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Intercity East Coast Franchise

Fifth Report of Session 2017–19

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Transport Committee

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Executive Summary

The Intercity East Coast (ICEC) franchise has a troubled history. The joint-venture between Stagecoach and Virgin, operated as Virgin Trains East Coast (VTEC), is the third time in just over a decade that this franchise has failed. The actual day-to-day operations of the franchise were managed successfully by VTEC. Based on passenger satisfaction, it was amongst the highest performing long-distance franchises on the network. In terms of VTEC's operational finances, the franchise was performing well and VTEC made an operational profit of around £260 million in the financial year prior to its termination.

Despite this, the operating surplus generated did not fully cover the premium obligations it had with the Department for Transport (DfT) as part of its franchise contract. To cover the revenue shortfalls, VTEC had to forego the £165 million parent company guarantee it committed to the DfT when the franchise was let. By the end of January 2018, the last parent company support was drawn down and the franchise went into technical default. The latest ICEC franchise therefore failed because the revenue projections underpinning the VTEC bid were over-optimistic and it simply ran out of money.

Revenue fell short of expectations from day one and passenger growth that was anticipated never materialised; the franchise eventually failed after just three years of operation. Franchises should be able to withstand normal fluctuations in the economic cycle. The fact that this franchise did not suggests that Stagecoach and Virgin built very little resilience into their bid. Their assessment of the financial risk associated with their bid was wholly inadequate and VTEC's bid for the franchise was over-optimistic. This was naïve, and it should have been more aware of the financial risks involved, particularly given the history of this franchise and Stagecoach and Virgin's long history of bidding for and running franchises in this country. We conclude that Stagecoach and Virgin bear prime responsibility for the failure of this franchise.

The DfT must also take responsibility for not managing the bid process effectively enough. The DfT encouraged overbidding by setting unrealistic benchmarks in the Invitation to Tender, and the bid process lacked the necessary boundaries to temper over-optimistic bidding. Specifically, the DfT's financial stress-testing of the bids was not robust enough. If the DfT had conducted appropriate due diligence and identified weaknesses in the assumptions underpinning the bid, it may not have been in this position today.

Network Rail do not bear any responsibility for the early termination of this franchise. To date, Network Rail have provided all the infrastructure upgrades that it had formally committed to when this franchise was let. A series of other upgrades were assumed to occur by the DfT and VTEC to deliver an enhanced timetable from 2019 onward; though there was no formal funding commitment to these upgrades when the franchise was let. The delivery of these enhancements will now occur but later than was initially anticipated by the DfT and VTEC. This delay would have undermined assumed revenue growth from 2019 onward but did not directly contribute to the early termination of this franchise. While Network Rail's performance in managing the ECML had not been up to standard, and this clearly undermined franchise performance, it was not on a scale that led to VTEC defaulting on their contract. Further, compensation for revenue losses are dealt with through normal industry mechanisms.

Knowing that the financial picture was bleak from day one of this franchise, it might have been a simpler for the DfT to find an early contractual solution to this problem. One option might have been to rebase the revenue forecasts at the beginning of the franchise. At the time the franchise was let, the DfT had a policy of not renegotiating franchises once they had been let. This was to preserve the financial interests of the taxpayer and to preserve the integrity of the franchising market. Given this policy and the fact that there were no material changes in the wider economic environment (e.g. a recession), renegotiation of the contract with VTEC may have set a precedent for other operators in similar financial positions. The DfT therefore had no alternative but to let the contract run its course to default.

Various reports of a bail-out emerged after it appeared, and was then confirmed, that the VTEC contract would be terminated prematurely. The franchise has not delivered the premiums to the taxpayer that were originally envisaged when the franchise was let. Because of the contract termination, the tax-payer will no longer receive the entirety of the £2 billion that had been expected over the remainder of the franchise. It is important to note, however, that based on the contract that was originally agreed with the Government, the taxpayer has not bailed out Stagecoach and Virgin. This is because Stagecoach and Virgin had their liability capped at £165 million, which was the amount of their parent company guarantee.

The Secretary of State terminated VTEC's contract on 24 June 2018 and transferred operations to the operator of last resort, under the brand 'London North Eastern Railway'. While it is too early to know whether the decision to transfer control to the operator of last resort was the right one, we are critical of the Secretary of State for a lack of a clear plan and timescales upon which the interim operator will run the franchise. We recommend that the Secretary of State set out how long he expects the operator of last resort to run the franchise and clarify exactly how the DfT will manage any operational and investment risks until the longer-term arrangements are in place. We are not aware of the existence of formal obligations and targets for the operator of last resort for the Intercity East Coast franchise. We recommend that whenever the operator of last resort arrangement is invoked, the DfT should revise and publish obligations and targets for the operation of the failed franchise by the operator of last resort, in order to provide passengers, taxpayers, Parliament and industry certainty of its business plan, strategy and development plans. This should be done within six months of assuming responsibility for a franchise.

The DfT are developing plans to launch the 'East Coast Partnership' in 2020, though the exact date remains uncertain. This new operating model, where both track and train operators will be managed 'under one roof', is designed to encourage a more integrated and joined up approach to running this franchise. We conclude that greater joint-working and clear lines of accountability through a single person responsible for track and trains offers potential for significant improvement in services. The mechanics and complexity of the current financial and regulatory environment has meant that all previous attempts to establish deep alliances have not worked. Based on the current framework, we conclude that the East Coast Partnership is unlikely to provide scope for the step-change in performance that the Secretary of State might be anticipating. This proposal also risks adding an additional layer of complexity to this part of the network. Passengers will ultimately bear the risk if this proposal goes wrong. This seems to be an unnecessary risk on this part of the network, particularly given that passenger satisfaction is already relatively high. We recommend that any review of franchising should consider what change would be needed to the financial and regulatory framework to make partnership working a viable and sustainable model for operating the railway in the future. We recommend that the Department set a timetable for publishing the detail of how it expects the East Coast Partnership will work.

Decision-making should be based on a clear plan and a transparent assessment of that plan. In the case of the East Coast Partnership, neither of those things has occurred and we are concerned that future operations on a major part of the UK's network will be captive to a concept for which there is no plan or impact assessment. Before experimenting with this Partnership, we recommend the Secretary of State lay out in detail how the new partnership will work and conduct a proper assessment of its feasibility against those plans. This assessment needs to demonstrate that his proposal will offer better value for money for the taxpayer and better outcomes for passengers than other ways of operating. We recommend the Secretary of State review his decision to go-ahead with this Partnership based on the findings of this assessment.

The East Coast franchise is but one vulnerable rail franchise on the network. There have been reports that several other franchises are either in revenue support, or potentially drawing on their parental guarantees to meet their obligations to the DfT. Given the problems on these franchises and the possibility of franchise failure, we conclude that the Government has not found the right balance between the risk of franchise failure and return they might obtain from encouraging ambitious bids. We recommend that the Department revisit its approach to franchise failure, which should be embedded in how they assess the risk and feasibility of each bid. We also recommend that it keep our Committee informed about any franchises that look likely to default on their contracts and whether it is resourcing the operator of last resort to take over any of these franchises and find a way to brief Parliament on the de facto reality on the railways.

1 Introduction

1. The Intercity East Coast (ICEC) franchise has a troubled history. The first franchise to fail was Great North Eastern Railway (GNER), owned by Sea Containers, which ran from 1996 to December 2007 when it was stripped of the franchise by the Department for Transport (DfT). Whilst the failure of GNER was primarily owing to the finances of its parent company, their franchise bid, based on strong projections of revenue growth, were deemed to be highly ambitious and were not realised.[1]

2. The franchise was then awarded to National Express in December 2007, but assumptions on passenger growth again failed to materialise during the recession. Following the announcement that parent company funding would be withdrawn, the ICEC was taken over by Directly Operated Railways (DOR) in November 2009, a subsidiary of the DfT. East Coast Trains, as the DOR operator was known, ran the line from November 2009 until it was eventually re-franchised in March 2015.[2]

Virgin Trains East Coast franchise

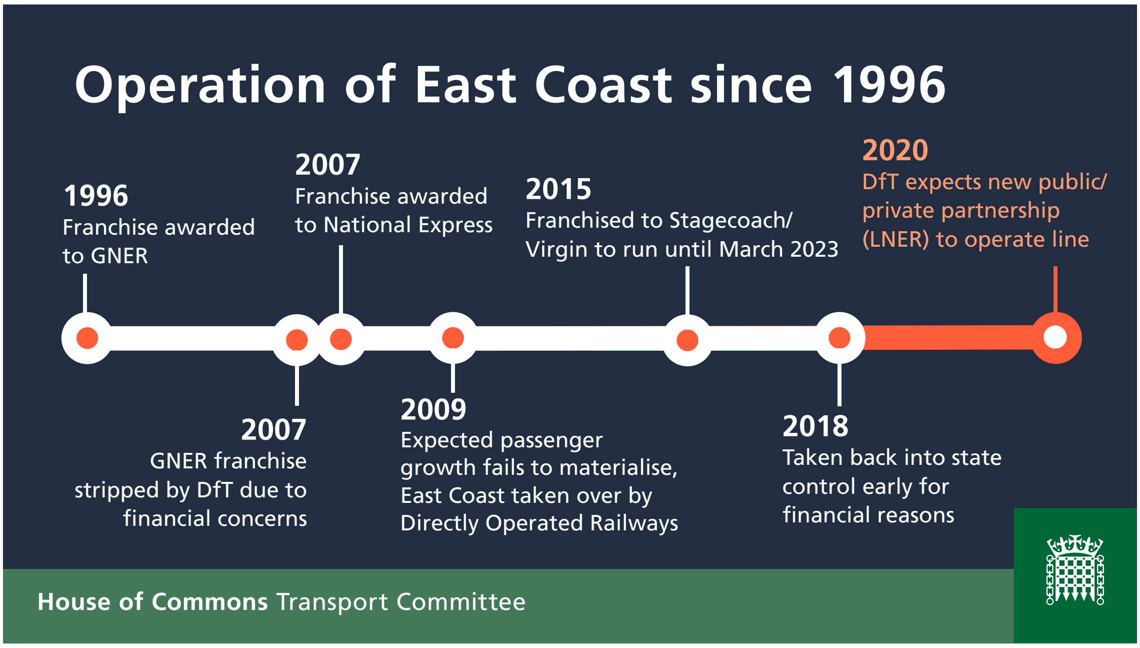
3. The DfT launched the consultation process for the now terminated ICEC franchise in June 2012.[3] The franchise procurement process commenced in March 2014, when the Invitation to Tender was made publicly available.[4] Bids for the ICEC franchise were received by the DfT in June 2014 and in November 2014, the DfT announced that it would let an 8-year franchise to Inter City Railways Limited, owned by Stagecoach Group and Virgin Group (90:10 split), under the brand name Virgin Trains East Coast (VTEC). Services under the franchise began in March 2015 and were contracted to run until March 2023.[5] At the time of changeover, the new franchise operated by VTEC was, according to the Government, anticipated to deliver more than £3 billion to the taxpayer.[6] This announcement was made by Ministers even though, at the time, they were aware that there was a considerable risk that the revenue projections would not be met (see Chapter 2).[7]

4. While there had been reports of financial troubles on the franchise,[8] the extent of the troubles only became known publicly when, in its preliminary results for 2016/17, Stagecoach Group made provision for losses of £84.1 million from VTEC over the subsequent two years.[9] With premiums set to increase substantially in the second half of the franchise, it became clear towards the end of 2017 that the franchise was not sustainable under the terms originally negotiated with the DfT. In November 2017 the Secretary of State announced that the franchise would be replaced by the East Coast Partnership in 2020 (see Chapter 4). While it was not explicitly stated by the Secretary

1 Transport Focus (ECR0009)
2 For full background, see: National Audit Office, *The InterCity East Coast Passenger Rail Franchise*, HC 824, Session 2010–11, 24 March 2011
3 Department for Transport, *Intercity East Coast franchise consultation launched*, 26 June 2012
4 Department for Transport, *InterCity East Coast rail franchise 2014: invitation to tender*, 21 March 2014
5 Department for Transport, *More seats, more services and new trains for East Coast passengers*, 27 November 2014; Railway Gazette, *3.3bn premium wins East Coast franchise for Stagecoach and Virgin*, 27 November 2014
6 Department for Transport, *New East Coast franchise starts*, 2 March 2015
7 Q252, Q259
8 The Telegraph, *Pressure on Stagecoach to defend East Midlands rail franchise amid 'renewal bulge'*, 1 March 2017
9 The Guardian, *Stagecoach says it has overpaid for East Coast rail contract as profitability plunges*, 29 June 2017

of State, this decision was a corollary of the financial troubles with the franchise[10] and, at that point, 'the operator of last resort'[11] had already been making contingencies for alternative operating arrangements.[12]

Figure 1: Timeline of East Coast since 1996



5. On 5 January 2018, the last of the parent company support was drawn down and on 30 January 2018 the franchise went into technical default.[13] In his statement to the House on 5 February, the Secretary of State announced that the franchise would "only be able to continue in its current form for a matter of a very small number of months", and that a decision would be made on interim operating arrangements in the following months. He had the option of enabling VTEC to continue operating on a not-for-profit basis, or to transfer operational control to the public sector via the operator of last resort. After a period of deliberation, during which a value-for-money assessment was completed, the Secretary of State announced that the franchise would be taken back under public control, via the operator of last resort, and be rebranded as London North Eastern Railway (LNER). Operational control of the railway was formally transferred from VTEC on 24 June 2018.

10 Q353
11 The Government, under the provisions of the Railways Act 1993, has an obligation to ensure that passenger services continue to be delivered, regardless of any eventualities with franchise contracts. The operator of last resort is effectively a team set-up by Government to ensure suitable contingencies are in place if, for whatever reason, an alternative operator is needed.
12 Q282, Q353
13 Q254, Q283

2 What went wrong with the franchise?

6. The East Coast franchise failed because the revenue projections underpinning the VTEC bid were over-optimistic. The reasons as to why it overbid to the extent that it did, however, are not straightforward. The bulk of this chapter considers how and why Stagecoach overbid to the extent that it did, how the bid process was run by the DfT and whether there were any other factors at play, particularly with respect to Network Rail, that contributed to the premature termination of this franchise.

VTEC's management of the franchise

7. The day-to-day operations of the franchise were managed successfully by VTEC. This point was reiterated by almost all our witnesses[14] and, based on passenger satisfaction, it was amongst the highest performing long-distance franchises on the network, at 92%, compared to 86% for the rest of the long-distance sector.[15] In terms of punctuality, VTEC, just prior to its termination, was toward the lower end of the performance range when compared with other franchised operators, with an average public performance measure (PPM)[16] of 81.5% over the preceding year. The national average PPM was 87.8%. While it is still an important issue for passengers, punctuality is arguably not as an acute issue on this part of the network,[17] particularly when compared with other commuter parts, where passengers are much more time sensitive. The fact that passenger satisfaction remained high indicated that VTEC handled any delays reasonably well.[18]

8. In terms of VTEC's operational finances, the franchise made an operational profit of around £260 million in the financial year prior to its termination.[19] £800m in premium payments were paid to the taxpayer over the life of the franchise prior to its termination and VTEC, on average, contributed 20% more per rail period[20] to the tax payer compared to when the franchise services were operated by DOR between 2009 and 2015.[21] Stagecoach told us that, of a total of £140 million committed to at the bid stage, it had invested around £75m in the franchise in three years.[22] The DfT acknowledged that as an operating business, the franchise was in good shape and commercial revenues more than covered the direct costs of the train business.[23]

The bid process and contractual arrangements

Revenue projections led to default

9. Despite the reasonable performance of VTEC in running this franchise, Stagecoach and Virgin, as part of their bid, forecast considerably higher revenue growth for this franchise than was eventually realised, with revenues growing at around 3% per annum,

14 Q80, Q81, Q196, Q227
15 *National Rail Passenger Survey*, Transport Focus, Autumn 2017 wave; Transport Focus (ECR0009)
16 The public performance measure (PPM) shows the percentage of trains which arrive at their terminating station within 5 minutes (for London & South East and regional services) or 10 minutes (for long distance services).
17 Q52
18 Q53
19 Public Accounts Committee, *Rail franchising in the UK*, Thirty-Fifth Report of Session 2017–19, 27 April 2018
20 There are fourteen rail periods per financial year.
21 East Coast Railway Line: *Written question - 118670*
22 Q167
23 Department for Transport (ECR0011)

compared with unprecedented[24] forecasts of around 10% per annum at the time of its bid.[25] Thus, the operating surplus generated by VTEC did not fully cover the premium obligations it had with the DfT as part of its franchise contract (see table below). To cover these premium obligations, VTEC had to forego the £165 million parent company guarantee it committed to the DfT when the franchise was let. This is a substantial sum for the main parent company (Stagecoach Group PLC), which has a market capitalisation of around £800m.[26] Stagecoach were thus running at a net contractual loss and, given that contracted premium payments were expected to rise significantly, the franchise was no longer viable under the contract originally agreed with the DfT. The contract was subsequently terminated by the Secretary of State and as he put it, "it failed because it ran out of money".[27]

Table 1: VTEC contracted franchise payments

Year	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
premiums £m	276.1	339.8	351.7	319.5	416.7	507.9	584.5

10. It was not immediately clear to us how VTEC got their revenue projections so wrong. In their submission, VTEC said that their bid was based on the "latest economic indices forecasts, provided to all bidders by the DfT and produced by the Office for Budget Responsibility." They also stated that their bid was classed as being of "low financial risk" by the DfT during their formal risk evaluation process.[28] The DfT corroborated this, saying that "VTEC submitted a bid that was assessed as reasonable in the economic climate of 2014, based on their best judgement of projected revenues and passenger growth."[29]

11. Passenger and revenue growth on this franchise is affected by what is happening in the wider economy.[30] VTEC identified several macroeconomic and external factors which contributed to the revenue shortfalls of the franchise, including:

a) the decline in fuel prices, which according to Neil Micklethwaite, Commercial and Business Development Director of Stagecoach Group, went from around £1.40 at the pump to around £1. He believed that, combined with a rise in rail fares, this meant the car was a "more attractive" travel option.[31]

b) a significant slowdown in GDP growth;

c) average weekly earnings grew at a slower rate than Stagecoach and Virgin expected;[32] and

d) Brexit and terrorism risks damaged consumer confidence and people's appetite for travel.[33]

24 Q373
25 The Sunday Times, *Is this any way to run the East Coast railway?*, , 7 January 2018
26 Stagecoach Group (ECR0004)
27 Q379
28 Stagecoach Group (ECR0004)
29 Department for Transport (ECR0011)
30 Q157
31 Q155
32 Q155
33 Stagecoach Group (ECR0004)

12. Martin Griffiths, Chief Executive of Stagecoach Group, also said that "structural changes in the market" affected revenue growth "in terms of people's propensity to travel both for employment and for social purposes."[34] The DfT, which is completing a programme of work to understand the slower than expected growth in passenger demand,[35] reiterated many of these points in its submission and in oral evidence.[36] Polly Payne, Director General of Rail Group at the DfT, recognised that "something structural is happening so that passenger numbers have not been increasing as fast as they had been in the previous decade", particularly with respect to changing work patterns and passenger habits.[37] One key point that emerged in oral evidence with the Secretary of State was that much of the early growth envisaged for the franchise had been predicated on the marketing initiatives under the Virgin brand.[38] These expectations, according to the Secretary of State, "were not met and that, more than anything else, is what caused the difficulties in the franchise."[39]

13. While passenger demand did not transpire as VTEC might have anticipated, the evidence suggests that the variation in these macroeconomic and external factors did not fall significantly outside normal ranges that might otherwise be expected in the economic cycle. To illustrate:

a) Stagecoach and the DfT, in their oral evidence,[40] seemed to pin much of the cause for the slower than expected passenger and revenue growth on an unexpected decline in petrol prices. As revealed in the figure below, petrol prices did indeed drop below levels realised prior to VTEC's bid submission; but they were not significantly below the longer-term average fuel price and were only below the long-term average for a period of around 18-months or so. Fuel prices have since recovered and remain on an upward trajectory.

34 Q133

35 The Department told the PAC that it has identified between 50 and 60 factors which impact the growth in passenger demand, including changes in working patterns towards more flexible working and a reduction in the number of people commuting five days a week into London. It told the PAC that the relatively low cost of petrol has also increased competition between rail transport and long-distance coaches and cars.

36 Department for Transport (ECR0011)

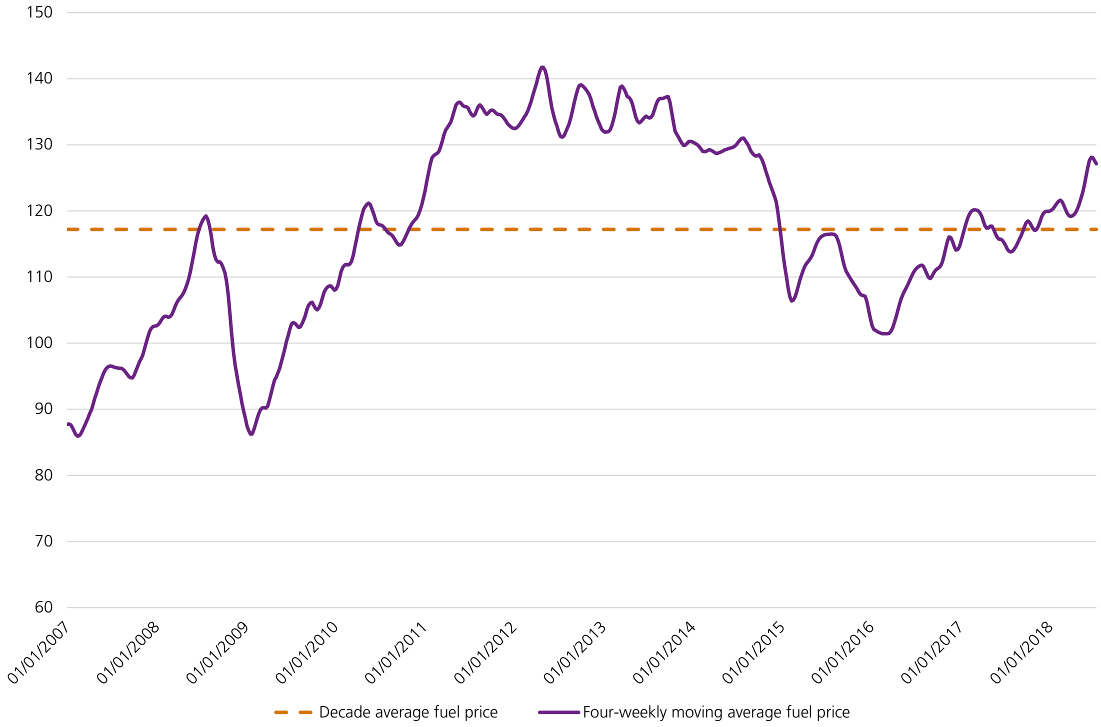
37 Q229

38 Q352

39 Q352

40 Q133, Q155, Q157, Q231

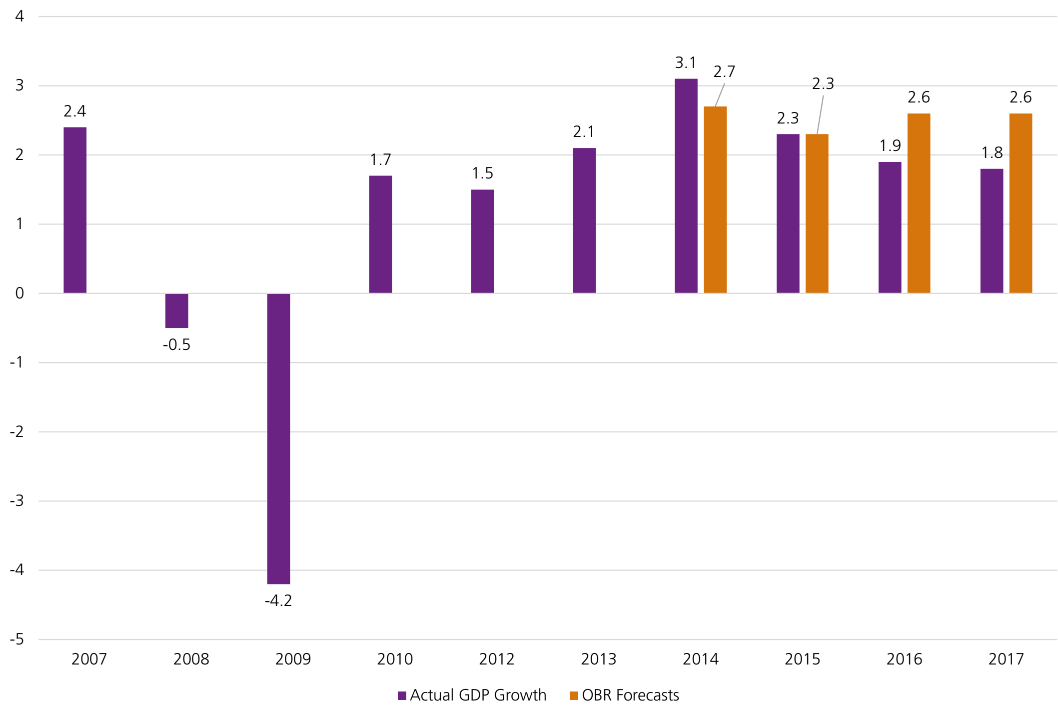
Figure 2: Average weekly petrol prices, pump price pence/litre, United Kingdom



Source: ONS

b) Similarly, economic growth has not been as muted as we might have been led to believe by Stagecoach's evidence. In fact, in the first year of the franchise, GDP growth was consistent with OBR forecasts that were made the prior year when VTEC's bid was submitted. GDP growth was more subdued in the subsequent two years of the franchise but was still positive and not remotely near recessionary levels.

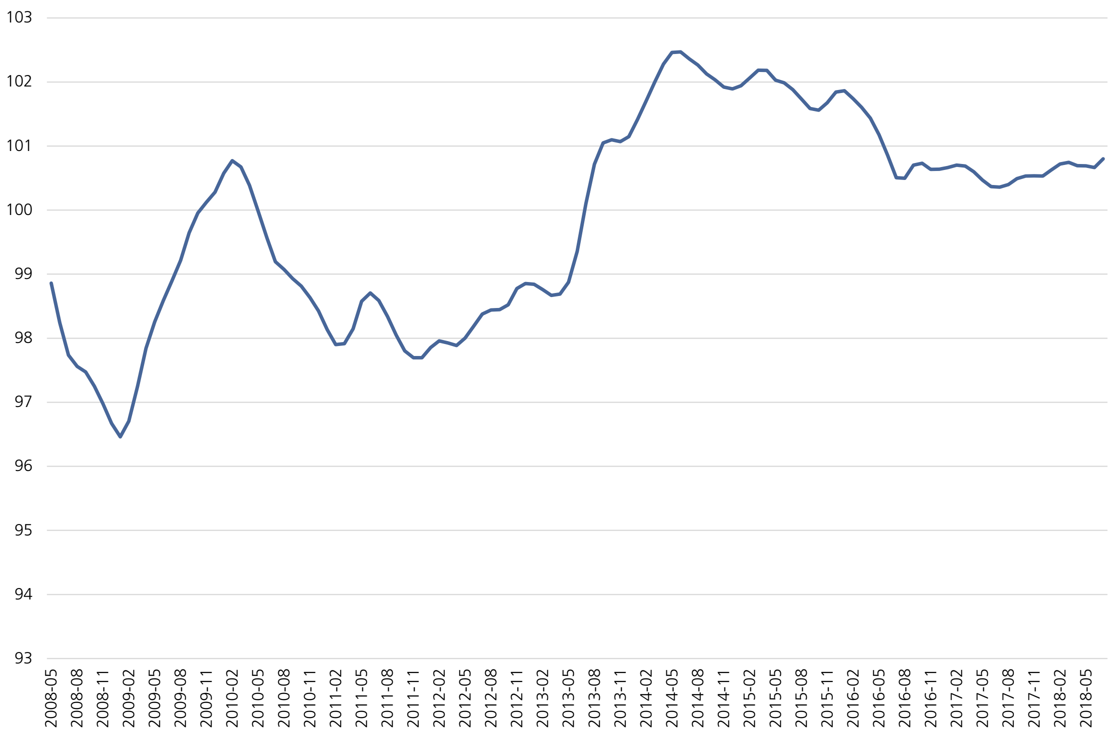
Figure 3: UK annual GDP growth, 2007–2017, vs. OBR forecasts



Source: ONS; OBR

c) Consumer confidence remains elevated when compared to the longer-term averages. While consumer confidence did trend down in the immediate period after VTEC took over operation of the franchise, it did not nosedive in a way that may not have been foreseeable at the bid-stage.

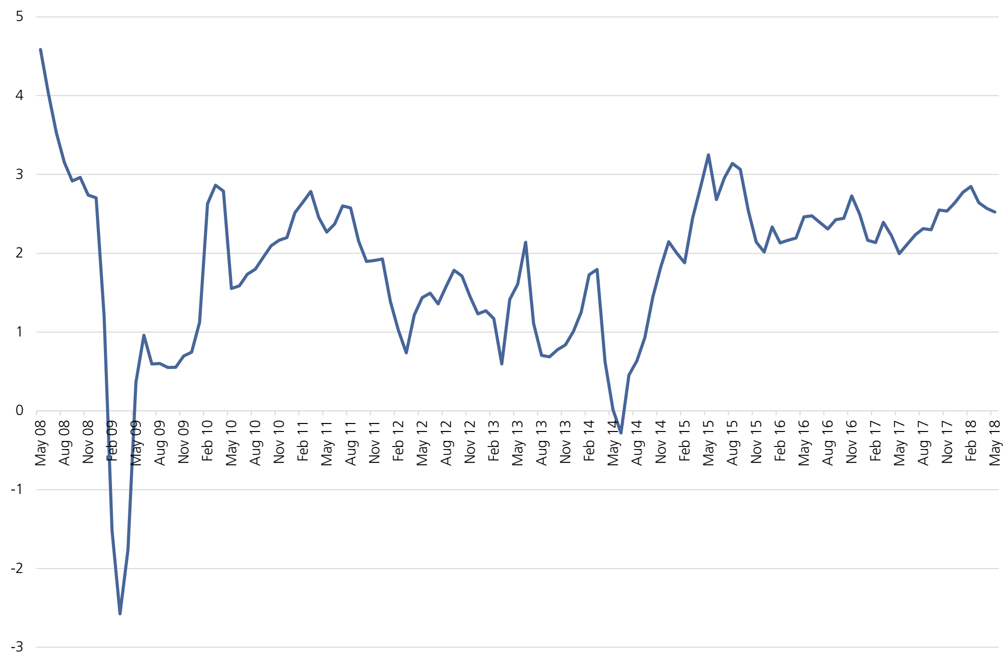
Figure 4: OECD Index of UK consumer confidence, 100 = long term average



Source: OECD

d) The growth in average weekly earnings in the UK were elevated in the period after VTEC took over operations when compared to the two-years prior.

Figure 5: Average Weekly Earnings - total pay, Great Britain (seasonally adjusted), annual change in three-monthly average



Source: ONS

14. The economic situation since the franchise was re-let has been more subdued than Stagecoach and Virgin might have desired or anticipated, but it was hardly a dire economic environment. This was acknowledged by the Secretary of State who said that "in this particular case, the collapse of VTEC cannot really be ascribed to a major economic shock or something similar, because there was not one at that period."[41] Revenues were behind expectations for the franchise at a very early stage of its operation[42] and it eventually failed after just three years of operation. **Franchises should be able to withstand normal fluctuations in the economic cycle. The fact that this franchise did not suggests that there was very little resilience built into the bid by Stagecoach and Virgin and it bid for the franchise on very optimistic grounds. This was naïve, and it should have been more aware of the financial risks involved, particularly given the history of this franchise and Stagecoach and Virgin's long history of bidding for and running franchises in this country. We conclude that Stagecoach and Virgin bear prime responsibility for the failure of this franchise.**

The DfT encouraged overbidding

15. While Stagecoach and Virgin were remiss in formulating their bid, because of the potential reputational and financial consequences, owning groups have no incentive to deliberately overbid. This was affirmed by Stagecoach in their written and oral evidence.[43] We asked whether the DfT deliberately encouraged overbidding.[44] It was clear from the evidence that the DfT did encourage ambitious bids for the ICEC franchise,[45] but the DfT said that they "did not actively encourage overbidding."[46] The DfT set out to secure the best deal for the taxpayer but the evidence suggests that the DfT encouraged overbidding by setting unrealistic benchmarks in the Invitation to Tender (ITT) and failing to include the boundaries in the bid process necessary to temper over-optimistic bidding. Specifically:

a) The rail timetable that was included in the ITT, and upon which the revenue projections were based, was unrealistic and was never confirmed as being deliverable by Network Rail to the timescale assumed;

b) There was no single set of realistic macroeconomic parameters upon which the bids could be based, and it was up to bidders to form their own view on wider macroeconomic eventualities;[47]

c) The stress-testing of the bids was not robust, and the rules of the tender meant that bids were not tempered by the prospect of bid evaluation against downside scenarios (discussed in section below); and

d) Bidders could propose an additional parental guarantee to support their ambitious revenue assumptions.[48]

41 Q361
42 Q255
43 Q126
44 That is, encouraging bids that are overly optimistic in terms of revenue expectations and which are unlikely to be deliverable or sustainable in practice.
45 Q14, Q16
46 Q226
47 Q24
48 Q14, Q18

16. In any realistic scenario, the bid the Department accepted could not be delivered. **We conclude that, while it is up to bidders to do their due diligence, and clearly Stagecoach and Virgin did not, the DfT encouraged over-bidding by setting unrealistic benchmarks in the Invitation to Tender (ITT) and failing to include the boundaries in the bid process necessary to temper over-optimistic bidding.** It is surprising the bid process was constructed in this way given the history of failure on this franchise resulting from over-ambitious revenue projections.[49]

17. **It is encouraging that the franchising system has now been adjusted to deter further optimism when bidding and is clearly recognition by the Secretary of State of the failings with this franchise bid process.**[50] For example, in almost every franchise competition the additional parental company guarantee has been capped, which puts a cap on how ambitious bidders can be about revenue.[51] The franchising system has also been adjusted by the DfT in terms of its future approach to stress-testing, macroeconomic risk and infrastructure assumptions in ITTs (discussed in sections below).

Stress-testing of bids by the DfT was insufficient

18. In the wake of the National Express failure in 2009, the National Audit Office (NAO) recommended the DfT conduct "robust stress testing of bids and franchises, against stressed economic scenarios like the recession experienced in 2008–09."[52] This was to identify potential weaknesses in the assumptions of franchise bids, so as to avoid similar franchise failures. It became clear during oral evidence that, while some downside testing was conducted by the DfT, the robustness of the bid was only evaluated against a single, central case scenario presented by Stagecoach and Virgin[53] and not in the way recommended by the NAO. Even against this more lenient evaluation, the DfT discovered that "revenue would be lower than [Stagecoach and Virgin] forecast"[54] and that there was not sufficient confidence in the financial robustness of the bid when downside scenarios were considered.[55] Given this, and knowing that there was a risk of franchise failure from lower than expected revenue growth,[56] it is not clear how the DfT still evaluated the Stagecoach and Virgin bid as "low financial risk"[57] and why they told the bidding group that the bid was "the best they had ever seen".[58] The Secretary of State conceded in oral evidence that "I certainly would never have assumed that it was a low-risk bid. In fact, I would have been very wary about accepting a high-risk bid on the line."[59]

19. As we know, the optimistic scenario that was initially envisaged by Stagecoach and Virgin did not come to fruition and revenues fell short of expectations. The fact that this franchise collapsed within such a short period and against a backdrop of a merely subdued economic environment, suggests that there was very little resilience built into the franchise bid. This is something that should have and could have been identified had

49 Q78, Q79
50 HC Deb, 5 February 2018, *col1238*
51 Q18
52 National Audit Office, *The InterCity East Coast Passenger Rail Franchise*, HC 824, Session 2010–11, 24 March 2011
53 Q231
54 Q231
55 Q244
56 Q231
57 Stagecoach Group (ECR0004)
58 Q125
59 Q374

appropriate financial robustness tests been completed. **We therefore conclude that the financial stress-testing of the bids by the Department for Transport was not robust enough and was inconsistent with the approach recommended by the NAO following the previous franchise failure in 2009.** It is encouraging to see that the Department have now revised their approach to bid evaluation for more recent franchise competitions,[60] which according to Simon Smith, Director for Policy, Operations and Change in Passenger Services at the DfT, will reduce the risk of default for future franchises.[61]

There need to be more appropriate risk sharing mechanisms

20. One of the recommendations from the Brown Review[62] was that "franchisees should be responsible for the risks they can manage and should not be expected to take external macroeconomic, or exogenous, revenue risk."[63] He added that:

> … there should be a clear mechanism to adjust franchise premium/support payments for variations in Gross Domestic Product and Central London Employment growth rates. Not taking exogenous revenue risk will enable franchisees to bid lower profit margins, so giving better value to Government.[64]

21. The reasoning behind this recommendation, as Martin Griffiths of Stagecoach explained during oral evidence, was that franchisees "had a fixed-cost base and therefore are very revenue dependent, so it is very difficult to take responsibility for all the macro factors that impact the revenue base."[65] He explained further:

> The point I was making is that this is a highly regulated, output-based contract. Let me make it simple for you. In theory, if I carried one passenger or 100,000 passengers, my costs are the same … If you are in the real world—if you want to call it that—and you are a house builder and demand drops away, what do you do? You cut the supply. On these types of contracts, you cannot; the supply is fixed, so the revenue is extremely important. That is why, on some of these contracts, the Government have shared in the macro risk.[66]

22. This recommendation was not incorporated by the DfT in the way that the review prescribed by Brown.[67] We heard conflicting views about what the exact macroeconomic risk sharing arrangements were for this franchise. According to Mr Griffiths, "there was no risk-sharing of downside, macroeconomic or any other, so the operator took the financial risk";[68] though that risk was capped at an agreed amount when the contract was signed. Polly Payne of the DfT said that for the ICEC franchise there was a GDP mechanism in place, which "is a risk-share mechanism, such that when GDP changed,

60 Q12, Q243
61 Q315
62 The Brown Review was commissioned in response to the failed re-let of the West Coast franchise in 2012 and examined the wider rail franchising programme, looking in detail at whether changes were needed to the way risk was assessed and to the bidding and evaluation processes.
63 Department for Transport, *The Brown Review of the Rail Franchising Programme*, January 2013
64 Department for Transport, *The Brown Review of the Rail Franchising Programme*, January 2013
65 Q152
66 Q158
67 Q23, Q24
68 Q132

and that impacted revenues out of certain bounds, the DfT took some of the risk and the franchise took some of the risk."[69] But there was no such mechanism covering oil prices,[70] which was, according to both Stagecoach and the DfT, one of the main determinants behind the revenue shortfalls. **Had a more comprehensive macroeconomic risk-sharing mechanism been implemented, as per the Brown Review recommendation, there might have been a chance that this franchise would have avoided premature termination.**

23. Both Nicola Wood and Iryna Terlecky, rail consultants, raised doubts as to whether the right approach has been taken by the DfT with respect to the distribution of macroeconomic risk in franchising. The rationale behind their position was that rail franchising is privatisation within "very tight parameters" and is more akin to a public/private partnership.[71] They believe that the risk will always come back to Government because it had "the deepest pockets".[72] Ms Wood suggested that given the risk would always end up with Government, it may be better off accepting it from the start.[73]As Ms Telecky said, the decision around risk-sharing in franchising ultimately comes down to how much Government values market stability.[74]

24. In oral evidence, the Secretary of State said that the West Coast Partnership, Southeastern and Midland Main Line franchises all have new mechanisms in place for risk sharing. He added that "I would not personally go back to the exact system that was there before."[75] On this point, Simon Smith of the DfT clarified that a forecast revenue mechanism (FRM) had since been implemented when letting new franchises, which:

> ...in effect, shares revenue variation risk outside a nil band either side of the bid revenue, usually 4%, and if revenue varies by more than 4% from the original bid forecast, 80% of that risk is covered by the Department. At the same time, if revenue support becomes payable under that mechanism, contractual incentive mechanisms start to apply, so the franchisee still has a strong incentive to deliver a good service for passengers, a high-performing service, and to grow revenue.[76]

25. ***We recommend that the Department clarify, in detail, exactly what its current and future approach to macroeconomic risk-sharing is, in doing so, it should make clear how it has implemented the relevant Brown Review recommendations.***

The Department had no other option than to let the franchise default

26. It is important to note that the financial picture was bleak from day one when VTEC began operations.[77] In the subsequent nine-month period between the franchise being bid for and then taken over by VTEC, the underlying financial assumptions behind their bid deteriorated considerably.[78] In short, they were playing catch up.

69 Q273
70 Q244
71 Q34
72 Q31
73 Q29
74 Q29
75 Q421
76 Q274
77 Q20, Q249, Q255
78 Q20

27. Knowing that the financial picture was bleak from the beginning of this franchise, it might have been a simpler for the DfT to find an early contractual solution to this problem. One option might have been to rebase the revenue forecasts at the beginning of the franchise, that is, to adjust bid assumptions for the macroeconomic changes that occurred in the intervening period between bid award and takeover. This option was raised with the DfT by Stagecoach, but at the time the franchise was let, the DfT had a policy of not renegotiating franchises once they had been let.[79] This was to preserve both the financial interests of the taxpayer and the integrity of the wider franchising market. There were also no material changes in the wider economic environment (e.g. a recession) to warrant rebasing.[80] Renegotiation of the contract with VTEC may have set a precedent for other operators in similar financial positions.[81] As the Secretary of State said, "it undermines the credibility of the system if you simply let somebody get away with a failure of this kind."[82] Lord Adonis explained that this was the key motivation behind his decision in 2009 not to renegotiate with National Express after its failure.[83] The NAO also commented in 2009 that "any change to the terms of the contract would encourage other franchisees to seek similar treatment."[84] As such, the contract was not rebased and the DfT instead simply waited for Stagecoach to draw down its parent company support until it eventually defaulted. **Because of the potential implications for the wider franchising market, we conclude that the Department had no alternative but to adhere to its policy of not renegotiating franchises and to let the contract run its course to default.**

The taxpayer has not bailed out Stagecoach and Virgin

28. Various reports of a bail-out emerged after it appeared and was then confirmed that the VTEC contract would be terminated prematurely. The franchise has not delivered the premiums to the taxpayer that were originally envisaged when the franchise was let. However, **based on the contract that was originally agreed with the Government, the taxpayer has not bailed out Stagecoach and Virgin. This is because Stagecoach and Virgin had their liability capped at £165 million, which was the amount they committed to the DfT though their parent company guarantee.**[85] It is unlikely that Stagecoach, or any prospective bidder for this franchise, would have signed up to deliver those premiums had the liability not been capped. The DfT, without conducting the necessary due diligence on the robustness of the bids, agreed to a contract that had unrealistic revenue expectations. With it, came the risk that it could collapse and that it would only be able to recoup a limited amount of the premiums that were originally agreed.

Network Rail's role

Delayed infrastructure works on the East Coast Mainline not to blame for default

29. VTEC's original revenue expectations for the franchise were predicated on an enhanced timetable being delivered from 2019 onward, underpinned by new rolling stock

79 Q26, Q251
80 Q383
81 Q251, Q253
82 Q383
83 Q82
84 National Audit Office, *The InterCity East Coast Passenger Rail Franchise*, HC 824, Session 2010–11, 24 March 2011
85 Q156, Q253

and accompanying infrastructure enhancements. In January 2018, Sir Richard Branson blamed part of the franchise failure on Network Rail and their delays in delivering the required enhancements for the new 2019 timetable. He claimed that the £3.3 billion bid was "based on a number of key assumptions" which have not come to fruition. He further claimed that "poor track reliability" cost VTEC "hundreds of millions of pounds and torpedoed the assumptions of our original bid".[86] This was a cynical attempt to divert attention from Virgin and Stagecoach's failures. This resulted in confusion around what was promised to be delivered in terms of infrastructure upgrades on the East Coast Mainline and by when, and whether any delays to infrastructure upgrades contributed to the early termination of this franchise. The Chair of the Committee wrote to both Network Rail[87] and VTEC[88] seeking clarity on these points.

30. **Network Rail** said there were three essential elements to ECML infrastructure works to enable substantial capacity improvements, with the first two essential for the new Intercity Express Programme (IEP) trains:

a) the East Coast Capability for IEP scheme;

b) the East Coast Power Supply Upgrade scheme; and

c) the East Coast Connectivity Fund.

31. The East Coast Capability for IEP has been completed on the entire ECML to Edinburgh, except for Edinburgh Waverley station, work on which is ongoing. East Coast Power Supply Upgrade had been planned in two parts: first from Wood Green to Bawtry (near Doncaster); then further north to Edinburgh. Network Rail said the first part had been "completed in August 2017 to budget and programme." Funding for the second part of the works, however, had not been included in the settlement for Control Period 5; consequently, they had not yet been programmed.[89] In relation to the East Coast Connectivity Fund, Network Rail claimed that "at the point the East Coast franchise was bid for and awarded" it was "at an early stage of development and funding for delivery had not been committed to individual projects." Moreover, it had not "specifically defined outputs in terms of quantum of increased capacity." It claimed this was made clear to all bidders. Network Rail said it "had not been asked to endorse the final assumptions used by the successful bidders."[90] On 23 July 2018, the Prime Minister confirmed that £780 million would be made available to finish the upgrades that were initially planned for the ECML.[91]

32. **VTEC** claimed that at the time of bidding, all necessary works to enable the new rolling stock and enhanced timetables from May 2019 had been scheduled for completion during CP5.[92] In oral evidence, Neil Micklethwaite, of Stagecoach, said that the ITT and the subsequent contract that was signed with the DfT "had a transformational timetable

86 Virgin, *Clarity on Virgin Trains East Coast media reporting*, 5 January 2018
87 *Correspondence between the Chair of the Transport Select Committee and Rob McIntosh of Network Rail*, 15 January 2018
88 *Correspondence between the Chair of the Transport Select Committee and David Horne of Virgin Trains East Coast*, 15 January 2018
89 *Correspondence between the Chair of the Transport Select Committee and Rob McIntosh of Network Rail*, 15 January 2018
90 *Correspondence between the Chair of the Transport Select Committee and Rob McIntosh of Network Rail*, 15 January 2018
91 Prime Minister's Office, *Cash injection for Northern Powerhouse as Cabinet visits North East*, 23 July 2018
92 As outlined in the CP5 determination documents.

for May 2019 that was predicated on a number of infrastructure enhancements being delivered by the end of 2019."[93] He also said that the infrastructure enhancements were in the Office of Rail and Road's final determination for CP5. With respect to the timetable that was specified in the ITT, Simon Smith of the DfT commented:

> The franchise specification reflected the best view at the time of the infrastructure that was expected to be delivered on the east coast. Clearly, subsequent to the franchise competition, we had the Hendy review and the changes to the enhancements programme that have resulted in changes of expectation around when some of the projects will be delivered.[94]

33. VTEC acknowledged that Network Rail "has mostly delivered the infrastructure which was due to be completed by now" but "future infrastructure enhancements and upgrades [are] comprehensively delayed, some without a new implementation date at all."[95] Mr Griffiths did acknowledge in oral evidence that the delays to the infrastructure upgrades were not responsible for the early termination of the franchise.[96]

34. When asked if Network Rail's programming of infrastructure work had played any part in the VTEC failure, the **Secretary of State** said there would "potentially" be infrastructure issues "down the track", but the current difficulties were "way before we get to that point".[97] The Government said that "from the start of this franchise to date, all infrastructure upgrades planned for the East Coast have been delivered."[98] The failure of the franchise up to this point was, according to the Secretary of State because VTEC had "overbid" for it[99] and in oral evidence, said that "I would not blame Network Rail for the failure of the franchise."[100]

35. **Sir Richard Branson's comments in January 2018 left the initial impression that the delay to assumed infrastructure enhancements contributed to the early termination of this franchise. We conclude that Network Rail do not bear any responsibility for the early termination of this franchise. To date, Network Rail have provided all the infrastructure upgrades that it had formally committed to when this franchise was let. A series of other upgrades were assumed to occur by the DfT and VTEC to deliver an enhanced timetable from 2019 onward; though there was no formal funding commitment to these upgrades when the franchise was let. The delivery of these enhancements will now occur but later than was initially anticipated by the DfT and VTEC. This delay would have undermined assumed revenue growth from 2019 onward but did not directly contribute to the early termination of this franchise.** This would have forced a change in the contract negotiated between the DfT and VTEC;[101] Mr Smith of the DfT said that there are already mechanisms embedded in the franchising process to enable contract changes from altered infrastructure enhancements.[102]

93 Q175
94 Q297
95 Stagecoach Group (ECR0004)
96 Q143
97 Q90, 22 January 2018
98 East Coast Rail Franchise: *Written question - 125443*
99 Q90, 22 January 2018
100 Q438
101 Q166
102 Q302

36. The DfT is responsible for specifying the assumed timetable in the ITT, which included an unrealistic timetable for infrastructure upgrades. **We therefore conclude that the Department for Transport are responsible for the confusion around what infrastructure enhancements on the East Coast Mainline were going to be delivered, and when, throughout the life of the East Coast franchise.** In specifying the ITT, the DfT should have been aware of the risks involved in delivering the franchise timetable it specified in the ITT, particularly given that the funding had not been committed and there were wider infrastructure enhancement issues happening in parallel elsewhere on the network. Network Rail claims to have provided transparent advice to the bidders around exactly what and was not deliverable and in doing so, fulfilled its obligations during the franchising bidding process. Importantly, though, they were not provided with formal sign-off during the bid process, which might have rectified such confusion before a contract was agreed. **We conclude that there was a failure from the Department in not providing Network Rail with formal sign-off of the infrastructure assumptions for the East Coast franchise.** ***We recommend that the Department for Transport clarify exactly what role Network Rail now have in the bidding process and recommend that, if it is still not the case, their relevant representatives have formal sign-off of any bids prior to a successful bid being decided. More generally, we would like to see much closer alignment between the invitation to tender in the franchise agreement and Network Rail's planned enhancements. The DfT has responsibility to ensure all parties to the franchise bid process are aligned and have equal and accurate sight of what infrastructure upgrades are planned.***

37. The Government has adopted a new approach to the way enhancements will be specified, funded and completed on the network. As opposed to this occurring as part of the control period process, there will now be a rolling programme of enhancements, otherwise known as the 'enhancements pipeline'.[103] Stagecoach and Network Rail both said that there needed to be a clear methodology for making sure contracts could be flexibly changed in the future in response to the additional uncertainty associated with the enhancements pipeline.[104] It is not clear whether the change mechanisms referred to by the DfT are sufficient to manage this additional uncertainty. ***We recommend that the Department outline how it will specify future infrastructure enhancements in the invitations to tender and what change mechanisms it has in place and whether they can cope with any uncertainty arising from the enhancements pipeline proposals.***

Network Rail performance poor but not significantly contributable to default

38. VTEC initially identified Network Rail's "sustained poor performance of the network", which between June 2015 and June 2017 fell below contractual thresholds under the track access agreement, as a reason for the financial difficulties it had on the franchise. They said this "clearly put passengers off travelling".[105] Network Rail acknowledged in their written[106] and oral evidence[107] that their performance in managing the ECML had not been up to standard. While this clearly undermined franchise performance, it

103 For full information, see: Department for Transport, *Rail Network Enhancements Pipeline: A New Approach for Rail Enhancements*, March 2018
104 Q184, Q209
105 Stagecoach Group (ECR0004)
106 Network Rail (ECR0010)
107 Q171

was not on a scale that led to VTEC defaulting on their contract. Additionally, as Mr Griffiths of Stagecoach acknowledged, these infrastructure performance issues were dealt with through “normal industry mechanisms”,[108] including the schedule 4, schedule 8 and sustained poor performance mechanisms, which remunerated VTEC. At the point of franchise termination, VTEC had a claim against Network Rail for £72 million for sustained poor performance, the quantum which is now being contested between Network Rail and the new operator, London North Eastern Railway.

108 Q135

3 Interim operating arrangements

39. In his statement to the House on 5 February, the Secretary of State confirmed that the East Coast franchise would "only be able to continue in its current form for a matter of a very small number of months and no more."[109] Faced with the impending termination of the VTEC contract, the Secretary of State had the option of either:

a) allowing VTEC to continue to operate services under a "short-term" and "not-for-profit" arrangement; or

b) returning the East Coast franchise to the direct control of the DfT, which in practice meant asking Arup, SNC-Lavalin Transport Advisory (InterFleet) and Ernst & Young to run the services as they were now the 'operator of last resort' following the winding up of Directly Operated Railways in 2015.

40. Either option was only intended to be an interim measure until 2020, at which point the East Coast Partnership is intended to be operational. To inform his decision, the Secretary of State commissioned a value-for-money assessment of these options and that the eventual decision would be:

> ...based on a number of criteria, including which option returns most money to the taxpayer, the risks attached to each, and the value of any improvements in passenger services. I will also have regard to the effect of my decision on other franchises. The decision will be taken in a transparent way; the Department's assessment of the option will be published and it will be properly validated.[110]

41. In his statement to the House on 16 May 2018, the Secretary of State informed the House that he would terminate Virgin Trains East Coast's contract on 24 June 2018 and bring operations back under public ownership via the operator of last resort.[111] At the same time, he published the DfT's Short-term Intercity East Coast train operator 2018 options report.[112]

42. The options report indicated that the transition to operator of last resort would be slightly more complicated and costlier than the VTEC arrangement. For example, it said that VTEC was better placed to implement the new rolling stock on the network because it had gained embedded knowledge through three years of running operations, infrastructure, control systems and their involvement in the design, testing and optimisation of the new trains.[113] In terms of value for money, the report stated that "both options are likely to offer comparable value for money".[114] In terms of premium for the taxpayer, it said that under either option the business revenues were estimated to reach around £2bn over the period of interim operation and the forecast income or premium for taxpayers was estimated at around £250 million.[115]

109 HC Deb, 5 February 2018, *col1238*
110 HC Deb, 5 February 2018, *col1238*
111 HC Deb, 16 May 2018, *col285*
112 Department for Transport, *Short-term Intercity East Coast train operator 2018 options*, May 2018
113 Department for Transport, *Short-term Intercity East Coast train operator 2018 options*, May 2018, p.15
114 Department for Transport, *Short-term Intercity East Coast train operator 2018 options*, May 2018, p.29
115 Department for Transport, *Short-term Intercity East Coast train operator 2018 options*, May 2018, p.21

43. The balance of operational risks and potential benefits of the options, according to the Secretary of State, was "finely balanced",[116] as was the impact for the taxpayer.[117] In oral evidence he explained the rationale behind his decision:[118]

> It was a judgment for me based on two things. The first was that I did not want to be seen to reward corporate failure. This Committee and others would have criticised me for doing that. The other point was that it makes it easier to migrate to the East Coast Partnership, because it can become a process of evolution, not revolution on a single date in 2020. We can start to mesh the two teams together now. We can create joint ways of working. We can begin to plan the railway together, so we can evolve the LNER into the east coast partnership rather than simply waiting for a handover date in 2020, which would otherwise have been the approach. For those two reasons, I judged that it was the right thing to follow the OLR route.[119]

44. The transfer took place on 24 June 2018 and seems to have gone relatively smoothly thus far, although it is too early to tell what the exact impact the change in management and branding will eventually have on the franchise operations and on passenger growth. It is still unclear exactly how long the current operational arrangements will last and when the new partnership will be put out for tender. The initial expectation was for the partnership to take over from 2020. This always seemed optimistic given that a typical franchise competition, which this is partnership is not, takes between two and two and a half years to run. This includes working out what the specification might be, working out the costs, writing the ITT, receiving the bids, awarding the franchise and then finally commencing the takeover of operations.[120] Further, the Government has not yet decided how it will run the tender process for the Partnership.[121] The 2020 Partnership start date has now started to shift and according to the Secretary of State, "is now no longer set in stone in the way it was ".[122]

45. One of the risks with the uncertain interim arrangements is that investment and other initiatives typically undertaken by the private operator may be delayed, particularly if there are complications the East Coast partnership. Delayed investment was a by-product of what happened when the public sector took over after the failure in 2009.[123] Directly Operated Railways was initially only anticipated to run for two years but ended up being in place for over five years. In this time, investment was delayed until the 'more permanent' operating arrangements were in place. Delays and uncertainty around the future operating arrangements also create unnecessary uncertainty for staff on the network. There is a risk of this uncertainty slowly undermining performance and passenger satisfaction for this franchise, which up until this point had been good. **While it is too early to know whether the decision to transfer control to the operator of last resort was the right one, we regret there is a lack of a clear plan or timescales upon which the interim operator will run the franchise.** ***We recommend that the Secretary of State outline the exact timescale for the interim operator and clarify exactly how operational and investment risks will***

116 HC Deb, 16 May 2018, *col285*
117 Q381
118 Q381
119 Q378
120 Q63
121 Q411
122 Q414
123 Q110

be managed until the longer-term Partnership arrangement is in place. We are not aware of the existence of formal obligations and targets for the operator of last resort for the Intercity East Coast franchise. We recommend that whenever the operator of last resort arrangement is invoked, the DfT should revise and publish obligations and targets for the operation of the failed franchise by the operator of last resort, in order to provide passengers, taxpayers, Parliament and industry certainty of its business plan, strategy and development plans. This should be done within six months of assuming responsibility for a franchise.

4 The East Coast Partnership

46. The DfT is developing plans to launch the East Coast Partnership (ECP) on the East Coast Mainline "as the first of the new generation of long term regional partnerships bringing together the operation of track and train under a single leader and unified brand."[124] At the start of our inquiry, the exact plans for the Partnership were not clear. In oral evidence, the Secretary of State elaborated that he expects:

> … it to be a single team—either a contractual or corporate joint venture. We will probably talk more about a contractual joint venture. The entity that is created will have one boss responsible for the train and the tracks, and will have a team of track engineering types and a team of train people working for him or her, but a joint team will be running it.[125]

47. In terms of whether they Network Rail and the operator would be financially integrated, Polly Payne of the DfT said:

> … we would not be hoping to have a single balance sheet or do anything very complicated in that way because of that experience. We would be looking more at trying to incentivise management incentives, KPIs and balance score cards.[126]

48. Both Network Rail[127] and Stagecoach[128] said they are supportive of the ECP proposal, with the latter of the view that "full route-level devolution will be required to deliver the step change needed … but [this] has not yet happened."[129] The Secretary of State agreed that route devolution[130] was needed to make the ECP "operationally workable".[131] When pressed on their reasons for supporting the Partnership proposal, Network Rail and Stagecoach said they supported the principle of more integrated working but did not know how it would work, or whether it would be a success or not.[132] While Lord Adonis accepted that while there was merit in a partnership approach, he was critical of the lack of clarity around the proposal and said that there could be considerable costs in planning for this, particularly if it is mishandled:

> It is an entirely back-of-the-envelope plan for a public/private partnership. Nobody can define it or has the faintest idea of its elements. Vast payments will be made to consultants and others to try to turn that into some kind of reality within 18 months. I doubt that is possible because I suspect that the east coast public company will end up being in existence for a lot longer but with a constant sentence of death over it, which will not give it a fair run.[133]

124 Department for Transport (ECR0011)
125 Q416
126 Q313
127 Network Rail (ECR0010)
128 Stagecoach Group (ECR0004)
129 Stagecoach Group (ECR0004)
130 Route devolution is the proposal to decentralise powers and decision-making to the Network Rail route level.
131 Q386
132 Q203
133 Q81, Q86

49. This is not the first time that a form of 'partnership' arrangement has been attempted on the UK network. For example, in April 2012, NR entered a 'deep alliance'[134] with South West Trains (operated by Stagecoach), putting in place a single joint management team responsible for infrastructure and train operations on NR's Wessex Route. In terms of what the alliance delivered, Martin Griffiths of Stagecoach commented:

> We got a single chain of command. There was one management team. We took a lot of day-to-day disruption and incident management down significantly. One of the questions was about conflict of interest. We managed that; there was no conflict of interest.[135]

50. He acknowledged that, at the time, there was a desire to financially integrate the operations, which was very difficult[136] and was eventually the reason why the deep alliance ended in June 2015.[137] Mr Griffiths said that these were issues that would remain with any Partnership form and ultimately it comes down to how much the operations can be financially integrated.[138] Rail consultant Iryna Terlecky was critical of the proposal on the financial grounds:

> I am not sure that there is necessarily a huge amount of logic in it. What Network Rail does in terms of looking after the infrastructure, it does very well. Train operators have a completely different outlook on the railway and passengers, and a completely different economic structure. It is not clear to me how you can ever squeeze those two things back together.[139]

51. One of the other main limitations of deep alliancing or partnership approaches is that, where there are multiple operators on a route, Network Rail is unable to establish deeper commercial relationships with a TOC. This is because it has an obligation to manage relationships with TOCs in a non-discriminatory manner. The ECML is part of London North Eastern and East Midlands (LNE & EM), which is a devolved route business within Network Rail. Franchised operators of intercity, regional and commuter services, as well as open access[140] and freight operators, also use the ECML. Current operators on the ECML include: CrossCountry; East Midlands Trains; First TransPennine Express; Grand Central; Great Northern; Hull Trains; Northern; and Virgin Trains East Coast.[141] Iryna Terlecky told us:

> I have no idea how it might work. I have to say that, if I was doing this kind of partnership, I would not do it on east coast. It seems completely counter-intuitive.[142]

52. The Secretary of State, in oral evidence, also conceded that "if you were starting off a strategy of joining up track and train on a blank sheet of paper, this is not the place you

134 A "deep" alliance can be defined as one in which one of Network Rail's routes (or potentially part of a route) and a train operator share upside and/or downside risk against an agreed baseline for all or most of their activities.

135 Q199

136 Q199

137 Q200

138 Q201, Q202

139 Q66

140 A train operating company not subject to the franchising process which instead purchases individual paths on the East Coast Main Line from Network Rail

141 Network Rail, *London North Eastern and East Midlands*, accessed 25 April 2018

142 Q61

would start."[143] Lord Adonis believed that "all the decisions [will be] made to prioritise [the partnership] services, including decisions on engineering works and the phasing of investment"[144] Jo Kaye of Network Rail said that these decisions would be taken by the system operator, which are dictated by the track access codes and the codes that are in place in the industry.[145] But Rob McIntosh, Route Managing Director of Network Rail's London North Eastern and East Midlands Route, expressed concerns about what it might mean for the operations on the network:

> The reason people say the east coast is not the best place to do that is the multi-operator nature of it. It is a large piece of railway that we have to operate, and I have a large number of customers. What people are concerned about is that the day-to-day operations become affected by this, and what would be called regulating policy—whose train gets to go first, on a particular day in a particular situation—starts to get clouded by that.[146]

53. Iryna Terlecky also said:

> One of the things that concerns me about the idea of an east coast partnership is that, in chasing something that is inherently very complex and very difficult to achieve, some of the good things might fall by the wayside, which are about continuing cultural alignment and the one industry way of working that can be done anyway.[147]

54. **We conclude that greater joint-working and clear lines of accountability through a single person responsible for track and trains offers potential for significant improvement in services. The mechanics and complexity of the current financial and regulatory environment has meant that all previous attempts to establish deep alliances have not worked. It is not yet clear how the East Coast Partnership will more successfully overcome the systemic difficulties presented by the current financial and regulatory environment. Based on the current framework, we conclude that the East Coast Partnership is unlikely to provide scope for the step-change in performance that the Secretary of State might be anticipating. This proposal also risks adding an additional layer of complexity to this part of the network. Passengers will ultimately bear the risk if this proposal goes wrong. This seems to be an unnecessary risk on this part of the network, particularly given that passenger satisfaction is already relatively high at 92%.** ***We recommend that any review of franchising should consider what change would be needed to the financial and regulatory framework to make partnership working a viable and sustainable model for operating the railway in the future. We recommend that the Department set a timetable for publishing the detail of how it expects the East Coast Partnership will work.***

55. Decision-making should be based on a clear plan and a transparent assessment of that plan. In this instance, neither of those things have occurred and we are concerned that future operations on a major part of the UK's network will be captive to a concept absent of a plan or an assessment. ***Before experimenting with this Partnership, we recommend the Secretary of State lay out in detail how the new approach will work***

143 Q397
144 Q118
145 Q191, Q213
146 Q190
147 Q64

and conduct a proper assessment of its feasibility against those plans. This assessment needs to demonstrate that his proposal will offer better value for money for the taxpayer and better outcomes for passengers than other ways of operating. We recommend the Secretary of State review his decision to go-ahead with this partnership based on the findings of this assessment.

5 Wider franchising issues

56. The East Coast franchise is the latest in a series of high-profile failings of the DfT-led franchising system, which have resulted in several reviews and inquiries.[148] Arguably the most notable failing was with the re-let of the West Coast franchise in 2012, which resulted in the Laidlaw[149] and Brown Reviews; the latter of which examined the wider rail franchising programme, looking in detail at whether changes were needed to the way risk was assessed and to the bidding and evaluation processes.

57. Our predecessor Transport Committee published its report on Rail Franchising in February 2017.[150] It acknowledged that the rail franchising programme had delivered benefits, and this was a view echoed by many witnesses.[151] Concerns were expressed by the Committee with respect to the capabilities of the DfT in running the franchising programme and the sustainability of the current franchising model.[152] The latest failure by VTEC on the ICEC franchise brings some of the issues raised by our predecessor Committee to the fore, and lessons need to be learned by the DfT for the wider franchising process.

58. Some of the failings in the bid process of the ICEC franchise do not reflect well on the DfT. It is encouraging to see that they have learned lessons in a number of those areas, and that reforms to the franchising programme have already been implemented. For many years, the franchising timetable has been fluid.[153] The main risks to the DfT's capabilities in the immediate future would be sudden changes to the franchising programme, as has occurred with the East Coast franchise, and what may occur potentially with other franchises elsewhere on the network facing revenue issues.[154] While performance bonds cover the direct costs of a refranchise,[155] several franchise bids all occurring at a very quick pace can be difficult for the DfT to resource and can potentially undermine the quality of the bid process and the eventual outcomes for the franchise. Unexpected changes to the franchise timetable can also difficult for the owning groups to resource. A bid is a very large and resource-intensive process.[156]

59. The DfT is yet to reach a steady state with franchising and it is not yet clear whether that is achievable with the current model. The success of the franchising system hinges, in a large part, on accurately forecasting the future economic and market environment. Even with the best of intentions, bidders and the DfT can get their numbers wrong and the implications, as the East Coast franchise shows, can be significant. There are no formal mechanisms for renegotiation. Iryna Terlecky suggested that what was needed was a "franchising system that recognises that life changes", adding:

> Franchises are not set in stone. Working patterns are not set in stone. What passengers want and the impact of competition are not set in stone. It is

148 The Laidlaw Inquiry (*published December 2012*) examined what happened during the West Coast procurement and why, with the aim of establishing the lessons to be learned.
149 Department for Transport, *The Brown Review of the Rail Franchising Programme*, January 2013
150 Transport Select Committee, *Rail franchising*, Ninth Report of Session 2016–17, 5 February 2017
151 Q69, Q84
152 Transport Select Committee, *Rail franchising*, Ninth Report of Session 2016–17, 5 February 2017
153 Q76
154 Q73
155 Q40
156 Q76

> becoming clearer to me that having a franchise that lasts seven years, when in year seven or year eight you have to deliver what you assumed was needed seven years ago, is potentially not a sustainable model for the future … You can deal with that in a number of ways. You can deal with it by a formal renegotiation point in the middle of the franchise. You can deal with it on a rolling basis as things happen, but that needs a very different mindset in terms of franchising, and will need different skills and competencies at the DfT.[157]

60. Former Managing Director of Directly Operated Railways Elaine Holt, told us:

> It is a question of going back and looking at the risk, and how to cope with change. Changes happen. What is the change mechanism in the franchise agreement? That needs to be looked at.[158]

61. The DfT, in its written submission, adopted the view that franchise failure is not a major problem, provided it is managed in the right way. There is a balance between the risk of franchise failure and the extraction of value from a franchise for the taxpayer. **We do not endorse removing all risk of failure from the system, and believe Brown was right in his review that in a well-functioning, good franchise system you sometimes have failure. But that failure should not be driven by flaws in the franchising process and there is an imperative to preserve a level of continuity on the railways.** Iryna Terlecky said that "instability is generally not good for the industry. The railway is a public service and a public/private partnership."[159] A franchising model where franchises default within three years, as occurred with the ICEC franchise, is unsustainable. The East Coast franchise is but one vulnerable rail franchise on the network. There have been reports that several other franchises are either in revenue support, or potentially drawing on their parental guarantees to meet their obligations to the DfT.[160] FirstGroup, which run the TransPennine Express franchise, has just made a £106 million provision against its revenue shortfalls and are drawing on their parent company guarantee.[161] We heard conflicting views from the DfT about the risk of these franchises defaulting in the same way as VTEC did with the East Coast franchise. Simon Smith initially said that "we do not have any franchise at short or medium-term risk of financial default".[162] Polly Payne later clarified:

> With both Govia Thameslink Railway (GTR) and Northern, we are at the moment looking at whether they have performed to their contract, and, as you know, with GTR in particular, we have a hard review happening at the moment. We do not know what that hard review will show yet, but if it shows that they have triggered an event of default, or they have been out with their contracts such that they can be terminated, that is a possibility, and in that case we would mobilise the operator of last resort.[163]

157 Q75
158 Q122
159 Q29
160 Q73
161 Q424
162 Q285
163 Q295

62. The Secretary of State also acknowledged that he had "stepped up the capabilities of the OLR team in case we had to take back control of [the GTR] franchise. That would not be for financial reasons; it would be for operational reasons. "[164] But according to the Secretary of State, no other franchises, apart from GTR, "fit into the service provision set-up that might lead to the operator of last resort."[165] It is unclear, at this stage, how the contracts of these other franchises that are in revenue support are different from that used in the East Coast franchise and what mechanisms are available for renegotiation, outside of franchise default. ***We recommend the Department outline what mechanisms it has available for franchise change and renegotiation. We also recommend that it keep the Committee informed about any franchises that look likely to default on their contracts and whether it is resourcing the operator of last resort to take over any of these franchises, and find a way to brief Parliament on the de facto reality on the railways.***

63. Given the problems on these franchises and the possibility of franchise failure, **we conclude that the Government has not found the right balance between the risk of franchise failure and return they might obtain from encouraging ambitious bids.** ***We recommend that the Department revisit its approach to franchise failure, which should be embedded in how they assess the risk and feasibility of each bid.***

164 Q427
165 Q428

Conclusions and recommendations

What went wrong with the franchise

1. Franchises should be able to withstand normal fluctuations in the economic cycle. The fact that this franchise did not suggests that there was very little resilience built into the bid by Stagecoach and Virgin and it bid for the franchise on very optimistic grounds. This was naïve, and it should have been more aware of the financial risks involved, particularly given the history of this franchise and Stagecoach and Virgin's long history of bidding for and running franchises in this country. We conclude that Stagecoach and Virgin bear prime responsibility for the failure of this franchise. (Paragraph 14)

2. We conclude that, while it is up to bidders to do their due diligence, and clearly Stagecoach and Virgin did not, the DfT encouraged over-bidding by setting unrealistic benchmarks in the Invitation to Tender (ITT) and failing to include the boundaries in the bid process necessary to temper over-optimistic bidding. (Paragraph 16)

3. It is encouraging that the franchising system has now been adjusted to deter further optimism when bidding and is clearly recognition by the Secretary of State of the failings with this franchise bid process. (Paragraph 17)

4. We therefore conclude that the financial stress-testing of the bids by the Department for Transport was not robust enough and was inconsistent with the approach recommended by the NAO following the previous franchise failure in 2009. (Paragraph 19)

5. Had a more comprehensive macroeconomic risk-sharing mechanism been implemented, as per the Brown Review recommendation, there might have been a chance that this franchise would have avoided premature termination. (Paragraph 22)

6. *We recommend that the Department clarify, in detail, exactly what its current and future approach to macroeconomic risk-sharing is, in doing so, it should make clear how it has implemented the relevant Brown Review recommendations.* (Paragraph 25)

7. Because of the potential implications for the wider franchising market, we conclude that the Department had no alternative but to adhere to its policy of not renegotiating franchises and to let the contract run its course to default. (Paragraph 27)

8. Based on the contract that was originally agreed with the Government, the taxpayer has not bailed out Stagecoach and Virgin. This is because Stagecoach and Virgin had their liability capped at £165 million, which was the amount they committed to the DfT though their parent company guarantee. (Paragraph 28)

9. Sir Richard Branson's comments in January 2018 left the initial impression that the delay to assumed infrastructure enhancements contributed to the early termination of this franchise. We conclude that Network Rail do not bear any responsibility for the early termination of this franchise. To date, Network Rail have provided all the infrastructure upgrades that it had formally committed to when this franchise

was let. A series of other upgrades were assumed to occur by the DfT and VTEC to deliver an enhanced timetable from 2019 onward; though there was no formal funding commitment to these upgrades when the franchise was let. The delivery of these enhancements will now occur but later than was initially anticipated by the DfT and VTEC. This delay would have undermined assumed revenue growth from 2019 onward but did not directly contribute to the early termination of this franchise. (Paragraph 35)

10. We therefore conclude that the Department for Transport are responsible for the confusion around what infrastructure enhancements on the East Coast Mainline were going to be delivered, and when, throughout the life of the East Coast franchise. In specifying the ITT, the DfT should have been aware of the risks involved in delivering the franchise timetable it specified in the ITT, particularly given that the funding had not been committed and there were wider infrastructure enhancement issues happening in parallel elsewhere on the network. Network Rail claims to have provided transparent advice to the bidders around exactly what and was not deliverable and in doing so, fulfilled its obligations during the franchising bidding process. Importantly, though, they were not provided with formal sign-off during the bid process, which might have rectified such confusion before a contract was agreed. We conclude that there was a failure from the Department in not providing Network Rail with formal sign-off of the infrastructure assumptions for the East Coast franchise. (Paragraph 36)

11. *We recommend that the Department for Transport clarify exactly what role Network Rail now have in the bidding process and recommend that, if it is still not the case, their relevant representatives have formal sign-off of any bids prior to a successful bid being decided. More generally, we would like to see much closer alignment between the invitation to tender in the franchise agreement and Network Rail's planned enhancements. The DfT has responsibility to ensure all parties to the franchise bid process are aligned and have equal and accurate sight of what infrastructure upgrades are planned.* (Paragraph 36)

12. *We recommend that the Department outline how it will specify future infrastructure enhancements in the invitations to tender and what change mechanisms it has in place and whether they can cope with any uncertainty arising from the enhancements pipeline proposals.* (Paragraph 37)

Interim operating arrangements

13. While it is too early to know whether the decision to transfer control to the operator of last resort was the right one, we regret there is a lack of a clear plan or timescales upon which the interim operator will run the franchise. *We recommend that the Secretary of State outline the exact timescale for the interim operator and clarify exactly how operational and investment risks will be managed until the longer-term Partnership arrangement is in place. We are not aware of the existence of formal obligations and targets for the operator of last resort for the Intercity East Coast franchise. We recommend that whenever the operator of last resort arrangement is invoked, the DfT should revise and publish obligations and targets for the operation of the failed franchise by the operator of last resort in order to provide passengers,*

taxpayers, Parliament and industry certainty of its business plan, strategy and development plans. This should be done within six months of assuming responsibility for a franchise. (Paragraph 45)

The East Coast Partnership

14. We conclude that greater joint-working and clear lines of accountability through a single person responsible for track and trains offers potential for significant improvement in services. The mechanics and complexity of the current financial and regulatory environment has meant that all previous attempts to establish deep alliances have not worked. It is not yet clear how the East Coast Partnership will more successfully overcome the systemic difficulties presented by the current financial and regulatory environment. Based on the current framework, we conclude that the East Coast Partnership is unlikely to provide scope for the step-change in performance that the Secretary of State might be anticipating. This proposal also risks adding an additional layer of complexity to this part of the network. Passengers will ultimately bear the risk if this proposal goes wrong. This seems to be an unnecessary risk on this part of the network, particularly given that passenger satisfaction is already relatively high at 92%. ***We recommend that any review of franchising should consider what change would be needed to the financial and regulatory framework to make partnership working a viable and sustainable model for operating the railway in the future. We recommend that the Department set a timetable for publishing the detail of how it expects the East Coast Partnership will work.*** (Paragraph 54)

15. *Before experimenting with this Partnership, we recommend the Secretary of State lay out in detail how the new partnership will work and conduct a proper assessment of its feasibility against those plans. This assessment needs to demonstrate that his proposal will offer better value for money for the taxpayer and better outcomes for passengers than other ways of operating. We recommend the Secretary of State review his decision to go-ahead with this partnership based on the findings of this assessment.* (Paragraph 55)

Wider franchising issues

16. We do not endorse removing all risk of failure from the system, and believe Brown was right in his review that in a well-functioning, good franchise system you sometimes have failure. But that failure should not be driven by flaws in the franchising process and there is an imperative to preserve a level of continuity on the railways. (Paragraph 61)

17. *We recommend the Department outline what mechanisms it has available for franchise change and renegotiation. We also recommend that it keep the Committee informed about any franchises that look likely to default on their contracts and whether it is resourcing the operator of last resort to take over any of these franchises and find a way to brief our Committee and Parliament on the de facto reality on the railways.* (Paragraph 62)

18. We conclude that the Government has not found the right balance between the risk of franchise failure and return they might obtain from encouraging ambitious bids. *We recommend that the Department revisit its approach to franchise failure, which should be embedded in how they assess the risk and feasibility of each bid.* (Paragraph 63)

Formal minutes

Wednesday 5 September

Members present:

Lilian Greenwood, in the Chair

Jack Brereton	Grahame Morris
Steve Double	Graham Stringer
Paul Girvan	Daniel Zeichner
Huw Merriman	

Draft Report (*Intercity East Coast Franchise*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 63 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Fifth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 10 September at 4.15pm

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Monday 21 May 2018

Iryna Terlecky, Director, TBI Consulting Ltd, and **Nicola Wood**, Director, UK Rail Advisory Ltd; **The Rt Hon the Lord Adonis**, and **Elaine Holt**, Former Chief Executive, Directly Operated Railways. Q1–122

Monday 16 July 2018

Martin Griffiths, Chief Executive, Stagecoach Group, **Neil Micklethwaite**, Commercial and Business Development Director, Stagecoach Group, **Jo Kaye**, Managing Director, System Operator, Network Rail, and **Rob McIntosh**, Route Managing Director, London North Eastern and East Midlands, Network Rail. Q123–320

Tuesday 24 July 2018

Rt Hon Chris Grayling MP, Secretary of State for Transport, Department for Transport. Q321–442

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

The reference numbers are generated automatically by the evidence processing system and may not be a complete sequence.

1 Andrew Marsay (ECR0018)

2 ASLEF (ECR0008)

3 Department for Transport (ECR0011)

4 Dr Luke Butler (ECR0017)

5 John Marriott (ECR0007)

6 Mr David Cooper-Smith (ECR0001)

7 Network Rail (ECR0010)

8 Newark Business Club (ECR0015)

9 Passenger Transport Networks (ECR0005)

10 Paul Woodhams (ECR0019)

11 Rail Delivery Group (ECR0014)

12 RMT (ECR0006)

13 Rog Laker (ECR0016)

14 Save East Coast Rewards (ECR0003)

15 Stonebridge Integration Ltd (ECR0012)

16 Transport Focus (ECR0009)

17 Virgin Trains East Coast (ECR0004)

18 We Own It (ECR0002)

19 Wendy Coker (ECR0013)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	Community transport and the Department for Transport's proposed consultation	HC 480 (HC 832)
Second Report	Improving air quality	HC 433 (HC 1149)
Third Report	Airports National Policy Statement	HC 548
Fourth Report	Rail Infrastructure investment	HC 582
First Special Report	Vauxhall Zafira fires: Government Response to the Committee's Tenth Report of Session 2016–17	HC 516
Second Special Report	Community transport and the Department for Transport's proposed consultation: Government Response to the Committee's First Report of Session 2017–2019	HC 832
Third Special Report	Improving air quality: Government Response to the Committee's Second Report of Session 2017-2019	HC 1149