

The Laidlaw Inquiry Report - Appendices

The Laidlaw Inquiry report: List of appendices

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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

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 information which is commercially sensitive to the bidders involved in the ICWC franchise competition process.*

THE LAIDLAW INQUIRY: INITIAL FINDINGS 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. Paragraph 2 of the Terms of Reference is as follows:
- “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.”*
- 1.4 The Secretary of State asked me to report my initial findings to him on 26 October 2012 and to produce my final report by the end of November 2012. This report sets out my initial findings. At this stage my initial findings are focussed on “what happened?”. I will address “why it happened and what can be learned?” fully in my final report, although I identify in section 6 of this report some areas that the Inquiry will investigate in relation to that question. It has recently come to my

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attention that the DfT has issued letters to the four bidders involved in the ICWC franchise competition process, which set out the DfT's understanding of events surrounding the cancellation of the competition. I shall of course consider this correspondence for the purposes of my final report.

- 1.5 Given the short period of time since the Inquiry was established and the limitations on the work undertaken to date (described in paragraph 2.4 below), my initial findings are necessarily provisional and subject to review as the Inquiry progresses towards the publication of my final report. In my final report I will make findings that confirm, vary or add to my initial findings and, as required by paragraph 3 of the Terms of Reference, I will then make recommendations based on my findings.
- 1.6 In this report I refer throughout to the DfT without identifying individuals or (in most cases) particular committees or other groupings. Of course it should not be assumed that references to the DfT necessarily imply involvement by, or escalation to, senior officials at the DfT. In my final report I will explain what evidence I have seen as to the level within the DfT at which relevant actions or decisions were taken.
- 1.7 This report is structured as follows. After this Introduction, section 2 describes the work on which my initial findings are based and section 3 summarises my initial findings. Section 4 provides some background and context relevant to the initial findings, which I then go on to set out in section 5. Section 6, as I have said, identifies some of the areas on which the Inquiry will focus in investigating why flaws in the ICWC franchise process occurred. Section 7 contains some brief concluding remarks.

2 Work undertaken

- 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 assisted by Ed Smith, who is also a non-executive DfT board member. (For convenience, I refer in the rest of this report to myself, Ed Smith and the teams from Linklaters and Ernst & Young as the “**Inquiry team**”.) Save where I expressly state otherwise, all of the views and the initial findings set out in this report are entirely my own.
- 2.2 I am satisfied that all members of the Inquiry team are conducting the Inquiry in an independent and objective manner. In the interests of full disclosure, I set out below a summary of my involvement and of the involvement of Ed Smith in the ICWC franchise process. I do not consider that any of the matters referred to in this summary detracts from the independence and objectivity of the Inquiry.
- 2.2.1 The Board of the DfT is an advisory board and the responsibility for the operation of the DfT is through the accounting officer to Ministers responsible to Parliament. As non-executives our role is to advise and challenge the DfT, but we are not responsible for the operational and procurement decisions. Those decisions are the responsibility of the executive management and Ministers. I attended one meeting of the Board Investment and Commercial Sub-Committee (the “**BICC**”) (as an observer) on 15 December 2011 prior to the issue of the Invitation to Tender for the ICWC franchise.
- 2.2.2 Ed Smith attended a BICC meeting on 2 August 2012 at which the BICC endorsed the award of the ICWC franchise. I am satisfied based on the interviews that I have had with him, the minutes of the meetings and the recollection of those present that in those meetings he provided considerable challenge to the process and is fully independent.
- 2.3 The Inquiry team has requested and reviewed a substantial amount of documentation. This document review, together with a number of interviews of DfT staff and meetings with representatives of bidders for the ICWC franchise, have formed the primary evidential basis for my initial findings. In addition, Ernst & Young has performed some preliminary financial modelling analysis on which I have relied in making the initial finding set out in paragraph 5.15 below.
- 2.4 I want to be clear about the limitations on the work that has been undertaken at this stage of the Inquiry. The limitations are as follows:
- 2.4.1 The document review referred to at paragraph 2.3 above is not yet complete. The Inquiry team has submitted a large number of document requests to the

DfT. Some of the documents received from the DfT have yet to be reviewed by the Inquiry team and some of the document requests have yet to be actioned by the DfT. In this regard, certain documents requested by the Inquiry team have been delayed or not yet produced by the DfT on grounds of legal professional privilege and/or third party confidentiality.

- 2.4.2 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 that separate investigation, I do not expect that issues of individual culpability will be an area of focus for the Inquiry. It is the case, however, that the parallel employment related investigation has meant that the witness interviews so far conducted by the Inquiry team have been subject to constraints as to the scope and nature of questions that could be put to witnesses. It is not clear to me at present whether these constraints will cease to apply prior to the publication of my final report.
- 2.4.3 The Inquiry team has not yet been able to interview a number of witnesses who are likely to have evidence relevant to some of the initial findings set out in this report.
- 2.4.4 I have not yet considered the conduct of the DfT's relevant external advisers in relation to the issues identified at paragraph 2 of the Terms of Reference. I intend do so in advance of the publication of my final report. In this regard, I note that the Inquiry team has not yet been given access to certain of the DfT's external lawyers because of concerns as to a possible waiver of legal professional privilege.
- 2.4.5 I considered that there was insufficient time to conduct an email capture and review in advance of preparing this report and have not instructed that to be done.
- 2.4.6 Ernst & Young has, as I indicated above, performed some preliminary financial modelling analysis. It has not yet, however, been given access by the DfT to the full base case and risk-adjusted bidder models. It has also not yet performed a detailed review of the models or of the application of key assumptions including elasticities drawn from the Passenger Demand Forecasting Handbook used in the bidder and DfT models and in the franchise agreements.
- 2.4.7 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 related exclusively to the issues set out in paragraph 2 of the Terms of Reference (see paragraph 1.3 above). 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 subordinated loan facility ("SLF") that it

required to be provided by the parents of two of the bidders. That flawed process, and the course of events that led to it, are therefore the areas of focus for the Inquiry. It is however important when reading this report to keep a proper perspective on the significance of the SLF 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.

- 2.4.8 I have not sought to form a view on any legal issues, such as the merits of the application for judicial review made by one bidder in Claim No. C0/9098/2012 or the extent to which any aspect of the ICWC franchise process complied with applicable procurement law.
- 2.4.9 I have 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.

3 Summary of initial findings

3.1 My initial findings, addressed in section 5 of this report, are summarised below.

3.1.1 The DfT was aware of a lack of transparency in the process for determining the level of required SLF and decided nonetheless to continue with the ICWC franchise process and to accept the risk of a bidder challenge (see paragraph 5.4 below).

3.1.2 Bidders in the ICWC franchise process were not provided with adequate information reliably to predict the likely size of any SLF requirement to be imposed by the DfT. This made it difficult for bidders properly to determine the optimal capital structure for their bids (see paragraph 5.6 below).

3.1.3 The amount of the SLF ultimately required by the DfT in respect of the two leading bids was not determined in compliance with the DfT's own published guidance (see paragraph 5.10 below).

3.1.4 The DfT's ultimate determination of the level of SLF required in respect of the two leading bids was influenced by extraneous factors with the result that the bidders were treated inconsistently (see paragraph 5.13 below).

3.1.5 The model that the DfT told bidders it would use (but did not ultimately use) to determine the level of the SLF that it required in respect of the two leading bids provided numbers in real terms which were used by the DfT as if they were in nominal terms. Had they been converted to nominal terms as they should have been, significantly increased SLF levels would have been required (see paragraph 5.15 below).

3.2 A variety of factors, operating together, appear to have caused or contributed to the issues raised in my initial findings (see section 6 below). These include matters relating to:

3.2.1 the inadequacy of the planning and preparation undertaken in respect of the financial risk evaluation of bids for the ICWC franchise, including during the period prior to the release of the Invitation to Tender on 20 January 2012;

3.2.2 the novelty of the risk transfer arrangements and their introduction in the particularly challenging context of the complex ICWC franchise;

3.2.3 the matrix organisational structure of the DfT and a lack of clarity and continuity in roles and responsibilities;

3.2.4 the significant resourcing challenges faced by the DfT during the ICWC franchise process;

3.2.5 the lack of efficacy of the applicable governance framework; and

3.2.6 the inadequacy of the quality assurance processes.

4 Background and context

- 4.1 It may be helpful to any readers of this report who are unfamiliar with the structure and economics of passenger rail franchises and franchise process competitions if I begin with a few brief and general points that are germane to various issues discussed later in this report.

Passenger rail franchises: general points

- 4.2 Since rail privatisation in the mid-1990s, most passenger rail services in Britain have been operated by private sector companies (commonly referred to as franchisees or train operating companies) under franchise agreements with the Government. A franchise agreement sets out what services and level of reliability each franchisee will deliver, how subsidy or premium is payable to/from the franchisee, and the measures to be taken if commitments are not met.
- 4.3 Passenger rail franchises are awarded by the Secretary of State for Transport usually following a franchise competition process conducted by the DfT. These competition processes are intended to produce comparable bids that are consistent with the DfT's specifications and that can be evaluated and ranked by reference to published criteria.
- 4.4 Under the current franchising model, a franchisee keeps the revenues derived from operating the franchise (i.e. essentially revenues from ticket sales to passengers) and (unless the franchise involves a subsidy payment from the DfT to the franchisee, which the ICWC franchise did not) is contractually obliged to make periodic franchise payments to the DfT.
- 4.5 These franchise payments represent a critical financial component of any bid in a franchise competition process.
- 4.6 In simple terms, the franchise payment amount is calculated for each year covered by the bid by:
- 4.6.1 subtracting projected costs from projected revenues for that year to produce a projected gross profit; and
 - 4.6.2 subtracting from this projected gross profit a projected profit margin to produce a net franchise payment for that year.
- 4.7 It is generally accepted that passenger revenues are intrinsically linked to general economic and employment patterns and that it is therefore difficult accurately to forecast passenger revenues over any period beyond the short term. This is a significant issue in the context of rail franchises as franchisees cannot control exogenous factors such as Gross Domestic Product ("GDP") and their cost base is largely fixed. A franchisee is contractually obliged to make the contracted level of franchise payment to the DfT regardless of the revenues actually generated. These

payments therefore expose the franchisee to considerable risk particularly with longer franchises. Conversely the DfT is exposed to the risk that the franchisee will generate insufficient revenues to make those franchise payments. Moreover, given that franchisees are set up as special purpose companies with limited recourse to the owning group and are typically thinly capitalised, the DfT is exposed to the risk of franchisee insolvency leading to premature termination of the franchise. The collapse of the National Express East Coast franchise provides a clear illustration of the risk to which the DfT is exposed.

- 4.8 The final general point to make is that the difficulty in accurately forecasting passenger revenue beyond the short term means that, in its assessment of the financial robustness of a bid, the DfT risk adjusts revenue (and costs) proposed by bidders to what it considers to be realistic and achievable revenues and costs.

Changes in rail franchising policy

- 4.9 The commercial structure of franchise agreements has evolved over the years. Changes have mainly involved the flexibility granted to franchisees in respect of their ability to specify services, the level of revenue risk that they are required to take and the length of the franchise.

- 4.10 Under the franchise agreement adopted by the DfT from March 2004 until the decision on the re-letting of the South Central franchise in June 2009, bidders were required to submit bids to provide specified services and share revenue risk under a so-called “cap and collar” revenue risk sharing mechanism. Franchises typically ran for seven years with an option for the DfT to extend for a limited period (generally two or three years) subject to the franchisee meeting contracted performance targets.

- 4.11 Following a consultation, in January 2011 the Government announced a new approach to rail franchising. Importantly, for the purpose of this report, that new approach included a move to longer franchises and the replacement of the “cap and collar” revenue risk sharing mechanism with a revenue risk sharing mechanism that would be linked to macroeconomic factors.

The ICWC franchise process: March 2011 to January 2012

- 4.12 The ICWC franchise provides train services from London Euston to the West Midlands, North West England, North Wales and Scotland and serves the cities of London, Birmingham, Liverpool, Manchester, Edinburgh and Glasgow. The franchise operates 26 million passenger journeys and 3.2 billion passenger miles per year. It is one of the largest and most complicated franchises and was chosen to be the first to seek to apply the new revenue risk sharing mechanism.

- 4.13 The DfT announced the four shortlisted bidders for the ICWC franchise on 24 March 2011 following a formal pre-qualification process. These bidders were First

West Coast Limited (“**First**”), Virgin Trains Limited (“**Virgin**”), Abellio InterCity West Coast Limited and Keolis/SNCF West Coast Limited. At that time the DfT expected the ICWC franchise to commence on 1 April 2012.

- 4.14 For various reasons, including a decision to consult on changes to the franchise specification to reflect the DfT’s adoption of recommendations made in Sir Roy McNulty’s May 2011 report on rail value for money, on 19 May 2011 the DfT announced a delay, until 9 December 2012, to the commencement of the ICWC franchise.
- 4.15 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.) Section 1.1 of the ITT states that its purpose was to set out:
- 4.15.1 the ICWC franchise proposition for which the DfT was seeking bids;
 - 4.15.2 how the competitive process would work;
 - 4.15.3 how bidders should complete their bids; and
 - 4.15.4 how the evaluation process should work.
- 4.16 The content of the ITT reflected the reforms to the franchising model and contract design announced in January 2011 (paragraph 4.11 above). The ICWC franchise process was the first franchise process to reflect these reforms. In particular:
- 4.16.1 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).
 - 4.16.2 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 contracts 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 Model**”, containing 500 stochastic economic scenarios. In establishing the impact of different economic scenarios on passenger rail revenues, it is clearly important to use correct and consistent passenger demand/GDP elasticities.

Risk mitigation through the SLF

- 4.17 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.)

- 4.18 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 stated purpose of the financial risk evaluation was to satisfy the DfT that the cost and revenue forecasts used in bidders' models were deliverable and that the bidders would remain financially robust across a range of economic scenarios.
- 4.19 The process for the financial risk evaluation described in these documents included the following steps:
- 4.19.1 the DfT making adjustments to the revenue and cost lines of each bid to reflect the DfT's view on the risks of each bid failing to meet its revenue and cost projections;
 - 4.19.2 the DfT then considering whether the risk-adjusted revenue and costs of each bid produced too high a risk of franchise insolvency;
 - 4.19.3 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
 - 4.19.4 the DfT then seeking clarification from the bidder as to whether its parent was "*prepared to inject additional funds, to robustly mitigate the issue*".
- 4.20 The ICWC franchise process was the first franchise process in which, following the experience of the collapse of the National Express East Coast franchise, the DfT adopted a new, stricter approach to evaluating the financial robustness of bids. Under the new approach, the DfT sought to establish the financial robustness of bids (i.e., the step described at paragraph 4.19.2 above) in poor economic scenarios, rather than just in a central economic scenario (as had previously been the DfT's approach). Moreover, the funding that was required in accordance with the step described at paragraph 4.19.3 above was the injection of contingent capital into the franchisee structured as an SLF from the parent companies of the bidding vehicles.
- 4.21 In February 2012 the DfT provided bidders with a document headed "*Supplementary guidance on the evaluation of financial capability compliance and sizing of the Subordinated Loan Facility*" (the "**SLF Guidance**"). Among other things, the document stated that it 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.*"
- 4.22 The SLF Guidance is an important document in the context of this Inquiry and is reproduced in full in Appendix B to this report.
- 4.23 In summary, the SLF Guidance stated that the DfT would determine the level of the SLF requirement (if any) by running the risk-adjusted revenue and cost projections

of a bid through the “**GDP Resilience Model**” (which was the same as the GDP Model referred to at paragraph 4.16.2 above - for clarity, in the rest of this report I shall refer to this model only as 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, 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. The absence of a minimum SLF requirement was also confirmed by the DfT in some bilateral bidder communications.

- 4.24 The GDP Resilience Model was not provided by the DfT to the bidders. Instead the DfT included, on the final page of the SLF Guidance, 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.”

- 4.25 In summary, the Ready Reckoner indicated that:

- 4.25.1 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;
- 4.25.2 where a bidder’s projected profit margin was higher than 5%, this excess could be used as a buffer against adverse risk adjustments before the DfT would require SLF in respect of the bid; and
- 4.25.3 where the DfT made adverse risk adjustments not covered by the margin as described at paragraphs 4.25.1 and 4.25.2 above, an SLF would be required in an amount of 60% of the value of the risk adjustments.

The ICWC franchise process: May to 15 August 2012

- 4.26 In early May 2012, the DfT received bids for the ICWC franchise from all four bidders and began a process of bid clarification and evaluation.
- 4.27 The DfT concluded its consideration of the risk of franchise insolvency and the determination of the level of SLF required from the bidders’ parents by 27 June 2012. The DfT determined that an SLF was required in respect of the bids by First and Virgin, but not in respect of the other two bids (over and above that which they had already offered in their bids). Accordingly, the DfT wrote to each of First and

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Virgin on 27 June 2012 to communicate the level of SLF that the DfT had determined was required. The DfT's letters stated that the SLF determination had been made in accordance with the relevant Process Chart and after applying the published "risk adjustment process". Notably, the letters did not refer expressly to the SLF Guidance.

- 4.28 The DfT required a [REDACTED] SLF in respect of the First bid ([REDACTED]) and a [REDACTED] SLF in respect of the Virgin bid ([REDACTED]).
- 4.29 On 2 July 2012 each of First and Virgin confirmed by letter to the DfT that its parent was willing to provide the required SLF.
- 4.30 The DfT announced on 15 August 2012 that the Secretary of State intended to award the ICWC franchise to First. On the same date, the DfT wrote to each bidder to inform it of the outcome of its bid and to provide a summary of the outcome of the DfT's evaluation of its bid (including, for the unsuccessful bids, relative to First's bid). The letter to Virgin, the bidder ranked second by the DfT, recorded that the total net present value of the franchise payments included in First's bid had been [REDACTED], compared with [REDACTED] in Virgin's bid.

5 Initial findings

5.1 In the course of the work undertaken to date, the Inquiry team has seen credible evidence to suggest that the DfT's process for determining the amount of SLF required in respect of the bids by First and Virgin was flawed. In this section 5 I set out my initial findings.

Transparency as to the process for determining the SLF requirement

5.2 During the ICWC franchise process, Virgin in particular complained to the DfT about a lack of transparency in how the DfT would determine the SLF requirement in respect of its bid.

5.3 I have considered what the DfT knew and understood about this transparency issue. The evidence suggests that:

5.3.1 the DfT was aware, in the first quarter of 2012, that 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;

5.3.2 the DfT had not been able, 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;

5.3.3 the DfT considered, in the first quarter of 2012, that 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;

5.3.4 the DfT was also aware, in the first quarter of 2012, that the decision not to provide the GDP Resilience Model to bidders 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;

5.3.5 the DfT had provided the bidders with the SLF Guidance, including the Ready Reckoner, in order to seek to mitigate this risk of challenge;

5.3.6 the DfT was aware, in the first quarter of 2012, that even after the provision to bidders of the SLF Guidance, including the Ready Reckoner, there remained a lack of transparency as to the DfT's approach to the calculation of any SLF requirement and a consequent risk of challenge to the ICWC franchise process; and

5.3.7 the DfT decided in March 2012 not to disclose the GDP Resilience Model to the ICWC franchise bidders and to accept the risk of challenge to the ICWC franchise process that this decision created.

- 5.4 **In light of this evidence, I make the following initial finding. The DfT was aware of a lack of transparency in the SLF process and decided nonetheless to continue with the ICWC franchise process and to accept the risk of a bidder challenge.**
- 5.5 As indicated above, the DfT intended the provision of the SLF Guidance, including the Ready Reckoner, to mitigate this lack of transparency. In my view, notwithstanding the provision of this document by the DfT 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 4.25.1 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 volunteering a higher level of subordinated capital. It is also relevant to note that, since this lack of transparency obviously made it more difficult for bidders to second-guess the DfT's determination of required levels of SLF, it may be important context for the DfT's decision to depart from its published process (as detailed in paragraphs 5.8 to 5.10 below).
- 5.6 **I therefore make the following initial finding. Bidders in the ICWC franchise process were not provided with adequate information reliably to predict the likely size of any SLF requirement to be imposed by the DfT. This made it difficult for bidders properly to determine the optimal capital structure for their bids.**
- 5.7 The provision to bidders of the GDP Resilience Model would have enabled bidders to calculate the likely minimum level of SLF required (on the assumption that the DfT made no risk adjustments to the revenue and cost projections contained in their bids). However, it would not have enabled them, at the point of submitting their bids, accurately to predict 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 paragraphs 4.19.1 and 4.19.2 above). 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). The significance of my initial finding set out at paragraph 5.6 above must be viewed in this context.

Compliance with published evaluation methodology

- 5.8 The evidence suggests that:
- 5.8.1 between around 19 to 21 June 2012:

- (i) the DfT considered that the process of making risk adjustments to the revenue and cost projections in each bid had been completed for the purpose of calculating the likely maximum SLF requirements in respect of the First and Virgin bids;
- (ii) the DfT ran First and Virgin's risk-adjusted projections through the GDP Resilience Model and then cross-checked the outputs against the Ready Reckoner;
- (iii) the DfT considered that because bidders had been provided with the Ready Reckoner but not the GDP Resilience Model, the DfT's determination of the SLF requirement should be determined by reference to the Ready Reckoner (notwithstanding that the terms of the SLF Guidance had stated otherwise); and
- (iv) the DfT informally notified First and Virgin of their likely maximum additional SLF requirements as determined by reference to the Ready Reckoner (*[REDACTED]*).

5.8.2 *[REDACTED]*

5.9 The evidence that the Inquiry team has seen to date as to how the final SLF requirements for First and Virgin (see paragraph 4.28 above) were ultimately determined is not clear or in some respects consistent. It is however clear that, whilst the DfT appears to have considered the numbers being generated by both the GDP Resilience Model and the Ready Reckoner, the final SLF requirements were not determined in accordance with the SLF Guidance (by reference to either the GDP Resilience Model or the Ready Reckoner). Rather, it appears that the SLF levels reflected a view taken by the DfT as to appropriate numbers.

5.10 **In view of the above, I make the following initial finding. The amount of the SLF ultimately required by the DfT in respect of the two leading bids was not determined in compliance with the DfT's own SLF Guidance.**

5.11 The Inquiry team is investigating the factors that the DfT took into account in determining the SLF levels. The evidence suggests that these factors included the following:

- 5.11.1 a desire that, notwithstanding the terms of the SLF Guidance, there should in any event be a minimum level of SLF imposed on all bids;
- 5.11.2 the risk that, notwithstanding the absence of a stated cap in the SLF Guidance, the imposition of too high a level of SLF on a bidder might knock that bidder out of the competition and/or impact its participation in other rail franchise competitions; and

- 5.11.3 the communication to both First and Virgin of likely maximum levels of required SLF in advance of the DfT becoming aware of further possible risk adjustments between around 22 to 27 June 2012.
- 5.12 In my view, against the background of the publication of the SLF Guidance, these were not factors that the DfT ought properly to have taken into account and they led to the inconsistent treatment of First and Virgin in relation to the determination of SLF requirements.
- 5.13 **Accordingly, I make the following initial finding. The DfT's ultimate determination of the level of SLF required in respect of the bids of First and Virgin was influenced by extraneous factors with the result that the bidders were treated inconsistently.**

The GDP Resilience Model

- 5.14 As noted above, whilst the DfT appears to have considered the numbers being generated by both the GDP Resilience Model and the Ready Reckoner, the DfT did not in fact use the GDP Resilience Model that the SLF Guidance stated would be used to determine SLF levels. Ernst & Young has conducted a preliminary analysis of the GDP Resilience Model and has informed me that:
- 5.14.1 with respect to the treatment of inflation in the GDP Resilience Model, the nominal inputs to the model are deflated to real 2010 prices in all years of the franchise term. The values of SLF requirements generated by the model were therefore calculated in real 2010 prices;
- 5.14.2 although Ernst & Young has yet to carry out testing to re-perform its functionality, the Ready Reckoner provided to bidders was generated from the output of the GDP Resilience Model and as such will also, in effect, provide an output in real 2010 prices;
- 5.14.3 the levels of SLF generated by the DfT by reference to the GDP Resilience Model and the Ready Reckoner as described in paragraph 5.8 above were erroneously treated by the DfT as if they were nominal; and
- 5.14.4 had the DfT appreciated that the GDP Resilience Model and the Ready Reckoner were providing outputs in real instead of nominal prices, the DfT would have needed to inflate those outputs such that the required SLF levels would have significantly increased.
- 5.15 **As a result of Ernst & Young's analysis, I make the following initial finding. The model that the DfT told bidders it would use (but did not ultimately use) to determine the level of the SLF that it required in respect of the two leading bids provided numbers in real terms which were used by the DfT as if they were in nominal terms. Had they been converted to nominal terms as they should have been, significantly increased SLF levels would have been required.**

6 Contributory factors

6.1 As I explained in section 1 above, in my final report I will set out my findings as to why the flaws in the SLF determination occurred. My strong initial view is that a number of factors, operating together, caused or at least contributed to the flaws. In this section 6 I briefly identify these factors. The Inquiry team will continue to investigate these and other potentially relevant contributory factors in advance of the publication of my final report.

Inadequate planning and preparation

6.2 There is a body of evidence that strongly suggests that the DfT's approach to the evaluation of the financial robustness of bids in the ICWC franchise process was developed late, in a hurry and without proper planning and preparation.

6.3 This position appears to have arisen for a variety of reasons, including:

- 6.3.1** the late development and clarification of new Government policy on issues such as whether there should be a minimum SLF requirement;
- 6.3.2** the consequent omission from the ITT of any detail as to the process for determining of the SLF requirement;
- 6.3.3** the introduction of novel risk transfer arrangements, such as the GDP Mechanism, in the particularly challenging context of the complex and long ICWC franchise;
- 6.3.4** the ensuing difficulties encountered by the DfT in understanding how best to compare bids with different risk profiles;
- 6.3.5** the absence of an available, suitable financial modelling tool that had been designed specifically for the purpose of a financial robustness evaluation and that could be communicated to bidders; and
- 6.3.6** the challenging overall timetable for the ICWC franchise process after the publication of the January 2012 ITT, driven by the final expiry of the existing franchise in December 2012 and consequently the hard deadline of August 2012 for franchise award.

Organisational structure and resourcing

6.4 In my view, there are firm indications that the organisational changes and structure of the DfT resulted in a lack of clarity around allocation of responsibility for the ICWC refranchising competition. As a general observation, the organisation has undergone a significant reduction in size accompanied by frequent changes of leadership at a time when the DfT's agenda has been expanding. In particular:

- 6.4.1** a matrix organisational structure was put in place at the DfT in late 2010, with full implementation of the organisational redesign in May 2011. This

- resulted in the splitting of rail franchising across the Director-Generals, instead of just one;
- 6.4.2 there was a lack of continuity in senior leadership roles within the DfT and the continuity in oversight of the ICWC franchise process was impacted by the fact that the Senior Responsible Officer for the franchise programme changed three times throughout the course of the competition;
 - 6.4.3 within the ICWC franchise project team, there was a lack of clarity in roles and responsibilities;
 - 6.4.4 a number of senior, experienced individuals had left the DfT prior to important stages of the ICWC franchise process competition and key members of the ICWC franchise team were relatively junior and inexperienced in comparison with the bidder representatives they were facing;
 - 6.4.5 in implementing substantial costs savings, the DfT had significantly reduced both its headcount and its use of external consultants and specifically financial advisers to support the refranchising programme; and
 - 6.4.6 there were a number of other significant projects running concurrently with the ICWC franchise competition that resulted in resource at the DfT being stretched.

Governance framework

- 6.5 A number of different committees and boards performed governance functions in relation to the ICWC franchise process. Serious concerns have emerged as to the efficacy of these bodies. In particular:
 - 6.5.1 both as a matter of form (in the drafting of the relevant terms of reference) and in practice, for certain of these bodies there is ambiguity as to their precise functions, authorities and interrelationships; for example, there appears to have been a lack of clarity around which body (if any) was responsible for approval of determination of SLF levels;
 - 6.5.2 there are no clear mechanisms for ensuring the appropriate escalation within the governance framework of significant risk issues; in this regard, the Inquiry team has found no evidence that (for example) the departure from the published process in relation to the determination of First and Virgin's SLF levels (see paragraph 5.10 above) was escalated to BICC;
 - 6.5.3 although the Inquiry team has seen evidence of the operation of various quality assurance procedures in the context of the ICWC franchise competition (but, significantly, not specifically in respect of the SLF determination process), including, for example, the Major Projects Authority's Gateway Review, there is a lack of clarity about the basis of

those procedures and their outputs, and the extent to which such outputs were taken into account by the relevant bodies; and

6.5.4 the anonymisation of bidders during the bid evaluation process is one way in which the DfT seeks to ensure that franchise procurement decisions are taken on objective grounds, free from bias; some individuals have expressed concern to the Inquiry team that this requirement for anonymity may in practice have hindered information flow and thereby restricted on-going peer review and governance oversight.

6.6 Clearly the factors identified in this section 6 raise potentially significant issues about the ability of the DfT effectively to conduct rail franchise competitions. I will be analysing these issues in detail over the next few weeks. I believe that there are practical and concrete steps that can and should be taken effectively to address these issues.

7 **Concluding remarks**

I trust these findings, albeit preliminary in nature, will be helpful in explaining the sequence of events and flaws in the process that led up to the decision to cancel the ICWC franchise competition. The Inquiry will continue to gather evidence as to why these events happened and the lessons to be drawn for a final report at the end of November.

Appendix C

Department for
Transport

**Franchise Evaluation Process
Charts for InterCity West Coast
Franchise competition**

Jan 2012
Issue 3

Introduction

This paper sets out the evaluation process which will be used in the evaluation of bids to operate passenger railway franchises. It should be read in conjunction with the 'A Guide to the Railway Franchise Procurement Process' published on the Department's website.

The six charts set out diagrammatically the key steps in the approach that will be used by the Department to evaluate the Bidders' responses and select the winning bid.

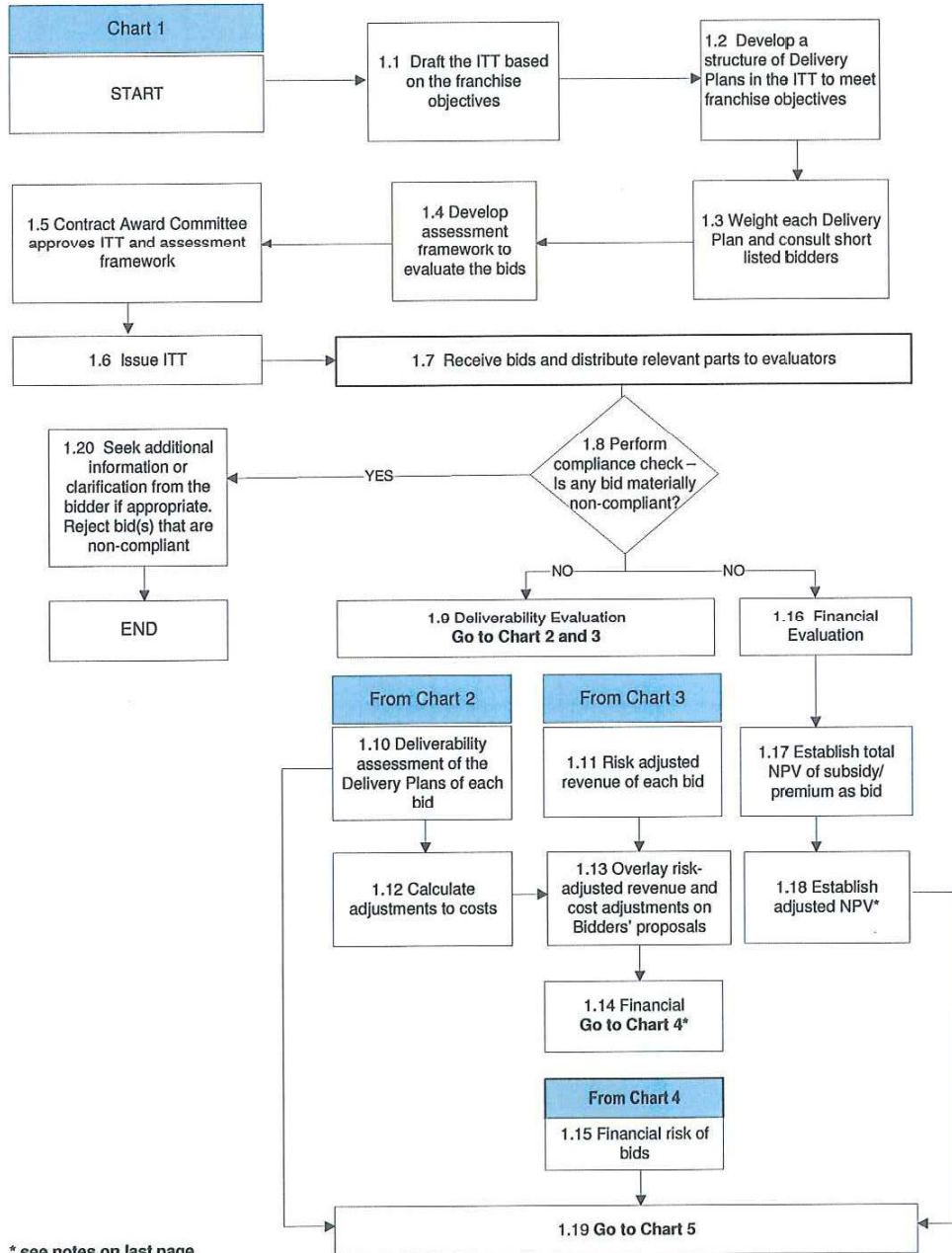
The document comprises the following charts:

- Chart 1 – Franchise Evaluation Process – Overview
- Chart 2 – Delivery Plan Assessment
- Chart 3 – Revenue Assessment
- Chart 4 – Categorisation of Financial Risk
- Chart 5 – Selection of Winning Bid
- Chart 6 – Selection of Leading Bid

Notes to the charts are attached after Chart 6.

This document is subject to change. Where there is a variance between this document and any notification relating to a specific franchise replacement process, such notification shall take precedence.

CHART 1 - FRANCHISE EVALUATION PROCESS - OVERVIEW



* see notes on last page

CHART 2 – DELIVERY PLAN ASSESSMENT

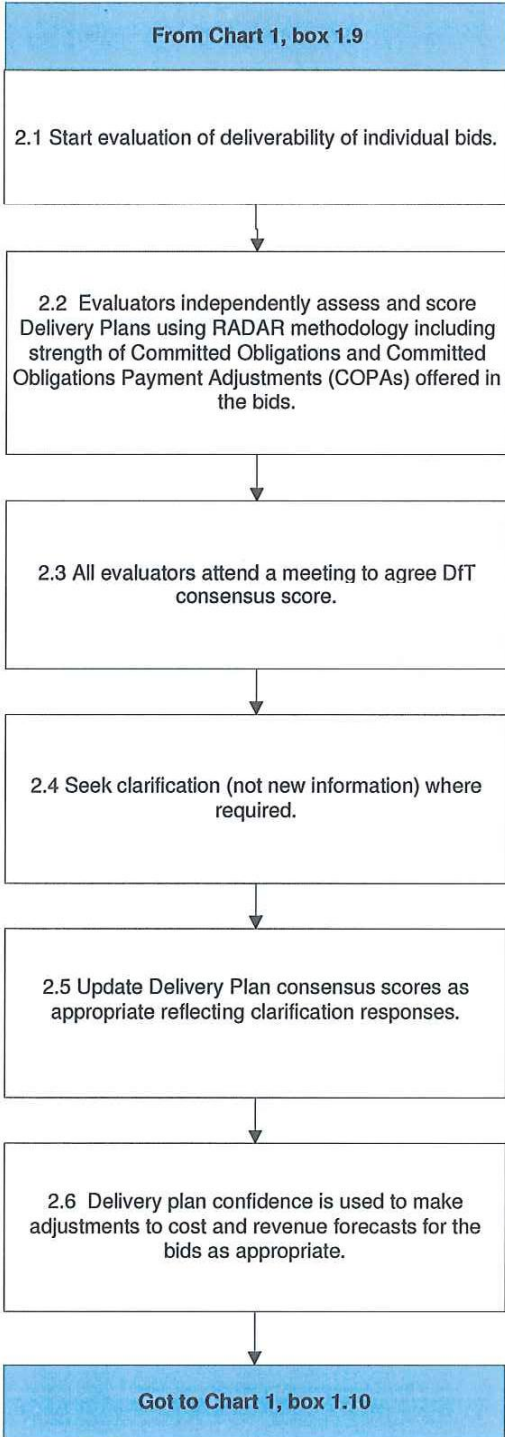


CHART 3 – REVENUE ASSESSMENT

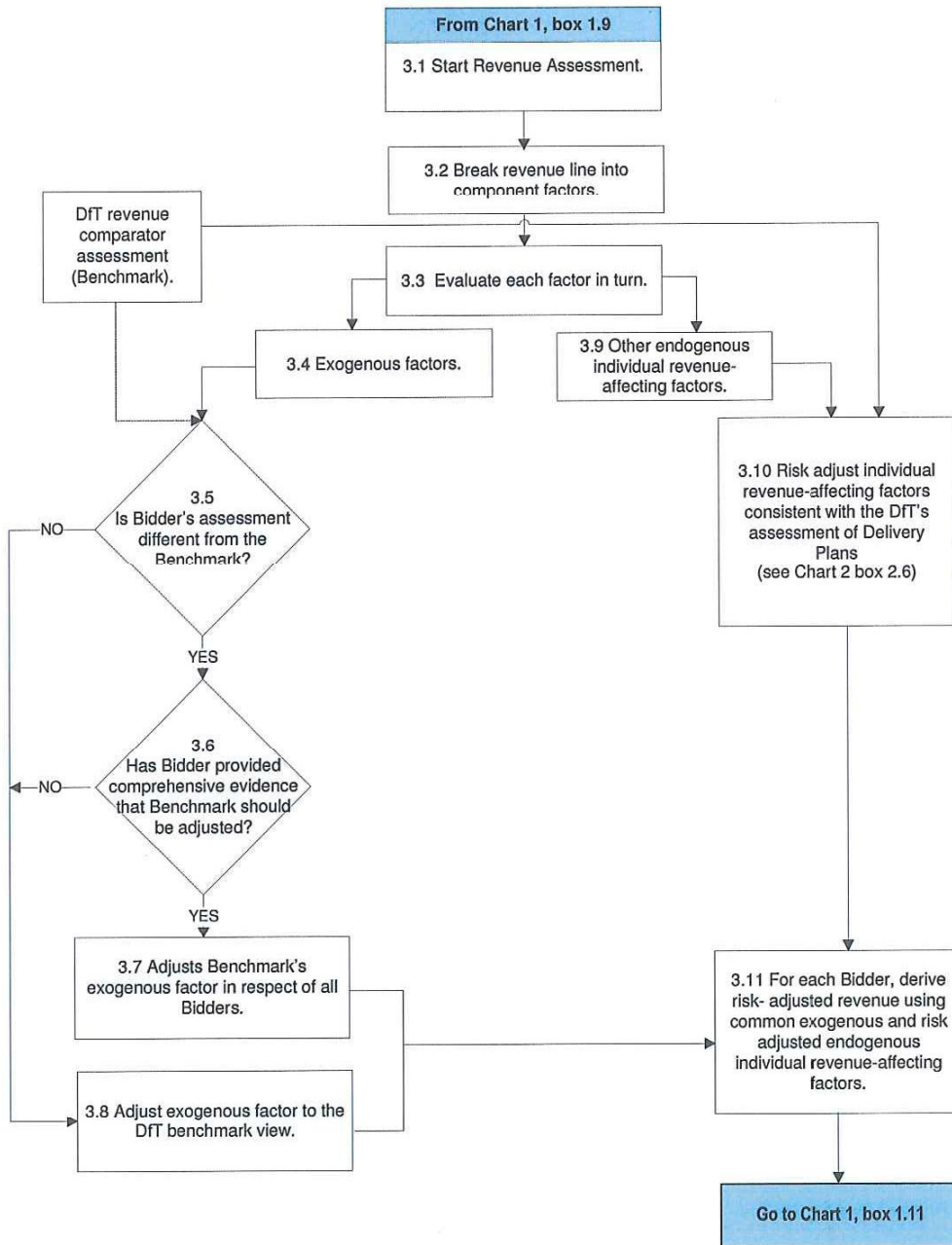
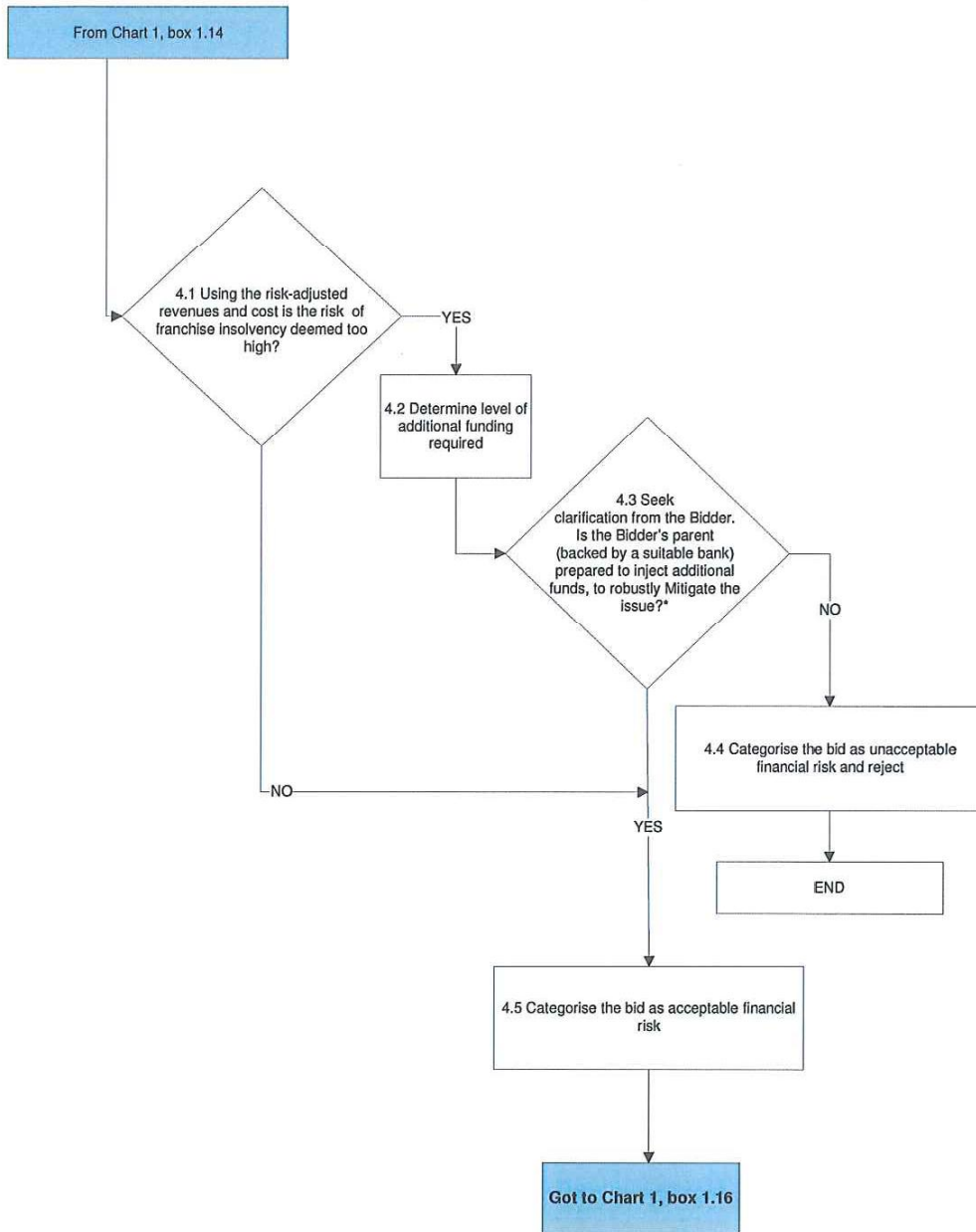


CHART 4 – CATEGORISATION OF FINANCIAL RISK
(Financial Capability Compliance)



* see note on last page

CHART 5 – SELECTION OF WINNING BID

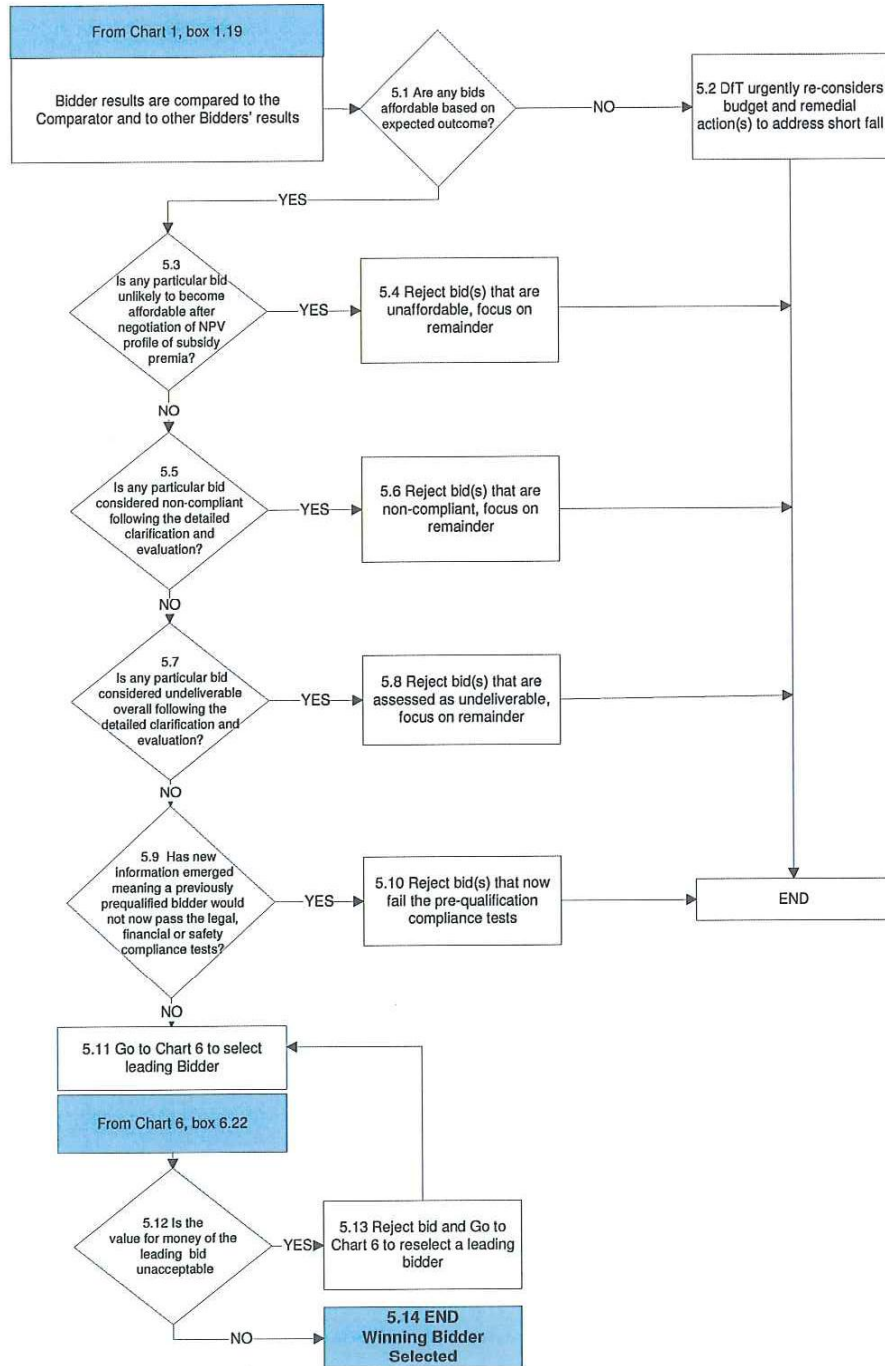
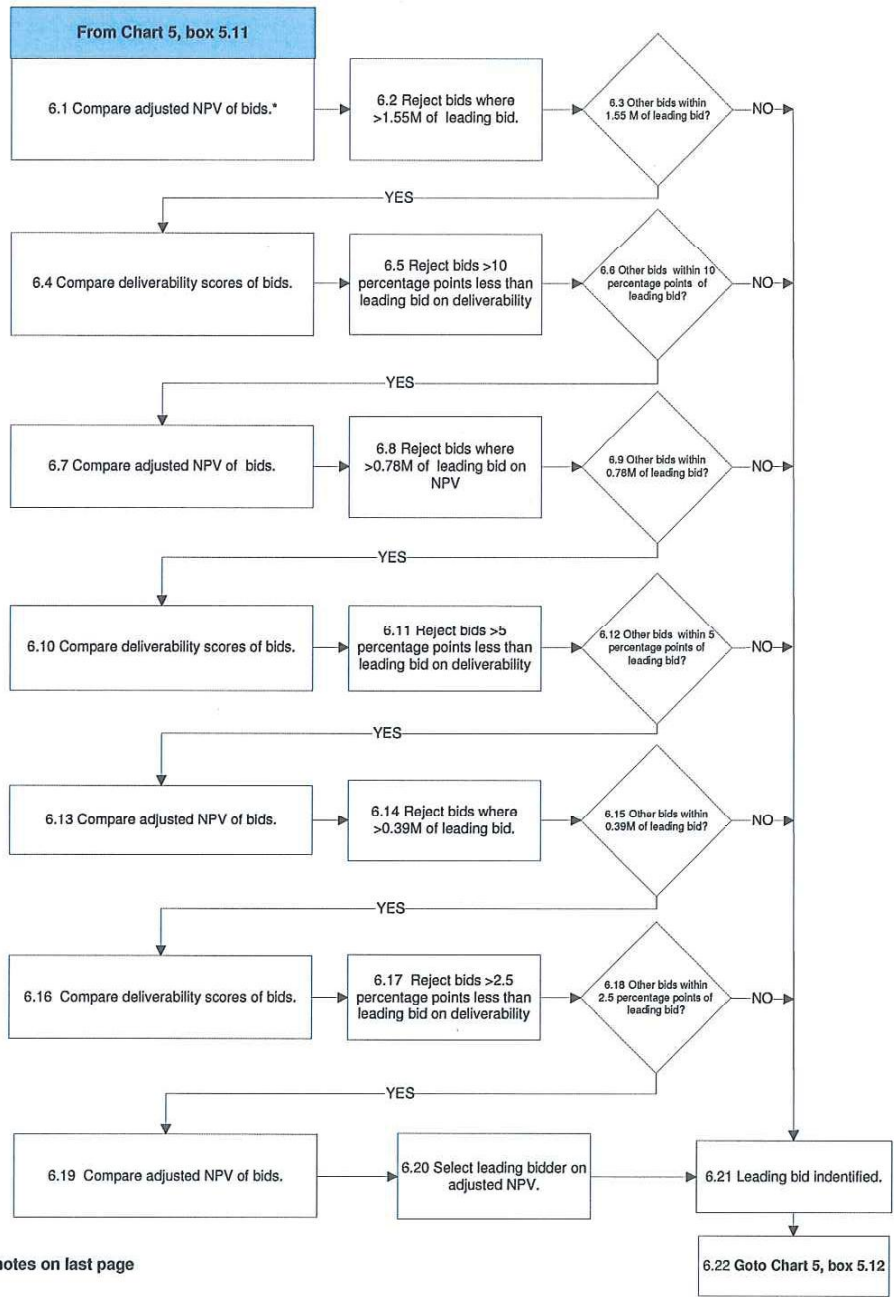


CHART 6 – SELECTION OF LEADING BID



* see notes on last page

Notes to charts

Chart 1- Franchise Evaluation Process Overview

Box 1.8

Non-compliant bids will include those containing Secretary of State Risk Assumptions (SoSRAs) that are unacceptable to DfT.

Box 1.13

The categorisation of the Bidder's financial risk reflecting the DfT view of revenue and cost, and a recession stress test. The Bidder's Base Case submission is risk-adjusted taking account of:

- clarifications answers from the Bidders;
- the DfT's view of Bidder's revenue net of GDP adjustment;
- the DfT's view of costs;
- a pre-determined recession stress test.

These assessments will be based upon the DfT's assessment of the bid Delivery Plans (see Chart 2, box 2.6).

Box 1.18

The methodology aims to adjust the expected net cost to DfT of selecting that bid. The Bidder's Base Case submission is adjusted taking account:

- DfT's liabilities not allowed for in the Bidders' models e.g. Secretary of State Risk Assumptions; rolling stock subject to Section 54 undertakings where the obligation passes to the Department.

Chart 2- Delivery Plan Assessment

The overall deliverability assessment will include the DfT's confidence in the Bidders' Models to price Change.

Chart 4 – Categorisation of the Financial Risk of Bids.

The effect of adjusted, revenue and cost figures on the Schedule 12 ratio (financial ratio) will be assessed on all submissions. However, the DfT will approach bidders for additional unfettered facilities only if required (see below).

Box 4.2

In calculating the financial ratio using risk-adjusted revenue, cost and performance figures the DfT will assume that the level of dividends is reduced in compliance with the lock up requirement.

Box 4.3

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

Chart 5 – Selection of the Winning Bid

Box 5.5

The compliance assessment will include an assessment of financial modelling compliance with the instructions in Section 5 of the ITT.

Box 5.12

The overall objective is to provide an assessment of the value for money of the proposal made by the bidder that is consistent with WebTAG guidance

A Value for Money assessment will be carried out on the leading bid only. It will not be used to choose between bids and will form no other part of the bid evaluation other than the DfT may reject the leading bid on the basis of poor Value for Money as measured against a fixed threshold benefit cost ratio (BCR). In these circumstances we would go to the second place bid.

The VfM assessment will be carried out against a 'do minimum' that represents the current service offer plus known and committed changes (train service plus quality) rolled forward with the demand grown according to the standard PDFH methodology. Bidders are to produce their own quantified baseline in line with WebTAG guidelines.

Bidders shall provide their own VfM analysis with the bid against their own quantified baseline. This will take the form of a 20 page 'economic case' report containing the description and quantification of costs and benefits with supporting Record of Assumptions and models where these are additional to the other bid models. We do not require this to be in the form of a '5 case model'. DfT will require that the costs and benefits included in the appraisal are internally consistent with the overall bid and that they can be traced back to one or more of the delivery plans or the financial model.

DfT in conjunction with its Technical Advisers will review the VfM assessment and may seek clarification from bidders where appropriate.

The DfT may adjust the BCR/NPV of the leading bid to reflect:-

- any errors in the bidder's VfM analysis (including but not limited to any non-conformance with Web Tag guidance or with any other of the instructions or requirements given to bidders in respect of the VfM analysis to be provided); and or
- DfT's view of any assessments/assumptions made by the bidder in its VfM analysis.

Chart 6 – Selection of the Leading Bid

Adjusted NPV is as explained under Box 1.18.

The threshold amount 'M' is defined as 1% of the NPV of Turnover. (NPV of 1% of aggregate franchise Turnover (total revenue approx) derived from the DfT comparator values).

Appendix D

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 be 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 <ul style="list-style-type: none"> • 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 <i>in the same year</i> 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.

Appendix E

ICWC – Supplementary guidance on the risk adjustment process for financial compliance when sizing of the Subordinated Loan Facility

Background

This note sets out the risk adjustment process as part of the financial robustness evaluation of bids for the ICWC franchise. They only cover the revenue and cost risk adjustments identified in Charts 2 and 3 in the January 2012 document "Franchise Evaluation Process Charts for the InterCity West Coast Franchise Competition (Issue 4)". This feeds into the process 1.13 (Categorisation of Bidder Financial Risk).

Deliverability Plan Assessment (Process 2.6)

As part of the deliverability assessment, the evaluation team will come to an agreed assessment of the degree of confidence that bidder-related initiatives will be achieved over the life of the franchise. This will take the following form:

- For individual initiatives for which costs and revenues are specifically identified within the financial plan, an assessment of the likelihood that this will be delivered (using the "RADAR" assessment as guidance for this assessment). To be clear, the deliverability assessment for risk adjustments of costs and revenues will only relate to individual initiatives, rather than the overall delivery plans – which will cover a wide range of initiatives as well as day-to-day delivery of franchises.
- Where there is insufficient confidence in the deployment associated with individual revenue initiatives, DfT may ask for clarification of existing deployment approach to improve understanding of the evaluators. On the basis of the available information, the evaluation will provide a percentage assessment of the likelihood of implementation of a bidder initiative, used to adjust associated revenue forecasts, or an assessment of additional (or reduced) costs likely to be required to ensure delivery of the initiative where this is possible. The approach taken will be dependent on the extent to which delivery is within the bidders' control or dependent on third parties, and will ensure no "double-counting" of revenue and cost adjustments with respect to the same initiative.
- All DfT risk adjustments will take into account any mitigation plans set out by bidders, including bidder identification of contingency costs. All deliverability adjustments will be taken on a "most likely" outcome, taking into account the information provided by bidders set against experience of similar initiatives undertaken elsewhere where appropriate.
- Where appropriate, the risk adjustment applied may be profiled by year to allow for delivery of an initiative later in the franchise term than envisaged in the bid, or for 'ramp-up' of the expected demand response.

Revenue Assessment (Process 3.10)

Following on from the deliverability assessment, bidders' revenues will be risk-adjusted to reflect (a) the confidence that the initiative will be delivered as per Process 2.6, above; and (b) the likelihood that the revenues forecast as the result of the initiatives would be achieved if they were delivered in full. This will be undertaken as follows:

- For each of the bidder initiatives, an adjustment to revenue may be made on the basis of the percentage confidence in delivery, as described in Process 2.6 above.
- Independently, the revenue forecast associated with a particular initiative will be assessed assuming that the initiative is delivered in full. Any adjustments will be made on the basis of the "most likely" outcome, taking into account existing industry / DfT guidance or research and new research or evidence put forward by bidders where included in associated delivery plans. This adjustment will take into account any risk adjustments already identified by bidders in their revenue forecasts and reported in the Record of Assumptions. To be clear, all forecasts will be reviewed on a "most likely" basis to ensure fairness of evaluation – hence there may be some situations where risk adjustments increase revenues to ensure consistent assessment of revenue risks across bids.
- The deliverability and forecasting based risk adjustment assessments will be undertaken in turn in relation to each of the revenue initiatives. As with the Deliverability Plan Assessment, the risk adjustment applied may be profiled by year to allow for delivery of an initiative later in the franchise term than envisaged in the bid, or for 'ramp-up' of the expected demand response.

Exogenous Revenue Adjustment (Processes 3.5 to 3.8)

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:

- It is not intended that bidders adopt parameters from the DfT's revenue support mechanism in forecasting exogenous revenue growth and indeed it is expected that they use a market segmented approach to forecasting as suggested by PDFH Guidance.
- 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 are more appropriate. In this case, DfT reserves the right to apply an alternative forecast to all bidder forecasts (Process 3.7).
- Adjustment to fares-related growth back to current DfT fares policy may be made should bidders decide to take their own independent views on future changes in fares policy.
- Bidders should ensure that their revenue models are capable of such adjustments as part of the "modelling change" requirements of their bid.

Overall Revenue Adjustments (Processes 3.11 and 1.11)

Both exogenous and bidder-related revenue adjustments will be made to revenue lines, including knock-on impacts on ancillary revenues and other factors such as crowding, where bidders' revenue models allow. Again, we emphasise the importance of the "modelling change" requirements of financial and revenue models as part of all bids.

Overall Cost Adjustments (Process 1.12)

Cost adjustments identified in Process 2.6 will be included in the financial model as appropriate and on a profiled basis.

Overlay of Cost and Revenue Adjustments (Process 1.13)

The revenue and cost adjustments will effectively feed in a "most likely" outcome of revenue and costs to the separate financial stress-testing process described in Chart 4 (which will test a range of GDP-related scenarios on the overall post-risk adjustment bid revenues). Any overall risk adjustments made by bidders will be taken into account as part of Process 1.13.

Appendix F

Appendix F - Application of elasticities

- F.1 Elasticities are used within bids for the forecasting of revenue, for the GDP Mechanism and for the risk adjustment of bidders' revenue lines. For example, a GDP to revenue elasticity of 1.4 would mean that for a 1% rise or fall in GDP, the corresponding rise or fall in revenue would be elevated to the power of 1.4 (ie. $GDP^{1.4}$).
- F.2 The relationship between revenue and GDP per capita is described in the PDFH. Versions 4.1 and 5 of the PDFH are relevant to the flaws associated with the sizing of the SLF. In respect of the ICWC franchise:
- PDFH v4.1 contains an average elasticity of 1.8; and
 - PDFH v5 contains an average elasticity of 1.4.
- F.3 The DfT used PDFH v4.1¹ in its preparation for the ICWC franchise process since this was the DfT's official guidance at the time of the procurement. PDFH v5 was adopted by the DfT in August 2012.
- F.4 The use of elasticities in the ICWC franchise process is outlined in the diagram below:

Elasticity/PDFH guidance and application

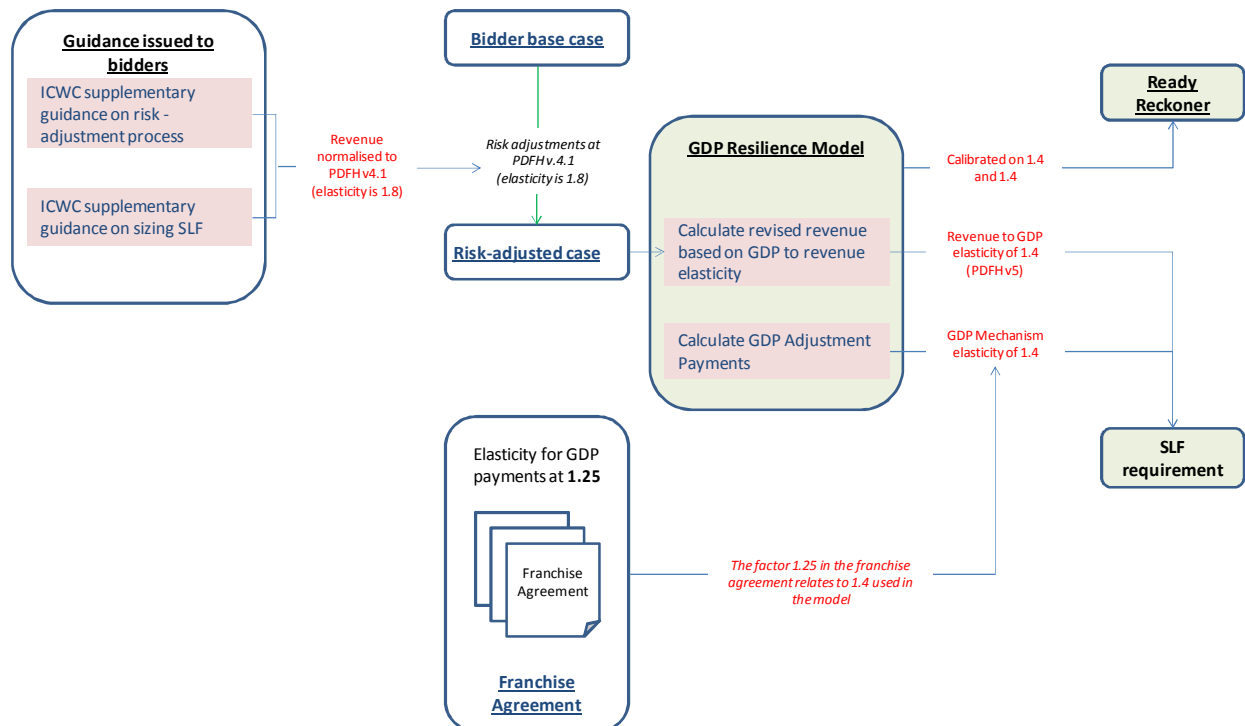


Figure 11: Illustrative diagram showing application of elasticities to different elements of the ICWC franchise process

¹ PDFH version 4.0 was used for fares

The link between the elasticity used in the GDP Resilience Model and the franchise agreement

- F.5 The GDP Resilience Model is based on GDP per capita and uses an elasticity of 1.4, whilst the franchise agreement is based on GDP and includes an elasticity of 1.25.
- F.6 Based on discussions with the DfT, the Inquiry team understands that the relationship between the two elasticities is broadly set out in the formula:

$$(\text{GDP}/c)^{1.4} = \text{GDP}^{1.25}$$

Where:

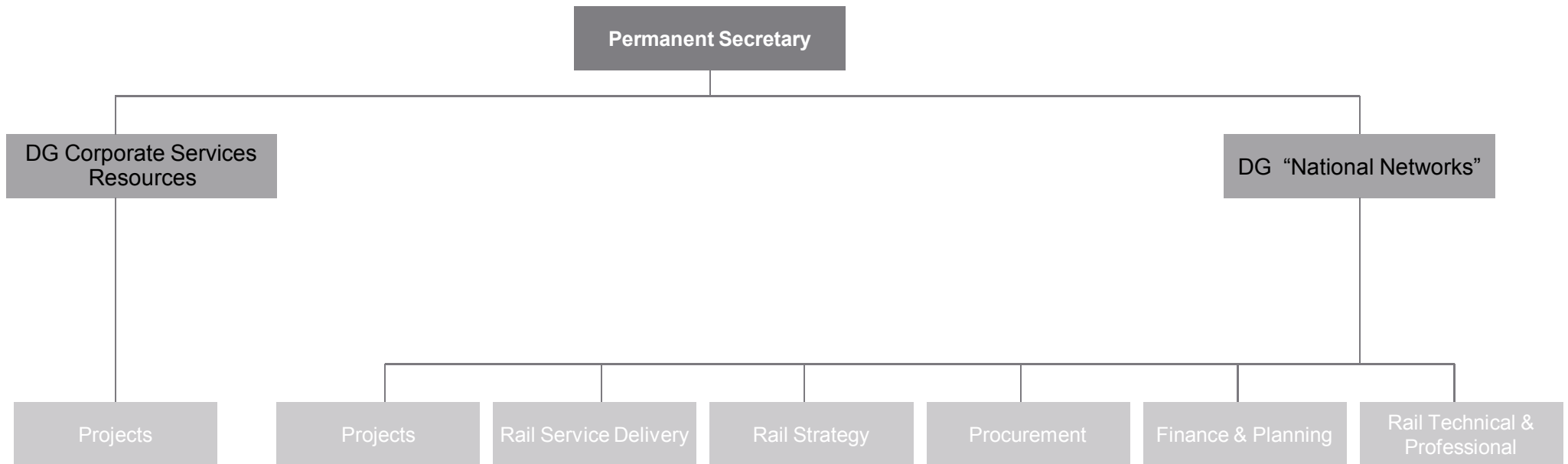
- GDP/c is GDP per capita; and
- GDP is the figure published by the Office for National Statistics.

The GDP Mechanism payments calculated in accordance with the franchise agreement are based on GDP and an elasticity of 1.25. As this is equivalent to using GDP per capita and an elasticity of 1.4, the GDP Resilience Model and the franchise agreement appear to have used a consistent set of elasticities.

Appendix G

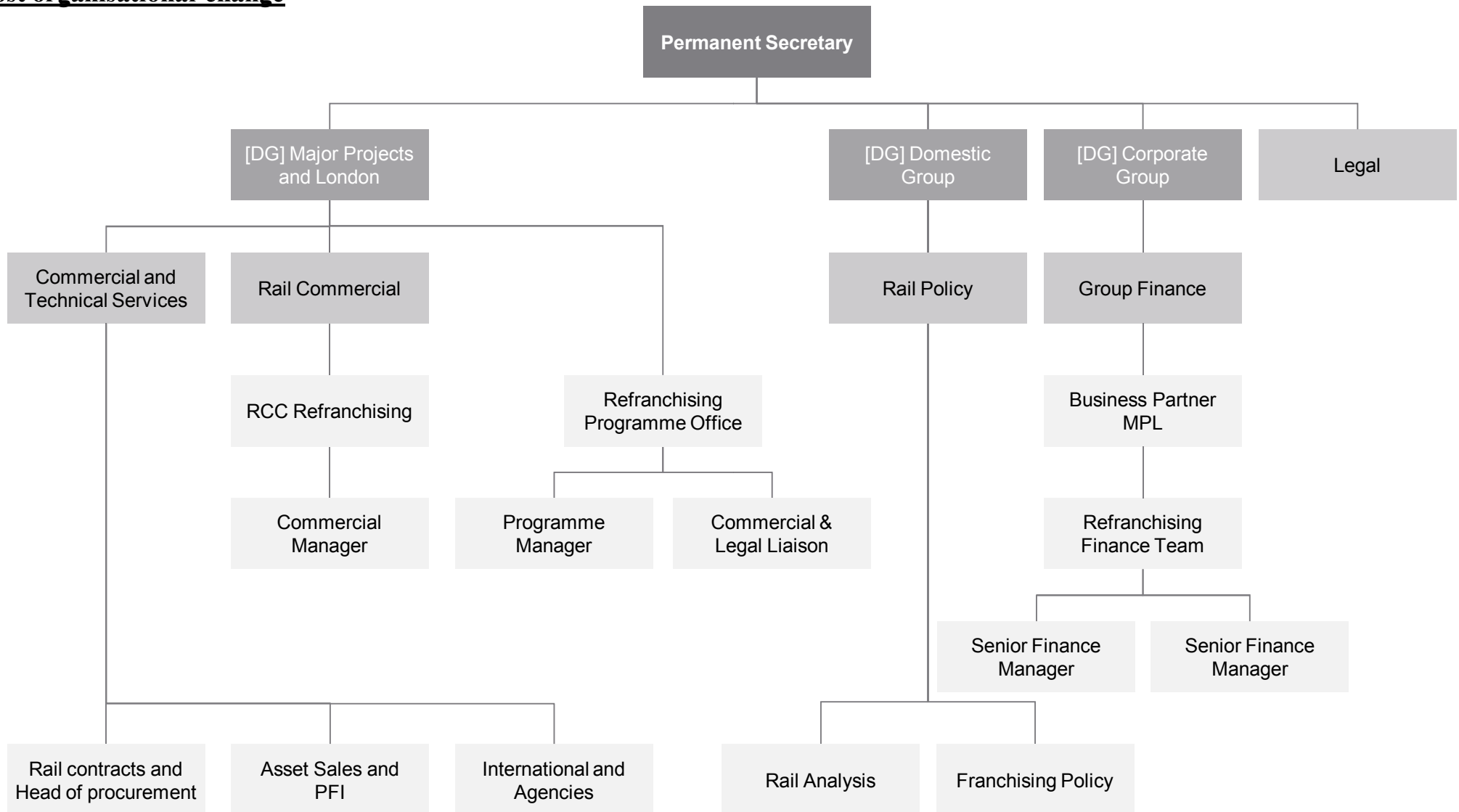
Appendix G - Rail structure prior to and post organisational change in early 2011

Prior to organisational change



Appendix G - Rail structure prior to and post organisational change in early 2011

Post organisational change



Appendix H

Appendix H - Terms of Reference (“TOR”) of DfT committees and boards¹

Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
DfT Executive Committee (“ExCo”)				
<p>The roles and responsibilities, as set out in the published ExCo remit are:</p> <ul style="list-style-type: none"> • conduct annual business planning, and determine appropriate reporting arrangements in order to track progress on key deliverables and budgets and to identify key risks; • assess progress and risks on the basis of that reporting, and assess the potential impact on plans of major new initiatives from ministers or beyond the Department (including revised plans for key public announcements); • decide adjustments to plans and resources in the light of this assessment, reporting the position, and key issues arising, for the Departmental Board; • provide steers as necessary to board sub-committees, and to progress any issues referred to it by the Board; • manage succession planning and remuneration for senior staff across the Department; and • lead the central Department (using the DfT(C) Management Committee to oversee and develop key initiatives to improve the way the central Department operates). 	<p>The membership as set out in the ExCo remit are:</p> <p><u>Membership</u> The Executive Committee is chaired by the Permanent Secretary. Members are the Directors General plus the Legal Services Director.</p>	<p>No reference in remit</p>	<p>No reference in remit</p>	<p>No reference in remit</p>

¹ Wording in the TOR as per source documentation provided to the Inquiry team

Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Board Investment and Commercial Sub-Committee (the “BICC”) - TOR dated 25/08/10 updated 17/01/12²				
<p>The roles and responsibilities, as set out in the original and updated TOR are:</p> <p>The BICC is a forum for making informed decisions on ‘Tier 1 Projects’ within an economic, financial and commercial context at the Provisional, Conditional and Full Approval stages as part of the Investment Appraisal Framework.</p> <p>It is also responsible to the DfT Board for:</p> <ul style="list-style-type: none"> • keeping abreast of trends and developments in the commercial market, both in terms of the players and in terms of the markets’ preferences for the nature and structure of commercial deals; • identifying and promoting best practice across the Department in terms of commercial and procurement processes; • offering to colleagues a one-stop mechanism for advice and guidance on the inter-related issues around procurement, corporate finance, commercial deals and programme management; and • advising the DfT Board on how it could improve the Department’s commercial capability. 	<p>The membership/chair as set out in the:</p> <p><u>original TOR:</u></p> <ul style="list-style-type: none"> • Director General for Corporate Support Functions (<i>Chair</i>) • <i>DfT Board:</i> D-G National Networks, D-G City and Regional Networks, one Non-Executive Director. • <i>Centres of Excellence:</i> Director of Finance and Estates, Procurement Director, Corporate Finance Director, Chief Economist, Head of Profession for Project and Programme Management. • <i>Other :</i> Chief Legal Advisor, HA Chief Executive, <p><u>updated TOR</u></p> <ul style="list-style-type: none"> • Director General for Corporate Group (chair) • <i>DfT Board:</i> D-G Major Projects and London Group, D-G Domestic Group, one Non-Executive Director • <i>Centres of Excellence:</i> Director of Group Finance, Director of Commercial and Technical Services, Director of Analysis and Science, Head of Profession for Project and Programme Management • <i>Other:</i> Group Counsel, Major Projects Director, HA Chief Executive 	<p>The quoracy requirements, as set out in the TOR are:</p> <p>A minimum of five BICC members is required for a meeting to be quorate. These will include at least two DfT Board Members and at least three Heads of the Centres of Excellence. The Director of Finance and Estates must attend or be represented at divisional manager level.</p>	<p>The frequency of meetings, as set out in the TOR are:</p> <p><u>Original TOR</u> The BICC will normally meet...each month, following the weekly DfT Executive Committee meeting. The Chair may convene additional meetings when investment decisions are required.</p> <p><u>Updated TOR</u> The BICC will normally meet monthly... following the weekly DfT Executive Committee meeting. The Chair may convene additional meetings when investment decisions are required.</p>	<p>The escalation procedures, as set out in the original and updated TOR are:</p> <p>The DfT Board will twice a year consider the BICC’s issues arising and forward agenda, including a forward look on all projects, highlighting those that may involve strategic risk or a change in policy.</p>

² As set out in section 7.23.2 the BICC were updated in January 2012 however the Inquiry team has not seen evidence that the updated TOR were formally approved.

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Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Contracts Award Committee (the “CAC”): original TOR dated February 2011.				
<p>The roles and responsibilities, as set out in the TOR are:</p> <ul style="list-style-type: none"> • The CAC provides assurance on procurement and market related issues as opposed to investment decisions which are governed by the Investment Appraisal Framework (IAF). • CAC gives approval to proceed with procurement activity (subject to relevant approvals under IAF) for contracts that are high risk/novel/contentious/exceeding £1m at the following milestones: (i) after Gateway 0, before the release of a PIN (ii) after Gateway 1, before the release of an OJEU (iii) before the announcement of shortlisted bidders (iv) after Gateway 2, before the release of an ITT (v) after Gateway 3 ,before contract award • CAC is responsible for reviewing; <ul style="list-style-type: none"> (i) procurement strategy, including (i) compliance with procurement regulations and DfT/OGC policy and best practice (ii) impact on price/VfM (iii) attractiveness to the market (iv) timescales (v) contractual terms and risk transfer (vi) evaluation process and criteria (vii) any documents to be issued to the market (ii) stakeholder engagement (iii) resourcing of the procurement activity (iv) co-ordination of procurement and project resource 	<p>The membership, as set out in the TOR are:</p> <p><u>Membership</u></p> <ul style="list-style-type: none"> • SRO and Deputy Director representatives from the key functions participating in the procurement process and the Head of Corporate Procurement . <p><u>Chair</u></p> <ul style="list-style-type: none"> • CAC will be chaired by the Director of Commercial and Technical Services (CTS) or the Head of Procurement for CTS projects. 	<p>No reference in TOR</p>	<p>No reference in TOR</p>	<p>No reference in TOR</p>

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Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Rail Refranchising Programme Board (the “RRPB”) – Original TOR dated 17/01/2011 – Revised TOR dated 17/05/2012				
<p>The roles and responsibilities, as set out in the TOR are: <u>Original TOR</u> To provide advice and assurance to the Refranchising Programme SRO in the discharge of their accountabilities. The Board shall endorse specifications, provide guidance with regard to the overall direction of the Programme, review progress against Programme milestones, ensure risks to successful delivery of the Programme are managed and endorse forward papers and reports to the Rail Board.</p> <p><u>Per revised TOR 17/05/2012</u> The Refranchising Programme Board will:</p> <ul style="list-style-type: none"> • Drive the programme forward to deliver the Programme Objectives as defined in the Programme Delivery Plan (including timescales, affordability and policy objectives); • Provide authority to Project Boards to deliver the projects within the constraints of the Project Initiation Document (including affordability, policy and timescales) and approve changes outside the scope of the PID; • Provide authority to the Policy Steering Board to take policy decisions within the constraints agreed for each issue; • Resolve strategic and directional issues within and between projects; • Resolve dependencies and directional issues within and between projects; • Resolve dependencies and interface issues between this programme and others in DfT, the wider government and rail industry; • Ensure resources are available for planning and delivery; and • Ensure the lessons are identified and shared across the programme and its projects. 	<p>The membership, as set out in the TOR are: <u>Membership/Chair per original TOR</u></p> <ul style="list-style-type: none"> • Director Rail, SRO Franchise Programme (chair) • Director Commercial and Technical Services • Rail Contracts & Head of Procurement, Rail Procurement • Director Rail Commercial Contracts, SRO Franchise Projects • Franchising Policy Representative, Rail • Business Partner MPL and Corporate, Group Finance • Rail Commercial Contracts and Procurement, General Counsel • Director, Rail and Road Projects <p><u>Membership/Chair per revised TOR</u></p> <ul style="list-style-type: none"> • Programme SRO (chair) • Director, Rail Policy • Director, Rail Commercial • Director, Commercial and Technical Services • Programme Director, Deputy Director, Refranchising • Deputy Director, Rail Franchise Policy • Deputy Director, Rail Contracts and Head of Procurement • Deputy Director, Finance and Planning • Head of Rail Commercial Contracts and Procurement, General Counsel’s Office • Deputy Director, Refranchising, Rail Commercial • Programme Manager 	<p>The quoracy requirements, as set out in the TOR are:</p> <p><u>Per original TOR</u> The meeting shall be quorate if the Refranchising Programme SRO, Refranchising Projects SRO, Head of Procurement and one other director or their duly authorised and briefed alternates are present.</p> <p><u>Per revised TOR</u> There is no requirement for the meeting to be quorate as the decision making authority is with the Chair, rather than the meeting.</p>	<p>The frequency of meetings, as set out in the TOR are</p> <p><u>Per original TOR</u> Monthly or more frequently if required.</p> <p><u>Per revised TOR</u> Every four weeks, with additional meetings called with the Chair’s agreement.</p>	<p>The escalation procedures, as set out in the TOR are:</p> <p><u>Per original TOR</u> RPB reports to the Rail Board.</p> <p><u>Per revised TOR</u> The Refranchising Programme Board will escalate to Executive Committee.</p>

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Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Refranchising Project Group– TOR dated 17/1/11				
<p>The roles and responsibilities, as set out in the TOR are:</p> <p>For the duration of each project, to provide an effective forum for those working on the project co-ordinate detailed planning and delivery, risk and issue management, specification, procurement and commercial activities. The meetings shall have particular regard to the detailed review of the progress against individual Franchise Project Plans and the identification and mitigation of risks to successful delivery of the new franchise.</p> <p>Role of the Franchise Project Group:</p> <ul style="list-style-type: none"> • Drives progress against agreed plans • Provides forum to review specifications and business cases • Monitors and proposes amendments to the individual Franchise Project Plans, monitoring progress against key milestones • Monitors and proposes amendments to the Project Risk Register created by the commercial manager • Identifies the resources required to secure the successful delivery of the individual Projects • Prepares any papers approval by Ministers, Programme Board, CAC and RIB for individual franchise projects 	<p>The membership, as set out in the TOR are:</p> <p><u>Membership</u></p> <ul style="list-style-type: none"> • Project Director (or their nominated alternate) • Procurement Lead • Lead Specifier • Programme Manager • Commercial Manager • Finance Manager • Rail Service Advisor • Others as necessary by agreement with the Project Director <p><u>Chair</u> To be agreed by the Project Group</p>	<p>The quoracy requirements, as set out in the TOR are:</p> <p>The meeting shall be quorate if the Project Director, Procurement Lead and Lead Specifier or their duly authorised and briefed alternates are present</p>	<p>The frequency of meetings, as set out in the TOR are</p> <p>Generally fortnightly, but not less than Monthly</p>	<p>The escalation procedures, as set out in the TOR are:</p> <p>Refranchising project group reports to Refranchising Programme Board</p>

Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Refranchising Project Boards – TOR dated 17/05/12				
<p>The roles and responsibilities, as set out in the TOR are:</p> <p>The Project Board is accountable to the Refranchising Programme Board for the successful delivery of the project. It will have the authority to drive the project within the constraints set by the Refranchising Programme Board.</p> <p>The Project Board will</p> <ul style="list-style-type: none"> • Obtain authority from the Programme Board to deliver within specified constraints (including affordability, policy and timescales) as set out in the Project Initiation Document • Be responsible for timely delivery of all the key project documentation (PID, Consultation, ITT, Franchise Agreement) and outputs • Resolve dependencies and interface issues between the project and others in DfT, the wider government and rail industry • Proactively review and manage project risks and issues • Approve all stage plans and validate that each stage is completed prior to the start of the next stage • Review and comment on all submissions relating to the Project issued to Ministers and Programme Board or any other formal meeting • Report on projects to the Programme Board via the Project Dashboard • Coordinate stakeholder communications 	<p>The membership, as set out in the TOR are:</p> <p><u>Membership</u></p> <ul style="list-style-type: none"> • Lead Specifier • Procurement Lead • Franchise Commercial Manager • Project Manager (secretariat) • Finance Lead (attending as appropriate) • Legal Advisor (attending as appropriate) • Economist Lead (attending as appropriate) • Policy Development (attending as appropriate) • Programme Office representative (attending as appropriate) • External advisors (as required) <p><u>Chair</u> The Chair will be appointed by the Programme Board</p>	<p>The quoracy requirements, as set out in the TOR are:</p> <p>The meeting will be quorate if each business area is represented to the satisfaction of the Chair. Deputies are acceptable only if they are fully briefed and authorised.</p>	<p>The frequency of meetings, as set out in the TOR are:</p> <p>Weekly</p>	<p>The escalation procedures, as set out in the TOR are:</p> <p>The Project Board will report to the Refranchising Programme Board via its monthly Dashboard and on other items by exception.</p> <p>The Project Board will escalate any policy issues that develop to the Refranchising Policy Steering Group.</p>

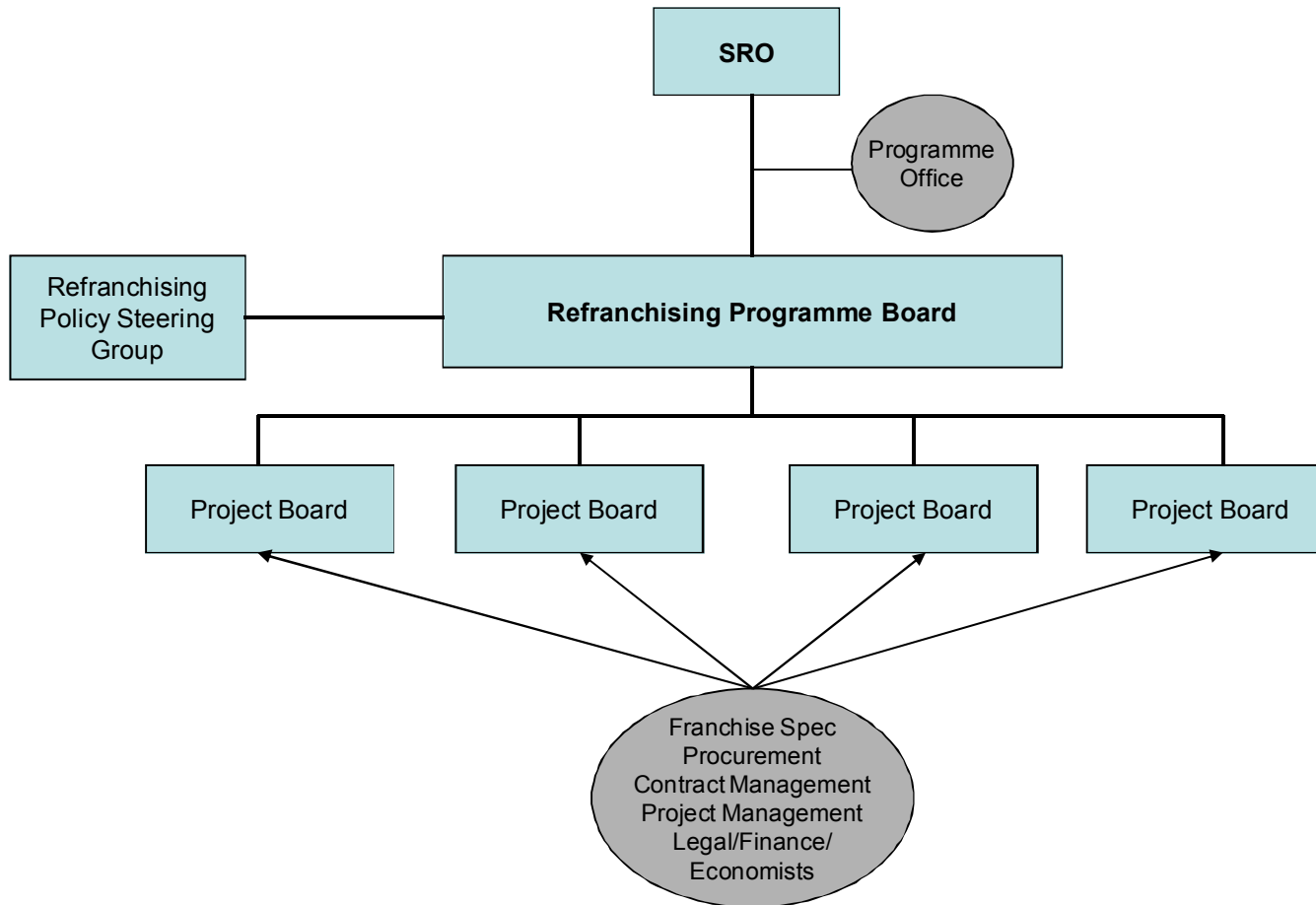
Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Refranchising Policy Steering Board – TOR dated 17/05/12				
<ul style="list-style-type: none"> • Refine and confirm Programme level policy objectives • Develop refranchising policy in response to ministerial direction and the wider rail reform agenda • Maintain overall Refranchising timeline (including commencement / extensions / length of new franchises) • Develop an approved “bank” of implementation solutions for different type of franchises within approved policy direction • Consider Remapping and devolution options and implications • Monitor links to other rail projects / programmes • Approve refranchising related submissions to Ministers that raise policy issues (other than those that fall within the remit of the Project Boards) • Approve non franchise specific changes to the Franchise Agreement • Project policy assurance 	<p><u>Membership/Chair</u></p> <ul style="list-style-type: none"> • Deputy Director, Franchise Policy (Chair) • Deputy Director, Refranchising Prog Office • Franchise Policy Team Leader • Franchise Policy • Rail Operations Advisor • Economic Advisor • Deputy Director, RC Refranchising • Deputy Director, CTS/Procurement • Commercial and Legal Liaison Manager • Head of Rail Commercial Contracts Legal • Programme Planning Manager 	Not specified	Fortnightly	<p>The Refranchising Policy Steering group will seek Refranchising Programme Board approval for:</p> <p>The impact and deliverability of all new policy propositions including remapping options</p> <p>Revisions to the overall franchising timeline</p> <p>The Policy Steering Board cannot submit papers directly to ministers.</p>

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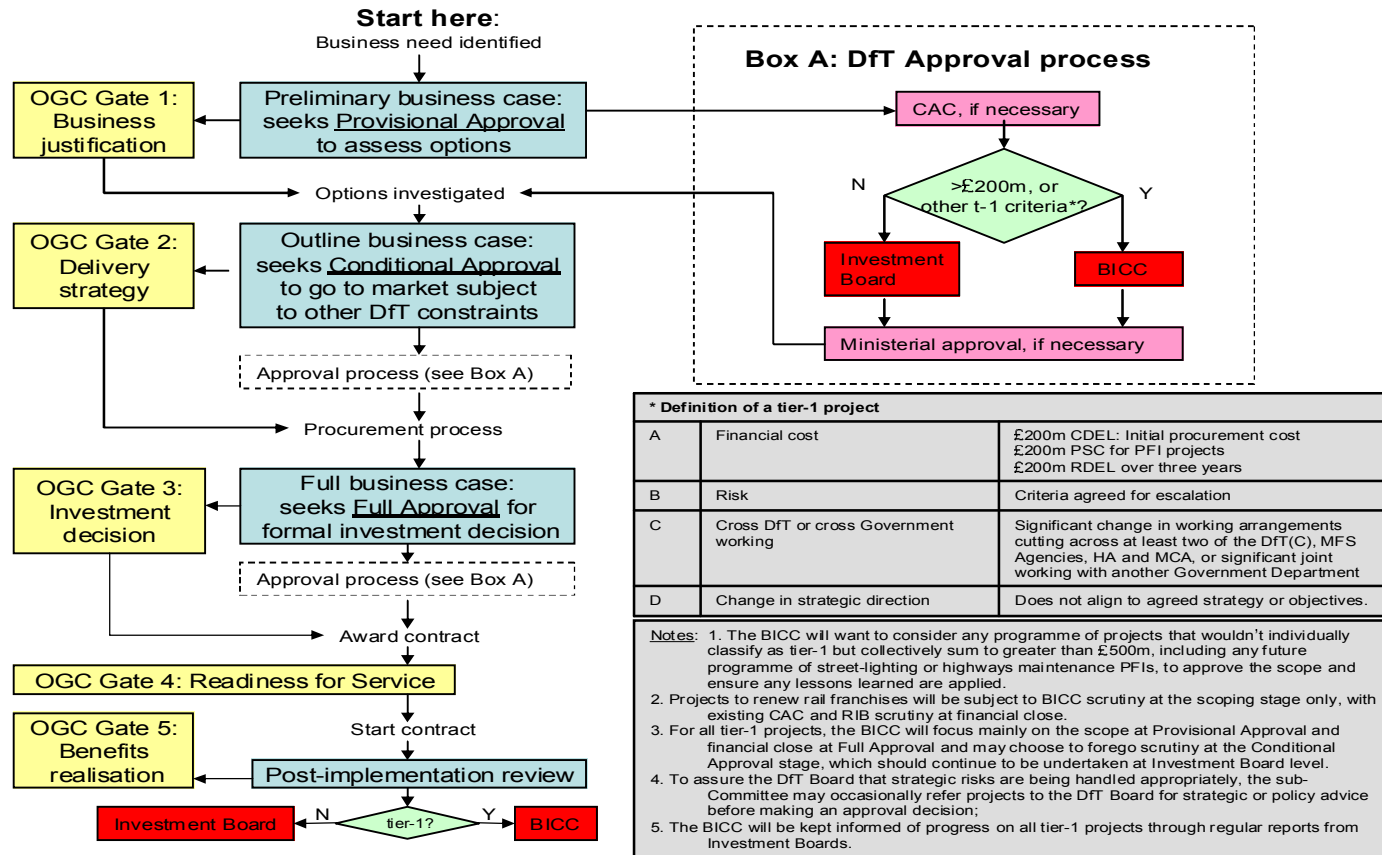
Summary of Roles & Responsibilities	Summary of Membership (including chair)	Quoracy	Frequency of meetings	Escalation
Rail Investment Board (RIB) – TOR Date Unspecified				
<ul style="list-style-type: none"> • Advise on franchise investment decisions at key points in the process other than for the larger or more novel franchises which are dealt with at BICC); • Advise on rail investment project decisions at appropriate Gateways for Financial Approval by the Director General, Major Projects and London and Director General Domestic – Gateway 1 onwards; • Be the Tier 2 scrutiny body for rail projects and as set out in the Department’s Investment Appraisal Framework (IAF) • Consider other procurements for which Contract Award Committee (CAC) approval is needed. 	<p><u>Membership/Chair</u></p> <ul style="list-style-type: none"> • DG Major Projects and London (chair). • DG Domestic • Director of Rail Policy • Director of Rail Commercial Contracts • Director of Rail and Road Projects • Director of Commercial and Technical Services • Deputy Directors: • Deputy Director of Rail Contracts and Head of Procurement • Deputy Director of Business partner MPL and Corporate • Deputy Director Rail Analysis • Deputy Director Rail Network Strategy • Head of Financial Strategy and Efficiency Division, Group Finance • Head of Rail Contracts, DfT Legal Services Directorate • Deputy Director, Commercial and Technical Services • Group Financial Efficiency and Strategy • Rail Secretariat (minute takers) 	<p>A minimum of 4 members or their SCS representatives who have been appropriately authorised and briefed are needed to make the board quorate. In the absence of the nominated chair, another Director General or Director may take this role.</p>	<p>Every four weeks, with additional ad hoc meetings called with the Chair’s agreement.</p>	<p>Not specified</p>

Appendix I

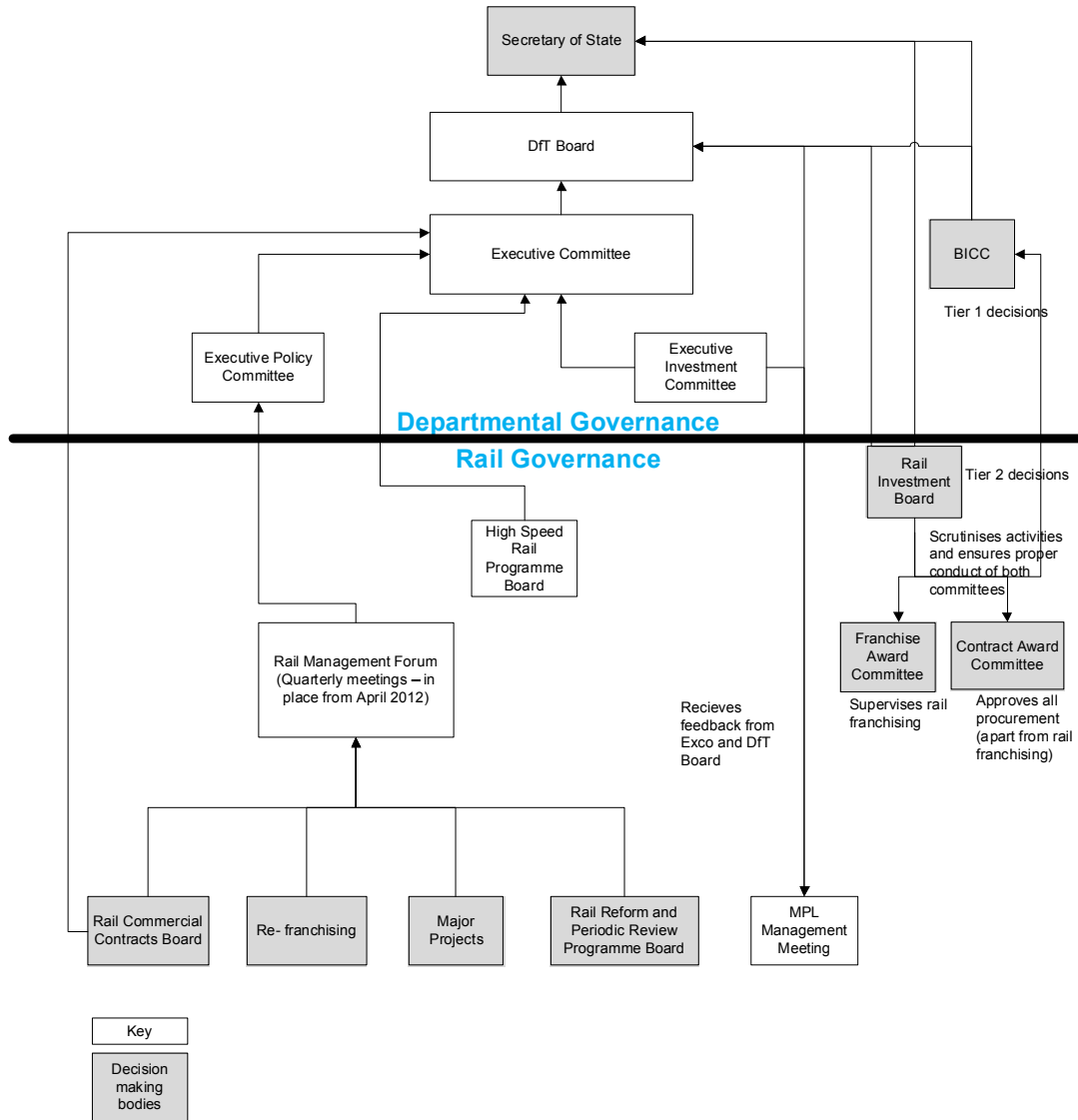
Simplified Governance Structure



ANNEX B



Rail Governance Map



Appendix J

Appendix J - Summary of OGC / MPA Gateway Review findings and recommendations

Key Review Findings ¹	Key Recommendations ¹
April 2011 – OGC Gateway Programme Review 0: Strategic assessment – AMBER	
<ul style="list-style-type: none"> • The DfT has recently undergone a major restructuring with the loss of expertise at the senior level. The new structure, whilst enabling collaborative working and being generally welcomed, is untested. • At working levels of the Rail Refranchising programme retained a good number of highly experienced and committed staff. • Policy finalisation was in process at the time of the Gateway Review resulting in a very tight timetable to issue the Inter-City West Coast Invitation to Tender. There is a high level of uncertainty about the overall financial implications of policy changes, part driven by timescales, part inevitable (the impacts only truly emerge through the competition). • The need to evaluate the options available on the start date for the new franchise for the Inter-City West Coast. • The need to maintain high quality services at the time of the London Olympics 2012 is seen as a key requirement but restricts choices. • Programme and project management are underdeveloped. 	<ul style="list-style-type: none"> • We recommend that DfT undertake an immediate review of the options available for the start date of the new franchise on the ICWC. The purpose of the review would be to assess whether the benefits to be achieved by taking more time to conduct a thorough understanding and rigorous testing of the implications of the policy decisions would outweigh the perceived downside of extending the existing franchise. • We recommend that the SRO appoint a suitably experienced programme manager and that each project has a suitably experienced project manager. • We recommend that the SRO has a single line for escalation on resource issues.

¹ Source: OGC Gateway Programme Review 0 (April 2011), MPA Project Assessment Review Report (29 March 2012) and OGC Gateway 3 Project Review (31 July 2012)

Appendix J - Summary of OGC / MPA Gateway Review findings and recommendations

Key Review Findings ¹	Key Recommendations ¹
March 2012 – MPA Project Assessment Review Report – AMBER / RED	
<ul style="list-style-type: none"> • This programme is amongst the most complex and challenging across government, made more demanding by the shifting policy platform. The programme is significantly under resourced and the restrictions applied for recruitment and cosourcing has meant that the existing teams have been under enormous pressure. This is not sustainable. It is to the credit of those involved that they have achieved so much within this challenging environment. • The current governance does not meet best practice and is unlikely to withstand the coming significant ramp up of workload, which will increase the requirement for collaborative working amongst teams and the need for more timely decision making. • The project organisation and programme management support (such as PMO) needs to be strengthened. • There is an urgent need to ramp up the capacity of the delivery teams in several technical commercial and procurement disciplines. The current scheme of delegations with the Cabinet Office will hinder this and should be addressed in the submission to ERG of the Integrated Assurance Plan. • DfT has developed a series of options to respond to the concerns of HMT and No 10 including the possible recalibration of the overall refranchising schedule and options for the application of the GDP mechanism within future franchise competitions. Despite good progress to address these issues there is an urgent need to close them out, focussing discussion on the practical issues, and have a plan to escalate to achieve resolution if officials fail to agree a way forward. • The procurement strategy needs to be adapted to meet the requirements arising from the agreement with HMT particularly for GDP mechanism and recalibration of the franchising schedule. The revised strategy should actively seek to encourage more innovative proposals from bidders within the constraints of the overall programme timescales 	<ul style="list-style-type: none"> • The governance of the programme should be strengthened immediately. One Director General should be made accountable for the whole programme and be the single SRO. He/She should be supported by a full time Programme Director with a fully staffed and dedicated programme management office led by a programme manager. Each individual franchise project needs a dedicated project manager to be appointed. • The SRO should undertake an immediate skills gap analysis and produce, agree and implement a forward resource plan for the programme which details how and when resources will be acquired either via co-sourcing or direct appointment. • The SRO to finalise the integrated assurance plan to reflect the revised governance and project organisation. Furthermore there is an urgent need to confirm and implement the revised scheme of delegations to facilitate the appointment of critical external resources more quickly. • The SRO should ensure closure of policy development issues raised by HMT and No 10 by the end of March 2012 and have a plan to escalate to achieve resolution if officials fail to agree a way forward. • The procurement strategy needs to be adapted to meet the requirements arising from the agreement with HMT particularly for GDP mechanism and recalibration of the franchising schedule. The revised strategy should actively seek to encourage more innovative proposals from bidders within the constraints of the overall programme timescales.

Appendix J - Summary of OGC / MPA Gateway Review findings and recommendations

Key Review Findings	Key Recommendations
31 July 2012 – OGC Gateway 3 Project Review - Investment decision – GREEN	
<ul style="list-style-type: none"> • The Review Team finds that the project is well placed for the intended award of contract on the 14th August 2012. Four good quality bids were received and the evaluation process has been completed successfully. Final negotiations with the two leading bidders are nearing completion and there is a high degree of confidence across the DfT team that an award of contract will be achieved in time. • There remain a couple of commercial risks; the size of the Subordinated Loan Fund (SLF) and the effect of the cross default clauses being used on other franchises currently at ITT stage. The Review Team is satisfied that these risks are well understood and managed and are being mitigated as far as possible. • There is broad consensus that the proposed solutions are deliverable. The Inter City West Coast Refranchising Project will be the first franchise to be awarded since the government’s new franchise policy of greater flexibility and space for more innovative service proposals and most interviewees feel that the quality and nature of the bids supports and reflects this change. • The plans and resources for the mobilisation and contract management phase are very sound; it is a good example of best practice that the contract manager has been involved and engaged throughout the procurement and negotiation stages of the process. There is a need to monitor carefully the deliverability of some of the proposals, especially those highlighted by Network Rail as being potentially problematic. • The project is on track to deliver against the business case and VFM has been confirmed to the satisfaction of all stakeholders through the robust evaluation process. • There is some potential, depending upon the final result of the competition, for intense publicity and perhaps challenge by unsuccessful bidders. The DfT team are confident in the robustness of the process, and prepared to address the risks through a planned communications strategy covering all levels, especially ministers and No.10. 	<ul style="list-style-type: none"> • The Department’s Franchise Management Team should work with the successful bidder and Network Rail to ensure that the concerns on Delivery Plan proposals are addressed as soon as possible following franchise award. • The Department’s Franchise Management team should ensure that appropriate performance measures are in place by franchise start date which will hold the successful bidder to account in respect of station “maintain and repair” obligations. The Department should work with the ORR during the mobilisation phase to ensure that the ORR fully understands its role where franchise asset management is concerned.

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