

LEADING THE RAIL INDUSTRY

RESPONSE BY PRICEWATERHOUSECOOPERS

TO THE

SECRETARY OF STATE'S CONSULTATION

ON HIS

**DRAFT DIRECTIONS AND GUIDANCE TO THE STRATEGIC RAIL
AUTHORITY AND DRAFT STATEMENT OF FRANCHISING POLICY**

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PRICEWATERHOUSECOOPERS 

INTRODUCTION

The SRA came into being last February with a mandate to remedy the chief weakness in the structure of the privatised rail industry – the lack of strategic leadership. In its first seven months it has had to deal with the widespread industry disruption following the Hatfield accident. The comments in this paper are not therefore focused on progress to date, but are intended to be constructive proposals to help the long term development of the industry.

This paper comprises two parts:

- A: Response to the draft Directions and Guidance to the SRA (DDG)
- B: Response to the draft Statement of Franchising Policy (DSFP)

In both cases, we comment on the major areas where we believe action is needed to enable the industry to make progress. We believe the DDG and the DSFP address many of the relevant issues, and in many cases we have therefore simply proposed amendments and additions which we believe would strengthen the respective documents. We have also amplified many of our comments with suggestions for the DTLR and SRA, even though we would not propose their inclusion in the formal published documents.

We have addressed some of the points in this paper in more detail in our paper “Upgrading the Rail Network: focusing on delivery”, published in August this year. Copies of this can be obtained from the contacts on the back page.

For a quick overview, the reader may wish to look at the “Key Points” at the beginning of each section.

This paper was produced by PricewaterhouseCoopers which provides advice on business strategy, regulation, project finance, franchising and mergers and acquisitions for companies, projects, governments, financiers and investors in the railway, bus, road, port, shipping, airport, and airline industries. Contact details are at the back of this document.

A: RESPONSE TO THE DRAFT DIRECTIONS AND GUIDANCE TO THE SRA

Our response to the DDG covers three principal issues:

1. Leadership
2. Funding, prioritisation and value for money
3. The SRA's Strategic Plan

Each is considered separately below. Suggested amendments to the DDG are included at the end of each section.

1. Leadership

Key points:

- The principal role of the SRA must be to provide leadership to the whole rail industry. It must consider the effect of possible strategic options on all stakeholders, set out a clear strategy giving industry players incentives to deliver, and lead the debate and provide clarity on key industry issues, recruiting additional skills where necessary.
- The SRA must plan the interaction of elements of the industry supply chain on behalf of the rail customer, providing the private sector with the framework to ensure resource utilisation is optimised to deliver the strategic outputs required.
- The SRA must act as a single voice for the Treasury, DTLR, and other government departments and ensure co-ordination of the activities of different industry regulators.
- The SRA must plan for the longer term.

Direction for the industry from the SRA

In our view, the most important of the draft Directions is that **the SRA should “provide leadership for the rail industry...”**. No one else can undertake this role, and it is desperately needed in the complex rail industry structure. This is listed as the twelfth objective but it should be first.

The SRA needs to have the capability, standing and mandate to fulfil this role. It should **develop workable solutions** to the very significant difficulties faced by the industry, and work to achieve consensus around them, even though it is not in total command of the means to deliver those solutions. The divergent interests and objectives of all the other industry players, and the scale of public support required by the industry, mean that it is inappropriate to expect strategic solutions to emerge from individual players.

The Government has set clear passenger and freight growth targets in the Ten Year Plan. However, with so many stakeholders, priorities and uncertainties, it must be the role of the SRA to **set out a strategy for how these targets will be achieved**, including what steps need to be taken, in which order of priority, when and by whom. Since the rail industry is in the private sector, the SRA cannot (and should not) normally direct individual companies to undertake specific actions. Instead it needs to **ensure that the companies in the industry are given the correct, co-ordinated incentives** to perform in a way which will deliver these objectives.

The incentive arrangements created at the time of privatisation are now in need of review and updating. On the one hand, the incentives for sustaining the infrastructure which the Rail Regulator has recently put in place for Railtrack still need to be aligned with the incentives faced by franchisees and other operators so that *inter alia* consistent, powerful,

incentives to improve operational performance flow through the industry. On the other hand, the industry still lacks a fully developed incentive framework within which enhancement investments can be undertaken (outside of the intermittent re-franchising of some operators on the network).

The industry suffers from major funding and resource constraints. Capacity is limited and a major increase in the role of rail will be costly and time-consuming to achieve. The SRA therefore needs **to ensure that the interaction of different elements of the industry's supply chain** (i.e. the chain of suppliers from passenger or freight TOC, through Railtrack to infrastructure maintenance, renewal and enhancement contractors) **are optimally planned** rather than leaving this entirely to the individual companies in the private sector. The industry's historic dependence on government funding is set to continue. This means that market mechanisms cannot be relied upon to supply resources as required without leadership from the SRA.

There is currently great uncertainty in the industry on a number of fundamental issues, such as:

- How are alternative funding vehicles such as SPVs and DBFTs to be used?
- What investment can be funded from the 10 Year Plan money?
- Whether and how some measure of vertical integration would solve the industry's problems?
- What is the best way to bring about rapid improvements in performance?
- What is happening with franchise replacement as the existing franchises near their expiry?

Whilst these debates continue, the issues remain unresolved. The SRA could **lead the debate and provide clarity** on these issues, even if it cannot supply final answers in all areas, in order to help the industry to focus its constrained resources on implementing solutions.

The DDG proposes much greater involvement by Ministers in SRA decisions and activities. Whilst it will be a positive step if this improves accountability, we do not believe that the people and resources available in the DTLR will find the task of leading the rail industry any easier than the SRA has. It is essential that the task of leading the industry remains with the SRA, which may need to **recruit additional skills** in order to discharge the demanding role the Government has now given it.

“Joined up” government

In order to do its job, the SRA needs the backing of the whole government and other relevant stakeholders. Without a single, integrating role for the SRA, the industry risks suffering from the different arms of government and regulators taking inconsistent decisions and taking different views over policy and funding.

A lack of co-ordination could damage the future credibility of the SRA with the private sector, and lead to continuing delays in decisions - the SRA must be able to **speak as the voice of government**. The SRA leadership role must include co-ordination and broking compromises so that the industry is not pulled in different directions. The Rail Regulator is statutorily independent from Government, and discharges specific roles in protecting the public interest. However, the Government (in its Statement of Principles with Railtrack) and the Regulator (in his stated intention to conclude a MOU with the SRA) have acknowledged the need to clarify how the respective roles of the SRA and the Regulator will complement each other going forward. The Regulator must therefore assist the SRA to prepare its Strategic Plan in a way which takes account of decisions he is likely to take, and work with the SRA to provide industry players with incentives to deliver the targets and outcomes in the Strategic Plan.

Long term planning

The rail transport sector has suffered for many years from short-term decision making and an inability to plan for the long term, often driven by variable and uncertain funding or political decision making cycles. The long lives of the assets concerned, and the long lead times to implement changes and new investments, have not been efficiently addressed by the short-term financial planning timeframes attached to the public funding which the industry continues to need.

The SRA should use its quasi-independence to allow it to **plan and deliver long-term strategies**, and thereby break out of the historic cycle of compromises and inefficiency which the clash of planning horizons has hitherto produced. The increased accountability proposed in the DDG should not be used to prevent this.

The industry and the SRA need to be able to respond to evolving longer term trends in the transport markets they serve. Section 3 below sets out in detail our proposal for a long term rolling Strategic Plan to ensure that the planning of the industry is regularly updated and responsive to changing circumstances.

Suggested amendments to DDG:

The draft broadly covers the above points but we propose the following:

Move Objective 12 in Annex A to first place and give it the appropriate emphasis to distinguish it from the other, subsidiary, objectives.

Add to this Objective: “The Authority should develop long term strategies for the industry including workable solutions to the challenges it faces which will command the support of those in the industry who will need to implement them.”

Add to Annex B a new section giving the SRA the obligation to play an active role in guiding the rail industry supply chain without intervening in the internal management of companies involved.

Add to section 7.4 of the DDG an additional bullet point:

- *“Explain what steps will be taken to manage efficiently the use of, and improve the availability of, scarce skills and equipment to underpin the industry’s ability to maintain, renew and invest in the network.*”

Add new section 12: “The Authority should also act as co-ordinator for all arms of Government and regulators and seek to ensure consistency between the actions and pronouncements of different regulatory bodies”.

2. Funding, prioritisation and value for money

Key points:

- The SRA (and the Treasury) must be clear about what public funds are available and what investment it assumes will be financed by the private sector, for at least 10 years ahead on a rolling basis.
- The SRA must show how private sector investment will be repaid and remunerated, taking account of the risk being transferred.
- The SRA must set the priorities for investment based on clear criteria related to social costs and benefits and the achievability of desired outputs, and must explain how inconsistencies between various targets are to be resolved through trade-offs and prioritisation.
- The SRA must produce a budget that explains the sources and uses of funds for the industry and how the public funding available will deliver the Government's output targets in the short and long term. Where the funding and the targets become inconsistent, the SRA should identify the inconsistencies and propose to Government how they should be resolved.
- The SRA must set out a clear policy on the extent to which customers should pay for services through fares and charges.
- The SRA must ensure that the proposed franchise and associated agreements, which will form the basis on which it invites tenders for franchises, reflect an optimum allocation of risk between public and private sectors, and between the different components of the industry (e.g. between train operations and infrastructure in draft access, DBFT and SPV agreements).
- The SRA should clarify its approach to the use of SPVs and DBFTs in procuring enhancements to network capability, and produce standardised terms and risk matrices. It should also produce standard terms for the use of the Rail Modernisation Fund.
- The SRA must ensure that successful bidders for franchises have the necessary project management and procurement capability, and the ability to achieve the necessary safety clearances, to implement efficiently any infrastructure enhancements they are required to undertake.
- The SRA must invite franchise replacement or extension bids for clearly defined current and enhanced outputs, without necessarily requiring future infrastructure enhancements to be priced by franchise bidders, and must ensure bidders are clear about the basis on which bids will be evaluated.

Uncertainty on funding

It is neither possible nor desirable for the Government or the SRA to plan now exactly how every penny of cash in the industry will be spent for each the next 10 years. Indeed, many individual decisions should continue to be driven by emerging market needs and managed by the private sector. There is however a clear need for **greater clarity than currently exists about where the public money is coming from, how much is available, and on what it will be spent.** Without this, valuable industry resources will continue to be spent on developing bids and projects that then risk not getting implemented. In the end the industry would be reluctant to commit additional funds and resources to even the viable projects. As the Government's 10 Year Plan makes clear, neither private nor public funding will be sufficient without the other – the SRA must manage a public-private partnership for the industry as a whole.

The Government has made a virtue of moving away from “boom and bust” public finances. Clarity on long term funding would benefit the rail transport sector more than most other areas of public spending because of the long time it takes to develop and implement expensive projects. These timescales are an unavoidable feature of the industry – in both the UK and other countries. The Treasury, while it should properly remain focused on value for money, should **give consideration to the value which can be achieved from long term stability to match the lead times concerned.**

In specific areas where the SRA assumes funding will be provided by the private sector, it needs to be clear **how it expects the private sector to provide that money and how investors will be repaid and remunerated.** The 10 Year Plan and the Strategic Agenda currently assume that £34 billion of investment will be financed by the private sector, but do not provide the detail of how private investors in specific areas will earn a return or be repaid. Since most efficient railway investment yields social benefits and cannot be funded purely by enhanced customer revenues, much of the envisaged private investment is likely to require additional subsidy to repay it. However, neither document explains how these increased requirements fit within the total of 10 Year Plan money, or the extent to which envisaged efficiencies and scope and scale economies are expected to offset the requirements for increased subsidies.

It would not be wise to publish a budget for every franchise and every investment project as this might disadvantage the SRA in negotiations with franchise bidders, other operators and infrastructure providers. However, it would be a major step forward to **clarify the total planned subsidy and which projects are expected to be prioritised** for funding over which timescale, and the basis on which these have been selected. Whilst the status of projects might change over time, for example a project may be cancelled, delayed or re-configured because of changes in demand or improved costings, this should be for clear and transparent reasons and should be explained. The industry will then have confidence to invest in both the development and delivery of propositions, and an improved incentive to deliver value for money. They would also know, if a project was cancelled for such reasons, whether there was likely to be another clearly identified project that would then become affordable, allowing resources to be reallocated efficiently.

Section 207 of the Transport Act 2000 states: “...the Authority must act in the way best calculated..... to enable providers of rail services to plan their businesses with a reasonable degree of assurance.” Construction companies, engineers, planners, bankers, operators, and Railtrack will find it difficult to plan their businesses to deliver services to passengers when there is uncertainty around funding and prioritisation.

Section 7.3 of the DDG says “The Authority must ensure that its strategies, including its overall strategy, are consistent with the resources available to it.” This paper does not offer a view on the adequacy of the resources available to the rail industry, but we are clear that whatever the level of those resources, the industry needs a published plan which is based on realistic assumptions about the funding which will be available.

In order to demonstrate the robustness of its financial analysis, the SRA should publish, as part of its Strategic Plan, **a year by year projection of Sources and Uses of Funds** for the 10 Year Period along the lines of Figure 1.

Figure 1: Illustrative format for rail industry projected Statement of Sources and Uses of Funds

Sources (split between contracted and planned)		Uses* (split between committed and planned)	
Net franchise payments (subsidy to TOCs)	X	Infrastructure maintenance and renewal	X
Rail Modernisation Fund grants/investment net of repayments	X	Infrastructure enhancement (list locations and analysis by purpose/output eg safety/capacity/performance)	X
Other public sector grants/funding	X	Replacement of life expired rolling stock	X
Private sector financing	X	capacity	X
Fare revenue	X	Investment in additional rolling stock	X
Other sources	X	capacity	X
		Operating costs	X
TOTAL	X	TOTAL	X

* each use will include the return on relevant private sector financing

Targets and priorities

As set out in section 7.4 of the DDG, the SRA should spell out in detail **how the amount of money allocated to rail investment will deliver the Government’s objectives**. The Government has published a 10 Year budget and 10 Year targets and the industry now needs to know how this budget will deliver the targeted 50% passenger and 80% freight growth as well as the target reductions in overcrowding, improvements in operating

performance, and other improvements on the network (e.g. in station facilities). In individual franchise competitions and negotiations, the SRA has sought commitments to increase punctuality such that 15 out of 16 trains arrive within 5 or 10 minutes of the published time, depending on the type of franchise. Whilst increased punctuality is clearly fundamental to making the railway more attractive to passengers, the target is a broad national standard, with no evidence of it having been evaluated in social cost:benefit terms in respect of the individual franchises to which it is applied. We believe that further consideration needs to be given to:

- whether this national target is equally appropriate or achievable in all franchises;
- over what timescale it can be delivered;
- the extent to which the targets should be achieved via graduated franchise incentives versus enforceable minima; and
- whether the TOCs can deliver their targets without complementary adjustments to Railtrack's incentives and targets.

Similarly, the published growth targets have hitherto been national. Yet, there will be wide variations between franchise areas and routes in the achievability, cost and social benefit of achieving contributions to these national targets. The SRA has indicated that, in general, intercity routes are likely to be expected to deliver relatively more growth than regional services but there needs to be a more detailed breakdown by franchise (and for freight) and route or district of how the targets are expected to be delivered.

Clearly these will be planning figures which will be subject to continual revision to take account of actual outcomes, changing priorities and new information. Nevertheless, geographic and market trade-offs must be made – either to minimise the public funding required to meet given national growth targets, or to maximise the net social value of growth that can be secured with a given quantum of funding. For example, the social values of growth are many times the farebox values in some congested urban markets. However, in some of these cases, the cost of new heavy rail capacity might still make major increases in traffic less cost effective to secure relative to investment in other modes, such as light rail or investment in other regions.

It follows that the Government must make clear to the SRA whether it wishes it to seek to **minimise the cost of reaching an output target, or maximise the outputs that can be delivered for a given quantum of funding**, as this will affect the prioritisation and evaluation process and results.

The SRA in turn will need to consider (by franchise/route) what proportion of the growth will come from each of economic growth, demographic change, real price reductions, capacity increases, quality increase, performance increases, improved inter-modal or inter-operator integration, journey time reductions and other drivers.

Fares

Whilst it now seems clear that at least some of the services using a majority of the rail network will require subsidy for the foreseeable future, the industry would be assisted if the SRA were to set out a clear policy on **the extent to which passengers and shippers (versus taxpayers) should pay for different services** on the network.

Franchise bids have been invited on the basis of a continuing 1% per annum real reduction in regulated fares, irrespective of service improvements. Annex B section 6 of the DDG states that “*The Authority should subject the existing range of regulated fares to an overall cap of RPI-1%...*” but allows for certain exceptions, including paying for quality improvements.

Many non-regulated fares are constrained by the need to maintain a relationship to the regulated fares. Customers do not object to paying for enhanced services, so there is a strong case for tapping this large potential source of funding to improve the standard of services. Indeed, many of the currently regulated fares will be affected by targeted improvements to franchise outputs. All passengers receiving an enhanced service might be expected to contribute to it (while not having to pay increased fares if the service improvements are not delivered). In many cases, selective increases in fares to help fund improvements may also mitigate overcrowding or allow demand to be spread more evenly and thereby further improve the journey experience for those who do travel. We propose that **fare regulation should be specific to each franchise**, and possibly more locally targeted than this (particularly for the larger, more complex, franchises). Such an arrangement would also facilitate local consultation with passengers, local authorities and other representative bodies on the trade off between service improvements and fare increases, and facilitate innovative development of fares products which better integrate them with other local public transport initiatives.

Value for money

The standard franchise agreement was designed for the first round of franchising for seven year terms, during which the nature of the franchise and its operations and outputs were not envisaged to change significantly. The second generation of franchises are currently being awarded for longer terms to deliver substantial increases in outputs, and will involve the TOCs and Railtrack in managing major change, whether from investment or other measures, designed to increase passenger numbers in an environment of continuing uncertainty about the condition of the infrastructure.

Despite this, the template franchise agreement being used is little changed from the first round, apart from arrangements to deal with investments and from measures to increase the financial incentives and penalties associated with TOCs’ performance. The Treasury’s guidance on Public Private Partnerships specifies that “... *deals are structured to leave*

*risk with the party best able to manage it and deliver value for money...*¹. The template franchise agreement should be amended to conform to this by a reallocation of certain key risks as follows:

- The template envisages franchisees taking full revenue risk for up to 20 years. As many of the drivers of these risks cannot be managed efficiently, if at all, by franchisees, bidders are likely to add significant risk premia to their bids. Since the main determinants of farebox revenues will be the performance of the economy and the policies adopted towards competing transport modes (e.g. new roads, the fuel price escalator, etc), **we believe it would be an efficient allocation of risk if at least some revenue risk remained in the public sector.** Depending on the specifics of the franchise, this could be achieved in a variety of ways, including:
 - through the ability of the franchisee to seek a reopening of fares controls in certain circumstances;
 - through reducing the franchise term in cases where there is no compelling investment case for a 15 or 20 year franchise; or
 - by periodic adjustments to the terms of the franchise to take account of deviations in revenues and costs from those assumed in the bid which are caused by factors which cannot be managed by the TOCs.

Significant revenue risk should however remain with TOCs to give them an incentive to attract passengers.

- The template franchise agreement currently assumes that TOCs will be responsible for managing and bearing almost all the cost risks which affect their business, even though many in fact need to be managed by others such as Railtrack and other operators. The financial compensation available to TOCs under industry agreements is often not sufficient to compensate TOCs for all the consequences of adverse events, such as service disruption caused by engineering work being done for others or by infrastructure failures. The SRA-led working group commented that the existing and proposed possessions compensation arrangements in the franchise and track access agreements imposed by the SRA and Rail Regulator respectively fail to align train operator and Railtrack incentives. Bidders' proposals to mitigate risks which they cannot manage through adjustments to franchise payments or by mitigation of penalties they would otherwise suffer under the franchise agreement should be seriously considered or anticipated by provisions in the franchise agreement on which they are asked to bid (for example, by making the future equivalent to Clause 18.1 in existing agreements more specific).
- The SRA has written stiff penalties for failure to perform into the revised template franchise agreement. Whilst it is recognised that there must be financial penalties for failure to perform to the standards written into the contract, the threshold at which the franchise agreement can be terminated is now very low. **The TOC now risks losing its franchise (and all other franchises through cross-default) for matters beyond**

¹ PPPs: the Government Approach, H M Treasury, 2000, pg13.

its control (eg delays caused by Railtrack), often before it has had an opportunity to remedy them. We believe this needs to be reconsidered

The overall effect of sub-optimal risk allocation in the contracts on which bidders have to bid and other elements of the contractual matrix is that some bidders will price for the risk, making their bids appear relatively expensive, while others may not price the risks properly (or even ignore them altogether), assuming that they will be able to negotiate concessions prior to signature or renegotiate the subsidy after they have started operations. The result may be that bids may not be comparable in terms of assessing value for money, the wrong bidder may preferred and/or the SRA may have to undertake extensive negotiations after selecting a preferred bidder, leaving it in a relatively weak negotiating position.

Securing infrastructure investment that is good value for money

The DDG require the SRA to: “*describe how and by when (it) will secure the introduction of third party project management and project finance to supplement Railtrack’s capabilities...*” and to “*use the franchise replacement process to require extra investment to be undertaken in infrastructure...*”

Our recent paper, “Upgrading the rail network”, sets out in detail how we believe this should be done. In summary, we are concerned that value for money may not always be achieved if bidders for franchises are expected to specify and offer fixed prices for infrastructure enhancements in their franchise bids. We believe that **franchise bids should be prepared on the basis of assumptions on infrastructure enhancements provided by the SRA**. Enhancement projects can then be developed by or with the winning bidder, and priced through a separate tendering exercise once the requirements are clearly defined. To do this, franchise bidders need to show that **they have procurement and project management capability** to undertake or participate in such a process and manage the development, tendering and implementation of enhancements. To assist bidders, the SRA should publish **standardised terms and risk matrices for investment vehicles and the Rail Modernisation Fund**. Further details on how this process would work are set out in our earlier paper.

Specification of outputs

We welcome the guidance in the DDG that, in running franchise competitions, the SRA should be more prescriptive in setting out what outputs it requires including what the priorities are:

“the Authority should provide, at a reasonably early stage, clear information on the scope of the specification that will be acceptable... taking into account the Authority’s overall priorities for its budget.” (section 10.3).

The benefits of this prescriptive approach would be:

- more effort may be spent on bidding the details of outputs that the SRA wishes to buy and less effort will be wasted analysing unaffordable or unwanted services; and
- the SRA can plan on a network-wide basis so TOCs do not duplicate work or make proposals that are rejected because they adversely affect other TOCs.

We suggest that the SRA prescribes the outputs (in particular with respect to enhancements) in the following terms at a higher level than the form of the PSR:

- Minimum frequency of service between points, and any requirements for first and last trains;
- Overcrowding standards;
- Punctuality and reliability standards;
- Quality of service standards (e.g. station and on-train services);
- Customer information standards; and
- The nature and type of investment it is willing to fund.

These outputs should only be specified after the SRA has carried out a high level cost:benefit analysis of the appropriate levels of each for each franchise, so that bidders know they are bidding for something the SRA wants to and can afford to buy.

It is often not practical to leave decisions about investment to deliver such outputs purely to operators as in many cases the short term impact on passenger numbers (especially in a short franchise) is small in relation to the size of the investment concerned. Much of the investment needs to be paid for by farebox revenues after the franchise has expired because of the long term benefit and/or by subsidy, because of the third party and social benefits it produces (for example, regeneration, reduced congestion, better inter-modal integration, enhanced image of rail generally and increased patronage for other operators).

In the case of rolling stock investment, the SRA is uniquely placed to take into account the longer term impact of investment on the national fleet in terms of average age, long term impact on constrained manufacturing capacity and availability of cascaded stock. It is however important to leave the details for individual TOCs or bidders to propose, subject to SRA approval, as the specification of rolling stock will need to be integrated with other aspects of their operations such as human resources and marketing.

Where there is a clear link between some of the above outputs and passenger demand, it could be left to bidders to propose the best means of influencing that demand. For example, if the SRA's objective for a route is to achieve a 50% increase in passenger numbers between a particular set of origin-destination pairs within the franchise, it could simply invite bidders to propose the best means of achieving that increase with whatever combination of investment or operational measures that they believe most likely to succeed at the most competitive price. However, before adopting such an approach, the SRA needs to be clear that the target is appropriate to the franchise, capable of being delivered in a

way which is good value for money in cost:benefit terms and high enough up the priority list to attract funding.

Even with this relatively open approach, the SRA would need to be clear about how it would evaluate side-benefits (e.g. increases in connecting journeys for other operators) and any approaches which would not be acceptable (e.g. for environmental reasons) and whether and how it would evaluate any infrastructure proposals which differed from its specified bidding assumptions. It would also need to ensure that the efficient risk allocations associated with the proposed packages could be enforced on both the bidder and other industry players concerned (e.g. via other TOCs' moderation of competition constraints or back-to-back access agreements with Railtrack and/or SPVs, pre-approved by the Regulator where investments would pass into Railtrack's Regulated Asset Base).

There is a precedent in the London Underground PPP, for which bidders have to submit investment plans to deliver upgrades to the London Underground network which are defined in terms of average journey time for a line (including platform waiting time between trains). With fixed length trains, any reduction in average journey time also has the effect of increasing capacity (in terms of passenger throughput). Such an approach would need to be adapted (e.g. with additional capacity requirements) for the national network but we believe the principle of comparing franchise bids in terms of a common unit would give bidders great clarity and is appropriate.

Evaluation of proposals

We welcome the statement that: *“All bidders... must be made aware of the criteria upon which their bids are being assessed.”* (section 10.5)

We would suggest this includes:

- How the trade off between value for money and affordability is to be handled. For example, if a bid offers the best value but exceeds an undisclosed budget limit, will the SRA:
 - offer the bidder (or all bidders) an opportunity to re-bid;
 - accept the highest value of the bids that do fit the budget; or
 - simply select the cheapest?
- How the trade off between conflicting priorities is to be handled (for example, is it more important to increase passenger numbers, ensure a minimum improvement in operating performance, or to stay within overcrowding limits?);
- How the SRA evaluates outputs which are not easily and objectively quantifiable within a cost-benefit framework (for example, different safety improvements such as CCTV versus train protection, relative to environmental benefits);

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- What normalising assumptions are made to bids, if these cannot be avoided by specifying assumptions?
 - How the SRA evaluates “primary” and “secondary” aspirations, compared to “committed” outputs; and
 - How the SRA evaluates costs and benefits beyond the term of the franchise.

These measures should ensure that:

- bid evaluation is easier and fairer, with the result that bidders will have more confidence in the process; and
- bidders can make informed choices about how to present their bids, knowing how they will be evaluated.

Without such steps, bidders cannot be expected to produce the bids the SRA wants to see.

Additionally, we would recommend:

- **Ensuring a level playing field for all bidders by ensuring that data is shared** (especially from any incumbent) and that all bidders use common assumptions (e.g. about transfer of the existing train fleet and staff, services to be provided, fares control, moderation of competition, committed infrastructure enhancements and Railtrack’s maintenance and renewal plans).
- **Ensuring sufficient accurate and consistent data and/or assumptions** are available in order to produce a robust bid. The data should also cover adjoining franchises whose operations and future upgrades would affect the franchise in question.
- **Considering affordability early** so that expensive unaffordable proposals are not encouraged. This would ensure that bids can be planned appropriately to match the funds available.

Further comments on the franchising process are included in our response to the DSFP in Part B.

Suggested amendments to DDG:

Add to section 7.3: “The Authority’s Strategic Plan must include a statement of projected Sources and Uses of Funds for the industry for both the long-term and (in more detail) the short term, to demonstrate what investment and other activities can be funded and how.”

Add to section 7.4 after the first sentence: “This explanation must be provided separately for each franchise or freight market and must state the steps required in each case and explain the risks associated with each and the steps taken to mitigate those risks.”

Section 6.2 of Annex B is arguably consistent with our above proposals but it could be re-worded to encourage the SRA and operators to be more proactive in seeking out opportunities to fund quality and capacity improvements from increases to fares.

Add a new Section 10.10.4 (and renumber): “The Authority must ensure that the draft franchise agreement and associated agreements on which it invites proposals for replacement franchises, and those which it eventually signs and endorses for each replacement franchise, both aim to reflect an optimum allocation of risk between the public and private sectors, and between different industry parties, in order to achieve good value for money. This allocation should generally be standardised but must be adapted to local circumstances where appropriate.”

Add to section 10.3 at the end of the second bullet point: “... but it should not require such improvements to be included as firm priced commitments as part of franchise bids unless to do so is likely to deliver best value for money compared with other possible approaches.”

Add to section 10.3 the following bullet point:

- “The Authority should ensure that there is a level playing field between the incumbent franchisee and other bidders by provision of adequate information to those other bidders and ensuring that its requirements are capable of being provided by other bidders on a similar basis to the incumbent TOC, for example by facilitating equal access to suppliers and sufficient time for handover.”

Add to section 10.4 an additional bullet point: “the capability of the proposer with regard to the procurement and project management of investment projects.”

3. The SRA's Strategic Plan

Key points:

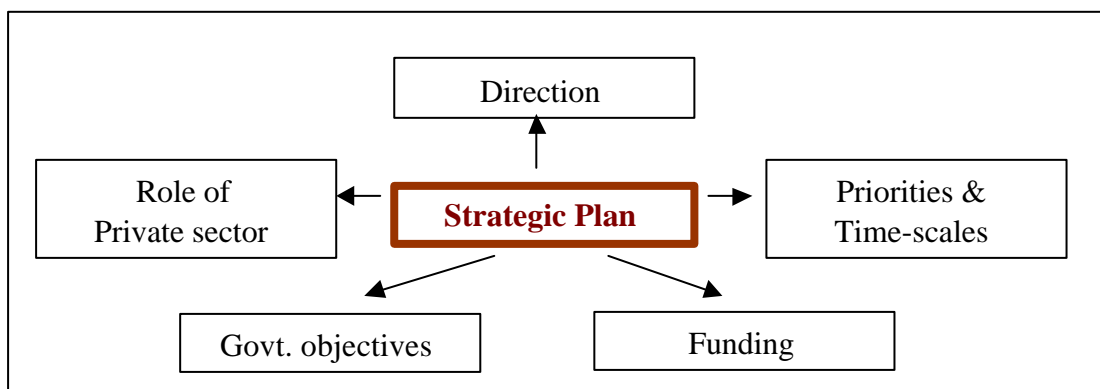
- The Plan must set out the high-level strategic direction for the industry, and how it proposes that the Government's objectives should be delivered.
- The Plan must address the shortage of skilled resources and the need to co-ordinate technology and availability of rolling stock.
- The Plan must be clear on funding, priorities, timescales and responsibilities, including a strategy for each franchise and for freight (integrating the existing freight strategy).
- The SRA should consult on the Plan with the rail industry in order to gain widespread support.
- Further clarity is required in the prioritisation of the SRA's objectives.

Requirements of the Plan

The SRA's requirement to produce a Strategic Plan ("Plan") by November is an opportunity for it to establish its credibility as leader of the industry. It is imperative that the Plan is comprehensive **and indicates the way forward on all the significant questions facing the industry**, even if final answers cannot be provided in some areas. It must also **command widespread support within the industry** for the actions it proposes if it is to have any chance of providing the ongoing platform for the regeneration of the industry.

The Strategic Plan should be a **rolling plan, continuously evolving and updated annually**. The SRA should not be criticised if priorities and plans change as this is simply the nature of the rail industry, which has to deal with evolving customer requirements, changing legislation, and different funders' changing priorities.

Requirements of the Plan



The 5 key requirements of the Plan are that it must set out:

- A clear **direction** for the industry starting with a vision, then working top-down to provide clear output targets, strategies, plans and incentives to deliver them as if it were a business plan for the holding company for the UK rail industry;
- How it delivers the **government's objectives**, especially the 50% and 80% growth and performance and overcrowding targets;
- Details about the amount and sources of **funding** including affordability constraints and a projection of sources and uses of funds for the industry, including long term support to Railtrack in respect of the expenditure and output consequences of transfers of new assets into its Regulated Asset Base;
- The **priorities and time-scales** for investment in the short and longer-terms; and
- What the SRA will direct and what it will leave to the **private sector** to manage, including a strategy for each rail **franchise** and for the **freight sector**.

As part of the above, the plan needs to address the role the SRA can play in areas where the industry does not currently have the right incentives to work together on industry wide issues. Three examples are skilled resources, technology and rolling stock.

Skilled resources

Under the current industry structure, train operators will compete to recruit skilled staff such as management and drivers, pushing up salaries and increasing the long term cost to the public sector. **Cross-industry co-operation on training and recruitment might be able to resolve the skills shortage** by bringing in more recruits and training them to add to the national pool of available resources. Similar considerations apply to scarce infrastructure engineering skills and Railtrack's current skills shortages may be exacerbated when other DBFT and SPV consumers of these same skills appear. The SRA should consider whether such steps, either funded directly by the SRA, or by the industry together, would reduce the long term cost of labour which is ultimately born from the SRA's budget. Any plans would clearly need to be prepared with involvement and support from the industry.

Technology

Various companies in the rail industry are developing new technology, sometimes in competition. Since the ownership of franchises is typically short term, there are benefits from ensuring compatibility of technology between franchises of overlapping durations, and between the infrastructure developed by different players and the requirements of the

different operators sharing that infrastructure. Also, the size of individual railway businesses and the need to recoup costs in the short term restricts the availability of funding for new technology so there may be areas where the **SRA could bring about greater innovation** through a combination of leading, co-ordinating and funding research or development, in co-operation with industry players.

Rolling Stock

The existence of 25 different TOCs with fixed terms and 3 ROSCOs means that the planning of rolling stock deployment is not optimised, as no one can be clear what stock will be available at any point in the future. Furthermore, franchise bidders find it difficult to know what assumptions to make, as they are not in a position to commit to take over cascaded rolling stock from other franchises. **We believe the SRA should prepare a detailed plan for the national train fleet**, including plans for buying new rolling stock and cascading existing rolling stock. The SRA should also provide assumptions to bidders on the rolling stock inheritance for each TOC (at least as a bidding assumption to ensure comparability). With these measures in place, the SRA would be in a better position to determine funding priorities for rolling stock investment

Franchise Plan

One of the most immediate areas where leadership is required is regarding franchise replacement. **The SRA should be clear on the role it envisages for TOCs: simply sub-contractors or commercial market driven operators with incentives to grow their business.** We are clear that the latter approach is right as the TOCs are best placed and inherently incentivised to optimise revenue in response to the day to day market for example through innovation or marketing. For this reason, the Government and SRA need to think carefully before finalising individual short term extensions in place of franchise replacement. There are cases when an extension will be appropriate, for example as a *quid pro quo* for specified investment towards the end of the franchise or as a vehicle for aligning the durations of remapped franchises, but they should not become the rule if the Government wants to encourage growth in the long term. Part B discusses this issue in more detail.

Most importantly, we believe that **the Plan should set out a vision for each franchise now**, irrespective of the specific means by which the vision is to be realised in each case, or whether the current franchise is due soon to end. Where the vision has not been fully developed, this should be transparent – and its definition should not be deferred to the bidding process. The vision should set out progressive targets over time, say 5-yearly for the next 20 years, and should be driven by passenger and other economic and social requirements, not the franchise replacement timetable. Once the vision is clear, the delivery mechanism can be determined in the light of the practical constraints in each circumstance – renegotiate existing agreement, negotiate an extension, or have a competition for a replacement franchise (and, where appropriate, a combination of these).

We have set out in Annex 1 our thoughts regarding what the Plan should state about each franchise.

Consultation

The SRA should consult extensively with all industry stakeholders regarding its Plan, not just those parties identified in paragraph 12.1 of the DDG. There should be active involvement (more than just consultation) on the Plan to improve the scope for securing a degree of consensus from all industry players and to ensure the Plan is achievable. We would suggest that either the SRA **publishes a draft Plan** which it has discussed with the Government (to meet the November deadline) and then consults industry or that it speaks to industry players first and delays publishing the Plan until early 2002, potentially to align it with Railtrack's 2002 Network Management Statement.

In either case, the final Plan would be delayed, but we believe this would be worthwhile if the time were well spent discussing the Plan with the industry. The SRA should be prepared to change the Plan if a large degree of agreement is not reached, although the optimum plan for the country may not attract a complete consensus and will require hard decisions to be made on priorities.

Clarity of objectives

The SRA has many objectives, purposes and aims. They are set out in various documents including the Transport Act 2000, the 10 Year Plan, the Directions and Guidance, and the Statement of Franchising Policy. **Further clarity must be given in the Directions and Guidance** regarding:

- Prioritisation of the SRA's objectives;
- Weighting of the objectives – is the passenger growth target as important as all others put together?
- Potentially conflicting objectives. For example is it more important to spend within the budget or to deliver growth?
- How is the successful fulfilment of an objective measured?

It would help the industry if the SRA set out a clear link between the Plan and other key industry documents – such as the Railtrack Network Management Statement (NMS) and ORR statements. For example, it might be beneficial for the annual Strategic Plan to set out issues for consideration and response in the following NMS, and also to respond to issues raised in the previous NMS. The Strategic Plan also needs to be clear about how the financial and other consequences of the Regulator's pronouncements (for example public sector financial consequences of the proposed Interim Review of possessions compensation) will be dealt with.

Suggested amendments to DDG:

Add to Section 7.2: “The Authority should aim to achieve a degree of support for its plan in the industry by consulting and involving industry participants in its drafting such that there is a reasonable prospect that actions set out in the plan can and will be implemented by those to whom they are assigned.”

Add to section 7.4 the following bullet points:

- “Explain how the SRA’s potentially conflicting objectives will be prioritised and reconciled;
- Explain what steps will be taken to co-ordinate and encourage the development and application of new technology in the industry.”

Also add to section 7.4: “ The strategy shall include a tailored plan for each franchise and each freight market or company setting out how the strategy, objectives and resource issues apply to that franchise, market or company and what steps the SRA proposes to take in relation to it.”

Add to Objective 10 in Annex A: “The SRA shall prepare a national rolling stock plan, setting out its proposals for the disposition of the train fleet between TOCs including new purchases, cascades and retirements. This plan shall be prepared in consultation with rolling stock companies and TOCs. The plan shall not be binding on industry participants but should be used as a basis for evaluation of new investment proposals.” ***Similar words might also be included in section 7.4.***

B: RESPONSE TO THE DRAFT STATEMENT OF FRANCHISING POLICY (DSFP)

Key points:

- Railway assets are best managed on a long term basis.
- Short franchise extensions may be appropriate to achieve quick wins, to revitalise a franchise for the last few years of its term or to assist in preparing for letting new long term franchises, but should not become the norm.
- Long term franchises are needed to deliver major investment in infrastructure and to enable long term planning and development of franchise businesses.
- The approach for each franchise should be considered on a TOC by TOC basis.

Many of our comments on the DDG are also relevant to the DSFP. We have avoided repetition and mention here only those points which are specific to the DSFP. The principal issue which is addressed by the DSFP but is, perhaps, too detailed for the DDG is the issue of how it should be decided whether a franchise should be replaced or extended.

Delivering in the short-term whilst planning for the long-term

The DSFP states that the Government wishes “*to deliver results in the short term as well as to plan for the long term*” (para 12), with the aim of improving services to passengers as soon as possible.

It is widely understood that there may be a conflict between short-term quick wins and long-term best planning. It is generally agreed **that railway assets are best managed with a 20 year view or longer**, as this takes account of the expected life of most assets and the lead times for investment projects or for major changes to services. There is a risk that investment in the short-term will be redundant following the implementation of a longer-term plan, with cost-effectiveness to the tax-payer being undermined as a result. However, in some circumstances, such consequences can be the unavoidable result of overriding concerns. For example, TPWS is being implemented to tight HSE deadlines in the full knowledge that some of this investment may rapidly be superseded by longer term ERTMS systems. The role of the SRA, in implementing its franchising policy, **must be to recognise and seek to minimise the conflicts between short-term requirements and the longer-term strategic vision.**

Benefits of short term extensions

In some circumstances, extending franchises by 2 years (thus giving up to 4 years from the date of extension, assuming this is done quickly) may **deliver some “quick wins” of immediate benefit to users of the railway without unduly compromising the efficient delivery of a longer term strategy**. Examples include station ambience and facilities, information systems, station staffing, CCTV and safety, car parking and station gating. These could equally well be delivered as part of a long term franchise, but the bidding process for complete franchise replacement would take longer and delivery might need to wait until either the end of the current franchise or a successful deal on early handover to the new franchisee. If the SRA wishes to avoid paying higher franchise payments than with a longer franchise, it will need to ensure that there is an effective mechanism for the access charges or other costs arising from shorter term investments to continue to be paid by any successor TOC. This may require an undertaking from the SRA to financiers.

Extensions may be a sensible means **of extracting additional benefits from an existing franchise**, as existing TOCs with only 2 years left on the franchise might otherwise have little incentive to manage their businesses effectively for other than short term gain, especially once a franchise has been awarded to a new franchisee. This is a particular concern in the light of the recognition by the SRA that the incentives and targets for franchise performance need to be strengthened. An extension also **gives more time to plan** a competition for a longer-term franchise to be let in (for example) 2005/6. This may be advantageous given the current uncertainty in the industry regarding Railtrack’s longer term role in developing the infrastructure, although it would not be beneficial if franchise extensions became an excuse for procrastination. However, **too great a degree of reliance on extensions may simply be storing up problems for the future**. Where the risks of major investments in services and infrastructure should most efficiently be shared with train operators, **franchise agreements should not be extended repeatedly for two years at a time**.

Franchise extensions are proving to have a particularly valuable role to play in the case of franchise boundary re-mapping. For franchises being re-mapped, **short-term extensions may be effective in order to establish a track record for the new operating business**. This would aid the achievement of value for money in a competition for a later, long-term franchise. This would also allow different franchises to be made coterminous where they are being merged on the new map.

Rationale for longer term franchises

Whilst short term extensions can deliver some additional investment, they are **unlikely to deliver the major upgrades required to achieve the step-changes in network capability** needed to deliver substantial growth in passenger and freight volumes. A short term TOC will not receive any extra revenue from such an investment so has no incentive to ensure it is delivered well with good value for money. Bidders may also refuse to accept

significant implementation risks if they are not able to benefit from any upside in later years.

Section 207 of the Transport Act 2000, obliges the SRA **to enable providers of rail services to “*plan their businesses with a reasonable degree of assurance*”**. If short term extensions were to become the norm, operators would have much less assurance than they do now because the majority of their business would be visible only two years ahead and this would severely inhibit their ability to raise finance for investment or to carry out any long term planning. (Similar issues arise in respect of the Rail Regulator’s parallel duty to Railtrack.)

Capacity constraints (in both the infrastructure and the rolling stock fleet) are holding back further growth in passenger numbers. Long-term franchises are required to provide a long enough planning time horizon for TOCs to plan and develop their businesses alongside planned investment. For example, there is no point investing in infrastructure unless the rolling stock, staff, marketing plans, inter-modal integration and other aspects are all in place alongside. Many of these measures do not deliver immediate benefits so they are likely to have to be funded by the SRA if the TOC does not have a long term franchise to allow it to gain the benefits. However, the optimum length may be less than 20 years, given bidders’ concerns about fixing a subsidy as far ahead as this.

Para 8.2 of the DDG states “*the authority must use the franchise replacement process to require extra investment to be undertaken in infrastructure and/or rolling stock*”. Our paper “Upgrading the Rail Network” sets out how we believe this should be done in cases where it is not appropriate for Railtrack to take the lead.

We recommend that:

- The decision on whether to extend or replace franchises should be considered on a TOC by TOC basis;
- The decision should be made by considering what are the objectives for the franchise. Generally, large-scale investment is best suited to longer-term franchises; and
- The Strategic Plan should record the SRA’s current thinking (see Part A, section 3) in all cases, and update this as the process unfolds.

ANNEX 1 : SUGGESTED CONTENTS FOR FRANCHISE-SPECIFIC PLANS

Example for each TOC:

Overall vision and objectives

- What are the aspirations of customers and other stakeholders (including PTEs and other transport authorities)?
- What are the incumbent TOC's aspirations and plans, and those of other relevant TOCs?
- After evaluating costs and benefits, what are the SRA's views on how the services of the franchise should be developed and any other objectives which need to be met (eg relieve specific road congestion)?
- How do these contribute to the SRA's national objectives (eg passenger growth targets)?

Franchise agreement issues

- Are there any plans to renegotiate the Franchise Agreement before the end of its current term?
- What are the plans for the TOC on expiry of the current Franchise Agreement?
- If an extension is planned, what are the plans post-extension?
- Is the intention to re-map / combine this franchise or keep borders the same?
- Can the TOC integrate and take on track responsibilities in a longer term franchise? How?

Process/Competition

- When would any competition for refranchising be likely to start?
- When would the SRA like the new franchise agreement to be signed?
- What are the main barriers to completing to this time-scale, if any, and how are they to be tackled?

Outputs and investment

- What are the key outputs from the franchise and how will these be developed?
- What would be the main investments expected to be made and when? (capacity, stations, etc)
- What priority does the investment have for funding?

Funding

- How will investment be financed?
- If through SPVs/DBFTS, what structure is envisaged?
- How will fares be regulated and will they increase to help pay for investment in improved levels of customer service?
- Is there likely to be any contribution from the Rail Modernisation Fund, and how much?

Affordability and cash

- It may harm the SRA's negotiating position to disclose the projected subsidy for each franchise beyond any period where it is contractually committed. However, some comment needs to be made about the likely impact of any affordability constraints, e.g. on new investment.

Impact of other players

- What are Railtrack's plans for the infrastructure used by the franchise operator over the period?
- What are other operators doing which will have an impact on this franchise?
- What are the implications for this franchise of the national rolling stock plan?

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