Department for Transport

Short-term Intercity East Coast train operator

2018 options report

Short-term Intercity East Coast train operator 2018 options report

Presented to Parliament
by the Secretary of State for Transport
by Command of Her Majesty

May 2018

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Summary

- Following the financial problems experienced by the operating company, the current Virgin Trains East Coast (VTEC) rail franchise contract will terminate shortly. The difficulties which VTEC has encountered will cost Stagecoach and Virgin, as owning companies, additional funds and financial support totalling £186 million.

- The Department is required to ensure the continuation of franchised passenger train services on the East Coast. This report considers two options for doing so: a new short-term contract with VTEC, with tightly defined performance requirements; or transferring the operation to an operator of last resort (OLR), a public sector operator wholly owned by the Department. The OLR are an integral part of the franchising system, and are able to take over operations in situations where an alternative operator is needed and such a course is found to be appropriate, in line with the Department's 2013 published statement of franchising policy[1].

- This report is structured around the key principles which the Secretary of State highlighted for this decision in his statement of 5 February 2017. These principles were:
    - Protecting the interests of passengers
    - Supporting investment and improvement in the railway
    - Ensuring value for money for taxpayers

    - **This assessment of options against these principles does not find strongly in favour of either option:**

        - Both options will deliver for **passengers**.

        - Both options are likely to support **investment and improvement** of the railway in different ways, and the assessment against this factor is finely balanced.

        - The **value for money** offered by each option is broadly similar and neither is clearly likely to offer better value.

- This analysis is finely balanced. The Secretary of State has considered this in determining the appropriate option for continuing services on Intercity East Coast, and has decided to transfer services to OLR. This option will provide maximum flexibility in order to drive his long-term vision for the future operation of services on the route, through the development and implementation of the East Coast Partnership.

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[1] *Statement of policy on the exercise of the Secretary of State's power under section 26(1) of the Railways Act 1993*
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/243471/9780108512322.pdf

Section 1: background to the current situation and the options

1. Virgin Trains East Coast franchise termination

1. The reason for early termination of the current Virgin Trains East Coast (VTEC) franchise agreement is that operating revenues have grown more slowly than VTEC had forecasted when the contract was awarded in 2014. VTEC are therefore not earning enough income from operating train services to continue to cover the ambitious monthly premium payments to the Department required under their contract. Stagecoach has been required to inject an additional £165m to support the business, and it has incurred significant losses. The VTEC franchisee will shortly have to cease trading, at which point a performance bond of a further £21m will be payable.

2. This sends a strong message to other companies in the franchise market. The company took a substantial commercial risk when it entered the VTEC franchise, and as result it has made a considerable loss. This £186 million is a loss for the company and a benefit for taxpayers, who have continued to receive high premium payments in a period of lower-than-expected revenue growth.

3. Whilst the current franchise is being terminated, the underlying railway operating business is healthy. VTEC has achieved passenger satisfaction rates of more than 90 per cent for the last two years, which is one of the highest satisfaction rates in the rail industry, and revenues are growing, albeit more slowly than predicted in the VTEC bid. As an operating business East Coast intercity services are in good shape and commercial revenues substantially exceed the direct costs of the train business. This is a successful enterprise that returns good value to taxpayers now, and in future. The substantial premium returned to the Department by train operators by services such as InterCity East Coast helps the Department offset the significant public sector funding that the Government provides for the rail network as a whole.

4. VTEC submitted a bid in 2014 that was assessed in accordance with the Department's evaluation criteria as being deliverable. The Department carried out a thorough assessment at the time to ensure that the bid was realistic and in the best interests of taxpayers and passengers. Following this assessment, the Department awarded the contract to VTEC, subject to the inclusion of robust provisions for parent company support to manage risks (£165 million), and an appropriate performance bond (of £21 million). Assessment of bids requires judgment, but draws on available evidence. The evidence used to support revenue growth predictions, for example, includes the large body of joint research and evidence which the rail industry collates and updates through

the Passenger Demand Forecasting Council. Since the East Coast franchise was awarded in 2014 both passenger numbers and business revenues have grown, but at a lower rate than was projected. There are a large number of complex factors which affect revenues, but the possible contributory factors behind the variance include a general slowdown of growth in demand across the national rail network along with factors specific to the East Coast operator:

- External factors have not played out as forecast – in particular a large decrease in petrol prices which was not predicted has resulted in increased competition from car and long-distance coach.

- VTEC's internal business initiatives (e.g. marketing and pricing) have not delivered as many passengers as the company expected at bid stage.

5. The Department keeps the way risk is allocated under regular review to ensure the risks taken on by operators and the Department create good incentives and deliver good value. The Department has therefore refined the way it tests bids since the VTEC franchise was let in 2014, and these changes now help us to more effectively test risk when we assess bids. Bid assessment now includes testing bids against a downside scenario. However, bid assessment does not remove the possibility of future default, and nor should it aim to do so. The 2013 *Brown review of rail franchising programme* [2] considered the key issues from first principles. It concluded that "it is neither sensible nor realistic to design franchise structures that seek to completely eliminate the risk of default".

6. The competitive franchise system means that competitions are designed to challenge operators to raise their game for the sake of passengers and taxpayers. Stretching contracts mean that operators have to deliver improvements to fleet, services, stations and customer care, while providing good value for taxpayers through contracted premium or subsidy payments. Franchise termination is not typical, and the Department seeks to let franchises which can run to full term. However, there will always be the risk that a franchisee does not achieve the ambitious revenue or quality targets set at bid and that this results in termination, as is the case on VTEC.

7. When a franchise termination occurs, what is most critical is how it is handled. Rail franchises are designed to ensure that terminations can be managed effectively, and include bonds that ensure the costs of re-letting do not fall on the taxpayer. The Department designs contracts so that we can monitor finances and delivery, ensuring early termination of a franchise is never a surprise. Our contracts provide powers that allow us to terminate the contract in an orderly way, while getting maximum value and

[2] https://www.gov.uk/government/publications/the-brown-review-of-the-rail-franchising-programme

holding the company to its commitments. This means that taxpayers have not lost out over the period of this contract because revenues are lower than was predicted at bid: only VTEC and its parent companies have made losses.   Our franchising powers help us ensure a smooth transition: protecting staff and ensuring services keep operating well for passengers.

8. These processes mean that the Department has choices about to how to secure the continued operation of rail services on the Intercity East Coast franchise. The choices are explained in more detail below.

2. The Intercity East Coast operating business

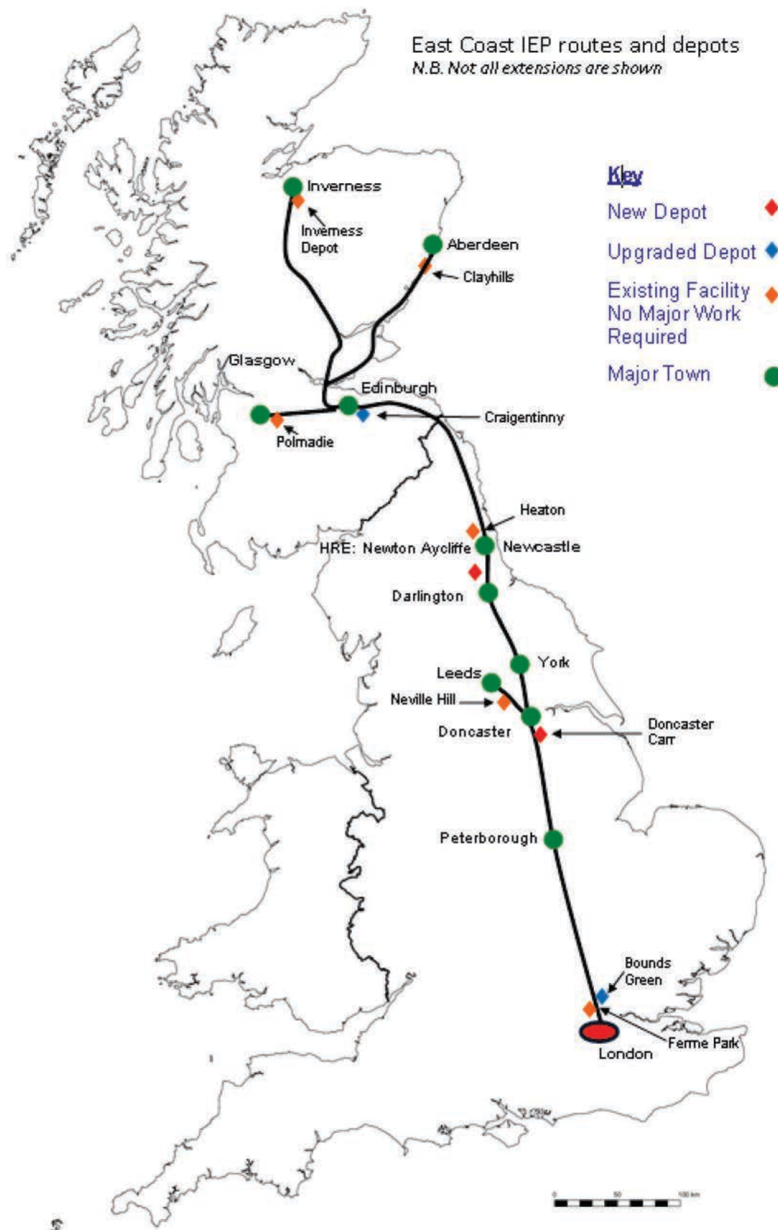
9. Intercity East Coast services carried around 22 million passenger journeys in 2017/18, linking London Kings Cross, the East Midlands, Yorkshire and Humberside, North East England and Scotland. The franchise has low levels of commuter travel and relies heavily on the discretionary and leisure travel markets.

Key franchise facts

- Start date: March 2015
- Type of franchise: intercity
- Operator: Virgin Trains East Coast
  (Joint venture between Stagecoach (90%) and Virgin (10%))
- Employees: 3200
- Stations operated: 11
- Stations served: 53
- Depots: 4
- Public Performance Measure: 81.5% (year ending 31 March 2018)
- Passenger satisfaction: 92% (National Rail Passenger Survey)
- Passenger journeys: 21.7 million
- Passenger kilometres: 5,510 million

10. New bi-mode and electric high speed Intercity Express trains (known as “Azuma”) are due to be introduced from December 2018. This will deliver the right trains for the East Coast route, improving reliability, offering more services, providing more seats and reducing journey times. The Intercity Express Programme is worth in the region of £2.7bn for the East Coast Mainline fleet[3], comprising rolling stock, maintenance depots, and a full maintenance and cleaning programme. In combination with more services the programme will increase the number of seats in the morning peak into Kings Cross by circa 28%. New Intercity Express trains are already in service on Great Western, bringing the flexibility to operate in diesel or electric mode. We can adapt these trains to bring more capacity for growth and to meet changing customer expectations such as offering new journey opportunities and reducing the need to switch services.

[3] In 2009 prices.



11. The Government announced in November 2017 that as a key part of its railway reforms, a competed commercial East Coast Partnership will be introduced on this franchise in future, to operate the train services on a new basis: joining up track and train for the benefit of passengers. More information is set out in the box below.

The East Coast Partnership

The Secretary of State announced on 29 November 2017 his intention to develop and launch a new operational model, the East Coast Partnership, to provide the intercity services on this route.

The East Coast Partnership will be the first of the new generation of long-term regional partnerships. The East Coast Partnership will be operated by a single management team, under a single brand and overseen by a single leader. It will see the train operator actively collaborate with Network Rail to bring its expertise and a passenger view to the planning of infrastructure management and to developing future plans for route infrastructure; create a unified 'one-team' identity and brand across Network Rail route and train operator; and ensure staff share in the success of the railway. Moving to this model will require changes in the way both the train operator and Network Rail are organised and work together in order to better align their incentives.

Starting to lay the groundwork for the East Coast Partnership quickly will ensure that passengers benefit from the improvements the partnership will introduce as soon as possible.

For a standard franchise competition it takes two years to develop, procure and mobilise operations. The work on designing the commercial model for this future operation is therefore already underway. The Department is drawing on experience and input from train and infrastructure operators, as well as experience from other sectors. The ongoing support of the railway businesses on the route has enormous value in making sure that contracts include the right incentives and that reforms work in practice, with the railway's people focussed on what matters to passengers and supporting the vital freight services that deliver benefits for the whole country.

3. The immediate choice for the Department as franchising authority

12. Following the decision to terminate the VTEC franchise, the Department as franchising authority needs to select a new train service operator or agree a new short-term contract with the incumbent, and make arrangements so that the operator can take over smoothly for passengers, workforce and suppliers from the first day of the new operation.

13. The train operator selected now is intended to operate for a short period while a new franchise competition is developed and a future commercial operator is appointed on a long-term basis (the East Coast Partnership).

14. The key task for a train operator is to operate train services for passengers, but the Department's franchisees also carry out a large range of supporting tasks, including ticket retail, catering, cleaning, operation of train depots and providing information and assistance. The train operator will have key safety responsibilities. It also employs the staff of the organisation, leases the train fleets from rolling stock companies and holds leases for specific stations and relevant depots. In the case of the East Coast operator, the next few years include managing the introduction and successful operation of a new train fleet through the Intercity Express Programme. This period will also be crucial to the key decisions the Department has to make about the design of the future East Coast Partnership and the formal arrangements that will underpin the joined up incentives and decision making being introduced.

15. On 5 February 2018, the Secretary of State set out to Parliament that his priority was to ensure the continued smooth running of services on the East Coast franchise for its passengers for this period up until the introduction of the East Coast Partnership. In this context, he set out that, "*My decision on which option to choose will be made in accordance with the key principles set out in the statement on how I use my rail franchising powers. These include: protecting the interests of passengers; preserving the interests of taxpayers by ensuring value for money; and supporting investment and improvement in the railway, including through the deployment of new inter-city express trains on the east coast line*." These three principles are considered separately in section 2 of this report. The Secretary of State also highlighted that there were a number of other relevant criteria that would be covered in the assessment of value for money, "*including which option returns most money to the taxpayer, the risks attached to each, and the value of any improvements in passenger services. I will also have regard to the effect of my decision on other franchises*." This is summarised in the box below.

The Secretary of State’s key principles for the choice between operators

1. Protecting the interests of passengers
2. Supporting investment and improvement in the railway
3. Ensuring value for money for taxpayers

Issues covered as part of the value for money assessment

- which option returns most money to the taxpayer,
- the risks attached to each option
- the value of any improvements in passenger services
- the effect of this decision on other franchises

4. The Secretary of State's franchising policy

16. The Department's statutory franchising policy was set out in 2013 in the *Statement of policy on the exercise of the Secretary of State's power under section 26(1) of the Railways Act 1993*[4]. The timing of VTEC termination has meant that that holding a franchise competition, by issuing an invitation to tender in the normal way, is not currently practicable given the risk of disruption to the continuity of rail services. The main reasons against holding a full competition are related to timing, given that the Department notified VTEC of the default under the contract in January 2018, with termination expected to occur shortly. In this case, the option of selecting a different private sector operating company other than the incumbent was considered but was discounted as impracticable because of the limited time available to develop a sufficiently fair and open selection process, and to allow time for the due diligence that would necessarily have been undertaken by an alternative private operator. This alternative would, furthermore, be unlikely to deliver better value or better passenger outcomes than the two options considered in this report.

17. The policy sets out the considerations that the Secretary of State will take into account when deciding whether to make a direct award. The policy also makes clear that if the Secretary of State considers the direct award would not be appropriate in light of the factors set out in the statement, "he will act in accordance with his operator of last resort duties under section 30 of the Act, which may include securing the services of a public sector operator." The Secretary of State's decision (to transfer this franchise to OLR) is consistent with this policy.

4 *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/243471/9780108512322.pdf*

5. The options

18. On 5 February 2018 the Secretary of State set out to Parliament that two options were being assessed. These options are:

- **OLR option: transfer to a subsidiary of the Department for Transport** using the Department's powers as Franchising Authority to appoint an operator of last resort (OLR).

- **A new short-term contract with VTEC following termination of the current contract**, using the established DfT process of direct award.

19. The Secretary of State was clear that, in the circumstance of termination, any short term contract with VTEC would be on a not-for-profit basis with the only possible financial reward coming at the end of the contract, through strictly defined performance related payments linked to delivery of clear passenger and taxpayer benefits.

20. The boxes below give an overview of the key characteristics of these options.

OLR option: how it works	Short-term VTEC contract option: how it works
• Public sector • Short term • Department receives net benefit of revenues (less costs) • Administrative arrangements will ensure delivery of train service pattern and key passenger and workforce improvements (including improved wi-fi, apprenticeships and workforce training) • Requires full mobilisation, with duties, workforce, assets and contracts transferred to new operator and required rebranding (similar to other new franchisees)	• Managed by private sector • Short term • Department receives net benefit of revenues (less costs) • Awarded using the Department's established and tested system of Direct Award • Contractual requirements on train service pattern and key passenger and workforce improvements (including improved wi-fi, apprenticeships and workforce training) • An end-of-contract payment for delivery can be made in return for strictly defined benefits for taxpayers and passengers • Requires only simplified mobilisation and no rebranding.

21. Work has progressed on a two-pronged basis in order to ensure either of the two operators could effectively take over the business on the first day after termination, giving the Department a genuine choice between these options. Since the closure of Directly Operated Railways following the sale of East Coast in 2015, an in-house team has been put in place which is responsible for monitoring across all the Department's rail franchises, and for leading OLR preparations whenever they become necessary. In parallel, the Department has been advancing negotiations and commercial agreements with VTEC to ensure there was a viable private sector option available. The short VTEC contract would be agreed and contracted using the established system of direct award to an incumbent franchisee. Direct award is a normal approach when a full franchise competition is not possible, risks disruption or is unlikely to deliver good value.

Section 2: comparison of options

1. Delivering for the railway's passengers

22. The first criteria set out by the Secretary of State on 5 February for this decision was that the option chosen should deliver in the interests of passengers. It is vital that passengers who rely on East Coast services continue to receive a good service and do not see services disrupted as a result of the contract termination on the current VTEC contract.

23. Both options (OLR and a short VTEC contract) can be expected to deliver a good service for passengers around the point of termination and mobilisation. VTEC are clearly well placed to take over the business that they already run, although there are a number of important processes that need to be completed to transition to a new contract. The scale of work OLR had to complete to prepare for transfer was considerably larger, and there were potential risks to achieving the programme of mobilisation on time, including risks around suppliers, workforce and regulation. However, OLR have made good progress against programme and has mitigated the potential risks, leaving them well placed to take over operations. The OLR leadership team judge that they are well placed to take over efficiently if required to do so on the target date.

24. Both options are expected to deliver the same train service, which is defined by the Department, and will be required to make planned improvements for passenger travel and experience. Passengers should therefore see the same benefits from each option. They include new wi-fi capability, staff training and other initiatives, as well as the introduction of brand new rolling stock to improve passenger experience and increase capacity and improvements to the timetable (an enhanced service on weekends and extending weekday services to new and additional locations). The Department retains a very high degree of control over the offer to passengers under the short VTEC contract option, via our contractual specification and enforcement powers, as well as under the OLR option.

25. Longer term passenger benefits from the Intercity Express Programme and the East Coast Partnership are covered below, in respect of investment and improvement, and value for money.

Conclusion

Both options are expected to deliver the same train services and customer offer, protecting passenger interests.

Both options provide a good basis for minimising disruption around the point of termination and OLR are in a good position to manage the issues that may impact passenger experience. Both options will deliver the Department's specified requirements for the train service and other improvements such as wi-fi.

2. Supporting the delivery of investment and improvement in the railway

26. The Secretary of State also set out that he would assess the ability of the different options to support investment and improvement in the railway, including through the deployment of new Intercity Express trains on the east coast line.

27. As set out above, the two major initiatives for the business are the delivery of the new Intercity Express fleet, with new trains due to start arriving from the end of 2018, and the development of the new East Coast Partnership – a reformed franchise model designed to deliver better for passengers.

28. The Intercity Express Programme requires a complete fleet replacement and will result in a restructuring of the operational business, with consequences for workforce, services and passengers. The programme includes a transfer of most depot staff from VTEC to Hitachi, alongside the launch and optimisation of an entirely new service pattern and timetable. The role of the train operator is important in making the introduction of the fleet into service work, as recent experience with the programme on Great Western has shown. VTEC has gained embedded knowledge through three years of running operations, infrastructure, control systems and their involvement in the design, testing and optimisation of the new trains. The Department's assessment is that they are well prepared for the transition.

29. However, although VTEC have made good progress so far, experience shows that any fleet introduction, and particularly one on this scale, presents significant technical and operational challenges. As well as fleet introduction, the operator will be involved in a major programme of integration, with developments to the infrastructure and other operators' plans at key timetable change dates. These are major challenges, irrespective of whether the operator is the incumbent (VTEC) or whether the services are transferred to OLR.

30. Transfer to OLR is a business change, and there is a risk that the other challenges facing the leadership team (including staff transfers and growing revenues) might reduce their focus on the Intercity Express Programme. However, the OLR leadership team are confident in their plans to manage the programme, and they have experience of introducing new rolling stock in coordination with infrastructure developments and other operators. The key staff in the train operator who are leading and delivering the programme are expected to transfer under the OLR option, which significantly reduces risks around continuity

31. The other major change facing the business in the coming years is the development and implementation of a new franchise model, the East Coast Partnership. This new

approach was announced in November 2017 in the Department's *Strategic Vision for Rail*. The new East Coast Partnership is intended to drive significant and lasting changes to how the railway operates for its passengers. The new approach developed on Intercity East Coast can be built upon and adapted to suit the range of different railway operations, as reforms are rolled out more widely on UK rail. As such, the success of this model is critical for the Government's plans to make the railway more responsive and more effective.

32. The administrative arrangements that would apply to OLR are likely to allow greater flexibility in introducing early benefits for passengers and preparing for the East Coast Partnership. The Department can make business changes under either option, but the evolution planned to support the new East Coast Partnership is likely to be simpler to deliver and may secure better value under the OLR option given the specific circumstances on this franchise. Choosing the OLR option will also allow more flexibility for the Department to align timing as the new East Coast model is developed and implemented.

33. The Department also considers that, in the context of an imminent franchise competition for the future East Coast Partner, the OLR option would present fewer barriers to close working collaboration between the Department and the operator than the VTEC option. As a probable future bidder, VTEC would have incentives to focus on a future bid, while the Department would face restrictions in sharing proposals and plans with VTEC to avoid conferring unfair advantages in the bidding process. In this specific case, when the Department is actively developing a major new franchising approach to deliver our rail reform objectives, these factors relating to flexibility and collaborative working on policy are likely to favour OLR because they have the potential to impact the future of the East Coast Partnership in a way that is not typically the case.

34. Alongside the transfer to OLR, the Secretary of State is announcing two significant business changes:

- A new, publically-owned brand that will become the long-term face of the railway for those who work on it and use it, and
- the creation of a board to join up teams across the track and train sides of the industry, and to advise the Department as the East Coast Partnership is delivered.

35. The conclusion below is that the options are balanced because there are factors in favour of both of these two options. However, this is a matter of judgment. Given that the OLR team are well placed to manage the challenges of continued delivery of the Intercity Express Programme, the benefits that the OLR option presents in respect of

flexibility to support the East Coast Partnership could be seen as more critical. This could have a substantial impact on the ultimate weighing of the two options.

Conclusion

The options are likely to support investment and improvement of the railway in different ways, and the assessment against this factor is finely balanced.

Delivering the Intercity Express Programme is a significant challenge for the business which might favour the VTEC option, in order to maximise continuity in the business. However, the OLR leadership team are well prepared and the core staff are expected to transfer to oversee continued delivery.

The OLR option gives the Department, as franchising authority, increased flexibility and – in the context of the new East Coast Partnership - opportunities for closer working. This can help ensure the East Coast Partnership achieves the Government's franchise reform objectives and delivers a step change for passengers.

3. Comparison of value for money

36. This section of the report addresses the question of value for money for taxpayers, which was highlighted specifically by the Secretary of State in his statement to Parliament on 5 February. As well as identifying it as one of the key three criteria for this decision, the Secretary of State highlighted some issues which would be covered in the value for money assessment: which option returns most money to the taxpayer; the risks attached to each option; the value of any improvements in passenger services; and the effect of this decision on other franchises. These are dealt with in the sections below.

37. The value for money analysis has been conducted in line with Treasury guidance and with the guidance set out by the Department. More background on the Department's approach to assessing value for money is provided in the annex to this report. The activities or factors which will affect revenues and costs and which can be assessed and given a monetary value with a reasonable degree of confidence are discussed in the section on "monetised factors" below. However, there are other potential factors that could have a very substantial impact on value for money that cannot be ascribed a monetary value in this analysis as the range of possible outcomes is large or unknown, and determining which option performs better is subject to a range of possible views. Despite the uncertainties, these factors are still part of the full value for money assessment. They are discussed below in the section on "non-monetised risks and benefits". For both of the options considered for East Coast, revenues are important as well as costs. Under either option, higher operating profits will directly improve the return taxpayers earn from the franchised business during the short term, but also into the future when franchises are competitively tendered.

38. The evidence and costings used in this analysis have been drawn from work done by our independent advisers and the OLR leadership team, and have been informed by the commercial work done with VTEC to develop and price a short-term contract.

INDEPENDENT ADVISER ACKNOWLEDGEMENT: OPTIONS ASSESSMENT

As independent advisors, we supported the Department for Transport's assessment of the two options for continuity of passenger services on the East Coast Mainline. These options were either a Direct Award to Virgin Trains East Coast or appointing the Operator of Last Resort. A team of rail advisors from CH2M/GHD/Tracsis advised the Department on the case for the Direct Award while industry experts from SNC-Lavalin, EY and Arup advised the Operator of Last Resort team.

We confirm that we were given full access to commercial-in-confidence information requested from the Department in order to provide our advice. We provided analysis and judgement on financial aspects of the two options and other rail industry issues as they affected the Virgin Trains East Coast franchise. In the case of CH2M/GHD/Tracsis the information given was taken into account in the modelling we provided to the Department. Our advisors provided challenge to the Department's views which helped inform the Department's final decision.

DfT advisors: CH2M/GHD/Tracsis

OLR advisors: SNC-LAVALIN/EY/ARUP

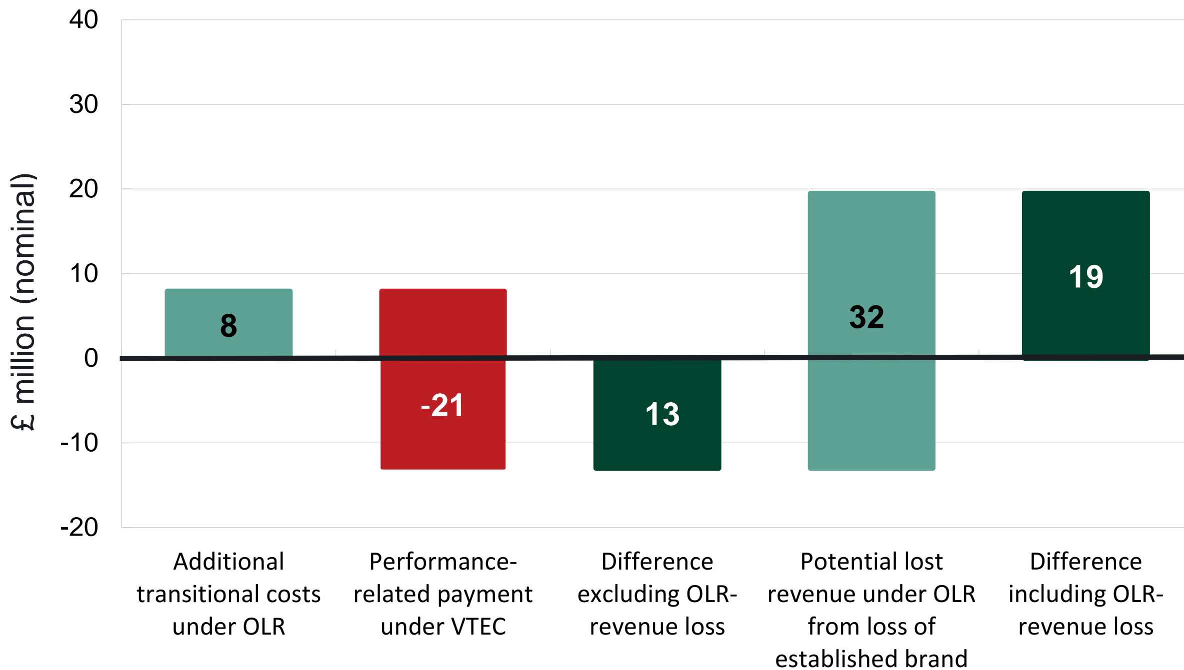
Comparison of monetised value

39. This section of the report sets out how costs and revenues for the East Coast business would be expected to vary between the two options under consideration over the period of operation. In this section, only the impacts which can be priced (monetised) with reasonable confidence are included. Wider issues considered as relevant to value for money are discussed in the next section.

40. To carry out this analysis, the Department has identified the specific costs attributable directly to the structure of the management arrangement and the characteristics of the operating entity, where these can be identified with reasonable certainty. The Department has also considered whether features specific to each option could affect revenue growth. The net payment returned to the Department is known as the franchise premium.

41. The operating business of the Intercity East Coast services will return premium payments to the Department under both options. However, one option could return less or more premia than the other, affecting taxpayer value. For the short VTEC option, the main specific cost is the contingent performance related payment which may be earned at the end of the contract in return for delivering clear benefits. For the OLR option, the main unique costs arise from those additional activities needed because of the transition to a new corporate entity during a period of major business change, as well as potential reduction in revenue. The analysis has considered two different scenarios: one with this revenue reduction, and one without, as shown in the chart below.

Chart 1: Premium returned by short VTEC contract option in comparison to OLR option (with and without potential lost revenues under OLR)



Comparison of monetised factors: summary table[1]		
	Excluding possible revenue loss from loss of established brand	Including possible revenue loss from loss of established brand
Difference in expected premium	**Short contract with VTEC returns £13m less premium** to the Department compared to OLR option	**Short contract with VTEC returns £19m more premium** to the Department compared to OLR option

42. **In respect of monetised cost and revenue impacts, the OLR option and the short VTEC contract option are finely balanced, with neither clearly likely to offer higher returns to taxpayers.** The VTEC short contract option is expected to return between £13 million less premium and £19 million more premium (nominal) to the Department when compared to the OLR option over the expected period of operation.

43. Under either option, OLR or VTEC, the business revenues are estimated to reach around £2bn over the period of interim operation and the forecast income or premium for taxpayers is estimated at around a quarter of a billion pounds. Regardless of operator,

[1] Nominal, value over period of expected operation

the total revenues (and therefore premium payments) will be affected by external factors, including economic growth and competition from other modes, and may vary from forecast. Whilst the differences between the options represent large sums of money, their relatively small size compared to overall revenue and premium, and the uncertainties in all these forecasts, emphasises the importance of considering the wider context for this decision, as set out elsewhere in this report.

Specific cost and revenue impacts arising from the OLR option

44. The Department has taken the evidence for the specific costs and revenue impacts expected to arise from choosing the OLR option from the substantive business planning work that has been carried out by the OLR's advisors, who include experts with long careers in UK railway operations, currently employed by Arup and SNC-Lavalin.

45. The OLR business planning report sets out the activities they believe are needed to take over the East Coast business safely, smoothly and professionally, protecting outcomes for passengers and the investments made by taxpayers. These activities have been quantified by the Department's technical advisors in order to determine the likely cost and revenue impact to the business. This has resulted in an estimate of £8 million for OLR costs directly related to managing transition which would not arise in a situation where the operator is not being replaced. This is shown in the chart above. The activities OLR expect to be covered by these costs include:

- additional OLR marketing above VTEC plans to ensure potential passengers are not discouraged from travel as the operator changes;
- professional advisor fees and staffing plans to manage transition; and
- IT set up and transition costs from VTEC systems.

46. In addition to these costs for the business, the OLR leadership team and advisors have concluded that there is likely to be a temporary slow-down in the rate of passenger revenue growth (despite additional marketing activity highlighted above) because a new and unfamiliar brand takes time to ramp up. Such a slow-down in income is a "cost" for taxpayers, should it occur. Using the change in growth rates proposed by OLR, this impact equates to taxpayers receiving around £32 million in lower revenues than the VTEC option over the comparison period, as shown in the chart above. This judgement is one reached from professional experience. The Department's view is that this impact on revenues is reasonably likely to occur. However, the OLR leadership team and advisors recognise the importance of urgently promoting a new brand in order to minimise any

perceived gap in customer perceptions of commercial responsiveness and to protect revenue growth.

47. The Department has taken a cautious approach in its monetised value for money assessment in determining which of the costs and revenue impacts in the OLR business plan to include. Only those activities are included which are clearly a result of the different choice of operator and around which we have reasonably high level of confidence. This is to ensure only those items of OLR expenditure (or revenues) which genuinely represent additional taxpayer cost compared to the VTEC option are being taken into account when deciding which option to implement.

48. The value for money comparison excludes those costs incurred in setting up OLR and making it ready to take over and mobilise in respect of the East Coast franchise. This is because these costs have already been incurred as part of its readiness preparations, and are therefore not a legitimate discriminator between options.

49. There are significant costs associated with changing a brand. OLR would incur these costs immediately, as it needs to replace the previous branding, logos and promotional materials of VTEC. However, because of the decision to immediately introduce a new railway brand that will apply for many decades to come, the OLR option will not incur further rebranding costs post-OLR. The VTEC option would keep current branding in the short term, but would require a rebranding exercise once VTEC ceased operation and the East Coast Partnership was in place. Therefore rebranding costs are not a significant factor in deciding between the options.

Specific cost and revenue impacts arising from the short VTEC contract option

50. A short VTEC contract will not incur the transitional costs identified by OLR, and will use the current brand. However, there would be potential for a contingent performance payment to be made to VTEC at the end of the contract, if they deliver defined improvements as set out earlier in the report.

51. This analysis has used a central estimate of just under 1% of forecast revenues being paid to the VTEC operator at the end of the operating period in return for delivering good results for taxpayers and passengers as set out in the contract. This equates to around £21 million. If the requirements set out in the contract were not achieved, VTEC would not receive any payment. If the short VTEC operator significantly outperformed the assumed level of delivery and achieved a higher incentive payment as a result, the Department would also benefit from the financial results of that higher performance, primarily through the higher revenues achieved as a result of higher train service reliability and very high levels of customer satisfaction. The maximum level of contingent payment would only be given in circumstances where VTEC's performance provided much more benefit for passengers and taxpayers than the financial benefit for VTEC, providing confidence that taxpayers would be better off.

Comparison of wider factors relevant to value

52. This section presents the Department's assessment of factors which may affect the overall value for money of the two options, but cannot be monetised at this point. The monetised assessment is finely balanced, and therefore the considerations set out in this section are of relatively high importance in the overall conclusion on value for money. The more significant factors covered here have the potential to affect the cost and revenues of East Coast (and therefore value for taxpayers) but they may also significantly affect passengers who rely on the railway's services, and the delivery of major programmes. Several of these themes have therefore been covered earlier in this report.

Intercity Express Programme and business transformation

53. The importance of delivering the business changes needed to successfully achieve the Intercity Express Programme milestones and introduce fleet into to service is set out earlier in this report, in the section on delivering investment and improvement, alongside our assessment of risk under the two options.

Either option provides the capability needed to deliver the programme from the train operator side.

Challenges exist whichever operator is appointed. The Department considers that the OLR option presents additional challenges in comparison to the VTEC option because the top leadership team will simultaneously be managing wider business change as a result of taking over the business. However, whilst the VTEC option reduces risk most effectively, OLR will be helped by the fact that the staff working on the programme for the train operator are not expected to change, providing continuity, and the OLR leadership team have relevant experience.

Avoiding risk of lower revenue growth rates

54. The OLR leadership team and advisors have identified a potential impact of lower revenue growth arising from the change in branding, which is included in the range of potential monetised outcomes above (and is therefore not considered in this section). However, they have also anticipated temporary lower revenue growth for a wider range of reasons, broadly associated with a lag in driving growth because of business change and the diverse challenges and priorities for the business in the early months of OLR operation. This estimate remains uncertain.

The VTEC short contract option is likely to be better placed than OLR to support initial revenue growth.

Transfer to OLR could result in a temporary lag in revenue growth in comparison to the VTEC option, although the scale and impact on value for taxpayers is uncertain.

Industrial relations

55. Under either option, the operator for the Intercity East Coast services will face a degree of business change over the next few months and years that will need to be well managed in order to ensure certainty for the people working on the franchise, and to deliver good industrial relations.

56. An announcement in favour of OLR is likely to be initially welcomed by the rail unions, however it cannot be assumed that support would continue throughout the period of operation. Conversely, there are factors which would favour continuation with the short VTEC contract option. VTEC has been able in past periods of industrial action to draw on resources from its wider railway businesses to help minimise the impact of industrial action on passengers. For the workforce themselves, stability of employer has benefits, and the short-term VTEC option would avoid creating uncertainty around TUPE arrangements and transfer.

There is no clear case for expecting either option to be significantly better in managing workforce relationships.

The factors are broadly balanced and either option will require an effective management approach.

Successful development and launch of East Coast Partnership

57. The importance of delivering benefits from the reformed East Coast Partnership was set out earlier in this document in the section assessing investment and improvement for the railway. In this specific case, as set out above, there are some important factors that favour the OLR option, including flexibility of the model that may support business changes, flexibility of timing and lower barriers to active collaboration. However, the comparative advantages of OLR need to be seen against a contractual model which, in the case of the short VTEC option, would give the

Department extensive powers to direct its franchisees and access information and data.

58. It is hard to ascribe likelihood or specific value to the flexibility provided by OLR in comparison to a short VTEC contract at this stage, which is why these benefits have not been monetised. However, the Department's view is that OLR is likely to, comparatively, reduce risks to the reform programme and maximise the opportunity to develop a private sector proposition that works with the public sector and delivers ambitious change - including significant improvements for the passengers on the East Coast railway and protection for freight operators and other users of the line.

OLR is better placed to support the development of the East Coast Partnership.

OLR provides additional flexibility through the management model which could support business changes. In the run up to a commercial franchise competition, reducing barriers to policy and procurement collaboration by appointing OLR would, in the specific circumstances of East Coast Partnership development, be likely to support better long-term value.

Influencing the behaviour of other franchised operators

59. Sending a clear message to other franchisees and bidders is important, and the choice to transfer to OLR makes it clear that termination would only be followed by a Direct Award where this is the appropriate choice for passengers and taxpayers.

60. However, the Department's choice of operator at this stage provides only a moderate influence on the commercial decisions of other franchisees or bidders. Any reward earned as a contingent performance payment under the VTEC option would be relatively small compared to the overall losses. Under either option, the significant losses incurred by Stagecoach as a result of the current VTEC franchise would continue to be a strong warning to future bidders to be cautious about predictions of future revenue.

The OLR option provides some reinforcement of the strong message which Stagecoach's losses have already sent to the rail franchise market.

These losses are already sending a strong signal to the market. A choice to proceed with a short VTEC contract with limited performance payments would not substantially weaken this message. However, the OLR option makes it clear to the market that the Department will not proceed with a Direct Award to a private incumbent operator if this is not the appropriate option overall.

Value for money conclusion

61. The conclusion of the value for money assessment reflects both those factors which have been monetised, and those which are less certain or harder to assign a specific monetary value to.

Conclusion

Both options are likely to offer comparable value for money.

The differences identified between the two options in relation to the monetised factors do not clearly favour either option. These are relatively small differences compared to the wider business, and are sensitive to assumptions The non-monetised factors considered in this assessment could affect value and outcomes for passengers more significantly than the monetised factors, however, the range of factors taken into account are broadly balanced, and there is therefore no conclusive argument that either option is likely to deliver better value for taxpayers.

ANNEX – Approach to VfM

Analytical approach to value for money

Value for money is one of the key considerations of any decision involving the use of public funds across government. Achieving good value for money can be described as using public resources in a way that creates and maximises outcomes and benefits for the taxpayer and wider society. An assessment of value for money represents our best view of whether investment or expenditure is worth making, in terms of the benefit we get in return. It also allows us to consider if financial savings are worth it, or whether we would lose more in wider benefits than we gain in financial terms. Crucially by using an established and consistent approach, the Department is able to look across different schemes and budgets and understand trade-offs. The framework the Department uses to assess value for money is published on the Government website[5], and is in line with the Green Book which is published by HM Treasury.

In order to assess the value for money of the two options, the Department has considered costs to taxpayers against the expected benefits to the economy (including wider benefits from reducing road congestion or improving environmental factors). In this case, as set out below, these economic and wider benefits are not expected to vary.

To estimate the taxpayer cost of the options, the Department had to reach a view of the business costs and business revenues under the two scenarios. How this was done for each option is set out in the report. Technically both options are earning money for taxpayers, not costing money because the Department will see substantial financial returns under either scenario. However, there will be comparative net costs to the taxpayer between the two options.

Revenues, as well as costs, are of major importance when assessing the net cost for taxpayers. This is true of franchising as a whole because, through competition, the Department benefits through contracted premium payments from Train Companies. Franchise agreements also typically contain profit share or other upside provisions leading to payments to the Department from train companies. Net Government support to the rail industry in 2016/17 was £4.2bn[6] after taking account of the premium and profit share

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5 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/630704/value-for-money-framework.pdf

6 Excluding Government loan to Network Rail

payments to the Department from train companies. Through the operation of the franchise system, both additional passenger revenues and lower operational business costs will reduce the need for overall net subsidy of the national rail network by taxpayers in the medium and longer term. In the specific case of the options being considered for East Coast, higher operating profits will directly improve the return taxpayers earn from the franchised business during the short term, but also into the future when franchises are competitively tendered.

On the economic benefits side of the value for money equation, there is expected to be no material difference between the two options. The benefits considered by DfT as part of an economic assessment for rail schemes are those that are delivered by carrying passengers or goods, in competition with other modes, as set out in our value for money framework. The railway is expected to deliver the same rail service pattern, with the same fleet under either option, and will therefore deliver the same benefits through the carriage of passengers. This simplifies the option assessment.

For clarity, in making the comparison between options, this analysis has not attributed any efficiency or value arising purely from the ownership model of the operating entity (ie private versus public). There is nevertheless a strong strategic case to be made for the benefits that the programme of franchising has delivered overall. Both of the options under consideration for the Intercity East Coast operator are useful tools in the overall privatised franchising system. Rail franchising has delivered significant benefits for passengers on a network-wide basis, including private investment totalling £6.4 billion over the last 11 years, and 7000 new carriages being delivered over the next few years.

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