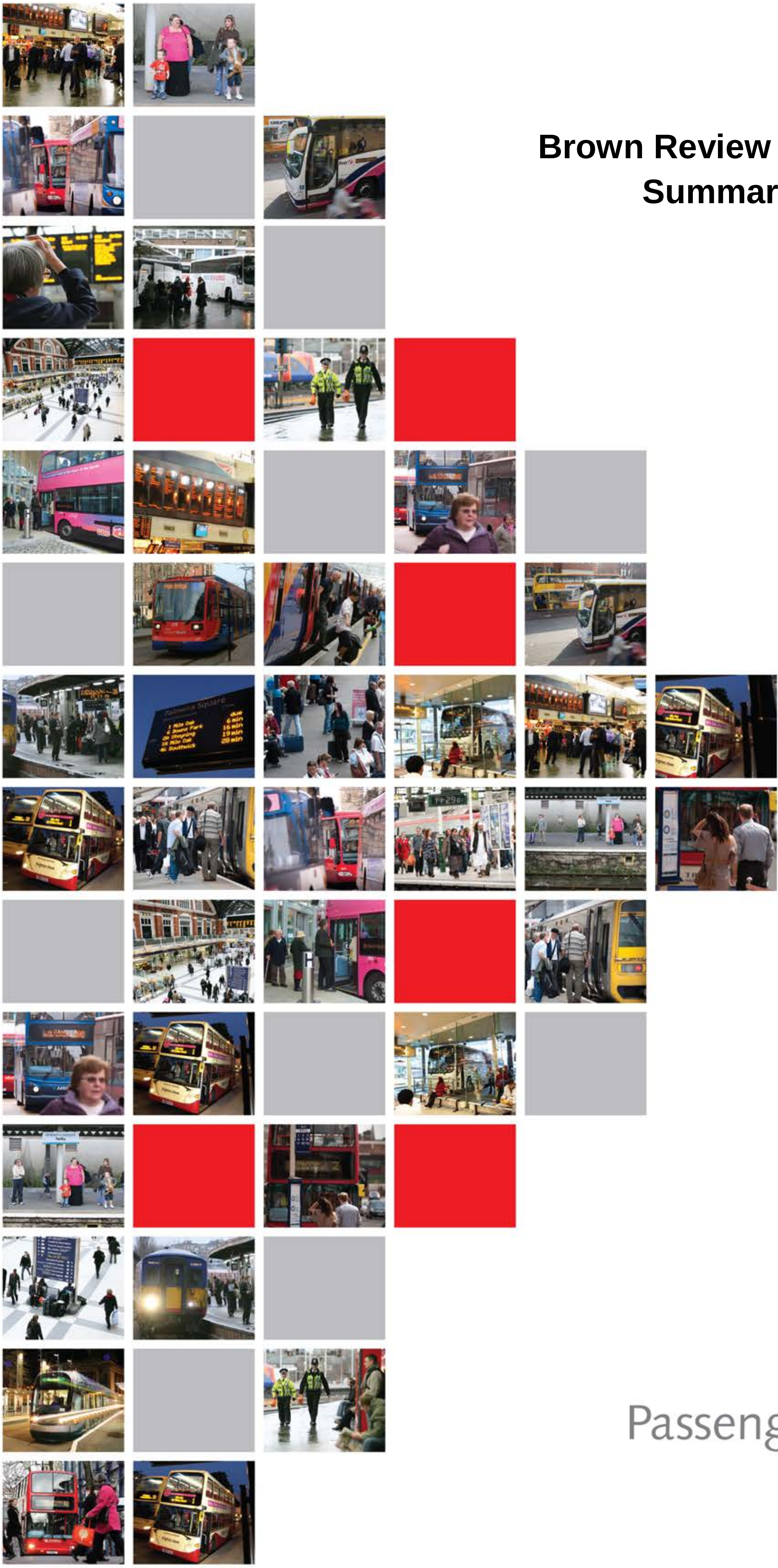

Brown Review of franchising: Summary of key points

11 January 2013

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Introduction

Richard Brown was commissioned by the Secretary of State to conduct a review of the rail franchising programme following the problems with the West Coast competition.
The Brown report covers five main issues:

- the principles of franchising and whether it is still fit for purpose
- the structure of franchises
- procurement
- management
- delivery.

The full report can be found at:
https://www.gov.uk/government/publications/the-brown-review-of-the-rail-franchising-programme

We submitted evidence to the review:
http://www.passengerfocus.org.uk/research/publications/brown-review-of-franchising-passenger-focus-response

We also submitted a separate response to DfT covering some of the more immediate problems facing passengers following the withdrawal of the West Coast award and suspension of the franchising programme:
http://www.passengerfocus.org.uk/research/publications/passengers-and-rail-franchise-replacement-letter-to-steve-gooding-department-of-transport-november-2012

Passenger Focus is pleased to see that many of our suggestions/concerns have been addressed within the report. Perhaps the most significant is Brown's endorsement of the use of National Passenger Survey (NPS) targets within franchises and a recommendation that DfT consider increasing its sample size.

Headlines

Franchising to continue as a model

Brown recognises that it needs improving and refining but believes that franchising has delivered benefits and should be continued.

Brown identifies four specific challenges that need to be addressed as franchise structures evolve:

1. Reducing unit costs and improving value for money for both taxpayers and passengers

2. Helping deliver "the unprecedented levels of investment" now going into the industry

3. Catering for the continued levels of high passenger growth expected, and achieving efficiencies without sacrificing passenger satisfaction

4. Facilitating closer partnership working to unlock efficiency and performance improvements.

He sets out a number of core principles that should underpin franchising.

- Competition
    - Competition for franchises generates better value for money for Government
    - To have effective competition you need to foster a healthy range of potential franchisees and ensure an active appetite for bidding
    - Franchising needs to be attractive to new entrants – with smaller franchises providing the most likely point of entry
    - More, smaller franchises will be more attractive to the market than fewer, larger franchises
    - Get right balance with capital requirements: not so high that new entrants are discouraged but enough to ensure obligations are met for the next 12 months.

- Avoid peaks and troughs in the re-franchising programme

- Accept that it is OK that a franchise may default – you can't remove risk entirely. He also does not favour the cross-default arrangement whereby if you default on one franchise you lose them all

- Each franchise is different and so will have its own specific set of objectives (not a one-size-fits-all approach)

- Only those risks that can be managed by a franchise should be transferred to it – Government to retain the risk for exogenous revenue risk (e.g. the current recession)
    - He argues that inappropriate risk transfer reduces value for money for Government as bidders add margins into their pricing for risks they cannot manage, thereby adding cost.

    - He even goes as far to say that when risks are high – e.g. infrastructure work bringing major disruption – a management contract may be more appropriate than a franchise. However, he does not favour a general move to management contracts or concessions other than in relation to devolution.

- Franchises should be sufficiently flexible to allow change where required by Government and should also encourage changes proposed by the franchisee where these would bring benefits.

- Partnership approach to franchising between the bidders and the franchisee.

- Simplify the process and ensure that the Government team has similar levels of skills to the private sector.

- Not just about letting franchises, important that equal attention is given to ongoing monitoring.

- The needs and expectations of passengers and franchise staff should be given greater weight and consideration in the whole approach to franchising.

Structuring Franchises

Length

Brown marks something of a shift away from the ‘longer is better’ argument. It is hard to make longer-term forecasts (especially of revenue) and doing so results in bidders factoring in the extra risk.

He suggests seven-10 years as the basic length with an automatic extension of three to five years (on the same basis as the initial term) if agreed financial, operational and quality criteria are met. He doesn’t rule out longer franchise terms but says that these should be the exception rather than the rule.

Brown also recommends an optional 26 reporting period extension (rather than the customary seven) should be contracted by the Department to give flexibility in planning the franchise programme and states that all continuation/extension decisions by DfT be mandatory for the franchisee.

Managing Risk

This was one of the core failings in the West Coast franchise. Brown argues that franchises

do not have sufficient commercial flexibility to manage exogenous risks – e.g. they cannot simply cut services or increase fares during downturns as would a normal business.
It was partly a result of this that the original cap-and-collar support regime was introduced. While this provided a safety net for big changes in demand, it brought about two perverse incentives:

- Temptation to be optimistic with revenue growth from year four (when the safety net kicks in) knowing that if they get it wrong the state fills the gap

- Disinclination to stimulate revenue once in revenue support as most of it went back to government.

Brown advocates that the Government retains full exogenous risk. Each franchise would contain an assessment based on GDP/Central London Employment indices (which he recommends should generally be conservative) and how much revenue growth this would be expected to generate in its own right. They would focus in their own bids on how much extra growth they can generate from their own activities.

Brown argues that this would prevent bidders making unrealistic growth assessments. He also supports continuing with the idea of profit share (whereby Government shares in profits that exceed a specified level - Brown suggests a notional 30 per cent above projected cumulative operating profit and a simple 50:50 split) to encourage alignment of incentives and partnership working.

Capital requirements
Brown wishes to strike a balance between sufficient guarantees to ensure continued operation and too-onerous requirements that inhibit the capacity of the industry or restrict new entrants into the market, or which are so complicated they lead to big errors as per West Coast.

He suggests:

- Enough liquidity/cash to fund the next 12 months
- A bond to cover the cost of needing to re-let the franchise
- A default 'penalty' payment supported by the parent company (based on a percentage of the bidder's cumulative revenue growth).

Cost risk
Brown notes that franchisees have not been exposed to infrastructure cost risk, despite this making up around half the industry cost base. He argues that this – balanced by appropriate incentives - must change if inroads into efficiency are to be achieved.

He recommends:

- Freedom to enter into alliances with Network Rail
- Ability to negotiate with Network Rail to take over station maintenance
- Encouragement to add cost saving proposals to bids.

Residual Value
Brown notes the importance of operators having the right incentives to invest across the life of the franchise. He recommends that, to encourage the use and enhance the effectiveness of residual value provisions, DfT issues guidance on when it will consider residual value contracts and how this might be calculated.

This allows one operator's investment to be transferred to the next – e.g. the incumbent enters a new rolling stock contract and there is a guarantee that the costs of this will be transferred to any subsequent winner of the franchise. This removes the risk of the original operator being saddled with the debt/costs but no longer having the franchise.

Procurement

Devolution
Brown is an advocate of greater devolution to the English regions. He does suggest, however, that this will require a phased approach, to allow the development of experience and capability in acquiring authorities, and may also require some remapping of franchise boundaries, with an attendant need for careful planning to integrate this with the wider franchise programme.

Specification
Brown recognises the challenging trade-off between a tight specification, which he identifies as leaving little room for innovation but making for easier bid evaluation, and a looser specification, with a correspondingly more demanding evaluation.

He welcomes recent moves towards more output-based specifications and states this should now be taken further, with inputs specified only for very specific purposes.

He recognises the desire of passengers and communities to protect existing services but argues that train services should be constructed to give flexibility to bidders to offer more resource-efficient ways of delivering them.

He recommends that DfT engages with the industry on a franchise- by-franchise basis to agree the framework for specifying train service requirements, including a capacity plan, and crowding standards to provide flexibility to bidders whilst also protecting minimum essential service levels for passengers.

Process

- Franchise procurement should follow an indicative 24-month timescale. (However, he notes that this may be shortened for franchises which have already been in preparation e.g. TSGN, or lengthened when considering remapping or devolution).

- More focus on the initial consultation.

- Currently both the Pre Qualification Questionnaire (PQQ) and the Invitation to Tender (ITT) assess the competence of the bidders. Brown suggests just doing this once in the PQQ to reduce unnecessary duplication and costs.

- The ITT should be streamlined further, removing any standard industry process/compliance requirements tested by other bodies and reducing the number of delivery plans to no more than eight.

- Quality and deliverability should have an overt and direct weighting in the bid evaluation process. Brown suggests this be between 20-40 per cent of the final evaluation.

Whilst this is good news in its own right, Brown goes one step further in commenting on the role of NPS in this process. He recommends:

- That NPS is used more widely both to set quality standards and objectives for bidders on a franchise by franchise basis, and to measure outcomes once franchises are let

- Increasing NPS sample sizes, to give reliable measures of performance at service group level, not just at overall franchise level.

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Franchise Management

Brown concludes that management of the franchise is as important as the letting of the franchise. He recommends a more flexible approach to specification and management:

- If the Government wishes to make changes it should do so on a ‘no net loss, no net gain’ basis

- TOCs should be enabled to make changes to franchises where these offer a better solution rather than having to stick to the original terms. He suggests that the bidder commits to a baseline level of value while retaining flexibility on how it might actually deliver this.

Brown further emphasises the need for a “mature franchisee/franchise authority relationship which seeks to grow the value of the franchise to the benefit of both parties.” He notes that franchise management should reflect the fact that franchises do not exist in a vacuum and encourage partnerships to be established with a wide range of industry organisations.

He also recommends a full review of the track access charging regime prior to Control Period 6 (CP6 – 2019 to 2024) to ensure that the infrastructure costs to which franchisees are exposed more closely reflect the costs imposed by train operations.

Delivering franchises

Brown endorses the conclusions of the Laidlaw report. He also makes recommendations on DfT’s management of franchising.

- Clear ownership, responsibility and accountability – someone senior to take on the role of Franchising Director

- Strengthened programme management capability

- The need for experienced, skilled staff. Brown points out the gap between DfT staff and those representing bidders

- Franchising to be the 'day job' rather than being added to someone's job description

- Franchising to be a discrete organisational unit – which includes both the procurement and the ongoing contract management functions

- The setting up of a small Franchising Advisory Board to support and give guidance to DfT.

In the medium term Brown does not rule out structural changes. He sets out three possible structures:

- Keep within DfT as now

- Create a new Executive Agency

- Create a standalone organisation (similar to the original franchising body back in 1994 – OPRAF).

Brown does not recommend one particular model; he simply suggests that DfT give it consideration. He does, however, rule out transferring responsibility to ORR. He believes that ORR is already heavily engaged in the Periodic Review and that franchising requires a different set of skills.

In the short term he wants DfT to re-start the franchising programme as soon as practicable. Part of this will be to issue a forward programme. He recommends:

- The Secretary of State should restate how he plans to exercise his franchising powers, updating the policy statement of March 2008 and also setting out how contract extensions following the paused franchise programme are to be handled

- The resource and capacity of the Department and industry should be considered when establishing the forward franchising programme and the Department should immediately put in place four "credible project teams"

- That no more than three or four franchises should be awarded in any one calendar year, each to take around 24 months

- He also makes specific comments on the three paused franchise competitions BUT these have deliberately been excluded from the published version due to issues over commercial confidentiality.

Next Steps

The Brown report is being considered by Government. The Secretary of State welcomed the report and has committed to three specific actions:

- Provide plans for the three franchise competitions put on hold by February
- Publish a clear programme for future competitions in the spring
- At the same time publish a statement of Government's rail franchising policy (also taking into account the Transport Select Committee's Rail 2020 inquiry).

Full details of his response can be seen in a written statement:
https://www.gov.uk/government/speeches/rail-franchising--15

Overall comments

On the whole this is a very welcome report which chimes with many of the comments made in the Passenger Focus submission on franchise policy in 2010 and, more recently, in our submission to Brown himself.

The emphasis on passenger satisfaction/service quality in awarding contracts and in monitoring performance is especially welcome. The endorsement of NPS and the recognition that a larger sample size would bring additional benefits would, if implemented, be a very positive enhancement of the passenger perspective in franchising.

However, at this stage, it is important to remember that the Brown review makes recommendations and is not a ‘done deal’; Government still has to agree to the conclusions and to confirm how the franchise programme will be progressed.

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