Appendix A

Terms of Reference: Inquiry into the Lessons Learned for DfT from InterCity West Coast ("ICWC") competition

1. The Inquiry shall identify the lessons to be learned from the Department's handling of the franchising process for ICWC in order to ensure the Department maximises benefits to transport users and value for money for taxpayers in future franchise competitions.

2. The Inquiry will comprise an immediate study of the lessons learned following the discovery of significant technical flaws in the way the franchising process for ICWC was conducted which resulted in the cancellation of the ICWC franchising process on 3 October 2012, in particular:

   a. The course of events in DfT that led to these technical flaws in order to identify what happened and why it happened up to the point that the intention to award the contract was announced on 15 August 2012:

   b. The roles and responsibilities of different advisory and decision-making parties within DfT and externally in relation to these flaws, including the Board Investment and Commercial Committee, the Contract Awards Committee and the Rail Refranchising Programme Board; how well these committees performed their roles, and what can be learned from this about the appropriate structure for governance and assurance of major contract awards:

   c. The arrangements for ensuring appropriate review of the technical elements of contract award and appraisal and appropriate quality assurance.

3. The Inquiry should make recommendations on the basis of its findings.

4. The Inquiry will be led by Sam Laidlaw, DfT's lead Non-Executive Board Member who also leads on procurement among Government Non-Executives. He will draw on others as he sees fit, including from other Non-Executive Board Members. By agreement, Linklaters and Ernst & Young have been appointed to provide an external perspective to the Inquiry.

5. The Inquiry should be completed as soon as possible. Initial findings shall be made available to the Department by 26 October.

6. The Inquiry will be taking place in parallel with the Department's HR investigations. The Laidlaw Inquiry Report will be published no later than end November 2012.

Appendix B

ICWC – Supplementary guidance on the evaluation of financial capability compliance and sizing of the Subordinated Loan Facility

Introduction

1. This document is intended to provide further guidance in relation to boxes 4.1/4.2/4.3 of Chart 4 (categorisation of financial risk) of the document entitled "Franchise Evaluation Process Charts for InterCity West Coast Franchise competition" and sets 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 Government is contracting with an entity that is robust enough to withstand business downturns.

Financial capability compliance in bid evaluation

2. The DfT requires that:
   - the cost and revenue forecasts used in bidders' models are sound and achievable; and
   - bids remain financially robust across a range of economic simulations.
3. The implication of this is that a combination of TOC profit margin and/ or owning group SLF could be needed to provide financial support to the franchisee in the event of an economic downturn. In addition, the TOC will no longer receive revenue protection for any shortfall in outturn revenue as a consequence of overly-optimistic forecasts made at competitive tender stage.
4. The DfT will evaluate each bid to consider whether it is financially robust.
5. Firstly, bidders' models will be reviewed by DfT's technical advisers and, as in previous competitions, adjustments made to revenue and cost lines to reflect deliverable outcomes and appropriate use of modelling guidance i.e. GDP elasticity in line with PDFH 4.1 (a more detailed note on risk adjustment will be made available in the data room).
6. The adjusted cost and revenue lines will then be used to forecast the potential rate of TOC default across a wide range of economic scenarios.
7. Where the outcome of the analysis described in paragraphs 5. and 6. results in a probability of TOC default which exceeds a level DfT considers 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. Note if a bid assumes an equity commitment into the franchise, then this will reduce the required SLF £ for £.

Process for sizing the SLF required to achieve financial capability compliance

8. The financial capability compliance process will involve the following steps:

a. Following submission, each bid will evaluated by DfT's technical advisers. This technical assessment could result in a series of risk adjustments to bid revenue and cost lines to take account of:

- Bid assumptions that are not compliant with DfT guidance (e.g. inflation assumptions);
- Questionable delivery identified in the evaluation of delivery plans (approach or deployment);
- Questionable assumptions in forecasting revenue; or
- Questionable pricing assumptions for costs.

Adjustments to revenue and cost line items will be made by substituting one or more input assumption(s) with more realistic alternatives (e.g. the most likely/ P50 outcome,) and/ or by applying a deliverability factor (judged by chances of success,) to a bidder's assumptions. Both upward and downward adjustments to costs and revenues are possible. The output of this stage will be 'normalised' cost and revenue forecasts which are considered by the technical advisers to be deliverable.

b. A model the "DfT GDP Resilience Model" developed by DfT will be populated with bidders' normalised cost and revenues (output of step a.) and premia from the bid model (which is not risk adjusted). This will give an adjusted bid margin which reflects the impact of risk adjustment. Any reduction in net income as a result of adjustments during the technical assessment will reduce the extent to which the bid margin is available to provide a buffer against economic downturns.

c. The DfT GDP Resilience Model, incorporating bidders' normalised costs and revenues (output of step a.), adjusted bid margin (output of step b.) and premia from the bidder's model, is then run to give the probability of default across 500 stochastic simulations of GDP.

   The distribution of the 500 economic simulations reflects the predicted distribution of economic outcomes, with more scenarios clustered around the central forecast and fewer at the extremes.

   The Department has set a default rate in the model at which it considers bids should be financially robust enough to withstand business downturns.

d. Where the output of step c. is a default rate of greater than the Department's rate, the DfT GDP Resilience Model will be re-run with increasing values of SLF to calculate the value of SLF required to adequately mitigate the risk of TOC default to the Department's set default rate (i.e. the level of SLF which returns the model to the Department's set default rate).

e. The DfT will seek clarification from each bidder as to whether its parent (backed by a suitable third party) would be prepared to inject additional funds in the form of a SLF to the value identified in step

d.[1] If the parent is willing and able to provide a subordinated loan facility of the required value, the bid will be categorised as having an acceptable financial risk. If not, the bid will be categorised as having an unacceptable level of financial risk and will be rejected.

SLF 'ready reckoner'

The DfT has used the DfT GDP Resilience Model and assumptions from its own comparator model to give bidders an indication of 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 at different levels of bid margin.

Item	Criteria	Indicative SLF
1[2]	Assumed Margin of 5% per year (assumption only for the purpose of calculating SLF, not intended as an expectation for bidders)	A risk adjustment of up to a maximum of £70m to £160m in total over the franchise will not require an SLF • A maximum of £160m if the risk adjusted values are spread evenly across the franchise term concentrated at the start or end *or*; • A maximum of £130m if the risk adjusted values are concentrated towards the start of the franchise *or*; • A maximum of £100m if the risk adjusted values are concentrated towards the middle of the franchise *or*; • A maximum of £70m if the risk adjusted values are concentrated towards the end of the franchise ;
2	Margin in excess of 5%	Margin above 5% revenue in a franchise year can be used to offset additional overbidding in that year at a ratio of 1:1, that is each £1 of margin in any year can be used to offset a risk adjustment of £1 *in the same year* without the need for additional SLF
3	Value of additional risk adjustment not covered by margin as described in items 1 and 2 in this table	Additional values of risk adjustment to be covered by an SLF at a ratio of 60% of the value of the risk adjustment

[1] DfT may elect to ask a Bidder to increase its unfettered facilities only if it is deemed the bid is competitive.

[2] For the purpose of calculating the SLF, risk adjustments in one year cannot be offset against adjustments in a different year. Upwards or downwards risk adjustments must occur in the same year to be offset against one another.