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

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.