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RAIL FRANCHISES, COMPETITION AND PUBLIC SERVICE

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Key Words

Rail transport, public contracts, comparative law, public service, competition

Abstract

The use of franchises to deliver rail services has raised major problems. Franchises restrict competition in the market, whilst competition for the market through bidding for franchises has also met with difficulties, notably in relation to risk transfer and the recent use of short-term contracts that have not been awarded competitively. Further, franchise agreements are detailed and highly stipulative and so do not achieve the flexibility and opportunities for innovation originally intended. This reflects an underlying lack of trust resulting from the arrangements adopted on privatisation. By contrast, in Sweden regional services have been procured through contracts with limited risk transfer, and in Italy provision of services has been entrusted to a dominant operator with comparatively limited detailed service specifications; both seem to have been more successful. For the future in the UK, possibilities include greater use of competition, a return to public ownership, regionalisation, and the use of concessions with limited risk transfer to secure stability.

Introduction

The use of contracts has now become not only a central means for the delivery of public services but has at last attracted the academic attention it deserves.² However, there has been limited discussion in the legal literature of one field of such contracting which has both a high

² See eg Hugh Collins, *Regulating Contracts* (Oxford: Oxford University Press, 1999) Ch. 13; Peter Vincent-Jones, *The New Public Contracting: Regulation, Responsiveness, Relationality* (Oxford: Oxford University Press, 2006); and A.C.L. Davies, *The Public Law of Government Contracts* (Oxford: Oxford University Press, 2008), esp. ch. 3.

public profile and has proved highly controversial; that of the franchising of rail services.³ Another theme has been rather neglected in the UK debates; that of comparison with the legal regimes of Continental Europe, which have well-established legal instruments for the delegation of the performance of public service tasks through concessions and other contractual devices. The aim of this article is to fill both these gaps by assessing the use of rail franchises in the UK and comparing it to the use of contractual tools in two other European nations. In this way we hope both to contribute to current debates on the future of franchising and to reflect on franchising as a mode of regulation.

Rail franchises: their origins and purposes

Rail franchises were an integral part of the fragmentation and privatisation of the British railway system under the Railways Act 1993. The idea had come from a number of sources, notably the Adam Smith Institute, when it was proving difficult to develop workable schemes for the introduction of private capital into British Rail.⁴ The provision of the rail infrastructure was to be separated from the operation of services; operators would compete for the right to provide such services, in some but not all cases for the same traffic flows. The 1992 White Paper, *New Opportunities for the Railways*, which set out the privatisation plans, described the role of franchises in nine paragraphs, stating that there would be no standard template for them nor any standard duration. Franchises would be awarded through an open competition by a Franchising Authority on the Government's behalf and would specify obligations such as minimum frequencies and the quality of service in a franchise

³ For exceptions to this neglect see Carol Harlow and Richard Rawlings, *Law and Administration* 3rd ed., (Cambridge: Cambridge University Press, 2009), 402-13; Davies, *The Public Law of Government Contracts* 20-23.

⁴ See Terry Gourvish, *British Rail 1974-97: From Integration to Privatisation* (Oxford: Oxford University Press, 2002), 368-9; Kenneth Irvine, *The Right Lines* (London: Adam Smith Institute, 1987).

agreement. Where possible, franchises would be designed to provide scope for competition between competing services from different franchise holders.⁵ No attempt appears to have been made to examine in any depth the nature of these contracts nor experience in other nations where, as we shall see, there was already extensive use of contracts for the provision of rail services.

What is franchising for?⁶ The franchise holders (the train operating companies or ‘TOCs’), despite being the public face of the railway, have a surprisingly restricted role; they do not typically own their own rolling stock (normally leased from specialist leasing companies) nor the track, signalling nor major stations. Our answer to this question would be to suggest that franchising performs two linked purposes. The first is that of bundling commercially profitable services with the unprofitable ones required for public service reasons, so requiring franchise holders to provide both. The role of the franchise here is to ensure that the public service requirements are met. The inevitable result is that there are severe restrictions on competition within the franchise area; as we shall see below, contrary to the plans in the White Paper, TOCs are given near-exclusive rights. Competition is for the award of the franchise (which may include profitable opportunities), not generally in the direct provision of the service to consumers. The second purpose is to provide specification of the required services necessary to meet a public service demand. Franchises thus offers an alternative to other means of ensuring that public services are provided in a way which meets social as well

⁵ Secretary of State for Transport, *New Opportunities for the Railways: the Privatisation of British Rail*, Cm 2012, (1992), paras 25-33.

⁶ This has become known in railway circles as the ‘Christian Wolmar’ question, named after the distinguished rail journalist who has repeatedly posed it: See e.g. Christian Wolmar, *RSA Speech: What is franchising not for?*, December 12, 2014, available at: <http://www.christianwolmar.co.uk/2014/12/rsa-speech-what-is-franchising-not-for/> (consulted 12 June 2017).

as competitive goals, for example the use of universal service funds for which competing companies can bid to provide socially necessary services at the lowest cost. If this is the most plausible understanding of the role of rail franchising, it raises issues which are at the heart of the current debates concerning contractual governance. In particular, it raises the issue of trust in relation to the provision of public services.

The use of franchises is a response to a lack of trust in the ability of the privatised operators to maximise returns for shareholders whilst at the same time maintaining public service provision. This lack of trust was exacerbated by the model adopted for privatisation, in which the formerly unitary British Rail was split into a large number of separate companies linked by contract. The use of franchises thus represents regulation designed to ensure that at least some form of trust can be maintained after privatisation and fragmentation of the rail industry. As Baldwin, Cave and Lodge have pointed out, one objective may be to ‘avoid the restrictiveness associated with classical command and control regulation while, nevertheless, enabling some degree of control to be retained.’ It also permits competition for the market rather than within the market, thereby maintaining the benefits of competitive pressure.⁷

As we shall discuss, control may be exercised in a number of ways in a rail franchise. A principal means is through detailed specifications for the service. The expectation would be that effective monitoring of the operator’s performance in meeting specifications would engender trust between the contracting parties; over time, increasing trust in the operator’s ability to meet expectations would correspondingly reduce the necessity to continue to prescribe or strictly enforce the precise content of specifications and other terms in the contract in future. There is of course a vast literature in the study of contract relating to trust,

⁷ Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy and Practice* (Oxford: Oxford University Press, 2nd ed., 2012), 166.

from Durkheim onwards; one summary which is particularly apposite here comes from Hugh Collins:

The ... effect of trust between the parties is that it reduces the need to guard against disappointment by specifying in detail the precise content of the reciprocal undertakings and then monitoring performance closely. In the presence of trust, it will be assumed that the intention to minimize disappointment will lead the other to fulfil reasonable expectations without the need to supply particulars of every aspect of those expectations and then check upon compliance with the terms of the contract. In other words, the transaction costs of contractual specificity and monitoring can be reduced by the presence of trust ... In short, trust functions as an antidote to transaction costs.⁸

If it was envisaged that franchising would ensure trust for the public through government oversight and trust between contracting parties through performance monitoring leading to a reduction in contractual specificity and transaction costs, the experience of rail franchising has not engendered such levels of trust, compromising contractual governance and the achievement of regulatory goals. As we shall discuss, trust leading to flexibility in the contract has been undermined by a tendency to specify in extreme detail the normative requirements applying to the delivery of rail services, a problem which has bedevilled rail franchises. Further, lack of effective performance monitoring from the outset in order to increase trust and reduce excessive monitoring over time has been a major issue exacerbating misplaced levels of control throughout the franchise duration; for example, through threatening regimes of penalties and termination which have, themselves, been largely ineffective. As a result, one of the great merits claimed for franchising as a regulatory strategy, namely flexibility and adaptability to the specific circumstances of its operation over

⁸ *Regulating Contracts* (1999), 100-101; see also 3, 98-102, 110-4, 129.

time, has instead manifested characteristics of that often mythical beast, ‘command and control regulation’ rather than permitting the service provider to judge changing market conditions and to innovate.⁹

‘Command and control’ regulation has come under massive criticism in recent years suggesting that ‘smarter’ forms of regulation which involve a more reflexive set of relations between regulator and regulatee have major advantages.¹⁰ As we shall discuss below, having identified the objectives of franchising, we have to ask whether franchising in its current form is always the ‘smartest’ way of achieving them. Regulation theory has identified franchises as having certain characteristics which offer an effective regulatory strategy provided they do not come to resemble certain less successful forms of command and control. However, it may be questioned whether the circumstances surrounding rail provision such as privatisation, competition for the market and detailed contractual forms could have rendered franchising effective across the spectrum of rail services provided. By contrast, there has been virtually no consideration of the potential and characteristics of other modes of regulation which could, in fact, be more responsive to public service demands. As we shall discuss, concessions can provide more appropriate specifications and risk allocation and which respond to regional needs, conditions which may be more conducive to fostering greater trust. These contracts do not avoid all of the problems of command and control regulation but recent experience suggests that they are worthy of detailed consideration as a regulatory strategy. At the very least, they reveal that the traditional franchise is not the only mode of regulation being deployed; there are important variations that must be examined.

The fostering of trust in regulatory relationships is also a major task for a procedural public law, especially where, as in the case of rail, there are complex regulatory relationships

⁹ Baldwin, Cave and Lodge, 192.

¹⁰ This huge literature is summarised in Baldwin, Cave and Lodge, esp. chs 7-8, 11-12.

between multiple actors.¹¹ This is applicable to franchising just as it is to any other mode of regulation; ‘franchising authorities should be expected to be as accountable as any other regulatory bodies ... and the processes whereby the terms of franchises are set and enforced should be designed to be as transparent, accessible, and fair as other regulatory mechanisms.’¹² These legitimacy questions have posed serious difficulties in relation to other areas of contractual governance.¹³ As we shall see below, the record of UK rail franchising is decidedly mixed in this regard; the overseas systems we shall study also have major problems of transparency, but may in part compensate for these through other factors which enhance trust.

The relevant law

Although the award of franchises is complex and rail franchise agreements highly detailed and stipulative, the Railways Act 1993 which forms the basis for rail franchising is singularly lacking in detail. S.23 imposes a duty on the Secretary of State to designate from time to time passenger services to be subject to franchises but the choice of services for designation is left to the minister’s discretion; discretionary exemptions may also be made to such designation.

¹¹ Tony Prosser et al., ‘Neo-Institutionalist and Collaborative-Relational Approaches to Governance in Services of General Interest: the Case of Energy in the UK and Germany’, in De Schutter and Lenoble, *Reflexive Governance* (2010), 67-95, 83, 90-4. For the role of trust in complex regulatory regimes see Frédérique Six and Koen Verhoest, ‘Trust in Regulatory Regimes: Scoping the Field’ in Six and Verhoest, eds, *Trust in Regulatory Regimes* (Cheltenham: Edward Elgar 2017), esp. at 9-14. For the role of contracts (and, in particular trust) as a complement to other regulation in network industries, see Jon Stern, ‘Regulation and Contracts for Utility Services: Substitutes or Complements? Lessons from UK Railway and Electricity History’ (2010) 6(4) *The Journal of Policy Reform* 193-215, esp.196-200.

¹² Baldwin, Cave and Lodge, 192.

¹³ See eg Collins, *Regulating Contracts* ch. 13; Davies, *The Public Law of Government Contracts* ch. 3, Vincent-Jones, *The New Public Contracting*, ch. 12.

UK public sector bodies are prohibited from bidding, though this has not prevented public enterprises from other European countries obtaining a substantial number of UK franchises.¹⁴ S.26 of the Act empowers the minister to select franchise holders from those who submit tenders but does not require a competitive tendering process. The key decisions are very much left to the minister rather than being subject to detailed legal provisions and clear legal constraints. However, the minister is required under amendments made by the Railways Act 2005 to issue a statement of policy on the exercise of his powers in relation to tendering.¹⁵ This states that it is likely that a tendering process will be used, except where this is not practicable because of potential disruption of services, or where tendering would not be conducive to the effective administration of a sustainable and well-resourced programme of franchise competition, or to the fulfilment of government objectives in relation to rail transport.¹⁶ In these circumstances a direct award will be made; as we shall see below, direct awards have been made extensively in recent years.

Most UK public contracting has been transformed by the EU public procurement rules.¹⁷ Historically, the provision of rail passenger services was considered to be exempt from the procurement directives. However, in practice franchises were typically awarded under the Public Contracts Regulations 2006 as ‘Part B Services’ but with no clear procedural rules for their award.¹⁹ To clarify the legal position, the 2014 Public Sector Directive and Concessions

¹⁴ S. 25.

¹⁵ Railways Act 1993 s. 26(4A); Department for Transport, *Statement of Policy on the Exercise of the Secretary of State’s Power under Section 26(1) of the Railways Act 1993* (2013).

¹⁶ *Ibid*, paras.9-11.

¹⁷ See e.g. Tony Prosser, *The Economic Constitution* (Oxford: Oxford University Press, 2014), ch. 9.

¹⁹ It is arguable that ‘rail transport services’ may have constituted a ‘Part B’ service (a classification which no longer applies under Directive 2014/24/EU) under the then UK Public Contracts Regulations 2006 (PCR 2006) and which were advertised in the Official Journal of the EU as such. Alternatively, it is arguable that rail

Directive have now excluded rail contracts from their scope.²⁰ Such contracts are now principally governed by the Public Services Obligation Regulation 1370/2007.²¹ This provides that exclusive rights and/or compensation must be allocated through the use of public service contracts, with a maximum of 15 years duration (this can be extended where there are special investment needs). Award may be by competitive tender, although direct awards are also permitted; in addition emergency measures may be used to deal with risks of disruption.²² The Fourth Railway Package proposed by the European Commission and now enacted, originally proposed ending the ability to make direct awards.²³ Quite apart from the uncertainty created by Brexit, however, this has been considerably watered down by the Council through the inclusion of wide exceptions permitting direct awards, including where justified by the structure and geographical characteristics of the market and network and if it

franchises may constitute a ‘service concession contract’ meaning a public services contract under which the consideration given by the contracting authority consists of or includes the right to exploit the service(s) to be provided. However, the PCR 2006 did not generally apply to a services concession contract (Reg.2 and 6(2)(m)). To this extent, it appeared that, at most, a limited number of provisions applied, in particular general EU law principles of transparency, equal treatment and non-discrimination; see Case C-48/03 *Parking Brizen GmbH v Gemeinde Brixen* [2005] ECR I-8585.

²⁰ See Directive 2014/24/EU Public Procurement Directive [2014] OJ L94/65 as implemented in The Public Contracts Regulations 2015, SI 2015/102 (Article 10(i); Reg.10(1)(i)) and The Concession Contracts Regulations 2016 and Directive 2014/23/EU Concessions Directive [2014] OJ L94/1 2014 as implemented in The Concession Contract Regulations 2016, SI 2016/273 (Article 10(3); Reg. 10(3)(b)).

²¹ Regulation (EC) No 1370/2007 of the European Parliament and of the Council of 23 October 2007, [2007] OJ L315/1.

²² Articles 3-5.

²³ *Communication from the Commission ... on The Fourth Railway Package – Completing the Single European Railway Area to Foster European Competitiveness and Growth*, COM(2013) 25 Final, 30.1.2013, 7.

would improve the quality of services or cost-efficiency.²⁴ The legal basis for rail franchising thus continues to impose only a patchwork of limited procedural restrictions on the powers of the Secretary of State in the award of franchises.

The performance of rail franchising

Despite daily media reports to the contrary, passenger rail services have clearly had some major successes in recent years with passenger numbers increasing by 60% over the past ten years, and journeys rising from 600 million in the mid-1980s to over 1.6 billion journeys in 2014-15.²⁵ This may in part be attributable to marketing and service improvement by the franchise holders, although the reasons for the increase are highly complex and include changes in the national economy and in lifestyles.²⁶ However, the franchising process has encountered serious problems. First it will be necessary to examine the relationship between franchising and competition.

Franchising and competition

It is, of course, in the very nature of franchising that it restricts competition in the provision of services to consumers through providing near-exclusive rights to the provision of services in the area covered. In the UK, so-called ‘open-access competition’ in passenger services, which gives another company the right to run selected services in the area covered by the franchise holder, is extremely limited; thus there are currently only two open access operators and their services represent less than 1% of passenger miles, though in May 2016 consent

²⁴ Regulation (EU) 2016/2338 of the European Parliament and the Council of 14 December 2016, OJ L354/22, art. 1.

²⁵ Competition and Markets Authority, *Competition in Passenger Rail Transport Services in Great Britain: A Policy Document* (2016), para. 1.1.

²⁶ Social Research Associates, *On the Move: Exploring Attitudes to Road and Rail Travel in Britain* (London: Independent Transport Commission, 2015).

was granted for further open access services on the East Coast main line, in this case to a different franchise-holder to the incumbent.²⁷ The limit to competition is due both to the restricted capacity for new services on potentially profitable routes, and a reluctance to allow ‘cream skimming’ through competing only for the most profitable services thereby threatening the revenues of franchise holders, deterring potential bidders and reducing income for government.²⁸ The Competition and Markets Authority has put forward ambitious recommendations to increase competition either with franchise holders or through replacing franchises with a licensing system for some main lines; we shall return to these later when we consider alternatives to franchises.²⁹ In addition, competition between overlapping and parallel franchises is very limited as a consequence of the reduction of the number of franchises from twenty-five to fifteen. The near-exclusive nature of franchises may thus be presented as limiting the increases in efficiency and in consumer choice which would be the outcome of more open competition in the provision of passenger rail services.

Franchises do, of course, appear to offer a different form of competition; competition for the market rather than competition in the market.³⁰ However, the history of passenger rail franchising shows considerable difficulties in the process for achieving this. First, the institutional arrangements for franchising have been changed several times and there has been a striking lack of stability in franchising policy, reflecting not only problems of the performance of franchise holders but inadequacies in the contractual management capacity and performance of the Department for Transport. Thus, after franchising was introduced by

²⁷ See Competition and Markets Authority, *Competition in Passenger Rail Transport Services...*, para. 1.23.

²⁸ Competition and Markets Authority, *Competition in Passenger Rail Transport Services...*, para 1.24.

²⁹ Competition and Markets Authority, *Competition in Passenger Rail Services in Great Britain...*

³⁰ For an account of franchises as a means of such competition see Baldwin et al, *Understanding Regulation*, 165-94.

the 1993 Railways Act, there were 25 franchises for (normally) seven years. Awards were initially made by a Franchising Director closely linked to the Department for Transport. However, under the Transport Act 2000 the process passed to the arm's length Strategic Rail Authority, which in turn was abolished under the Railways Act 2005. Awards are now made by the Passenger Services Directorate within the Department's Rail Executive; there are now only 15 franchises.

The Coalition Government envisioned franchises of fifteen years or more to facilitate investment through increased stability. However, very serious problems emerged with the aborted renewal of the InterCity West Coast franchise in 2012. Here, after the commencement of judicial review proceedings by the incumbent operator, material came to light showing serious impropriety and inefficiency in the Department's decision-making process; this was caused both by poor financial modelling in relation to risk transfer considered necessary for longer term contracts, and inequality of treatment of bidders, including in the communication of information to them. As a result of these revelations the award had to be withdrawn, other franchising suspended and a new award made.³¹ The resulting Brown Review of franchising recommended a more cautious approach of shorter initial franchises with the possibility of extensions and intermediate break points. It also recommended revised arrangements for risk sharing between operating companies and the

³¹ For details of these events see House of Commons Transport Committee, 'Cancellation of the InterCity West Coast Franchise Competition, HC 537, 2012-13 and the official inquiry into the events; 'Report of the Laidlaw Inquiry', HC 809 (2012-13).

Department.³² The franchising process re-commenced with the adoption of these arrangements.³³

However, two competition-related problems remain. The first is that, partly due to the disruption of the franchise re-letting programme after the InterCity West Coast fiasco and disruptive infrastructure improvement work, a profusion of short direct awards, normally lasting for two-three years, has replaced the longer franchises in many cases. These do not result from a process of competitive tendering but from direct negotiation with the incumbent bidder. Following the collapse of the InterCity West Coast award process in 2012, direct awards were used for ten of the next fifteen awards, and such contracts were in place for a third of all franchises in 2017.³⁴ Though intended to be a temporary measure, the use of short direct awards thus represents a major change of substance to the nature of franchising. As we shall see in a moment, some direct awards also involve a major difference in the allocation of risk, taking the form of management contracts in which risk of financial loss is borne by the Department, not the TOC.

Moreover, it seems that the number of bidders for franchises is limited. The major operators in the past have been large transport groups such as FirstGroup, Virgin or Stagecoach, or subsidiaries of public-owned railways of other European countries, most notably Arriva, owned by Deutsche Bahn and most recently Trenitalia. The prohibition on public bidders for franchises in the Railways Act 1993 does not apply to foreign-owned enterprises, and around half of franchises are either run by subsidiaries of public sector operators abroad or have substantial involvement by them; uncertainty over Brexit does not seem to be a deterrent. An

³² Department for Transport, *The Brown Review of the Rail Franchising Programme*, Cm 8256 (2013).

³³ Department for Transport, *Government Response to the Brown Review of the Rail Franchising Programme*, Cm 8678 (2013).

³⁴ Transport Committee, 'Rail Franchising', HC 66, 2016-17, para. 19.

emerging problem is that it has been difficult to attract new bidders; since the recommencement of the franchising programme in 2013 three bids were received for each of the first five franchises, this representing the minimum considered by the Department to create competitive tension and to increase the likelihood of receiving high quality bids. The limited number of bidders has been characterised by the Public Accounts Committee as a real risk to value for money.³⁵ Only two bidders entered the competition for the South West and West Midlands Franchises to be allocated in 2017. This reluctance to enter the market reflects in part the fact that it now costs over £10 million to prepare a bid, and the figure was close to £15 million in the case of InterCity West Coast.³⁶ It is also likely due to uncertainty in government policy which could create further market instability and increase costs should the Government implement the proposals of the Competition and Markets Authority referred to above. Thus competition for services is almost non-existent, whilst competition for franchises is now also limited.

Specification of service requirements and financial arrangements

The service requirements for franchise holders are set out in an astonishing level of detail. For example, the 2016 rail franchise agreement for Northern Rail has a basic service level commitment running to 275 pages including specifications such as ‘One service from Sheffield [to Wakefield] shall be provided departing between 1000 and 1030 and shall provide a through journey to Carlisle.’³⁷ Indeed, the major difficulty in identifying relevant information is the sheer volume and complexity of the documents; the Northern Rail agreement runs to no less than 609 pages, supplemented by a further seven schedules setting out train service requirements, totalling 450 pages. At the point of privatisation, it was

³⁵ ‘Reform of the Rail Franchising Programme’, HC 600, 2015-16, Conclusion 2 and paras 8-14.

³⁶ Roger Ford, ‘What Next for the Passenger Railway’, *Modern Railways*, July 2016, 24-31, 25.

³⁷ Department for Transport, *Northern Rail 2016: Rail Franchise Agreement* (2016).

expected that the Franchising Director would prescribe service specifications to a degree appropriate to the level of competition, for example, with detailed specifications where the operator was a near monopolist to substitute for market pressure but only service specifications necessary to ensure good value for money where there was market pressure.³⁸ Yet, for many years, detailed service specifications appear to have been applied across all franchises, irrespective of levels of competition achieved.

Financial details are also complex; for example, the Intercity East Coast Franchise helpfully tells us that ‘The Franchise Payment for any Reporting Period shall be an amount equal to: $3FP = PFP + TAA + SCA + GDPA + GDPR_1 + GDPR_2 + TUA + CPS + TMDPS...$ ’. These values are defined, but the actual amounts are redacted.³⁹ Such complexity has the dual effect of amounting to a serious constraint on the ability of operators to innovate and meet changing need (a far more intrusive constraint than ever applied to British Rail before privatisation) and undermining transparency by making it very difficult to work out what the financial requirements actually are.

The allocation of risk

A major problem associated with the management of franchises as part of the wider rail industry has been that of the allocation of risk. Whilst operators’ costs are relatively fixed, there is the issue of who bears risk regarding revenues and operator performance. The key point is that risk may be endogenous (reflecting the performance of the operating company, for example a decline in passenger numbers due to poor quality services) and exogenous (outside the control of the company, most importantly reflecting the performance of the

³⁸ Baldwin, Cave and Lodge, 176 citing Secretary of State for Transport, *Guidance to the Franchising Director* (London 1994).

³⁹ *Franchise Agreement – InterCity East Coast* (Department for Transport, 2014), sch. 8.1.

national economy to which passenger numbers, especially on commuting routes, are closely aligned). A variety of different techniques have been adopted to allocate risk; for example, the use of ‘cap and collar’ arrangements by which operators received revenue support payments from the Department to compensate them for losses caused by exogenous influences. The InterCity West Coast fiasco concerned precisely the issue of risk, with the main problems relating to flawed modelling and bias in the setting of subordinated loan facilities for bidders designed to reduce the risk of their default. However, financial aspects of risk are never clearly defined in franchises. Whilst there may be an issue concerning over-specification of service levels which hamper innovation, financial aspects of risk should always be clearly specified (within the bounds of confidentiality).

The consequences of poor risk management are seen in instances of contract termination and renegotiation. For example, in 2003 the Connex South East franchise was terminated after a shortfall had been covered up because of a failure to reach cost reduction targets. In 2006 a financial crisis in the parent company led to the premature end of the East Coast franchise, and the successor operator surrendered the franchise prematurely once more in 2009, services being operated successfully by a public sector operator of last resort until it was refranchised in 2015. In 2011 First Great Western indicated that it wished to take advantage of a contractual break clause to terminate its franchise early after substantial losses due to a decline in passenger numbers; it continues to operate the franchise under a renegotiated direct award with most revenue risk borne by the government.⁴⁰ The use of mechanisms such as break clauses to justify the case for contract renegotiation or a direct award in order to recalibrate risk is unlikely to instil trust and undermines the importance of consistent performance monitoring and risk assessment as an incentive to improved future performance.

⁴⁰ For an assessment of these events see Andrew Bowman et al, *The Great Train Robbery: Rail Privatisation and After* (Manchester: Centre for Research on Socio-Cultural Change, 2013), ch. 5.

It brings into question how accurate the assumptions underpinning risk allocation were at the outset as well as whether risk can be effectively managed in the long-term business relation; it appears that such mechanisms have been used to deal with generally foreseeable issues rather than exceptionally unforeseeable events beyond the control of the contracting parties.

The Brown Report on the future of franchising recommended that revised risk sharing arrangements be adopted with the Government retaining elements of exogenous revenue risks, for example those related to fluctuations in GDP, and this has been the approach adopted in more recent franchises. Management contracts with the Department bearing such risks have also been adopted for some direct awards where disruption is caused by infrastructure work; this is most notably the case for the Govia Thameslink Railway (GTR) management contract covering Southern services, the largest of all franchises. This has not been successful; the GTR contract has been plagued by disruption caused by a combination of major infrastructure work and industrial action. It has been suggested that the management contract limits the incentives on the operator to settle disputes, although the contract also contains a system of penalties which could be used by the government, a point to which we shall return below. Overall, the Transport Committee has concluded that, in rail franchising in general, although **‘[t]he transfer of financial risk to the private sector was a central premise of rail franchising, ... historically there has been a relatively low level of financial risk from operating a passenger rail franchise.’** However, risk for the private operator may now be increasing due to falling profit margins and the increasing size and complexity of franchises.⁴¹

A different approach has been adopted for areas of urban railway, the London Overground, Crossrail and Merseyrail, in the form of a concession. The use of this term ‘concession’ does

⁴¹ Transport Committee, ‘Rail Franchising’, para. 52 (emphasis retained).

not directly correspond to the concept of a franchise nor to the term as used under EU law and in continental Europe. An order is made by the Secretary of State to exempt the service from the franchising requirement in s.23 of the Railways Act 1993. Instead a transport authority enters into a concession agreement with a service provider (concessionaire) to provide the services. A key difference between a UK concession and traditional franchises and the concession under EU law is that under the concession, there is no transfer of risk. The revenue risk is borne by the public authority issuing the contract, Transport for London and Merseyrail, and these public bodies set fares. In principle, the service specification is to be more detailed than that in a franchise agreement, but in practice, as noted above, franchises in fact contain much greater specification of the details of the services required than was originally intended, thus reducing the formal difference between the two types of contract. The use of concessions so far seems to have worked reasonably well, and we shall return to the subject when we discuss alternatives to franchising below.

Fragmentation

A further very important problem of franchising is fragmentation of the rail industry; this differentiates the UK model of rail privatisation from that adopted in other nations. Fragmentation has created problems of management coordination between Network Rail and service operation, resulting in high costs in the form of increased fares and lack of public support.⁴² Thus the McNulty Report commissioned by the Department into value for money in GB rail found that:

[h]aving multiple industry players, together with misaligned incentives and the existing railway culture, has made it difficult to secure co-operative effort at operational interfaces, or active industry engagement in cross-industry activities...

⁴² 'Rail Franchising', ch. 6.

These effects of fragmentation are exacerbated by misaligned planning and budgeting cycles between the various players and by having, in effect, two separate regulators – in the Office of Rail Regulation (ORR) and the Department for Transport (DfT). The DfT’s role in this respect is largely the enforcement of franchise obligations and fares regulation.⁴³

One example of the serious effects of such a lack of coordination is the failure to manage a coordinated response when engineering works overrun.⁴⁴ There have been several initiatives adopted to try to deal with the deficiencies of coordination through the development of alliances between different actors, including franchise holders. The most developed of these was the ‘Deep Alliance’ between Network Rail and South West Trains. Although both companies retained a separate identity, they were effectively merged for management purposes through the establishment of a single organisation with its own executive and governance board. However, after three years the alliance was ended in this form, partly because of problems of predicting Network Rail costs but mainly because the Department had decided not to make a direct award at the end of the South West Trains franchise but to seek competitive bids for a new franchise. Nevertheless, there may be a continuing role for such alliances after a recent ministerial announcement that some form of alliancing would be required for new franchises, and a small new project would integrate infrastructure and operations on one route.⁴⁵ The Shaw Report on the future of Network Rail proposed a major devolution within Network Rail from the national level to that of regional routes, and a much

⁴³ Department for Transport 2011, *Realising the Potential of GB Rail: Report of the Value for Money Study* (the McNulty Report), (Department for Transport 2011), para. 4.1.

⁴⁴ See e.g. Office of Rail Regulation, *Investigation Report: Disruption Caused by Engineering Overruns on 27 and 28 December 2014 at King’s Cross and Paddington Stations* (ORR, 2015).

⁴⁵ Secretary of State for Transport, ‘Rail Reform: Future of the Rail Network’, HLWS321, 6 December 2016.

closer focus on customer needs, especially those of train operating companies.⁴⁶ This would also facilitate adoption of some form of alliance, but there are severe limits to the potential of alliances in other areas, not least because they are not suitable where there are multiple operators on a Network Rail route.⁴⁷ This issue of how best to minimise the effects of fragmentation is likely to be a major concern in the development of future institutional and regulatory policy relating to rail, and we shall return to it in our recommendations for reform.

Transparency and the franchising process

It thus appears that there have been serious difficulties in balancing competition and flexibility for train operators with regulation to maintain rail's role as a nationwide public service. It will be recalled that the burgeoning literature on the use of contractual modes of governance in the UK has had as one of its major themes the requirement that contracts for public services are also responsive in the sense of complying with public law norms of transparency. This would involve some element of public input in the drawing up of the contracts, especially if they are seen as a means of implementing public interest norms which may be highly contestable. It would also imply that, unlike in the case of ordinary private law contracts, the maximum possible amount of information is made publicly available, including the content of the contracts themselves subject only to deletions for reasons of commercial confidentiality where absolutely necessary. Finally, it would imply that there is a means of monitoring the operation of the contracts which is accessible to interests other than merely the two parties to the contract. It should be emphasised that this is different from the question of whether or not contracts should be awarded by competitive tendering. Such tendering may be an important means of achieving pro-competition goals and value for money and may also

⁴⁶ Department for Transport, *The Future Shape and Financing of Network Rail: The Recommendations* (the Shaw Report), (Department for Transport, 2016).

⁴⁷ Transport Committee, 'Rail Franchising', para. 88.

help to comply with public law norms, but tendering still concentrates on the formation of what are ultimately bilateral relationships between contracting parties. Rail franchising involves broader public interest and public service considerations, and a wide range of different interested parties, including of course passengers, funders and different territorial levels of government.

Rail franchising is more transparent than the previous arrangements under British Rail. Costs were often opaque, the compensation under the Public Service Obligation introduced by the Railways Act 1974 was not broken down in any detail and did not refer to particular groups of services but rather acted as a top-down cash limit, and the internal relations within a unified enterprise (albeit one with marked internal divisions) were not publicly set out or structured.⁴⁸

Invitations to tender for new franchise awards are published on the Department's website, accompanied by a press release. A guide to the franchise process has been published setting out the procedures which the Department will follow in making awards.⁴⁹ However, the lack of transparency in the conduct of tendering processes is evidenced by the InterCity West Coast process and was heavily criticised in the official report into what had gone wrong.⁵⁰ The subsequent Brown review of franchising recommended that an overt and direct weighting be given to quality factors with greater transparency.⁵¹

⁴⁸ For these general problems of nationalised industries see Tony Prosser, *Nationalised Industries and Public Control: Legal, Constitutional and Political Issues* (Oxford: Basil Blackwell, 1986) and for the British Rail Public Service Obligation see Gourvish, *British Rail 1974-97*, 147-9.

⁴⁹ Department for Transport: *Passenger Services Franchise Competition Guide* (2016).

⁵⁰ 'Report of the Laidlaw Inquiry', paras 3.2-3.

⁵¹ Paras 5.24, 5.30.

In terms of devising specifications for the franchise to be tendered, in the case of the 2015 process for the award of the Greater Anglia franchise for example, a three-month consultation was undertaken via use of the Department's website and the distribution of leaflets at stations; five consultation events were held in local towns. The consultation attracted over 1300 responses, and a detailed overview document was published.⁵² However, the consultation questions were relatively narrow, concerning possible individual changes to the current services, and once more the Transport Committee was highly critical.⁵³ By contrast, the Welsh Government (to which franchising will be fully devolved from 2017) adopted a much more wide-ranging and bottom-up approach to developing the specification for the Wales and Borders franchise. It engaged in strategic consultation well before issuing its specification, including asking consultees to identify relevant quality characteristics. This resulted in high-level policy priorities to be used as the basis for competitive dialogue with bidders.⁵⁴ This goes beyond fostering trust between the franchisor and franchisee; it renders more explicit the responsibility of both contracting parties to the public, having placed their trust in both parties to meet expectations. It is also more reflexive; as has been suggested in a different public service context:

⁵² Department for Transport, *Delivering Transformation and Growth for Passengers East Anglia Rail Franchise Stakeholder Briefing Document and Consultation Response* (2015), available at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/481392/east-anglia-stakeholder-briefing.pdf (consulted 12 June 2017).

⁵³ 'Rail Franchising', paras 93-6.

⁵⁴ Welsh Government, *Setting the Direction for Wales and the Borders Rail* (2016), available at:

<http://www.fsb.org.uk/docs/default-source/fsb-org-uk/walesandborders.pdf?sfvrsn=0> (consulted 12 June 2017);

Welsh Government Policy Priorities for Wales and Borders Rail Services and Metro Operator and Development Partner Procurement (2017), available at: <http://gov.wales/docs/det/publications/170301-policy-priorities-en.pdf> (consulted 12 June 2017).

government policy should pay specific attention to the *social learning* dimension of governance in public service sectors ... as distinct from more familiar issues of efficiency, legitimacy and accountability. Such recognition might lead to a better understanding of the relationship between the economic and democratic strategies ... and of the need to avoid undermining the basic collaborative and relational conditions of effective social learning.⁵⁵

In addition to problems of transparency in the franchise procurement process, the Transport Committee has also pointed to a lack of information after the franchise award. Redacted versions of the rail franchises are published and much other information is available on a Department for Transport website.⁵⁶ The previous concession for London Overground was published, as is that for Crossrail and Merseyrail. Detailed financial information is, however, excluded; it was noted above that the complex financial provisions of the agreements are not accompanied by the amount of money involved, which is redacted for reasons of commercial confidentiality. Some information on the financial performance of operators can nevertheless be extracted from the Office of Rail and Road's statistical database.⁵⁷ The franchise agreements contain a standard set of detailed conditions on confidentiality and freedom of information. This makes information supplied by each party confidential, subject to exceptions. The latter include, at the discretion of the Secretary of State, information relating to performance measurement and information required from the Secretary under the Freedom

⁵⁵ Peter Vincent-Jones and Caroline Mullen, 'From Collaborative to Genetic Governance: The Example of healthcare Services in England' in Oliver De Schutter and Jacques Lenoble, *Reflexive Governance: Redefining the Public Interest in a Pluralistic World* (Oxford: Hart Publishing, 2010), 147-78, 176 (emphasis retained).

⁵⁶ See <https://www.gov.uk/government/collections/rail-franchising> (consulted 12 June 2017).

⁵⁷ See e.g. Office of Rail and Road, *Rail Finance: 2014-15 Annual Statistical Release* (2015).

of Information Act. In the latter case disclosure is the responsibility of the Secretary of State, who will also decide on the application of exemptions.⁵⁸

Management of the franchise is also subject, of course, to scrutiny by the National Audit Office, the Public Accounts Committee and the Transport Committee, but this has not always been straightforward. The most striking example of difficulties is the 2016 dispute about extensive train cancellations under the GTR contract. Here it was simply not clear what the role of the government was in determining whether there had been a breach of contractual terms and any remedial steps necessary to address ongoing performance, both of central importance in seeking resolution of the dispute. Civil servants repeatedly failed to clarify to the Transport Committee the nature of the Department's involvement.⁵⁹ A subsequent exchange of letters between the junior minister involved and the Chair of the Committee noted that the latter was 'appalled' at the responses which were 'unacceptably opaque and failed to answer any of these questions adequately.'⁶⁰ In a subsequent report, the Committee concluded that 'despite the Department's consistent claims of a commitment to transparency, our experience would suggest that transparency in franchising monitoring appears to be very poor.'⁶¹ There is thus some transparency in the sense of public availability of information about franchises, but very limited transparency in relations between government and franchise holder after the franchise has been awarded, including both monitoring and changes to the contract.

⁵⁸ See e.g. *Franchise Agreement – InterCity East Coast* sch. 17.

⁵⁹ See Transport Committee, 'Improving the Rail Passenger Experience' HC 64 (2016-17), paras 58-75 and oral evidence qs 316-65.

⁶⁰ Transport Committee, 'Letter from the Chair to Paul Maynard MP...', 23 August 2016.

⁶¹ 'Rail Franchising', para. 115 (emphasis retained).

The above discussion suggests that rail franchising has met with a two-fold failure as a means of responsive contractual government. It has not succeeded in providing a form of regulation which offers flexibility and scope for innovation for operators, nor has it met the goals of increased transparency. Have other systems elsewhere performed better in meeting these objectives?

Overseas experience

In the UK there has been very little use of experience elsewhere as a guide to developing a system which combines a degree of competition for the market with the protection of public service objectives. However, this has been the practice for many years in other European systems. The first example is that of Sweden, which split its rail network into a number of different enterprises even before the UK did so. The second is that of Italy which has a long history of the use of contractual instruments to protect public service goals. It is, of course, necessary to employ international comparative work with caution and some of the major characteristics of the other systems described cannot be duplicated in the UK. As we shall discuss, examples are the incremental approach to liberalisation adopted in Sweden and the role of constitutional provisions as a basis for public service norms (and a public service culture) in Italy. However, it is still possible to draw lessons from the overseas experience described here.

Sweden

The Swedish railway was split in 1988 into two parts; the National Rail Administration, Banverket, was responsible for the infrastructure and was retained in public ownership as a government agency and Statens Järnvägar (SJ) was a separate body responsible for running railway services. The planning and subsidy of regional services was delegated to regional transport authorities and they were given the power (though not the duty) to procure them

through competitive tendering. As early as 1989 a regional contract was awarded to a private company; by 2008 there were nine passenger operators. More recently, inter-regional services have also been opened up to competitive tendering, in this case responsibility for the tendering lying with the infrastructure authority.⁶²

Despite the apparent similarities with the UK, there are important differences. The Swedish network is substantial, but, given the lower population and the relatively small size of Swedish cities, congestion is much less than in the UK, with an intensity of track-usage below the European average.⁶³ Whilst there might appear to be scope for open-access competition, the liberalisation of rail has instead been characterised by the use of competitive tendering for unprofitable services, competition for the market rather than in the market, although, since 2010 the market for profitable services has been opened to competition through open access.

The reasons for the break-up of the Swedish system were also very different from those in the UK. The latter was the culmination of a radical programme of privatisation of public enterprises and contained a strong ideological theme, including a belief that open markets would benefit consumers. By contrast, that in Sweden has been characterised as an ‘unintentional deregulation’; ‘the chain of events should be seen as moves to protect an ailing

⁶² For a summary see Chris Nash, ‘What Does a Best Practice Network Look Like?’ in Matthias Finger and Pierre Messulam, eds., *Rail Economics, Policy and Regulation in Europe* (Cheltenham: Edward Elgar, 2015), 232-47, 240-1. For more detailed treatment see Jan-Eric Nilsson, *Restructuring Sweden’s Railways: The Unintentional Deregulation* (Swedish National Road and Transport Research Institute, 2003); Matthias Finger and Andrea Rosa, *Governance of Competition in the Swiss and European Railway Sector* (Florence: European University Institute, 2012), 84-98 and Gunnar Alexandersson and Staffan Hultén, *Competitive Tendering of Railway Services in Sweden: Extent and Effects 1989-1999* at: http://www.thredbo-conference-series.org/downloads/thredbo6_papers/thredbo6-theme1-Alexandersson-Hulten.pdf (consulted 10 June 2017).

⁶³ Nilsson, *Restructuring Sweden’s Railways*, 5-6.

industry and to hold the cost for procuring unprofitable railway services as low as possible. The use of deregulation to strengthen the consumer perspective has at most been of secondary importance.⁶⁴ This is reflected in the gradual process of liberalisation.

There is also an important difference in the nature of the contracts used for the provision of rail services. In the case of regional services, gross-cost contracts are used by the regional authorities. These are similar to the concessions discussed above according to which authorities carry the risk, pay a specified sum to the operator to provide the services, set the fares and plan the services. The operators bid for the lowest amount of subsidy required to operate these services, although in some cases there are profit-sharing arrangements to stimulate performance and penalties are employed. The contracts are relatively short-term (3-5 years with the possibility of a short extension), and planning is for the regional authorities; the latter also provide the rolling-stock through a jointly-owned leasing company so entry costs are low.⁶⁵ Longer distance services are contracted out by the infrastructure company; in this case net-cost contracts are used with the bidder retaining passenger revenue and estimating any subsidy needed to cover the gap between costs and revenues, and unforeseen deficits cannot be refunded. Bidders have more freedom to shape the services, but they are fixed for the duration of the contract. Evaluation of bids includes a quality element, and there are performance-related payments. Contract duration has been as short as one year but is now normally from three to twelve years with an option for a short extension.⁶⁶

How successful has this system of competitive procurement been? It has been subject to some of the same problems as those in the UK; for example failure to perform by bidders,

⁶⁴ Nilsson, *Restructuring Sweden's Railways*, 4.

⁶⁵ Chris Nash, 'What Does a Best Practice Network Look Like?', 240, 245; Finger and Rosa, *Governance of Competition in the Swiss and European Railway Sector*, 90-91.

⁶⁶ Finger and Rosa, *Governance of Competition in the Swiss and European Railway Sector*, 91.

predatory behaviours by bidders, a scarcity of bidders and reduction in connecting services.⁶⁷ However, it does seem to have been more successful in reducing the cost to the public of the rail system; as mentioned above, this, rather than increased competition to benefit the consumer, was the major justification for the reforms of the Swedish rail system. Thus, whilst support from the state has grown in proportion to passenger traffic, this has been in the form of support for infrastructure investment rather than operating subsidies, and it has been suggested that the increased costs of vertical separation have been more than offset by the savings from competitive tendering.⁶⁸ This is in marked contrast to the UK where the costs of the rail system have substantially increased since privatisation and fragmentation, and are now double in real terms the levels of 1985-86.⁶⁹ Indeed, Sweden was one of the comparator nations used in the benchmarking exercise carried out by the value for money study commissioned by the Department for Transport. It found that GB rail costs would need to be reduced by around 40 percent to meet those of the comparators, and that there was a substantially higher taxpayer subsidy per passenger-kilometre in the UK.⁷⁰

There are two lessons to be drawn from the Swedish experience. The first is that of the central role of regional authorities in both the development of the service requirements and in tendering. The second is that there has been an extensive reliance on gross-cost contracts with risk retained by the public authority; further, at regional level there has not been any attempt at the complex risk sharing arrangements adopted in the UK. The Swedish experience is,

⁶⁷ Finger and Rosa, *Governance of Competition in the Swiss and European Railway Sector*, 92.

⁶⁸ Chris Nash, 'What Does a Best Practice Network Look Like?', 240-1.

⁶⁹ Transport Committee, 'Rail Franchising', para. 44.

⁷⁰ Department for Transport 2011, *Realising the Potential of GB Rail*, 28-32. The report notes that the subsidy figures should not be regarded as indicative because they can be affected by debt write-offs, the treatment of capital expenditure and other factors.

however, less transparent even than that of the UK; the contracts do not seem to be publicly available nor can we find evidence of open procedures in drawing them up. Indeed, an economic study of the types of contract used has complained of the limited amount of information available and the difficulties of obtaining it from some authorities, whilst a potential bidder for contracts has also complained that ‘[v]ery little detail of tender bids is published and with improved quality being such a key element of the evaluation criteria, it is difficult to be specific about the financial and other benefits that competitive tendering has delivered’.⁷¹ There is also no single central repository or standard template for the contracts.

On balance, however, the Swedish arrangements have proved less problematic and have achieved greater legitimacy than those in the UK for three reasons: the extensive role of regional authorities; the limited degree of risk transfer (in contrast to franchises but comparable to concessions in the UK); and the successful reduction in costs through competitive tendering.

Italy

The Italian rail network is extensive, with a similar size to that of the UK. It has invested heavily in new high-speed lines linking Turin, Milan, Rome and Naples with high capacity, but there is also an extensive network of regional and local lines serving small populations and performing an important public service role.⁷² One radical difference from the UK is that

⁷¹ Jan-Eric Nilsson and Lina Johnsson, ‘Lessons from the Tendering of Railway Services in Sweden. Are Some Contracts Better than Others?’, (2011) XXXVIII *International Journal of Transport Economics*, 71-90, 87-90: Arriva, *Liberalisation and Competition in the European Regional Rail Market* (2013), 31, available at: <http://www.arriva.co.uk/~media/Files/A/Arriva-Corporate-V2/press-release/2013/29-10-2013-2.pdf> (consulted 10 June 2017).

⁷² For a brief overview of the Italian system in English see OECD, *Policy Round Tables: Recent Developments in Rail Transportation Services 2013*, 125-33.

constitutional provisions form the background to decisions on managing the rail network. Article 16 of the Constitution provides a right to reside and travel freely and this is treated as constituting a fundamental right to mobility which forms part of the relevant regulatory environment.⁷³ This provides a firm basis for public service requirements. Article 41 provides the basis for a mixed economy with both private and public property, whilst Art. 43 permits the reservation to the state of an enterprise in the field of essential public services.

In 1905 the enterprise Ferrovie dello Stato was established; in 1992 it was transformed into a company in which all shares were held by the state; plans to sell a 40 percent stake have not yet been implemented. In 1993 it was given a seventy-year concession to provide public transport services; this was reduced to 60 years in 2000 in a process which also provided for an internal organisational division between the management of infrastructure and the provision of services over it. Thus the holding company of Ferrovie dello Stato spa [FS] has as subsidiaries Rete Ferrovia Italiana spa [FSI] owning and managing the infrastructure and Trenitalia spa operating the services. This is, of course, not a fragmentation as seen in the UK but a differentiation of subsidiaries under an overall holding company, a model more commonly adopted in Continental Europe to comply with EU requirements for accounting separation. The infrastructure company operates under a sixty year concession conferring exclusive rights and is linked to the state through a programme contract for a minimum of three years setting out investment and state financing. The exclusive right to provide services was replaced by a system of licences to provide rail transport services, the first of which was given to Trenitalia.⁷⁴ The minister is responsible for issuing such licences (which only

⁷³ Giachetti Fantini, 'La liberalizzazione del trasporto ferroviario: l'esperienza italiana nel contest europeo', [2016] 5 *Federalismi.it: Revista Di Diritto Pubblico Italiano, Comparato, Europeo* 2-61, 58-9.

⁷⁴ Fantini, 'La liberalizzazione del trasporto ferroviario', 19-21.

concern technical issues regarding the right to operate) and the operator must also agree a concession with the infrastructure owner.

The institutional structures for regulation in Italy are also highly complex, involving the Ministry of Infrastructure and Transport, the antitrust authorities and regional and local authorities.⁷⁵ Since the beginning of 2014 an important actor has also been l'Autorità di regolazione dei trasporti [ART], a new independent regulatory commission which is responsible for regulating access to infrastructure, the service regime and passengers' rights across all areas of transport.⁷⁶

Open access competition has been introduced for the high-speed lines and, after initial difficulties, is now a major feature of their operation. The first attempt at such access failed after strong opposition by FS.⁷⁷ The second open-access operator, Nuovo Trasporto Viaggiatori (NTV), competes solely on the high-speed network and was more successful after the Italian antitrust authority had settled its case against the FS Group on terms requiring much more beneficial conditions for access than those originally proposed by the latter.⁷⁸ NTV engages in competition on price and especially on the basis of quality of service at the top end of the market through the purchase of a new fleet of trains and through quality

⁷⁵ For an overview see Alessandro Candido, 'La Governance Dei Trasporti in Italia: Soggetti, Livelli di Governo, Competenze' in Laura Ammannati and Allegra Canepa, eds, *La Politica in Europa: Verso Uno Spazio Unico?* (Torino: G. Giappichelli Editore, 2015), 105-29, 107-22.

⁷⁶ For a summary in English see Carlo Cambini and Luisa Perrotti, 'The New Transport Regulation Authority in Italy: Structure, Competencies and First Regulatory Decisions' (2015) 54 *Network*, 1-6.

⁷⁷ L'Autorità Garante della Concorrenza e del Mercato, A436-Arenaways, provvedimento n. 23770, Bollettino n.30/2012 del 13 agosto 2009.

⁷⁸ A443-NTV/FS, provvedimento n. 24804, Bollettino n.1/2014 del 19 febbraio 2014. For discussion of these decisions see Fantini, 'La liberalizzazione del trasporto ferroviario', 26-31; Candido, 'La Governance Dei Trasporti in Italia...', 122-7.

improvements and has achieved considerable success.⁷⁹ Thus the Italian system has permitted much greater open access competition than the UK.

Public service requirements are also an important part of the regulatory landscape in Italy, reflecting the constitutional norms referred to above. However, there is no agreed single definition of universal service in this context.⁸⁰ This vagueness has been criticised by the antitrust authority as blurring the distinction between competitive and universal services and so making the introduction of competition more difficult.⁸¹ Definition of public service obligations is for the ministry and the regions, now in conjunction with the ART which is also responsible for issuing rules relating to quality standards such as ticketing, passenger information and treatment of delays. The ministry was required by a law of 2007 to conduct an investigation into the balance between costs and receipts of different services, but this has never been made public.⁸² The main responsibility for public service requirements lies with two levels of government. For long- and medium-distance services, these requirements are set out in law and in the public service contract between the state and Trenitalia.⁸³ That applying up to 2016 was a document of 20 pages and is publicly available; it set out general

⁷⁹ See Angela Stefania Bergantino, 'Incumbents and New Entrants' in Finger and Messulam, eds, *Rail Economics, Policy and Regulation in Europe*, 171-209, 196-7.

⁸⁰ Fantini, 'La liberalizzazione del trasporto ferroviario', 33-4.

⁸¹ L'Autorità Garante della Concorrenza e del Mercato, Segnalazione AS453 dell'11 giugno 2008.

⁸² Legge n. 244 del 2007, art. 2, co. 253.

⁸³ Ministero Delle Infrastructure e dei Trasporti, e Ministero Dell'Economia e delle Finanze, *Contratto Relativo ai Servizi di Trasporto Ferroviario Passaggeri di Interesse Nazionale Sottoposti a Regime di Obbligo di Servizio Pubblico per il Periodo 2009-2014*. This contract was extended to the end of 2016; from 2017 a new ten-year contract has been drawn up, though it is not yet publicly available; see FS, *Firmato un nuovo contratto di servizio Intercity per i prossimi 10 anni* at <http://www.fsnews.it/fsn/Sala-stampa/Cartelle-stampa/Firmato-nuovo-contratto-di-servizio-Intercity-per-i-prossimi-10-anni> (consulted 10 June 2017).

obligations for the company, which include the tariffs to be charged; financial penalties are also included for breach of the obligations. It did not, however, include the detailed service prescription characteristic of the UK franchises; services were based on the existing Trenitalia patterns. Similarly, the new ten-year contract from 2017 bases services on existing patterns but with requirements for quality improvements and investment. In the case of regional services, the regions are required by law to approve three-yearly plans for services, which specify the network and the organisation of services, integration with other modes, the resources to be made available, tariffs and the arrangements for monitoring. These are then implemented by means of contracts with operators, with a maximum duration of six years, renewable once, specifying service standards and tariff structures in detail.⁸⁴ For example, the contract between the Lazio region, which includes Rome, and Trenitalia is forty-one pages long, and sets out the public service compensation to be paid, requirements for investment in specified types of rolling stock, tariffs to be charged and penalties for breach. Services are based on Trenitalia's existing ones, though further documents may specify services required. Such documents are very brief compared to UK franchises; for example, the specification in the contract for Piemonte runs to only thirteen pages.⁸⁵ In both national and regional contracts revenue risk is borne by the public authority; thus in the new Intercity contract, tariffs for public service provision and the compensation awarded to the operator are determined directly by the state with penalties and incentives based on operating performance.

⁸⁴ Candido, 'La Governance Dei Trasporti in Italia...' 119-20.

⁸⁵ Regione Lazio, *Contratto di Servizio per il Trasporto Pubblico Ferroviario di Interesse Regionale e Locale per gli Anni 2009-2014*; Agenzia della Mobilità Piemontese, *Contratto di Servizio Per il Trasporto Pubblico Foeerroviano Di Interesse Regionale e Locale, Anno 2011-16, Allegato 1*.

In principle regional contracts were to be awarded by competitive tendering since 1999, but the legal position is complex and the requirement of such tendering has been eroded. Indeed, funding has often been made conditional on the services being provided by Trenitalia, the incumbent operator. This has been criticised by the antitrust authority but in 2012 a new law which required the adoption of competitive tendering for local services was held to be unconstitutional by the Constitutional Court as infringing the rights of regions, and so it remained possible to use direct procurement.⁸⁶ Nevertheless, several regions have decided to proceed by competitive tendering.⁸⁷ The ART has now been given the responsibility for defining the principles on which competitive tendering should be based, and issued a set of rules for this in 2015. This includes rules relating to the award procedure, for example on transparency and avoiding conflicts of interest, and rules relating to passenger service standards in order to achieve uniform standards throughout the regions; these latter also apply to directly-awarded contracts.⁸⁸

Transparency is limited. Most of the contracts are publicly available (though important annexes may not be) but there is no central repository or standard set of procedures for drawing them up. *Ex ante* scrutiny is very restricted. There is some consultation before regions develop their transport plans but these are only with a very limited number of organisations. The Lazio contract requires that its renewal should take place through a public procedure.⁸⁹ However, the type of bottom-up consultation used by the Welsh Government as discussed above was described by our Italian collaborator as ‘science fiction for Italy’.

⁸⁶ Corte Costituzionale, sentenza n. 199 del 2012.

⁸⁷ The complex legal provisions are summarised at Fantini, ‘La liberalizzazione del trasporto ferroviario’, 36-7.

⁸⁸ Candido, ‘La Governance Dei Trasporti in Italia...’ 126.

⁸⁹ Artl 4(2).

Instead, there is some use of legal challenges in the courts but only after decisions have been taken. These have generally been unsuccessful.⁹⁰

This complex picture raises a number of important issues which are relevant to the UK; once more, there is an apparent paradox between a system characterised by limited transparency but which appears to work reasonably smoothly avoiding the serious legitimacy problems in the UK. However as in Sweden, the regions have a major role in determining public service in Italian railways. This is part of a more recent trend towards regionalisation of the management and regulation of railways in Europe; thus a comparative study of the governance of competition in rail found that regionalisation was a major characteristic of all six countries studied, with the exception of the UK. It concluded that such regionalisation had produced satisfactory results.⁹¹

The second key point is that there is a well-established system of contracts setting out public service requirements. These have been criticised for their vagueness, but they have avoided the highly complex and detailed specifications characteristic of UK franchise agreements. This is in part because of the availability of a single dominant operator with whom long-term relations can be built up. In addition, revenue risk is borne by the public authorities so there is no need for complex formulae to allocate risk. Together, these factors appear to have avoided the serious lack of trust so characteristic of the UK, especially given the rooting of public service norms in constitutional requirements.

The future

⁹⁰ See e.g. Tribunale Amministrativo Regionale per il Lazio, Sezione Terza Ter, sentenze n.11301 del 2005, n. 01972 del 2012.

⁹¹ Finger and Rosa, *Governance of Competition in the Swiss and European Railway Sector*, 136.

The different cultures and background in Sweden and Italy might seem to make it very difficult to draw lessons for the UK. However, we would suggest that this overseas experience can feed into a number of possible scenarios for change in the provision of passenger rail services.

More competition?

One criticism of franchising is that it is anti-competitive as it severely restricts competition in the market place for the provision of rail services, and so it should be supplemented or replaced by the entry of competing providers. This is the view presented by the Competition and Markets Authority in its 2016 report on Competition in Passenger Rail Services.⁹² The Commission presents four possible options for increasing competition; they are, first, a significantly increased role for open access operators operating alongside the franchised companies; second, splitting franchises between two successful bidders; third, redrawing the franchise map to increase overlaps providing competition on particular traffic flows, and, fourth, replacing franchising with a licensing regime permitting multiple operators to serve the same routes. Its preferred options are the first and the fourth. Both would require major changes; for example, the first would require a substantial increase in track access charges for open access operators, who currently pay only the marginal costs of running their services without contributing to fixed infrastructure costs, and the funding of public service obligations through universal service levy or similar mechanism to avoid cream-skimming by new entrants.⁹³ The fourth option would involve the requirement to provide socially necessary services through licence conditions, which themselves could be made tradeable.⁹⁴

⁹² *Competition in Passenger Rail Services in Great Britain ...* (2016).

⁹³ *Ibid.*, para. 6.18.

⁹⁴ *Ibid.*, para. 6.54.

It is highly unlikely that these reforms will replace the franchising system. First, the report makes it clear that they are not appropriate for the whole of the rail network, but rather for the three main intercity routes: the East Coast Main Line, the West Coast Main Line and the Great Western routes, with the possible addition of the Midland Main Line. Some system such as franchising would need to be maintained for the rest of the network. Second, the heavily used nature of the UK rail network, particularly in the case of these lines, would be likely to cause capacity problems which would limit the scope for new entry. The Authority considers that this is solvable through improved incentives and new technology, but this remains untested. It is striking that in Italy open access has been used successfully only for the recently constructed high speed lines which have much higher capacity than the conventional network. In the UK HS2 would appear to be the most suitable candidate for such competition, but this is only referred to briefly by the Authority in view of uncertainties, for example the impact of open-access competition on the HS2 business case.⁹⁵ The Department for Transport has now announced that HS2 will initially take the form of an integrated franchise with InterCity West Coast and there will be a single operator.⁹⁶ Third, the Authority's proposals will do nothing to minimise the problems of fragmentation of the railway system; indeed, they are likely to make it worse with a proliferation of different operators. Moreover, increased open access would also complicate even more the already highly-complex fares system which has been heavily criticised in passenger surveys.⁹⁷ Finally, whilst operators facing increased competition may be incentivised to better

⁹⁵ Ibid., paras 6.12-14.

⁹⁶ *Rail Franchising: InterCity West Coast and HS2*, HCWS236, 4 November 2016.

⁹⁷ See e.g. Passenger Focus, *Passenger Focus Response to the Government's Rail Fares and Ticketing Review* (2012) available at:

<file:///C:/Users/lwjawp/Chrome%20Local%20Downloads/Passenger%20Focus%20response%20to%20the%20rail%20fares%20and%20ticketing%20review%20-%20June%202012.pdf> (consulted 10 June 2017).

performance, it is equally likely that even more regular and diverse competitions could also compromise the trust of existing operators that are used to competition but who believe in the core rationale of competition *for* the market, namely the limitation of the market to a community of trusted providers tasked with exercising exclusive rights.

A return to public ownership?

With the re-classification of Network Rail as a public body by the Office for National Statistics in 2014 and related changes to its borrowing arrangements, the core of the rail system is now in public ownership, and the Shaw Report on the future of Network Rail has made it clear that wholesale privatisation is not a current option.⁹⁸ One possibility for the future would be to take this process further by taking the franchises back in to public hands as they expire, possibly using the model adopted temporarily for the East Coast main line franchise through use of a public sector operator. This is the policy of the opposition Labour party and the trade unions, and from polling evidence seems to have public support; it also has its academic advocates; further, as mentioned above, there is already extensive participation in the operation of services by publicly-owned overseas companies.⁹⁹ It would permit administrative coordination of a unified rail network and could avoid the need for the use of formal contractual arrangements, although internal ‘administrative’ contracts would still be needed. It would resemble the use of such coordination in the last years of British Rail, when it was split into business sectors creating greater transparency within the overall enterprise.¹⁰⁰ It would also be closer to the Italian model which, as we have seen, appears to have avoided many of the serious problems experienced in the UK.

⁹⁸ Department for Transport, *The Future Shape and Financing of Network Rail*.

⁹⁹ See e.g. Bowman et al., *The Great Train Robbery...*, 152-66.

¹⁰⁰ Gourvish, *British Rail 19745-97*, ch. 4.

However, it is unlikely that it will be possible to return to the old days of British Rail even if this were desirable. There are doubts as to the government's capacity to undertake the task; the public sector operator of last resort was wound up in 2015 and replaced by a public-private partnership.¹⁰¹ Further, EU law also requires a much clearer identification of state aid for public service requirements than was the case with the old British Rail public service obligations. The EU Public Services Obligation Regulation provides that exclusive rights and/or compensation must be allocated through the use of public service contracts, with a maximum of fifteen years duration (this can be extended where there are special investment needs);¹⁰² however, the general principles of EU law require that public service compensation be clearly identified and costed in advance as a result of the *Altmark* case in 2003.¹⁰³ As the experience of other European countries shows, this in no way precludes public ownership, and of course the future effect of EU provisions in the UK is uncertain after Brexit; however, any publicly owned system would still most likely be dependent on the use of contracts to show the transparent use of public funds (as in the Italian case). This may be highly desirable on accountability grounds but limits the possibility of simple reliance on administrative coordination. In any event, any return to public ownership would still need to address the concerns raised in this article, and we shall now suggest how this could be done either with such ownership or with the retention of private operators.

Regionalisation and concessions?

There is another future possibility which will retain the use of contractual relations but in a rather different form through the devolution of the rail network with greater involvement of

¹⁰¹ See Transport Committee, 'The Future of Rail: Improving the Rail Passenger Experience', paras 76-82.

¹⁰² Regulation (EC) No 1370/2007 of the European Parliament and of the Council of 23 October 2007, [2007] OJ L315/1.

¹⁰³ *Altmark Trans GmbH* (Case C-2800/00) [2003] ECR I-7747.

local government. Already, the national governments in Scotland and Wales play a major role in the rail franchising process. An unexpected development since the 2015 election has been the rapid movement towards the creation of city regions under the Cities and Local Government Devolution Act 2016, effectively a regional tier of government, and also a move towards larger administrative entities outside the cities. These are most advanced in the north of England, where in March 2015 management of two franchises was delegated to Rail North, a consortium of local authorities acting in partnership with the Department; these will become part of the Transport for the North partnership when the latter gains statutory recognition under the Act. As noted above, this reflects a more general trend in European rail towards greater regionalisation; in both Sweden and Italy regional authorities play a major role in tendering and in the setting of public service requirements. It also fits with other trends in the organisation of the railways; the Shaw report on the future of Network Rail recommended large-scale devolution to routes which would broadly reflect regional structures, and the possibility of such devolution was also supported in the Brown report.

In the regions, the possibility of open access competition is limited, as regional and commuter services predominate, and are excluded from the recommendations of the Competition and Markets Authority discussed above. They also require particularly strong public service requirements and monitoring, whilst the opportunities for innovation by operating companies are relatively limited. Thus the most appropriate model would seem to be that of a concession of the sort already used for London and Merseyside, with revenue risk carried by the public authority, which also sets fares. This could be combined with the development of deep alliances with routes of a devolved Network Rail (as envisaged in the Department's December 2016 announcement referred to above), the use of concessions avoiding many

uncertainties associated with franchising. Such a solution has been strongly advocated by Transport for London based on its own experience of using concessions.¹⁰⁴

The counter example is that of the GTR referred to briefly above. Though formally a franchise, this is characterised as a management contract. In reality, it is more like a UK concession in that a fee is paid to GTR to cover its operating costs and a small operating margin with revenue risk borne by the Department rather than the operator; however, unlike London and Merseyside, this contract is managed centrally rather than through locally accountable transport authorities. In the context of a serious industrial dispute resulting in the wholesale cancellation of trains, a common criticism has been that there has been little incentive on the company to improve performance notwithstanding an apparent incentive regime to meet quality standards on customer experience and performance benchmarks. However, as noted above, the problem seems less to do with the allocation of risk and more to do with a failure to monitor performance properly, to apply remedial measures to rectify performance, to design adequate penalty systems and to the unwillingness of government, which supports the company in the dispute, to trigger and enforce them.¹⁰⁵ Regionalisation could also create the risk of horizontal fragmentation, but this would be much less disruptive than the current vertical fragmentation between infrastructure owner and train operator.

This leaves the inter-city services which would not be appropriate for regionalisation. There are several possibilities here. One is to increase significantly the opportunities for competition, as proposed by the Competition and Markets Authority report discussed above, though we are doubtful whether this would work for the reasons set out earlier. Another would be to retain the system of franchising for them. A third would be to replace franchises

¹⁰⁴ Transport Committee, 'Rail Franchising', Written Evidence Submitted by Transport for London (RFG0025) (2016).

¹⁰⁵ Transport Committee, 'Improving the Rail Passenger Experience' HC 64 (2016), paras 32-4, 58-75.

with concessions, potentially awarded to public or private bodies, thus moving closer to the arrangements in the other European countries we have discussed and avoiding the absurdity of permitting public enterprises from outside the UK to bid whilst prohibiting UK-based ones from doing so. Such a role for concessions was considered and rejected by the Brown report on grounds that this would require a body other than the franchise holder to be able to market and sell tickets and that leaving the revenue risk with the franchisee has provided powerful incentives to grow revenue and patronage.¹⁰⁶ However, we have seen a move towards short-term franchises with limited revenue risk for operators anyway in recent years, and the detailed specification of franchise terms means that recent franchises are in practice not that different from concessions. This model might also provide a means of avoiding the serious problems of risk allocation experienced in the past. It corresponds with what we have found in our overseas comparisons; a similar set of proposals has also been made recently by Roger Ford, a leading UK railway journalist. He concludes that ‘the franchising experiment has run its course’, partly because it does not reward long-term commitment to investment and improvement of services and partly because of the vagaries of risk transfer. Stability favours instead management contracts or concessions with the risk retained by government, negotiated as extensions to existing franchises where they have been competently run.¹⁰⁷ Such a model would also permit the development of longer concessions, with break points (used for periodic monitoring, not for recalibrating risk), providing a more stable framework for operators. Again, longer-term contracts may lead to greater trust between the contracting parties over time as contracts become more like collaborative partnerships. Interestingly, in the West Coast partnership franchise for the initial services on HS2 and for those on the West Coast Main Line, once HS2 services are launched, revenue and operating costs will not be

¹⁰⁶ Department for Transport, *The Brown Review of the Rail Franchising Programme* (2012), para. 4.41.

¹⁰⁷ ‘What Next for the Passenger Railway?’ (2016).

transferred to the franchise holder and instead there will be a performance-based management contract with incentive mechanisms.¹⁰⁸

Conclusion

Due to a rail privatisation perceived as threatening uneconomic but socially-desirable services, and the continued unpopularity (and often low quality service) of the privatised operators, the UK rail environment has been characterised by extremely low trust. Flexible use of franchise contracts which gives operators space for responsiveness and innovation has simply not proved possible. Instead there has been a crude form of regulation characterised by the highly complex and over-prescriptive franchise agreements, coupled with ambiguity on the centrally important issue of risk transfer. Such attempts as there have been to build trust by increased transparency have not succeeded, especially as transparency in relation to the operation and monitoring of the contracts is very restricted, as is shown strongly by the GTR fiasco. By contrast, it was made clear to us that in Italy the existence of an established dominant operator created relationships which were characterised by a higher degree of trust, something also reinforced by a strong public service tradition and indirectly by underlying constitutional norms.¹⁰⁹ This is what explains the different forms of governance of public service in rail transport in the two nations. In Sweden the major role for the regions and a different approach to risk, in which revenue risk is borne by regional authorities, also seems to have produced a much more stable system. These successes result notwithstanding less transparency than in the UK.

¹⁰⁸ Department for Transport, *The West Coast Partnership: The Route to High Speed Rail* (2017), 27

¹⁰⁹ For an interesting comparison of the UK, Germany and Sweden in this context see Chris Nash, Jan-Eric Nilsson and Heike Link, *Comparing Three Models for Introduction of Competition into Railways – is a Bad Wolf so Bad After All?*, CTS Working Paper 2011:19, (Stockholm: Centre for Transport Studies).

The changes we have proposed on the basis of study of other systems, in particular regionalisation, the assumption of greater risk by public authorities and a more stable set of concessions, may provide a means by which the UK system can move away from highly detailed and prescriptive, low-trust norms towards a more collaborative and responsive mode of governance for our rail services over time. The usual argument deployed against this is that our proposed changes would restrict opportunities for innovation and a flexible response to changing customer demand by operators.¹¹⁰ However, in the UK the opportunities for innovation and flexibility have always been limited. At the point of privatisation it was considered necessary for franchises to be stipulative to compensate for lack of trust and uncertainty in market pressure; whilst better performance monitoring over the years should have engendered trust and reduced prescription, the trend towards over-stipulation continues without flexibility or innovation. Uncertainty in franchising policy and recurring issues with existing franchises suggest that, whilst there remains a need for control in the continuing absence of trust, concession-style agreements may continue to offer that control but in the form of more adaptable contractual techniques that are better equipped to deal with economic and other uncertainty and the prevalence of devolution in all its forms.

More clearly defined allocations of risk, more broadly informed specifications and well-planned systems of performance monitoring, may shift the balance away from what has been characteristic of rail franchises, namely misplaced exercises of public control through excessively specified contracts on issues of quality and over-reliance on the threat of penalties as a poor substitute for effective contract management. Concessions may do more than create stability and incentivise compliance with a contract in the short term. Concessions may lead contracting parties to think about contracts for rail services as opportunities for the development of long-term business relations that look beyond short-termism to strategic

¹¹⁰ See Baldwin, Cave and Lodge, *Understanding Regulation*, 176, 192.

partnerships for the longer-term. The latter may even lead to innovation of the kind franchising has failed to provide. As Collins has observed: ‘reliable assurance of quality in performance depends ultimately not on contract terms but on trust and non-legal sanctions. Relations of trust and powerful non-legal sanctions depend upon the establishment of long-term business relations and the confinement of competition to a known and trusted “procurement community” of contractors.’¹¹¹ It is evident both that reform is sorely needed to build trust and that study of other systems can contribute to it.

¹¹¹ *Regulating Contracts* (1999) 314-315 citing at fn. 13 Colin Turpin. *Government Procurement and Contracts* (Harlow: Longman 1989) 259.