

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

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

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.