

Franchising process and the role of the Government

Introduction

1. This appendix describes the franchising process and the role of the Government in the market for the leasing of rolling stock.
2. We consider the following:
 - the rail franchising process;
 - the franchise framework (including franchise length, end dates and agreements);
 - the Government's section 30 duty;
 - the use of options and call options in direct agreements between the Government and the ROSCOs;
 - the DfT's ability to approve leases between ROSCOs and TOCs;
 - the specification of franchise ITTs; and
 - the use of section 54 undertakings.

A short history of the departments responsible for franchising

3. When the rail industry was privatized, the Railways Act 1993 (RA93) established two new bodies to regulate and administer the new structure: the Rail Regulator (now the ORR) and the Franchising Director (head of OPRAF). OPRAF was responsible for negotiating, awarding and monitoring franchises granted to TOCs and agreeing the maximum level of regulated fares that they could charge. OPRAF was succeeded in 2001 by the SRA, following a period from 1999 to 2001 in which OPRAF operated as the shadow SRA.
4. As a result of the White Paper *The Future of Rail*, published in July 2004, which reviewed the structure of the rail industry, a number of further changes were made to the role of Government. This review led to the Railways Act 2005 (RA05), which abolished the SRA. In July 2005 its functions were transferred to the Secretary of State for Transport (the Secretary of State),¹ who is now responsible for specifying and awarding franchises to TOCs to run passenger rail services in England and Wales and intercity services to and from Scotland.

Scotland

5. Under RA05, Scottish Ministers take sole responsibility for securing future ScotRail franchises and manage and monitor the performance of ScotRail services. In January 2006, Transport Scotland became the national transport agency for Scotland, with responsibility for the majority of rail powers in Scotland. Safety and the

¹In this appendix where reference is made to the Secretary of State's statutory functions, where relevant such functions also apply to Scottish Ministers for the ScotRail franchise.

licensing of railway operators remained reserved to UK ministers discharged through the ORR.

Wales

6. RA05 also made provision for the National Assembly for Wales to be a joint signatory with the Secretary of State to the Wales and Borders franchise for train services operating within Wales. As co-signatory, the Welsh Assembly, through Transport Wales, is responsible for the financial and performance management of passenger services and any enhancements to them.

Role of the Secretary of State

7. The Secretary of State is the minister in charge of the DfT.² Within the DfT responsibility for railways is with the 'Rail and National Networks Group'. Its objectives are to:
 - ensure delivery of improved operational and financial performance, and safety, by the railway;
 - secure appropriate rail passenger services at an acceptable price through effective specification and procurement;
 - develop and deliver a robust, affordable and sustainable strategy for the development of the railway that supports wider transport objectives; and
 - ensure the cost-effective and timely delivery of major rail projects.
8. The Secretary of State has a statutory duty to ensure the continuity of rail passenger services under section 30 of RA93.³ In carrying out this duty the Government is often referred to as the 'operator of last resort'. The DfT also has a role in rolling stock deployment, both strategically in the development of franchises and through the specification of franchises. The DfT also aims to deliver value for money for the taxpayer.
9. In accordance with RA05, the Secretary of State sets the strategy and budget for the railways. Once every five years the Secretary of State must set out the rail improvements he or she wants to secure for the coming five-year period. The Secretary of State must clearly specify what the Government wishes the railway to deliver and how it expects this to be funded. The improvements the Government wishes to see are outlined in a High Level Output Specification (HLOS),⁴ the first of which was published with the budget (Statement of Available Funds) in July 2007.⁵ Alongside these papers the DfT published a White Paper *Delivering a Sustainable Railway* which set out the long-term strategic direction for the railway with regard to increasing the capacity, delivering a quality service for passengers, and fulfilling the environmental potential of the railways.

²In this appendix where reference is made to the DfT's role, where relevant, Transport Scotland has a similar role for the ScotRail franchise.

³We discuss the Government's section 30 duty in paragraphs 32 to 52.

⁴We discuss the HLOS and the DfT's rolling stock plan in Section 2 of the main report.

⁵These documents inform the periodic review of Network Rail's outputs and access charges conducted by the ORR, the determination of which was published in October 2008.

Rail franchising process

10. This section outlines the current franchising process and how the process has changed since its inception.

Background

11. Under section 26 RA93 the Secretary of State selects the person to provide rail passenger services under a franchise agreement. Under the franchising regime, the DfT awards a franchise by competitive tender. The successful franchisee operates specified passenger services for a specific period of time. The DfT determines the length of the franchises, including start and end dates. We discuss franchise length and end dates in paragraphs 19 to 29 below.
12. The DfT can make changes to the collection of routes in a franchise. This process is referred to as franchise remapping. Twenty-six passenger franchises were created at privatization and, as a result of re-mapping, as at the end of 2008 there were 17 franchises and two concessions (Merseyrail and London Overground).⁶

Overview of the franchising process

13. The DfT manages the franchising process. This process has a number of key stages, which are:
 - (a) *Prequalification*: The DfT publishes a Prior Information Notice (PIN) which sets out the anticipated programme for procuring a specific franchise. The DfT then publishes an advertisement in domestic, European and international journals and the specialized press. Interested parties are invited to fill in a pre-qualification questionnaire. Finally, the DfT selects three to five bidders for the next stage.⁷
 - (b) *Invitation to tender (ITT)*: Each short-listed bidder receives a franchise ITT, which is simultaneously published on the DfT's website, redacted where necessary to protect the DfT's commercial negotiating position. An ITT includes a base service specification. The DfT told us that it considers the benefits of different rolling stock options in putting together the base case specification for a franchise because it evaluates incumbent rolling stock and new rolling stock on a like-for-like basis and over a common timeframe, which may be longer than the franchise term where appropriate. A franchise bid which does not comply with the base service specification will be rejected as non-compliant.⁸ The ITT may also invite bidders to submit priced options which will cover specified increases or decreases in service levels and the resulting costs or savings. In addition, bidders can develop their own options. Short-listed bidders approach ROSCOs to negotiate rolling stock leases—conditional upon their winning the tender—that will allow them to comply with the ITT.⁹ They then develop their bids and submit them to the DfT for evaluation. We consider the DfT's role in franchise ITT specification in more detail in paragraphs 80 to 113.

⁶The Gatwick Express service was absorbed into the South Central franchise in June 2008.

⁷The DfT stated that 'procurement best practice regards three to five bidders as the optimum to provide adequate competition'. The DfT further added that 'the Department would regard a field of more than five bidders as unlikely because that would add to both suppliers' and the Department's costs, without commensurate benefits in terms of stronger competition'. *A guide to the railway franchise procurement process*, paragraph 5.

⁸Ibid, paragraph 11.

⁹Alternatively, if the ITT specifies new rolling stock, short-listed bidders would at this stage try to find bids and funding for the new rolling stock.

- (c) *Franchise award*: The DfT selects the preferred bidder. The selection of the winning bidder is based purely on the proposition submitted to operate the base service specification. The DfT will only consider acceptance of priced options and alternative options from the preferred bidder.¹⁰ The award criteria are compliance, deliverability¹¹ and value for money. Bids are assessed first on deliverability and then on price, so that the franchise is awarded to the bidder offering the lowest price over the franchise term for a robust delivery of the services and targets in the franchise contract. After the franchise award, the preferred bidder will have to turn its conditional agreements with the ROSCOs and other third parties into binding contracts, bearing in mind that it will be expected to deliver the services for the price that it has committed to in the bid.¹²
- (d) *Start of franchise*: The DfT will monitor the performance of the franchise. The DfT has an obligation to ensure continuity of rail passenger services and in the case of franchise failure, it has to act as the operator of last resort. The DfT has put in place a Revenue Support/Revenue Share Mechanism.¹³ This mechanism does not cover changes in costs for which the TOC remains solely responsible.¹⁴

14. In [Annex 3](#) to this appendix we set out a brief history of franchising policy under OPRAF and the SRA, highlighting the differences to the current approach.

Timing of the franchising process

15. The franchising process takes up to two years:
- (a) In the first year, the DfT publishes its PIN, advertises the tender and issues ITTs. The publication of the PIN and the tender advertisement take place within the first six months. It takes six more months for the DfT to issue ITTs and to select TOCs for the bidding stage.
- (b) In the second year, selected TOCs prepare and submit their bids to the DfT over a period of about three months; the DfT then chooses its preferred bidder and the preferred bidder has around three to four months to finalize its contractual arrangements with ROSCOs and mobilize resources.
16. The franchises commence approximately one year from the issue of the ITT and two years from the initiation of the franchising project.
17. Two TOCs suggested to us that a lack of time in the franchising process means that TOCs might be impaired in their ability to develop a range of alternative proposals to meet either the base case specification or any variants of it and to negotiate over these proposals.
18. We reviewed bid submissions to identify cases where TOCs have stated that the franchise timescales have affected their choice of rolling stock. We only found a small number of examples, including on the Northern franchise where Serco developed two new DMU options to replace all existing DMUs but was unable to

¹⁰A *guide to the railway franchise procurement process*, paragraph 23.

¹¹In assessing deliverability the DfT told us that this examined the extent to which bidders were able to deliver the specified services for the whole life of the franchise such that it minimized the risk that the DfT would have to intervene to ensure continuity of services.

¹²A *guide to the railway franchise procurement process*, paragraph 24.

¹³The Revenue Support/Revenue Share Mechanism is explained in Section 2 of the main report.

¹⁴The TOC remains solely responsible for costs unless a change in a particular cost item is a Qualifying Change in terms of Schedule 9 of the franchise agreement.

propose it as a base case because it was ‘unable to develop the proposal in sufficient detail and obtain sufficient certainty within the time available’.

The franchise framework

Franchise length

19. Current franchises typically run for seven years with an option for the DfT to extend the franchise for another two to three years depending on the franchisee meeting performance targets. However, policy on franchise length has varied since privatization (see [Annex 3](#) to this appendix) and several longer franchises have been agreed at various points in the past (for example, Virgin West Coast and Chiltern). These longer franchises have tended to be linked to commitments to service improvements—either through new rolling stock or, in the case of Chiltern, infrastructure enhancements.
20. We examined these longer franchises to see if they provided evidence that franchise length affected the incentives and ability of TOCs to propose alternative used or new rolling stock.
21. Table 1 comments on the rolling stock proposed on those franchises agreed at privatization which originally had longer terms.¹⁵

TABLE 1 Rolling stock introduced on original longer franchises

<i>Franchise</i>	<i>Franchise length (years)</i>	<i>Rolling stock proposals</i>
West Coast	15	Bidders were asked to bid for two franchise options, each requiring significant investment, and lasting 15 years. Virgin won the franchise with new Pendolino rolling stock to be introduced as part of a comprehensive package for upgrading the West Coast Main Line. The introduction of the tilting Pendolino trains was heavily dependent on infrastructure upgrades. The DfT told us that the introduction of this rolling stock was required to replace existing rolling stock, some of which was life expired.
Cross Country	15	The franchise included a commitment to introduce new Voyager rolling stock, which was financed by a non-ROSCO.
Thameside (LTS)	15	The franchise ITT was based on a seven-year franchise. It was originally awarded on a seven-year basis to Enterprise Rail, which was offered a 15-year lease if it committed to replace the existing slam-door trains. When Enterprise Rail’s bid was disqualified due to ticketing irregularities, the franchise was re-tendered. Prism Rail won the re-tender on the basis of a 15-year franchise and its commitment to acquire new Class 357 trains.
South Eastern	15	The franchise award included a commitment to introduce new rolling stock.
Gatwick Express	15	The Gatwick Express 15-year franchise term was conditional upon replacement of the entire fleet with new rolling stock by mid-1999.

Source: CC analysis.

22. Table 1 shows that new rolling stock was introduced under these longer franchises initially agreed at privatization. Although new rolling stock was also introduced on shorter franchises, some of the longer franchises were awarded conditionally upon new rolling stock being introduced.
23. Following a policy of trying to introduce long-term franchises (of between 10 and 20 years, with termination or renegotiation possible after reviews every five to seven

¹⁵The DfT commented that many of these franchises had been subsequently terminated early or renegotiated.

years), the SRA negotiated with a number of incumbent TOCs in the hope that they would relinquish existing franchises before the end date in return for the opportunity to bid for the longer-term franchise.¹⁶ However, only a small number of franchises were actually relinquished before the end dates and only the Chiltern franchise was agreed (in February 2002) as a new long-term franchise. Table 2 comments on the rolling stock proposed on those franchise re-lets which proposed or agreed longer terms.

TABLE 2 Rolling stock proposals on proposed or agreed longer franchise re-lets

<i>Franchise</i>	<i>Franchise length (years)</i>	<i>Rolling stock proposed</i>
Chiltern*	20	Two bidders were shortlisted (Laing (now DB Regio) and Go-Ahead) for the franchise. Both proposed significant refurbishment to the Class 165 fleet and both proposed new vehicles to meet passenger growth. In its submissions, the DfT told us that both bidders were obliged to plan for the introduction of significant new rolling stock. It stated that new stock was required as the SRA wanted to buy additional capacity and a budget was available. The SRA intended that the franchise agreement should run for 20 years subject to the investments being agreed. Chiltern told us that it had only been able to make such investments because of its 20-year franchise term.
Wales and Borders†	15	The franchise ITT stated that 'the Authority does not expect to see new rolling stock to replace existing trains as part of the baseline proposal'. No bidders formally proposed new rolling stock although Connex was considering new rolling stock options. Over 80 per cent of the incumbent rolling stock was leased on a long-term basis.
South Central‡§	20	Following bidders' inability to deliver the proposed longer franchise, reworked proposals for a shorter franchise did not include the electrification of the Uckfield line. The winning bidder, Govia, ordered new Class 171 Turbostars to replace the Mark I Class 205/207s. No other rolling stock proposals were materially affected.
South Western¶¶	20	When the proposed franchise term was shortened from 20 years (as provided for in the original agreement) to 4 years, the main difference to the composition of rolling stock in initial bids was that fewer new Class 444/450 vehicles introduced and retention of all the Class 159/170 rather than replacing part of this fleet. No other rolling stock proposals were materially affected. However, Angel told us that when the franchise was shortened, a 20-year lease had already been agreed on the Class 444/450s. [X]

Source: CC analysis.

*Although the Chiltern franchise is 20 years long, it is dependent on the DfT and Chiltern agreeing infrastructure investments. If they fail to agree, then it may be reduced to the current minimum franchise term (making it 12 years plus 8 years).

†This franchise is 15 years long but has five-yearly performance review assessments.

‡These franchises were both shortened following failure to negotiate the proposed longer franchise. The assessment in the table is made on the basis of the difference between rolling stock proposals for the proposed longer franchise and the agreed shorter franchise.

§Govia was announced as preferred bidder for the South Central franchise in October 2000 for a 20-year franchise but in August 2002 a (less than) nine-year franchise was agreed. As part of the change, the SRA was to lead the substantial programme of track and signalling improvements instead of the TOC. The TOC was to be responsible for delivering the trains, station upgrades and information systems. At the time, the SRA stated that 'taken together, these elements will deliver substantially the same benefits as those originally planned for the 20-year franchise'.

¶¶Stagecoach signed heads of terms for a 20-year South Western franchise in March 2001 but a short-term franchise of only four years (one-year extension plus three years to 2007) was agreed in November 2002. This franchise originally contained a provision for shortening the term from 20 to 15 years if certain capacity schemes were not implemented.

24. Table 2 shows that the long 20-year franchise, linked to infrastructure improvement, was an important factor in the introduction of new rolling stock on the Chiltern franchise. The Wales and Borders franchise had no new rolling stock proposed, in part due to the criteria laid down in the franchise ITT. In terms of the two proposed long franchises which were ultimately shortened (South Central and South Western),

¹⁶We discuss these policy changes in more detail in [Annex 3](#) to this appendix.

it is not clear that the shorter franchise lengths in either case led to significant changes in the rolling stock proposed. This is partly because both franchises contained large quantities of Mark I rolling stock that had to be replaced with new rolling stock in any event because of safety requirements.¹⁷

25. Our assessment shows that past experience of longer franchises provides some indication of the relationship between longer franchise terms and the incentives for introducing new rolling stock, with the relationship appearing to be clearest in the case of the West Coast and Cross Country franchises. We recognize that these franchises were awarded in different circumstances from the present and other factors often played a role in rolling stock decisions. Moreover, new rolling stock has also been introduced on shorter franchises. Past experience can therefore only serve as a limited guide to the impact of longer franchises.
26. We asked the TOCs whether franchise length imposed a constraint on the rolling stock they had offered in franchise re-lets.¹⁸ These responses suggested that shorter franchises generally made it more difficult to make a competitive financial case for alternative used or new rolling stock in a franchise bid:
 - (a) Arriva submitted that the South Western, East Midlands, New Cross Country and Intercity East Coast franchises were all of insufficient length for its new rolling stock options to show a positive financial case compared with incumbent or alternative used rolling stock. Arriva noted that for higher-earning services (eg Intercity or outer-London commuting), a positive financial case is more likely to arise over 15 years.
 - (b) Stagecoach submitted that considering alternative used or new rolling stock on the four-year Thameslink franchise would have been 'a waste of time'. It added that, absent a section 54 undertaking, it would need a minimum of a ten-year franchise length for new rolling stock (with 15 years on larger franchises with larger fleets). For large fleets of alternative used rolling stock, it considered that a minimum franchise length of seven years was required.
 - (c) Govia submitted that when it was bidding for the West Midlands franchise, it did not initially think that new rolling stock was a viable alternative for the incumbent Class 321 and Class 150 units. Although it was able to put forward a new rolling stock proposal late in the bidding process, Govia stated that if the franchise length had been longer (say ten years), it would have been able to decide that new rolling stock was viable at an earlier stage in the process.
 - (d) First submitted that it was likely that the financing of any new rolling stock solution with a franchise term of less than perhaps 15 to 20 years would require section 54 undertakings from the DfT in order to be viable.
 - (e) Chiltern stated that it had chosen not to bid for franchises where the franchise length would prevent it from undertaking investment plans which it thought necessary.

Timing of franchise start and end dates

27. The DfT sets franchise start and end dates. The DfT aims to stagger its franchise re-lets so as to let one to three franchises per year. It is therefore relatively unusual for

¹⁷For example, more than half of the vehicles on the South Western franchise were Mark I rolling stock.

¹⁸Franchise bids did not comment on whether the franchise length was too short or long to introduce alternative rolling stock.

franchises to be coterminous, although the November 2007 East Midlands, West Midlands and the New Cross Country franchise lettings ('the Midlands Three')¹⁹ ended simultaneously. However, in this case the DfT was re-mapping the franchises.

28. There was some overlap in rolling stock requirements in the Midlands Three franchises in terms of DMUs and high-speed trains. The DfT had a major role as arbiter of rolling stock on these franchises and each bidder had to submit iterations of rolling stock as the DfT worked out which rolling stock was most suitable and best value for each franchise. The multiple claims on trains added to confusion for bidders and resulted in the DfT having to allocate certain rolling stock to particular franchises, once those franchises had been awarded.²⁰ As we set out in paragraph 78, the DfT also had to make a number of interventions in order to allocate rolling stock and this had effects on other franchises. Although we found that lease rentals for certain rolling stock fell on the Midlands Three franchises, this appeared to be more related to the surplus of that type of rolling stock than to the cotermination of the franchises.
29. In addition to the need to resolve competing demand for rolling stock, the DfT also told us that, based on its experience of the Midlands Three, no more than two or three simultaneous franchise competitions are 'manageable' from the perspective of industry resources.

The Franchise Agreement

30. The Secretary of State and the TOC enter into a Franchise Agreement setting out the terms of the franchise.²¹ It is a bespoke agreement containing franchise-specific details, including performance benchmarks, target revenue, revenue-sharing thresholds and details of the rolling stock to operate on that particular franchise at the start, as well as any additional stock to be introduced during the franchise period. The Franchise Agreement also incorporates a standard set of terms that apply to all franchises, called the National Rail Franchise Terms.²²
31. A profile of subsidy/premium payments is agreed for the duration of the franchise. Franchisees under the first round of franchising after privatization had fixed franchise payments (either premium payments or more likely subsidy payments) contractualized into the Franchise Agreement. However, this changed in March 2004 when the revenue share/revenue support mechanism (often referred to as 'cap and collar') was introduced. In this mechanism the Government takes a share of revenue if it rises above a target level, but also provides support if revenue falls below a specified level. As a general rule, the franchisee is allowed to retain cost savings but also bears any cost increases. However, the franchise agreement contains a change mechanism which deals with changes to particular cost items such as access charges and could result in any savings accruing to the Government.

¹⁹These three franchise re-lets were known collectively as 'the Midlands Three'.

²⁰For example: 'in order to give certainty to bidders and the industry more widely, the proposed allocation of existing 15x and 170 planned to be in place to deliver the operational service from 11 November 2007 will be in place in the Data Site shortly and form the basis of a common approach for all three franchises'.

²¹The Franchise Agreement sets out the specific clauses relevant to the franchise.

²²The latest version of the National Rail Franchise Terms was developed by the SRA over 2001/02 and was designed to rectify the perceived faults of earlier agreements and reduce the cost of bidding and negotiation.

The Government's section 30 duty

32. The Secretary of State²³ has a duty under section 30(1) RA93 to provide, or secure the provision of, services for the carriage of passengers by railway where a franchise agreement (in respect of the services) is terminated or otherwise comes to an end but no further franchise agreement has been entered into in respect of the services provided under such terminated or expired franchise agreement.
33. Subsection (3)(a) states that subsection (1) does not 'require the Relevant Franchising Authority to provide or secure, the provision of services if and to the extent that, in its opinion, adequate alternative railway passenger services are available'.²⁴
34. This means that the extent of the duty on the Secretary of State to provide passenger rail services when a franchise is terminated or comes to an end can be limited where the Secretary of State is of the opinion that adequate alternative railway services are available.
35. Angel submitted that the section 30 duty 'is not necessarily the same level [of] passenger service that the defaulting TOC had bid to run and therefore could be carried out with a different rolling stock requirement'.
36. HSBC submitted that the DfT could meet its section 30 duty without committing to take *all* of the ROSCOs' rolling stock and that it could replace a ROSCO's incumbent rolling stock with alternative available rolling stock, or take a short-term lease on the incumbent rolling stock whilst procuring new rolling stock.
37. Porterbrook stated that the section 30 duty only obliged the DfT to ensure that services continued.
38. The DfT told us that, although its section 30 duty gave it some freedom of action, 'it is implausible that Government would reduce services in the event of the section 30 duty arising when the stated policy is to increase services to meet growth' and that 'the expectation must be that the same services will continue to run'.
39. In order to be able to fulfil its section 30 duty the Government has entered into direct agreements with the ROSCOs, which among other things give the Government various contractual options to lease rolling stock from the ROSCOs in the event of an early termination of a lease between a ROSCO and a TOC. There are various direct agreements containing these options covering both MOLA and post-MOLA rolling stock:
 - (a) For MOLA rolling stock, at privatization the Government (OPRAF) entered into a direct agreement with each of the ROSCOs covering all MOLA rolling stock (we sometimes refer to these as OPRAF/ROSCO agreements).²⁵
 - (b) For post-MOLA rolling stock the Government has entered into a direct agreement with the relevant ROSCO each time new rolling stock is introduced on a franchise

²³Following RA05, section 30 applies to the relevant franchising authority being the person who has the appropriate franchising authority in relation to the terminated Franchising Agreement which is the Scottish Minister in relation to Scottish Franchise Agreements and the Secretary of State in relation to all others.

²⁴Subsection (2) provides that the duty in subsection (1) in relation to any services ceases if the services begin to be provided again under a franchise agreement.

²⁵The original OPRAF/ROSCO agreement was signed on 4 May 1995 but there have since been a number of supplemental agreements.

for the first time. These direct agreements continue in place on subsequent leasing of rolling stock (ie there is no new direct agreement on franchise re-let). Direct agreements apply to a particular number and a particular class of rolling stock.

40. Details of the options in these direct agreements are summarized in Table 3.²⁶

²⁶Table 3 does not detail the call options contained in the direct agreements which are discussed later on in this appendix.

TABLE 3 Summary of options in direct agreements

<i>Type of rolling stock</i>	<i>Applicable direct agreements</i>	<i>Details of the first option contained in the direct agreements ('First option')</i>	<i>Rolling stock that first option applies to</i>	<i>Terms of the new lease</i>	<i>Time period</i>	<i>Details of a further option ('Second option')*</i>
MOLA	One direct agreement for each ROSCO covering all its MOLA rolling stock (often referred to as OPRAF/ROSCO agreement). Entered into at privatization but there have been several supplements since then	The Government has the option to require a ROSCO to enter into a new lease with the Government if the ROSCO terminates its lease with the TOC early†	All (but not some only) of the rolling stock subject to the lease that is terminated	Same terms of lease that was terminated	New lease applies until the date of the next timetable change at least 12 months after termination of lease or, if earlier, the date when the original lease would have ended by effluxion of time	The Government has a further option to extend the term of the new lease by giving notice before timetable change—terminates on lease expiry by effluxion of time Further option relates to all or some of the rolling stock (ie specified number of vehicles or units and not necessarily all rolling stock)
Post-MOLA	One direct agreement for each set of new rolling stock entered into when rolling stock is first leased by a ROSCO	The Government has the option to require a ROSCO to enter into a new lease with the Government if the ROSCO terminates its lease with the TOC early†‡	All (but not some only) of the rolling stock subject to the direct agreement (failed rolling stock can be rejected)	Terms are set out in a Mark-up of the lease agreement attached to the direct agreement	As with MOLA	The Government has a further option to extend the term of the new lease as with MOLA described above For a fixed period of time, the further option applies to all (but not some only) of the rolling stock After this date it applies to all or some—ie the Government can select which rolling stock to lease (as with MOLA)

Source: CC analysis.

*HSBC told us that it is able to serve a counter notice in response to the DfT's further option. The amount of re-leased rolling stock will then be decided by a dispute resolution panel based on the 'principle that the vehicles or units selected are representative in quality and maintenance status...' of the relevant fleet.

†The Government also has an option to require a ROSCO to terminate its lease with the TOC if a franchise agreement is terminated early. If the Government exercises this option (which it is not required to do) then it is required to give the ROSCO a new lease on the terms specified in the fourth column.

‡Usually the direct agreement for post-MOLA rolling stock contains a clause whereby up until a stated date the Government agrees to exercise the option if within the previous month it has already exercised a similar option under the OPRAF/ROSCO agreement to take a new lease of rolling stock used to operate passenger services under the same franchise agreement.

41. Angel, HSBC and Porterbrook commented on the effect of the DfT's options available to it to fulfil its section 30 duty:
- (a) Angel stated that the DfT had no duty to continue to lease all the rolling stock under the lease because the options only provided an 'all or some' guarantee.
 - (b) Porterbrook suggested that the section 30 duty and the direct agreements did not provide it with any degree of protection. It considered that the direct agreements gave the DfT, in some circumstances, the right to enter into lease agreements with ROSCOs on substantially similar terms but not the obligation to do so. Furthermore, Porterbrook said that the section 30 duty had been curtailed by RA05, which allowed the DfT to walk away from this duty to the extent that devolved bodies such as the Scottish Ministers and Welsh Assembly did not underwrite the cost of providing the services. Under the OPRAF/ROSCO agreement and the direct agreements for post-MOLA rolling stock, the DfT is able to reject 'failed rolling stock',²⁷ which could enable it to refuse to lease an entire fleet of rolling stock. The DfT is also able to sub-lease rolling stock leased under these agreements without the consent of the ROSCO. Porterbrook told us that these rights enable the DfT to recoup the cost of leasing surplus rolling stock.
42. Whether or not the DfT chooses to exercise its option to require a ROSCO to enter into a new lease with the DfT on early termination of a lease will depend on the circumstances of the case. However, the options available to the DfT to require a ROSCO to terminate its lease with a TOC when a franchise agreement is terminated early make it a condition that if the DfT exercises such option, the DfT will enter into a new lease with the ROSCO for all (but not some only) of the rolling stock formerly leased.
43. The DfT added that the 'all or nothing' provisions in the direct agreements were there to prevent the ROSCOs from being in a worse commercial position in consequence of the section 30 duty arising.
44. There has been only one instance since privatization where the section 30 duty has arisen and the franchise authority has stepped in as operator of last resort. This was when the SRA, through the SRA-owned subsidiary South Eastern Trains, assumed responsibility for the Connex South Eastern franchise from November 2003 to March 2006.
45. In the Connex South Eastern case, the SRA chose not to exercise the options in the direct agreements, although the DfT noted that the ROSCOs' position was fully protected. The assets of the franchise were transferred into a company which was a wholly-owned subsidiary of the SRA by way of a statutory transfer scheme, which included the rolling stock leases. The ROSCOs waived any rights in their leases to treat designation of leases as primary franchise assets as an event of default. The leases were transferred to government control 'as is'. There was a section 54 undertaking given to the ROSCOs which required the successor franchisee to take on the leases. The DfT told us that there was no material depreciation of service leading to a reduced requirement for rolling stock.
46. The DfT noted that there had been several other circumstances (eg the ICEC franchise in 2007) where it had fulfilled its section 30 duty by placing a failing franchise on a management contract. The replacement franchisee was required to

²⁷Failed rolling stock is rolling stock which is not redelivered by the outgoing lessee in the redelivery condition.

take novations of the existing lease agreements. It added that the ROSCOs had been protected through direct specification in these circumstances.

ROSCOs' views on the section 30 duty

47. To assess the ROSCOs' views on the section 30 duty we examined contemporaneous internal papers.
48. In its internal papers Angel has in the past conducted a risk assessment. This assessment states that:

Under the terms of section 30 of the Railways Act the SRA [DfT] is obligated to secure the provision of passenger rail services. To date, this has provided significant protection to Angel Trains given that there has been equilibrium in the supply and demand for rolling stock. In the future this may no longer be the case.
49. For these papers Angel produced a risk matrix in which it identified a 'possible termination sum exposure if all rolling stock not taken up under SRA "second option"'. However, it goes on to state in relation to the 'all or some' clause in the 'second option' that: 'the prevailing circumstances at the time will dictate the SRA's response to this option. However, Angel Trains believes that the overriding probability is the SRA will take up the current rolling stock'.
50. Angel also stated that 'the SRA has limited scope (without major political fallout) to cut service levels to an extent that it would have a material impact on the number of vehicles required'.
51. We note that this risk analysis has not been appended to internal papers since Connex's failure in November 2004. We are therefore unable to assess Angel's position since this time and whether this led to a change in Angel's perception of the risk. Angel told us that because the risk analysis took largely a standard form in the period since 2004 it has often not been included because Angel's board has become familiar with its content.
52. We did not find explicit mention of the options available to the Government in HSBC's and Porterbrook's board papers. Porterbrook told us that this was because the section 30 duty applies equally to all leases.

Direct agreements and call options

53. Call options give the Government the right to require the ROSCOs to enter into a new lease with the Government for up to three years from the end of the current franchise at essentially the same rental for the rolling stock as the previous lease between the ROSCO and the TOC (allowing for some adjustments for the ROSCO to retain a net tax rate of return). Call options currently exist in all direct agreements covering post-MOLA rolling stock entered into since 1995 and had existed in relation to the OPRAF/ROSCO agreements (covering MOLA rolling stock) following a Supplemental Deed dated 22 June 1999.

Direct agreements covering post-MOLA rolling stock

54. There are two call options set out in the direct agreements:

- (a) First, the call option that applies to the original franchise agreement (this is the franchise agreement that applies when the relevant rolling stock is first introduced). This call option relates to 'all (but not some only)' of the rolling stock (subject to the direct agreement) operated pursuant to that franchise agreement.
- (b) Second, the call option that applies to all subsequent franchise agreements. This call option relates to 'all or some' of the rolling stock (subject to the direct agreement) operated pursuant to that franchise agreement (ie the Government can choose the rolling stock on which it wants to exercise its call option). Not all direct agreements for post-MOLA rolling stock contain this call option. Where they do, new leases will be on the terms of the mark-up attached to the direct agreement.

OPRAF/ROSCO agreements

55. The call option in the OPRAF/ROSCO agreement was similar in wording and terms to that contained in the direct agreements covering post-MOLA rolling stock but:
- (a) it applied to 'all or some' of the rolling stock (MOLA rolling stock) operated pursuant to the franchise agreement;
 - (b) the new lease following exercise of a call option would be on the same terms as the expired lease; and
 - (c) it was time limited and has now fallen away (applying to franchise agreements existing at 22 June 1999, all of which have now expired).

Exercise of call options

56. Both types of direct agreement permit the Government to exercise the call option in two circumstances: first, when a duty under section 30 RA03 is triggered,²⁸ and second, in connection with or arising out of an abuse of a dominant position in the rolling stock market. To exercise these call options, the Government needs to give notice to the ROSCO before the end of the franchise.²⁹
57. The Government has never exercised its call option.
58. There was a difference of interpretation between the ROSCOs and the DfT in terms of when and how the call option could be exercised and whether it would be exercised in the future.
59. In terms of the future, we noted that the time expiry of the call option in the OPRAF/ROSCO Agreement meant that the call option can no longer have an effect on MOLA rolling stock.

²⁸This can occur in the following three cases: a franchise was due to expire and (a) no new franchise agreement had been entered into; (b) a TOC had been offered unacceptable terms from the ROSCOs and refused to provide rail passenger services; and (c) a new franchise had been entered into but it failed to commence on time.

²⁹The call option that applies to the Original Franchise Agreement in direct agreements covering post-MOLA rolling stock is only exercisable on at least six months' notice. The call option for replacement Franchise Agreements is exercisable on at least one but no more than six months' notice.

Views of the parties on the exercise of the call option

60. We now consider the views of the parties as to whether the threat of use of the call option has served to constrain rental increases in the past.

The DfT's view

61. The DfT submitted that the situations in which the call option could be exercised were limited as, in the absence of the section 30 duty arising, it would need to establish infringement of Chapter II of the Competition Act 1998. The DfT considered that it would be difficult to meet the legal test to establish an abuse of dominance.
62. The DfT stated that exercising the call option without justification would be undesirable as ROSCOs might 'seek to include a price premium in the first lease period to compensate them for the loss of flexibility in relation to their portfolio'. The DfT added that it is unlikely to use the call option, noting that it 'simply preserves the rental levels for a further three years'.

The ROSCOs' views

63. All three ROSCOs said that, despite the Government not exercising a call option to date, there had been a threat of it being exercised which would continue into the future.
64. Porterbrook stated that the DfT could use the call option as a bridging mechanism to bring in new rolling stock. Porterbrook argued that the DfT could use these powers to facilitate the introduction of new rolling stock in accordance with the Government's section 30 duty to ensure continuity of services. This is because the section 30 duty applies to all cases where a franchise agreement expires, is terminated, or otherwise comes to an end, and no further franchise agreement is entered into with the incumbent franchisee, irrespective of the reason why.
65. Porterbrook added that the argument that the ROSCOs would increase their lease premiums if call options were to be used more liberally was not necessarily true, as it already negotiated lease rentals on the assumption that the call option might be exercised if the DfT considered that Porterbrook was seeking to impose excessive lease rentals (or was otherwise acting to trigger the call option).
66. HSBC suggested that it had always conducted lease negotiations recognizing that the DfT might have recourse to the call option. It stated that the call option had been a constraint on its behaviour and would continue to be so. In terms of the circumstances in which the call option could be used, HSBC noted that the DfT could use the call option if it had good grounds to assert that a ROSCO was abusing a dominant position (or there was a case under the DfT's section 30 duty). However, it thought that the notion that the call option could be exercisable merely by the DfT giving notice was misconceived.
67. Angel stated it saw the call-option as a very real threat. It noted that the knowledge that the DfT may step in and force a lease extension on the same terms as the expiring lease, places pressure on the ROSCOs to be cooperative and competitive in negotiations with TOCs and that the threat of the exercise of the call option was a constant consideration for the ROSCOs. Angel submitted that it expressly considered the risk of the call option being used in its board papers. It told us that on the [X] franchise its rentals were largely 'capped' by the call option and the Code of Practice.

Angel offered the Class [X] fleet at the existing rental level despite the fact that this fleet was in strong demand on other parts of the network [X].

The DfT's right to approve leases between TOCs and ROSCOs

68. Under the franchise agreements, the TOCs must obtain the approval of the DfT before entering into a lease of rolling stock with a ROSCO. The DfT requires this right because the leases contain contractual terms that might bind the Secretary of State or nominee in circumstances requiring exercise of the options contained in the direct agreements.
69. The DfT told us that 'in general, [the] DfT is very unlikely to refuse to allow a TOC [to] enter a lease'. It added that this was because of the risk that the operation of the franchise would not proceed and the DfT's duty under section 30 would be engaged.
70. The DfT told us that in reviewing rolling stock leases it was primarily examining those provisions that might interfere with the Secretary of State's ability to discharge its section 30 duty.³⁰ The DfT stated that over the last two to three years, ROSCOs had agreed a 'template' lease agreement which addressed these concerns.
71. The DfT submitted that its position in relation to MOLA rolling stock was different to that of new rolling stock:
- (a) For MOLA rolling stock, the DfT stated that it was not usual for it to comment to the TOC and ROSCO on the underlying rental agreed for MOLA rolling stock.
 - (b) For new rolling stock, the DfT expected to see full transparency of the transaction and provided comments on terms of the transaction during the procurement process.
72. The DfT told us that it did not have the power to approve lease rentals at each lease negotiation because:
- (a) rentals are not transparently determined so it is unable to form a view on whether the rental offered is the best price;
 - (b) it does not have locus in commercial negotiations between the TOCs and ROSCOs;
 - (c) in the absence of alternative substitutable rolling stock and, given its section 30 duty, it does not have any practical ability to leverage rental reductions from the ROSCOs; and
 - (d) use of its rights to leverage a rental reduction would 'probably not be legally sound' because the franchise agreement was based on the ROSCOs' offer letters.
73. In contrast to the DfT's views, Porterbrook told us that 'DfT has the ability and propensity to determine—or, at an absolute minimum, significantly influence—the price and other terms on which the TOCs lease rolling stock from the ROSCOs'.

³⁰The DfT told us that such clauses include termination and default provisions, information provisions, 'quiet enjoyment' provisions, minimum insurance requirements and livery changes.

74. Given the difference between this view and the DfT's view of how lease approval rights can be used, we assessed the situations where the DfT has intervened in lease negotiations prior to the signing of the lease. These can be divided into (i) actions relating to lease rentals and (ii) actions relating to rolling stock allocation.

(i) Actions relating to lease rentals

75. We are aware of only one case where the DfT (or its predecessors) has intervened and lease rentals have been changed: [redacted] provided evidence that in 2003 the SRA questioned the affordability of [redacted] rental proposal for Class [redacted] on [redacted]. As a result, [redacted] reduced its capital rentals.
76. In other cases, where a section 54 undertaking has been given to a ROSCO, this has resulted in lower capital rentals. We consider the circumstances in which section 54 undertakings have been used in paragraphs 116 and 117.
77. The DfT also became involved in negotiations with Angel following its rejection of Virgin's proposal for the lengthening of the Class 390 Pendolino fleet. The DfT told us that Virgin had wanted a two-year extension on its franchise, to be awarded without competition, in order to facilitate the lengthening. The DfT is now proceeding with the Pendolino lengthening project. Following a competitive tender for the required train operator support, Virgin Rail Projects Ltd was chosen in July 2008 by the DfT to be the Service Provider, which will support the DfT throughout the design, manufacture, delivery, testing and commissioning of the lengthened Pendolino trains until the end of the West Coast franchise on 31 March 2012, after which the new vehicles will be introduced into service.

(ii) Actions relating to rolling stock allocation

78. The DfT made a number of interventions on the Midlands Three franchises in 2007 to resolve conflicting rolling stock requirements. We were told that these interventions had a number of consequent knock-on effects on other franchises:
- (a) [redacted]
- (b) SercoNed and Angel mentioned a delay in the approval of 30 additional Class 158 units for the Northern franchise. SercoNed believed that the delay was caused by the implications that the deal might have had for the West Midlands and East Midlands franchises.
- (c) Angel told us that the DfT directed the West Midlands franchise bidders to include new rolling stock so as to replace its Class 150s. However, the DfT told us that it only requested bidders to provide a priced option for the replacement of the existing DMUs operating on the Snow Hill lines and that it decided to take this option because it offered value for money.
- (d) Angel told us that approval of cascades of Class 158s to ScotRail and Wales and Borders were delayed whilst awaiting the outcome of the Midlands Three franchises.
- (e) [redacted]

79. We were told of a number of other instances where the DfT was actively involved in determining cascades:³¹
- (a) Two TOCs (Arriva and National Express) told us that Porterbrook's Class 150 fleet was due to come off-lease from the Central franchise in 2006. This fleet was offered by Porterbrook to Arriva Trains Wales and Northern. However, the DfT refused to permit Arriva Trains Wales and Northern to sign the contract. National Express believed that this was because it would have left it short of rolling stock on the Central franchise.
 - (b) Angel told us that the deal to lease [redacted] Class [redacted] to [redacted] for use on the [redacted] main line was announced by the DfT prior to Angel being made aware of [redacted] requirement.
 - (c) Porterbrook told us that the DfT encouraged Northern to take Angel's Class 158s from the Central franchise instead of Porterbrook's Class 158s.
 - (d) Porterbrook told us that the DfT refused to allow Porterbrook to be released from the call option provision of the OPRAF/ROSCO agreement so that it could lease rolling stock to Grand Central.

Specification of franchise ITTs

80. In this section we consider the extent to which the DfT has specified rolling stock in its franchise ITTs.
81. We identified three ways in which the DfT has specified rolling stock:
- (a) *Direct specification*—where the franchise ITT specifies which vehicles to use (or not to use) on a given franchise.
 - (b) *Indirect specification*—where the Service Level Commitment in the franchise agreement (covering issues such as minimum capacity or services, journey times or stopping patterns) dictates which vehicles can be used on a given franchise; and
 - (c) *Providing 'pointers' during the franchise process*—where the DfT does not formally state any limitations but gives further information to bidders during the franchise bidding process that effectively limits choice.
82. We consider first the views of the parties and then our analysis of franchise ITT specification.

Views of the parties on franchise ITT specification

83. The ROSCOs stated that, although they did not see franchise ITTs, they understood that the ITTs had become increasingly prescriptive over time.
84. The DfT submitted that direct specification usually occurred where a franchise terminated early. In its opinion, direct specification had been relatively rare and implemented for specific and compelling reasons in the context of the DfT's statutory duties. The DfT said that specification could only be harmful if the DfT had the ability

³¹For a further discussion, see Appendix 4.2.

to be less specific in the franchise ITT as to the particular rolling stock to be used but chose to be more specific, removing the opportunity for other suitable and available rolling stock to be used. It suggested that the lack of surplus rolling stock and the lack of speculative purchasing by ROSCOs meant that it did not have this ability in practice.

85. The DfT told us that it undertook an assessment of the case for investing in new rolling stock ahead of specifying a franchise ITT. It said that it compiled a list of options for rail provision which might include a 'do minimum' scenario and various alternative scenarios, which might include investing in new rolling stock. The DfT assessed the rolling stock options that formed these scenarios subject to budget constraints, taking account of financial factors (ie increased revenue and operating costs) and economic factors (ie improved quality and crowding relief). Following this scenario assessment the DfT determines an 'internal comparator' based on value for money, affordability, deliverability and fit with policy objectives. This internal comparator influences the outputs specified in the base case of the franchise ITT.
86. The DfT acknowledged that specification of franchise services through Service Level Commitments had an impact on the type of rolling stock that is suitable. However, the DfT further stated that 'indirect specification is a legitimate and proper exercise of its powers and does not adversely impact on competition in the prevailing market circumstances' (ie where there has been a shortage of supply). The DfT added that its specification of SLCs and capacity levels took into account 'wider economic and policy reasons'.
87. The DfT submitted that a higher degree of specification had been required in the recent franchise lettings because the original franchises tendered between 1995 and 1997, which contained only light specifications, proved problematic. In particular, the DfT found bids hard to compare as they did not give a single price for a standardized proposal. It also identified a danger of inconsistent rolling stock purchases which did not take account of the network as a whole. According to the DfT, this led to 'unstable and unsustainable' outcomes and necessitated intervention.
88. TOCs told us that the most recent rounds of franchise ITT specifications had become more prescriptive in relation to rolling stock requirements. Their responses varied as to whether this degree of prescription was justified. TOCs made the following comments:
 - (a) two TOCs [redacted] considered specification to be very prescriptive; and
 - (b) two other TOCs [redacted] suggested that, whilst the DfT was not fully prescriptive, it provided franchise specifications knowing what rolling stock was available to lease. As a result, it was extremely difficult for the bidder to do much beyond assume that it would continue leasing the rolling stock already on the franchise.

Our analysis of franchise ITT specification

89. To assess the extent to which the DfT's franchise ITT specification has limited choice we examined past ITT specifications and bidders' choice of rolling stock. In examining TOCs' bid submissions we noted that it is difficult to understand the extent of limitation of rolling stock choice as TOCs are unlikely to declare disagreements with the DfT's franchising approach (as the bid is about meeting the DfT's requirements rather than the opposite). To account for this, we asked each of the TOCs to provide examples of cases where choice of rolling stock has been narrowed by franchise ITT specification.

90. We considered separately each type of specification described in paragraph 81.

Direct specification

91. We conducted a detailed review of the text in the franchise ITTs for the 18 DfT/SRA franchise re-lets³² since privatization to assess whether rolling stock was directly specified.³³ Annex 1 to this appendix sets out for each franchise re-let since privatization some extracts to show the way in which rolling stock was specified in the franchise ITT.

92. We found that three broad types of direct specification were used by the DfT/SRA:³⁴

(a) restriction of use to incumbent vehicles³⁵ (3,498 vehicles or 30 per cent of incumbent vehicles on these franchises);³⁶

(b) specification of vehicles to be replaced or cascaded out (1,471 vehicles, 13 per cent of incumbent vehicles); and

(c) restriction of choice in terms of alternative rolling stock that could be taken on.

93. We consider each in turn.

(a) Restriction of use to incumbent vehicles

94. Table 4 shows our analysis of the number of incumbent vehicles that have been specified by the DfT or its predecessors since privatization. Our analysis suggests that the restricted use of rolling stock to incumbent vehicles accounted for 30 per cent of incumbent vehicles involved in the 18 franchise re-lets since privatization.³⁷

95. Table 4 shows that there have been two main reasons for restricting use of rolling stock to incumbent vehicles:³⁸

(a) *Rolling stock specified following an early franchise termination (2,110 vehicles)*—this occurred in three franchises: Integrated Kent, New Cross Country and ICEC 2007. In each case, we found that the rolling stock was leased with largely the same capital rentals and for the remaining lease lengths. The DfT said that TOCs would in any case have chosen to use the incumbent fleets even if the DfT had

³²This does not include Merseyrail and London Overground, which were not let by the DfT/SRA.

³³Our analysis was limited on five of the earlier franchises re-lets conducted by the SRA, where the DfT was unable to provide the franchise ITTs. Our assessment of specification in these five earlier franchises was therefore based on the DfT's recollections of the extent of specification.

³⁴We distinguished between situations where the DfT directly specified rolling stock and those where it intervened in the allocation of rolling stock to assist the franchise process. We deal with the former in this section and the latter in paragraphs 78 and 79. The latter relates specifically to situations where the DfT was involved in rolling stock allocation issues, notably on the Midlands Three franchises. The DfT acted as arbiter between competing demands by more than one TOC for the same rolling stock. We have not included these situations in our figures for direct specification.

³⁵Incumbent rolling stock is the rolling stock that was in use on the franchise prior to the franchise re-let.

³⁶We also found a few instances where the DfT appeared to recommend using incumbent or other vehicles. For example, on the Wales and Borders franchise, the DfT recommended using existing rolling stock only. However, the DfT submitted that this suggested that if bidders could find a way of providing new rolling stock at no extra cost then this would have been acceptable.

³⁷The DfT submitted its own analysis that also suggested that 30 per cent of incumbent rolling stock had been directly specified in the 18 franchise re-lets since privatization.

³⁸Table 4 shows that rolling stock was also specified where vehicles were franchise assets. This is where rolling stock is owned by the franchise and not by the ROSCO. This was a minor issue covering only 85 vehicles. We also identified 22 incumbent Class 175 vehicles on the Wales and Borders franchise, where the DfT specified Class 175s so as to keep costs down. The DfT told us that the only incumbent vehicles that matched the characteristics of the Class 175s were the Class 158s, so it is possible that some competitive pressure could have been placed on the Class 175s absent specification.

not specified vehicles.³⁹ We considered that, irrespective of whether TOCs would have chosen alternative rolling stock, a franchise re-let in these situations is only created by a previous franchisee's failure so the use of specification on these occasions is a direct result of the DfT fulfilling its section 30 duty.

(i) *Rolling stock specified because it is covered by a section 54 undertaking* [X].⁴⁰ In these cases, it is possible that the DfT could choose not to specify the rolling stock, but it would then be faced with the challenge of trying to find a lessee for the rolling stock in order to fulfil the section 54 undertaking. The DfT submitted that, in cases where it had specified rolling stock covered by a section 54 undertaking, specification did not change the effective choice of rolling stock available to bidders in practice when compared with the choice without such specification. We considered whether relaxed specification would have made any difference in the three instances where rolling stock has been specified due to section 54 undertakings: [X].

96. The DfT has awarded franchises since the Greater Western franchise in 2006, having taken over responsibility from the SRA. Table 4 supports the view that specification of incumbent vehicles has increased under the DfT (although three of the eight franchises the DfT has awarded have been the result of early franchise termination). Prior to that the SRA appeared to specify relatively little of the incumbent rolling stock.

³⁹On Integrated Kent, all three bidders stated that the section 54 undertakings on the rolling stock constrained their choice. They did not state what rolling stock they would otherwise have chosen, although one bidder investigated use of Class 458s and new rolling stock.

⁴⁰We consider the impact of section 54 undertakings on competition in paragraphs 121 to 124.

TABLE 4 CC analysis of franchise ITT specification of incumbent rolling stock

Franchise name	Franchise start date	Restricted to incumbent rolling stock				Number of vehicles specified		% of total franchise vehicles	Total incumbent franchise vehicles
		Early termination	Section 54	Franchise assets	Other	Replacement of incumbent rolling stock Cascade out	Total vehicles specified		
South Central	Aug 01	0	0	0	0	618	618	66	930
Chiltern	Jan 02	0	0	0	0	0	0	0	118
South Western (2003)	Feb 03	0	0	0	0	572	572	46	1,242
Wales & Borders	Dec 03	0	0	16	22	0	38	19	199
TransPennine	Feb 04	0	0	0	0	143	143	100	143
Great Western Link	Mar 04	0	0	0	0	0	0	0	165
Greater Anglia	Apr 04	0	0	0	0	114	114	9	1,243
ScotRail	Oct 04	0	0	0	0	24	24	4	674
Northern Rail	Dec 04	0	64	56	0	0	120	21	583
Intercity East Coast (2005)	May 05	0	0	0	0	0	0	0	504
Greater Western	Apr 06	0	0	6	0	0	6	1	837
Thameslink/Greater Northern	Apr 06	0	0	0	0	0	0	0	619
Integrated Kent	Apr 06	1,328	0	0	0	0	1,328	100	1,328
South Western (2007)	Feb 07	0	1,097	7	0	0	1,104	76	1,455
East Midlands	Nov 07	0	0	0	0	0	0	0	360
West Midlands	Nov 07	0	120	0	0	0	120	25	476
New Cross Country	Nov 07	275	0	0	0	0	275	79	347
Intercity East Coast (2007)	Dec 07	507	0	0	0	0	507	99	511
Total		2,110	1,281	85	22	1,471	4,969	42	11,734
% of total franchise vehicles		18	11	1	0	13	42		

Source: CC analysis.

Note: Figures may not sum due to rounding.

(b) Specification of vehicles to be replaced or cascaded out of the franchise

97. In addition to incumbent vehicles specified, we found 1,471 incumbent vehicles (13 per cent) were specified to be replaced. The majority of these vehicles (1,304 vehicles, 89 per cent)⁴¹ related to the required replacement of Mark I rolling stock, which were replaced under the Railway Safety Regulations 1999. The DfT questioned the inclusion of the replacement of Mark I vehicles as direct specification. The DfT considered that with or without SRA specification, the franchise bidders would have been required to procure new rolling stock to enable them to deliver the franchise. We consider that specification of the replacement of Mark I vehicles was clearly vital to fulfil safety requirements.
98. The remaining vehicles (143 vehicles on TransPennine to be replaced by new rolling stock and 24 Class 150 vehicles on ScotRail which were to be replaced by new Class 170 vehicles) were in each case specified to be replaced by new rolling stock. On TransPennine the whole fleet was to be replaced as part of a step change in service levels so the specification is unlikely to have had much effect. On ScotRail, the Class 170s could have replaced Class 150s, 156s or 158s. Although the Class 150s would be the obvious vehicles to replace due to their performance characteristics compared with the alternative fleets, it is again unclear why bidders were not left to decide, particularly given the shortage of DMUs at the time, which might have created competitive pressure at the margin across all DMU fleets.

(c) Restriction of choice in terms of alternative rolling stock that could be taken on

99. We also found cases where (i) new rolling stock was specified or (ii) new rolling stock was excluded.
- *New rolling stock that was specified*
100. Table 5 shows the franchises where new rolling stock was specified in the franchise ITT.

⁴¹These were on the South Central, South Western 2003 and Greater Anglia franchises.

TABLE 5 CC analysis of franchise ITT specification of new rolling stock

Franchise name	Franchise start date	New rolling stock specified (no of vehicles specified)	% of total leased vehicles on vehicles	Total vehicles leased on franchise
South Central	Aug 01	600	72	832
Chiltern	Jan 02	20	15	134
South Western (2003)	Feb 03	225	40	568
Wales & Borders	Dec 03	0	0	243
TransPennine	Feb 04	153	100	153
Great Western Link	Mar 04	0	0	151
Greater Anglia	Apr 04	84	8	1,073
ScotRail	Oct 04	99	13	734
Northern Rail	Dec 04	0	0	407
Intercity East Coast (2005)	May 05	0	0	489
Greater Western	Apr 06	0	0	814
Thameslink/Greater Northern	Apr 06	0	0	595
Integrated Kent	Apr 06	174	12	1,502
South Western (2007)	Feb 07	0	0	1,341
East Midlands	Nov 07	0	0	338
West Midlands	Nov 07	0	0	320
New Cross Country	Nov 07	0	0	370
Intercity East Coast (2007)	Dec 07	0	0	511
Total		1,355	13	10,575

Source: CC analysis.

Note: Figures may not sum due to rounding.

101. Our analysis found that that the DfT specified new rolling stock in relation to 1,355 vehicles (13 per cent of leased vehicles). The majority of these vehicles (909 vehicles, 67 per cent) related to the replacement of Mark I rolling stock, which in paragraph 97 we agreed were specified for mandatory safety reasons.⁴²
102. The other cases (covering 446 vehicles) where new rolling stock was specified were:
- (a) Chiltern—bidders were obliged to plan for the introduction of significant new rolling stock;
 - (b) TransPennine—the DfT told us that the franchise ITT specified that bidders should introduce new rolling stock as the incumbent fleet was perceived to be incapable of achieving the step change in service quality that the SRA was seeking;⁴³
 - (c) ScotRail—bidders were required to take on the leases for 29 new Class 170 trains; and
 - (d) Integrated Kent—new Class 395s were specified as the DfT had already initiated the procurement process for the Channel Tunnel Rail Link domestic services (CTRL DS).
103. The DfT stated that if new rolling stock was specified, each of the ROSCOs and potential entrants could compete freely for the contract. However, we noted that specification of new rolling stock in these instances sends a signal to bidders when new rolling stock should and should not be used (ie unless new rolling stock is specified it is unlikely to be seriously considered). This offers less of an incentive to bidders to consider use of alternative used rolling stock except where it has been specified.

⁴²These were on the South Central, South Western 2003 and Greater Anglia franchises.

⁴³However, the DfT noted that it did not have a copy of the franchise ITT.

- *New rolling stock that has been excluded*

104. We found five cases where the DfT suggested that new rolling stock should not be proposed by bidders (as described in [Annex 1](#) to this appendix):
- (a) Wales and Borders—the franchise ITT stated that ‘the Authority does not expect to see new rolling stock replace existing trains as part of the baseline proposal’. However, the DfT submitted that the franchise ITT suggested that if bidders could find a way of providing new rolling stock at no extra cost then this would have been acceptable.
 - (b) Thameslink/Greater Northern—the franchise ITT steered bidders away from new rolling stock by stating that:

any final decision on the use of new rolling stock will be dependent on value for money and affordability constraints. The continued use of the current fleets for up to nine years following commencement of the Thameslink/Greater Northern franchise is considered consistent with the Thameslink 2000 programme.
 - (c) Greater Western, ICEC 2005 and ICEC 2007—in each of these three franchises the bidders were told that replacement of HSTs was being managed through the DfT’s IEP. Stagecoach considered purchasing Class 222s to replace Class 180s and HSTs on the Greater Western franchise. It did not do so, because, among a number of reasons, the DfT bid instructions limited the number of HSTs that could be replaced. The other bidder, National Express, stated that it offered the Class 222s in an alternative option, but this was not considered by the DfT as National Express did not win the franchise on the base case. GNER stated that explicit or implicit conflict with specification was the key reason for not deploying new rolling stock, such that it would have proposed new build on both ICEC franchises but for the ITT.

105. In total, the ruling out of new rolling stock effectively specified 1,712 vehicles.⁴⁴

106. The DfT considered that disbarring new rolling stock in a franchise ITT did not restrict or inhibit the degree of inter-ROSCO competition. The DfT also added that this meant a new rolling stock ‘price cap’ on used rolling stock would not be applicable in these circumstances.

Summary of our analysis of direct franchise ITT specification

107. Some vehicles have been specified for legitimate reasons (for example, the Mark I rolling stock was specified for safety reasons). However, we found that direct specification could potentially have been less restrictive in the following situations:
- (a) where incumbent vehicles were specified even though the franchise was not terminated early and viable alternatives were available; these situations have been mostly confined to rolling stock covered by section 54 undertakings, where the DfT might have been able in some instances to be more flexible in allowing the rolling stock to be used elsewhere (this would have allowed alternatives to be considered in respect of up to 1,303 incumbent vehicles);

⁴⁴This comprises all 619 vehicles on Thameslink/Greater Northern, the HSTs on Greater Western (444 vehicles), the HSTs on ICEC 2005 and 2007 (450 vehicles and 496 vehicles) and all 199 vehicles on Wales and Borders. Excluding the ICEC 2007 franchise which was specified for other reasons (and therefore avoiding double counting), this amounts to a further 1,712 incumbent vehicles (15 per cent) that were effectively specified by ruling out new rolling stock.

- (b) where incumbent vehicles were specified to be replaced by new vehicles for non-legislative reasons⁴⁵ (this would have allowed alternatives to be considered in respect of up to 167 incumbent vehicles); and
 - (c) where new rolling stock was specified or excluded for non-legislative reasons (this would have allowed alternatives to be considered in respect of up to 436 new vehicles plus up to 1,712 incumbent vehicles).
108. By avoiding specification of these rolling stock inputs and focusing on the service outputs required, we calculated that this would have allowed alternatives to be considered in respect of up to 3,618 vehicles (31 per cent of vehicles that were let on the franchises we examined).

Indirect specification

109. The DfT's franchise ITTs have tended to set out the following detail, although the extent of detail varies from franchise to franchise:
- (a) Service details (contained in the Service Level Commitments)—for example, the number of trains per hour during certain parts of the day with required stopping patterns and journey times.
 - (b) Requirements to plan to meet crowding and manage demand—these have sometimes been expressed as a requirement for the base-case train service to provide a certain level of capacity (for instance, that passengers stand for no more than 20 minutes for any part of a journey; or standing density should not exceed the train's capacity by more than a specified average or that vehicles arrivals in the peak should increase by a specific number).
 - (c) Performance—for example, delay minute targets, cancellations targets, capacity requirements (in terms of seats).
110. We examined franchise bid submissions for comments suggesting that alternative rolling stock might have been put forward had there been materially less specification in the Service Level Commitment. We found the examples set out in [Annex 4](#) of this appendix.
111. In addition to this analysis we also attempted to understand the impact of indirect specification in our assessment of the difference between technical alternatives and operational alternatives in Appendix 4.1.⁴⁶ The difference between these two measures of alternatives suggested that indirect specification reduces the extent of alternative rolling stock that could be considered suitable.
112. Based on the analysis and responses set out in [Annex 4](#), the following aspects of specification of service inputs rather than service outputs could be considered to be potentially restrictive in terms of the choice of rolling stock:
- (a) certain train lengths or formations;
 - (b) fixed number of diagrams per day or fixed frequency of services; and
 - (c) specific seating requirements.

⁴⁵By non-legislative reasons, we mean, for example, reasons other than safety, such as the Mark I replacement.

⁴⁶This assessment attempted to isolate the impact of indirect specification but did not take into account the economic viability of alternatives.

The DfT providing 'pointers' during the franchise process

113. In relation to the DfT giving 'pointers' during the franchise process, a number of TOCs commented that specification of rolling stock occurred informally during the bidding process:
- (a) First submitted that the clarification meetings with the DfT during the bidding process led to bidders forming an understanding over what adjustments to the Service Level Commitments were likely to be treated as compliant.
 - (b) Govia commented that bilateral bidder briefings with the DfT generally drew bidders to the low-risk course of using the existing rolling stock.
 - (c) Quasar Associates commented that bidders were given an impression that the DfT had a certain strategy in mind during feedback sessions with the DfT.

Section 54 undertakings

114. Section 54 of RA93 gives the Secretary of State (and gave its predecessors OPRAF and the SRA) the ability when exercising or not exercising franchising functions to take into account the desirability of encouraging railway investment.
115. The DfT told us that the principal purpose of section 54 undertakings was to encourage railway investment through mitigation of stranding risk and accordingly reducing related risk premiums and lowering the cost of leased assets.⁴⁷
116. Table 6 sets out the section 54 undertakings that have been awarded.⁴⁸

⁴⁷Section 54 undertakings have been applied to rolling stock and other leased assets such as new depots.

⁴⁸Two section 54 undertakings have been awarded on each of the [] but we have in each case only counted this as one undertaking.

117. Table 6 shows that since privatization, the DfT has granted section 54 undertakings to ROSCOs in a range of circumstances. We set out in [Annex 2](#) to this appendix some detail on the circumstances under which each of the section 54 undertakings have been awarded. Although in some cases there were a number of reasons for the award of the section 54 undertaking, we considered that they could be broadly categorized under the following circumstances:

- (a) on early termination of a franchise due to the financial failure of a TOC ([REDACTED], covering [REDACTED] vehicles);
- (b) where the franchise length has been shortened following an original agreement for a longer franchise ([REDACTED], covering [REDACTED] vehicles);⁴⁹
- (c) where the timing of the commencement of a franchise would have otherwise caused delays in the investment ([REDACTED], covering [REDACTED] vehicles);
- (d) where refurbishment was required on used rolling stock ([REDACTED], covering [REDACTED] vehicles); and
- (e) where a ROSCO was investing in new rolling stock ([REDACTED], covering [REDACTED] vehicles).

Impact of section 54 undertakings on capital rentals

118. In this section we assess the impact that section 54 undertakings have had on capital rentals. In situations (a) to (c) in paragraph 117, the section 54 undertakings were awarded to deal with franchise issues. In each case they were awarded *after* the new rolling stock or additional investment was agreed such that the ROSCO did not simultaneously offer a capital rental with and without a section 54 undertaking. As a result there are only a few instances where we can gain an understanding of the impact of a section 54 undertaking on capital rentals.

119. We had 11 comparable data points⁵⁰ (shown in Figure 1) and found that in nine of these cases the capital rental reduction generated by the offer of a section 54 undertaking was less than 10 per cent in exchange for an additional five years or more of leasing. There were two occasions where the reduction was greater than 10 per cent—one related to the Class [REDACTED] on [REDACTED] (offering a 15 per cent reduction for an extra three years lease) and the other to Class [REDACTED] on [REDACTED] (offering a 27 per cent reduction for six and a half additional years lease).

FIGURE 1

Impact of section 54 undertakings on lease rentals

[REDACTED]

Source: CC analysis.

120. The extent of reduction in capital rentals may give some indication as to the level of risk reduction the ROSCOs attribute to a section 54 undertaking. In particular, Angel did not see the undertakings as a ‘guarantee’ of lease rentals because section 54 undertakings only applied at the expiry of the franchise and did not apply in the event of the lessee’s default or the early termination of the franchise. Porterbrook also

⁴⁹[REDACTED]
⁵⁰[REDACTED]

stated that a section 54 undertaking gave only limited comfort and that it would prefer the market to price the risks that the section 54 undertaking was intended to mitigate.⁵¹ HSBC told us that section 54 undertakings did not give it access to a Government credit covenant but rather to a succession of future franchisee counterparties. The DfT stated that a section 54 undertaking did not put a ROSCO in a better position regarding customer default and insolvency risk than would otherwise be the case.

Impact of section 54 undertakings on competition

121. The effect of section 54 undertakings on competition is unlikely to be benign because they may prevent competition taking place for that rolling stock at the next franchise. There may also be knock-on effects on other franchises because, if there is an implicit assumption that the rolling stock will remain on the same franchise for the duration of the undertaking, the choice of rolling stock available to bidders on other franchises becomes more limited.
122. The DfT submitted that it was not the case that the rolling stock leasing market was flawed if competition did not occur at franchise letting provided that there was an opportunity for the market to operate at some other time. It added that specification of rolling stock to enable the section 54 undertaking to be complied with should not be regarded as having an adverse impact on competition. In its view, such specification simply permitted the implementation of the terms which were commercially agreed and contractualized when the original lease and accompanying section 54 undertaking were agreed.
123. Given the expiry dates of the existing section 54 undertakings, a number of future franchise re-lets will require specification of vehicles in order to deal with the need to meet the undertaking. These franchises will be: [X].
124. In addition, if the IEP programme uses a section 54 undertaking to cover two-thirds of the asset life this will require specification at future franchises.

⁵¹Porterbrook said that the limited comfort to investors was due to a number of factors, such as section 54 undertakings only applying in certain circumstances; they are subject to failed rolling stock provisions; and that future Governments may determine they were given ultra vires. Therefore any decision to undertake investment is taken prior to any section 54 undertaking.

Details of specification in franchise ITTs

Table 1 provides detail of the specification used in each of the franchise ITTs.

TABLE 1 Review of franchise ITT specification

<i>Franchise</i>	<i>Rolling stock specified</i>	<i>Details of franchise ITT specification (including extracts where relevant)</i>
South Central	Class 377s Mark I rolling stock to be retired	ITT unavailable but 240 new Class 377 vehicles had already been ordered so bidders were obliged to use these vehicles. The Mark I rolling stock (205, 207, 411, 423) was also required to be retired.
Chiltern	New rolling stock	ITT unavailable but the DfT told us that bidders were obliged to plan for the introduction of significant new rolling stock.
South Western 2003	New rolling stock Mark I rolling stock to be retired	ITT unavailable but new rolling stock required to replace Mark I rolling stock: 'All potential operators of the SWT franchise will acquire 135 new electric trains during the first five years of the franchise by working in partnership with the SSRA in the replacement programme for Mark I rolling stock (411, 412, 421, 423).'
Wales & Borders	Existing rolling stock recommended No new rolling stock Class 175s	'For Baseline Proposals, Bidders should base their plans on the use of existing rolling stock only ... The Authority does not expect to see new rolling stock to replace existing trains as part of the Baseline proposal. However, if Bidders consider that such an approach is the only viable way to operate the railway and/or is the lowest cost way to run it, they may include it in their Proposal.' 'Bidders are to commit to the establishment or continuation of inter-TOC trading with TPE/Northern in respect of Class 175 units which currently cover W&B, TPE and Northern services. Bidders should assume that this trading continues until the start of the Winter Timetable 2005 at which point the whole fleet will become available for use on Wales & Borders services. Given the need to minimise Franchise Payments these units are to be treated as replacements for, rather than additions to, existing rolling stock.'
TransPennine	New rolling stock	ITT unavailable but the DfT told us that the ITT specified that bidders should introduce new rolling stock as the incumbent fleet was perceived not to be capable of achieving the step change in service quality that the SRA was seeking.
Great Western Link	None	ITT unavailable but no vehicles believed to be specified.
Greater Anglia	Class 312s out, Class 360s in	Mark I Class 312s were required to be replaced by Class 360s.
ScotRail	87 new Class 170 vehicles should replace 12 Class 150s	'The Scottish Ministers are funding the procurement of 29 new Class 170 trains ... the Franchisee is required to take on the leases of the new trains ... This purchase will allow 12 older Class 150 trains to be withdrawn from service.'
Northern Rail	Class 144, 155, 158, 321 franchise assets	'The Authority believes that it is likely that any major discretionary spending on additional rolling stock or infrastructure enhancement will be constrained at least for the initial 4 years of the Franchise period and Bidders should not base any of their plans on the expectation that such funds will necessarily become available.'
InterCity East Coast 2005	No new rolling stock	'Bidders should note the existence of section 54 agreements with the leasing companies in respect of Class 225 train-sets until April 2008 and the majority of the HST rolling stock until January 2007.' 'Bidders should note that the Authority does not want the successful franchisee to be the procurement agent for national HST replacement.' In addition, the DfT noted that the ITT excluded any rolling stock which is not capable of operating at 125 mph. It also excluded rolling stock which is not of at least a similar capacity and quality as the incumbent stock.

Greater Western	No new HSTs	<p>'Bidders should note that, the Authority is not inviting, nor will it accept, offers from Bidders to replace the existing HST fleet with new trains.'</p> <p>'Bidders should note that if they choose to retain the existing Class 153 fleet currently operated by Wessex, the Authority would expect a refurbishment of these vehicles to take place early in the Franchise Term.'</p>
Thameslink/Great Northern (Capital Connect)	No new rolling stock	'The service specification intended by the Thameslink 2000 Programme is currently predicated on the use of new rolling stock. Any final decision on the use of new rolling stock will be dependent on value for money and affordability constraints. The continued use of the current fleets for up to nine years following commencement of the Thameslink/Greater Northern franchise is considered to be consistent with the Thameslink 2000 Programme. Where new rolling stock is being procured, the Authority expects to receive rolling stock proposals that set higher standards in train performance, reliability and presentation than the fleet currently operated by the Incumbent TOCs and meet with the objectives the Authority has stipulated for the Thameslink/Greater Northern franchise.'
Integrated Kent	All rolling stock New Class 395s	<p>'The Class 375, Class 376, Class 465, Class 466 and Class 508 fleets all have leases to October 2011. It is expected that approximately 100 of these vehicles will be surrendered when SLC2 is introduced. These vehicles are protected by section 54 undertakings made by the Authority and bidders should assume their cost will continue within the franchise accounts unless the Authority arranges a cascade of the vehicles to another operator.'</p> <p>'The Authority initiated the procurement process for the CTRL DS rolling stock and this has resulted in the appointment of HSBC Rail UK Ltd as the preferred fleet lessor (ROSCO), and Hitachi as the preferred manufacturer of the rolling stock. A fleet of 28 units of 6-car formation is being procured.'</p>
South Western 2007	Class 455, 444 and 450 Class 421	<p>'The Class 455 and Desiro (Class 444 and Class 450) units are covered by section 54 agreements which mean that the successful Bidder must take these as part of the Franchise. The Class 421 units are actually owned by the Franchise and are listed as an asset.'</p> <p>'Bidders are required to be explicit about the financial and economic impacts of overcrowding and/or unsatisfied demand. Bidders should not assume that Government financial resources will be available to support any Bidder's proposed capital investments to address such constraints.'</p>
East Midlands	None	Following initial bids, bidders could not propose to use Class 170, 220 or 221 rolling stock. The DfT set a maximum number of vehicles for each Class of DMU in the second stage.
West Midlands	Class 350s	<p>'The Class 350 Desiro vehicles are covered by section 54 agreements and therefore the DfT will require the Franchisee to enter into a rolling stock lease with the relevant ROSCO on substantially the same terms to that which currently applies.'</p> <p>Subsequent DfT restrictions prevented use of Class 156s, 158s and ex-Midland Mainline Class 170s—restricting choice to 150s, 153s and 170s.</p>
New Cross Country	Class 220s, 221s	<p>'For the Base Case, Bidders are to assume that 34 Class 220 units, 22 Class 221 (five car) units and 1 Class 221 (four car unit):</p> <ul style="list-style-type: none"> – continue to be leased on the terms of the existing Operating Lease dated 9th December 1998 made between Voyager Leasing Limited and Cross Country Trains Limited until the expiry of the Operating Lease on 31st March 2012 – continue to be maintained on the terms of the existing Train Service Agreement dated 9th December 1998 and made between Cross Country Trains Limited and Crossfleet Limited until the expiry of the Train Service Agreement on 31st March 2012' <p>The ITT also stated that two base cases were required and that bidders could not use Classes 150, 153, 156 or 158 for one of the proposals.</p>
InterCity East Coast 2007	All rolling stock transferred No new rolling stock	<p>'All Rolling Stock leases relating to the Great North Eastern Railway (GNER) fleet will wholly transfer to the successor operator at the end of the GNER franchise. The current contractual arrangements, including the refurbishment work will be unaffected by the transfer.'</p> <p>'Intercity Express Programme (IEP) is the programme for replacement of the existing High Speed Train Fleet with a new train that can deliver the flexibility, performance and carrying capacity the railway will need to 2040 and beyond. IEP is being led by the DfT. There will be a requirement for the InterCity East Coast Franchisee to fully cooperate with the IEP which, it is anticipated, will reach an advanced stage of development during the currency of the franchise.'</p>

Source: CC analysis of DfT franchise ITTs.

Details of section 54 undertakings since privatization

1. In this annex, we set out some of the detail in relation to the circumstances in which section 54 undertakings have been awarded since privatization.

TOC failure—three undertakings

2. Three separate undertakings related to HSBC's Class 375, 376 and 465 and Angel's Class 465, 466 and 508 as a result of Connex's Southeastern franchise being terminated early in November 2003.
3. Connex had been scheduled to run the franchise through to 2011. From November 2003 to April 2006, the franchise was operated by a wholly-owned subsidiary of the SRA, South Eastern Trains Ltd (SET). Connex's rolling stock leases were transferred to SET and section 54 undertakings were given to the ROSCOs to guarantee that the successor to SET would continue to lease all of the incumbent rolling stock through to October 2011. The undertakings did not therefore provide any additional security to that which existed at the time the leases were originally agreed with Connex.

[redacted]⁵²

⁵²[redacted]

Brief history of franchising policy

1. The original franchise-letting process took place between 1995 and mid-1997. Under RA93, the Franchising Director was responsible for letting franchises through OPRAF.
2. The franchises were let based on a core service specification called the Passenger Service Requirement (PSR), which was usually a minimum specification to ensure that basic public service needs were met. There was leeway for franchisees to develop services outside the PSR and bidders were able to propose innovative ideas within their bids. This enabled such proposals as Virgin's 15-year West Coast franchise in which Virgin proposed a new fleet of tilting trains, which were subsequently purchased by Angel.⁵³ Franchisees managed much of the rolling stock procurement under light specification in franchise ITTs from OPRAF.
3. The DfT told us that such flexibility in the tendering process made bids difficult to compare and that new investment in rolling stock was not always the best use of public funds, nor was it always in the best interests of the public. The DfT also told us that added capacity often led to sub-optimal or unsustainable use of the railways and contributed to a reduction in punctuality.
4. The Transport Act 2000 led to the creation of the SRA. Between November 1999 and August 2002, the SRA adopted a policy of trying to introduce long-term franchises (of between 10 and 20 years, with termination or renegotiation possible after reviews every five to seven years). The objectives of this policy were to enable TOCs to take greater delivery risk on new investment in both rolling stock and rail infrastructure, whilst also mitigating stranding risk for the ROSCOs.
5. The SRA negotiated with a number of incumbent TOCs in the hope that they would relinquish existing franchises before the end date in return for the opportunity to bid for the longer-term franchise. However, the position of the franchisee within the industry structure meant that it was not well placed to plan and deliver large-scale investment projects. Only a small number of franchises were actually relinquished before the end dates and only the Chiltern franchise was agreed (in February 2002) as a new long-term franchise before the SRA then determined that franchise terms should generally be between five and eight years.⁵⁴
6. The SRA had seen a number of problems arising from the first round of privatized franchising, including renegotiating franchises that had been based on unrealistic expectations, and in one case, the SRA had become the operator of last resort. This led to a new franchise model, which was to be publicly specified and privately delivered. The PSR was replaced with Service Level Commitments, which defined a minimum service the franchisee must provide. Any further services had to be approved by the SRA.
7. Public subsidy to the railways increased from £1.2 billion in 2000/01 to £4.6 billion in 2005/06. In response to rising costs, the Government wound up the SRA in 2005 and

⁵³However, the DfT told us that most of the original franchises could not be considered to be particularly innovative, were for a duration of around seven years and did not involve substantial rolling stock fleet replacement.

⁵⁴There were two franchises (South Central and South Western) on which the TOC relinquished the franchise and bid on the basis of a long-term franchise which ultimately failed to be negotiated. The franchise length was subsequently shortened from the planned long-term franchise.

took control of the railways by making the Secretary of State for Transport responsible for franchise allocation, with strong emphasis on deliverability and value for money. Franchise length was set at seven to ten years, with the last two to three years dependent on performance targets being met.

Analysis of indirect specification

1. In this annex we set out in more detail our analysis of indirect specification based on assessment of franchise bids and submissions by the TOCs.
2. We examined TOC bid submissions for comments that suggested that alternatives might have been put forward in the absence of specification in the Service Level Commitment. We found the following examples:
 - (a) Northern franchise—First commented that it had not proposed new DMUs because ‘an assessment of such new units against the service criteria specified in the ITT has shown that, in all other respects, the benefits are likely to be minimal given the nature of the Northern operation.’
 - (b) Intercity East Coast 2005—the ‘Variant 2 timetable descriptor’ specifies an assumed train length of HST 2+9 or Class 91 2+10. Virgin also noted that five-car and nine-car Meridians were non-compliant to the ITT on seating capacity in comparison to the HSTs.
 - (c) On the TransPennine franchise, First/Keolis stated: ‘we have seriously considered the alternative of a small number of new trains in 2004/05 and completing the entire replacement later on in the franchise in 2008 but have strongly discounted this option as we do not believe it meets stakeholder requirements’.
 - (d) On the Greater Western franchise, Stagecoach weighed up replacing the Class 180s with HSTs or new rolling stock but found that it was not able to do so given the need to operate 52 diagrams instead of 47 (which compared to the 36 diagrams prior to franchise re-let).
 - (e) On the East Midlands franchise, National Express’s bid noted that the Class 180s could have been an alternative but ‘with this reliability level 11 diagrams could be covered with consistency from a fleet of 14 but a fleet of 14 is insufficient to meet the full Mainline diagram requirement of 13 per SX day’.⁵⁵
 - (f) On the West Midlands franchise, Govia’s bid stated that ‘Class 170 units could potentially operate these Snow Hill routes, however, while sufficient vehicles are available to lease, we believe it is unlikely that enough could be leased without impacting on the deliverability of the New Cross Country franchise’.
 - (g) On the New Cross Country franchise, Virgin’s bid stated that ‘we have considered every possible vehicle type and suitability that could be used on all or any part of the route network of services. Many fail because they are unable to meet elements of the SLC2 timetable or meet the capacity requirement. Many of the options fail because they do not represent value for money or because they represent a performance risk not only at the start of but also throughout the NCC franchise life’.

⁵⁵National Express added that only 14 units were built and the production line had been dismantled.

- (h) On the Intercity East Coast 2007 franchise, National Express's bid stated that '125mph 5-car diesel Class 180s would need to operate in multiple to meet ICEC seating requirements'.
3. We also asked the TOCs to comment on further examples where they felt indirect specification had limited choice:⁵⁶
- (a) National Express stated that it had never experienced the problem of indirect specification and Arriva gave no specific examples.
 - (b) Chiltern noted that the requirement (perceived or stated) to use certain depots had been an issue, for example the Tyseley depot on the Midlands Three franchises.
 - (c) Stagecoach submitted that the East Midlands franchise provided a 'broad hint' that the Class 222 rolling stock should be used. It stated that (i) the fast Sheffield path in the ITT was timed for Class 222 traction and (ii) the ITT required splitting and joining at Leicester which meant that an HST timetable was not really possible. Stagecoach noted that it was able to offer a variant within the base case and that it did not necessarily disagree with the DfT's reasons for such specification.
 - (d) First, although not providing specific examples, submitted that the DfT's approach to the construction of the Service Level Commitment necessarily led to specification in terms which reflected the existing timetable and rolling stock. It noted that journey times, capacity and 'dwell time' specifications had all restricted rolling stock choices in the past.

⁵⁶GNER submitted that 'In all franchises the detailed train service timetable specification restricts the range of suitable rolling stock solutions'.