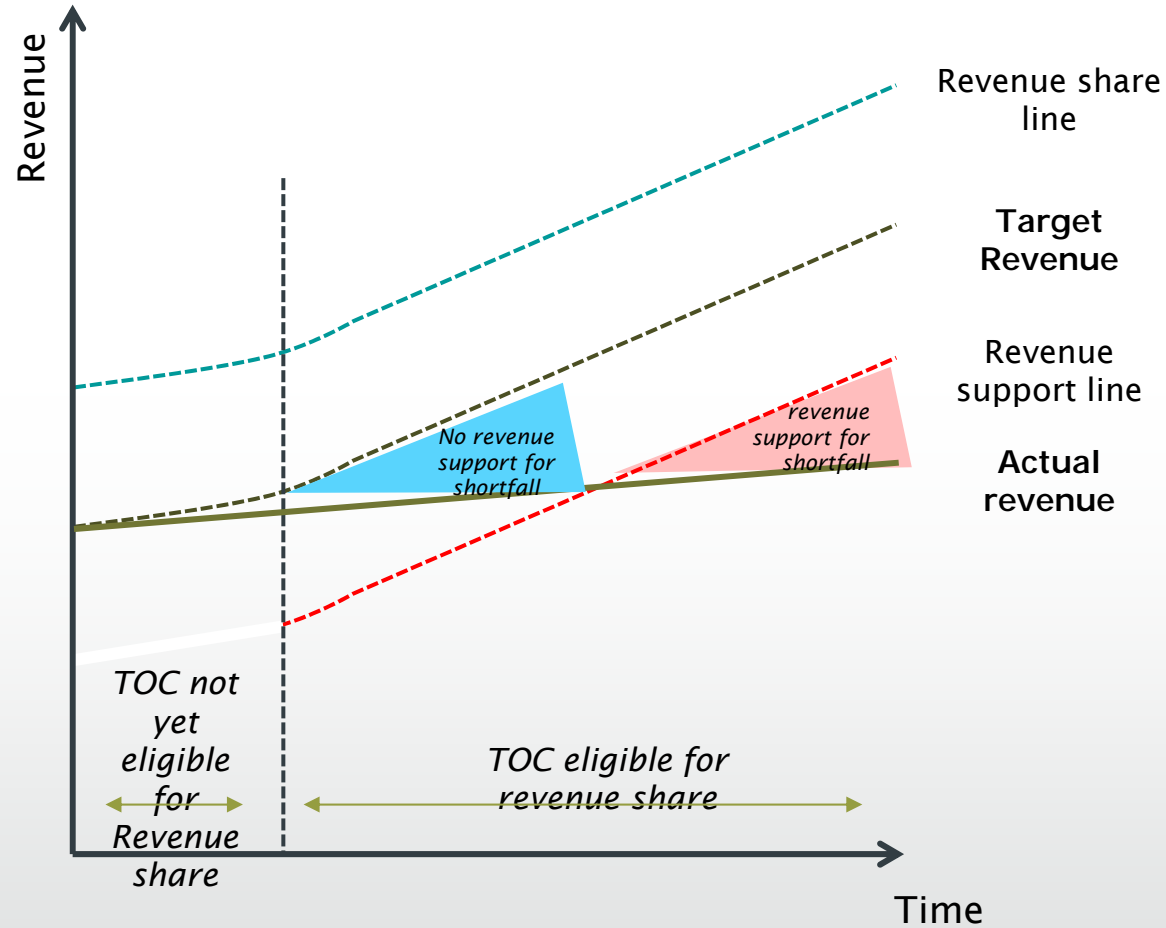
For some franchises, the DfT may offer to share some or all financial risk with a franchisee.

The design of the risk sharing arrangement will depend on the characteristics of the particular franchise and will affect TOC financial stability and incentives.

A few ways of doing this are set out below:



Risk allocation – an illustration



Conclusions

- Service requirements not stable – large growth.
- Some technology issues.
- Some sunk costs.
- Some issues concerning definition and letting of the contracts.
- Some difficulties in enforcing service delivery.

Further refinements of the franchising process likely.

The DfT are indicating a ‘horses for courses’ approach but which horse for which course?