National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 824
SESSION 2010–2011

24 MARCH 2011

Department for Transport

The InterCity East Coast Passenger Rail Franchise

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Department for Transport

The InterCity East Coast Passenger Rail Franchise

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

18 March 2011

The InterCity East Coast franchise is a high profile service, operating passenger trains between London, the North East and Scotland. This report examines whether the Department's handling of the franchise safeguarded the interests of passengers and protected the taxpayer.

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This report can be found on the National Audit Office website at www.nao.org.uk/intercity-east-coast-2011

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Summary

1 Since the mid 1990s, passenger rail services have been delivered through a system of rail franchises. Each franchise is a competitively procured contract typically lasting seven to ten years between the Department for Transport (the Department) and a private train operating company, usually a subsidiary of a larger holding company. When letting franchises, the Department's key objectives are to provide: safe and reliable services; and value for money.

2 The Secretary of State for Transport has a statutory duty to ensure that passenger services continue if a franchise fails. In such circumstances, the Department may have to intervene and make arrangements to run the franchise until it can be re-let. As with other key public services, this means that the business risk when things go badly wrong cannot be transferred fully to the private sector.

3 The InterCity East Coast franchise is a high profile service, operating passenger trains between London, the North East and Scotland. In 2005, following a competition, the franchise was re-awarded to Great North Eastern Railway but 18 months later its holding company, Sea Containers Ltd, faced financial difficulties. In late 2006, the Department negotiated an end to the franchise, allowing Great North Eastern Railway to run the franchise under a management contract until a new operator could be procured.

4 Following a further competition, National Express East Coast (the franchisee), a subsidiary of National Express Group (National Express), was awarded the contract in 2007 on the basis that it would pay £1.4 billion, the largest ever payment offered for a franchise, to operate the service for seven and a half years. At the time, this was the third franchise operated by National Express, which had operated services in the South East and East Anglia since 1996 and 2004 respectively.

5 However, the Department had to intervene for a second time, following an announcement by National Express in 2009 that it would not provide further financial support to the franchisee. Franchisees can fail for a number reasons, including:

- problems specific to the train operator or its holding company; and/or
- the franchisee is unable to cope with a severe and prolonged downturn in the economy, which reduces passenger revenues.

In this instance, the franchisee failed primarily because its business plan was not sustainable against an economic downturn.

6 The Department had three options: renegotiate the contract with National Express; negotiate a consensual exit by National Express from the contract; or, terminate the contract for default. Following negotiations with National Express, the Department notified the franchisee in November 2009 that the franchise would be terminated and transferred to Directly Operated Railways, a publicly owned company, until a new franchise contract could be awarded. The Department expects that a new operator will be in place by late 2012. A chronology of key events is at Appendix One.

7 This report examines whether the Department's handling of the franchise safeguarded the interests of passengers and protected the taxpayer. Our methods are set out at Appendix Two.

Key findings

In awarding the contract to National Express, the Department got a good deal

8 The Department applied lessons learned from the failure of the previous franchisee to the procurement of its successor. The difficulties encountered by Great North Eastern Railway's holding company resulted in the Department requiring more information about the financial health of bidders' holding companies, albeit limited to published accounts and analysis published by investment banks and others. The Department also required National Express to make available, from the outset, up to £40 million in the form of a subordinated loan to its subsidiary to cover operating losses.

9 While not offering the highest payments to the Department, the National Express bid was selected on the balance of price and delivery plans. As in many previous competitions, there was keen interest in the franchise, with four bidders submitting final bids. The Department expects any holding company wishing to maintain a presence in the rail franchise market to support any of its franchisees that encounter financial difficulty. However, a holding company is under no requirement to do so and may be unwilling or unable to support its franchisees beyond the terms of the franchise and any agreement to provide funding, such as a subordinated loan. In such cases, consensual exit or termination, followed by a retendering exercise, are available options but they are not cost or risk free for the Department and franchise bidders.

10 The Department put adequate protections for the taxpayer in the contract. At the time the Department was evaluating bids for the franchise, economic forecasts indicated there was a very low probability that annual growth in the UK's gross domestic product would fall below 1 per cent by 2010. If the franchisee defaulted on its obligations and the contract was terminated, National Express would have to pay the Department £31 million and would be liable to pay any outstanding balance on the £40 million subordinated loan. In view of the then economic forecasts, the Department did not consider it necessary to stress test bids for deliverability in an economic downturn. This was a reasonable view, given the contractual protections built into the franchise agreement.

Effective monitoring arrangements were in place

11 The Secretary of State for Transport has a statutory duty to ensure the continuity of passenger rail services and the Department closely monitors all train operating companies. Each franchisee provides the Department with, amongst other things, monthly management accounts setting out costs and revenues, along with forecasts for the remainder of the year. To accompany this information, the Department holds formal meetings every month with each franchisee to discuss financial and operational performance.

12 Detailed monitoring of financial performance flagged up potential difficulties with the franchise as early as summer 2008. The Department began raising concerns as early as June 2008, some seven months into the franchise agreement. During regular monthly meetings in late 2008, the Department and the franchisee discussed cost-cutting measures. By January 2009, the Department considered the franchisee to be at high risk of failure.

Termination of the contract was the best means of protecting the taxpayer

13 National Express wanted changes to the terms of the franchise contract, but the Department took a tough line and refused to renegotiate. Increasing losses from the franchise threatened the future of the company. In February 2009, National Express proposed to the Department a number of measures to cut costs in the franchise, but the company also considered that major changes to the terms of the contract, including a reduction in the payments would be needed. The Department was concerned that any change to the terms of the contract would encourage other franchisees to seek similar treatment. At the time, five of the other fifteen franchisees were seen as high risk due to falling passenger revenues. Our analysis shows that the potential cost to the taxpayer of changing the terms for other franchisees would have amounted to between £200-450 million.

14 The Department considers it did not need a formal appraisal of high level options at an early stage. In our view, a formal appraisal early on would have helped clarify and quantify the available options, ensuring that the Department could draw upon the collective experience of its staff. While the Department considers that it did not need a formal appraisal, it is something we would expect to be performed, given the amounts at stake. There were weaknesses in the Department's records of key discussions at various points in the process, such as what might or might not have been on offer from National Express during negotiations. The Department had to spend significant time identifying and supplying relevant records to us.

15 **When it became clear that National Express would not continue with the franchise, the Department offered a deal requiring a payment of £200 million and the surrender of the company's two other rail franchises.** Following a default under a franchise agreement, the Department may terminate any other franchises owned by a holding company if, for example, there are concerns relating to the probity or competence of the holding company. In the case of National Express, the financial difficulties within its InterCity East Coast operations did not impact on the delivery of services by its two other franchises. The Department based its offer on the view that a company holding more than one franchise should not be able to preserve its reputation after walking away from a failing franchise, while continuing to profit from successful ones. In our view, such a demanding offer was necessary to deter other holding companies from seeking to hand back their loss-making franchises.

16 **Termination for contract default was the best option for preserving the integrity of the rail franchising system and protecting the taxpayer.** National Express rejected the proposed deal and made a lower counter offer to exit from the InterCity East Coast franchise alone. However, the payment offered was not high enough to offset the risk of other franchisees asking for similar deals. If they had sought consensual exits similar to that offered by National Express, we estimate that they would have paid £60 million, well below the £140-280 million of likely losses the taxpayer would have taken on.

Termination had no adverse impact on the taxpayer

17 **The failure of the franchisee led to a shortfall in expected premium income.** We estimate that the Department will receive between £330-380 million less than expected to the end of 2012 and this has had to be accommodated in its budget. However, our view is that the shortfall was unavoidable following the steep fall in passenger revenues due to the economic downturn during 2008-09, which led to the termination of the contract with National Express.

18 **The Department took the franchise into public ownership at no cost to the taxpayer.** National Express continued to deliver passenger services until the point of handing back the franchise in November 2009. The costs of setting up the new publicly owned company to run the franchise and its eventual return to the private sector are estimated at £15 million, considerably less than the £31 million paid by National Express on termination. However, the final outcome for the taxpayer will not become clear until the franchise has been re-let in 2012.

19 **In December 2010, National Express also agreed to transfer franchise assets that it had valued at £45 million at nil cost to the public sector operator.** This transfer was good value for the taxpayer. As part of the final settlement negotiations, the Department provided an assurance that the termination would not preclude the company from bidding for future franchises.

Deterioration of punctuality on passenger services is being investigated

20 The termination was handled well and without disruption to passenger services, but since then there has been a dip in train punctuality, although the causes are being investigated and plans are under development to rectify this. Analysis indicates that just over 60 per cent of the delays are the responsibility of Network Rail rather than the train operator. The amount of delay attributable to the train operator has increased, but the reasons for this are unclear because of the number of influencing factors including management of stops at stations, adverse weather conditions and train maintenance issues. Directly Operated Railways and Network Rail are developing measures to improve punctuality.

21 The Department has captured the lessons learned from the termination and mobilisation process and is updating guidance. Departmental officials and external consultants maintained a record of their experiences which were used to produce a lessons learned paper. Revisions to existing internal Departmental guidance are expected to be completed by 31 March 2011.

Conclusion on value for money

22 In terminating the franchise, the Department achieved its objectives to avoid any disruption to passenger services and to protect the taxpayer. The Department took a tough line in discussions with National Express. A deal in which the company remained in place under easier terms was rejected from the outset and the price offered for a negotiated exit was judged to be insufficient. Termination was value for money as the Department avoided the significant risk that other franchisees would seek negotiated exits from their loss-making franchises, costing the taxpayer a minimum of £140 million.

23 Protections incorporated in the contract may result in an estimated net cash inflow for the taxpayer of £16 million. The final outcome is, however, dependent on the costs and terms of a successful re-tendering of the franchise, which is expected to be completed by late 2012.

Recommendations

24 The Department announced in January 2011 that changes would be made to the rail franchising system, including the introduction of longer franchises of up to 22 years. In this context, the successful resolution of problems with the InterCity East Coast franchise illustrates a number of key lessons.

a **Robust stress testing of bids and franchises in operation, against stressed economic scenarios similar to the recession experienced in 2008-09, will identify potential weaknesses in the assumptions that underpin future franchises.** With a gradual move to longer franchises of up to 22 years, winning bidders and the Department will be taking on much longer-term risks. Bidders should, therefore, be required to set out the effects of a severe economic downturn on their finances and what they would do to ensure the franchisee remains viable. Such a requirement may result in more conservative bids and additional costs for all parties, but the risk to the taxpayer of reduced premium payments can be partially mitigated by the introduction of profit share arrangements in longer-term franchises. Regular updates of stress testing, across all franchises, would also alert the Department at an early stage to the possibility that a number of franchisees might seek to renegotiate contracts at the same time and the size of any additional support that might need to be provided by the taxpayer.

b **Over the past two years, the Department has accumulated much knowledge and experience of dealing with a franchisee in difficulty. Many of the Department's team handling discussions with National Express had long careers in the rail industry.** Current reductions in staffing and the move to a new franchising system, make it all the more important that 'corporate memory' is maintained:

- Lessons learned papers have been produced and the Department should now complete its plans to update guidance and ensure that it is disseminated to all interested parties.
- Appropriate in-house skills need to be maintained and refreshed by ensuring that staff have industry experience and that such expertise can be easily accessed if circumstances demand.

c **Franchise monitoring has been developed and improved over the years and served the Department well in flagging up potential problems in the InterCity East Coast franchise at a relatively early stage.** Against a background of reductions in staffing and a new franchising system, this capability needs to be maintained and refined to target high risk contracts. The Department should also consider whether more detailed information might be gathered on the financial health of holding companies. This is particularly important where franchises may be awarded for much longer periods of time.

Part One

Letting the franchise

1.1 This part of the report provides background to rail franchising and considers whether the Department safeguarded the interests of the taxpayer in the InterCity East Coast franchise award to National Express.

Background to passenger rail franchising in England and Wales

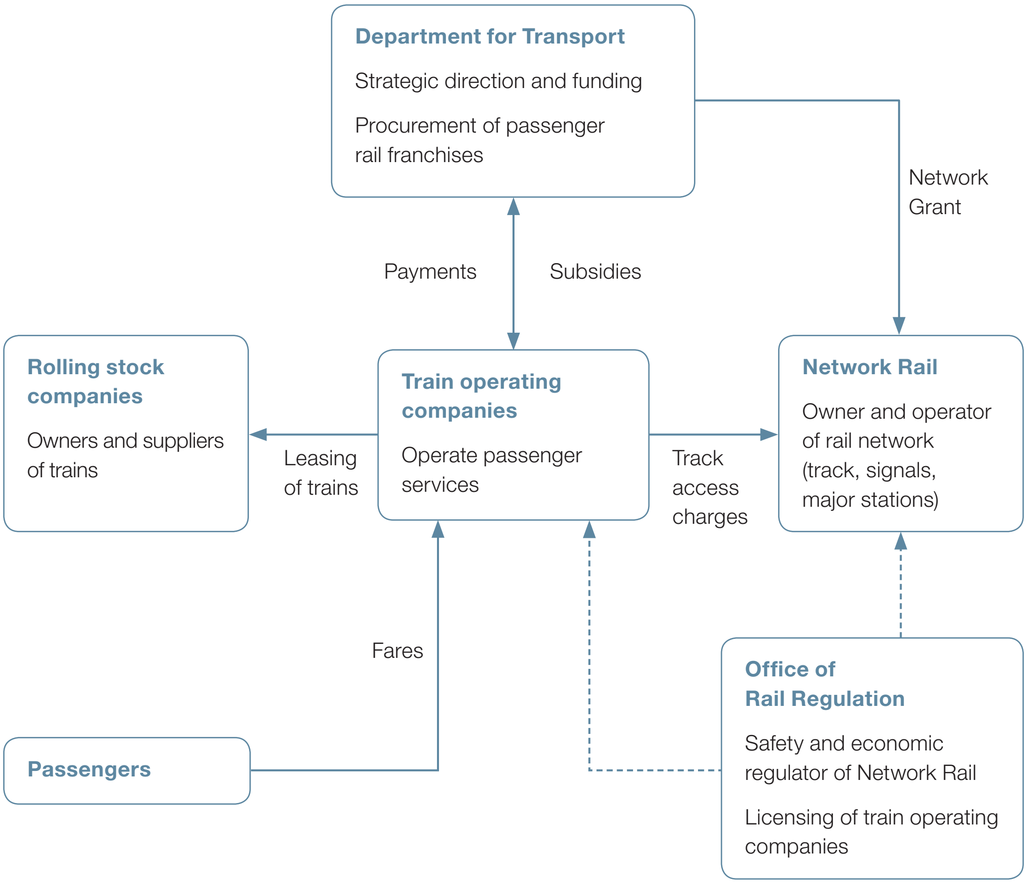
The role of the Department

1.2 The Department's primary role is to determine overall transport strategy and to manage relationships with the bodies responsible for delivering the strategy (**Figure 1**). Its responsibilities for rail in England and Wales include securing appropriate rail passenger services at an acceptable price, through effective specification, procurement and monitoring of delivery.

The structure of passenger rail franchising

1.3 Train operating companies provide passenger services while maintaining and investing in the track are the responsibility of Network Rail. It is government policy that rail services are publicly specified, procured and where necessary funded but are privately delivered by train operating companies under franchise agreements. Franchises confer the right to run passenger services for a specified period, usually between seven to ten years, on a specified part of the network.

Figure 1
Passenger rail industry in England and Wales



NOTE

1 The Office of Rail Regulation is legally independent of the Secretary of State for Transport and regulates Britain's railways.

Source: National Audit Office

1.4 Across England and Wales in 2009, the Department was responsible for franchises run by 16 train operating companies, owned by eight holding companies or groups (**Figure 2**).

Allocating and mitigating risks when letting passenger rail franchises

1.5 Under the Railways Act 1993, there is a statutory duty on the Secretary of State to ensure the ongoing provision of passenger rail services in the event of a failure of a franchisee. This means that the Department will have to provide passenger rail services until a replacement operator can be identified. If it is not possible or practicable to keep operation of the service in the private sector, the Department will act as 'operator of last resort' and take over the running of the franchise.

Figure 2
Passenger rail franchises operating in England and Wales in 2009

Holding company or group	Train Operating Company
Arriva UK Trains Ltd	Arriva Trains Wales/Trenau Arriva Cymru Ltd Cross Country
DB Regio UK Limited	Chiltern Railways
FirstGroup Plc	First Capital Connect First Greater Western Ltd First TransPennine Express
Go-Ahead Group Plc Keolis UK Ltd	London Midland Southern Southeastern
National Express Group	National Express East Coast c2c National Express East Anglia
Serco Abellio	Northern Rail
Stagecoach Group Plc	East Midlands Trains South West Trains
Virgin Rail Group Stagecoach Group Plc	Virgin Trains

Source: Department for Transport

1.6 In most franchise agreements, the risk that passenger revenues fail to meet levels agreed when the franchise was let remains with the train operating company for the first four years. Beyond the first four years, a point at which revenue forecasts are judged to be increasingly uncertain, the Department will support a franchisee by paying a proportion of any shortfall measured against forecast revenues. This assistance is known as revenue support. If, however, revenues exceed expectations, the Department receives a proportion of those revenues from the start of the franchise.

Protecting the taxpayer

1.7 Franchise contracts contain a number of provisions designed to protect the taxpayer in the event of failure. In particular:

- On termination for contract default, the Department will call on a performance bond provided by the holding company of the franchisee. The proceeds will, amongst other things, offset the costs incurred in re-letting the franchise. The size of the bond is set by the Department, commonly 5.5 per cent of a franchisee's annual operating costs.
- To further protect the taxpayer, and to ensure the holding company supports its subsidiary, the Department requires the holding company to provide a loan to help cover any losses that the franchisee incurs. The loan is subordinated to claims from other creditors of the franchisee and therefore, in the event of the franchisee failing, the holding company is unlikely to be repaid. The size of the loan is determined by the Department based on its assessment of risks to forecast revenue contained in the winning bid.

Changes to rail franchising from 2011

1.8 Following a public consultation, the Department announced in January 2011 that changes would be made to the rail franchising system, including:

- Bidders will be invited to compete for longer franchises of between 15 and 22.5 years, with the exact length determined on a case by case basis.
- If revenues fall below expectations, payments of a proportion of any shortfall will be replaced by payments based on the characteristics of individual franchises and linked to economic indicators, such as changes in GDP.
- Rather than take a share of higher than expected revenues, the Department will introduce a profit share mechanism, determined on a franchise by franchise basis, to ensure the taxpayer benefits from any unexpectedly large profits.
- Performance bonds will be increased to reflect likely costs of £10-15 million for replacing a franchisee or 6 per cent of annual fare revenue, whichever is higher.
- Additional funding from holding companies if risks materialise will continue to be required.

In awarding the contract to National Express, the Department got a good deal

The Department did well to learn and apply lessons from the failure of the previous franchisee

1.9 The InterCity East Coast line is an important route between London, the North East and Scotland (**Figure 3**). Typically the franchise runs around 44,000 trains a year, carries some 19 million passengers and, in 2010, earned gross revenues of around £640 million. There is little commuter traffic and profits are highly reliant on discretionary business and leisure travel which make up almost nine out of ten passenger journeys on the line.

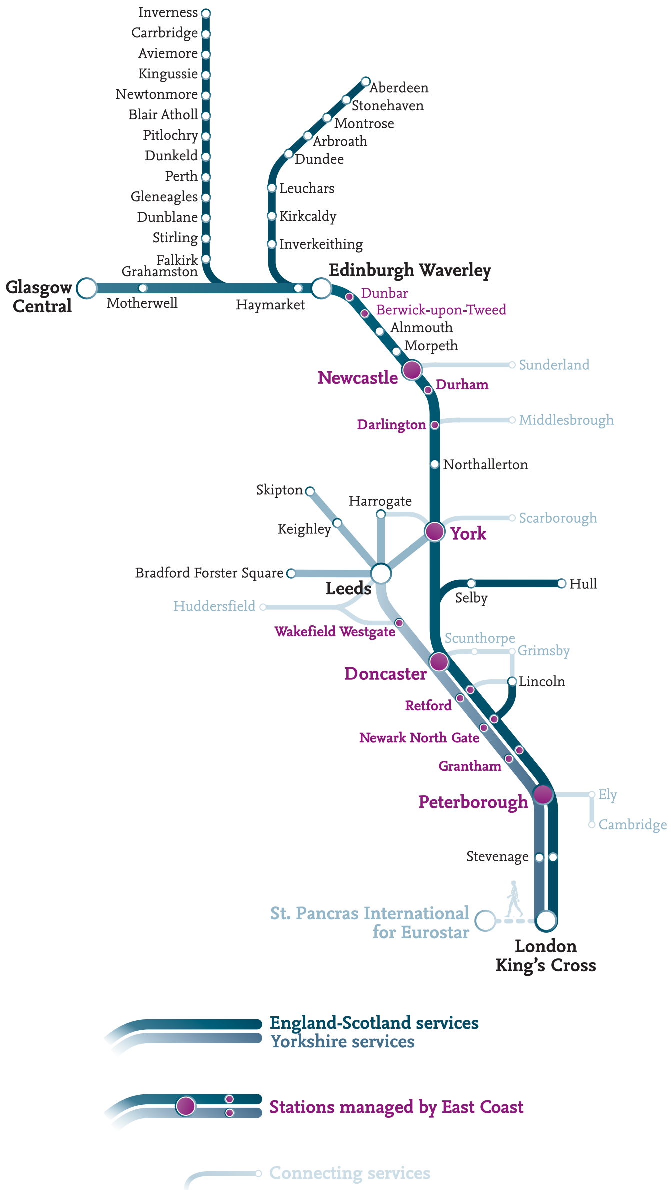
1.10 Great North Eastern Railway relinquished the InterCity East Coast franchise in 2006 when its holding company encountered financial difficulties. This meant that the Department had to re-let the franchise. It considered that the key terms of the contract with Great North Eastern Railway remained valid and could form the basis of the bid documents and draft franchise agreement for the 2007 procurement. The Department made two key changes:

- The financial difficulties encountered by Great North Eastern Railway's holding company (Sea Containers Ltd) resulted in the Department requiring, as part of the bid submission, more information about the financial health of bidders' holding companies. The Department also required the winning bidder to provide information about the financial health of its holding company during the term of the franchise agreement.
- In Great North Eastern Railway's franchise agreement, as in other agreements at that time, losses incurred on the franchise would have to be made good by a loan from the holding company. The loan to Great North Eastern Railway was staged on an annual basis over the life of the franchise. When the holding company failed in the second year of the contract, the stage payments meant that Great North Eastern Railway did not receive the full amount of the loan. In the franchise agreement with National Express East Coast, the Department did not permit staging of the loan, meaning that, if necessary, the full loan could be drawn down from National Express at the outset.

The franchise was awarded on a sound basis

1.11 In December 2006, the Department invited expressions of interest and shortlisted four parties who were invited to submit detailed bids for the franchise. In early June 2007, four bidders submitted bids offering payments to the Department over the seven and a half year life of the franchise, ranging from £907 million to £1,558 million (2007 present values).

Figure 3
East Coast Main Line route



Source: East Coast Mainline Company

1.12 The Department assessed and scored the deliverability of each of the bids. Each bidder submitted detailed plans for running the franchise and how these plans affected their revenue estimates. The assessment resulted in the Department classifying three of the four bids as sound approaches to delivering the specification, with the bid from National Express receiving the second highest score. The remaining bidder, which had offered the highest franchise payments, had the lowest score for delivery. However, its proposal was still judged to be deliverable and therefore given further consideration.

1.13 The Department also assessed the operational risks including deliverability of revenue assumptions made by each bidder. As part of this process, the Department looked at bidders' proposals to assess the level of revenue growth that depended on each bidder's business plans. Where this process flagged up concerns about the relevant bidder's ability to deliver the predicted revenue growth, the Department adjusted the offered payments downwards. Under this procedure, the National Express offer remained the second highest payment. The difference between the top two offers reduced and was so close that the Department selected National Express as it had the higher score for its delivery plans.

1.14 The revenue testing by the Department revealed that two of the bids, including the National Express bid, risked breaching the Department's minimum revenue to cost ratio of 1.05:1. Under the contract, this breach would constitute a default. The Department determined that National Express East Coast would need approximately £40 million of support from its holding company, National Express, if the franchisee were to avoid breaching the ratio. The Department therefore requested and received a contractually enforceable commitment from National Express to provide the support in the form of a subordinated loan.

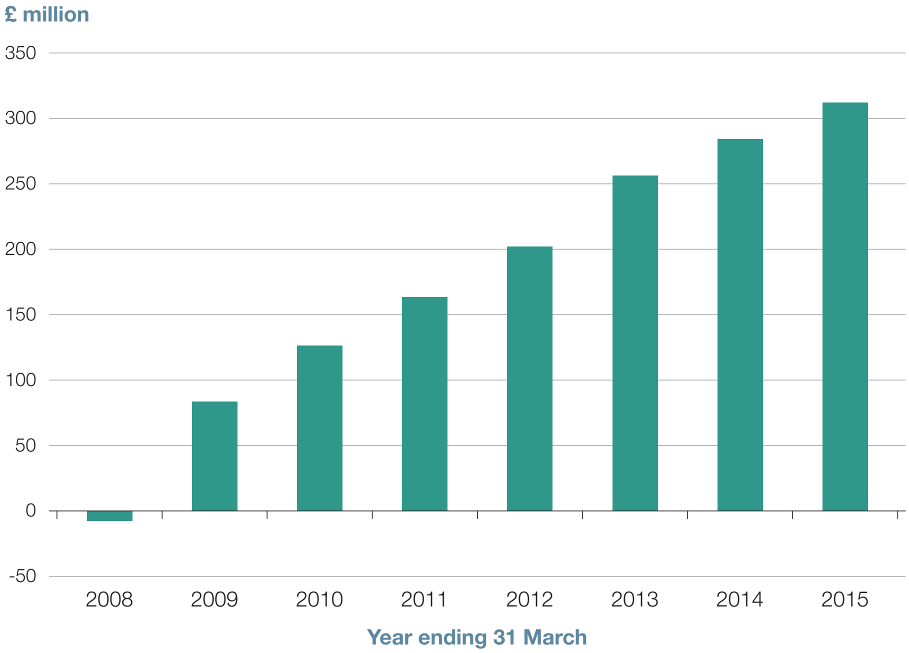
1.15 In its assessments of the bids, the Department used economic forecasts for the UK's economy produced by the Bank of England and Oxford Economics. During the bid evaluation period in June-July 2007, both institutions were forecasting sustained growth in the economy. At the time, economic forecasts indicated that there was a very low probability that by 2010 annual growth in the UK's gross domestic product would fall below 1 per cent. In view of these economic forecasts, the Department did not consider it necessary to stress test bids for deliverability in an economic downturn.

1.16 In awarding the franchise to National Express, the Department had ensured that, against the then current economic forecasts, it was maximising income from the franchise for a set of performance risks. Moreover, the Department had secured contractual protection through a performance bond. The bond was an agreement by National Express to pay up to £31 million to cover the costs incurred by the Department if the franchise was terminated. The bond, if called, was designed to cover the costs of the Department stepping in and re-letting the franchise.

1.17 On the basis of annual growth in passenger revenue ranging between 5 and 12 per cent, National Express agreed to pay the Department £1.4 billion[1] over the life of the franchise, with the bulk of the money being paid towards the end of the franchise term (**Figure 4**).

Figure 4

Payment profile for National Express East Coast franchise, 2008 to 2015



NOTES

1 The payments shown are 2007 present values of franchise payments discounted using HM Treasury's discount rate (3.5 per cent real).

2 In the franchise agreement, the Department agreed to pay National Express £6.7 million over the first four months of operation.

Source: Department for Transport Stock Market Statement, 14 August 2007

1 2007 present value. Franchise payments or subsidies paid by the Department are dependent on the level of track access charges that train operating companies pay to Network Rail. These charges were reduced in April 2009. The reductions were passed to the Department through either increases in franchise payments, or reduced subsidies. For National Express East Coast, the 2007 present value of the franchise payments increased to more than £1.9 billion.

Part Two

The decision to terminate the National Express East Coast Franchise

2.1 In this part, we examine whether:

- the Department's monitoring and oversight of the franchise flagged up, in good time, National Express East Coast's emerging difficulties, and the severity of those difficulties;
- the Department's decision to terminate was based on a comprehensive appraisal of available options; and
- the decision to terminate has impacted on the taxpayer.

Monitoring and oversight

The Department has effective arrangements for monitoring franchise performance

2.2 The Department's franchise monitoring builds on the arrangements introduced and developed under the Strategic Rail Authority, which was abolished in 2006. In addition, the Department drew upon recommendations contained in our report on the failure of the South Eastern Passenger Rail Franchise (HC 457 Session 2006-07), strengthening its monitoring of each franchisee's financial performance and longer-term viability. In particular, the Department required each franchisee to provide regular forecasts of costs and revenues over the remainder of the financial year.

2.3 Following our subsequent report, *Letting Rail Franchises 2005-2007* (HC 1047 Session 2007-08), the Committee of Public Accounts concluded in May 2009 that the Department had effective arrangements for monitoring the operational and financial viability of franchisees. Each franchise contract sets out the range of information that the franchisee and its holding company have agreed to supply. Typically, this information will cover four weekly reports on financial and operational performance, and compliance with franchise commitments. For example, the franchisee is required to provide:

- data on punctuality, reliability, safety and service quality;
- annual business plans and subsequent updates;

- management accounts that set out operating costs and revenues; and
- forecasts of profits and losses for the rest of the financial year.

2.4 The Department assigns a manager to each of the 16 passenger rail franchises who uses this information to review performance and holds formal meetings with the franchisee's senior managers every four weeks to discuss performance. To address lessons learned from the failure of Great North Eastern Railway, where difficulties stemmed largely from underlying financial problems with the holding company, the Department routinely reviews published accounts and investment bank analysis of the financial health of holding companies. The Department had all of these arrangements in place for monitoring National Express East Coast.

Routine monitoring flagged up problems with the franchisee early on

2.5 The Department's franchise manager began raising concerns as early as June 2008 that cost and revenue pressures might affect the profitability of the franchisee. Our analysis of the financial information that National Express East Coast provided to the Department shows that operating profits began deviating considerably from bid forecasts at around the same time (**Figure 5** overleaf).

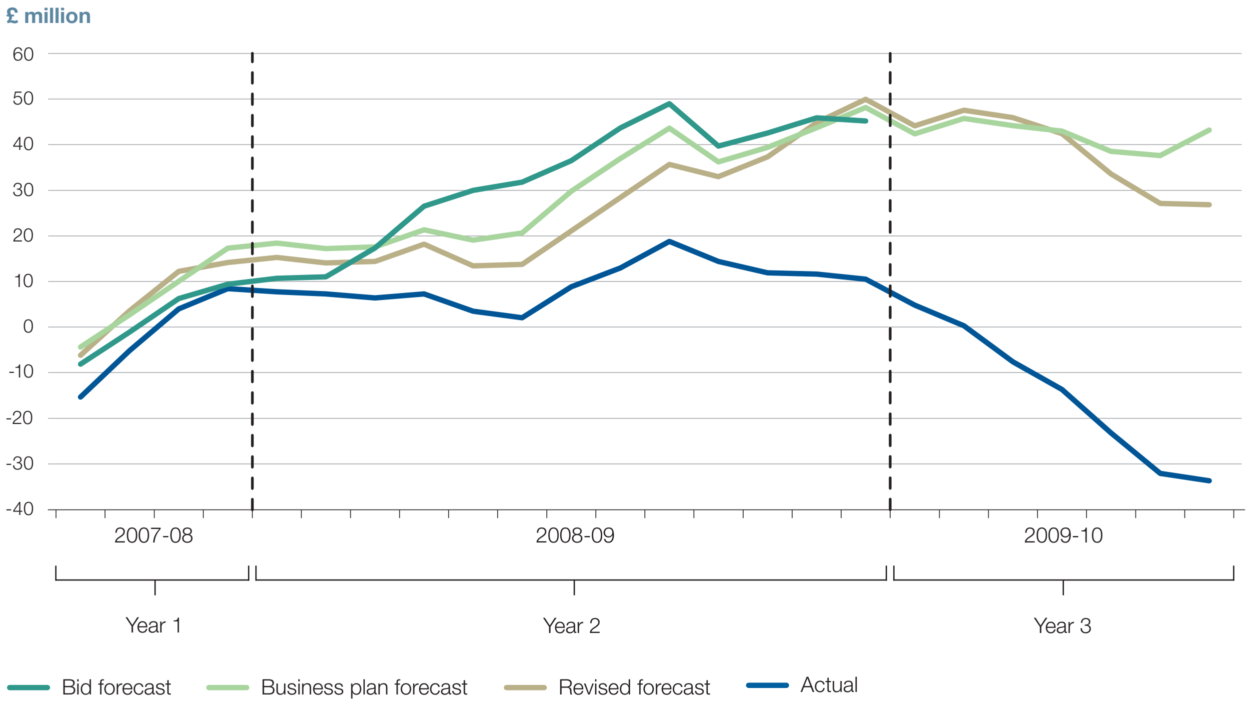
2.6 Falling revenues resulting from the economic downturn put substantial pressure on the profitability of the franchisee. Figure 5 shows that National Express, in its bid, had forecast that the franchisee would have earned a cumulative profit of £45 million, by the end of March 2009. Actual cumulative profit amounted to £10 million. After April 2009, cumulative profits quickly became cumulative losses and totalled £33 million by the time the franchise was terminated.

The Department discussed its concerns with National Express

2.7 Towards the end of 2008, the franchisee's weakening revenue position was causing further concern, leading to early discussions of cost-cutting measures at the regular monthly meetings between the franchisee and the Department's franchise manager. After November 2008, there was a significant decline in passenger revenues and as a result, the Department rated the continuing viability of the franchisee as high risk at the beginning of 2009.

Figure 5

National Express East Coast: Comparison of actual cumulative operating profits with bid, business plan and adjusted forecasts for profits, December 2007 to October 2009



Source: National Audit Office analysis of Department for Transport data

2.8 In the early part of 2009, the Department had classified five other train operating companies as high risk. Passenger rail demand and revenues were falling across the rail industry. National Express East Coast was particularly vulnerable as it had relatively low income from season tickets and therefore relied on business and leisure travel, sources of revenue that were more at risk in an economic downturn. The Department, however, did not consider that the National Express portfolio of rail franchises warranted greater concern than franchise portfolios held by other holding companies, because National Express East Anglia was in revenue support and c2c was operating at a profit.

2.9 Between 2004 and 2008, National Express was in a period of expansion. Using equity and bank debt, the company financed various acquisitions in the UK and abroad. Net debt increased from £438 million in 2006 to £1.18 billion in 2008 but the acquisitions contributed to a steady growth in revenue and profits. National Express considered that this level of debt was not atypical for a UK listed company in a period when debt was readily available. The company found that the global credit crisis severely curtailed the availability of debt funding for refinancing in 2009. A portion of the debt had to be refinanced in 2011 and the company considered that the best course of action would be to issue new shares to existing shareholders, a process that would be unlikely to succeed unless losses incurred on the InterCity East Coast franchise were addressed.

The Department took a tough line with National Express

National Express sought renegotiation of the terms of its InterCity East Coast franchise agreement

2.10 In February 2009, National Express notified the Department that it expected large losses on the franchise, particularly if the Department insisted that the franchisee honour its contractually committed franchise payments. The predicted losses ranged from £36 million in 2009 to £120 million in 2011. Revenue support from the Department would only begin in December 2011, reducing predicted losses to around £70 million a year.

2.11 While the franchisee was not entitled to contractual relief from the financial difficulties that it faced, National Express approached the Department with a request to renegotiate the terms of the franchise contract. The company proposed a number of cost-cutting measures and also considered that major changes to the terms of the contract, including a reduction in the payments to be made to the Department or the early provision of revenue support, would be needed. As the economic downturn was something over which National Express had no control, the company judged that it should receive exceptional relief.

2.12 Between February and June 2009, there were a number of meetings between the Department and National Express to resolve the difficulties with the franchise, but agreement could not be reached. The Department refused to consider any renegotiation of the terms. The Department took the position that National Express should look to cut costs and provide support to the franchisee from profits elsewhere in the group.

The Department considered but did not formally appraise three high-level options

2.13 In early 2009, when the prospect of franchisee default was seen as more likely, the Department began considering a number of options should the franchisee fail. These were:

- **Renegotiate** the terms of the franchise with National Express East Coast remaining as the operator.
- **Negotiate a consensual exit** by National Express. Withdrawal from the franchise on a consensual basis meant that National Express would not be seen as having defaulted on the terms of the franchise agreement.
- **Termination for contract default.**

2.14 There was never an option to 'do nothing' as this could have led to the franchisee falling into administration, putting at risk the continuation of passenger services, which the Department has a statutory duty to maintain. The Department also had a policy of not renegotiating the terms of franchise agreements with incumbent operators. Such renegotiations risk being poor value for money because bargaining power often lies with the incumbent operator and any concessions granted are also likely to be sought by other franchisees.

2.15 Under a consensual exit and termination of the contract, National Express East Coast could be retained, or replaced by a third party (private or public), to operate the franchise while the Department retendered the contract to find a new operator. Only upon termination of the contract for an event of default could the Department step in as operator of last resort under Section 30 of the Railways Act.

2.16 In its value for money reports, the National Audit Office has identified that the quality of option appraisals prepared by departments to help inform major decisions is a recurrent weakness. In considering the options listed above, we found that the Department did not formally assess and quantify the value for money implications of each option. **Figure 6** shows our assessment of the advantages and disadvantages of these options.

The Department rejected a renegotiation of the contract to avoid wider risks to the taxpayer

2.17 The Department rightly refused to consider any changes that would relax the terms of the franchise agreement on the grounds that other train operating companies facing financial difficulties would have sought similar treatment. Using the Department's analysis and our own, we estimate that the cost to the taxpayer of providing support to these other franchisees would have ranged between £200-450 million.[2] This range represents additional financial support beyond that which would have been provided from the start of the fifth year of each of the relevant franchise agreements.

2.18 Furthermore, relaxing the contractual provisions would have risked longer-term changes in bidding behaviour, possibly promoting excessive optimism in revenue projections. Winning bidders that subsequently found themselves in financial difficulty might then seek to exploit the grounds upon which the Department had supported National Express East Coast. The choice was therefore whether to negotiate a consensual exit by National Express or terminate the contract. In May and June 2009, the Department and National Express held a number of discussions about the terms for a consensual exit. In early June, the Department also started contingency planning for a termination in the event that these discussions failed.

2 April 2009 present values.

Figure 6

Comparison of the options available to resolve difficulties with the National Express East Coast franchise

	Renegotiate the contract with National Express	Negotiation of a consensual exit	Termination
Maintenance of services and rail safety	Lower risk of service disruption	High risk of service disruption ahead of and during transfer to new franchisee	High risk of service disruption ahead of and during transfer to new franchisee
Management	Continuity of management	Short to medium term continuity of service management, but risk of losing senior operational managers	Short to medium term continuity of service management, but risk of losing senior operational managers
Future premium payments to the Department	Negotiated reduction	Market determined reduction	Market determined reduction
Effect on other franchisees	High risk that other franchisees in difficulty would be encouraged to seek renegotiation of terms and that future bids received would be over-optimistic (moral hazard)	Risk that other franchisees in difficulty would be encouraged to seek renegotiation of terms (moral hazard)	Clear warning signal that renegotiation of terms would not be contemplated

Source: National Audit Office

The Department decided not to pursue a consensual exit

2.19 The form of consensual exit offered by the Department required National Express making a cash payment of £200 million and surrendering all three of its passenger rail franchises, without any compensation for investments made. Following an event of default within a franchise, the Department may terminate any other franchise agreements held by the relevant holding company, where the reasons for the default could have a material impact on the other franchises. An event of default may be judged to be material if, for example, there are reasonable grounds for concerns relating to probity or competence of the holding company. In the case of the National Express franchises, the financial difficulties within its InterCity East Coast operations did not impact on the delivery of services by its East Anglia and c2c franchises. In these circumstances, the Department did not have clear grounds to force a return of the other two franchises.

2.20 The Department based its offer on the view that companies holding more than one franchise should not be able to preserve their reputations after walking away from a failing franchisee, while continuing to profit from successful ones. The Department considered that a no-fault, consensual termination of the InterCity East Coast franchise alone would reduce any reputational impact on National Express and undermine the willingness of other holding companies to continue to support loss-making franchises.

2.21 National Express made a counter offer in June 2009, asking the Department to consider a payment of £150 million in return for a consensual exit from the InterCity East Coast franchise alone. National Express was concerned that contractor default termination would reduce its chances of qualifying to bid for future franchises. The Department did not discuss with National Express the structure of the payment although it considered that the proposal comprised four items which would be due anyway if the contract was terminated for default:

- proceeds from the performance bond, £31 million;
- full drawdown of the subordinated loan, £40 million;
- payment of the season ticket bond[3], £5 million;
- the National Express valuation of its investments in the franchise, £45 million; plus
- an additional £29 million cash payment.

2.22 In our analysis we found that, for three of the five other franchisees judged by the Department to be in severest financial difficulty, contract default may have been financially advantageous. We estimate that, had this happened, the loss to the taxpayer would have ranged between £140-280 million.[4] This range represents the cost to the Department for estimated losses on the three franchises through to their re-letting in 2012, net of proceeds from performance bonds and procurement costs.

2.23 If the three franchisees had sought consensual exits and offered additional cash payments similar to that offered by National Express, we estimate that the Department would have received only £60 million, well below the £140-280 million of likely losses taken on by the taxpayer.

Termination was the best means of protecting the taxpayer

2.24 The Department decided to terminate the contract and not to attempt to seek cross defaults on the other two franchises held by National Express. The Department wanted to send a strong message that it places greater weight on holding companies' supporting their loss-making franchisees, thereby preserving their reputations, than on payments for consensual exit. Despite a number of other franchisees being in financial difficulty during the economic downturn, none have sought a consensual exit. The Department told us that the holding companies had chosen instead to support franchisees by managing costs and generating sufficient revenues to minimise losses.

3 The season ticket bond ensures that the balance of advance payments for season tickets can be transferred to a new operator.

4 April 2009 present values.

2.25 Having decided to terminate the contract, the Department could secure continued operation of passenger services until the franchise was re-let by:

- agreeing a management contract with National Express; or
- tendering a management contract to find a new temporary operator; or
- setting up a new, publicly owned train operating company.

2.26 The Department concluded that continuing the franchise on a management contract with National Express East Coast represented poor value for money. Under such an arrangement, the outgoing operator continues to run the franchise, with the Department receiving any surplus revenues or underwriting any future losses. While this arrangement would support the orderly exit of the franchisee, the Department considered that a management contract with National Express East Coast would:

- need to incentivise National Express East Coast's performance in areas such as punctuality and revenue protection; and
- through payment of contract fees estimated to amount to about £12 million, be perceived as a 'reward for failure'.

2.27 Similar to a management contract is a tendered management contract. In this scenario, instead of negotiating a management contract with the incumbent franchisee, the management contract is tendered on the open market. The costs of this exercise could be drawn from the performance bond. However, the Department rejected such an option because:

- it could not start until an event of default had occurred or an agreement had been negotiated by the Department and National Express that permitted such a process to go ahead;
- it would have taken at least four months to complete; and
- such an arrangement might have given the incumbent management contract team an unfair advantage when re-letting the franchise.

2.28 The Department, as operator of last resort under Section 30 of the Railways Act 1993, therefore decided to transfer the franchise to a new publicly owned train operating company. National Express continued to deliver passenger services until the point of handback.

The Department's decision to terminate the franchise has not had an adverse impact on the taxpayer

The failure of the franchisee has led to a shortfall in expected premium income

2.29 While private sector incentives are absent, the Department has put in place a framework agreement that requires Directly Operated Railways to maintain and enhance the value of the franchise. The Department estimates that the public sector operator (East Coast Main Line Company, trading as East Coast) will make almost £530 million[5] in premium payments to the Department by the end of 2012.[6] Any profits remaining after these payments will be returned to the Department.

2.30 Through to the end of 2012, the franchise premium payments that East Coast is scheduled to pay to the Department are about half the amount that National Express East Coast was contracted to pay. For the period from November 2009 until December 2012, the expected date of completion for the re-letting of the franchise, we estimate that the Department will receive between £330-380 million[7] less income, net of revenue support, than had National Express East Coast been able to meet its obligations. The shortfall, together with increased amounts of revenue support paid to other franchises due to the economic downturn, has had to be accommodated within the Department's overall budget.

The Department has taken the franchise into public ownership at no cost to the taxpayer

2.31 The Department estimates that the cost of terminating and re-letting the franchise will be around £15 million between 2009-10 and 2011-12, substantially less than the value of the performance bond of £31 million. Of this amount, £5.6 million was spent on the termination of the franchise and mobilisation of a replacement operator.

2.32 In order to meet the challenges of ensuring continuity of services and the establishment of a replacement operator, the Department made good use of its internal expertise and employed specialist consultants effectively in key delivery areas where internal expertise was lacking. For example, KPMG was used to support financial modelling of East Coast and to undertake due diligence, and Eversheds undertook many of the legal arrangements associated with mobilisation of East Coast. The Department estimates that the overall costs of consultancy during the termination and mobilisation phase were some £4.9 million, with the remainder representing internal staff costs.

5 April 2009 present value, or £480 million in 2007 present value terms.
6 This is based on reduced track access charges introduced by Network Rail following the Office of Rail Regulation's periodic review of such charges for all train operating companies. The new charges took effect in April 2009.
7 April 2009 present value. The range is £300-340 million when converted to 2007 present values. On this basis the range is comparable to the £1.9 billion present value for the sum of franchise payments included in the National Express East Coast franchise agreement, after increasing the payments following the reductions, introduced in 2009, in Network Rail's track access charges.

National Express decided not to pursue compensation for its investment interests in the franchise

2.33 National Express valued its past investment in the franchise at £45 million. This investment included assets acquired at the time of transfer from Great North Eastern Railway and new assets such as ticket machines and station gating. After negotiations with the Department and Directly Operated Railways, National Express decided not to pursue compensation for its past investment and transferred the assets at nil cost to the Department. In December 2010, the Department informed the company that the failure of its InterCity East Coast franchise would not be held against National Express if it bid for future franchises.

2.34 Separately, the Department agreed to extend the two other franchises in order to facilitate the development of a new franchising process from 2011 onwards.

2.35 The problems with the InterCity East Coast franchise cost National Express nearly £120 million. Apart from surrendering interest in the franchise assets (£45 million) and paying the performance bond (£31 million), the company also lost £40 million associated with non-recovery of its subordinated loan. During the two years that National Express ran the franchise it paid £235 million[8] to the Department in accordance with the contract.

8 This is a cash figure which equates to £210 million in 2007 present value terms.

Part Three

Handling the termination and mobilising a replacement operator

3.1 In this part, we examine whether the Department:

- managed well the risks of terminating the franchise and mobilising a replacement operator;
- minimised the impact of termination on passengers; and
- identified lessons for the future.

Termination risks were managed well

3.2 The Department faced significant uncertainty surrounding the exact date of the termination of the franchise as this relied on the identification of an event of default and the exhaustion of the subordinated loan of £40 million.

The Department's existing guidance positioned it well to terminate the franchise and set up a new publicly owned train operating company

3.3 The Department drew on its own pre-existing guidance to terminate the franchise and set up a new publicly owned holding company, Directly Operated Railways, under which the replacement operator, East Coast, would be a subsidiary. Directly Operated Railways and its subsidiary were established using existing 'off the shelf' shell train operating companies.

3.4 In setting up Directly Operated Railways and East Coast, the Department aimed to replicate as far as possible the structure and governance arrangements used by other train operating companies and their holding companies. East Coast operates under a service agreement similar to National Express East Coast's franchise agreement. The logic of the new holding company structure was that the Department would be better able to take other failing franchisees into public ownership, if necessary.

3.5 While the Department's guidance envisages setting up a 'Directly Operated Railways-like' holding company, it provides little in the way of what such a holding company should look like or its governance arrangements. During June 2009, the Department decided that Directly Operated Railways should have greater delegated authority over operational activities than envisaged in the guidance. The Department therefore put in place a framework agreement for corporate governance and decided that the body should be staffed by rail industry professionals who possessed rail-specific commercial skills and were experienced in the running of train operating companies, rather than civil servants.

3.6 The Department and Directly Operated Railways put in place comprehensive plans to terminate the National Express East Coast franchise. They mobilised a replacement operator that would deliver the Secretary of State's statutory responsibility to ensure the continuity of passenger rail services.

The impact of the termination on passengers was minimised

Upon transfer to public ownership there was no significant disruption to services

3.7 In handing over the franchise to East Coast, the Department sought to maintain the operating specification for the frequency and timetabling of passenger rail services that National Express East Coast had been contracted to deliver. Operations were successfully transferred to East Coast on 13 November 2009 with no break in service.

Measures are being developed to address a deterioration in punctuality

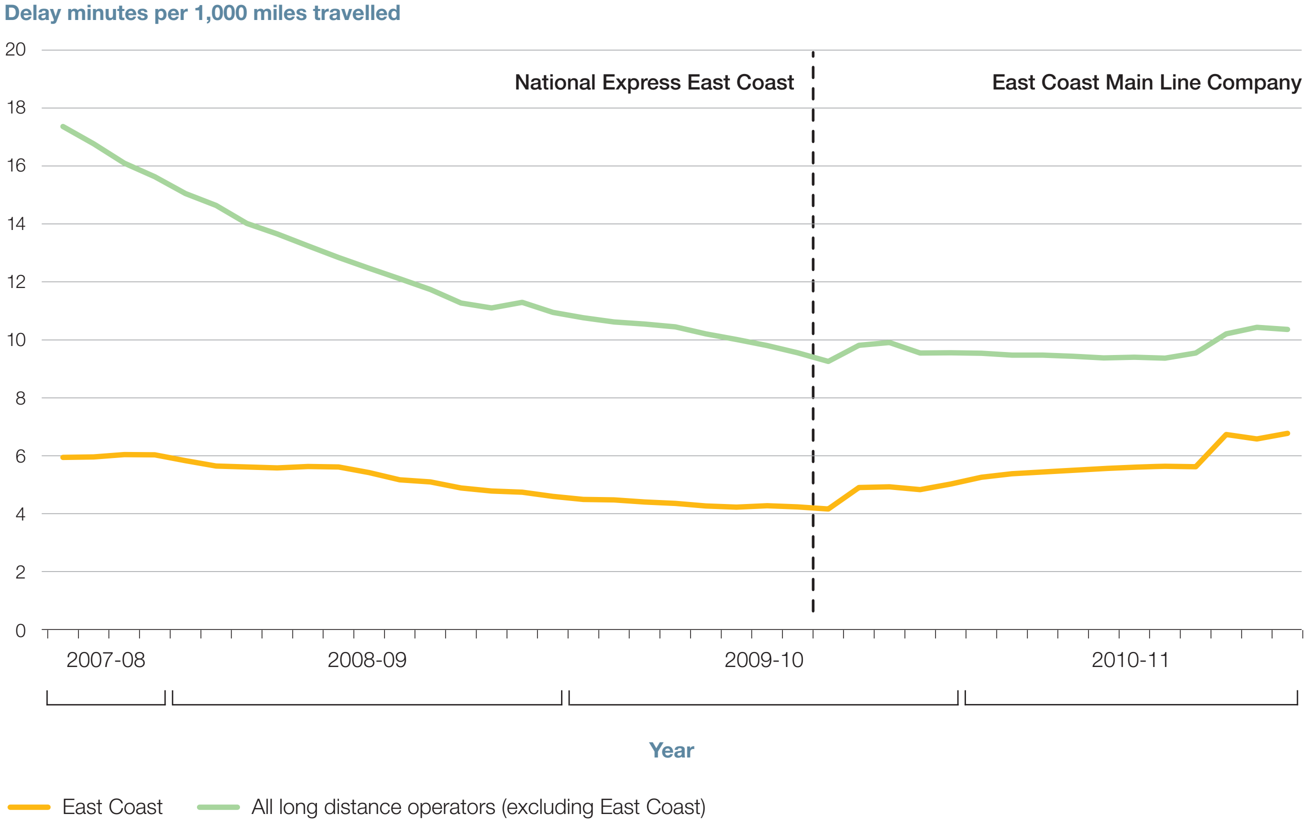
3.8 For East Coast, punctuality is defined as the percentage of trains arriving within ten minutes of schedule. At the time of handover, the moving annual average for punctuality stood at 89 per cent. By the beginning of 2011, punctuality had fallen to 83.7 per cent. For the rail industry as a whole, over the same period, punctuality averaged just over 91 per cent; and, for long distance operators, just under 88 per cent. While punctuality has worsened since handover of the franchise, the percentage of train cancellations on the East Coast Main Line has remained unchanged at 2.9 per cent.

3.9 To help understand performance on punctuality, we examined data on delay attribution. Most delay on East Coast services, just over 60 per cent, is attributable to problems with the infrastructure, which is the responsibility of Network Rail; and 16 per cent of delay is caused by other train operating companies that run on parts of the line. The remaining delay, almost 25 per cent, is attributable to East Coast but the reasons for this are unclear because of the number of influencing factors including management of stops at stations, adverse weather conditions and train maintenance issues.

3.10 Since handover of the franchise, the number of delay minutes attributable to East Coast per 1,000 miles travelled has increased from 4.2 minutes to 6.8 minutes at the beginning of 2011 (a 60 per cent increase). Though East Coast's performance has worsened, it compares well with other long distance rail operators (**Figure 7**).

Figure 7

Self delay minutes per 1,000 miles travelled among long distance train operating companies between December 2007 and January 2011



NOTE

1 All data are measured on a moving annual average basis.

Source: National Audit Office analysis of performance data obtained from the Department for Transport

3.11 To address delays, East Coast and Network Rail have entered into a joint plan to improve performance. Among other measures, Network Rail is seeking to keep incidents on the line below 100 a month. East Coast has introduced fleet maintenance improvement plans, including a 'common failure review' process, and has implemented a separate initiative designed to reduce small delays.

The Department has identified lessons for the future

3.12 The Department built ongoing learning and knowledge management into the project to terminate the National Express East Coast franchise and mobilise a replacement operator. During the project, the Department and its consultants maintained journals to record their experiences with the intention of helping inform the revision of existing franchise termination and mobilisation guidance. In July 2010, the Department produced a 'Lessons Learnt' document, which also incorporated recommendations from an OGC Gateway Review in October 2009, as well as findings from the Department's internal audit reviews. The Department expects to have updated its internal guidance by 31 March 2011.

Appendix One

Chronology

Date	Event
9 December 2007	National Express East Coast begins operation of the East Coast Main Line franchise.
November 2008	The Department's franchise manager's report identifies a fall in passenger numbers of 2 per cent in October 2008, giving the first sign of the impact of the recession. At the monthly franchise meeting between the Department and National Express East Coast, the operator sets out measures it intends to take to save costs. The Department changes National Express East Coast's risk rating from 'Green' to 'Amber'.
January 2009	In response to another month of continued decline in passenger revenues, National Express East Coast revises its financial forecasts downwards. The Department changes the franchise's risk status to 'Red'.
3 February 2009	National Express gives a presentation to the Department about the East Coast franchise and options going forward. Its view is that the economic downturn represents a force majeure event that can only by mitigated by a combination of self-help actions and renegotating the terms of the franchise agreement.
9 February 2009	National Express gives a second presentation to the Department about the franchise's worsening position. The Department reiterates its position that it does not renegotiate franchises.
23 April 2009	National Express seeks to renegotiate the terms of the franchise. If negotiations do not produce a satisfactory outcome the company proposes that the Department puts the franchise on a management contract.
1 May 2009	The Department writes to National Express confirming that it was prepared to commence negotiations on a 'possible' management contract with a view to finalising those negotiations by 31 May 2009.
26 May 2009	Discussions continue between the Department and National Express. The Department states that National Express should continue operation of all three of its franchises to their expiry dates. Failing this, the Department will seek a return of all three franchises.

Date	Event
4 June 2009	National Express proposes to return National Express East Coast to the Department by end of June 2009 and return its other two franchises by the end of December 2009.
9 June 2009	The Department initiates contingency plans to take over the franchises held by National Express.
11 June 2009	National Express proposes to withdraw from the East Coast Franchise on 1 July 2009 and continue to operate the service under a management contract.
16 June 2009	The Department sets out its terms for the withdrawal of National Express from the East Coast franchise, including a cash payment of £200 million and the return of its other rail franchises.
25 June 2009	National Express offers the Department £150 million in return for a consensual exit from the East Coast franchise and the retention of its two other franchises. The Department rejects the offer.
1 July 2009	National Express announces it will not give further financial support to the East Coast franchise beyond the subordinated loan (£40 million) and performance bond (£31 million). The Secretary of State announces the establishment of a new publicly owned company – Directly Operated Railways – to take over the franchise.
8 October 2009	The Department concludes that an Event of Default has occurred as National Express East Coast had breached its financial ratios.
19 October 2009	The Department issues National Express East Coast with a Default Notice.
4 November 2009	The Department issues National Express with a Termination Notice with effect from 23:59 hours on 13 November 2009.
13 November 2009	East Coast commences operations on the InterCity East Coast franchise.

Appendix Two

Methodology

Study scope

The study reviewed the Department's handling of the InterCity East Coast passenger rail franchise and whether the interests of taxpayers and passengers were safeguarded.

The fieldwork for the report was carried out during December 2010 and January 2011. The study's methods are set out below.

Methods

Method	Purpose
Document review We reviewed documents provided by the Department and National Express, including: • key submissions and supporting papers; • franchise performance monitoring reports; • notes of Departmental Boards and other meetings; • project management documentation; • Office of Government Commerce reviews; • Department internal audit reviews; and • Departmental guidance on franchise letting and termination.	**To identify** • The chronology of events leading up to termination of the franchise and subsequently. • The Department's objectives. • The Department's testing of the deliverability of bids received to operate the East Coast Main Line franchise. • The Department's processes for monitoring passenger train operating company performance. • The Department's appraisal of its available options. • The planning and management of the project to terminate the franchise and mobilise a replacement operator. • The lessons that the Department has learnt.
Semi structured interviews We interviewed: • Department for Transport officials • National Express • Directly Operated Railways • East Coast	**To establish** • The chronology of events leading up to termination of the franchise and subsequently. • The Department's objectives. • The Department's processes for monitoring passenger train operating company performance. • The Department's appraisal of its available options.

Method	Purpose
Semi structured interviews We interviewed: The Association of Train Operating Companies (ATOC)	**To establish** • The Department's understanding of the risks inherent in the options available to it. • The Department's testing of the deliverability of bids received to operate the East Coast Main Line franchise. • The planning and management of the project to terminate the franchise and mobilise a replacement operator. • The impact of termination on the wider passenger rail franchising sector. • The lessons that the Department has learnt.
Financial analysis	• To determine the severity of National Express East Coast's financial difficulties and when they began to emerge. • To scrutinise the Department's appraisals of its available options. • To estimate the financial value of the risks inherent in the available options.
Quantitative analysis	• To assess punctuality and reliability on the East Coast Main Line.
Use of National Audit Office option appraisal toolkit	• To evaluate the quality of the Department's option appraisals.
Use of in-house expertise	• We drew on the knowledge and expertise of National Audit Office colleagues with experience of corporate finance and the rail industry to provide expert advice and support.
Literature review We reviewed: • the published reports and accounts of National Express and Directly Operated Railways; • relevant reports of the Transport Committee and the Committee of Public Accounts on passenger rail franchising; and • reports in the specialist transport press and the wider media.	**To establish** • The wider context leading up to National Express East Coast difficulties and subsequent events. • Developments relevant to the termination of the franchise.

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