



House of Commons
Committee of Public Accounts

The South Eastern Passenger Rail Franchise

**Forty-first Report of
Session 2005–06**

*Report, together with formal minutes,
oral and written evidence*

*Ordered by The House of Commons
to be printed 19 April 2006*

HC 770
Published on 11 May 2006
by authority of the House of Commons
London: The Stationery Office Limited
£10.00

The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine “the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit” (Standing Order No 148).

Current membership

Mr Richard Bacon MP (*Conservative, South Norfolk*)
Annette Brooke MP (*Liberal Democrat, Mid Dorset and Poole North*)
Angela Browning MP (*Conservative, Tiverton and Honiton*)
Mr Alistair Carmichael MP (*Liberal Democrat, Orkney and Shetland*)
Greg Clark MP (*Conservative, Tunbridge Wells*)
Rt Hon David Curry MP (*Conservative, Skipton and Ripon*)
Mr Ian Davidson MP (*Labour, Glasgow South West*)
Helen Goodman MP (*Labour, Bishop Auckland*)
Mr Sadiq Khan MP (*Labour, Tooting*)
Mr Edward Leigh MP (*Conservative, Gainsborough*)
Sarah McCarthy-Fry MP (*Labour, Portsmouth North*)
Mr Austin Mitchell MP (*Labour, Great Grimsby*)
Jon Trickett MP (*Labour, Hemsworth*)
Kitty Ussher MP (*Labour, Burnley*)
Rt Hon Alan Williams MP (*Labour, Swansea West*)

The following was also a Member of the committee during the period of the enquiry:

Stephen Williams MP (*Liberal Democrat, Bristol West*)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at <http://www.parliament.uk/pac>. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Emma Sawyer (Committee Assistant), Ronnie Jefferson (Secretary), and Luke Robinson (Media Officer).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee’s email address is pubaccom@parliament.uk.

Contents

Report	<i>Page</i>
Summary	3
Conclusions and recommendations	4
1 Why the franchise experienced difficulties	7
2 The decision to terminate the franchise	11
3 Protecting taxpayers' interests	13
Formal minutes	16
Witnesses	17
List of written evidence	17
List of Reports from the Committee of Public Accounts Session 2005–06	18

Summary

In June 2003, the Strategic Rail Authority (SRA) announced that it would be terminating Connex South Eastern's (CSE's) franchise for providing passenger rail services in Kent, parts of Sussex and South East London within six months and transferring the franchise to an SRA subsidiary. The SRA decided to terminate the franchise to protect taxpayers' money and passenger delivery. This was the first, and so far only, instance where a train operating company's franchise has been terminated early.

CSE won the 15-year franchise in 1996 with a bid for £535 million of public subsidy, based on the assumption it could realise cost savings and increase passenger numbers over the life of the contract. It increased passenger and other revenue ahead of its bid projections, but in common with other early franchise operators CSE had made unrealistic assumptions about the cost savings it could achieve. By 2001, some five years into the franchise, CSE faced mounting financial difficulties. Rather than alerting the SRA to these problems immediately, it chose to try to resolve them itself.

The SRA's franchise monitoring procedures failed to detect the emerging difficulties. Instead the SRA became aware of them only when CSE requested a franchise extension. With help from consultants, the SRA reviewed CSE's financial position and identified weaknesses in its financial management and a significant funding gap, which neither CSE nor the SRA was able to quantify with any certainty. In December 2002, the SRA issued a deed of amendment to the franchise under which CSE was provided with an additional £58.9 million of subsidy for 2003 as a 'stop-gap' measure. The deed also required CSE to make changes to its financial management, control and reporting. In June 2003, the SRA terminated CSE's franchise, frustrated by CSE's slow progress and apparent lack of commitment to improving its financial management. It also considered that CSE would require additional public subsidy to deliver the remainder of the franchise.

In November 2003, the SRA transferred the franchise to its subsidiary, South Eastern Trains (SET), in an orderly and well managed transfer. SET will continue to operate the franchise until 1 April 2006, when it will be incorporated into the newly created Integrated Kent Franchise, which the Department for Transport¹ awarded to GoVia after competition in November 2005.

On the basis of a Report by the Comptroller and Auditor General² the Committee took evidence from the Department for Transport, the SRA, South Eastern Trains and Connex Transport on the impact of CSE's financial difficulties, the SRA's decision to terminate the franchise and how taxpayers' interests were protected.

¹ Under the Railways Act 2005, the government is abolishing the SRA. In July 2005, the Department for Transport took over the SRA's franchising roles in England and Wales, while the Scottish Executive took over these roles in Scotland in October 2005.

² C&AG's Report, *The South Eastern Passenger Rail Franchise* (HC 457, Session 2005–06)

Conclusions and recommendations

- 1. The cause of Connex South Eastern's (CSE's) financial difficulties lay in an ambitious franchise bid which the Strategic Rail Authority's (SRA's) predecessor, the Office of Passenger Rail Franchising (OPRAF) accepted in line with its policy of awarding franchises to bidders requiring the least public subsidy.** The termination of CSE's franchise shows that franchising cannot transfer to train operating companies all the financial risks of operating trains. To reduce the risk of future franchise failures, the Department should base franchise award decisions on a balanced and transparent assessment of costs and the realism and deliverability of the assumptions and plans on which a bid is based.
- 2. OPRAF recognised at the time of franchise award that CSE's bid was ambitious, but neither OPRAF nor the SRA adapted their franchise monitoring to manage the associated risks.** The Department should identify train operating companies at greatest risk of financial or operational failure, target its monitoring accordingly and use variations against key performance measures as an 'early warning system' of problems arising.
- 3. Periodic viability reviews during the lifetime of the franchise would have detected CSE's emerging financial difficulties more quickly.** At the point of franchise award, not all developments which may impact on passenger revenues and operating costs across the franchise term can be foreseen with certainty. The Department should carry out continuing viability reviews at appropriate points throughout franchises and discuss the results with train operating companies to achieve a common understanding of the strengths and weaknesses of the franchise going forward.
- 4. The proposed provision of further subsidies to CSE of £183 million for 2004–06 was not made conditional on identified improvements in financial management, controls and reporting.** Where a franchisee is required to take remedial actions, the Department should make provision of further subsidy conditional on delivery of the remedial actions required. It should specify the time period allowed for implementation and agree with the franchisee how improvements in performance will be measured.
- 5. The costs of terminating CSE's franchise amounted to some £6.4 million, making termination a costly option.** The Department's franchise management procedures should therefore set out a range of remedial actions, and the criteria and circumstances in which they would be applicable, together with some consideration of the potential costs, risks and benefits of each option.
- 6. The SRA recovered only £2.8 million of its £6.4 million losses, liabilities and expenses from CSE's Performance Bond of £19.5 million because it was concerned that further action might lead to CSE's insolvency, potentially triggering liabilities to rolling stock leasing companies (ROSCOs).** In practice, the SRA entered into agreements with the ROSCOs to guarantee future lease payments to secure the continued availability of rolling stock to SET and its successor. The Department should take a more robust line on cost recovery in future.

7. **The SRA spent some £2 million on consultants' reviews of CSE's financial performance, but a failure to specify clearly the work required led to duplication of effort and unnecessary expenditure.** When commissioning consultants, the Department should specify clearly what is required, and how findings should be reported and shared, including with the franchisee.
8. **Misunderstandings arose between the SRA and CSE, reflecting ineffective communications and a lack of mutual trust.** Train operating companies and the Department should have open dialogue and transparency in their dealings at all times. When franchise difficulties arise the Department may need to consider putting in place special measures to strengthen communications such as taking advice from a skilled arbitration service to forge effective negotiation and open communication between the parties.
9. **The Department's franchise management and monitoring will only be effective if staff have the necessary skills to interpret and question financial information.** The Department should put in place the right resources and skills to provide robust, risk based monitoring to avoid another case of late identification of franchise failure.
10. **Overall, the transfer of CSE's operations to SET went smoothly and led to improvements in passenger services.** The Department should reflect the lessons of the CSE case in its franchise termination contingency plan, and also in its franchising and monitoring activities.

1 Why the franchise experienced difficulties

1. When Connex South Eastern's (CSE's) rail franchise was awarded in 1996, the Office of Passenger Rail Franchising (OPRAF) assessed rail franchise bids largely on the basis of requiring the least public subsidy. The philosophy of franchising was that financial risk was fully transferred to private sector train operating companies, with the franchisee bearing any cost overruns or revenue shortfalls if the bid assumptions were unrealistically optimistic. In CSE's case OPRAF had concerns that the bid was overambitious, but it did not probe the assumptions underlying CSE's income and expenditure forecasts. There was no benchmark against which to judge whether the bid was too low to succeed, and the revenue and cost estimates in the bid were consistent with the market. OPRAF assumed that CSE's owners, a multinational group of companies operating in a range of industries, would support CSE to protect the group's international reputation.³

2. In the event, CSE, in common with other operators generally, managed to achieve anticipated revenue changes, but failed to deliver the expected cost savings. Revenues rose because more people used trains. Franchise bidders had, however, generally assumed that cost savings could also be achieved, but most had underestimated the extent to which British Rail had already achieved efficiencies. Further, to reduce the number of drivers in the train cab, long-distance operators had increased driver wages. With the benefit of hindsight, and based on the subsidy paid subsequently to South Eastern Trains (SET), the Strategic Rail Authority (SRA) concluded that CSE's original bid had not specified adequate funding for the franchise.⁴

3. The CSE experience demonstrates that the award of a franchise does not transfer all financial and operational risks to train operating companies. The SRA acknowledged that lowest subsidy alone was not a sound basis for franchise letting, and confirmed that it had revised its approach to take account of what was deliverable for the sums bid. Responsibility for franchising now rested with the Department. In the latest awards of franchises the Department had considered the cost to the taxpayer, but also the reliability of the bid and the past performance of the train operating company. The process involved testing the credibility of the franchisees' business plans, on the basis that franchisees initially bear the risk but in the event of default the risk comes back to the government. The Department considered that the contract awarded to GoVia for the Integrated Kent Franchise was challenging, involving lower subsidies than those provided to SET, but the Department was confident that this would not result in a decline in standards.⁵

4. The SRA was slow to recognise CSE's impending financial difficulties (**Figure 1**). CSE became aware of its problems in July 2001, but chose not to alert the SRA, wanting to resolve the difficulties itself, rather than seeking additional monies. In December 2001, however, it approached the SRA to request a two-year extension of the franchise to 2013.

3 Qq 87, 91; C&AG's Report, para 2.2

4 Qq 55, 75–78, 86, 121

5 Qq 8, 68–69, 75, 89

The SRA and CSE started discussions during which the SRA began to challenge CSE on its projections and to question their lack of clarity.⁶

5. The SRA commissioned a review to establish the financial future for the franchise. The review found that CSE lacked appropriate financial management processes and forecasting capability. The SRA also looked at ways of addressing some of the considerable uncertainties affecting the franchise, including the Channel Tunnel Rail Link. In December 2002 the SRA agreed additional subsidy of £58.9 million for 2003 to stabilise the franchise. It also agreed a deed of amendment to the franchise requiring that financial management processes be put in place and giving the SRA the option to terminate the franchise in due course. The SRA considered that this approach would give it time to address a medium and long-term solution should a funding gap remain, as the SRA lacked confidence about the amount of revised subsidy that CSE would require. By the end of March 2003 the SRA found that CSE had already spent more than it had forecast.⁷

6 Qq 14, 46

7 Qq 46, 50, 82, 93

Figure 1: Chronology of events leading to the termination of the CSE franchise

August 1996	The Office of Passenger Rail Franchising (OPRAF) awarded CSE the 15 year franchise, to run from 1996 to 2011. OPRAF was to pay CSE subsidies totalling £535 million over the lifetime of the franchise.
July 2001	CSE became aware of its impending financial difficulties but sought to rectify matters itself without bringing them to the SRA's attention.
December 2001	CSE requested a two-year extension to the franchise and indicated that £400 million of additional subsidy would enable CSE to improve its operational performance and quality of service to 2013.
January–May 2002	The SRA assessed CSE's finances. A review by the SRA's lead financial advisers (KPMG) identified weaknesses in the quality of CSE's management information, project management, risk monitoring and linkages between financial and operational management, and a lack of rigour in CSE's financial projections to 2010–11. The review could not establish with certainty the extent of CSE's funding gap.
July 2002–December 2002	CSE projected a £47 million loss in 2003, but further work by the SRA and CSE led to continuing uncertainty over the extent of projected losses looking further forward. The SRA considered combining CSE's franchise with domestic services on the Channel Tunnel Rail Link to form a new, integrated franchise to be let through full competition.
December 2002	In return for providing CSE with up to £58.9 million of additional subsidies for 2003, payable in monthly instalments, the SRA and CSE agreed a deed of amendment to the franchise. The deed's key features included required changes to CSE's financial management, including inter-company transactions; bringing forward the franchise end date from 2011 to 2006; and negotiations between SRA and CSE on a new funding package for 2004 to 2006.
January–March 2003	A series of reports by the SRA's consultants Mott MacDonald found that CSE had not complied with all its key obligations to improve its financial management, control and reporting.
March 2003	The SRA was satisfied that CSE's financial model for 2004–2006 produced accurate calculations, but remained unconvinced as to the robustness of projected costs and revenues. The SRA and CSE's holding company had negotiated a further deed of amendment to cover 2004–2006, providing CSE with additional subsidy of £183 million for this period. But the SRA remained unconvinced as to the robustness of CSE's financial model and projected costs and revenues.
May 2003	Another set of SRA consultants, PriceWaterhouseCoopers (PwC), concluded that CSE had been slow to focus on the SRA's requirements and had not complied fully with them. PwC recommended that the SRA should not advance additional subsidy to CSE for 2004–06 unless CSE addressed certain key actions, including that CSE should strengthen its finance function and appoint a compliance officer. CSE's holding company appointed a new Managing Director of CSE and a compliance officer. CSE's holding company told the SRA it was appointing a new Chairman.
June 2003	The SRA informed CSE and its holding company of its Board's decision to terminate the franchise.
November 2003	South Eastern Trains, a subsidiary of the SRA, took over the running of the franchise. The SRA intended to relet the franchise to a private sector train operating company 18 months later.
November 2005	The Department for Transport (the Department) re-let the new Integrated Kent franchise to GoVia, to start from 1 April 2006.

Source: National Audit Office

6. The SRA agreed that it should have questioned the viability of CSE's franchise earlier. The SRA and the Department had made fundamental changes to their franchise monitoring procedures in 2002 and 2003 to improve their alertness to emerging financial problems. These changes involved closer scrutiny of performance against business plans and models used in the franchise bids, and improved dialogue with the train operating companies to identify reasons for divergence from business plans. For franchises let since 2004, the Department carried out monthly monitoring of the franchisee's financial viability and projections for the business year. The Department also looked for danger signals such as instability within the finance team, excessive claims and significant changes in financial performance reported.⁸

7. The Comptroller and Auditor General's Report found there were 15% fewer staff involved with the management of franchises in the Department than had been the case at the SRA. The Department reported that it now had a similar number dealing with franchise management, most of the staff having previously worked at the SRA. Staff needed more training and development on how to make best use of financial data to assess the risks presented by individual train operating companies, and the Department was developing plans further.⁹

8 Qq 6, 9, 48, 51–52, 63, 67

9 Qq 9, 51; C&AG's Report, para 5.11

2 The decision to terminate the franchise

8. The SRA attributed its decision to terminate the franchise to a fundamental loss of confidence in CSE's financial management and the lack of certainty about the franchise's future funding needs. The SRA had little confidence that CSE would be able to run the franchise within the funding it was prepared to accept. The SRA considered that CSE was not addressing with sufficient vigour the underlying causes of its financial difficulties. The SRA's consultants had found that CSE's financial information systems were basically sound, but the SRA considered that CSE was not applying them consistently. The SRA was also concerned about CSE's governance arrangements, in particular CSE's French holding company taking direct responsibility for its finances and for the project to replace slam-door trains, and the extent and nature of inter-group trading.¹⁰

9. An underlying tension developed between the SRA and CSE, reflecting the lack of trust and respect between them, which undermined their ability to work together. The SRA considered that it had been clear about the actions needed by CSE to address its financial and operational difficulties. In the SRA's view, CSE's management had not addressed the requirements of the deed of amendment, or appointed a dedicated finance director. CSE had underestimated the SRA's frustration at the lack of progress. It had focussed on the funding package and cost reduction rather than on shorter term financial management requirements. CSE's holding company had appointed a new Chairman, who had expected to appoint a new finance director. CSE considered that it had been committed to the franchise, contributing £11 million of additional share capital to the company in December 2002.¹¹

10. The SRA considered a range of options in respect of CSE's franchise, but its Board received analysis of only two options – to retain the CSE franchise until 2006 with additional subsidies contingent on improved financial management or to terminate the franchise on 31 December 2003 (see **Figure 2**). The SRA considered that a management contract¹² would not be appropriate as the SRA did not have the required confidence, understanding and visibility of the funding requirement of the business, and imposing requirements on CSE would have shifted responsibilities and risks to the public sector. The SRA concluded that termination was the only viable option given its statutory duty to achieve value for money for any additional subsidy. SET had taken on the Managing Director recruited by CSE, CSE's financial management arrangements and all bar 12 of its staff. CSE therefore argued that termination of the franchise was unnecessary.¹³

10 Qq 5, 46, 57, 105–106

11 Qq 74, 81, 84, 103, 111, 113, 132

12 The SRA placed Train Operating Companies (TOCs) on management contracts when they had financial difficulties, the SRA bearing more financial risk and monitoring more closely a TOC's revenue and costs than under normal franchise agreements. The nature of the management contracts has varied but many have been "cost plus" contracts whereby the SRA paid the TOC an agreed margin on the costs the TOCs expected to incur.

13 Qq 4, 94–95, 109–113; C&AG's Report, para 2.23

Figure 2: The SRA's assessment of the relative advantages and disadvantages of continuing with CSE or terminating the franchise

The SRA considered the advantages and disadvantages of continuing with CSE and providing additional subsidies, or of terminating the franchise

Continuing with CSE and providing additional subsidies for 2004 to 2006

Advantages	Disadvantages
<ul style="list-style-type: none"> ■ CSE would retain revenue and performance risks ■ Connex Transport UK Ltd would remain in the UK rail market and as a potential bidder for the new integrated Kent Franchise ■ Likely to be the cheapest option for operating the franchise for a three-year period 	<ul style="list-style-type: none"> ■ The SRA would continue to have concerns about CSE's financial management and its ability to keep within the total subsidies that might be agreed for 2004 to 2006 ■ The SRA would have to continue the same level of detailed engagement in CSE's on-going financial management, which the SRA considered was disproportionate ■ Potential public criticism of giving more subsidy to a TOC in financial difficulty ■ Difficulty agreeing a six-month rolling management contract¹ with CSE as it might pose problems for the TOC's retention and recruitment of staff ■ A six-month rolling management contract might also discourage the TOC from investing in improvements
<p>Termination of the franchise</p> <p>Advantages</p> <ul style="list-style-type: none"> ■ Would send a public message that the SRA would not tolerate poor TOC financial management ■ More direct control over bidding information for an Integrated Kent Franchise 	<p>Disadvantages</p> <ul style="list-style-type: none"> ■ Potentially, an extra £42 million in subsidies would be required to meet the additional costs of recruiting and employing staff on short-term contracts and of employing advisers as the SRA had no previous experience of managing a franchise ■ Revenue and performance risk would return to the SRA if the franchise were taken in-house for a period of time until it were re-let or were managed under a 'cost-plus' contract ■ Risk of deterioration in performance during any handover period ■ Likely to lead to the withdrawal of Connex Transport UK Ltd from the UK rail market, including bidding for current and any future franchises and, therefore, a reduction in competition in the UK rail market ■ CTUK Ltd might challenge the termination in the courts

¹ The SRA placed TOCs on management contracts when they had financial difficulties, the SRA bearing more financial risk and monitoring more closely a TOC's revenue and costs than under normal franchise agreements. The nature of management contracts has varied, but many have been 'cost plus' contracts, whereby the SRA paid the TOC an agreed margin on the costs the TOCs expected to incur.

Source: National Audit Office summary of SRA documents

3 Protecting taxpayers' interests

11. The transfer from CSE to SET safeguarded the passenger rail service, with services improving following the transfer of the franchise, although this had been due mainly to improvements in Network Rail's performance. Uncertainty remains as to whether termination was the most cost-effective option for the taxpayer. The transfer of the franchise involved considerable effort and costs amounting to some £6.4 million, including £557,000 to provide incentives to some managers to remain with the operation. The SRA also provided subsidies to SET of some £22 million more than those CSE had agreed. The SRA nevertheless considered that it had paid SET an appropriate amount.¹⁴

12. The SRA's costs for investigating the difficulties with CSE's franchise, monitoring CSE's compliance with the deed of amendment and the termination included consultants' fees of £4.6 million. The SRA had employed consultants because it did not have the necessary resources in-house to deal with the volume of work and the complex issues that arose. It had sought extra assurance by engaging two different firms to carry reviews with some duplication of work to compare their findings and recommendations. The SRA put this in the context of the scale of the task to transfer a business with 4,000 employees, £450 million turnover and 300,000 passengers a day. It nevertheless accepted that in a similar future situation it would spend less on consultancy.¹⁵

13. The SRA had spent £300,000 on rebranding trains and staff uniforms from CSE to SET which was necessary in their view to demonstrate to passengers and staff that there had been a change. The Department considered this was not an unreasonable cost for the size of the fleet of trains involved. The new franchise agreement with GoVia does not specifically mention rebranding of rolling stock or uniforms, and GoVia had indicated that service delivery was a more important priority for them. Rebranding of stations was required within three years of the franchise term and would most likely be undertaken as part of general maintenance rather than as a specific activity.¹⁶

14. The SRA recovered from CSE £2.8 million of the £6.4 million costs it had incurred in the termination of the franchise (**Figure 3**). Under the terms of the franchise agreement, the SRA had a contractual right to deduct from CSE's £19.5 million Performance Bond¹⁷ its losses, liabilities, costs and expenses incurred as a consequence of CSE's failure to comply with its obligations. The SRA obtained independent legal advice on which costs associated with the termination of the franchise it could recover from CSE. It did not, however, test the advice given by its internal legal advisers that it had no contractual right to recover £2 million spent on consultancy and external advisers in the lead up to the termination decision.

14 Qq 15, 55, 82, 108, 114

15 Q 101

16 Qq 58, 60; Ev 15

17 A TOC's holding company must take out a Performance Bond with an insurance company to guarantee that the TOC will comply with its franchise agreement obligations. In the event of default, the SRA could retain some, or all, of the Bond.

15. The SRA considered that there were significant financial and operational risks of CSE's holding company becoming insolvent if all the costs were recovered. The SRA feared that insolvency could trigger Rolling Stock Leasing Companies (ROSCOs) to terminate CSE's leases and claim significant sums in compensation for early termination, putting the continued availability of the rolling stock at risk. However, in practice, in October 2003 the SRA entered into agreements with the relevant ROSCOs under Section 54 of the Railways Act 1993 prior to completion of the franchise exit negotiations with CSE. The Section 54 agreements provided the ROSCOs with certainty over the future leasing of their rolling stock and removed their right to seek termination payments from CSE. At that point, therefore, there was therefore no potential liability for lease termination payments which could have pushed CSE into insolvency.¹⁸

Figure 3: Costs which the SRA had or may have had a right to recover from CSE under the franchise agreement

SRA costs recovered from CSE		SRA costs not recovered from CSE that the SRA appeared to have a contractual right to pursue		SRA costs not recovered from CSE where the SRA's contractual right to pursue cost recovery was not independently tested	
Nature of cost	£'000	Nature of cost	£'000	Nature of costs	£'000
Consultancy costs incurred by the SRA in connection with the decision to terminate the franchise	2,600	Rebranding costs associated with creating South Eastern Trains (SET) and its holding company, SET (Holdings), including new staff uniforms (£274,000) and IT costs (£326,000)	600	Fees for consultancy reviews of CSE's financial difficulties and the extent of CSE's compliance with the deed of amendment	2,000
Media costs associated with the SRA's announcement of the termination	106	Retention payments to key CSE staff	557		
The cost of Network Rail carrying out a dilapidations survey of CSE's franchised stations on behalf of, and paid by, the SRA	98	SRA staff time spent managing the termination (based upon the SRA's estimate of the additional work involved)	500		
	2,804		1,657		2,000

Source: National Audit Office summary of SRA information

16. The SRA had a generic contingency plan to enable it to take over a franchise should a train operating company, for whatever reason, be unable to continue running train services. The CSE case showed that the SRA could terminate a franchise and carry out its role as operator of last resort, protecting passengers' interests. The handover had been achieved with the vast majority of staff, including the new Managing Director appointed by CSE, transferring over to SET and rolling stock maintenance contracts and purchase agreements for new trains continued on SET's behalf by CSE. The handover went well. Some deterioration in CSE's operational performance occurred during the handover period but overall passenger satisfaction increased. SET improved the financial management procedures inherited from CSE, including financial forecasting, and addressed a backlog of station painting and cleaning work.¹⁹

19 Qq 103, 113, 115–117; C&AG's Report, paras 2.24, 4.5–4.6

Formal minutes

Wednesday 19 April 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon

Greg Clark

Helen Goodman

Mr Sadiq Khan

Sarah McCarthy-Fry

Mr Alan Williams

A draft Report (The South Eastern Passenger Rail Franchise), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 16 read and agreed to.

Summary read and agreed to.

Conclusions and recommendations read and agreed to.

Resolved, That the Report be the Forty-first Report of the Committee to the House.

Ordered, That the Chairman 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 until Monday 24 April at 4.30 pm.]

Witnesses

Monday 12 December 2005

Page

Dr Mike Mitchell, Department for Transport, **Mr Nick Newton**, Strategic Rail Authority, **Mr Michael Holden**, South Eastern Trains and **Mr John O'Brien**, Connex Transport UK Ltd

Ev 1

List of written evidence

Department for Transport

Ev 15

List of Reports from the Committee of Public Accounts Session 2005–06

First Report	Managing National Lottery Distribution Fund balances	HC 408 (<i>Cm 6712</i>)
Second Report	The regeneration of the Millennium Dome and associated land	HC 409 (<i>Cm 6689</i>)
Third Report	Ministry of Defence: Major Projects Report 2004	HC 410 (<i>Cm 6712</i>)
Fourth Report	Fraud and error in benefit expenditure	HC 411 (<i>Cm 6728</i>)
Fifth Report	Inland Revenue: Tax Credits and deleted tax cases	HC 412 (<i>Cm 6689</i>)
Sixth Report	Department of Trade and Industry: Renewable energy	HC 413 (<i>Cm 6689</i>)
Seventh Report	The use of operating theatres in the Northern Ireland Health and Personal Social Services	HC 414 (<i>Cm 6699</i>)
Eighth Report	Navan Centre	HC 415 (<i>Cm 6699</i>)
Ninth Report	Foot and Mouth Disease: applying the lessons	HC 563 (<i>Cm 6728</i>)
Tenth Report	Jobskills	HC 564 (<i>Cm 6724</i>)
Eleventh Report	Local Management of Schools	HC 565 (<i>Cm 6724</i>)
Twelfth Report	Helping those in financial hardship: the running of the Social Fund	HC 601 (<i>Cm 6728</i>)
Thirteenth Report	The Office of the Deputy Prime Minister: Tackling homelessness	HC 653 (<i>Cm 6743</i>)
Fourteenth Report	Energywatch and Postwatch	HC 654 (<i>Cm 6743</i>)
Fifteenth Report	HM Customs and Excise Standard Report 2003–04	HC 695 (<i>Cm 6743</i>)
Sixteenth Report	Home Office: Reducing vehicle crime	HC 696 (<i>Cm 6743</i>)
Seventeenth Report	Achieving value for money in the delivery of public services	HC 742 (<i>Cm 6743</i>)
First Special Report	The BBC's investment in Freeview: The response of the BBC Governors to the Committee's Third Report of Session 2004–05	HC 750 (<i>N/A</i>)
Eighteenth Report	Department for Education and Skills: Improving school attendance in England	HC 789 (<i>Cm 6766</i>)
Nineteenth Report	Department of Health: Tackling cancer: improving the patient journey	HC 790 (<i>Cm 6766</i>)
Twentieth Report	The NHS Cancer Plan: a progress report	HC 791 (<i>Cm 6766</i>)
Twenty-first Report	Skills for Life: Improving adult literacy and numeracy	HC 792 (<i>Cm 6766</i>)
Twenty-second Report	Maintaining and improving Britain's railway stations	HC 535 (<i>Cm 6775</i>)
Twenty-third Report	Filing of income tax self assessment returns	HC 681 (<i>Cm 6775</i>)
Twenty-fourth Report	The BBC's White City 2 development	HC 652
Twenty-fifth Report	Securing strategic leadership in the learning and skills sector	HC 602 (<i>Cm 6775</i>)
Twenty-sixth Report	Assessing and reporting military readiness	HC 667 (<i>Cm 6775</i>)
Twenty-seventh Report	Lost in translation? Responding to the challenges of European law	HC 590 (<i>Cm 6775</i>)
Twenty-eighth Report	Extending access to learning through technology: Ufi and the learndirect service	HC 706 (<i>Cm 6775</i>)
Twenty-ninth Report	Excess Votes 2004–05	HC 916 (<i>N/A</i>)

Thirtieth Report	Excess Votes (Northern Ireland) 2004–05	HC 917 (N/A)
Thirty-first Report	Northern Ireland's Waste Management Strategy	HC 741
Thirty-second Report	Working with the voluntary sector	HC 717
Thirty-third Report	The Royal Parks and the Diana, Princess of Wales Memorial Fountain	HC 644
Thirty-fourth Report	Returning failed asylum applicants	HC 620
Thirty-fifth Report	The refinancing of the Norfolk and Norwich PFI Hospital	HC 694
Thirty-sixth Report	Tackling the complexity of the benefits system	HC 765
Thirty-seventh Report	Inland Revenue Standard Report: New Tax Credits	HC 782
Thirty-eighth Report	Channel Tunnel Rail Link	HC 727
Thirty-ninth Report	Consular services to British nationals	HC 813
Fortieth Report	Environment Agency: Efficiency in water resource management	HC 749
Forty-first Report	The South Eastern Passenger Rail Franchise	HC 770

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Monday 12 December 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Greg Clark
Sarah McCarthy-Fry
Mr Austin Mitchell

Jon Trickett
Kitty Ussher
Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General and **Mr Keith Holden**, Director, National Audit Office, were in attendance and gave evidence.

Mr Brian Glicksman CB, Treasury Officer of Accounts, HM Treasury, was in attendance and gave evidence.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL THE SOUTH EASTERN PASSENGER RAIL FRANCHISE (HC 457)

Witnesses: **Dr Mike Mitchell**, Director General, Rail, Department for Transport, **Mr Nick Newton**, Chief Executive, Strategic Rail Authority, **Mr Michael Holden**, Managing Director, South Eastern Trains and **Mr John O'Brien**, Chairman, Connex Transport UK Ltd, gave evidence.

Q1 Chairman: Good afternoon, welcome to the Committee of Public Accounts, where we are discussing the C&AG's Report on *The South Eastern Passenger Rail Franchise*. We welcome Austin Mitchell to our Committee as a new Member. We are very grateful he has agreed to join us. I should just say that we are very sad though that Brian Glicksman, our Treasury Officer of Accounts is retiring this week so this will be his last meeting. He has been our Treasury Officer of Accounts for a number of years; I think since 2001.

Mr Glicksman: Even earlier; 2000.

Q2 Chairman: You have a lifetime of service to the Treasury and we are very grateful for all you have done for us. Thank you very much.

Mr Glicksman: Thank you very much too; it has been a great privilege to work with the Committee over these past few years.

Mr Williams: May I echo that because you have been here a long time and given us an enormous amount of help. You have found yourself in the firing line occasionally and you have always stood up to us and given us good responses. Probably just before Christmas is the ideal time to take your last meeting with the PAC. Best wishes to you.

Q3 Chairman: You have always managed to drop a straight bat on all our difficult questions, but you can kick one to the boundary this afternoon and nobody will mind. Today we are looking at the Report on *The South Eastern Passenger Rail Franchise* and we welcome to our Committee Mike Mitchell, who is the Director General of the Department for Transport's Rail Group and additional accounting officer at the Department; Nick Newton, who is Chief Executive of the Strategic Rail Authority;

John O'Brien, who is Chairman of Connex Transport UK and Mike Holden who is Managing Director of South Eastern Trains. You are all very welcome. May I start with a couple of questions to Mr Newton and refer you to figure 3 on page 21 which deals with the SRA's assessment of the advantages and disadvantages of continuing with Connex South Eastern or terminating the franchise. That is obviously what we are talking about principally this afternoon. Why was termination the only option?

Mr Newton: It was not the only option.

Q4 Chairman: Why was it the only viable option?

Mr Newton: We exhausted the other potential options through a long period from late 2002 and came to the conclusion that, recognising our key statutory duty of being comfortable that further public subsidy would be spent in an appropriate way, we had no other option than to terminate.

Q5 Chairman: Some of this is dealt with in paragraph 2.22 as well. Why did you not just carry on with Connex and change the managing director, which is pretty well what happened? Actually, what has happened is that Connex South Eastern has gone and the managing director lives on with SET, does he not? Why did you not just change the managing director and leave the company there?

Mr Newton: The issues we were concerned about with Connex South Eastern were far deeper than simply changing the managing director or any personnel. The Report very comprehensively describes that it was about our continuing lack of confidence in the financial management of the company, our inability to feel comfortable that the numbers, the forecasts, the future projected subsidy

Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK

were legitimate numbers, numbers which we could rely on, that there was stability and certainty about the future funding needs.

Q6 Chairman: Of course it has strengthened the hand of the Government with other train operating companies; to encourage the others, one might say.

Mr Newton: The Report suggests only to a minimal extent. What is particularly critical here is that it reinforces the changes which we brought about with the announcement of the revised franchising policy in 2002 and the most recent announcements or awards, which are very much predicated on and structured around long-term business plans, business models, which is the mechanism by which you track progress, identify issues, address them as they emerge and any divergence from that model.

Q7 Chairman: If we look at what was going on, which is dealt with in paragraph 2.27 on page 22 and paragraph 3.13 on page 31, obviously this all required disproportionate effort, did it not? You spent about £2 million in consultancy fees. Why did you not spend more time trying to recover all this money from the train operating company?

Mr Newton: Before we reached the decision to terminate and during that process, we were very conscious of some of the key risks. Whilst we had legal advice on those costs which we could recover through contractual rights, it was very much a question of negotiating a controlled and managed exit and we were glad that Connex agreed to this when we told them in June of the decision to terminate. Our judgment was that if we had pushed too far to recover some of those costs, it could have pushed the company into default, when we would effectively have lost control of all the key financial risks. In particular—the figure is not mentioned but the circumstance is mentioned—under the rolling-stock lease agreements that Connex and all train operators have with lease companies, if a franchisee defaults, then the rolling-stock lease companies can claim termination payments which effectively add up to the total value of the remaining lease payments over the unexpired portion of the lease and on this franchise that could have totalled something like £800 million.

Q8 Chairman: Dr Mitchell, could you please look at page 54, paragraph 5.5? You have obviously learned lessons on how to award these contracts. If you look at the middle of that paragraph, you now appear to be going back to what was done before, awarding franchises to bidders requiring the least subsidy. Was this not the root cause of Connex South Eastern's problems?

Dr Mitchell: No. We are determined to review the position in regard to the cost offer and also the deliverability of franchise propositions. What we are looking at as well though, is the extent to which, if a default does occur, we have a situation where the effect on the public will be minimised; in the event of a default the train service continues as normal and then we have a controlled exit by the previous

franchisee. I should not want to give the impression that we are moving back to a policy of highest bid and that being the only consideration.

Q9 Chairman: Let us go back to the history of this. If you look at page 15, paragraph 2.5, the SRA were unaware of CSE's longer-term financial difficulties. If you were unaware of what was going on, why should we be confident that you will be more aware, if a similar situation happens in the future, when you are going to have fewer people to deal with this sort of problem?

Dr Mitchell: First of all, most of staff transferring across from the SRA to deal with it now are the same people who dealt with it in the past. Secondly, the reduction has been elsewhere within the total headcount and the number of people dealing with franchise management now is similar to the number dealing with it in the past. As the Report itself makes clear, we have learned a lot of the lessons and we have continued many of the initiatives which the SRA put in place in terms of how they control the franchise, how they monitor it and the financial monitoring. Finally on this point, may I just say that in the newer franchises, by that I mean those which have been let within the last 12 months or so, we do have a monthly financial review with the franchise companies, whereas in the older franchises the review was less frequent?

Q10 Chairman: Mr O'Brien, am I right in thinking that you were the person who awarded this contract in the first place?

Mr O'Brien: No, I was a member of the team which awarded the contract, but the time this particular contract was awarded predated the time I was appointed director of franchising.

Q11 Chairman: But you were a member of the team which awarded the contract to Connex South Eastern.

Mr O'Brien: Yes.

Q12 Chairman: You have now ended up as chairman of Connex.

Mr O'Brien: That is correct.

Q13 Chairman: That seems very interesting, although, to be fair to you, it was a number of years later, was it not?

Mr O'Brien: It was seven years later. Again for the avoidance of doubt, I am the person referred to in the Report as the person Connex was looking to recruit.

Q14 Chairman: Why did Connex South Eastern fail to inform the Strategic Rail Authority what was going wrong as soon as it knew of its impending financial difficulties?

Mr O'Brien: The way that Connex has typically approached its businesses over the years is that it takes seriously its obligations in deciding deals with its counterparties. When it realised it had financial

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

difficulties, the initial reaction was to try to fix the problem itself rather than try to get someone else to pay the additional monies.

Q15 Chairman: Let us look at what is going on now. Pages 44 to 47 deal with the performance of South Eastern Trains now they have this new contract. You spent millions of pounds filling vacancies and recruiting additional staff. If you strip away the effects of Network Rail, you have only made a modest contribution to your own improved operational performance, have you not?

Mr M Holden: We have made an improvement. The business plan for South Eastern Trains was to secure an improvement in the quality of the outputs across the board for our passengers and to do it in a cost-effective way. I suppose the answer to your question probably is that Network Rail's improvement in their Kent route has actually improved at a faster rate than our own; hence the reference in the figures you see. So they have done very well.

Q16 Jon Trickett: I am quite alarmed about what happened once the decision had been taken to terminate the franchise. On page 30 we have paragraph 3.8 which says that legal counsel had advised the SRA that substantial monies might be charged against the franchisee. There was a bond for £90.5 million but that bond was not utilised to recover all the costs, which I calculate add up to about £4.25 million, which you simply handed back to the franchisee. Is that figure about right?

Mr Newton: Yes. I am not sure I would agree that it was "simply handed back".

Q17 Jon Trickett: You failed to recover it, which is even worse. You failed to recover about £4.25 million.

Mr Newton: No, we did not seek to recover.

Q18 Jon Trickett: You failed to recover an amount of money which your legal advisers advised you were entitled to. You are acting on behalf of the taxpayer, are you not?

Mr Newton: Yes.

Q19 Jon Trickett: In my Yorkshire language I read the argument you have used for failing to recover £4.25 million, as I would describe it, to mean that they had you over a barrel, that is this thing called a ROSCO. The franchisee was operating trains which were owned and leased from a rolling-stock leasing company, one of these ROSCOs. Was that part of the same group as the franchisee belonged to?

Mr Newton: No.

Q20 Jon Trickett: It was a completely separate financial corporate organisation.

Mr Newton: Yes.

Q21 Jon Trickett: What it says is that the leasing company could have claimed large amounts of money if the franchisee had simply become insolvent. Therefore you took a decision not to drive them into insolvency. Is that right?

Mr Newton: Yes.

Q22 Jon Trickett: Can you tell me how much the public purse might have had to pick up if that had happened?

Mr Newton: The rolling-stock lease has a facility in it that if a franchise is terminated early, then the rolling-stock leasing company can claim from the franchise operator the value of the unexpired lease arrangement.

Q23 Jon Trickett: Yes; I understand that. How much was that?

Mr Newton: Our calculation was that it was in the order of £800 million across all the rolling-stock leasing companies.

Q24 Jon Trickett: Had you not failed to collect this money and the franchisee had gone into insolvency, you could have ended up with a bill for £800 million.

Mr Newton: Yes. The process generally was to mitigate that and if a new lease were signed, then as lease rentals flowed from that so that would diminish and they would pay back the £800 million. The rolling-stock lease had had that provision in it.

Q25 Jon Trickett: Why did you allow such a contract to be entered into?

Mr Newton: It was not a question of allowing it. At the time of privatisation one of the elements of the privatisation was that the Government conducted what was known as a trade sale of the rolling-stock leasing companies; they took what was in the British Rail fleet and allocated it between three rolling-stock leasing companies and then sold them in a trade sale.

Q26 Jon Trickett: Did you not envisage that any of the companies which were operating the trains in any franchise might at some time fall into insolvency?

Mr Newton: Yes.

Q27 Jon Trickett: Would it not have been better for the rolling-stock not to have been contingent upon the solvency of the train operating company?

Mr Newton: Possibly, but the process of disposing of the rolling-stock leasing companies had nothing to do with the railway franchising authority: it was a government driven trade sale.

Q28 Jon Trickett: So to whom should I address my question? Is it for you, Dr Mitchell?

Dr Mitchell: I regret not. This was all determined at the time of sale of the rolling-stock leasing companies.

Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK

Q29 Jon Trickett: Who took that decision? Was that a statutory decision? Was it in the Act of Parliament? How was that decision arrived at? Is nobody prepared to accept—

Mr Newton: As I recall, it was a policy decision taken by the Department of Transport, which is what they were called at the time.

Q30 Jon Trickett: Is it the same situation in every single franchise in the entire country?

Mr Newton: Yes. The structure of the rolling-stock leases was what is called a master operating lease, which has those overall provisions in and the individual rolling-stock leases fall below that.

Q31 Jon Trickett: Would I be right in concluding that in the event of any other franchisee getting into difficulty, which would not happen, the Department or the public purse would be in the same situation of not being able to allow that franchise to be terminated since the valuation of terminating the franchise would certainly be less than the cost of the rolling-stock lease?

Dr Mitchell: Clearly it is a consideration we should have to apply in looking at allowing an insolvency to occur. What we would seek to do would be to make an agreement with the rolling-stock leasing company that since the likelihood, the very strong likelihood if not certainty, would be that the leases would continue for a further period, they would not in fact operate that provision. It would not be in the interests of the rolling-stock leasing company to terminate the business in that way.

Q32 Jon Trickett: You have rested your case on the failure to collect the money on the suggestion that they might well have triggered exactly that particular clause within the lease, have you not? That was the argument Mr Newton was making.

Mr Newton: Yes.

Q33 Jon Trickett: If they were not likely to trigger that clause, why did we give away £4.25 million or fail to collect £4.25 million to which we were entitled?

Mr Newton: It was not that certain. It was about assessing and managing the risks involved and one of the other key elements—

Q34 Jon Trickett: Did you take legal advice?

Mr Newton: Yes.

Q35 Jon Trickett: Was the legal advice that, notwithstanding the fact that this money was owing to you, the fact of the matter was that a much larger sum of money was available and therefore you should not claw back that amount of money?

Mr Newton: The legal advice was on what we could claim under the contract. We were aware in any event; that provision in the master operating lease of the ROSCOs is known to us and is very evident.

Q36 Jon Trickett: Did you obtain legal advice on your decision not to recover the money and was that advice the one which is in here, that the risk was so great?

Mr Newton: The advice about the risk was not the legal opinion, it was a management decision based on the legal advice we had about whether or not we could claim. We made a judgment about the risks involved in this very complex transaction.

Q37 Jon Trickett: Might we see the paper which went to the board, which recommended that you ought not to recover this money, notwithstanding the fact that it was owing to us? Was that recommendation the subject of a board paper? Can we see the paper which went to the board?

Mr Newton: On the final conclusion of the negotiations? I am sure we can arrange that.

Q38 Jon Trickett: You can let us have a look at it. May I ask Sir John whether there might be other contractual arrangements which might be entered into in relation to these leases? It seems to me that whenever an operating company is in danger of falling into insolvency the much greater risk is of possibly hundreds of millions of pounds of leasing being rolled up. Were there other options than the particular contractual structure which was set up?

Sir John Bourn: The point you make is a good one. I do not know whether Mr Holden can comment on the detail of it.

Mr K Holden: The key thing here is that the primary assets of a TOC are the leasing agreements it has with the ROSCOs to run its trains. Obviously there is an issue here that the SRA took a decision that even though they had legal advice that they did have a contractual right to recover, they considered that if they pushed for recovery of these costs—

Q39 Jon Trickett: No, I understand that. I was wondering whether there was any other way in which these rolling-stock leases could be entered into than the one with the operating company such that the risk of all insolvency would be faced with the same consequences again. Every time it would be taxpayers' money placed in jeopardy, would it not?

Mr K Holden: The point Dr Mitchell makes is probably the right one here which is that, looking at the interests of the ROSCO as a business, it is not really in its interests going forward to call in that particular agreement.

Q40 Jon Trickett: In that case, basically what you are saying is that we have a bigger gun than they have. I just think that it is worth exploring further. I do not know how to get a further note on it.

Sir John Bourn: We shall look into that and comment.

Jon Trickett: Because we were unable to drive them into insolvency or to risk insolvency and we left £4.25 million uncollected, that then left the company with a series of other contracts, as we see in paragraph 3.15. So the consequences were even

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

more far reaching than simply failing to claw back £4.25 million. It would be interesting to see some further notes on all that.

Q41 Chairman: Directly arising from this question about papers sent to the board I should like to ask a question of Keith Holden of the NAO. When the paper was sent to the board did they mention the appointment of a new MD and chairman?

Mr K Holden: Not in the papers, but the SRA told us that they informed the board orally.

Q42 Chairman: Do you want to comment on that Mr Newton?

Mr Newton: Is this about the appointment of Mr O'Brien?

Q43 Chairman: Yes; presumably.

Mr Newton: We were not aware of Mr O'Brien's appointment at the time we went to the board.

Q44 Chairman: Would it be helpful at all for the Committee to see these papers? Have you seen these papers?

Mr K Holden: Yes.

Q45 Chairman: Perhaps it would be helpful if they formed part of our evidence, would it?

Mr K Holden: Yes, if you would like.

Q46 Kitty Ussher: Could you perhaps explain to us in a bit more detail how you arrived at the decision to terminate the franchise? What was the straw that broke the camel's back? What was in your thoughts in the weeks and months leading up to that decision and why did you finally decide to do it?

Mr Newton: As the Report accurately describes, it was a fairly lengthy process. The genesis was an approach by Connex South Eastern for a two-year extension, which was, in the context of the policy at the time for 20-year franchises which were being negotiated with South West Trains and South Central, a perfectly legitimate approach for them to take. In the context of the policy then, we were encouraged to talk to them. As we started to get numbers from them we started to investigate and challenge and ask further questions and we began to get very uncomfortable with the flexibility and volatility of the numbers. At a point, we decided to cease any further discussion about an extension until we got a clear picture of what the numbers looked like. That is when we started to spend money on a very high quality review and concentrated review. What then happened was that effectively the prospect of a two-year extension faded away; it was no longer the issue. The issue was the financial future and stability of the franchise, particularly looking at the responsibilities and the interests of both the taxpayer and the passenger. We are blessed with this probably being the most complex railway operation on the network, critical in terms of numbers of people carried, economic wellbeing and so on. We started to explore how we might stabilise the business and we were looking at some considerable

uncertainties: Channel Tunnel Rail Link; domestic services; possible Thames link; the introduction of the new trains as the result of the regulation to replace the slam-door stock. What emerged was a lack of some sensible processes for financial management, but no consistent application of them and very little evidence of any forecasting capability. The numbers were moving all over the place and we became increasingly concerned, to the extent that we were not convinced that the business was not on the brink of failure. So our immediate priority was to stabilise and within the context of the volatility of the numbers, we worked hard to fix a number of around £58 million to stabilise for the immediate future, to give us the time to examine what the future looked like. In order to increase our flexibility at that point, we negotiated a revision to the franchise agreement which demanded financial management processes to be put in place and delivered and applied, but also gave us an option to terminate in the event that we could not agree forward provision. As we continued that process, our discomfort from the lack of ability to come up with some firm numbers and see a clear financial future for the business got to a point where we were not convinced that we could properly protect the future flow of subsidies into this business. It was at that point and on that basis that we decided to terminate.

Q47 Kitty Ussher: At the final point it was the protection of the taxpayer rather than the customer that made the final decision for you.

Mr Newton: Probably the taxpayer in terms of the decision to terminate and then what came after, the nature of the negotiation and how we assessed the risk, was very much a balance between the two. For this operation to cease like that would have been fairly catastrophic from the point of view of the passengers.

Q48 Kitty Ussher: I understand. Knowing then what you knew, compared with where you had been before you started asking the questions, did you wish you had started asking the questions earlier? With hindsight do you wish you had got to that stage earlier?

Mr Newton: Yes, and in parallel we had just published our revised franchising policy in November 2002 which had a number of mechanisms in it to address the deficiencies we were dealing with.

Q49 Kitty Ussher: So you believe you have learned from that.

Mr Newton: Absolutely.

Q50 Kitty Ussher: Are there examples elsewhere in the country of where the lessons have been applied? Some other franchises have changed, have they not?

Mr Newton: There have been several well-publicised cases where stabilisation payments have been made when franchises hit difficulties. What made this unique was that in those cases there was a clear robust process to identify what the funding needs were and therefore we could provide. Here we had

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

no confidence that the number we agreed today would be the number needed tomorrow and the particular evidence was that three months into the period when we had agreed a budget, there was already a deficit, or a deviation from budget, of something like £17 or £18 million after three periods as an indication of that continuing volatility.

Q51 Kitty Ussher: So that we can understand fully what the improvements are, can you describe how you start asking when the franchise is not coming up at the moment?

Mr Newton: There are two things. There has certainly been much more training, development, emphasis put on the financial literacy—if that is not a contradiction in terms—of the franchise management people. That is something which the Department have taken on and further developed. The other thing is that in the new franchise model the bid needs to be justified on a whole series of interlinked business plans, whether cash plan, employment plan, training plan, recruitment plan and so on. Therefore with regular monitoring of progress against the plan you can very quickly identify any divergence and look to the operator to come up with a plan to bring it back on or explain why there is that divergence.

Q52 Kitty Ussher: How regular is the regular monitoring? If you have a 20-year franchise, is there team in the SRA whose job it is to check when the annual Report comes out?

Mr Newton: No; there are no more 20-year franchises. That was consigned to history. The maximum is 10 years. Dr Mitchell is now responsible for that and there is a series of four-weekly, quarterly, six-monthly and annual reviews. The whole policy is designed to encourage the operators, oblige the operators to have a dialogue with the franchising authority almost on a day-to-day basis.

Q53 Kitty Ussher: Do you want to comment Dr Mitchell?

Dr Mitchell: Just to confirm what Mr Newton has said. We now look for a franchise to give us a financial projection to the year end and beyond that as well, so that any changes in their forecast start ringing alarm bells for us.

Q54 Kitty Ussher: Do you have examples of where you have managed to prevent problems getting out of control through this new system?

Dr Mitchell: It is quite early days for that yet, but the mechanism is in place for that to happen and I am quite confident of that.

Q55 Kitty Ussher: I am sure that customers were delighted when Connex lost their franchise; as a user I was not very satisfied with it myself. What I find quite interesting is that the taxpayer is actually paying more now than it was to subsidise Connex because Connex had not actually been asking for help when perhaps it should have done. Am I right in my reading of the Report? Is that correct?

Mr Newton: Yes; they are certainly paying considerably more than the original franchise bid and the original franchise agreement. Given the volatility of the numbers, as far as we can judge the amount we are now paying to run South Eastern Trains is probably broadly comparable. We are satisfied that it is the right figure to run those sorts of services of that quality, employ those people and so on. What it exposes is that probably the original bid did not specify adequate funding.

Q56 Kitty Ussher: Coming back to the taxpayers' interests, which is of course what this Committee are particularly interested in, at the point you realised that Connex was probably not going to be viable for much longer and there were some serious weaknesses, you made the decision to protect the taxpayer not because you were subsidising Connex on a monthly or annual basis, but because you thought it was going to collapse, which could potentially have had far greater implications for the taxpayer. You are actually paying more on a regular basis now. I do not know whether I am making myself clear, but is that correct?

Mr Newton: The other element is to establish some degree of stability. The numbers were moving around and the volatility was there and our judgment was that the volatility was not in the best interests of the taxpayer. That was the situation.

Q57 Greg Clark: I have a reasonable familiarity with some of these issues because the franchise goes into my constituency and my constituents experience both Connex and more recently South Eastern Trains. Unlike Kitty Ussher I interpret this Report as saying broadly that this was an appropriate intervention on the part of the SRA and the Department, with some caveats as to how it was done, and that the performance of South Eastern Trains subsequently has been a great improvement; certainly that is the feeling of my constituents. On that first element, paragraph 1.32 of the Report, page 7 says "The SRA had little confidence . . . that CSE would be able to run the franchise within the £383 million it was prepared to accept". That strikes me as the crux of the matter. Sir John, I have interpreted a broad support for that assessment from your Report. Would that be correct?

Sir John Bourn: Yes; broad support.

Q58 Greg Clark: In terms of the improvement in performance as regards passengers' experience, I think Mr Holden was unduly modest in his earlier remarks. Certainly my constituents find a transformation in the management and the performance of the operation and the company is to be congratulated on that. The questions I have are on lessons to be learned going forward. We have the unusual position of a new franchise having just been let to take over from South Eastern Trains, the Integrated Kent Franchise, so my questions are really around that. One of the unrecovered costs in this particular case was for the re-branding of the rolling-stock and staff uniforms and that sort of

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

thing, which came to nearly £300,000, which would probably pay for the redecoration of every station in my constituency. Is it necessary to incur that cost?

Mr Newton: We took a judgment. We had a plan which of necessity needed to be modest but needed to address the essentials. We felt that it was essential, for a number of reasons, certainly to demonstrate to the passengers that there was a change, but equally importantly to demonstrate to staff that this was a new company, it was not an *ad hoc* temporary arrangement—although it was temporary—and to establish a strong brand fairly modestly costed. Although £300,000 is a significant sum of money, when you look at the size of the fleet and the amount of work which was needed, we employed very low cost and minimal re-branding changes.

Q59 Greg Clark: We have a new brand there now which is fairly well regarded. Would you expect these costs to be re-incurred? Do you expect the whole fleet to be repainted in the colours of GoVia, or do you expect the South Eastern brand to continue?

Mr Newton: I am not actually sure; that might be a question for Dr Mitchell. I am no longer involved at all.

Dr Mitchell: I do not know in detail what GoVia's plans are, but I should be surprised if they did not intend to re-brand and re-livery the trains.

Q60 Greg Clark: If it is something like £300,000, do you think that is a reasonable expense? Do you not think that would be better spent on repainting stations rather than repainting trains?

Dr Mitchell: I think £300,000 for a fleet the size of South Eastern's operation and the uniforms is not an unreasonable cost. One also has to remember that uniforms wear out and therefore to some extent one can replace them at the normal wear schedule.

Q61 Greg Clark: Precisely. Presumably that is part of the normal operating cost; there would not be a special item for that. What would you consider to be a reasonable sum to spend on this re-branding exercise? Some of our stations could do with a lick of paint, not to mention improvements. If there were £300,000 to spend, I should be first in the queue to make a bid for that. What would you consider a reasonable sum for GoVia to spend?

Dr Mitchell: I do not think £300,000 is an unreasonable amount in the context of what was done by South Eastern Trains. I do not know the plans of GoVia in that detail and what they intend to spend on branding and livery.

Q62 Greg Clark: Could you perhaps write to us to reassure us?¹

Dr Mitchell: I shall check the franchise specification and come back to you on that.

Q63 Greg Clark: Thank you very much indeed. One of the more significant issues was the monitoring of the financial performance of the business and this has come out in some earlier questions. Could you just describe to me what arrangements you have put in place in the new GoVia franchise to challenge the viability of their business plan, given that in the case of Connex it was so underestimated?

Dr Mitchell: Every new franchisee has to deliver a number of interlocking business plans as part of the franchise proposition. Also, in all the new franchise agreements we have the ability to check the financial viability of the company at monthly intervals and for the company to produce financial projections through to the year end. One of the danger signals we look for is any significant change to that forecast. At the same time we maintain close dialogue with the company—this is not particularly for GoVia but any new franchise—we look for the danger signals of instability within the finance team, excessive claims, movement in numbers, those sorts of things.

Q64 Greg Clark: You did a lot of this last time and the Report makes clear that you misperceived some of those signals, in fact you had a consultant's Report which gave you false reassurance, false comfort. What steps have you taken to make sure that you make an accurate assessment?

Dr Mitchell: First of all, we have the confidence within DfT and we also use the services of the DfT central finance unit.

Q65 Greg Clark: That must have changed then since the original operation as you got it wrong last time.

Mr Newton: I am sorry; I did not recognise the description of being misinformed by a consultant.

Q66 Greg Clark: There is reference to a consultant's Report which seemed to be a bit blasé.

Mr Newton: Perhaps it is the PriceWaterhouseCoopers' audit where, although they said the financial systems were broadly comparable with those you would find elsewhere in the industry, they nevertheless would not recommend that we spend any more taxpayers' money with the degree of uncertainty. Mott MacDonald actually said that CSE had not complied with its obligations to improve its financial management, control and Reporting.

Q67 Greg Clark: I do not want to get bogged down on this particular point, but clearly you were quite late in intervening last time. Are you confident that you will notice a failure much earlier on in future?

Mr Newton: Yes, there has been a fundamental change in the level of monitoring, the scrutiny of the bid, the continual dialogue to identify divergence and address it as Dr Mitchell described.

Q68 Greg Clark: In awarding the contract to GoVia for IKF the Minister described it as a tough contract. What did he mean by that? You must have advised him?

¹ Ev 15

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

Dr Mitchell: The contract awarded to GoVia was quite a challenging one, both in terms of the revenue they have to derive and also the performance targets that they have to achieve. Arising from the White Paper last year, we now award contracts particularly on the proposition of price, but also on reliability and with due recognition for past performance. These are significant changes from what was done in the past.

Q69 Greg Clark: Are you confident that this tough regime, which is going to get much less subsidy than South Eastern Trains has had over the course of the contract, will not lead to a decline in standards of performance that we had under Connex South Eastern?

Dr Mitchell: Yes; I am confident of that.

Q70 Greg Clark: In terms of the pricing of it, the tender document had two scenarios for pricing: one was that the fares should rise by 1% above inflation and the Department has chosen a rise of 3% above inflation. In other words, it is expected that fares will rise at more than twice the rate of inflation. Why is that?

Dr Mitchell: That was the assumption we were authorised to carry out in terms of what should be placed in the price assumptions for the franchise.

Q71 Greg Clark: In other words you are saying that was a ministerial decision.

Dr Mitchell: Absolutely.

Q72 Greg Clark: The fact that both scenarios were modelled there meant that the decision was left until relatively late in the day.

Dr Mitchell: It was to get what we felt was the right balance between what the taxpayer was contributing and what the passengers were contributing, particularly bearing in mind the large investment in rolling-stock which has taken place over the past couple of years.

Q73 Greg Clark: Just to understand that, is that because of the investment in the Channel Tunnel Rail Link? Is it to pay for those costs?

Dr Mitchell: No; not directly. It is mainly to do with the £600 million of new rolling-stock which has gone in. It does take account of the fact that in 2009 there will be the Channel Tunnel domestic service as well.

Q74 Sarah McCarthy-Fry: I know Mr O'Brien that you were not in charge at the time of the bid but nevertheless you are here speaking on behalf of Connex. Do you think Connex was fairly treated by the SRA?

Mr O'Brien: In the round, having looked at all the evidence myself, which is what I have done since I arrived, what has struck me is that a lot of what Connex was doing was correct, but they did not seem to have been dealing with the SRA in a way which enabled the SRA to take confidence that the right things were being done. My overall feeling was one of real sadness, to be honest, because it did seem,

certainly as far as the financial management of the business was concerned, which was at the crux of the SRA's concerns, that Connex thought they were doing the right things. The SRA clearly did not think they were and I actually think there was a mismatch.

Q75 Sarah McCarthy-Fry: Do you think the bid was costed properly in the first place?

Mr O'Brien: May I change hats for a moment and say that at the time the contract was awarded I was on the team which was evaluating the bid. It was within the first few months of the rail franchises being awarded, when there was relatively little experience as to what was going to be a good bid or too tough a bid. At the time the criticism which was being levelled towards the bid, not just for Connex but a general point, was that the bidders were being far too optimistic about their revenue forecasts because everybody knew that fewer people were using the trains day by day. However, people were generally comfortable with the fact that the franchise operators could cut costs because there must be opportunities for cutting costs. In reality what has happened is that Connex, very much as a lot of the other operators have managed as well, actually achieved the revenue forecasts and there has been a complete turnaround in the number of people using the trains, which in turn has driven the revenue coming into the industry. Where they failed was that they were too optimistic on the level of costs they could save.

Q76 Sarah McCarthy-Fry: You do not think it was deliberately underbid to win the contract then.

Mr O'Brien: I should be amazed if that were the case and I have absolutely no reason to believe that.

Q77 Sarah McCarthy-Fry: Given that Connex were running another franchise at the same time, were economies of scale built into the bid, assuming that they would be able to mix overheads or was it a totally separate bid?

Mr O'Brien: It was evaluated as a totally separate bid and that was the basis on which they put in their bid, from recollection.

Q78 Sarah McCarthy-Fry: I was a bit confused by page 15. Perhaps you could explain this to me. Why did none of the train operating companies know what the train drivers' wages were? Paragraph 2.3 says "In common with other TOCs, train drivers' wages were also much higher than expected". Why was that?

Mr Newton: At the time of privatisation there was probably a perception that there was scope for cost reduction and headcount reduction across the piece based on what British Rail costs had been. The Report says that probably a lot of the train operating companies underestimated the exigencies that British Rail had driven. The other thing was that, whilst some operators did economise on headcount, certainly long-distance operators typically inherited two drivers in the cab and by getting rid of one they could increase wages and save

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

quite a bit of money, that had a ripple effect because they were all members of the same trade union so aspirations generally rose. I also think, if you look at the length of time it takes to train a driver and some of the issues around performance regimes, that with the benefit of hindsight a very strong leverage was given to the train drivers' union, which has probably been one of the reasons why train drivers' earnings are so much higher now than they were before. No one predicted that to be the case at the time. They knew what the costs were, but they assumed that costs could be saved, efficiencies could be driven, which was not the case, as it turned out.

Q79 Sarah McCarthy-Fry: Were health and safety aspects taken into account as part of your evaluation when nearly all the train operating companies put these efficiencies in? Was that part of it?

Mr Newton: Safety issues as such were not a core part of the evaluation, but a fundamental requirement, a yes or no decision, was. You could only be awarded a franchise on condition that you had a legitimate safety case which was awarded by the safety authorities and that covered a whole range of safety management within the business including safety plans going forward. It was a precondition; a bit like a licence.

Q80 Sarah McCarthy-Fry: Did that include the number of drivers on a train? You said that originally they had two and they thought they would take one off. There must have been a safety aspect to that?

Mr Newton: Yes, but the operators satisfied the safety authorities that that was not in any way detrimental to safety.

Q81 Sarah McCarthy-Fry: May I come back to Mr O'Brien for Connex? Does Connex agree with the NAO Report when it says that when you received the additional subsidy in 2003 you thought there were going to be further subsidies so you focused your attention on negotiating subsidies rather than looking at getting a cost reduction? Do you think that is a fair comment?

Mr O'Brien: No, I do not. The reality was that during that period two pieces of work were going on. One was that Connex needed to satisfy the rail authority about its financial management, but actually a large part of the agreement which Connex had entered into with the rail authority was around the assessment of the future subsidy requirement. During that crucial three-month period from January to March 2003 Connex put in place a whole variety of investigations, which they believed was addressing the SRA's concerns about how to save money and provide a better railway service and provided opportunities which could have saved up to £20 million in terms of cost savings. In fact that was never followed through because I understand that was not where the SRA's focus was at the time. I imagine Mr Newton could answer better than I for himself. Certainly as far as Connex was concerned, I am very much aware that they were putting a lot of

work into how they could make the franchise operate more economically. Alongside that, they were also doing whatever was necessary to improve the financial management to satisfy the SRA.

Q82 Sarah McCarthy-Fry: Do you want to comment Mr Newton?

Mr Newton: Yes. There are several things. On this period January to March, March was three periods into the new Connex financial year on which we had agreed a budget. Towards the end of March there was already a gap between actual and budgeted expenditure, a negative gap of something around £17 million. That served to reinforce our concern about the robustness of the numbers. Mr O'Brien is right that our focus shifted round about that time to the priority issues around the future of the franchise, but, on the savings, to the extent that we did analyse them, if they were robust, they also required some additional capital expenditure which did not seem consistent with the sorts of numbers which were coming out. The third thing was that we were negotiating a £250 million budget which my guys negotiated down to £183 million, which was further evidence that the numbers coming out through the Connex model were very volatile and flaky if you could push them back to that extent.

Q83 Sarah McCarthy-Fry: Mr O'Brien, do you think it was a particularly difficult contract, a difficult franchise to manage?

Mr O'Brien: Certainly operationally it was a very difficult train franchise because it is one of the most intensively used parts of the network. Yes; operationally it was.

Q84 Sarah McCarthy-Fry: Because your costs were so much greater and the contract was difficult, were you actually looking for an exit strategy? Is that why you did not comply with all the SRA's requirements, because £15 million may be quite a small price to pay for getting out of a contract which is going to lose you money?

Mr O'Brien: Absolutely not. I should make a number of points. First of all, at the end of December 2002, Connex contributed a further £11 million of additional share capital into this company. I may be wrong, but I am not aware that any other train operator had done that. That was their vote of confidence in taking the business forward. They believed at that time that they were working closely with the SRA to make things better.

Q85 Sarah McCarthy-Fry: Yet you believe you were treated fairly by the SRA.

Mr O'Brien: No, I am saying that the information which was provided to the SRA was obviously done in a way which did not satisfy them. Do I think they came to the correct conclusion? In my opinion the evidence I have been able to see would not support the grounds on which they took the action they did.

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

Q86 Mr Mitchell: Perhaps you would bear with me as a new chum on the Committee; in fact I am beginning to think already that I am too nice for the Committee. Let me start with the assumptions that Connex South Eastern made. Why were the assumptions so optimistic? Was it that you thought British Rail had not made it more efficient and cost effective, in other words you underestimated the achievement of your predecessor? Was it that you attributed too much dynamism and impact to the wonders of capitalism and new management, or did you just not know the circumstances of the contract?

Mr O'Brien: The reality was that it is probably true to say that British Rail had been operating at a level where the level of cost efficiencies which Connex were hoping for were not going to be available because they had already been achieved. Therefore they were not able to do the cost savings which they expected they might be able to achieve incrementally. I have to say that I do not believe this was something special to Connex. I should not be surprised if there were a similar thing across the network. As far as your second point is concerned, may I refer you back to my earlier comment? It was generally accepted at the time that the number of people travelling by train was reducing and in fact had been for decades. It is the case that round about this time, across the network, passenger numbers did increase and that was why, generally speaking, the train operators were able to exceed the forecast they had made for income. Very simply, they were leasing the trains and they typically ran the trains more often because they were paying for the trains anyway; with more services, more people use the trains.

Q87 Mr Mitchell: What responsibility attaches to the SRA here? Why did you not question these optimistic assumptions? Why did you not tell them that trains had to have drivers and drivers had to be paid? The kind of experience that happened to Arriva in our area was not untypical. They seemed to think that they could run things on the cheap. Why were SRA not more involved and more effective in assessing the quality of the bid?

Mr Newton: At the time OPRAF were delivering a clear policy of lowest subsidy wins and risk goes out to the private sector. If private sector operators were prepared to take the risk on cost efficiencies, cost reductions and revenue growth—and that was typically the response of the market; there were no outliers who said there was going to be revenue reduction and cost increase—if that was what the market was saying based on the risk going to the private sector, then that was the policy and that was the policy OPRAF was implementing.

Q88 Mr Mitchell: The logic of that situation, capitalism red in tooth and claw, is that those who make mistakes go under. The concomitant of what you are saying is that it should be allowed to fail.

Mr Newton: Yes, but—

Q89 Mr Mitchell: You were not prepared to allow it to fail.

Mr Newton: No, because the backstop was that it was a statutory requirement on OPRAF to act as operator of last resort, so we had a statutory obligation to maintain the services in the event of failure. This is why—and I do not disagree with your analysis of the problems—the policy which was being implemented by OPRAF was that lowest cost wins, risk goes to private sector. You might say that the policy which is now applied is a more mature policy which looks at and assesses the deliverability of the bid and it is a very structured process around testing credible business plans rather than just saying you are prepared to take the risk, go away and take the risk. History has shown that that risk is borrowed by the private sector and it comes back.

Q90 Mr Mitchell: Therefore you are saying that you are operating somebody else's policy, in other words accepting the lowest bid. You must therefore have been aware, this being the lowest bid and being a pretty low bid in any case, that there were problems when you gave the contract.

Mr Newton: When we awarded the contract? No, at that time—

Q91 Mr Mitchell: Even though it was too low to succeed, you did not see any problems.

Mr Newton: We had no benchmark against which to judge that. The market was all saying broadly the same thing, that revenue could grow and cost could reduce. The Connex bid for South Eastern was consistent with that approach.

Q92 Mr Mitchell: You, having decided that the bid was low and therefore should win, that was policy, then started doling out money on quite a considerable scale, not only to Connex South Eastern but to other operators as well. Why was that? Was that to make the system succeed despite its inherent faults?

Mr Newton: I am not quite sure when we started doling out money.

Q93 Mr Mitchell: You started to give them more money, to keep them going presumably. Why was that?

Mr Newton: In the Connex South Eastern case the additional subsidy was paid expressly to stabilise the business once we had identified the major financial problems, so we had time to address the medium- and long-term solution which is exactly what we did.

Q94 Mr Mitchell: You put other companies under management contracts.

Mr Newton: Yes.

Q95 Mr Mitchell: Why not here?

Mr Newton: There is a whole range of types of management contract, but the other management contracts were driven, for instance, by major

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

external factors like Hatfield where revenue collapsed. On the Virgin stabilisation, that was around the non-delivery of the West Coast upgrade on time, which was the critical driver of very significant revenue growth. It just did not materialise. In all those situations the judgment you need to make is whether indeed you do step in and act as operator of last resort, terminate or whether you actually stabilise and try to find the balanced way forward in the best interests of the taxpayer and the passenger. The other thing I would say is that Connex was unique in that it was the only franchise that had a facility whereby we could terminate because we had built that into the variation to the franchise agreement.

Q96 Mr Mitchell: I am trying to find out what the tipping point was between your faith in putting in more money and your sudden decision to take industrial Viagra and boot them out. What produced the change of mind? Was it that Connex was uniquely incompetent, or what?

Mr Newton: No; it was not a sudden decision, it was a very developed and reviewed and managed decision where we had exhausted options and got to the point, given that we no longer had confidence that additional significant sums of subsidy going into this business could be properly spent in the taxpayers' interest. That was inconsistent with our statutory duties and we needed to terminate at that point.

Q97 Mr Mitchell: What was the uniqueness of Connex? Sir John remarks that SRA's loss of confidence was unique to Connex South Eastern. He does not say anything about it being significant; I just read significance into what it says. Unique means that there is something unusual, that there is an unusual mess, an unusual incompetence, whatever it might be.

Mr Newton: Yes and the Report identifies all the way through what that was, which was a loss of confidence in the robustness and the believability of the numbers which were coming out, significant sums of taxpayers' money which Connex were saying they needed to continue to run the business. They moved around, they were volatile, they were not stable. We looked at why that was.

Q98 Mr Mitchell: It was not customer dissatisfaction. I see from the two sections on that in the Report that there was customer dissatisfaction and it was the worst service operating in London, but that is still the case. There has been no real improvement. What part did consumer dissatisfaction play?

Mr Newton: No part.

Q99 Mr Mitchell: So you were not bothered that there were commuters all over the South East moaning and groaning about Connex and there was an audience out there asking why the SRA did not get its act straight and discipline somebody. It was not that kind of pressure.

Mr Newton: No. It is the pressure to take action in the context of what the contract allowed us to do.

Q100 Mr Mitchell: That is very interesting. Why then did you get consultants to do your dirty work for you? Did you not have confidence in your own abilities to do this? I see a consultant, Mott MacDonald, was put in. He went native and started being sympathetic to Connex South Eastern, so you then put in PricewaterhouseCoopers obviously to kill. According to the Report, they found faults in five areas and Connex then replied that they only applied to three and Sir John's Report says that some of the estimates were wrong. Paragraph 3.15 is the point where PwC are putting in the boot, "PwC had expressed concerns about the transparency of this intra-group arrangement in their May 2003 Report", although that was incorrect. In other words, the consultants are in there doing your dirty work for you, trying to find evidence which will allow you to boot out Connex South Eastern. Is that right?

Mr Newton: No.; it is not dirty work.

Q101 Mr Mitchell: It is unique, though, is it not?

Mr Newton: In running an operation the size of the SRA, which is entirely funded by taxpayers' money, what you do not do is resource against the worst case event. You have to manage the peaks as they arrive. We were never resourced to deal with this degree of complexity in the termination. It would have been irresponsible to have a whole army of people sitting there waiting for an event which has happened once in eight years. What you do in that situation is buy in expertise to address the particular peak of workload, both to address the workload but also to provide expertise which you do not carry in house because for most of the time it is redundant. The other thing was that this was a very complex and novel situation. Yes, in terms of lessons learned, if we ran through an exact same set of circumstances again we would not spend as much on consultants and the Report is accurate in saying that we probably duplicated some effort to make absolutely sure. This was critical. This is a huge business, 4,000 employees, £450 million turnover and 300,000 passengers a day. I would rather have belt and braces than have my trousers fall down on this one. So that is the situation.

Q102 Mr Mitchell: There is a common assumption, which I share, that you bring consultants in to get the verdict you wanted in the first place and you got it. That coincided with a rising cry in the country that the Strategic Rail Authority should get off its backside and do something about the quality of service, so an example was made of Connex South Eastern.

Mr Newton: No. Quality of service is a separate issue which has been addressed in the new franchises. One of the other deficiencies in the franchise agreement was that it relied on performance regimes which were independent of any specific franchise management action by the authority. They run themselves and they incentivise performance. It is

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

quite interesting to see that this one and only termination was driven by something as specific as having a concern about or losing confidence in the proper expenditure of taxpayers' money rather than operational performance. I accept your analysis in that respect.

Q103 Mr Bacon: Mr O'Brien, may I ask you to turn to page 32? At the bottom in paragraph 3.20 it states that "SET's new Finance Director concluded at an early stage that the underlying financial systems and processes inherited from CSE were generally sound" and it goes on to refer to a number of changes which SET made including "... improvements to financial management that CSE had not introduced before CSE's exit from the franchise" and then at the top of page 33 it continues "and has improved its internal controls and financial forecasting. It has also appointed a regulatory compliance officer" and lo, one finds that by January 2004 the business had improved and in a follow-up Report in April 2004 there had been a very significant improvement and SET and the SRA considered the problems which SET inherited had been addressed. What I do not understand is why Connex could not have implemented the changes which are described in that paragraph. None of them sounds like rocket science. It does not sound like deep-seated issues, fundamental failures, all these things which we have heard here and elsewhere about Connex. Why could Connex not have implemented these changes?

Mr O'Brien: Your point is absolutely correct. The question I would be asking would be what the deep-seated problems were. Just to make your point for you, the earlier consultants' Reports, the PricewaterhouseCoopers' Reports referred to just a moment ago, said that the systems were robust and as good as those of anybody else in the industry. The new finance director appointed by SET said that the processes were generally sound and I understand that most of the staff implementing them are still there as well. I actually am not aware what was so fundamentally wrong that needed to be corrected.

Q104 Mr Bacon: You would take issue with the pulling of the franchise basically.

Mr O'Brien: I would absolutely take issue with it on the grounds that the SRA took the action they did.

Q105 Mr Bacon: Thank you for that; that is very clear. Mr Newton, you are representing the SRA who did the pulling of the franchise. What was it that was so fundamental and deep-seated that it could not have been addressed?

Mr Newton: It was the consistent application of those systems. To take one example, one of the things that PricewaterhouseCoopers refer to in their Report is the lack of a finance director dedicated to the train operating company, Connex South Eastern. The finance director was actually Reporting to Paris and when we took over one of the first things we did was put in a finance director who was the finance director for that train operating company and Reported to the managing director.

Prior to that the finance director did not Report to the managing director. There is also another structural thing, which is not to do with the finances at all, but out of interest: the delivery of the new trains replacing the slam-door trains, that whole project, critical to the business, was being dealt with outside the train operating company. Mr O'Brien refers to the PricewaterhouseCoopers' Report. The Report said that the systems were not untypical: true. It was the consistent application of those.

Q106 Mr Bacon: It says they were generally sound.

Mr Newton: Yes, but it is the application of them. There was no need to change the systems, but the consistent application of them was what changed when South Eastern Trains took over.

Q107 Mr Bacon: You are basically saying that you lost confidence in the management.

Mr Newton: The financial management; yes.

Q108 Mr Bacon: Why did you then pay £557,000 to a group of managers to get them to stay; to incentivise them to stay.

Mr Newton: Financial management was not core to the train operating company. Michael Holden, for instance, had been there a few months and had no finance director Reporting to him. He had no financial management capability of that business. One of the things we did, post the decision to terminate, pre the takeover, was to employ some consultants to do a very thorough, really thorough review of the business overall, ranging from safety management, safety strategy, through all the operating systems and out of that came a view of the key people, the critical people, their competencies and the contribution they could make going forward. We put in place retention of those people to make sure that the business did not collapse on day one.

Q109 Mr Bacon: What you ended up doing was pulling the franchise, incurring a huge range of costs, paying bonuses to all the people you wanted to keep and all but 12 members of staff transferred. It was a huge amount of effort, a huge amount of risk. Why could you not just have let a management contract and gained more control? Before you say that would have required more financial risk, which is the answer it gives in paragraph 3.32 "... the SRA would have taken more financial risk", at least I think that is what the SRA considers it would have done, that really brings me to my next question. Why would letting a management contract in the way described in paragraph 3.32 have involved the SRA in greater financial risk?

Mr Newton: Because a management contract requires fundamentally clear confidence and understanding and visibility of the funding requirements of the business and that was not what we were getting from the financial management processes and system from Connex.

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

Q110 Mr Bacon: Could you not just have let a management contract in which you insisted on the replacement of certain managers, if this was your problem? Paragraph 3.32 says "... the underlying issue of the SRA's lack of confidence in CSE would not have been solved", but the fact was that virtually all the same people, with very few exceptions, carried on.

Mr Newton: But, they carried on with the addition of a dedicated finance director for that business.

Q111 Mr Bacon: In that case I go back to my question. Why could you not then just have let a management contract, having insisted as part of its terms, that there be new financial management in place?

Mr Newton: In the deed of amendment we asked Connex specifically to address a number of concerns we had around financial management. One of those was the appointment of a dedicated finance director. They failed to do that.

Q112 Mr Bacon: Why could you not have imposed that through a management contract?

Mr Newton: If you start imposing, then you really do blur responsibilities. What you are saying is that this is a problem; you solve it by doing what we tell you. I think the responsibilities and the risk would have shifted to the public sector and that was not an acceptable position to be in.

Q113 Mr Bacon: Mr O'Brien, would you like to comment on what you have heard, particularly about the question of a finance director not Reporting to the management in the UK and other issues as well?

Mr O'Brien: Around the whole issue of management generally, including finance, first of all I was surprised to hear earlier that the SRA was not aware at the time they had their board meeting that I was due to join the company. I was being specifically recruited to ensure that whatever the SRA required Connex to do, apart from developing the business, happened. I understood that the SRA had been informed. That is the first point. The second point is that I arrived in the office for my first day at work on 23 June. In my first meeting at nine o'clock that morning I met PricewaterhouseCoopers who were there for another audit and the first thing I said to them was that we were going to appoint a new finance director and they could take that and Report wherever needed, because I could see that it was important and that was what we were going to do. I do not understand why the SRA was not able to take cognizance of those sorts of things which were very relevant. The reality is that Mr Holden was recruited by Connex; he has been retained by the SRA and I have no doubt has done a very good job. I was recruited by Connex to improve the relationship with the SRA and ensure what they required to be done was done. I have to say that the handover process, which you may want to talk to me about later, was handled extremely well. I am very

disappointed that the SRA took the action they did, because I believe that what they could have achieved could have been achieved another way.

Q114 Mr Bacon: Presumably with less disruption and less cost.

Mr O'Brien: Absolutely. It is all very well to say, as I heard earlier on, that the figures are broadly comparable. Connex was offering to do it for £22 million less. You may say that they would not have delivered it, but the reality is that this Report says the SRA drove down the numbers to that level. Connex was looking for more than that; it was the SRA which was driving it down to that and yet was nevertheless prepared to give that additional money to South Eastern Trains.

Q115 Mr Bacon: One more on the question of the handover. Paragraph 3.15 says that Connex remains a party to several contracts including the purchase agreements for new trains. It says at the conclusion that one of the consequences was that SET could benefit from train maintenance at lower than market rates. Is Connex Transport UK Ltd still a party to those contracts or have they all now unwound?

Mr O'Brien: No, we have been in discussions with SET and our other partners as to how we can be taken out of that situation, because in my view it is quite inappropriate that we are still there.

Q116 Mr Bacon: So you did not get rid of them at all in actual fact, did you Mr Newton?

Mr Newton: The Report is very clear about the circumstances around the SETML, the South Eastern Trains management contract which was very complex and we were negotiating for two years to try to come up with a revised arrangement. There was a flaw in that contract and we failed to do so because we could never get to a point where we could reach a satisfactory deal with Bombardier Trains UK.

Q117 Mr Bacon: Mr Holden, one very quick question. On page 34 it refers to the fact that SET made provision for £2 million to tackle a backlog of station painting and deep cleaning work inherited from CSE. How much of that £2 million have you spent on clearing that backlog?

Mr M Holden: We arranged a three-year programme to cover every station, and two thirds of the programme has been carried out and effectively that money has been spent.

Q118 Mr Bacon: When you say "effectively", has it actually been spent?

Mr M Holden: Yes, it is part of our ongoing business planning arrangements. I would expect that to continue in the future on a reasonable cycle.

Q119 Mr Bacon: Is it possible you could write to the Committee with a note on just exactly what has been spent on station painting to date and about your forthcoming plans as well?

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

Mr M Holden: Of course.²

Q120 Greg Clark: In response to an earlier question Mr O'Brien said that one of the reasons why the Connex franchise failed was that the cost savings which were anticipated had actually already been made, by implication before the privatisation kicked in. Is that a fair summary?

Mr O'Brien: Yes; I said that was one of the things it is likely this particular bidder incorrectly estimated.

Q121 Greg Clark: Dr Mitchell, would you agree with that? Do you think that cost savings were made before the franchise?

Dr Mitchell: I would agree with Mr O'Brien to the extent that there was a large amount of optimism in the early stages of franchising both in terms of revenue and in terms of the ability of franchisees to remove costs. I would not, however, agree that all costs had been removed which could be. Some of the apparently easy hits that some of the early franchise companies were looking for clearly failed to materialise and that particularly refers to staffing levels on trains.

Q122 Greg Clark: If costs and revenues were both optimistic at that stage, how can you reassure us? The subsidy for South Eastern Trains has been £400 million over three years; the new subsidy in the IKF contract is going to be £585 million over eight years. If the costs have been squeezed out, or a large part of them, where is this reduction in subsidy going to come from?

Dr Mitchell: Most of the train companies have far more experience now of running, managing and estimating for franchises in the 10 or 12 years since the process started. People are not making the same mistakes as they were earlier; we are not seeing the same level of instability.

Q123 Greg Clark: But it is consuming less money. Is that coming from costs being squeezed further or revenues?

Dr Mitchell: It is largely from revenue growth. As other witnesses have said, one of the significant changes in the late 1990s was the change in the number of people using trains. Because more and more people are using trains, in fact we are now carrying more people than at any time since 1946, that flows through in additional revenue. To some extent that has rescued the original optimism.

Q124 Greg Clark: In summary, the trains are already crowded and they are going to get even more crowded under the new arrangements.

Dr Mitchell: To some extent what is happening is that the peak is spreading. People are inevitably moving to off-peak periods. As we have seen from some of the train companies such as Stagecoach,

there have been some very innovative attempts to spread the peak by offering very competitive prices. I have seen, for example, £1 to Southampton being quoted and that kind of thing. The train companies are becoming much more sophisticated at demand management and that is one of the reasons why I have more confidence in how they are approaching their task.

Q125 Greg Clark: Just to be clear, that is where the revenue is coming from, from these more imaginative spreading of loads.

Dr Mitchell: Yes, that is part of it.

Q126 Jon Trickett: I want to ask the NAO about the PricewaterhouseCoopers' analysis. It is obvious, just listening to what has been said and reading the Report as well, that this is a much larger group than simply Connex UK. There must have been some fear in somebody's mind that decisions were being made outwith the particular company but within the overall Connex group and that there was a possibility of intra-group transfers of finance. There must have been some worries and I guess that was exacerbated by the fact that there was no dedicated finance director within Connex UK. When you look at the Report, PwC in each case seem to have been satisfied retrospectively that nothing of the kind was happening. Although I am not here to speak at all for Connex UK—I am surprised in a way that I have come to this view—it seems that nothing was being done and it just was not particularly apparent, perhaps because of the corporate structures and so on. When I looked at your methodology at the back, it refers only very briefly to an interview with PwC. It does not specifically say that you looked at PwC's documents at the time. Did you look at the documents? If you did not, why not? If you did, were you satisfied that the worries about the way in which this group was operating were so great that there was no option other than to terminate the contract? I do not think a very strong case has yet been made as to why this particular franchise was terminated.

Mr K Holden: We did of course look at PricewaterhouseCoopers' Report in detail—it is a very long Report—as part of our forensic review of the papers the SRA had. It was in that bundle of papers, so I can assure you that we did look at that particular Report. Obviously, having read that Report, we also went to see the two partners who were involved in that particular piece of work and discussed it with them in terms of how they did it, their conclusion and their view of the issues they found. We also obviously spoke to Mr O'Brien and some of his people around the additional information they provided subsequent to PwC's work, which we point out at paragraph 2.18 where CSE were responding to those particular concerns. You are right to point out that actually CSE were able to reassure PwC and satisfy them that there were no issues around—

² Note by witness:

2003–04—12 stations were painted at a cost of £475k

2004–05—44 stations were painted at a cost of £1,029k

2005–06—by 31 March, 70 stations will have been painted at a cost of £1,755k.

**Department for Transport, Strategic Rail Authority, South Eastern Trains
and Connex Transport UK**

Q127 Jon Trickett: I am sorry to interrupt, but my time has run out. Did you satisfy yourself that PwC were recommending clearly that this franchise should be terminated?

Mr K Holden: No, they were not recommending that. They were recommending to the SRA that if the SRA were going to put more money into this particular TOC, somewhere in the region of an additional £400 million between 2004 and 2006—

Q128 Jon Trickett: Sorry to keep interrupting you. As far as you are aware no advice was given by PWC to terminate. Reading the document, do you think that PWC had effectively been sent in there consequent upon a decision to terminate the franchise? Were they really in there as a hit squad?

Mr K Holden: No, from the evidence we have seen the SRA's decision to terminate had not then been taken. Mr Mitchell mentioned Mott MacDonald. The situation was that a consultant from Mott MacDonald had been working for three months monitoring CSE's compliance against what the SRA required, he could not come up with a conclusive view one way or the other, so the SRA commissioned PWC to go in and do more of a proper audit to establish the facts and they Reported.

Q129 Jon Trickett: And they did not come to a conclusion either that the franchise should be terminated. That was a decision made by the SRA.

Mr K Holden: Correct, but they did make recommendations to the SRA that if they were going to put in any further subsidies they would require CSE to take a series of actions, but they did not make a specific recommendation that the SRA should actually terminate the franchise.

Q130 Chairman: Mr Holden, you are the future. What three things should Integrated Kent Franchise do to improve passenger comfort?

Mr M Holden: The big opportunity with the Integrated Kent Franchise comes with the launch of the high-speed service some time in 2009. It provides the opportunity to restructure the timetable and provide a much better service right across the network as well as for the people who will benefit from the high-speed service itself. The future franchise gives stability over an eight-year period which is what you need most importantly of all if you are going to run a train service properly.

Q131 Chairman: Mr Newton, do you think your predecessors failed in the age old injunction that if you take out a contract with somebody you should make sure they can fulfil it?

Mr Newton: No, they delivered something consistent with the policy. History has shown that policy was flawed, which is why the franchising policy has been changed so dramatically since.

Q132 Chairman: Mr O'Brien, what final lessons are there for the train operating companies from this?

Mr O'Brien: To ensure that in their dealings with the SRA they are very aware that they need to communicate what it is they are doing and to go overboard in communicating because I do believe, and it does come out from this Report, that a lot of the things Connex were doing were broadly okay, but they had not done a good job in communicating to the rail authority. I have no doubt that was part of the reason why they lost confidence ultimately in Connex. Unfortunately underneath it was largely okay.

Chairman: Gentlemen, thank you very much. I must admit I was very concerned about the interchange between Mr Newton and Mr O'Brien during Richard Bacon's questioning. I think that must be reflected in our Report. We seem to have gone to a lot of effort and a lot of expense but the personnel has remained much the same. Thank you very much.

Supplementary memorandum submitted by the Department for Transport

Question 62 (Greg Clark): *GoVia Rebranding*

The franchise agreement for IKF makes no specific mention of rebranding, either in general terms or with particular reference to rolling stock, stations or staff uniforms. Nor, therefore, does it seek to identify any costs associated specifically with rebranding.

The agreement does require GoVia to repaint and rebrand all stations within three years of the start of the franchise term. This, though, will be undertaken as part of general maintenance rather than as a specific rebranding activity. We do, of course, expect GoVia to adopt their own colours and house style. On the other hand, a three year repainting cycle simply continues the regime which had been followed by SET and is more or less standard across the industry. It is therefore unlikely that there will be any costs attributable specifically to station rebranding beyond any design costs which GoVia have already or may yet incur.

The agreement makes no direct reference at all to the rebranding of rolling stock or uniforms. In our discussions with them both before the franchise contract was awarded and since, GoVia have made it clear that they will want to concentrate on delivering the service and that they do not regard rebranding of either trains or staff uniforms to be a high priority.