Department for Transport

NOTICE IN ACCORDANCE WITH SECTION 57C OF THE RAILWAYS ACT 1993

09 May 2022

1. This is a notice, given in accordance with section 57C of the Railways Act 1993 (the Act), stating that the Secretary of State for Transport (SoS) has imposed a penalty of £23.5m on London & South Eastern Railways Limited (trading as Southeastern) (LSER) pursuant to section 57A of the Act, for contraventions of the Franchise Agreement entered into between the SoS and LSER on 10 September 2014 (the 2014 FA) and of the Franchise Agreement entered into between the SoS and LSER on 27 March 2020 (the 2020 FA).
2. This notice has been published on the Department for Transport (DfT) website and a copy served on LSER.
3. The contraventions relate to admitted breaches of LSER's obligation to act in good faith in and about the performance of its obligations and the exercise of its rights pursuant to the 2014 and 2020 FAs.
4. The acts and omissions which, in the opinion of the SoS, constitute the contraventions and justify the imposition of the penalty are more fully set out in paragraphs 9 to 57 of this notice.
5. In accordance with the Act, the penalty should be paid to the SoS by 23 May 2022, unless LSER make an application with 21 days from the date of this notice for the SoS to specify different dates by which portions of the penalty are to be paid.

Relevant Legal Provisions

6. Under section 57A of the Act, the SoS may impose a penalty of such amount as is reasonable, if he is satisfied that a relevant operator is contravening or has within the last two years of the notice of proposed penalty contravened a term of a franchise agreement. The amount may not exceed 10 per cent of the relevant operator's turnover, defined in accordance with the Railways Act 1993 (Determination of Turnover) Order 2005 (SI 2005 No 2185).
7. Section 57B(3) of the Act provides that, in deciding whether to impose a penalty, and in determining its amount, the SoS shall have regard to the statement of policy published by the SoS at the time when the contravention occurred. For the purposes of this notice the Rail Franchise Agreements and Closures Enforcement Policy, published in July 2008[1] (the Enforcement Policy), applies.
8. Pursuant to section 57A(5) the SoS shall not impose a penalty unless he has given notice to the Office of Rail and Road (ORR) specifying a period within which the ORR may give notice if the ORR considers that the most appropriate way of proceeding is under the Competition Act 1998, that period has expired and the ORR has not given notice within that period. The SoS provided such a notice to the ORR on 27 January 2022. The ORR confirmed on 2 February 2022 that it did not consider that it was appropriate to proceed under the Competition Act 1998 in relation to the contraventions with which this notice is concerned.

Franchise Agreement Terms which have been contravened

1 https://www.gov.uk/government/publications/enforcement-policy-rail-franchise-agreements-and-closures

9. The 2020 FA was the most recent in a series of franchise agreements entered into by the SoS with LSER.

10. The first franchise agreement with LSER dated 29 November 2005 in relation to the Integrated Kent Franchise (the IKF FA) commenced on 1 April 2006 and on its expiry on 12 October 2014 was replaced by the 2014 FA. The 2014 FA was extended several times before coming to an end on 1 April 2020 when it was replaced by the 2020 FA. As a consequence of the COVID-19 pandemic, the 2020 FA was entered into on the basis of an Emergency Measures Agreement under which LSER was paid a fixed fee, with potential to earn a performance based incentive fee (in contrast to the IKF FA and 2014 FA under which revenue and cost risk rested with LSER). The 2020 FA expired on 17 October 2021.

11. Clause 4.3 of the IKF FA, Clause 5.3 of the 2014 FA and Clause 6.3 of the 2020 FA are in identical terms and each states:

    "*The Franchisee shall co-operate with the Secretary of State and act reasonably and in good faith in and about the performance of its obligations and the exercise of its rights pursuant to the Franchise Agreement*."

    ("the Good Faith Obligation").

12. Additionally Clause 6.6 of the 2020 FA states:

    "*Anything done or omitted to be done by the Franchisee under or in relation to or during the term of the Previous Franchise Agreement shall be regarded for the purpose of the Franchise Agreement as if it had been done or omitted to be done by the Franchisee under or in relation to and (only to the extent necessary to give effect to this clause) during the term of the Franchise Agreement. Without limiting the generality of this clause 6.6 any contravention of the Previous Franchise Agreement shall be a contravention of the Franchise Agreement, in so far as necessary to ensure that the Secretary of State shall have the same rights under and in respect of the Franchise Agreement in respect of that contravention as it would have had under or in respect of the Previous Franchise Agreement had the Previous Franchise Agreement continued in force. The Secretary of State agrees not to take any action to enforce or terminate the Franchise Agreement in respect of any Event of Default which may have existed or been alleged to exist at the Start Date*"

    and for the purpose of this clause, "the Previous Franchise Agreement" is defined in the 2020 FA as the 2014 FA, and "the Start Date" is 1 April 2020. Clauses 6.1-6.3 of the 2014 FA were in substantially similar terms (but by reference to the IKF FA) to Clause 6.6 of the 2020 FA.

Summary of contraventions

13. In the opinion of the SoS, Clause 5.3 of the 2014 FA and, by virtue of clause 6.6 of the 2020 FA, the 2020 FA have been contravened by LSER failing to act reasonably and in good faith in its dealings with the SoS by virtue of:

    a. LSER's wrongful retention of significant amounts of public monies which, as LSER was aware, were due to the SoS under the 2014 FA[2] (the Overpayments);

    b. LSER's admitted failures to disclose to the DfT the amounts due to it;

[2] The identified Overpayments did not continue during the 2020 FA, because the basis of the franchise payments changed under the new arrangements.

c. the taking of steps by LSER to conceal the true position from the DfT (including by the reporting of non-specific accruals to the DfT); and

d. further measures to seek to maximise LSER's profits from such conduct, including allocating the revenue from the release of accruals in respect of previous overpayments to the IKF period so as to avoid any sharing of profit on such revenue with the DfT and using misleading descriptions of such accruals to conceal the true position from the DfT.

Such conduct constitutes "the Good Faith Contraventions". These contraventions are summarised and explained in more detail at paragraphs 34.a and 34.b below.

14. As explained in more detail at paragraphs 34 to 36 below, LSER has demonstrated a pattern of similar conduct under successive franchise agreements, which has continued for more than 13 years (during which time various extensions and new franchise agreements have been awarded to LSER, resulting in significant revenues and profits being generated by LSER). For the purposes of this Penalty Notice, the SoS relies upon the Good Faith Contraventions, but in relation to his decisions as to whether to impose a penalty in respect of the Good Faith Contraventions and determining the amount of the penalty the SoS has taken into account, amongst other factors, similar conduct to that set out in paragraph 16 above between no later than 2007 and 2014 which constituted admitted breaches of the IKF FA (the Previous IKF Contraventions).

Basis on which the existence and nature of contraventions have been established

15. This section summarises briefly how the SoS first became aware of the possibility of the contraventions described in this Notice and has subsequently become satisfied as to the fact and nature of those contraventions.

16. In July 2020 the DfT identified that an indexation error had been made in the calculation of an element of the franchise payments payable under the 2014 FA relating to HS1 track access charges, resulting in overpayments in LSER's favour over a number of years. At this time, the DfT believed that the amounts overpaid would have to a large extent been recovered through the profit-sharing arrangements under the 2014 FA.

17. At that time, the DfT and LSER were in dispute as to the amount of profit share payments properly payable by LSER under the 2014 FA, and there followed a period during which they continued to correspond about these issues and the HS1 track access overpayments. Consequently:-

a. a letter was sent from the DfT to LSER dated 29 April 2021, in which the DfT required payment of, amongst other amounts, what it believed to be the amount owed including in respect of the HS1 track access charge overpayments;

b. an e-mail was sent by the DfT to LSER on 12 May 2021, requesting a full breakdown of the DfT creditor balances; and

c. a letter in response to the DfT's letter of 29 April 2021 was sent by LSER to the DfT dated 24 May 2021, in which LSER explained amongst other things that the amount (of overpaid subsidy) to be repaid in respect of HS1 track access charges was higher than the amount identified by the DfT, and that there had also been overpayments to LSER under the 2014 FA in respect of HS1 depot rental adjustments. LSER confirmed that accruals had been made in its accounts for both overpayments on the basis that LSER recognised that both sums would fall to be repaid to the DfT.

18. On 28 May 2021, LSER paid to the DfT a sum which included the amounts of principal in respect of the HS1 track access and depot rentals overpayments referred to in paragraph 17.c.

19. On 28 July 2021, the DfT wrote to LSER indicating that it considered that there had, prima facie, been a contravention of the Good Faith Obligation as a result of LSER's conduct in respect of the admitted overpayments, and that the SoS's right to make a financial penalty under s57A of the Act was engaged. The DfT invited LSER to provide any further information it wished in order to explain its conduct, to explain whether the inferences drawn by the DfT in respect of the prima facie breach were correct and to explain why LSER considered it would be appropriate for the SoS to enter into a further rail contract with LSER on expiry of the 2020 FA. The letter also dealt with other matters of concern to the DfT including levels of affiliate trading and directors' remuneration (relevant to the calculation of profit share payments under the 2014 FA). It sought a response by 12 August 2021.

20. On 11 August 2021, the Chairs of LSER's ultimate shareholders[3], The Go-Ahead Group plc (the majority shareholder) and Keolis (UK) Limited (the minority shareholder), responded to the DfT's 28 July 2021 letter explaining that they had been appointed by LSER as an independent committee with authority to establish the facts, to respond to the letter and to direct any necessary corporate renewal action to prevent reoccurrence of the matters raised ("the LSER Independent Committee"). The LSER Independent Committee explained it proposed (with the assistance of external professional advisers) at the expense of its shareholders to lead an investigation into the matters identified by the DfT ("the Company Investigation"). The LSER Independent Committee's letter accepted that preliminary enquiries suggested that LSER had made a grave error of judgement and committed to cooperate with the DfT in respect of the matters of concern.

21. On 24 September 2021, the LSER Independent Committee wrote to the DfT with its interim findings from the Company Investigation, enclosing interim reports from its professional advisers, shared with the DfT. LSER asserted legal professional privilege and/or confidentiality in respect of the content of such reports, and shared such reports on a confidential and limited waiver of privilege basis. In consequence of the interim findings, the LSER Independent Committee acknowledged that mistakes and serious errors of judgement had arisen in relation to LSER's franchise arrangements and apologised unreservedly for those. It committed to further investigation work and to the sharing of the findings of that further work with the DfT, as well as committing to immediate remedial action to give effect to the findings and recommendations of the interim reports.

22. On 28 September 2021, the SoS wrote to LSER confirming that he would not enter into a new contract with LSER upon the expiry of the 2020 FA on 17 October 2021.

23. The LSER Independent Committee wrote to the DfT on 26 November 2021 with its overall findings from the Company Investigation, enclosing further reports from its professional advisers which it shared with the DfT on a confidential and limited waiver of privilege basis. It apologised unreservedly and accepted the DfT's assessment that LSER's conduct constituted contraventions of the Good Faith Obligations, and identified a number of instances where LSER did not comply with the Good Faith Obligations by failing to notify to the DfT that certain monies were owing to the DfT (under the IKF FA and the 2014 FA) and instead by retaining those monies. It also identified for completeness further examples of contraventions in respect of non-reporting of amounts due under the IKF FA and 2014 FA. It enclosed LSER's assessment of the overall net sum payable as between the DfT and LSER in respect of the contraventions it had admitted, taking

[3] LSER is a wholly owned subsidiary of Govia Limited, which in turn is ultimately owned by The Go-Ahead Group plc and Keolis (UK) Limited (the ultimate shareholders). Unless otherwise stated in this Notice or inconsistent with the context, references to the "shareholders" include each of Govia Limited and the ultimate shareholders.

into account various other outstanding matters under the relevant Franchise Agreements[4]. In addition to the steps referred to in its previous letters, the letter confirmed the steps being taken to strengthen the governance of Govia Thameslink Railway Limited (GTR), the remaining franchise operator ultimately owned by The Go-Ahead Group plc and Keolis (UK) Limited through their joint venture company, Govia Limited, including personnel changes; changes to the operation of the GTR board; changes to the purpose and remit of the Govia Limited board; changes to the assurance and governance of GTR at the boards of The Go-Ahead Group plc and Keolis (UK) Limited; changes to the boards of both The Go Ahead Group plc and Keolis (UK) Limited (in addition to Keolis (UK) Limited commissioning a review of board and subsidiary board governance); and each of the ultimate shareholders reviewing and seeking to improve whistleblowing policies. The Go-Ahead Group plc has confirmed that each of it and Keolis (UK) Limited are appointing a third party to review and report on compliance with the steps and principles being put in place on an ongoing basis, and it has confirmed it will provide updates to the DfT in this respect.

24. Following feedback from the DfT, the LSER Independent Committee agreed to supplement the reports and include as part of its investigation a series of written questions to key individuals. Responses to those questions were provided to the DfT by the LSER Independent Committee in the week commencing 17 January 2022.

25. The SoS has taken account of all evidence, including the findings of the Company Investigation and points made to date by LSER in its correspondence with the DfT, in reaching the conclusions set out in this Notice.

Contraventions in respect of which a penalty has been imposed

26. Clause 5.3 of the 2014 FA and, by virtue of clause 6.6 of the 2020 FA, the 2020 FA have been contravened by LSER, by LSER failing to act reasonably and in good faith in its dealings with the SoS in relation to its wrongful retention of the Overpayments, the failure to notify the SoS of the Overpayments, the reporting of non-specific accruals to the DfT by LSER and various other steps taken by LSER to conceal the position from the DfT and to seek to maximise LSER's profits from such conduct.

27. LSER knew that the DfT was unaware of the Overpayments and made deliberate decisions not to bring the Overpayments to the attention of the DfT over an extended period of several years. Instead, LSER reported non-specific accruals to the DfT in relation to the Overpayments, such that the Overpayments were concealed from the DfT. Moreover, as LSER sought to attribute the revenue from the release of certain accruals arising from the Previous IKF Contraventions in the period of the 2014 FA to the period of the IKF FA, the effect of this was that LSER did not share the profit with the SoS on these releases. LSER deliberately described the accruals in such a way as to conceal the true nature of the underlying accruals which had been released. Further details are set out in paragraph 34 below.

28. In addition to the admitted breaches of the Good Faith Obligations in wrongfully retaining and not disclosing the Overpayments to the SoS, paragraph 6.1 of Schedule 13 of the 2014 FA (and paragraph 1.1 of Schedule 10.1 of the 2020 FA) requires LSER to notify the SoS as soon as reasonably practicable of any contravention of the franchise agreement. LSER was aware that it was not entitled to the Overpayments. Therefore, not reporting the wrongful retention of the

[4] LSER has repaid the amounts determined to be due by the DfT in its determination letter dated 29 April 2021 and indicated that it would repay any further amounts which are properly due to the DfT including interest.

Overpayments and other contraventions to the DfT represents a further contravention of the 2014 FA.

29. By operation of Clause 6.6 of the 2014 FA, the admitted breaches by LSER of the 2014 FA are also breaches of the 2020 FA.

30. Section 57D(1) of the Act provides that no penalty may be imposed in respect of a contravention unless a copy of the notice of the proposed penalty is served on the relevant operator within two years of the time of the contravention. A copy of the notice of the proposed penalty was served on LSER on 17 March 2022.

31. The Good Faith Contraventions were ongoing throughout the period of the 2014 FA (which expired on 1 April 2020) and during the 2020 FA and continued at least until LSER accepted the amounts owing to the DfT in respect of the HS1 track access charges and depot charges in its letter to the DfT dated 24 May 2021 and paid the principal amount of the Overpayments to the SoS in the week commencing 24 May 2021.

32. The SoS is issuing this notice in respect of the Good Faith Contraventions only, but has had regard to the Previous IKF Contraventions, as described in paragraphs 33 and 35 to 39 below.

33. Clause 4.3 of the IKF FA was also contravened by LSER, by LSER failing to act reasonably and in good faith in its dealings with the SoS in relation to its wrongful retention of significant amounts of public monies which it was aware had been overpaid by the SoS, the failure to notify the SoS of various amounts which LSER has admitted it knew or believed to be due to the SoS under the IKF FA, the reporting of non-specific accruals to the DfT by LSER and various other steps taken by LSER to conceal the position from the DfT and when LSER considered particular amounts were unlikely to be detected, LSER released part or all of those accruals in its accounts and benefited financially from such releases. LSER did not inform the DfT of the nature of these releases in a transparent way, so as to minimise the risk that the SoS would detect the overpayments. In the opinion of the SoS, this conduct constitutes the admitted breaches of the IKF FA and is explained in more detail at paragraphs 35 and 36 below.

Further details of the acts or omissions which in the opinion of the SoS constitute contraventions of the Franchise Agreements

Breaches of the 2014 and 2020 FAs

34. LSER has admitted a breach of the Good Faith Obligations in respect of each of the following matters. Reference is made below to amounts which were calculated by KPMG LLP (KPMG) for the purposes of the Company Investigation[5].

a. <u>HS1 VTAC overpayments:</u>

i. The contract between LSER and HS1 Limited required LSER to pay variable track access charges (VTAC) and essentially the SoS agreed to pay these VTAC payments on a pass-through basis; the DfT would make an advance payment to be subsequently adjusted by reference to actual charges.

ii. An indexation error occurred under the 2014 FA resulting in the DfT making overpayments in respect of HS1 VTAC over the life of the 2014 FA totalling approximately £20,573k. The error appears to have been discovered by LSER by no later than December 2014 when an accrual was made in LSER's accounts (and thereafter increased over the life of the 2014 FA to reflect the continuing overpayments). The DfT identified the error leading to the

[5] The relevant amounts have subsequently been confirmed between KPMG LLP and the DfT's advisers, with minor adjustments to the figures following further review of LSER's financial records and to take account of interest.

overpayment in July 2020 but, since it was unaware of the accrual, believed that the effect of the overpayment would have been mitigated by additional amounts having become due and been paid by LSER by way of profit share payments under the 2014 FA, such that only a smaller amount (approximately £3.7m) would therefore be due. LSER did not inform the DfT at this time that it had known about this error since 2014, that it had accrued for it in full, and therefore that the DfT had not received any of the amount by way of profit share. LSER repaid the full principal of the accrued amount in May 2021, although still did not acknowledge at that time how long it had been aware of and accruing for the overpayments. As part of the Company Investigation, KPMG calculated the amount of the overpayment as approximately £22, 673k (inclusive of interest), of which £20, 573k was repaid by LSER in May 2021.

b. HS1 Depot rent overpayments:

i. As with VTAC, HS1 depot rent payments were to be paid by the DfT on a pass-through basis pursuant to the 2014 FA.

ii. Overpayments in respect of HS1 Depot rentals occurred under the 2014 FA because LSER was being charged less than it was being paid under the 2014 FA, as a result of the depot rents being reduced from October 2014 in a manner not anticipated in the 2014 FA financial model. LSER made an accrual for this (totalling approximately £6,463k over the life of the franchise). It appears that LSER began making an accrual for the overpayments no later than December 2014. Thereafter LSER added to and retained the accruals until May 2021, when it decided to make the DfT aware of the overpayment and repay the overpaid amount at the same time as acknowledging and repaying the 2014 HS1 VTAC overpayment (as described in paragraph a.ii). At that time, by an e-mail of 12 May 2021 (see paragraph 20.2 above), the DfT had been requesting details of creditor balances due to the DfT which would have revealed the existence of the HS1 Depot rent overpayment and the full amount outstanding in relation to the HS1 VTAC overpayment (and indeed did provide detail of these items the day after LSER had written to the DfT in relation to the HS1 VTAC and HS1 depot rental charges overpayments). At that time, LSER did not acknowledge how long it had been aware of, or been accruing for, the HS1 depot rental overpayment. As part of the Company Investigation, KPMG calculated the amount of the overpayment as approximately £7,051k (inclusive of interest) of which £6,463k was repaid by LSER in May 2021.

c. In respect of each of the above admitted breaches, LSER failed to inform the DfT that it had received public money to which LSER was not entitled and instead wrongfully retained such amounts and created an accrual in its accounts on the basis that the sum accrued would need to be paid to the DfT if and when claimed. In each case, it is clear from the evidence of numerous accounting papers and reports that LSER's intention was that the Overpayments would be repaid only if and when they were discovered by the DfT and that if they were not discovered the Overpayments would be treated as LSER revenue. There is also evidence of LSER seeking to allocate the revenue from released accruals made in the IKF FA period but released during the term of the 2014 FA in such a way so as to maximise profits whilst continuing to conceal the nature of the underlying accrual and also considering the impact of the timing of any release of the Overpayment accruals to minimise the risk of detection of the Overpayments and take account of the impact of any profit share.

Breaches of the IKF FA

35. LSER has also admitted breaches of the Good Faith Obligations in the IKF FA in respect of each of the following matters:-

a. HS1 VTAC overpayments: Paragraph 2 of Schedule 8.5 of the IKF National Rail Franchise Terms comprised in the IKF FA provided for the franchise payments in any given Reporting Period to be adjusted to reflect the actual variable track access charges payable by LSER to HS1. By no later than March 2011, LSER had identified that the DfT was making overpayments in respect of HS1 VTAC. It appears LSER understood this to be because of an indexation error by the DfT. Rather than informing the DfT of this, LSER retained the overpayments and made an accrual for the overpayments in its accounts (and thereafter increased the amount of the accrual to reflect the continued overpayments by the DfT over the term of the IKF FA). Once the 2014 FA negotiations were complete, LSER apparently determined that the risk of the DfT detecting the overpayment was now remote, such that 100% of the accrual could be released, which it apparently was at the end of June 2014. Although it now appears from the outcome of the Company Investigation that LSER had mischaracterised the issue which was causing the overpayments, LSER has admitted that there has nevertheless been a series of overpayments to it in respect of HS1 VTAC over the course of the IKF FA.

b. HS1 Depot rent overpayments**:** In 2012 LSER believed that there had been a model error (i.e. an error in the financial model on which franchise payments were based) and that as a consequence, the DfT had over-compensated LSER for HS1 depot rents. LSER made an accrual for these overpayments which it later released when it considered that the DfT would not discover this error. The release was made in two tranches (in October 2014 and by June 2015). LSER sought to attribute that part of the accrual made in the IKF FA period but released in the period of the 2014 FA to the period of the IKF FA, such that 100% of the benefit of the release of the relevant accrual sat with LSER. LSER put forward a misleading position regarding the accrual which concealed the fact that the accrual was in relation to amounts owed to the SoS. As with the HS1 VTAC overpayments in the 2014 FA term, it now appears from the outcome of the Company Investigation that LSER had mischaracterised the issue but as a minimum LSER has admitted that it looked to retain what it believed to be overpayments made to it over the life of the IKF FA in respect of HS1 depot rents.

c. Greenline Maintenance and Electrostar Maintenance: Under the IKF FA, LSER received subsidies for the maintenance of the Eversholt Electrostar fleet which included a "Greenline" payment for light maintenance and Electrostar "maintenance reserve" for heavy maintenance, on the basis that franchise payments to LSER were to be adjusted based on the actual costs incurred by LSER compared to those modelled. There were variances in the costs incurred by LSER compared to the modelled amounts from 2008 up to the execution by LSER of a new maintenance agreement (TSSSA) in December 2013. The TSSSA was to replace the Electrostar heavy maintenance reserve from January 2014 and the Greenline light maintenance charges from March 2014. However, LSER did not make the DfT aware of these pre-TSSSA variances. Instead, LSER had made an accrual in respect of the Greenline and Electrostar maintenance reserve pre-TSSSA position. It appears that with effect from April 2014 onwards, LSER shared information about the variances between the modelled amount and the actual costs incurred by LSER under the TSSSA with the DfT, and on the basis of the post April 2014 position LSER and the DfT agreed a settlement on 13 June 2016 (the DfT being unaware of the pre-TSSSA position). Following and on the basis of the settlement, LSER concluded that the DfT was unlikely to detect the pre-TSSSA variance, and the accrual was released in June 2016. LSER attributed the amount

released in the period of the 2014 FA to the period of the IKF FA, such that 100% of the benefit of the release of the accrual sat with LSER. LSER put forward a misleading position regarding the accrual which concealed the fact that the accrual was in relation to amounts owed to the SoS.

d. Class 395 Subsidy: The IKF FA obligated LSER to take delivery of the class 395 units in good time so that it could test equipment, train staff and ensure a smooth introduction of the service. Under the IKF FA if LSER failed to secure timely delivery of the class 395 units liquidated damages would be payable to the DfT. These liquidated damages obligations were mirrored in LSER's contract with the supplier of the class 395 units such that when the delivery date was missed in April 2009 LSER claimed liquidated damages from the supplier. Paragraph 6.5 of Schedule 8.1 of the IKF FA states that LSER must reimburse payments that the DfT advances during any delay period in relation to rentals, spares and other maintenance costs. There was also a reporting obligation on LSER at paragraph 6.8 of Schedule 8.1 in respect of the amounts properly payable. However, notwithstanding this, LSER has admitted that DfT was not fully informed of the relevant amounts and that not only did the DfT not receive liquidated damages under the IKF FA but it also paid a sum of money to LSER for the leasing costs of the class 395 units which were not at that time being incurred. LSER retained the money paid by the DfT (making an accrual of £1,152k in its accounts) and on 16 December 2013 released this into income, as it was determined that by that time, the DfT was unlikely to discover its right to receive liquidated damages or the overpayment in respect of lease payments.

e. Rolling Stock Franchise Modifications: The IKF FA obligated LSER to perform a modification programme on rolling stock and subsidy was received from the DfT in order to do this, on the basis that franchise payment adjustments were to be made if the capital costs of the modifications were lower than an amount provided for in the IKF FA. From as early as June 2007, LSER was aware that it had received (and was likely to further receive) excess subsidy from the DfT in respect of the modifications. LSER were aware that the DfT may have been entitled to reclaim an amount in respect of this excess subsidy. It continued to make accruals in this respect until around February 2011. On 17 March 2011, LSER and the DfT entered into a Deed of Variation as part of a settlement in respect of the franchise modifications programme. Following that Deed of Variation, LSER released the balance of the accrual which had not been paid to the SoS. However, further savings on the franchise modifications were identified by LSER. LSER made an accrual for 50% of these sums as it recognised that the DfT was entitled to this amount. This accrual remained in LSER's accounts until it was released to income in December 2013, when LSER believed that it was unlikely that the DfT would claim or that LSER would need to repay these sums to the DfT.

36. In respect of each of the above admitted breaches of the IKF FA, LSER failed to inform the DfT that it had received public money to which LSER was not (and/or believed it was not) entitled and instead wrongfully retained such amounts and created an accrual in its accounts on the basis that the sum accrued would need to be paid to the DfT if and when claimed. Once LSER considered that the risk of the DfT becoming aware and seeking to claw-back the money was reduced, the accruals were released to LSER's income and therefore to profit. As set out in paragraphs 34.c, 35.b and 35.c above, there is also evidence of LSER seeking to allocate the revenue from certain released accruals to maximise profits whilst continuing to conceal the nature of the underlying overpayments.

Factors that justify the imposition of a penalty

37. The Enforcement Policy (paragraph 4.8) states that the SoS's overarching objective in imposing financial penalties is to incentivise compliance with franchise agreements without introducing

unwarranted risk to operators. It also provides (paragraph 4.9) that in deciding whether to impose a penalty, the SoS will take into account all relevant facts and circumstances of the contravention and will consider whether other enforcement action would be more appropriate.

38. The stated aims of the Enforcement Policy also include (at paragraph 2.7) ensuring franchise commitments are delivered and franchise agreements are complied with and to ensure that, if appropriate, the taxpayer is reimbursed if operators do not deliver the obligations in their franchise agreements.

39. The SoS considers that a penalty in relation to the Good Faith Contraventions is consistent with the stated overarching objective and aims of the Enforcement Policy because a penalty will both (i) operate to incentivise rail operators to comply with their franchise agreements and deliver their franchise commitments, and (ii) act as a deterrent to other operators from contravening their obligations. Current and future contracts for the provision of franchise services are, and will remain, highly dependent on high value money flows between the contractual parties, frequently based on complex contractual terms. Rail operators will often have more information than the DfT regarding the operations and finances of the franchise. Very substantial amounts of taxpayer monies are involved. In this context it is imperative that the SoS is able to have confidence in the behaviour of operators in the reporting and payment of any sums due to the SoS, and acting in a good faith manner with the SoS and the DfT, including in relation to any matters where there may be any uncertainty.

40. In considering whether or not to impose a penalty the SoS has also had regard to the non-exhaustive list of matters which paragraph 4.9 of the Enforcement Policy indicates may be relevant facts and circumstances to be considered. The paragraph 4.9 matters which the SoS considers to be relevant in this case are:

a. *The consequences of the contravention, including its effect on the interests of users of railway services and any resulting increase in public expenditure* - although railway services have not been directly impacted by the contraventions, had the contraventions not been discovered by the DfT, LSER's intention was to wrongly retain a significant amount of taxpayer money to which it was not entitled and which would otherwise have been available to the DfT and therefore potentially available to users of railway services (and/or the absence of which would have increased the draw on public expenditure). It is only as a consequence of the DfT's investigations that sums in respect of the Overpayments have been repaid. In addition, the DfT's work (both internally and via external advisors) in identifying, investigating and working with LSER to rectify the contraventions has resulted in the expenditure of significant amounts of time and public monies. Further, the contravention is likely to significantly undermine public trust in the delivery of railway passenger services by the private sector.

b. *The extent to which the operator has co-operated in developing and implementing plans to remedy the contravention* - the SoS recognises that in May 2021 LSER acted to repay not only the amount in respect of HS1 VTAC which had been identified by the DfT in its letter dated 29 April 2021, but rather the full principal amount accrued in respect of the Overpayments. The SoS further recognises that since 11 August 2021 (following the indication by the DfT that enforcement action under the Act was being considered) LSER and its shareholders have demonstrated a high level of cooperation with the DfT in relation to these matters. This co-operation has included:-

    i. the undertaking of the Company Investigation, and the inclusion within its scope of all sums in which accruals had been made by LSER, some of which were not at that stage known by the DfT, under the IKF FA as well as the 2014 FA, as well as consideration of whether there were similar issues arising at

GTR. The LSER Independent Committee, with the benefit of its review, also identified and brought to the DfT's attention certain sums owed to it which neither the DfT, nor LSER, had previously identified. SoS acknowledges the extent of the resources committed and diligence demonstrated in the undertaking of the Company Investigation and the LSER Independent Committee's constructive approach in seeking input from the DfT and willingness to take account of feedback provided by the DfT in respect of the Company Investigation. The SoS also acknowledges the decision of the LSER Independent Committee to disclose to the DfT, on a confidential and limited waiver basis, material over which it asserts legal privilege, including the Company Investigation reports and also contemporaneous legal advice which LSER received and which was relevant to the subject matter of the contraventions considered in this Notice. The SoS also notes the LSER Independent Committee's co-operation in disclosing to the DfT a significant volume of relevant material.

ii. The SoS notes that the commitment to the Company Investigation did not diminish when the SoS decided that there would be no new contract with LSER on the expiry of the 2020 FA;

iii. transparency and proactivity in the development of plans to change personnel and/or governance arrangements in respect of LSER (whilst that was, and to the extent it is, still relevant), and its shareholders; and

iv. transparency in relation to resolution of outstanding financial balances, including preparedness to accept obligations to repay sums in respect of the Previous IKF Contraventions and interest on the Overpayments.

c. However, the SoS also notes that this cooperation is only relatively recent, taking into account that LSER (and in turn certain individuals within its shareholders) became aware of the Overpayments almost immediately on the commencement of the 2014 FA and taking into account also the protracted pattern of retaining significant public monies to which it was aware that it was not entitled and seeking to conceal the position from the DfT over many years. Prior to the DfT's reasonable determination letter of 29 April 2021 (which also indicated that the DfT might be considering enforcement action), LSER failed to bring the Overpayments to the DfT's attention, pursued a deliberate strategy of reporting non-specific accruals to the DfT to conceal the Overpayments in the hope they could be retained and apparently structuring its reports to the DfT with the aim of concealing the true position, minimising the risk of the DfT's detection of subsidy clawbacks and apparently giving consideration to the impact on LSER's potential future profits. Further, on occasion LSER actively avoided engagement with the DfT where questions might be raised on this subject and failed to be fully open and transparent regarding the extent of the Overpayments. In July 2020, LSER knew that the DfT had misunderstood the amount of the Overpayments in respect of HS1 VTAC because the fact of the accruals was known only to LSER and not to the DfT, and LSER did not take any step to correct that misapprehension. It can be inferred from the evidence that LSER made the full payments in May 2021 because the DfT had requested details from LSER of LSER's creditor balances which would have revealed the full amount of the HS1 accruals under the 2014 FA. In short, LSER not only knew that it had received Overpayments and that it was not entitled to such significant amounts of public money, but it took active steps to conceal the fact of the Overpayments from the DfT in order that it might retain public money which it knew it was not entitled to. This was a course of conduct that persisted over a period of many years.

d. *The desirability of deterring other operators from committing contraventions in the future* – as described in paragraph 39, the SoS considers that it is important to demonstrate that the kind of behaviour in relation to public funds demonstrated by LSER is not acceptable. From the evidence it appears that in making accruals for the Overpayments, LSER thought that it would not lose out as a result of the deliberate course it was taking and with the intention that it would positively benefit. If the DfT discovered the sums which were due to it, LSER would repay them, but if not then LSER would retain them (subject to any applicable profit share arrangements at the time). LSER was not transparent with the DfT and issued ambiguous and misleading communications to conceal the nature of certain overpayments made during the IKF period which were released in the 2014 FA term in order to seek to maximise the benefit from its conduct. If the only impact of the contraventions is that LSER repays the sums that were due (even if contractual interest is also payable), on the face of it, this would suggest that there is potentially little or no downside associated with such contraventions. The imposition of a penalty therefore upholds the SoS's overarching objective, as set out in the Enforcement Policy, of incentivising compliance with franchise agreements and ensuring that franchise agreements are complied with.

e. *The extent to which the operator was at fault or negligent* and *the extent to which the contravention was caused by circumstances beyond the operator's control (e.g. by acts or omissions of third parties)* - in the SoS's view LSER was at fault for the contraventions[6] and they were caused by circumstances within its control. The evidence is that the fact of the Overpayments and the steps taken to retain them, were known and considered at a senior level within LSER, including at director level, and was also discussed in papers and meetings involving senior representatives of LSER's ultimate shareholders. The SoS recognises that LSER's third party auditors were aware of the accrual of the Overpayments and the auditors signed off LSER's accounts. In 2018 and 2019, LSER's auditors recommended that LSER consider discussing the position with the DfT and, in 2007 and 2019, sought details of any legal advice provided to LSER associated with these matters. Notwithstanding such communications, it was decided not to discuss the matter with the DfT and it appears that in 2019 legal advice was not shared with (and was not accurately summarised to) the auditors. In any event, the awareness of LSER's auditors does not alter the conclusion that LSER was at fault for the Good Faith Contraventions and the decision not to disclose the Overpayments to the DfT was made by LSER. The circumstances giving rise to the contraventions were caused by and within the control of LSER rather than by the acts or omissions of third parties. In particular:-

    i. the evidence available indicates that by October 2018 at least one director of LSER had received legal advice as to the existence and potential breach of the Good Faith Obligation in respect of the Overpayments (as well as express notification obligations on LSER in respect of contraventions of the 2014 FA);

    ii. the SoS notes that the Good Faith Obligation appeared in all franchise agreements which LSER (and all other franchises operated by Govia-owned rail subsidiaries at the relevant time) was party to, commencing in 2006, and that it is the responsibility of and within the control of operators to be knowledgeable as to their contractual obligations;

    iii. it would be reasonable to expect that directors of a company providing public services and dealing with public money would consider that it would not be

[6] Although it is acknowledged that the 2014 FA HS1 VTAC overpayment initially arose from an error by the DfT in calculating the amount of the relevant element of the franchise payment, that does not affect the Good Faith Contraventions by LSER. Indeed the Good Faith Obligation is included in franchise agreements to cover this type of scenario.

consistent with the company's legal obligations to retain public money to which it was not entitled and/or to take steps to conceal the position from the DfT. In this context, the SoS notes that the accounting papers LSER prepared for its auditors, and the reports prepared by LSER's auditors were clear that the accruals in respect of the Overpayments were each made explicitly on the basis that the sums were recognised as being owed to the DfT;

iv. there is evidence that The Go-Ahead Group plc's Audit Committee explicitly considered the accruals in respect of the Overpayments, including in two successive meetings in July and August 2019. The evidence indicates Go-Ahead Group plc and LSER director level presence at those meetings, and that the meetings considered whether LSER should change its approach and disclose the Overpayments to the Department, and decided that it should not do so; and

v. the SoS considers it is not open to LSER to rely on the auditors' concurrence or apparent concurrence with management's view (in relation to the making and value of accruals in relation to the Overpayments) to escape responsibility for LSER's own acts and omissions, although it may provide some limited mitigation.

f. *The extent to which the contravention was allowed to continue after the operator became aware of it* - as set out above:-

i. the behaviour which constituted the contraventions was allowed to continue over a considerable period of time. LSER were aware of the existence of and failed to disclose the Overpayments to the DfT since the start of the 2014 FA and only disclosed the full extent of the Overpayments after the end of the 2014 FA, when it was evident that information was being requested by the DfT which would reveal this;

ii. the evidence available indicates that at least one LSER director was aware of the existence of the Good Faith Obligation in this context by October 2018, but LSER continued wrongfully to retain public monies to which it was not entitled and to make accruals in respect of the Overpayments.

g. *The extent to which the contravention would have been apparent to a diligent operator* - the SoS considers that the Good Faith Contraventions should and would have been apparent to a diligent operator. In particular:

i. the Good Faith Obligation appeared in the IKF FA, the 2014 FA and the 2020 FA.

ii. the underlying facts constituting the contraventions of the Good Faith Obligation are straightforward i.e. LSER was aware that it was not entitled to the Overpayments and in those circumstances the SoS considers that it is clear that it would not be acting in good faith to retain those sums and to conceal the position from the DfT.

h. *The extent to which the contravention has resulted, or will result, in the operator losing any performance payments or suffering any other adverse consequence under the terms of its franchise agreement* - The SoS recognises that the 2020 FA with LSER has been allowed to expire without a further contract with LSER being put in place, and that the Good Faith Contraventions were an important factor in this decision. The SoS also recognises that LSER and its ultimate shareholders have suffered reputational damage as a consequence of this

decision and associated publicity. The SoS does not consider that this of itself is a reason for a penalty not to be imposed. However, the SoS recognises that this is a relevant consideration for the purposes of the size of any penalty, and this is considered further in paragraph 48 below.

41. The Enforcement Policy states at paragraph 2.10 that "*The Department will seek to respond in a consistent manner where different train operators commit similar contraventions*". The SoS has considered but is not aware of any previous similar contraventions which would act as a comparison or precedent in this situation. Therefore, the SoS is satisfied that the approach taken in relation to the contraventions considered in this Notice will not be inconsistent with any position adopted with any other train operator.

42. As provided in the Enforcement Policy, the SoS has considered whether other enforcement action would be more appropriate than a penalty in relation to this contravention. LSER's franchise agreement has now expired, and that LSER has agreed to repay any outstanding sums to the SoS, such that the contractual remedial and termination provisions are no longer directly applicable. Similarly, with respect to the SoS's power to make an enforcement order under section 55 of the Act, the SoS is satisfied at this point that LSER has agreed to take and is taking appropriate steps to secure compliance with the relevant terms, and in any case notes that a penalty under s57A of the Act can be imposed whether or not the relevant contravention is continuing and whether or not an enforcement order has already been made. Furthermore, for the reasons given in paragraph 40.d, the SoS is not satisfied that on its own, repayment of the amounts involved in this case would achieve the objectives of incentivising compliance and deterring non-compliance by rail operators with the terms of franchise agreements which are key objectives of the Enforcement Policy. Whilst the SoS reserves the right to exercise contractual remedies and/or to make an enforcement order in relation to any of the franchise agreements, the SoS is therefore satisfied that other enforcement action would not be more appropriate in this case at this time.

43. The SoS has considered whether a decision to impose a penalty will of itself introduce unwarranted risk to LSER and is satisfied that it will not. All operators who are party to franchise agreements are or should be aware that such a risk of a penalty being imposed exists in the case of a contravention of franchise agreement terms. This issue is considered again in relation to the SoS's conclusions in respect of the amount of the penalty in paragraph 56 below.

The amount of the penalty

44. The Enforcement Policy provides a two-step process for determining the amount of a penalty. The first step is for the SoS to seek to identify a figure proportionate to the seriousness of the contravention. The second step is for the figure to be adjusted to take account of factors referenced in paragraph 4.12 of the Enforcement Policy and any other factors that the SoS considers to be relevant to produce the final penalty amount.

Level of Seriousness

45. The more serious the contravention, the higher the appropriate figure.

46. In assessing the seriousness, the Enforcement Policy provides that the SoS will take into account all relevant facts and circumstances, and that these are likely to include the matters set out at paragraphs 4.9 and 4.11 of the Enforcement Policy.

47. The SoS's consideration of the matters set out in respect of paragraph 4.9 of the Enforcement Policy is set out in paragraph 40 above and paragraph 48 below, and the SoS has had regard to those matters in respect of considering the level of seriousness.

48. As indicated in paragraph 40.h, the Enforcement Policy provides that the SoS will take into account *the extent to which the contravention has resulted, or will result, in the operator losing any performance payments or suffering any other adverse consequence under the terms of its franchise agreement*. It is not the case that there have been any adverse consequences for LSER under the terms of any of the relevant Franchise Agreements. The SoS has, however, noted and had regard to the fact that the Good Faith Contraventions prevented LSER from being able to have the opportunity of a further directly awarded rail operation contract on the expiry of the 2020 FA, and that this represented a loss of a potential financial benefit to LSER (as well as reputational damage). The SoS considers that the weight to be attached to this consideration should be balanced against the position that in normal circumstances, there should be no expectation that an operator would have a follow-on contract following the expiry of its franchise agreement, the reputational damage being a consequence of LSER's misconduct and to take into account the benefit which has accrued to LSER as a consequence of the SoS not being aware of the Previous IKF Contraventions at the time when LSER was awarded the 2014 FA, and/or of the Previous IKF Contraventions and the Good Faith Contraventions at the points when the 2014 FA was extended or the 2020 FA entered into.

49. The matters described in paragraph 4.11 of the Enforcement Policy are set out below:

    a. whether the operator has previously contravened its franchise agreement, particularly in the same area;

    b. the duration of the contravention;

    c. the extent to which the operator gained, or tried to gain, an advantage (financial or otherwise) from the contravention; and

    d. the degree to which the operator has taken steps in its own initiative to report the contravention, to co-operate with any investigation and to remedy the contravention.

50. Paragraph 3.9 of the Enforcement Policy is not directly relevant to the decisions to be made in respect of the imposition of a penalty, but it also sets out matters which would prevent a contravention being considered trivial and which include those set out below, which the SoS also considers are relevant facts and circumstances to take into account for the purposes of an assessment of the seriousness of the contravention in this case:-

    a. a decision or omission by a director or member of senior management which leads to the contravention; and

    b. attempts to keep details of the contravention from the DfT.

51. Having had regard to all these matters, the SoS considers that the Good Faith Contraventions are very serious. The contraventions involved large amounts of public money and continued for a long period (the duration of the 2014 FA). The Good Faith Contraventions involved and resulted from decisions made by a number of different individuals in senior positions (including at director level) at LSER and its ultimate shareholders, who knew that the sums involved were due to the DfT and that the DfT was unaware of this. From the evidence, it is clear that LSER intended to benefit financially from the Good Faith Contraventions, through the release of the relevant accruals if the DfT had not detected the Overpayments. The amount of the Overpayments was calculated to be c.£27.02 million (exclusive of interest of £2.71 million). Given that the Good Faith Obligation was a key term LSER and its directors should have been aware of it throughout (and in any event the available evidence indicates that at least one LSER director was aware of the existence of the Good Faith Obligation in this context by October 2018). Even after the HS1 VTAC issue was first raised by the DfT in July 2020, LSER still failed to disclose the full extent of the contraventions and was content for some time to allow the DfT to continue to believe that the amount of the

Overpayments was lower than was actually the case. There is evidence (in the context of steps by LSER in 2019 to attribute to the period of the IKF FA the revenue from the release during the period of the 2014 FA of certain accruals originally made during the IKF FA term), of LSER using misleading descriptions of the accruals, in order to conceal that the accruals related to public monies owed to the SoS and therefore to maximise its profits. Moreover, there is evidence of other active steps to prevent the Overpayments coming to the attention of the DfT, which is indicative of LSER knowing that was not entitled to retain the Overpayments. This includes guidance to finance team members from, at the latest, February 2017 in the form of a template spreadsheet for submissions to the DfT which stated *"Remove/amend any comments about balances that would be sensitive with the DfT, i.e. about clawbacks",* and a decision in July 2020 that a member of the finance team should not attend a call with the DfT in case the issue of the Overpayments was raised and so as to avoid answering questions about it.

52. In addition, the SoS considers that the extent and nature of other contraventions of the IKF and 2014 FAs are also highly relevant factors which should be taken into account and are a significant aggravating factor in this case. In particular, the SoS has noted:

IKF FA

a. the Previous IKF Contraventions involve substantially the same behaviours as the Good Faith Contraventions and are of comparable severity. They involve in each case the same pattern of known or believed overpayments being identified relatively early in the term of the franchise agreement (the first instance arising in 2007), and accruals being made in respect of these rather than the issue being reported to and the sums being repaid to the DfT. The Previous IKF Contraventions concerned significant amounts of public monies and also involved and resulted from decisions made by senior personnel (including at director level), who knew or believed that the DfT was entitled to the sums involved and that the DfT was unaware of this. In the case of the overpayments relating to Class 395, the non-reporting of the true position itself constituted an admitted self-standing franchise agreement contravention of a term which is directly relevant to the Good Faith Contraventions i.e. relating to the transparency and accountability in dealings with public money;

b. in addition, legal advice was received as early as 2007 regarding the obligation to share savings on maintenance and the Rolling Stock Franchise Modifications with the DfT. There is evidence of deliberate decisions at LSER director level not to alert the DfT to sums owed – including by the approach of reporting non-specific accruals to the DfT, and also through the way in which LSER dealt with the timing and reporting of releases of the accruals to ensure that they would be kept "under the radar" from the DfT. Furthermore, the Previous IKF Contraventions benefited LSER financially where accruals were released in the period of the IKF FA as such accruals were released to income and there was no profit share in place. LSER did not transparently report the nature of the accruals which were released to the DfT. Where the release of overpayment accruals was made in the period of the 2014 FA, LSER allocated the revenue from such releases to the period of the IKF FA such that these sums were not reflected in any profit share arrangements with the SoS. LSER has in any event now agreed that all sums due to the SoS will be paid in full. However, this would not have been the case if the DfT had not independently identified certain of the Overpayments;

c. therefore, in substance, LSER has demonstrated a pattern of non-compliance in relation to the Good Faith Obligations under successive franchise agreements, which has continued for more than 13 years (during which time various extensions and new franchise

agreements have been awarded to LSER, resulting in significant revenues and profits being generated by LSER); and

2014 FA

d. LSER has admitted other failures to report accurately its relevant profit for the purpose of the profit share mechanism in the 2014 FA (specifically in relation to the levels of affiliate trading and directors' remuneration). Whilst the DfT is dealing separately with LSER in resolving the relevant financial impacts of these matters, the existence of these issues which relate to the accuracy and transparency of LSER's financial reporting and dealings with the DfT are therefore directly relevant to the SoS's consideration of the appropriate penalty associated with the Good Faith Contraventions.

53. The SoS has considered the extent to which there are factors which may operate to mitigate the seriousness of the contraventions and therefore the size of the penalty in this case. The SoS has had regard to the following points:

a. There is evidence of limited awareness of certain LSER Directors prior to the DfT's letters of 28 July 2021 as to the obligations on LSER under the Franchise Agreements and whether LSER had contravened and/or was contravening its Good Faith Obligations or the specific notification obligations in respect of contraventions of the 2014 FA. However, the SoS considers that this point in mitigation has limited weight because of the evidence that there was at least some knowledge at director level and in any case because any ignorance of such a significant term in the Franchise Agreements for such a protracted period and the apparent failure of other senior personnel at LSER to be aware of the company's obligations is of itself a significant concern.

b. In relation to the Overpayments, there is some evidence that, assuming that the DfT did not discover the accruals and they were released, LSER expected that this would result in a substantial amount of the Overpayments being paid to the DfT via the profit share mechanism in the 2014 FA. For example, internal reports produced in the context of the issue being considered by LSER's auditors and The Go Ahead Group plc's Audit Committee meeting in August 2019, estimated that the net financial benefit to LSER associated with the release of the £26.2m accrual would be £4.4m after consideration of profit share of £21.8m payable to the DfT. In deciding how much weight to give to this point, the SoS has however also taken into account that the timing of any release of an accrual was substantially a matter for LSER, and therefore despite the commentary in 2019 relating to the proposed timing and effect of the release, it would have been open to LSER to adopt a different position. If it chose ultimately to release the accruals after the final year in respect of which profit share was payable, LSER may have sought to retain the full benefit of the released accrual, and despite the commentary as to the "moral position", the SoS notes and has taken into account that:-

    i. there is evidence that LSER had previously considered the timing of the releases of accruals, having regard to (i) minimising the risk of detection of the overpayments and accruals by the DfT, (ii) the potential benefit for LSER of having regard to the profit share implications, and (iii) the process for settlement at the end of the franchise period;

    ii. LSER had retained the full benefit of the Previous IKF Contraventions;

iii. rather than pay profit share on the overpayments in the period of the IKF FA which were released during the period of the 2014 FA, LSER allocated those payments to the IKF accounting period, such that no profit share was paid. LSER used misleading descriptions of the underlying accruals in communications with the DfT to conceal the fact that the accruals related to public monies owed to the SoS; and

iv. in its negotiations with DfT about the 2020 Franchise Agreement in early 2020, LSER proposed a "closed list" of balances in respect of which any movement after the expiry of the 2014 FA was to be considered in the calculation of profit share under the 2014 FA rather than the 2020 FA, which did not include the accruals which LSER had made in respect of the Overpayments.

The SoS has also taken into account that the DfT's entitlement to the Overpayments should not have been dependent in any case on the extent of LSER's profitability and obligation to pay profit share, which is a further reason as to why this consideration should be given limited weight.

c. LSER repaid the principal amounts of the Overpayments as part of the payment it made in May 2021 following the DfT's reasonable determination letter of 29 April 2021. However, as noted in paragraph 40.c, the evidence is that this was prompted by the DfT's discovery of the HS1 VTAC issue, and there was still a significant delay in LSER making the repayments after the DfT became aware of this issue in July 2020.

d. The LSER Independent Committee has, since its inception on 11 August 2021, co-operated with the DfT on an open and transparent basis to date, has committed to making further payments which are properly due to the DfT in respect of the IKF FA and 2014 FA (including interest), has made new appointments and suggested various further actions to strengthen and improve the governance arrangements at its shareholders to prevent the likelihood of such contraventions reoccurring in LSER, or occurring in relation to GTR. It is recognised that significant costs and resources have been incurred in undertaking the Company Investigation and that the LSER Independent Committee adopted a constructive and transparent approach to the Company Investigation in seeking input from the DfT and being willing to take account of feedback provided by the DfT. The LSER Independent Committee's co-operation has included a limited waiver of rights of legal professional privilege, on a confidential and limited waiver basis, in relation to the Company Investigation reports and contemporaneous legal advice which LSER received which was relevant to the subject matter of the contraventions considered in this Notice. Its co-operation also included disclosing to the DfT a significant volume of relevant material. Whilst this co-operation has been welcome and is taken into account, the SoS notes that the LSER Independent Committee was only established after the DfT's letter of 28 July 2021, indicating that the DfT was considering enforcement action under the Act, and that LSER had not been transparent in its dealings with the DfT prior to that date. The SoS has also taken into account as mitigating factors the limited waiver of privilege in respect of the Company Investigation reports and legal advice provided to LSER and the substantial commitment by LSER in undertaking a thorough investigation and in making the conclusions of that Company Investigation available to the DfT. Taking all these matters in the round the SoS considers this to be a significant mitigating feature.

e. LSER co-operated with transitioning the provision of services to the DfT's operator of last resort following the expiry of the 2020 FA. Whilst, in many respects this was simply consistent with LSER's legal obligations under the 2020 FA, this also included co-operation

by LSER in addition to that which it was contractually obliged to provide in relation to specific personnel matters.

f. The significance of deterring LSER itself from committing similar contraventions in the future is now less relevant as a result of the SoS's decision to allow the 2020 FA to expire.

54. On the basis of these considerations, the SoS has decided that, absent the mitigating factors set out above, a proportionate penalty would have been £29.72m. However, taking into account the mitigating factors set out above, the SoS has decided that £23.5m would be a figure proportionate to the seriousness of the Good Faith Contraventions.

Other Factors listed in paragraph 4.12 of the Enforcement Policy

55. In accordance with paragraph 4.12 of the Enforcement Policy, the SoS has considered the extent to which there are other relevant factors by reference to which the initial penalty figure should be adjusted, including the matters listed in that paragraph. To the extent relevant, these are set out below:-

a. *to ensure that the operator does not profit from the contravention:* this is not a significant consideration in this case, where LSER has already repaid the principal value of the amount by which it has profited from the contraventions and has also committed to make further repayments of any sums which the Company Investigation has shown to be repayable to the DfT (plus interest).

b. *to take account of any penalty or fine imposed by another body in respect of the same contravention:* no penalty or fine has been imposed by another body in respect of the same contravention and so no adjustment is required to be made to the amount of the penalty.

c. *to take account of the extent to which the contravention has resulted or will result in the operator losing any performance payments or suffering any other adverse consequence under the terms of the franchise agreement:* as discussed in paragraph 48, the SoS considers that the impact of the contraventions on the decision as to whether LSER should receive a further contract on the expiry of the 2020 FA (and the associated reputational damage resulting from the public announcements of such matters) are relevant factors in the consideration of the size of the penalty, but these factors have already been taken into account by the SoS in determining the amount of the penalty referred to in paragraph 54.

d. *to take account of the desirability of deterring future contraventions:* as explained above (see paragraphs 39 and 40.d above), the SoS considers this to be a very significant factor, but this has already been taken into account by the SoS in determining the amount of the penalty referred to in paragraph 54. The SoS therefore considers that no further adjustment is appropriate to take account of this.

e. *to ensure that the penalty does not exceed 10% of the turnover of the operator:* The Railways Act 1993 (Determination of Turnover) Order 2005 provides that the applicable turnover for this purpose is for the business year preceding the date on which this notice is served and (because the relevant contravention continued for longer than 24 months) the whole of the previous business year[7]. The SoS is satisfied that a penalty of the amount set out in paragraph 54 would not exceed 10% of the applicable turnover of LSER.

56. The SoS has also considered whether a penalty at this level would represent an unwarranted risk to LSER and has concluded that there is no reason to consider that this would be the case.

57. Overall, considering all the relevant facts and circumstances, and their seriousness, the SoS considers that no further adjustment to the figure identified in paragraph 54 is required.

7 Article 4(1)(b)

Representations

58. In accordance with s.57C(1)(e), the SoS specified in the notice dated 17 March 2022 that he proposed to impose a penalty on LSER and would consider representations or objections with respect to the proposed penalty made and not withdrawn before the end of 7 April 2022.

59. The SoS received one response, which was not withdrawn, during the specified period.

60. Bring Back British Rail (BBBR) and the Association of British Commuters (ABC), through their legal representatives, responded to the notice of the proposed penalty in a letter dated 7 April 2022 (BBBR ABC representations on proposed amount of LSER penalty.pdf) ("the Response").

61. The BBBR / ABC comments considered to be relevant to the level of the proposed penalty are summarised below. The Response asserts that:

    a. there is a lack of any detail as to how the proposed penalty had been calculated;
    b. the proposed penalty is largely based upon the internal Company Investigation which lacked independence and transparency; and
    c. improper account had been taken in determining the level of the proposed penalty of (i) any reputational damage to LSER and its owning group, and (ii) the co-operation by the LSER Independent Committee.

62. The SoS has given careful consideration to the Response. A brief explanation summarising the position on the points raised in paragraph 64 is set out in turn below.

63. In determining the amount of the penalty which was proportionate to the seriousness of the contraventions, all relevant facts and circumstances were considered. The Enforcement Policy does not require specific weightings or values to be attributed to relevant factors. The SoS took account of all relevant factors in determining the amount of the penalty.

64. In addition to the Company Investigation, the SoS took proper account of the work undertaken by DfT officials and external experts engaged by it, including a review of LSER's contemporaneous communications and financial records. As noted in paragraph 27 above, the DfT also considered the responses to written questions by senior individuals at LSER and its owning groups.

65. Under the Enforcement Policy, as part of an overarching objective to incentivise compliance with franchise agreements, the SoS was required to take account of all relevant facts and circumstances, which include (i) the consequences which have resulted from the contraventions (including LSER's lost opportunity of a further directly awarded rail operation contract on the expiry of the 2020 FA (and associated reputational damage)), and (ii) the co-operation on behalf of LSER since August 2021. These matters are summarised in paragraphs 51 and 56.4 above.

66. Following careful consideration of all the points raised in the Response, the SoS has determined that none of the points raised require or justify an adjustment to the amount of the proposed penalty.

Conclusion

67. Having had regard to the factors listed in the Enforcement Policy and for the reasons set out above, the SoS has imposed a penalty of £23.5m in respect of LSER's contraventions of Clause 5.3 of the 2014 FA and of the 2020 FA as described in this notice.

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