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The South Eastern Passenger Rail Franchise

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 457 Session 2005-2006 | 2 December 2005

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The South Eastern Passenger Rail Franchise

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PART ONE
Summary

1.1 In June 2003, the Strategic Rail Authority (SRA) announced that it would be terminating, within six months, Connex South Eastern's (CSE's) franchise for providing passenger rail services in Kent, parts of Sussex and South East London. This was the first, and so far only, occasion where the franchise of a Train Operating Company (TOC) has been terminated early. It had implications for passengers, taxpayers and the rail industry and also raised issues about the government's approach to franchise management.

Implications for passengers:

Connex South Eastern held the second largest passenger rail franchise in the UK and employed some 3,500 staff. The services provided under the franchise are among the most complex and demanding in the UK. Services call at 182 stations and carry around 400,000 passengers a day, including some 120,000 during each weekday peak, with many passengers depending on daily commuter services to and from London. At the time of the termination of the franchise, CSE was also part-way through a programme of introducing new trains to replace 622 of its oldest trains including its 558 slam-door vehicles.[1]

Implications for taxpayers:

The SRA agreed to provide further subsidies of £58.9 million for 2003 on top of considerable existing taxpayer subsidies of some £38 million for that year, to stabilise CSE's finances.

Implications for the rail industry:

The SRA demonstrated to the rail industry that it was both willing and able to use its statutory powers, should the need arise. As well as the immediate impact on CSE and its employees, the termination had implications for TOCs and their owning companies, and CSE's suppliers including the Rolling Stock Leasing Companies (ROSCOs) that leased trains to CSE.

Implications for government:

Events on the franchise raised issues about the effective management of passenger rail franchises, which are now relevant to the Department for Transport and the Scottish Executive as they take over the SRA's franchising roles.[2]

1 The Railway Safety Regulations 1999 set TOCs a statutory requirement to remove from service all of their oldest slam-door trains by December 2004. This deadline was subsequently extended by Her Majesty's Railway Inspectorate (HMRI) until the end of November 2005.

2 Under the Railways Act 2005, the government is abolishing the SRA. In July 2005, the Department for Transport took over the SRA's franchising roles – specifying, awarding, managing and monitoring franchises, including monitoring TOCs' compliance with franchise terms – in England and Wales, while the Scottish Executive took over these roles in Scotland in October 2005.

1.2 The SRA's predecessor, the Office of Passenger Rail Franchising (OPRAF), awarded the franchise to CSE for a period of 15 years, to run from 1996 to 2011. The franchise envisaged that OPRAF would pay CSE subsidies totalling £535 million over the lifetime of the franchise. Annual subsidies would decline year on year, from some £125 million during the first 12 months of the franchise until, in the final 12 months, CSE would pay OPRAF around £2.8 million. In December 2001, CSE requested a two year extension to the franchise suggesting that £400 million of additional subsidy be provided to improve its operational performance and quality of service over the period to 2013, to bring it into line with franchises that the SRA was then considering for two other TOCs. Subsequent work by the SRA and CSE, however, indicated significant impending financial difficulties on the franchise.

1.3 In December 2002, at the same time that it agreed to provide CSE with additional subsidies for 2003, the SRA required improvements to CSE's financial management, particularly in the transparency of CSE's trading with other businesses within the wider group of companies of which CSE was a part,[3] brought forward the franchise's end date from 2011 to 2006 and entered into negotiations on possible further subsidies for 2004 to 2006. In June 2003, however, following a series of reviews, the SRA announced its decision to terminate the franchise and in November 2003 South Eastern Trains (SET), a subsidiary of the SRA, took over the running of the franchise.

1.4 The SRA intended that SET would run the franchise for 18 months before it relet the franchise to a private sector TOC. The reletting of the franchise has been delayed, however, and is now scheduled to take place in December 2005. The new franchise is expected to become operational in April 2006, by which time SET will have been running the franchise for some two-and-a-half years. The Department for Transport (the Department) is reletting the franchise as part of a new Integrated Kent Franchise, combining the services that SET currently provides with new domestic services on the Channel Tunnel Rail Link (CTRL), which are expected to begin operating in 2009.

1.5 Government policy remains that Britain's passenger rail services are publicly funded, where necessary, but privately delivered. As it is not a private sector TOC, SET has been precluded from bidding for the new franchise. The SRA decided that SET's management team should not put a bid together, because this might have distracted it from running existing services. SET will continue to run the franchise until the Integrated Kent Franchise commences, at which point the SRA will be fully wound up.

What we examined

1.6 We examined:

- why the SRA terminated Connex South Eastern's franchise;
- how much the termination cost taxpayers;
- the impact on passengers; and
- the impact on the rail industry, and on the government's approach to franchise management.

1.7 The main methods used to obtain evidence for our report are set out in the Appendix.

The source of CSE's financial difficulties was an ambitious franchise bid in response to the government's emphasis on privatising typically at the lowest level of subsidy

1.8 OPRAF awarded the franchise to CSE primarily because, at a time of growing competition between bidders, CSE bid for the lowest level of subsidy over the franchise term. Annual subsidies were projected to fall over the lifetime of the franchise, most aggressively over the first three full financial years, and CSE quickly ran into financial difficulties. Rather than achieving anticipated profit margins of 5 per cent – around £15 million a year – between 1997-98 and 2001-02, CSE achieved average margins of 1.7 per cent – around £5 million. It made a pre-tax loss of £2.4 million in 2001-02 and would have made a loss as early as 1998-99, the second full financial year of the franchise, had its financial position not been alleviated by rolling stock lease charges £20 million a year lower[4] than projected in its bid for the franchise.

3 Connex South Eastern was owned by Connex Transport UK Ltd, which in turn was part of Vivendi (now Veolia), a multinational group of companies.
4 In 1999, CSE re-negotiated its train lease agreements on more favourable terms, and there was a delay in introducing new trains to replace its oldest slam-door vehicles.

1.9 Although over the first three years of the franchise CSE increased its passenger and other revenue ahead of the projections in its franchise bid, its operating costs increased by 27 per cent compared with an anticipated fall of 11 per cent. Like other bidders, it underestimated the extent to which British Rail had made efficiencies in preparation for privatisation. It employed more support and revenue protection staff than planned and, in common with other TOCs, had to employ more train drivers and spend more than anticipated on wages, overtime and driver training.

1.10 The SRA learned from the experience of the earliest franchises, adopting a new policy of evaluating bids to take account of what was realistically deliverable, rather than focusing primarily on lowest cost and the maximum amount of risk that a bidder was prepared to take. The SRA applied this policy in awarding the four most recent franchises in 2004 and 2005. In taking over the SRA's franchising responsibilities, the Department has adopted the SRA's policy in awarding the Integrated Kent Franchise, and the Thameslink and Great Western franchises. The Department is, however, re-considering its franchising policy. It has reservations about rejecting bids that offer the best deal for the taxpayer and passengers in terms of price and service provision on the basis of civil servants' and consultants' assessments of what is realistically deliverable, rather than on bidders' own judgements. It is therefore reviewing the case for such deliverability assessments, which it aims to complete in time for new invitations to tender for franchises from February 2006.

CSE did not alert the SRA to its emerging difficulties, while the government's approach to franchise monitoring relied on TOCs to assure their own longer-term viability

1.11 CSE had become aware of its impending financial difficulties in July 2001, but had sought to rectify matters itself rather than bring them to the SRA's attention. The philosophy of franchising was that the financial risk was fully transferred to private sector TOCs under their franchises. OPRAF therefore expected TOCs to monitor their own longer-term viability and request a viability review[5] if necessary. The franchise monitoring arrangements used by OPRAF focused on TOCs' short-term solvency. The arrangements did not involve scrutinising or challenging TOCs' longer-term business projections to assess their longer-term financial viability to deliver franchise obligations. When the SRA was set up in February 2001, it inherited OPRAF's statutory duty under the 1993 Railways Act to secure the provision of passenger train services. It had to be ready to step in at any time, and perhaps act as an 'operator of last resort' if necessary, to ensure that services continued to run. The SRA therefore continued with the franchise monitoring arrangements it inherited from OPRAF.

1.12 The magnitude of CSE's financial difficulties only became apparent after a series of reviews initiated by the SRA after a request from CSE's holding company, Connex Transport UK (CTUK) Ltd, for a two-year extension to the franchise. But even then CSE, and consequently the SRA, could not quantify the size of the funding gap with any certainty, with estimates ranging between £384 million and £820 million.

1.13 The SRA learned from the CSE case, which showed that risks were not fully transferred through franchising and that there was residual risk to taxpayers and passengers. The CSE case contributed to changes in the SRA's franchise management approach. The SRA strengthened its ability to scrutinise and interpret financial information, identify problems three to five years ahead and understand the risks to the taxpayer. The SRA required TOCs to provide more financial and management information and it subjected such information to a greater degree of challenge. The SRA's revised franchise monitoring reports continued, however, to focus on TOCs' shorter-term performance and, in our view, the reports still did not give sufficient attention to TOCs' longer-term financial viability.

1.14 The abolition of the SRA and the Department for Transport's assumption of the SRA's franchising responsibilities present risks to the continuity and rigour of franchise monitoring. The Department told us that it will be adopting the SRA's policy in taking over the SRA's franchising responsibilities, but is focusing further on identifying the key risks facing each franchise. In its July 2005 report, *Network Rail: making a fresh start* (HC 556 2004-05), the Committee of Public Accounts recommended that, in taking on its new responsibilities, the Department should recruit enough staff with commercial and technical skills and with the stature necessary to deal effectively at the highest levels of the railway industry. Comparisons between the number of staff employed by the SRA and by the Department on

5 A TOC can request a viability review of the terms of its franchise agreement if it considers that compliance with its obligations would result in default before the end of the franchise term.

franchising issues are not straightforward, because the SRA organised its team in a different way to the structure that the Department has now adopted for its teams. Focusing specifically on those staff most closely involved with the management of franchises, we found that the Department's staffing complement was 15 per cent less than that of the SRA. All but six of the 79 staff currently in post are former SRA employees.

CSE failed to satisfy the SRA that it was taking vigorous action to improve its financial management as a matter of urgency

1.15 A series of reports carried out by a consultant from Mott MacDonald on behalf of the SRA between January and March 2003 found that CSE had not complied with its obligations to improve its financial management, control and reporting. Indeed, CTUK Ltd told us that, because it had contributed £11.1 million of its own money to strengthen CSE's franchise, it saw the £58.9 million of additional subsidy agreed for 2003 as an SRA vote of confidence in the TOC as a prelude to negotiating a stable funding arrangement to the end of the franchise, although the SRA never expressed its agreement to the deed of amendment in such terms. CSE therefore focused more of its attention on negotiations on possible further subsidies, and its proposals for reducing costs for 2004 to 2006, than on the SRA's immediate requirements for improved financial management.

The SRA's approach did not produce conclusive results, and the SRA had to engage auditors to determine CSE's compliance

1.16 The three months between January and March 2003 were a critical period for CSE to demonstrate its compliance with its obligations. The SRA expected CSE to comply with its obligations, but seconded a consultant from Mott MacDonald to monitor CSE's compliance. The SRA spent £163,000 on the secondee and SRA staff held regular meetings with CSE. But the extent and nature of the engagement between the SRA and CSE were unclear from the documentation we have seen, and the SRA's approach, particularly the consultant's reports, did not produce conclusive results. In particular, we found no evidence as to whether the SRA had approved the required programme of financial management improvements that CSE had submitted to the SRA on 15 January, or formally shared with CSE the consultant's report highlighting the deficiencies in the programme, and on which CSE's subsequent work to improve its financial management depended. Further, the consultant's reports relied heavily on statements of compliance from CSE itself, without any independent verification, which the SRA had not asked the consultant to provide. The consultant's March 2003 report did not provide the SRA with a reliable view of the extent of CSE's compliance with its obligations. By then, the SRA considered that termination was a real possibility but that the consultant's report did not provide a robust basis for it to take vital longer-term decisions on the franchise. The SRA therefore commissioned PriceWaterhouseCoopers (PWC) to assess CSE's compliance, at a cost of some £177,000.

Although CSE made some improvements, the SRA ultimately lost confidence in CSE and issued a termination notice

1.17 In their May 2003 report, PWC concluded that CSE had been slow to focus on the deed's requirements and was not compliant with five of them. In response, CSE subsequently provided evidence of compliance in three of these five areas. PWC also concluded that CSE's budget-setting and review process had no significant weaknesses and was comparable with other companies of a similar size and complexity, and did not identify any instances where CSE was financially supporting the other businesses within the wider group of companies of which CSE was a part.

1.18 PWC recommended that the SRA should not provide additional subsidy for 2004-06 unless CSE addressed certain key actions, including some that had been required under the deed of amendment. They also recommended that CSE be required to appoint a Finance Director with sole responsibility for the TOC (whereas the existing Finance Director worked for both CSE and its holding company, Connex Transport UK Ltd) and a compliance officer responsible for addressing the SRA's requirements and ensuring full and timely compliance with financial controls. CTUK Ltd appointed a new Managing Director of CSE, and a compliance officer, both of whom began work in May 2003. CTUK Ltd told us that, in the same month, it had informed the SRA that it was appointing a new Chairman, who was highly regarded within the rail industry, to take whatever action the SRA required of CSE. But, by then, the SRA had lost confidence in CSE's financial management and it was too late for CSE to regain it. The SRA had provided funding to other TOCs in financial difficulty, but the SRA's loss of confidence was unique to CSE.

1.19 CSE had engaged consultants to help it develop an improved financial model, as required by the SRA, and another set of consultants at a cost of £400,000 to identify ways of reducing costs and minimising CSE's call on the public purse. CSE presented its own proposals for reducing costs and the amount of subsidy it needed, which it estimated could yield annual savings of some £20 million. It proposed running fewer carriages on off-peak services, installation of more ticket vending machines at stations to reduce staff costs, combining retail and ticket-selling operations, reducing train leasing charges by extending leases on better terms and mounting CCTV cameras on many trains to replace conductors. By March 2003, the SRA was satisfied that CSE's financial model for 2004 to 2006 produced accurate calculations, but remained unconvinced as to the robustness of the projected costs and revenues. The SRA was also unconvinced that CSE would be able to deliver its proposals for reducing costs. It considered the proposals impractical because they would require significant investment in 2003-04 and that some might constrain the commercial interests of an incoming franchisee.

1.20 The SRA considered that CSE's progress was insufficient for it to regain the confidence lost over the previous year. It considered that nothing Connex had done since the beginning of 2003 with regard to financial management had demonstrated either urgency or an ability to change behaviour so as to produce a culture of compliance. The management effort required by the SRA to spot and manage errors and deficiencies had been disproportionate compared with both other franchises and other SRA functions. In particular, the SRA was concerned that CSE's management was insufficiently pro-active and transparent in its dealings with the SRA and that it focused on meeting the reporting needs of its parent company, giving a lower priority to meeting the needs of the SRA.

1.21 Papers submitted to the SRA Board included all of the key information that we would have expected the Board to take into account, except for mention of the recent appointment of CSE's new Managing Director and recruitment of the new Chairman, and the PWC report in full. The SRA told us that the Board knew that the new Managing Director had taken up post. The lead financial adviser from KPMG attended the Board meeting. He told the SRA Board that CSE's financial management regime was very weak and that it could not be assured that CSE would spend additional funds efficiently and economically, as required by the Transport Act. The SRA Board approved termination of the franchise. He told us that he gave his advice in the context of the material available to the Board and of the level of confidence in CSE's financial management that the SRA required.

1.22 In our view, there were weaknesses in CSE's financial management, control and reporting, but we consider that KPMG expressed the weaknesses in CSE's financial management regime in stronger terms than is supported by the evidence we have seen. We concluded, however, that the Board had considered most of the key, relevant information and that the papers presented to the Board had been carefully balanced in setting out both the evidence and the options for the Board's deliberation. It was appropriate for the Board to exercise its statutory duty under the Transport Act and decide to terminate the franchise, where it had lost confidence in CSE's ability to use additional subsidy efficiently and economically.

1.23 The SRA Board recognised that termination of CSE's franchise would send a very strong message to the industry, indicating the seriousness with which the SRA was undertaking its responsibilities. We found that the termination decision prompted some TOCs to conduct their own internal reviews of their compliance with SRA requirements and of their finances and financial management. But the decision otherwise had a limited impact on the rest of the rail industry. Much of the industry believed that the Department would terminate a franchise again should the circumstances require it.

The SRA transferred the franchise to SET in a short space of time and secured a reasonable financial settlement with CSE

1.24 The termination was not straightforward. CSE had 42 primary contracts with its suppliers, in addition to its leases with Network Rail for stations, depots and related property, making a total of over 3,000 contracts. The SRA acquired only assets and liabilities related directly to the provision of train services. The SRA completed the exit negotiations and enabled SET to take over operations in early November 2003, less than five months after announcing the termination in June 2003. The SRA secured a reasonable financial settlement for CSE's exit from the franchise, with CSE paying SET £15 million in settlement for the net liabilities transferred to SET.

SRA costs recharged to CSE, and CSE costs reimbursed by the SRA	
Nature of cost	**Cost**
SRA costs recharged to CSE	
Consultancy costs incurred by the SRA	£2.6 million
Media costs associated with the SRA's announcement of the termination	£106,000
The cost of Network Rail carrying out a dilapidations survey of CSE's franchised stations on behalf of, and paid by, the SRA.	£98,000
Total SRA costs recharged to CSE	**£2.8 million**
CSE costs reimbursed by the SRA	
Additional operational costs incurred by CSE because of the early termination, including:	£600,000
■ the higher costs of insuring CSE's rolling stock, reflecting higher premia charged for renewing the insurance policy for a short period of time until termination;	
■ termination payments and legal costs relating to two CSE staff, including the Finance Director who resigned in September 2003; and	
■ salary and other costs of a new Finance Director, from his taking up post in October 2003 to the transfer of the franchise to SET in November 2003, and the costs of recruiting another member of staff.	

Source: National Audit Office summary of SRA information

The SRA only recovered the costs that it considered it could reasonably recover and reimbursed CSE for some of its costs

1.25 Under the terms of the franchise agreement, the SRA had a contractual right to recover from CSE sums it considered reasonable for the losses, liabilities, costs and expenses it incurred or was likely to incur as a result of CSE's failure to comply with its obligations. The SRA recharged £2.8 million to CSE, mostly relating to the cost of consultants assisting with the high risk business, financial, legal and communications issues associated with the termination.

1.26 But the SRA incurred other costs totalling at least £3.8 million that it decided not to exercise its contractual right to recover from CSE. The SRA reimbursed CSE some £600,000, including higher insurance costs and staff-related costs. The SRA decided to reimburse CSE for these costs as they arose directly from its decision to give notice of termination. The SRA did not recover from CSE:

- some £600,000 of costs associated with creating SET and its holding company, SET (Holdings), concerning re-branding including new staff uniforms (£274,000) and IT costs (£326,000);
- retention payments of £557,000 to key CSE staff; and
- the costs of its own staff time spent in managing the events on the franchise. There was the extraordinary work involved in managing CSE's franchise in the period leading up to the termination decision, which was disproportionate compared with what SRA staff normally did in discharging their statutory duties in managing other franchises. The SRA did not record or estimate the cost of this additional work. There was also the termination itself, on which a core team of ten SRA people worked alongside consultants full time for six months on the business, financial, legal and communications issues associated with the termination. The SRA did not record the time spent, but estimated the cost of this team to be in the region of £500,000. The work did not entail any cash costs, but an opportunity cost to the SRA because of the significant additional work for staff.

1.27 The SRA decided not to invoke its contractual right to recover these costs, as it was concerned about the significant financial and operational risk of CTUK Ltd becoming insolvent in the face of such claims. The SRA told us that insolvency might have triggered third party rights to the assets and sums transferred from CSE to SET as part of the financial settlement.

1.28 Nor did the SRA recover the £2 million that it spent on the several consultants' reviews of CSE's financial difficulties and the extent of CSE's compliance with the terms of the deed of amendment leading up to the termination decision. Oral advice from the SRA's internal legal advisers was that these costs had been part of the SRA's routine day-to-day management of the franchise and that the SRA had no contractual right to recover them from CSE. The SRA believed that no useful purpose would be served in seeking to recover costs that it had no contractual right to recover, and that doing so would have undermined already difficult exit negotiations and increased the risk of CTUK Ltd becoming insolvent.

1.29 Given the extraordinary work involved in managing CSE's franchise in the period leading up to the termination decision, on account of CSE's failure to satisfy the SRA's requirements, we consider that the SRA should have done more to test the case for recovering such costs, with the support of independent and formal legal advice, particularly as this case set a precedent for the government should it decide to terminate other franchises early in future.

On a like-for-like basis, SET might cost less than estimated at the time of termination

1.30 When it decided to terminate CSE's franchise, the SRA estimated that a replacement franchise run by an SRA subsidiary would require some £425 million in subsidy for 2004 to 2006. Based on actual costs from November 2003 to the end of March 2005 and projected costs to December 2006, the SRA expects SET to cost the taxpayer £403 million – some £22 million less than originally anticipated – to run the franchise over this period. But comparisons between the actual and likely cost of SET and what was originally envisaged are not as straightforward as this comparison suggests. Based on actual costs to March 2005 and projected costs, we estimated that on a like-for-like basis SET might cost the taxpayer £12 million (2.9 per cent) less than the amount the SRA estimated if SET were to run the franchise until December 2006. The franchise is likely, however, to be relet as part of the Integrated Kent Franchise to start from April 2006. We estimate that, on a like-for-like basis, SET might cost the taxpayer £6 million (2 per cent) less than the amount the SRA estimated if SET were to run the franchise until the end of March 2006. SET's costs to the taxpayer have therefore been well controlled to keep them in line with the SRA's original estimate. Based on the efficiency measures used by the SRA and inherited by the Department, SET was in line with its two comparator TOCs in London and the south east in 2004-05.

On a like-for-like basis, SET might cost more than the subsidies that CSE was prepared to accept to operate the franchise

1.31 The SRA's estimate that an SRA subsidiary might require subsidy of £425 million reflected its own assessment of what a robust operator might require, and included the £42 million of additional costs that it considered might be incurred from recruiting and employing staff on short-term contracts and employing advisers as the SRA had no previous experience of managing a franchise. At the same time, the SRA had been in negotiation with CSE over the level of additional subsidy for 2004 to 2006. CTUK Ltd had told the SRA in January 2003 that it would need additional subsidy of £250 million for 2004 to 2006, over and above the existing subsidy of £200 million under the original franchise agreement. The SRA had subsequently, through negotiation, driven down to £183 million the amount of additional subsidy that CSE was prepared to accept. CSE was therefore prepared to accept subsidies totalling £383 million to operate the franchise until December 2006.

1.32 We estimate that, on a like-for-like basis, SET might cost the taxpayer £30 million (8 per cent) more than the amount that CSE was prepared to accept by way of subsidy if SET were to run the franchise until December 2006. On a pro-rata basis, SET might cost almost £22 million (8 per cent) more were it to run the franchise until March 2006. The SRA had little confidence, however, that CSE would be able to run the franchise within the £383 million it was prepared to accept. The SRA had been considering placing CSE on a management contract, like that for other TOCs in financial difficulty, which would have provided some means of controlling CSE's costs and subsidy. The SRA considered that it would have been difficult placing CSE on such a contract, however, given the SRA's lack of confidence in CSE's budgeting and forecasting.

SET is working to reduce the £16 million that it estimates it is losing each year through fare evasion

1.33 As a subsidiary of the SRA operating on a management contract,[6] SET's losses from fare evasion result in lower surpluses, reducing the public money available to be surrendered to the SRA or invested in SET's business. The SRA recognised that revenue risk would return to the SRA upon the franchise being taken in-house.

1.34 The SRA expected TOCs to manage, rather than completely eliminate, fare evasion, expecting that between 2.5 per cent and 3.5 per cent of travel on each TOC's services would be ticketless. Estimates of the level of evasion across the network vary: the SRA estimated that it lay between 3 and 6 per cent depending on different routes and services, equating to lost revenues of between £120 million and £235 million a year; and, in April 2005, the Minister for Transport told Parliament that over £200 million of revenue was lost annually. SET has estimated that it loses £16 million a year as a result of fare evasion, representing 4.8 per cent of its annual passenger income or 19.8 per cent of its annual direct subsidies of £81 million. This is greater than the level of ticketless travel that the SRA expected TOCs to achieve but within the range it had estimated across the network as a whole.

1.35 The SRA expected that SET would manage the risks of fare evasion as part of a more general improvement in the running of the franchise and therefore it did not require SET to strengthen its revenue protection measures when it took over from CSE. SET would have to spend to save, and therefore not all of the £16 million is recoverable. SET's holding company approved budgets for SET that included £2.5 million for additional revenue protection measures in 2004-05 and 2005-06, and SET has strengthened its revenue protection activity where its holding company has approved the business case for measures that it considers to be cost effective. The measures were expected to be self-financing within three years of implementation. SET has, for example, appointed additional revenue protection staff and extended its penalty fare area. SET spent £500,000 on additional measures in 2004-05, and expects to spend £780,000 on additional measures in 2005-06. It recovered £219,000 (1.4 per cent of estimated annual losses) more in penalty fares in 2004 compared with the sum that SET and CSE together had recovered in 2003. It aims to recover an additional £500,000 (3.1 per cent of estimated annual losses) in 2005. Revenue protection staff have a deterrent effect, leading to more passengers paying at ticket offices, although by its nature this effect cannot be quantified. Most recently, however, SET has announced plans to recruit fewer additional revenue protection staff than it had anticipated, and to install instead automatic ticketing gates at some of its stations at a capital cost of £900,000. It plans to complete their installation by March 2006.

CSE's operational performance deteriorated a little, but its customer satisfaction levels improved slightly, during the high risk handover period

1.36 CSE's operational performance in the period leading up to June 2003, when the SRA announced the termination of the franchise, was in line with that of comparator TOCs. But this was mainly due to Network Rail recovering from low levels of performance. There was a real risk, heightened by CSE's introduction of an increasing number of new trains onto the network, that services might deteriorate in the period running up to SET taking over the franchise in November 2003. CSE's operational performance deteriorated, while overall passenger satisfaction increased, a little during the handover period. Network Rail was the single biggest cause of the deterioration in CSE's operational performance, although CSE itself was the next largest.

6 The SRA placed TOCs on management contracts when they had financial difficulties, the SRA bearing more financial risk and monitoring more closely a TOC's revenue and costs than under normal franchise agreements. The nature of management contracts has varied, but many have been 'cost plus' contracts, whereby the SRA paid the TOC an agreed margin on the costs the TOC expected to incur.

Passenger train services and passenger satisfaction have improved under SET, but most of the improvement in performance has been due to Network Rail recovering from low levels of performance

1.37 The SRA equipped SET to manage the franchise effectively from the day it took over from CSE. Under SET, operational performance has improved in line with that of similar London commuter TOCs, although improvements in Network Rail's performance have made the biggest single contribution to reduced delays on train services across the national rail network and for SET and its comparator TOCs, as Network Rail continued to recover from low levels of performance after the Hatfield derailment in October 2000. Since April 2004, SET and its comparator TOCs, have also contributed to the improved performance despite introducing new train fleets, which have historically been less reliable in the first months of operation than the old trains they replace. Passenger satisfaction has also improved and in the most recent National Passenger Survey it had reached the highest level for the South Eastern Franchise since the Survey started. Like CSE before it, however, SET has one of the lowest passenger satisfaction ratings of all TOCs.

Value for money conclusion

1.38 The SRA terminated the CSE franchise because it did not believe it would get value for money from the hundreds of millions of pounds of subsidy CSE needed to run the franchise until 2006. Although termination resulted in higher subsidies for South Eastern Trains' temporary operation of the franchise than CSE was prepared to accept, the SRA did not have confidence in CSE's ability to manage within the proposed subsidies. Overall, the case demonstrates that the SRA's powers, now assumed by the Department for Transport, can be used successfully to terminate franchises that perform unsatisfactorily. The new arrangements provide the basis on which the incoming franchisee for the Integrated Kent Franchise, when chosen, will have the opportunity to demonstrate value for money.

RECOMMENDATIONS

1.39 The SRA learnt lessons from the CSE case, and also from events on other franchises, and took action to strengthen its approach to franchise award and franchise management. With the transfer of the SRA's franchising roles to the Department for Transport, there are lessons that the Department needs to be aware of and build on as it inherits the legacy left to it by the SRA:

a The Department should complete its review of its approach to the awarding of future franchises and, if it decides to abandon its assessments of whether bids are realistic and deliverable over the lifetime of the franchises, it should clearly define the criteria and conditions under which it would be prepared to provide additional subsidies to TOCs experiencing financial difficulties. The Department would also need to have available at short notice enough people with the right skills to take over a failing franchise and continue to run the trains.

b The Department should review the on-going viability of franchises at regular intervals, rather than rely on TOCs requesting a viability review if circumstances change from those originally envisaged.

c The Department should target its requests for information from TOCs and its monitoring of TOCs' finances over the short and longer term based on the risks presented by individual TOCs in order to identify emerging problems early and head them off before they become acute.

d The Department should build on the training that the SRA provided to its staff involved in franchise management, to embed the skills, experience and capacity necessary for effective oversight of TOC finances.

e The Department's franchise monitoring reports should place particular emphasis on TOCs' longer-term financial viability to deliver their franchise obligations over the following three to four years in addition to their more immediate financial situation.

f Particularly where it has concerns about information a TOC has provided, the Department should quickly bring them to the TOC's attention so that the TOC may act quickly on the issues it needs to address.

g Particularly where difficulties arise on a franchise, the Department should provide the TOC concerned with formal feedback on progress and developments, and should document clearly the extent and nature of its liaison with the TOC.

h The Department should establish, with the support of formal independent legal advice, the full range of costs – including the cost of its own staff time – that it may recover from TOCs upon the termination of a franchise, in preparation for any future franchise terminations. It should also do this in respect of any costs for which it should in turn reimburse TOCs. Where the cost of its own staff time may be recovered, the Department should put appropriate recording systems in place to support its recharging.

i The Department should review the level of fare evasion being experienced by those TOCs that are currently operating under a management contract and their revenue protection measures, and assess the business case for investing in stronger measures to reduce fare evasion and losses to the taxpayer.

j The Department should bring this report to the attention of the Scottish Executive, which has recently acquired the SRA's responsibility for passenger rail franchising in Scotland.

PART TWO
The SRA lost confidence in CSE

2.1 This Part of the report examines Connex South Eastern's financial difficulties, and how they were identified and addressed. It examines the options that the SRA considered for the future of the franchise, and the SRA's preparations for the possibility that termination would be needed. It also examines why this case is the only one to date where a franchise has been terminated early.

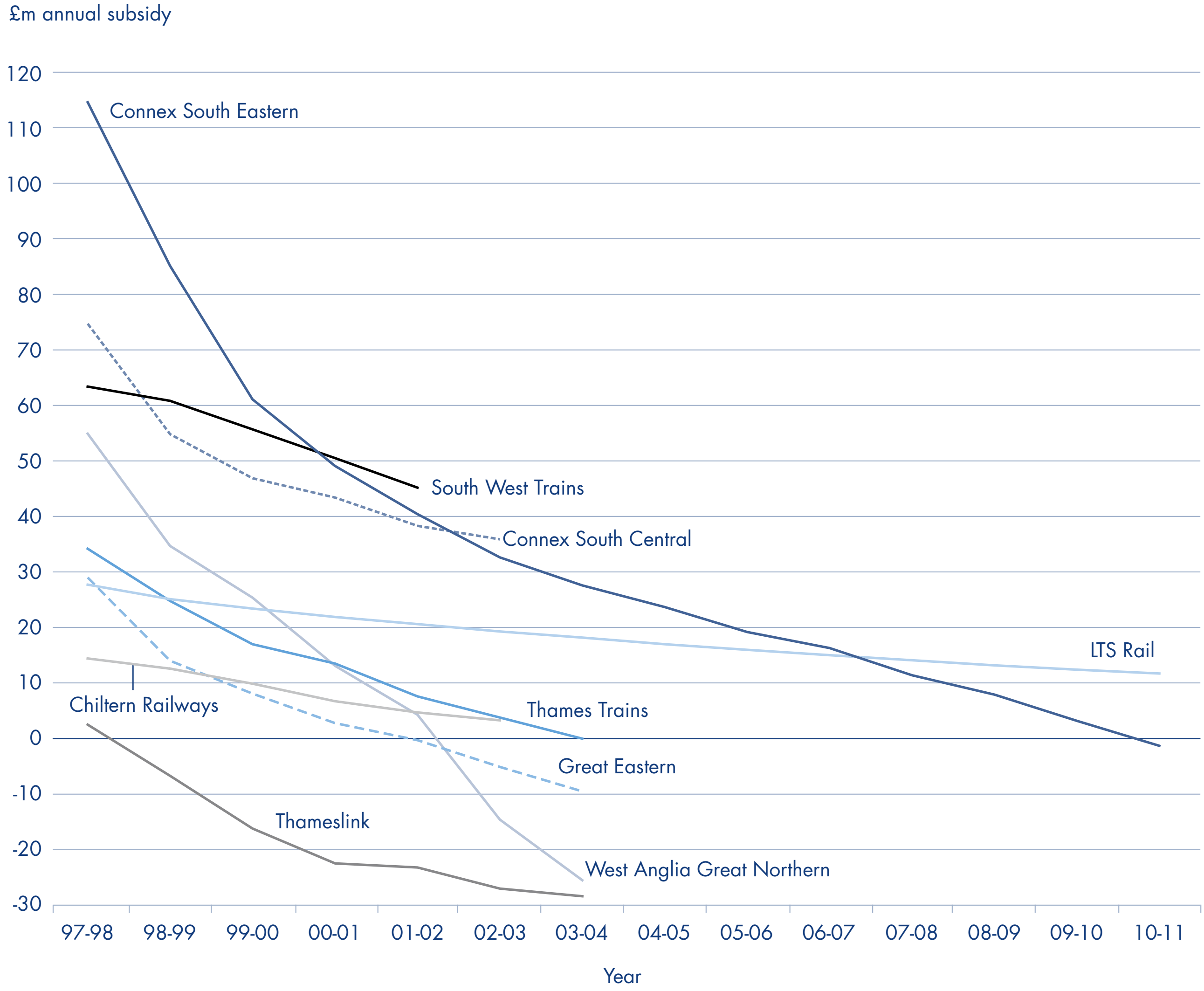
The seeds of CSE's financial difficulties were sown when it won the franchise with an ambitious bid, at a time when the government was awarding franchises to bidders typically requiring the least subsidies

2.2 Connex South Eastern's franchise was the ninth to be let and was signed at a time of growing competition between bidders. The prime factor OPRAF considered when it awarded the franchise was the level of financial subsidy required by competing bidders.[7] CSE's holding company, Connex Transport UK (CTUK) Ltd, won the franchise because, as well as proposing service improvements and the introduction of new trains, it bid for the lowest level of subsidy over the franchise term. Its annual subsidies were projected to fall over the 15-year lifetime of the franchise, most aggressively over the first three full financial years[8] from 1997-98 to 1999-2000 compared with those for the other TOCs in London and the south east **(Figure 1 overleaf)**. When it awarded the franchise, OPRAF had concerns that CSE's bid might be too ambitious, although OPRAF had only limited experience of franchise operations at this time as the first franchises had been operating for only a few months. OPRAF considered, however, that CSE's owners, Vivendi,[9] a multinational group of companies operating in a range of industries in 84 countries, had an international reputation to protect and the financial strength to support CSE should the TOC encounter any financial difficulties during the lifetime of its franchise. Within the Vivendi group, CTUK Ltd was the UK holding company for Connex South Eastern and Connex South Central.[10] OPRAF also noted that the difference between the subsidy Connex bid for and the next lowest subsidy bid gave considerable scope for it to increase subsidies to CSE if Connex were to request a franchise review[11] because of problems caused by an economic downturn.

7 *The Award of the First Three Passenger Rail Franchises*, National Audit Office (HC 701, Session 1995-96).
8 Unless otherwise indicated, the figures in this report are for financial years, from 1 April to 31 March, the period over which CSE reported to the SRA. CSE's franchise began in October 1996, so the first full financial year of the franchise was 1997-98.
9 Vivendi changed its name to Veolia in 2003.
10 CSE's sister TOC until Govia took over the South Central franchise in August 2001.
11 See footnote 5.

1 Comparison of subsidy profiles in the original franchises of TOCs in London and the south east

Annual subsidies to CSE were projected to fall over the 15-year lifetime of the franchise, most aggressively over the first three full financial years from 1997-98 to 1999-2000 compared with the subsidies for the other TOCs in London and the south east.



Source: NAO analysis of data in OPRAF Annual Report 1996-97

NOTE

Subsidy profiles are full year figures relating to financial years from 1 April to 31 March. The original franchises had different start dates between February 1996 and March 1997. 1997-98 was therefore the first full financial year in which all of the original franchises operated.

CSE's costs increased significantly, whereas its bid envisaged a significant fall

2.3 With annual subsidies profiled to fall significantly between 1997-98 and 2001-02, CSE aimed to:

- increase passenger and other revenue under its control by 18 per cent, which was challenging because CSE obtained over 60 per cent of its fare income from regulated fares.[12] This was unusually high,[13] and meant that CSE would have to look to growth in passenger numbers, rather than fare increases, to secure higher revenues. Despite the constraint of regulated fare increases, and the reduction in passenger services following the Hatfield derailment in October 2000, CSE increased its passenger and other revenue by 19 per cent over the period; and
- cut operating costs under its control[14] by 11 per cent. But these costs actually increased by 27 per cent over the period. CSE had planned to cut staff numbers by 32 per cent, but cut them by only 20 per cent over the period. Like other bidders, CSE underestimated the extent to which British Rail had made efficiencies in preparation for privatisation. It employed more support and revenue protection staff than planned. In common with other TOCs, train drivers' wages were also much higher than expected. In addition, CSE estimated that its costs increased by an estimated £4 million a year from 2002 due to lost economies in overheads following Connex Transport UK Ltd's loss of the Connex South Central franchise in August 2001.

2.4 In its bid for the franchise, CSE anticipated that its annual net profit before tax between 1997-98 and 2001-02 would be some 5 per cent of operating income – around £15 million a year. CSE's average annual net profit before tax was actually £5 million over this period, representing 1.7 per cent of operating income or a third of what it had originally expected. It made a pre-tax loss of £2.4 million in 2001-02 and its financial position would have been even worse, with a financial loss as early as 1998-99, the second full financial year of the franchise, had it not been alleviated by rolling stock lease charges £20 million a year lower[15] than projected in its bid for the franchise.

The SRA was unaware of CSE's longer-term financial difficulties as CSE did not alert it, while the SRA focused on TOCs' short-term solvency

2.5 CSE had become aware of its impending financial difficulties in July 2001, when its consultants identified a £19 million funding gap for 2002 but it did not bring them to the SRA's attention. CSE took action, seeking to rectify matters itself rather than request a franchise viability review. The philosophy of franchising was that the financial risk was fully transferred to private sector TOCs under their franchises. OPRAF had expected TOCs to monitor their own longer-term viability. The franchise monitoring arrangements used by OPRAF therefore focused on TOCs' short-term solvency, involving monthly, quarterly and annual monitoring of TOCs' accounts for any variances between budgets and actual results. When the SRA was set up in February 2001, like OPRAF before it, it had a statutory duty under the 1993 Railways Act to secure the provision of passenger train services. It had to be ready to step in at any time, and perhaps act as an 'operator of last resort' if necessary, to ensure that services continued to run. The philosophy that franchising fully transferred financial risk to TOCs, coupled with the imperative for the SRA to be able to step in at any time and secure the provision of passenger train services, underpinned the SRA's approach in continuing with the franchise monitoring arrangements it inherited from OPRAF. The arrangements did not involve asking for or scrutinising TOCs' longer-term business projections based on actual results and forecasts to assess a TOC's longer-term viability in delivering its franchise obligations, although the SRA did carry out monthly reviews of financial viability of TOCs' holding groups on the grounds that holding companies stood behind TOCs' financial position (paragraph 2.2). The SRA's annual assessment of CSE in November 2001, based on information provided by CSE, concluded that there was not a high risk of the TOC requiring additional subsidy.

12 Under the fare regulation regime, OPRAF and the SRA set maximum values for how much TOCs could increase regulated fares each calendar year.
13 On average across all TOCs over the period 1997 to 2002, around 40 per cent of fare revenue was regulated.
14 Mainly staff costs. Over two-thirds of CSE's expenditure, relating to track access and rolling stock lease charges, was fixed and outside its control.
15 See footnote 4.

2.6 In December 2001, Connex Transport UK Ltd requested a two-year extension to CSE's franchise, arguing that the 20-year franchises that the SRA was then considering for South Central and South West Trains would provide those TOCs with increased levels of subsidy for service improvements and additional capacity and result in CSE falling behind. An extension to its franchise and £400 million of additional subsidy would enable CSE to introduce new rolling stock more quickly and improve its operational performance and quality of service over the period to 2013. The SRA responded positively, telling Connex Transport UK Ltd that it would review the underlying financial analysis, value for money and affordability of the proposal with the aim of concluding a deal by March 2002, if possible.

CSE, and consequently the SRA, could not quantify the size of the funding gap with any certainty

2.7 In mid-February 2002, when the SRA extrapolated CSE's financial results over future years, the SRA calculated that, in addition to the agreed subsidies of £430 million[16] over the remaining life of the franchise, CSE would need around £456 million of additional funding from the SRA, consisting of:

- £272 million to break even between 2002-03 and 2010-11; and
- £184 million to achieve the 5 per cent annual net profits that CSE originally envisaged under the franchise.

2.8 In March 2002, the SRA told CSE that the funding gap was so large that it would be unable to conclude any settlement for further subsidies and an extended franchise without a detailed financial review. KPMG, the SRA's lead financial advisers, led a joint SRA-CSE team in carrying out a review of CSE's operational performance, governance and financial forecasts for 2002-03 to 2010-11. The review, which reported in May 2002, identified weaknesses in the quality of CSE's management information, project management, risk monitoring and linkages between financial and operational management, and a lack of rigour in CSE's financial projections. It also noted that CSE was making payments to affiliates in the Vivendi group of companies. The review, together with subsequent work by CSE and the SRA, could not identify with certainty the extent of the funding gap, estimates ranging between £384 million and £820 million.

The SRA agreed to pay CSE £58.9 million of additional subsidies to stabilise the franchise, whilst requiring improved financial control and reducing the franchise term

2.9 In late July 2002 CSE projected a loss of £47 million in 2003.[17] Both Connex Transport UK Ltd and the SRA were concerned that, without additional subsidy, shareholders in CTUK Ltd would call for the company to surrender CSE's franchise before 2003. By autumn 2002, the SRA concluded that it could reduce risks and improve value for money if it combined CSE's franchise with domestic services on the Channel Tunnel Rail Link (CTRL) to form a new, integrated franchise to be let through full competition. In December 2002, the SRA and CSE agreed a deed of amendment to the franchise. The deed's key features included:

A financial stabilisation package for 2003

- The provision of up to £58.9 million of additional subsidy to CSE, payable in monthly instalments, to stabilise the franchise in 2003 and allow sufficient time for the SRA to consider future arrangements for delivering the franchise. CTUK Ltd also paid CSE £11.1 million in cash by way of subscription for ordinary shares in CSE to strengthen CSE's balance sheet and reduce the risk of insolvency.

Improvements in financial management, control and reporting

- In addition to the weaknesses identified in the May 2002 report on CSE (paragraph 2.8), during the course of negotiating the deed, the SRA became uncomfortable about the transparency, and therefore its understanding of, CSE's funding arrangements, bank overdraft and short-term investment facilities and loans between CSE and other companies in the Vivendi group. CSE pointed out to us that it did not have any bank overdraft facilities, as its cash facilities were provided by its holding company,

16 Subsidies set out in the original franchise agreement, plus further sums that the SRA had subsequently agreed to pay to CSE as "no loss, no gain" adjustments to compensate it for higher track access charges set by the Rail Regulator and payable to Network Rail.

17 CSE accounted internally, and reported to its parent company, on a calendar year basis.

CTUK Ltd. CSE's annual financial statements clearly disclosed that CSE's short-term investments consisted of its Season Ticket Bond[18] secured under a bank guarantee, while CSE's Performance Bond[19] was invested and secured at arms' length by CTUK under a bank guarantee. CSE's annual financial statements disclosed amounts owed to or by other organisations in the group of companies of which CSE was a part, although not in any detail. CSE agreed to the deed's requirement that it improve its financial controls and reporting and develop and submit to the SRA within five weeks a programme of improvements to its financial management. The deed required the programme to be capable of being implemented by 31 March 2003. CSE accounted internally, and reported to its parent company, on a calendar year basis, so much of its finance team's attention during the first three months of 2003 would have been on completing CSE's financial statements for 2002 alongside meeting the deed's requirements. The deed therefore acknowledged that the programme would not be implemented in its entirety by the end of March 2003 **(Figure 2)**.

A considerable reduction in the term of the franchise

- Reduction of the franchise term by five years from 2011 to the end of 2006. This reduced the risk that CSE presented to the taxpayer and enabled the SRA to seek better value for money by combining CSE's existing services with CTRL domestic services into an Integrated Kent Franchise, which the SRA would let competitively.

2 Key requirements for CSE to improve its financial management, control and reporting

The deed of amendment required CSE to make specified improvements in its financial management, controls and reporting.

Programme of improvements to financial management

- Develop a programme of improvements to its cash flow management, cost control, budgeting and financial reporting, including milestones showing how and when improvements would be introduced and a monitoring/review process to enable improvements to be assessed
- Submit the programme to the SRA by 15 January 2003
- Implement the programme of improvements through a management team of demonstrated competence, and include the recasting of budgets in the light of variances

Financial controls

- Take all reasonable steps to ensure cash balances were efficiently managed on an arm's length basis
- Retain within the business all income derived from the investment of any cash balance
- Not make any loans or otherwise extend credit other than in the normal course of business (inter-company trading was defined as not in the ordinary course of business)

Financial reporting

- Submit to the SRA management accounts on the basis of railway reporting periods,[1] with a reconciliation of variances of actual results against the current year budget and the financial forecast, together with an explanation for material variances and corrective action plans, from 1 January 2003
- Every 12 weeks, provide the SRA with an updated forecast for the remainder of the year of its profit and loss account, balance sheet and cash flow statement, from 1 January 2003
- At the end of every railway reporting period make full disclosure of movements in provisions and reserves and full and detailed disclosure of material trading or financial transactions within group companies, including detailed financial breakdowns, descriptions of services, any change in the terms of trading and supporting invoices, from 10 December 2002
- Bring transparency to its arrangements for intra-group trading by 15 January 2003, allowing for recording and reporting the details of income and expenditure arising from intra-group transactions and commitments and of amounts on deposit with or from other companies in the Vivendi group
- Report its financial results in accordance with railway reporting periods, from 1 April 2003

Source: NAO summary of deed of amendment to CSE's franchise, December 2002

NOTE

1 A railway reporting period is usually 28 days.

18 TOCs are required to invest deferred season ticket income under a bank guarantee, to guarantee that the TOC will comply with its franchise agreement and meet agreed levels of performance. In the event of default, the SRA could retain some, or all, of the Season Ticket Bond.

19 A TOC's holding company similarly takes out a Performance Bond with an insurance company. In the event of default, the SRA could retain some, or all, of the Bond.

Agreeing a new funding package for 2004 to 2006

- The deed required CSE to develop by 15 January 2003 a revised financial model with the advice of external consultants. The SRA and CSE would then negotiate over the inputs and assumptions to be used in the model and on the level of subsidy required for 2004 to 2006. The deed did not make the specified improvements in financial management, control and reporting a condition of agreeing a new funding package.

  If CSE breached the requirements of the deed, or the SRA and CSE did not agree a new funding package for 2004 to 2006, the SRA reserved the right, if exercised by 30 June 2003, to terminate the franchise by 31 December 2003.

CSE failed to satisfy the SRA that it was taking vigorous action to improve its financial management as a matter of urgency

2.10 The SRA expected CSE to comply with the terms of the deed, but seconded a consultant from Mott MacDonald to monitor CSE's compliance with the requirement to improve its financial management, control and reporting. The SRA told us that, between January and March 2003, it also provided ongoing support through the SRA's internal finance team to aid CSE's compliance with the deed and that it held regular meetings with CSE, although these were unminuted. In February 2003, the SRA wrote to CSE's Finance Director informing CSE that its management report for the previous month was not compliant with the requirements of the deed. In late February 2003, at a meeting pre-arranged to be halfway through the critical January to March period, the SRA's Chairman and Chief Executive told Connex's Chairman that the SRA was not yet satisfied that CSE had adopted the level of improvement in financial control sought under the deed.

2.11 The secondee from Mott MacDonald produced a series of monitoring reports between January and April 2003. He reported that CSE had made some progress, but that it was not compliant with some key aspects of the deed of amendment. For example, CSE had developed and submitted to the SRA a programme of improvements to its financial management by 15 January 2003 as required by the deed, but the programme was too general for the consultant to assess its effectiveness in improving the company's financial management. Nor did it provide any details of the system of controls over the company's cash resources. We reviewed the programme and found that it covered the broad areas specified in the deed but at a very high level and without much detail or explanation of how the different elements satisfied the various requirements of the deed. The consultant reported at the end of March 2003 that it was difficult for CSE to comply with all of the deed's requirements for a programme of improvements in the limited time available and that it was too early to comment on CSE's initiatives as most of them were in their infancy. The consultant and the SRA's internal finance team confirmed that the quality of CSE's financial reporting to the SRA had improved, as had its disclosure of material trading and financial transactions with related parties, although the level of disclosure did not comply with all aspects of the deed.

2.12 CSE engaged consultants to help it develop an improved financial model, as required by the deed of amendment, and another set of consultants at a cost of £400,000 to identify ways of reducing costs and minimising CSE's call on the public purse. CSE presented to the SRA's advisers on the operational aspects of running a franchise and to the SRA's legal Counsel its proposals for reducing costs and the amount of subsidy it needed, which it estimated could yield annual savings of some £20 million. It proposed running fewer carriages on off-peak services, installation of more ticket vending machines at stations to reduce staff costs, combining retail and ticket-selling operations, reducing train leasing charges by extending leases on better terms and mounting CCTV cameras on many trains to replace conductors.

2.13 By March 2003, the SRA was satisfied that CSE's financial model for 2004 to 2006 produced accurate calculations. By then, CTUK Ltd and the SRA had developed through negotiation a draft of a further deed of amendment to the franchise to cover the period 2004 to 2006. Under the draft deed, subject to the approval of the SRA Executive and Board, they agreed that CSE would accept additional subsidies of £183 million to run the franchise from 2004 to 2006.[20] But separate from, and alongside, these commercial negotiations the SRA remained unconvinced as to the robustness of assumptions in CSE's financial model and the TOC's projected costs and revenues, which were showing a

20 CTUK Ltd had told the SRA in January 2003 that CSE would need additional subsidy of £250 million for 2004-06, over and above its existing subsidy of £200 million under the original franchise agreement. This level of subsidy would have allowed CSE to make a 5 per cent profit margin. The SRA subsequently negotiated the level of additional subsidy down to £183 million, the break even point for CSE.

£17 million shortfall against CSE's budget for the period. Although it was unable to provide us with any analysis it undertook of them, the SRA was also unconvinced that CSE would be able to deliver its proposals for reducing costs. It considered the proposals impractical because they would require significant investment in 2003-04 and some might constrain the commercial interests of an incoming franchisee. The SRA did not inform CSE or CTUK of its concerns at that stage and decided not to give further consideration to CSE's proposals because it was focusing on CSE's compliance with the deed.

2.14 Connex told us that, because it had contributed £11.1 million of its own money to strengthen CSE's franchise, it saw the £58.9 million of additional subsidy agreed for 2003 as an SRA vote of confidence in the TOC as a prelude to negotiating a stable funding arrangement to the end of the franchise. It did not see the deed of amendment as the final opportunity to satisfy the SRA as to its financial competence. CSE did not systematically seek clarification on what it needed to do to satisfy the SRA or inform the SRA regularly about its progress in addressing its obligations. It focused more of its attention on the funding package and its proposals for reducing costs and increasing revenue for 2004 to 2006 than on the deed's shorter-term financial management requirements.

The SRA's approach did not produce conclusive results, and the SRA had to engage auditors to determine CSE's compliance

2.15 The three months between January and March 2003 were a critical period for CSE to demonstrate its compliance with its obligations. The SRA spent £163,000 on the consultant seconded from Mott MacDonald responsible for monitoring and reporting on CSE's compliance, and provided its own ongoing support, over the period. But the extent and nature of the engagement was unclear from the evidence we have seen. The SRA did not always provide CSE with formal feedback at key stages during the period, or document its contact with the TOC. The SRA's approach did not produce conclusive results. In particular:

- we found no evidence as to whether, from the outset, the SRA had approved the programme of improvements that CSE had submitted on 15 January, or formally shared with CSE the consultant's report commenting on the deficiencies in the programme, and on which CSE's subsequent work to improve its financial management depended (paragraph 2.11). Whereas the deed set out broadly defined obligations for CSE to include in its programme of improvements (Figure 2), the consultant from Mott MacDonald set out in his report much more detailed elements that he considered should be part of the programme. Given that the programme of improvements was fundamental to CSE's complying with the deed, we would have expected the SRA to have alerted CSE to the identified deficiencies as soon as they came to its attention so that CSE could take corrective action and provide what the consultant was looking for. This was particularly important given the difficulty that the consultant acknowledged of CSE complying in the limited time available and that the SRA did not formally extend the deadline for CSE to demonstrate compliance;
- we found no evidence that the SRA shared the consultant's subsequent reports with CSE, as a means of verifying the reports' accuracy and of underlining the need for the TOC to take more urgent action; and
- the consultant's reports relied heavily on statements of compliance from CSE itself because the SRA had not asked the consultant to provide any independent verification. By the end of March 2003, the SRA considered that termination was a real possibility but that the consultant's March 2003 report did not provide a reliable view of the extent of CSE's compliance with its obligations or a robust basis for it to take vital longer-term decisions on the franchise, which had the potential to affect the rail industry more generally.

2.16 The SRA wrote to Connex Transport UK Ltd in March 2003 pointing out that its consultant's work was not conclusive but had raised questions about the speed and commitment of CSE to implement the required improvements in financial management and control. The SRA could not contemplate additional subsidy without confirmation that CSE's financial management processes were as efficient and effective as possible. The SRA pointed out that this was consistent with what it had been telling CSE over the preceding weeks since the February 2003 meeting between the SRA's and Connex's respective chairmen. The SRA also had concerns that CSE had not rigorously tested the figures in its financial model and that CSE did not plan to use the model to forecast its financial position. The SRA therefore extended into May 2003 the deadline for agreeing a new funding package for 2004 to 2006. It engaged PriceWaterhouseCoopers (PWC), at a cost of £177,000, to ascertain the facts of whether CSE had complied with the deed's requirements and identify any matters that needed to be addressed before any agreement could be reached on further subsidies.

Auditors concluded that CSE was not compliant with several obligations in the deed and that no additional subsidy should be advanced unless CSE addressed certain key actions to improve its financial control environment

2.17 In their May 2003 report, PriceWaterhouseCoopers found that CSE had been slow to focus on the deed's requirements and was not compliant with five of the deed's 29 clauses. We investigated these areas:

- one concerned CSE's failure to prepare a satisfactory programme of improvements to financial management;
- another concerned CSE's failure to include in its reports to the SRA a reconciliation of outturn to CSE's financial model and action plans to close material variances. The quality of CSE's reporting had improved, but CSE's reports did not include all the information required under the deed. For example, four-weekly reports to the SRA did not compare results to the financial model or include an action plan to close material variances; and
- the other three concerned the transparency of intra-group transactions. Some transactions with affiliate companies were not disclosed, such as payments for train leases and trading with another organisation in the group. There were no written agreements to support certain transactions, and CSE's reports to the SRA did not accurately state inter-company balances.

2.18 PWC had been unable to determine whether payments to two group companies were at arm's length or cost. However, in response to the audit:

- CSE provided the SRA with evidence that train maintenance joint venture arrangements had been competitively tendered with maintenance companies outside the group and that transactions were at cost, and that another item – training to CSE's staff – had been provided at the market rate or lower. The SRA already knew about both arrangements, from its oversight of the procurement of CSE's new trains and because the training company had been set up to meet a specific commitment in CSE's franchise agreement.
- Connex Transport UK Ltd wrote to the SRA on 12 May 2003 to confirm that a payment of £100,000 to a sister company in the Veolia group without a supporting invoice related to training courses that CSE's staff had attended. The payment therefore related to services received and did not represent a loan of funds. The delay in invoicing had been due to the death of the accountant in the sister company. CSE told the SRA on 6 June 2003 that it had cleared the balance and would make no payments in advance of receipt of an invoice in future.

2.19 PWC also found that CSE's budget setting, calculation of data and review process had no significant weaknesses and was comparable with other companies of a similar size and complexity. They did not identify any instances where CSE was financially supporting the rest of the Veolia group. They told us that, in their view, the deficiencies they identified did not constitute fundamental failings in CSE's financial management and control.

2.20 They recommended in their report, however, that the SRA should not advance additional subsidy for 2004-06 unless CSE addressed certain key actions, several of which – including that CSE should prepare and deliver a satisfactory programme of improvements to its financial management – had been required under the deed of amendment (paragraph 2.9). They also recommended that CSE be required to strengthen its finance function and appoint a compliance officer responsible for addressing the SRA's requirements and ensuring full and timely compliance with financial controls. The SRA gave CSE a copy of the executive summary of PWC's report on 6 May. Following advice from the SRA's legal Counsel, the SRA sent a copy of the full report to CSE on 19 May.

The SRA issued a termination notice to CSE, having lost confidence in the TOC

2.21 The SRA told us that, in a telephone conversation in May 2003, the SRA informed the Chief Executive Officer of CTUK Ltd's holding group that the SRA no longer wished to consider a new three-year funding package for 2004-06 and was considering its options. The SRA had lost confidence in CSE's financial management. In particular, it was concerned that CSE's management was insufficiently pro-active and transparent in its dealings with the SRA and that it focused on meeting the reporting needs of its parent company – CSE's Finance Director reported to the holding company rather than the TOC's Managing Director – giving a lower priority to meeting the needs of the SRA. Connex told us that it did not hear this message stated with such clarity which, in effect, signalled that the franchise would end in or before December 2003.

2.22 CTUK Ltd wrote to the SRA contending that CSE had made considerable progress in improving its financial management, providing further evidence and explanation against some of PWC's concerns. But it accepted most of PWC's findings and acknowledged that further improvement was needed, pointing out that action was underway or planned. CTUK Ltd had appointed a new Managing Director and a compliance officer for CSE, both of whom took up post in May 2003. The new Managing Director remained at the TOC and continues to be the Managing Director of SET. CTUK Ltd told us that it informed the SRA in May 2003 that it was also in the process of recruiting a new Chairman, who was highly regarded within the rail industry, to take whatever action the SRA required of CSE.

2.23 The SRA considered the advantages and disadvantages of various options associated with either providing CSE with additional subsidies and retaining CSE's operation of the franchise from 2004 to 2006, or terminating the franchise on 31 December 2003 **(Figure 3)**. The SRA's legal Counsel considered PWC's report (paragraph 2.17), together with a letter from CSE responding to the executive summary of the report. Counsel pointed out that the SRA had to have regard primarily to its statutory duties to ensure that any grants or other payments that it made would further its purposes efficiently and economically and to secure the provision of services where a franchise agreement was terminated early. Counsel considered that PWC's report did not, of itself, determine any particular course of action.

3 The SRA's assessment of the advantages and disadvantages of continuing with CSE or terminating the franchise

The SRA considered the advantages and disadvantages of continuing with CSE and providing additional subsidies, or of terminating the franchise.

Continuing with CSE and providing additional subsidies for 2004 to 2006

Advantages	Disadvantages
■ CSE would retain revenue and performance risks ■ Connex Transport UK Ltd would remain in the UK rail market and as a potential bidder for the new Integrated Kent Franchise ■ Likely to be the cheapest option for operating the franchise for a three-year period	■ The SRA would continue to have concerns about CSE's financial management and its ability to keep within the total subsidies that might be agreed for 2004 to 2006 ■ The SRA would have to continue the same level of detailed engagement in CSE's on-going financial management, which the SRA considered was disproportionate ■ Potential public criticism of giving more subsidy to a TOC in financial difficulty ■ Difficulty agreeing a six-month rolling management contract[1] with CSE as it might pose problems for the TOC's retention and recruitment of staff ■ A six-month rolling management contract might also discourage the TOC from investing in improvements

Termination of the franchise

Advantages	Disadvantages
■ Would send a public message that the SRA would not tolerate poor TOC financial management ■ More direct control over bidding information for an Integrated Kent Franchise	■ Potentially, an extra £42 million in subsidies would be required to meet the additional costs of recruiting and employing staff on short-term contracts and of employing advisers, as the SRA had no previous experience of managing a franchise ■ Revenue and performance risk would return to the SRA if the franchise were taken in-house for a period of time until it were re-let or were managed under a 'cost-plus' contract ■ Risk of deterioration in performance during any handover period ■ Likely to lead to the withdrawal of Connex Transport UK Ltd from the UK rail market, including bidding for current and any future franchises and, therefore, a reduction in competition in the UK rail market ■ CTUK Ltd might challenge the termination in the courts

Source: NAO summary of SRA documents

NOTE

1 The SRA placed TOCs on management contracts when they had financial difficulties, the SRA bearing more financial risk and monitoring more closely a TOC's revenue and costs than under normal franchise agreements. The nature of management contracts has varied, but many have been 'cost plus' contracts, whereby the SRA paid the TOC an agreed margin on the costs the TOCs expected to incur.

2.24 The SRA had a generic contingency plan, as required under the Railways Act 1993, to enable it to take over a franchise should a TOC, for whatever reason, be unable to continue running train services. The plan outlined the key stages and tasks, including the legal aspects, that would be involved in terminating a franchise in an emergency. The SRA began to adapt the plan for the specific circumstances of the CSE franchise and prepare for termination in case it were needed. The SRA was unsure how CSE might react if the SRA decided to terminate the franchise, so it planned for two possible scenarios:

- CSE might not agree to a managed handover of the franchise, in which case the SRA would have to take over train operations immediately on telling CSE of its decision; or
- CSE might agree to a handover period (either the full six months of the notice period, or less).

2.25 If CSE were not to agree to a managed handover, it would have to surrender its Performance Bond[21] of £19.5 million. The SRA considered, therefore, that CSE would most likely agree to a short handover period seeking an early exit of less than six months, which would allow CSE to keep some of its Performance Bond. But the most serious risk was that CSE would not co-operate in a managed handover, leaving the SRA to run the franchise immediately upon informing the TOC of its decision to terminate. The SRA, which had never run a franchise before, would have to be ready to take over an unfamiliar, multi-million pound business with only a few hours notice whilst maintaining service continuity and safety. The SRA therefore put most effort into planning for this high risk scenario.

2.26 On 12 June 2003, the SRA Board considered information provided by its senior management team about CSE's franchise. The papers included all of the key information that we would have expected the Board to take into account, except for:

- mention of the recent appointment of CSE's new Managing Director and the recruitment of a new Chairman (paragraph 2.22). The SRA told us that it informed the Board that the new Managing Director had taken up post, as part of its assurance that the SRA could take over the franchise and run it effectively; and
- the May 2003 PWC report in full. Only the executive summary was included in the papers to the Board, despite PWC's recommendation in the executive summary that the report be read in its entirety to obtain a full understanding of their findings. The SRA told us that Board members were aware that a full copy of the report was available if they wished to see it. The SRA considered that the executive summary was sufficient for the purposes of the Board, alongside the other papers presented to them, particularly as it would not, by itself, determine the action that the Board should take (paragraph 2.23).

2.27 A memorandum by the SRA's senior management team set out the arguments for and against continuing with CSE's franchise. The memorandum stated that all the areas of non-compliance were, in principle, capable of remedy and that none had consequences so irrevocable that remedial action was impossible. But the accumulation of evidence of non-compliance indicated a culture that did not treat compliance with discipline and rigour. Having weighed up the evidence and material considerations and the SRA's purposes and statutory duties, the SRA's senior management concluded that, on balance, the right recommendation was that CSE's franchise should be terminated. The SRA considered that CSE's progress was insufficient for it to regain the confidence lost over the previous year. The SRA considered that it did not have sufficient information from, or confidence in, Connex to enable it to conclude that Connex would apply additional subsidy efficiently and economically, as required under the Transport Act. It considered that nothing Connex had done since the beginning of 2003 with regard to financial management had demonstrated either urgency or an ability to change behaviour so as to produce a culture of compliance. The management effort required by the SRA to spot and manage errors and deficiencies had been disproportionate both compared with other franchises and other SRA functions. Although the SRA had not terminated a franchise before, it considered that it would be able to deliver a successful termination.

2.28 The Board also considered a paper describing some additional information provided by CSE subsequent to the circulation of the main Board papers, including a revised programme of improvements to financial management and a follow-up to the recommendations of PWC's report. The SRA had sent a copy of CSE's revised programme to PWC asking for their observations on it. In an oral response, PWC noted that the programme was an improvement on the previous version, demonstrating that someone within CSE was taking charge of the programme and indicating sensible progress was being made on broadly the right

21 See footnote 19.

things, but that it still had no milestones and few outputs, while some of the actions stretched a considerable way into the future and some key actions that should have been closely linked appeared to be treated separately.

2.29 PWC's view was that the additional material indicated an intention to comply, but they considered that there was nothing in the programme that would lead them to change the conclusions in their May 2003 report or their recommendation that the SRA should not advance additional subsidy for 2004-06 unless CSE prepared and delivered a satisfactory programme of improvements to its financial management, strengthened its finance function and appointed a compliance officer. The SRA's management team advised the Board that it did not believe the steps Connex was taking were sufficient to allay its underlying concerns, or to cause it to reverse the recommendation in its memorandum.

2.30 The SRA's lead financial adviser from KPMG attended the Board meeting. The SRA told us that PWC did not attend the Board meeting because the Board's practice was to look to KPMG for advice on issues that had a direct bearing on the SRA's overall exposure to financial risk. The lead financial adviser had produced the May 2002 report on CSE (paragraph 2.8), and had been involved in meetings with CSE concerned with the TOC's financial management and in the negotiation of the original deed of amendment and the draft deed of amendment for 2004 to 2006. He had also been involved in the SRA's internal deliberations and had sight of the compliance monitoring reports from Mott MacDonald, the May 2003 PWC report and the subsequent papers to the Board. He advised the Board that CSE's financial management regime was very weak. He told us that he gave his advice in the context of his knowledge of the SRA's interactions with CSE, the primary recommendation made by PWC in their May 2003 report and their subsequent comments, and of the reliance that the SRA would need to place on, and level of confidence that it required in, CSE's financial management to achieve the SRA's duties as part of any agreement on additional subsidies for 2004 to 2006.

2.31 The lead financial adviser from KPMG told the SRA Board that, from the evidence available, he could not assure them that the provision of additional funds would create a stable financial regime. In KPMG's view, it would be very much more difficult to justify that such additional subsidies would be well spent than to justify the additional expenditure required of the SRA were the franchise to be terminated. The SRA Board approved the termination of CSE's franchise, recognising that termination would send a very strong message to the market and indicate the seriousness with which the SRA was undertaking its responsibilities.

2.32 Given the limited reliance that the SRA was able to place on the reports from Mott MacDonald and the need for the SRA to commission PWC to ascertain the facts, and in light of the findings of the May 2003 PWC report, we consider that KPMG expressed the weaknesses in CSE's financial management regime in stronger terms than is supported by the evidence we have seen. In our view, there were weaknesses in CSE's financial management, control and reporting. But, we noted that, after CSE and CTUK responded to PWC's report, CSE was found to be non-compliant with only two aspects of the deed of amendment, PWC had concluded that CSE's budget setting and review process had no significant weaknesses and was comparable with other companies of a similar size and complexity, and CSE was taking steps to improve, notably through the appointment of a new Managing Director and Chairman. We concluded, however, that the Board had considered most of the key relevant information and that the papers presented to the Board had been carefully balanced in setting out both the evidence and the options for the Board's deliberation. It was appropriate for the Board to exercise its statutory duty under the Transport Act and decide to terminate the franchise, where it had lost confidence in CSE's ability to use additional subsidy efficiently and economically.

2.33 CTUK Ltd told the SRA on 20 June 2003 that its new Chairman had started work. But by then, it was too late. The SRA considered that the appointment provided no cause for it to recommend that the SRA Board change its decision to terminate the franchise. In a meeting on 26 June 2003, the Chairman and Chief Executive of the SRA informed Connex Transport UK Ltd and CSE of the termination decision. He told them that the principal reason for the decision was the failure to conclude a funding package for 2004-06 by the date required under the deed. In a letter handed to Connex, the SRA concluded that Connex would not be able to satisfy the SRA within a reasonably short timescale that the additional subsidy[22] sought for 2004-06 would be applied efficiently and economically.

22 See footnote 20.

Connex Transport UK Ltd expressed concern about the reporting of the reasons for the early termination

2.34 CTUK Ltd expressed concern about the information that the SRA provided to the press and passengers regarding the reasons for termination. In its press notice, the SRA stated that it had taken the termination decision to protect taxpayers' money and passenger delivery and that the reasons for the decision included Connex's failure to meet a detailed action programme of improvements. The press notice stated that the programme of improvements had been a requirement before the SRA was prepared to consider any increase in subsidy for 2004-06. The deed had not, however, made the specified improvements in financial management, control and reporting a condition of agreeing a new funding package (paragraph 2.9). A full-page notice to passengers from the SRA's Chairman and Chief Executive that featured in the local press stated that the SRA had terminated the franchise because Connex had failed to satisfy its financial responsibilities to passengers and taxpayers. CTUK Ltd considered that the notice implied financial irregularities, and this implication had appeared in some media reports.

2.35 The Chief Executive of CTUK Ltd expressed concern in a letter to the SRA's Chairman and Chief Executive a fortnight after the SRA's announcement. In reply, the SRA's Chairman and Chief Executive stated that the SRA had not implied that there had been financial irregularities at Connex, nor had it intended to do so. The SRA was not aware of any reasons to believe that Connex was responsible for fraud, unlawful misappropriation, unlawful misuse of funds, fraudulent accounting or any similar misuse of franchise payments.

The SRA had provided additional funding to other TOCs in financial difficulty, but the loss of the SRA's confidence was unique to CSE

2.36 CSE was not the first TOC to have had financial difficulties. Like CSE's, other TOCs' costs had not fallen in line with franchise bid projections. Original franchise bids had assumed a reduction in operating costs - primarily staff costs - between 1997-98 and 2001-02, but the number of staff employed on UK railways in 2001-02 was a third more than had been assumed in the bids and operating costs had risen by 28 per cent. The SRA placed some TOCs under management contracts,[23] rather than conventional franchises, to facilitate changes to franchise boundaries, but in others in response to changed economic circumstances. By early 2003, over a third of TOCs were operating under management contracts.

2.37 The SRA told us that, between 2000 and 2003, nine of the original 25 TOCs requested additional subsidy. In four cases, additional subsidies were required because of the adverse impact of the Hatfield derailment on passenger income. In the case of Virgin West Coast, additional subsidies were required because of the TOC's involvement in the West Coast Route Modernisation project, while Virgin Cross Country's cost projections in its bid for the franchise had proved too optimistic. The SRA placed some TOCs on management contracts, while negotiating revised franchise agreements or putting out for competition alternative propositions for franchises. For others, it commissioned detailed reviews and analyses and, except in the case of Thames Trains, agreed to pay additional subsidies. In the case of this TOC, the SRA considered that the TOC's parent company had made significantly better returns than originally forecast at the time of bidding on its Thameslink franchise, which provided adequate compensation without the need for additional subsidy.

23 See footnote 6.


Connex stripped of rail franchise after SRA loses faith
The Independent, Saturday 28 June 2003
Authority's patience finally reached the end of the line
Financial Times, Saturday June 28/ Sunday June 29 2003
Financial management at centre of Connex dismissal
Daily Telegraph, Saturday 28 June 2003

PART THREE
Taxpayers' interests were, on the whole, protected

3.1 This Part of the report examines the cost to taxpayers of the termination of the franchise. It examines the financial settlement for CSE's exit from the franchise, including the costs recovered by the SRA. It also examines SET's financial performance since taking over the franchise and compares how much SET has cost taxpayers with what was envisaged and with how much CSE was prepared to accept in the way of subsidy to continue to run the franchise.

Thorough due diligence work and clear objectives informed the SRA's negotiations for CSE's exit from the franchise

3.2 The SRA set seven objectives for negotiating CSE's exit from the franchise **(Figure 4)**. It recognised that, to be in a strong position to negotiate the terms of CSE's exit and take over a substantial business, it needed a more thorough and detailed understanding of CSE's business than it had from its franchise oversight role and the reviews it had undertaken.

3.3 The SRA appointed a range of consultants to assist with the termination because it did not have the necessary specialist resources in-house to manage, alongside its normal day-to-day activities, the high risk business, financial, legal and communications issues associated with the termination **(Figure 5)**. The SRA drew its advisers from a standing panel, which it had already established through competitive tendering. The SRA told us that, because the risks associated with the termination were high, it took a cautious approach that resulted in some duplication of work. On some occasions, the SRA asked two different firms to carry out the same, or similar, work – for example, on the financial aspects and risks associated with the termination – in order to be able to compare their findings and recommendations, for extra assurance.

4 The SRA's objectives for the exit negotiations

The SRA set seven objectives for the exit negotiations.

- Maintain the stability of CSE's business in the period between the termination announcement and the transfer of operations to SET
- Avoid loss of focus on day-to-day train operations
- Ensure a smooth transition when CSE exited and SET took over
- Avoid action that might cause Connex Transport UK Ltd to become insolvent. The SRA recognised that CSE had some contracts – for example for car parking and rolling stock – which, if the other party to the contract had negotiated strongly and CSE's holding company had not provided sufficient funding to cover the liabilities, might have rendered Connex Transport UK Ltd insolvent
- Minimise future contingent liabilities
- Avoid a long transactional tail, which would continue to distract SRA and SET management attention and prevent the achievement of a clean break from CSE
- Achieve as early an exit as possible, but with no financial disbenefit to the SRA

Source: SRA

5 Scope and cost of consultancy advice and support for the termination

The SRA spent some £2.6 million on consultancy advice and support in terminating the franchise.

Firm	Scope of advice and support	Cost £000
Business advice		
First Class Partnerships	■ Advice on the operational aspects of running a rail franchise ■ Development of a strategy for the exit negotiations ■ Business due diligence review for exit negotiations ■ Overall project management support for the termination	670
Financial advice		
PriceWaterhouseCoopers	■ Financial and risk advice ■ Corporate recovery advice ■ Financial due diligence review for exit negotiations ■ Weekly financial reviews of CSE's accounts during handover period ■ Preparing the final accounts setting out the assets and liabilities to be transferred to SET	595
KPMG	■ Financial and risk advice ■ Assisting with preparation of the strategy for the exit negotiations ■ Providing a letter of comfort that the outcome of exit negotiations achieved a fair result for taxpayers	421
Legal advice		
Linklaters	■ Advice on rolling stock leases and liabilities	385
Eversheds	■ Legal due diligence review for exit negotiations ■ Legal documentation, such as the notice of termination	261
Clifford Chance	■ Advice on exit negotiations	156
Communications advice		
AB Publishing Ltd	■ Communications plan to inform CSE staff and passengers of the termination decision	54
Hwe8 Ltd (JMclaren)	■ Assistance in preparing the communications plan, including determining key messages for the media	17
	Total	**2,559**

Source: National Audit Office summary of SRA information

3.4 The SRA commissioned from the consultants:

- a business review to inform the SRA about all aspects of the business it would be acquiring, including the commercial, safety, engineering and operational aspects, and assess CSE's organisational and management effectiveness. The consultants identified all the contracts that CSE's successor would need to run train services effectively;
- a legal due diligence review of the actions needed to transfer to SET the different types of contracts identified above; and
- a financial due diligence review to consider whether CSE's management accounts presented accurately the company's assets and liabilities, including balances with affiliate companies and any contingent assets and liabilities.

Between the termination announcement in June 2003 and CSE's exit in November 2003, consultants also carried out weekly financial reviews of CSE's accounts.

The SRA secured a reasonable settlement for the assets and liabilities transferred from CSE to SET

3.5 Some aspects of the transfer were not straightforward. CSE had 42 primary contracts with its suppliers, as well as leases with Network Rail for stations, depots and related property, which brought the total number of contracts to over 3,000. The SRA acquired only assets and liabilities related directly to the provision of train services, such as items of stock for train maintenance and the account for passengers who had bought season tickets. The SRA chose not to acquire assets or liabilities not directly related to train services, such as outstanding passenger compensation claims. Taking on all of CSE's assets and liabilities would have exposed taxpayers to a higher level of liabilities than was necessary. Connex Transport UK Ltd agreed that it would bear any previously unknown liabilities that might arise after the transfer date.

3.6 The SRA appointed a team of professional advisers to negotiate the terms of CSE's exit. The lead negotiator had experience of sensitive commercial negotiations and was supported by a full-time legal adviser. When negotiations started, the SRA and CSE had significantly different opening positions in terms of how to transfer the business, what would happen to CSE's contract for train maintenance, and whether the SRA would pay CSE the balance of the settlement or vice versa. Negotiations continued until 9 November 2003, the date SET took over the franchise.

3.7 The completion balance sheet[24] provided the main basis for the financial settlement, under which CSE transferred assets and liabilities to SET and made net payments of £15 million to SET to cover the net liabilities transferred. The SRA carried out a fair value review of the completion balance sheet at the point of transfer and, following some adjustments, the NAO acting as the SRA's external auditors carried out an audit of the opening balance sheet transferred to SET. The audit did not identify any significant issues. CSE's external advisers also agreed the completion balance sheet. For the purposes of this report, we carried out our own review, assisted by our advisers PKF, to assess whether the financial settlement was reasonable as well as accurately stated. We considered how the assets and liabilities were valued and whether they could have been valued differently, and whether the SRA did everything that could reasonably be expected of it to ensure it received and paid a fair value for the business on its transfer to SET. We concluded that the SRA secured a reasonable settlement for the assets and liabilities transferred from CSE to SET. CSE also paid £6.3 million to SET as a contribution towards re-instating rolling stock to an acceptable condition.[25] CSE de-branded[26] the stations and trains at its own cost.

24 The completion balance sheet set out the net assets of CSE as at 8 November 2003, the final day that CSE operated the franchise.
25 Reinstating for train dilapidations is a normal part of a TOC's obligations at the end of a franchise.
26 Franchise agreements require outgoing TOCs to meet the costs of de-branding, for example, trains and stations.

The SRA only recovered the costs that it considered it could reasonably recover and reimbursed CSE for some of its costs

3.8 Under the terms of the franchise agreement, the SRA had a contractual right to deduct from CSE's Performance Bond[27] the amount it considered reasonable for the losses, liabilities, costs and expenses it incurred or was likely to incur as a result of CSE's failure to comply with its obligations. The SRA asked its internal legal adviser and its lead financial adviser to determine which costs it could reasonably seek to recover. The advisers suggested:

- increased insurance premium costs;
- the costs of setting up SET, together with any of SET's operational costs that were incremental to CSE's existing subsidy;
- the costs associated with the retention of key CSE employees; and
- a proportion of the salary costs of SRA personnel reflecting the time spent on the termination and negotiations for CSE's exit from the franchise.

3.9 Legal Counsel subsequently advised the SRA that these appeared to be an appropriate statement of the costs that could be recovered under the Bond. The SRA actually recharged to CSE a range of costs, totalling £2.8 million **(Figure 6)**.

3.10 But the SRA incurred other costs totalling at least £3.8 million that it decided not to exercise its contractual right to recover from CSE. Figure 6 shows that the SRA reimbursed CSE some £600,000, including higher insurance costs and staff-related costs that CSE incurred during the period between the SRA issuing the termination notice in June 2003 and terminating the franchise in November 2003. The SRA decided to reimburse CSE for these costs as they arose directly from its decision to give notice of termination. Having agreed a budget for CSE for 2003, the SRA decided that, in equity, it should reimburse CSE for these unfunded costs. The SRA also wanted to prepare CSE's successor, South Eastern Trains, for a smooth transfer of the franchise.

6 SRA costs recharged to CSE, and CSE costs reimbursed by the SRA

The SRA recharged over £2.8 million to CSE, whilst re-imbursing it £600,000 for costs incurred by the TOC.

Nature of cost	Cost
SRA costs recharged to CSE	
Consultancy costs incurred by the SRA – see Figure 5	£2.6 million
Media costs associated with the SRA's announcement of the termination	£106,000
The cost of Network Rail carrying out a dilapidations survey of CSE's franchised stations on behalf of, and paid by, the SRA	£98,000
Total SRA costs recharged to CSE	**£2.8 million**
CSE costs reimbursed by the SRA	
Additional operational costs incurred by CSE because of the early termination, including: ■ the higher costs of insuring CSE's rolling stock, reflecting higher premia charged for renewing the insurance policy for a short period of time until termination; ■ termination payments and legal costs relating to two CSE staff, including the Finance Director who resigned in September 2003; and ■ salary and other costs of a new Finance Director, from his taking up post in October 2003 to the transfer of the franchise to SET in November 2003, and the costs of recruiting another member of staff.	£600,000

Source: National Audit Office summary of SRA information

3.11 The SRA also did not recover from CSE other costs that its legal and professional advisers suggested it had a contractual right to pursue:

- some £600,000 of costs associated with creating SET and its holding company, SET (Holdings), concerning re-branding including new staff uniforms (£274,000) and IT costs (£326,000);
- retention payments of £557,000 to key CSE staff; and
- the costs of its own staff time spent in managing the events on the franchise. There was the extraordinary work involved in managing CSE's franchise in the period leading up to the termination decision, which was disproportionate compared with what SRA staff normally did in discharging their statutory duties in

27 See footnote 19.

managing other franchises. The SRA did not record or estimate the cost of this additional work. There was also the termination itself, on which a core team of ten SRA people worked alongside consultants full time for six months on the business, financial, legal and communications issues associated with the termination. The SRA did not record the time spent, but estimated the cost of this team to be in the region of £500,000. The work did not entail any cash costs, but did involve an opportunity cost to the SRA because of the significant additional work for staff.

3.12 The SRA decided not to invoke its contractual right to recover these costs, as it was concerned about the significant financial and operational risk of CTUK Ltd becoming insolvent in the face of such claims. The SRA told us that insolvency might have triggered third party rights to the assets and sums transferred from CSE to SET as part of the financial settlement (paragraph 3.7). The Rolling Stock Leasing Companies (ROSCOs) that leased trains to CSE, for example, would have been entitled to terminate their leases and claim significant sums in compensation for early termination of their leases and put the continuation of train services at risk, although the SRA did not know how the ROSCOs might exercise their rights, if at all, in the event of CTUK Ltd becoming insolvent because this was the first and only time that the SRA had been in such a situation.

3.13 Nor did the SRA recover the £2 million that it spent on the several consultants' reviews of CSE's financial difficulties and the extent of CSE's compliance with the terms of the deed of amendment leading up to the termination decision. Oral advice from the SRA's internal legal advisers was that these costs had been part of the SRA's routine day-to-day management of the franchise and that the SRA had no contractual right to recover them from CSE. The SRA believed that no useful purpose would be served in seeking to recover costs that it had no contractual right to recover, and that doing so would have undermined already difficult exit negotiations and increased the risk of CTUK Ltd becoming insolvent. Given the extraordinary work involved in managing CSE's franchise in the period leading up to the termination decision, on account of CSE's failure to satisfy the SRA's requirements, we consider that the SRA should have done more to test the case for recovering such costs, with the support of independent and formal legal advice, particularly as this case set a precedent for the government should it decide to terminate other franchises early in future.

The SRA decided that SET should take over a small number of contracts involving some of CSE's sister companies

3.14 CSE had 11 contracts with other companies owned in whole or in part by Veolia, the parent company of Connex Transport UK Ltd. The SRA decided that SET should continue with six of these contracts when it took over the franchise because they related directly to the provision of train services and offered competitive terms. SET relet two of the contracts to alternative providers when the contracts reached the end of their terms soon after it took over the franchise.

3.15 One of the SRA's objectives in negotiating CSE's exit from the franchise was to achieve a clean break from CSE (Figure 4). Connex Transport UK Ltd, however, remains a party to several contracts that SET has retained with CSE's sister companies within the Veolia group. Some of the contracts are purchase agreements for new trains. Another relates to the maintenance of SET's new trains. In 1997, CTUK Ltd and Adtranz (now Bombardier Transportation UK Ltd), who manufactured CSE's fleet of new trains, set up South Eastern Train Maintenance Limited (SETML) as a joint venture company to maintain and repair CSE's trains. Connex and Adtranz had 40 per cent and 60 per cent shares respectively. PWC had expressed concerns about the transparency of this intra-group arrangement in their May 2003 report, although CSE had subsequently provided evidence that the joint venture arrangements had been competitively tendered and that transactions were at cost (paragraph 2.18). The joint venture provided favourable prices for CSE, but its details were complex and the SRA needed to understand the deal before deciding on whether it should acquire Connex's share. In addition, Connex Transport UK was not entitled to sell or transfer its shares without consent from Adtranz. The SRA and CTUK Ltd therefore agreed that the SETML arrangements should remain in place until a way forward could be agreed in a less pressurised timescale. This approach enabled early termination of the franchise, whilst allowing SET to benefit from train maintenance at lower than market rates.

3.16 More than two years after the termination, however, the SETML joint venture remains in place. SET has been seeking to agree revised maintenance arrangements with Bombardier Transport UK Ltd, but has not secured terms that adequately protected SET's interests. At the same time, and as a back-stop, SET has been negotiating with CTUK Ltd for SET to acquire Connex's interest in the joint venture, but has recently terminated the negotiations on the instruction of the Department for Transport. The Department considered that such an acquisition could be regarded as novel and contentious, requiring the unlikely approval of the Department and the Treasury. The Department has now told Bombardier Transport UK Ltd that it may discuss putting in place a new maintenance agreement with the preferred bidder for the Integrated Kent Franchise when the preferred bidder is announced by the end of December 2005. If any problems were to arise with SETML in the remaining period of SET running the franchise, Bombardier would supply train parts directly to SET and maintenance work would be reassigned to existing SET depots, Bombardier depots, or both. Connex pointed out, however, that any new arrangements between Bombardier and the operator of the Integrated Kent Franchise would require CTUK's agreement to the termination of the existing joint venture arrangements.

The SRA equipped SET to manage the franchise effectively from the day it took over from CSE

3.17 The SRA created South Eastern Trains and its holding company, South Eastern Trains (Holdings) (SET(H)), from two shell companies its predecessor, OPRAF, had set up in 1996 in case OPRAF needed to take over the provision of services in the event of a franchise termination. Both SET and SET(H) are wholly-owned subsidiary companies of the SRA. SET operates under an agreement similar to CSE's franchise agreement. In setting up SET, the SRA aimed to replicate as far as possible the structure and governance arrangements of other TOCs and their holding companies, so that the running of the business would be transparent to any external scrutiny and the business would be attractive to future bidders when it came to be relet to the private sector. The SRA's Chief Executive is the Non-Executive Chairman of SET and the SRA's Finance Director is the Chairman of SET(H). SET's Board includes non-executive directors with experience of rail safety and engineering.

3.18 All of CSE's systems, and all but twelve members of its staff, transferred to SET. Shortly after announcing the termination, the SRA organised the early appointment of a new Finance Director with senior level experience of rail sector finance, upon the resignation of CSE's Finance Director (Figure 6). The SRA offered 44 senior CSE staff an incentive bonus scheme to keep them in post with SET until at least January 2005. Ten staff left before the first payment, while 34 remained in service for the lifetime of the scheme at a total cost of £557,000 (paragraph 3.11). The scheme covered a period of 15 months from November 2003 to January 2005, during which time the staff covered by the scheme were unable to leave the organisation. The average bonus was £16,382 paid in two unequal instalments of £6,553 in January 2004 and £9,829 in January 2005. Six managers have since left.

SET strengthened its financial management as a subsidiary of the SRA

3.19 The establishment of SET and SET(H) as subsidiaries of the SRA addressed the SRA's concerns about the transparency of CSE's arrangements for intra-group trading. The SRA did not specifically require of SET the financial management improvements that it had required of CSE, even though SET inherited all of CSE's systems and all but twelve members of its staff. Rather, as a subsidiary of the SRA, SET was subject to the SRA's standards of financial management under the oversight of SET(H), with its own Finance Director, and with SET's new Finance Director, who now reports formally to SET's Managing Director. The SRA did not require SET to improve the financial model it inherited from CSE and adopt it as a forecasting tool, because it expected SET to operate the franchise for only 18 months and not to bid for the franchise when it was to be let through competition.

3.20 SET's new Finance Director concluded at an early stage that the underlying financial systems and processes inherited from CSE were generally sound, but that the processes were not being applied consistently. SET considered that it would not be practicable or cost-effective to develop the financial model inherited from CSE so, with the agreement of the SRA, it does not use it. SET did, however, implement some of the improvements to financial management that CSE had not introduced before CSE's exit from the franchise and has improved its internal controls and financial forecasting. It has also appointed a regulatory compliance officer. Consultants commissioned jointly by the SRA and SET found that, by January 2004, SET's business reporting had improved from that which it inherited from CSE, but that further improvements were needed. In a follow-up review in April 2004, the consultants found that SET's reporting had improved significantly. SET(H) and the SRA consider that the problems that SET inherited have been addressed, through SET's strengthening of its governance, financial management and internal controls, filling key staff vacancies and improved reporting to the SRA.

On a like-for-like basis, SET might cost less than estimated at the time of termination

3.21 Of the £58.9 million of additional subsidies that the SRA had agreed to pay CSE in 2003 (paragraph 2.9), the SRA actually paid the TOC £48 million for the ten months leading up to November 2003. The SRA agreed an expenditure budget of £189 million for SET for the period November 2003 to March 2004 and paid it subsidies of almost £46 million **(Figure 7)**, in line with a combination of the subsidy profile in CSE's franchise agreement and the additional monthly subsidies agreed under the deed of amendment. SET made a £100,000 operating surplus (before interest) over this period.

7 SET's budgeted and actual income and expenditure, 9 November 2003 to 31 March 2004

SET made a small operating surplus (before interest) of £100,000 between 9 November 2003 and 31 March 2004.

	Budget £m	Actual £m	Difference £m
Passenger income	127.3	125.3	(2.0)
Other operating income			
SRA subsidy payments	54.8	45.5	(9.3)
Other income	10.3	10.0	(0.3)
Total operating income	**192.4**	**180.8**	**(11.6)**
Net receipts/(payments) under the SRA and Network Rail performance regimes[1]	(1.3)	5.7	7.0
Total income	**191.1**	**186.5**	**(4.6)**
Operating expenditure			
Track & station access charges	72.6	72.6	–
Rolling stock leasing charges	34.4	33.2	(1.2)
Staff costs	43.5	42.5	(1.0)
Other operating costs[2]	38.5	37.4	(1.1)
Pension cost accounting	–	0.7	0.7
Total operating expenditure	**189.0**	**186.4**	**(2.6)**
Surplus/(Deficit) before interest and tax	**2.1**	**0.1**	**(2.0)**
Net interest	**(0.1)**	**0.1**	**0.2**
Surplus/(Deficit) after interest and before tax	**2.0**	**0.2**	**(1.8)**

Sources: Budgets based on SET's management accounts. Actuals based on SET's audited financial statements for 2003-04.

NOTES

1 TOCs operate under two performance regimes: one with the SRA, where performance incentive payments or penalties are based on train operating performance, and the other with Network Rail, where payments are made according to responsibility for delay.

2 Actual operating costs include a £2.7 million provision for the long-term maintenance costs of new trains.

The SRA budgeted to pay £44 million more in subsidies in 2004-05 than it had paid in 2003-04

3.22 Total budgeted subsidies from the SRA to SET in 2004-05 were originally some £152 million, some £44 million more than total subsidy payments to CSE and SET combined in 2003-04. Alongside an additional £21 million of forecast passenger and other revenue, the additional budgeted subsidies were expected to be needed for a number of reasons:

Increases in costs and a reduction in income that any operator of the franchise would have experienced

- track and station access charges that SET estimated would be almost £16 million higher than in the previous year, mostly due to the Rail Regulator's 2000 Review;[28]
- SET was expected to receive £18 million less in net penalty payments from Network Rail and the SRA due to expected improvements in Network Rail's performance, bringing the TOC lower penalty receipts alongside a forecast increase in penalty payments that SET would have to pay to the SRA;[29]

Higher staff and other operating costs within the SRA's and SET's control

- SET expected staff and other operating costs to be some £17.6 million more than in 2003-04, £15.5 million of which related to staff costs. SET had to fill 260 vacancies (7.5 per cent of its workforce) that it inherited from CSE among its station and train driver crews and some key senior and professional posts and planned to appoint a further 134 staff, at a total combined cost of £13.6 million. It also increased the salaries of existing staff, at a cost of £1.9 million;
- as part of the budget process, SET made provision for £2 million to tackle a backlog of station painting and deep cleaning work inherited from CSE. CSE paid SET £1 million to address these costs as part of the financial settlement; and

Perceived risks to SET's finances

- to cover the perceived risks in the business, the SRA budgeted to provide SET with financial headroom to make a surplus of £7.9 million in that year.

3.23 During the setting of SET's budget for 2004-05, however, there was a shift in the funding of Network Rail – away from TOC access charges and towards more direct SRA grant payments – following the Rail Regulator's 2003 Review which was concluded in December 2003.[30] Following these changes, the SRA was obliged to pay SET subsidies of almost £81 million[31] in 2004-05, £71 million less than originally budgeted. The reduction was offset by a corresponding reduction in SET's track access charges and a projected increase in performance income, and was matched by a corresponding increase in direct grant payments from the SRA to Network Rail.

SET made a surplus of some £14 million in 2004-05, £4.5 million more than planned

3.24 The SRA expected SET to make a surplus of £9.3 million after interest but before tax, or 2.1 per cent of total income, in 2004-05. SET made an actual surplus of £13.8 million, or 3.1 per cent of income **(Figure 8)**. Rolling stock leasing charges were £5.7 million less than expected due to delays in the introduction of new trains, and at the same time SET received £3.7 million from Bombardier Trains UK, the manufacturer of the trains, to compensate it for the trains' late delivery. SET surrendered £11.9 million to the SRA and retained £1.9 million.

3.25 The SRA budgeted subsidies for SET for 2005-06 at a similar level to those in 2004-05. SET expects to operate within its budgeted subsidies for 2005-06 despite a loss of passenger revenue following the terrorist attacks in London in July 2005.

28 Network Rail received government support in the form of direct grants from the SRA. It also receives access charges from TOCs and freight operating companies. The Rail Regulator set the level of access charges that TOCs were required to pay to Network Rail. Any increases in charges during the lifetime of, and not anticipated in, a TOC's franchise are met by increased taxpayer subsidies from the SRA. The Rail Regulator's 2000 Review identified a higher revenue requirement for Network Rail, which the government was obliged to meet through higher track access charges payable to Network Rail by TOCs but funded by way of additional subsidy from the SRA.

29 TOCs operate under two performance regimes: one with the SRA, where performance incentive payments or penalties are based on train operating performance, and the other with Network Rail, where payments are made according to responsibility for delay.

30 The Rail Regulator's 2003 Review identified a higher revenue requirement for Network Rail and, in implementing the Review, the government agreed to meet more of its obligations through direct grant rather than through track access charges.

31 The SRA reduced its subsidy payments to SET to ensure that SET did not gain or lose from the changes from the Rail Regulator's 2003 Review.

8 SET's budgeted and actual income and expenditure, 1 April 2004 to 31 March 2005 compared with 2003-04 CSE and SET combined

SET made a surplus of £13.8 million in 2004-05.

	Actual (CSE and SET combined) 2003-04 £m	Budget 2004-05 £m	Actual 2004-05 £m
Passenger income	313.9	331.1	331.3
Other operating income			
SRA subsidy payments	107.5	80.7[1]	80.7
Other income	24.9	28.4	31.6
Total operating income	**446.3**	**440.2**	**443.6**
Net receipts/(payments) under the SRA and Network Rail performance regimes	17.3	3.6	(0.5)
Total income	**463.6**	**443.8**	**443.1**
Operating expenditure			
Track & station access charges	178.7	127.7[1]	127.2
Rolling stock leasing charges	85.5	85.5	79.8
Staff costs	105.8	121.3	120.3
Other operating costs[2]	99.3	101.4	101.2
Pension cost accounting	–	–	2.4
Total operating expenditure	**469.3**	**435.9**	**430.9**
Surplus/(Deficit) before interest and tax	**(5.7)**	**7.9**	**12.2**
Net interest	**0.3**	**1.4**	**1.6**
Surplus/(Deficit) after interest and before tax	**(5.4)**	**9.3**	**13.8**

Sources: CSE part-year 2003-04 data based on NAO analysis of management accounting data drawn from SET records rather than from CSE's financial statements, which were prepared on a calendar year basis. Budgets based on SET's management accounts. Part-year 2003-04 actuals for SET based on SET's audited financial statements for 2003-04. SET actuals for 2004-05 based on SET's unaudited financial statements for 2004-05.

NOTES

1 SRA subsidy to SET was reduced from its 2003-04 level following the Rail Regulator's 2003 Access Charges Review. The government chose to meet more of its funding obligations by increasing the level of direct grant paid by the SRA to Network Rail whilst at the same time reducing the level of track access charges met by, and the subsidy paid to, TOCs.

2 SET's budgeted and actual operating costs include a £3.7 million provision for the long-term maintenance costs of new trains.

3.26 When it decided to terminate CSE's franchise, the SRA estimated that an SRA subsidiary would require some £425 million in subsidy to run the franchise from 2004 to 2006. Based on actual costs from November 2003 to the end of March 2005 and projected costs to December 2006, the SRA expects SET to cost the taxpayer £403 million – some £22 million less than originally anticipated – to run the franchise over this period. But, comparisons between the actual and likely cost of SET and what was originally envisaged are not as straightforward as this comparison suggests. For our comparisons, we have had to take account of several adjustments, which have been hampered by lack of detail supporting the SRA's estimate:

Changes in regulated charges that all TOCs have to pay

- given that the SRA's estimate was made at the time of the termination decision in June 2003, it could not include the effects of the Rail Regulator's December 2003 Access Charges Review. The estimate was not supported by sufficient detail to enable us to adjust it for the effects of that Review. We therefore adjusted SET's actual costs in 2004-05 and its future cost projections to remove the impact of the changes introduced by the 2003 Review and ensure a like-for-like comparison in terms of costs to the taxpayer;

Adjusting for SET accounting changes

- SET has adopted a prudent policy of making provisions for pension costs and train maintenance charges. The SRA's estimate is unlikely to have included such provisions. We therefore adjusted SET's actual costs to take account of actual provisions totalling £6.4 million in 2003-04 and 2004-05, and adjusted its projected costs to reflect projected provisions of £26.9 million for the period April 2005 to December 2006; and

Stripping out actual and projected SET surpluses and adding back windfall gains

- any surpluses made by SET may be surrendered to the SRA and are, in effect, available to the taxpayer. We therefore stripped these out of SET's actual and projected costs. Conversely, windfall gains of £9.4 million from the late delivery of new trains (paragraph 3.24) have to be added back as they are unlikely to have been included in the SRA's estimate. The late delivery of new trains and SET's need to continue running old vehicles of decreasing reliability are likely to have contributed to SET's making net payments rather than receiving net receipts under the railway performance regimes in 2004-05 (Figure 8), although just how much of a contribution cannot readily be quantified.

3.27 For consistency with the time period for the SRA's estimate – from January 2004 to December 2006 – and based on actual costs to March 2005 supplemented by the most up to date projections to December 2006 and adjusting for the factors outlined above, we estimated that on a like-for-like basis SET might cost the taxpayer £12 million (2.9 per cent) less than the amount the SRA estimated if SET were to run the franchise until December 2006.

3.28 The franchise is likely to be relet as part of the Integrated Kent Franchise, however, to start from April 2006. We therefore revisited the SRA's estimate of £425 million, and on a pro-rata basis identified that portion of the estimated costs that would fall within the period from January 2004 to March 2006. Similarly, we identified SET's actual and projected costs until March 2005 and March 2006 respectively. We estimate that, on a like-for-like basis, SET might cost the taxpayer £6 million (2 per cent) less than the amount the SRA estimated if SET were to run the franchise until the end of March 2006. SET's costs to the taxpayer have therefore been well controlled to keep them within the SRA's original estimate.

Measures used to assess TOCs' efficiency indicate that SET is in line with its two comparator TOCs

3.29 **Figure 9** shows that SET had a subsidy per passenger kilometre of 2.1 pence in 2004-05. This was higher than that of South West Trains (0.8 pence) but below that of Southern, SET's two closest comparator TOCs in London and the south east. It was also below the national average (both 2.4 pence). There has been significant annual variation in the data, however, and the national average subsidy per passenger kilometre in 2004-05 was less than half of that in 2003-04 because of the effects of the change in the balance between access charges and direct funding of Network Rail following the Rail Regulator's 2003 Review, which had the effect of significantly reducing the SRA's subsidies to TOCs whilst increasing the SRA's direct subsidies to Network Rail.

3.30 The SRA's franchise monitoring reports include a range of other efficiency measures that relate to a TOC's total or non-subsidy income. **Figure 10** shows that, across these measures, SET was in line with its two comparator TOCs in London and the south-east in 2004-05.

9 Subsidy per passenger kilometre, 2002-03 to 2004-05

In 2004-05, the subsidy per passenger kilometre for SET was higher than that for South West Trains but lower than that for Southern. SET's subsidy per passenger kilometre has been below the national average since it started operating the franchise.

	Subsidy per passenger kilometre (pence)		
	2002-03	2003-04	2004-05
National average	3.3	5.0	2.4
CSE	1.3	4.3	–
SET	–	3.8	2.1
South West Trains	0.9	2.7	0.8
Southern	0.2	3.3	2.4

Source: National Audit Office summary of SRA data

On a like-for-like basis, SET might cost more than the subsidies that CSE was prepared to accept to operate the franchise

3.31 The SRA's estimate that an SRA subsidiary might require subsidy of £425 million reflected its own assessment of what a robust operator might require, and included the £42 million of additional costs that it considered might be incurred from recruiting and employing staff on short-term contracts and employing advisers as the SRA had no previous experience of managing a franchise (Figure 3). At the same time, the SRA had been in negotiation with CSE over the level of additional subsidy for 2004 to 2006. Connex Transport UK Ltd had told the SRA in January 2003 that it would need additional subsidy of £250 million for 2004 to 2006, over and above the existing subsidy of £200 million under the original franchise agreement. The SRA had subsequently, through negotiation, driven down to £183 million the amount of additional subsidy that CSE was prepared to accept. CSE was therefore prepared to accept subsidies totalling £383 million to operate the franchise until December 2006.

10 Efficiency indicators for SET and its closest comparator TOCs, 2004-05

Based on the efficiency measures used by the SRA and inherited by the Department, SET was in line with its two comparator TOCs in London and the south-east in 2004-05.

	SET	South West Trains	Southern
Ticket revenue as a percentage of total income	75%	85%	68%
Total operating costs/total non-subsidy income	118%	99%	120%
Operating profit(loss)/total non-subsidy income	4%	10%	7%
Operating profit(loss)/total income	3%	9%	5%
Total non-subsidy income per employee	£94,920	£91,890	£92,520
Operating profit(loss) per employee	£3,870	£8,910	£6,080
Total income per vehicle mile	£4.03	£3.74	£4.42
Operating costs per vehicle mile	£3.90	£3.41	£4.19

Source: National Audit Office analysis of DfT data, 2004-05, for SET and South West Trains, and of data provided directly by Southern for Southern.

3.32 We estimate that, on a like-for-like basis, SET might cost the taxpayer £30 million (8 per cent) more than the amount that CSE was prepared to accept by way of subsidy if SET were to run the franchise until December 2006. On a pro-rata basis, SET might cost almost £22 million (8 per cent) more were it to run the franchise until March 2006. The SRA had little confidence, however, that CSE would be able to run the franchise within the £383 million it was prepared to accept. The SRA had been considering placing CSE on a management contract, like that for other TOCs in financial difficulty (see Note 1 at Figure 3, and paragraph 2.36), which would have provided some means of controlling CSE's costs and subsidy. The SRA considered that it would have been difficult placing CSE on such a contract, however, and such contracts are not a fully effective means of controlling a TOC's costs. In particular, the SRA would have taken more financial risk, the underlying issue of the SRA's lack of confidence in CSE would not have been solved, and the effort needed to manage the franchise would have had to continue at a level that the SRA Board considered already disproportionate.

SET is working to reduce the £16 million that it estimates it loses each year through fare evasion

3.33 Any revenue losses that SET incurs from fare evasion result in lower surpluses to be surrendered to the SRA or invested in SET's business. The SRA recognised that revenue risk would return to the SRA upon the franchise being taken in-house (Figure 3). Under conventional franchise agreements, the SRA provided subsidies to most[32] TOCs to make up the gap reflected in their franchise bids between their income from fares and other sources and their operating costs over the lifetime of their franchises. In assessing franchise bids, the SRA took account of previous levels of ticket revenue and reviewed revenue projections to ensure that bids were robust and based on realistic estimates of fare income and that it did not pay a higher level of subsidy than necessary. The SRA considered that the emphasis on minimising the level of subsidy required in the competition for franchises (paragraph 2.2) encouraged potential franchisees to maximise their revenue. Having bid for and agreed a level of subsidy, TOCs carry the revenue risk associated with protecting their sources of income. Revenue lost due to fare evasion results in lower profits. Where cost-effective, TOCs have invested in revenue protection measures, sometimes with funding from the SRA.

3.34 The SRA expected TOCs to manage the risk of, rather than completely eliminate, fare evasion. It expected that between 2.5 per cent and 3.5 per cent of travel on each TOC's services would be ticketless. It estimated that the level of evasion across the network varied depending on different routes and services, but was between 3 and 6 per cent, worth between £120 million and £235 million a year, while in April 2005, the Minister for Transport told Parliament that over £200 million of revenue was lost annually. Both of these estimates were based on limited information provided following exercises to detect ticketless travel, which was then extrapolated to produce national estimates.

3.35 The SRA was satisfied with CSE's revenue protection measures as CSE's passenger revenues had exceeded the projections in its franchise bid (paragraph 2.3). CSE had given greater attention to reducing the level of fare evasion and had created a senior management post to oversee the work. The SRA expected that SET would manage the risks of fare evasion as part of a more general improvement in the running of the franchise and therefore did not require SET to strengthen its revenue protection measures when it took over from CSE.

3.36 SET has estimated that it loses £16 million a year as a result of fare evasion, representing 4.8 per cent of its annual passenger income or some 19.8 per cent of its annual direct subsidies of £81 million. This is greater than the level of ticketless travel that the SRA expected TOCs to experience, but within the range that it had estimated across the network as a whole. In order to reduce these estimated losses, SET would need to invest in further revenue protection measures. It would have to spend to save, and therefore not all of the £16 million is recoverable.

32 Gatwick Express, GNER, Midland Mainline and Thameslink paid, rather than received subsidies, to run their franchises.

3.37 SET has taken steps to reduce fare evasion where these have been supported by a business plan and budget that SET(H) has approved as being cost-effective and where the steps have been agreed with the SRA. SET's holding company, SET(H), approved budgets totalling £2.5 million for additional revenue protection measures during 2004-05 and 2005-06. The measures were expected to be self-financing within three years of implementation. Measures have included the appointment of 22 additional revenue protection staff, the extension of its penalty fare area to cover all of its franchised stations and the introduction of a policy under which persistent fare evaders are prosecuted after being caught more than twice. SET spent £500,000 on additional measures in 2004-05, and expects to spend £780,000 on additional measures in 2005-06. It recovered £219,000 (1.4 per cent of estimated annual losses) more in penalty fares in 2004 compared with the sum that SET and CSE together had recovered in 2003. It aims to recover an additional £500,000 (3.1 per cent of estimated annual losses) in 2005. Revenue protection staff also have a deterrent effect, leading to more passengers paying at ticket offices, although by its nature this effect cannot be quantified. SET now plans to recruit fewer additional revenue protection staff than it had anticipated, and to install instead automatic ticketing gates at some of its stations at a capital cost of £900,000. It plans to complete their installation by March 2006.

PART FOUR

Passenger rail services have been protected

4.1 One of the SRA's objectives was to avoid loss of focus by CSE on its train operations and any deterioration in services in the period running up to SET taking over the franchise in November 2003. This Part of the report examines whether passenger services and satisfaction were sustained after the termination announcement, and SET's performance and passenger satisfaction ratings since taking over the franchise.

CSE's operational performance improved during the two years prior to the termination decision, but mainly due to Network Rail recovering from low levels of performance

4.2 TOCs' operational performances are affected by different factors, complicating any inter-TOC comparisons. All three TOCs in the south east of England, for example, have been introducing new train fleets of different sizes and complexities. Notwithstanding these particular factors, **Figure 11 overleaf** shows that CSE's performance[33] declined from summer 1999 to autumn 2001 alongside that of its two closest comparator TOCs, South Central and South West Trains. The sharpest drop in CSE's performance followed the Hatfield derailment in October 2000, when speed restrictions applied across the network. All three TOCs' performance improved from their troughs in December 2001 until June 2003 when the SRA announced that it was terminating CSE's franchise, CSE outperforming South Central and South West Trains but without recovering its earlier levels. The SRA's National Passenger Surveys,[34] however, showed that passengers were less satisfied with CSE's train services than with those of South Central and South West Trains in all surveys between spring 2001 and autumn 2003 except spring 2002. Passengers were particularly concerned about the upkeep, repair and cleanliness of CSE's trains and stations.

4.3 The Public Performance Measure (PPM)[35] does not identify which organisations have contributed to improvement or deterioration in TOCs' operational performance. Network Rail records data, measured in delay minutes, to identify delays in services attributable to Network Rail, other TOCs (for example, if a train operated by one TOC breaks down, it might affect another TOC's services, known as 'TOC on TOC' delays) or to a TOC that affect the TOC's own services (known as 'TOC on self' delays). There is a strong statistical correlation[36] between the PPM and delay minutes. Attribution of changes in delay minutes on a TOC's train services is therefore a reliable indicator of whether any improvement or deterioration in a TOC's PPM is due to Network Rail, other TOCs or the TOC itself. We therefore analysed data on delay minutes to determine the reasons for the improvement in CSE's and its comparator TOCs' performance from the trough towards the end of 2001 until the termination decision in June 2003.

33 Using the moving annual average of the Public Performance Measure (PPM), expressed as the percentage of scheduled trains that arrive at their destinations within five minutes of their planned arrival times. The PPM takes account of late running, as well as cancelled, trains. The moving annual average measures the average level of performance over the previous 12 months to smooth out seasonal fluctuations.

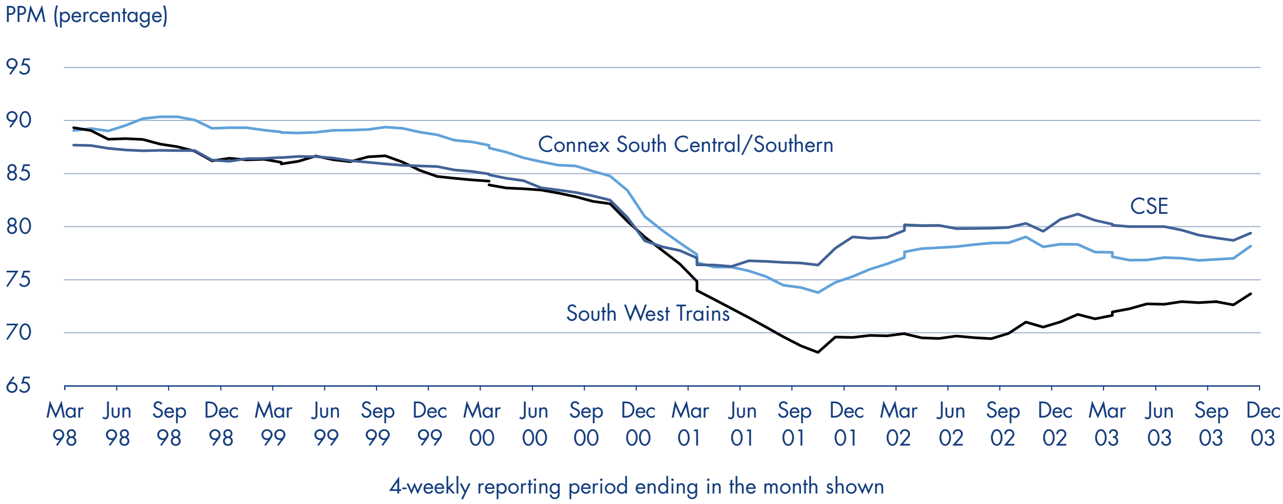
34 Carried out in the autumn and spring each year.

35 See footnote 33.

36 For SET, the R-squared value (the statistical measure of closeness of fit between two variables) is 0.89 (1 is a perfect fit; 0 is no relationship) for the PPM and delay minute data over the two years up until September 2005. For Southern and SWT, the equivalent R-squared values are 0.92 and 0.97 respectively.

11 Operational performance of Connex South Eastern and its two closest comparator TOCs, March 1998 to November 2003

CSE's performance declined from summer 1999 alongside that of its two closest comparator TOCs, before improving through to June 2003 although never recovering its earlier levels.



Source: NAO analysis of SRA data

NOTES

1 Each point on the chart represents the moving annual average of the Public Performance Measure (PPM) over the preceding 12 months.

2 Connex South Central was CSE's sister TOC until Govia took over the South Central franchise in August 2001. Govia re-named the franchise as Southern in May 2004.

4.4 Total delays fell over the period **(Figure 12)**. But CSE caused itself delays, partly offsetting a combined reduction of 5.6 per cent in delays due to Network Rail and other TOCs and resulting in a total net reduction in delays of 2 per cent on CSE's services.

CSE's operational performance deteriorated a little, but its customer satisfaction levels improved slightly, during the high risk handover period

4.5 The SRA recognised the risk that train services might not be able to run if, for example, CSE decided to hand over the franchise immediately or its staff took industrial action, or that CSE's operational performance might deteriorate in a handover period if, for example, poor staff morale and increased absenteeism led to more late running or cancelled trains. The SRA therefore:

- had a team of 40, including external expertise, on hand on the evening of the announcement in case it needed to take over from CSE immediately;
- jointly briefed CSE's staff at a meeting held on the morning on which it announced its termination decision to the media, in order to explain its decision and reassure staff;
- notified Her Majesty's Railway Inspectorate (HMRI) in advance of the termination announcement and obtained its agreement that, if CSE decided to hand over the franchise immediately, the incoming TOC could continue to run services by adopting CSE's safety case[37] provided no significant changes were made to railway operations; and
- made retention payments to key CSE staff to ensure they continued to run the franchise following termination (paragraph 3.18).

37 A formal document that has to be submitted to Her Majesty's Railway Inspectorate (currently part of the Heath and Safety Executive, but transferring to the Office of Rail Regulation in 2006) before a TOC can run services on the rail network. HMRI will only give its approval if the document shows that all risks to safety have been satisfactorily mitigated.

12 Attribution of changes in delay minutes on train services run by CSE and its comparator TOCs, November 2001 to June 2003

Delay reduced at CSE and its two London comparator TOCs between November 2001 and June 2003. But, both CSE and Connex South Central/Southern caused an increase in delays, partly offsetting the reductions attributable to Network Rail and other TOCs.

	CSE	Connex South Central/Southern	South West Trains
Total delay minutes in November 2001	**117,987**	**127,605**	**161,409**
Total delay minutes in June 2003	**115,575**	**118,317**	**155,796**
Reduction in delay minutes due to Network Rail	**(4,155)**	**(11,607)**	**Nil**
Percentage of total improvement attributable to Network Rail	63%	83%	0%
Reduction in delay minutes due to other TOCs ('TOC on TOC')	**(2,471)**	**(2,462)**	**(333)**
Percentage of total improvement attributable to other TOCs	37%	17%	4%
Reduction in delay minutes due to TOC ('TOC on self')	**Nil**	**Nil**	**(9,086)**
Percentage of total improvement attributable to TOC	0%	0%	96%
Gross reduction in delay minutes	**(6,626)**	**(14,069)**	**(9,419)**
Offset by:			
Increase in delay minutes due to TOC (TOC on self)	**4,214**	**4,781**	**Nil**
Increase in delay minutes due to Network Rail	**Nil**	**Nil**	**3,806**
Net increase/(reduction) in delay minutes between November 2001 and June 2003	**(2,412)**	**(9,288)**	**(5,613)**
Total percentage net reduction in delays	(2%)	(7%)	(3%)

Source: National Audit Office analysis of Network Rail data

NOTE

1 All data based on moving annual averages.

4.6 During the handover period, CSE's operational performance deteriorated a little, with an average of 78 per cent[38] of trains arriving on time each month from July to October 2003, one percentage point lower than the moving annual average for the previous 12 months and one and a half percentage points lower than the average for the same months in the previous year. CSE's PPM[39] continued to be better than that for South West Trains (74.5 per cent) but slightly worse than Southern's (79 per cent). Overall passenger satisfaction increased slightly during the handover period, from 65 per cent in spring 2003 to 66 per cent in autumn 2003 when the average for TOCs in London and the south east was 70 per cent and the national average was 73 per cent. Passengers' perception of train punctuality, and satisfaction with the attitude and helpfulness of staff, also improved slightly in the handover period.

4.7 We analysed data on delay minutes to determine whether the small deterioration in CSE's operational performance during the four-month handover period was due to CSE, Network Rail or other TOCs. Delay increased at CSE during the period, due to a combined deterioration in Network Rail's, CSE's and other TOCs' performance **(Figure 13 overleaf)**. Network Rail was the single biggest cause of the deterioration in CSE's performance, although CSE itself was the next largest.

38 Average PPM across the four months July to October 2003, rather than the moving annual average of the PPM which would smooth out performance and thereby mask actual performance during the handover period.

39 Average PPM across the four months July to October 2003.

13 Attribution of changes in delay minutes on train services run by CSE during the handover period, July 2003 to October 2003

Delay increased at CSE during the handover period, due to a combined deterioration in Network Rail's, CSE's and other TOCs' performance.

Total delay minutes in July 2003	**117,822**
Total delay minutes in October 2003	**122,036**
Increase in delay minutes due to Network Rail	**2,134**
Percentage of total increase attributable to Network Rail	51%
Increase in delay minutes due to other TOCs ('TOC on TOC')	**808**
Percentage of total increase attributable to other TOCs	19%
Increase in delay minutes due to TOC ('TOC on self')	**1,272**
Percentage of total increase attributable to TOC	30%
Gross increase in delay minutes	**4,214**
Total percentage net increase in delays	3.6%

Source: National Audit Office analysis of Network Rail data

SET filled 260 vacancies and recruited a further 107 staff, and completed the introduction of new trains and train maintenance facilities to improve the quality of its services

4.8 By the end of March 2004, SET had filled 141 of the 260 staff vacancies it had inherited from CSE among its station staff and train driver crews and key senior managers and professionals (paragraph 3.22). These included the appointment of all key senior managers and professionals, in addition to that of SET's own Director of Engineering whom CSE had recruited. SET filled the other 119 vacancies by March 2004. By March 2005, SET had recruited a further 107 people to improve its quality of service.

4.9 By November 2003, CSE had introduced 210 new train vehicles into service. SET told us that, when it took over the franchise, there was a delivery schedule but no recognisable plan covering all of the aspects needed to introduce and maintain the other 408[40] new vehicles yet to enter service. By March 2004, SET's new Engineering Director had introduced a delivery plan and project management techniques to help ensure the smooth and efficient introduction of new trains. All of SET's new trains were running on the network by June 2005.

4.10 The SRA had granted CSE an exemption from starting work on new depot facilities for maintaining trains at Ramsgate because it had not approved CSE's proposals. After the transfer of the franchise, the SRA Board approved the work, at a budgeted cost of £3.1 million, to provide interim facilities at Ramsgate to maintain the new trains. These new facilities actually cost £2.8 million and were completed by May 2005.

4.11 As part of the settlement on CSE's exit from the franchise, CSE paid £6.3 million to SET to bring rolling stock back to an acceptable standard. The two[41] ROSCOs that leased the largest fleets to CSE also agreed to meet half of the expected £7 million cost of fitting CCTV cameras on rolling stock that they would lease to SET, to improve train and passenger security. However:

- SET is spending £6.9 million to bring its trains up to the condition that SET and its ROSCOs require, £0.6 million more than it received from CSE, based on the detailed specification for the work developed a year after the financial settlement; and
- SET decided not to go ahead with the fitting of CCTV because it was not convinced that this would be an efficient method of improving passengers' confidence in their own personal safety on SET's trains. There is no time limit on the offer from the ROSCOs, which remains available until the train leases expire.

40 CSE and SET introduced a total of 618 new trains. This was a smaller number than the 622 old trains they removed from service (paragraph 1.1) because a fewer number of the new trains would be unavailable for passenger service at any one time because of the need to maintain them, and because the design of the new trains meant that passenger capacity could better be matched with demand for services.

41 Angel Trains Ltd and HSBC Rail (UK) Ltd.

SET's operational performance is improving alongside that of similar London commuter TOCs

4.12 In November 2003, SET's holding company (SET(H)) issued guidance that required SET to stabilise overall operational performance and deliver cost-effective improvements to services. In September 2004, SET(H) updated its guidance so that, from April 2005, SET's focus changed from stabilisation of the franchise to improving the value of SET's business, including by improving the quality and reliability of services. Some of SET's expenditure since taking over the franchise in November 2003, for example, has been on capital items that have been accepted by the SRA as primary franchise assets to be passed on to, and paid for by, the incoming operator of the Integrated Kent Franchise. Further, the SRA and SET considered that SET's turning of a loss-making franchise into a business generating annual surpluses would have influenced the Integrated Kent Franchise bidders' views on the value of the business.

4.13 SET's operational performance, in comparison with that of other TOCs, needs to be seen within the context of the temporary nature of its running of the franchise and the uncertain environment within which SET has therefore been running its business. SET's operational performance, as measured by the moving annual average of the Public Performance Measure, has been improving since January 2004, two months after SET took over the franchise **(Figure 14 overleaf)**, reflecting SET's increased spending on staffing. From April 2004 to June 2005, SET's operational performance was better than that of its closest comparator TOCs. Data to September 2005 show that 85.7 per cent[42] of SET's trains arrived on time, exceeding the 85 per cent target that the government set for the rail industry as a whole to achieve by 2006. SET's comparator TOCs, South West Trains and Southern,[43] achieved similar punctuality scores of 86.8 per cent and 85 per cent respectively. By September 2005, SET's performance had improved by 6.3 percentage points since the transfer[44] of the franchise, equivalent to around 33,000 more trains a year running on time. The improvement was, however, less than the 6.8 percentage point improvement achieved by Southern and the 13.1 percentage point improvement achieved by South West Trains over this period, although South West Trains was improving from a lower base.

4.14 The SRA and TOCs also measure train punctuality against targets set in a TOC's Passenger Charter, based on the percentage of peak hour trains arriving within five minutes of their advertised arrival time. Passengers are eligible for discounts of 5 per cent on season ticket renewals if performance falls below specified thresholds of 86.5 per cent for SET's local services, operating in south London, and 82 per cent for its mainline services, principally to and from the Kent coast:

- Measured on a moving annual average basis, punctuality on SET's mainline services was above the threshold in November 2004 for the first time since October 2000. It has remained above the threshold until September 2005, the latest period for which data are available. Improved punctuality resulted in savings to the public purse through SET not having to make compensation payments to passengers.
- Punctuality of SET's local services is below the compensation threshold, although it has improved by almost four percentage points (from 81 per cent to almost 85 per cent) since the transfer of the franchise.

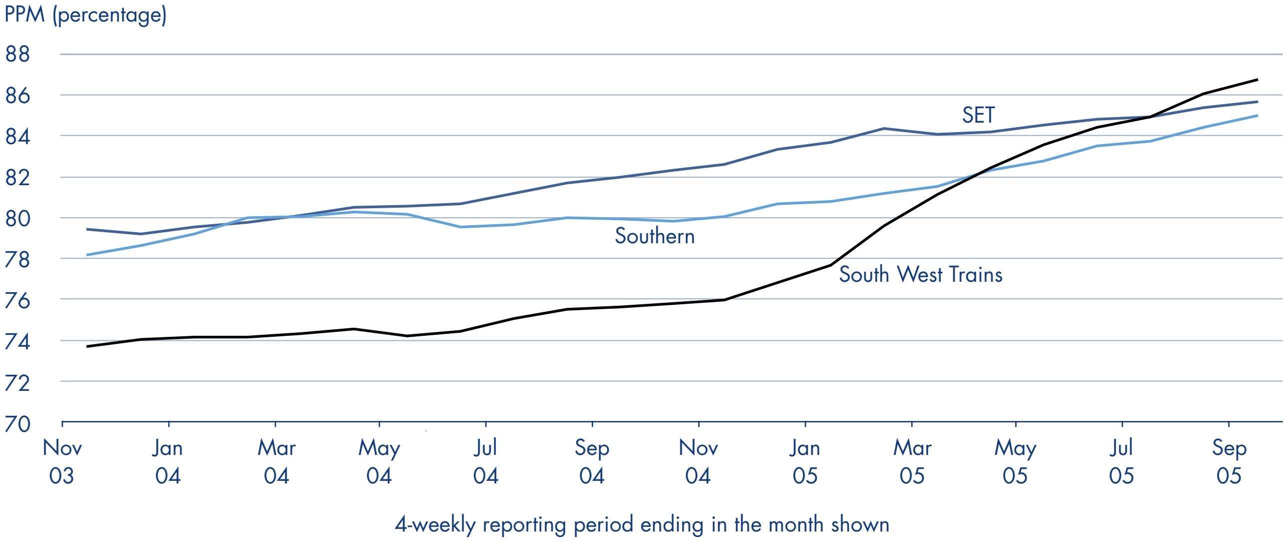
4.15 Service levels for SET's main comparator TOCs are below their compensation thresholds:

- Measured on a moving annual average basis, Southern fell short of its 84 per cent threshold for its Sussex Coast services in September 2005, although by only three tenths of one percentage point. Over the same period, Southern's South London service fell 2.5 percentage points short of its compensation threshold of 87 per cent.
- Measured on a moving annual average basis, South West Trains fell only four tenths of one percentage point short of the 89.5 per cent compensation threshold for its suburban services in September 2005, and 3.1 percentage points short of its threshold for mainline services over the same period.

42 Moving annual average of the PPM.
43 Govia's South Central franchise was renamed Southern in May 2004.
44 The moving annual average of the PPM under CSE for the 12 months to October 2003 was 79.4 per cent.

14 Operational performance of South Eastern Trains and its two closest comparator TOCs, November 2003 to September 2005

SET's operational performance was better than that of its closest comparators between April 2004 and June 2005, but between June and September 2005, South West Trains' performance was better than SET's.



Source: Network Rail

But it has been Network Rail that has made the single biggest contribution to improved train service performance

4.16 We analysed data on delay minutes to determine the reasons for the improvement in performance of SET and its comparator TOCs. It took time for SET to get its full management team in place (paragraph 4.8). We therefore assessed performance in the five-month period from November 2003 to March 2004, when vacancies were still being filled, separately from performance from April 2004 to September 2005.

4.17 Over the first five months of SET running the franchise, from November 2003 to March 2004, improvements in Network Rail's performance made the biggest contribution to reductions in delays[45] on SET train services and across the national rail network, as Network Rail continued to recover from low levels of performance after the Hatfield derailment in October 2000. Improved performance by other TOCs also contributed to reduced delays on SET's services. SET's own performance deteriorated, however, turning a combined reduction of 3 per cent in delays due to Network Rail and other TOCs, into a 1 per cent net increase in delays on SET's services. By comparison, South West Trains contributed to an overall net reduction of 5 per cent in delays on its services over the same period. And, although Southern's own performance also deteriorated, this was insignificant and still left Southern with a net reduction of 3 per cent in delays on its services.

4.18 **Figure 15** shows that improvements in Network Rail's performance have made the biggest single contribution to reduced delays on train services across the national rail network and for SET and its comparator TOCs since April 2004. But, with its full management team in place since then, SET has reduced train delays that it caused itself, accounting for 32 per cent of the reduction in delays in its services over the period to September 2005. Southern and South West Trains also contributed to overall reductions in delays over the same period, both TOCs making a bigger contribution to their own overall improvement than SET in absolute terms.[46] Improvements

45 Based on the moving annual average of total delay minutes.
46 In terms of reduction in the number of delay minutes.

15 Attribution of changes in delay minutes on train services run by SET and its comparator TOCs, April 2004 to September 2005

Delays in all three TOCs' train services fell between April 2004 and September 2005. Improvements in Network Rail's performance made the biggest single contribution to reductions in delays over the period.

	SET	Southern	South West Trains
Total delay minutes in April 2004	122,988	119,443	141,965
Total delay minutes in September 2005	95,266	96,972	83,965
Total reduction in delay minutes between April 2004 and July 2005	27,722	22,471	58,000
Reduction in delay minutes due to Network Rail	15,717	10,421	37,847
Percentage of total improvement attributable to Network Rail	57%	46%	65%
Reduction in delay minutes due to TOC ('TOC on self')	8,746	9,532	16,835
Percentage of total improvement attributable to TOC	31%	43%	29%
Reduction in delay minutes due to other TOCs ('TOC on TOC')	3,258	2,518	3,317
Percentage of total improvement attributable to other TOCs	12%	11%	6%

Source: National Audit Office analysis of Network Rail data

NOTE

All data based on moving annual averages. Data might be subject to change, following resolution of any remaining uncertainties concerning delay attribution.

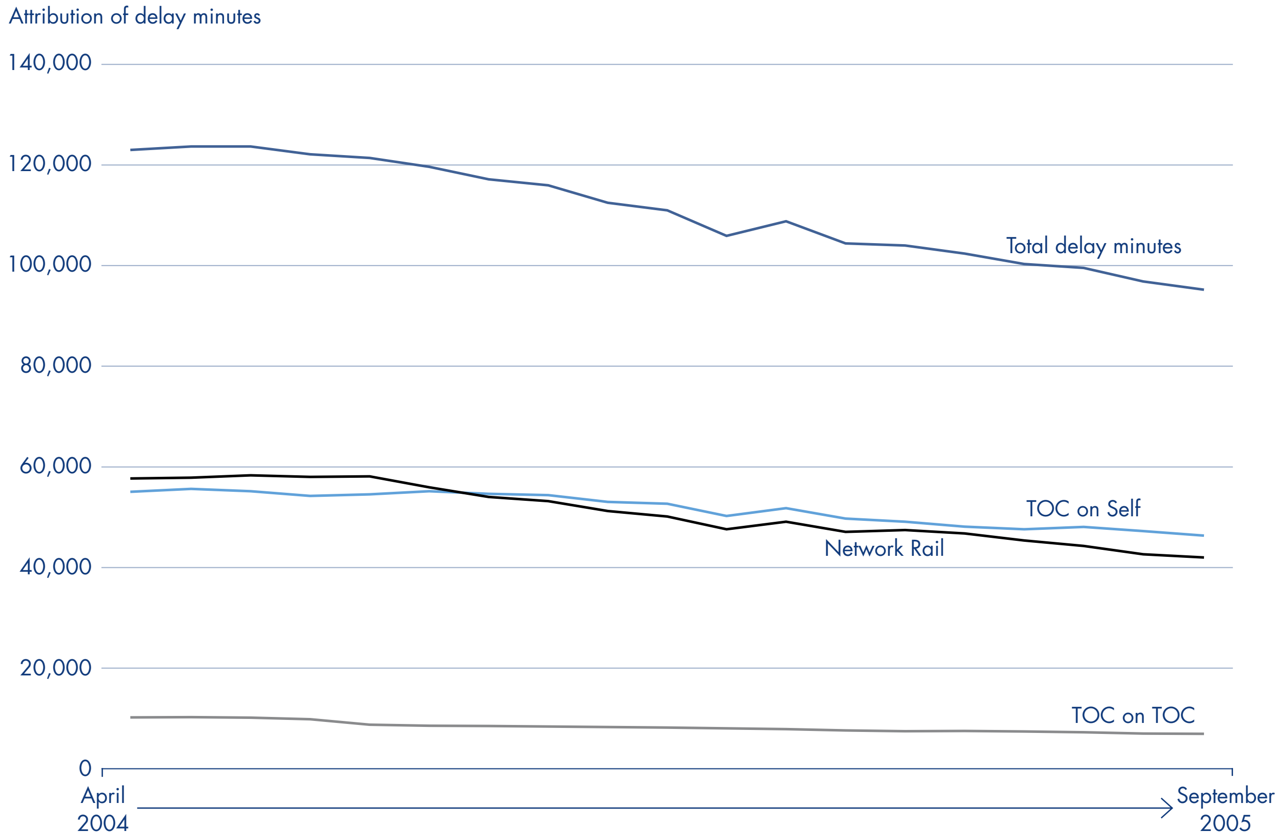
in performance have been assisted by the introduction of integrated control centres for managing all three TOCs' train operations, which have encouraged closer working relations between TOCs and Network Rail.

4.19 SET and its comparator TOCs improved their performance over this period despite introducing new train fleets, which as we highlighted in our February 2004 report *Improving passenger rail services through new trains* (HC 263, Session 2003-04) are often less reliable than the old trains they have replaced, particularly in the first months after entry into service. Improvements in the reliability of SET's train fleet, in addition to timetable changes in September 2003, underpinned the reduction in delays and improvement in its operational performance. Delays due to train engineering problems fell by 28 per cent between April 2004 and September 2005. Timetable changes reduced the number of trains stopping at certain key pinch points on the network, such as London Bridge during peak hours, and increased journey times into London prior to the evening peak and dwell times by one minute at London Bridge. Neither SET nor Southern have had an opportunity to revise their timetables on the scale of South West Trains' changes, in agreement with Network Rail. SET told us that its managers paid particular attention to the basics of railway operation over this period.

4.20 **Figure 16 overleaf** shows that the total volume of delay minutes on SET's train services has been falling since April 2004, with Network Rail, SET and other TOCs contributing to the improvement. SET, rather than Network Rail, is now the main cause of delays in SET's train services. In April 2004, 47 per cent of the delays in SET's services were due to Network Rail, 45 per cent were due to SET and 8 per cent were due to other TOCs. In September 2005, 44 per cent of the delays in SET's services were due to Network Rail, 49 per cent were due to SET and 7 per cent were due to other TOCs.

16 Trend in reduction in total delay minutes on SET's train services attributable to Network Rail, SET and other TOCs, April 2004 to September 2005

The total volume of delay minutes on SET's train services has been falling since April 2004, with Network Rail, SET and other TOCs contributing to the improvement.



Source: National Audit Office analysis of Network Rail data

NOTE

All data based on moving annual averages. Data might be subject to change, following resolution of any remaining uncertainties concerning delay attribution.

SET's passenger satisfaction levels have increased to their highest ever level, although like CSE before it SET has one of the lowest ratings of all TOCs

4.21 Figure 17 shows that overall passenger satisfaction increased between the autumns of 2003 and 2004 from 66 per cent to 68 per cent, and between the springs of 2004 and 2005 from 63 per cent to 71 per cent – the highest ever level for the South Eastern franchise since the National Passenger Survey began. Average overall satisfaction levels increased over the same periods for London and south east TOCs and nationally. Passenger satisfaction has increased on most of the key measures that SET has been able to influence since taking over the franchise, including train frequency and station related factors and, in particular, train cleanliness, upkeep and repair. SET considered that passenger satisfaction would have improved further had it not been for the delay in the delivery of new trains.

17 Passenger satisfaction with key aspects of CSE's and SET's train services, spring 2003 to spring 2005

Passenger satisfaction has improved on most of the key measures that SET has been able to influence since taking over the franchise.

	Spring 2003 CSE	Autumn 2003 CSE	Spring 2004 SET	Autumn 2004 SET	Spring 2005 SET
Overall satisfaction	65	66	63	68	71
Station factors					
How staff handle requests	71	79	78	78	76
Provision of information	67	67	66	66	71
Ticket buying facilities	51	56	53	51	57
Station environment	46	46	43	49	50
Train factors					
Frequency	67	66	63	68	70
Punctuality & reliability	59	61	62	66	69
Train cleanliness	41	44	41	49	57
Upkeep and repair of the train	37	37	37	45	55

(green) denotes satisfaction of 70 per cent or more (amber) denotes satisfaction of 50 to 69 per cent (red) denotes satisfaction below 50 per cent.

Source: SRA's National Passenger Survey

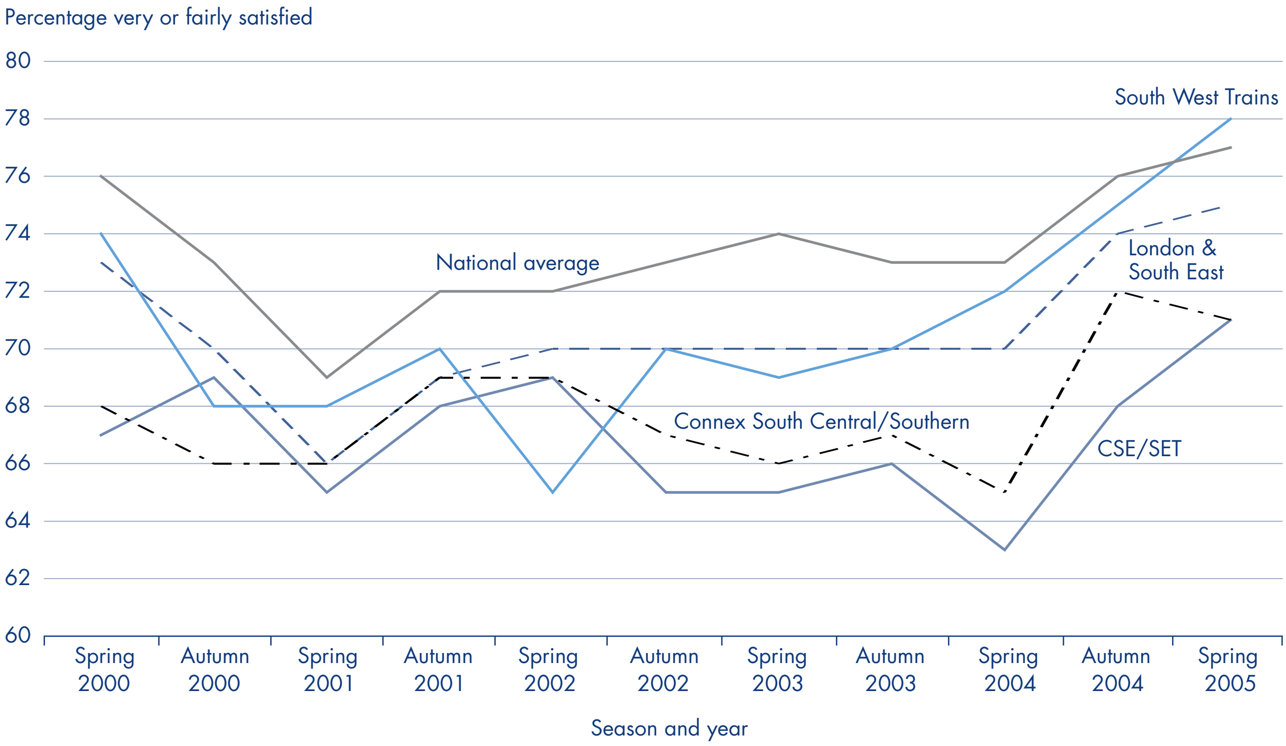
4.22 The latest results from SET's own quarterly surveys of passengers, covering the three-month period April to June 2005, also show signs of improvement. All of the 15 key indicators used to measure passenger satisfaction have improved since the transfer of the franchise. Nine[47] of these achieved their highest levels of passenger satisfaction since CSE began these surveys in their present format in 2001. Three indicators – availability of seats, cleanliness of trains and the helpfulness and attitude of staff – equalled their previous highest levels of passenger satisfaction. The number of passenger complaints has also fallen by 46 per cent, from an average of almost 4,000 a month when SET took over the franchise to 2,142 in September 2005. This compares with reductions of 22 per cent and 4 per cent for Southern and South West Trains respectively over the same period. The Rail Passengers Committee for Southern England carried out two small-scale passenger projects in 2004 to measure the quality of travel for 50 volunteer commuters. The Committee concluded that, based on passengers' observations, SET was the best performing of the four commuter TOCs south of the Thames.

4.23 Despite the improvements under SET, the SRA's National Passenger Survey shows that, since spring 2000, overall passenger satisfaction ratings for the South Eastern franchise have been consistently lower than both the average for TOCs in London and the south east and the national average. The Survey also shows that, since autumn 2002, satisfaction with CSE and, subsequently, SET has been the lowest among the closest comparator TOCs **(Figure 18 overleaf)**. Passenger satisfaction with commuter TOCs has historically been lower than that with TOCs catering for a higher proportion of leisure travellers and has therefore been lower than the national average. The most recent Survey, for spring 2005, showed that 71 per cent of SET passengers were very or fairly satisfied with service overall, the same percentage as four other TOCs including Southern, and one percentage point higher than the TOC with the lowest rating, First Great Western Link. The average for London and the south east was 75 per cent, and the national average was 77 per cent.

47 Upkeep and repair of stations, the provision of facilities and services at stations, quality of information provided at times of normal service, quality of information provided at times of disruption, availability of staff, personal security during the day, reliability of service, frequency of trains and the length of train journeys.

18 Overall passenger satisfaction ratings, spring 2000 to spring 2005

Since autumn 2002, CSE and SET have had lower overall passenger satisfaction ratings than comparator TOCs, the average for London and the south east, and the national average.



Source: NAO analysis of National Passenger Survey data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PART FIVE
The SRA strengthened its franchise management

5.1 This Part of the report assesses the impact of the termination decision on the rail industry beyond Connex South Eastern itself, including its implications for other TOCs and their owning companies. It also examines the impact on the SRA's approach to franchise management.

The termination decision prompted some TOCs to conduct their own internal reviews, but otherwise had a limited impact

5.2 Between February and April 2005, we surveyed the 23 TOCs and their nine owning companies that were operating rail franchises at the time the SRA terminated CSE's franchise:

- Following the termination announcement, eight of the 23 TOCs reviewed their own compliance with the SRA's requirements but took no further action. A further six TOCs made changes that gave them added assurance of their compliance with the SRA's requirements.
- Seven TOCs also reviewed their finances and financial management and four reviewed their working relationship with the SRA. None found it necessary to make any changes.
- Three of the nine TOC owning companies also reviewed the management of their franchises to ensure that appropriate processes were in place. One ensured that appropriate processes were in place to govern trading with affiliate companies.

5.3 Eight of the nine owning companies told us that the termination decision had had no impact on their strategies for bidding for rail franchises in the future. All nine owning companies and 14 of the 23 TOCs believed that the SRA's successor, the Department for Transport, would terminate a franchise again should the circumstances require it. But eight companies told us that the termination would not discourage them from asking the government for additional subsidies or other financial assistance should the need arise. Other stakeholders, including rail industry and passenger groups, told us that the termination had no significant impact on them.

The CSE case contributed to a strengthening of the SRA's approach both to awarding and managing franchises

5.4 The awarding of the earliest franchises primarily on the basis of which TOC bid for the lowest level of subsidy, coupled with aggressive reductions in the level of subsidy over the first few years, were key factors in the financial difficulties that CSE and other TOCs experienced subsequently in running their franchises. The SRA acknowledged in its Franchising Policy Statement in November 2002 that, with the benefit of hindsight, the approach of awarding franchises to bidders requiring the least subsidy had not delivered the outcomes envisaged at the time of privatisation. The SRA set out a new policy of evaluating bids to take account of what was realistically deliverable, rather than focusing primarily on lowest cost and the maximum amount of risk that a bidder was prepared to take. Risks had to be allocated according to what a well managed and reasonably profitable TOC could bear over the whole life of a franchise. The SRA applied this policy in awarding the One, Northern and Scottish franchises in 2004 and the East Coast franchise in 2005.

5.5 The Department has adopted the SRA's policy in awarding the Integrated Kent Franchise, and the Thameslink and Great Western franchises. The Department is, however, reconsidering some aspects of its franchising policy, in particular the appropriateness of relying on civil servants and consultants to assess what is realistically deliverable, in terms of cost, revenue growth and service provision, rather than on bidders' own judgements based on their experience of running train and bus services. It is therefore reviewing the case for such deliverability assessments, which it aims to complete by the end of December 2005, in time for new franchise awards from February 2006. If the Department were to abandon such assessments and return to the position where franchises were awarded to bidders offering the best service for the least subsidy and more of the risks were assumed to have passed to TOCs, it would have to define in clear terms the criteria and conditions under which it would be prepared to provide additional subsidies to TOCs experiencing financial difficulties. The Department would also need to have available at short notice enough resources with the right skills to take over a failing franchise and continue to run the trains. It has retained the contract that the SRA had with an external organisation as a standby facility to handle any future TOC failure or franchise termination.

5.6 The terms of the original franchise agreements provided the basis for the franchise financial monitoring arrangements used by OPRAF and inherited by the SRA when it was set up in February 2001. The philosophy that franchising fully transferred financial risk to TOCs, coupled with the imperative for the SRA to be able to step in at any time and secure the provision of passenger train services, underpinned the SRA's focus on TOCs' short-term solvency. The CSE case showed that risks were not fully transferred through franchising and that there was residual risk to taxpayers and passengers. After announcing the termination, the SRA carried out an exercise to learn lessons from its management of the CSE franchise and recognised the need to strengthen its ability to identify problems early, scrutinise and interpret financial information in order to assess and understand longer-term risk to the public purse, and establish better relations with TOC senior management across all franchises.

5.7 The SRA had started to make changes in its franchise management following publication of its Franchising Policy Statement, in which it signalled a move to greater specification of franchise agreements and to require TOCs to provide more financial and management information. The SRA took account of the lessons from the CSE case in making changes to its franchise management approach, some of which were already underway by the time CSE's franchise was terminated in November 2003 **(Figure 19)**. The SRA's approach involved subjecting the information provided by TOCs to a greater degree of challenge, more closely reflecting the performance and risks associated with individual franchises.

5.8 The franchise monitoring reports have since included a more comprehensive review of a TOC's operational and financial performance than was previously the case. They have continued to focus, however, on TOCs' performance in the coming four-week period and financial year, and have not included any projections of TOCs' longer-term financial viability and their ability to meet their obligations over the lifetime of their franchises. The SRA had not refocused its franchise monitoring reports to include longer-term projections by the time of the Rail Review in July 2004. As the SRA's abolition was announced in the Review, the SRA stopped its planned development of these reports, which would be taken forward by the Department for Transport.

5.9 The Railway Forum and the Association of Train Operating Companies told us that many TOCs considered the changes in franchise management to be onerous and intrusive. Seventeen of the TOCs that responded to our survey did not consider that the changes had benefited them, although the SRA told us that the purpose of the changes was to protect the interests of taxpayers and passengers. TOCs' main concerns were over the increase in data that the SRA required, although only three had spent additional staff and management time on meeting the SRA's requirements. Three of the TOCs responding to our survey considered that the changes had brought benefits, however, including more focus on issues of real importance, a greater emphasis on TOCs' providing evidence of compliance with franchise obligations, and improved relations with the SRA.

5.10 The abolition of the SRA and the Department for Transport's assumption of the SRA's franchising responsibilities presents risks to the continuity and rigour of franchise monitoring. In its July 2005 report, *Network Rail: making a fresh start* (HC 556, Session 2004-05), the Committee of Public Accounts recommended that, in taking on its new responsibilities, the Department should recruit enough staff with commercial and technical skills and with the stature necessary to deal effectively at the highest levels of the railway industry. The Department told us that it will be adopting the SRA's policy in managing and monitoring franchises, but is refining it to bring a stronger focus on identifying the key risks facing each franchise.

19 Key changes to the SRA's approach to franchise management

The SRA made key changes in its approach to franchise management.

To enable it to identify problems early, the SRA:

- brought together the monitoring of TOCs' operational and financial performance, which had previously been carried out by different SRA teams and senior managers;
- refocused its franchise management on looking forward and managing risks, rather than looking retrospectively at performance and compliance with franchise commitments as the SRA had done previously;
- required TOCs to provide three-yearly business plans and started to monitor performance against them on a quarterly basis; and
- by January 2004, provided training to its franchise managers on understanding business plans and the elements of good business planning.

To enable it to scrutinise and interpret financial information, the SRA:

- developed a range of financial indicators covering TOCs' efficiency (for instance, operating costs per vehicle mile), profitability (such as the ratio between net current assets and liabilities) and liquidity (for example trading with affiliates as a proportion of total expenditure);
- began to benchmark TOCs' operational and financial performance against those of other TOCs in the same geographical region, and to report benchmarking data to the SRA Operations Board. Previously, the SRA had not done any such benchmarking between TOCs;
- introduced a new policy, and procedures, for financial scrutiny with a focus on forecasting, reviewing TOCs' business plans and control over contracts;
- put in place a finance manager and additional financial assistance dedicated to each franchise team;
- required its franchise managers to look beyond basic compliance and assess the on-going financial viability of a TOC; and
- by January 2004, provided training to its franchise managers on understanding TOCs' financial statements and the use of financial ratios.

To enable it to understand and assess risk, the SRA:

- required its franchise managers to undertake a quantified risk assessment of each TOC;
- by January 2004, provided its franchise managers with training on risk management, knowledge of train operations and understanding legal issues; and
- introduced new systems under which franchise managers and directors reported on, and the SRA Operations Board monitored, TOCs' operational and financial performance, risk and compliance with franchise agreements on a four-weekly basis.

To establish better relations with TOC senior management, the SRA:

- enhanced the role of its franchise managers to be more pro-active in managing relationships with TOC senior management.

Source: National Audit Office summary of SRA documents

5.11 The SRA's Operations Directorate, which was responsible for franchising issues, had a total staff complement of around 140 in early 2005. Those parts of the Department's Rail Group responsible for franchising in the Department – the Rail Group Procurement and Service Delivery Directorates – have a staffing complement of 86. At the beginning of November 2005, 79 of these posts were filled. Comparisons between the number of staff employed by the SRA and by the Department on franchising issues are not straightforward, however, because the SRA organised its team in a different way to the structure that the Department has now adopted for its teams. Focusing specifically on those staff who are most closely involved with the management of franchises, we found that the Department's staffing complement was 15 per cent less than that of the SRA. Whereas the SRA had 45 staff – 20 franchise managers and 25 contract managers – involved in franchise management, the Department has 38 staff - 18 franchise managers and 20 contract managers.

5.12 The Department told us that the key determining factor in the appointment of staff to positions in the Group was previous experience in similar roles. All but six of the 79 staff currently in post are former SRA employees. Of the seven vacancies, three are for contract managers and one is for a franchise manager.

APPENDIX
Study methods

Forensic review and analysis of documentary evidence to piece together and build up a reliable picture of the events that led up to CSE's exit from the franchise

We obtained and analysed key papers to establish how well the Strategic Rail Authority (SRA) managed the South Eastern passenger rail franchise prior to termination, why it decided to terminate the franchise and how well it managed the risks associated with termination. Key papers included:

- the SRA's franchise agreement with Connex South Eastern (CSE) and the deed of amendment;
- the SRA's franchise monitoring reports, consultants' and auditors' reports on the CSE franchise and file notes and correspondence within the SRA team handling the franchise;
- SRA minutes of meetings, together with internal memos and emails documenting the SRA's engagement with CSE and Connex Transport UK Ltd;
- correspondence between the SRA and CSE and Connex Transport UK Ltd, and between the SRA and the Department for Transport;
- the legal, consultancy and other advice that informed the SRA Board's decision to terminate the franchise;
- the SRA's plans for termination and the establishment of South Eastern Trains (SET), and cost estimates for terminating the franchise;
- the negotiated financial settlement for the terms of CSE's exit from the franchise;
- the SRA's post-termination reviews to learn the lessons from the termination; and
- documents provided by Connex relevant to the period leading up to the termination decision.

Interviews with key organisations to supplement our documentary review

We carried out a programme of semi-structured interviews between March and September 2005 with senior staff at the SRA, Connex, SET, the Department for Transport and HM Treasury to supplement the evidence we gathered from our forensic review of documentation.

At the **SRA**, we interviewed key officials involved in the management of the franchise and the termination to establish how the SRA identified the emerging problems with the franchise, the adequacy of the SRA's routine monitoring and oversight of the franchise, the reasons for terminating the franchise, how well the SRA managed the risks associated with the termination and lessons learned. These officials included:

- the former director of franchise operations for the south and east, who led on the termination of CSE's franchise and its transfer to SET;
- the former director with responsibility for monitoring TOCs' performance and compliance with their franchise agreements;
- the former franchise manager for Connex South Eastern and the finance manager for franchises in the south and east;
- the director of risk assurance; and
- the director of communications.

We also interviewed PriceWaterhouseCoopers, who carried out the April/May 2003 audit of CSE's compliance with the terms of the deed of amendment and the consultants who led the exit negotiations with Connex Transport UK Ltd, to support our evidence concerning the events leading up to the termination and the settlement on the transfer of the franchise to SET.

At **Connex**, we interviewed the former Chief Executive Officer and Managing Director of CSE and the current and former chairmen of Connex Transport UK Ltd to gain Connex's perspective on events leading up to the termination of the franchise and the termination itself.

At **SET**, we interviewed key officials and senior staff to establish how effectively SET is fulfilling the role that it was set up to deliver:

- the Business Development Director and the former Finance Director at SET(H), SET's holding company;
- SET's Managing Director; and
- senior staff in SET's finance, operational performance and engineering directorates.

At the **Department for Transport,** we interviewed senior staff responsible for overseeing events on the franchise in the period leading up to and including the termination decision. To establish how well the Department is overseeing SET's management of the franchise and progress with the letting of the Integrated Kent Franchise, we also interviewed the Department's officials responsible for overseeing the South Eastern passenger rail franchise, for taking forward the SRA's franchise award, monitoring and management roles, and for letting the new Integrated Kent Franchise.

At **HM Treasury**, we interviewed senior staff about the Treasury's knowledge of, and involvement in, events on the franchise leading up to and including the termination decision.

Analysis of financial information

We obtained and analysed the published statutory financial statements of CSE and SET where available, together with other financial information from the SRA and from SET's management accounts in order to:

- establish when and why CSE's financial position deteriorated, the full extent of the funding shortfall at CSE and the full extent of the SRA's financial support of CSE;
- estimate the cost to the SRA of terminating the franchise;
- establish whether the SRA recovered the full costs of termination;
- assess the reasonableness of the financial settlement for the assets and liabilities transferred from CSE and SET;
- assess the total cost of SET operating the franchise and SET's financial performance and variances in costs since the transfer of the franchise;
- compare the costs of SET running the franchise with the SRA's cost estimates. To put our analysis on a comparable basis, we adjusted running cost data to take account of the Rail Regulator's 2003 Access Charges Review, and changes in SET cost and revenue streams which had not been anticipated at the time the SRA performed its projected cost estimates; and
- compare the costs of SET running the franchise with the amount of subsidy that CSE was prepared to accept to run the franchise until December 2006.

We made our cost comparisons: to March 2006, on a pro-rata basis, to reflect the likelihood of the South Eastern franchise being replaced by the Integrated Kent Franchise from April 2006; and to December 2006, for consistency with the period of time over which the SRA calculated its cost estimates when it decided to terminate the franchise.

Statistical analysis of operational performance data

We obtained from the SRA, Network Rail and SET data on operational performance and passenger satisfaction surveys. We then carried out a range of statistical analyses:

- statistical analyses of punctuality, delay and delay attribution data to establish the reasons for changes in performance over time and the extent to which operational performance improved under SET. We analysed Public Performance Measure (PPM) data, which measure the percentage of scheduled trains that arrive at their destinations within five minutes of their planned arrival times. The PPM takes account of late running, as well as cancelled, trains. To examine trends over time, we calculated the moving annual average (MAA) of this data. The moving average smoothes out fluctuations caused by seasonal factors;
- to establish the reasons for changes in punctuality over time, we used data on delay and delay attribution. The delay statistic is measured in minutes and attributes delay to Network Rail, other TOCs (for example, if a train operated by one TOC breaks down, it might affect another TOC's services, known as 'TOC on TOC' delays) or to a TOC that affect the TOC's own services (known as 'TOC on self' delays). There is a strong statistical correlation between PPM and delay data. Again, to smooth out variation caused by seasonality, we used the MAA of delay data;
- using data on punctuality, delay and delay attribution we assessed the extent to which operational performance improved, or deteriorated, under CSE and SET; and benchmarked the performance of CSE and SET against similar London commuter TOCs;
- to determine levels of passenger satisfaction with the rail services provided by CSE and SET, we obtained the detailed results of the SRA's national passenger satisfaction (NPS) surveys which are carried out biannually. We used this survey data to: assess levels of satisfaction over time; establish whether passenger perceptions changed following the transfer of the franchise to SET; and compare the performance of CSE and SET against similar London commuter TOCs; and
- to drill down further into levels of passenger satisfaction at CSE and SET, and changes in satisfaction over time, we also obtained and analysed the detailed results of their own customer satisfaction surveys (CSS's) which are carried out quarterly.

Advice from consultants on the reasonableness of the financial settlement of CSE's exit from the franchise

We commissioned financial consultants, PKF, to advise us during our review of the negotiations for CSE's exit from the franchise and on the financial settlement on termination. We asked PKF to provide us with advice in answering two key questions:

- **How the SRA decided what assets to transfer from Connex to SET:** including the results of due diligence work and the reasons for excluding some contracts from, and including others in, the final settlement.
- **Whether the SRA agree a reasonable value for the assets and liabilities transferring from Connex to SET:** including the exit negotiations between Connex and the SRA, the results of the audit of completion accounts, how the assets and liabilities were valued and whether the assets and liabilities could have been valued differently. The aim of this element of our work was to assess whether the SRA did everything that could reasonably be expected of it to ensure that it paid/received a fair value for the business on its transfer from Connex to SET.

Questionnaire surveys of TOCs and their owning companies

Between February and April 2005, we surveyed the 23 TOCs in Britain that were operating passenger franchises at the time the SRA terminated the CSE franchise, as well as their nine owning companies. We developed the surveys in January and February 2005 in consultation with the SRA, the Department for Transport and the Association of Train Operating Companies.

We sought to establish:

- how TOCs and their holding companies first heard of the SRA's decision to terminate CSE's franchise and their initial reaction to it, to assess whether the decision had been communicated clearly and consistently and whether it had been expected;
- whether the announcement prompted them to review and/or change any aspects of the management of their franchises, and whether TOCs and their owning companies considered that the SRA or its successor organisations would terminate a franchise again if it were needed, to assess the impact of the decision on TOCs' management of their franchises;
- TOCs' reaction to, and any implications of, the changes in the SRA's management of franchises following the termination, to determine whether the changes had had an impact on TOCs; and
- whether the announcement had any impact on TOC owning companies' strategies for bidding for future franchises or would deter them for asking for additional financial support from the SRA if it were needed.

We received responses from all 23 TOCs and all of their owning companies, and used the results to inform Part 5 of the report.

Consultation with key stakeholders

We invited other key stakeholders to comment on the issues under investigation. In particular, we asked stakeholders how they first heard of the SRA's decision to terminate CSE's franchise, their initial reaction to the announcement and the impact of the SRA's decision on their organisation and on the rail sector more widely. We received written responses and/or met with officials from the following organisations:

Angel Trains Ltd

Association of Train Operating Companies (ATOC)

HSBC Rail (UK) Ltd

London Transport Users Committee

Network Rail

Office of Rail Regulation

Porterbrook Leasing Company Ltd

Railway Forum

Railway Industry Association

Rail Passengers Committee for Southern England

Transport for London