

COMMITTEE STAGE

The Select Committee report on franchising found many faults with the current franchising model. Stuart Cottis and Matthew Hanslip Ward look at the legal aspects of its findings

In early November, the House of Commons Transport Committee lit the blue touch paper on its long-awaited report on franchising policy and stood back. But for some, the report has been something of a damp squib. We take a look at the committee's recommendations, with a particular focus on the new approach towards competition law policy as it relates to the award of passenger rail franchises (House of Commons Transport Committee Fourteenth Report of Session 2005/06 *Passenger Rail Franchising* (HC1354), published on 5 November 2006).

Over the years, the franchise model has evolved into something quite distinct from the original 1990s proposition, with a number of u-turns and changes of direction along the way. Following the most recent industry overhaul effected by last year's Railways Act, the committee thought that now seemed a good time to take stock. It set out to address the following questions: what should be the purpose of passenger rail franchising? How well does the process for awarding franchises work? Are franchise contracts the right size, type and length? And do we need more competition and vertical integration? Heady stuff. The committee canvassed a broad cross-section of views and took evidence from all quarters, including from government, the regulatory authorities, operators and consultants.

RECOMMENDATIONS

Overall, the committee doesn't think the current franchising policy works very well. It wants the Government to complete a strategic review of the long-term needs of passengers and carry out a fresh appraisal of the structure best suited to fulfil these needs over the next 10-20 years. In the meantime, it identifies some issues it thinks need to be tackled now in order for the current system to function better.

The committee is not convinced that the current system can achieve the Government's objectives of improving passenger services and maximising value for taxpayers' money. It wants the Government's forthcoming long-term strategy for the railways (the much talked of High Level Output Statement and accompanying white paper, due next year) to show how capacity will be increased and to set out a structure capable of securing quality passenger rail services to meet rising demand. It urges the Government not to bail out operators through renegotiation of franchise agreements because it says that to do this, despite taking over most of the medium and long-term revenue risks, would be a 'double failure' on the part of the Government.

It believes that the relative lack of risk transfer calls into question the fundamental assumptions and objectives of the franchising system and suggests that if risk is not transferred, there is little point in involving the private sector in the running of the railways in the first place. As for the

process of awarding passenger rail franchises, the committee welcomes the fact that the DfT is taking steps to better integrate the franchising process with long-term strategic plans, but has some concerns about the specifics. In addition, it recommends that the Government ensures that real innovation contained in franchise bids is rewarded, even where it goes beyond the strict requirements of the franchise specification. Care will clearly have to be taken here to ensure that each bidder is treated fairly as required by the procurement rules.

It also wants the Government to re-balance the bid evaluation criteria and assess cost relative to proposals for innovation and franchise development over and above the base case specification. Less tangible costs and benefits such as wider environmental and socio-economic factors should increasingly be taken into account.

The committee is concerned that the drive to extract premiums from some parts of the network will result in further above-inflation fare increases and a deterioration in customer service, investment and innovation. Where a franchise is profitable, it believes that the Government should provide incentives for investment and innovation by providing for part of the premiums to be available for such reinvestment. Clear, specific and innovative investment proposals should be sought from bidders – presumably during the bid process. And it thinks the Government should do more to reduce what it considers to be barriers to entry to new franchise participants.

Turning to the nature of the franchise proposition, the committee approved of the split in franchise agreements between the 'standard' national rail franchise terms and franchise-specific arrangements. It recommended varying the tightness of franchise specifications, so that those franchises that are expected to require greater amounts of subsidy have specifications that are more tightly prescribed. It believes there is a tension between the need for loose and flexible franchise specifications, to allow for private sector innovation and risk-taking, and the need for very tight specifications and targets, to ensure compliance.

The committee recognises that the tension cannot be fully resolved within the current framework but considers that the DfT should mitigate the problem by reassessing the gains and losses of its current approach with a view to achieving greater flexibility. The committee recommends franchise lengths are increased to 15-year terms, but with the inclusion of break clauses to retain the ability to set incentives and targets for franchisee performance. But it believes the number and geographic spread of franchises are about right.

Perhaps to the disappointment of some, the committee did not recommend a wholesale return to vertical integration. It did, however, observe that it would have merit in some regions, such as Merseyside. It recommended that Network Rail and DfT, with advice from ORR, carry out



Money down the drain? The committee identified several areas in which millions of pounds are being spent unnecessarily.

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pilot vertical integration projects on self-contained parts of the network.

The committee didn't shy away from the topical and difficult subject of open access. It accepted that open access services can bring significant benefit to passengers on some routes. But it recommended that such access should not be allowed to reduce the capacity and jeopardise the efficiency of the network as a whole. When open access is granted, the ORR should ensure that timetables are co-ordinated between open access and franchised operators and open access decisions need to be made with due regard for overall network strategy and existing contractual obligations. ORR and DfT should establish clear lines of communication about network capacity and access and the scope for extra paths to be allocated. The risk of new open access operations should be shared between the Government and the franchise operator and the DfT should be more explicit about the potential for open access in the course of the franchising process.

COMPETITION LAW POLICY

The Committee had a lot to say about the nature and application of competition law policy in the franchising process. This has become something of a Rubik's cube. Franchise awards are treated as 'mergers' under the Enterprise Act 2002. If certain thresholds are met, which is almost always the case with rail franchises, they are subject to regulatory oversight by the UK competition regulators, the Office of Fair Trading (OFT) and the Competition Commission (CC). Bids are initially referred to the OFT for an evaluation of the potential competition issues, and where concerns are identified, the case is referred on to the CC for an in-depth investigation. The CC may impose restrictions or conditions on the bid if those concerns prove well founded. And in some cases, there is a European dimension that requires the involvement of the European Commission.

The committee found that a total of five franchise bids, involving three different owning groups, had been referred to the CC since 2002. The CC imposed conditions in only one of those cases: the Scotrail franchise awarded to First Group where a substantial lessening of competition was anticipated, particularly in the Glasgow area. As a result, First Group was required to agree to certain controls including, for example, in relation to fares.

The committee observed that the way competition law policy had applied to rail franchises had changed several times in recent years. To start with, notification was voluntary, and investigations carried out retrospectively (after being awarded to the preferred bidder) – sometimes these investigations

were initiated on the basis of complaints, for example, from a losing bidder or from passengers' groups. During the 2004-05 period, every single bid was required to be referred to the OFT at the bidding stage. Referrals to the CC were also initiated before the franchise was actually awarded. This meant that all bidders had to go through the OFT process, and sometimes the CC process as well, even though only one in each case would actually go on to win the franchise. This meant that for each franchise being let, up to five bids were reviewed, all but one of them in vain. Representatives of the owning groups explained to the committee that it can cost a bidder in the region of £1m to take a bid through the full competition process, including a referral to the CC. And to this needs to be added the costs to the taxpayer of the regulatory authorities scrutinising the bids.

The CC, OFT and DfT have now agreed to change the system so that in future, only the winning bid will be subject to the process. While it is hoped that this will reduce the cost to the taxpayer as well as the costs and extra frustration of companies who fail in their bids, it may not be all good news. This approach effectively passes the competition risk to bidders who, having won a franchise and with no obvious escape route, might subsequently find that there are extra costs to be met to ensure compliance with various conditions or other requirements imposed by the competition authorities. Bidders will, therefore, no doubt still want to assess at an early stage in the bid process the risks of OFT/CC action, albeit stopping short of a notification.

The OFT itself expressed concern that the competition process for rail franchises is generally less than effective. It argued that competition considerations should be brought into the process at a significantly earlier stage and incorporated into the design of franchises. The committee agreed and recommended that the Government co-operate with the competition authorities to find a more effective approach for the longer term.

It remains to be seen how many of the committee's ideas take off.

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