



2. About the franchising of Melbourne's train and tram system



2.1 Recent history

Railways are vital to Victoria's economic growth. They link people to services, employment and each other. The provision of rail (train and tram) services is also a major financial commitment by the government.

Victoria's train and tram system has seen major changes in recent years. Before 1999, the Public Transport Corporation (a statutory body) provided passenger train and tram services across Victoria. In 1999, the (then) government awarded 5 separate franchises to private sector companies to operate trams and trains for periods of up to 15 years. The 5 franchise businesses were:

- M>Train (15 years)
- M>Tram (12 years)
- Connex (15 years)
- Yarra Trams (12 years), and
- V/Line Passenger (10 years).

Three of these businesses (M>Train, M>Tram and V/Line Passenger) were owned by National Express Group Australia.

The Department of Infrastructure (DoI) is the government agency with primary responsibility for public transport policy in Victoria.

2.1.1 The 1999 franchise agreements

The 1999 franchise agreements aimed to improve service quality, increase patronage, minimise long-term costs to the taxpayer, transfer risks to the private sector and maintain safety standards. The (then) government estimated that the franchising of passenger train and tram services (including V/Line Passenger) would cost \$161 million less per year over the 15-year franchise terms than would public provision of the services¹. It anticipated that these savings would result from competition among service providers, and from incentives for franchisees to pursue efficiencies.

¹ Department of Treasury and Finance 2000, *Passenger Rail Franchising in Victoria: An Overview*, Department of Treasury and Finance, Melbourne.

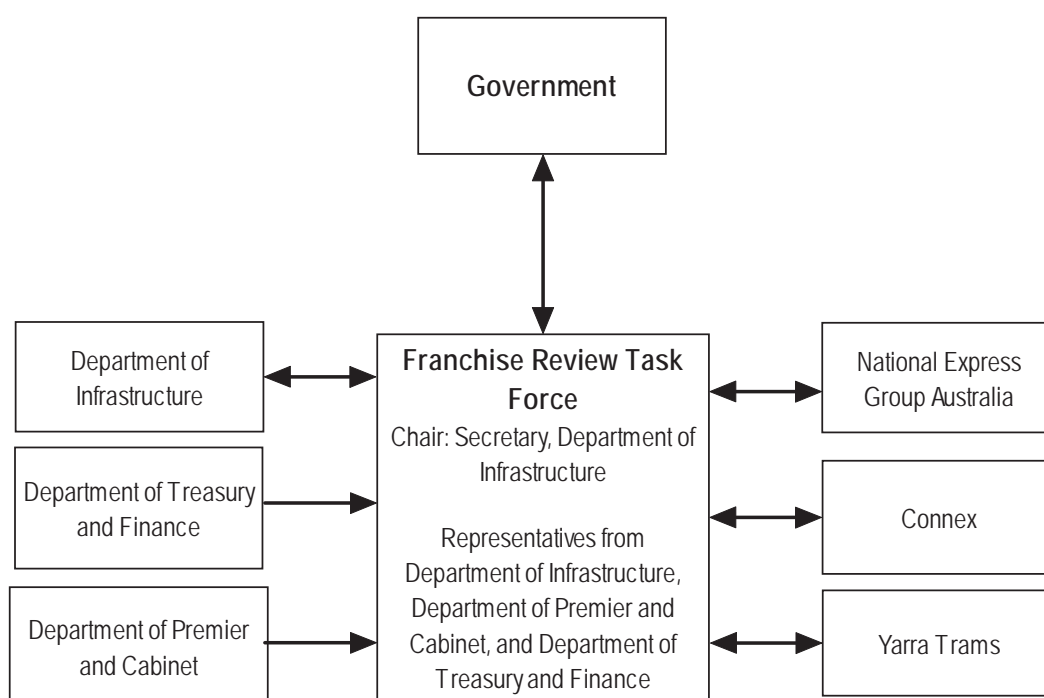
In the first 2 years of operation, the franchisees did not meet their passenger growth and cost reduction targets, which jeopardised their financial viability. Consequently, at the end of 2002, the government entered into 2 interim operating agreements with Connex and Yarra Trams. It did so to ensure the short-term viability of the businesses, to resolve contractual disputes and to restructure the industry. The National Express businesses also went into administration, and the government appointed receivers and managers to operate them.

Difficulties with the 1999 franchise agreements

In December 2001, the government established the Franchise Review Task Force to, among other things, identify the main problems with the 1999 franchise agreements, and to provide advice on the ways forward for the metropolitan train and tram system².

Figure 2A shows the structure and relationships of the task force.

FIGURE 2A: FRANCHISE REVIEW TASK FORCE AND ITS RELATIONSHIPS



Source: Victorian Auditor-General's Office.

² The role of the Franchise Review Task Force was to: minimise long-term risk adjusted costs to the state of passenger train and tram services by promoting patronage growth and improving the operational efficiency of the train and tram businesses; ensure that the full range of services continue to operate safely and without interruption; and to establish a clear, stable and lasting basis for the future provision of the services, broadly consistent with the structure of the existing franchises.

The main problems with the 1999 franchise agreements, as identified by the task force, were:

- inaccurate passenger and revenue growth forecasts by the franchisees
- inappropriate allocation of revenue risk
- fare evasion
- a flawed system of revenue allocation
- inaccurate franchisee cost forecasts
- financial shocks
- gaps in performance monitoring
- lack of coordination between franchisees, and
- contractual flaws.

The task force reported in detail on its analysis of these problems in submissions to government, and DoI made public a summary of its analysis in *Public Transport Partnerships - Passenger Rail Franchising in Victoria: An Overview*³.

2.1.2 The 2004 franchise agreements

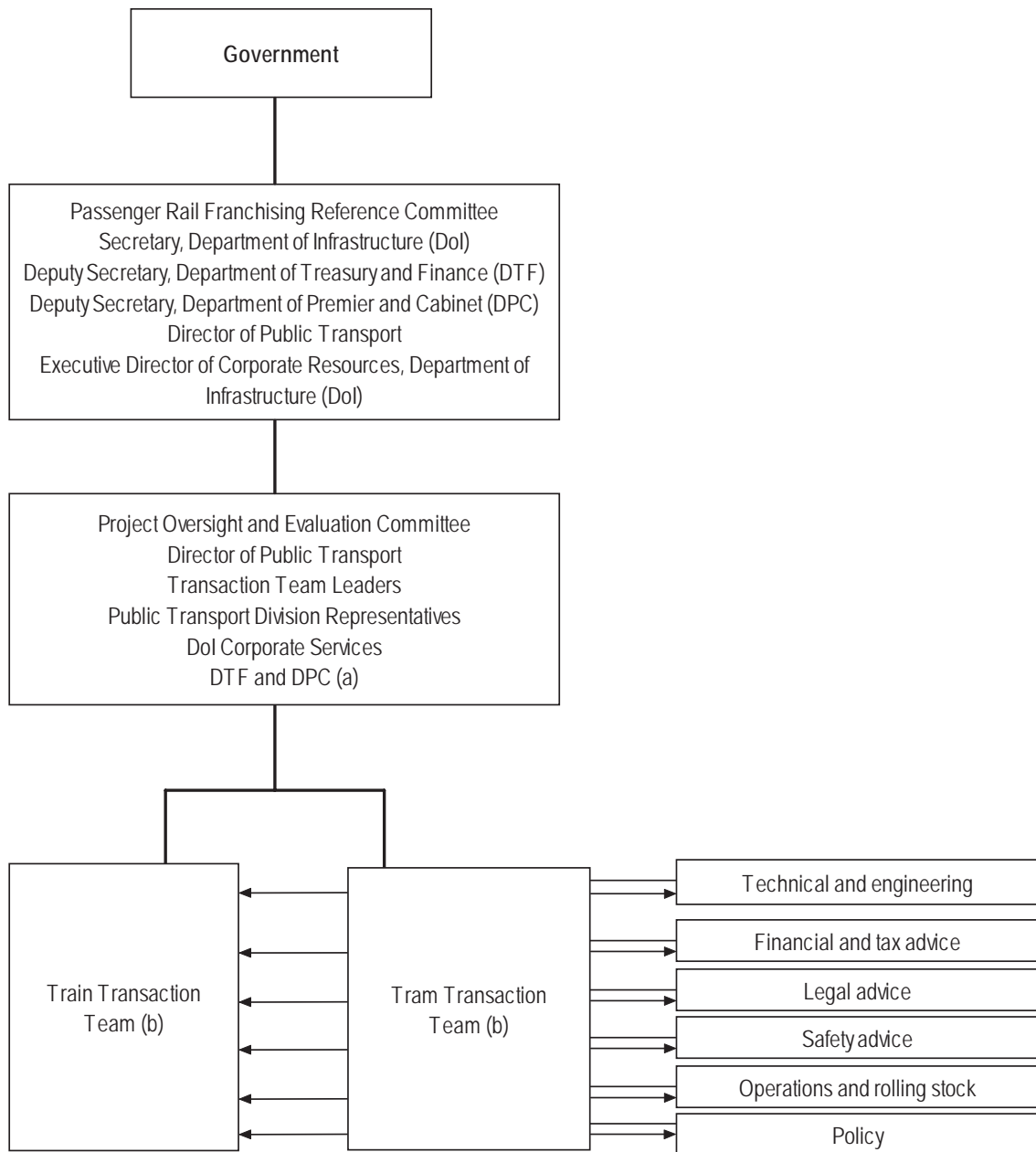
In July 2002, the government decided to restructure the metropolitan passenger train and tram system into one train and one tram franchise. In April 2003, the government decided to negotiate the single train and tram franchises with the remaining franchisees (Connex and Yarra Trams). A Refranchising Team⁴ was established within DoI to achieve a set of objectives established by the government for the new franchise agreements. The objectives are discussed later on in this section.

Figure 2B shows the structure of the renegotiation process.

³ Department of Infrastructure 2004.

⁴ The Refranchising Team comprised representatives from DoI's Public Transport Division and Corporate Finance group, and a number of expert external consultants.

FIGURE 2B: STRUCTURE FOR THE RENEGOTIATION PROCESS



(a) The role of the Project Oversight and Evaluation Committee was to ensure that the renegotiation process was delivered in accordance with agreed timelines and processes, and to consider the offer evaluation reports prepared by the Transaction Teams as a basis for advice to the government.

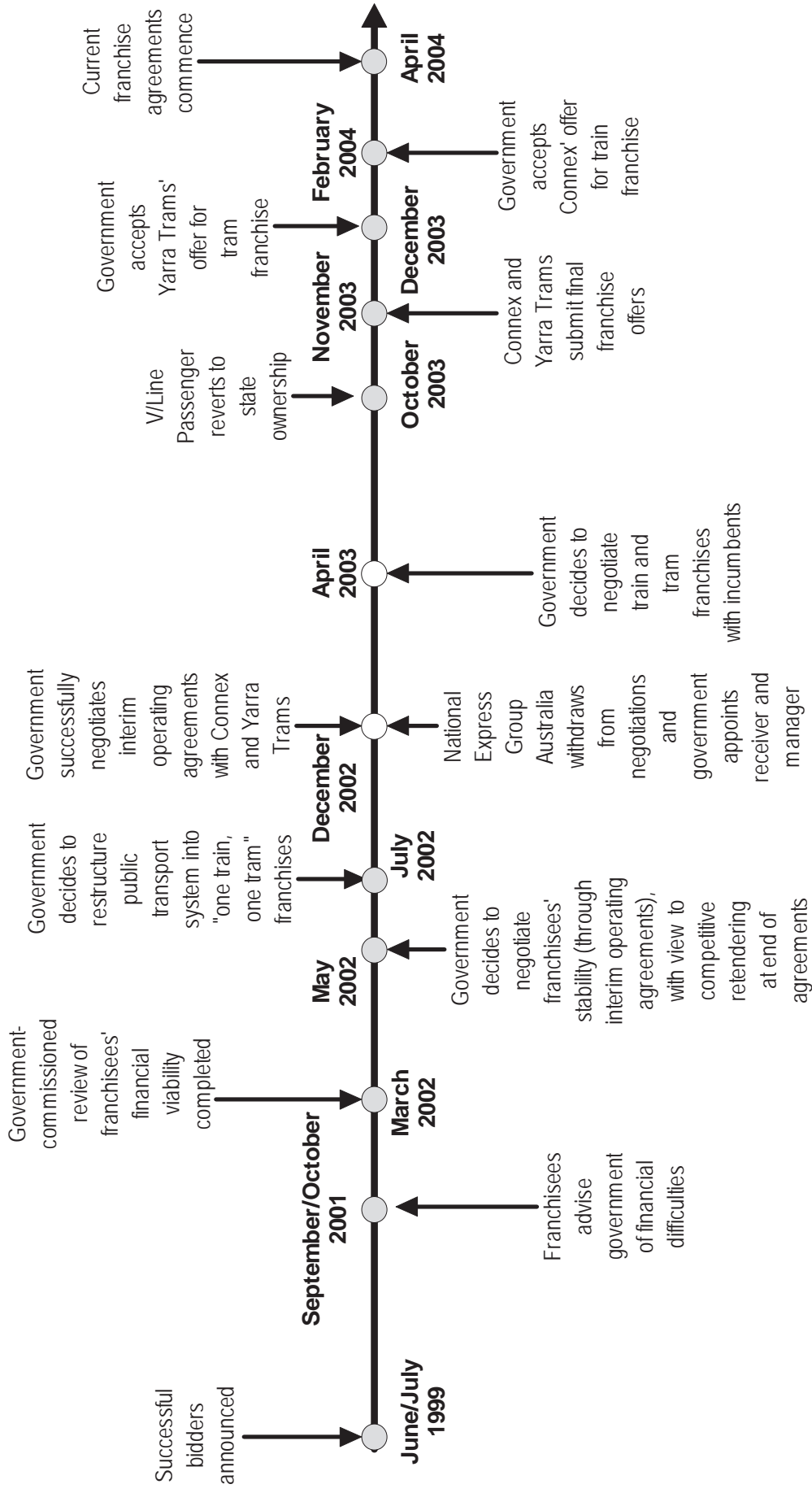
(b) The role of the Transaction Teams was to manage government interaction with franchisees during renegotiation process, and prepare offer evaluation reports for further consideration.

Source: Department of Infrastructure.

In February 2004, after extensive negotiations, the government awarded Connex the metropolitan passenger train franchise and Yarra Trams the metropolitan tram franchise, for the period 18 April 2004 to 30 November 2008 (with the option of extending this period for not less than 6 months and up to 31 May 2010). (The background to these decisions is discussed in full in Part 3 of this report.) Both immediately started operating under the new agreements. (Separate to the renegotiation process, the government also decided that V/Line Passenger would be transferred back to state control to assist in the delivery of a number of projects, such as the Spencer Street Station redevelopment).

Figure 2C summarises the major events affecting the Victorian public transport system since 1999.

FIGURE 2C: EVENTS IN MELBOURNE'S PUBLIC PASSENGER TRANSPORT SYSTEM SINCE 1999



Source: Victorian Auditor General's Office.

DoI manages the train and tram franchise agreements for government. DoI's Director of Public Transport signed the agreements, on behalf of the government.

Objectives of the 2004 franchise agreements

When deciding to restructure the metropolitan train and tram system into one train and one tram franchise, the government set the following objectives for the new franchise agreements. These were:

- to establish franchise arrangements which deliver rail services which are safe, operationally efficient and supported by convenient intermodal connections, and high quality passenger information
- to encourage and achieve innovation in the delivery of public transport services
- to establish stable and sustainable relationships with franchisees that offer proven managerial experience, and are committed to positive action, in key areas such as: operational safety; innovation; technology planning; operational planning and management; asset maintenance, renewal and improvement; marketing; project development and implementation; financial management; ticketing; revenue generation and protection, and industrial relations
- to establish franchises which are financially sustainable but which do not earn excessive profits
- to achieve value-for-money in the franchise contracts
- to secure acceptance by the franchisees of institutional reforms, contractual obligations and commercial risks which support the state's policy objectives for public transport, and
- to complete negotiations with incumbent franchisees by the end of 2003⁵.

These objectives were included in the criteria that DoI used to evaluate the franchisees' offers.

The government also settled on a set of specifications for the train and tram services that would realise its objectives⁶. The specifications were set out in a *Contract Design Guide*, which formed the basis of the requests for proposals from the franchisees, DoI's public sector benchmarks and offer templates used by the franchisees.

⁵ Department of Infrastructure 2004, *Public Transport Partnerships, Passenger Rail Franchising in Victoria - An Overview*, Public Transport Division, Department of Infrastructure, Melbourne.

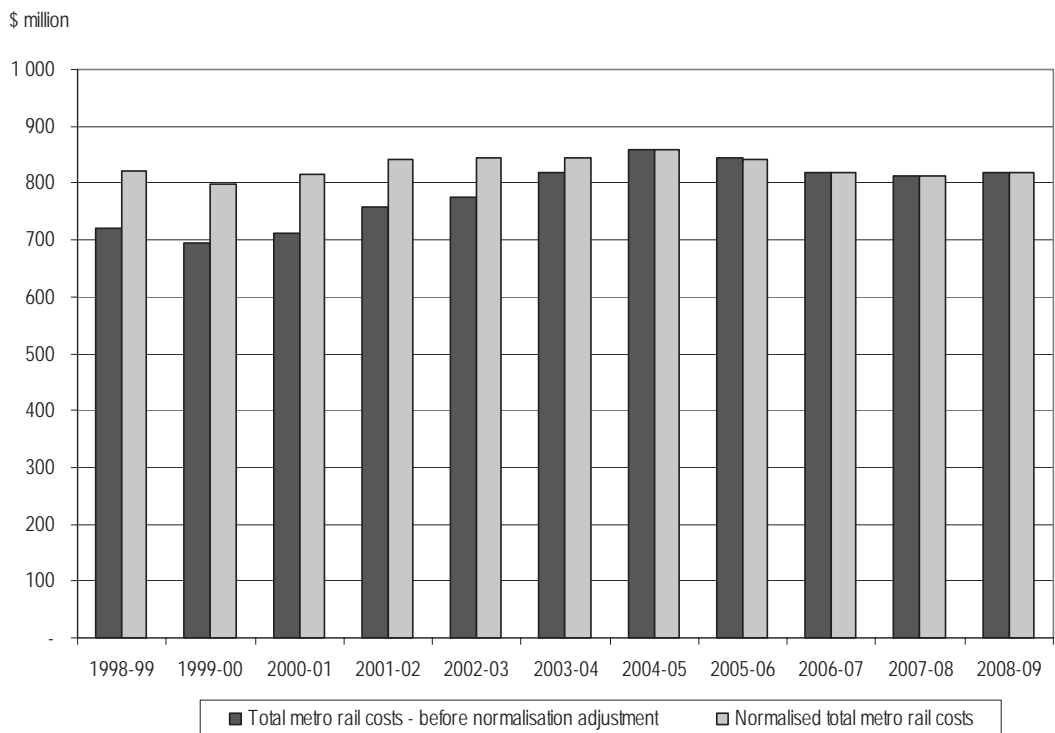
⁶ Department of Infrastructure 2003, *Passenger Rail Franchising in Victoria, Contract Design Guide*, Public Transport Division, Department of Infrastructure, Melbourne.

2.2 Costs of operating the metropolitan train and tram system

2.2.1 Total costs

Figure 2D shows the total cost of operating Melbourne's tram and train system. It shows that the cost has remained (and is expected to remain) relatively constant over time, with the exception of the costs of introducing the new rolling stock.

FIGURE 2D: TOTAL COST OF OPERATING MELBOURNE'S TRAINS AND TRAMS (\$MILLION PER YEAR)



Note: Normalised costs include adjustments made to present the results on a comparable basis. These mainly include constant investment in rolling stock. Figures are in net present value terms.

Source: Information provided by Department of Infrastructure.

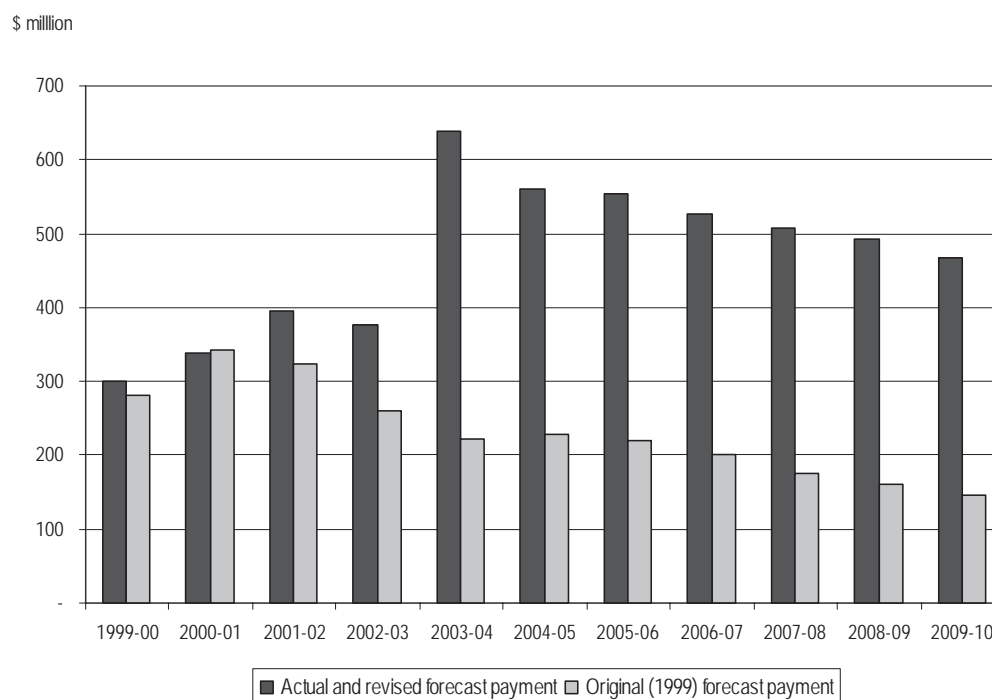
2.2.2 Government payments to franchisees

Melbourne's passenger railways depend on taxpayer funding to supplement fare revenues.

The 1999 franchise agreements were based on forecasts that total government payments would gradually decline, and that franchisees would become largely self-supporting, towards the later years of the 12-15 year franchise terms as revenue grew. Following the renegotiation of the franchises in 2004, government payments to the franchisees increased significantly. They are forecast to drop slightly over the 5 years of the franchises, mainly due to expected growth in fare revenues (which will decrease the payments needed to meet revenue shortfalls).

Figure 2E compares actual and projected payments under the original 1999 and the new 2004 franchising agreements.

FIGURE 2E: MELBOURNE'S TRAIN AND TRAM PAYMENT PROFILE (2004-05 REAL DOLLARS) – PAYMENTS TO FRANCHISEES



Note: Consumer price index (CPI) sourced from the Australian Bureau of Statistics for the period 1999-2004. Base year of 1999-2000 used (March 2000). Forecast CPI sourced from the 2005-06 state budget.

Based on 30 June figures.

Includes additional costs associated with running the metropolitan train and tram system that are paid to the franchisees (such as rolling stock adjustments, concession fare payments and other service costs). These differed slightly between 1999 and 2004.

Source: Information provided by Department of Infrastructure.

Under the renegotiated franchises, the payments to both franchisees increased by \$330 million a year to about \$560 million in 2004-05, and will be more than \$3 billion for the whole franchise term (2004-2010)⁷. About 85 per cent of each payment is a base payment, and a payment to fund the leasing costs of new rolling stock. This part of the payment is fixed. The balance is a variable amount to compensate for concession fares and various forecast adjustment payments that are subject to particular events occurring.

Of the \$330 million in extra payments to be provided each year, around 5 per cent is for requirements new to the revised agreements. These new requirements are for extra employees to check tickets, and for extra employees on trains and trams and in stations. In other words, almost all the extra payment is to secure the franchisees' operation over the franchise period.

1999 franchise agreement costs

Between the commencement of the franchise agreements in 1999 to the date of restructure (April 2004), a number of events took place that had or will have an impact on the government's finances above what was forecast. These events mainly resulted from government policy initiatives, the interim operating agreements and the withdrawal of National Express Group Australia.

Figure 2F shows these transactions.

⁷ All amounts are in 2004-05 dollars.

FIGURE 2F: OVERALL IMPACT ON THE STATE'S FINANCES (\$MILLION)

Transaction item	Total public transport system (a)		Metropolitan train and tram franchises only	
Policy initiatives -				
Employment of roving conductors and Safe Travel staff	37.7	37.7	37.7	37.7
Costs associated with the collapse of the 1999 franchise agreements -				
Settling outstanding claims and disputes with the franchisees	68.2		64.4	
Funding of December 2002 interim operating agreements by sharing franchisees' operating losses	55.0		55.0	
Fees for appointing a receiver and manager for the National Express Group Australia franchises	11.0		9.2	
Funding shortfalls of franchisees in receivership to ensure services continued to operate	257.6		244.8	
Net asset gain on National Express Group Australia rolling stock companies acquired by the state	(1.3)		0.0	
Less receipt of performance bond paid by National Express Group Australia	(135.0)	255.5	(90.0)	283.4
Costs subsequent to the collapse of the 1999 franchise agreements -				
Franchise Review Task Force and Refranchising Team costs (including consultants and in-house staff)	37.6		37.6	
Assumption of employee entitlements (b)	172.6		148.0	
Assets purchased from Connex and Yarra Trams following restructure	107.0		107.0	
Less value of old rolling stock returned to the state and revalued (c)	(568.0)	(250.8)	(448.0)	(155.4)
Net impact to the state		42.4		165.7

(a) Includes V/Line Passenger, but excludes buses.

(b) At the inception of the franchise agreements in 1999, accumulated employee entitlements (valued at around \$136 million) were assumed by the franchise operators. Under the 2004 franchise agreements, these obligations have been resumed by the government, along with the subsequent movement in the liability.

(c) The old rolling stock was originally provided to the franchisees for nominal consideration. Under the new franchise agreements, the old rolling stock is leased back to the franchisee for nominal consideration.

Note: Does not include any infrastructure renewals that may be attributable to a backlog of infrastructure maintenance over the original franchise term, which were being examined by DoI at the time of the audit. See Part 4 of this report for further discussion on infrastructure maintenance.

Some of the transactions listed in the above table are also accounted for in the payments made to the franchisees, as described earlier in Figure 2E.

Source: Information provided by Department of Infrastructure.

Other costs to government

Under the 2004 franchise agreements, the state assumed responsibility for some of the ongoing costs of operating the metropolitan train and tram system. This included insurance (estimated at \$16.6 million a year) and contributions towards MetLink's operations and marketing. The state also retained the costs of operating the current ticketing system (previously channelled through the franchisees), movements in CPI (payments are indexed to CPI) and the cost of introducing a new ticketing system.

In addition, the state has assumed the risks that:

- insurance premium may increase
- actual employee leave balances may be lower than balances forecast by the franchisees
- latent defects in the train infrastructure may be higher than the thresholds
- the new ticketing system may result in a fall in revenue (for example, if there are problems with its introduction)
- the works set out in asset management plans may not prevent the infrastructure from deteriorating over time, and
- actual revenue may be below thresholds set for each of the franchise years, in which case the government will cover 50 per cent of the shortfall for trains and 75 per cent of the shortfall for trams.

The key risks and other costs retained by the government include:

- providing additional services for the 2006 Commonwealth Games
- acquiring or leasing additional rolling stock to increase capacity, and
- guarantees over the condition of the new rolling stock, in the event that the franchisees do not meet condition targets.

Thus, in addition to the \$560 million annual payment provided to the franchisees, the government will also incur additional costs associated with assumed and retained risks.

2.2.3 Franchisees' costs

As Figure 2G shows, the franchisee's biggest operating costs are labour, maintenance (which also includes a major labour component) and new rolling stock lease payments.

FIGURE 2G: ESTIMATED OPERATING COSTS FOR METROPOLITAN TRAIN AND TRAM SYSTEM FOR 2004-2008 (\$MILLION)

Metropolitan service	Labour (excluding maintenance)	Maintenance (rolling stock and infrastructure)	New rolling stock lease payments	Other	Total operating expenditure
Tram	512	368	152	172	1 204
Trains	736	774	375	366	2 251
Total	1 248	1 142	527	538	3 455

Based on franchisee final offer price over the franchise term (in net present value terms).

Source: Final franchisee offers.

Labour (excluding maintenance)

Although each franchisee decides on the size and composition of its own labour force, the government has set minimum staffing levels for some of the franchisees operations to ensure the quality of services and to protect revenue. The government has also assumed the employee leave entitlement liability for most franchisee staff from the start of the new franchise agreements. This means that where the actual employee leave balance is greater than the balance the franchisees forecast, the franchisee is required to pay the difference to the state. Where the actual employee leave balance is lower than the forecast balance, the state must pay the difference to the franchisee. Employee leave entitlement liability is discussed further in Part 4 of this report.

Labour issues can also result in indirect costs for the franchisees. For example, the shortage of train drivers at the time of the audit resulted in more trains being cancelled, which in turn increased penalties for the train franchisee.

Maintenance (rolling stock and infrastructure)

The main maintenance items for franchisees are the rails, stations, signalling and traction power equipment. Victorian Rail Track (VicTrack - a state-owned entity) owns the infrastructure and leases it to the Director of Public Transport, who then leases it to the franchisees for nominal consideration.

Under the renegotiated agreements, franchisees must submit (and implement) an annual infrastructure works plan to keep the infrastructure operational and safe. The risks of residual asset condition (beyond the minimum work required by the annual plan) have returned to the state. The franchisees are also required to maintain the old and new (leased) rolling stock in specified conditions. The renegotiated agreements also provide that maintenance services are provided within and outside the franchisees structure.

New rolling stock lease payments

The original franchise agreements required franchisees to bring new rolling stock into service by specified dates, to replace existing rolling stock and to increase the capacity of the system.

Since the start of the original franchise agreements, over 95 new trams and 65 new metropolitan trains have been ordered. The average age of the stock has fallen, to around 12.9 years for trains and 15.5 years for trams (excluding the heritage W, Z1 and Z2 class trams).

Under the original agreements, rolling stock leasing companies contracted with manufacturers to build new trains and trams, and leased them to the franchisees to operate. The rolling stock leasing companies funded the purchase of the new stock, and the franchisees paid them leasing charges out of the government's payment. The government provided a number of guarantees to the rolling stock leasing companies and had wide-ranging step-in rights, as well as the option to acquire the rolling stock.

These arrangements are the same under the renegotiated agreements except that the lease agreements are assigned to the relevant franchisee, and the government now pays the insurance on the rolling stock.

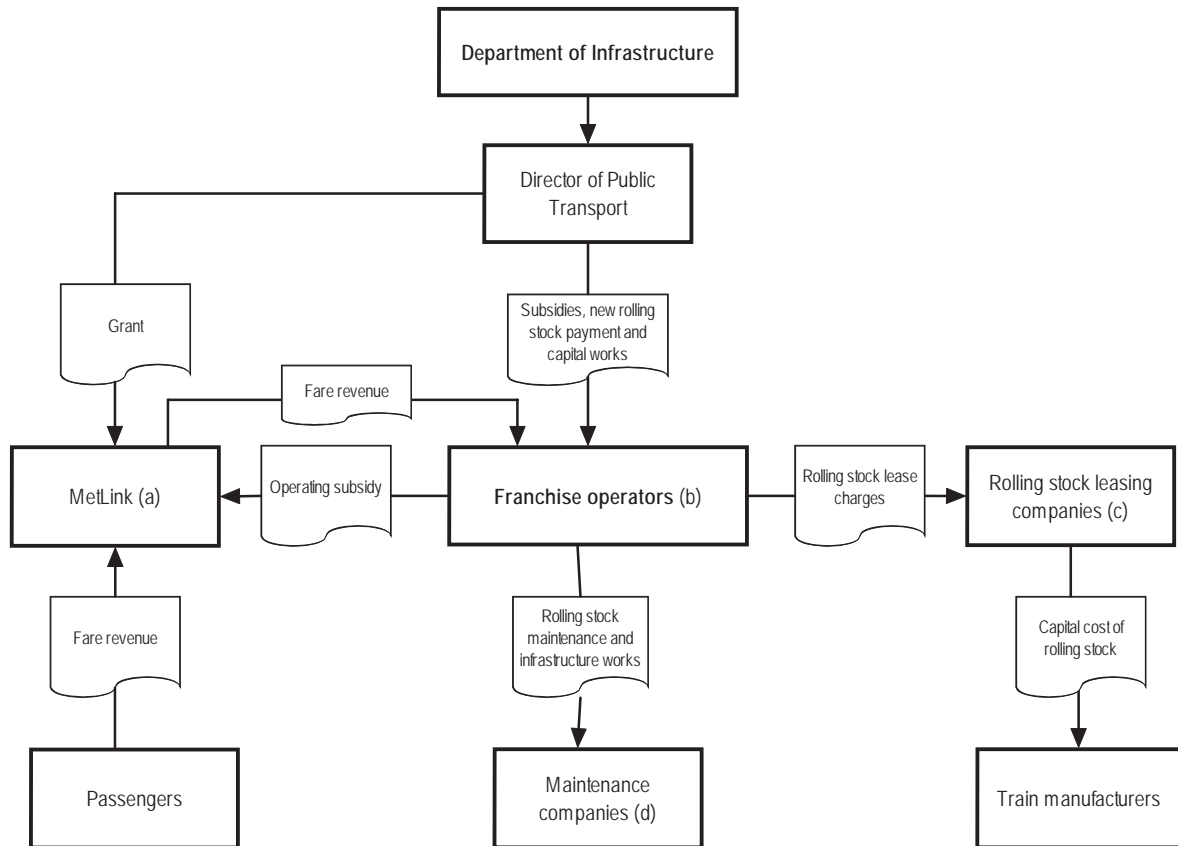
The government will fund all (or almost all) of the rolling stock's fair value through the new rolling stock payments to the franchisees (which the franchisees then pays to the rolling stock leasing companies) over the 15-year lease term. If the state elects to acquire the new leased rolling stock at the end of the lease term, it will make a final termination payment, which DoI estimates will be about \$100.8 million⁸ for all the new leased metropolitan trams and trains.

2.2.4 Money flows for the metropolitan train and tram system

The major money flows for the metropolitan train and tram system in 2004 are shown in Figure 2H.

⁸ Amount is in net present value terms.

FIGURE 2H: TAXPAYER AND PASSENGER FUNDING OF MELBOURNE'S TRAIN AND TRAM SYSTEM IN 2004



- (a) MetLink is wholly-owned by the franchisees and is responsible for fare revenue allocation, customer information and marketing.
- (b) The franchise operators are Connex and Yarra Trams.
- (c) Rolling stock leasing companies responsible for the acquisition and lease of the new rolling stock.
- (d) Yarra Trams does most of these functions in-house and Connex Trams has a 30 per cent equity in the company responsible for maintenance of infrastructure and most rolling stock.

Source: Victorian Auditor-General's Office.

2.3 Audit objective and scope

The objective of this audit was to determine whether the 2004 metropolitan tram and train franchise agreements represent value-for-money. In particular, the audit examined whether:

- the responsible agencies effectively managed the process of developing the current franchise agreements, with due regard to ensuring value-for-money, and
- the 2004 franchise agreements adequately took account of the lessons learnt from the 1999 franchise agreements.

The scope of the audit was the renegotiation of the 1999 franchise agreements to establish the 2004 agreements, and the essential events preceding the process. We did not examine the government's decision to return control of V/Line Passenger to the state. We did not assess whether franchisees are meeting the conditions of the franchise agreements as, at the time of the audit, it was too early to make this assessment. From some of the franchisees' perspective, however, the current agreements provide qualitative benefits, such as a clearer understanding by the franchisees of the state's expectations. We also did not analyse why the 1999 franchise agreements led to the franchisees sustaining financial difficulties.

2.4 Audit method and report structure

2.4.1 Assessing value-for-money

For the purposes of this audit, we defined the question of value-for-money in 2 ways.

First, we considered whether the government received effective advice on which to base its decision to renegotiate with the franchisees (examined in Part 3 of this report).

Second, we considered whether or not the government (through DoI) negotiated the franchise agreements for Melbourne's train and tram services for the best possible price.

Best possible price comprises 2 components:

- the *price* the government paid for the train and tram services – in this case, as the government payment to the franchisees for operating the train and tram services, and
- whether this price was the *best possible*.

Our preliminary research for the audit told us that DoI would have obtained the best possible price if it:

- distributed risks between the government and the franchisees according to who was best able to mitigate them, and paid franchisees an appropriate premium for the risks they were taking on (examined in Part 4)
- accurately identified the costs of providing the train and tram services, and realistically forecast fare revenue, to determine the lowest level of payment the government would need to provide to franchisees. DoI brought this information together in 2 financial models, one for trains and one for trams, called public sector benchmarks (examined in Part 5)

- ensured that the final offers DoI accepted from Connex and Yarra Trams were comparable to the public sector benchmarks (examined in Part 5), and
- used any other available means (such as strategies to share excessive profits) to negotiate prices (examined in Part 6).

The audit also examined 2 other matters that are fundamental to any procurement process:

- whether probity requirements were observed (examined in Part 7), and
- whether DoI built adequate performance monitoring arrangements into the new agreements (examined in Part 8).

Examining DoI's response to difficulties with the 1999 franchise agreements

The value-for-money picture is not complete without an examination of the difficulties associated with the 1999 franchises. Although the 1999 agreements may have appeared at the time to represent value-for-money, they were ultimately unsustainable.

An essential part of our value-for-money assessment was, therefore, whether DoI took account of the difficulties with the 1999 franchise agreements. With the government intent on new franchise agreements, it was crucial that DoI identified the problems that caused the difficulties, and ensured that these problems did not recur in any new agreement.

Figure 2I shows how we examined whether DoI addressed these difficulties with the 2004 franchise agreements.

FIGURE 2I: OUR APPROACH TO EXAMINING DOI'S RESPONSE TO THE DIFFICULTIES IN THE 1999 FRANCHISE AGREEMENTS

Assessing value-for-money	Examining whether DoI addressed difficulties with the 1999 franchise agreements
Public sector benchmarks	⇒ Did DoI ensure that franchisees' fare revenue forecasts were realistic? Did DoI ensure that franchisees' costs estimates were accurate?
Risk allocation	⇒ Did DoI reallocate risks, particularly fare revenue risks, to the party best able to mitigate them? Did DoI limit the volatility in franchisees' fare revenue flows? Did DoI adopt the most appropriate contract length?
Performance monitoring	⇒ Did DoI establish performance monitoring arrangements that will enable it to identify if the same difficulties are emerging again? In particular: <ul style="list-style-type: none"> • Did DoI establish arrangements to ensure that franchisees reduce fare evasion? • Did DoI establish arrangements to monitor franchisees' financial viability?

Source: Victorian Auditor-General's Office.

A consolidated summary of the difficulties with the 1999 franchise agreements, and the ways in which they were addressed in the 2004 agreements, is provided at Appendix A of this report.

2.4.2 Conduct of the audit

We conducted detailed audit fieldwork, addressing all these areas of interest including:

- document reviews (such as reviews of the franchise agreements, and submissions to government)
- interviews with DoI and Department of Treasury and Finance (DTF) personnel and representatives of Connex and Yarra Trams, and
- analysis of the financial models used by DoI during the renegotiation process.

The audit team used Partnerships Victoria guidance⁹ as a guide during the audit. However, we recognise that the franchise agreements for Melbourne's trains and trams are not, strictly speaking, subject to this guidance.

The audit was performed in accordance with the Australian auditing standards applicable to performance audits. The cost of the audit was \$1 040 000. This cost includes staff time, overheads, expert advice and printing.

We thank staff from DoI, DTF, Connex, Yarra Trams and members of the audit reference group for their assistance with the audit. We would also like to thank consultants from Frontier Economics Pty Ltd and Ove Arup Pty Ltd for their assistance.

⁹ Department of Treasury and Finance 2001, *Partnerships Victoria Guidance Material*, Department of Treasury and Finance, Melbourne.