2019 RAIL FRANCHISING LITIGATION – WHEN THE GAMBLE DOESN'T PAY OFF

By Fionnuala McCredie QC and Rachael O'Hagan

Earlier this year Mr Justice Stuart-Smith handed down judgment in what is formally known as: *Stagecoach East Midlands Trains Ltd v Secretary of State for Transport; West Coast Trains Partnership Ltd v Department for Transport; Stagecoach South Eastern Trains Ltd v Secretary of State for Transport*[1]. This was a beast of litigation, which earned its own short-form title: "2019 Rail Franchising Litigation".

The issues which gave rise to the litigation are summarised in paragraph 1 of the judgment:

> *"The Defendant Secretary of State was conducting three franchise procurement competitions during a period when there was considerable uncertainty about the scope of potential pension liabilities because of intervention by the Pensions Regulator ("TPR")."*

In his judgment, Mr Justice Stuart-Smith dismissed the three claims in their entirety. The judgment is detailed and lengthy, running to some 601 paragraphs. In summary, the Judge found that the Secretary of State ("SoS") and the Department for Transport ("DfT") had made a lawful decision to disqualify several train operating companies because the train operating companies had proposed amendments to the franchise agreements which would transfer a greater proportion of the pensions risk to the Government than that which had been envisaged under the franchise agreement. The gamble taken by the train operating companies in marking up the franchise agreements had not paid off.

Fionnuala McCredie QC, Rachael O'Hagan and Harriet Di Francesco acted for SoS in this litigation. In this article, Fionnuala and Rachael shall consider the following aspects of the 2019 Rail Franchising Litigation:

- The background.
- Some of the key legal principles.
- Key findings.
- Franchising post COVID-19.

THE BACKGROUND

The litigation concerned three separate competitions for the West Coast, East Midlands and South East rail franchise competitions. The competitions were not subject to the provisions of the Public Contracts Regulations 2015. It was common ground between the parties that the competitions were subject to: (1) Articles 49 and 56 of the Treaty on the Functioning of the European Union ("TFEU"); (2) duties imposed by the Railway Regulation (1370/2007); and (3) the general principles of EU law (and, more specifically, the principles of non-discrimination, proportionality, transparency, equal treatment, the protection of legitimate expectations, the requirement to act without manifest error and good administration).

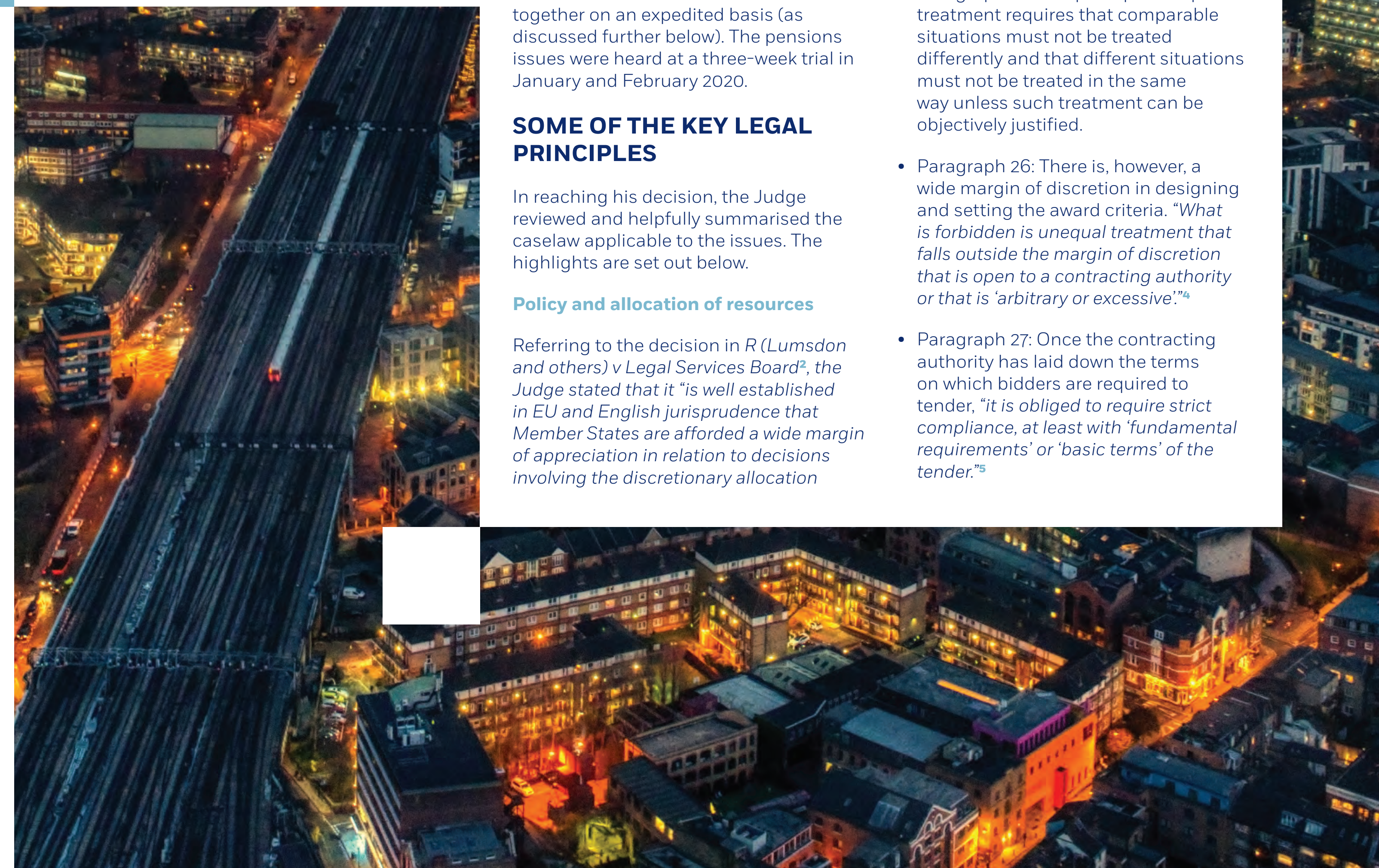
By way of background to the issues which arose, the Railway Pension Scheme is a shared cost defined benefit private scheme, which is under investigation by the TPR in relation to its funding levels. Rail franchisees are responsible for employer contributions. The TPR's investigation into the railways pension scheme at the time of the competitions meant that the future position and the funding of the scheme was uncertain. As a result, DfT offered contract terms for each franchise which would place the risk of pension liabilities on the successful bidder, subject to limited protection by way of a mechanism called the Pensions Risk Sharing Mechanism ("the PRSM").

Significantly, the Invitations to Tender ("ITTs") provided that:

- Bidders *"shall not propose amendments"* to the franchise agreements.
- SoS had a discretion to reject a non-compliant bid and (amongst other things) to disqualify the bidder from the competition.

The Claimants were train operating companies who submitted bids which rejected SoS's allocation of risk and offered to contract on different terms. SoS did not accept the bidders' alternative proposals and disqualified those non-compliant bidders, notifying the bidders by way of disqualification letter.

The Claimants brought claims challenging SoS's decision to disqualify the non-compliant bidders and making other complaints about the procedure which had been adopted by SoS. The Claimants claimed that there had been breaches of the Railway Regulations and the EU principles of proportionality, equal treatment and transparency. The Court directed that the claims be heard together on an expedited basis (as discussed further below). The pensions issues were heard at a three-week trial in January and February 2020.



SOME OF THE KEY LEGAL PRINCIPLES

In reaching his decision, the Judge reviewed and helpfully summarised the caselaw applicable to the issues. The highlights are set out below.

Policy and allocation of resources

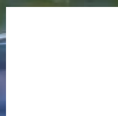
Referring to the decision in *R (Lumsdon and others) v Legal Services Board*[2], the *Judge stated that it "is well established in EU and English jurisprudence that Member States are afforded a wide margin of appreciation in relation to decisions involving the discretionary allocation of public resources" (para 20). Applying the further guidance in R (Rotherham Metropolitan BC) v Secretary of State for Business, Innovation and Skills*[3], the Judge found that this was a "classic case" where the courts should afford a wide-margin of appreciation. At paragraph 23 he said:

> *"Two points illustrate the potential sensitivity of whatever decision might be made. First, increasing the contractual support for the TOCs would give rise to contingent liabilities that could affect other areas of government, all of which were competing for limited resources. Second, any proposal for support in the present franchising competitions would give the successful bidder a level of government protection against pension risks that was not available to existing franchisees who were exposed to the same risks by TPR's intervention."*

Equal treatment

With regards to the principle of equal treatment, the Judge summarised the applicable principles as being:

- Paragraph 26: The principle of equal treatment requires that comparable situations must not be treated differently and that different situations must not be treated in the same way unless such treatment can be objectively justified.
- Paragraph 26: There is, however, a wide margin of discretion in designing and setting the award criteria. *"What is forbidden is unequal treatment that falls outside the margin of discretion that is open to a contracting authority or that is 'arbitrary or excessive'."*[4]
- Paragraph 27: Once the contracting authority has laid down the terms on which bidders are required to tender, *"it is obliged to require strict compliance, at least with 'fundamental requirements' or 'basic terms' of the tender."*[5]



> *"It remains my view that a procurement in which the contracting authority cannot explain the reasons for its decision fails the most basic standard of transparency*

- Paragraph 28: *"one of the consequences of the principle of equal treatment is that a contracting authority may not subsequently change one of the essential conditions for the award if it may have enabled the tenders to submit a substantially different tender."*[6]

Transparency

With regards to the principle of transparency, the Judge summarised the principles as follows:

- Paragraph 29: *Case C-19/19/00 SIAC Construction Limited County Council of the County of Mayo* [2001] WCR 1-772 provides a convenient and succinct summary of the principle of transparency.[7]
- Paragraph 30: The principle applies to all conditions and detailed rules of the award procedure, which could cover conditions about disqualification of bidders.
- Paragraph 31: Evidence about what tenderers themselves thought a tender document meant will generally be irrelevant – its meaning is to be assessed objectively.[8]
- Paragraph 33: The principles of equal treatment and transparency also require an authority to disclose any matter which it intends to consider when evaluating bids.[9]
- After reviewing further authorities, the Judge concluded:

"36. In practice this means that there will be very limited circumstances in which it could be appropriate for a bidder to be permitted to amend their bid after the deadline for submissions: and it will seldom, if ever, be permissible for a contracting authority to vary the criteria that it has laid down or to permit non-compliance with them. Transparency and equal treatment require rigour in maintaining and enforcing the framework against which bidders have been asked to tender.

37. One gloss needs to be added. A contracting authority is generally not obliged to divulge its system of marking or its methodology of evaluation though, if it does so, it would be obliged to stick to that too..."

Financial robustness tests

The ITT set out a financial robustness test, the utility of which was criticised by the Claimants. With regards to such a test, the Judge stated (amongst other things) that:

"39. There was and is no requirement of EU or UK Law that there should be a Financial Robustness Test or any test of the ability of franchisees to withstand downside risks or the vagaries that may affect the operation or financial outcome of the franchise.

....

40. ... if a contracting authority chooses to introduce a Financial Robustness Test as part of its procedure for choosing to whom a contract should be awarded, it must set out the requirements of the test clearly and must then stick to them."

Exercising discretions

The ITT provided (amongst other things) for SoS to have an unqualified discretion with regards to disqualification. As to the principles to be applied to such a discretion:

- Paragraph 45: The relevant principles when considering an apparently unqualified unilateral discretion are set out in *British Telecommunications Plc (Appellant) v Telefónica O2 UK Ltd and Others.*[10]
- Paragraph 54: After reviewing further authorities, the Judge found that neither *R (Law Society) v Legal Services Commission*[11] nor *Succhi di Frutta* supports a submission that the reserved power of disqualification in the ITTs in the present case was inherently unlawful.

Proportionality

After reviewing the decisions in *Lumsdon*[12] and Case *265/87 Schrader*,[13] the Judge made the following distinctions concerning the principle of proportionality:

"59....

i) Where a Member State acts in a way that imposes restrictions on EU fundamental rights ... although the Member State will enjoy a margin of discretion in its choice of policy choices and implementation, that discretion is subject to relatively rigorous scrutiny: and the principle of proportionality will be applied so that the measure must not go beyond what is necessary and appropriate to safeguard and achieve the relevant policy objective and must not be disproportionate to the benefits secured by it.

ii) On the other hand, where a Member State is acting within the scope of EU law and does so without imposing restrictions on an established right conferred by the EU Treaties, it enjoys a very broad discretion and the Court will only intervene on proof of 'manifest error'."

Manifest error

The Judge reviewed the applicable authorities and added at paragraph 65:

"It is not necessary and would be wrong in my judgment to import an additional requirement that the error must be 'fundamental', though it must be of sufficient materiality to justify the Court's intervention."

Duty to give sufficient reasons

After reviewing the relevant authorities, the Judge stated at paragraph 76:

"It remains my view that a procurement in which the contracting authority cannot explain the reasons for its decision fails the most basic standard of transparency. That said, there is no requirement that the reasons and reasoning must all be contained in one document (whether that be the document conveying the decision or otherwise), though the later the purported explanation, the greater the scrutiny that will be required to ensure that what is being provided is in fact the reasons or reasoning that prevailed at the time and not merely an ex post facto justification."

KEY FINDINGS

The Judge dismissed each of the Claimants' claims, resulting in a resounding victory for SoS. The key findings are summarised in this Section below.

***Issue: Discretion to disqualify:* Did the terms of the ITT governing SoS's treatment of non-compliant bids and disqualification breach their duties of transparency and fairness?**

The answer to this question was: No. The Judge held that the terms of the ITT regarding amendments were clear and *"admitted of no misunderstanding"*. They did not create unfairness between the respective bidders and SoS. The terms concerning the allocation of risk are subject to a wide margin of appreciation as they were part of an *"overall package of rights, risks and obligations"* and manifested policy decisions about the allocation of public resources. Applying *Telefónica*, the discretion had to be exercised rationally and in accordance with policy could not be exercised in an *"unlimited or arbitrary or capricious basis."*

***Issue: Uncertain risk/margin of appreciation:* Was there a breach of the duties of transparency/fairness due to seeking to impose large/uncertain risks?**

The answer to this question was: No. There was no principle of EU or UK law that limited the size of the risk that may be allocated to a contracting party in a public procurement exercise. The Judge held that a contracting authority is afforded a wide margin of appreciation in relation to the allocation of public resources, including the level of state support or protection that it would make available to a prospective bidder. The writers respectfully suggest that this finding accords with good commercial common sense: the bidder has the option to (i) price the risk (as with any other contractual risk) or (ii) choose not to bid for the contract.

***Issue: Treatment of exogenous risks freedom to contract:* Did SoS breach its duties of proportionality or fairness, or the Claimants' rights under the Railway Regulation or the TFEU by seeking to allocate pensions risks to the franchisees which were exogenous or outside their control?**

The answer to this question was: No. There was no principle of EU or UK law which precluded the allocation of exogenous risks to bidders rather than the Government. The Claimants could have chosen to bid at a level which would have given them protection under the PRSM. However, the Claimants chose not to bid in that way.

***Issue: Disqualification:* Were the decisions to disqualify unlawful?**

The answer to this question was: No. With regards to the Claimants' complaints about SoS's marking and evaluation criteria, the Judge held that a contracting authority is not required to divulge its system of

FOOTNOTES

marking or its methodology or evaluation. SoS had some "leeway" in how it assessed the bids provided that it did not change the award criteria.

***Issue: Reasons:* Did SoS provide sufficient reasons?**

The answer to this question was: Yes. SoS's reasons as set out in its disqualification letters were concise, clear and sufficient to enable the Claimants to know that they had been disqualified for non-compliance with the pensions requirements.

***Issue:* Did SoS breach its duties by failing to take proper account of financial robustness of the pensions compliant bids and by relying on additional reports?**

The answer to this question was: No. There was no requirement of EU or UK law that required a contracting authority to include a test of financial robustness in the criteria for accepting bids. Even if such a test were to exist, the requirements of that test had been set out clearly and SoS had complied with the test. SoS was entitled to determine the extent of any robustness testing that he wished to put in place.

Also, DfT had commissioned PwC to analyse the leading bids to determine whether they remained robust if various downside pensions risks materialised. SoS said that the purpose of this exercise was to determine whether to continue with the competitions or to abandon them. The Claimants claimed that this exercise was used to evaluate the financial robustness/assess the sustainability of leading bids. The Judge found that there was no provision of EU or UK law that required a decision to cancel a competition to be taken solely on the basis of information generated by the terms of the ITT. The PwC analysis was used only to inform the decision whether or not to cancel the competitions.

THE END OF AN ERA: RAIL FRANCHISING POST COVID-19

No sooner than the dust had started to settle on our closing submissions and whilst we eagerly awaited the judgment, the COVID-19 pandemic started to kick-in resulting in low passenger numbers on the train services and the Government agreeing to pay the losses of rail companies (which have cost more than £3.5bn) which had been affected by dwindling passenger numbers. Judgment was handed down on 17 June 2020 but only a few months later, on 21 September 2020, the Government announced the "end of the era" for rail franchising after some 25 years. Instead, a series of Emergency Recovery Management Agreements were put in place whilst the Government works towards a more long-term overhaul: https://commonslibrary.parliament.uk/research-briefings/cbp-8961/

It remains to be seen what the future holds for rail franchising contracts.