Threat to Richard Branson's train empire

Virgin's presence on Britain's rail network could be derailed as FirstGroup offers £1bn more for the West Coast franchise.

Virgin Rail looks to have been comprehensively outbid by FirstGroup in the fight for the 14-year West Coast contract starting in December. Photo: ALAMY

By Alistair Osborne

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No one lobbies like Sir Richard Branson. So, when the Virgin king fires off letters of complaint to the Government even before it's announced the winner of a bid, it's easy to be dismissive.

This time, though, he may have a point. If the crackles across the station loudspeakers are right, Virgin is about to be kicked off Britain's railways after **losing the battle for the West Coast main line** – the London to Glasgow service it has run with partner Stagecoach for the past 15 years.

Virgin Rail, 51pc-owned by Sir Richard and 49pc by Stagecoach, looks to have been comprehensively outbid by **FirstGroup** in the fight for the 14-year West Coast contract starting in December.

The Virgin founder is spitting tacks, as is clear from his letter to the Transport Secretary, Justine

Greening, and copied to David Cameron. But not just because he thinks he's lost. It's the thought he's been done over by an "unrealistic" bid.

In short, he is playing the East Coast main line card, claiming the Government risks a re-run of the bid fiascos on that franchise. First GNER in 2005 and then National Express two years later triumphed at the bid stage, only to career swiftly into the buffers when their heroic revenue forecasts failed to materialise.

Both walked out on their contracts. The result was a clean-up job for the taxpayer from which the East Coast is yet to recover.

In both cases, Virgin Rail was a defeated rival bidder. As Sir Richard said in his letter, the company had made "realistic bids after an extremely expensive tendering process" – only to be beaten by rivals that came "nowhere close to delivering their promised plan".

This time round, Virgin has offered to pay the Government about £6bn over 14 years to retain the West Coast line – FirstGroup is thought to have bid around £7bn. But rail franchise bids are not as straightforward as they look. Not least one as big as this – the first awarded under the Coalition's new rail franchising policy.

The stakes are high, and not just for Virgin. Fresh from **a profits warning**, and with the market steamed up about its overly-geared balance sheet, FirstGroup's under-fire chairman, Martin Gilbert, is desperate for some good news. Meanwhile, the Government is cash-strapped. These are just the sort of circumstances for a racy bid – even without Sir Richard's huffing and puffing.

To understand what's going on, it helps to know that with rail franchise bids no money changes hands upfront. Bidders undertake to deliver a certain level of performance, such as service frequencies or station upgrades. Then, after forecasting revenues and costs, they offer to pay a yearly amount to run the service.

But how can the Government be sure this will ever arrive? It asks for two things. Bidders must lodge a "performance bond" that is forfeited if the operator defaults, and a "shareholder loan", which is supposed to increase with the riskiness of the bid. When National Express ducked out of the East Coast, it lost its £32m bond and £40m loan – though the penalty was seen as derisory given that it bid £1.4bn for the franchise.

The Government is now taking a harder line. On the West Coast, the bond is expected to be around £70m. The important question is how big a loan the Government demands. There is talk it could request around £300m from FirstGroup. But, crucially, that's not cash. Bidders have to give only a guarantee with a credit rating of A-, proving they can pay out.

Sir Richard claims the only way FirstGroup can justify its bid is to "drastically cut the quality of services". The unions fear as many as 800 job cuts, including guards, catering and station staff. But, as Nomura analyst Mark McVicar says: "You are only playing with 20pc-30pc of the cost base, max, because of all the fixed costs."

Broadly, much of the remaining disparity between bids turns on forecasts of passenger volumes and fares – numbers that the Channel Tunnel, its fast rail link HS1 and the East Coast have all shown to be notoriously hard to predict. Current volumes are 30m passengers a year – up from 14m seven years ago, boosted by the snazzy Pendolino tilting trains.

The current and new West Coast franchises are not directly comparable. But even Sir Richard's promised payment is punchy. In the year to March 31, Virgin Rail had £938m revenues and £34.4m operating profits. It is currently paying £160m a year to run the service. So, if FirstGroup pays £7bn, that is an average of £500m a year.

One senior figure at a rival transport group said: "Virgin Rail's bid is already aggressive. Yet FirstGroup is said to be bidding £1bn more. We think that requires 8.5pc to 9pc growth every year for 14 years off the back of a double-dip recession. That just beggars belief."

As if to reinforce the point, the two other shortlisted bidders – France's SNCF and Holland's Abellio – are thought to have offered £5bn.

But the quantum only tells half the story. The viability of a rail franchise also depends on the profile of premium payments. Typically, bidders pay little in the early years of the contract when investment is at its highest, with the payments cranking up towards the end. It is this ratchet which kills ill-judged bids.

Here, FirstGroup has form. In May last year, it controversially handed back its First Great Western rail franchise three years early to avoid more than £800m in payments to the taxpayer.

To be clear, FirstGroup did nothing wrong. When it signed the contract in April 2006, it negotiated something unique in the rail industry: a break-clause, where it could opt out of the 10-year contract after seven years without penalties. The upshot was that, of the £1.13bn FirstGroup agreed to pay, £826m never materialised as it fell in the final three years.

All that's provided more fuel for the critics. They see how FirstGroup's board is under pressure from shareholders, not least given the risk that it loses the auctions for the new Great Western and First Capital Connect franchises.

So, as HSBC analyst Joe Thomas notes, FirstGroup has an "incentive to overpay". He believes its

“weak finances mean it could look to win rail contracts to bolster its balance sheet”. Indeed, FirstGroup cannot afford to lose rail earnings without risking breaching its earnings covenants.

Such pressures may push FirstGroup to bid big for the West Coast and cut costs early on, generating decent earnings growth. There is, of course, a risk things go wrong down the track, not least with the new franchise model recompensing bidders only if the Government’s GDP forecasts – on which they are partly based – are out by a colossal 5pc. But, by then, Gilbert will have retired, while chief executive Tim O’Toole may be back in his native America. So, even if the shareholder loan gets called in, it won’t be their problem.

What of the Government? The Department for Transport has not always picked the highest bidder. But, with a novice such as Greening in charge – under immense pressure from the Treasury to maximise franchise proceeds to fund other rail projects – it will be hard to reject a £7bn bid for a £6bn one. Besides, given the DfT’s revolving door, if the franchise fails, Greening’s likely to be gone.

Neither FirstGroup nor the Government would comment, though McVicar says: “I don’t think O’Toole’s the sort of guy to bid like that.”

But, as one rival executive said: “If this bid plays out like I think it might, it will prove so outrageously cynical as to boggle the mind.” It’s certainly boggling Sir Richard’s.

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