A New Approach to Franchising?

The Transport Committee Report asks probing questions in its East Coast Report, **Stefan Eilts** and **Darren Fodey** of law firm Stephenson Harwood LLP explain

The Transport Select Committee (TSC) report on the failure of the East Coast franchise, published on September 12 2018, contained few surprises. Whilst the TSC found that this was principally the train operator's responsibility, there was criticism for others. In particular, the approach of the Department for Transport (DfT) to accepting over-ambitious assumptions about the delivery of infrastructure during the bid process was questioned.

As well as apportioning blame, the TSC also asked pointed questions about the 'de facto reality on the railways' and the DfT's strategy for handling future challenges: including the possibility of other franchises defaulting. The TSC's report – together with the report from the ORR on the May timetabling issues – has led to the Government launching a review of the rail industry, to be led by Keith Williams of the John Lewis Partnership.

What factors are likely to be taken into account as part of that review? Here, we consider in a little more detail some of the key messages of the TSC report and its potential implications for the rail industry. In fact, the DfT may already have anticipated some of the TSC's criticisms in more recent franchises. We consider those, what further approaches could be considered, and (the ever-present elephant in the room) what effect Brexit could have on these.

A red herring?

The TSC accepted that the DfT had to let the train operator default on East Coast because renegotiation would have sent the wrong message to the industry. However, there is a clear sense of unease about the consequences of a hardline approach being taken too far.

The TSC has therefore requested greater clarity from the DfT about ways of avoiding franchise failure, such as through contract change and that old bugbear: renegotiation.

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When it comes to renegotiation, the DfT's response may well be that 'the medicine is worse than the malady'. Renegotiation, so the argument goes, will encourage bad bidding behaviour and risks a repeat of the very overbidding that undid East Coast. On the other hand, bids are made using information that will be at least two years out of date by the time the franchise goes live. There are only certain risks which are genuinely within the control of the train operator – particularly around revenue. Where does the balance lie? The DfT may have found a new answer to that question.

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Cap and collar 1.0

First, a little bit of history. 'Cap and collar' was introduced into franchise agreements in the second round of franchises from around 2003. It sought to protect train operators – to some extent – from changes in revenue where ticket sales declined.

Equally, the Government would share in any upside if ticket sales increased more than expected. Operators would receive 'revenue support' if revenue fell below a certain percentage of predicted revenue, while 'revenue share' would be paid to the DfT if revenue exceeded a particular percentage of predicted revenue.

There was a 'nil band' either side of the predicted revenue, on which the operator would be entirely at risk. The revenue share and revenue support payments would only be a proportion of the shortfall (or excess) so, in theory, the operator always remained incentivised to perform.

Cap and collar ensured that the franchise market remained buoyant. However, over time it became widely criticised because it encouraged over-optimistic bids, particularly in later years of the franchise. Bidders knew that they would receive protection within certain bands and therefore were 'enthusiastic' about the levels of revenue they would generate, to win the franchise in the first place.

In the early 2010s, the Government moved away from cap and collar towards a 'forecast GDP' mechanism, whereby protection was by reference to changes in economic conditions. However, there were criticisms that this did not properly recognise external revenue risks which franchisees could face.

Forecast revenue mechanism: cap and collar 2.0?

Recent franchises have seen the introduction of 'new' protections – the Forecast Revenue Mechanism (FRM) – although readers would rightly ask what the difference with cap and collar is, as they look remarkably similar.

One key difference is that under the old cap and collar approach an operator usually had to wait until the fourth year of the franchise for revenue support to kick in. The FRM is more generous, although the principles are largely the same.

The franchise agreements issued for the South Eastern and West Coast Partnership competitions suggest that the DfT is open to revenue support being available much earlier in the franchise. Under the current West Coast direct award, meanwhile, the FRM seems to have been made available from the start.

This could provide a welcome innovation. The DfT appears to be addressing the issue of overbidding, in part by saving operators from themselves. It is not easy to imagine an operator going into financial default under the new system.

The FRM represents evolution rather than revolution. Franchising may be evolving to a place where there is less chance of contracts needing to be renegotiated. In light of this trend, the DfT's warnings about renegotiation sending the wrong message seem somewhat misplaced. Should a limited use of renegotiation be entirely out of the question? Perhaps not, judging by the TSC's report.

Contract change and renegotiation

The FRM may well offer some degree of stability that wasn't possible under the old cap and collar approach. But it doesn't address the TSC's concern about the possibility of further defaults under current franchise agreements. These, in the TSC's view, may warrant 'in-life' solutions, such as franchise change and renegotiation.

One of the tools already available to DfT and operators is the 'change' mechanism. This mechanism allows the financials set out in the franchise agreement to be reopened if a relevant event occurs, following a pre-specified process. Whilst usually this event will be one that raises the train operator's costs through no fault of its own, it can work both ways and apply to events which lower costs (with changes being made in favour of the DfT).

Applying the change mechanism is not renegotiating the contract. It is simply revising payment terms within parameters negotiated at the start. By contrast, renegotiation involves doing things not contemplated during the negotiation.

To date, renegotiation has generally been a non-starter for the DfT, despite the fact that there can be compelling arguments for it. Often, this is presented as 'sending the wrong message' but there may well be legal hurdles as well – as 'renegotiation' in its purest form may not be consistent with EU regulations. These restrict changes to the scope of a contract or shifting the economic balance of the contract – and indeed, the scope of permissible renegotiation has not been well tested in the courts. This may be from where the concern arises.

Interim arrangements

The TSC was agnostic about the Transport Secretary's decision to transfer control of the East Coast franchise to the operator of last resort (OLR). The OLR is ultimately a Government-owned and controlled company – transferring to OLR essentially means renationalisation. The TSC noted that OLR can result in delays to investment by private sector operators and can run for much longer than expected.

From what we have seen, the decision to renationalise was nothing to do with perceived value for money. Whilst perhaps political 'spin', the key factor appears to be that OLR will drive forward the Transport Secretary's strategic vision for East Coast. In theory at least, this will involve greater collaboration between track and operator. But for as long as the logistics – and even feasibility – of the strategic vision remain murky, this rationale seems less than convincing.

We should also not forget another option: direct awards. The DfT's decision on East Coast should not detract from the clear benefits that direct awards offer.

By way of a reminder, a 'direct award' is a franchise agreement which is awarded by the DfT – usually to the incumbent operator – without a competitive process. Using this option to give the contract to an incumbent whose contract is about to terminate, the DfT is not forced to simply wait for the money to run out in order to extract full value from the contract.

Termination can be more orderly and greater surpluses created by earlier termination – whether from operating revenue or financial guarantees – could be rolled over into the subsequent agreement. However, to the tabloid press this could very much be denounced as rewarding the incumbent for failure – and we cannot underestimate the political drivers behind these kinds of decision.

Brexit

The TSC was sceptical about the feasibility of the East Coast Partnership proposal and its reliance on an ill-defined collaboration between the train operator and Network Rail. In fact, not only logistical, but also legal obstacles may stand in the way of this strategy coming to fruition. This is only one of the reasons why rail regulation will be a crucial part of the post-Brexit landscape.

The Government has signalled its intent for the UK to chart its own course in the area of rail regulation after Brexit. Of course, this could just be a sop to the members of the European Research Group – particularly as the UK pioneered what is now the European model much before the EU became involved.

And even if these plans are genuine, they are likely to face staunch pushback from Brussels, given the saturation of the UK rail market by state-owned companies from other counties within the EU.

EU regulations also limit the use of direct awards. Generally, the 'emergency' direct award used in the case of delays to the franchising program is limited to two years. This is not ideal, and we wonder whether it is genuinely an 'emergency' when it is partly caused by the DfT. Generally, the shorter the direct award, the less value the operator can be expected to deliver under the contract. A two-year direct award can also be inconvenient as it usually takes at least two years to run a franchise competition.

Lastly, should the UK have greater flexibility in renegotiating contracts in situations where the only conservative option now is to terminate the contract and make an emergency direct award? As discussed in this article, current rules don't preclude the use of renegotiation. But greater clarity in this area would be helpful and could set useful parameters for negotiation.

What would the contours of a bespoke rail regulatory system in the UK look like? For one, this could involve liberalising the current EU rules on vertical integration between track and train. Doing this does not have to be incompatible with preserving rights of passenger and freight operators to access to rail infrastructure. However, we cannot forget that this will very much depend upon the UK's future relationship with Europe.

Avoiding a zero-sum game

Extracting full value from a contract need not mean waiting until your counterparty runs out of money. Rights of termination are just that – rights, not obligations. These principles may be the basis of a better accommodation to the current challenges facing the rail industry. We agree with the key messages from the TSC – but it remains to be seen what the DfT will do in response. It is hoped the Williams review will shed some light on this.

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