

GREATER MANCHESTER INTEGRATED TRANSPORT AUTHORITY**REPORT FOR RESOLUTION****DATE:** 15th October 2010**SUBJECT:** REFORMING RAIL FRANCHISING CONSULTATION
RESPONSE**REPORT OF:** Rail Programme Director, GMPTE

PURPOSE OF REPORT

To provide Members with the proposed ITA response to the 'Reforming Rail Franchising' consultation exercise.

RECOMMENDATIONS

Members are recommended to:

- i. note the response and comment as appropriate; and
- ii. subject to any amendments made at this meeting of the Authority, approve submission of the response to the Government.

BACKGROUND DOCUMENTS

Reforming Rail Franchising, DfT, July 2010

Reforming Rail Franchising, Report to Policy and Resources Committee, 10th September 2010

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REFORMING RAIL FRANCHISING CONSULTATION RESPONSE

1. BACKGROUND

- 1.1. On 22nd July 2010 the Department for Transport began a new consultation exercise on rail re-franchising. This followed a commitment in the Coalition Agreement to “grant longer franchises in order to give operators the incentive to invest in the improvements passengers want – like better services, better stations, longer trains and better rolling stock”. The consultation runs until 18th October 2010.
- 1.2. A report was considered at the September meeting of the Policy and Resources Committee highlighting the key points of the proposed policy and suggesting those areas which the Authority’s response would cover. At that meeting Members asked that the proposed response be considered by a meeting of the full Authority prior to being submitted to Government. This report contains that proposed response.
- 1.3. The DfT consultation document asks a series of questions which respondents are requested to answer. The draft response is included in the Appendix to this report.

2. NEXT STEPS

- 2.1. Members are invited to comment on the contents of the response, in time for final approval and submission to the Government before the 18th October.

3. RECOMMENDATION

- 3.1. A detailed list of recommendations appear at the front of this report.

**STEPHEN CLARK
RAIL PROGRAMME DIRECTOR
GMPTE**

APPENDIX: DRAFT RESPONSE TO FRANCHISING CONSULTATION

GMITA RESPONSE TO THE 'REFORMING RAIL FRANCHISING' CONSULTATION

Introduction

Review of railway policy for local rail services in the Greater Manchester area

1. Development of local rail services in Greater Manchester over the past five decades has been driven almost exclusively on a cost reduction strategy. The most significant reductions in cost have been associated with long-term decisions about asset renewal. This was true of the rail modernisation in the 50s and 60s that led to the introduction of 'diesel railcars', and the 'sprinterisation' of the 80s and 90s that led to the removal of the remaining loco-hauled trains. At the same time railway infrastructure was pared back as demand fell: for example in Manchester two major terminal stations were closed.
2. More recently when the first franchises were let in 1997 bidders assumed they could continue to make significant in-roads into the cost base – but found instead that the operations were as efficient as the specification would allow. The franchise was re-let in 2003, and in 2005 the Treasury and DfT reviewed the franchise cost-base with a view to making savings. The Northern Review concluded that it was very difficult to make advance savings over the duration of the franchise without eroding the economically most valuable elements of the service. They concluded that, given the specification, the railway operations were very efficient (see Box 1).
3. It could be argued that the approach of cost reduction had worked well during decades when demand was falling. It is however a policy that is failing in a world in which the railway is playing an increasingly important economic role for our city and region. Around one quarter of all commuters into central Manchester arrive by rail – and the rate of growth of rail has far outpaced bus and private car over the past ten years.
4. The bidders for the 1997 local franchises were fortunate that whilst they had overestimated the extent to which they could make savings they had underestimated the impact of the growing city economy on their revenue. The same pattern has been repeated more recently in the letting of the Northern and Transpennine express franchises. For example, when the Northern franchise was let in 2003 it included no provision for growth, and a presumption that the operator would be able to make savings. The Northern Review (see Box 1) established that there were few opportunities to reduce costs within the terms of the franchise. However, once again, the franchise exceeded revenue

projections such that for most of the franchise the operator has been sharing 40% of its unexpected revenues with DfT.

Box 1: Conclusions of “Northern Review”, DfT 2005
A review into work seeking to improve the value for money of Northern Rail franchise

The findings of the review are that the Northern Rail franchise is an efficient and well managed operation and that there are no obvious and acceptable ‘quick wins’ to improving value for money. Northern Rail continues to develop and improve the overall efficiency and value for money of the franchise through well developed and focused initiatives.

During the review Northern Rail has continued to optimise its fleet diagrams. Initially it was thought that some fleet reductions might be possible without impacting upon service provision and the quality of service (reliability, availability and levels of crowding). Since the December 2005 diagrams were introduced this no longer appears to be the case.

Three areas of the Northern review have emerged as providing *potential* for optimising the overall value for money of the franchise:

- i. Fare increases;
- ii. Reduced service specifications;
- iii. Re-profiling Network Rail’s renewal expenditure across the franchise.

Initiatives i) and ii) have significant *net negative* economic benefits and would run counter to the thrust of the DfT’s transport and wider social and economic policies such as increasing the public transport mode share, reducing road congestion, reducing environmental impacts improving quality and accessibility.

The general stakeholder acceptance or ‘buy-in’ to the sort of initiatives assessed – fares increase and selected or targeted service reductions is likely to be very low – not least because of the economic and wider policy implications.

Franchising policy objectives for the north of England

5. On this basis GMPTE/GMITA firmly believes that rail franchises in the north of England need to:
 - a. accommodate the high levels of growth that sustain the region’s economy, whilst,
 - b. drive long term reductions in the railway cost base.

The previous two rounds of franchising have failed to do this, and whilst the new consultation document offers a welcome change of direction, we are concerned that it is too closely focused on a small number of cash-positive franchises, and that it is not currently suitable for defining franchises which operate dense urban commuter networks.

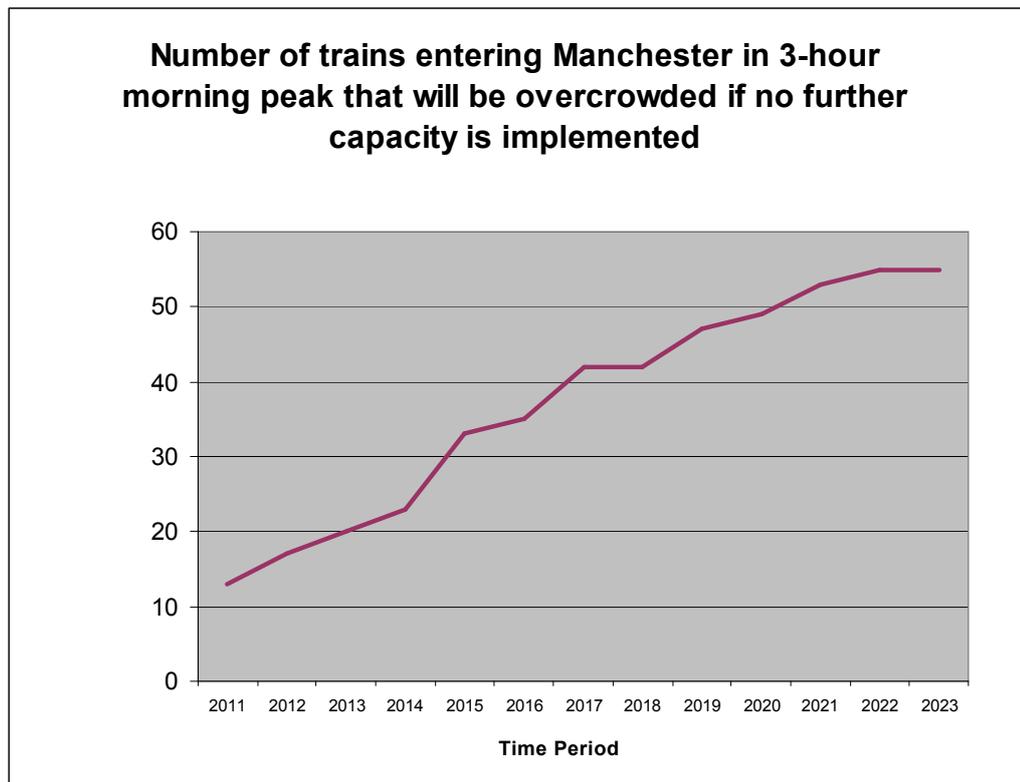
The role of the specifier

6. Despite the importance of the rail network to Greater Manchester the franchises which serve it require a high level of subsidy. Greater Manchester agrees with Government that these costs must be challenged. Nevertheless it is likely that many improvements to local services are unlikely to deliver a short-term commercial return, and hence they will require a contribution from the taxpayer in addition to the fares received from passengers. In the longer-term the taxpayer and national benefit from this investment will be re-couped in the form of increased economic activity, and higher local and national returns from general taxation. However if these longer-term economic benefits for the region and nation are to be secured then we believe that a high degree of specification is necessary in order to ensure that public funds are properly directed at those services that maximise economic advantage. This is the role of the specifier.

Length of franchise

7. The Authority is keen to see private sector initiative and innovation focussed on improving franchise outputs, and believes that franchise incentives are likely to be strongest for the operators of longer-distance services.
8. The public subsidy required for our local services, coupled with the relatively low-yields in terms of passenger revenue, means that the returns from private sector investment are more difficult to realise than on longer-distance services. This is regardless of franchise length. A different approach should therefore be taken to franchises with dense urban networks, than to franchises where many improvements will benefit both the passenger and franchisee alike.
9. Furthermore it may be very difficult to transfer revenue risk to operators of dense urban networks, such as those around Greater Manchester, without Government shouldering a very high proportion of that risk. If Government is to take a high proportion of the revenue risk then the commercial incentives on the operator are diminished – which in turn would weaken the benefits of a very long franchise. In particular the history of the last 15 years of the Northern franchise (and its predecessors) have demonstrated the near-inability of forecasters both in 1996/7 and 2002/3 (either in Government or amongst bidders) to accurately predict the growth.
10. Of particular interest to Greater Manchester is the issue of overcrowding. The failure to adequately predict the growth in passenger demand, or to develop a long-term rolling stock strategy has led to significant levels of overcrowding, particularly on the commuter network. In a longer franchise there will be a need to create much more effective mechanisms for ensuring that additional rolling stock is

provided quickly and efficiently in line with Government policy. The criticality of this issue is illustrated in the chart below.



11. The current Northern franchise was let for 7 years with a performance-related extension for a further three years. Looking ahead ten or more years one can see that there are a huge number of possible changes that must be encompassed in the successor franchise (see Box 2). We believe that Government should take these factors into account when designing new franchises. The greater the uncertainty in the shape of the possible changes the more difficult it may be for Government to get best value for the taxpayer from a very long franchise. A successor to the Northern franchise with a similar ten-year length is appropriate – although for the “Inter-city” franchises serving Greater Manchester longer franchises may be justified.

Box 2: Potential major rail interventions in North of England over next ten years

- Strengthening of local government in city region.
- Completion of HLOS 1 commitments to additional capacity
- Electrification of Lancashire Triangle corridor covering Manchester, Liverpool, Bolton, Wigan, Preston and Blackpool.
- Potential implementation of Northern Hub proposals.
- Replacement of Pacer rolling stock once it falls foul of DDA Act legislation in 2019.
- Potential to exploit tram-train technology if DfT pilot in South Yorkshire prove effective.
- Implementation of smartcard on Metrolink, Rail and Bus across Greater Manchester.

12. The Authority would like to see the factors set out above reflected more clearly in the final Franchising policy document.

Local decision-making

13. The franchise policy document is silent on the role of strengthened local decision-making. The Greater Manchester local authorities have strengthened the way they work together over time. In March they agreed proposals to create a statutory city region – which amongst other things would lead to co-ordinated management of programmes of public expenditure across the conurbation (see Box 3). The central tenet of this work is that by acting in this way public expenditure in the region can be better focussed on interventions that give the strongest possible regional economic outcomes. As part of this work Greater Manchester and DfT agreed a rail protocol that involves creating a clear voice for Greater Manchester in the process “of developing franchise service specifications using the Southern Franchise arrangements as a starting point”. It is disappointing that the consultation document makes no reference to this.

Box 3: The Greater Manchester City Region

Stronger local governance must promote better deployment of public expenditure towards interventions that maximise regional and national economic benefits – but this stronger local government must be accompanied by stronger and more accountable local structures. Legislation that would allow statutory changes to local government was passed in 2009 as part of the Local Democracy, Economic Development and Construction Act. The Act creates the possibility that a city region may create a "Combined Authority" that would exercise economic development powers as well as the powers of the Integrated Transport Authority. In its exercise of transport powers the body would be known as Transport for Greater Manchester (TfGM).

The 10 Greater Manchester district leaders have acted in voluntary partnership through the Association of Greater Manchester Authorities (AGMA) for many years. During 2009 the ten district leaders agreed unanimously that they would seek to create a Combined Authority across Greater Manchester - and that proposal has now been the subject of formal Secretary of State consultation.

A key element of the proposal was that GM would work more closely with DfT in order to seek better outcomes linked to stronger economic performance in relation to rail, bus and highways. As part of this a series of transport protocols were developed earlier this year. The early aim of the Rail Protocol was to improve the level of involvement of GM in rail decision-making. The Protocol also flags up that in the longer term GM and DfT may work to examine whether there could be any formal devolution of rail powers and responsibilities. GM feels that it is well placed to get better value per £ of transport spend. There are several reasons we believe this (i) we have a clearer understanding of the economic and wider priorities that transport should serve in the GM area, (ii) we are better able to plan interventions on rail with that of other modes, (iii) we are closer to the customer and stakeholder issues. Critically TfGM would have clear decision-making authority.

14. The Authority welcomes the Government's commitment to localism and wishes to see this reflected in the rail franchising policy. We have the best knowledge about rail travel demand in our area. Given the constraints on expenditure it is particularly important that funds are used in a way which best ensures value for money. Greater Manchester well organised to carry out the task of managing a programme of public expenditure to maximise economic outcomes, given its understanding of the local economy, the role that rail plays within it, and its ability to closely monitor investment programmes as they are implemented on the ground. The Authority is also of the view that there are significant benefits to be made in managing rail alongside bus and tram.
15. Given the progress made with the Rail Protocol, and the steps made towards putting the city region governance on a statutory footing, we would expect to have a particular input into the development, specification and letting of those franchises which operate within our area. There are several ways in which this could be achieved and we would like to discuss these options further as the plans for the individual franchises in our area are developed. The box below (Box 4) sets out four possible options – although we are open to other options emerging from discussion with DfT as well.

Box 4: Options for stronger involvement of Greater Manchester in franchising

Option 1: Build on present structure. Retain the current co-signatory status of GMPTE (TfGM – see Box 3) in successor to the Northern franchise. Build on the good working relationships that GM has with other franchises in region, most notably the successor to Transpennine Express. Work with DfT to strengthen franchise contracts so as to include stronger rights for GMPTE (TfGM) within the franchise in line with aims of Protocol.

Option 2: As above but, in the case of the successor to the Northern franchise, also create a business unit within the franchise that focuses on Greater Manchester and its journey to work area. Create structures in the franchise that put in place the right conditions for a strong relationship to develop between the business unit and TfGM. These could include consideration of a distinct franchise identity in the Greater Manchester area, or new arrangements at stations.

Option 3. Create a new franchise built around the wider Greater Manchester journey to work area. This would need to extend well beyond the conurbation and build on our developing relationships with neighbouring authorities. This approach would complement any plans for the closer integration of track and train services in Merseyside. Consideration would also need to be given in particular to how to deal with the services into Yorkshire. A stronger focus of Network Rail in the North West might be a natural complement to this option – as that could lead to a closer alignment of the infrastructure manager's management structure and the train operator's services.

Option 4. As option 3 but with Greater Manchester rather than DfT being the franchising authority.

16. The rest of this response provides answers to the questions set down in the consultation document.

FRANCHISE SPECIFICATION

Is the suggested model of specification practical and would it deliver good outcomes for passengers and taxpayers? What are the key unresolved issues? Are there alternative models that work better, and what are these?

Level of Specification

17. The central issue for franchising policy, and for the local railway in the Greater Manchester area is to find ways of both reducing the cost base, whilst ensuring that growth is accommodated on those services that have the strongest impact on the wider regional and national economy. The previous franchises have failed to plan for these outcomes. We therefore welcome both this review of franchising and the linked McNulty review of rail value for money.

18. GMITA welcomes the Government's renewed focus on those measures which impact directly on passenger perception, including customer care, and station/train quality. However, as already noted, the nature of the rail network in the north of England is such that, despite the crucial role it plays linking people with jobs, very few of the services operated are cash-positive and the operation requires a high level of Government subsidy.

19. As such we would be concerned that without a high degree of service specification for the dense urban networks, an operator would naturally tend to place capacity not where demand is highest, but where the opportunities for profit are most available. As such, and given the proportion of operator income which will be received from the taxpayer as opposed to the passenger, we believe that a high degree of specification will inevitably be necessary. The Government has a responsibility to protect taxpayers money and if, in its role as the franchising authority, it is not explicit about its expectations around dense urban networks then there is an inherent risk that bidders will provide a supply-led solution when more of a demand-led solution is required.

20. As regards the local services we would have concerns in any franchising model that did not specify train service frequencies, stopping patterns, maximum journey times, first and last trains, peak capacity and a clearly defined set of provisions to allow the operator to respond to future growth. Unlike longer distance operators the degree

of specification for our local rail services has changed very little since the original Passenger Service Requirements were drafted in 1996.

Cost Saving

21. As already noted the last two rounds of franchising for the local services in and around Greater Manchester had assumed that profits could be best generated by making cost savings in the operation of the franchise. In both rounds this has been found to be unachievable, and as the box above highlights the 2005 Northern Review found the franchise was run as efficiently as was possible (Box 1).
22. In light of this, we believe that if the Northern franchise should be let with a focus on achieving greater levels of private sector investment in initiatives that reduce the long term cost-base of the railway – and hence improve its long term sustainability. We welcome Government’s desire to provide the right incentives for a private sector-led approach to cost savings. It is also important that Government gives a strong strategic steer as to what it would like to see – linked to the conclusions of the McNulty review. Where the returns from cost saving investments are very long-term then some public sector investment may be needed alongside the private sector; this may also take the form of more effective guarantees around the residual value of assets and investments at the end of the franchise.

What factors should be considered in determining franchise length?

23. The Authority’s position as regards the length of franchises is set out in paragraphs 7 to 12 above.
24. We note that research conducted, on behalf of the Department, by KPMG found that “whilst there might with very simplistic assumptions, e.g. about cost recovery during a franchise, be some theoretical basis to consider that longer franchises could provide stronger performance incentive, amongst the TOCs we have studied there is no strong evidence for or against a direct link between contract length and the outcomes delivered.

Would the proposal to supply an initial “affordability” figure for premium or subsidy help bidders submit realistic proposals?

25. Whilst we recognise that there are benefits in supplying an initial affordability figure to bidders as a guide, we also believe it would be remiss of the Department not to give bidders a clear specification of its required franchise outputs at the same time. The arguments for such an approach are strongest on the franchises which require the greatest levels of taxpayer funding.

26. The department already has a model to make a pre-estimate of the likely costs of any given specification. If this model does not enable the department to make a good estimate of the likely fit of its own specification within its own affordability envelope then it would be valuable for the model's predictive capability to be improved.

FRANCHISE PROCUREMENT

What are the benefits and downsides to the procurement process outlined in the document?

27. We would welcome the opening up the procurement process to take account of qualitative measures, and encouraging bidder innovation to suggest improvements to the specification. We would very much support the consideration of factors such as the wider economic benefits of any bid at this stage.

CONTRACT DESIGN AND MANAGEMENT

What services, outcomes and commitments should be contracted?

28. As regards the local services we would have concerns in any franchising model that did not specify train service frequencies, stopping patterns, maximum journey times, first and last trains, peak capacity and a clearly defined set of provisions to allow the operator to respond to future growth. Unlike longer distance operators the degree of specification for our local rail services has changed very little since the original Passenger Service Requirements were drafted in 1996.

29. In the case of the successors to both the Northern and Transpennine Express franchises it is important that proper incentives are put in place to ensure that where trains are planned to be strengthened that that strengthening is actually delivered.

30. The quality and level of station and train facilities should also be an integral part of the contract (see below).

What is the best way to structure outcome measures based around passenger satisfaction levels?

31. Scores related to crowding, customer satisfaction and mystery shopping are necessary but they may not be sufficient to measure success. We expect that DfT will use the work it is currently carrying out with PTEs on the Northern franchise to inform its thinking in relation to measuring and incentivising customer-facing outputs. The

measures of customer-facing quality issues in the contract need to be relatively precise and actionable.

What sanctions should be used to ensure operators deliver their commitments, including outcome measures?

32. This question is key to determining the emphasis the Department places on different franchise outcomes. If the Department wishes to see a greater emphasis on customer-facing outcomes then it is important that a larger subset of these outcomes can lead to situations which may place a poorly performing operator into breach and default.

What level of performance bond and/or parental guarantees are appropriate?

33. Given that the chance of an operator “handing back the keys” is greater, all other things being equal, on a longer franchise then it is important that the Department has at its disposal a range of measures in order to influence operator behaviour in such circumstances. We would expect this to include performance bonds and robust mechanisms around cross-default.

REVENUE RISK

Should the risk inherent in forecasting revenue over a longer period be shared between operators and government, and if so, how? What are the merits or drawbacks of review points? What are the merits or drawbacks of economic indexation compared to the existing revenue support/share or leaving revenue risk entirely with the operator?

34. The issue in relation to revenue risk are discussed in the section on franchise length (paras 7 to 12 above). The forecasts of the last 15 years for the Northern franchise (and its predecessors) have demonstrated the near-inability of forecasters (in either Government or amongst bidders) to accurately predict the growth. In the case of the current Northern franchise this has led to the franchisee paying a share of its outperformance back to DfT. As far as we are aware the benefits of this outperformance has not been recycled into the franchise – and hence it represents a diminution of franchise value both Greater Manchester and north of England.

35. We believe that an agreed share of any franchise outperformance should be reinvested by the franchisee and/or DfT on interventions prioritised by the levels of regional GVA generated.

FRANCHISE INVESTMENT

How can we add to incentives from longer franchises to remove the barriers to private sector investment?

36. Franchise length is not a key determinant of private sector investment. In the north of England we have seen a mix of long and short franchises, and a mix of investment levels. No matter how long a franchise lasts there will always come a point when investment becomes commercially disadvantageous. A more effective way to ensure investment is to contractualise bidder commitments to invest in rolling stock, stations or infrastructure, with appropriate measures in place to capture any residual value at the end of the franchise. Longer franchises may give bidders more options when they consider their rolling stock procurement.

How can we encourage investments with long payback periods throughout the franchise term, not just at the start?

37. The residual value mechanism outlined in the consultation documentation seems appropriate.