

## Railway law & policy briefing

# Rail franchise change of control policy – illegal

7 May 2008

Secretary of State tries to impose new franchise tax

### Essential points

- **DfT policy statement on additional fees for consent to change of control**
- **£1m or 5% of value to transferor to be demanded**
- **Issued without prior consultation**
- **PPP/PFI precedent offers no support**
- **Illegal as unauthorised by legislation and made for improper purpose**
- **Time limits for legal challenge are tight**

### DfT statement of policy

On 28 March 2008, the Department for Transport published a statement of its policy on change of control of passenger rail franchisees.

It states that the DfT will, in all future cases of change of control of a franchisee or franchise operator, require two kinds of payment as a condition of DfT's giving its consent to the change. The payments are:

- a facilitation fee which will "generally be the greater of £1 million or [sic] 5% of the value of the change of control of the franchise to the vendor"
- an administration fee based on the amount of civil servants' time spent on considering the change of control.

The facilitation fee therefore comes over and above the administration fee. Neither payment is provided for in the Railways Act 1993 or the standard franchise agreement.

### Asserted justification

Under the template franchise agreement, it is an event of default for a franchisee to undergo a change of control which has not been authorised in advance by the DfT. Control is widely defined. It includes both changes in overall control, changes of control of related companies, and acquisitions of shareholdings which take the acquiring party over 30% of the issued share capital of the entity being acquired.



### Our Rail Practice

White & Case is a leading global law firm, with extensive experience in rail privatisation, industry restructuring, concessions, competition, rolling stock leasing and builds, infrastructure, financing and economic regulatory policy, dynamics and design

In London, the rail practice is led by partner Tom Winsor who, from 1999-2004, was Rail Regulator and International Rail Regulator, Great Britain

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DfT's proposed change of control policy contravenes public law rules on collateral purposes, and is unauthorised by railways legislation

The proposed facilitation fee of up to 5% of the value of the change of control to the vendor could be a substantial sum.

An event of default can lead to termination of the franchise, so compliance with this condition is of course important.

The DfT has explained its policy in the following terms:

*"The prohibition [on unauthorised change of control] is important because franchisees and franchise operators deliver front line public services. Rail franchises are vital to the Government's delivery of its broader policy objectives on the environment, the economy, social inclusion and accessibility. Ensuring the continued success of a franchise is therefore a matter of legitimate public interest. All franchisees are vetted by the Secretary of State to ensure that they are financially robust and have a track record of successful delivery. The Secretary of State will wish to have confidence that the new owners will continue to honour their obligations under the franchise agreement and, as the success of a franchise is ultimately dependent on delivery by its people, in the quality of the proposed management team."*

This is a fair and defensible elaboration of the purpose of the change of control clause in the franchise agreement, which may be summarised as ensuring that the new controlling party is a fit and proper person to have control of a franchisee.

The DfT continues its statement in the following terms:

*"The Secretary of State considers it appropriate to require payment of a facilitation fee because it is the reasonable expectation of the Secretary of State that a change of control represents a value to the vendor. The opportunity to realise that value is a product of the system of franchising established and maintained by [the] Secretary of State at public expense, and the value of franchises is in many cases a product of substantial public*

*subsidy. Therefore, the Secretary of State considers it appropriate that the public should also realise a benefit from a change of control. The Strategic Rail Authority, and prior to that the Office of Passenger Rail Franchising, used to require a passenger dividend - agreed infrastructure or service investments - in consideration for consent to a change of control. Passenger dividends were in substance and effect similar to the facilitation fee which the Secretary of State is now seeking as consideration for his/her consent to the change of control and for reinvestment in the railway network."*

The DfT also says:

*"The Secretary of State considers that [the stated basis of calculation of the fee] strikes an appropriate balance between realising the full commercial value of the Secretary of State's consent for the benefit of the public and avoiding undue interference in the market."*

The proposed facilitation fee of up to 5% of the value of the change of control to the vendor could be a substantial sum.

### **Legal position**

A public authority, such as the DfT, can only exercise its powers for the purposes for which those powers were conferred on it. Exercising power for a different – collateral – purpose is illegal.

The DfT has made it quite plain that the change of control clause in the franchise agreement is there to enable the Secretary of State to ensure that the person acquiring control of a franchisee is a fit and proper person to do so. Indeed, that has always been the position. It is also the stance taken by the Office of Rail Regulation (and the Rail Regulator before it) since the change of control regime was devised in 1994 for franchises and licences.

The DfT's statement makes it clear that even if the Secretary of State is satisfied that the change of control is unobjectionable on 'fit and proper person' grounds – and so passes the 'fit and proper person' test - it will still be refused if the facilitation fee is not paid. This demonstrates that the purpose of the facilitation fee is outside the legally permitted objective.

In addition, section 29 of the Railways Act 1993 authorises the Secretary of State to include in a franchise agreement provisions which require the franchisee or the franchise operator to make payments *"of such amounts and at such intervals as may be specified in, or determined by or under, the franchise agreement."*

Neither the facilitation fee nor the administration fee is included in the franchise agreement. These are new payments which the DfT have decided to demand, outside the franchise agreement, simply because they believe they can extract them. On a correct legal interpretation of the DfT's powers, if the payment is not contemplated by the franchise agreement itself, it may not be demanded as an addition to the deal which the franchisee has already struck with the DfT.

The prior practice of OPRAF and the SRA is no justification for the proposed facilitation fee. Passenger dividends were illegal for precisely the same reason. They were paid in practice because franchisees were, in the main, being asked to commit to expenditure on their franchises which they already intended to make. Whilst franchisees disliked passenger dividends, in the past none has been so large as to impel a franchisee to launch a legal challenge.

DfT may try to cite the precedent of PPP and PFI contracts for their proposed approach to change of control fees. This would be unjustified. In PPP and PFI schemes, extra economic value is

generally extracted by the public authority from the private sector party when there is a refinancing of the scheme, which often involves a change of control of one or more of the private sector companies involved. However, the additional payments are not triggered by the change of control, but by the refinancing. Moreover, and crucially, the additional payments are expressly provided for in the contract. This is not the case with passenger rail franchises.

It is also noteworthy that the Office of Rail Regulation has announced no corresponding intention to levy additional licence payments when it is asked for its consent to a change of control under any of the licences issued under section 8 of the Railways Act 1993.

It is therefore our view that the DfT's new policy is legally unsound.

#### **Possible challenge**

The DfT's policy was announced without consultation. Franchisees probably have a legitimate expectation that such a radical move would be subject to consultation in advance.

More substantively, franchisees must consider what they should do by way of possible challenge to the legality of the DfT's stated policy.

The time limits for judicial review are very short. Claims must be brought as soon as reasonably practicable, with an outer time limit of 90 days from the public authority's action. If a claim could be brought earlier, even acting within the 90-day period may be too late.

It is arguable that no claim needs to be brought until the DfT tries to apply the policy in a particular case. However, in such circumstances it is quite likely that DfT will argue that the claim is out of time; the policy was announced on 28 March 2008.



Judicial review time limits are tight and strict; claims brought late can be rejected



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