



## IN THE NORTH EAST TRAFFIC AREA

### Transport Act 2000

#### Proposal for a Quality Contracts Scheme in Tyne & Wear

#### **OPINION**

##### The Transport Act 2000 (TA 2000))

Section 125: Nexus fails to comply with the statutory requirements on consultation

Section 124(1)(a): The proposed scheme cannot demonstrate that it would increase use of bus services because its affordability is not demonstrated

Section 124(1)(b): Service quality would improve

Section 124(1)(c): The proposed scheme would contribute to the implementation of the local transport policies

Section 124(1)(d): The proposed scheme does not provide value for money

Section 124(1)(e): The proposed scheme imposes disproportionate adverse effects on operators

## **The Quality Contracts Scheme Board**

Kevin Rooney, Traffic Commissioner, Chair  
Alan Wann  
David Humphrey

## **Tyne & Wear Passenger Transport Executive (Nexus)**

Represented by James Pereira QC, and Jack Connah, Francis Taylor Building instructed by DLA Piper

Tobyn Hughes	Managing Director of Transport Operations
John Fenwick	Director of Finance and Resources
Fiona Bootle	In-house Solicitor (Nexus employee lead)
Tom Clarke	Project Accountant
Catherine Massarella	Head of Quality Contracts Scheme Programme
Paul Woods	Chief Finance Officer, North East Combined Authority
Stephen Hunter	Associate, Steer Davies Gleave
Edward Spencer	Barnett Waddingham

## **Arriva North East**

Represented by Kassie Smith QC, Monckton Chambers, instructed by Herbert Smith Freehills LLP

Nicholas Knox	Area Managing Director, Arriva North East
Dr Gunnar Niels	Partner, Oxera Consulting LLP

## **Busways Travel Services Limited t/a Stagecoach and Stagecoach UK Bus**

Represented by Tim Ward QC, Monckton Chambers and Naina Patel, Blackstone Chambers instructed by Herbert Smith Freehills

Robert Montgomery	Managing Director, Stagecoach UK Bus
Philip Medlicott	Managing Director, Busways t/a Stagecoach
John Hamilton	Pensions Director
Dr Luis Correia da Silva	Partner, Oxera Consulting LLP
Joseph Bell	Economic Consultant, Oxera Consulting LLP

## **Go North East Ltd**

Represented by Alan Maclean QC, Blackstone Chambers instructed by FieldFisher

Kevin Carr	Managing Director (and Chair, North East Bus Operators Association)
Bojana Ignjatovic	Partner, RBB Economics

## **Unite the Union**

Martin Meyer  
John Neal  
Bobby Morton

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**Note:** Where a footnote appears thus: 3:101:16, it refers to the transcript of the oral evidence sessions, in this case, day 3, page 101, line 16. Copies of the non-confidential transcript are available from Nexus.

## BACKGROUND

### 1. Overview of Quality Contract Schemes

1.1. At present, outside Greater London, bus transport in Great Britain is deregulated, pursuant to the Transport Act 1985 (as amended) ["TA1985"]. Under the deregulated system, a public service vehicle ["PSV"] operator's licence is required to operate most types of bus services. Once a PSV operator's licence is obtained, if an operator wishes to run a local bus service carrying passengers for separate fares, section 6 of the TA1985 requires that the "prescribed particulars" of that local service be registered with the Traffic Commissioner. The "prescribed particulars" are set out in the Public Service Vehicles (Registration of Local Services) Regulations 1986 (as amended). For a standard (non-flexible) service these particulars include (among other things):

- a. the date on which the service is to start;
- b. the times during the year when the service will be provided;
- c. the principal starting and finishing points of the service;
- d. a description of the route together with a map; and
- e. a timetable and an indication of stopping places.

1.2. Under that deregulated system, routes, frequencies, fares, ticket types, vehicle types and customer service provision are at the discretion of the operator (save for wider obligations to Traffic Commissioners to operate safe and legal vehicles and reliable services).

1.3. Quality Contracts Schemes are a departure from that deregulated system. They were first introduced by the TA 2000 following the 1998 White Paper "A New Deal for Transport: Better for Everyone". Following its enactment, the legislative regime has been subject to a number of amendments, with the latest being made by the Local Transport Act 2008 ["LTA 2008"]. Section 124(3) TA 2000 [AB/10] defines a Quality Contracts Scheme as a scheme under which:

- a. the authority or authorities determine what local services should be provided in the area to which the scheme relates and any additional facilities or services which should be provided in that area; and
- b. local services may only be provided in that area in accordance with quality contracts (subject to some exceptions).

1.4. It is important to emphasise the distinction between a quality contracts scheme and a quality contract. The quality contracts scheme is the overarching scheme made by the local transport authority or authorities; once in operation, a scheme will comprise one or more individual quality contracts. Each quality contract is a contractual agreement between the authority and an operator under which the operator is to provide specified services. A quality contract may include provision for payment of a subsidy by the authority to the operator (or possibly of a premium to the authority by the operator, in relation to highly profitable routes). Alternatively, as happens in London, the authority can opt to collect the revenue, take the revenue risk and purchase the services it requires through a quality contract. A quality contract may normally be entered into only after a competitive tendering process, and the usual requirement that the authority will select the tenderer(s) offering best value for money applies.

1.5. The Department for Transport's Statutory Guidance on Quality Contracts Schemes published in December 2009 ["the Statutory Guidance"] explains that the aim of the LTA 2008 amendments to the TA 2000 was *"to make QCSs a more realistic option for LTAs where there is a demonstrable public interest case for making such a scheme, while also ensuring appropriate safeguards to protect the legitimate interests of bus operators. This latter point reflects the fact that a QCS would have a substantial effect on the operators of existing bus services within the area of the scheme. However, LTAs are no longer required to show that a QCS is the "only practicable way" of achieving their local transport policies."*

1.6. Despite those amendments, this proposal for a QCS in Tyne & Wear is the first time any local authority has sought to take advantage of the legislation.

## 2. Role of the Quality Contracts Scheme Board

2.1. The remit and functions of the Quality Contract Scheme Board ["QCSB"] are governed by the statutory provisions contained in the TA 2000 and the associated Quality Contracts Schemes (QCS Boards) (England) Regulations 2009 ["the 2009 Regulations"]. Further insight is provided by the Statutory Guidance.

2.2. Pursuant to section 126D(1) TA 2000, in this case, the issues for the QCSB are twofold:

a. To form an opinion on whether the conditions set out in the paragraphs of section 124(1) TA 2000 ["the Public Interest Tests"] are met in the case of the Proposed QCS; and

b. To form an opinion on whether the authority or authorities have complied with the requirements of section 125(1) to (3) TA 2000 (that is, the notice and consultation requirements).

2.3. Where the QCSB is of the view that those conditions and requirements are not met, sections 126D(2) and (3) TA 2000 provide that the QCSB may make recommendations as to actions that might be taken in response. The QCSB is to give notice of the opinions it has formed, any recommendations it makes and its reasons (section 126D(5)TA 2000).

2.4. The issue for the QCSB is not, therefore, whether the Proposed QCS should be made. Section 127 TA 2000 reserves that decision to the relevant authority, in this case NECA. The role of the QCSB is to give an opinion. That was accepted by all parties. Nexus put forward in its skeleton argument that the Board should take the approach of an appeal body. It was argued that the Board's concern was not whether or not the arguments of the operators might contain more merit than those of Nexus. Our role was to form an opinion on whether the Nexus case was reasonable. This was argued in particular in the Nexus skeleton argument<sup>1</sup>

*"Moreover, the Statutory Guidance makes it clear that the QCSB's function is a reviewing one. In other words, the touchstone for its decision making is not whether it agrees with the assumptions made and the conclusions reached by Nexus and NECA, but rather whether those assumptions and conclusions can properly be judged as "reasonable" ones."*

2.5. Alan Maclean QC for Go North East Ltd countered this in opening submissions. He took the Board through the law and case law. The most relevant point for the Board is the distinction between the role of a review jurisdiction and ours. As Mr Maclean put it<sup>2</sup>

*"There's no question, obviously, of substituting your opinion for anybody else's. That's what happens in judicial review. That's why the courts are wary of getting in to its facts, because if they start quashing decisions and sending them back or making this decision, then they are trespassing in to the territory of someone else. But you are not substituting your view for anybody else's view. You are simply giving your opinion, which is in the public arena, in which regard would be had, when and if NECA considers what to do next with this rather wretched scheme"*

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<sup>1</sup> I1, para 9

<sup>2</sup> 1:109:3

2.6. In response, James Pereira QC for Nexus acknowledged that our role was a proactive one<sup>3</sup>:

*“Nexus acknowledges, of course, that your role is, as it were, to roll your sleeves up and dive in to the evidence”*

And

*“But what it does mean is that having assessed the evidence and the facts, when you exercise your judgement upon whether the statutory tests have been met, the way you should do that is to ask: are the assumptions and methodology of the ITA, Nexus as represented here, are they reasonable or not?”*

2.7. We reject the submission that our role is to act in some way as a review body taking a light touch approach and that appears now to be accepted. The statute is quite clear that we are not a decision-maker. Having regard to the Statutory Guidance is of assistance to us and no-one contends that it cannot be interpreted in a way that assists in the application of the statute. Section 126D (1) of TA 2000 is clear “... the QCS Board is to consider the proposed scheme and form an opinion whether the conditions set out in the paragraphs of section 124(1) or, as the case may be, section 124(1A) are met in the case of the proposed scheme”. Had parliament wished that we confined ourselves to an assessment of whether or not the local authority had acted reasonably, it would have said as much. Our role is to come to our own assessment based on our own analysis of the evidence and that is what we have done.

2.8. In practice, all this boils down to the Board making an assessment of whether or not the arguments put forward by Nexus, and the operators, are reasonable. In some cases, we are able to come to a clear opinion one way or another. In others, we can see a range of outcomes that seem equally likely to be right. In every case, we seek to set out our reasoning so that the reader, at least a reader with access to the supporting documents but hopefully also, to a degree at least, the lay reader, can understand why we have found what we have found.

2.9. The evidence produced in this case runs to over 10,000 pages accompanied by 50 hours of oral evidence. In coming to our findings in relation to the statutory requirements, we have focussed on the issues that have the greatest impact. In the context of a proposed scheme with a 10-year operating cost of £1.6 billion, we have not engaged in analysis of relatively small issues.

2.10. Some of the economic issues are technically complex. We were greatly assisted by all counsel and witnesses for presenting and expressing them in a logical and understandable way. We are extremely grateful.

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<sup>3</sup> 1:153:18



### **3. The proposed Quality Contracts Scheme for Tyne & Wear**

3.1. On 23 October 2014, the Tyne and Wear Passenger Transport Executive ["Nexus"], acting on authority delegated by the North East Combined Authority ["NECA"], sent a written request to the QCSB for it to begin the performance of its functions under section 126D TA 2000 in respect of the proposed QCS. NECA was formed upon the commencement of the Durham, Gateshead, Newcastle Upon Tyne, North Tyneside, Northumberland, South Tyneside and Sunderland Combined Authority Order 2014 ["the 2014 Order"] and upon being formed replaced the former Tyne and Wear Integrated Transport Authority ["TWITA"]. Article 6 of the 2014 Order provided that the functions, property, rights and liabilities of the TWITA transferred to NECA, and Article 8 transferred to NECA certain functions of Durham and Northumberland County Councils, including functions under the TA 2000.

3.2. In its letter to the QCS Board dated 10 November 2014, Arriva contended that NECA's interests and those of the previous ITA were divergent in legal and factual terms because NECA was established on a different basis and its responsibilities covered a different geography. It was argued that NECA could not therefore lawfully rely on the conclusions reached by its predecessor and could not satisfy the statutory test for making a QCS. The Board has considered this point and taken our own legal advice. Noting our earlier comments about our role, we concluded that this point of law raised by Arriva is not one for us to deal with. It is for Arriva to decide whether or not to pursue this argument through a different mechanism, most likely a judicial review.

3.3. Nexus is the trading name of the Tyne and Wear Passenger Transport Executive ["PTE"], first established by the Transport Act 1968 ["TA 1968"] and subsequently expanded to cover Tyne and Wear in 1974. The TA 1968 specifies the powers of the PTE, which are fairly wide-ranging in terms of the ability to provide and procure passenger transport services, along with related activities that would facilitate the delivery of passenger transport. These powers have generally remained unaltered since 1968, with the significant exception of the removal of the power to run bus services following de-regulation under the TA 1985 which was replaced with a duty to secure the provision of bus services where they would not otherwise be provided.

3.4. Further powers, duties and obligations have been accorded to Nexus through time. For example, the construction of the Tyne and Wear Metro system and its subsequent extensions required specific Acts of Parliament; as an operator of a railway Nexus is bound by the Railways and Other Guided Transport Systems (Safety) Regulations 2006 which is a statutory regime for rail safety; and Nexus was designated a Travel Concessionary Authority by the Concessionary Bus Travel Act 2007, with a statutory duty to reimburse bus operators for concessionary travel. Nexus obtains its funding for operational activities from a variety of sources, including grant funding from NECA, the Metro Rail Grant from Central Government, commercial fare revenue, deferred capital grants and revenue reserves.

3.5. NECA is headed by the North East Leadership Board ["the Leadership Board"], which is made up of the Leaders or Elected Mayors of the seven constituent councils, and the Chair of the North East Local Enterprise Partnership. The Leaders and Elected Mayor are elected representatives and therefore have a democratic mandate. Pursuant to that mandate, the decision to make a request to the QCSB to begin the performance of its functions under section 126D TA 2000 was taken by the Leadership Board on 21 October 2014.

3.6. Tyne and Wear covers the geographical areas of the councils of Gateshead, North Tyneside, South Tyneside, Sunderland and Newcastle. While the administrative area covered by the NECA as a whole also includes Durham and Northumberland, the area covered by the Proposed QCS does not extend to those areas. Nexus describes the characteristics of the existing bus network in Tyne & Wear in its Public Interest Test Report. Some of the key points are as follows:

- a) Buses are the principal mode of public transport in Tyne and Wear, with 78% of public transport trips in 2013/14 being taken by bus, accounting for over 135m passenger journeys in 2013/14 alone;
- b) In 2012/13, Tyne and Wear had the highest number of local bus trips per head of the population outside of London, Nottingham and Brighton & Hove;
- c) Of those journeys roughly a third are for access to employment or education, a further third for shopping and accessing essential services and a final third are for leisure;
- d) Children account for 10% of all passengers, with two-thirds using child concessionary tickets and 50% of journeys made by children being for educational purposes;
- e) The level of car ownership in the region is the lowest in England, outside of London;
- f) Tyne and Wear is an area with typically higher levels of unemployment. In that context, bus services can provide an important function in economic development;
- g) There are three main operators of local bus services; Go North East, Stagecoach and Arriva. Go North East is responsible for approximately 50% of the overall mileage of local bus services in Tyne and Wear, with Stagecoach responsible for 37%, Arriva 11% and the remainder being provided by smaller operators. In practice, there is little on-road competition;
- h) In total, there are approximately 400 different registered bus services in the area, with approximately 210 of those forming the main commercial network, approximately 150 being Scholars Services and the remainder being bespoke or infrequent services;
- i) Levels of passenger satisfaction, as measured by Passenger Focus, are amongst the highest in the country, although satisfaction with fare levels is average;
- j) Patronage is in decline.

3.7. Nexus describes its involvement in the provision of services as limited to the securing of services on a discretionary basis using funding partly sourced through the NECA revenue grant. It explains that there are two key issues with the funding available to Nexus through this grant. First, Nexus faces increasing pressures on its limited resources, especially from increased mandatory payments in respect of the English National Concessionary Travel Scheme which erode the resources available for discretionary spending, such as secured bus services and other concessionary schemes. Secondly, despite the former TWITA and the NECA protecting the level of the transport levy and therefore the grant to Nexus as compared to other spending reductions seen elsewhere, Nexus' grant funding from the

NECA has been cut by 13.1% since 2011. Nexus contends that there is a real prospect that in the absence of a QCS the level of public funding for buses could well be reduced further than would be the case if there was a realistic prospect of maintaining and potentially enhancing the current secured bus network as well as the wider network. In the meantime, as a result of this decrease in funding and the increase in mandatory expenditure, Nexus has had to fall back on its reserves to maintain services. Understandably, Nexus maintains that this cannot continue indefinitely.

## The Board's Assessment of the Evidence and Statutory Requirements

### 4 Consultation – the Statute - Section 125 Transport Act 2000

#### **125.— Notice and consultation requirements.**

(1) If an authority or authorities propose to make a quality contracts scheme, they must—

- (a) publish, in such manner as they think fit, a consultation document complying with subsection (1A),
- (b) supply a copy of that document to each of the persons mentioned in subsection (3),
- (c) give notice in accordance with subsection (2) of the proposed scheme in at least one newspaper circulating in the area to which it relates, and
- (d) if the proposed scheme relates to an area in England, send a copy of that notice to the senior traffic commissioner as soon as reasonably practicable after its publication.

(1A) The consultation document mentioned in subsection (1)(a) must include—

- (a) a description of the proposed scheme;
- (b) a statement of the reasons why the authority or authorities are satisfied that the conditions in subsection (1) or, as the case may be, (1A) of section 124 are met;
- (c) a description of any arrangements which the authority or authorities intend to make (including arrangements with other authorities or other persons) for or in connection with the implementation of the scheme;
- (d) a statement of how any costs which the authority or authorities expect to incur under the scheme are to be defrayed;
- (e) a declaration by the chief finance officer or officers of the authority or authorities that, after taking into account—
  - (i) any estimated income from fares, and
  - (ii) any grants from Ministers of the Crown or government departments,any remaining funding required to implement the scheme can be provided from other resources available to the authority or authorities;
- (f) the date by which any written responses to the consultation must be submitted to the authority or authorities.

(1B) The description of the proposed scheme contained in the consultation document in accordance with subsection (1A)(a) must include—

- (a) an outline of the local services which are proposed to be provided under it;
- (b) a statement of any proposed exclusions from the scheme by virtue of section 127(4).

(1C) In subsection (1A)(e) "*chief finance officer*", in relation to a local transport authority, means that officer of the authority who is responsible under—

- (a) section 151 of the Local Government Act 1972, or
- (b) section 73 of the Local Government Act 1985,

for making arrangements for the proper administration of the financial affairs of the authority.

(2) The notice must—

- (a) describe the proposed scheme, and
- (b) state where a copy of the scheme and the consultation document may be inspected.

(3) After giving notice of the proposed scheme, the authority or authorities must consult—

- (a) all persons operating local services in the area to which it relates,
- (b) all other persons holding a PSV operator's licence or a community bus permit who would, in the opinion of the authority or authorities, be affected by it,
- (c) such organisations appearing to the authority or authorities to be representative of users of local services as they think fit,
- (d) any other relevant local authority any part of whose area would, in the opinion of the authority or authorities, be affected by it,
- (e) if the proposed scheme relates to an area in Wales, a traffic commissioner,
- (f) the chief officer of police for each police area covering the whole or part of [the area to which the proposed scheme relates] , and
- (g) such other persons as the authority or authorities think fit.

(4) For the purpose of subsection (3)(d) the following are relevant local authorities—

- (a) local transport authorities,
- (b) district councils in England,
- (c) London transport authorities, and
- (d) councils in Scotland.

(5) The authority or authorities may modify the proposed scheme following those consultations.

## KEY REFERENCES

Document	Reference
Nexus statutory consultation document	A6
Nexus consultation report	B4
Counsel's advice to Nexus on consultation, 16 July 2013	A32
Counsel's opinion on consultation and process, 1 October 2014	B3
1 <sup>st</sup> witness statement of Catherine Massarella, 12 March 2015 and exhibits	F1.7 & F2D
2 <sup>nd</sup> witness statement of Catherine Massarella, 27 May 2015 and exhibits	F1.8 & F2E
Oxera (Stagecoach) Report (Consultation), 1 May 2015	G4
Oxera (Stagecoach) Overview of economic changes in the QCS proposal since 2013 consultation	G6
Nexus skeleton argument	I1
Nexus closing submissions	I51
Transcript day 8, Catherine Massarella	I12
R (Moseley) v London Borough of Haringey [2014] UKSC 56.	AB70
Cover Letter, 9 April 2014	A24
Supplemental Consultation (April 2014), with respect to the Proposal for a Quality Contracts Scheme in Tyne and Wear	A25
Statutory Consultee non confidential responses	B7

4.1. Nexus undertook three stages of consultation. An informal consultation took place during August to October 2012. The formal consultation was undertaken from July to November 2013. This gave rise to a number of proposed amendments to the scheme and these were the subject of a supplemental consultation through April to June 2014. Extensive public awareness activity was undertaken in parallel and all statutory consultees were engaged. The Board is satisfied that the consultation *process* was such that a compliant consultation could be achieved.

4.2. Concerns arise from the content of the consultation documents. This is set out in the Oxera (Stagecoach) consultation report. The concerns set out fall into two categories:

- a) The current proposal is materially different to that which formed part of public consultation, and
- b) The information in the consultation documents relating to the impact of the QCS contained material errors and/or was based on assumptions that were incorrect.

4.3. The Board is satisfied that the current proposal, insofar as it relates specifically to the arrangement of the proposed Quality Contracts Scheme, is not materially different to that on which consultation was undertaken. We have seen no evidence of any change save for those elements which formed part of the targeted further consultation in the spring of 2014.

4.4. The Board is concerned that the circumstances and financial performance of the two proposals currently before us differ from those as presented in the consultation documents. In assessing the impact this has on the statutory compliance of the consultation, we are greatly assisted by the relevant legal submissions of both Stagecoach and Nexus.

4.5. Section 125(3) TA 2000 placed a duty on Nexus to consult certain persons and to publish the consultation document. It is common ground that this includes the requirement for Nexus' consultation to satisfy the requirements of procedural fairness. In determining what this means, both Nexus and Stagecoach refer to the recent Supreme Court case of *R (Moseley) v London Borough of Haringey* [2014] UKSC 56.<sup>4</sup>

4.6. Moseley makes it clear that, where consultation is carried out, in order for consultation to be fair it is necessary for the four so-called Sedley criteria to be satisfied. These are that:

- a. Consultation be undertaken at the time when proposals are still at a formative stage;
- b. Sufficient reasons for particular proposals be given to allow those consulted to give intelligent consideration and an intelligent response;
- c. Adequate time must be given for this purpose; and
- d. The product of consultation be conscientiously taken into account when the ultimate decision is taken.

4.7. In Moseley, it was further held that *“the degree of specificity with which, in fairness, the public authority should conduct its consultation exercise may be influenced by the identity of those whom it is consulting”*. Similarly, it was held that where there is a statutory duty to consult, the content of that duty varies *“greatly depending on the particular provision in question, the particular context, and the purpose for which consultation is to be carried out”*. It was also recognised that *“the demands of fairness are likely to be somewhat higher when an authority contemplates depriving someone of an existing benefit”*.

4.8. Finally, their Lordships also held that *“when statute does not limit the subject of the requisite consultation to the preferred option, fairness will require that interested persons be consulted not only upon the preferred option but also upon arguable yet discarded alternative options”* and that when the statute does limit the subject of consultation *“fairness may nevertheless require passing reference to be made to arguable yet discarded alternative options”*. On the same matter, Lord Reed held that *“the question will generally be whether, in the particular context, the provision of such information is necessary in order for the consultees to express meaningful views on the proposal”*.

4.9. These principles of consultation are not in dispute.

4.10. Among others, Oxera for Stagecoach<sup>5</sup> set out the movement in the value for money indicators since the consultation process began. We have reproduced a similar table here but giving a column of figures that the Board finds to be the most likely outcome (see, in particular, our analysis at paragraphs 8.26 and 8.30 below).

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<sup>4</sup> AB70

<sup>5</sup> Oxera (for Stagecoach) Report (Consultation), 1 May 2015; G5

Indicator (vs do minimum)	Nexus Consultation 2013	Nexus October 2014	Nexus May 2015	QCSB
<b>QCS</b>				
Effectiveness (£m)	1606	373	398	251
Economy (£m)	-262	-100	-120	-121
Efficiency	1.2	3.7	3.4	2.07
NPV (£m)	262	272	279	130
<b>VPA</b>				
Effectiveness (£m)	7	229	251	190
Economy (£m)	-3	-65	-51	-47
Efficiency	1.9	3.5	5.0	4.04
NPV (£m)	3	165	200	141

4.11. It is clear that the gap between the options has narrowed very dramatically with the passage of time. The issue for consideration here, however, is whether this movement is such that the consultation is flawed to the extent that it is no longer compliant with the statutory requirements. That requires that we consider the materiality of the difference and whether, had it been correct, or corrected, it may have caused consultees to respond differently.

4.12. The timing of the changes in reported value for money indices in relation to the consultation phases is important. The initial statutory consultation process ran from 30 July 2013 until 22 November 2013. The response to the consultation led to the change in the value for money metrics from those in the statutory consultation to those put before the NECA in October 2014. In the intervening period, starting on 9 April 2014<sup>6</sup>, Nexus launched a supplemental consultation. In the covering letter, Bernard Garner, then Director General of Nexus, said *“Nexus is in the process of analysing the responses received at formal consultation”*. Later it says *“in light of some aspects of consultation feedback received, Nexus is considering making a limited number of potential changes to the QCS proposal when it is considered by the Combined Authority”*. It is clear then, that Nexus will have considered the operators’ comments in relation to the value for money metrics prior to launching the supplemental consultation. Indeed, one might have expected substantive consultation comments in relation to the overall value for money of the scheme to have taken precedence over the more detailed issues which were the subject of a supplemental consultation.

4.13. Ms Massarella for Nexus gave evidence on the re-consultation point<sup>7</sup>

*“The issue as I’m advised is that we are obliged to re-consult where there is a matter that will vary within the scheme itself. Therefore, the five matters that are outlined in supplemental consultation, and we sought feedback on, directly input into the scheme. The 3Es do not. They are part of the material that supports the process, and also I think it’s valid to say that at that point, until we had certainty as to the outcome and feedback we received on the matters in*

<sup>6</sup> See A24 & A25, covering letter and supplemental consultation documents dated 9 April 2014

<sup>7</sup> 8:24:25



*supplemental consultation, it is plausible that some of the tests could yet change further.”*

4.14. Ms Massarella also asserted in evidence<sup>8</sup> that the consultation did not need to be public. This is addressed in Nexus closing submissions<sup>9</sup>:

*“c. Thirdly, the statutory framework does not require a “public” consultation in the traditional sense. The TA 2000 is very specific on who must be consulted for the purposes of section 125(1) to (3). Section 125(1)(b) requires a copy of the consultation document to be supplied to each of the persons mentioned in section 125(3), namely...”*

4.15. We do not agree with this assertion. As always, legislation needs to be read in context and it is neither appropriate nor safe to derive meaning from individual sub-sections. Section 125(1) makes the making of a QCS conditional upon consultation and describes how that is to be achieved:

s.125(1)(a) directs that the ITA must “publish” a “consultation document”. The term “publish” is defined in the Oxford English Dictionary as to “prepare and issue (a book, journal or piece of music) for public sale”, or “to print something in a book or journal so as to make it widely known”.

s.125(1)(b) and (c) deal with the delivery mechanisms for the consultation document. A very particular group of consultees is to be positively provided with the document; the wider public is to be told (in conjunction with s.125(2)) where to find it for themselves.

s.125(1A)(a) through to (e) set out the minimum content of the consultation document, which includes issues of affordability and value for money.

s.125(1)(f) sets out a deadline for responses. In doing so, there is a clear implicit invitation to all those who are intended to be aware of and have access to the consultation document to take it up, read it, consider it and respond to it.

4.16. Rather than exclude the public as consultees, the legislation requires the public to be told of the consultation document, where to find it and by what time to respond. What it also does is place a positive duty on the local authority to proactively ask for a response from specified persons. The differentiation is on the way persons are to be told; there is no differentiation on how they are to be heard.

4.17. Nexus’ closing submissions further assert that<sup>10</sup>:

*“It follows that the operators complaint on this matter is that other consultees may have responded differently to the consultations if they had been aware of the figures Nexus now advances or those that were given in the Public Interest Test report (or indeed those that the operators themselves are advancing). It is important to emphasise no evidence has been presented that those other consultees would have respond differently. Indeed, the evidence of Ms Massarella was that no other consultee beyond the three operators appearing*

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<sup>8</sup> 8:4:14

<sup>9</sup> I51: para 520

<sup>10</sup> I51: para 525(d)

*before the QCSB discussed the 3Es or value for money assessment and instead they focus on the details of the proposed QCS which would not be affected by the 3E values”.*

4.18. This closing submission references an element of Ms Massarella’s oral evidence. It is important to see what she actually said<sup>11</sup>:

*“I referred earlier in my earlier answer to the two parallel processes: the statutory consultation process, for which we’ve seen the list of consultees, and the public engagement process. We received feedback from both avenues. So again, I think the consultation was successful in drawing feedback from all parties whether they at the beginning of the process were statutory consultees or chose to opt in.*

*From the public engagement responses which we received, from memory, from 69 organisations or individuals, there was no comment on the matter of the three Es or modelling. It was all very much focused on the matters and the features that the customer would see or feel in the provision of a bus service. But yes, I accept in terms of the answer that the legislation required us to set out our position on the three Es in that document.”* (emphasis added)

4.19. So Ms Massarella did not say that what she terms as the statutory consultees did not comment on the economic assessment. The Board has re-read the responses to the formal consultation. It is clear and unsurprising that the economics of the proposition were in the mind of at least the local authorities who responded, for they fail to support any scheme through the levy funding system. As an example Councillor Nick Forbes, leader of Newcastle City Council in a letter dated 25 November 2013<sup>12</sup> said this:

*“The Quality Contract Scheme does appear to be a way to deliver the ITA’s Bus Strategy Vision and Objective, and Newcastle Council would want to support the option if it does not prove possible to deliver equivalent benefits from improved Voluntary Bus Partnership agreement.”* And

*“Given the potential for further cuts in government funding for several years and the uncertainty about the scale of the cuts, it is unlikely we could agree at this point in time to uplift in the levy to reflect increases in the RPI, as assumed in the QCS model”.* (emphasis added)

4.20. The response from Sunderland City Council dated 22 November 2013 shows a similar interest in economic matters

*“the Voluntary Partnership Agreement proposal described within the consultation document offers improvement in a number of areas compared to the current position. Given the information provided in the consultation document, it appears that the Quality Contract Scheme could provide a means of achieving the overall objectives of the Bus Strategy Delivery Project providing further elements not possible through a Voluntary Partnership Agreement. However we also remain keen to see any updated proposals for a Voluntary partnership Agreement and the comparative benefits this could bring. We will be interested to see the outcomes of the consultation process*

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<sup>11</sup> 8:11:6

<sup>12</sup> B7

*We would be keen to reflect on the relative benefits and risks of these before our Members on the Integrated Transport Authority formally consider the next steps to be taken.” (Emphasis added)*

4.21. While it is true that these consultees did not refer explicitly to Effectiveness, Economy or Efficiency, it is very clear that the overall economic and value for money benefit of the scheme was central to their support for it. They expressed affordability concerns and wished the VPA to be pursued. In considering why they may not have addressed the modelling in detail, it is instructive to look at what is said in the comparison between the QCS and VPA within the consultation document itself<sup>13</sup>.

*“6.11.16 (g) The Effective measure derived for the QCS Proposal, represents the total benefit delivered by the scheme and the level of confidence that this will be delivered. Appraisal of the VPA Proposal over 10 years values the central case estimate of this measure at £7 million, less than one hundredth of the QCS equivalent of £1,606 million. Nexus considers £7 million to be an optimistic estimate of the net benefits that would result given the material uncertainty regarding the deliverability of the VPA proposal including how long any partnership introduced would last.*

*(h) The Economic measure used by Nexus in considering the QCS Proposal represents a net difference between the cost and benefits of the scheme. The central case estimate of this net benefit for the VPA proposal is a present value of £3 million, around one hundredth of the QCS equivalent of £262 million. For the same reasons given above Nexus considers that £3 million is in any case an optimistic estimate of the net benefit of the scheme.*

*(i) The Efficiency measure derived for the QCS Proposal represents the ratio of the benefits to the cost of the scheme, the costs in the case of the VPA proposal being the total of the increased operating costs and loss in revenue (from the reduction in average fare) to operators who are parties to the VPA Proposal. The ratio for the VPA proposal is derived as £6.62 million of net benefits : £3.5 million of net cost, or 1.88:1. This demonstrates that the VPA proposal is more efficient in comparison to the Do Minimum if delivered as represented within the modelling and appraisal framework, including lasting in an effective form for 11 years; as set out for the previous measures Nexus considers there to be considerable delivery risk and therefore can have much less confidence in the scale of this measure than in the fact that the benefits exceed the costs of the partnership. A modest change in the forecast operating costs or revenue of the VPA proposal could therefore have a significant impact on the resulting Efficiency Ratio. For example, if the revenue impact of the VPA proposal was a loss of a further £3.1 million (present value) over 10 years (a doubling of the impact), the Efficiency Ratio would reduce to 1.01 to 1.*

*(k) Taking the three measures in Test (D) in combination it is clear that the scale of impact resulting from the VPA Proposal is a very small proportion to that which results from the QCS Proposal.*

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<sup>13</sup> Proposal for a Quality Contracts Scheme in Tyne & Wear, July 2013, A(1)(6)

4.22. It is helpful that the core principles of a fair and legal consultation are agreed. We noted at paragraph 4.1 above, that the process itself was one that was capable of delivering a compliant consultation. We are also drawn to the words of Lord Reed in *Moseley*, where, in the context of the content of consultation needing to reflect the circumstances, he says “*a mechanistic approach to the requirement of consultation should therefore be avoided*”.

4.23. It is accepted that the 3Es must be considered within the consultation. It is accepted that, in relation to tests D and E, a comparison to the QCS must be considered and, in this case, that is the VPA. It has now been accepted that the value for money numbers presented in the statutory consultation document were in error and we find they were seriously in error; the Effectiveness, for example, was over-stated four times because the revenue figure appears to have been used in error. It was knowable that they were in error at the time they were published since they derive from a straightforward lack of understanding of the terms. Nexus was made aware of the errors in November 2013. It is clear from the consultation responses of the local councils that affordability was a concern and they remained keen for the VPA to be progressed as a viable alternative. Not only were the numbers in relation to the value for money indices in error in the 2013 consultation document, the narrative in the text as can be seen above presented the VPA in a dismissive manner. In fact the effect of the narrative is to present the VPA proposal as not a valid alternative at all.

4.24. Nexus’ closing submissions contend that no one apart from the bus operator representatives responded in detail in relation to the economic analysis. That is not surprising given that the consultation document runs to 380 pages plus appendices. It cannot be expected that the public or organisations without significant financial wherewithal could meaningfully engage with the consultation document. It would be entirely reasonable for those constituent councils who expressed affordability concerns to assume that the modelling and numbers expressed within the consultation document were correct.

4.25. Having accepted the errors in the consultation document, the Board finds that Nexus was under a common-law duty to re-consult to correct the erroneous statements – and not because the scheme itself was to be modified. In saying that, we remind ourselves that *Moseley* found “*the demands of fairness are likely to be somewhat higher when an authority contemplates depriving someone of an existing benefit or advantage and when the claimant is a bare applicant for a future benefit*”. In this case, of course, it is accepted that there is a significant degree of negative financial impact on the bus operators of the QCS proceeding. We also remind ourselves that Lord Reed in *Moseley* commented that “*the question will generally be whether, in the particular context, the provision of such information is necessary in order for the consultees to express meaningful views on the proposal*”. Having been potentially misled by the erroneous material in the initial consultation, Nexus failed to take steps to prevent the situation from continuing.

4.26. We make no criticism of Nexus for not re-consulting in relation to the revised VPA proposals. The bus operators were aware of the consultation phases as they emerged. It would seem their early offers were conservative. It was only following the statutory consultation that they added an offer of fifty additional buses. They were aware of the timescales for the supplemental consultation but were slow in producing a revised proposal. We do not underestimate the complexities and practical difficulties of compiling a proposal of that size involving three very large businesses and others who formed part of NEBOA, yet it is hard to avoid concluding that the operators put forward as little as possible until the very last minute.

**4.27. The Board finds that Nexus fails to satisfy the statutory duty on consultation** because it failed to correct material errors in the consultation document which had a clear potential to have disadvantaged consultees.

## 5. Criterion A – the Statute - Section 124 Transport Act 2000

### **124.— Quality contracts schemes.**

(1) A local transport authority, or two or more such authorities acting jointly, may make a quality contracts scheme covering the whole or any part of their area, or combined area, if they are satisfied that—

(a) the proposed scheme will result in an increase in the use of bus services (see subsection (9B)) in the area to which the proposed scheme relates,

(9B) The reference in subsection (1)(a) to increasing the use of bus services includes a reference to reducing, arresting or reversing decline in the use of bus services.

## KEY REFERENCES

Document	Reference
Nexus Public Interest Test Report	B12
QCS Affordability Analysis, October 2014	B14
1 <sup>st</sup> witness statement of Tom Clarke, 12 March 2015 & exhibits	F1.9 & F2F
2 <sup>nd</sup> witness statement of Tom Clarke, 27 May 2015	F1.10
Oxera (Stagecoach) report 30 January 2015 “The revised QCS proposal for Tyne & Wear: An independent economic assessment”	G2
Oxera (Stagecoach) rebuttal response (public interest criteria), 1 May 2015	G3
Oxera (Stagecoach) further response, 19 June 2015	G5
Oxera (Arriva) economic assessment of QCS proposal, 30 January 2015 and technical appendices	G7, G8
Expert Report of Bojana Ignjatovic, RBB Economics, 17 February 2015	G10
Supplemental report of Bojana Ignjatovic, 1 May 2015	G11
Experts statement of common ground	G12
Transcript Day 1, Gunnar Niels	I5
Transcript Day 2, Gunnar Niels, Bojana Ignjatovic, Dr Luis Correia da Silva, Joseph Bell	I6
Transcript Day 6, Tom Clarke, John Fenwick	I10
New Risk Appendix, 9 January 2015	D2
Transcript Day 7, Mr Hunter	I11
Transcript Day 9, Mr Hunter	I13

5.1. Criterion A is satisfied if it can be demonstrated that the proposed QCS will deliver a greater use of bus services than the *do minimum*. There is no statutory requirement for the QCS to out-perform any other intervention, for example, a VPA. There is also no requirement to deliver a greater number of individual users nor greater sales of any particular type of ticket nor any particular mix of bus users. The Statute simply requires an “increase in the use of bus services”. In practice, this is taken as a greater number of bus passenger journeys. It can also be satisfied by arresting a decline in patronage; an increase is not required so long as the reduction is less than would occur in the *do minimum*.

### **The *do minimum***

5.2. The *do minimum* scenario is Nexus’ forecast of the local bus market if no intervention takes place and therefore current trends continue. The *do minimum* therefore assumes that no QCS or VPA comes about. An important aspect of the *do minimum* scenario is the assumption made as to the average rate of fare increases, because this has implications for changes in patronage and fare revenue. It also has implications for Nexus’ expenditure on statutory and discretionary concessionary travel. A second important aspect is the affordability of the QCS. That is important as the QCS provides for fare increases limited to RPI which is a driver to increased patronage. Thirdly, the QCS aims to increase patronage through simplified ticketing and a common customer charter.

5.3. Taking the *do minimum* first, it is common ground between the parties that changes in fares should be forecast using a percentage figure above annual changes in bus costs, and that bus costs are to be based upon the Confederation of Passenger Transport UK Index [the “CPT Index], and commonly referred to in terms of “bus costs + x%”.

5.4. The impact of fare increases in the *do minimum* is effectively two-fold. First, following a price rise, individual service users will make their own decisions on whether or not to (continue to) use a bus. Second, commercial fare rises tend towards an increase in the level of reimbursement required from the local authority for concessionary passengers. The principle is that operators are reimbursed for concessionary travellers on a “no better, no worse” basis but the reality is that this is subject to some negotiation so is more complicated. Tom Clarke of Nexus explains this in his first witness statement at paragraph 21:

*“...The Models use elasticity values to demonstrate the patronage effects resulting from price changes, as detailed below:*

- a) Within transport modelling a fare elasticity of demand is used to predict changes in customer behaviour due to changes in price. These values can reflect both short-term and longer term effects on passenger behaviour. For example, an above inflationary increase in ticket prices may be expected to reduce passenger demand. Fare elasticity value allows a modelling of the impact of different increases.*
- b) The DfT “Black Book” (the DfT publication “Demand for public transport: a practical guide”), widely used in transport modelling (for example, as a base for calculating ENCTS reimbursement), provides a fare elasticity of demand value of -0.42 (short-term) and -0.56 (medium-term) which, when applied, means that for every 1% increase in fares above the level of retail price inflation (RPI) there will be a 0.42% reduction in demand in the short term and*

*a 0.56% reduction in demand in the medium term. This is explained in more detail within paragraph 6.2.6 of the Financial Record of Assumptions.*

- c) These fare elasticity values used by Nexus are such that the demand response to the fare change will mean total fare revenue received by the operators in each year increases even though the fare increases result in some passengers choosing not travel.*
- d) As the fare revenue increases at a higher rate than the forecast level of bus operating costs this means that the operating profit margins in the do minimum increase over time.*
- e) As the annual fare increases are one of the variables used in calculating ENCTS reimbursement, a higher commercial fare increases the amount of ENCTS reimbursement Nexus must pay to the operators. In turn this reduces the amount of funding available to Nexus to support discretionary schemes”*

5.5. Predicting future price rises is clearly a complex matter. Historical price progression is an obvious potential indicator. Nexus contends that the eight-year period from 2006 to 2014 is representative of longer term fare price trends in the bus market. Nexus had originally used a period of 2004 to 2012 but updated its model to include the latest two years data which became available. It has now discounted the years 2004 and 2005 from its analysis. It is notable that those years were years of below bus cost fare price rises. Nexus’s argument for this is that periods of low or no increases in fares are followed by periods of higher increases in fares. They argue that prices are cyclical.

5.6. Operators argue that the reference period has been selected by Nexus to provide an artificially high figure. In evidence for RBB for GNE, Ms Ignjatovic argued that the price movements over the focal period did not provide evidence of cyclical trend. Analysis of their own fare movements by operators showed evidence of much lower fare increases, in particular over the past five years, or when choosing different reference periods.

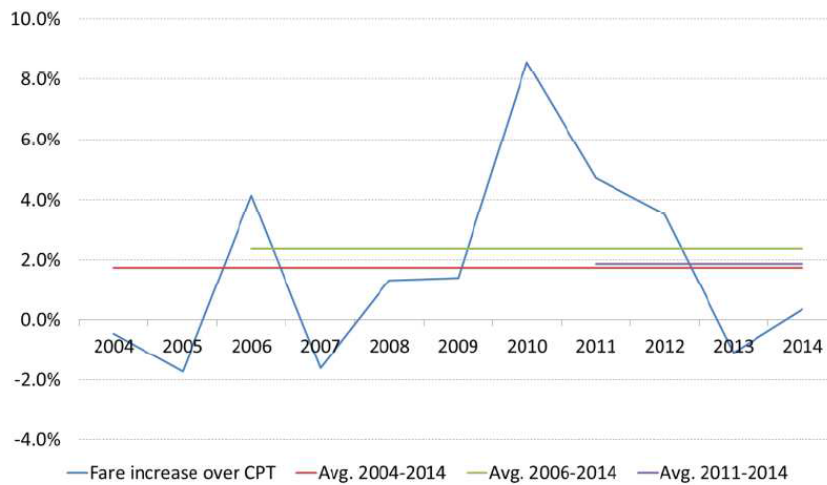
5.7. The argument is complicated further by the initial selection by Nexus of the adult single cash fare as the basis of fare movements. Nexus subsequently included weekly season tickets purchased on the bus. The data available to Nexus indicated that the adult cash and weekly tickets accounted for approximately 72% of the total fare revenue earned by operators. Nexus considered that to be a reasonable representation of the market. Operators disagreed. They argued that, for example, a passenger who bought a weekly season ticket may well then use it to undertake more bus journeys, thus meaning that the cost per journey was actually lower. Additionally, differential pricing between single and season tickets is creating a reducing proportion of single ticket holders. Operators contended that the relevant metric was not the cost of a ticket, but the revenue per passenger journey. It is understood that this is now accepted by all parties. However, the passenger projections for the *do minimum* have not consequently been adjusted.

5.8. The Board’s view is that historical data can inform likely future behaviour but it is too simplistic simply to project forward on the basis of the past 5, 8, 10 or however many years. Our view is that, if one is to take that approach, one should use as much historical data as is available and seek to understand any anomalous years such that consideration can be given to whether such anomalies are likely to reoccur. The logic of this approach was placed under scrutiny when Mr Maclean for GNE cross-examined Mr Clarke. During that



cross-examination,<sup>14</sup> Mr Clarke acknowledges that he only had access to data from 2004 so that was the start of his historical knowledge. Fare movement since then is shown in this graph taken from Mr Clarke’s first witness statement:

**Figure 1: Nexus’ weighted average fare increase over bus costs 2004 to 2014**



Source: Historic Weighted Fare Increases based on Nexus’ Continuous Monitoring Survey, 2004 to 2014

5.9. Mr Clarke accepted under cross-examination that he had not compensated for “shocks” during the period. There were at least two, including a deep economic recession and a significant reduction in BSOG. Mr Clarke suggested that there had been two BSOG “shocks”, one being an uplift to encourage the use of automated vehicle location. It seems highly likely to us that the steep increase in fares in 2010 may well have been a response to a reduction in BSOG. We are therefore not convinced that the data presented for the years 2006 to 2014 is adequate to show a cyclical trend in fare rises without significant further econometric analysis. Furthermore Nexus, having identified “shocks”, was wrong to have ignored them. We also see no merit in excluding the data for 2004 and 2005. We therefore find Nexus’s central case that bus fares are likely to rise at bus costs +2% is not made out. Including all the available years and excluding the 2010 increase, for example, gives an average of bus costs + 1.05% and such an outcome is at least as justifiable as the Nexus approach. We find that, subject to our conclusions on affordability, QCS patronage will be above the *do minimum*. Given the lack of strong data and noting our earlier comments, based on the May 2015 Oxera (Stagecoach) modelling,<sup>15</sup> increases of 66 million and 89 million are equally justifiable; the true value is likely to lie somewhere in between (in fact, given our findings on soft measures, these numbers should be further reduced by around 3% but the effect is not material).

<sup>14</sup> 6:157:7

<sup>15</sup> Oxera response to Nexus’ rebuttal evidence served in March 2015 (Public Interest Criteria) G3

## Affordability and Risk

5.10. The second factor in determining whether or not this criterion is met is the affordability of the QCS such that the intention that fare rises limited to RPI can be maintained. A number of factors impact. Nexus models fare-box increases arising from the implementation of soft measures in years 1 and 2, providing a total patronage growth of 4.4% and generating revenue of £44 Million for an investment of £0.6 Million. This is discussed under criterion D where we conclude that the soft measures benefits are significantly overstated.

5.11. A central assumption on affordability is that operators will bid at an EBIT margin of 8%. The Board heard much evidence on this matter, from Mr Cheek<sup>16</sup> of the TAS Consultancy called by GNE, from the economic experts and, from Nexus, from Messrs Woods,<sup>17</sup> Fenwick,<sup>18</sup> Clarke,<sup>19</sup> Hunter<sup>20</sup> and Hughes<sup>21</sup>. Both Stagecoach and GNE sought to rely on the TAS Bus Industry Monitor, Autumn 2014, which, at paragraph 3.7.1 says:

*“This analysis suggests the operators outside London should be earning an operating profit margin of between 10.5% and 11% in order to earn a return in line with the Competition Commissions 2009 assessment of the industries weighted average cost of capital (WACC).”*

5.12. This was not challenged in cross-examination of Mr Cheek but was challenged in evidence by Mr Fenwick for Nexus. Nexus produced a note during the hearing identifying a series of apparent errors within the structure of the notional balance sheet which leads to the conclusion at paragraph 3.7.1. The Board has made its own assessment of that balance sheet. There are a number of errors which, as Nexus point out, are errors in the notes to the calculation rather than in the calculation themselves. Other errors are more fundamental.

5.13. As an example, the report does not use the conventional definitions and therefore calculations of return on capital employed; it makes assumptions on the cost of borrowing (base rate +5.5%) which seem high in today’s market for secured borrowing; it adds inflation to figures which are expressed in real terms; and it does not reflect the recent reduction in the corporation tax rate.

5.14. Whether and to what extent criticisms of the TAS report are valid, however, does not address the overriding observation that the report posits GB bus industry EBIT targets either for London or for the deregulated market. There is no QCS comparator to analyse. The considerably different, and partially undefined, risk profile of the Nexus quality contracts mean that the target is essentially unknowable. The risks are discussed further at Appendix 1.

5.15. The Board has also considered the evidence in relation to a number of other arguments in this area. Whether or not operators choose to lease or buy buses is an operational matter for them. It may have a technical impact on the balance sheet but it is our view that the impact on overall costs is not material. We note that, in fact, Busways currently leases its vehicles from another Stagecoach Group business, albeit at marginal cost. We are not persuaded by the argument, advanced by Mr Montgomery, that a business

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<sup>16</sup> 4:103:2

<sup>17</sup> 5:36:95

<sup>18</sup> 6:9:54

<sup>19</sup> 6:182:188

<sup>20</sup> 7:38:71

<sup>21</sup> 9:7:15 and 9:134:149

the size of Stagecoach would not be able to absorb the Tyne & Wear fleet elsewhere should it become redundant at some point in the future; it represents less than 5% of the Stagecoach UK bus fleet and the QCS vehicle specification is not unusual.

We considered the Nexus assertion that operators in a regulated market would wish to operate at a lower EBIT margin than in a deregulated market but can find no evidence to support that. It is correct there is a transfer of risk but there is a transfer in both directions. The comparison with London is not helpful. The plain fact is that a bus running in London will carry more passengers for more hours of each day so the margin required is lower for the same cash return. Neither can London be used as a comparison in relation to the management of quality contracts. Contracts in London change hands very frequently and the market is far more dynamic. It is quite simply a different proposition to operating outside the capital. For all these reasons, the assumption that operators will bid at an 8% EBIT margin is not unreasonable. To the contrary, it appears supported by the evidence, albeit there is no direct comparator so any QCS-specific risk premia are unknown.

5.16. Any judgement on affordability is necessarily informed by an assessment of risk. Before analysing the approach to risk in detail it is worth reminding ourselves of the flexibilities within the proposed quality contracts scheme

- Additional services may be tendered during the 10 year period where changes to the network are identified through the governance procedures. Such decisions would be supported by patronage information;
- Services may be flexed by increasing the peak vehicle requirement or mileage by up to 10%;
- Mileage can be reduced by up to 10%;
- Fares can rise above RPI;
- Changes can be made through the emergency network change procedure<sup>22</sup> for example where a major generator of patronage opens or closes; and
- Contracts let initially for seven years with the potential to extend for a further three years.

5.17. Nexus has identified a risk contingency of £79 million. The contingency was calculated based on an analysis of four main risks: fare revenue, inflation, transition costs for employees and cross boundary issues. Nexus's position is that, whilst the risk contingency was calculated using these four key risks, it is not ring fenced and can be used should other risks become issues. It is accepted that the risk contingency is built around Nexus's central case, analysis of which is undertaken mainly under criterion D. The complexity of the risk modelling was reinforced in the week directly preceding the oral evidence sessions when Nexus accepted a modelling error, the effect of which was to make the £79 million risk contingency adequate 69% of the time rather than 84% of the time as presented in the October report to the NECA. Mr Maclean put the impact of this change to Mr Fenwick<sup>23</sup>:

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<sup>22</sup> Quality Contract Scheme, Annex 7, Part 5: B10

<sup>23</sup> 6:23:20

*Q. Now, as this is your area of both expertise and responsibility, you must have been horrified, weren't you, when you realised this mistake had been made?*

*A. To pretend otherwise, you know, would clearly be disingenuous. The mistake, or rather the finalisation of the various discussions with Oxera Stagecoach, was only notified to me in the week or two weeks before the QCS Board, my reaction was that obviously it was or is problematic.*

5.18. Mr Ward put the same point to Mr Woods (of NECA):<sup>24</sup>

*Q. So you accept this is actually material to the decision to press ahead with this?*

*A. It's an important issue that needs further explanation for the North East Combined Authority, and I will certainly be providing more background information that was in the original statement, because in my view the issues are particularly important about the mitigating factors, management factors, and the upsides as well as the downsides. So we didn't focus on any upside in the evidence we gave. We were trying to be prudent in terms of that position.*

5.19. In their closing submissions<sup>25</sup>, Nexus state that first, any QCS is inevitably going to import a degree of financial risk into the public sector, and secondly, as a public sector project, the proposed QCS is not set up or structured so as to deliver a surplus. The Board accepts both those statements but would qualify the first by saying that this particular structure of QCS imports the highest possible risk because Nexus has taken the decision to take the risk on revenue. It is not necessary for a QCS to be structured in that way. We understand that to do otherwise would not allow Nexus to address its wider funding issues.

5.20. Nexus' basic approach to assessing the risks has not been challenged by the operators. What is challenged is the adequacy of the quantum of the risk contingency. We share those concerns in particular, it is not clear why Nexus has based its risk contingency on four risks. In the QCS Value for Money Assessment: Record of Risk Assumptions<sup>26</sup> produced in January 2015 by Steer Davies Gleave, twenty-six separate risks are identified. (we make a separate analysis of operational risks at Appendix 1). Accordingly the analysis shows that the scheme is likely to exhaust its risk contingency in 31% of possible scenarios.

5.21. Nexus has not applied any overall optimism bias to its figures. Mr Maclean asked Mr Hunter about this<sup>27</sup>:

*Q. Optimism bias, yes, to the budget that it was presented with for the scheme, so that you are given a number, and then you build in optimism bias, and then you proceed on the basis of the price presented, the cost presented, plus that bias?*

*A. That's not quite - it's not in terms of the price presented. Optimism bias is an adjustment that we only make at an economic appraisal. It isn't something that you say: oh, if my budget for the scheme was 50 million and it has an optimism bias of 50%, you wouldn't say: therefore I need to have a budget of 75 million. When you put it into a value for money assessment, you would apply the optimism bias at that stage, and it's a sort of rebalancing between the cost benefits in the appraisal. If you like it's a check. The DfT say: we want to make sure that you are value for money,*

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<sup>24</sup> 5:40:25

<sup>25</sup> 151: Pg 68, para 191

<sup>26</sup> D2

<sup>27</sup> 7:64:5

*our BCR would still be right even if the optimism bias turned out to be true and the scheme ended up costing more”*

*Q. You have applied an optimism bias to certain elements of the scheme which as I understand it, taken in the round, comes out at about 10% for those elements that you have applied the bias to, is that right?*

*A. I don't think so. I don't believe we've actually applied-specifically applied optimism bias. The element of the scheme that would be appropriate is the budget for the scheme, which I can never remember the exact value, but in present value terms something of the order... 1.3 million, equivalent to initial capital, if you like, for a capital scheme. It's the money they spent in getting there.*

*Q. So you haven't directly applied the type of optimism bias commonly seen in that type of -*

*A. Yes, and it wouldn't make much of a difference to the answer when we're talking the present value of costs of 120 million. Even if I was to double the 1.3 million scheme set up costs, that would make very little proportion change to 120 million total cost.*

5.22. Mr Hunter was further questioned on this point on the final day of the hearing by the Board<sup>28</sup> and he accepted that Nexus had not applied optimism bias in the way envisaged by the Treasury Green Book. Nexus picks up this point in its closing submissions and helpfully encloses a copy of the DfT WebTAG Unit A1.2, Scheme Costs. Para 1.1.2 explains how to cost a scheme:

There are three main elements of the scheme cost estimate that need to be estimated and reported in scheme appraisal:

- the base cost - the basic costs of the scheme before allowing for risks, though these should incorporate realistic assumptions of changes in real costs over time, e.g. cost increases or reductions relative to the rate of general inflation;
- Adjustment for risk - which should cover all the risks that can be identified, the majority of which they need to be assessed and quantified through a Quantified Risk Assessment and included in the risk-adjusted cost estimate;
- And adjustment for optimism bias - to reflect well-established and continuing systematic bias for estimated scheme costs and delivery times to be too low and too short, respectively, and results in the risk and optimism bias adjusted cost estimate.

5.23. Section 3.5 of the unit deals with optimism bias. It defines it thus: “optimism bias is the demonstrated systematic tendency for appraisers to be overly optimistic about key parameters. Theories on cost overrun suggest the optimism bias could be caused by the organisation of the decision-making process and strategic behaviour of stakeholders involved in the planning and decision-making processes”. It goes on to say that the Department requires a four step approach to adjustment for investment costs optimism bias:

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<sup>28</sup> 9:59:6

1. Determine the nature of the project
2. Identify the stage of scheme development
3. Apply the recommended uplift factors to the risk-adjusted transport cost estimate
4. Provide sensitivity analysis around a central estimate

5.24. One of the issues continually facing this QCS proposal is its novel nature. The WebTAG unit offers, at Table 8, five project categories. These are roads, rail, fixed links, building projects, and IT projects. The definition of “roads” includes park-and-ride, bus lane schemes and guided buses on wheels. Whilst far from a clean fit, it is closer than any of the other options. It is also the option with the lowest levels of optimism bias uplifts. WebTAG is more helpful with identifying the stage of scheme development. For local authority and public transport schemes it identifies three stages the first is program entry, the second is conditional approval and the third is full approval. The QCS proposal currently has conditional approval from the NELB. WebTAG then suggests that an optimism bias of 15% is appropriate. That is 15% of the overall programme cost, which in this case is £1.6 billion deriving an optimism bias of £240 million.

5.25. An alternative to using the WebTAG table to identify a level optimism bias is to use the Treasury supplemental guidance on the matter. The panel put this to Mr Hunter on the final day of the oral evidence session.<sup>29</sup> Mr Hunter had previously been provided with a copy of supplemental guidance and was in any case aware of it. The chairman questioned him:

*Q. I look at the table, table 1, which looks at the optimism bias, and I consider this piece of work, the quality contract, really to be an outsourcing piece of work. Would you agree with that?*

*A. No*

*Q. Why not?*

*A. Because the-sorry, just let me check the...*

*Q. How is this not outsourcing? The local authority wants to run some buses. It wants to let a contract to somebody to run it on their behalf. It is putting out the sourcing of the running of the buses.*

*A. On page 315, I think, outsourcing projects are described as those concerned with the provisions of hard and soft facilities management services e.g. ICT services, facilities management and maintenance projects. I'm not quite sure they are exactly the same as what we deal with here*

*Q. Well, maybe not exactly, but this isn't building a road. It's not building a bridge. It's not building another Tyne Tunnel?*

*A. No I agree with that.*

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<sup>29</sup> 9:60:12

*Q. This is closest to asking somebody to run some services on my behalf. I think in fact is exactly asking somebody and contracting somebody to run services my behalf?*

*A. Yes*

*Q. On that basis, how can that not be an outsourcing project?*

*A. I think that sounds a reasonable argument, Sir.*

*Q. So then if I look at the table, table 1, optimism bias and then look at this little asterisk next to it, outsourcing, where it says I should be looking at 41%, and in relation to optimism bias the asterisk says: "the optimism bias for outsourcing projects is measured for operating expenditure"?*

*A. Yes*

*Q. Do you accept that?*

*A. Yes*

5.26. The Board's conclusion is that optimism bias should have been and has not been applied in this case. We accept that the Treasury and Department for Transport guidance do not provide precise values of optimism bias for a quality contracts scheme – this being the first proposed scheme, there is no comparator. The QCS is, in fact, a mix between a transport programme and a more generalised outsourcing programme. We do not accept the assertion in Nexus' closing submissions that the quality contracts scheme is simply a contract management exercise. Had Nexus chosen not to take on the revenue risk that argument may have had more merit. By taking on the revenue risk and taking on the network design and management roles, Nexus has taken on risks on both income and expenditure. That distinguishes the QCS from a straightforward contracting exercise where the income is generated for example from council tax revenue or central government grant and is, in relative terms at least, safe. The correct level of optimism bias to be applied requires careful consideration. It is not our role to make those judgements for Nexus, other than to say that a realistic level of optimism bias must be applied. The guidance would suggest that the level of optimism bias is between zero and 41%, and the relative maturity of planning of this proposed program suggest it is nearer to the lower end of that range.

5.27. Optimism bias is not, as Mr Hunter contended, simply a tool to be used in the modelling stage. It exists within Treasury guidance because many large projects have run into problems. Many of those projects will not have the novel character of this QCS proposal. We note that a level of optimism bias as low as 5% would require Nexus to allocate an additional £80 million to its risk contingency. For clarity, we are not saying that 5% is the correct level of risk contingency, we simply use that figure to indicate the scale of additional risk contingency that is necessary, in addition to the £79 Million already set aside.

5.28. There is a further and important issue with the £79 million risk contingency which is within the proposal. The £79 million is built up over time through operating profits. The Board posed to Mr Fenwick the question: what would happen if the risks crystallised in the early years. Mr Fenwick responded:

*“It’s back to what we talked about earlier. So having the data surrounding the entire network, you would be better placed in my view to be able to make decisions, to adjust and flex things. Ultimately you would need to fall back on those provisions within the scheme that sit outside of the annual development cycle, and that’s around flexing vehicle mileage, that is also around, in emergency situations, doing something outside of the normal fares review in order to look at the fares proposition. But I would think there would need to be number of risks crystallising before you got to that point”*

## **Conclusions**

5.29. The Nexus model overstates the likely fare increases in the *do minimum* which paints an overly-pessimistic picture. The assumption that operators will bid at an EBIT margin of 8% is not unreasonable, subject to the lack of knowledge of QCS-specific risk premia. There has been no application of optimism bias which means that the level of risk contingency available is highly likely to be inadequate and we have concerns over its availability in the early years. It appears more likely than not that the scheme will run in to funding issues and that will put pressure on fares and the network. **In our opinion, Nexus has failed to demonstrate that Criterion A is met.**



## 6. Criterion B – the Statute - Section 124 Transport Act 2000

### **124.— Quality contracts schemes.**

(1) A local transport authority, or two or more such authorities acting jointly, may make a quality contracts scheme covering the whole or any part of their area, or combined area, if they are satisfied that—

(b) the proposed scheme will bring benefits to persons using local services in the area to which the proposed scheme relates, by improving the quality of those services

### **KEY REFERENCES**

<b>Document</b>	<b>Reference</b>
Nexus Public Interest Test Report	B12
Nexus closing submissions	
Stagecoach closing submissions	
Oxera (Stagecoach) response to Nexus rebuttal evidence served in March 2015 (public interest criteria)	G3
First witness statement of Toby Hughes	F1:1
Transcript Day 4, Mr Montgomery	I8

6.1. This criterion does not require any comparison with the VPA. It simply concerns itself with whether or not the QCS will bring any benefit to passengers by improving the service quality. Any quality improvement whatsoever means that the criterion is satisfied. The statutory guidance says:

*“Quality of service is likely to include matters such as the standard of the vehicles used to provide services (e.g. accessibility for disabled persons, emissions standards, audiovisual information), the frequencies or timings of services, punctuality, reliability, standards of driver training and arrangements for integration of ticketing with other services or transport modes.”*

And

*“better integration of fares or ticketing, or the introduction of smart ticketing, could be viewed as an improvement in service quality”*

6.2. Nexus sets out its claimed benefits under six headings.

## **Bus Network**

6.3. In terms of improvements in the bus network, the argument put forward is that the QCS will avoid the reductions in services in the *do minimum*. In relation to criterion A, the statute specifically prescribes that arresting a reduction in patronage can be seen as an improvement. There is no similar clause in relation to criterion B. The arguments advanced by Nexus in relation to the bus network cannot succeed.

## **Fares and Ticketing**

6.4. In relation to fares and ticketing, it is clear that the *do minimum* has moved on significantly since Nexus began work on the scheme. The Board heard evidence on this from Mr Montgomery.<sup>30</sup> We were told that fare capping, smart ticketing and payment systems were the fastest developing elements in the bus industry at the moment. However, even the latest version of the VPA did not at the date of the hearing include fare capping although it was promised. And whilst the operators have done much work in terms of cross ticketing, this is largely restricted to the bus operators and does not include the Metro nor the Ferry. The QCS proposal, on the other hand, does. Furthermore, it draws the current six disparate fare zone structures into a single geographically unified structure. The Board considers this does offer benefits to persons using the transport systems in Tyne & Wear and is a relevant improvement of quality.

## **Vehicle and driver standards**

6.5. The QCS prescribes vehicles that meet tough modern emission standards meeting Euro five requirements by the second anniversary of the QCS, with 60% achieving that standard at the start of the QCS. That will mean a significant investment in new vehicles and the Board considers that is also a relevant quality improvement. Nexus claims that it will incentivise improved driver training through the procurement process. A very high proportion of bus services in Tyne & Wear are operated by three large businesses. Each of those businesses already invests heavily in driver training. The “driver standards” in the Quality Contract Scheme (section 4) lists solely elements that are already required, or derived from, current legislation. It is difficult to see how the QCS could deliver any material improvement.

## **Customer experience and journey information**

6.6. The benefits arising from a standardised customer charter are discussed under criterion D. We do not need to consider them here. Journey information under the proposed QCS will be enhanced, standardised and centralised. There will be a single website providing a single source of information for service information, service changes and fares. The Board considers this to be a relevant quality improvement, but notes that information technology is moving rapidly in public transport. Websites and apps for smart devices already exist which provide real-time journey information, with some also providing full multi-modal journey planning. The Board considers that a large element of this quality improvement may well be delivered in the *do minimum*.

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<sup>30</sup> 4:21

## **Governance**

6.7. The QCS offers a formal democratic process to consider proposals for service changes involving local authorities making the decisions that are best from a strategic and macro-economic level. In the *do minimum*, services are designed to meet the needs of customers through customer research. The formal governance procedure proposed by the QCS has the capability of delivering a fully-integrated transport system for the longer term and is a demonstrable quality improvement.

## **Economic, social and environmental considerations**

6.8. The statutory guidance is clear that emissions standards can be a service quality benefit and it is clear that emission standards will be improved under the QCS. The Board considered this a relevant improvement.

## **Discussion**

6.9. The operators argue that these quality improvements are not sustainable beyond the term of the QCS. The Board can find nothing in the statute that causes us to look beyond the contract period. The legislation simply requires that the proposed scheme will deliver quality benefits. The Board considers that it will **and this criterion is met**.

## 7. Criterion C – the Statute - Section 124 Transport Act 2000

### **124.— Quality contracts schemes.**

(1) A local transport authority, or two or more such authorities acting jointly, may make a quality contracts scheme covering the whole or any part of their area, or combined area, if they are satisfied that—

- (c) the proposed scheme will contribute to the implementation of the local transport policies of the authority or authorities,

### KEY REFERENCES

Document	Reference
Nexus Public Interest Test Report	B12
First witness statement of Catherine Massarella	F1:7
First witness statement of Tobyn Hughes	F1:2
The ITA Bus Strategy for Tyne & Wear 2012	H21

7.1. The requirements of this criterion are met if the proposed QCS contributes to any of the transport policies published by NECA. The QCS does not need to contribute to all of the transport policies, nor does it need to deliver any in full. The relevant policies are set out in The ITA Bus Strategy for Tyne & Wear 2012 and comprise of three key objectives:

- To arrest the decline in bus patronage
- To maintain (and preferably grow) accessibility
- To deliver better value for public money

7.2. The strategy document sets out 10 key deliverables that aim to deliver these objectives followed by three targets which are described as being necessary *“to judge how effective these deliverables will be”*. The three targets set for the bus strategy are:

- Increased total bus passenger journeys in Tyne & Wear from a baseline of 139 million to 149 million by 2022
- Maintain or increase the patronage of the Tyne & Wear population within 400m of a frequent (10 minute) daytime service at 56.8% by 2022
- Reduce the reliance of the bus network on public sector support from the benchmark of £0.49 in 2012

7.3. Operators point to the fact that the QCS is planned to make a deficit in its final year. It is argued that this means any contribution to these policies is not sustainable. It is, without doubt, of concern that the scheme is planned to conclude without being able to break even.

However, the Board's role is simply to give an opinion on the scheme's compliance with the statutory criteria. We see nothing in the statutory criteria that causes us to look beyond the term of the proposed QCS. Indeed there is nothing in the statutory criteria that allows us to look beyond the term of the proposed QCS. We also note that the duration of the relevant policies set out in the 2012 strategy document extends only to 2022. We therefore do not find that the "11<sup>th</sup> year argument" is relevant to our considerations, the 11<sup>th</sup> year being 2028.

### **Arresting the decline in bus patronage**

7.4. We have discussed bus patronage under Criterion A. It follows from our finding under that Criterion, that, for affordability reasons, the QCS has not demonstrated that it will arrest the decline in bus patronage.

### **Maintaining accessibility**

7.5. Whether or not the QCS maintains accessibility also depends on affordability. For that reason, the QCS has not demonstrated that it will maintain accessibility.

### **Better value for money**

7.6. It is clear from the table at paragraph 4.10 above, that the QCS performs significantly better than the *do minimum* in terms of economy, effectiveness and efficiency which are each value for money indicators. The QCS clearly contributes to this policy.

### **Fully integrated multi-modal public transport network**

7.7. By its very nature, this objective is not specifically assigned to any one mode for delivery. The QCS provides the opportunity for one coordinating organisation to collect and analyse data across all modes of transport across the entire network. It therefore enables effective network planning. In doing so, it creates the opportunity to contribute to this key deliverable of integration.

### **Conclusion**

7.8. Criterion C is satisfied.

## 8. Criterion D – the Statute - Section 124 Transport Act 2000

### **124.— Quality contracts schemes.**

(1) A local transport authority, or two or more such authorities acting jointly, may make a quality contracts scheme covering the whole or any part of their area, or combined area, if they are satisfied that—

- (d) The proposed scheme will contribute to the implementation of those policies in a way which is economic, efficient and effective

## KEY REFERENCES

Document	Reference
Nexus Public Interest Test Report	B12
Statutory Guidance	AB74
First witness statement of Stephen Hunter	F1.14
Second witness statement of Stephen Hunter	F1.15
Oxera (Stagecoach) report 30 January 2015 “The revised QCS proposal for Tyne & Wear: An independent economic assessment”	G2
Oxera (Stagecoach) rebuttal response (public interest criteria), 1 May 2015	G3
Oxera (Stagecoach) further response, 19 June 2015	G5
Oxera (Arriva) economic assessment of QCS proposal, 30 January 2015 and technical appendices	G7, G8
Expert Report of Bojana Ignjatovic, RBB Economics, 17 February 2015	G10
Supplemental report of Bojana Ignjatovic, 1 May 2015	G11
Experts statement of common ground	G12
Transcript Day 1, Gunnar Niels	I5
Transcript Day 2, Gunnar Niels, Bojana Ignjatovic, Dr Luis Correia da Silva, Joseph Bell	I6
Transcript Day 7, Stephen Hunter	I11
Transcript Day 9, Stephen Hunter	I13
Transcript Day 9, Tobyn Hughes	I13
AECOM Soft Measures Report, October 2009	H1
A1-3 user and provider impacts	H23

8.1. This is the first of the criterion for which it is necessary to conduct a comparison of the performance of the proposed QCS with that of the VPA. That is because, as the statutory guidance says, at paragraph 62:

*“the three E’s [i.e. economy, efficiency and effectiveness] are closely associated with the widely recognised concept of “value for money”. It is envisaged that an LTA would satisfy itself that a proposed QCS meets this criterion in the same way as it would show that any proposed action in other fields of its work will deliver good value for money, which you would generally do by assessing carefully the costs and*

*benefits that can reasonably be expected to arise from the proposals. It is also expected that the LTA's assessment of "economy, efficiency and effectiveness" would include some discussion of alternative options that had been considered and why they had been dismissed."*

8.2. The statutory guidance goes on to refer to National Audit Office definitions as follows:

- Economy:** minimising the cost of resources used or required
- Efficiency:** the relationship between the output from goods or services and the resources used to produce them
- Effectiveness:** the relationship between the intended actual results of public spending

8.3. Nexus has adopted this as follows:

- Economy:** PVC, the present value of costs represented by a negative figure
- Efficiency:** PVB, the present value of benefits, represented by a range of positive figures to reflect variability of outcomes
- Effectiveness:** represented as the ratio of effectiveness to economy (PVB/-PVC)

8.4. Nexus has also modelled the impact on the net present value (NPV) of the options. NPV is the sum of effectiveness and economy. The Board accepts that NPV is a commonly used measure informing the value for money of investment proposals. The Board therefore agrees that consideration of the NPV can be helpful, that no single measure could be taken alone and that the overall performance of each option needs to be considered in the round.

8.5. The modelling associated with the 3 Es is complex and detailed. However it has already been the subject of a very high level of scrutiny, most modelling errors have been ironed out and the approach, in general terms at least, is agreed. There remain relatively few areas of disagreement. We deal with each of those in turn now.

### **Soft measures – simplified ticketing**

8.6. The first issue of concern is the claim by the operators that Nexus has attributed too high a benefit to existing bus users in the QCS arising from the implementation of simplified ticketing. Nexus has used values of soft measures benefits that have been derived from the Department for Transport WebTAG and the Aecom study. This is best practice and is not contested. The concern relates to the way in which the methodology has been applied by Nexus and by their adviser Mr Hunter of Steer Davies Gleave. The Board heard much evidence on this matter both from the operators' expert witnesses and Mr Hunter.

8.7. The Aecom study<sup>31</sup> gives values in minutes relating to a number of soft benefits or quality improvements to bus services. These minutes are in fact notional and relate to the perceived benefit of customers. As Mr Maclean put it in cross-examination "sitting on a leather seat doesn't mean you get there any quicker". However, for simplicity, we refer to

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<sup>31</sup> H1

them simply as “minutes”. In relation to simplified ticketing, the Aecom study provides three values. There is a value of 0.84 minutes for existing bus users. There is a value of 2.06 minutes for existing car users. Finally there is a non-segmented value of 1.43 minutes. Nexus has applied the value of 1.43 minutes to all users when looking at the overall value of simplified ticketing on the bus network. Nexus accepts that the vast majority, some 97%, of bus journeys in the QCS will be existing bus journeys today. Mr Hunter was unwavering in his evidence that WebTAG allowed him to use the non-segmented value of 1.43 minutes. The Board has considered extensive written evidence on this matter from Mr Hunter, from Oxera Stagecoach, from Oxera for Arriva and from RBB for GNE. We have also read the relevant units of WebTAG and the Aecom study.

8.8. Perhaps the most useful base evidence appears in page 92 of the Aecom study where the relevance of the three separate values is discussed:

*“Table 6.6 sets out the values presented in table 6.5 segmented by bus and car users. This demonstrates the relative important (sic) each group places on each type of intervention. Generally, this represents intuitive values, for example these values suggest that bus users value interventions such as CCTV at bus stops, the in vehicle seating plan and climate control highly which reflects common safety and comfort concerns of bus users. Conversely the values suggest that car users place more relative importance on interventions including CCTV on bus, leather seats, new interchange facilities and simplified ticketing. This seems to be commensurate with the different concerns and expectations car users generally have of buses.”*

8.9. There is an explanation under Table 6.6 for the lack of segmented figures for some interventions:

*Only overall figures are presented for audio announcements, climate change and new bus shelters because the segmented bus and car user values obtained from the models are not statistically significant.*

8.10. The Board’s logical interpretation is that the segmented values are provided to be used wherever possible, particularly where the make-up of the passenger group is known. Non-segmented values are provided for when either the passenger group constituency is not known, or for those quality attributes for which the improvement was not statistically significant at individual bus and car user level. Mr Hunter may be correct in that WebTAG does not prohibit him from using his approach. We have not been pointed at anything within any of the guidance that makes such a prohibition. Mr Hunter also argues that the approach used by the operators’ experts conflicts with the “rule of a half”.

8.11. The “rule of a half” is explained in WebTAG unit A1 .3<sup>32</sup> at paragraph 2.1.4:

*“The service associated with making a journey will not be the same for everybody and depends on the benefit each individual derives from making that journey. Transport demand generally responds to changes in cost, with a reduction in cost leading to increased demand. It follows therefore, that the benefit associated with any new trips will be lower than that for trips that were already being made (or else they would have been made before the reduction in cost). Therefore, transport demand can be represented by a traditional, downward sloping demand curve where the demand curve shows the benefit associated with an additional trip at different levels of demand”*

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<sup>32</sup> H23



8.12. Mr Hunter refers us to paragraph 2.1.6 where there is a formula which sets out the rule of a half. We heard much evidence on this argument and supplementary written evidence was provided during the oral evidence sessions. Mr Hunter relies on the fact that the sample formula in paragraph 2.1.6 only include a single change in travel cost. He contends that he is therefore constrained to using only a single value. In doing so, he has adopted the non-segmented value which sits broadly midway between the values for existing bus users and existing car users, despite the fact that we know virtually all the users are existing bus users. Having considered the extensive evidence on the subject, the Board is inevitably drawn to paragraph 2.1.8 of the WebTAG unit which states:

*“In general, the true situation is highly complex compared with the above [i.e. the formula in paragraph 2.1.6 and its graphical depiction in 2.1.7]. The main substitutes and complements for travels from A to B are travel from A to other destinations, by other modes, using other routes and so on. However, provided that consistency can be achieved between the pattern of travel demand in the outturn, the rule of a half formula can be extended to cover network appraisal with many modes and origin/destination pairs.”*

8.13. Paragraph 2.1.8 therefore invites appraisers to use the rule of a half in a more sophisticated way. It appears logical that sophistication could be added by using the segmented, statistically significantly different, values for existing car and existing bus passengers and that this is highly likely to provide a more robust outcome. The situation, though, is complicated by the fact that the reference material refers to “bus users”, “car users” and “car available” passengers without apparently ever defining those terms, whereas the 3% uplift we know of is “bus journeys”. If one applies the segmented values using “car available” and “bus users” as the segments, one arrives at broadly similar outcomes to Mr Hunter.

8.14. As we have discussed earlier, our role is to consider whether or not the approach taken by Nexus is reasonable and justifiable in terms of the elements that make up their case. Having reviewed all the guidance, the base research, and the arguments from all parties, our view is that there are justifiable arguments for using either the segmented value or non-segmented value. We therefore find Nexus’ approach to be reasonable, if not cautious.

8.15. Operators complain that Nexus has applied the benefits of simplified ticketing to concessionary passengers who will not buy a ticket. This arises because the combined value of benefits of simplified ticketing at 1.43 minutes (as used by Nexus) and 0.88 minutes for a customer charter is applied to all passengers. Mr Hunter addresses this in his first witness statement where, at paragraph 115 he says:

*“The improvement in passenger quality brought about by the Tyne & Wear QCS is being represented within Nexus’ QCS Affordability Model as a package of soft measures valued in minutes. This package is based upon the Aecom values (see figure 1) for the attributes of customer charter (0.88 minutes) and simplified ticketing (1.43 minutes) giving a combined value of 2.31 minutes. Although the customer charter and simplified ticketing are attributes of the Tyne & Wear QCS which have been valued by Aecom, they are not the only soft measures benefits of the QCS. Consequently, the value of 2.31 minutes should be seen as a conservative proxy measure of the value of all the soft measures introduced by the QCS, not only the customer charter and simplified ticketing”*

And, at paragraph 117:

*“Within the value for money modelling, the value of the soft measures package represents the overall improvement in passenger quality from the Do Minimum to the Quality Contract Scheme.”*

8.16. Mr Hunter’s witness statement<sup>33</sup> appears to be the first formal time that the soft measures benefits have been expressed in this way. The Public Interest Test of October 2014, paragraph 1.6.2 (g) states:

*“The Nexus Affordability Model also takes into account an anticipated increase in demand resulting from certain improvements for passengers that will be introduced by the QCS. These are collectively known as “soft measures” and were examined in the DfT study. The two soft measures incorporating the QCS demand forecast, applicable from the first year of contract operation, are:*

- I. Customer charter...; and*
- II. Simplified ticketing”*

8.17. Paragraph 5 of the Public Interest Test report deals with criterion D. It explains the approach at 5.2.1(a)(iii) thus:

*“The most appropriate methodology for undertaking this assessment is the guidance set out in DFT’s WebTAG, which is well-established and has direct relevance to transport intervention such as the QCS.”*

At 5.2.2 (d), it says:

*“The value for money appraisal framework developed for this proposal is based on the Nexus Affordability Model described in section 1.6. It includes the aspects of the QCS which have been quantified within the model, comparing them to the do minimum scenario. Nexus considers that this represents a balanced and robust assessment of the costs of setting up and operating the QCS for a 10 year period, and the benefits that arise from the QCS, insofar as these have been monetised. The results of this appraisal have been used to inform Nexus’ judgement and recommendation to the NECA.”*

At 5.2.2 (g):

*The approach includes passenger travel time and fare change impacts, in addition to the costs and revenues represented in the Nexus Affordability Model. Time savings in this context can include: journey time improvements; wait or walk time savings (from frequency or bus stop location changes); and time-saving “equivalents” for other interventions, for example the quality package representing customer charter and simplified ticketing proposals, as specified in appraisal guidance. The impact represented is the “net benefit”, taking into account reductions and increases in units of “in vehicle travel minutes” and also the balance with any changes in the fare paid. The total benefit is a function of the scale of all the benefits (and disbenefits) and the number of passengers receiving them. Time impacts are converted into monetary*

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<sup>33</sup> F1 14

*terms by the application of appropriate values of time (£ per hour) as set out in WebTAG, which vary by journey purpose and change over time. (Emphasis added)*

8.18. As the Public Interest Test report<sup>34</sup> says that the value for money modelling relies upon the affordability modelling, it is instructive to consider what is written in the affordability analysis of October 2014. At paragraph 3.9.1, it says this in relation to Soft Measures:

*“Nexus has given credit to both the QCS and VPA proposals in terms of increasing demand for services from the use of “soft measures”. Please see the public interest test report, sections 1.6.2 (g) and (h), for an explanation of the treatment of soft measures within the affordability modelling. Within the QCS Nexus has applied a demand uplift resulting from the introduction of a customer charter and simplified ticketing, whilst the VPA proposal benefits from the same customer charter uplift, but not from a simplified ticketing uplift since simplified ticketing is not offered by the VPA” (emphasis added)*

8.19. Further, in relation to any wider package of benefits for the QCS, it is necessary to take account of what is written in appendix 3 of the Public Interest Test report. Soft measures fall under section 6 of that appendix which is described as an impacts comparison table for the *do minimum*, VPA and QCS. The comparison falls as follows:

<b>Bus strategy objectives/deliverables</b> Key indicators for each objective	<b>do minimum</b>	<b>VPA proposal</b>	<b>QCS</b>
Soft measures	Operators are likely to progressively rollout soft measures designed to increase patronage, including but not limited to, audiovisual next stop announcements, plugs for laptops and mobile phones, free customer Wi-Fi, improved seating. Investments made in accordance with commercial needs	VPA commits operators to equip new buses in the T&W fleet with free customer Wi-Fi, to operate on appropriate routes. Otherwise as <i>do minimum</i>	Provision of soft measures such as those in the do minimum to be incentivised through procurement process but cannot be guaranteed. Quality contracts will maintain the flexibility to allow installation of new innovations and equipment to QCS buses, subject to funding availability.

8.20. It is clear from all these core scheme documents, documents which formed the basis of the NECA decision, that the only soft measures modelled were simplified ticketing and customer charter. We can find no reference in any of the formal documentation relating to these acting as some form of proxy for a wider basket of measures. The comparison table at appendix 3 of the Public Interest Test report makes no claims to any further soft measures benefits for the QCS over and above the *do minimum*. It is difficult to avoid the conclusion that Mr Hunter’s assertion that simplified ticketing and customer charter were used as a proxy for a wider package of measures is simply reverse engineering. We can find no evidence to support the contention that the 2.31 minutes is somehow a supportable proxy for some wider package of measures. That leads us to conclude that Nexus has been in error in applying the benefits of simplified ticketing to passengers who do not buy tickets.

<sup>34</sup> B12

8.21. The final area of concern in relation to simplified ticketing is the degree in which it is already in place, or will be in place, in the *do minimum* and the VPA, and therefore whether the full values from the Aecom study can be ascribed to the QCS whilst zero is ascribed to the *do minimum* and VPA. This is set out in appendix 3 of the Public Interest Test report. Simplified Ticketing falls under section 9 of that appendix. The QCS offers a broad range of benefits, simplifying fare structures, providing full interoperability across transport modes, a daily fare, all delivered on a single smartcard which allows for both season ticket and pay-as-you-go purchases. When the QCS was designed, this was clearly a major improvement on the existing offer and Nexus sets out its assessment of the market at that time on page 55 of the Public Interest Test report:

*“Nexus is not aware of any proposals to introduce smart ticketing in the D M scenario beyond that already achieved through NESTI and offered by operators, therefore no change to demand is anticipated as a result”*

8.22. We do not criticise Nexus for applying the full Aecom value for simplified ticketing at that time. The problem arises because, as Mr Montgomery told us, fares and ticketing is the fastest moving element of public passenger travel at the moment. It is apparent from the evidence of Mr Montgomery that the *do minimum* option will be greatly enhanced, and those enhancements could potentially be in place before a QCS. It is therefore necessary, given the very recent progress in fares and ticketing, for a reduction to be applied to the Aecom value used in the QCS. In doing so, we note that the QCS offer will still be stronger particularly across modes, and it appears to us that delivering a daily fare cap across different operators and transport modes in a commercial environment will be challenging. We would recommend that Nexus conduct further analysis given the recent changes to the *do minimum*, but for the purposes of this report, we apply a modest 12.5% discount to the simplified ticketing value. Note that this affects only Criterion D in relation to the value for money comparison between the QCS, the *do minimum* and the VPA. Any patronage increase arrived from simplified ticketing will still exist regardless of whether the simplified ticketing has come about through the QCS or the business-as-usual commercial activities of the operators.

## **Customer Charter**

8.23. Nexus has applied a soft measures benefit of 0.88 minutes for the introduction of a single customer charter for all transport modes. The characteristics of the customer charter are set out in paragraph 3.3.5 (c) of the Public Interest Test:

- i. A single customer charter with a single point of contact for each channel of communication (telephone, email and letter) will be available for all QCS services;
- ii. The customer charter will provide details of what passengers can expect on any QCS service, as well as details of how to complain when they feel the charter has been breached. Refunds will be available for passengers in certain defined circumstances. Importantly the customer charter will set out the expected standards of performance of the punctuality, reliability and customer’s satisfaction, and updates on performance will be produced each period. Customers will therefore be able to see what operational standards they can expect from bus services, have confidence that those standards are contractually required to be delivered, and hold both Nexus and operators to account on the occasions that performance does not achieve the required standard;

- iii. Operators will have their level of complaints measured for each contract and examined during contract management meetings. Where poor performance and/or recurring complaints are observed, corrective action will be required;
- iv. The QCS will provide a single central means of reclaiming property lost on all QCS services;
- v. Where vulnerable passengers are not able to make their journey due to the failure of a QCS service, an alternative means of travel will be provided as long as the passenger advises Nexus of their problem. This is an enhancement on the provisions within the customer charters of current operators; and
- vi. The customer charter will mandate all operators to display notices on the QCS vehicles that detail performance against key performance indicators, both of that operator and across the QCS as a whole.

8.24. This customer charter has much to commend it. There are two issues that arise. The first is the degree to which this customer charter goes beyond that already in place in the main bus operators. We were told, for example, that Stagecoach buses in Tyne & Wear carry posters showing their punctuality. Where punctuality falls below prescribed standards<sup>35</sup> an operator can be referred to the Traffic Commissioner. Traffic Commissioners have the power to fine operators where punctuality is poor, stop them from operating services, or make a range of other interventions.

8.25. Secondly, it is notable that the Aecom study was based on the introduction of the customer charter by GNE. There is, as Ms Ignjatovic<sup>36</sup> put it a “black hole” in terms of information relating to the value of the QCS customer charter above that used in the core research study. The second issue we have is with the robustness of the 0.88 minute figure in the first place. The Aecom study which derived the 0.88 minute figure does not provide a figure to be used in modelling. At paragraph 6.2, it says

*“no figures have been provided for the introduction of a customer charter or leather seats because user valuations of these factors are not statistically different from zero.”*

8.26. Because of its lack of statistical significance, the customer charter does not appear in WebTAG table 3.2.1. Its use therefore appears inconsistent with the approach set out by Mr Hunter. Using a figure that is not statistically significant from zero, which does not appear in the DfT WebTAG guidance and which does not in itself appear applicable to the current change from an existing customer charter to a common customer charter appears unsound and unfounded. We note that Mr Hunter has recently advanced the argument that the combined figures for simplified ticketing and customer charter are simply a proxy for some other package of measures. As can be seen from the discussion at paragraph 8.14 to paragraph 8.18 above, there is nothing in the core documents describing the Tyne & Wear quality contract scheme that were put to the North East Combined Authority in October 2014 that suggests these figures were a proxy for a wider package of quality contract benefits. To the contrary, the derivation of the figures was clear and there was no claim of any wider soft measures benefit. That is a recent contention unsupported by any wider

<sup>35</sup> Broadly speaking, where fewer than 95% of services operate within a window of tolerance of one minute early, five minutes late, without reasonable excuse. See the Senior Traffic Commissioners Statutory Guidance and Statutory Directions, available on the gov.uk website

<sup>36</sup> 2:101:15

analysis or description of those wider benefits other than mere assertion on the part of Messrs Hughes and Hunter. That is not enough to make a business case and the soft measures benefits associated with a customer charter are not demonstrated and we find it unreasonable to include them.

### Cumulative impact on economic performance of the QCS

2010 GDP real market prices and values	Nexus March 2015 <sup>37</sup>	Removal of simplified ticketing benefits from those who do not buy tickets	12.5% discount as some simplified ticketing benefits in <i>do minimum</i> and VPA	Removal of customer charter benefits
Economy	-£121M	-£121M	-£121M	-£121M
Effectiveness	£406M	£361M	£341M	£251M
Efficiency	3.52	2.98	2.82	2.07
NPV	£293M	£240M	£220M	£130M

### VPA – 50 additional buses

8.27. The version of VPA proposed by the operators and before the Board includes provision for 50 additional buses into the network. The benefits arising from these new buses was originally modelled using a KickStart approach based on the X47 KickStart scheme. Nexus was concerned that the data was based upon an analysis of a single Kickstart scheme, and did not give any consideration to whether that scheme is comparable to the route and circumstances where additional buses would be deployed. The operators responded by modelling the benefits using a service elasticity approach and for a period of time this was accepted. However, in the statement of common ground provided to the Board on the first day of the hearing, the position was that the approach was no longer agreed. The argument turned round the use of short run and long run elasticities and whose approach aligned with the Black Book<sup>38</sup>. The debate became known as the “juvenile giraffe” question based on this extract from the Oxera Stagecoach June report:

*“Mr Clarke has misinterpreted what the Black Book is suggesting. This distinction is a simple one: by way of example, the juvenile (short-run) height of giraffe might be estimated in the first year of its birth. The full-grown (long-run) height of a giraffe might be estimated after 10 years or so from its birth. This does not imply that, until it reaches the age of 10, a giraffe remains the same size as it was when it was only one-year-old. Yet, as we will show, this is exactly the form of reasoning Mr Clarke applies in his second witness statement.”*

8.28. The issue was fully debated and ultimately accepted by Nexus. There are two further issues with the treatment of the benefits arising from the 50 additional buses. Nexus remains highly sceptical of the deliverability of these benefits. That may well be the case,

<sup>37</sup> Note that the median efficiency ratio and NPV are separately calculated within the Nexus value for money model and are not therefore the sum and ratio of the PVC and PVB in this table

<sup>38</sup> The Black Book refers to TRL Report TRL593, “The demand for public transport: a practical guide”

but the modelling that produces the benefit figures is as robust as that used throughout the process. The Board has no doubt that, should the operators enter into a VPA, they would deliver the promise to introduce the additional buses. They are highly likely to do so on the routes most likely to give a higher rate of return. We see no reason therefore to discount the level of benefit that derives. The second issue arose on the final morning of the hearings and related to Stagecoach already having taken delivery of a number of additional VPA buses. Mr Hunter said this:<sup>39</sup>

*“So the two columns which are useful to compare in this are the second and third columns, where we’ve got consistent May 2015 values for the VPA with 50 buses and the VPA without any buses. Everything about appraisal is always representing this step. So the step on the day in this case the day that the VPA is introduced, whether it brings 50 buses. Now, if some of those buses are included in the network already, and it can’t be said that it is the VPA that is bringing those buses.”*

8.29. This appeared to generate a degree of surprise on all sides of the room. There is no doubt that Mr Hunter’s position is technically correct. However it raises a number of issues. It does indeed mean, from a technical perspective, that a further 50 additional buses now need to be provided as part of the VPA. It also means that the 50 buses now go into the *do minimum* scenario. Finally, it exposes a major weakness in Nexus’ current position, in that operators, any operator, appears free to introduce as many buses as they wish to the Tyne and Wear network and all those buses will become contracted from the date the QCS becomes live. We have discussed this risk earlier in the report. It is extremely unhelpful for Nexus, or Mr Hunter, to introduce this new approach at this stage. It was not possible for any of the operator witnesses to address it. It has been a characteristic of this process that new evidence or new approaches have been introduced almost at will by Nexus. In this instance, it is simply too late to introduce this new argument and the Board disregards it.

8.30. For all these reasons, we adopt the economic assessment of the VPA, including 50 buses, made by Mr Hunter in March 2015, less the reduction in benefit for the customer charter using the value (-£110 M) from the statement of common ground:

2010 GDP real market prices and values	VPA
Economy	-£47M
Effectiveness	£190M
Efficiency	4.04
NPV	£141M

8.31. The effectiveness of the QCS has been significantly overstated due to errors within the modelling. In particular, Nexus attributed benefits associated with simplified ticketing to passengers who did not buy a ticket. We reject, as reverse engineering, the latest version of events that simplified ticketing and customer charter were simply a proxy for a wider package of benefits. That assertion is not supported by any of the core documentation of the scheme. **It is our opinion that Section 124(1)(d) TA2000 is not met.**

<sup>39</sup> 9:70:2

## 9. Criterion E – the Statute - Section 124 Transport Act 2000

### **124.— Quality contracts schemes.**

(1) A local transport authority, or two or more such authorities acting jointly, may make a quality contracts scheme covering the whole or any part of their area, or combined area, if they are satisfied that—

(e) any adverse effects of the proposed scheme on operators will be proportionate to the improvement in the well-being of persons living or working in the area to which the proposed scheme relates and, in particular, to the achievement of the objectives mentioned in paragraphs (a) to (D).

### **KEY REFERENCES**

<b>Document</b>	<b>Reference</b>
Nexus Public Interest Test Report	B12
Nexus closing submissions	
Stagecoach closing submissions	
Confidential transcript day 5, witnesses John Hamilton and Edward Spencer	I9A
Confidential report of Edward Spencer of Barnett Waddingham	F1.16
First and second witness statements of Robert Montgomery	E1.8, E1.9
First witness statement of John Hamilton	E1.10
Pensions funding implications paper by Hymans Robertson	E2 F
Transcript day 4 Kevin Carr	I8
Transcript Day 9 Tobyn Hughes	I13
Letter from NEBOA to Nexus (dated 9 July) and enclosed clarification document	I32

9.1. The statutory guidance describes criterion E as “a key safeguard for the legitimate interests of existing bus operators” and says its inclusion in the five public interest criteria “recognises that a QCS could have a substantial adverse impact on these operators”. Guidance says that the local transport authority must show that it has identified the nature of any adverse effects, the likelihood of those effects arising and the likely scale of impact of the adverse effects identified. It notes that it may not be necessary or possible to place a cash value on each impact identified, but indicates the local transport authority should be able to gauge the scale of the impact in relation to the overall size of the business in question.

9.2. The guidance says that relevant benefits “could include benefits to existing bus passengers, to those who switch from other modes to the bus as a result of improvements to bus services, to users of other modes who benefit (e.g. motorists who benefit from reduced traffic congestion because the QCS has encouraged modal shift) and the local residents and others who benefit from environmental improvements such as improved air quality”.

9.3. Finally, the guidance sets out that it is the role of the QCS Board to consider:



- Whether the LTA has properly identified the significant adverse impacts on operators that might arise and made a reasonable assessment of the potential severity of those impacts and their likelihood of arising. If the LTA has failed to take into account adverse impacts which may be significant enough to change the overall judgement of proportionality, the QCS Board may conclude that (in its opinion) the criterion is not met.
- Whether the LTA has formed a reasonable assessment of the likely benefits to persons living or working within the area of the scheme. If the Board concludes that the assessment is unreasonably optimistic, to the extent that the LTA's overall judgement proportionality may be affected, the QCS Board may again conclude that (in its opinion) the criterion is not met.
- Whether the LTA has acted reasonably in concluding, on the basis of all the evidence available to it (including evidence submitted by bus operators in their consultation responses), that the identified adverse impacts are proportionate to the identified benefits.

9.4. Nexus sets out the adverse impact on operators in section 6.3 of the Public Interest Test and has done so using the following headings:

- i. Loss of profits (including those caused by increased costs) and loss of business value;
- ii. Operational losses under QCS contracts;
- iii. Cost of complying with higher specification;
- iv. Stranded assets;
- v. Cross boundary operations;
- vi. Wasted bid costs;
- vii. TUPE and redundancy costs; and
- viii. Pensions.

9.5. The Board notes that not all operators have provided information to allow Nexus to make informed judgements, and there were no responses to the consultation from smaller operators. We agree with Nexus that there will be winners and losers. Our role, however, is to focus on the adverse effects on incumbent operators. We are satisfied that these have been understated in a number of areas, for example in relation to costs associated with bus depots which are no longer viable. Much of the evidence is confidential in nature. We do not find it necessary to rehearse it here specifically, as, whilst there are financial effects, the scale of the figures accepted by Nexus are sufficient to allow us to conclude our findings under this criterion. The one exception to this is an issue raised solely by one operator in relation to pension schemes. A discussion of that issue is in Appendix 2 which is confidential to that operator and Nexus. Once again, though, we do not need to disclose that figure here. Our conclusion is adequately supported by the figures in the Public Interest Test report where the range of quantifiable adverse effects was identified as lying between

£85.3 million and £226.7 million. It was considered unlikely that either the maximum or minimum adverse effects would occur. The adverse effects are highly dependent on the outcome of the procurement process for the quality contracts. The mean figure is £156 million.

9.6. Nexus has conducted an assessment of the likely benefits to persons living or working within the area of the scheme at paragraph 6.4 of the Public Interest Test. To the extent that these are monetised, they are affected by our findings under criterion D where, to use Nexus' preferred metric, the NPV of the QCS is found to be £130 million, and of the VPA is found to be £141 million.

9.7. This criterion looks at benefits wider than those considered under Criterion D in that it considers the impacts of the QCS on the entire community of people who live or work within the area. Nexus sets out at paragraph 6.4.2 the negative effects of the *do minimum* scenario which it says arise from:

- i. Fewer people able to afford regular travel by bus because of significant fare increases;and
- ii. Fewer opportunities to travel by bus because of fewer bus services.

9.8. Nexus goes on to list a range of effects including matters such as congestion affecting air quality, reduced access to employment, and a reduction in the ability of citizens to participate in education, healthcare, and retail and social communities. Greater public expenditure on bus will be required. That will lead to local councils having to increase the levy contributions to the NECA which may require them to divert funds from other expenditure generating a further detrimental consequence on well-being.

9.9. The Board fully endorses that a quality contracts scheme that delivers a coherent integrated and accessible transport system can contribute very significantly to the well-being of those who live and work within the area, whilst those intangible benefits do not lend themselves readily to being quantified financially. In coming to our finding of this criterion, we give Nexus significant credit for compiling a proposed scheme that genuinely aims to, and has the potential to, improve the lives of Tyne & Wear citizens.

9.10. Nexus' assessment of improvements in well-being generated by the QCS run from pages 257 to 280 inclusive of the Public Interest Test report. In contrast, the assessment of the comparable benefits for the VPA takes place over just 3 ½ pages. It is acknowledged at paragraph 6.5.9(c) that:

*“the benefits that arise from the VPA proposal are therefore not simply desirable in their own right, they are also expected to deliver a bus network as a facilitator of additional social and environmental benefits to the local area-these benefits go beyond those that have been monetised.”*

9.11. The Public Interest Test report then goes on to list the benefits to include improving access to jobs and training, improving health, improving environment, improving journey quality and providing greater option values. However at paragraph 6.5.10(b), Nexus tempers its enthusiasm for the VPA:

*“Nexus has examined the VPA in detail and has concerns about the deliverability of various aspects of the VPA proposal, as well as concerns about the way in which the*

*VPA proposal can be terminated in various circumstances. Furthermore, there are concerns that the current draft of the VPA proposal, which is offered by NEBOA as a best and final offer, contains clauses that Nexus is unable to commit to.”*

9.12. On 9 July, the Thursday before the Monday morning on which the oral evidence sessions began, NEBOA wrote to Pat Ritchie, chief executive of Newcastle City Council, addressing the termination arrangements in the draft VPA. That letter said the following:

*“During discussions on the VPA, Nexus expressed the view that they would like to see the VPA drawn up in legal form. That process led to the drafting of a series of termination clauses which have been interpreted by Nexus as indicating a lack of commitment to the VPA by operators. I now write to confirm that NEBOA would be happy to revisit those termination clauses to properly reflect the spirit of partnership and commitment in which NEBOA would enter VPA with Nexus.*

*For example, in the event of material changes to the funding landscape et cetera, NEBOA would engage in constructive discussions with Nexus to reflect their impact on the VPA rather than terminate and, similarly, NEBOA would be happy to confirm that, prior to its expiry, NEBOA would engage in constructive discussions on a successor agreement.”*

9.13. We can't help but note that the timing of this letter is not atypical of the bus operators' apparent reluctance to offer concessions until the last possible moment. The operators have throughout criticised Nexus for providing information late. It would appear that their own approach has, at times at least, not been dissimilar. This late concession was put in cross-examination by Mr Pereira to Kevin Carr, chair of NEBOA<sup>40</sup>:

*Q. Termination arrangements. You know that this has been a great concern of Nexus from an early stage, the various terminations?*

*A. Not from an early stage. I think when we got the VPA3, I think it was, was when it was first raised as an issue. I think the VPA process, we started off with the VPA that was very much customer focused. The VPA was all about improving and increasing passenger numbers, and if you look at the Better By Far document that was produced at that time, it was all about the customer and how we were going to try and improve.*

*As negotiations or discussions continued, it became very clear that it was a funding issue, and the emphasis moved away from the customer, from Nexus' point of view, not ours, in terms of how we can fill the funding gap. At that point in time it was determined that we needed to legalise the document because it was very much a customer facing document with lots of commercial initiatives in it. At that point the termination clauses arose.*

*What we are saying at this point in time is we are happy to review those clauses with Nexus and agree some further wording or some changes to the wording. I think in hindsight - hindsight is a wonderful thing – the intention was never to put termination clauses in that indicated that the VPA would be surrendered or cancelled at the whim. It was always intended that we were genuine in our approach. So I think it's because we legalised the document that those termination clauses arose, we are happy to discuss those and change them accordingly.*

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<sup>40</sup> 4:132:11

*Q. One person's early may be another person's late. There's a letter, for example, at appendix 23 of Mr Hughes' statement.*

*"13 November 2012:*

*Dear Kevin, partnership proposal from NEBOA... Write further to the letter of 29 October 2012."*

*We can see that the first heading there dealing with the concerned is about enforceability and termination and that's 13 November. That's 2 ½ years ago*

9.14. Nexus' concern at the termination clauses has been flagged, in one form or another, for a considerable period of time. They appear to have been properly addressed only two working days before the oral evidence sessions began. The Board can then have significant sympathy with the view of Nexus that some of the benefits of the VPA may not have materialised. It follows that we understand why Nexus might have held the position that the benefits in the QCS were more certain to be delivered than those in the VPA. We now have on record that NEBOA is willing to revisit those clauses, and can continue to understand why Nexus may be sceptical of the chances of coming to a mutual agreement.

9.15. Nexus' continuing concern with the VPA was confirmed in cross examination of Tobyn Hughes by Mr Ward<sup>41</sup>:

*Q. I'd simply put to you this is the first of many examples we are going to talk about where your view is just unduly gloomy of the prospects for constructive cooperation*

*A. Well, that's your view. My view that we require some certainty if we are to introduce benefits to local people and to maintain the bus network that we've got and the benefits it provides.*

*Q. That's the certainty that you believe will be achieved through the QCS?*

*A. It is indeed*

And further<sup>42</sup>:

*Q. What I want to suggest to you is that that [the VPA] is more flexible and represents a sensible balance between commercial freedom and the need to consult with local public authorities. Would you accept that?*

*A. I certainly wouldn't, I'm afraid, no, and I don't think you expected me to*

*Q. I'm disappointed but not surprised*

*A. I think I'd challenge one of your opening statements that it's a more balanced method of achieving the flexibility of the network. I don't see that as more balanced. I see it very much more in the camp of the bus operators to continue what they do today, which is to determine which routes are appropriate to serve, serve the demand*

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<sup>41</sup> 9:98:18

<sup>42</sup> 9:101:22

*that they perceive needs to be served, and to adjust fares in the way that commercially they consider they need to be adjusted.*

*In the current environment that is how it works, and I don't have a criticism of how it operates in the current environment. But in the VPA we're seeking a balanced approach to it and we are seeking - we were at least, sorry, during the discussions, seeking an approach where the public authorities, who do after all contribute a significant amount of funding to the bus network each year, and whose residents have their well-being affected by what the bus network delivers, we were seeking an ability for the local authorities to be able to influence those decisions.*

*The processes that you've described we don't judge do achieve that. For example, the provision of information about fare increases that you describe, this is not any form of regulatory pricing, voluntary or otherwise. This is the bus companies in a private discussion coming to Nexus, and saying: this is what we are doing with fares, Nexus saying: Right, thank you. Because it's confidential information, Nexus can't actually provide information to the NECA, and the NECA, even if it took a view, is unable to have any influence on what the effect is. I'm not sure that helps us in any way, shape or form.*

Q. *I think –*

A. *The changes to the bus network operate in a similar way. There is discussion and consultation which we welcomed, because more consultation and involvement than there is today is always a good thing. However, in terms of any influence, any meaningful influence that the NECA would have over the changes to bus services doesn't appear to us to be present.*

And finally<sup>43</sup>:

Q. *What you're really saying, I think, Mr Hughes, is that you don't regard this as meaningful because it doesn't give Nexus a veto, is that fair?*

A. *Substitute the word "Nexus" with the word "NECA" - -*

Q. *Sure*

A. *- - Yes*

9.16. It is clear from this exchange that Nexus values **control** over the entire bus network and that is an entirely understandable proposition. It is our view that a QCS is best-placed to offer local authorities the ability to design and deliver effective integrated transport systems for their citizens.

9.17. We must now consider whether Nexus has acted reasonably in concluding, on the basis of all the evidence available, that the identified adverse impacts are proportionate to the identified benefits. Nexus sets out its approach to assessing proportionality in paragraph 6.6.1 (g) of the Public Interest Test report. It relies on a recent case of *Bank Mellat*<sup>44</sup> where Lord Sumption set out the relevant tests. Nexus states these in a "suitably amended" form as:

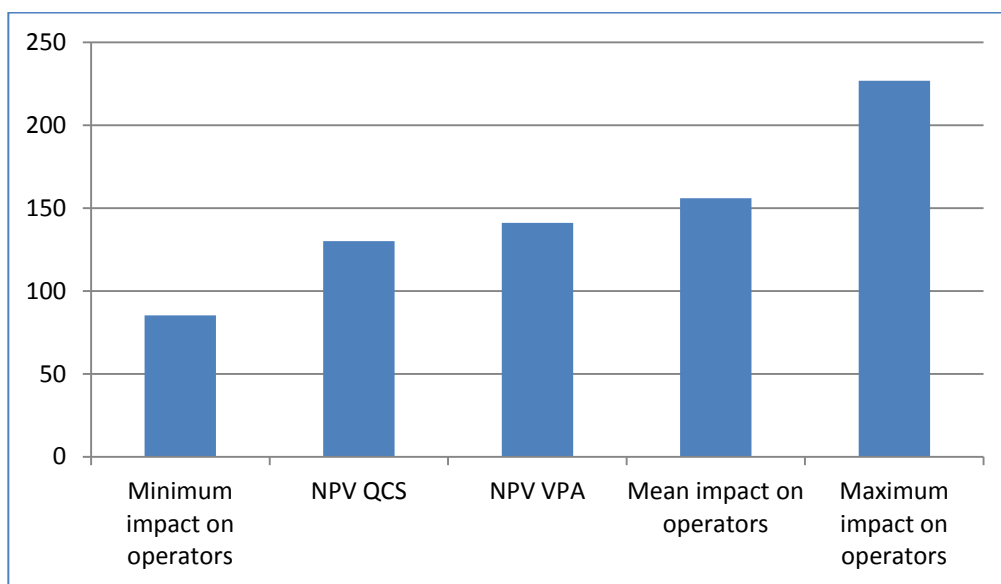
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<sup>43</sup> 9:110:25

<sup>44</sup> *Bank Mellat v HM Treasury* (No 2) [2013] 3 WLR 179

- i. Whether the objectives sought to be achieved through the QCS are sufficiently important to justify the adverse effects on operators;
- ii. Whether the QCS is rationally connected to those objectives;
- iii. Whether a potentially less intrusive measure, such as a VPA, could have been used; and
- iv. Whether, having regard to these matters and to the severity of the consequences, a fair balance has been struck between the rights of the operators and the interests of the persons living and working in the QCS area.

9.18. We deal with each of these in turn. In terms of the first test, we find appropriate to consider here narrower, monetised benefits of the QCS proposal, the VPA and compare them to the range of impacts on operators:



9.19. It is clear that the central case net present value of the QCS lies well below even the mean impact on operators as stated in the Public Interest Test, and not corrected for the issues we have found in relation to an operator’s pension schemes, nor is it corrected for any of the other areas where the operators believe the impact is understated.

9.20. It is not questioned that the QCS is rationally aligned with the strategic objectives and we have covered that in criterion C above.

9.21. We turn now to consideration of the VPA. We have set out above where Nexus considers that the VPA has benefits to offer above those that have been monetised, and heading towards the benefits that can be delivered by the QCS. We have also set out, in particular from the evidence of Mr Hughes, why Nexus believes the VPA will fail to deliver those benefits. We of course now have the benefit of the 9 July 2015 letter from NEBOA to the chief executive of Newcastle City Council and Mr Hughes accepted in his evidence that the letter represented progress, at least in relation to the ticketing offer<sup>45</sup>:

<sup>45</sup> 9:201:15

*“The first thing to say is it’s welcome - and Mr Montgomery said that it was a result of a conversation that he and I had a few weeks ago, where I said: look, you keep on making pronouncements about smart, but we haven’t actually had in writing if it affects the VPA. So I welcome the fact that NEBOA have put this forward..... So I would hope that we can have discussions with NEBOA to explore what this means, and with NTL perhaps, in a bit more detail. But, on the face of it, it offers a price cap for most journeys, and that moves the VPA4 offer along a little bit.”*

9.22. Given that the monetised benefits of the VPA now exceeds those of the QCS, that it is accepted that the VPA offers wider benefits in terms of well-being, and there has been an, albeit last-minute, written commitment to develop the termination clauses and to work on a smart, simplified ticketing arrangement that is moving very close to Nexus’ vision, it does appear that a less intrusive option is available.

9.23. The scale of impact on the operators ranges from £85 million to £226 million. No compensation to the operators is on offer. Whilst there are wider benefits to the travelling community of Tyne & Wear, these are largely intangible and, apart from where they contribute to patronage growth, they are unlikely to be demonstrated to have been delivered, particularly where they rely on the soft measures. Even if the benefits, described as the NPV, significantly exceeded the potential impact on operators, we do not consider that they can be compared like for like. We remind ourselves what is said at paragraph 67 of the statutory guidance:

*“In reaching this judgement, it would be appropriate for the LTA to attach different weight to different benefits and adverse impacts, according to the likelihood of those benefits and adverse impacts arising in practice.”*

9.24. Apparent value for money benefits that accrue from minutes and fractions of minutes per journey multiplied by hundreds of millions of journeys are, we consider, unlikely in practice to be perceived as in any way transformative by the travelling public. When we add to that the considerable uncertainty relating to the various interpretations of the Aecom study, including that the study considered changes to individual services rather than at a network-wide level, our confidence that the soft measures will deliver real tangible benefits of the scale set out cannot be high.

9.25. On the other hand, the operators have demonstrated that at least the minimum level of impact is highly likely to occur. Indeed it is Nexus’s own assessment within the Public Interest Test, that neither the highest nor the lowest levels of impact are likely to happen. It follows that we should consider an order of magnitude of impact around about the mean which is £156 million. The Board finds it highly unlikely Parliament intended implementation of quality contracts schemes to lead to hard cash impacts of that order of magnitude on individual businesses. It is worth recording here, that we have seen no evidence that persuades us that the size of the parent groups is a relevant consideration.

9.26. To give the maximum impact figure of £226 million some context, Barclays was fined £284 million in 2015 for allowing its staff to manipulate the foreign exchange markets. This was the largest fine ever imposed by the Financial Conduct Authority following serious and systemic failings over a period of about six years. In the case of the QCS, of course, there is no allegation of wrongdoing against the bus companies although some are clearly unhappy at the level of profits made by one. To risk imposing a financial impact of a similar order of magnitude as that imposed on a bank for interfering with foreign exchange markets is clearly massively disproportionate. We repeat that we do not consider that Parliament ever

had in its mind that incumbent bus operators would be subject to losses of this scale without compensation. We therefore find that the impact on the operators is wholly disproportionate in relation to the benefits to both the travelling public and the wider citizens of Tyne & Wear.

**9.27. Criterion E is not met.**



## Summary of the QCS Board's Opinion

10.1. This is the first time that the 15-year-old legislation supporting Quality Contract Schemes has been put to the test. It seems to us, that the legislators probably had in mind that it would be tested in a rather smaller scale first. The scale of the Tyne & Wear proposal is large. The proposal is enormously ambitious and could, if delivered successfully and the risks don't materialise, provide Tyne & Wear with a transport system unrivalled in Great Britain outside London.

10.2. By its very nature, virtually everything that Nexus was trying to assess was a novel intervention. There was little, if any, truly relevant research for them to draw upon. It is the Board's view that they have done exceptionally well to get where they have got to today. It is always far easier to criticise, than to create. Appendix 3 deals with some of the learning points we have found in our consideration of the proposal.

10.3. In the VPA, Nexus can be proud that it has led three bus companies to put forward a proposal that is in itself novel and groundbreaking, with the makings of potentially effective governance allowing local citizens real influence over their bus services. From our understanding, it is likely that there will be clauses in the forthcoming Buses Bill that could allow, should they wish to, Nexus to establish greater certainty through a new version of a statutory quality partnership. It is against that very difficult background, and recognising the immense progress made by Nexus, that we set out here a summary of our findings.

## Consultation

10.4. It is our opinion that Nexus fails to comply with the statutory requirements on consultation set out in Section 125 of TA2000. This is primarily because the representation of the difference in scale of benefits between the QCS, and the VPA in the formal consultation document was such as potentially to mislead respondents and we saw evidence respondents had been so misled<sup>46</sup>.

## The public interest test criterion

10.5. Nexus did not apply an optimism bias on top of its modelling of the four specific risks chosen. We saw that the risk contingency was likely to be spent on 31% of possible outcomes. An optimum bias should have been applied on top of this risk contingency. There is therefore a likelihood that the scheme will run out of money. There is a further cash flow issue in the early years. For those reasons, the Board is not convinced that the scheme is affordable and, on that basis, we cannot conclude that it will lead to an increase in the use of bus services and it is our opinion that the requirements of Section 124(1)(a) TA2000 are not demonstrated.

10.6. We are satisfied that service quality would improve compared to the *do minimum*. In our opinion, section 124(1)(b) TA2000 is satisfied.

10.7. We saw how the QCS would contribute to local policies and strategies. In our opinion, section 124(1)(c) TA2000 is satisfied.

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<sup>46</sup> For example, see paragraph 4.19 above

10.8. The effectiveness of the QCS has been significantly overstated due to errors within the modelling. In particular, Nexus attributed benefits associated with simplified ticketing to passengers who did not buy a ticket. We reject, as reverse engineering, the latest version of events that simplified ticketing and customer charter were simply a proxy for a wider package of benefits. That assertion is not supported by any of the core documentation of the scheme. It is our opinion that Section 124(1)(d) TA2000 is not met.

10.9. The proposals generate negative cash impacts on the three existing operators in the range of at least £85 million to £226 million. The mean of those figures is significantly in excess of the net present value of benefits likely to be delivered by the QCS. The sheer scale of those figures is such that they will do real harm to the existing operators. The Board is firmly of the view that Parliament never had in mind that the introduction of a quality contract scheme would lead to cash impact on businesses of the order of hundreds of millions of pounds. In addition, the benefits that could be delivered by the VPA are of similar orders of magnitude to those delivered by the QCS. In fact, in cash terms as modelled, they are greater but we accept that the governance arrangements for the QCS are superior, at least as the VPA is currently defined. We have no hesitation in concluding the negative impacts on the operators are wholly disproportionate to the benefits accruing both to the travelling public in Tyne & Wear and the well-being of the wider citizens. It is our opinion that Section 124(1)(e) TA2000 is not met.

## Operating Risks in the Proposed Tyne & Wear Quality Contract Scheme

In addition to forming views about the many individual aspects of the QCS and whether the statutory tests are met, the Board has formed its view of the Scheme in the round. The Board is of the view that the following risks inherent in the Scheme have either not been fully appraised, are still significantly undefined, or indeed have not been considered at all.

- Paul Woods' evidence and supplementary clarification confirms that the risk contingency of the QCS is "the difference between the QCS's estimated revenues and estimated costs". This gives rise to a question of an immediate cash flow problem in the first six months (or longer). Para. 5.2.1 of the Affordability Analysis displays a chart showing the QCS to be running in deficit (explicitly stated in Para 5.2.2) in year one and the first part of Year 2. In Para. 3.11.2 a chart shows an allocation of Contingency in Year 1 of £10.650m and £8.386m in Year 2 (10% and 7.5% of the total contingency). Those key sections of the Affordability Analysis appear to be contradictory, and the latter to be diametrically at odds with Paul Woods' evidence, in which he explicitly indicates that there is no initial funding for any contingency. The validity of the Affordability Analysis must be questioned.
- Paul Woods' evidence indicates that there is no working capital at the start of the Scheme. Most of Nexus' analysis (and the cross-examination) considered the financial performance of the QCS over its full ten years in total - whether £79m contingency was sufficient. Little or no attention was paid to the first two years (or longer if passenger generation does not materialise as forecast) which are forecast to be cash negative. How will Nexus pay the contract fee for each four weekly period if revenues are less than costs? This is made even worse by the proposed introduction date of December 2017. The first four periods of the proposed QCS are the lowest income periods of a bus company's year.
- Debate about revenue growth and the economic techniques merely demonstrate that there is real risk of depressed revenue over the life of the QCS, and therefore whether the risk contingency will ever be built up.
- Some risks are still undefined - the contracts are not finalised and termination and variation risks are completely at large. There is no mention at all of early termination conditions. In evidence, Toby Hughes said he would "expect" operators to offer a price per mile variation figure which means that the differential effects of increasing or decreasing contracts, and of step changes in costs brought about by variations; both remain undefined. It also does not deal at all with the pricing of variations involving an increase in PVR.
- Nexus did not consider the substantial difference that exists between the nature of London contracts and that of their own and the consequences for risk and bid pricing. London bus contracts are awarded route by route for five year terms. There is therefore an almost constant "churn" of contracts, with operators at any one time either preparing bids, waiting to hear the outcomes, preparing to demobilise due to a lost tender or preparing to take on a new one. Operators can mitigate any drift towards lower profits by increasing prices in imminent bids, or deliberately not bid, or bid to lose in order to reduce overhead costs. The QCS is a once for all seven to ten year bid for the whole network (in an untested market). Nexus admitted that they had not considered the difference between London and the QCS in their assessment of risk and its consequences for bid pricing.

- Tobaugh Hughes in evidence expected that operators would add risk premiums, the first we had heard mention of that. That means that their own risk analysis should have been skewed to the higher side of profit margins, and with wider parameters (their risk analysis was applied only to a range of EBIT 6%-10%).
- Mr Hughes reckoned that they would act "just like a normal bus company". But they are not, the operation is completely contracted out. They cannot respond by reducing costs: they cannot reduce their unit costs (pence per mile) - those are set by the contract - nor can they reduce their total costs (no reductions in PVR). Costs for Nexus can only be achieved by reductions in marginal mileage (therefore mostly limited in effect to evenings and Sundays, and that subject to favourable variation terms) or by terminating the smaller contracts, the very cases that they are most anxious to protect. Increasing income from fares is of course constrained by the promise to limit increases to RPI (any fare increase over RPI will reduce patronage).
- Within a QCS contract, productivity improvements and cost reductions are the only ways that operators can hope to improve profit margins, and they therefore will work at doing these, but there is no contractual requirement nor incentive to share any such gains.
- Who is going to do the service planning? Fiona Bootle indicated that no service planners nor scheduling staff would be transferring from the existing operators, but the financial analysis shows that the costs for such staff have been transferred across. This suggests that Nexus will recruit new staff (therefore either with little or no knowledge of the local market or little or no planning and scheduling experience) to carry out this fundamental function. We saw nobody from Nexus who had had any real commercial responsibilities for bus operation, so there is a potential for very weak oversight as well. Tobaugh Hughes and others referred to their experience of running the Metro in rebutting charges of inexperience, but the comparison they made was to the scale of passengers and revenue on the Metro (therefore a substantial business), but made no reference to the geographical spread and complexity of the network of Tyne and Wear bus services. Having little or no such technical expertise constrains to a considerable degree the ability of Nexus to act as an "intelligent buyer", or, similar phrase, "competent client" in dealing contractually with suppliers who most certainly are competent. Nexus may have some staff whose job it is to define gaps in the commercial bus network as services are cut or new demands are not met in order to propose supported replacements, but that is quite different in both scale and expertise from planning some 400 bus services within a network context.
- Very little evidence was supplied that objective service planning guidelines will be used to verify and rank various proposals coming forward from the local bus boards. Who decides, and on what criteria, which proposals are to be implemented? We have an assurance that variations would be in accordance with the legislation, that the criteria for judging variations would be that they would continue to satisfy the statutory tests. That implies that an exercise in evaluating each and every proposal against the five criteria would have to be carried out. Alternatively, a set of guidelines could be developed for judging and ranking proposals as a proxy for a full evaluation. London has been operating such a set of guidelines since the 1960s, with refinement and modification over time. No evidence exists that any such appraisal is to be used for the QCS.
- Nexus will need to mitigate obsolescence or take advantage of developments in IT, such as contactless bank card payment, Uber, Google journey planning, "mobility as a service", driverless cars on demand, etc., yet doing so within a contractual framework,

confined to a deliberately slow change process, and with no spare money, will be a challenge.

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### Lessons learned relevant to wider franchising proposals

**Note – this Appendix is not part of the Board’s formal opinion**

#### Introduction

1. This is the first time that any local authority has taken advantage of the legislation to seek to introduce a Quality Contracts Scheme. Since the start of the proposal, and particularly very recently, there has been much discussion, and in some areas progress in agreements to devolve powers, funding and responsibilities to authorities (as in the case of Cornwall) and to combined local authorities usually based on recognised economic areas or city regions (as in the case of Manchester Combined Authority, North East Combined Authority and Tees Valley). Some of the devolution deals include powers to franchise bus services in the area within a broader package to tackle the barriers to economic growth in those regions. It is possible then that this could be the only example of testing Quality Contract proposals against the criteria and that future proposals will take some form of franchising in a variety of situations.

2. Whatever approach is pursued to seek changes in the operation of bus services in the future, this Board considers that there are valuable lessons to be learnt from this QCS process which has now taken three years and involved a great deal of public and private investment in time and money. The following thoughts and suggestions are not seen as an exhaustive list of lessons to be learnt but merely some helpful ideas to help others involved in discussions or proposals to change the way bus services are provided in their area. They are grouped into a number of themes but there are strong links between the themes and the suggestions that follow and the reader is recommended to consider the appendix in the round.

#### Initiation, funding and subsidy

3. In a Foreword to a recent book on London’s Buses, then Commissioner of Transport for London, Sir Peter Hendy commented “*Public transport in a major city properly designed to cope with the peak flows of people to jobs creating wealth, education, healthcare and leisure, consumes public subsidy..*” (emphasis added). The QCS in Tyne and Wear was driven by the need to protect services in the light of reducing public sector funds. Whilst a laudable aim, any such approach has inherent conflicts. A more positive approach would be to identify where enhancements to bus services would eliminate constraints to enhanced economic growth and well-being, develop an enhancement plan to the point where incremental costs began to outstrip incremental benefits, and thus identify a subsidy requirement for a new network. An appropriate procurement structure might then be more readily apparent.

#### Process of development and assessment

4. There were many things which contributed to the lengthy timescale for this QCS proposal and which, in the Board’s view, could have been reduced. All the way through the process, the Board has had to consider differing views on the information, assumptions and

guidance and as the report shows in some areas we can see a range of outcomes that seem equally to be right. One of the key problems was that, even with the offer of confidentiality agreements, important base information was not made available to Nexus at the start of the process.

5. The economic advisors sought to achieve common ground as far as possible over a considerable period of time. In fact, a further error was conceded (in relation to risk modelling) only a few days before the oral evidence sessions began. It's notable that the statement of common ground was dated 10 July – the Friday before the hearings began on Monday 13 July. In addition it was well into the process before there was an opportunity to openly debate and constructively challenge the views of all parties. As a result it is suggested that the following is considered

- There should be a staged, independently scrutinised, approach to the process of development and assessment of any proposal. This staged process would require agreement at each stage before progression to the next stage.
- The first stage may agree the scope of the initiative and the area to be covered. This would, for example, examine the relevance to the proposal of LA boundaries, the recognised economic area, and travel to work areas. Approval at this stage may place an obligation on parties to make relevant data available to the local authority on a confidential basis. We recommend that obligation is statutorily defined and includes information on patronage, ticket sales and fare box revenue at an individual route and time basis). A further stage would involve agreement to the intelligence from the data and parameters/forecasts to be used.
- The independent scrutiny should be supported by independent expert capability and the costs borne by the sponsor of the proposal.
- In addition to economic experts, experts in accountancy, procurement contracting, commercial bus operation, and public sector bus network planning should be called upon
- The independent scrutiny process could continue following the introduction of a scheme with annual scrutiny review of progress in delivering outcomes/ adequacy of governance arrangements etc. This could usefully include a SWOT analysis.
- It is recommended that advice be developed on an appropriate staged process for future proposals.
- There should be an agreed process for changes to the existing bus services once the project development/scrutiny process has started.

## **Scope**

6. The remit and functions of the Quality Contracts Scheme Board are governed by the statutory provisions contained in the Transport Act 2000 and the associated Quality Contracts Schemes Regulations. Further insight is provided by the Statutory Guidance. In short the issues for the Board were twofold:

- i. To form an opinion whether the proposal meets the conditions of the public interest test, and
- ii. To form an opinion on whether the consultation complied with the requirements.

7. It is the Board's view that scrutiny of any future proposals should enable a wider view than the QCS Board remit allows. Any assessment must be more about how the proposal will contribute to tackling the key issues of the area e.g. local economy, accessibility to employment etc on a more subjective basis, supported by, rather than potentially constrained by monetary benefits. Whilst it may appear that Criterion B, contribution to local policies, addresses this, its scope is strictly limited to simply whether or not the proposal does more than the *do minimum*.

8. The Board encouraged an inquisitorial approach to the process but it was inevitable with the scale of financial implications possible for all parties that a more adversarial approach to the process emerged. However it is acknowledged that many of the errors identified may not have been uncovered without an opportunity to independently challenge. We recommend:

- The adoption of an independently scrutinised, staged approach to the process as outlined above could encourage a more inquisitorial and less adversarial and less academic approach.

## **Guidance**

9. The statutory guidance for quality contract schemes suggests that LTAs may wish to refer to the Department for Transport's extensive guidance on transport scheme appraisal found in the WebTAG documents. The QCS guidance also states that compliance with this guidance is not a legal requirement, but it may assist LTAs in preparing a high-quality and persuasive assessment of different impacts that might arise from their proposed scheme. All parties agreed that use of the guidance in WebTAG (and documents that had informed WebTAG such as the Aecom report - The Role of Soft Measures in Influencing Patronage Growth and Modal Split in the Bus Market in England) was appropriate and helpful.

10. WebTAG has been shaped over many years essentially for the development and evaluation of capital transport schemes, both highway and public transport. The Quality Contract proposal is different. There is not a large up front capital cost. There is an ongoing stream of contract costs to be judged against potential fare box revenues for the scheme proposer and real financial implications for operators to be assessed. The Board found that, because it was not developed for this kind of project, the guidance was in some cases not helpful and encouraged different views to be taken on key issues. As a result the Board recommends:

- The appraisal process must be more about sensible judgement and less about the minutiae of economic/statistical factors.

## Flexibility

11. The July 2013 consultation document explains in section 2.10 the development of the QCS proposal. During 2011/12 Nexus developed an initial QCS proposal based on a theoretical bus route network which it considered might, if implemented, deliver enhanced social and economic benefits across the region as well as delivering enhanced patronage levels. Nexus recognised however that this proposed route network did not reflect the current network in actual operation across the region. Following informal dialogue with Operators and other stakeholders on the untested route structure, Nexus decided to abandon the first proposal and develop a QCS based on the current route structure in day to day operation.

12. The proposed QCS therefore assumes the bus network as it exists and contracts for bus services across that network for a minimum of 7 years with the potential to extend to 10 years (the life of the QCS). Within the QCS, there is scope to vary the contracts but this does not give the opportunity for reducing services or for radical change. The collection of new data from day one of the QCS or for any other proposal would enable planning for network changes to follow a settling-in period. This suggests that any rationalisation proposals could be contemplated much sooner than 7 years. We therefore recommend that:

- Consideration should be given to a mixed approach with 3,5,7 year contracts (with the option to extend a further 2 years). The shorter contracts could be those where it appears there is scope and need for early change e.g. for rationalising main corridors, optimising the network to reduce costs, stimulating demand by increasing frequencies and/or widening the service day, developing routes which are not constrained by historic operating areas, or improving accessibility to employment, education, retail and leisure.
- Mix contract lengths and starting dates would smooth out the demands for contract renewal.

## Risk

13. It is well understood that the drivers of risks can be financial, operational and strategic, influenced both internally and externally. The identification, quantification and management of risk in the development, assessment, introduction and monitoring of the QCS proposal is a subject that has engaged the Board throughout this process. There are some obvious key risks such as the way in which the Tyne & Wear QCS proposes the shift of an enormous financial risk from the private sector to the public sector but there are many other key risks that impact both positively and negatively on the potential success or otherwise of the proposal.

14. The QCS as proposed essentially moves the majority of the financial risk for operating services from the private sector to the public sector. Under the proposed QCS Nexus will put the main group of services out to tender in 11 lots. Operators will consider the lots and submit bids to operate the services in each of the 11 lots for contracts of 7 years duration and the possibility of extension to ten years. Operators would bid on the basis that Nexus would retain all revenue from fares collected.

15. The financial risk of meeting the contract cost during the lifetime of the contracts would be with Nexus. Alternative forms of a QCS could be considered that retained the key features considered vital to securing the benefits and which would leave the majority of the financial risk with, or shared with, the operators. Contracts could be let on a subsidy/premium basis or a mix with Nexus taking a proportion of the risk.

16. The capacity and capability of an organisation to develop and take forward a project that is possibly larger and different to its core functions may require additional and new skill sets. These additional and new skill sets may be within the organisation itself or provided by experts contracted to support it. The Board has suggested in this Appendix that the scope of assessment of such proposals should also look at the broader economic issues of the area and the big picture and the skills need to be available to do this. This would also reinforce the value of an intelligent client function.

17. In addition the persistent risk management problem, that of over-optimism and unrealistic expectations, referred to as optimism bias has also exercised the board in this process. It is recognised that the risks associated with optimism bias and therefore the allowance can be reduced as more is known and agreed in the development of a project. The process adopted for this project, which meant that independent challenge or scrutiny took place sometime after the publication of the proposals, meant that it was difficult to readily identify the level of optimism bias that should be allowed in the risk contingency. The Board considers that the staged scrutinised approach to such a project would allow an appropriate and proportionate approach to optimism bias to be adopted.

- Adopt an appropriate and proportionate application of optimism bias within the proposed staged scrutinised approach to project development, assessment and approval.
- Carefully consider the capacity and capability and skill sets needed to develop and deliver such projects.

## **Proportionality**

18. Proportionality in the context of a QCS or franchising is a subject that the Board consider could benefit from clarification in law, in particular, in considering the adverse effects on operators against the relevant benefits. The QCS is novel and is unlike a conventional transport project. It is the Board's understanding that in a conventional transport project the possible adverse effects on individuals, communities and businesses are identified and where possible quantified. This QCS involves a significantly different set of effects.

19. The statutory QCS guidance recognises that it is inevitable that there will be a degree of subjectivity associated with this where the adverse effects on one group need to be weighed against benefits that accrue to another. The guidance also suggests that it would be appropriate to attach different weight to different benefits and adverse impacts. The difficulty in the context of this proposal is weighing up whether the notional benefits gained are proportionate to the real financial adverse effects to be experienced by the operators, not least where pension schemes are affected. In view of this, the Board recommends:

- Legislation enabling franchising should specifically address the issue of proportionality of financial loss of bus operators. It may be that some form of compensation is considered appropriate.