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: ■ 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

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.