

ALL AT SEA



With predicted revenues failing to materialise, a failed court case to challenge open access, and its parent company Sea Containers in severe financial trouble, GNER is in dire peril. Paul Coleman reports

Perhaps only senior managers at GNER and its parent company can explain what has really gone wrong for the East Coast Franchise holder. The rail operator's Bermuda-based owner, Sea Containers, is burdened by £340m of debt, and now GNER appears to be foundering too.

Christopher Garnett resigned as GNER's chief executive and as senior vice president of Sea Containers on 25 July. It is now abundantly clear that GNER heavily over-bid when it promised £1.3bn for its East Coast Main Line franchise, and it seems very likely that the company will prove unable to make the promised payments.

This parlous state of affairs is in sad contrast with GNER's victorious euphoria last year after the SRA accepted its massive bid, which was a full £300m higher than the second-highest bid from Virgin/Stagecoach. 'I would rather overbid and win than underbid and lose,' stated Garnett afterwards – words that now ring pretty hollow.

The operator's plight has not been helped by open access operators being given more routes on GNER's patch than it anticipated, but GNER failed to get the ORR's ruling on this overturned at a judicial review which it lost, horribly publicly, in July.

Two days before critical transatlantic meetings between Sea Containers' board and its shareholders and bondholders, rumours of a possible take-over bid began to appear in the Scottish national press and in English regional dailies. Sea Containers said it had received a bid for GNER from one of the UK's 'big rail groups'.

These groups have since told *Rail Professional* that they had made no such bid. Will Whitehorn of Virgin, speaking from New York, voiced his surprise: 'It's not us. In fact, I'm not sure that it's anybody. Nobody could make an offer for GNER, because it simply overbid for the franchise.'

So what should we make of the alleged bid for GNER? Was this just a line designed to pour some perfume on Sea Containers' New York-listed share price? On 15 August, the day prior to the first meeting, Sea Containers' stock steadied at \$2.90, up 12 cents on that day's opening price but still a long drop from its \$14.21 price on 20 January.

Sea Containers' press release of 11 August was a mix of legal issues, financial facts, and pleading about 'events beyond our control'. The press release was an attempt to convince the shareholders and bondholders that GNER remains a viable business that is suffering from 'force majeure' events beyond its control.

However, whatever the causes, the effects were all too starkly plain. The quantifiable facts contained in the release were that passenger revenues to 30 June had risen just 3.3 per cent in the first 14 months of the franchise, a heavy 6 per cent below the 9.9 per cent growth that GNER needed to meet the projections in its franchise agreement. All businesses have to assume that things might not go quite as planned; but there was precious little room for manoeuvre in the skinny margins dictated by the promise to pay back the taxpayers £1.3bn over the course of the 10-year franchise.

All this means that the new Transport

Secretary Douglas Alexander faces some awkward questions. Today, only just over a year after the franchise was won, GNER's stratospheric bid looks completely untenable, especially given the shaky state of its parent company – so why did the Strategic Rail Authority accept the bid in the first place? Did the sheer volume of cash on the table blind the SRA? Cautionary checking with City analysts ought to have revealed GNER's revenue promises as dangerously optimistic. The question is all the more acute because Sea Containers has looked pretty sick for some time – this is not a sudden collapse in the organisation's business fortunes.

Why was the SRA prepared to take the risk that this franchise deal, which is supposed to pass all the risk and cost of running one of Britain's most important railway lines safely across to a private company, might be derailed at the first sharp bend, rebounding onto the taxpayers?

An adamant DfT spokeswoman says that franchising guidelines include, or at least imply, thorough financial health checks on the parent companies of bidding Tocs – and 'franchises are never renegotiated', she added.

However, that won't stop Sea Containers' Bob MacKenzie from knocking on the DfT Rail Group's door to plead that the franchise be 're-evaluated' or 're-aligned' or some other politically acceptable euphemism for being rewritten from top to bottom.

MacKenzie, 53, became Sea Containers' chief executive in January. Even he was taken aback by growing problems with GNER's East Coast franchise. 'I was very surprised at the situation in GNER,' MacKenzie recalled in his address to his shareholders. 'It was very different from what I'd expected.'

MacKenzie discovered, as he expected to, that GNER was a rail business whose hardworking 3,200 staff were offering



passengers reliability and good customer service. What he didn't expect to find was chronic underperformance on the financial projections contained in its franchise bid.

MacKenzie blames most of GNER's laggard figures on events beyond its control. GNER's 'force majeure' claims include the lingering impact of the 7 July bombings in London and a 26 per cent rise in electricity costs. MacKenzie says that electricity prices in GNER's bid were based on 2003-04 prices and on government forecasts of 2.5 per cent hikes. In 2007, prices are expected to rise by 65 per cent. 'This will cost another £10m to this business,' MacKenzie explained at the shareholder's meeting. 'That's completely

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outside the indications of our franchise.'

Sea Containers has also been complaining that GNER actually has to make net payments to Network Rail because the latter has improved its performance in securing GNER's access to the railways. In the past, Network Rail used to make payments to GNER because of timetable disruption caused by track maintenance.

Likewise, the Office of Rail Regulation's decision to grant additional open access competition in the shape of Grand Central is another of Sea Containers' frequent and doleful GNER-related laments.

But the harsh business reality MacKenzie is wrestling with is the fact that GNER's passenger revenue of £510m, earned between 1 May 2005 and 30 June 2006, represents a hefty £33m shortfall on the increase that

GNER projected in its franchise bid.

MacKenzie told the bondholders that GNER wouldn't be making the net profit of 3.75 per cent that it had originally estimated. GNER is highly unlikely to make any dividend payments in the short-to-medium term to its hungry parent. As a result, Sea Containers' worried shareholders and powerful bondholders are questioning the future value of GNER's business to their corporate interests.

That's pretty rich, according to GNER's stakeholders. Some senior GNER managers claim in private that Sea Containers has milked GNER as a cash cow for many years to subsidise its failing ferry and ailing container businesses.

They are now understandably worried that MacKenzie seems to want to renegotiate the franchise with the Department for Transport on the back of job cuts, a recruitment freeze and the hastened loss of 150 ticket staff. They also know that the DfT's stated position is that if a franchisee can't adhere to its subsidy/premium agreement then it must give up the franchise – i.e. face the ignominy of 'handing back the keys'.

MacKenzie tried to explain to the New York gathering that certain GNER costs and staffing levels are fixed by the franchise agreement. 'But,' he added ominously, 'that doesn't mean that we can't and won't attack our cost base. I am in the process of examining unregulated fares and the whole cost and service base of the railway.

'GNER has hit record levels of reliability and gives an absolutely first-class service,' MacKenzie said, but also stated without any hesitation: 'I believe we can help ourselves by reducing costs. I've been doing that for the last 25 years.'

MacKenzie went on to point the finger at one basic, grim fact underlying the desperate

situation at GNER: that the company has promised more than it could deliver. MacKenzie, who admitted that Sea Containers 'came within a few weeks of going completely and absolutely bust', told the bondholders that GNER had 'overcommitted and agreed to pay too much for the franchise'.

So: what's he going to do about it? 'In Britain, there is a lot of press speculation,' MacKenzie told shareholders. 'Any discussions I have with the DfT are going to be private, so I'm not going to discuss them publicly. You've got to trust me to fight GNER's corner. I'm an extremely combative person.'

Several scenarios for GNER's future were mooted during August. Large amongst them was the one that foresees the DfT doing what it says it will and refusing to renegotiate, 'realign' or 'readjust' or in any other way tweak GNER's franchise to suit MacKenzie. In this scenario, MacKenzie simply 'hands back the keys', Sea Containers cuts its losses and GNER slides into oblivion. First Class Partnerships, the DfT's retained consultants, would then run the franchise as 'operator of last resort' for a year, before Douglas Alexander proclaims a brave new dawn and launches a new re-letting process for the East Coast business.

But Gwynneth Dunwoody MP and her Transport Select Committee might want to know more about what (if any?) checks were made on Sea Containers' debts and whether the franchise was awarded in the knowledge that the promised payments could probably not be made. In August, DfT economists were said to be briefing some transport journalists that they had warned the DfT last year that GNER would be likely to fail to make its fifth year payments to the Government.

Another casualty of this sorry affair has been Christopher Garnett, one of the country's most respected railway professionals. GNER's version of events is that he decided, before the judicial review result, that it was time for someone else to take the helm; but that has done nothing to diminish a tide of speculation putting forward darker explanations for his departure. Did Garnett just get the bid completely wrong, and has now paid the price for this corporate failure? Was he over-confident after helming GNER to its pre-bid status as one of the most successful brands in the industry? Or was he ordered by his embattled parent company to win the franchise at any cost, and is now the fall guy? We don't know, and Garnett remains tight-lipped. Perhaps the truth, whatever it is, may simply be too painful to contemplate.

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