

**Date: 5 June 2014**

**Item 10: Docklands Light Railway Franchise Procurement**

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**This paper will be considered in public**

**1 Summary**

- 1.1 The purpose of this paper is to update the Committee on the procurement process being undertaken by Docklands Light Railway Limited (DLRL) for the new franchise for the provision of passenger operations and maintenance of the Docklands Light Railway (DLR).
- 1.2 A paper is included on Part 2 of the agenda, which contains exempt supplementary information. The information is exempt by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the business affairs of TfL. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

**2 Recommendations**

- 2.1 **The Committee is asked to note the paper, the supplementary information on Part 2 of the agenda and the information provided at the meeting and to recommend that the Board:**
  - (a) **approves entering into the Franchise Agreement and ancillary agreements (“Franchise Agreements”) with the bidder identified at the meeting;**
  - (b) **if recommended at the meeting, approves the termination of the City Airport and Woolwich Arsenal Concession Agreements;**
  - (c) **if recommended at the meeting, approves the dissolution of City Airport Rail Enterprises (Holdings) Limited, City Airport Rail Enterprises plc, Woolwich Arsenal Rail Enterprises Limited and Woolwich Arsenal Rail Enterprises (Holdings) Limited (together the “Concession Companies”);**
  - (d) **delegates to the TfL Officers and the Subsidiaries (as described in paragraph 2.2 below) the authority to finalise the terms of the Franchise Agreements and any notices or documentation in relation to the termination of the City Airport and Woolwich Arsenal Concession Agreements and the dissolution of the Concession Companies;**

- (e) authorises the agreement and execution (whether by deed or otherwise on behalf of TfL or any Subsidiary (as appropriate)) any documentation to be entered into in connection with:**
  - (i) the completion and implementation of the Franchise Agreements and any of the matters referred to therein (including, without limitation, all agreements, deeds, guarantees, indemnities, property or other licences, announcements, notices, contracts, certificates, letters or other documents); and**
  - (ii) the completion of any notices and other documentation in relation to the termination of the City Airport and Woolwich Arsenal Concession Agreements and the dissolution of the concession Companies; and**
- (f) authorises TfL Officers and Subsidiaries to do all such other things as they consider necessary or desirable to facilitate:**
  - (i) the execution and implementation of the Franchise Agreements and the matters referred to therein; and**
  - (ii) the termination of the City Airport and Woolwich Arsenal Concession Agreements and the dissolution of the Concession Companies.**

**2.2 The following Officers and Subsidiaries shall have delegated authority:**

- (a) TfL Officers: the Commissioner, Managing Director Finance, Managing Director Rail and Underground and General Counsel; and**
- (b) Subsidiaries: Subsidiaries of TfL including Transport Trading Limited and any other subsidiary (whether existing presently or to be formed) of Transport Trading Limited and any of the directors of the relevant company shall be authorised to act for and on behalf of that company.**

### **3 Background**

- 3.1 DLRL currently franchises all aspects of train and passenger service operations and maintenance of rolling stock and maintenance of the majority of the infrastructure under a Franchise Agreement with Serco Limited.**
- 3.2 Whilst operations and the majority of maintenance responsibilities sit with the current franchisee, DLRL owns the infrastructure of the original sections of the railway and also the extensions to Bank, Beckton and Stratford International. In addition, the infrastructure on the extensions to City Airport and Woolwich Arsenal were acquired by TfL from the private sector in November 2011; however, the infrastructure on the extension to Lewisham remains private sector owned under a long term Private Finance Initiative (PFI) concession**

whereby the private sector is responsible for the design, construction of the infrastructure and its subsequent maintenance and renewal until 2021.

- 3.3 The majority of the rolling stock fleet is owned by DLRL, but 24 of the vehicles are owned by the Royal Bank of Scotland under a finance lease signed in April 2005.
- 3.4 The current franchisee is remunerated for meeting a target level of service performance metrics with a package of incentives for increased performance and abatements for below target performance. These metrics relate primarily to achieving departures on time, journey times and customer service. In addition, the current franchisee also receives a small per passenger charge as an incentive to increase passenger numbers (which the current franchisee manages through responsibilities included in the Franchise Agreement in relation to advertising, marketing, revenue protection, and project work in relation to major DLR capital programmes, for example enabling extensions and capacity upgrades).
- 3.5 DLRL currently retains the majority of revenue risk on the DLR network as well as the right to specify services.
- 3.6 The current franchise has been highly successful in performance terms with consistent high levels of operating performance (regularly achieving 99 per cent of trains on time) and rising customer satisfaction based on the results of customer surveys (achieving a score of 88 in the latest periodic survey results).
- 3.7 In January 2013, DLRL issued an OJEU notice to start a procurement process to appoint a new franchisee for a period of approximately seven years (with a pre-priced option to extend to nine years). The procurement also includes an option to consolidate the maintenance arrangements for the City Airport and Woolwich Arsenal extensions should it be value for money to do so. These maintenance arrangements currently remain the subject of the legacy PFI concessions referred to in paragraph 3.2 above.

## **4 The Scope of the New Franchise**

- 4.1 The new franchise will continue to integrate operations and maintenance and, by reducing the number (and associated costs of) complex interfaces with other maintenance arrangements, the new franchisee will be in a position to make the best operational decisions as both operator and maintainer.
- 4.2 The new franchisee will be responsible for:
  - (a) train and passenger service operations across the whole DLR network;
  - (b) train maintenance; and
  - (c) in respect of all other DLRL infrastructure and assets:

- (i) the maintenance of all infrastructure and assets managed by the current franchisee;
- (ii) the maintenance of the Stratford International extension (as the current maintenance arrangements between DLRL and Colas will terminate at the end of the current franchise); and
- (iii) should it prove value for money to do so based on the outcome of the procurement evaluation, DLRL will terminate the current maintenance arrangements for the City Airport and Woolwich Arsenal extensions and maintenance of the infrastructure and assets will become the responsibility of the new franchisee.

4.3 DLRL also manages a PFI concession with City Greenwich Lewisham Rail Limited for the Lewisham extension infrastructure, which expires in 2021 and hence maintenance of the infrastructure on that part of the DLR network will sit outside the responsibilities of the new franchisee.

4.4 DLRL has reviewed the current Franchise Agreement in light of lessons learned in the current franchise and best practice drawn from other similar arrangements in TfL (such as the London Overground Concession and the proposed Crossrail Operating Concession) and the wider franchising market. As a result of this review, certain amendments have been included in the scope and structure of the new Franchise Agreement. These are summarised below.

#### **Maintenance and Asset Management**

4.5 The new franchisee shall be responsible for daily delivery of asset performance and asset stewardship, whilst ensuring that the assets are maintained so as to allow DLRL to deliver a safe and performing railway for the whole life of the assets.

4.6 The new Franchise Agreement contains additional requirements that will enable DLRL to provide and monitor some input measures; in addition to the output based performance regime. For example, the new franchisee will be required to significantly redevelop the asset management system, work bank management, materials management and knowledge of asset condition. This, coupled with specific condition based input requirements, is intended to enable better decision making regarding improved asset performance, condition, costs and risk.

4.7 In addition, this will enable DLRL to improve decision making regarding capital investment projects and long term asset management and renewal strategy which will remain the responsibility of DLRL.

#### **Capital Projects and Variations**

4.8 The current Franchise Agreement splits the responsibility for capital investment between DLRL and the current franchisee in certain circumstances. The new Franchise Agreement will instead provide that capital

investment projects will be managed, funded and procured by DLRL. This reflects that DLRL will be best placed to manage capital investment as infrastructure owner, taking account of asset condition requirements over the whole life of the assets.

- 4.9 The new Franchise Agreement will guarantee that DLRL spends a minimum budget on capital investment projects.
- 4.10 The new Franchise Agreement will contain a new contractual variation procedure, based on a mechanism that will enable DLRL to claw back certain benefits of capital investment from the new franchisee. This is primarily intended to result in lower fixed fees being payable by DLRL should such capital investment have the effect of lowering the new franchisee's costs or increasing their performance revenue. The current Franchise Agreement does not allow for DLRL to claw back such benefits to the franchisee as a result of DLRL funded variations.
- 4.11 In addition, the new Franchise Agreement will include a better defined possessions and asset adoption regime, designed to ensure that the new franchisee is incentivised to work with DLRL to introduce capital enhancements into operation on the railway.
- 4.12 The new Franchise Agreement also requires that certain known variations are "pre-priced" before entering the contract. This enables DLRL to obtain competitive pricing through the procurement process for matters such as known future enhancements to service plans and to standardised labour rates and margins for minor future variations.

### **Safety**

- 4.13 The new franchisee will be required to comply with a number of safety management requirements which include, inter alia, the Health and Safety at Work Act (1974) and the Railways and Other Guided Transport Systems (Safety) Regulations 2006 (ROGS). In addition, DLRL will require the new franchisee to comply with a number of specific requirements, such as adhering to DLRL specified business critical processes, establishing and maintaining safety management systems that are suitable and sufficient to support safe (and reliable) operations, participate in wider safety governance arrangements with key stakeholders and monitor and manage certain safety related metrics across the railway.
- 4.14 Under ROGS, DLRL holds a Safety Authorisation as Infrastructure Manager (excluding stations) and the new franchisee will be required to hold both a Safety Certificate as a Transport Undertaking and a Safety Authorisation as Infrastructure Manager (Stations). The Office of Rail Regulation (ORR) requires that this is place before commencement of the new franchise.

## **Payment Mechanism and Revenue Risk**

- 4.15 The current franchisee is currently remunerated through the payment of a “Fixed Fee” by DLRL. The Fixed Fee is adjusted for bonuses or abatements that DLRL pay or charge depending on the franchisee’s performance against specified performance metrics. This mechanism will continue in the new Franchise Agreement and is outlined further in paragraph 4.18 below.
- 4.16 The current franchisee also receives a share of revenue generated on the DLR through the payment of a small “fee per passenger”. In practice, this has not been demonstrated to incentivise growth in revenue or influence revenue outcomes. Instead, this has been predominantly influenced by DLRL’s capital investment in the network (for example, three-car upgrades and line extensions) and TfL’s overall responsibility for determining fare policy.
- 4.17 Continuing this arrangement in the new Franchise Agreement is therefore unlikely to be value for money in the context of the DLR. This is because the new Franchise Agreement will not transfer the responsibility for the matters that influence revenue outcomes (such as investment decisions, marketing and so on) and because the DLR has a reasonably high level of base demand which is relatively inelastic.
- 4.18 Therefore, the new Franchise Agreement will not contain any payment related to revenue/patronage; instead the payment mechanism will comprise only a Fixed Fee payable on the basis of achieving certain predetermined performance targets with bonuses and abatements made to the Fixed Fee should the new franchisee achieve increased or poorer performance. The Fixed Fee will also index in line with the Retail Price Index as TfL is likely to be better placed than a franchisee to manage inflation risk on a holistic basis, in a wider portfolio of revenues and costs.

## **Performance Regime**

- 4.19 As set out in paragraph 4.18, the new franchisee will be measured against predetermined performance targets and will be paid bonuses and/or charged abatements should actual performance be better and/or worse than target.
- 4.20 The current Franchise Agreement includes operational performance targets related to:
- (a) departures (a capacity measure which compares the percentage of operated train services versus those planned);
  - (b) journey time (the percentages of operated train services achieving defined target journey times);
  - (c) 20 minute delays (a one-off penalty for delay to passenger journey of twenty minutes or more); and
  - (d) station closures (a one-off penalty for each station closure with some variable element to reflect impacted passenger journeys).

- 4.21 The new Franchise Agreement continues to include these metrics although the base performance target for each of these metrics has been adjusted to reflect future anticipated performance levels and wider strategic objectives related to service delivery. In addition, a new target related to excess waiting time (a measure of actual intervals between trains on a route versus planned intervals, weighted by number of passengers affected) will supplement the existing metrics set out above, in order to bring the new Franchise Agreement performance regime in line with wider benchmarking metrics from across TfL.
- 4.22 The current Franchise Agreement also includes certain customer service targets measured against results of customer surveys. This continues in the new Franchise Agreement although base performance targets have been adjusted to reflect future anticipated performance levels. The new Franchise Agreement shall also include a “Customer Facing Regime” (similar to the London Overground Concession), whereby the new franchisee are financially incentivised to ensure matters such as station and train cleanliness, ticket vending machine availability and lift and escalator reliability are maintained at appropriate levels.
- 4.23 The monetary values ascribed to bonuses and abatements have been recalibrated for the new Franchise Agreement, to better provide sufficient financial incentives and to reflect the cost to the new franchisee (plus a reasonable margin) of achieving increased levels of performance or otherwise avoiding costs, whilst remaining value for money.
- 4.24 The financial incentives are valued at a level that will encourage the new franchisee to correct any failures as rapidly as possible and to avoid repeated failures through the use of rectification periods and escalating abatements. The value of the bonuses payable also escalate to reflect the increase in cost of delivering higher levels of performance; but the overall amount that the new franchisee can earn from increased performance is capped at a level which is economically desirable for DLRL.
- 4.25 For example, the base target for departures (that is the target at which the franchisee shall receive only the fixed fee and not be paid bonuses or be charged abatements) is to be set at 98.4 per cent (of operated services versus those planned). The new franchisee shall receive or be charged £55,000 per one per cent variation as a bonus or abatement should performance be higher or lower than the target.
- 4.26 Within the regime the bonuses and abatements for departures will ratchet up or down to reflect DLRL’s view of an optimum performance band and the relative cost of making improvements in performance (in the case of departures, largely driven by additional staff costs). This is set out in the table below. This regime acknowledges that performance over a certain level (a “maximum target”) is likely to only be driven by significant capital investment, the responsibility for which will reside with DLRL. Therefore, DLRL does not wish to encourage franchisee spending at the upper limits of the performance regime when it intends to make investment decisions itself.

### Target Levels of Performance – Departures

Penalty Limit	94.0%
Minimum Standard	98.0%
Base Target	98.4%
Upper Threshold	98.9%
Maximum Target	99.5%

### Payment Rates– Departures

Below Penalty Limit	No further abatements
Between Penalty Limit and Minimum Standard	2 x abatement
Between Minimum Standard and Target	1 x abatement
Target	No payments or abatements
Between Target and Upper Threshold	1 x payment
Between Upper Threshold and Maximum Target	6 x payment
Above Maximum Target	0.5 x payment

4.27 The contractual enforcement regime includes the ability for DLRL to require remedial plans and escalates through step in rights and warning notices. The performance regime should, therefore, encourage real spending by the new franchisee to deliver increased levels of performance.

4.28 In addition, the current franchisee is entitled to relief against performance abatements in relation to certain interface risks and events that occur on the railway that may result in the franchisee delivering lower levels of performance than otherwise anticipated (for example, suspension of passenger services if required by the emergency services). The new franchisee will be entitled to such relief in fewer circumstances going forward, as experience suggests that whilst the franchisee is not directly in control of certain events which impact performance, it does have the ability to significantly influence the impact of them on the railway.

## **Other Commercial Matters**

- 4.29 The current Franchise Agreement requires an on-demand bank bond of £10m to secure the franchisee's obligations. The new Franchise Agreement shall specify that the franchisee instead provides an on demand bank bond of £15m and a parent company guarantee (which reflects the franchisee's limits on liability of £60m, excluding certain general indemnities where liability remains uncapped). This change in requirements for financial support reflects a review of any credit risk in the new Franchise Agreement and takes into consideration the structure of the bidding entities.
- 4.30 Ancillary activities currently undertaken by the current franchisee will be brought in-house (for example, certain customer service activities such as responding to telephone queries/complaints, retail activities, estate management, marketing, advertising) where better value may be generated by grouping DLR with the wider TfL organisation (particularly the work being undertaken in the Commercial Development directorate).

## **Cost of the New Franchise**

- 4.31 An estimate of the increased cost of the new franchise has been included in the Business Plan, approved by the Board in December 2013.

## **5 New Franchise Pre-Qualification and Invitation to Tender**

- 5.1 In April 2013, the following four bidders pre-qualified to receive an Invitation to Tender ("ITT"):
- (a) Stagecoach Rail Projects Limited;
  - (b) Keolis (UK) Ltd/Amey Rail Limited (Joint Venture);
  - (c) The Go-Ahead Group plc/Colas Rail Limited (Joint Venture); and
  - (d) Serco Limited.
- 5.2 Prior to the ITT bid response date, the Go-Ahead Group plc/Colas Rail Limited (Joint Venture) withdrew from further participation in the procurement. The remaining three bidders submitted responses to the ITT on 9 September 2013.
- 5.3 The key principle of the evaluation methodology was to ensure that the new Franchise Agreement would be awarded to the most economically advantageous bid allowing for a balance between technical, commercial and price factors. The ITT responses were evaluated for technical, commercial and price components according to the following weightings:

<b>Component</b>	<b>Weighting</b>
Price	45%
Technical	40%
Commercial	15%

- 5.4 The evaluation methodology takes account of the commercial structure of the new Franchise Agreement with bidders required to submit bids against the performance regime and a draft new Franchise Agreement specified by DLRL.
- 5.5 The technical evaluation relates to DLRL’s confidence that bidders can deliver the required performance base targets and prescribed inputs.
- 5.6 DLRL has followed a detailed procurement process, set out in appropriate procurement documentation. The primary areas of evaluation are set in further detail below.
- 5.7 Where appropriate, DLRL has sought assurance from expert advisors, including Ashurst (legal advisors), Interfleet and Steer Davies Gleave (technical advisors) and Grant Thornton (financial advisors).
- 5.8 In addition, TfL Internal Audit conducted a review of the procurement process and was satisfied that effective controls have been applied to the refranchising of operations and maintenance for the DLR.

**Technical**

- 5.9 Bidders were required to provide written responses to the following nine “Delivery Plans”.

<b>Delivery Plan 1 (Mobilisation)</b>
<b>Delivery Plan 2 (Business Management)</b>
<b>Delivery Plan 3 (Safety)</b>
<b>Delivery Plan 4 (Asset Management)</b> Delivery Plan 4A (Policy, Strategy and Principles) Delivery Plan 4B (Delivering Asset Management) Delivery Plan 4C (Resources)

<p><b>Delivery Plan 5 (Service Delivery)</b></p> <p>Delivery Plan 5A (Railway Operational Planning)</p> <p>Delivery Plan 5B (Railway Operational Delivery)</p> <p>Delivery Plan 5C (Railway Performance Review and Management)</p>
<p><b>Delivery Plan 6 (Customer Satisfaction, Security and Revenue Protection)</b></p> <p>Delivery Plan 6A (Customer Satisfaction)</p> <p>Delivery Plan 6B (Security)</p> <p>Delivery Plan 6C (Revenue Protection)</p>
<p><b>Delivery Plan 7 (Environment)</b></p>
<p><b>Delivery Plan 8 (Working With Stakeholders)</b></p>
<p><b>Delivery Plan 9 (Responsible Procurement)</b></p> <p>Equality and Supplier Diversity</p> <p>Strategic Labour Needs and Training</p> <p>Ethical Sourcing</p>

- 5.10 Each Delivery Plan was evaluated for the bidder’s understanding of the requirements and DLRL’s confidence that these plans would deliver the relevant sections of the new Franchise Agreement.
- 5.11 Bidders were scored using a six point scale within which scores of 0, 20, 40, 60, 80 and 100 could be awarded. This scoring framework represented characteristics of the bid ranging from “Major Concerns” to “Excellent”. Bidders were required to score a minimum of 40 (“Minor Concerns”) in the majority of the Delivery Plans, otherwise DLRL retained a discretionary right to exclude the bidder from further participation in the competition.

**Price**

- 5.12 Bidders were required to provide a financial model, record of assumptions, financial management and funding plan and other supporting documentation to support the submission of a price. The price submitted was the net present value of the base bid fees (in real terms), comprising:
- (a) the fixed fees DLRL would pay for the initial period;
  - (b) the fixed fees DLRL would pay during the extension period (discounted by 20 per cent to reflect that the extension remains an option);
  - (c) the incremental/decremental fixed fees that DLRL would pay should it exercise pre-priced contractual options related to step changes in service plans; and

- (d) the incremental fixed fees that DLRL would pay for marginal service changes, based on a scenario provided by DLRL.
- 5.13 The bidder with the lowest net present value of base bid fees was awarded full marks for this component and other bidders were assigned a score in inverse proportion.
- 5.14 Bidders were also required to submit standardised prices related to labour rates and margin to be applied should DLRL exercise the variation procedure in the contract. The bidder with the lowest labour rates and margin was awarded full marks for this component and other bidders were assigned a score in inverse proportion.
- 5.15 Financial submissions were also reviewed to consider if any bid appeared to be abnormally low.

### **Commercial**

- 5.16 Bidders were required to provide a “mark up” of the draft franchise agreement. This was evaluated for the extent to which the proposed mark up transferred risk, obligations or had any other adverse impact on DLRL.
- 5.17 Bidders were restricted from amending various key components of the new Franchise Agreement; in particular the base service plans, fare setting, performance regime, asset maintenance requirements and safety requirements.
- 5.18 Bidders were scored using the same six point scoring scale as described in paragraph 5.11.
- 5.19 In addition, bidders’ financial documentation was scored for its completeness, clarity, ease of use and the robustness of the underlying pricing assumptions (and ultimately the risk of financial default). Bidders were scored using the same scoring framework as described in paragraph 5.11.

### **The DLRL Option**

- 5.20 In February 2003, DLRL entered into a 30 year concession agreement with City Airport Rail Enterprises Plc (CARE) for the design, construction, financing and maintenance of the infrastructure on a 4.4km extension of the DLR network from Canning Town to King George V station via London City Airport.
- 5.21 In May 2005, DLRL entered into a separate 30 year concession agreement with Woolwich Arsenal Rail Enterprises Limited (WARE) for the design, construction, financing and maintenance of a further 2.4km extension connecting the City Airport extension with a new station at Woolwich Arsenal.
- 5.22 In March 2011 the Board approved the acquisition by TfL of CARE and WARE and their respective holding companies (City Airport Rail Enterprises (Holdings) Limited and Woolwich Arsenal Rail Enterprises (Holdings) Limited) (together the “Concession Companies”). The transaction completed in

November 2011 and the companies became wholly owned subsidiaries of TfL.

- 5.23 Since the acquisition in November 2011, the concession arrangements and structure have remained in place as termination of the concession agreements would have triggered an automatic termination of the underlying maintenance agreements and it may not have delivered value for money for TfL to re-procure maintenance agreements separately in advance of the procurement of the new franchise.
- 5.24 In the ITT, bidders were asked to provide submissions and pricing for the maintenance of the City Airport and Woolwich Arsenal extensions should DLRL wish to include this within the maintenance obligations in the new Franchise Agreement (“DLRL Option”).
- 5.25 The decision whether or not to exercise the DLRL Option is to be based on value for money considerations and wider DLRL business plans and operations to ensure that DLRL enters the new franchise on the basis that is most economically advantageous to DLRL as a whole. The price and any technical and commercial submissions in relation to the DLRL Option were evaluated in accordance with the same evaluation methodology as described in paragraph 5.11. Consequently, each bidder has been awarded an overall score with and without the DLRL Option being exercised.

## **6 Best and Final Offer (BAFO) Phase**

- 6.1 Following evaluation of the ITT bid submissions, DLRL invited all bidders to proceed with a BAFO phase with all bidders in order to take account of a further developed new Franchise Agreement (including amendments to certain minor areas of scope where DLRL believed better value for money could be achieved) and to provide individual feedback to each of the bidders arising from the ITT evaluation phase.
- 6.2 In addition, DLRL required bidders to provide further clarity in certain areas in order to fully evaluate confidence in delivery. These areas included sub contracting proposals, mobilisation costs, capital expenditure assumptions and management of DLRL capital projects, rationale for deployment of resources, and key risks and mitigations.
- 6.3 Bidders were provided with an updated draft of the new Franchise Agreement and supplementary BAFO bid instructions on 29 January 2014. BAFO responses were received from all three bidders on 14 March 2014.
- 6.4 DLRL is currently evaluating the submission of bids in response to the BAFO using the same evaluation methodology as the ITT phase.

## **7 Next Steps**

- 7.1 The evaluation will not be complete in advance of the submission of this paper. Therefore, DLRL will provide an update at the meeting of the Committee.

**List of appendices to this report:**

Exempt supplemental information is included in a paper on Part 2 of the agenda.

**List of Background Papers:**

None

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