National Audit Office

Report
by the Comptroller
and Auditor General

Department for Transport

Procuring new trains

HC 531 SESSION 2014-15 9 JULY 2014

Key facts

£7.65bn
the estimated total amount train operators will pay for using the new Intercity Express trains over 27.5 years (2014 prices, present value)

£2.8bn
the estimated total amount train operators will pay for using the new Thameslink trains over 20 years (2014 prices, present value)

2,006
the total number of new train carriages, of which 1,140 is for Thameslink, and 866 – 369 for the Great Western Main Line and 497 for the East Coast Main Line – are for Intercity Express

13	the total number of new, reconstructed or refurbished depots being delivered by the contractors: two for Thameslink, eleven for Intercity Express
24	trains per hour through the core Thameslink route upon completion of the programme
4	trains per hour between London and Bristol on the Great Western Main Line upon completion of the Intercity Express programme – twice the current number of services
1.42	benefit–cost ratio for the Thameslink programme (trains and wider infrastructure programme)
2.7	benefit–cost ratio for Intercity Express
3	years of delay to the Thameslink programme (trains and wider infrastructure programme)
2.5	years of delay to Intercity Express

Summary

1 The Department for Transport (the Department) has awarded contracts for both the Intercity Express and the Thameslink programmes to private sector consortia to supply, finance and maintain new trains. Train operators on the Great Western Main Line, East Coast Main Line and an expanded Thameslink network will pay the consortia to use the trains, subject to specified performance and availability levels being met. The Department estimates future payments will be around £7.65 billion for Intercity Express and £2.8 billion for Thameslink (2014 prices, present value) over 27.5 and 20 years respectively.

2 The procurements comprise the following:

- **Thameslink** – 1,140 new train carriages to provide increased capacity, reliability and frequency of service; two new train maintenance depots; a maintenance contract lasting up to 30 years with options to break at the first franchise change after year ten of the contract and every franchise change thereafter; financing; and a contract which incentivises the consortia to provide and maintain reliable trains.
- **Intercity Express** – 866 new carriages in total – 369 for the Great Western Main Line and 497 in total for the East Coast Main Line – to replace ageing fleets; four new or reconstructed maintenance depots and seven refurbished depots; maintenance and cleaning of both rolling stock and depots for the 27.5 year lifetime of the contract; financing for the transaction; and a contract which incentivises the consortia to provide and maintain reliable trains.

Scope of the report

3 This report, our first on Intercity Express and second on Thameslink, examines whether the Department is well placed to achieve value for money from these two major procurements. It focuses on:

- the programmes' objectives (Part One);
- the procurements (Part Two);
- the contracts (Part Three);
- managing current and future risks to value for money (Part Four); and
- the decision to order more trains for the East Coast Main Line part of the Intercity Express programme (Part Five).

4 We summarise our audit approach and evidence base in Appendices One and Two.

Key findings

The Department's objectives and approach

5 **There was good evidence of the need for new trains to increase capacity for both programmes.** Our June 2013 report on Thameslink showed that in 2002 the Thameslink route was already the most crowded commuter route in London, and that demand was set to increase significantly. On Intercity Express, existing intercity trains were reaching the end of their expected time in service and the business case for Intercity Express showed that, by 2015-16, many trains would be operating well above capacity. Value for money will depend, in part, on passenger demand forecasts being met (paragraphs 1.5 and 1.6).

6 **Through these procurements, the Department was attempting to minimise the effects of some of the long-standing issues with the rail industry, for example by reducing long term costs to the whole rail system.** The Department had identified that train operating companies were not incentivised to consider long term costs to the whole rail system when deciding which trains to use. In addition, the Department's 2004 White Paper also stated that charges paid by train operators to Network Rail bore little relation to the maintenance costs for tracks. The Department therefore included the objective to minimise these broader costs in both procurements. Following the 2011 McNulty report on the value for money of UK rail, which stated that these systemic issues had not been resolved, the Department has begun to work with industry and the rail regulator to address them (paragraphs 1.7 to 1.11).

7 **These structural issues and the scale of the procurements led to the Department's decision to lead the procurements itself despite not having led a major rolling stock procurement before.** In the case of Thameslink, the Department also cited the fact that the trains would operate over multiple existing franchises as a reason why a single operator could not lead the procurement. Having enough staff with the right skills and experience is vital to manage such programmes. As we have reported on other major programmes run by the Department, the Department's teams are often stretched and this was the case again, although it made extensive use of consultants and advisers, and train operating companies were involved in the design of the train specifications, the procurement requirements and the contracts (paragraphs 1.12 to 1.16).

8 **Better strategic planning of infrastructure and train needs could have prevented the significant changes which occurred to the Intercity Express programme.** Buying trains depends on the nature of the infrastructure on which they will run. The Department told us that its decision on the specification for Intercity Express was made against a backdrop of rapid change in design and technology and in recognition of infrastructure as a contributor to economic growth. Because the Department began the Intercity Express programme when it considered that there was not a case for a major electrification programme it was reasonable for the Department to introduce flexibility to the programme and to procure self-powered (diesel) trains, trains that are powered by overhead electric lines and trains which can use both forms of power (bi-mode). However, in 2009 – just two years after the procurement began – the Department decided to electrify the Great Western Main Line, which meant that diesel trains were no longer needed (paragraphs 2.2 and 2.3).

9 **It is not clear, with differing views, whether the decision to carry out two procurements at similar times, combined with the decision to procure all the required trains in single, large procurements to achieve economies of scale, impacted on the market's appetite to respond.** The Department and some manufacturers are of the view that rolling stock manufacturers operate in a global market and that the timing and size of procurements have little or no bearing on the level of competition achieved. Moreover, the Department contends that the timing of the procurements was based on the ageing profile of the trains that needed to be replaced in the case of Intercity Express, and upgraded for Thameslink to provide increased capacity in the interest of passengers. However, others contend that achieving value for money requires manufacturers to have greater clarity of demand and avoiding peaks and troughs. The level of competition achieved compares favourably with that achieved for rolling stock procurements in recent years, although bidders did drop out during the procurements for their own commercial reasons, and on Intercity Express, two major manufacturers decided to join a single bidding consortium (paragraphs 2.5 to 2.11).

10 **The Department concluded that for both procurements, the preferred bidders had offered significantly better value for money and that the second placed bidder was unlikely to be able to improve its bid enough to overcome this gap.** On both Thameslink and Intercity Express, the Department's evaluation of the bids was in line with evaluation criteria set out in the invitation to tender (paragraph 2.12).

11 **The Department decided to proceed with a significantly revised bid from its preferred bidder for Intercity Express without going back to the market.** The Foster Review into the value for money of Intercity Express, commissioned by the Secretary of State in March 2010, stated that he was "not convinced that all the potentially viable and possibly preferable alternatives to IEP (Intercity Express programme) have been assessed alongside it, on an equal footing". In September 2010, the Department received a revised proposal from its preferred bidder, Agility Trains, to provide fewer trains with a revised design at a lower price. The Department carried out extensive analysis of a range of options and concluded that Agility Trains' revised bid offered better value for money than the other options, which would have involved reopening the procurement (paragraphs 2.14 to 2.17).

12 **The Department adopted a Private Finance Initiative-type approach to both procurements but, in the case of Thameslink, it did not explore the costs and risks of financing the procurements from the public purse.** The Department did consider a publicly funded option for Intercity Express but dismissed it on the basis that the Department, as owners of the trains, would retain too much risk. In the case of Thameslink, the Department did not consider public funding as it decided it did not want to absorb the cost of this project at the expense of other transport priorities, and that, as a result, private finance was the only practical option given the existing industry structure (paragraphs 1.19 to 1.20 and 2.20).

13 **The Department concluded both deals at a time when there were difficulties in the financial markets, but it does have the opportunity to improve value for money by refinancing both deals when it judges that conditions are more favourable.** Overall, final costs for both projects were lower than at the initial bid stage (paragraphs 2.19 to 2.29).

14 **The Department awarded both contracts more than three years later than intended, largely due to pauses to the procurements and the challenge of securing finance.** On Thameslink, the contractors will provide trains in line with the programme's revised infrastructure timetable for completion by 2018, which is also three years later than originally planned. The Department forecasts that the last trains for Intercity Express will enter service in 2020, nearly two and a half years later than planned (paragraphs 1.4, 2.24 and Figure 2).

15 **In our opinion, the Department has not handled relationships with bidders well during the procurements, which increased the risk of legal challenge.** The Department kept bidders informed about progress following appointment of the preferred bidder, but this was primarily through the media, Parliament and public meetings rather than communicating directly with them. On Intercity Express, we consider that the Department could have done more to explain to the unsuccessful bidder the features of the Agility Trains' revised bid which led the Department to proceed with that bid. In our view, this increased the risk of legal challenge (paragraph 2.18).

16 **The Department secured contractual terms that incentivise the suppliers to provide and maintain reliable trains, in line with its key objectives.** However, contractual provisions for Intercity Express give the Department an extensive oversight role, which could slow down decision-making and increase costs for compliance if not managed well. In contrast, the Thameslink contractual structure includes more immediate incentives for the owner and maintainer to improve value for money such as break clauses to facilitate potential competition around maintenance (paragraphs 3.1 to 3.5).

17 **The Department's decision in July 2013 to exercise an option in the original contract with Agility Trains to add 270 carriages to its Intercity Express order at a cost of £1.4 billion[1] has created confusion in parts of the industry about the Department's role.** The Department considered that exercising the option offered better value for money than any of the options available to bidders through the franchising process. The option expired in August 2013 and the Department also considered that it would be more likely that the East Coast franchise would be let according to schedule in February 2015 if it exercised the option. This meant that it did not leave it to train operating companies to purchase the trains through the franchising process. The Department's stated policy is that it will leave future train procurement to industry, although it reserves the right to intervene where scale and complexity make it necessary. Its decision to exercise the option and to initiate procurements of additional trains to bridge service gaps prior to completion of the Thameslink programme appear to us to stretch this policy (paragraphs 2.34 and 5.1 to 5.6).

18 **On both programmes, the Department needs to continue to manage risks going forward and maintain an effective oversight role.** A particular risk that the Department will need to monitor on Intercity Express, is progress on electrification works, which has been identified as a significant risk and which is currently over budget. Once trains are operational, as well as ensuring that parties, including operators and the consortia, are meeting their obligations under the contracts, it will have to encourage cooperative and efficient working relationships particularly between the owner, maintainer and train operator and Network Rail (paragraphs 4.1 to 4.7).

Conclusion on value for money

19 The Department had broad objectives for both procurements to minimise the effects of long-standing issues in the rail industry, including reducing the long term costs to the whole rail system and improving the reliability and availability of trains by transferring risk to the train service suppliers. The Department has signed contracts for the provision of new train services in line with these objectives. The Department has begun working with industry to address the issues around long term, whole system costs more generally.

1 Cost expressed in 2014 prices, present values.

20 We are not able to conclude fully on value for money on either project until the new trains are in service and benefits are being realised. This is dependent on the Department and train operators managing the contracts and the wider programmes effectively, and assumptions, such as passenger demand forecasts, holding true. We are concerned that in the case of Intercity Express, the Department decided to proceed with a revised bid without competition, which means that the Department's view that no other manufacturer could offer better value for money is untested. The Department has the opportunity to gain from future reductions in the cost of financing for both procurements to improve value for money.

Recommendations

a **The Department should act to ensure that the industry understands its policy on the procurement of trains and that its actions are seen to be consistent with the stated policy.** At the moment there is a gap between the Department's stated desire to only play a strategic role and how it is acting, particularly following the decision to exercise an option in the contract to order more trains. A clear understanding of the Department's role will help the industry make plans, and will reduce costs associated with uncertainty.

b **To improve its planning of major procurements, the Department should:**

- produce a detailed, integrated plan which brings together infrastructure, rolling stock and franchising strategy;
- understand what the project will involve before fixing the timetable and starting the competition; and
- identify a critical path and key tasks and their dependencies, and actively manage key risks.

c **The Department should increase and maintain competitive pressure in future procurements.** Sustaining competitive tension is central to getting value from competitions. Where possible, the Department should limit changes once it has chosen a preferred bidder and the time spent on this phase.

To ensure that it achieves the intended benefits for both programmes, the Department should:

d **Make use of its opportunity to refinance both deals in a way which maximises value for money.** The Department should work with Agility Trains and Cross London Trains to monitor closely developments in the debt finance markets before choosing when to refinance the deals.

e **Build on the contract terms by supporting collaborative working between the train operators and the consortia supplying the trains.** The Department must monitor the consortia, franchisees, and others to encourage them to work to reduce whole system costs. It should continue to consider bidders' ability to work collaboratively when it selects franchisees and drafts the franchise agreements.

f **Maintain appropriate oversight and interventions when managing the contract.** It should:

- not impede flexibility between the owner, operator, manufacturer and Network Rail, which could increase the risk of additional cost and delay;
- determine whether all parties are acting collaboratively as the Department envisages, and act to encourage this if required; and
- monitor the financial markets to determine whether there is an opportunity to reduce the cost of the projects' debt in the future.