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Virgin battles for west coast franchise

By Rose Jacobs and Mark Odell

Virgin Group is fighting an increasingly desperate battle to retain its only hold on the UK rail market amid growing signs the government is favouring a rival bid from FirstGroup for the high-profile west coast main line franchise.

The Department for Transport is expected to name the winning bidder this month from a shortlist of four – which includes two foreign, state-backed operators – to take over the management of the country's most lucrative franchise for the next 14 years from the end of 2012.

Virgin, in a joint venture with Stagecoach, has operated the route since 1997, during which time passenger volumes have increased by more than 9 per cent a year on average, exceeding UK-wide compound annual growth of about 3 per cent.

People familiar with the matter have confirmed that FirstGroup has put in the highest offer for the new contract, outbidding the incumbent by at least 15 per cent. They believe the company has promised a £6.5bn premium to the government over the length of the franchise, implying an average payment of almost £500m a year.

Virgin Trains paid the government a £160m net premium last year, the highest in the industry for a long-distance rail operator. But it also spent many years in receipt of subsidies for the line, totalling more than £1.4bn.

The risk to Sir Richard Branson's rail business is that if Virgin Trains loses the bid, the joint venture with Stagecoach could fall apart, although executives have signalled that the companies would consider retaining the structure to bid for the east coast main line service, which is currently run by the government and is due to be relet to the private sector in December 2013.

Virgin Trains used to operate the cross-country franchise, a network of long-distance routes that bypass London, but lost it to Arriva – now a division of Deutsche Bahn – in 2007.

Sir Richard has written to Justine Greening, the transport secretary, warning that awarding the franchise to FirstGroup could lead to a repeat of the east coast franchise debacle.

The government renationalised the operation in 2009 because the incumbent, National Express, walked away from the franchise after the economic downturn hit demand. The franchise fell short of what many in the industry considered to be optimistic forecasts.

In the letter, copied to the prime minister and first reported by the Daily Telegraph, Sir Richard argued FirstGroup's bid was only viable if the company "drastically cut the quality of services". In contrast, he said: "We submitted a strong and deliverable bid based on improving the customers' experience through increased investment and innovation."

Winning the west coast franchise is increasingly important to FirstGroup, which is already the biggest rail operator in the UK, because it has been hit by problems at its US school bus and UK bus businesses. Analysts predicted the company would have to cut its dividend or raise money through a share offering if it failed in its bid.

But overpaying for the business could prove perilous. HSBC analysts wrote in a note this week: "The shape of new rail franchises looks frightening to us. They carry significantly more risk than the old ones and operators who bid too aggressively could end up in serious financial difficulty for a period of up to 15 years."