

Transport Committee

Oral evidence: Intercity East Coast rail franchise, HC 891

Monday 21 May 2018

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Members present: Lilian Greenwood (Chair); Jack Brereton; Ronnie Cowan; Steve Double; Huw Merriman; Grahame Morris; Luke Pollard; Iain Stewart; Daniel Zeichner.

Questions 1 - 122

Witnesses

[I](#): Iryna Terlecky, Director, TBI Consulting Ltd; and Nicola Wood, Director, UK Rail Advisory Ltd.

[II](#): The Rt Hon the Lord Adonis; and Elaine Holt, Former Chief Executive, Directly Operated Railways.

Examination of witnesses

Witnesses: Iryna Terlecky and Nicola Wood.

Q1 **Chair:** Welcome, and thank you for coming along this afternoon. We are looking forward to hearing from you. For the record of our proceedings, please introduce yourselves with your name and the organisation you represent.

Nicola Wood: I am Nicola Wood from UK Rail Advisory Ltd.

Iryna Terlecky: I am Iryna Terlecky from TBI Consulting Ltd.

Q2 **Chair:** Thank you. Looking at the bidding process and risk management, it appears that many of the problems with the east coast franchise are related to the bidding process. Before we get into the detail, would you briefly explain what is involved in the franchise bidding process and how it has evolved in recent years?

Iryna Terlecky: That could probably take most of the day, but I will try to be as brief as possible. Essentially, the Government set the parameters for what they want to buy. They set out a specification for each franchise. They consult stakeholders and the industry about the services to be run, and the aspirations of regional and local governments and passengers, and formulate an ITT—an invitation to tender.

One of the key elements of the invitation to tender is making decisions on the shape of the financial return or the financial subsidy that the Government believe is possible or desirable from that franchise. The invitation to tender will include a whole set of other things that the Government want to buy—for example, a franchisee prepared to put in place stringent environmental initiatives, initiatives around leadership and training, and initiatives around customer service and improving stations. All of those things are packaged together in an invitation to tender.

Q3 **Chair:** It is a mixture of the numbers—the money—and the qualitative aspects of what is on offer.

Iryna Terlecky: That is absolutely right. One of the key things that has changed in recent years for franchises, since the Brown review, is that there is a much heavier focus on what we might describe as quality in its broadest sense—quality in how franchises treat and train their people, and quality in their customer service and in ideas for improving stations and introducing technology. Over the last few years, the quality element has become significantly more important in franchises.

Q4 **Chair:** Nicola, is there anything you want to add to Iryna's description of what the process looks like?

Nicola Wood: The description of what the process looks like is absolutely right. The only thing I would add is that the changes that have been made post Brown included things like talking more to bidders about what the specification should include. Specifications used to be written very



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much by the Department almost on its own. Now the Department involves all the bidders in the competition in discussion about what should be included in the specification.

Q5 Chair: Is that because it wants to be nearer customers and it sees the TOCs as the voice of the customer in that sense?

Nicola Wood: Yes, that is part of it. It is also because no one person has the answer to everything. It is fair to say that specifications have been stronger since there has been more consultation with bidders.

Q6 Chair: Presumably, you are always looking for the greatest financial return, but equally there are quality aspects. How are those two things being balanced post Brown? Obviously the east coast franchise was let after the Brown review.

Iryna Terlecky: It is balanced in a number of different ways, franchise by franchise. There is no single answer that will fit every franchise. The weight put on the quality aspect of a franchise will depend on a number of things. It will depend on whether it is a subsidy-driven franchise or a more commercial franchise. It will depend on how stringently the Government specify what they want in the franchise and how much room they leave for bidders and other initiatives.

Q7 Chair: How would that be different between franchises?

Iryna Terlecky: Different franchises have very different characteristics. For example, Essex Thameside is a very heavily commuter-driven franchise. There is much less scope for commercial initiatives to grow the market. The market depends, essentially, on central London employment. East coast is a very different franchise that is driven largely by discretionary travel—people deciding whether or not they want to use the train as opposed to the car to get to different places on the network.

Q8 Chair: Would you expect quality to be weighted more heavily?

Iryna Terlecky: Because Essex Thameside has a captive market, the Government would weight quality more heavily than on east coast. The other factor with east coast is that, because it is a commercially-driven railway, you would expect improvements in quality to feed through to the revenue line and have a financial impact. The value of quality chosen is very different for each franchise.

Q9 Ronnie Cowan: Does the Government's specification include capping rail fares or the cost to carry freight, or is that entirely up to the provider?

Iryna Terlecky: It would not include freight.

Nicola Wood: No. It depends a little bit on what the policy is at the time as to whether fares would be specified. The specification is normally around specific things—for example, the quality of service required in terms of customer experience and the minimum timetable that can be operated.



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Q10 **Ronnie Cowan:** But not the cost to the commuter.

Nicola Wood: No, I think that is separate.

Iryna Terlecky: Fares are generally regulated through a separate fares policy, which is reflected in the franchise agreement. Invitations to tender will include, for example, aspirations for smart ticketing and making ticket buying easier for customers, but will not generally say, "You must do this, that or the other with fares." There is a separate, overarching fares policy.

Q11 **Chair:** Can you explain how the bids are assessed by DFT? In fact, does DFT use any external bodies to look at and validate bids or help with the assessment process?

Nicola Wood: There are two ways in which bids are assessed. There is the P, the price assessment of bids, and the Q, which is the quality assessment. The quality assessment is done by a team at the DFT, half of whom are generally either DFT employees or what are called technical advisers—specific firms of economic and other advisers who have specific knowledge and helped put together the specification. Half of the team is made up of people like that and the other half of the team is made up of people like myself and Iryna, who have had experience in bidding and evaluating. We are more independent and have had no part at all to play in setting the specification.

The quality teams are completely separate. As an evaluator, you are not allowed to talk to any others in your team. There are normally four people for each individual part of the response. You are not allowed to talk to anybody else in the team. You evaluate very separately. You upload your views and your scores separately, and then you come together in a consolidation meeting. All four of you come together for the first time to discuss what your views were. Sometimes those views are very similar and sometimes they can be quite different. Together, as a team, you come up with your ultimate view of each particular individual element of the franchise specification. The franchise responses come back in a series of plans. There are about eight per franchise, and the teams are split.

The price evaluation is done separately, again by teams of accountants—firms such as PWC, KPMG and others—who are all involved in assessing the particular financial outcomes. The two are merged, and there is a mathematical calculation to work out the eventual winner.

Q12 **Chair:** We were reassured back in 2014 by the then Secretary of State that there had been robust and rigorous scrutiny of the numbers. Obviously, that was post Brown. Have you seen a change in the way the Department does that scrutiny of the numbers? It says that Virgin Trains did not do their sums properly. Is there any evidence that the Department has changed the way it checks the train operators' sums?



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Iryna Terlecky: Yes. There has been a significant change to the way that financial robustness of a bid is assessed. I think it first came up on the south eastern franchise, where it was made clear that the financial robustness tests that were being done would now be on a much more cautious central estimate. That was not the case before.

Q13 **Chair:** Just remind us, Iryna, when that was done.

Iryna Terlecky: South eastern was about six months ago.

Q14 **Chair:** Do you think that is a reflection of the Department itself thinking that its processes were not robust enough?

Iryna Terlecky: Yes, I do. The Stagecoach/Virgin bid for east coast was very ambitious, which was, essentially, what the Department asked for in the invitation to tender. It was asking for ambitious bids. It gave additional credit in the quality score for ambition and for introducing new and more services earlier. That obviously led to a particular set of revenue forecasts.

There are two forms of parental guarantee. There is the p

arental guarantee that is fixed by the Department. Then bidders are able to propose an additional parental guarantee to support their revenue assumptions. That additional guarantee supports ambitious revenue assumptions.

Those things happened on east coast, and everyone here is well aware of the outcome of the ambition that was shown in those bids. That ambition was evaluated using the process at the time, and got through the financial risk assessments and the financial robustness tests.

Q15 **Chair:** It is clear that the east coast franchise has now failed three times. There is a suggestion that there is a common theme of overbidding. Do you think there is overbidding? Is the operator incentivised to overbid? Does the Department encourage overbidding? Is there any evidence of that?

Iryna Terlecky: Overbidding is a slight misnomer. Invitations to tender have encouraged bidders to be innovative and come up with all kinds of new solutions to do the very best for the passenger, and to introduce new services and new rolling stock. The process has encouraged bidders to stretch themselves as far as their own boards allow. Of course, bids have to go through an internal governance process before the bid team is allowed to submit it. The process has certainly encouraged people to stretch themselves as far as their boards believe it is reasonable to go, on the assumptions they have made.

Q16 **Chair:** Given that the franchise has now failed three times, is it fair to say that they were ambitious rather than over-ambitious? What do you think on this point, Nicola?



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Nicola Wood: I entirely agree with Iryna. The bidders in each case responded to the specification put out by the Department. The Department encouraged ambition in the particular franchise. Bidders work on very thin margins. You do not have a big margin as a train operating company. Any financial movement in the business can make that margin disappear quite quickly, and I think we have seen that too. The Department has encouraged ambition. Whether or not bidders have been over-ambitious, the Department has encouraged the ambition and that is part of what it does.

Q17 **Chair:** Iryna, you were saying something about the way in which the parental bond is structured that seems to have had an impact. Can you explain that a little bit further?

Iryna Terlecky: It is one of the changes that has been made since east coast. As I said, there are two parts to the parental guarantee. There is the part where DFT says you must have £X million as a parental guarantee.

Q18 **Chair:** And that is to be forfeit in the event of failure.

Iryna Terlecky: If your financial projections go wrong, that parental guarantee is drawn down to top it up so that the Government get the money that you promised in the first place. That is exactly what Stagecoach and Virgin have done with east coast.

Part of the parental guarantee is fixed, and, on top of that, on east coast the bidders were able to propose an additional parental guarantee, which, in the case of east coast, was an additional £65 million. That is an additional £65 million of their own money, which was, in broad terms, supporting their ambitious revenue projections.

Since east coast, what has happened in almost every franchise competition is that the additional parental guarantee has been capped, which in itself puts a cap on how ambitious they can be about revenue. Some of the caps are very low. On the west coast partnership, the cap on additional parental guarantee is £20 million, which is significantly less than was the case with east coast.

Q19 **Chair:** Do you think that is telling us something about the Department's own assessment of things it may have got wrong at the time it let east coast?

Iryna Terlecky: I think it is. The fact that there was a large additional parental guarantee would have supported the robustness evaluation of the ambitious revenues. Clearly that has gone wrong. It seems to me that the Department has decided that it needs to take a more prudent and cautious approach. One of the ways it has done that is by damping down bidders' ability to overbid revenue.

Q20 **Chair:** It sounds to me that they realised pretty quickly that they had got it wrong on east coast, even though that was quite a high-profile



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franchise let.

Iryna Terlecky: I do not know, but I suspect they knew on the first day of the franchise that it was a franchise that would be in a bit of trouble. Part of the reason is that between submitting the bid and actually starting the franchise there is a period of nine months. You put in your bid on the assumptions that you have made and you start on day one. The successful bidder has no control over what happens in that nine-month period. On east coast, things started to go wrong in that nine-month period. They would have started on day one down on all the assumptions that they had made.

Q21 **Chair:** Nicola, following the National Express failure in 2009, the National Audit Office recommended that the Department conduct “robust stress testing of bids against economic scenarios similar to the recession in 2008.” I think we might already have covered this, but does the Department conduct such stress testing? Do you think it might have done too little in the context of east coast?

Nicola Wood: First of all, yes, the Department, in my experience, conducts stress testing on bids. For the bids I was involved in at the Department, that is exactly what happened. As to what actually happened on east coast, I was not there, so it would be wrong of me to say what happened. I can only surmise that it did, but I was not there. Whether or not the stress tests are robust enough is possibly what we are seeing the result of now. I genuinely do not know; I was not there. As far as I know, yes, they conduct stress testing.

Q22 **Iain Stewart:** I would like to focus a little bit more on the revenue projections that bidders make, particularly in the east coast context but also more generally. You rightly said that the east coast line is more of a discretionary market, in that people can choose other train operating companies or air/car alternatives. There is also the risk not just of general economic changes but of changes in working patterns, with people using season tickets less, and so on. Can you talk me through how a TOC would try to balance all those risks and uncertainties in the context of making an ambitious bid?

Iryna Terlecky: How do they balance it? They take a number of factors into account. They do their own assessment of general macroeconomic factors that influence their train operation. They make an assessment of what that means for fares. They look back at history to see what the split of fares is between business travel, leisure travel, first class, standard class and advance purchase. They look at the impact of the initiatives that they are proposing. There are standard industry forecasting tools that help them to do that. If they are improving a station or refurbishing trains, there is an associated revenue impact. They put all that together and look as far ahead into the future as they reasonably can, and make sets of assumptions that appear to be reasonable against their heavy fixed costs, and they do their own sensitivity testing.



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There are some things that they will not be able to predict, or predict well. The Department's own analysis of its options for east coast said that one of the things that had impacted them was lower than expected petrol prices. Things will happen over which you have no control. At the point of bidding, you are making the most robust assessment you can on the assumptions you have at the time.

Q23 Iain Stewart: Does the Department prepare for each potential bidder a central forecast of what they expect to happen against which the bidders can say, "We can do better than this because of all the things we will do"?

Nicola Wood: It certainly has been done in the past, where the Department has prepared what is called exogenous factors—things that are not within the bidders' control or are outside the bidders' control. Again, I have not been involved in the most recent bids, so I cannot be sure whether or not that still happens. We believe it does not happen now. It would be possible for the Department to say, "Well, this is our view of exactly those factors and the things over which a bidder has no control."

Q24 Iain Stewart: Did it happen in the east coast case, Iryna?

Iryna Terlecky: I am not sure. I cannot say whether it did or did not. The Department does not give bidders, in effect, a base bid; it certainly does not give bidders that. It will give bidders some of the exogenous assumptions, such as GDP and that sort of thing. It also tells bidders in the invitation to tender that they must take their own view. They do not have to believe the Department, but they have to provide evidence of not believing the Department. It is not an instruction from DFT that says, "These are your macroeconomic assumptions. Use these." In fact, a recommendation of the Brown review was that bidders should be given a single set of macroeconomic assumptions and be held harmless against them, but it was a recommendation that DFT, for whatever reason, did not implement.

Q25 Chair: Can I ask a quick follow-up question? It is not around macroeconomic information. On east coast, because it was run by Directly Operated Railways at the point it was refranchised, would bidders have had more information than normal when there was an incumbent bidder—for example, about what the revenues and growth had been and what assumptions DOR was working on?

Nicola Wood: No. In fact, the Department opens the data site and the incumbent has to put lots of information into that data site. The Department also creates something called a long-form report, which describes the business over a recent period. It includes all of that information, so in fact I do not think there would have been any difference in what bidders received for east coast from what they received for the recent south eastern competition or any of the other recent competitions.



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- Q26 **Iain Stewart:** You said in answer to an earlier question that something went wrong between the bid being awarded and them starting their operation, in that nine-month period, so that they knew from day one there was a problem. Could the Department have been more proactive in trying to adjust the revenues? What sort of levers would they have to try to get back on track, if you will pardon the pun?

Nicola Wood: The Department, under the rules of that competition, could not have adjusted the revenues because there is no mechanism for it to do that. It would be possible to say that perhaps it might have been useful. The period of time is, as Iryna said, a very long one. A bidder has to take the risk for whatever might happen to the economy, over which the bidder has no control at all, and anything else within the business for that nine months. A bidder can turn up on day one and have a fairly different business from the one they were expecting to get when they submitted their bid.

There is an argument for saying that that position should be re-baselined at the beginning of the franchise. What is difficult is trying to balance a re-baselining while making sure that the bidder does not then benefit to the detriment of the taxpayer. Obviously, it would be possible for bidders to game the period when they are no longer on risk. It would be a sensible thing to consider, but all those risks would need to be weighed up.

Iryna Terlecky: In fact, a sentence in the most recent franchise invitations to tender says that the DFT will consider re-baselining at day one. Clearly, that lesson has been learned as well.

- Q27 **Iain Stewart:** My final question is to try to judge whether the problems that have happened in east coast are specific to it or whether there is a more general issue for rail revenue. There seems to have been a change in the market, with fewer season ticket purchases but more off-peak and regular, but not enough for a season ticket, travel. Do you have any ideas as to why that is changing? Is it something we have to consider for other franchises, or did East Coast simply get its sums wrong?

Iryna Terlecky: Working life is changing generally. It has been an issue for East Coast, but not for East Coast alone. It is an issue for TfL at the moment. Patterns of work and travel are changing, and it is quite likely that those patterns and the reasons for them are not yet properly understood—what the underlying reasons are and whether it is a long-term trend.

One of the things that needs to happen is what the Rail Development Group is doing at the moment, which is looking at fares and fare structures more generally. Done right, that will move fare structures to match how people are travelling, and create a greater understanding of what is actually going on, and it undoubtedly needs to be fed into future franchise competitions. The world does not stand still.



Q28 Luke Pollard: You mentioned re-baselining franchises. Would an alternative not be to allow the winning bidder access to the business at the point when decisions are made? My understanding is that at the moment, if a franchise is won by one bidder, they are prevented from speaking to the current franchise holder for the entirety of the remaining period. Wouldn't greater communication help to avoid the necessity for re-baselining?

Nicola Wood: They are not forbidden from talking to the bidder once the mobilisation period starts. When they have been awarded the franchise, there is a mobilisation period of three or four months, depending on the complexity of the franchise that is being mobilised. There is a requirement for the new bidder to receive licence to operate, safety certificates and other very important things, and to transfer the business. It is at that point that an incoming bidder can start to talk to the new management team, but it depends on the incumbent bidder being happy for that to happen, and in my experience that depends very much on the incumbent themselves. Some incumbents are happy for the team to talk and some are not. Part of that is because part of the transfer process includes a valuing of the assets, so the outgoing bidder has a value of assets that they then need to receive in terms of money from the incoming bidder. It is not as open a process as perhaps it might be because there is still, effectively, a negotiation to happen at that point.

Iryna Terlecky: I am not actually sure that it would make a difference in practice. You are still held to the bid that you put in. However much you talk in the intervening period, your numbers are still the numbers that you bid, and you still have a problem at day one if things are going wrong.

Q29 Steve Double: It would appear on the east coast franchise that the franchisee took on all the risk for the macroeconomics, whereas the Brown review recommended that the franchisee should only be responsible for the risk that they can manage. What is your view on that?

Iryna Terlecky: In subsequent franchises, there is some protection against macroeconomic risks that affect the revenue that you originally bid. There is a mechanism for revenue support that does not fully compensate you but goes some way towards compensating you.

My personal view is that the whole issue of macroeconomic risk needs to be looked at again. It is quite legitimate for a Government to want to pass on risk or lay it off against the private sector. It is quite a legitimate thing for a Government to do and to decide that is how they want to do it, but, particularly when we are living through what could be volatile economic times, the Government also need to decide how much they value stability over letting the market do what the market does.

It is an area that the DFT should look at. There are some very high profile and very important franchises coming up for renewal. Instability is generally not good for the industry. The railway is a public service and a



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public/private partnership. The balance of risk and reward needs to be looked at again.

Nicola Wood: I entirely agree with Iryna. In the case of east coast, the DFT put the exogenous risk on to the bidder, but the bidder accepted that risk. They knew what they were signing up to; it was part of the contract. They accepted the risk as part of that.

The other difficulty with macroeconomic risk is that there is a desire to put the risk on bidders as a way of saying, "This is not now a Government risk but your risk as the private sector." But, as Iryna so rightly says, it is a public/private partnership, and ultimately the risk always comes back to the Government. Is delaying the risk coming back to the Government the right answer? If the risk is always going to come back to the Government, is it not perhaps better to start off with that and say, "We know that is our risk so we will accept it now"?

Q30 **Chair:** It sounds like they did not implement what Brown said. Is that right?

Iryna Terlecky: No, they did not. That specific recommendation was not implemented, but Brown also said that you cannot give absolute protection, and that you should be prepared for the possibility of franchises failing. It has happened, and not for the first time.

Chair: That is precisely what Ronnie is going to pick up.

Q31 **Ronnie Cowan:** The Department's submission said that franchise failure is not necessarily a bad thing, provided it is managed in the right way. Would you agree?

Iryna Terlecky: As Nicola was saying, it is an issue of taxpayer value: how much risk you are prepared to take and how much risk you want to lay off to somebody else. At the end of the day, risk always comes back to the person with the deepest pockets, and that will always be the taxpayer in this situation.

The big issue is about how you manage the risk and what is most important to you. Do you want the promise of very high premium payments with bigger risk, or are you prepared to accept lower premium payments for less risk of failure? How do you deal with things when they start to go wrong? Do you wait until the last minute, as Nicola says, when there is no alternative, or do you do what Rail Development Group suggests and take a more commercial approach to the life of the franchise—"Things aren't going quite right, so let's have an adult conversation that gives us a win-win for the taxpayer and the passenger"—and not let it slide to the point of no return?

These are all decisions for Government: balance of risk and balance of reward. You could argue that chasing higher premiums will inevitably carry with it a higher risk of franchise failure.



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Q32 **Ronnie Cowan:** Do you have anything to add, Nicola?

Nicola Wood: No, I entirely agree with Iryna.

Q33 **Ronnie Cowan:** Is there an argument for public ownership rather than private franchises?

Nicola Wood: I am certainly not going to take that too far.

Q34 **Ronnie Cowan:** Why not? Go on.

Nicola Wood: There is a particular case where we believe that we have a privatised industry, and we do have a privatised industry, but it is a privatised industry that is very heavily regulated. If I were running an entirely private business operating trains on east coast, more analogous to an open access operator but even then not quite so much, I might make different choices from a bidder on east coast, where a large amount of what I am giving back to you is specified, and the Government have told me the minimum service I must run.

As a private sector operator, I might choose not to run services to a particular station, but obviously the Government quite understandably say, "No, you cannot suddenly decide you are not going to serve this station; we still require that service." It is a privatised industry, but it is privatised within very tight parameters. It is a public/private partnership.

Iryna Terlecky: Full public ownership does not make economic upheaval go away. Right now, a public sector operator would be facing exactly the same issues of a large base of fixed costs, economic upheaval, and people deciding to travel by car rather than on your trains. The only difference would be that you, the Government, would feel the revenue loss absolutely immediately.

Q35 **Ronnie Cowan:** But the debate really is about whether the rail infrastructure is there to be profitable or to provide a service for the public. Even if it is running at a loss, if it is taking commuters to and from work at a reasonable cost and it is not costing commuters as much as it would be, then it is paying itself back anyway.

Iryna Terlecky: If you ask anybody who works on the railway, one of the things that you will see—I have certainly seen it from the days of BR until now—is that everybody who works on the railway has a really strong sense that they provide a public service. They are there to provide a safe railway and the services that passengers want at the best value that the Government allow them to give.

It is a public service, and that ethos runs throughout the railway like the writing in a stick of rock. Even though franchises are run by private companies, exactly the same ethos exists. Nobody takes on a franchise to do a rubbish job.

Q36 **Ronnie Cowan:** But we have changed this one three times in the last few years and you yourselves talked about continuity. Continuity is a



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problem. Public ownership would lend itself to continuity.

Iryna Terlecky: One of the issues that preserves continuity is that frontline staff transfer under TUPE from one operator to another. That is really quite important. The ownership at the top changes, and the complexion of the board running it, but all the staff who are doing the frontline job stay the same.

Q37 **Ronnie Cowan:** I come back to my original question. I veered off at a junction. When a franchise is changed, does the Department have the resources to handle it?

Nicola Wood: Do you mean at the point of handover?

Q38 **Ronnie Cowan:** In the state we are in now, where it is being changed from one to another; yes. It is a drain on the resources the Department already has. It is not something it was planning for.

Nicola Wood: Because it has suddenly had to take on a new one. I do not know the resourcing structure of the Department at the moment. I am not in the Department. There has been a recent change to the ability to bring other workers into the Department, and that has sometimes made it quite difficult for the Department to be able to resource up quickly in the way that it perhaps previously did. There is no doubt that a sudden change to the franchising timetable will inevitably have an impact on the Department's resources.

Iryna Terlecky: The Department is required by the legislation to keep running railway services. In a situation such as east coast, where something has to be brought back in-house, it has to find the resources to do it.

Q39 **Ronnie Cowan:** But we are back to the situation you described a moment ago. The people doing the job on the ground day in, day out are providing a service. The people at a higher level of the structure are letting them down time and time again.

Iryna Terlecky: You could call it letting them down.

Ronnie Cowan: I did.

Iryna Terlecky: They are the ones that provide the leadership and management, and in some cases that will go wrong for a whole host of reasons. In the meantime, East Coast has carried on running a pretty good service that over 90% of passengers are satisfied with, which is quite some achievement in very difficult times.

Ronnie Cowan: I take my hat off to the people who actually do the work and run the franchise.

Q40 **Chair:** There is a cost to re-letting the franchise when it was not planned. It seems to me that part of the purpose of the parent guarantee or the bond was to recompense the Department when a franchise fails, but in this case they will have drawn down all the bond in order to maintain the



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premium payments that they had promised. Who will meet the extra cost of having to re-let a franchise we were not expecting to have to re-let three years in?

Nicola Wood: There are two sorts of funding that we talked about. One is the parental guarantee, which is about recompensing for falling revenues effectively, and there is the performance bond, which is specifically for that purpose. The performance bond is called by the Department in cases when the franchise can no longer continue. That bond is specifically to cover the Department's costs in re-letting.

Q41 **Chair:** Does the amount of the bond they have to pay directly relate to the costs to the Department?

Nicola Wood: Yes.

Q42 **Chair:** It is pre-set, so there should not be a cost to the taxpayer for the re-letting process itself.

Nicola Wood: That is right.

Chair: That is helpful. Thanks.

Q43 **Jack Brereton:** In relation to Network Rail, Virgin Trains East Coast stated that the role of Network Rail has been "sustained poor performance... between June 2015 and June 2017." How much risk do you think Network Rail poses to franchise bidders?

Iryna Terlecky: Network Rail obviously has its plans for improving performance, together with train operators. It has its investment plans. More and more, we see a very much closer relationship between Network Rail and the train operators, which are its customers, to do whatever they can to mitigate the effects of planned and unplanned engineering works and improvements. Of course, there is a financial regime that compensates. When train operator services are delayed, they have to pay compensation to passengers. They get compensation from Network Rail that goes towards paying the passengers.

I do not think that Network Rail poses a risk for franchising or train operators in the way that maybe the question was put. Network Rail manages a very complex infrastructure. The system is running to capacity. On top of that, there are major enhancements that need to be done. There is continual pressure on the network, and the job of Network Rail is to keep it all running. Sometimes, it does not happen.

Q44 **Jack Brereton:** It is interesting that you mention that there is opportunity for claims. Currently, I believe there are £75 million of claims that Virgin Trains East Coast has outstanding against Network Rail. There is a significant amount where clearly something with regards to Network Rail has not gone quite as it should have done.

Iryna Terlecky: Yes. I would have thought that the prospect of having to pay that kind of money to Virgin should be a very strong incentive for Network Rail to do whatever it can to minimise that.



Q45 **Jack Brereton:** Would you like to add anything, Nicola?

Nicola Wood: No. Network Rail is an important part of running any franchise, running the infrastructure as it does. The relationship between Network Rail and the TOC can be quite difficult to navigate sometimes. Network Rail obviously had an important part to play in this too, which is why that claim exists.

Q46 **Jack Brereton:** Do you think sufficient information is provided to bidders from Network Rail about agreements and when those agreements take place?

Iryna Terlecky: There is full disclosure of anything to do with Network Rail—infrastructure performance, past performance, payments and past performance statistics. There is full transparency and disclosure for bidders. What the bidders then have to do is talk to Network Rail and make their own assumptions about how it is going to be in the future.

Q47 **Jack Brereton:** I want to move on to the bid process and ensuring that the right infrastructure is in place for the bid. There have been concerns raised about whether the elements of infrastructure alongside the bid were committed to by Network Rail. Certainly Network Rail, for example, was adamant that the infrastructure enhancements were not committed to at the bid stage. Do you think that Network Rail should have had some formal sign-off through the bid process?

Nicola Wood: Network Rail does not have formal sign-off through the bid process. It provides what is called a specialist report. It is able to review all the bids, and at the point I described earlier—the quality evaluation with the evaluators—one of the things the evaluators take into account is the specialist reports. The specialist reports are just taken into account; they do not form a formal part of the evaluation, so Network Rail does not sign off the formal evaluation of bids.

The bidders themselves work very closely with Network Rail, and Network Rail works very closely with each of the bidders, keeping all of them separate, which is quite a big resource drain for Network Rail in large competitions. Network Rail does not sign off the evaluation itself.

Q48 **Jack Brereton:** Do you think it would be better if there was some form of sign-off?

Nicola Wood: Personally, yes.

Q49 **Jack Brereton:** Would you agree with that, Iryna?

Iryna Terlecky: Yes, absolutely right. In what bidders assume about the timetables they can run, there should be, at the point of bid submission, a much more committed sign-off from Network Rail, subject of course to the industry processes. You will know that there is a separate industry process that eventually comes up with the timetable that will be run, with opportunities for appeal to ORR. You cannot pre-empt those industry



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processes, but there could be a much stronger role for Network Rail in working with bidders and signing off on bids.

- Q50 **Jack Brereton:** Do you think that the infrastructure programme needs to be more effectively aligned with franchises? Obviously the situation at the moment is that there is no alignment between franchises and the infrastructure programme of Network Rail.

Iryna Terlecky: The only answer is yes. I personally find it rather odd that the DFT is doing franchise specifications and invitations to tender. DFT, the Government, own Network Rail. The people sit in the same building. Why the two things are not absolutely aligned is beyond me.

- Q51 **Chair:** Let me double-check. It seems to me that if Virgin made assumptions about what would be done as infrastructure enhancement, but Network Rail says that was not committed, the DFT is in a perfect position to know precisely what it had asked Network Rail to do and what it had committed funds to.

Iryna Terlecky: I would have thought so.

- Q52 **Chair:** Virgin Trains say that Network Rail's poor performance was part of the reason that their revenues failed. Their PPM is 81.5%, which is not great, but on the other hand they had the best passenger satisfaction. That suggests that their performance may not have been great but, if passenger satisfaction is high, it was not the issue driving revenue growth.

Iryna Terlecky: No, I do not think it is. Certainly, if you are on a four-hour journey, getting to your destination 10 minutes late is possibly less critical than if you are doing a half-hour commute.

- Q53 **Chair:** Particularly if you are a leisure passenger.

Iryna Terlecky: Yes. It would matter less.

Nicola Wood: It also depends on how companies deal with the delay. My reading of that would be that there have been delays, but the very good passenger survey results suggest that the way in which Virgin/Stagecoach have dealt with those delays has been very good, and has been well received by customers.

Chair: We want to look at what happens next and what the future operating arrangements on east coast will be.

- Q54 **Daniel Zeichner:** Last week, we had the Secretary of State's announcement that management would be transferred to the operator of last resort. In his report, the options were deemed to be very finely balanced between a continuing arrangement with the current operator or moving to the operator of last resort. The deciding factor seemed to be the suggestion that that would make it easier to get the transition to a partnership arrangement in future. It is not entirely clear to me what the logic of that is. How do you think it helps the transition to the



partnership?

Nicola Wood: The way it would help the transition is that clearly it is very likely that Virgin/Stagecoach would want potentially to be a bidder for east coast in the future. The report clearly stated that their view had been that working with someone who might be a potential bidder might present a conflict of interest. The advantage of working with the operator of last resort, which is entirely separate, means that they could potentially test ideas with the operator of last resort without worrying about infecting a future bid.

Q55 **Daniel Zeichner:** So it is a way of keeping Virgin/Stagecoach in the game.

Nicola Wood: It is a way of preserving the market, to make sure that there could not be any influence if they decided to bid in the future.

Q56 **Daniel Zeichner:** What do you think?

Iryna Terlecky: I think that is absolutely right. The decision was made simply to preserve all the options in moving towards the partnership idea, but without having to work with somebody who might have a major interest and who might then go into the bidding for that partnership with much more inside information than anyone else.

Q57 **Daniel Zeichner:** To the outside world, it all looks rather extraordinary. You have a failure and then you set up a system to allow the people who failed to stay part of the future system. Is that an unfair characterisation?

Iryna Terlecky: To a large extent, it is. There has been a lot of talk about what happened with East Coast, but it really is worth reiterating that the operation of East Coast is good. There is passenger growth. It is not as much as was assumed, but there is passenger growth. Revenues are reasonably healthy, although not as healthy as was assumed in the bid. Passenger satisfaction is very high.

The other important thing is that Virgin and Stagecoach have complied to the letter with the contractual obligations that they signed up to. They paid over almost £200 million, which was their contractual obligation. That £200 million has been propping up the premium payments to DFT, which DFT would otherwise not have had.

You can call it a failure, and other people will. You can call it a bail-out, and other people will. Actually, it is a train operator doing well in its own terms and an owning group that has been absolutely honest in complying with all of its contractual obligations. On those terms, if you have an owning group that you know complies absolutely with its contractual obligations, why wouldn't you let it bid again?

Q58 **Daniel Zeichner:** Possibly partly because there is huge disruption. We now have a situation where the operation has been shifted to an operator of last resort, which appears to be another odd grouping, pretty much untested. It is uncertain exactly who is running it. We will come in a



minute to what the partnership might look like in a couple of years' time. What kind of organisational risks are involved in all the changes we are going to see on these routes over the next couple of years?

Nicola Wood: There are obviously some organisational risks, but, as Iryna said earlier, the vast majority of the companies tend to stay the same. There will be a change in ownership and no doubt there will be a change in some of the composition of the board, but the rest of the operation will roll on exactly as it is at the moment, just as it did when east coast changed before, and just as it does on every single franchise change.

Q59 **Daniel Zeichner:** Going on with the partnership idea, which suggests that it will be Network Rail and presumably the new franchise operator working together, I do not quite understand how that works. Do you have an understanding of how it works?

Nicola Wood: No. It would be fair to say that I do not. You possibly have more knowledge than I have.

Q60 **Daniel Zeichner:** I would be a bit worried if that was the case, because you are the experts and we are only asking questions.

Nicola Wood: But we do not have access to information that is not public knowledge. Public knowledge about what the east coast partnership may or may not look like is scant. It is interesting that the Department has chosen east coast to try the partnership model in the way it has, but I do not know what it is actually going to look like. I have heard that there is a desire for one person to run the route. It is a very complex route with many freight and passenger operators running its length up to Scotland. It is a very difficult thing to do.

Q61 **Daniel Zeichner:** Do you have a sense of how it might work?

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

Q62 **Daniel Zeichner:** How long do you think it might take to sort out something like this, given that we have a limited timeframe?

Iryna Terlecky: The Secretary of State says that it will be about two years.

Q63 **Daniel Zeichner:** It is a lot to achieve in that time, if even experts like yourselves have very little idea of how it might work.

Nicola Wood: That is a fair comment. Generally, a franchise competition, from the Department's perspective, takes two to two and a half years to run. From the moment at which the work starts on working out what the specification might be, working out the costs and right through to writing the ITT, receiving bids, award and starting, it takes about two and a half years. Two years to do all of that with a brand new untested concept seems very ambitious.



- Q64 **Daniel Zeichner:** Very ambitious. I quite agree. I do not know the details, but apparently there was a so-called deep alliance on the south western franchise a few years ago, which ended up finishing because of some of the difficulties encountered. Why should it be any different now?

Iryna Terlecky: That is a really good question. I do not have an answer. Alliancing, partnering, is primarily about aligning objectives and behaviours. It is a cultural thing. It can be made to work in all kinds of situations without necessarily needing to go into complex restructurings.

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

- Q65 **Huw Merriman:** I am interested in the whole concept of how the public/private partnership model would work. I understand that we are somewhat in the realms of speculation. Of course, we already have the model of public/private partnership, because Network Rail is running the asset and the train operators, with the franchise running the trains.

Do you think it is likely that we will end up with one single entity that would involve Network Rail running both? We have heard there is a march towards having the two entities working more closely together. We have also heard that Network Rail issues may have caused this particular issue or had some impact. Do you think that is a likely outcome for the route?

Iryna Terlecky: Absolutely honestly, I have no idea. No idea at all.

- Q66 **Huw Merriman:** Let me put it another way. Do you think there is some logic in that, and what would it do to the model of franchising overall?

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

- Q67 **Huw Merriman:** One of the other things that often comes up whenever an opportunity exists is that open access is mooted. Wouldn't what I have just described make open access even more challenging? Indeed, do you see possibilities for open access on this particular network, or is it particularly difficult to deliver?

Iryna Terlecky: The main problem with open access is the congested network. There are very few available paths. Open access operators have generally been very inventive in finding new destinations to serve or finding new paths. The sheer congestion on the network means that those prospects are now slimmer than they ever were before.



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Nicola Wood: There are actually two open access operators already operating on the east coast main line.

Q68 **Chair:** I don't know if you are just being overly kind to the Department, but it seems to me that, given the number of operators on the east coast main line, including franchise operators, open access and freight, and the fact that the east coast franchise itself is a minority operator on the line, actually it is the last place you would look to try a partnership. Would that be unfair?

Iryna Terlecky: I don't think I would disagree with you.

Chair: Finally, we would like to look at the implications of the east coast failure for the wider franchising system.

Q69 **Luke Pollard:** There has been review after review of franchising, but we seem to be going round in circles. Do you think franchising is in a better place now than it was in 2012 when the Brown review was conducted?

Nicola Wood: There were some very positive changes after Brown. Greater consultation with bidders is a very positive thing. In my experience, it has allowed a more robust specification to be delivered, and that is very positive.

Some things are still the same as ever they were. Although in recent competitions the move towards quality has increased and, as Iryna said, there has been more weighting in favour of quality than on price, ultimately price tends to win, not in every competition but in most. That is a reflection of the influence and power of money in the country and the Treasury itself. Quality is not a free option in a franchise, and the Government need to wrestle with the issue of quality and price balanced together.

Iryna Terlecky: There have been improvements since the Brown review. The franchising process is generally robust. The governance around franchising is good. That does not mean that everything is done right every time, but things do not go wrong by accident. There has been greater emphasis on quality, innovation, environmental and people factors, and training, apprenticeships, graduate schemes and diversity have all been given greater weight in franchise invitations to tender. SMEs have been encouraged. There is a lot that is better about the invitations to tender that go out, and that is a big positive.

Q70 **Luke Pollard:** Do you think that the DFT has enough experience, skills and knowledge to run the franchising system properly?

Nicola Wood: There are a lot of very dedicated staff in the DFT who work very hard to run the system as well as they can and as well as they are resourced to do so.

Q71 **Luke Pollard:** Forgive me, but that sounds like a very political answer.



Nicola Wood: That is amazing, because I am not a very political person. I do not work for the Department, so it would be very unfair of me to comment particularly on that, because I am not there to know. My experience of working at the Department is that the people there are very dedicated to doing a very good job, just as people in the TOCs are equally very dedicated to doing a very good job too.

Q72 **Luke Pollard:** Is the DFT getting enough expert advice, and the right expert advice from due diligence accountancy firms, and does it have the right skills to interpret that advice?

Iryna Terlecky: I think it does, but the key to the question is what you said earlier about whether it has the skills and experience to manage franchises properly. It rather depends on what you mean by properly. They have the skills and experience to manage the process as it is now. As we move to a more complex world and a more complex railway structure, it is one of the things that the DFT will have to look at.

Q73 **Luke Pollard:** We have heard that east coast is not the only franchise with financial difficulties. Are you aware of other franchises that are experiencing difficulties delivering against their franchise obligations on a financial basis?

Nicola Wood: I do not have knowledge of that.

Iryna Terlecky: It is fairly common knowledge that there are a number of franchises who are either in revenue support or potentially drawing on their parental guarantees to meet their obligations to DFT. That has to be a concern.

We were talking earlier about risk, and the point at which you step in to manage risk and how you do it. That is going to become a much bigger issue. It will be an issue about whether the Department says to some of the franchisees, "Let's have an adult conversation and see how we jointly get out of this," or whether it is going to do in effect what it did on east coast and wait until all the risks have materialised and it gets to the point of no return.

Q74 **Luke Pollard:** If there is more than one franchise encountering these problems and difficulties, does that reflect a bigger systemic problem in the way the DFT procures franchises?

Nicola Wood: It almost undoubtedly reflects the point we were talking about earlier in terms of macroeconomic risk. If there is a macroeconomic downturn, all the franchises on which that risk is based will inevitably face some difficulty. Some of them will be more immune than others. We talked earlier about the difference between the Essex Thameside franchise, which runs along the Thames corridor, as opposed to east coast, which is largely discretionary travel. Each of those will be affected in their own way by any economic change.



Iryna Terlecky: It is not just operations that are subject to franchising that will feel it. Earlier, we mentioned TfL. The underground, buses and overground are seeing the same kinds of impacts. As I think we said earlier, dealing with life not being quite as you would like it to be is a key issue for the Department and the industry going forward.

Q75 **Luke Pollard:** Our predecessor Committee, when looking at rail franchising last year, concluded that “without change, it is difficult to see how the current model will be sustainable in the longer term.” How sustainable do you feel franchising is in the long term, and what improvements and reforms are necessary to continue with the system and keep the success going?

Nicola Wood: Gosh. We are seeing the effect of some bits of franchising that need to change. We have talked quite a lot about that today. For me, the big difference between when you submit your bid and when you start your bid is fairly fundamental. You are entirely on risk for that, and that is probably the thing that is most necessary to change in the future.

Iryna Terlecky: In addition, for me, it would be a franchising system that recognises that life changes. Franchises are not set in stone. Working patterns are not set in stone. What passengers want and the impact of competition are not set in stone. It is becoming clearer to me that having a franchise that lasts seven years, when in year seven or year eight you have to deliver what you assumed was needed seven years ago, is potentially not a sustainable model for the future.

You can deal with that in a number of ways. You can deal with it by a formal renegotiation point in the middle of the franchise. You can deal with it on a rolling basis as things happen, but that needs a very different mindset in terms of franchising, and will need different skills and competencies at the DFT.

Q76 **Luke Pollard:** On your point about decisions made seven years ago, do you think the increased use of direct awards by the DFT shows that the franchising model is not sustainable, because it is not going back to the franchising process but simply giving away extended contracts?

Iryna Terlecky: What the DFT is trying to do with the direct award process, which is a very limited process, is more about having a sensible and smooth programme in the light of what is going on around things. If there is major infrastructure work going on, it does not make sense to have the disruption of a franchise competition, so let's just move it a bit. Direct awards give a bit more flexibility to smooth the programme and recognise what is going on around it.

Nicola Wood: That is important for bidders too. A large number of franchise bids all occurring at a very quick pace is difficult for the Department to resource. It is also incredibly difficult for the owning groups to resource. A bid is a very large and resource-intensive process. You can only really sustain a few of those a year. As an industry, I do not



think it does us any favours at all if we end up with a very constrained timetable. That is something that the Department has worked very hard on, certainly post 2012. It has tried to smooth and provide some heads-up to the industry as to when they can expect the bids.

Of course, various things have happened. There have been infrastructure issues, and franchises have come back earlier than expected. That has disrupted the timetable, so the timetable has been a bit of a moving feast, but the general idea of keeping it smooth, and using the direct award process to enable that for both the Department and bidders, has been very successful when it has happened.

Chair: Thank you very much for giving evidence today. That concludes our questions to the first panel.

Examination of witnesses

Witnesses: Lord Adonis and Elaine Holt.

Q77 **Chair:** Welcome, and thank you for joining us this afternoon. I am sorry we are slightly late starting our second session. For the record of our proceedings, please would you introduce yourselves?

Elaine Holt: My name is Elaine Holt. I was the chairman of East Coast and the chief executive of Directly Operated Railways last time the franchise came into Government ownership.

Lord Adonis: I am Andrew Adonis. I appointed Elaine Holt to those posts in 2009 when the East Coast company was nationalised.

Q78 **Chair:** This is the third time that the operators of the east coast franchise have had to walk away or hand back the keys. Is there something inherently wrong with this franchise rather than any other that makes it vulnerable to default?

Lord Adonis: It clearly has a history of overbidding. I think that may have something to do with the fact that the east coast main line is regarded as the flagship franchise, with all the romantic associations of the Flying Scotsman. It may be a reason why it has been more susceptible. It may also have something to do with the fact that people have always had delusions about the capacity for massive passenger growth. Unusually, there is unused capacity on the line. There is capacity to offer many more services, partly because the east coast main line does not go through anything like the density of population that other franchises go through.

It is a very highly engineered line. It is straight almost the whole way from London to York, so the capacity to offer additional services is there. The combination of the romantic association of the line plus the capacity to offer much more intensive services has produced a culture of overbidding, which accounts for the reason why it has failed more often than other franchises.



Q79 **Chair:** Elaine, do you have anything to add?

Elaine Holt: I was going to say that it is viewed as the jewel in the crown of the railway, and that has led to optimism. It is a simple railway. When I ran it, there were 131 trains a day. It is relatively straightforward. We have heard about complexities and various other things. Actually, it is not that. It is a good railway with a loyal work force and hugely supportive stakeholders. It is a very profitable franchise.

Q80 **Chair:** From a passenger perspective, the franchise is operating reasonably well. It has 92% passenger satisfaction for long distance, which is pretty good, and it returns an operating profit of around £200 million a year. Do you think the problems on the franchise relate more to the failures of the bidding process as opposed to the actual operation of the service? Elaine, what do you think?

Elaine Holt: The operation is very straightforward. It has been a well-run franchise for some time. When we took it over there were some problems. It was with National Express and there were financial challenges. We took it over and improved the service quite a lot. It has gone on to improve from there, so operationally I do not think the franchise is an issue at all, which points towards there being issues with the bidding process.

Lord Adonis: I entirely agree.

Q81 **Luke Pollard:** You have been quite scathing about the Secretary of State's handling of the east coast franchise. If you were in his shoes, what would you have done that was different from the actions he has taken?

Lord Adonis: I would have done what he has done much sooner. I faced a very similar situation in 2009, and it was abundantly clear when Stagecoach and Virgin said they intended to hand back the keys that this needed to be resolved quickly. Rather than spinning it out and assessing a whole range of different options, when it was clear that the public interest dictated one option, which was that the state should take over the franchise using the powers in the Railways Act to be operator of last resort, he should have done that immediately.

The reason he did not do it immediately was that he did not want to do it. He wanted to continue some form of private operation for ideological reasons. That was a huge mistake. It caused a great deal of uncertainty in the industry. It has probably caused a loss to the taxpayer and it has led to great uncertainty of policy. In 2009, I sought to make a success of a state company with Elaine and her brilliant team, at least for a defined period. The problem is that the Railways Acts are unclear in their powers as to how long you can keep that going. We can come back to that in a moment. My own view is that they need amendment.

Instead of doing that, the Secretary of State has in fact given a very unclear signal. He has said that the operator of last resort will be for a



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

He has no time at all for the principle of public operation of the railways, so he will be constantly seeking to limit its scope. He will not offer any possibility of its being able to bid for future contracts, which is what I would have done if Labour had been returned in 2010. We would have sought to change the law so that that could happen. That is partly because I was so impressed with the job that Elaine and her colleagues had done in operating the East Coast company.

Crucially, he has not said what I said in 2009, which is that a defaulting private company should not be allowed to bid for future contracts. This is an issue of dispute between him and me. He has tried to rewrite the record, but it is very clearly on the public record. I can give documentation to the Committee to back it up, if need be. If I had remained Secretary of State, and Labour had remained in power in 2010, National Express would not have been permitted to bid for future contracts.

I stated it in terms to Parliament when I took over the franchise in July 2009, and repeated it in November 2009, in *Hansard*, when we exercised the break clause in respect of the other franchise that National Express had. The Secretary of State has not done that in this case. He was entirely silent in his statement last week as to whether or not Virgin and Stagecoach will be permitted to bid for future contracts, including the public/private partnership that he is holding out as being on offer in 2020. For as long as he is silent on that, it will create further massive uncertainty, including the possibility of giving false hope, or possibly real hope, to other defaulting bidders that, after a very short period of public ownership, they too will be allowed to bid for contracts from which they default. If that happens, it will cause the collapse of the entire franchising system.

What he did last week was the right thing in terms of the immediate public interest, but he has not done the follow-up steps that are essential both to maintain the health of the current franchising system, which is crucial, and to develop the potential strengths that could come from having an effective public operator.

Q82 Luke Pollard: A lot of parallels have been drawn between his decision now and your decision when you were in his shoes. Do you regard the context of the situation as being the same? What is different between the decision that you took then and the decision the Secretary of State has



taken now?

Lord Adonis: It is very similar. There are obviously differences of detail; there always are and we could go through them. What happened was that a bidder had overbid. We were in a very tough economic climate. Their view was that they were not going to be able to turn it around. They may or may not have been right about that. Time will tell whether that is true or not. They wanted a renegotiation.

What happened behind the scenes then is quite similar to what has happened behind the scenes now, and has a crucial bearing on your inquiry. I was told privately by the then chief executive of National Express that I had no choice but to renegotiate the contract because the whole system was bankrupt. All the things that have been said about the franchising system now were said about it then: there were fundamental flaws in the franchising system; people were encouraged to overbid; the economic situation was much worse than had been predicted; the economic growth projections were not there; and the franchising system could not accommodate them.

I was told in terms by the then chief executive of National Express that either I renegotiated or the entire franchising system would collapse. He told me that it would be between six months and a year, and that I would have to cope with the consequences. That is roughly similar to the evidence you have been given and what people have said in the current context.

The view I took then as Secretary of State was on the "Do no harm" principle. They may have been right. I cannot predict the future, but for me as Secretary of State, to pull up the entire franchising system by its roots, and renegotiate a contract that would be of immediate commercial benefit to the people who had an interest in the case—National Express—was not in the public interest. The view I took was that I should take the steps that were most consistent with maintaining the operation of the existing system and the commitments that had been made freely by private sector companies who had very big liabilities to the state, and then make a success of the immediate step, which was the enforced nationalisation of the east coast, and we should take it from there.

My strong advice to those taking decisions at the moment is to operate on the same principle. Before you cost the taxpayer potentially billions of pounds in rewriting contracts and setting up completely new franchising systems, at least see whether you can make the existing system work with the minimum changes consistent with delivering the objectives for the taxpayer and the state. I am quite conservative on these issues. Only if they prove not to be feasible, should you go for more radical alternatives.

The one thing anyone who has been involved in this industry for the last 25 years knows is that, as soon as you start trying to do radical options, it is rather like getting engaged in military conflicts. As the Duke of



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Wellington famously said, "The best laid plan does not survive the first engagement with the enemy." As soon as you start trying to reform this labyrinthine and extremely complicated system, the one thing you can guarantee is that your plans will come off the rails quite quickly—if I can mix my metaphors—and you will end up having to do a massive and largely improvised reinvention of the entire system for operating the railways. The only thing you can be confident of is that it will cost billions of pounds.

Q83 Luke Pollard: You mentioned barring bidders from failed franchises. I am curious about the advisers to the franchising process, in particular the big six accountancy houses that are supposed to scrutinise bids. From your experience, do you think there is a case for looking at the advice the DFT has been given from the big six accountancy firms, and whether their continued involvement in the process, especially given the due diligence of the latest east coast bid, does not seem to have been as robust as perhaps it should have been?

Lord Adonis: I looked at all this stuff when the announcements were made last autumn about the franchise collapsing. What happened immediately was that the Department—indeed the Secretary of State, to be blunt, because these things are, effectively, done in his name—started briefing that the thing had been wildly overbid, and that it was not on his watch but he had to pick up the pieces. That always happens politically in these situations.

If you look at the situation in 2013-14, when there was strong underlying growth in rail passenger numbers, the actual assumptions on which the bid were based did not look to me to be implausible. Elaine will have views on this because she manages these things. Certainly the Department itself did not regard them as so in 2013-14. It put out a very robust statement about having kicked the tyres, done the due diligence and all of that. It thought them credible.

What would I have done as Secretary of State if I had been handed those numbers, with the Department advising me? Remember that, if you do not accept the advice, you are potentially taking a massive loss for the taxpayer and sending a signal to bidders on all other franchises that you think they have been optimistic too, so you will not want so much money from them. I do not think any responsible Secretary of State in that situation would have thought it unreasonable to accept the bid, accepting always that the private operators are taking risk. That is the whole purpose of the way the system works. In retrospect, they overbid and what should have happened then, which is what the whole system is geared to, is that they should have paid the penalty and had the franchise removed from them.

Q84 Luke Pollard: Do you think that the expert advice the DFT would have received is sufficiently robust to inform the Secretary of State in making those decisions?



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Lord Adonis: Advisers can always be better. Ministers can always be better. Parliament can always be better. I am not saying that there are not things that can improve. But do I think that in the context of 2013-14 it was unreasonable to accept that bid? No, I do not. If I had been Secretary of State, I would probably have accepted a bid on the same basis.

It clearly was overbid, but the design of the system is actually not bad for dealing with those situations. When a contract is significantly overbid, the right thing is that the company that has overbid pays the price, which is that it loses the contract, and the state comes in and a rebidding process takes place.

I strongly urge that the Committee does not, in a kind of kneejerk reaction to what has happened, recommend wholesale redesign of a franchising system that is working reasonably well. It is not working badly in returns for the taxpayer. You yourself, Chair, have said repeatedly in the exchanges I heard that passenger satisfaction and quality of service on the line are perfectly good. Actually, they improved when we nationalised the line in 2009. Elaine and her team made themselves almost folk heroes on east coast. The system has not worked badly, if you look at it in the light.

The only mistakes that have been made were, first, not to allow a successful public company, once installed on east coast, to continue and to bid for future contracts. If it had continued and been able to bid, we would not have had this Virgin/Stagecoach situation in the first place. Secondly, the Secretary of State engaged in a great prevarication of policy last year, when Virgin and Stagecoach threatened to hand in the keys, in not immediately accepting the keys back and setting up a state company then. If that had happened, we would not have had the intervening five or six months of huge uncertainty, which has created a great deal of real and potential damage to the franchising system.

Q85 **Chair:** On that point, Andrew, I think you said in your evidence a few moments ago that the failure, as you see it, of the Secretary of State immediately to take the franchise back into public ownership not only created a period of uncertainty but created losses to the taxpayer. Can you say a little more about what you mean, and what losses were incurred?

Lord Adonis: I assume that you are asking the Department how much it has spent on consultants, advisers and everything that led to the decisions announced last week. Like members of the Committee, I speak to my colleagues in the industry a lot; the last five months have been a bonanza for lawyers, accountants and consultants, including very highly paid lawyers who have been advising on state aids and the legality of handing a further contract to companies that had defaulted on the previous contracts.

Q86 **Chair:** The costs of doing that assessment of options are what you are



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referring to when you say there are costs to the taxpayer.

Lord Adonis: Yes. There could be further costs if the process hereafter is mishandled, and it may be mishandled because of the reluctance of the Secretary of State to give a clear view of what forthcoming policy is going to be. Since, as I say, the proposal for a public-private partnership is a few words on the back of an envelope at the moment, if that policy is got wrong, it could cause the taxpayer huge further costs down the line.

Q87 Huw Merriman: Lord Adonis, you said that the bail-out will cost taxpayers hundreds of millions of pounds, possibly billions. I think you just mentioned billions again. But isn't talk of a bail-out slightly confusing in the sense that, for three years, VTEC was paying 20% more than had previously been paid into the Department for Transport? It is not so much a bail-out; it is actually more that those increased premiums are not going to carry on.

Lord Adonis: They were premiums that were contracted. You are right that there were higher payments, but they were contracted payments. VTEC was contracted to make payments totalling £3.3 billion over the seven years, of which £2 billion fell in the last three years of the contract, which are the three years that it is no longer going to fulfil. We can have a debate about the best term to describe the missing £2 billion, which is the £2 billion that VTEC was going to pay the taxpayer, which it is no longer going to pay. I think it is appropriate to call it a bail-out, particularly in the context of what appeared to be happening, which was the Secretary of State being prepared to give VTEC a new contract.

I am prepared to use more emollient language if VTEC not only does not get a contract in 2020, when the new public-private partnership comes in, but is forbidden from bidding for future contracts. Then it will definitely have paid a significant penalty for not fulfilling its contract to the taxpayer. In the context of the announcements made by the Secretary of State last autumn, and possibly in the context of what he said last week, from which it is still not clear that Virgin/Stagecoach will not be allowed to bid for lucrative future contracts, having walked away from £2 billion of commitments, I think that the term bail-out is perfectly fair and reasonable.

Q88 Huw Merriman: That being the case, you must have bailed out National Express, because it did not have to pay the remainder of the £1.4 billion premiums running into 2015.

Lord Adonis: I would contest that, because I banned it from bidding for future contracts. It paid an ongoing penalty, and it is not in the rail business today.

Q89 Huw Merriman: Did you ban it?

Lord Adonis: Yes.

Q90 Huw Merriman: According to the research that we have been given by the Committee Clerks, National Express was never formally banned from



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bidding for new contracts and, indeed, retained its franchises on two other parts of the network, c2c and National Express East Anglia. If you banned it, how did that carry on?

Lord Adonis: This has been an ongoing source of dispute between the Secretary of State and myself, and there have been numerous exchanges about it. However, *Hansard* is the great source of authority for what Ministers do and do not say, and the Secretary of State has constantly refused to cite it, because he knows what was said in *Hansard*. I said to the House of Lords on 1 July 2009, when I announced that the state was taking over the east coast franchise: "It would clearly be reasonable not to invite a company to bid for future franchises in circumstances where it had recently failed to deliver on a previous franchise. A company which had defaulted in the way National Express now intends would not have pre-qualified for any previous franchises let by the department." That statement was made on substantial legal advice that, if I said that to Parliament, it would be taken as meaning by National Express that it would not be shortlisted for any future contract. And it was not.

Q91 **Huw Merriman:** But you would agree that it carried on with the two franchises I have just cited.

Lord Adonis: I could not take away its existing franchises; that is very different. What I could do was ban it from bidding for future franchises.

Q92 **Huw Merriman:** How would you do that? I am just thinking of EU tendering rules, and so on. The advice you got, which I think was from David Pannick QC, was that the reason you could not take away the existing franchises, was that there was no cross-default provision that would be triggered. On that basis, it had not done anything wrong, so what legal advice were you given to say that you could stop it from bidding for future franchises?

Lord Adonis: The existing franchises had already been let. By definition, they were existing franchises. In assessing the public interest in respect of future franchises, whether the potential franchisee was a reliable partner for the state was, I was advised, a perfectly reasonable and legitimate factor to take into account. If a company had walked away from previous commitments to the state, my legal adviser told me that I would be in a cast-iron position to refuse to put it on a shortlist, which is why I made that statement.

Not only did I make that statement, but, four months later, when the break clause came up in respect of the East Anglia franchise, I chose to terminate the franchise at that point. I made a statement to Parliament at that point, too, which the Secretary of State has resolutely refused to quote as well. I said in terms to Parliament that the reason why I was exercising that break provision was that I no longer regarded National Express as a fit and proper partner for the state in managing new contracts. The legal advice I was given was that the break provision gave me an opportunity to define the ongoing contract as new, whereas I



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could not terminate the contract until the break point because the decision had already been taken by my predecessors.

The point about taking those statements together is that, on the record, it was clearly the policy of the Government for whom I was Secretary of State from 2009-10 that National Express would not have been able to be shortlisted for any future franchises for the foreseeable future. How long you would define the foreseeable future for would be a matter for discretion, but it was certainly going to be for a significant number of years, given its default on the east coast in 2009.

Q93 **Huw Merriman:** From your recollection, there is legal advice that suggests that you were absolutely entitled to make that decision.

Lord Adonis: Yes. My chief legal adviser, to whom I have spoken since and who has now left the Department, would be perfectly happy to give advice to your Committee to support that.

Q94 **Huw Merriman:** To come back to the potential cost—if we call it that rather than a bail-out—of billions, wouldn't that be the case if the Department had actually allowed some form of restructure of that franchise, because then all other franchises would look to have a restructure as well, and basically hand the keys in? But that did not happen, so I am not quite sure where the billions come from.

Lord Adonis: It has not happened yet. We still do not know what this public-private partnership in 18 months will be. The Secretary of State has not said.

Q95 **Huw Merriman:** The point I was trying to make is that, because there has been no restructure, and it has just been "The End," there is not the same incentive for the other franchised entities to try to get a restructure, because they clearly will not get one. They will lose their franchise.

Lord Adonis: It all depends on what happens in 18 months, doesn't it? If Virgin and Stagecoach reappear as the private sector partners in this public-private partnership on east coast in 18 months' time, it does not look to me to be much of a penalty. A crucial issue for your Committee is what you recommend in respect of this public-private partnership and, in particular, whether the two operators that have defaulted, and deprived the taxpayer of £2 billion of payments that they were going to get under that contract, are allowed to bid for that public-private partnership.

Last week, the Secretary of State would not answer the question in the House as to whether they will be allowed to bid. It is very clear to me that the public interest requires that they should be banned from bidding in that public-private partnership in 18 months' time, or whenever he is able to get a plan together that he can then seek private sector partners for.

Q96 **Ronnie Cowan:** Last week, the Secretary of State announced that



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management of the east coast franchise would be transferred to the operator of last resort until the east coast partnership is introduced in 2020. Is it in the interests of passengers to change the management of the franchise, since from their perspective it seems to be performing reasonably well?

Lord Adonis: If they get managers of the quality of Elaine Holt, they will be doing very well. It is perfectly possible for the state to get first-class rail managers. I do not know whether Elaine has been approached to run the franchise again. It all depends on the quality of the management. If they get second-rate management, they will get second-rate service; if they get first-rate management, they will get a decent service, and the state is perfectly capable of hiring first-rate managers.

Q97 **Ronnie Cowan:** Elaine? If you can get a word in edgewise.

Elaine Holt: When I took over east coast last time around, we kept some of the existing managers and we put in some of our own, because it was good to have a mix, to have some continuity and some new faces as well. I think there is a balance.

Q98 **Ronnie Cowan:** In the interests of the current employees, is that the right thing to do? Current employees must be looking at this and saying, "I understand what the previous panel said; it will just move on." If I were an employee of the current set-up, a driver, a ticket inspector or a cleaner, I would be thinking, "What's happened to my working conditions, my pension rights and my wage?" There is uncertainty.

Elaine Holt: For employees of a franchise when it transfers, whether it is to a new franchisee or an operator of last resort, TUPE applies. All their terms and conditions are protected, and they do not have to worry about that. Inevitably, when a business is going through challenging times, there is a lot of uncertainty, and people think about what is in it for them and how it affects them.

When we took over east coast, morale was pretty low, which affected delivery of the business. One of the things I am sure the new team going in will do is to focus a lot on the people, as we did, and make sure that they understand what is happening, why it is happening and what it means to them, enabling them to deliver for the passenger. The staff on east coast, I have to say, are passionate about the railway and very committed. They almost view it as, "We'll just keep going because so many people own us and we know what we're doing." They are quite open about that.

Q99 **Ronnie Cowan:** Is there something we could do now to help those people?

Elaine Holt: It is all about communication and being open with them, explaining what is going to happen. We had a very clear plan and said what we were going to do. We went over the top with communications to help people to feel engaged, so that they could see what was happening.



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In fact, they even dug out some of the stuff that we did. It was all about helping them to understand, and keeping them safe and secure, keeping the focus on safety. Railways are not dangerous, but they have challenges. One of the issues when we took over was poor safety performance in certain areas. It was about making people focus on the day job. Andrew was very clear: he wanted a seamless transfer, and that was what we did. It is about engaging with both staff and stakeholders.

Lord Adonis: And I didn't interfere—at least unless Elaine thinks I did. There were one or two particular things that I wanted to do, as does anyone who is in charge of these things. I particularly wanted to bring the Flying Scotsman back, because I wanted to get a journey time from London to Edinburgh of less than four hours.

Elaine Holt: You did.

Lord Adonis: And I did get it.

Elaine Holt: You did.

Lord Adonis: I saw the less than four-hour journey as a vital instrument for maintaining the Union, and I thought it was vitally important that we got best value out of that railway. I was very keen to do that, but beyond that I basically just said that I wanted the best possible railway that you could deliver. And you did it, Elaine.

Elaine Holt: Thank you. One of the things that worked when it was DOR last time around was that there were very clear roles as to who was doing what. Andrew was very clear: he was the shareholder, and he was clear about what he wanted. I was running the railway, and I was very clear about that; I was not a civil servant but a railway operator. There was a franchise team in the DFT that ran it as a kind of franchise process. We kept it all very separate because, if civil servants try to get involved in running a railway, that is not what they are employed to do. It was important for us to keep those roles separate, so that people who understood about running railways could get on and do it.

Q100 **Ronnie Cowan:** I could not help but notice over the course of the weekend while other things were happening down here that there was a lot of media coverage of the Flying Scotsman going over the Forth rail bridge, both stunning Scottish engineering achievements. It is amazing what we can do.

Lord Adonis: It is a great tribute.

Chair: We are getting a bit off track.

Q101 **Daniel Zeichner:** You said that it is a relatively simple railway to run, but, with this kind of transfer, what are the immediate challenges?

Elaine Holt: The immediate challenges are that, clearly, there are commercial negotiations with the outgoing franchisee that need to take place, as well as agreements, contracts and all sorts of procurement



stuff, which need to be pinned down. The outgoing franchisee will have invested in certain things and will be trying to get money back on that investment, if it has paid up. All sorts of complex negotiations need to happen. It is about making the staff feel valued, and that they have a good future. Then there are a lot of negotiations and discussions with suppliers and with Network Rail, setting out a clear plan. It is just good business practice, really. It is complicated and there is a short timescale, and you need a good, strong team to do it.

It was interesting that you were talking earlier about the costs of a franchise transfer. My budget for the transfer of setting up Directly Operated Railways and East Coast was just under £10 million. I had a team of 35, which was a mix of consultants, some people seconded from the DFT and some direct employees. That was the budget for negotiating with National Express, and setting it all up, as DOR and East Coast. I do not know whether that number is helpful, but that was what it cost in 2009.

Q102 **Daniel Zeichner:** How long did that take you?

Elaine Holt: I started in July and we were due to take it over, potentially, in December, and it actually went in November. It was a very uncertain time. We were watching the cash flow at National Express to see how it was going and whether they could pay the wages at the end of the month. It was that kind of situation, and it was quite a long way down the line before the decision was taken that it was going to come under DOR's control. We probably had from the end of August to November, when we finally took it over.

Q103 **Daniel Zeichner:** What is the difference between the position of you running Directly Operated Railways and what we now have as the operator of last resort, which appears to be a further outsourced version, as far as I can see?

Elaine Holt: I do not know a great deal about who is doing what in the current set-up.

Daniel Zeichner: I do not think any of us do.

Elaine Holt: When I was there, I wanted to make sure, if this happened again, that lessons were learned and processes were in place. There were some very good DFT people on the team, who took away a lot of lessons learned. That was all there—it exists—so I am kind of hoping that somebody has got that out and that they are using some of it this time around. Okay, it is a few years later, but a lot of the good practice will exist. I cannot comment on who is there today, because I do not know who it is.

Lord Adonis: Chair, can I make one point, to add to what Elaine has just said? I was told at the time, in 2009, by a lot of people, including some officials in my Department, that it was extremely risky to take the franchise back, and that I should do the deal with National Express,



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purely because of the risks involved in setting up a new company, particularly that people had completely lost faith in the capacity of the state to run anything. I was told, including by some very senior railway managers, that it would inevitably be a disaster, purely because we were now going to try to run it as a state entity.

I took the view that, in the balance of risk, and there clearly were risks, because the state had not operated railways for some time, the risks from the collapse of the franchising system at large were much greater than the risks of us being able to operate a service. The crucial thing was the quality of the managers; there was no reason why we could not run a decent railway if we had good managers. I asked my chief official—sparing Elaine's blushes—if he would produce for me a list of the three or four best railway managers in the country, who I might persuade, for Queen and country, to run the railway. I had conversations with them directly, and it became immediately clear to me that, once we had sorted out that issue, just getting very high-quality managers in place, there was absolutely no reason why we could not have both a seamless transition and a very high-quality service.

I do not think Elaine was underpaid, but she was paid only a fraction of what the previous National Express managers were paid on the contract. I can predict that it would not be possible to justify to this Committee or to Parliament salaries of the level being paid at the top of VTEC. The people who run this railway for the state from the end of next month will be paid a fraction of that. It is a very interesting question, which I looked at when I was responsible for this, as to whether the difference in salaries made any difference at all to the quality of the management and the passenger experience. Actually, what happened in 2009-10 was that the quality of passenger experience rose, and the salary bill fell. Maybe that is an argument for significantly cutting the levels of salaries at the top of the industry, which are sky high.

Q104 Huw Merriman: I wanted to ask for your comments about what has happened since 2015, when VTEC has been operating. The claim is that since 2015, it has invested £40 million in the fleet, and that there are 48 additional services between Edinburgh and London every week, an extra 22 Saturday services between Leeds and London, and 1.74 million additional seats. When you are making comparisons, does there also need to be some recognition that this operator, notwithstanding that it has not delivered the entirety of its contract as required, has upped the game in terms of what it has delivered as an offer?

Lord Adonis: All the points that you have just made, which are absolutely valid, were in the contract; they were from the contracting process. They were not delivered by the graciousness of Virgin and Stagecoach out of the goodness of their hearts; they were the result of a very hard-headed negotiation between the Government and the contractors. They delivered those benefits and committed to deliver a lot more benefits, too. The issue now for the state is how it takes forward



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the public company, and what happens with this so-called public-private partnership, is whether those gains can be further enhanced.

Q105 Huw Merriman: This is a difficult question to ask the operator up to 2015, but the point I am trying to get to is whether it is fair to say that comparing like for like is not always the case. VTEC put an extra 20% into the Exchequer in terms of premium payments over the three years, but it has also whacked on a lot of additional services, which were not being operated in the six years that you had the franchise. Could you comment on the fact that, like for like, it seems to have stepped up a bit?

Elaine Holt: All train companies should evolve, and they have evolved from when we had Directly Operated Railways. They have invested in the service and obviously made some improvements in additional seats, which is a good thing. My role was to make sure that it was in a fit state to go back to the private sector, and run it very effectively, and Virgin/Stagecoach have built on that, which has to be a good thing. This is a really good railway, with a very loyal customer base and very supportive stakeholders along the route. They really support the railway. It is a good one to run and make things go well.

Q106 Huw Merriman: Given that you have so much experience in this, and there is no accounting for experience, have you been approached in terms of whether you are available to lend us your expertise again? It is a serious question, because you have done this.

Elaine Holt: To be honest, I have not. I have been doing other things. I have run cruise ships and a couple of other things since. I work with the DFT; I am a non-exec director for Highways England, so I am still involved in the public sector, which is good. I would be delighted to be a non-exec director somewhere else. This is a great railway; I have a huge passion for it, and always want to see it do well.

Chair: Daniel wants to ask more about how you made it into a success.

Q107 Daniel Zeichner: I am still puzzled in the differences between the time it took you to set it up and what is now going to have to be done very swiftly, as far as I can see. What do you feel would need to be done to do it so quickly, without putting future success at risk? Can it really be done that quickly?

Elaine Holt: As I understand it, there has been a team in place at the DFT for a while. When I knew that I was coming here, I looked on the internet, and they have websites set up. A team is in place—quite a large team as I understand it—and has been preparing for this or for one of a number of options. It seems that they are ready, and they will have to work very hard to get to the end of June and take over.

Q108 Daniel Zeichner: To go back to comparisons, it has been said by some that, during the period when you were running the franchise, it ran well but there was not much investment in it. Is that a fair comment?



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Elaine Holt: I think that is fair comment. We were running it in preparation to return it to the private sector, but every time I asked the shareholder for investment and put a good business case forward, that investment was forthcoming. There was some investment, but it was not of a huge scale. For example, in East Coast, catering at the time was losing about £21 million on the franchise a year, so we were looking to do different things. I put a case forward asking for investment, and the case was good and was signed off. But it was not investment in new rolling stock or anything.

Lord Adonis: There is an important historical point. I was advised in 2009 that the Railways Act meant that the state can operate as an operator of last resort only for a short period. I cannot remember the actual wording. There is some wording in there, which I was advised meant that, in a reasonable period, I had to re-let the contract. At the time, reasonable was taken to mean about two years, which was the time it would take us to reconstitute the franchise, work out what we wanted, including the investment horizon and plans we wanted to set, and then re-let the contract.

The complicating factor is that that spanned the 2010 election. It was my intention, if Labour won that election, to seek a legal change to enable state companies to continue for more than just an interim period and then allow them to bid. I do not think Elaine knew that at the time; I could not tell her, not least because—how can I put it?—it was not obvious that Labour was going to win the 2010 election, so they were only plans.

What in fact happened was that, because of the time it took to get the refranchising under way, which is part of the reason why I am sceptical about this public-private partnership being able to get going in 18 months, the state company continued for a lot longer than had been previously envisaged. In the light of knowing how long it took, it might have been sensible to have more investment, but at the time we all thought that it was going to be terminated in two years, and there would be a new contract let.

On that horizon, it clearly was not sensible to have a big investment plan alongside. The sensible thing was to do a very good care and maintenance job, with the best possible quality of service, as a preparation for re-letting the contract, which is why the investment was not high. The investment plans were then all pushed into the next franchise, which is of course the franchise that Virgin and Stagecoach inherited.

Q109 **Daniel Zeichner:** Given all that experience, is there a danger of its being repeated? Given the evidence from the previous witnesses as well, two years looks optimistic.

Lord Adonis: It looks to me as if, so far, it is being replicated in every particular.



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Q110 **Daniel Zeichner:** The danger would be that you would have the same problem around investment again.

Lord Adonis: Huge danger.

Q111 **Daniel Zeichner:** Should we not be learning lessons from the past?

Lord Adonis: Yes, absolutely. My own view is that, in learning lessons from last time, what the Secretary of State should have said last week was that the Government intended to operate it for five years, which is a proper time horizon for being able to invest, employ good managers, motivate staff and all of those things. He should have said that last week, and said that they were intending to make a great success of the company, instead of hiding behind his hand and saying that they were the operator of last resort and that as soon as they could get it back into another entity, the better.

Whether he likes it or not, he is the Secretary of State now responsible for this railway. He should have made a virtue of the situation, said that they are going to do it really well, and given himself time to work out what is genuinely the best thing to happen in five years' time. What will happen now, unfortunately, is that there will be a great political rush to try to find something that enables him to deliver on his claim of a public-private partnership in 18 months' or two years' time, which at the moment exists as nothing more than a few jottings on the back of an envelope.

Q112 **Chair:** That is the area we will probably come to next. Just before we do, Elaine, you said earlier that you had £10 million to mobilise East Coast at the time when it was brought into DOR. It occurs to me that in the next few weeks all those trains that are full of Virgin livery and staff wearing Virgin uniforms will all be rebranded. East Coast was rebranded from National Express. Do you know what the cost of that process was?

Elaine Holt: Any costs associated with rebranding were in the £10 million. We did not go out and spend a lot of public, taxpayers' money on rebranding; we rebranded when the trains were coming in for repainting or some other kinds of servicing, to keep the costs down.

You have to do certain things when you take over a franchise. The outgoing franchisee has to remove its branding. It is obliged under the franchising agreement to do that, unless it has changed; it has to take it off. You can have a discussion with it to say, "While you're taking it off, can you put ours on?" Sometimes that happens. We did one or two trains up front, but we generally did it as they went through servicing.

Q113 **Chair:** You would anticipate that the responsibility and cost of taking out the new red seats on East Coast with Virgin written on them—I am sure that Virgin/Stagecoach will want that removed—lies with them.

Elaine Holt: When I was running it, the obligation was on the outgoing franchisee, and there was a franchise agreement to remove the branding.



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Unless that has changed in recent years, it is down to them. That is why you do not usually see things written across a lot of seats.

Chair: Thank you.

Q114 **Jack Brereton:** Before I come to my main question, I want to ask Lord Adonis about one point that he made. You suggested that the operator of last resort would have to be for around two years, and that is how the legislation works; it would be only for as long as necessary. Would there need to be legislative change first, before a Secretary of State could suggest a longer period of time for the operator of last resort?

Lord Adonis: I do not think so, because nobody legally challenged it. How long did the East Coast company last in the event? Was it five years?

Elaine Holt: Yes.

Lord Adonis: It was five years, until 2014. Given that we have had one operator of last resort operating for five years, and nobody challenged that legally, I cannot see any reason why the Secretary of State could not have said the same this time, without needing to change the law at all. Of course, precedent being the killer argument in all these cases, if he had said that last time it was five years, and that was the period it took to reconstitute the franchise and work out what we were going to do, and he was going to do the same this time, I doubt whether anyone would have challenged him legally.

Q115 **Jack Brereton:** Thank you. My main question is on the public-private partnership. Lord Adonis, you have already expressed your scepticism, so I will come to Elaine first. What is your view of the public-private partnership model that has been proposed? Do you think it could work as a model for running the railway—between the franchisee and Network Rail?

Elaine Holt: As the two ladies said previously, there is not a lot out there and not a lot of information, so it is really hard to comment. Having run that particular route, I can say that there are a number of operators and a lot of freight on the route, and a lot of infrastructure investment is needed on the route. More partnership in some shape or form, whatever that might look like, has to be a benefit. There can be disagreements between Network Rail and the train operators, so I would support a partnership approach, but I cannot comment on what is being proposed, because the information is not available.

Q116 **Jack Brereton:** Would you both agree on the need for more partnership to ensure that there is alignment between the infrastructure spending and how the operator is running the rail system?

Lord Adonis: There is a big difference between partnership, which is a great thing—we always want people talking to each other, liaising and all that—and trying to set up a completely new legal and management



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model. The very positive language of partnership is being used to apply to the second, but you have to define what the second means. Will it be a single company running the track and trains?

Elaine has just mentioned the fact that there are multiple operators on the east coast. Indeed, the East Coast company is a minority operator on the entire route. They cannot answer even the most basic questions. Will this public-private partnership now embrace all the operators on the east coast line or just, as the Secretary of State initially indicated, the intercity operator? If it is just the intercity operator, what does that mean for the other operators on the route? If it means all of them, how is that going to work? Is there going to be a single monopoly, which is then set in stone?

On this route, open access operators have come in and have actually been quite an important source of innovation. That is particularly important on the route, because there are a lot of communities that do not have direct services, which is a really big issue for communities off the east coast line. There are a lot of small communities, which crucially depend on better services; places such as Lincoln, for example, do not have a direct train service to London. If I was Secretary of State for Transport at the moment, I would be busting a gut to try to get direct services from some of those places to London, but it is a high-risk and very difficult thing for the state to contract it all and set it in stone.

Q117 Jack Brereton: In a partnership between Network Rail and operators, how would you envisage that the infrastructure investment being spent by Network Rail is more effectively aligned with franchises?

Lord Adonis: There are two things. The first would be getting Network Rail actually to deliver on the commitments that it makes, which, to be blunt, it is not desperately good at doing. We need a more efficient Network Rail. Then we need more alignment between the Network Rail plans and whatever franchise commitments are put together. One of the things that became clear last autumn, in the argument that was going on about how far it was Network Rail's fault, which itself is a very big and ongoing issue, is that a lot of commitments were made by Virgin and Stagecoach in their contracts that depended implicitly on investment by Network Rail, but that investment was never explicit. There is no contractual commitment, and there was no contractual commitment at that time, for the specific elements of investment that were needed to deliver the service improvements.

As it happens, I do not think that is the reason why the contract went belly-up. They were losing money on it from the very beginning, because they massively overbid. But it is pretty unacceptable that you should have a set of commitments made by a train franchise operator dependent on infrastructure upgrades that are not properly defined or contracted for. Surely, it is not beyond the wit of the civil servants who are supposed to be joining this up in the Department for Transport to see that the two sides of the contract are equally robust.



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Q118 **Jack Brereton:** Elaine, when running the rail network, did you experience similar issues with Network Rail and not getting some of the infrastructure that you requested, and ensuring that that happened properly?

Elaine Holt: Yes. I have run several railways and it was a few years ago, but it was always a challenge. They have to balance a lot of priorities. In the case of east coast, although it is the big jewel in the crown, the intercity railway is the small operator on the route. At King's Cross, there are a lot of other priorities. Yes, there was a lot of debate; there could have been a much stronger approach to partnership. We made some improvements, but there was a long way to go at the time. It is a few years on and maybe it has moved on, but a lot more could be done on partnership.

Lord Adonis: Can I elucidate this a bit further? Some very important public policy decisions are going to be made in the next year. If you take the lines going out of King's Cross, a lot of services to very important and crucial destinations, including Mr Zeichner's constituency, use the east coast main line for the first part of their journey. All the trains going to Cambridge go to Hitchin, and then on to the Hitchin flyover, which is a very worthwhile piece of investment, and then they go off to Cambridge. If a public-private company is responsible only for the east coast line but operates the trains, the services and track, are Mr Zeichner's services to Cambridge going to become second-class services, because it is not the company in charge of running them?

One thing we can be sure of is that the train operator, if it also directly controls the track, will see that all the decisions that are made prioritise its services, including decisions on engineering works and the phasing of investment. The Department will have to wrestle with the fact that we will inevitably get sucked into that, and the only way to deal with it is to have all the companies that come into King's Cross as part of the public-private partnership. That is about one third of the national rail network. You need to ask some of those questions.

I have been there and done that job, and we are Alice in Wonderland at the moment. If it ain't broke, don't fix it. Some mistakes have been made that led to problems in the last year or two, but I urge the Committee, and the Secretary of State through the Committee, to be very wary, in a fit of ideological fantasy, of throwing the whole railway industry up into the air. It could cost billions and could lead to a lot of places in the UK ending up with worse railway services as a result.

Q119 **Chair:** Before we finish, I have a couple of questions. Reflecting on some of the answers you have given, who do you think was most responsible for the failure of this franchise? To what extent was the responsibility with Network Rail, Virgin Trains East Coast and the Department for Transport?



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Lord Adonis: Sir Richard Branson and Sir Brian Souter signed the franchise, and they are two of the most brilliant business people in the world. They do not enter into contracts lightly. They entered into this contract completely freely; they messed up. It is their fault.

Q120 **Chair:** Elaine, do you have a view?

Elaine Holt: I have been running cruise ships and other things in recent years, so I shall be very diplomatic.

Q121 **Chair:** Okay. You heard my final question previously. Our predecessor Committee concluded last year that, "without change, it is difficult to see how the current model of franchising will be sustainable in the longer term." How sustainable is the franchising model, and are there any obvious areas for reform in order to maintain it as sustainable?

Lord Adonis: In 2009, I was told that it was on its last legs and about to collapse. It is still there, and railways on many measures are more successful than they have ever been. I would caution very seriously against throwing the whole thing up in the air when, at the moment, it basically appears to be working fine, with some problems caused by operators not doing a good enough job, such as Southern. Let us be clear: there have been problems because an operator has not been doing a good enough job, and there has been a default on one out of 16 franchises, which does not represent the entire system collapsing.

Q122 **Chair:** Elaine, I appreciate that you are not currently in rail franchising, but, as someone who has experience of it, looking from the outside, do you agree with Andrew? Do you think it is sustainable?

Elaine Holt: I agree with Andrew. Some tweaks need to be made, particularly in the case of east coast. There has been overbidding on several occasions, it appears. It is a question of going back and looking at the risk, and how to cope with change. Changes happen. What is the change mechanism in the franchise agreement? That needs to be looked at. Fundamentally, the franchise process has delivered a lot of good things.

Chair: Thank you both very much for appearing before us today and giving evidence. That concludes our session.