



Department  
for Transport

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From the Minister of State  
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Dear Huw,

I was pleased to write to you on 4 October about London and South Eastern Railway and update you on the work the Department is undertaking on this issue.

I am writing now to provide you with the additional information you requested in your letter to me of 11 October, which you copied to Dame Meg Hillier MP, Chair of the Public Accounts Committee. This material is detailed below in Annex A under the original headings set out in that letter.

I hope you find this information helpful.

Yours sincerely,

**Chris Heaton-Harris MP**

**Minister of State for Transport**

## Annex A

### Discovery

***When did the Department first become aware of the underpayment? Was its discovery the result of routine scrutiny via the termination process of legacy agreements or a targeted investigation? When were you, as the responsible Minister, and the Secretary of State informed?***

The Department originally contracted with London South Eastern Railway (LSER) in 2006 after the Southeastern Franchise transferred back into the private sector. The Department then entered into a further direct award contract with LSER from 2014 up to the Emergency Measures Agreements in March 2020.

Since 2019 the Department has been engaged with LSER to determine the correct level of profit due to the Department through contracted 'profit share' arrangements. Through this work, the Department first identified in summer 2020 irregularities in historic payments to LSER specifically in relation to LSER train services operating on High Speed One (HS1).

Following further investigation into the irregularities, in spring 2021, the Department became aware of material sums owed but not declared or repaid to the Department specifically in relation to services operating on HS1, against which it appeared that LSER had breached the good faith obligation within the franchise agreement. Having completed extensive enquiries and come to their conclusions, Officials notified me of the HS1 issue, alongside other contractual issues such as the calculation of profit share payments due to be paid to the Department, in June 2021 via a submission.

***What was the exact nature of the underpayment? Can you set out in detail what amount(s) should have been paid, when and for what?***

The contractual breach relates to the failure to repay to the Department an amount of franchise payment for charges on the privately operated HS1 network. It is not possible to accurately forecast HS1 costs due to bespoke contract mechanisms which can alter charges retrospectively, such as cost re-openers, and for this reason the Department has never transferred commercial risk to the operator. Within the contract there exists a mechanism which works by paying an initial payment to the operator (in this case LSER) and then a subsequent process (referred to as a wash-up) takes place to true up the initial payment to equal those costs actually incurred. The exact value of these payments are commercially sensitive, but the net position meant LSER should have returned over £25 million to the Department over a number of years.

***Why were the underpayments not identified earlier? Was this due to the complexity of the process or deliberate obfuscation on the part of LSER?***

These are long standing and complex financial arrangements, unique to the Southeastern contract. Contracts rely on a mature, transparent and trusting relationship between the parties which is reflected in the inclusion of a contractual obligation for both parties to act in good faith. LSER concealed the money owed through their financial reporting to the Department over several years. It is incumbent on the operator to act transparently and in good faith to declare payments rightfully due to the Department, and LSER did not do so.

### **Investigation**

***Can you set out a timeline of steps your Department took as part of its investigation?***

Since the identification of payment irregularities relating to HS1 charges in summer 2020, the Department has worked to calculate the sums of monies involved and ultimately owed to the tax-payer. This work required technical financial analysis of complex historic payments which took place over several years and where key information was concealed by LSER in their financial reporting to the Department. As part of this work, the Department has formally engaged directly with LSER on this subject and other contractual matters of dispute. It is through these discussions and further investigation that the Department became aware during spring 2021 of the material sums owed but not declared or repaid to the Department.

***Go-Ahead reported to its investors that you formalised the dispute in March 2020. Had you had relevant correspondence or meetings before that? If so, when did that start, and what was discussed? What was LSER's initial response when questioned?***

The reference in Go-Ahead's annual audited accounts relates to the separate dispute between the Department and LSER over the calculation of profit share due back to the Department. This is a contractual dispute which is ongoing and is commercially sensitive in nature.

The Department was not aware of the monies owed to the Department relating to HS1 costs at the point in time that the dispute, referenced in Go-Ahead's annual accounts, was formalised in March 2020. It appears that Go-Ahead and LSER were aware at this time of the HS1 services monies due back to the Department. However, LSER did not declare this to the

Department and were continuing to minimise the risk of detection by the Department.

***At what point did you decide LSER had breached its good faith obligations? On what basis was this judgement made? Can you set out in detail the exact legal or contractual arrangements that were breached? Did LSER's management dispute your conclusion? If so, on what basis?***

The Department's position is that the contractual obligation to act in good faith<sup>1</sup> clearly includes declaring payments rightfully due to the Department, something that I am satisfied LSER did not do in relation to HS1 services. When the materiality of the monies owed became apparent in spring 2021, the Department considered and later decided that, based on the available evidence, this was a significant breach of the good faith obligation within the contract.

After seeking legal advice and carefully considering LSER's obligations within the franchise agreement, the Department wrote to LSER on 28 July 2021 in relation to these serious matters and to give them an opportunity to comment on the Department's view on these prima facie contraventions of the franchise agreement. The chairs of Go-Ahead Group PLC and Keolis UK as the owning groups for LSER (65% Go-Ahead, 35% Keolis) responded on 11 August to this letter, explaining that they had formed a non-executive committee to investigate the issues raised by the Department. The Department's position has not been disputed by LSER or the owning groups to date, noting the Chair of Go-Ahead has also publicly apologised to the Department in Go-Ahead's press release on 28 September 2021.

***When did you, or the Department, first discuss or correspond on this matter with Go-Ahead and Keolis, the parent companies of LSER? Did one, or both, of these parent entities, become the lead for discussions (as opposed to the management of LSER)? If so, at what date did the parent assume the role as the answering entity?***

The Department has shared formal correspondence on several occasions with LSER relating to on-going contractual disputes since 2019. Then on 28 July 2021 the Department wrote to LSER specifically regarding the prima facie breach of the franchise agreement relating to HS1 monies due back to the Department. The letter was responded to directly by the Chairs of Go-Ahead Group PLC and Keolis UK outlining that they had formed a non-executive committee to review the issues. From this point onwards and at the request of the owning groups given the nature and seriousness of the issues, the non-executive committee has been the Department's sole contact on these issues.

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<sup>1</sup>01 April 2020 LSER Franchise Agreement, Clause 6.1 and Clause 5.4 of 2014 LSER Franchise Agreement

***Given your Department appears to have been aware of these matters for some time, why was action not taken sooner? Particularly considering agreements negotiated due to the pandemic have guaranteed LSER profits in recent months? Was it a mistake to make a Direct Award to LSER in 2018?***

Although there have been on-going discussions on contractual issues from 2019, the Department became aware of the irregularities relating to the HS1 costs in summer 2020 and only through diligent investigation identified the materiality of the monies concealed and thus the significance of the contractual breach in spring 2021.

The contract was due to expire on 17 October 2021 and at that time termination of the franchise was not considered to be appropriate or practical in the circumstances. The decision to directly award the last contract to LSER was made significantly before the Department became aware of the HS1 issues.

### **Further action**

***You state that further investigations are underway. What is the nature of these investigations? Do you expect further underpayments to be identified?***

Further investigations are being conducted by the non-executive committee formed by the owning groups into historic contractual issues with LSER. Following these investigations, the Department will consider further options for action (including the imposition of a statutory penalty under the Railways Act 1993), further investigation, and recovery of any further money owed, including interest, if necessary.

In addition to the work of the owning groups' non-executive committee, the Government Internal Audit Agency (GIAA) have been commissioned by the Department to review existing controls and assurance procedures that protect the Department against the risks it faces, and to provide advice on any areas for improvement. The Department will carefully consider the GIAA's advice and take action as appropriate.

***Do you expect criminal charges to be laid? What investigations are the Serious Fraud Office (SFO) undertaking and was the involvement of the SFO initiated by the Department or by one of LSER, Go-Ahead or Keolis? If one of the latter three entities, are you aware why this matter was not disclosed to the London Stock Exchange or upon inquiry by interested parties?***

The Department cannot comment on any potential investigation by the SFO. Neither would it be appropriate for the Department to comment on disclosures made to the stock exchange by a publicly listed company.

***Might any steps be taken against LSER's external auditors?***

This will be a decision for the relevant competent bodies, or the parties contracted in the statutory audit engagement. This process is independent of the Department and we are not a contracted party.

***What role has the National Audit Office performed prior to the decision to remove the contract and since?***

The Department has notified the NAO of the issues and the Department will engage with the NAO as appropriate through the on-going investigation.

**Go-Ahead and Keolis**

***Did you consider that employees of Go-Ahead and Keolis were (i) aware of the underpayment prior to the Department discovering the same and (ii) responsible for a breach of good faith? If so, at what level of seniority were these individuals employed and are they still within the employment of Go-Ahead and Keolis?***

The role of the owning groups in these issues forms part of the scope of the on-going investigation by the owning groups' non-executive committee, the outputs of which will be heavily scrutinised by the Department. It would not be appropriate for the Department to comment on any on-going investigation. The Department does not consider that it is appropriate for it to comment on matters relating to individuals, these are a matter for the company.

***Do you, the Secretary of State and the Department, believe that Go-Ahead and Keolis are fit to run the Thameslink, Southern and Great Northern franchise, given recent events with LSER?***

The current contract with Govia Thameslink Railway (GTR), which operates the Thameslink, Southern and Great Northern (TSGN) franchise, does not expire until 01 April 2022, and the decision not to award a further contract to LSER has no direct impact on the current operations of that franchise. The owning groups' non-executive investigation will carefully examine the role of the owning groups in the governance and oversight of LSER to understand the extent of the issues. The Department will undertake a rigorous review and examination of the evidence provided, to consider whether further action or investigation is required. The outputs of the current investigation will be a relevant factor in respect of decisions on the TSGN franchise. If required, the Operator of Last Resort is always available, in accordance with the Secretary of State's statutory obligations.

## **Wider network**

***Do you expect further financial irregularities to be discovered across the network? What steps are you taking to investigate this possibility?***

Due to the unique arrangements of the HS1 contract within the LSER franchise agreement, there is no reason to currently believe the issues will be present on other operators. As part of its ongoing assurance activity around Rails spend, the Department has commissioned an external financial adviser to undertake a review to check that monies have flowed correctly between Department and TOCs, that those are being properly accounted for and that taxpayer value is not being lost.

The GIAA have also been commissioned by the Department to review existing controls and assurance procedures that protect the Department against the risks it faces, and to provide advice on any areas for improvement. The Department will carefully consider the GIAA's advice and take action as appropriate.

***Does the Department's more direct role overseeing the finances of Train Operating Companies (TOCs) since the beginning of the pandemic make identifying further irregularities, from the franchising period, more likely?***

The nature of the contracts now awarded during the pandemic where the taxpayer is now significantly and directly funding all TOCs and where TOCs bear no material financial risk has deliberately and by design given the Department the necessary enhanced oversight of the financial decisions made by rail operators that it did not possess under the franchising regime because operators were then on more financial risk. The unprecedented level of Government subsidy to support operators through the pandemic, means that a fundamental aspect of our new contractual arrangements has been the inclusion of enhanced controls. We have designed contracts which provide more oversight and include the Department in the financial decision-making process. We have also enhanced our rights to inspect and audit operators, and more importantly have used those rights.

***In the event the underpayment was a result of amounts not being paid when due to the Department, does the Department consider that the current and future concessionary model will increase the risk of future underpayment (compared to the franchise model where all fare revenues were retained by the TOCs)?***

The Department does not consider that the current model or future concessionary one will increase the risk of future underpayment. Under our

reforms, we will keep the best elements of the private sector that have helped to drive growth and innovation. Great British Railways will contract private partners to operate the trains to the timetable it sets. These contracts will build on the new contracts now in place and thus include strong incentives for operators to run high-quality services and increase passenger demand. These contracts will include strict financial checks to mitigate the risk of any under- or over-payments.

### ***How will this incident inform future contractual negotiations with TOCs?***

Operators are contracted to act in good faith. The decision to move the Southeastern Franchise to OLR makes it clear that the Department will not hesitate in taking swift and effective action to protect taxpayer's interests. The Department is committed to ensuring appropriate levels of monitoring and inspection of TOCs' finances and the appointment of OLR on the Southeastern Franchise should also act as a deterrent against inappropriate behaviour by other TOCs.

### **Operator of last resort (OLR)**

***What assessment have you made of the OLR's capacity to take on LSER services? Has a determination been made by the OLR as to which of the senior management of LSER will be retained? If so, can a breakdown be provided of the individuals transferring and those who will not?***

The OLR is designed to be available if required in accordance with the Secretary of State's statutory obligations. My Department engaged with colleagues at the OLR to ensure the team was appropriately resourced to ensure a smooth continuation of passenger services on 17 October 2021. This took into account those staff who did and did not TUPE across from LSER, noting that a number of LSER employees (including several senior finance staff) chose not to transfer.

### **Future of LSER**

***What are your plans for the long-term future of the LSER franchise? Could some of its services be transferred to TfL? When will these services be put back out to tender?***

The agreement with the OLR is currently contracted for six years, with an option to end the contract early. In the future, it remains the Department's expectation that it will let the franchise as a Passenger Service Contract, in line with the Williams-Shapps Plan for Rail.