

Return to an Address of the Honourable  
the House of Commons  
dated 6 December 2012  
for

# **Report of the Laidlaw Inquiry**

**Inquiry into the lessons learned for  
the Department for Transport from  
the InterCity West Coast Competition**

Ordered by the House of Commons to be printed on 6 December 2012

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***Redacted version: In this version of the report which has been produced for publication, the Department for Transport has redacted certain passages on the basis that they contain sensitive information, such as information which is commercially sensitive to the bidders involved in the ICWC franchise process.***

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**Appendices referred to in this report are available on [www.gov.uk/dft](http://www.gov.uk/dft).**

# THE LAIDLAW INQUIRY: REPORT

## 1 Introduction

- 1.1 On 3 October 2012 the Secretary of State for Transport announced that the competition to run passenger trains on the West Coast Main Line had been cancelled following the discovery of significant technical flaws in the way the InterCity West Coast (“**ICWC**”) franchise process was conducted.
- 1.2 By letter dated 15 October 2012 the Secretary of State asked me as lead non-executive board member of the Department for Transport (the “**DfT**”) to lead an independent inquiry (the “**Inquiry**”) into the DfT’s handling of the competition. I am also the Chief Executive of Centrica plc, a non-executive director of HSBC Holdings plc and a member of the Prime Minister’s Business Advisory Group.
- 1.3 The formal Terms of Reference for the Inquiry are reproduced in full in Appendix A to this report.
- 1.4 The Secretary of State asked me first to report my initial findings to him and then to produce a final report. My initial findings were set out in my Initial Findings Report of 27 October 2012. In light of the further work undertaken since I issued that report, I am in a position to confirm and add to my initial findings. This is my final report.
- 1.5 My Initial Findings Report is reproduced, without its appendices, in Appendix B to this report. It may be helpful to any readers who are unfamiliar with the structure and economics of passenger rail franchises and franchise process competitions, or with the background to the ICWC franchise process, to read paragraphs 4.1 to 4.14 of my Initial Findings Report (in section 4 headed “*Background and context*”) before reading the rest of this report. In particular, it is important for readers to be aware that passenger rail franchisees are set up as special purpose companies with little recourse to their owning groups and are typically thinly capitalised. The DfT is exposed to a risk of franchisee insolvency leading to premature termination of the franchise. The DfT’s determination of whether (and to what extent) to require bidders to obtain commitments from owning groups for a subordinated loan facility (“**SLF**”) is one of the ways in which the DfT seeks to address this risk.
- 1.6 This report is structured as follows:
  - 1.6.1 after this Introduction, section 2 describes the scope of the Inquiry, the work that has been undertaken in order to produce this report and the limitations on that work;

- 1.6.2 section 3 is a summary of my findings and recommendations;
- 1.6.3 section 4 describes the course of events in relation to:
- (i) the process by which the DfT told bidders it would determine, and in fact determined in June 2012, the level of the SLF that it required to be provided to two of the bidders in the ICWC franchise process by their owning groups; and
  - (ii) the subsequent consideration of, and challenge to, that SLF sizing process until the DfT's announcement on 15 August 2012 that the then Secretary of State for Transport intended to award the ICWC franchise to First West Coast Limited ("**First**"),
- although it does not purport to be a comprehensive account of all events. Section 4 also sets out my findings (in bold and underlined text) which arise from these events;
- 1.6.4 section 5 sets out my findings (again in bold and underlined text) concerning the model which the DfT told bidders it would use to calculate SLF levels. Sections 4 and 5 are accordingly focussed primarily on matters relating to the SLF sizing process, which reflects the fact that it was flaws identified in this process which led to the cancellation of the competition. It is clear from these two sections that the process followed by the DfT to determine the levels of SLF required in respect of the bids of First and Virgin Trains Limited ("**Virgin**") was seriously flawed;
- 1.6.5 section 6 considers the roles, responsibilities and conduct of the DfT's principal external advisers in relation to the facts covered by my findings;
- 1.6.6 section 7 analyses why the flaws in the SLF sizing process arose, which involves the consideration of broader issues across the ICWC franchise process. Again, I set out my findings in bold and underlined text; and finally
- 1.6.7 section 8 identifies lessons to be learned by the DfT and various steps that I recommend the DfT should take to reduce the risk of a recurrence of similar problems in future franchise processes.

## 2 Scope and work undertaken

### The Inquiry team

- 2.1 As explained in paragraph 4 of the Terms of Reference, Linklaters LLP (“**Linklaters**”) and Ernst & Young LLP (“**Ernst & Young**”) have been appointed to provide an external perspective to the Inquiry. Teams from those firms have assisted me in undertaking the work described below. I have also been greatly assisted by Ed Smith, who is also a non-executive DfT board member. (Where I refer in the rest of this report to the “**Inquiry team**”, I am referring to some or all of myself, Ed Smith and the teams from Linklaters and Ernst & Young.) Save where I expressly state otherwise, all of the views and the findings set out in this report are entirely my own.
- 2.2 In my Initial Findings Report I stated that I was satisfied that all members of the Inquiry team were conducting the Inquiry in an independent and objective manner and I summarised my involvement and the involvement of Ed Smith in the ICWC franchise process. I remain satisfied with the independence and objectivity of the Inquiry.

### Scope

- 2.3 On 15 August 2012 the DfT announced that the then Secretary of State intended to award the ICWC franchise to First. Paragraph 2a. of the Terms of Reference makes this the cut-off point for the Inquiry. I therefore do not address in this report any events after that announcement.
- 2.4 I have not conducted any form of audit or other review either of the entire ICWC franchise process or of all aspects of the narrower bid evaluation process. The work done by the Inquiry team has focussed on the issues set out in paragraph 2 of the Terms of Reference. Paragraph 2 refers to the flaws that resulted in the cancellation of the ICWC franchise process. These flaws related to the process by which the DfT determined the level of the SLF that it required to be provided to two of the bidders by their owning groups. That flawed process, and the course of events that led to it, are therefore the areas of primary focus for the Inquiry. Of course, considering what may have led to or contributed to these flaws has involved the consideration of broader issues across the ICWC franchise process.
- 2.5 As I noted in my Initial Findings Report, it is, however, important when reading this report to keep a proper perspective on the significance of the SLF sizing process in the context of overall bid evaluation. The evaluation and ranking of bids in a rail franchise competition will involve consideration of a wide range of criteria, not least of which is the value of the promised franchise payments. The level of any SLF requirement is but one aspect of the overall evaluation, albeit if a bidder is

unable or unwilling to obtain any SLF required by the DfT, that bidder cannot participate further in the competition.

2.6 Although not expressly referred to in the Terms of Reference, I am conscious that there has been speculation in the media that I will address in this report the issue of whether I have seen evidence of any deliberate “anti-Virgin” bias at the DfT. In the absence of a full, independent email capture and review (as to which see paragraph 2.16.2 below), I can only express a qualified view on this issue. Based on the documentation and witness evidence obtained by the Inquiry team, I can confirm that (notwithstanding my finding at paragraph 4.64.4 below as to the inconsistent treatment of First and Virgin) I have seen no evidence of any such bias.

2.7 I have not formed or expressed a view on:

2.7.1 the extent to which (if at all) bidders in the ICWC franchise process might have bid differently if the transparency issues that I identify in this report in relation to the SLF sizing process had not existed;

2.7.2 the extent to which (if at all) the DfT might have announced an intention to award the ICWC franchise to a bidder other than First if the flaws in the DfT’s SLF sizing process that I identify in this report had not occurred; and

2.7.3 any legal issues, such as the merits of the application for judicial review made by one bidder in Claim No. C0/9098/2012, the extent to which any aspect of the ICWC franchise process complied with applicable procurement law, or whether the DfT and the Secretary of State could lawfully have continued with the ICWC franchise process in October 2012 rather than cancelling the competition.

2.8 I have also not sought to ascertain whether the current franchising model is the most appropriate for rail franchises going forward given the longer franchise periods and therefore the greater risks involved. This is a matter for the separate review that the Secretary of State has asked Richard Brown to conduct. However, I hope that the recommendations that I set out in section 8 will be helpful in that regard.

2.9 Paragraph 6 of the Terms of Reference states that “*The Inquiry will be taking place in parallel with the Department’s HR investigations.*” In view of those separate DfT investigations (the “**HR investigations**”), I stated in my Initial Findings Report (at paragraph 2.4.2) that I did not expect issues of individual culpability to be an area of focus for the Inquiry. In this report, although I have identified various failings, for example, in relation to formal escalation and internal reporting, I have not made (and should not be taken to have made) any findings as to whether conduct by any individual DfT official was inappropriate (or whether that conduct was deliberate, careless or otherwise). The Inquiry has, as required by paragraph 2 of the Terms of

Reference, involved “*an immediate study*” into the relevant issues. Any findings on individual culpability would of course require a detailed examination of the particular circumstances applying to each relevant individual and an assessment of what it was reasonable to expect of each individual in those circumstances. I have not carried out such an examination or assessment. I have however considered in section 6, as required by paragraph 2b. of the Terms of Reference, the extent to which the DfT’s principal external advisers were responsible for the facts covered by my findings set out in sections 4 and 5.

- 2.10** I have not identified any DfT officials by name in this report. I decided that it was unnecessary for me to do so in order for the Inquiry properly to comply with the Terms of Reference. I am also conscious of the need to ensure that the Inquiry does not in any way prejudice the HR investigations.
- 2.11** In my Initial Findings Report I said that I would explain in this report the levels within the DfT at which relevant actions or decisions were taken. In setting out the key events in section 4 below, I have sought to identify:
- 2.11.1** which DfT committees took relevant decisions;
  - 2.11.2** which actions or decisions were taken by the middle ranking DfT officials (and some contractors) who comprised the ICWC franchise project team that undertook the day to day conduct of the ICWC franchise process; and
  - 2.11.3** which actions or decisions were taken by more senior DfT officials or by Ministers.
- 2.12** In relation to this, I have seen no evidence that any of the flaws set out in my findings contained in sections 4 and 5 below were known, on or before 15 August 2012, by any individuals who were members in 2012 of the DfT Executive Committee or by the individuals who were the Secretary of State and Minister of State for Transport during this time.
- 2.13** In this report where I refer to the “**ICWC Project Team**”, I am referring to the project team described at paragraph 2.11.2 above, the members of which changed during the course of the ICWC franchise process. Where I refer in this report to actions or decisions taken by, or knowledge of, the ICWC Project Team, I do not mean to imply that all members of the team were necessarily involved in taking those actions or decisions, or had that knowledge.
- 2.14** I refer in this report to the middle ranking DfT official who performed the lead role on the ICWC Project Team during the procurement phase (from January 2012 onwards) as the “**ICWC Project Team Leader**”.

### Work undertaken

**2.15** The evidential basis for this report is made up of the four elements described below.

**2.15.1** The Inquiry team has requested a substantial number of documents, principally from the DfT and from DfT officials, as well as some documents from external advisers to the DfT and other parties.

**2.15.2** A large number of interviews have been conducted by the Inquiry team, including with:

- (i) DfT officials, both former and current, who were involved in the ICWC franchise process;
- (ii) officials from HM Treasury (“**HMT**”) involved in the ICWC franchise process and from the Major Projects Authority (“**MPA**”), which undertook two reviews of the ICWC franchise process in the period up to 15 August 2012;
- (iii) representatives of WS Atkins Plc (“**Atkins**”), Eversheds LLP (“**Eversheds**”) and Grant Thornton UK LLP (“**Grant Thornton**”), as well as Leading and Junior Counsel, who were external advisers to the DfT in the period up to 15 August 2012; and
- (iv) two former Secretaries of State and a former Minister of State for Transport who between them were in office in the period May 2010 to 15 August 2012.

**2.15.3** The Inquiry team has spoken with representatives of the four bidders for the ICWC franchise.

**2.15.4** Ernst & Young has performed financial modelling analysis on which I have relied in making the findings set out in section 5 below.

### Limitations on work undertaken

**2.16** As with my Initial Findings Report, I want to be clear about the limitations on the work undertaken by the Inquiry team.

**2.16.1** The Inquiry has no statutory underpinning and no powers of compulsion in relation to document production. The Inquiry team has necessarily relied on the parties to whom document requests have been made, principally the DfT, to comply fully with those requests and has assumed that all documents provided to the Inquiry team are authentic and true copies of the originals.

**2.16.2** In my Initial Findings Report I explained (at paragraph 2.4.5) that I considered that there had been insufficient time to conduct an email capture and review in advance of preparing that report and so had not instructed that

to be done. On 31 October 2012 the Inquiry team submitted to the DfT a request for email searches to be done by the DfT by reference to specified custodians, time periods and search terms. In the event, the DfT was unable to transfer the data to the Inquiry team in sufficient time for an email review to be carried out because of Government data security and related issues. No email capture and review has therefore been carried out for the specific purpose of this report. The Inquiry team has, however, reviewed a number of emails made available by the DfT, including emails captured for the purpose of the HR investigations. Whilst I recognise that the absence of a full email capture and review is a limitation on the evidence available to the Inquiry team, the Inquiry team has conducted an intensive programme of work for this Inquiry. It has reviewed a large amount of documentation and conducted a large number of interviews. I am accordingly satisfied that I have a proper evidential basis for making the findings set out in this report.

- 2.16.3 The DfT instructed the Inquiry team that in interviews of DfT officials the Inquiry team should not ask questions which go to the personal accountability, culpability or mindset of DfT officials. The DfT has explained this limitation on the basis that such questions might prejudice the HR investigations. Given that the Inquiry is not focussed on individual culpability (see paragraph 2.9 above), I consider that this limitation has not, in practice, prevented the Inquiry team from obtaining through interviews the evidence that it needed to ensure that the Inquiry was carried out in accordance with the Terms of Reference.
- 2.16.4 Some of the DfT officials interviewed by the Inquiry team have been suspended by the DfT and, as a result, did not have access to the same documents as they would have had access to had they not been suspended. I have taken this position into account when considering the evidence given by these individuals.

### **3 Summary of findings and recommendations**

- 3.1 In seeking to run the complex and, in some respects, novel ICWC franchise process, an accumulation of significant errors, described in this report, resulted in a flawed SLF sizing process. The responsibility for this flawed process rests with the DfT, rather than with any of its external advisers.

#### Transparency issues

- 3.2 As senior DfT officials were aware, there was from early 2012 a lack of transparency as to how the SLF requirements would be determined and a consequent risk of legal challenge by bidders. Bidders were unable reliably to predict the likely size of the risk capital that the DfT would require their owning groups to commit by way of an SLF.
- 3.3 Although the DfT tried to mitigate this lack of transparency by taking various steps, including issuing bidders with guidance, these steps were inadequate. The difficulty arose because the build and assumptions underpinning the DfT's own model used for SLF sizing meant, as senior DfT officials were aware, that it was not a model that could be shared with bidders without a risk of challenge.

#### The sizing of the SLF requirements

- 3.4 The guidance that the DfT issued to bidders committed the DfT to sizing its SLF requirements by following a particular methodology. This methodology involved running the DfT's model to establish the level of SLF required to avoid a bid exceeding a specific maximum default level. However, when it came actually to determining the level of SLF requirements in late June 2012, the Contract Award Committee (the "CAC", a committee of senior DfT officials referred to in paragraphs 4.53 to 4.64 below) conducting this exercise departed from the DfT's own published guidance and instead based the final numbers on its view of what was an appropriate level of capital to be injected into the bid vehicles. [REDACTED] advised the CAC, without taking into account the DfT's own published guidance, that it was entitled to take this approach.
- 3.5 In reaching its view on appropriate SLF levels, the CAC took into account extraneous factors that ought properly not to have been taken into account and treated bidders inconsistently.

#### External advice and internal reporting

- 3.6 Just a few days after the CAC meeting, the DfT's external legal advisers, Eversheds, raised with both the ICWC Project Team Leader and DfT internal lawyers a concern as to possible process risks associated with the manner in which the CAC had determined the level of SLF requirements.

- 3.7 Even though the SLF requirements had been communicated to bidders immediately following the CAC meeting, there were a number of opportunities for a full and proper explanation as to how the SLF requirements had been sized to be formally escalated and reported within the DfT in the seven weeks after the CAC meeting and before the award announcement was made on 15 August 2012. These opportunities appear not to have been taken.
- 3.8 Not only do these opportunities to escalate and report within the DfT appear not to have been taken, but inaccurate reports as to how the SLF numbers had been produced by the DfT were made to senior DfT decision makers and ultimately to the then Minister of State. The material on which these senior DfT decision makers and the Minister made their decisions to award the ICWC franchise to First included these inaccurate reports.

#### Technical modelling flaws

- 3.9 To the extent that the CAC considered the SLF numbers generated by the DfT's model in determining the SLF levels, those numbers were understated by nearly 50% because DfT officials did not appreciate that the outputs from the model were in real terms and needed to be inflated to nominal figures.
- 3.10 The DfT used an elasticity factor (which governs the relationship between Gross Domestic Product (“GDP”) and revenue) of 1.4 in the DfT's model. However, the DfT advised bidders it would use a different elasticity factor (of 1.8) to carry out revenue risk adjustments. Since the DfT's model was calibrated using an elasticity factor of 1.4, this was inconsistent with the elasticity used in the guidance the DfT had given to bidders. The guidance may have created an impression in the minds of bidders that the model would be calibrated by reference to 1.8. Had the DfT applied the same elasticity factor as that set out in guidance to bidders, the SLF numbers generated by the DfT's model would have been significantly higher. This issue also meant that the implicit default rate for the levels of SLF in fact sought by the DfT in respect of bids was much higher than the DfT's target default rate.
- 3.11 These technical modelling flaws, which impacted both the DfT's model and the Ready Reckoner<sup>1</sup> which was calibrated to that model, meant that the SLF numbers generated by the DfT's model were substantially understated. In addition to the transparency issues noted at 3.2 above, inconsistencies in the use of elasticity factors meant that the bidders were provided with inconsistent and confusing information that also prevented them from determining the level of SLF required and the optimal capital structure for their bids.

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<sup>1</sup> The Ready Reckoner was the final page of the guidance provided to bidders as further set out at paragraph 4.15 below

### Contributory factors

- 3.12** A number of factors, operating together, caused or at least contributed to the flaws identified above:
- 3.12.1** significantly, the opportunities identified at paragraph 3.7 above formally to escalate or report appear not to have been taken;
  - 3.12.2** planning and preparation in respect of the ICWC franchise was inadequate and failed to allocate time appropriately or incorporate sufficient flexibility in respect of the process timetable;
  - 3.12.3** the organisational structure at the DfT failed to set out roles, responsibilities and associated accountabilities clearly, and the resources of the DfT were excessively stretched due to the Government's spending review and the competing pressures of other projects;
  - 3.12.4** the effectiveness of the governance framework was severely reduced by the lack of clarity in the functions, authorities and interrelationships of various committees and boards;
  - 3.12.5** significant risk issues were identified through internal and external quality assurance procedures over the course of the ICWC franchise process; however, the quality and robustness of the ICWC procurement was subordinated to an overriding pressure to complete the procurement on time; and
  - 3.12.6** whilst the governance framework was not effective in escalation or resolution of the flaws in the ICWC franchise process, as noted in paragraph 3.12.1 above there appears to have been a failure on the part of those responsible for escalation and resolution, indicating a culture of limited ownership and ineffective oversight.

### Lessons learned

- 3.13** I believe the recommendations which are set out in section 8 below and summarised here, if acted upon quickly and effectively, will help to restore confidence in the DfT's conduct in rail franchising and procurement.
- 3.14** To reduce the risk of a recurrence of similar flaws in future franchise processes, the DfT should ensure that:
- 3.14.1** appropriate discipline is applied in the allocation and balance of time and resource to officials in procurements, including consultation with the bidding community, enabling translation of policies into commercially viable contractual propositions, rigour in testing and effective development and scrutiny of contractual documentation and access to effective external advice;

- 3.14.2 a review is made of the use of the SLF as the most appropriate means of mitigating the risk of franchisees walking away from the franchise;
- 3.14.3 reconsideration is given to how the DfT provides the necessary commercial flexibility during the procurement phase within legal constraints and what information is provided to bidders;
- 3.14.4 a credible timeline, with appropriate reference to the complexity of the procurement involved, is assessed and agreed at procurement inception and contingency planning is carried out and reviewed at regular intervals;
- 3.14.5 the governance, Director General and senior responsible officer (“SRO”) structure of the franchising programme is redesigned to establish clear roles, responsibilities and delegations of authority for all individuals and clear methods for escalation of risks and concerns under the oversight of a dedicated senior responsible DfT official;
- 3.14.6 a review is carried out of escalation policy and of the effectiveness of communication to staff of expectations and responsibilities in respect of line reporting;
- 3.14.7 consideration is given to establishing structures to bring the necessary level of industry expertise and non executive oversight to the rail franchising programme and individual procurements;
- 3.14.8 a skills review is carried out and a thorough needs assessment undertaken to establish whether there are capability, experience or leadership gaps within the DfT and the nature and extent of external support required by the DfT;
- 3.14.9 the terms of reference of bodies responsible for governance of the franchising programme are reviewed for completeness and consistency and for clarity of functions and interrelationships. This should include a review of anonymisation procedures; and
- 3.14.10 a review is conducted of internal and external quality assurance procedures, including of the clarity as to the basis and outputs of the procedures undertaken and of the effectiveness of the various bodies with responsibility for undertaking and following up on those procedures.

#### 4 The course of events in relation to the SLF sizing process

##### Publication of SLF sizing methodology and lack of transparency: Spring 2012

- 4.1 The Invitation to Tender (the “**ITT**”) for the ICWC franchise was published by the DfT on 20 January 2012. (A copy is available on the DfT’s website.) The ITT was approved prior to publication by both:
- 4.1.1 the DfT’s Board Investment and Commercial Sub-Committee (the “**BICC**”, a committee responsible to the DfT board, made up of senior DfT officials and a non-executive DfT board member, and chaired by a DfT Director General) at a meeting on 15 December 2011 that I attended (see paragraph 2.2.1 of my Initial Findings Report); and
  - 4.1.2 the then Minister of State for Transport (having first obtained the agreement of the Chief Secretary to the Treasury).
- 4.2 Section 1.1 of the ITT stated that its purpose was to set out:
- 4.2.1 the ICWC franchise proposition for which the DfT was seeking bids;
  - 4.2.2 how the competitive process would work;
  - 4.2.3 how bidders should complete their bids; and
  - 4.2.4 how the evaluation process should work.
- 4.3 The content of the ITT reflected reforms to franchising policy and contract design announced by the Government in January 2011 (see paragraph 4.11 of my Initial Findings Report), in particular as to franchise duration and revenue risk sharing. The ICWC franchise process was the first franchise process to reflect these reforms. In particular:
- 4.3.1 section 3.1 of the ITT provided that the ICWC franchise length would be 13 years and 4 months (subject to extension by up to 20 months); and
  - 4.3.2 sections 5.4 and 5.8.4 of the ITT explained that the franchise agreement would include a mechanism (the “**GDP Mechanism**”) that sought, by varying the amount of the annual franchise payment that the franchisee contracted to make to the DfT, to reduce the exposure of the franchisee and the DfT to fluctuations in national GDP, the key exogenous variable. To calibrate the GDP Mechanism, the DfT developed a financial model, known as the “**GDP Resilience Model**”, containing 500 economic scenarios.
- 4.4 In relation to the bid evaluation process, section 2.15 of the ITT provided that the evaluation of bids was to be conducted in accordance with the ITT, the DfT’s “*Guide to the Railway Franchise Procurement Process*” (the “**Guide**”) and the DfT’s “*Franchise Evaluation Process Charts for InterCity West Coast Franchise*

*Competition*” (the “**Process Charts**”). (Copies of the Guide and the Process Charts are available on the DfT’s website.)

- 4.5 The ITT, the Guide and the Process Charts explained that the evaluation process would include an evaluation of the financial risk of the bids. The process for the financial risk evaluation described in these documents included the following steps:
- 4.5.1 the DfT making adjustments to the revenue and cost lines of each bid to reflect:
    - (i) in relation to endogenous factors (i.e. individual bidder initiatives), the DfT’s view on the risks of each bid failing to meet its projections; and
    - (ii) in relation to exogenous factors (i.e. macroeconomic factors such as GDP), the DfT’s comparator model;
  - 4.5.2 the DfT then considering whether the risk-adjusted revenue and costs of each bid produced too high a risk of franchise insolvency;
  - 4.5.3 where the DfT considered the risk of franchisee insolvency to be too high in relation to a bid, the DfT determining the level of additional funding required from the bidder’s parent; and
  - 4.5.4 the DfT then seeking clarification from the bidder as to whether its parent was “*prepared to inject additional funds, to robustly mitigate the issue*”.
- 4.6 Chart 3 of the Process Charts (headed “*Revenue Assessment*”) (“**Chart 3**”) set out in diagrammatic form the step described at paragraph 4.5.1 above. Boxes 3.5 to 3.8 of Chart 3 related to revenue adjustments for exogenous factors. Chart 4 of the Process Charts (headed “*Categorisation of Financial Risk*”) (“**Chart 4**”) set out in diagrammatic form (in boxes 4.1 to 4.3) the steps described at paragraphs 4.5.2 to 4.5.4 above. Charts 3 and 4 are reproduced in full in Appendix C to this report.
- 4.7 By the time of publication of the ITT (20 January 2012), the DfT had determined that any funding required by the DfT in accordance with the step described at paragraph 4.5.3 above would be structured as an SLF from the owning group of the bidding vehicle backed by a third party guarantee.
- 4.8 The DfT had not, however, by that time established its precise methodology for determining whether it would require an SLF in respect of a particular bid and, if so, the level of that SLF.
- 4.9 At some point, apparently around the time of the publication of the ITT, a decision was made within the DfT to use the GDP Resilience Model for determining the level of SLF, if any, required in respect of bids. It is unclear precisely when or at what level that decision was made, but it appears from a paper presented to a meeting of the Rail Refranchising Programme Board (the “**RRPB**”) on 9 February

2012 that the decision had by that time been taken. That meeting was attended by (among others) a senior DfT Director General and chaired by a senior DfT official who at that time had responsibility for the DfT refranchising programme. That 9 February 2012 RRPB paper also indicates that it was by this time already envisaged that:

- 4.9.1 a default rate of 4.4% (by reference to the 500 economic scenarios in the GDP Resilience Model (see paragraph 4.3.2 above)) would be used as the maximum default rate acceptable to the DfT before it considered that there was too high a risk of franchise insolvency (see the step described at paragraph 4.5.2 above); and
- 4.9.2 there would be no minimum SLF requirement in respect of bids – i.e. the DfT would be prepared to award the ICWC franchise to a bidder that provided no financial support in the form of an SLF provided that the bid met the DfT’s required financial robustness criteria.

4.10 Nonetheless, members of the ICWC Project Team were aware from an early stage in the process that:

- 4.10.1 the GDP Resilience Model had been developed as an internal DfT risk modelling tool to calibrate the revenue risk sharing mechanism, the GDP Mechanism, and not for the purpose of SLF calculation;
- 4.10.2 the DfT was unlikely, in the timeframe in which the ICWC franchise process was being conducted (with bids due to be submitted in early May 2012), to develop a model for the specific purpose of determining a bidder’s SLF requirement;
- 4.10.3 there was a risk of challenge to the GDP Resilience Model if it were provided to bidders because the build and assumptions that underpinned it reflected the fact that it was built to be an internal risk modelling tool rather than for external use; and
- 4.10.4 the failure to provide the GDP Resilience Model to bidders also created a risk of challenge to the franchise process because there was a lack of transparency as to the DfT’s approach to the calculation of any SLF requirement.

4.11 In order to seek to mitigate this lack of transparency and the resulting risk of challenge, a decision was taken to provide the ICWC franchise bidders with additional guidance. So on 24 February 2012 bidders were provided with a document headed “*ICWC - Supplementary guidance on the evaluation of financial capability compliance and sizing of the Subordinated Loan Facility*” (the “**SLF Guidance**”).

- 4.12 The evidence is not clear as to who took or approved the decision to issue the SLF Guidance. The SLF Guidance itself was produced by DfT officials, with input from the ICWC Project Team and a Deputy Director, together with the assistance of DfT internal lawyers and Eversheds. The stated purpose of the SLF Guidance was to set out *“the process that the DfT will use to evaluate bids for financial capability compliance, including the methodology for determining the size of any Subordinated Loan Facility (SLF) needed to give comfort that the Government is contracting with an entity that is robust enough to withstand business downturns.”*
- 4.13 The SLF Guidance is an important document in the context of this Inquiry and is reproduced in full in Appendix D to this report.
- 4.14 In summary, the SLF Guidance stated that the DfT would determine the level of a bidder’s SLF requirement (if any) by running the risk-adjusted revenue and cost projections of a bid through the GDP Resilience Model. Where this exercise produced a risk of default for the bid that exceeded the default level that the DfT considered to be the maximum default level for a financially robust bid (which, although included in a draft of the SLF Guidance, was not identified in the final SLF Guidance, but which appears to have been communicated on an approximate basis by the DfT to at least one bidder bilaterally), the GDP Resilience Model was to be re-run with increasing values of SLF (importantly, with no stated cap) until the acceptable default level was obtained. The SLF Guidance suggested that no SLF would be required where the risk of default did not exceed the relevant level.
- 4.15 The GDP Resilience Model was not provided by the DfT to the bidders. Instead the final page of the SLF Guidance included a table that was described as the *“SLF ready reckoner”* (the **“Ready Reckoner”**). The SLF Guidance described the Ready Reckoner in the following terms:
- “The DfT has used the DfT GDP Resilience Model and assumptions from its own comparator model to give bidders an indication as to the size of SLF that might be required at different margins/levels of risk adjustment. The figures in the table below are for illustrative purposes only and should not be regarded as the confirmed level of financial support that might be required in different levels of bid margin.”*
- 4.16 In summary, the Ready Reckoner indicated that:
- 4.16.1 the GDP Resilience Model would allow a bidder with a projected profit margin of 5% to sustain adverse risk adjustments of between £70 million and £160 million (depending on how these risk adjustments were spread over the term of the franchise) before the DfT would require any SLF;
  - 4.16.2 where a bidder’s projected profit margin was higher than 5% in a particular year, this excess could be used as a buffer for that year against adverse risk adjustments before the DfT would require an SLF in respect of the bid; and

- 4.16.3 where the DfT made adverse risk adjustments not covered by the margin as described at paragraphs 4.16.1 and 4.16.2 above, an SLF would be required in an amount of 60% of the value of the risk adjustments.
- 4.17 It is important to note that the ITT, the Guide and the Process Charts do not describe any detailed methodology that the DfT committed itself to follow in determining whether it would require, and if so the level of, any SLF in respect of a bid. In particular, Chart 4 (see Appendix C) simply stated (in so far as relevant) as follows:
- 4.17.1 Box 4.1: *“Using the risk-adjusted revenues and cost is the risk of franchise insolvency deemed too high?”*;
- 4.17.2 Box 4.2: *“Determine level of additional funding required”*; and
- 4.17.3 Box 4.3: *“Seek clarification from the Bidder. Is the Bidder’s parent (backed by a suitable bank) prepared to inject additional funds, to robustly mitigate the issue?”*
- 4.18 Prior to the issue of the SLF Guidance, the existence of a degree of discretion exercisable by the DfT in relation to SLF sizing (in the sense of the DfT being able to take its own view, not constrained by any particular methodology, as to the appropriate level of an SLF requirement) was affirmed by Eversheds (by reference to Chart 4) when it advised the ICWC Project Team Leader (and DfT internal lawyers) by email on 23 February 2012 (the day before the issue of the SLF Guidance) as follows:
- “It appears from the Charts as they stand that under the process already advised to bidders, DfT was reserving the ability to make the judgement about the appropriate level of risk of franchise insolvency and also to judge the extent to which the bidder was prepared to inject additional funds ‘to robustly mitigate the issue’.”*
- 4.19 By contrast, the wording of the SLF Guidance (including the Ready Reckoner) issued on the following day, as I read it, committed the DfT to determine whether it would require, and if so the level of, any SLF in respect of a bid by following the particular methodology summarised at paragraph 4.14 above. This involved the application of a specific default level established by reference to the GDP Resilience Model. Although of course I recognise that in the context of a procurement process the DfT must in practice have a degree of discretion, the issue of the SLF Guidance did, on any view, significantly curtail the margin of discretion available to the DfT in relation to SLF sizing.
- 4.20 Following the issue of the SLF Guidance, in March 2012 the ICWC Project Team also provided bidders with guidance in relation to the DfT’s approach to risk adjustments (the step described at paragraph 4.5.1 above). This was done in a document headed: *“ICWC - Supplementary guidance on the risk adjustment*

process for financial compliance when sizing of [sic] the Subordinated Loan Facility” (the “**Risk Adjustment Guidance**”). The Risk Adjustment Guidance was produced by DfT officials and Atkins, with input from the ICWC Project Team and a DfT Deputy Director, and was shown in draft form to a DfT internal lawyer and Eversheds.

- 4.21 The Risk Adjustment Guidance is reproduced in full in Appendix E to this report.
- 4.22 The Risk Adjustment Guidance “sets out the risk adjustment process as part of the financial robustness evaluation of bids for the ICWC franchise.” For the purpose of this report, it is sufficient to note those provisions of the Risk Adjustment Guidance that are relevant to the consideration at paragraphs 4.45 to 4.51 below of the risk adjustment identified by Atkins on 22 June 2012 relating to a forecast revenue growth uplift in First’s bid. These provisions appear in the section of the Risk Adjustment Guidance headed “*Exogenous Revenue Adjustment*”. They amplify the contents of boxes 3.5 to 3.8 of Chart 3 (see paragraph 4.6 above and Appendix C). They state as follows:

*“As in previous franchise competitions, all bidders’ exogenous growth forecasts will be adjusted to a common view of revenue growth associated with exogenous demand growth for the purpose of risk assessment. For the sake of clarity:*

...

- *The adjustment to bidders’ exogenous revenue forecasts will be using current government forecasts and guidance (including for market segmentation), except in the situation where a bidder provides strong evidence that alternative forecasts may be more appropriate. In this case, DfT reserves the right to apply an alternative forecast to all bidder forecasts.”*

- 4.23 Even after the issue of the SLF Guidance (including the Ready Reckoner) and the Risk Adjustment Guidance, there was a continuing lack of transparency as to how the DfT would determine SLF requirements in respect of bids. In my view, notwithstanding the provision of these documents to bidders, a bidder was unable reliably to predict the likely size of any SLF requirement to be imposed by the DfT in the event that its risk-adjusted bid profit margin fell below the 5% margin that the Ready Reckoner stated would prevent the imposition of any SLF requirement (see paragraph 4.16.1 above). It was therefore not clear to bidders whether their prospects of winning the ICWC franchise competition would be better enhanced by seeking a higher profit margin in their bids or by volunteering a higher level of SLF.

- 4.24 As I noted in my Initial Findings Report, the significance of this point must, however, be viewed in context. The provision to bidders of the actual GDP Resilience Model would have enabled bidders to calculate the minimum level of SLF likely to be required only on the assumption that the DfT made no material

risk adjustments to the revenue and cost projections contained in their bids. It would not, however, have enabled them accurately to predict, at the point of submitting their bids, the level of SLF which might in fact be required in respect of their bids. This is because the inputs into the GDP Resilience Model included the risk-adjusted bid profit margin which was derived in turn from the risk-adjusted revenue and cost projections (see paragraph 4.5.1 above) to be carried out by the DfT in accordance with the Risk Adjustment Guidance. These adjustments were necessarily only determined by the DfT as part of its process of evaluating the submitted bids (i.e. after submission of bids).

- 4.25 Even after the provision to bidders of the SLF Guidance (including the Ready Reckoner) and the Risk Adjustment Guidance, bidders continued to raise concerns regarding the lack of transparency as to the DfT’s approach to the determination of any SLF requirement. The ICWC Project Team was aware of this and of the consequent risk of challenge to the ICWC franchise process. This was the subject of a number of internal DfT emails, including an email from the ICWC Project Team Leader to colleagues on 13 March 2012 which asked:

*“Is the exposure so great that we should dispense with the solvency test/subordinated loan requirement?”*

- 4.26 Because of its concerns on the transparency issue, the ICWC Project Team prepared a paper, with the assistance of DfT internal lawyers and Eversheds and seen in draft by DfT Deputy Directors, for the 21 March 2012 meeting of the RRPB. The paper is stated to be sponsored by a DfT Deputy Director and headed *“ICWC consideration of the use of solvency assessment tool in evaluation”*.

- 4.27 The purpose of the paper was stated to be to explore the *“risk around the [DfT] not providing ICWC bidders with enough transparency on how the subordinated loan is calculated to enable them to estimate the level themselves.”* The paper:

4.27.1 explained that there had been *“insufficient time to develop an evaluation tool which we consider we are able to share with bidders so there is a risk of challenge that our evaluation process is not open and transparent enough”*; and

4.27.2 recommended that the RRPB should recognise that for the ICWC franchise process *“no further mitigation is proposed and there remains some risk of challenge”*.

- 4.28 At its 21 March 2012 meeting, the RRPB was chaired by a DfT Director and attended by, among others, DfT Directors, DfT Deputy Directors and a DfT internal lawyer. The RRPB decided to accept the paper’s recommendation not to disclose the GDP Resilience Model to the ICWC franchise bidders, notwithstanding the risk of challenge to the ICWC franchise process that this non-disclosure created.

4.29 Unsurprisingly, given the continuing lack of transparency, bidders complained and pressed the DfT for more guidance and information as to the DfT's approach to determining the level of any SLF requirement. In addition to the issue of the SLF Guidance (including the Ready Reckoner) and the Risk Adjustment Guidance, the DfT responded to these requests for greater transparency by providing additional guidance to bidders in a range of ways, including through responses to formal requests for clarification (some of which were shared with all bidders) and in bilateral meetings and calls.

4.30 I do not propose in this report to set out all of this guidance or to explore any differences in the guidance given by the DfT to different bidders. For the purpose of this report, it suffices to note that the DfT represented at different times to one or more of the ICWC franchise bidders that it had no policy of requiring a minimum level of SLF in respect of a bid and that it would not impose an SLF requirement on a bid with a profit margin, after risk adjustment to revenue and cost lines, of 5% or more.

4.31 **I therefore make the following findings:**

4.31.1 **individuals within the ICWC Project Team were aware from January 2012 that there were likely to be transparency problems associated with using the GDP Resilience Model for the purpose of SLF calculation;**

4.31.2 **even after the provision to bidders of the SLF Guidance (including the Ready Reckoner) and the Risk Adjustment Guidance, these transparency problems persisted because bidders remained unable reliably to predict the likely size of any SLF requirements. This made it difficult for bidders properly to determine the optimal capital structure for their bids; and**

4.31.3 **at the 21 March 2012 meeting of the RRPB, senior DfT officials decided not to disclose the GDP Resilience Model to the ICWC franchise bidders, notwithstanding the increased risk of challenge to the ICWC franchise process that this non-disclosure created.**

The SLF sizing for First's and Virgin's bids: June 2012

4.32 In early May 2012, the DfT received bids for the ICWC franchise from all four shortlisted bidders (First, Virgin, Abellio InterCity West Coast Limited and Keolis/SNCF West Coast Limited) and began a process of bid clarification and evaluation.

4.33 Each bidder, apart from Virgin, included an SLF of at least £[REDACTED] million in its bid. First's bid (which offered franchise payments over a specified period with a net present value of £[REDACTED] billion) included a £50 million SLF in addition to £10 million of equity. Virgin's bid (which offered franchise payments

over the same period with a net present value of £5.3 billion) contained no SLF and no material equity investment.

- 4.34** The evaluation of the financial risk of the bids (i.e. the process described at paragraph 4.5 above) primarily took place in June 2012.

*The 20 June 2012 “first pass” SLF figures*

- 4.35** There appears to have been a desire within the DfT to inform bidders as early as possible in the evaluation process of the likely level of additional SLF, if any, required in respect of their bids. The purpose of this seems to have been to establish whether the likely required SLF levels in respect of bids were, in broad terms, acceptable to bidders’ owning groups.

- 4.36** As a result, the ICWC Project Team asked Atkins in early June 2012 to provide a “first pass” set of risk adjustments, which Atkins provided on or about 17 June 2012. It was understood by both Atkins and the ICWC Project Team that the first pass would not incorporate all adjustments and that Atkins’ final risk adjustments would likely differ from Atkins’ first pass risk adjustments as a result of incorporating further adjustments.

- 4.37** However, the ICWC Project Team at this time wanted the first pass risk adjustments to be, in the words of an internal DfT paper stated to be prepared by the team and in an email sent to Atkins on 17 June 2012, the “worse case position”. In interview, Atkins stated that it did not agree to provide the first pass risk adjustments as an unequivocal worst case; rather the first pass adjustments were subject to a number of qualifications and limitations and did not incorporate all exogenous risk adjustments. It also said that it was not aware that the DfT intended to use the “first pass” risk adjustments for the purposes of advising bidders of likely SLF levels. These issues are dealt with further in section 6 below.

- 4.38** The “first pass” risk adjustments supplied by Atkins were run through the bidders’ models by the ICWC Project Team to generate re-profiled revenues and costs which in turn were modelled through the GDP Resilience Model (by reference to the 4.4% maximum default rate – see paragraph 4.9.1 above) to produce additional SLF requirements for First and Virgin. The additional SLF requirements generated by the GDP Resilience Model from these numbers were:

**4.38.1** approximately £[REDACTED] million in respect of First’s bid (including the £10 million of equity but in addition to the SLF contained in First’s bid – see paragraph 4.33 above); and

**4.38.2** approximately £90 million in respect of Virgin’s bid.

- 4.39** These same numbers were also run through the Ready Reckoner, which produced materially different SLF numbers. The Ready Reckoner numbers were:

- 4.39.1 approximately £[REDACTED] million in respect of First's bid (including the £10 million of equity, but in addition to the SLF contained in First's bid); and
- 4.39.2 approximately £72 million in respect of Virgin's bid. (The evidence is unclear as to whether the amount was approximately £71 million or £72 million. In this report I have referred to £72 million.)
- 4.40 A meeting of the DfT's CAC was convened on 19 June 2012, at which these numbers were discussed. (As set out in the Guide, the CAC is a committee of senior DfT officials that takes decisions on selecting winning bids in passenger rail franchise competitions.) The meeting appears not to have been treated by attendees as a formal CAC meeting. No minutes of that meeting were produced and a final paper prepared in respect of it was only circulated by the ICWC Project Team Leader in an email sent to attendees following that meeting, which requested that they confirm by return email that they approved the paper.
- 4.41 At that meeting, a decision appears to have been taken to:
- 4.41.1 use the numbers being generated by the Ready Reckoner as opposed to the GDP Resilience Model for the purposes of determining SLF levels, since bidders had only been provided with the Ready Reckoner; and
- 4.41.2 authorise the ICWC Project Team Leader to communicate those numbers to bidders to indicate to them the potential size of SLF that might be required by the DfT in respect of their bids.
- 4.42 The SLF numbers derived from the Ready Reckoner (see paragraph 4.39 above) were orally notified to First and Virgin by the ICWC Project Team Leader on or about 20 June 2012.
- 4.43 In using the Ready Reckoner numbers, rather than the materially different GDP Resilience Model numbers, the DfT departed from the process that the DfT had told bidders it would follow in the SLF Guidance. The SLF Guidance was clear that the GDP Resilience Model would be used to size any SLF requirements (see paragraphs 4.12 and 4.14 above) and that the guidance in the Ready Reckoner was "*for illustrative purposes only*" (see paragraph 4.15 above).
- 4.44 The ICWC Project Team understood from the reactions of First and Virgin to the oral notification of SLF requirements on or about 20 June 2012 that:
- 4.44.1 [REDACTED]; and
- 4.44.2 [REDACTED]. Indeed, Virgin reacted to the oral notification by sending a letter to the ICWC Project Team Leader dated 22 June 2012 challenging the £72 million SLF figure and reminding the ICWC Project Team Leader of the DfT guidance described in paragraph 4.30 above. It is not clear on the

available evidence to what extent, if at all, this letter was circulated within the DfT.

*The “second pass” risk adjustments*

- 4.45 In the event, it turned out that the SLF numbers notified to First and Virgin on or about 20 June 2012 were not the “*worse case position*”. On 22 June 2012 Atkins identified an “overlay” to First’s bid relating to the fact that First’s forecast revenue growth in the first year of the franchise was higher than the level assumed in the DfT’s comparator model.
- 4.46 According to the provisions of the Risk Adjustment Guidance quoted at paragraph 4.22 above, bidders’ exogenous revenue forecasts would be adjusted by the DfT to a DfT comparator model except “*where a bidder provides strong evidence that alternative forecasts may be more appropriate*”, in which case the DfT “*reserves the right to apply an alternative forecast to all bidder forecasts.*” (Chart 3, boxes 3.5 to 3.8, are in similar terms, although box 3.6 refers to “*comprehensive evidence*” (not “*strong evidence*”) and box 3.7 suggests that where such evidence is provided the DfT will (not just “*may*”) adjust the benchmark in respect of all bidders.)
- 4.47 First was requested by the ICWC Project Team on the evening of 22 June 2012 to provide evidence to the DfT on an urgent basis in support of First’s forecast revenue growth uplift. First provided its evidence on 25 and 26 June 2012 and Atkins was instructed by the ICWC Project Team to consider it and to establish whether, and if so how much, of First’s proposed uplift was justified on the evidence.
- 4.48 Atkins advised that, although the evidence produced by First suggested that the DfT’s own passenger revenue assumptions were likely to be an underestimate, First had not provided sufficient evidence to justify adopting the full forecast revenue growth contained in First’s bid as a benchmark for all bids. Instead, Atkins advised that the evidence supported adopting approximately two-thirds of it – in other words, a partial risk adjustment (the “**Partial Risk Adjustment**”).
- 4.49 In addition to the risk adjustment in respect of First’s forecast revenue growth, Atkins continued its work to determine and apply various other risk adjustments, having regard to the bidders’ responses to clarification questions. This included refinements to an adjustment in respect of the effect on passenger growth of increased bus and coach costs in the first pass. This further work resulted in Atkins advising the DfT to make further risk adjustments to all bids.
- 4.50 The effect of these further risk adjustments (including the Partial Risk Adjustment) proposed by Atkins on the SLF requirements for the First and Virgin bids would have been as follows:

- 4.50.1 the SLF figures in respect of First's bid (approximately £[REDACTED] million and approximately £[REDACTED] million per the GDP Resilience Model and the Ready Reckoner respectively – see paragraphs 4.38 and 4.39 above) would have increased to approximately £[REDACTED] million (GDP Resilience Model) and approximately £[REDACTED] million (Ready Reckoner) - in each case including the £10 million of equity but excluding First's bid SLF; and
- 4.50.2 the SLF figures in respect of Virgin's bid (approximately £90 million and approximately £72 million per the GDP Resilience Model and the Ready Reckoner respectively) would both have reduced to zero.
- 4.51 [REDACTED]. The SLF figure in respect of Virgin's bid would still have reduced (due to the rest of the further risk adjustments) from approximately £72m to approximately £41m.
- 4.52 Conversely, had First been able to produce evidence to justify in full its forecast revenue growth uplift and the DfT then adjusted all bidders' base revenues accordingly, First's SLF requirement would have been [REDACTED], but Virgin's SLF requirement would have reduced from approximately £72 million to zero.

*The 27 June 2012 CAC meeting*

- 4.53 The amount of SLF required in respect of First's and Virgin's bids was finally decided at a meeting of the CAC on 27 June 2012. At this meeting the numbers outlined at paragraphs 4.50 to 4.52 above were presented as options to the CAC in a paper noted on its face to have been prepared by the ICWC Project Team. The final decision was for an additional £140 million in respect of First's bid (in addition to First's bid SLF and equity in an aggregate amount of £60 million) and £40 million in respect of Virgin's bid.
- 4.54 Where I refer in this report to the CAC or the BICC considering matters relating to the bids of First and Virgin, it should be understood that code names were used for First and Virgin in the papers for the meetings.
- 4.55 The 27 June 2012 CAC meeting was attended by 14 DfT officials (including DfT internal lawyers), not all of whom were formally members of the CAC. It was chaired by a DfT Director and attended by a number of DfT Deputy Directors. No Director General attended the meeting, including the Director General charged with responsibility for the DfT's franchising programme.
- 4.56 I explained at paragraph 5.9 of my Initial Findings Report that the evidence that the Inquiry team had seen at the date of that report as to how the final SLF requirements for First and Virgin were ultimately determined is not clear or in some respects consistent.

**4.57** The Inquiry team has now interviewed all of the 14 attendees at the 27 June 2012 CAC meeting. There remains a significant lack of clarity and a large degree of inconsistency in the evidence as to the discussions and decisions taken at the meeting. This is surprising, not least because it was an important and fairly recent meeting attended by some senior DfT officials.

**4.58** In particular, although it is clear on the available evidence that:

**4.58.1** the CAC meeting considered various SLF numbers being generated by both the GDP Resilience Model and the Ready Reckoner on the basis of rejecting First's overlay in its entirety, the Partial Risk Adjustment proposed by Atkins or, apparently, even no risk adjustment in relation to First's bid; and

**4.58.2** the final SLF levels in respect of the First and Virgin bids reflected a view taken at the meeting as to appropriate numbers (rather than the application of the DfT's published processes),

it is not clear whether by setting the additional SLF requirement in respect of First's bid at £140 million the CAC was effectively deciding:

**4.58.3** entirely to ignore the overlay identified by Atkins on 22 June 2012 (see paragraph 4.45 above) and, contrary to the terms of the Risk Adjustment Guidance and Chart 3, neither to adjust First's bid to remove the overlay in its entirety nor to accept the Partial Risk Adjustment proposed by Atkins; or

**4.58.4** to adjust First's bid to remove the overlay in its entirety or to make the Partial Risk Adjustment but then, contrary to the SLF Guidance, to take its own view as to what changes should be made to the SLF numbers resulting from those adjustments to arrive at SLF numbers that it regarded as appropriate.

**4.59** In any event, it has become clear from the further work that the Inquiry team has carried out since I issued my Initial Findings Report that there was no single, agreed set of factors that informed the view taken by the CAC at its 27 June 2012 meeting as to the appropriate SLF requirements for First's and Virgin's bids. A range of factors appears to have been considered and different attendees at the meeting seem to have attached different weight to different factors. (I note in passing that there is even some conflict in the witness evidence as to whether the decisions taken by the CAC at this meeting were formally the decisions of the committee or decisions of its Chair based on advice from other committee members. I do not think it is necessary for me to resolve this issue for the purpose of this report and it is in any event clear from the evidence that many attendees at the meeting participated in an active discussion in relation to the SLF sizing issues.)

**4.60** Unhelpfully, from the perspective of the Inquiry, the short draft minutes of the meeting that were circulated following the meeting were replaced with even shorter final minutes. However, on the basis of the evidence that I now have, the facts that I am satisfied are established by that evidence are as follows:

- 4.60.1** the issue of whether the DfT was entitled to exercise discretion in sizing the SLF requirements in respect of the First and Virgin bids (i.e. not simply to use the numbers generated by the GDP Resilience Model or the Ready Reckoner) was expressly considered at the CAC meeting;
- 4.60.2** none of the 14 attendees at the meeting referred in this context to the SLF Guidance that the DfT had issued to bidders in February 2012 and which (as explained at paragraph 4.19 above) committed the DfT to follow a particular methodology using a specific default rate established by reference to the GDP Resilience Model;
- 4.60.3** instead the discretion issue was considered exclusively by reference to Chart 4 (see paragraphs 4.4 to 4.6 and 4.17 above and Appendix C to this report);
- 4.60.4** [REDACTED] advised at the meeting that it was open to the DfT to exercise discretion in sizing the SLF requirements in respect of the First and Virgin bids;
- 4.60.5** there is some conflict in the witness evidence as to whether in giving this advice [REDACTED] referred to the CAC's approach involving risk;
- 4.60.6** in any event, that advice was given solely by reference to Chart 4, without any regard to the SLF Guidance, and was therefore given on the basis of incomplete information;
- 4.60.7** in sizing the SLF requirements in respect of the First and Virgin bids, the CAC meeting took into account various factors that the DfT ought properly not to have taken into account against the background of the publication of the SLF Guidance and/or the Risk Adjustment Guidance;
- 4.60.8** the accounts given by attendees at that meeting as to what extraneous factors were discussed and which ones ultimately influenced the decisions made differ in a number of respects, but the evidence suggests that there was at least some discussion at that meeting of the following matters:
  - (i) the fact that both First and Virgin had already by this point been informed of likely maximum levels of required SLF in advance of the DfT becoming aware of further possible risk adjustments on 22 June 2012;
  - (ii) the possibility that (if the Partial Risk Adjustment was applied or First's overlay was rejected in its entirety) a higher level of SLF than

that already communicated to First could knock First out of the ICWC franchise process (leaving the DfT with a lead bidder who would then have a zero SLF);

- (iii) the possibility that a higher level of SLF than that already communicated to First could have a knock-on effect on First's participation in other franchise processes;
- (iv) the fact that the level of SLF already communicated to First was significant, and that (if the Partial Risk Adjustment was applied) increasing that SLF requirement by a further £[REDACTED] million or so was not considered likely to change First's behaviour in operating the franchise;
- (v) the fact that the risk profiles of First's and Virgin's bids were similar for the first 10 years of the franchise, and so it seemed odd in those circumstances to be calling for such a substantial SLF from First and a zero SLF from Virgin;
- (vi) the question of whether there should be a minimum level of SLF imposed on all bids; and
- (vii) [REDACTED];

**4.60.9** some attendees at the meeting recall that the DfT internal lawyers at the meeting warned the meeting, in relation to certain of the factors under discussion, that they were extraneous factors that could not properly be taken into account in the DfT's exercise of discretion or that care needed to be taken not to treat First and Virgin inconsistently; and

**4.60.10** because at least some of the extraneous factors referred to above were taken into account at the CAC meeting, First and Virgin were treated inconsistently by the DfT in relation to the sizing of their respective SLF requirements.

#### *SLF letters to bidders*

**4.61** The CAC approved, at its 27 June 2012 meeting, the issue of letters to First and Virgin requiring an SLF of £140 million in respect of the First bid (in addition to its bid SLF and equity) and £40 million in respect of the Virgin bid.

**4.62** The ICWC Project Team Leader sent these letters out later that evening. The letters, which were drafted with the assistance of Eversheds, stated that the SLF level had been determined in accordance with Chart 4 and (in a reference to the Risk Adjustment Guidance) "*after the application of the risk adjustment process as published to bidders on the data site...*". As I stated at paragraph 4.27 of my Initial

Findings Report, it is notable that the letters (a first draft of which was prepared in advance of the CAC meeting) did not refer to the SLF Guidance.

4.63 On 2 July 2012 each of First and Virgin confirmed by letter to the DfT that its owning group was willing to provide the required SLF. They also both sought to re-price their bids to reflect the cost of the financing of the SLF, but this was successfully resisted by the DfT.

4.64 **I therefore make the following findings:**

4.64.1 **the final SLF requirements in respect of both the First and Virgin bids were not determined in accordance with the DfT's own published processes (by reference either to the GDP Resilience Model or the Ready Reckoner). Rather, the SLF levels reflected a view taken at the CAC meeting as to appropriate numbers;**

4.64.2 **that decision by the CAC was taken following [REDACTED] advice provided at a meeting by [REDACTED] to the effect that it was open to the DfT to exercise discretion in sizing the SLF requirements. That [REDACTED] advice was given without regard to the SLF Guidance;**

4.64.3 **in sizing the SLF requirements in respect of the First and Virgin bids, the meeting took into account various factors which ought properly not to have been taken into account against the background of the DfT's own published processes; and**

4.64.4 **the effect of this was that First and Virgin were treated inconsistently by the DfT. In particular, discretion was exercised by the CAC in such a way as to have the effect of reducing the level of SLF calculated in respect of First's bid but increasing the level of SLF calculated in respect of Virgin's bid.**

Consideration of and challenge to SLF sizing: July 2012 – 2 August 2012

4.65 The DfT held an evaluation meeting on 29 June 2012 at its offices at which representatives from Eversheds were present. Eversheds attended the meeting to report on legal evaluation issues arising from the bids.

4.66 Towards the end of the meeting there was some discussion about the way in which the DfT had risk-adjusted First's bid, which led the Eversheds partner attending the meeting (the "Eversheds Partner") to have concerns, in particular, as to whether:

4.66.1 there was any inconsistency between the way in which risk adjustments had been made to the various bids; and

4.66.2 the DfT may have exercised a discretion in sizing the SLF requirements in respect of the bids that was inconsistent with the SLF Guidance.

- 4.67** The Eversheds Partner raised these concerns with the ICWC Project Team Leader at the end of the meeting. She explained to the ICWC Project Team Leader that she did not have a copy of the SLF Guidance at the meeting but that she recalled that it required the SLF to be sized using a model and not discretion. The ICWC Project Team Leader told the Eversheds Partner that the CAC had exercised some discretion in determining the level of SLF requirements. It was agreed that the Eversheds Partner would check the SLF Guidance and revert.
- 4.68** The Eversheds Partner reverted by email to the ICWC Project Team Leader on 2 July 2012 attaching a copy of the SLF Guidance. The email stated that “*Our understanding is that this sets out what DfT told the Bidders about how the SLF would be determined*” and asked him to contact Eversheds “*if you have any queries or concerns or wish to discuss further how it relates to the decisions made by CAC last week.*” The email did not otherwise provide any advice.
- 4.69** The ICWC Project Team Leader responded by email also on 2 July 2012. He referred to paragraph 7 of the SLF Guidance and said: “*I believe para 7 is where we got to in our approach. The outcome of the SLF analysis showed the default level and financial implications. We then determined the level of SLF to satisfy our requirements.*”. However:
- 4.69.1** The SLF Guidance was not considered at the 27 June 2012 meeting of the CAC (see paragraph 4.60.2 above).
- 4.69.2** Paragraph 7 of the SLF Guidance (when read with the previous paragraphs – see Appendix D to this report) stated that where the outcome of the process of risk-adjusting the cost and revenue lines of bidders’ models resulted in a probability of default across a range of economic scenarios which exceeded a level the DfT considered to be financially robust, “*DfT will calculate the additional financial support (in the form of a SLF backed by a third party guarantee) that would be needed to satisfy its requirements.*”
- 4.69.3** If and to the extent that the ICWC Project Team Leader was suggesting that the language quoted in paragraph 4.69.2 above gave the DfT the discretion that had been exercised by the CAC on 27 June 2012, this was incorrect. In fact, as is clear from the SLF Guidance (and as the Eversheds Partner pointed out by a response email a few minutes later), paragraph 7 of the SLF Guidance is part of an introduction section that clearly has to be read in the context of the detailed modelling exercise described in paragraph 8, as well as the section containing the Ready Reckoner, which were more specific as to the process that the DfT would follow to size the SLF.
- 4.70** The Eversheds Partner also had a discussion on 2 July 2012 with DfT internal lawyers at the end of a training day. During this discussion she expressed some

concern as to the manner in which the DfT may have determined the SLF levels. The evidence as to this discussion is not consistent in all respects.

4.70.1 The Eversheds Partner's file note, prepared a week later on 8 or 9 July 2012, stated:

*"It seems they were unaware of the constraint stated/implied by the SLF sizing guidance (and can see the issue it raises). However, are clear that the decision will not be revisited. We have some discussion about the extent to which another bidder would be aware that the SLF which another bidder is asked to put forward doesn't match what might have emerged if process had been followed more closely. [Eversheds Partner] says that can't assume that bidder will not ask information which would draw this out."*

4.70.2 The DfT internal lawyers told the Inquiry team in interview that they recalled this conversation with the Eversheds Partner but that they questioned or challenged aspects of, or at least the emphasis in, this file note, in particular in relation to the suggestion that they had expressed a firm view that *"the decision will not be revisited"*. The DfT internal lawyers said in interview that the concern of the Eversheds Partner had been expressed in a relatively low-key manner. They said that if the Eversheds Partner had advised them that there was a significant problem, they would have explored what could be done to revisit the SLF sizing decision and/or formally escalated the issue.

4.70.3 The Eversheds Partner told the Inquiry team in interview that, although not stated in her file note, she recalls telling the DfT internal lawyers during this conversation that if there was a challenge to the DfT's SLF sizing process, the DfT would need to be able to establish that it had followed its own procedures. The DfT internal lawyers do not recall this.

4.71 Another Eversheds partner recalls speaking separately with a DfT internal lawyer, also on 2 July 2012, to raise concerns as to whether the SLF requirements had been sized in accordance with the SLF Guidance. The DfT internal lawyer also recalls this conversation and believes that it preceded the discussion referred to at paragraph 4.70 above with the Eversheds Partner.

4.72 Although the ICWC Project Team Leader believes that he may have raised the issue with a DfT Deputy Director, the Inquiry team has seen no clear evidence of this and the Deputy Director concerned does not recall it. Having considered all of the available evidence, it does not appear to me that any of the participants in the discussions referred to above between 29 June and 2 July 2012 formally escalated within the DfT the concerns raised.

4.73 **I therefore make the following finding: in the days following the 27 June 2012 CAC meeting at which the SLF levels in respect of the First and Virgin bids**

**were determined, Eversheds raised with DfT officials a concern as to possible process risks associated with the manner in which the CAC had determined those SLF levels. This information appears not to have been formally escalated within the DfT by any of the participants in those discussions.**

- 4.74 Members of the ICWC Project Team made presentations to the CAC at its meeting on 3 July 2012 on the evaluation of the ICWC bids (following the 29 June 2012 evaluation meeting) and the negotiating brief. The ICWC Project Team explained that there was “*clear blue water*” between the first and second place bidders (First and Virgin). The CAC agreed to the commencement of negotiations with both First and Virgin, recognising that this would maintain competitive pressure on First. Later, at its meeting on 16 July 2012, the CAC agreed that final negotiations should be commenced with the lead bidder only (First).
- 4.75 On or around 20 July 2012, Virgin was told by the DfT that it was not the preferred bidder. Sir Richard Branson sent a letter dated 23 July 2012 to the then Secretary of State for Transport, copied to the Prime Minister and the Chancellor of the Exchequer. The letter expressed Virgin’s disappointment that it was not the preferred bidder and put forward arguments as to why it should be. These arguments included the expression of a suspicion that First had overbid in order to secure the franchise. The letter concluded with a request to the then Secretary of State to “*look closely at all the facts before making a definitive decision*” and offered a meeting.
- 4.76 The then Secretary of State responded by letter dated 1 August 2012 explaining that as the ICWC franchise process remained a live competition it would be inappropriate for her to comment at that stage on the details of the procurement process. Sir Richard Branson’s letter also led to a number of other actions.
- 4.76.1 It prompted questions from, and a briefing to, the Prime Minister’s office about the ICWC franchise process, as well as a briefing to the then Secretary of State. In addition to members of the ICWC Project Team, the briefings involved senior DfT officials, including the Permanent Secretary at the DfT and the Principal Private Secretary from the then Secretary of State’s office, as well as the Cabinet Secretary. I have seen no evidence that the briefings referred to any details or concerns as to the manner in which the levels of the SLF requirements for First or Virgin had been determined (which was also not a focus of Sir Richard Branson’s letter of 23 July 2012).
- 4.76.2 It led to the then Secretary of State, on advice from the ICWC Project Team Leader, deciding to pass Ministerial responsibility for the award of the ICWC franchise to the then Minister of State on the basis that the 23 July 2012 Virgin letter risked compromising the anonymity protection in relation to the bidders. The advice also extended to suggesting that the circulation of

the Virgin letter should be strictly limited and, in particular, should not be passed to the then Minister of State.

4.77 A further meeting of the CAC was held on 25 July 2012. A paper (noted on its face as having been prepared by the ICWC Project Team and sponsored by the ICWC Project Team Leader) was submitted to the CAC for this meeting. The paper updated the CAC on the progress of the ICWC franchise process and specifically on the results of the negotiations with First (as leading bidder). It requested the CAC, among other things, to authorise:

4.77.1 the award of the ICWC franchise to First; and

4.77.2 the submission of a paper to the BICC seeking the BICC's endorsement of the decision to award the ICWC franchise to First.

4.78 In relation to the SLF requirement, the paper noted that the level of the SLF required by the DfT in respect of First's bid "*reflects the view taken by the Department following the risk adjustments made to [First's] costs and revenues and was agreed at the CAC of 27 June.*"

4.79 The paper attached various appendices, including:

4.79.1 a draft letter to be sent by the then Secretary of State to the Chief Secretary to the Treasury seeking his agreement to proceed with letting the ICWC franchise to First; and

4.79.2 a draft paper to the BICC.

4.80 The draft letter to the Chief Secretary to the Treasury did not explain that the DfT had exercised discretion in determining the SLF requirement in respect of First's bid. In this regard it stated:

*"In addition, we have assessed the residual risk that the leading bidder may face financial instability in the event of it not reaching its own growth forecasts, and hence increase the prospect of franchise failure in future years. In light of recent economic uncertainty **we have rigorously assessed the solvency requirements for this franchise to ensure that the risk of franchise failure is reduced including consideration of the robustness of the franchisees offer in a range of 500 different economic scenarios.**"* (emphasis added)

4.81 The draft paper to the BICC contained similar text. It stated:

*"In light of recent economic uncertainty for all bids we have assessed the residual risk that a bidder may face financial instability in the event of it not reaching its own growth forecasts, and hence increase the prospect of franchise failure in future years. **We have rigorously assessed the solvency requirements for each bidder to ensure that the risk of franchise failure is reduced including consideration of the robustness of the franchisees offer in a range of 500 economic scenarios. This resulted in** a level of Subordinated Loan Facility (SLF) to be requested from each*

*bidder. The two lead bidders required the following SLFs [First] £190m and [Virgin] £40m.” (emphasis added)*

4.82 In my view, this text in the draft letter and draft paper was inaccurate. On any view, it did not explain that the DfT had not based its SLF sizing on its published SLF Guidance (i.e. solely by reference to the GDP Resilience Model and its 500 economic scenarios). This inaccuracy was repeated in a further passage in the draft BICC paper:

4.82.1 whereas the paper prepared for the 25 July 2012 CAC meeting had stated (as set out at paragraph 4.78 above) that the level of the SLF required by the DfT in respect of First’s bid:

*“reflects **the view taken by the Department following** the risk adjustments made to [First’s] costs and revenues and was agreed at the CAC of 27 June” (emphasis added);*

4.82.2 the draft paper to the BICC used only the words:

*“reflects the risk adjustments made to [First’s] costs and revenues and was agreed at the CAC of 27 June”.*

It can readily be seen from a comparison of the quoted text in the paragraphs 4.82.1 and 4.82.2 above that the emphasised words in the first quoted passage – “*the view taken by the Department following*” – were omitted in the draft BICC paper. These words are, of course, significant in the context of this report as they clearly indicate the exercise of discretion by the DfT in sizing the SLF requirement in respect of First’s bid. In my view the omission of these words from the draft BICC paper rendered the sentence inaccurate.

4.83 The minutes of the CAC meeting on 25 July 2012 record, among other things, that:

4.83.1 one member of the CAC (a DfT Director who had not attended the 27 June 2012 CAC meeting) “*sought assurances that the ICWC procurement had followed the DfT’s published procurement process and would be robust in the face of any challenges*”;

4.83.2 the ICWC Project Team Leader responded by confirming that “*the process remained robust and that any issues raised would be more focussed around policy than process*”;

4.83.3 the CAC authorised the award of the ICWC franchise to First (subject to a number of points that are irrelevant to this report);

4.83.4 the CAC authorised the submission of the BICC paper (with some amendments) to the BICC;

4.83.5 the letter to the Chief Secretary to the Treasury would be sent by the then Minister of State rather than (as envisaged in the draft) by the then Secretary of State; and

4.83.6 no further meetings of the CAC were required in relation to the ICWC franchise process.

These parts of the minutes are not contradicted by witness evidence.

4.84 Sir Richard Branson sent a letter to the Prime Minister dated 30 July 2012 stating that he had copied to the Prime Minister his letter to the then Secretary of State of 23 July 2012 (see paragraph 4.75 above) “*as we were troubled by the evaluation process*”. The letter (to which the Prime Minister responded on 10 August 2012 stating that the Cabinet Secretary would make contact with Sir Richard to discuss the issues raised) stated that no response had been received to the letter of 23 July 2012 and, among other things:

4.84.1 expressed concern that the ICWC franchise would be “*awarded on the basis of what we believe to be an unsustainable bid*”;

4.84.2 urged the Prime Minister “*to ensure the DfT Ministers pause the process and satisfy themselves the financial risks and the technical parameters being assessed are the correct ones*”; and

4.84.3 proposed a conversation “*between the right people on both sides about the issues raised*”.

4.85 On the same day, 30 July 2012, Virgin sent a further letter to the Director General at the DfT with responsibility at that time for the DfT’s refranchising programme. Virgin’s letter:

4.85.1 sought information from the DfT, including about:

(i) how the DfT had evaluated the competing bids (including how any SLF requirement of the preferred bidder had been calculated and the amount of any such SLF requirement); and

(ii) why Virgin’s bid was “*not being taken forward*”;

4.85.2 expressed Virgin’s “*serious doubts about the deliverability of any bids involving significantly higher premia than ours*” and challenged the DfT’s assessment of risk in its evaluation of bids for the ICWC franchise; and

4.85.3 raised the possibility of a judicial review challenge.

4.86 The Director General sent Virgin a holding response to this letter on the following day. Also on 31 July 2012, a DfT internal lawyer instructed Leading Counsel to advise the DfT on its response to the Virgin letter. The advice was given at a consultation on 3 August 2012 (see paragraphs 4.96 and 4.97 below).

- 4.87 As authorised by the CAC, the BICC paper (which stated that it was sponsored by the Chair of the CAC) was submitted to the BICC for the BICC meeting on 31 July 2012. The paper stated that its purpose was to update the BICC on the progress of the ICWC franchise procurement and to seek authority to continue to franchise agreement signature. The paper recommended the BICC to endorse the decision of the CAC on 25 July 2012 to award the ICWC franchise to First and to authorise the submission of a paper to the then Secretary of State seeking endorsement of that decision.
- 4.88 The inaccurate text from the draft BICC paper, identified in paragraphs 4.81 to 4.82.2 above, appeared in the final paper as submitted to the BICC. The paper attached a further version of the draft letter to be sent by the then Minister of State (rather than, as originally envisaged, by the then Secretary of State) to the Chief Secretary to the Treasury which contained the same text as set out at paragraph 4.80 above.
- 4.89 The BICC meeting on 31 July 2012 was chaired by a DfT Director General and attended by senior DfT officials including another Director General and the DfT General Counsel. Neither the Director General at the DfT with responsibility at that time for the DfT's refranchising programme nor the Permanent Secretary attended, and no non-executive director attended. The Director who had been the Chair of the CAC meeting on 27 June 2012 attended the BICC meeting. On the basis of the witness evidence, I am satisfied that at this meeting no proper explanation was given to the BICC of how the CAC had determined the level of the SLF requirement in respect of First's bid at the CAC meeting on 27 June 2012. The minutes of this meeting were not approved by the BICC prior to the commencement of my Inquiry, and I understand that approval has been postponed because of it. The draft and brief minutes that I have seen record that:
- 4.89.1 a number of the attendees of the CAC meeting on 27 June 2012, at which the CAC had exercised discretion in setting the levels of the SLF requirement in respect of First's and Virgin's bids, attended the relevant part of this BICC meeting;
- 4.89.2 the BICC was informed by the DfT's General Counsel, in a reference to the correspondence from Sir Richard Branson referred to above, that *"correspondence had been received raising some questions about the process that has been followed to date and the rigour of the analysis of different bids that has been undertaken. It was therefore important that BICC fully satisfied itself on these issues."*;
- 4.89.3 members of the ICWC Project Team attending the BICC meeting *"explained that the [CAC] meeting on 25 July had sought assurance that the DfT's published procurement process had been followed and was robust"*;

- 4.89.4 the ICWC Project Team Leader discussed various points arising out of the paper to the BICC;
- 4.89.5 following a discussion by the BICC of various issues, including issues relating to the assessment of risk associated with First's bid, the BICC agreed that it needed to see additional information on the selection of the preferred bidder "to provide the required level of assurance and clarity to BICC on why [First] was selected as the preferred bidder";
- 4.89.6 the Chair of the BICC therefore requested an additional BICC meeting to be scheduled for 2 August 2012; and
- 4.89.7 the BICC requested that a further paper be prepared for the 2 August 2012 BICC meeting.
- 4.90 A paper was produced for the 2 August 2012 BICC meeting, the authors of which were noted on the paper's face as being members of the ICWC Project Team and the sponsor of which was noted as being a Deputy Director who had attended the 27 June 2012 CAC meeting. The paper stated that it was to be read as a supplement to the paper prepared for the 31 July 2012 BICC meeting and that its purpose was to give "further information as to the evaluation process and risk adjustment that has been undertaken in order to select a winning bidder for the ICWC franchise competition."
- 4.91 This paper was an important paper. It was being submitted to the BICC meeting at which a final approval was sought of the decision to recommend that the then Minister of State award the ICWC franchise to First. The paper included the same inaccurate text as is set out at paragraph 4.81 above and then made the following further inaccurate statement:
- "The project team presented their risk adjustment findings to CAC and an SLF of £190m [First] and £40m for [Virgin] of [sic] was endorsed at the CAC meeting on 27 June. Both bidders agreed to provide the additional funding into the bid vehicle at the ultimate cost to the parent. The bidders were not allowed to include the costs in their submission. **The SLF required is calculated by reference to the 500 macro-economic scenarios ..., to ensure that the calculated probability of default for a particular bidder is no higher than 4.4%.**"* (emphasis added)
- 4.92 The BICC meeting on 2 August 2012 was chaired by a DfT Director General and attended by senior DfT officials including another Director General. The Permanent Secretary and the Director General at the DfT with responsibility at that time for the DfT's refranchising programme did not attend. Ed Smith, a non-executive director, did attend (see paragraph 2.2.2 of my Initial Findings Report). As with the BICC meeting on 31 July 2012, the final minutes of this meeting have not yet been approved by the BICC. The draft and brief minutes that I have seen record that:

- 4.92.1 a number of the DfT officials who attended the CAC meeting on 27 June 2012 at which the levels of the SLF requirement were set in respect of First's and Virgin's bids attended this BICC meeting, although not the Chair of that CAC meeting;
- 4.92.2 the objectives of the meeting were *"to assess the robustness of the evaluation criteria used to award the contract and the rigour of the analysis presented"*;
- 4.92.3 *"The detailed risk adjustment process which had led to CAC's decision on the size of [First's] SLF was discussed"*; and
- 4.92.4 the BICC agreed with the recommendation to select First as the successful bidder.
- 4.93 On the basis of the witness evidence, I am satisfied that:
- 4.93.1 at this meeting the BICC was not provided with a proper explanation of how the CAC had determined the level of the SLF requirement in respect of First's bid at the CAC meeting on 27 June 2012; and
- 4.93.2 specifically, the BICC was not told that the CAC had departed from the DfT's published processes and had exercised discretion in determining the SLF requirement in respect of First's bid.
- 4.94 There is some witness evidence that the BICC was expressly told at the meeting by a DfT official present that the level of the SLF required by the DfT in respect of First's bid was based on a default rate of 4.4% as derived from the DfT's model, but this evidence is contradicted by other witnesses. If made, that statement was clearly inaccurate. However, in light of the points already noted in paragraphs 4.91 and 4.93 above, I do not think it is necessary for me to resolve this conflict in evidence.
- 4.95 **I therefore make the following findings:**
- 4.95.1 **the BICC was not given an appropriately accurate and full report as to the manner in which the CAC had approached the SLF sizing process. This was the case even though some of the DfT officials who attended the BICC meetings on 31 July 2012 and 2 August 2012 had also attended the 27 June 2012 CAC meeting; and**
- 4.95.2 **inaccurate statements were made to the BICC in writing as to the manner in which the CAC had approached the SLF sizing process in respect of First's bid at its meeting on 27 June 2012.**

Decision to award franchise to First: 3 August to 15 August 2012

- 4.96** As described at paragraph 4.86 above, a DfT internal lawyer had instructed Leading Counsel on 31 July 2012 to advise the DfT on how to respond to correspondence from Virgin. Those instructions were supplemented by further instructions on 2 August 2012.
- 4.96.1** The further instructions enclosed a copy of the papers submitted to the BICC meetings held on 31 July and 2 August 2012. Leading Counsel was instructed that these papers “*explain the evaluation process that has been conducted and the basis for DfT’s proposed decision in this procurement*” and was specifically referred to particular paragraphs of the 2 August 2012 BICC paper addressing the SLF sizing process, including the paragraph containing what I have described as the inaccurate text identified at paragraph 4.91 above.
- 4.96.2** The further instructions referred Counsel to a link to a page on the DfT website which contained (among other documents) a copy of the Charts, but not the SLF Guidance or the Risk Adjustment Guidance.
- 4.97** A consultation with Leading Counsel took place on 3 August 2012 and was attended by a DfT internal lawyer, the Eversheds Partner, the ICWC Project Team Leader and a DfT Deputy Director. At this consultation, Counsel was told that there was a potential issue about the manner in which the SLF requirements had been determined by the DfT.
- 4.98** Also on 3 August 2012 the DfT requested approval from the then Minister of State:
- 4.98.1** to award the ICWC franchise to First; and
- 4.98.2** for a letter to be sent to the Chief Secretary to the Treasury seeking his agreement to proceed with letting the ICWC franchise to First.
- 4.99** This request was made by email on 3 August 2012 from a member of the ICWC Project Team copied to, among others, the then DfT Parliamentary Under Secretaries and the Permanent Secretary. The email attached a briefing paper stated on its face to have been prepared by the ICWC Project Team Leader. This paper stated, among other things, that:
- 4.99.1** the winning bid (identified by a code name) had been selected “*based on a transparent process published in the Department’s website alongside the ITT*”; and
- 4.99.2** the decision as to the winning bid had been approved by the CAC on 25 July 2012 and endorsed by the BICC on 2 August 2012.

4.100 It also repeated materially the same inaccurate text which was used in the 31 July and 2 August 2012 BICC papers (referred to in paragraph 4.81), as well as the following inaccurate statement:

*“...the SLF is calculated so as to leave the probability of default (measured against 500 different possible future economic scenarios) at 4.4%.”*

4.101 In response to this email, an email request was made on behalf of one of the Parliamentary Under Secretaries on 6 August 2012 to the ICWC Project Team member who sent the 3 August 2012 email. The request was for an assurance, before a final decision was taken, that First (referred to by a codename) had not overbid. The request was copied to the then Secretary of State, the then Minister of State, the Permanent Secretary, the Cabinet Office and various DfT officials (including at Director General level).

4.102 The ICWC Project Team member’s email reply to this request on 7 August 2012, copying the same people, included the following statement:

*“The four bids have been assessed by DfT officials and external technical consultants, Atkins. Costs and revenues proposed in bidders financial submissions were all subject to a rigorous risk adjustment process. **The outputs from this adjustment then informed the levels of subordinated loan facility (SLF) required for all bidders.** In [First’s] case this resulted in a facility provision of £190m being made available to support their bid.”* (emphasis added)

4.103 Once again, in my view the language highlighted above does not properly explain how the SLF levels were determined.

4.104 There were a number of briefing meetings held with the then Minister of State in the run-up to the announcement of the intention to award the ICWC franchise to First on 15 August 2012, which included some of the attendees at the 27 June 2012 CAC meeting. Following one such meeting on 6 August 2012, the then Minister of State sent the Chief Secretary to the Treasury a letter of that date (drafts of which had been annexed to the papers submitted to the CAC for its meeting on 25 July 2012 and the BICC for its meeting on 31 July 2012) seeking his agreement to proceed with the letting of the ICWC franchise. The letter included text in materially the same form as that set out at paragraph 4.80 above. The Chief Secretary provided his agreement by letter to the then Minister of State dated 8 August 2012.

4.105 During this period Virgin continued in correspondence to (and through telephone contact with) the Director General at the DfT with responsibility at that time for the DfT’s refranchising programme, to demand information and to challenge the decision not to prefer its bid. After the Director General’s letter to Virgin of 9 August 2012 refusing to provide the requested information (following his earlier holding response referred to at paragraph 4.86 above and Leading Counsel’s advice

on 3 August 2012), on 10 August 2012 Virgin forwarded copies of correspondence with the Director General to the then Secretary of State.

**4.106** Also on 10 August 2012 Virgin sent that Director General and, separately, the then Secretary of State a copy of a report (the “**Europa Report**”) of that date by Europa Partners Limited (“**Europa**”) headed “*Risk Analysis and the West Coast Tender Evaluation*”. Europa described itself in the report as “*an independent corporate finance advisory firm based in London*”.

**4.107** The Europa Report expressed various opinions, including that the DfT’s “*approach to risk evaluation and the incorporation of risk in the overall assessment is structurally flawed*” and that “*the quantum of extra capital sought by the Department is highly unlikely to be sufficient to convert a high risk bid into a low risk bid*”. The thrust of the report was that the DfT should have used a different risk evaluation process to that which the DfT had followed, rather than being focussed on specific issues as to SLF sizing methodology. However, the Europa Report did:

**4.107.1** state that Virgin was particularly concerned about the SLF element of the bid evaluation process;

**4.107.2** suggest that the DfT had taken a “*rough-and-ready approach*” to that process “*with guidance being given in the form of ‘Ready Reckoners’ to guide bidders*”; and

**4.107.3** set out the following, which the Europa Report presented as an excerpt from a Virgin note of a conversation between Virgin and a “*DfT official*” (who, according to the full Virgin note (which was subsequently made available to the DfT in the course of the judicial review proceedings referred to in paragraph 2.7.3 above), was the ICWC Project Team Leader) on 15 March 2012:

*“Eventually, after MUCH more debate and probing, I believe I got to the heart of the matter. Whilst it was presented less obviously, he was effectively telling me that they COULD NOT contemplate releasing their stress-test model because it is very basic and would be open to challenge!”*

**4.108** Following receipt of the Europa Report, a DfT Deputy Director carried out “*a high level review of the report so that we are in a position to provide assurance to the Minister that we do not think that there is anything in this report that would mean that she cannot be asked to endorse the decision and agree the announcement of the winning bidder.*”

**4.109** A short note was produced to reflect this review, the key passages in which were as follows:

*“All bidders have had sight of the planned process for evaluation for a significant period of time. The Invitation to Tender was published in January 2012 and there*

*had been pre-briefing of the proposed evaluation process in advance of that. We are satisfied that the process we have followed represents a systematic risk analysis. To act as we are being invited to, and use an alternative evaluation process to that which the bidders had been advised, would require the Secretary of State to step outside of the Procurement Regulations and/or rerun the process by reissuing the ITT.*

*This review did not identify any new, significant issues that would mean that the decision cannot be put to the Minister for her endorsement.”*

**4.110** The note also included the following recommendation:

*“That the Minister notes the content of this paper and the fact that the review that has been conducted has not identified any significant issues that means that the Minister cannot be asked to endorse the decision to agree the announcement of the winning bidder.”*

**4.111** The Europa Report and the note describing the DfT’s review of it were provided to the then Minister of State. At a meeting on 14 August 2012 with DfT officials including members of the ICWC Project Team, the Deputy Director who did the high-level review of the Europa Report (see paragraphs 4.108 to 4.110 above) and a DfT internal lawyer, the then Minister of State reviewed the Europa Report before approving the decision to award the ICWC franchise to First. I have seen no evidence that the passages in the Europa Report referring to concerns relating to SLF issues (see paragraph 4.107 above) were specifically drawn to the then Minister of State’s attention or discussed with her in that meeting.

**4.112** By email on the evening of 14 August 2012 the Assistant Private Secretary to the then Minister of State emailed various DfT officials and DfT internal lawyers (including at Director General and General Counsel level) in the following terms:

*“I can confirm that, after receiving the clearance letter from the Chief Secretary to the Treasury, the Minister agrees to the award of the InterCity West Coast franchise to First West Coast Limited.*

*She also noted the paper that had been prepared in respect of the report by Europa Partners Limited entitled ‘Risk Analysis and the West Coast Tender Evaluation’ and the fact that a high level review of this report has been conducted and that no significant issues had been identified that would mean that she could not be asked to agree to the award.”*

**4.113** The DfT’s internal lawyers continued working with Eversheds and Leading and Junior Counsel following the 3 August 2012 consultation referred to at paragraphs 4.96 to 4.97 above on the drafting of correspondence and on preparation to defend any legal challenge by Virgin. As part of the defence preparation:

**4.113.1** it was recognised that likely areas for challenge would include the DfT’s mechanism for determining levels of required SLF and that there were potential concerns over the manner in which the SLF requirements had been calculated;

4.113.2 consideration was given to the Europa Report; and

4.113.3 the ICWC Project Team Leader (with input from at least one colleague) prepared for the internal and external legal team a “*Short outline in simple terms of how we reached our view on the bid*” which explained the application of discretion in sizing the SLF as follows:

*“Applying judgement as allowed for under Flow Chart 4 box 4.2, the SLF for [First] was set at £190m (£[REDACTED]m rounded up [sic] to £[REDACTED]m and reduced by £10m removed [sic] taking account £10m being put into the business on day 1)...Similarly applying judgment to [Virgin] it was not felt appropriate for a contract of this size should [sic] not to have an SLF. [REDACTED]. On that basis the SLF figure for [Virgin] would be £41m and CAC agreed to a rounded level of £40m.”*

4.114 On 14 August 2012 Sir Richard Branson wrote again to the Prime Minister explaining that it had not been possible for the Cabinet Secretary and Sir Richard to discuss the issues raised in Sir Richard’s letter of 30 July 2012 (see paragraph 4.84 above) and urging the Prime Minister to delay announcing the ICWC franchise award “*so that an audit can be done to make sure that the right decision is being made.*”

4.115 On the same day the DfT wrote to First on behalf of the then Secretary of State informing First that, subject to various terms set out in the letter, the then Secretary of State had decided to award the ICWC franchise to First.

4.116 On the morning of Wednesday 15 August 2012 the DfT announced to the London Stock Exchange that the then Secretary of State intended to award the ICWC franchise to First and issued a press release stating that the then Minister of State had unveiled First as the new operator for the ICWC franchise.

4.117 **I therefore make the following findings:**

4.117.1 **despite the fact that DfT officials were aware that the SLF sizing was a likely area of challenge in any litigation, the then Minister of State was not given an appropriately accurate and full briefing as to the manner in which the CAC had approached the SLF sizing process in advance of her decision to approve the intention to award the ICWC franchise to First; and**

4.117.2 **inaccurate statements were made to the then Minister of State in writing as to the manner in which the CAC had approached the SLF sizing process in respect of First’s bid at its meeting on 27 June 2012.**

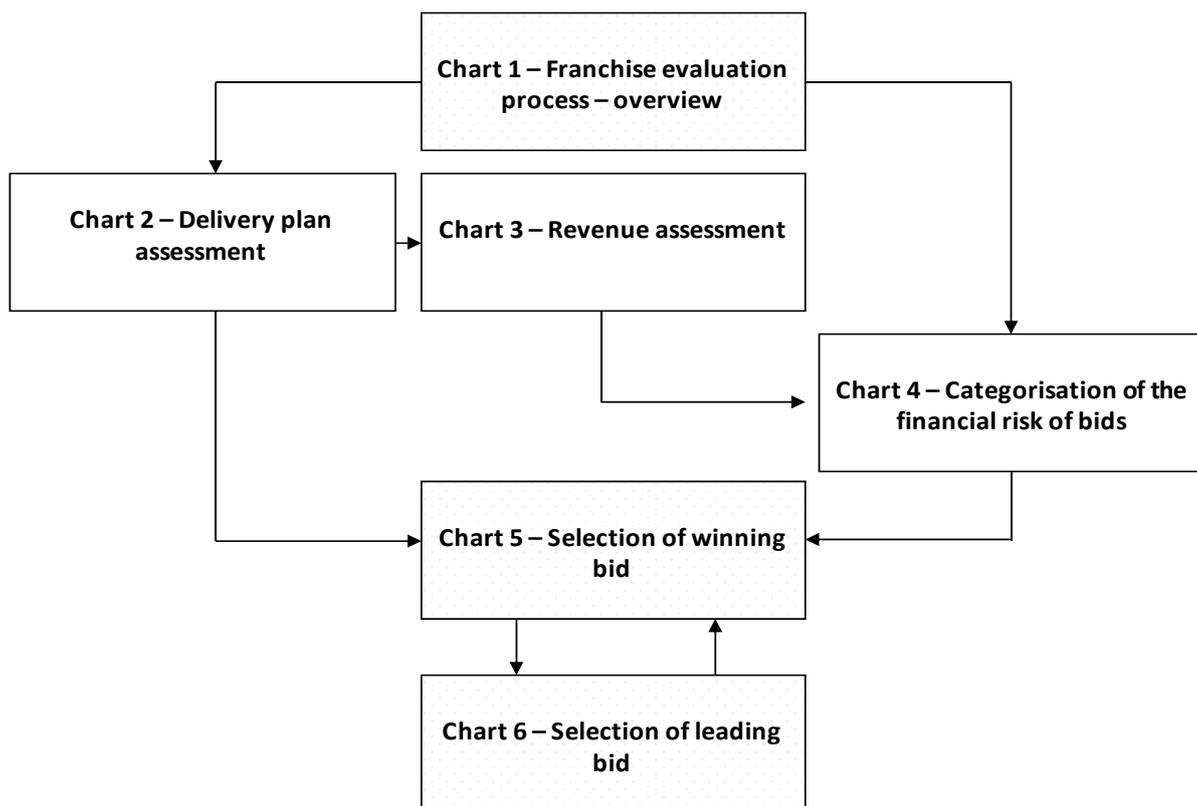
## 5 Findings concerning the GDP Resilience Model

- 5.1 It is clear from my description of events in section 4 that the process followed by the DfT in sizing the SLF requirements in respect of First's and Virgin's bids was seriously flawed.
- 5.2 The flaws need to be considered in the context of the franchise structure and the evaluation criteria set out by the DfT, of which the SLF is one of the criteria.
- 5.3 As described at paragraph 4.3 above the ICWC franchise structure differed from other rail franchises because it included a number of features intended to reflect the Government's revised objectives for the rail industry. Specifically, it included:
- 5.3.1 the GDP Mechanism;
  - 5.3.2 the derivation of the SLF through the GDP Resilience Model, supported by a third party guarantee;
  - 5.3.3 the 15-year franchise duration;
  - 5.3.4 the adoption of long-term station leases; and
  - 5.3.5 the leading bid being selected on the basis of an adjusted net present value ("NPV")<sup>2</sup> as opposed to a risk-adjusted NPV, as in previous franchises.
- 5.4 The evaluation methodology is outlined in the Process Charts<sup>3</sup> referred to at paragraph 4.4 above. An outline of the Process Charts is provided below:

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<sup>2</sup> The *adjusted NPV* is the NPV submitted by the bidder adjusted for any DfT liabilities not allowed for in the bidders' models, such as Secretary of State Risk Assumptions

<sup>3</sup> The version of the Process Charts used in the evaluation of the ICWC franchise is "issue 3" dated January 2012 published on the DfT website



- 5.5** The objective of the competition is to award the franchise to the bidder who offers the best, most robust proposition, in terms of price and reliability, for operating the base service specification in the ITT.
- 5.6** For this purpose, once the DfT has checked bidders' submissions for compliance with the ITT (chart 1), it assesses the deliverability and quality of the bidders' propositions (chart 2). If this assessment indicates a significant risk that costs or revenues will not be delivered (chart 1 & Chart 3), the DfT and its technical advisers will risk adjust the bids and use these risk adjustments to assess whether the franchisee is likely to be financially unstable under a number of economic scenarios. The DfT may exclude bids from the competition on the grounds that they are financially high risk. Alternatively the DfT will seek to mitigate the risk of the bidder walking away by asking the bidder's parent (backed by a suitable bank) whether it is prepared to inject additional funds (see box 4.3 of Chart 4).
- 5.7** The size of the SLF is based on a risk-adjusted view of costs and revenues to reflect the DfT's technical advisers' assessment of:
- 5.7.1** bid assumptions that are not compliant with DfT guidance (e.g. inflation assumptions);
  - 5.7.2** the revenues and costs associated with individual bidders' initiatives (termed endogenous factors); and

5.7.3 the DfT's benchmark<sup>4</sup> macroeconomic factors (e.g. GDP and Central London Employment) which are normalised for all bidders (termed exogenous factors).

5.8 For the purposes of franchise award, the price offered by bidders is the NPV of the premium/subsidy offered, using the same discount factor as the DfT applies in appraising investments. The NPV is calculated over the period of the franchise and 50% of that in the extension period<sup>5</sup>.

5.9 The leading bid (chart 6) is selected by comparing the adjusted NPV of affordable, compliant, deliverable bids which have passed a re-fresh of the legal, financial and safety pre-qualification compliance tests (chart 5). Risk adjustments are made only for the purpose of financial robustness testing (Chart 4).

5.10 Having set the context, I now describe the key technical flaws relating to the GDP Resilience Model that the Inquiry team has identified.

### **Issues relating to the GDP Resilience Model**

5.11 The SLF Guidance referred in paragraphs 8b and 8c to the DfT using the GDP Resilience Model to determine the SLF based upon the DfT's view of risk-adjusted revenues and costs and a maximum default rate<sup>6</sup>.

5.12 Ernst & Young has identified a number of technical flaws and inconsistencies in the application of the GDP Resilience Model and the interpretation of its results by the DfT in the context of determining SLF levels. By inference, these issues will also have impacted the Ready Reckoner, which was calibrated using the GDP Resilience Model. These issues are:

5.12.1 **Real vs. Nominal** – the GDP Resilience Model requires inputs to be in nominal terms. Inputs are then deflated by the Retail Price Index to real 2010 prices and used to set the parameters for the GDP Resilience Model based on 500 economic scenarios. However, Ernst & Young has confirmed that the output of these calculations was not re-inflated to nominal terms within the model when sizing the SLF requirement. The GDP Resilience Model outputs and, by inference, the Ready Reckoner, which were calibrated using the output from the GDP Resilience Model, are therefore in real 2010 prices. However, they were interpreted as nominal by the DfT. As a consequence of this, the SLF levels considered in the DfT decision making process were understated by a factor of approximately 50%<sup>7</sup>.

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<sup>4</sup> The benchmark is based on the DfT's revenue comparator. Individual factors may be changed if bidders provide comprehensive evidence that a particular factor or factors should be adjusted.

<sup>5</sup> As specified in Section 2.15 of the ITT.

<sup>6</sup> The DfT proposed to use a maximum default rate of 4.4% - see paragraph 4.9.1 above.

<sup>7</sup> The real to nominal factor is heavily dependent on the profile of the risk adjustments and the associated timing of potential franchisee default.

5.12.2 **Inconsistent use of elasticities** – the GDP Resilience Model assumes that changes in GDP are linked to changes in revenues through an “elasticity factor”<sup>8</sup>. The elasticity factor is derived from guidance set out in the Passenger Demand Forecasting Handbook (the “PDFH”) (see Appendix F for further details). The GDP Resilience Model incorporated an elasticity of 1.4, in accordance with version 5 of the PDFH, to calculate the impact of GDP scenarios on revenues. The model also uses an elasticity of 1.4 for the purpose of calculating payments under the GDP adjustment mechanism which is consistent with the franchise agreement<sup>9</sup>. However, the risk adjustment methodology outlined in the SLF Guidance stated that the DfT would use an elasticity of 1.8, in accordance with version 4.1 of the PDFH, for the purposes of deriving risk adjusted revenues. The SLF Guidance may have created an impression in the minds of bidders that the model would be calibrated by reference to 1.8. This approach has two further implications:

- (i) if the DfT had applied an elasticity of 1.8 in the GDP Resilience Model rather than the 1.4 it actually used, the levels of SLF required to meet the target default rate of 4.4% would have been significantly increased, in some cases by a factor of 2 to 3 times the amounts actually sought from bidders; and
- (ii) at the levels of SLF actually sought by the DfT, the effective default rate of the bids was much higher than the 4.4% being targeted by the DfT. This issue was recognised by the DfT in an internal undated paper<sup>10</sup> which noted that, in the event the actual elasticity was greater than that in the GDP Mechanism, the default rate would increase<sup>11</sup>. To illustrate the point, Ernst & Young carried out some scenario testing which suggests that, for the levels of SLF determined by the DfT, if the 1.8 elasticity had been used default rates could be approximately 30%.

5.12.3 In summary, the inconsistent use of the elasticity factors meant that, irrespective of the real versus nominal modelling flaw identified above, the levels of SLF generated by the model were not in compliance with the stated policy of seeking a default rate of 4.4%.

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<sup>8</sup> For example, an elasticity of 1.4 means that for every 1% fall in GDP, demand (and hence revenues) falls to the power of 1.4 times.

<sup>9</sup> Which states 1.25 but is derived from an elasticity of 1.4. Refer to Appendix F.

<sup>10</sup> “believed by the Inquiry team to have been prepared in January 2012 and titled “ICWC – Financial Stability Testing in Bid Evaluation”

<sup>11</sup> Specifically, the paper stated that “*the impact of a higher outturn relationship between demand and GDP would require SLFs of a size that is unlikely to be deliverable by bidders*”

- 5.12.4 Furthermore, the DfT did not clearly communicate to bidders what elasticity they would be using in the GDP Resilience Model and, by inference, what elasticity they had used in the calibration of the Ready Reckoner.
- 5.13 These technical flaws and inconsistencies meant that the SLF numbers generated by the DfT's GDP Resilience Model and, by inference, the Ready Reckoner were substantially understated.
- 5.14 The inconsistent use of elasticities, in conjunction with the transparency problems referred to at paragraph 4.31 above, meant that the information provided to bidders was inconsistent and confusing preventing them from determining the level of SLF required and the optimal capital structure for their bids.
- 5.15 **Inconsistencies with the franchise agreement** – The Inquiry team has also identified a series of inconsistencies between the GDP Resilience Model and the terms of the template franchise agreement (which would, once executed, have governed the franchise). While these inconsistencies might not, if corrected, have resulted in a large variation in the levels of SLF calculated, this issue does highlight the lack of quality assurance. The two key areas where inconsistencies have been identified are:
- 5.15.1 **GDP indices** – there is an inconsistency between the GDP forecast index used in the GDP Resilience Model and that provided to bidders on which to base the GDP mechanism and stated in Schedule 8.5 of the franchise agreement. The simulations were based on the March 2011 Office Budget Responsibility's forecast, whilst the forecast index in the franchise agreement was based on the March 2012 forecast. The cumulative base GDP forecast in the franchise agreement is lower than that in the GDP Resilience Model, which would have led to lower revenue differences and lower GDP sharing amounts in the GDP Resilience Model if the franchise agreement values had been used. The effect of using the franchise agreement index in the GDP Resilience Model would have been slightly to reduce the calculated SLF requirements of bidders.
- 5.15.2 **Liquidity ratios** – The GDP Resilience Model did not align with the franchise agreement requirement to maintain a liquidity ratio of 1.07. As a consequence the SLF levels calculated using the model for a specified target default rate overstated the actual requirements. The Inquiry team understands that the GDP Resilience Model has since been amended for future franchises to rectify this inconsistency.
- 5.16 A prerequisite in adopting the GDP Resilience Model (and indeed any model) is that inputs, calculations and outputs are appropriately reviewed and quality assured. Given the importance placed on the GDP Resilience Model in the evaluation process, the Inquiry team questioned the level of review, checking and

model audit undertaken. The Inquiry team notes that while interview evidence points to an internal review of the GDP Resilience Model having been conducted, there is no record of any model audit or best practice review having taken place.

**5.17 I therefore make the following findings:**

- 5.17.1 **the GDP Resilience Model used by the DfT to calibrate the Ready Reckoner was inaccurately interpreted as being in real rather than nominal terms;**
- 5.17.2 **there were further inconsistencies in the use of elasticity factors, which further understated the level of SLF. These flaws meant that bidders were provided with inconsistent and confusing information that prevented them from determining the level of SLF required and the optimal capital structure for their bids;**
- 5.17.3 **these flaws and inconsistencies resulted in SLF levels that substantially understated the level of SLF required to comply with the DfT's target default rate; and**
- 5.17.4 **the quality assurance of the GDP Resilience Model was inadequate, particularly considering the importance of the model and its inputs/outputs to the ICWC franchise process.**

## 6 External advisers

6.1 On the basis of the available evidence, and taking into account the nature of the agreed roles of the DfT's various external advisers, I have concluded that the conduct of those advisers cannot fairly be criticised in relation to the facts covered by my findings set out in sections 4 and 5 above.

### Atkins

6.2 The DfT appointed Atkins as "Technical Advisor" on the ICWC franchise process in early 2011. Atkins had a number of roles including, relevantly, advising the DfT on the level of information to be provided to bidders, providing technical support in bid evaluation, identifying and assessing assumptions underlying the bids, and producing a risk adjusted view of revenue and costs. Both Atkins and the DfT told the Inquiry team in interview that it was understood that Atkins was to have no role in developing the SLF sizing methodology, or in determining the SLF levels.

6.3 The DfT instructed Atkins to deliver its risk adjustments in two passes – a preliminary "first pass" and a final "second pass". These were delivered on or about 17 June 2012 and 26 June 2012 respectively. The DfT told Atkins that the first pass would be used to give a preliminary view of risk adjustments and likely SLF levels to the CAC. It is unclear from the evidence whether Atkins knew that the DfT intended to inform bidders of the SLF levels generated by the first pass risk adjustments.

6.4 There is evidence that the DfT told Atkins that it wanted the first pass to be a "*worse case*" view of costs and revenues so far as was possible, and that Atkins made efforts to apply as many significant down-side adjustments as it reasonably could – but that the DfT and Atkins shared an understanding that the first pass would be a preliminary view, subject to various qualifications and limitations and not adjusting for all exogenous effects. Only the second pass would reflect Atkins' final professional opinion.

6.5 After Atkins provided its first pass, it discovered the significance of the overlay assumption in First's bid model described in paragraph 4.45 above, and recommended the application of the Partial Risk Adjustment (an exogenous adjustment) in light of it (see paragraph 4.48 above). Atkins' work involved applying its professional judgment to anticipate which assumptions might have the greatest impact and prioritising consideration of them. The Inquiry team has not seen compelling evidence that Atkins should have identified the overlay and its significance earlier. Relevantly, the record of assumptions accompanying First's bid model only briefly described the overlay and did not identify its significance.

6.6 In reaching my conclusions on Atkins' conduct, I have taken note of the fact that Atkins raised concerns about solvency testing and SLF sizing on at least three

occasions – in December 2011 whilst commenting on a draft of the ITT, in discussions and emails in early January 2012, and at a meeting with the DfT on 29 June 2012. Various concerns were raised but most relevantly these included concerns about transparency to bidders and the defensibility of the procurement approach, and on 29 June 2012 about whether the correct risk adjustments were used in determining the SLF levels. In my view, particularly in light of the agreed scope of Atkins’ role, it was not Atkins’ responsibility to follow up on these concerns or to ensure that they were appropriately escalated or reported within the DfT. I make no criticism of Atkins’ conduct.

#### Counsel

- 6.7 I can address the position of Counsel briefly. As I set out in section 4 above, Leading Counsel was only asked to advise on 31 July 2012 and it was only during the consultation on 3 August 2012, less than two weeks before the announcement of the intention to award the ICWC franchise to First, that any mention was made to Leading Counsel that there was an issue as to the use of discretion in the sizing of the SLF requirements (see paragraphs 4.96 and 4.97 above).
- 6.8 Leading Counsel (as well as Junior Counsel who were subsequently also engaged by the DfT) were not responsible for advising the DfT on its internal escalation or reporting. Together with Eversheds and the DfT’s internal lawyers, they were responsible for advising the DfT in relation to correspondence and for assisting the DfT in preparing it to be ready to defend any legal challenge by Virgin to the outcome of the ICWC franchise process.
- 6.9 Accordingly, I have seen no basis on which to criticise the conduct of Counsel.

#### Eversheds

- 6.10 Eversheds was appointed by the DfT in March 2011 as the DfT’s external legal adviser in relation to the ICWC franchise process. The agreed scope of Eversheds’ role included “*protecting the interests of the DfT*” throughout the ICWC franchise process and advising “*on the franchising process and, in particular... on any potential defects in the process which could give rise to a judicial review*”.
- 6.11 In relation to the requirement as to advice on the franchising process, the Eversheds Partner confirmed to the Inquiry team in interview that Eversheds understood its role to require it to raise with the DfT any concerns it had as to process issues as and when it became aware of those issues and regardless of whether the DfT had specifically requested advice on such issues from Eversheds.
- 6.12 In relation to the matters relevant to this report, the principal DfT contact person for Eversheds (and the person from whom Eversheds mostly took instructions and to whom Eversheds mostly gave legal advice) was the ICWC Project Team Leader.

Eversheds also, however, took instructions from and gave advice to DfT internal lawyers. The Eversheds Partner explained to the Inquiry team in interview that if Eversheds wished to escalate an issue (i.e. not just leave it with the ICWC Project Team Leader) it would do so by raising it with the DfT internal lawyers.

- 6.13** Eversheds advised the DfT in relation to the content of the draft ITT, the related draft documentation, including the draft Process Charts, the SLF Guidance and the Risk Adjustment Guidance. Eversheds did not assume any responsibility for, or advise in relation to, the financial or technical aspects of SLF sizing or risk adjustments, or the robustness of the methodology described in either the SLF Guidance or the Risk Adjustment Guidance. Rather, Eversheds advised in relation to the transparency of the methodologies and on drafting issues.
- 6.14** I do not think that Eversheds' conduct can fairly be criticised in relation to the facts covered by my findings on the transparency issues set out in section 4 above. Eversheds gave clear and appropriate advice in relation to the transparency issue and the risks were understood by the DfT at a senior level.
- 6.15** Eversheds also gave some advice to the DfT from 26 June 2012 to 2 July 2012 in relation to the DfT's approach to risk adjustments and SLF sizing. In this regard:
- 6.15.1** On 26 June 2012, at a meeting at the DfT's offices, Eversheds became aware that there was an issue as to a possible further risk adjustment that the ICWC Project Team Leader said could, depending on the view taken, increase the SLF required in respect of First's bid and reduce to zero the SLF required in respect of Virgin's bid. This was the risk adjustment referred to at paragraph 4.48 above.
- 6.15.2** Eversheds advised the 26 June 2012 meeting that the DfT's published process required the DfT to obtain strong evidence from a bidder before accepting a revenue forecast from a bidder that was different from that in the DfT's comparator model (as to which see paragraphs 4.22 and 4.46 above).
- 6.15.3** Eversheds did not attend the 27 June 2012 meeting of the CAC.
- 6.15.4** As set out in some detail at paragraphs 4.65 to 4.73 above:
- (i) Eversheds obtained some limited information on 29 June 2012 as to how the DfT had risk adjusted First's bid and how the CAC had sized the SLF requirements at its 27 June 2012 meeting; and
  - (ii) based on this information, on 29 June 2012 and 2 July 2012, Eversheds expressed concerns as to possible process risks to the ICWC Project Team Leader and to DfT internal lawyers.

- 6.15.5 After 2 July 2012 Eversheds did not repeat to the DfT its concerns as to these process risks (although the SLF sizing concerns were raised with Counsel in the context of litigation defence preparation).
- 6.15.6 The Eversheds Partner explained in interview with the Inquiry team that, consistent with her file note of her 2 July 2012 discussion with DfT internal lawyers (see paragraph 4.70.1 above), which records that it was made “*clear that the decision will not be revisited*”:
- (i) after those discussions she considered that the issue “*had been closed down and that it wouldn’t be helpful to provide further advice, which is why I didn’t follow back up and go back to [the ICWC Project Team Leader]*”;
  - (ii) “*it was only because of this impression I’d formed that things weren’t going to change that I didn’t take the matter further*”; and
  - (iii) “*the reason for not going back to [the ICWC Project Team Leader] on the point was because my understanding had been that this was a closed issue.*”
- 6.15.7 As recorded at paragraph 4.70.2 above, there is some conflict in the evidence as to how firmly this issue had in fact been closed down by the DfT internal lawyers. This issue is closely related to the question of how strongly Eversheds expressed its concern (also addressed in that paragraph).
- 6.15.8 Eversheds did not obtain significant additional information during the rest of July 2012 as to the CAC’s approach to sizing the SLF requirement.
- 6.16 There is in my view a real issue as to whether Eversheds should have done more to ensure that its concerns as to the process followed by the CAC in sizing the SLF requirements were expressed more forcefully and considered at a more senior level within the DfT, for example by the DfT General Counsel.
- 6.17 I have not found this an altogether easy issue to resolve. I have concluded that, although Eversheds certainly could have escalated its concerns within the DfT, for example to the General Counsel, particularly given its long-standing relationship with the DfT, Eversheds did discharge its agreed role. In reaching this conclusion, I have had particular regard to the following:
- 6.17.1 all available evidence, including the nature of Eversheds’ agreed role;
  - 6.17.2 the need to exclude the benefit of hindsight in reaching my view;
  - 6.17.3 the fact that Eversheds did flag its concerns as to the possible process risks both with the ICWC Project Team Leader and with DfT internal lawyers and that it was not Eversheds’ responsibility to ensure that risks were escalated or reported appropriately within the DfT; and

6.17.4 whether Eversheds should have done more during July 2012 to gain a fuller understanding of what had occurred at the 27 June 2012 meeting of the CAC. Consideration of this question necessarily requires a view to be taken on the conflict in the evidence as to the extent to which Eversheds' view that the SLF sizing decision would not be revisited (see paragraph 6.15.6) was reasonably held. I do not intend to resolve this conflict of evidence in this report. I am mindful of the ongoing HR investigations and, in any event, I do not think that I need to resolve the issue. I am satisfied, as I say above, that Eversheds had flagged its concerns to the ICWC Project Team Leader and the DfT internal lawyers, all of whom had attended the 27 June 2012 CAC meeting and all of whom were in a position, if they had chosen to do so, to escalate the risk issue identified by Eversheds or to provide Eversheds with further information.

6.18 Eversheds was involved, together with DfT internal lawyers and DfT officials, in obtaining advice from Counsel in August 2012 and generally on working with Counsel on preparations to defend any legal challenge to the ICWC franchise process (see paragraphs 4.96, 4.97 and 4.113 above). I make no criticism of Eversheds' conduct in this regard.

#### Grant Thornton

6.19 The DfT engaged Grant Thornton in November 2011 to report on the options available to the DfT to improve the financial robustness of rail franchises generally. The available evidence suggests that Grant Thornton's report was intended to inform the DfT's response to certain recommendations of the National Audit Office and the Public Accounts Committee about measures to ensure franchise viability in a downturn, and the testing of bids against different economic conditions. It was not intended to focus only on the ICWC franchise process; its report was to inform procurement methodology for future franchise processes in general. Significantly, Grant Thornton was instructed to use the GDP Resilience Model and not to develop a separate model.

6.20 Grant Thornton's instructions called for work to be done in three categories. Only the third category is directly relevant to this Inquiry: to "*design procurement stress-testing and mitigation criteria for bid evaluation*".

6.21 Grant Thornton requested instructions on that category from at least mid-December 2011 (when it provided its first draft report) and there were subsequent related discussions involving Grant Thornton, the DfT and Atkins. However, Grant Thornton received no substantive instructions in response. Accordingly, in its final draft report it included a brief section dealing with this category in basic terms. Grant Thornton explained to the Inquiry team in interview that this was simply to ensure the engagement was formally completed.

- 6.22** In any event, DfT officials told the Inquiry team in interview that the DfT did not rely on the Grant Thornton report when designing the SLF sizing methodology for the ICWC franchise process. None of the SLF sizing documents presented at key meetings of the BICC and the CAC in 2012 refers to the Grant Thornton report.
- 6.23** In view of the above, I have concluded that Grant Thornton had a narrow and indirect role in the ICWC franchise process and its work had no direct bearing on the facts covered by the findings set out in sections 4 and 5 above. I therefore make no criticism of the work of Grant Thornton.

## **7 Contributory factors**

### Context

- 7.1** As I explained in my Initial Findings Report, a number of factors, operating together, caused or at least contributed to the flaws that I have identified in sections 4 and 5 of this report.
- 7.2** One significant factor contributing to the flaws relates to the conduct of individual DfT officials, including in relation to the opportunities that were missed to escalate or report information as to how the SLF requirements were sized. However, as I explain in paragraph 2.9 above, individual culpability is not a focus of this report and I do not wish in any way to prejudice the HR investigations. Nevertheless, many of the issues identified in sections 4 and 5 were the result of individual actions and omissions, and organisational structures and governance processes can only go so far in militating the actions of individuals. Accordingly, whilst what follows in this section focuses on the failings of those structures and processes rather than individual actions or omissions, I do not intend by this to downplay the significance of those actions and omissions. Nor do I consider that the failings of these structures and processes were such as to prevent appropriate escalation of the issues identified in section 4.
- 7.3** The contributory factors that I will address in this section include:
- 7.3.1** inadequate planning and preparation (paragraphs 7.7 to 7.14);
  - 7.3.2** deficiencies in the organisational structure and in resourcing at the DfT (paragraphs 7.15 to 7.19); and
  - 7.3.3** a lack of efficacy in the governance framework for the franchising programme (paragraphs 7.20 to 7.40).
- 7.4** These factors need to be considered in the context of the timeline planned by the DfT to conclude the ICWC franchise process. The DfT planned to complete the ICWC procurement in approximately eight months (i.e. from issuance of the ITT in January 2012, to announcement of the intention to award the franchise in August 2012), which is much shorter than the timetables in previous complex procurements.
- 7.5** It should also be noted that the Civil Service in general and the DfT in particular have recently been undergoing significant change as resource budgets have been necessarily reduced. With all change management programmes, understanding where the heightened risks are and whether they are acceptable or whether they need to be mitigated is of paramount importance. Given the substantial agenda of the DfT at this time, which included HS2, Crossrail, Thameslink, Aviation and Road Strategy as well as the Olympics, it is not clear that the risks around the

ICWC franchise process were sufficiently elevated and understood across the DfT. Indeed, if they were understood, there may have been the mistaken belief that the addition of process, both as set out in the ITT and the evaluation approach, was sufficient to mitigate the risk whilst in reality the replacement of commercial judgement with process may have had the reverse effect.

- 7.6 Having set the context, I now describe the contributory factors and explain their impact below.

### **Inadequate planning and preparation**

- 7.7 A number of policy and procurement issues, such as the mechanism to determine SLF levels, had not been fully settled at the time of publication of the final ITT. Notwithstanding the eight month delay to the process agreed by Ministers in May 2011, the mechanisms to implement key policies in respect of the ICWC franchise were yet to be finalised when the ITT was published. Furthermore, I consider that inadequate focus was given to ensuring that policy and its implications were fully reflected in the commercial franchise proposition and the way in which it would be evaluated.
- 7.8 A key part of the new policy was the requirement for franchisees to provide greater financial security through “contingent equity” or an SLF as described in section 4. Whilst the Inquiry team has seen evidence that certain policies (such as the new GDP compensation mechanism) underwent a significant amount of development and consultation with stakeholders and a hostile review was performed (see paragraph 7.33.1 below), there is limited evidence of any development of the financial evaluation prior to the issue of the ITT in January 2012. This was confirmed in interviews with DfT staff. In particular, the Inquiry team has seen limited evidence of the DfT performing modelling testing and assessing the implications of requiring SLFs from the bidders, although some analysis was carried out by Grant Thornton to determine the potential size of SLF levels using dummy numbers.
- 7.9 From a policy perspective, HMT’s approval to publish the ITT in January 2012 was on the basis that the new ICWC franchise process would be a pilot to inform future decisions, but would not represent a final model for future franchises. A letter from HMT to the DfT dated 12 January 2012 raised concerns about the volatility of the GDP-based risk sharing mechanism and its potential impact on the franchising programme. I recognise the risk was raised in the context of the portfolio of franchises that the DfT has to manage (i.e., the risk that all franchises could go wrong at the same point leading to reduced revenue for the Exchequer). However, whilst it is clear that certain risks had been identified with respect to the introduction of novel risk transfer arrangements over long franchises, such as the

GDP Mechanism, the implementation of the GDP Mechanism in the context of the ICWC franchise process was subject to inadequate attention and planning.

**7.10** There were further deficiencies in planning and preparation such that, on issuing the final ITT:

**7.10.1** whilst the DfT had performed some analysis relating to SLF levels, it had not formed a view on what amounts might be necessary and accordingly did not appear to have a full understanding of the impact of SLF levels on bid pricing and financial deliverability; and

**7.10.2** there was no available financial modelling tool, designed specifically for the purpose of a financial robustness evaluation, that could be communicated to bidders. As set out at paragraph 4.10.1 above the ICWC Project Team was aware from an early stage in the process that the GDP Resilience Model had not been developed for the purpose of SLF calculation.

**7.11** Notwithstanding the existence of these significant issues, following publication of the final ITT in January 2012, the timetable for announcement of the intention to award the ICWC franchise by August 2012 was set.

**7.12** The Inquiry team understands that the process timetable was driven by the final expiry of the existing franchise on 9 December 2012, noting that an extension to the existing ICWC franchise had already been negotiated. The Inquiry team has heard consistent evidence at interviews indicating that the achievement of the timeline compromised resolution of the issues raised. This approach resulted in insufficient time being allocated to consider and address concerns raised during the process. For example:

**7.12.1** at the CAC meeting of 27 June 2012, information required from external advisers was received by an ICWC Project Team member just prior to the actual meeting and thus only presented to the CAC during the meeting, significantly limiting the level of quality assurance that the CAC could perform over the impact of risk adjustments on SLF levels; and

**7.12.2** important questions were raised by the BICC at its 31 July 2012 meeting, as set out in paragraph 4.89 above, as to the work undertaken by external advisers and DfT officials in respect of the evaluation and decision-making process. However, the time allocated to consider and address these issues was limited to the period until the following BICC meeting, only two days later on 2 August 2012.

**7.13** There is also evidence of a lack of any contingency planning carried out to explore what options existed to delay<sup>12</sup> further the ICWC franchise start date. Whilst the

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<sup>12</sup> Notwithstanding the original delay of eight months, as referred to in paragraph 7.7.

DfT implemented the recommendation of the Office of Government Commerce/Major Projects Authority (“OGC/MPA”) Gateway 0 review<sup>13</sup> that there should be a review of options for the start date of the franchise in 2011, at no stage following the ITT being issued was any consideration given to developing a contingency plan. Further interview evidence confirms that, for example, there was limited investigation into whether the DfT could negotiate an extension outside the existing contract beyond 9 December 2012.

**7.14 I therefore make the following findings:-**

**7.14.1 the planning and preparation for the ICWC franchise process was inadequate as a number of policy and procurement issues had not been clarified or finalised when the ITT was issued. Specifically:**

- (i) the GDP Resilience Model was late in development and there was insufficient focus on ensuring that in this regard policy and its commercial implications were fully considered;**
- (ii) with regard to the SLF, the DfT had not considered the implications of this requirement on bidders from a financial deliverability and pricing perspective, nor determined fully prior to the ITT being issued the mechanism to calculate SLF levels;  
and**

**7.14.2 following issue of the ITT, the quality and robustness of the ICWC procurement was subordinated to an overriding priority to achieve stated timetable deadlines.**

**Deficiencies in organisational structure and resourcing**

**7.15** The Inquiry team has considered the organisational changes at the DfT in early 2011 and the impact of multiple changes in leadership and the significant reduction in resources at the DfT over the relevant period<sup>14</sup>. I consider that these organisational changes and resourcing constraints contributed to the flaws in the ICWC franchise process and adversely impacted the DfT’s effectiveness in identifying and/or resolving those flaws. Specifically, I would draw out the following material points in this regard:

**7.15.1** until late 2010 the DfT’s activities in relation to refranchising were organised under a single Director-General (“DG”) (refer to Appendix G for details). From late 2010, a client provider relationship, effectively a partial matrix structure, was put in place, with full implementation of the organisational redesign completed in May 2011. This resulted in rail

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<sup>13</sup> The OGC Gateway 0 review was conducted in April 2011.

<sup>14</sup> For example during the relevant period approximately 500 staff left through retirement, redundancy or moved to the private sector.

franchising responsibilities within the DfT being split across three DGs (as illustrated in Appendix G). As a result, there was no single accountable lead within the DfT for rail refranchising as a whole;

7.15.2 there was a lack of continuity in senior leadership roles within the DfT and in oversight of the ICWC franchise process. There was a disconnect in the SRO role for the ICWC franchise process, which was initially held by “Rail Policy” prior to the ITT being issued but then which passed to “Major Projects and London Group” in early April 2012. In addition to this disconnect there is conflicting evidence as to who the SRO was in the intervening period. I consider that this lack of continuity in leadership reduced the consistency of oversight over the ICWC franchise process and the extent of understanding and ownership of the flaws identified in this report; and

7.15.3 an OGC/MPA Review<sup>15</sup> recommended a single accountable SRO at DG level for the whole refranchising programme, who would also have the responsibility for ICWC. However, based on evidence collected by the Inquiry team, it is clear that there was little change in practice in the governance arrangements for the ICWC franchise. It was suggested during interviews that the procurement process for ICWC was too far advanced for this restructuring of responsibilities to make any significant changes to it.

**7.16** The Inquiry team has found strong evidence to suggest that reporting lines from the ICWC Project Team were not clear. Specifically, I would draw out the following points:

7.16.1 while there was a commercial manager who performed the lead role in co-ordinating and driving the project forward in the procurement phase, there was no consistent project manager across the process (from policy to close);

7.16.2 there was no clear, single point of accountability across the process, with a lack of clarity as to responsibilities between the directorates within the DfT, in particular following publication of the ITT. For example the Inquiry Team has been advised at interview that the ICWC Statement of Responsibilities was not formally agreed following publication of the ITT;

7.16.3 the ICWC Project Team comprised individuals from a number of sub-teams, namely: franchising policy; commercial and technical services; legal; finance: rail commercial; and rail analysis. A number of employees within the sub-teams were dedicated to the ICWC franchise process; however some were shared, working concurrently on other departmental objectives. Evidence from interviews suggests a culture whereby each team tended only

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<sup>15</sup> Report of OGC/MPA Gateway dated 29 March 2012.

to consider a narrow set of issues relevant to its functional area without a clear view on the implications for the overall project. As an example, while individuals from the rail analysis sub-team developed the GDP Resilience Model, they appear to have believed they were only responsible for providing modelling input and were not responsible for sense checking the outputs; and

**7.16.4** there was a lack of clarity in the reporting structure, with no formal reporting lines from the ICWC Project Team to the SRO. In effect, responsibility of the complex procurement was left in the hands of relatively junior civil servants, without credible oversight by senior civil servants. In fact, except for the CAC and the BICC meetings (a number of which are referred to in section 4), the Inquiry team has seen no evidence of formal reviews or challenge meetings being carried out either of the project as a whole, or of individual workstreams by line managers of the civil servants leading those workstreams.

**7.17** A number of senior, experienced individuals left the DfT over the course of the ICWC franchise process without being replaced, and the key members of the ICWC Project Team were relatively junior and less experienced in comparison with the bidder counterparties they were facing. I would emphasise the following:

**7.17.1** the previous “Rail” DG, the Policy Director, the Rail Service Delivery Director and the Procurement Director all retired in December 2010 and only the Policy Director and the Rail Service Delivery Director were replaced, resulting in a loss of both “corporate memory” and individual commercial experience;

**7.17.2** over the course of the ICWC franchise process, departures from the DfT included some experienced commercial managers within the rail refranchising programme, with extensive refranchising and commercial experience, who left to join private sector organisations, including the bidders; and

**7.17.3** there is evidence to suggest that there was no one above PB7 grade<sup>16</sup> working full-time on refranchising and that, relative to private sector bidders, many of the DfT’s full-time ICWC Project Team were relatively junior and did not have experience comparable with those of their counterparts.

**7.18** I note that, in implementing substantial cost savings required by the Government’s spending review in 2010, the DfT significantly reduced its headcount, the number of contractors used and its use of external consultants. This was corroborated at

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<sup>16</sup> Pay band 7.

interview and in review of the DfT board minutes<sup>17</sup>. That is not to say however that, with appropriate escalation and follow up of the issues, sufficient resources could not or would not have been found. In respect of the ICWC franchise process specifically, the DfT used external technical advisers (Atkins) and external legal advisers (Eversheds) but, in a departure from previous complex franchise processes, had not appointed external financial advisers (with the exception of the narrow engagement of Grant Thornton for franchise policy support as referred to in paragraphs 6.19 to 6.23 above). This is a critical point and I make the following observations in this regard:

- 7.18.1 given the scale of the refranchising programme, the DfT was not resourced or prepared for the extent of activity involved, and the level of resource allocated by the DfT to the ICWC franchise process was in stark contrast to the significant resources deployed by the bidders;
- 7.18.2 having decided not to use external financial advisers, the DfT relied on in-house resource (many of whom were contractors) to perform such activities as the preparation of long form reports, the ITT and the evaluation process preparation, undertaking comparator modelling, answering bidder clarification questions and attending meetings, and carrying out financial bid evaluation. I note that the DfT used external financial advisers on most of its franchise processes prior to the ICWC franchise process and that the DfT is using external financial advisers on other complex transactions, such as IEP, Thameslink rolling stock and Search & Rescue Helicopters<sup>18</sup>;
- 7.18.3 the DfT faced other challenges that resulted in resources being further stretched, including the pressures of running a number of other significant projects concurrently with the ICWC franchise process (as noted at paragraph 7.5 above). These resourcing constraints were discussed in various forums<sup>19</sup> and I specifically note the following:
  - (i) senior management attention on the ICWC franchise process was constrained by the demands of other major projects being undertaken, which included IEP, Thameslink rolling stock, HS2, Search & Rescue Helicopters and other significant franchise processes (e.g. Greater Western, Essex Thameside and Thameslink);

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<sup>17</sup> DfT board 29 October 2010: consultancy spend was running 40% lower in 2010/11 than in 2009/10 as a result of cost saving initiatives introduced,

<sup>18</sup> On IEP and Thameslink, the spend on financial advisers was 12% and 17% of total consultancy costs respectively.

<sup>19</sup> Including at a BICC meeting held on 15 December 2011.

- (ii) two OGC/MPA Gateway reviews<sup>20</sup> highlighted resourcing as a key risk; specifically the loss of senior expertise and the pressure put on the project teams;
- (iii) whilst a risk in respect of resourcing was considered by the ICWC Project Team in February 2012<sup>21</sup>, the risk was closed in June 2012. There is, however, no evidence to suggest that the DfT considered making any material changes to the level of resource in respect of the ICWC Project Team; and
- (iv) interview evidence confirms a wider concern as to the adequacy of resources for the ICWC franchise process.

7.18.4 I consider that, in relying upon internal resources, particularly as regards financial analysis and evaluation, there was a failure to address the burden placed on the DfT from other major projects and procurements already underway and the need for appropriately experienced and qualified staff.

**7.19 I therefore make the following findings:**

- 7.19.1 **organisational restructuring at the DfT resulted in a lack of clarity in roles and responsibilities and in associated accountabilities, including a failure to get the SRO structure to work for the benefit of the project. These deficiencies adversely impacted the DfT's effectiveness in identifying and/or resolving flaws in the ICWC franchise process; and**
- 7.19.2 **the scale of the franchising programme and the number of other concurrent significant and complex transactions meant that the DfT's resources were being stretched at the same time as expenditure on external advisers generally, and financial advisers specifically, was being cut and senior resource had been lost. Accordingly, due to other departmental priorities, insufficient senior management attention was given to the ICWC franchise process, despite its scale and complexity.**

**Lack of efficacy in the governance framework**

7.20 There are a number of contributory factors in the failure to prevent the flaws identified in the ICWC franchise process, which result from a lack of efficacy in the governance framework. I set out these deficiencies below and explain the way that they contributed to a failure effectively to identify, escalate and resolve significant risk issues relevant to the flaws identified in sections 4 and 5 of this report. I have considered these deficiencies under the following headings:

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<sup>20</sup> Specifically the review in April 2011 noted the loss of expertise at a senior level, whilst noting that the rail refranchise programme had retained a number of experienced and committed staff at a junior level. In March 2012 an OGC/MPA review found that the rail refranchising programme was "significantly under-resourced" with "enormous pressure" being put on existing teams.

<sup>21</sup> The risk was included on the risk register maintained by the ICWC Project Team in February 2012.

- 7.20.1 lack of clarity as to the function, authority and interrelationship of committees and boards;
- 7.20.2 lack of appropriate escalation of significant risk issues; and
- 7.20.3 lack of clarity and effectiveness of quality assurance procedures:
  - (i) internal quality assurance procedures; and
  - (ii) external quality assurance procedures.

Lack of clarity as to the function, authority and interrelationship of committees and boards

- 7.21 A number of different committees and boards performed governance functions in relation to the ICWC franchise process. A summary of the roles and responsibilities of these bodies as defined in their terms of reference (“**TOR**”) is set out in Appendix H.
- 7.22 The Inquiry team has been provided with a number of diagrams setting out the governance structure within the DfT in relation to the rail refranchising programme which are set out in Appendix I. I consider that the absence of a single point of reference in respect of the governance structure within the DfT exacerbated the lack of clarity as to responsibilities and accountability.
- 7.23 The Inquiry team has identified evidence that the lack of clarity in the functions, authority and interrelationship of certain bodies (specifically the BICC, the CAC, the RRPB, the Executive Committee of the DfT (“**ExCo**”) and the DfT board) can in part be traced to incompleteness in and inconsistencies between the TOR of the respective bodies. In particular I note the following:
  - 7.23.1 the BICC’s TOR limit its authority in respect of rail franchise processes to the scoping stage only with no involvement in the latter stages of the process. As the BICC was requested by the CAC<sup>22</sup> to endorse the CAC’s decision to award the ICWC franchise to one bidder this would appear to represent the BICC acting outside its TOR. However, at the start of the rail refranchising programme the BICC revised its roles and responsibilities (although not its formal TOR) to include approving the issue of ITTs and the award of contracts for major franchises, of which the ICWC franchise was the first. Whilst it would therefore appear that the BICC was not acting outside a common understanding of its responsibilities, the Inquiry team has seen no evidence that the decision taken by the BICC to amend its role and responsibilities was formally endorsed by the ExCo or the DfT board;

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<sup>22</sup> At its 31 July 2012 meeting.

- 7.23.2 the BICC's TOR are undated and the DfT has subsequently confirmed that the TOR were last revised in 2010. As a result of not updating the TOR, the membership requirements as stated within the TOR refer to positions within the DfT prior to the restructuring in early 2011. Whilst the Inquiry team understands that the BICC's TOR were informally revised in January 2012 to include membership requirements following the restructuring, there is no evidence to suggest that the revision was approved by the ExCo or the DfT board;
- 7.23.3 the Inquiry team has been provided with a dated version of the CAC's TOR<sup>23</sup>, and the DfT has subsequently confirmed that there were no changes to the TOR during the period of the ICWC franchise process. However, whilst the CAC's TOR remained unchanged, interview evidence suggested a level of ambiguity in that the ICWC Project Team was unaware of the TOR in practice;
- 7.23.4 the CAC's TOR were incomplete in two key respects:
- (i) first, the CAC's TOR do not define the frequency of CAC meetings. I note that, as the CAC is a project-based committee, some irregularity in the timing of its meetings may be expected. However, given that the CAC's TOR specifies an assurance role for the committee, I would also expect that the CAC would meet sufficiently frequently to provide an effective assurance function. In this regard, the Inquiry team has also identified a five month gap between the CAC meetings of 16 January 2012 and 19 June 2012; and
  - (ii) second, the CAC's TOR do not set out the quoracy requirements for meetings. This was identified in an internal audit review of the CAC completed between May and June 2012. This review, whilst finding "*substantial*" assurance, including that "*control and governance processes...by the Contract Award Committee were well established and operated effectively*", noted that the CAC's TOR were not complete, with a lack of "*documented procedures on how the Committee will conduct its business, including the minimum number of core members required to attend...for a decision to be made*";
- 7.23.5 the CAC's TOR set out the role of the CAC as "*providing assurance on the procurement process*" and interviews with the ExCo confirmed this role. Whilst the TOR state that the CAC is responsible for reviewing the

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<sup>23</sup> Dated February 2011.

evaluation process and criteria, they do not state that the CAC has the authority to intervene in the actual process<sup>24</sup>;

7.23.6 the CAC's TOR do not set out the extent of the role of the CAC Chair. As set out at paragraph 4.59 above there appears to be a lack of clarity in respect of whether the CAC makes collective decisions by committee or whether it was the role of the CAC Chair to make decisions; and

7.23.7 the RRPB's TOR were revised in May 2012. A summary of the changes is set out at Appendix H. The revised TOR removed the direct function of the RRPB to "*ensure risks to the successful delivery of the Programme are managed*". The Inquiry team has not identified evidence that this responsibility was passed to another body.

7.24 As a result of the incompleteness and inconsistency between the TOR of the boards and committees I note that it is not always possible to conclude whether these bodies acted appropriately within their authority. Notwithstanding this inherent uncertainty, I have also identified a number of inconsistencies in practice between the activities of the boards and committees and their TOR and set these out below:

7.24.1 as noted in paragraph 7.23.5 above, the CAC's role was to provide "*assurance on the procurement process*". However, the actions of the CAC in practice<sup>25</sup> extended beyond this role to include, as set out at paragraph 4.58 above, making commercial decisions regarding the levels of SLF required in respect of First's and Virgin's bids. I note though that the Inquiry team has been consistently informed at interview that members of the CAC believed they had the authority to make decisions in respect of SLF levels, based on interpretation of the Process Charts. In contrast, there is evidence that members of the ExCo were clear that the CAC's role was to provide assurance on the procurement process and not to make decisions or exercise discretion;

7.24.2 the meeting minutes of the different committees and boards provide evidence of overlapping attendance at the CAC, the RRPB and the BICC meetings. For example, all RRPB members with one exception were members of the CAC or the BICC (or attended the CAC or BICC meetings as a proxy for a member and not in the role of presenter/project team). This limited the effectiveness of independent challenge by senior committees in the governance framework;

7.24.3 as set out at paragraph 4.40 above, the Inquiry team has identified that on one occasion a CAC paper was circulated for approval by email rather than

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<sup>24</sup> For example in establishing or agreeing the levels of SLF required of bidders.

<sup>25</sup> At a meeting of 27 June 2012.

being considered at a subsequent meeting. This may have limited the opportunity of the CAC members to review collectively and challenge robustly the issues and recommendations set out in the paper;

- 7.24.4 committee papers were not always submitted in advance of meetings, thus limiting the ability of attendees to fully understand and consider key issues prior to a meeting, particularly given the volume of work associated with other complex projects going on at the time. This is supported by recollections at interview and was particularly apparent at the CAC meeting of 27 June 2012 where risk adjustment results were only available very shortly before the meeting. Indeed the paper submitted to the CAC members in advance of that meeting contained blank columns in respect of the ‘risk adjustments to bids’;
- 7.24.5 as set out in Appendix H, the quoracy requirements of the BICC were five members; however the Inquiry has heard at interview that, in relation to the BICC meeting held on 2 August 2012 although the meeting was quorate, certain key individuals, including the SRO, were not in attendance. The process of anonymisation (see further paragraphs 7.36 – 7.40 below) appears to have reduced the availability of key personnel who might otherwise have been able to address any issues highlighted. This limited the robustness and effectiveness of challenge by the BICC;
- 7.24.6 as set out in Appendix H the key responsibilities of the ExCo, as set out in its remit, are to determine appropriate reporting arrangements, assess progress and risks, decide adjustments to plans and resources and manage succession planning. The Inquiry team understands that in 26 ExCo meetings held between 10 January 2012 and 14 August 2012 there was reference in the minutes to rail refranchising on only three occasions and no explicit reference to the ICWC franchise process. The Inquiry team has also been informed at interview that the ExCo members, aside from involvement at the BICC meetings, received very little information from the ICWC Project Team, which was in contrast to other large procurement projects;
- 7.24.7 the Inquiry team further understands that the minutes of the DfT board during the period of the ICWC franchise process make limited reference either to rail refranchising generally (with reference made in only two meetings of May 2011 and July 2012), or to the ICWC franchise process specifically (reference made only in the meeting of July 2012); furthermore, the risk registers presented to the DfT board for review between January 2011 and August 2012 contain no specific risk in relation to the ICWC franchise process; and

7.24.8 authors' and sponsors' names on committee papers were ill-defined. On at least one occasion a 'sponsor' named on a paper had not necessarily reviewed or approved the paper. For example, with respect to the paper prepared in advance of the 31 July 2012 BICC meeting, for reasons of anonymity, the original sponsor was substituted with a 'replacement' sponsor who stated at interview that they had "*no role in the papers submitted*". Thus effective review and challenge of the papers prior to meetings of committees and boards was limited.

**7.25 I therefore make the following findings: there was a lack of clarity in the governance framework in respect of the functions, authorities and interrelationships of the committees and boards involved in the ICWC franchise process. These deficiencies in the governance framework inhibited the effectiveness of these committees and boards.**

Lack of appropriate escalation of significant risk issues

7.26 The Inquiry team has identified that a number of significant risk issues which were raised during the ICWC franchise process, either internally at the DfT or by external advisers, were not escalated to senior DfT officials or boards or committees. I set out below a number of such issues relevant to the flaws set out in sections 4 and 5 of this report, which I believe represented significant red flags during the process but which were not appropriately escalated:

7.26.1 the length of time taken to devise the policy in relation to the ICWC franchise was not considered a key red flag, notwithstanding the fact that the process had been delayed by eight months, as set out in paragraph 7.4 above. However, despite the delay and concerns noted by DfT officials in autumn 2011 as to the continuing amount of time dedicated to policy development, it is unclear whether consideration was given to the ramifications on the later stages of the ICWC franchise process of the length of time taken;

7.26.2 the RRPB gave consideration at its meeting on 21 March 2012 to the concern that the DfT did not have an evaluation tool that could be shared with bidders and the resulting risk of legal challenge. However, as I set out in paragraph 4.28 above, the minutes of the relevant RRPB meeting merely note the concern<sup>26</sup> and do not recommend further review by the CAC or the BICC despite the risk of legal challenge being noted in the paper. Subsequently, this risk was not escalated to the CAC, the BICC or any other higher authority;

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<sup>26</sup> The paper prepared in advance of the meeting set out a recommendation not to provide bidders with the GDP resilience model. The minutes of the meeting state "*the recommendations of the paper were agreed*".

- 7.26.3 as described at paragraphs 6.19 to 6.23 above, Grant Thornton was engaged under a narrow scope to provide a report in support of franchise policy. The report prepared by it identified a number of significant issues; however, there was limited awareness and escalation of the report's findings;
- 7.26.4 as set out at paragraph 4.44.2 above Virgin sent a letter on 22 June 2012 to the DfT, highlighting its concerns with the calculation of an SLF of £71 million. The letter does not appear to have been considered in the subsequent CAC meeting<sup>27</sup> (the Inquiry team was advised at interview that not all CAC members were aware of the letter), nor is there evidence of consideration by the BICC of the issues raised in that letter;
- 7.26.5 At the BICC meeting of 31 July 2012, the BICC was asked to endorse the CAC's decision, made at a meeting on 25 July 2012, to award the ICWC franchise to First. The paper prepared in advance of the BICC meeting did not set out:
- (i) the range of SLF values that had been calculated corresponding to various risk adjustment scenarios;
  - (ii) the fact that the CAC had departed from the published process in finalising the SLF values for First and Virgin;
  - (iii) the fact that the CAC had exercised discretion in determining the SLF levels;
  - (iv) the fact that a bidder had raised serious concerns formally about the SLF; nor
  - (v) the fact that the external legal advisers had raised concerns on 2 July 2012 as to the manner in which the DfT may have determined the SLF levels.

As also noted in paragraph 4.82 above a key statement which appeared in the CAC paper did not appear in the corresponding BICC paper.

**7.27** With respect to the impact of the governance framework on appropriate escalation of risk issues, in paragraph 7.22 above I noted that the Inquiry team has been provided with three diagrams setting out the governance structure in relation to the rail refranchising programme. Although the three diagrams provide evidence of a governance framework, I make the following observations with respect to how the limitations of the framework adversely impacted the effectiveness with which significant risk issues were escalated:

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<sup>27</sup> The CAC meeting of 27 June 2012.

- 7.27.1 there was no defined interrelationship between the SRO and the CAC and no clear reporting line from the ICWC Project Team through the various boards and committees to the DfT board. It was therefore unclear how significant risk issues should be escalated through the organisation;
- 7.27.2 although a review by internal audit into rail governance between December 2011 and March 2012<sup>28</sup> found that the rail governance arrangements in place were generally established and working effectively, it highlighted that projects “*determine their own governance route at their initial stage... [which] gives rise to the risk that projects may take the path of least resistance, may not follow the most appropriate governance route, or miss out an important element along the way*”;
- 7.27.3 schemes of delegation of authority are not clear; and
- 7.27.4 there is limited evidence of escalation of issues to the SRO or the SRO seeking assurance during the ICWC process on the key risks impacting the project.
- 7.28 I also note from interviews with the members of the ExCo that the issue of bidder anonymity may have prevented the escalation of risks and this insulated certain key senior officials from an awareness of all key risks associated with the ICWC franchise process. I consider the impact of anonymisation of bidders further at paragraphs 7.36 to 7.40 below.
- 7.29 Much of the evidence reviewed by the Inquiry team points towards risk management primarily taking place at the level of the ICWC Project Team with limited escalation to senior officials or review taking place in higher forums. Whilst the Inquiry team has seen some evidence that project level risk registers were maintained (considered further at paragraph 7.33.4 below) there is limited evidence that the risks captured were escalated<sup>29</sup>.
- 7.30 Lastly, I consider it appropriate to draw out certain cultural aspects of this area of governance. The Inquiry has been provided with consistent evidence from interviews to suggest that DfT officials felt inhibited from escalating significant risk areas. This inhibition may in part be attributed to the fact that, when attempts were made to escalate such issues, in some instances senior officials were perceived to be unreceptive or not willing to give due attention to the concerns raised. Ensuring that there is an appropriate culture that drives performance but also encourages constructive challenge and enables risks to be elevated is ultimately the responsibility of management. Improved processes are necessary but

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<sup>28</sup> Internal Audit report dated 17 May 2012.

<sup>29</sup> For a small number of risks identified on risk registers between October 2010 and August 2012 the action to escalate to the BICC is noted.

on their own they are not sufficient to engender an open culture; good leadership is essential.

**7.31 I therefore make the following findings:**

7.31.1 **the mechanisms for ensuring appropriate escalation of significant risk issues within the governance framework were ineffective. However I recognise that individuals should be responsible for escalation and that the governance framework did not of itself prevent appropriate escalation; and**

7.31.2 **there were extensive and significant failures within the DfT to escalate risks and concerns, both those identified internally and those raised by external advisers. The extent of these failures reflects a culture in the ICWC Project Team which might have been influenced by an overriding expectation and pressure to complete the procurement on time. This failing must be addressed and remedied in future procurements not only by process improvements but also through the leadership provided to the process.**

Lack of clarity and effectiveness of quality assurance procedures

7.32 The Inquiry team has reviewed a number of internal and external quality assurance procedures that were applied over the course of the ICWC franchise process as part of the governance framework described above.

*Internal quality assurance procedures*

7.33 I set out below my observations in respect of both the clarity of the basis and outputs of internal quality assurance procedures and of the extent to which those outputs were taken into account within the DfT:

7.33.1 **hostile review** - the ICWC “franchise specification drafting” was subject to a hostile review in November 2011. The Inquiry team has noted that there were no formal TOR in respect of the hostile review; indeed there is contradictory evidence as to whether the hostile review was formally a part of the governance framework. The hostile review examined three key elements: stations, service specification and commercial proposition. However, there is no evidence that the hostile review considered the concept of the SLF or its determination, pricing implications and financial deliverability;

7.33.2 in its report dated 15 November 2011 the hostile review team refers to “*the main risks to the delivery of the contract as currently proposed*” which included “*...resourcing at DfT...*” and “*...the risk of overcompensation should the GDP Mechanism not work, and the need to analyse the*

*mechanism's parameters...*” The Inquiry team has identified evidence that at both meetings of the RRPB and the BICC reference was made to the hostile review following completion of the hostile review report<sup>30</sup>. However, whilst there is evidence that the RRPB and the BICC may have identified actions to mitigate the risks identified it is unclear if and how any such actions were followed through to resolution;

- 7.33.3 **model audit** - given the importance placed on the GDP Resilience Model in the evaluation process, the Inquiry team questions the basis and extent of review, checking and model auditing undertaken by the DfT. The Inquiry team notes that several internal reviews of the GDP Resilience Model were reportedly undertaken but there is no documentary evidence on the facts and nature of the review. There is also no record of any model audit or best practice review being undertaken which, based upon the Inquiry team's experience, would usually have been undertaken;
- 7.33.4 **risk registers** - the DfT compiled a risk register in relation to rail refranchising and specifically for the ICWC franchise process to evaluate and track risks associated with it. The register was started in October 2010 and updated on a monthly basis by the ICWC Project Team. The Inquiry team has noted that the risk register of 22 June 2012 includes for the first time the following risk: “*Level of SLF required may not be accepted by bidder(s)*”. However, there is no evidence that prior to 22 June 2012 the ICWC Project Team had considered the risk that the DfT did not have an appropriate tool to evaluate the SLF, or that the SLF might be incorrectly evaluated;
- 7.33.5 the Inquiry team has identified evidence that, whilst the original TOR of the RRPB included a detailed review of risk registers, when the TOR were revised in May 2012 this requirement was diluted to a review of “top project risks”. The Inquiry team has identified that, between March 2011 and February 2012, the RRPB infrequently reviewed the risk registers, and that, following the revision of the TOR in May 2012, the RRPB considered only a dashboard containing between one and three risks per project whilst a substantial number of other risks remained on the risk register. Therefore the escalation of risks to the RRPB was limited to a small number only;
- 7.33.6 **internal audit** - the Inquiry team has been informed at interview that internal audit considered a number of scope areas for undertaking a review of the ICWC franchise process when planning its 2012/13 audit programme on the basis that it was a complex, high risk project and indeed this view was considered following discussion with senior DfT officials. During

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<sup>30</sup> Hostile review report dated 15 November 2011.

discussions with management on the audit programme for 2012/13, following challenge from a number of DfT officials, citing both timing and resource constraints, and the fact that the ICWC franchise process would be subject to other forms of assurance (such as the MPA/OGC Gateway, and by HMT), the scope of the review was refined to consideration of ‘lessons learned’ from the ICWC franchise process. The review was to be conducted after the announcement of the preferred bidder and to provide guidance for future refranchises rather than assurance in respect of the ICWC franchise process itself. The Inquiry team has seen evidence that the DfT audit committee formally approved the 2012/13 audit programme, which included the ICWC review as a lessons learned exercise;

- 7.33.7 **SRO** - I have made a number of observations at paragraphs 7.15.2, 7.16.4, 7.19.1, 7.27.1 and 7.27.4 above in respect of the role of the SRO in the ICWC franchise process. With respect to quality assurance, whilst a single SRO was appointed in April 2012 following the 29 March 2012 Gateway review (as noted at paragraph 7.34.5 below), this was at a refranchising programme level rather than at a project level and I note that this SRO did not attend certain RRPB and BICC meetings between the change in role in April 2012 and 15 August 2012. It should be noted that the SRO role is an important one not only in ensuring that the required resources are available but also in providing overall oversight, quality control and risk review as well as, where appropriate, escalation to Ministers.

#### *External quality assurance procedures*

- 7.34 In addition to the internal quality assurance procedures described above, the rail refranchising programme and the ICWC franchise process were subject to external review by the OGC/MPA Gateway and by HMT. In the following paragraphs I set out my observations in relation to the scope and output of the assurance provided by the OGC/MPA and HMT, and my findings in respect of how much clarity there was as to the basis and outputs of those external quality assurance procedures:

- 7.34.1 **OGC/MPA Gateway review** - the OGC/MPA Gateway team performed three reviews in respect of the rail refranchising programme and the ICWC franchise process:

- (i) in a report dated 20 April 2011 (the “**April 2011 review**”) the OGC Gateway team awarded an “amber” rating to the rail refranchising programme, and reported concerns related to a recent major restructuring, loss of expertise at senior level, and acknowledgement of a “*very tight*” timetable;
- (ii) in a report dated 29 March 2012 (the “**March 2012 review**”) the OGC Gateway team awarded an ‘amber/red’ rating to the rail

refranchising programme, concluding that the programme was highly complex and challenging and setting out concerns in relation to resourcing, governance and the options for the application of the GDP mechanism within future franchise processes; and

- (iii) in a report dated 18 July 2012 (the “**July 2012 review**”) a separate OGC Gateway team awarded a ‘green’ rating to the ICWC refranchise process<sup>31</sup>. The report concluded that the competition was “*well placed for the intended award of the contract on 14 August 2012*”.

7.34.2 The published OGC guidance on the Gateway process<sup>32</sup> states that there should be three project level (i.e. franchise level) reviews prior to an investment decision (though I note that it is not the responsibility of MPA reviewers to ensure that Gateway reviews are conducted). I make the following observations in respect of the various Gateway reviews:

- (i) the July 2012 review states that no prior Gateway review had been conducted in respect of the ICWC franchise process (although the Inquiry team notes that the Gateway 2 review was conducted as part of the April 2011 review); and
- (ii) the lack of specific Gateway 2 reviews conducted on the ICWC franchise process contrasts with other franchise processes where separate Gateway 2 reviews were held (for example, in respect of Essex Thameside and Great Western Franchises).

7.34.3 In respect of the quality of the Gateway reviews I make the following observations:

- (i) the Inquiry team has reviewed the documentation provided to the Gateway team in respect of the July 2012 review, and I note that the Gateway review team did not consider or review the SLF determination or the process carried out by the DfT to determine the SLF. Further, whilst the Gateway team considered the risk registers maintained by the DfT, they were only provided with a single risk register dated 22 June 2012 which could have restricted the ability of the Gateway team to review the evolution of risks over the period of the ICWC franchise process; and
- (ii) the Inquiry team further notes that a number of senior DfT officials and key members of the ICWC Project Team were not interviewed during the July 2012 review and that, of the DfT officials interviewed

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<sup>31</sup> Specifically in relation to the award of the contract.

<sup>32</sup> OGC Gateway Process.

during the March 2012 review, only three were reinterviewed for the July 2012 review;

7.34.4 despite the limitations of the OGC/MPA Gateway reviews, the Inquiry team has identified consistent evidence from interviews that significant reliance was placed on the outputs of those reviews by senior DfT officials;

7.34.5 in respect of the DfT's response to the Gateway reviews I make the following observations:

(i) the March 2012 review made a number of recommendations as set out in Appendix J. Whilst the Inquiry team has seen evidence that the recommendations in the March 2012 Gateway 0 report had been implemented in part (for example the appointment of a single SRO, the creation of a programme office and the appointment of a project manager in respect of the ICWC franchise process), there is evidence to suggest that a number of other recommendations had still not been actioned by June 2012<sup>33</sup> (for example, vacancies remained in the programme team and work still needed to be done to overhaul the risk and issues registers); and

(ii) there is no evidence that the recommendations made were escalated to the CAC or the BICC for further consideration in the specific context of ICWC, save that the CAC meeting of 25 July 2012 noted the results of the July 2012 Review and some operational recommendations in respect of "*Delivery Plan issues and required station obligations*". However, not all recommendations were noted and no follow up was specified in the minutes;

7.34.6 **HMT** - the Inquiry team understands that whilst guidance<sup>34</sup> sets out the requirements for HMT involvement at a high level, there are no specific procedures documented in respect of HMT's role in approving DfT policies. Indeed the guidance states that it is the responsibility of a department to provide "*...timely and accurate information to the Treasury.*" The guidance further sets out that a department should consult HMT at an early stage where unusual transactions or financing techniques are to be used; and

7.34.7 as part of the Treasury approval procedures, a Treasury Approval Point Panel was conducted in January 2012. The Inquiry team understands that whilst it was the responsibility of HMT officials and DfT officials to work together in advance of the panel to identify risks which could be considered by the panel, HMT did not review detailed documentation in obtaining

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<sup>33</sup> Assurance of Action Plans (AAP) 13 June 2012.

<sup>34</sup> As set out in public document *Managing Public Money* on the treasury website.

comfort over the ITT (for example, at interview the Inquiry team heard that in relation to an issue of which version of the PDFH to use, it was explained that this was a level of detail that was beyond the HMT review and was a matter for the DfT).

**7.35 I therefore make the following findings:-**

7.35.1 **there was a lack of clarity as to the basis and outputs of internal quality assurance procedures, and the extent to which such outputs were taken into account within the DfT;**

7.35.2 **with respect to the OGC/MPA Gateway reviews specifically I consider that there was a disconnect between the limited nature of the review carried out and the reliance placed on the review by DfT officials;**

7.35.3 **the effectiveness of quality assurance procedures in respect of the ICWC franchise process was significantly limited due to failures in the DfT to follow up on the outputs of those procedures. The absence of clear accountability for consideration and resolution of the outputs raised fostered a culture of limited ownership and resolution.**

**Restrictions in governance oversight due to anonymisation of bidders**

7.36 The anonymisation of bidders during the bid evaluation process is one of the ways in which the DfT seeks to ensure that franchise procurement decisions are taken on objective grounds, free from bias.

7.37 A number of senior DfT officials expressed concern in interview that this requirement for anonymity may in practice have hindered information flow and thereby restricted on-going peer review and governance oversight. Some ExCo interviewees suggested that this issue meant that only the ICWC Project Team had exposure to key issues and expressed concern that the anonymity process may have been followed without full recognition of the need to escalate certain issues to higher levels of authority within the DfT. The Inquiry team understands that anonymity concerns led to a number of senior DfT officials having to absent themselves from committee meetings on the grounds that they were conflicted.

7.38 However, such interviewees generally also emphasised that anonymity concerns should not have hindered the flow of information in respect of the calculation of SLF levels as this process was common to all bidders and that issues should have been capable of being described without bidders being identified.

7.39 The Inquiry notes that the DfT's interpretation of anonymity is unique to it and the Inquiry team has not yet come across a similar process in other parts of the Government.

- 7.40 While I recognise the DfT has delivered previous franchise procurements using the same method, I note that the complexity of a new franchise structure required a significantly greater consultation and review mechanisms internally at the DfT; however the manner in which the requirement for anonymisation was interpreted within the DfT may have hindered effective flow of information, review and oversight.
- 7.41 I summarise below my key findings in respect of the factors that contributed to the failure to prevent the flaws identified in the ICWC franchise process from occurring:
- 7.41.1 planning and preparation in respect of the ICWC franchise was inadequate and failed to allocate time appropriately or incorporate sufficient flexibility in respect of the process timetable;
- 7.41.2 the organisational structure at the DfT failed to set out roles, responsibilities and associated accountabilities clearly, and the resources of the organisation were excessively stretched due to the Government's spending review and the competing pressures of other projects;
- 7.41.3 the effectiveness of the governance framework was severely reduced by the lack of clarity in the functions, authorities and interrelationships of various committees and boards;
- 7.41.4 significant risk issues were identified through internal and external quality assurance procedures over the course of the ICWC franchise process; however, the quality and robustness of the ICWC procurement was subordinated to an overriding pressure to complete the procurement on time; and
- 7.41.5 whilst the governance framework was not effective in escalation or resolution of the flaws in the ICWC franchise process, there was a failure on the part of those responsible for escalation and resolution, indicating a culture of limited ownership and ineffective oversight.

## 8 Lessons to be learned and recommendations

- 8.1 I have identified throughout this report a number of findings. This section focuses on the lessons to be learned from the ICWC franchise process and my recommendations with respect to those lessons.
- 8.2 The contents of this report and the analysis completed by the Inquiry team provide an uncomfortable narrative for the DfT at many levels, including policy interpretation; execution; organisational structure; quality assurance; and cultural aspects. Nevertheless, these issues have to be seen in the context of a department undergoing significant change, with a number of concurrent procurement programmes with some of these, such as the Intercity Express Programme, being very complex.
- 8.3 I have been asked in this Inquiry to consider only the ICWC franchise process and, whilst there is no absolute certainty that the flaws in this process are isolated and wholly specific to that process, it would equally be wrong to assume that they are commonplace in the DfT or across other Government departments.
- 8.4 The DfT has successfully procured and managed complex projects in the past (not least the transport solutions for the 2012 London Olympics) and it is core to its purpose that it continues to do so in the future.
- 8.5 My objective coming out of this Inquiry has been to provide firm recommendations which provide the DfT with a clear plan to ensure that the problems identified in this report are not repeated and that the rail refranchising process can resume with the full confidence of Ministers, taxpayers, passengers and the rail industry.
- 8.6 I have set out the lessons learned and recommendations below in accordance with the categories of findings in respect of contributory factors in section 7 above. I believe the recommendations, if acted upon quickly and effectively, will help to restore confidence in the DfT's ability to conduct effective rail franchising and procurement.

### *Inadequate planning and preparation*

- 8.7 ***While it is not within the scope of this Inquiry to take a view on Government policy, any policy must recognise the risks which are inherent in its inception, implementation and operation and consider whether those risks are appropriately mitigated or taken on with clarity as to the potential consequences. In delivering the policy objectives, the DfT should ensure:***
- 8.7.1 ***a balance of resources between policy development including consultation with the bidding community and that policy objectives are clearly***

*understood and well defined in sufficient time to allow their consequences to be carefully considered and robustly tested;*

- 8.7.2 *policies are translated into commercially viable contractual propositions which are rigorously tested and subject to independent challenge (in this respect I note that complex procurement processes are particularly vulnerable to challenge by the losing bidders); and*
- 8.7.3 *effective external advice is sought to supplement the DfT's own resources through the whole of the franchising procurement process, including financial, technical and legal advice.*
- 8.8 *Specifically on franchising, should the DfT continue with the GDP based policy, it should ensure that it reviews whether the use of SLFs remains appropriate as a means of ensuring that franchisees commit capital which is proportionate to the risks in their bids and develop an appropriate model to determine the SLFs or any other capital requirements; in making this determination the DfT will have to be mindful of the creditworthiness and financial capacity of bidders.*
- 8.9 *I recommend the DfT ensures that bidders are provided with adequate information and transparency of the DfT's expectations to be able to complete their bids. Consideration also needs to be given to whether the DfT needs flexibility to exercise commercial judgement during the procurement phase; and whether that flexibility is best achieved by way of formally including a period of engagement with the market following publication of the ITT. I fully recognise that the DfT has to work within the constraints of EU procurement law.*
- 8.10 *I recommend that the DfT ensures that a credible timeline, with appropriate reference to the complexity of the procurement involved, is assessed and agreed at inception, to include:*
- 8.10.1 *contingency planning which is both carried out at inception and is reviewed at regular intervals over the course of the procurement process; and*
- 8.10.2 *comprehensive quality and commercial reviews which are carried out during the procurement cycle.*

*Deficiencies in organisational structure and resourcing*

- 8.11 *I recommend that the DfT ensures that:*
- 8.11.1 *the governance of the franchising programme is redesigned in its entirety to establish clear roles of individuals including:*
- (i) *a single SRO over the life of each franchise process, who is fully involved with the procurement process and acts as the first point of*

- escalation of issues by the project team and who ensures regular reviews are carried out;*
- (ii) a project manager, of sufficient commercial capability, for each franchise process, reporting directly into the SRO;*
  - (iii) clear roles, responsibilities and delegation of authority for all team members; and*
  - (iv) clear mechanisms to escalate risks and concerns;*
- 8.11.2 *an assessment is made to determine whether responsibilities would be clearer and accountability more effective under a single DG structure; and*
- 8.11.3 *a skills review is carried out and a thorough needs assessment undertaken to establish whether there are capability, experience or leadership gaps within the DfT and the nature and extent of external support required by the DfT. Consideration should be given to supplementing internal resource with external rail franchising experience.*

*Lack of efficacy in governance framework*

8.12 *I recommend that the DfT ensures that:*

- 8.12.1 *consideration is given to establishing structures to bring the necessary level of industry expertise and non-executive oversight to the rail franchising programme and individual procurements;*
- 8.12.2 *a review is carried out of the roles to be undertaken by the bodies tasked with governance of the franchising programme, ensuring reporting and escalation mechanisms are appropriate and clearly defined;*
- 8.12.3 *a review is carried out of the TOR of the bodies with responsibility for governance of the franchising programme, including the CAC, the BICC and the RRPB, to ensure:*
  - (i) completeness and consistency both within each set of TOR and between the TOR of the relevant bodies;*
  - (ii) clarity over escalation procedures between bodies;*
  - (iii) clear details as to the extent and limitations of any discretionary powers of each body;*
  - (iv) clarity over the extent of any decision-making powers of each body's Chair;*
  - (v) that the requirements to achieve a quorate meeting are defined;*

- (vi) *that any requirements for mandatory attendance of particular members for the purposes of decision-making or other defined activities are set out; and*
  - (vii) *that membership of each body is reconsidered to ensure the SRO attends the CAC and is the reviewer and sponsor of all documents submitted to the CAC and the BICC;*
- 8.12.4 *committee TOR are published and communicated to members and to refranchising project teams;*
- 8.12.5 *a single, dated document is prepared and made widely available within the DfT for each committee within the governance framework setting out the function, authority and interrelationships of each body in the framework;*
- 8.12.6 *committee meetings are planned and agenda items are scheduled with due reference to the cycle of business and priorities, which should incorporate basic good practice with regard to timely issue of papers, preparation and approval of minutes and attendance of members and key people for each agenda topic; and*
- 8.12.7 *a review of anonymisation procedures is undertaken to ensure that the ability of committees to escalate and review issues is not compromised by excessive recusal.*
- 8.13 *I recommend that the DfT ensures that, where risks of bidder challenge are identified, these are escalated appropriately and considered at the ExCo level with appropriate independent legal and commercial advice where necessary.*
- 8.14 *I recommend that the DfT ensures that:*
- 8.14.1 *a complete review is conducted of quality assurance procedures, including of the effectiveness of the various bodies with responsibility for those procedures;*
  - 8.14.2 *use of hostile reviews is continued, with:*
    - (i) *the TOR of such reviews being signed off by ExCo; and*
    - (ii) *formal milestones established over the course of hostile reviews with formal follow up and sign off on their recommendations by the ExCo and the BICC;*
  - 8.14.3 *formalised Quality Assurance procedures are established in respect of modelling, encompassing best practice, audit and other testing procedures at appropriate stages of procurements; and*

- 8.14.4 *the timing and scope of internal audit reviews are set appropriately according to an assessment of the risk profile of procurements, and are not subject to amendment on the basis of representations by project teams.*
- 8.15 *I recommend that the DfT ensures that adherence to published methodologies and processes is independently monitored throughout the procurement phase in future rail franchising processes.*
- 8.16 *I recommend that the DfT ensures that progress against these recommendations is regularly monitored by the DfT board.*

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