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COMPTROLLER AND
AUDITOR GENERAL

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Department for Transport

Lessons from cancelling the InterCity West Coast franchise competition

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National Audit Office

Department for Transport

Lessons from cancelling the InterCity West Coast franchise competition

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report sets out the chronology of events that led to the Department cancelling the InterCity West Coast franchise competition. It comments on the wider lessons for the Department.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/west-coast-2012

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Key facts

£720m

the revenue from the InterCity West Coast line in 2009-10

£8.9m

the total estimated cost to date in terms of staff and advisers to run the competition, prepare for the judicial review and conduct reviews since the cancellation

3

franchise competitions the Department paused while it reviews the cancellation

£1.9 million	staff and advisers' costs of running the cancelled competition[1]
£2.7 million	Department's costs for preparing to defend its decision in court[1]
£4.3 million	advisers' costs for the reviews commissioned since the cancellation[1]
January 2011	Department started franchise process by inviting interested parties to express an interest
May 2011	Department originally planned to issue the franchise tender documents
20 January 2012	Department issued InterCity West Coast tender documents
4 May 2012	Department received bids from four shortlisted bidders
15 August 2012	Department announced its intention to award the franchise to First Group
3 October 2012	Department cancelled awarding the franchise because of errors in the procurement process

1 These costs form part of the £8.9 million given above.

Summary

Introduction

1 On 3 October 2012, the Department for Transport (the Department) cancelled its provisional decision to award the InterCity West Coast franchise to First Group and, with it, the franchise competition. It also paused three other franchise competitions: Essex Thameside, Great Western and Thameslink.

2 The Department made this decision because its analysis led it to conclude that there were:

- technical errors in an evaluation tool used to calculate the subordinated loan facility; and
- problems in the procurement process including a lack of transparency and failure to treat bidders consistently.

The Department identified these issues while preparing to defend its decision against legal proceedings by one of the bidders, Virgin. Our chronology of the events leading to the Department cancelling the competition is at Appendix Three.

3 The Department has commissioned two independent reviews. The first, led by Sam Laidlaw, to examine the events leading to the Department cancelling the franchise competition. The second, led by Richard Brown CBE, will report on the wider franchise programme by the end of 2012.

4 Sam Laidlaw reported[2] his initial findings on 29 October:

- There was a lack of transparency. The Department did not give bidders enough information on which to base their bids.
- The Department did not follow its own published guidance.
- The amount of capital that the two final bidders were asked to put into their bids was understated and inconsistently determined.
- The Department's planning and preparation was inadequate.
- Roles and responsibilities for the project were unclear and resources were stretched.
- The Department's governance lacked efficacy.
- Quality assurance was inadequate.

2 *The Laidlaw Inquiry: Initial Findings Report*, available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/9171/laidlaw-report.pdf

5 We have had access to the same evidence base as the Laidlaw inquiry team (Appendix Two). This report sets out the chronology of events, commenting on the wider lessons for the Department, drawing from our knowledge of the Department and our past reports. We do not comment on what the size of the subordinated loan facility should have been. Appendix One provides details of our audit approach. We intend to carry out a further examination of the costs and consequences to the Department of cancelling the competition in due course.

Key findings

6 The refranchising of InterCity West Coast was a major endeavour, with considerable complexity and uncertainty and a range of overlapping issues. It was implemented by a multidisciplinary team whose activities needed to be coordinated and aligned. It was also making new demands of bidders in their offer and how it was financed. In such circumstances, Departments may make poor decisions. There are in essence five safeguards against making poor decisions:

- Clarity of objectives helps decision makers to form appropriate judgements by being a touchstone to refer back to throughout the decision-making process.
- Strong project and programme management brings together and coordinates the different streams of work, identifies interdependencies and the sequence of events – the critical path – a programme needs to follow.
- Senior oversight acts as a sense check.
- Effective engagement with stakeholders, such as suppliers, helps by contributing their knowledge, signalling problems and brings them into the process.
- Internal and external assurance provides a sense check and can identify any areas of concern to management.

It is clear that none of these lines of defence operated effectively in the refranchising of InterCity West Coast.

Clarity of objectives

7 The Department's objectives were insufficiently clear during the franchise competition as evidenced by:

- On 10 May 2011 the Department delayed the issue of the invitation to tender by eight months because it had not finalised how policy changes, such as operators becoming responsible for stations, would be implemented (paragraph 3.3).
- When the Department finally issued the invitation to tender, there were still significant gaps, for example on how the Department would calculate any capital needed from bidders (subordinated loan facility) (paragraphs 4.3 to 4.13).

- There was considerable confusion among staff about the primary purpose of the subordinated loan facility – varying from protecting the taxpayer against default to requiring bidders to put 'skin in the game', that is to have their money at risk should they default (paragraph 4.13).
- Some bidders told us that when they asked for clarification on issues, such as taking over stations and the subordinated loan facility, staff did not appear to know the answers. It was often some time before there was any clarification (paragraphs 4.10 to 4.13).
- There was a risk that bids could be based on over-optimistic projections of revenue growth. If the franchise is profitable, the risk to bidders from not achieving passenger projections reduces over the contract, as they will have already generated considerable profit should they default. The subordinated loan facility was one of the key protections against the risk of overbidding leading to default. The effectiveness of the measure was reduced by the fact that bidders could not predict the size of their subordinated loan facility (paragraph 4.4, and 4.10 to 4.12).

8 **Although as yet unused, the GDP compensation mechanism would have addressed the perverse incentives of 'cap and collar' and reduced the risk of operator failure by providing support from the first year of operation.** Testing the mechanism's sensitivity to a range of economic scenarios was a reasonable response to recommendations by the Committee of Public Accounts. The policy of ensuring bids were resilient to an economic downturn, delivered by changing how the subordinated loan facility was calculated, had a significant impact on the capital structure of bidders' proposals (paragraph 3.8).

9 **A particular area of confusion was how the subordinated loan facility would be calculated.** The Department used a model designed for a different purpose and which contained an error to calculate the subordinated loan facility. The Department developed its models independently, and we are unclear whether it fully appreciated what impact the assumptions and decisions it used would have on the size of subordinated loan facility required. Other areas of government are also involved in determining the capital requirements for private companies. Regulators have formal and well established processes of consultation and dialogue with industry. The regulator's role is to scrutinise and challenge the private sector's judgements from a sceptical perspective, and to supplement private sector analysis with its own. The Department developed its own model and did not subsequently share the full model with bidders, which laid it open to risks of challenge from bidders that subsequently materialised (paragraphs 4.3 to 4.9).

Strong project and programme management

10 The competition lacked strong project and programme management, which included the following issues:

- There was more than one senior responsible owner in the course of the competition, nor was there a single programme manager from the outset who brought together and coordinated the policy and delivery streams (paragraph 2.3).
- The Department delaying the issue of the invitation to tender to allow more time for policy development used up all of its contingency within the timetable (paragraph 3.3).
- The Department's documentation was poor and it did not submit papers to internal decision-makers in sufficient time for them to consider the information within them (paragraph 4.34).
- Staff worked hard to meet the deadline for awarding the contract. More widely within the refranchising programme concerns were raised about resources by the Major Projects Authority. However, nobody sought to address these issues in relation to this franchise competition (paragraph 2.9).

Senior management oversight

11 There has been considerable turnover in departmental senior positions. The Department has had four permanent secretaries in two years and changes of directors general. This was particularly unfortunate when the Department had undergone major change. Such high turnover impedes the Department's ability to discharge its responsibilities for managing long-term projects and procurements (paragraphs 2.5 to 2.6).

12 There was a lack of management oversight and ownership of the franchise competition. We are surprised that there was no one senior person overseeing this competition, given that this was the first big franchise that the Department planned to let under its new organisation structure and franchise policies. Staff in the project team reported to different parts of the organisation which meant no one person oversaw the whole process, or could see patterns of emerging problems. After Virgin raised concerns about the procurement process no one in the Department reviewed independently the procurement process (paragraphs 2.2 to 2.3, 2.13 and 4.33).

13 The Department's governance of the franchise project was confused, partly because the remits of committees and the information they require are not clear, and membership is fluid. There was no clear route for the project team to get approval for issues such as guidance to bidders on how the Department would calculate the subordinated loan facility (paragraphs 2.3 and 4.33).

Effective engagement with stakeholders

14 The Department did not engage with bidders as effectively as it should have:

- In May 2011 the Department announced it would delay the invitation to tender on the day that bidders were expecting the invitation to be issued. Some bidders told us that they had already engaged contract staff and temporary premises to prepare their bids (paragraph 3.3).
- Bidders had to ask for more information on a number of issues in order to make their bid, in particular to calculate the likely size of their subordinated loan facility (paragraphs 4.10 to 4.13).
- The Department responded to some questions from bidders slowly, inaccurately or with contradictory responses (paragraph 4.13).

Assurance

15 There was a significant error in the Department's tool that it used to calculate the subordinated loan facility. The model had been designed to inform internal discussions about the GDP mechanism. It received no extra quality assurance once the Department decided to use it to calculate how big a subordinated loan facility to ask from bidders. The Department has developed quality assurance protocols, against which it is assessing its business critical models. We support this action but because the Department relies heavily on technical analysis and modelling we are concerned that these protocols were not in place earlier (paragraphs 4.9 and 5.5 to 5.6).

16 Management took too much comfort from assurance processes that have a limited scope and ability to identify issues. Assurance such as internal audit reports and 'gateway reviews' are not a substitute for management controls, which should always be the first line of defence against poor decision making and poor quality work. Reviewers often rely on the Department to provide information and highlight concerns. The Department did not use internal audit as a tool to investigate problems: internal audit was encouraged to look at governance and to carry out a lessons-learned exercise after the competition, rather than a review while the competition was live (paragraphs 4.28 to 4.32).

Conclusion on value for money

17 It is clear that the Department's conduct in the InterCity West Coast franchise competition was not value for money. It is likely to result in significant cost for the taxpayer, the full value of which is unknown at present. The five safeguards set out above are essential to enable officials to assure ministers and Parliament that decisions are sound and are value for money. The Department's failure to operate them effectively in this case inevitably raises wider questions, since each area is a product of a broader management approach.

18 It is commendable that once it uncovered the problems on the franchise, the Department has sought to be open about what has happened, investigate further and is seeking to learn lessons. It is only if the Department applies these lessons widely, however, that future public value will have been protected at the cost of this failure.

Recommendations

19 Our recommendations are designed to help identify and isolate any wider systemic failings.

Clarity of objectives

The Department should do the following:

a **Apply project and programme management disciplines to forming policy.** It should set timetables, identify key tasks and their dependencies, identify a critical path for making policy changes and allocate clear roles and responsibilities to deliver individual elements and the policy as a whole.

b **Identify the technical tools and models it requires to implement policy before delivery commences.** It needs to develop, quality assure and test these processes before it moves to the operational phase. We note that there were no external financial advisers used on this franchise competition. Where the Department is approaching the market with a new proposition or method of evaluating bids, it should commission external advisers to test the process.

c **Provide training to staff on any new tools or policies.** Before projects enter operational stages, staff need training so that they understand objectives and how to apply processes and tools.

Project and programme management

The Department should regularly review the following:

d **Timetables for major projects and programmes so they are realistic.** It should consider the 'usual' timescales for typical projects and programmes, identify novel factors that might impact on these and be cautious in shortening existing timetables.

e **Staffing, so it is appropriate both in terms of numbers and skills.**

f **Key decision points.** It needs to build in sufficient time to properly consider decisions, include contingency in case extra work is required, and consider other options if it cannot decide to proceed.

Senior oversight

g **The Department needs more continuity in its senior management.** In considering the Department's senior staff, the Permanent Secretary and the Head of the Civil Service should make this a priority, and ensure that corporate responsibility and memory is maintained when individual post holders change.

h **The Department needs to review its governance structures to ensure there is effective oversight and clarity over roles and responsibilities.** In particular it needs to:

- provide greater clarity over the role of the Department's various boards and committees; and
- ensure each programme has one senior responsible owner overseeing its delivery.

i **The Department should appoint someone with sufficient seniority to oversee each significant commercial transaction and major project.** It is important that someone within the Department oversees high-risk work, such as reletting this franchise who knows the detail and has commercial skills and the authority in the Department to take action if things are going wrong.

Effective engagement with stakeholders

j **The Department should aim to be transparent and to provide as much information as possible to suppliers and stakeholders.** This includes giving access to models that underpin decision-making.

k **The Department should learn lessons from regulated sectors.** For example, it should seek to learn about their approach to engaging with industry when making decisions that affect the capital structures of suppliers. There is a more structured process of engagement and more transparency which both supports the accountability of public sector decision-makers and manages expectations on all sides, thereby reducing uncertainty for private sector bidders.

Assurance

l **It needs to make clear that assurance processes are not a substitute for proper supervision and management controls and that staff with line-management responsibilities are responsible for the quality of the work in their areas and for ensuring that there are proper processes and controls.**

m **As part of an integrated assurance process, the Department needs to revise its approach to internal audit to use it as a proper tool to give assurance on risk and investigate problems.**

- it needs to consider each of its major programmes and identify appropriate points where internal audits should take place. Once identified these should not be negotiable.
- it should ensure that internal audit provides assurance over substantive elements of highest risk projects and programmes while they are live.
- it needs to examine the appropriateness of ratings so that they do not detract from important report findings.

Part One

The flaws that led to cancelling the competition

1.1 This part of the report sets out the background to the competition for the InterCity West Coast franchise, and the flaws that led to cancelling it.

The franchise

1.2 The InterCity West Coast franchise operates from London Euston to Glasgow, and serves cities including Birmingham, Liverpool, Manchester, and Edinburgh. The franchise is one of the largest that the Department lets, with revenue of £720 million in 2009-10 compared to £679 million for Great Western in 2010-11.[3]

1.3 The franchise was last let in 1997 to Virgin Rail Group.[4] In January 2011 the Department started reletting the contract with a view to issuing the invitation to tender (the Tender) to shortlisted bidders in May 2011. It intended the contract to start on 1 April 2012. The Department decided only in May 2011 it could not meet this timetable because it needed to consult further on proposed changes, and extended Virgin's franchise by nine months. It issued the Tender in January 2012 intending that the new contract would start on 9 December 2012. It announced on 15 August that it intended to award the contract to First Group but cancelled this decision and the competition on 3 October 2012.

Events leading to cancelling the competition

1.4 Appendix Three sets out the key events that led to the Department cancelling the competition. The Department commissioned an inquiry by Sam Laidlaw to investigate the circumstances leading to this decision. As the inquiry's initial findings report[5] states there were technical and procedural issues concerning the tool that the Department used to calculate the amount of subordinated loan facility required from bidders. The subordinated loan facility was intended to protect the taxpayer from the risk of bidder default.

1.5 In the initial findings, the technical and procedural issues arose from:

- using a model to calculate the subordinated loan facility that the Department had developed for a different purpose, namely to test its new policy of protecting bidders from the risk that GDP growth differs from forecast;

3 Data taken from *Official Journal of the European Union* advertisements for each franchise and therefore are from different years.
4 Virgin Rail Group is jointly owned by Virgin Management and Stagecoach plc.
5 *The Laidlaw Inquiry: Initial Findings Report*, available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/9171/laidlaw-report.pdf

- the model calculated the amount in 2010 prices, thereby reducing the amount required from bidders because it did not take account of inflation;
- the process lacked transparency because the Department felt unable to release the model to bidders although it did provide a simplified tool (the 'ready reckoner'), to help them develop their bids; and
- the Department applied judgement to decide the subordinated loan facility required from the two leading bidders, and in doing so treated them inconsistently.

1.6 There were wider problems with how the Department introduced changes to the franchising process and ran the procurement. There were signs at many different times pointing to these problems:

- An internal 'hostile' review in November 2011 identified a significant number of issues, particularly on the policy for operators to take over stations. Such a review was good practice but it was carried out too late given that the Tender had to be issued in January 2012.
- HM Treasury agreed that the InterCity West Coast tender could proceed, but only as a pilot which would inform the Department's development of future franchises.
- Bidders asked for clarification on a number of issues, for example on how the subordinated loan facility would be calculated.
- A report from Grant Thornton made clear that the size of subordinated loan facility required was sensitive to the risk adjustment the Department applied, and riskier bids could require a commercially unviable subordinated loan facility.
- Internal audit identified some issues with governance for rail projects and the terms of reference for the Department's contract award committee.
- Reports by the Major Projects Authority on the refranchising programme highlighted that policies were still changing; there were inadequate resources; the Department lacked project and programme management expertise; and there were governance issues.
- Finally, Virgin wrote to the Department and the government raising concerns about the process before the contract was awarded.

Given these warning signs the Department's processes and controls should have triggered greater scrutiny and mitigation of the risks to the procurement.

1.7 We provide a chronological account of events and, drawing on our knowledge of the Department and previous reports, comment on issues that raise wider concerns for the Department. Part Two comments on the environment in which the franchise was let. Part Three and Part Four comment on the problems that occurred in planning and during the procurement. Part Five describes the action the Department has taken since 15 August 2012.

Part Two

Contributory factors

2.1 This part comments on the organisational changes and cultural issues which contributed to problems on the InterCity West Coast competition.

Structural reorganisation

2.2 In 2010, the Department established its current structure (**Figure 1** overleaf). One of the objectives of the change was to provide greater segregation of duties and provide more transparency internally on the Department's work on rail. In franchising, the client role, for example the specification of franchise requirements, was separated from the delivery role. Before the re-structure, one director general had been responsible for all aspects of policy and delivery of the Department's work on rail. Following the restructure, this responsibility was split across three director generals.

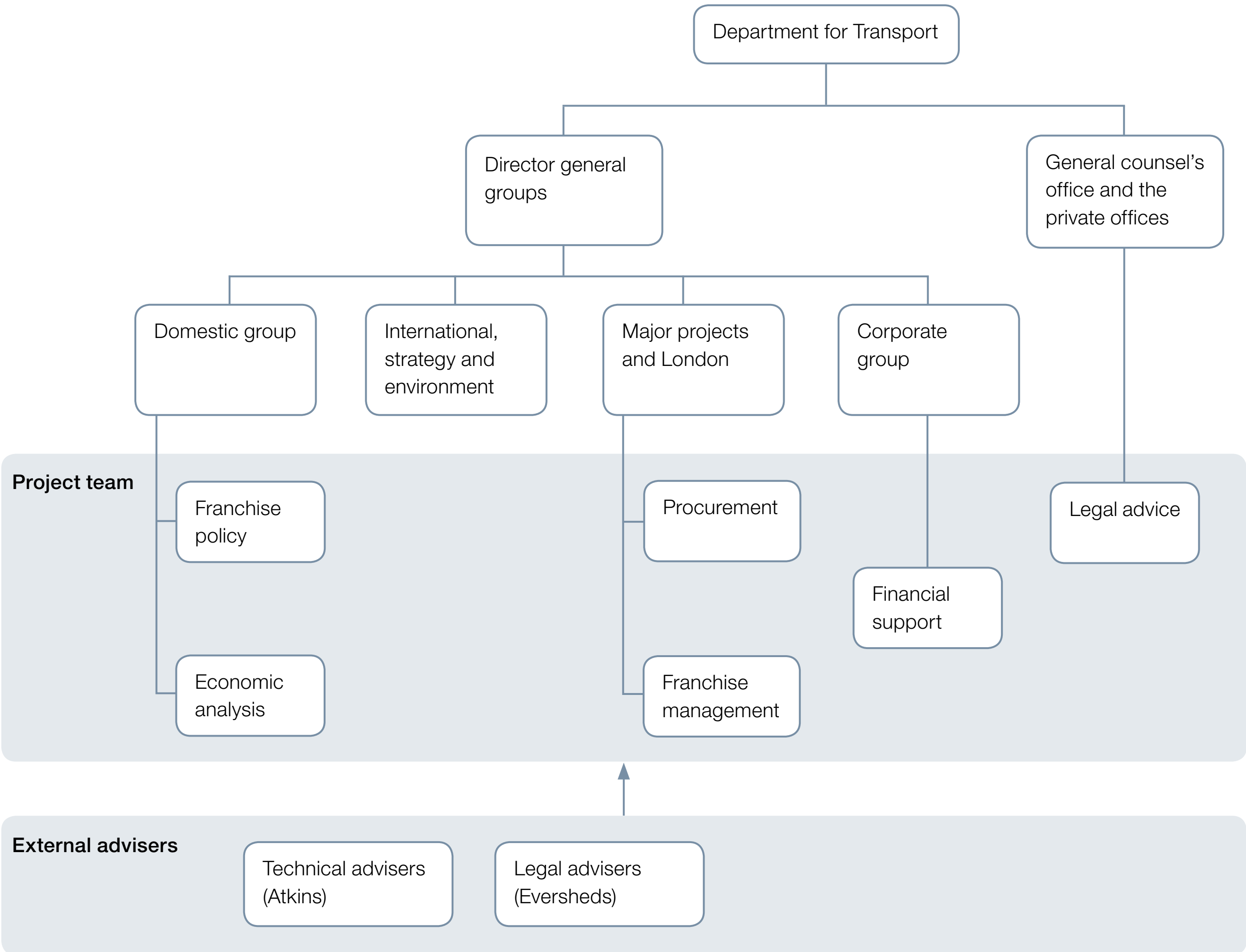
2.3 This was the first major franchise in which these complex arrangements were used. The result in this instance was that no one oversaw the whole refranchising process.

- Franchise projects were to have two senior responsible owners with responsibility transferring from policy to delivery once the Department had issued tender documents.
- There was inadequate programme management for refranchising up to March 2012.
- The route for escalating issues outside formal approval points (**Figure 2** on page 17) was unclear and the project team determined at the outset where and when it needed formal decisions from the Department's boards and committees.
- Membership of boards and committees was unclear, leading to a lack of continuity in how the Department considered issues.

2.4 The Department has split responsibilities on other projects and will therefore need to apply the lessons from this franchise to ensure that roles and responsibilities are clear.

Figure 1
The Department's rail team showing franchise responsibilities

In 2010, rail policy and delivery was split across three directors general, whereas previously one director general was responsible



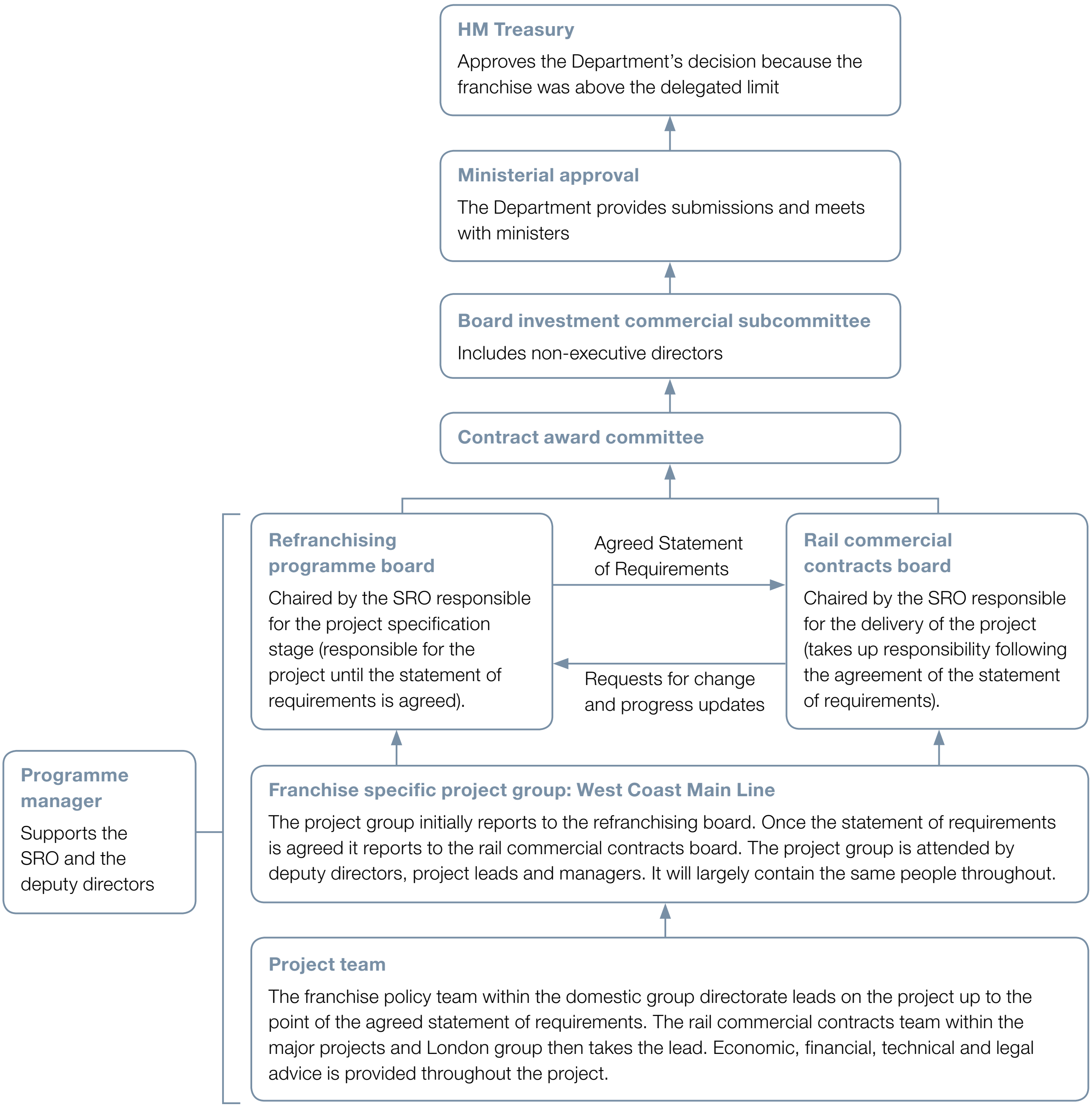
NOTES

1 Staff in the Domestic Group are the client for the franchise, while those in Major Projects and London group are responsible for delivering the procurement.

2 General Counsel is the chief legal adviser at the Department and is supported by a team of lawyers.

Source: National Audit Office analysis

Figure 2
Governance structure for formal approval points for the InterCity West Coast franchise



NOTES

1 SRO refers to senior responsible owner.

2 The Department changed the programme governance in March 2012 in response to findings by the Major Projects Authority (see paragraph 4.15).

Source: National Audit Office review of the Department's delivery plans

Staff changes

2.5 The Department experienced considerable staff changes not all of which were within its control:

- Within the Department's leadership team, there have been four permanent secretaries since 2010, and two of its four current directors general have been in post for a year or less.
- A number of senior staff with a role in rail refranchising had left in 2010-11, including the director general previously responsible for rail and the Department's head of procurement.
- As a result of the spending review the number of staff directly working in rail reduced by 20 to 30 per cent (between 50 and 70 staff members) between May 2010 and May 2011. Since January 2011, the Department has increased the number of staff working directly on franchising by 70 per cent (18 staff).

2.6 While all organisations experience senior staff turnover and this can be out of their control, it is unfortunate that there have been so many changes of permanent secretary during a period of intense reorganisation. The frequent changes at senior level raise questions about whether there is sufficient continuity to achieve long-term infrastructure projects or service contracts, which is a key part of the Department's responsibilities.

2.7 In relation to the spending review cuts, we have consistently highlighted the risks that departments run in cutting costs without fully understanding value. In our report *Managing change in the Defence workforce*[6] we noted the importance of a targeted approach to maintain key skills when restructuring a workforce. In *Managing early departures in central government*,[7] we recommend that the Head of the Civil Service and permanent secretaries actively monitor:

- current and planned staffing levels and workforce shape, drawing on appropriate benchmarks for different business areas; and
- the effect of early departures on the civil service's skills, experience and equality profile, to identify any erosion of capability.

2.8 In *Reducing costs in the Department for Transport*[8] we noted that the Department:

- received a settlement that required it to reduce its £295 million administration budgets by 33 per cent by 2014-15 (real terms); and
- chose to restructure quickly, reducing staff numbers by 502 in the year to April 2011.

6 Comptroller and Auditor General, *Ministry of Defence: Managing change in the Defence workforce*, Session 2010–2012, HC 1791, National Audit Office, February 2012.

7 Comptroller and Auditor General, *Cabinet Office: Managing early departures in central government*, Session 2010–2012, HC 1795, National Audit Office, March 2012.

8 Comptroller and Auditor General, *Department for Transport: Reducing costs in the Department for Transport*, Session 2010–2012, HC 1700, National Audit Office, December 2011.

2.9 The Department identified resourcing as a key risk to achieving the franchise programme, and agreed to provide extra resources in July 2011. Nonetheless, a staff survey in autumn 2011 found that half of staff in directorates involved in rail refranchising agreed that they had an acceptable workload, in line with the rest of the Department. It is clear from documents that staff worked long hours to meet deadlines. The Major Projects Authority identified under-resourcing as a significant issue when it reviewed the programme in March 2012.

2.10 The Department depended on the knowledge and skills of experienced staff, and needed to manage staff reductions carefully. In our report on *The InterCity East Coast Passenger Rail Franchise*,[9] we praised the Department for its staff's knowledge and experience but expressed concern that reductions in staffing and the move to a new franchising system made it more important to maintain 'corporate memory'. We also recommended that the Department needed to maintain and refresh appropriate in-house skills by ensuring that staff have industry experience.

2.11 During the restructuring the Department matched staff to posts by assessing their skills and experience. Since skills, learning and development records and past experience are not held centrally, we have been unable to verify that this process ensured the right skills were in place.

2.12 We have the benefit of hindsight but, in our view the Department's restructuring decisions regarding rail franchising increased risk as it was about to embark on a major refranchising programme.

Oversight and escalation

2.13 There were issues around the structures for staff to escalate problems:

- In our view, job descriptions for franchising posts show that the Department expected post-holders to make complex and sensitive decisions without reference to more senior staff, and to defend these during formal governance procedures.
- There were no senior staff in the project team.
- We could not find evidence of effective management oversight. Some bidders also told us they had less access to senior staff compared to previous competitions, and there was a lack of a 'guiding mind' – someone who had oversight and carried out sense checks on what the system was producing.

9 Comptroller and Auditor General, *Department for Transport: The InterCity East Coast Passenger Rail Franchise*, Session 2010-11, HC824, National Audit Office, March 2011.

Refranchising programme

2.14 The Department paused its refranchising programme following the 2010 general election. To do so, it extended some franchises by a short period, including the InterCity West Coast. This, combined with the early termination of three franchises, resulted in a more compressed timetable than planned although historically the Department has let several franchises in close succession (**Figure 3**).[10]

2.15 The Department originally planned to let the franchise within 15 months, an ambitious timescale given the policy changes. The fastest previous refranchising was 12 months. Under new processes, the Department has tended to take two years to complete a refranchising. Although it extended the timetable by eight months, once underway there was a pressure to meet its revised timetable to have the new franchisee in place on 9 December.

2.16 The Major Projects Authority carried out two critical reviews of the refranchising programme in April 2011 and March 2012. In both reviews it highlighted that the programme was made more complex because franchise policies had not been finalised. The Authority judged there were significant risks to successfully achieving the programme, because it also identified problems with resourcing, governance and programme management.

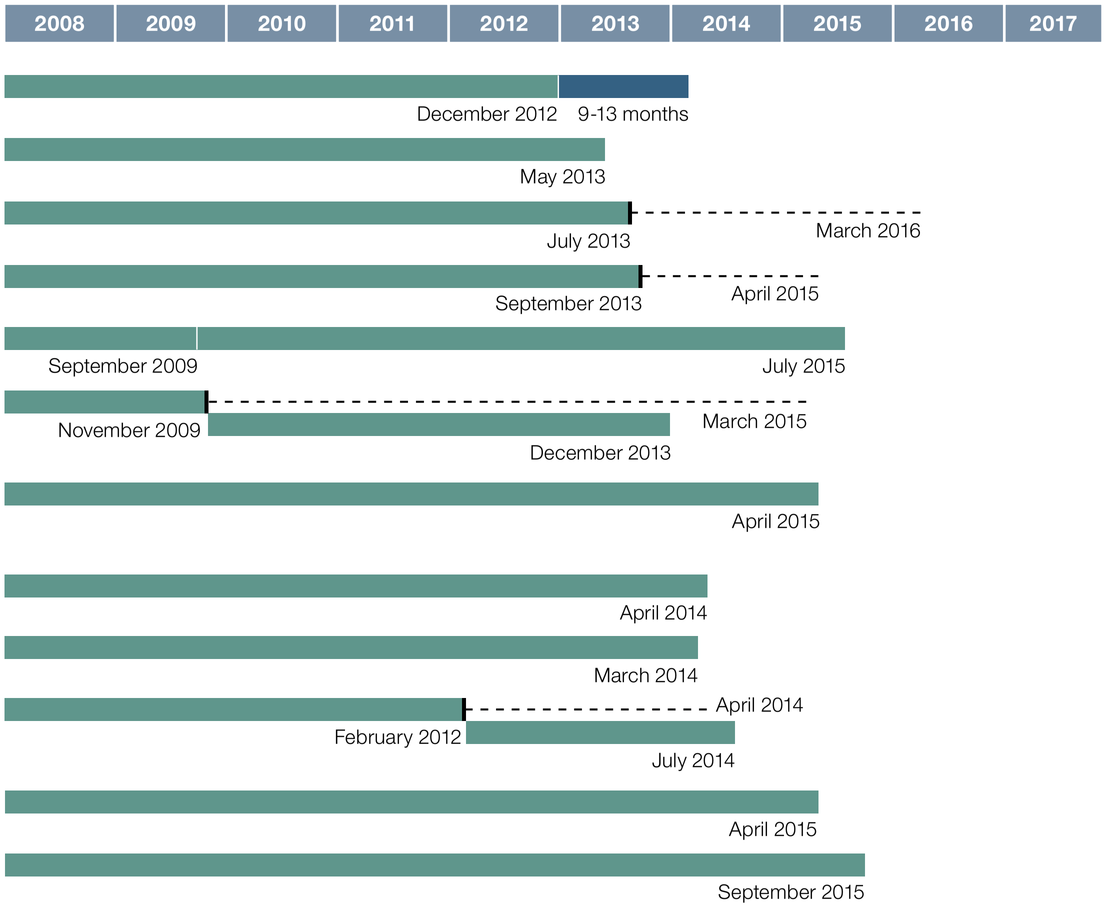
10 We reported on the eight franchises the Department let between 2005 and 2007 in Comptroller and Auditor General, *Department for Transport: Letting Rail Franchises 2005-2007*, Session 2007-08, HC 1047, National Audit Office, October 2008.

Figure 3

The planned franchise renewal programme up to 2015 before it was put on hold

There were a significant number of franchises that needed to be let between 2011 and 2015

Franchise	Train operating company	Start
InterCity West Coast	Virgin Trains	March 1997
Essex Thameside	c2c	May 1996
Great Western	First Great Western	April 2006
Thameslink	First Capital Connect	April 2006
South Central	Southern	September 2009
InterCity East Coast	National Express East Coast	December 2007 November 2009
TransPennine Express[1]	First Keolis TransPennine Express	February 2004
Northern	Northern Rail	December 2004
Integrated Kent	Southeastern	April 2006
Greater Anglia	National Express Abellio	April 2004 February 2012
East Midlands[2]	East Midlands Trains	November 2007
West Midlands[2]	London Midland	November 2007



Franchise actual and expected end date   Possible contract extension (in negotiation)   Early termination

NOTES

1 The Department has the flexibility to terminate the TransPennine franchise between April 2014 and 1 April 2015.

2 The franchise end date is subject to performance criteria being met. If the franchisee fails to meet the performance requirements, the Department can terminate the franchise at a specified initial expiry date.

3 Figure does not include franchises which had been due to be renewed after 2015.

Source: Adapted from assets.dft.gov.uk/publications/rail-franchising-timetable/rail-franchising-timetable.pdf

Part Three

Preparing for the competition

3.1 This part explains how the Department developed changes to franchises up to issuing the Tender in January 2012. It outlines what drove the changes and explains how the Department developed its GDP compensation mechanism as an alternative to its existing revenue support mechanism.

Procurement timeline

3.2 In March 2011, the Department shortlisted four bidders to invite to tender, based on pre-qualification checks. This involved assessing the governance, financial solvency and safety record of potential bidders and ranking those who passed by historic performance and plans for the franchise.

3.3 On 10 May, the day that the Tender had been scheduled to be issued, the Department told bidders that there would be a delay. This decision had significant implications for bidders as they were ready, having engaged contract staff and premises, to prepare their bids. The delay was because the Department:

- had not finalised how to implement policy changes, including operators taking over responsibility for stations; and
- it wanted to consult on changes to the franchise around train service specification and how it would test franchise value for money in line with the rail value-for-money report, by Sir Roy McNulty,[11] which recommended less prescriptive franchises allowing operators to respond to the market and restructuring the rail industry to reduce costs and public subsidy.

The delay did not greatly reduce the procurement timescale but the Department no longer had any contingency within the existing contract despite the significant changes it still needed to finalise (**Figure 4**).

11 Sir Roy McNulty, *Realising the potential of GB rail: final independent report of the rail value for money study*, May 2011.

Figure 4

The Department's timetable for the InterCity West Coast franchise competition

Stage	Description	Planned date	Actual
Initiating the competition	The Department publishes a notice in the *Official Journal of the European Union* inviting expressions of interest from train operating companies.	January 2011	11 January 2011
Shortlisting of bidders	The Department announces a shortlist of bidders.	29 March 2011	24 March 2011
Publishing the franchise requirements	The Department issues the Tender, setting out the proposition for which it will seek bids from the shortlisted bidders.	10 May 2011	20 January 2012
Bid preparation	The bidders prepare bids.	May to August 2011	January to May 2012
	The bidders submit their bids to the Department.	17 August 2011	4 May 2012
Bid evaluation and negotiation of bids	The Department evaluates the bids, and works with bidders to clarify, negotiate and agree the terms of the franchise agreement and related documentation.	August to December 2011	May to August 2012
	The Department announces the winning bidder.	5 December 2011	15 August 2012
Mobilisation	The franchisee prepares to transfer operations.	December 2011 to March 2012	N/A
Franchise starts	New contract for the franchise begins, lasting till 2026.	1 April 2012	N/A

Source: National Audit Office review of the Department's published information

Changes in franchising

3.4 The InterCity West Coast was the first franchise to incorporate changes including:

- the new GDP compensation mechanism to replace its previous revenue support system which was called 'cap and collar' (see paragraph 3.5); and
- stress testing bids' sustainability in prolonged economic downturns in response to the Committee of Public Accounts' recommendations following the termination of the InterCity East Coast franchise.[12]

Improving incentives for operators

3.5 Under 'cap and collar', from the fourth contractual year the Department reimbursed operators 80 per cent of the shortfall if actual revenue was lower than forecast in their bids. The Department was concerned that this introduced perverse behaviours by:

- encouraging operators to submit over-optimistic bids as they would receive up to 80 per cent of the difference between their bid and actual revenue; and
- incentivising providers to cut costs rather than invest to increase revenue once they are in support, as they will receive 100 per cent of the benefit of cost-cutting measures but only suffer 20 per cent of associated lost revenue.

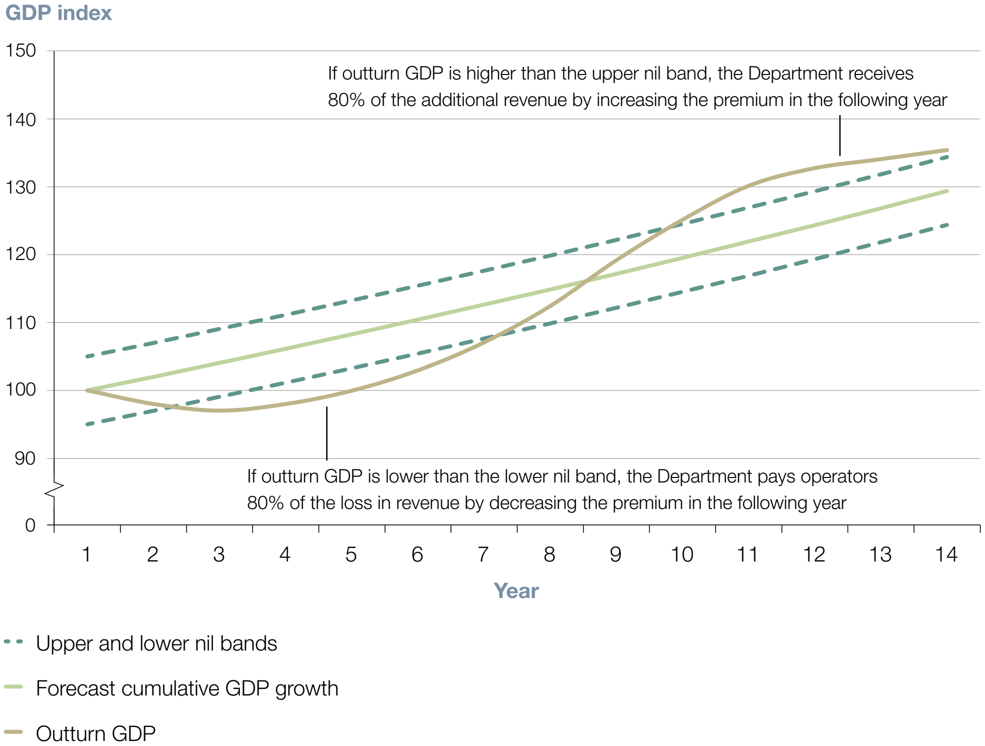
3.6 To address this, the Department developed a GDP compensation mechanism, which it planned to use for the first time on the franchise. It would adjust premium payments from the first year of operation if actual GDP differed significantly from forecasts used in the bidding process.

- There is a band of 5 per cent above and below the central forecast in which no payments would be made (**Figure 5**).
- Otherwise, if the cumulative change in annual GDP growth was less than forecast, the Department would reimburse operators with 80 per cent of the difference in revenues attributable to this change. Conversely if the cumulative change was greater than forecast the operator would reimburse the Department with 80 per cent of the difference.
- As premiums are adjusted in the following financial year, the mechanism provides greater budgeting certainty to the Department than under 'cap and collar'.
- The mechanism meant that operators would hold the risk that they could not deliver their initiatives to increase passenger revenue while the Department would hold the risk that revenue would be lower than forecast due to poor economic growth.

12 HC Committee of Public Accounts, *Department for Transport: The InterCity East Coast Passenger Rail Franchise*, Thirty-ninth Report of Session 2010–2012, HC 1035, July 2011.

Figure 5
The GDP compensation mechanism

The premium payments the Department will receive from an operator will depend on how outturn GDP compares to the forecast at the time the franchise was let



NOTES

1 The 'outturn GDP' projection is hypothetical to illustrate how the Department would adjust the premium payment.

2 No payments are made between the upper and lower nil band which are set 5 per cent above and below the forecast GDP respectively.

Source: National Audit Office analysis

3.7 To test the mechanism the Department built a 'GDP resilience model', which it populated with 500 scenarios of GDP growth over the life of the franchise. The Department used assumptions about how operators would behave when making losses to forecast the number of scenarios in which they would default on contractual obligations (the default rate). The Department's board investment and commercial subcommittee approved a target default rate of less than 5 per cent of the 500 economic scenarios.

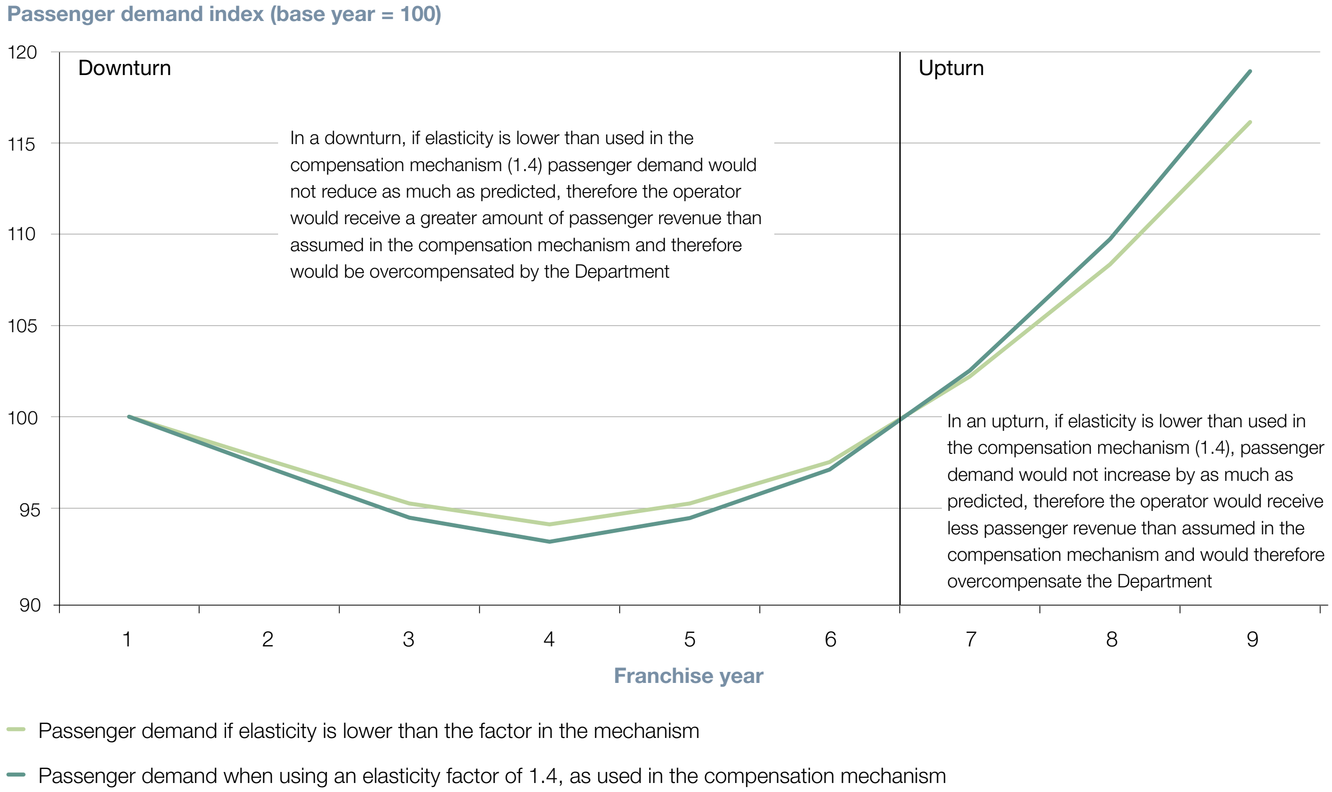
3.8 Although as yet unused, the GDP compensation mechanism would have addressed the perverse incentives of 'cap and collar'. Analysis by Grant Thornton showed that the GDP compensation mechanism reduced the risk of operator failure by providing support from the first year of operation and provided the Department with more stable budgets. Testing the mechanism's sensitivity to a range of economic scenarios was a reasonable response to recommendations by the Committee of Public Accounts.

Relationship between GDP and passenger demand

3.9 A crucial assumption in the model is the elasticity of passenger demand. This is a measure of how responsive passenger demand is to changes in GDP. Higher elasticity means that passenger demand is very responsive – so the number of passengers grows substantially during an upturn, but also falls substantially during a downturn. If the actual level of elasticity is lower than the value used to set the mechanism, the Department will over-compensate operators in a downturn. This is because passenger demand would not reduce as much as forecast, therefore the operator would receive a greater amount of passenger revenue than assumed in the model, which would be used to set the compensation for operators (**Figure 6**).

Figure 6
Illustration of the effects of actual elasticity compared to that used in the GDP mechanism

If the elasticity of demand is lower than the factor used in the mechanism this can lead to the Department overcompensating operators in a downturn



Source: National Audit Office analysis

3.10 The board investment and commercial subcommittee approved an elasticity factor of 1.4 on 15 December 2011. The subcommittee made its decision in the knowledge that:

- if actual demand elasticity was higher than the 1.4 used in setting the GDP mechanism then the risk of provider failure would increase; and
- if bidders thought the GDP mechanism understated true elasticity then they would reflect this through higher margins at a cost to the taxpayer.

The 1.4 elasticity factor was lower than the demand elasticity for long-distance rail journeys of 1.8 derived from the Department's published guidance[13] when it was developing the GDP mechanism but was based on guidance it was considering at the time and has since adopted.[14] This decision was to prove significant for the size of the subordinated loan facility (see paragraphs 4.6 and 4.18).

Readiness to go to tender

3.11 In November 2011 the Department carried out a 'hostile review' on the franchise policy such as the specification to test its readiness to go to tender. This was a sensible challenge for management in which experts reviewed changes, including the GDP mechanism, to test the robustness and coherence of the tender. The review was carried out late however, and during our fieldwork we did not see evidence that the Department addressed all of the extensive issues that had been identified before the competition started. The review is not a replacement for management oversight and it did not identify the problems with the evaluation tool that subsequently came to light.

3.12 In December 2011 a joint meeting of the contract award committee and rail refranchising programme board approved the letting of the Tender, which was endorsed by the board investment and commercial subcommittee and ministers. HM Treasury approved the Tender for issue in January 2012 but only as a pilot which would inform the Department's development of franchises. HM Treasury raised concerns about the risk profile of the franchise programme and the potential implications on its affordability.

13 The Department's guidance used assumptions from *Passenger Demand Forecasting Handbook* version 4.1 for demand elasticity until August 2012, when it adopted the assumptions from version 5.

14 It is widely accepted in the industry that there is a log linear relationship between GDP and demand. This means that premiums are adjusted by the cumulative difference between forecast and outturn GDP raised to the power of the chosen elasticity factor. Applied over 15 years the choice of elasticity factor can have a very significant impact on the level of premiums which the Department receives and the compensation it would have to pay should GDP be less than forecast.

Part Four

The franchise competition

4.1 This part covers the period from January 2012, when the Department issued the Tender, to awarding the contract on 15 August 2012. The key activities during this period were as follows:

- The four shortlisted bidders developed their bids based on tender documents, information and assumptions the Department provided including GDP forecasts and their relationship to passenger demand, and responses to clarification questions raised with the Department. The bidders submitted bids on 4 May.
- The Department evaluated the bids between May and July. It did so by reviewing compliance with the Tender requirements, assessing their deliverability and the value of premium payments (the amount of money a bidder is offering for a franchise), and calculating the subordinated loan facility required based on the size of risk adjustments applied to their cost and revenue projections.
- The Department identified a leading bidder primarily based on the value of premiums which its board investment and commercial subcommittee and its ministers endorsed. If two or more bidders had total premiums with a present value within £200 million the Department would also have used the deliverability scores to select a preferred bidder.
- Following the completion of its internal procurement processes the Department sought HM Treasury approval to enter into the new franchise contract, which was given on the receipt of assurance that the Department was satisfied this represented value for money for the taxpayer.

4.2 In this section we highlight the key issues which occurred first during the competition, and then those which have since come to light.

Problems during the competition

4.3 It became apparent that there were problems with the competition after the Department released the Tender:

- The Department had not developed a tool to calculate the subordinated loan facility value.

- The Department had not thought through how it would provide bidders with information to predict the likely size of their subordinated loan facility, given that the Department had changed how it would be calculated.
- Ownership of the project was unclear.

Lack of evaluation tool

4.4 The Department had to guard against a risk that bidders offered large premiums based on over-optimistic projections of revenue growth. If the franchise is profitable, the risk to bidders from not achieving these projections reduces over the contract, as should they default they will have already generated considerable profit. The Department regards any bidders' margin over 5 per cent, the performance bond[15] and the subordinated loan facility as key protections against the risk of overbidding leading to default. The subordinated loan facility is capital provided by the bidder's parent company, used to cover operator losses, protect the Department against default and to guarantee premium payments. In past franchises the subordinated loan facility was typically small. For example National Express provided a subordinated loan facility of £40 million for the InterCity East Coast contract in 2007.[16]

4.5 The Department introduced the following two significant changes to the subordinated loan facility for the franchise:

- value would be determined by testing against a range of economic scenarios and not a central projection as was the case previously; and
- capital had to be guaranteed by a third party.

4.6 The Department's policy of ensuring bids were resilient to an economic downturn, which it delivered by changing how the subordinated loan facility was calculated, had a significant impact on the capital structure of bidders' proposals. For the subordinated loan facility to serve its primary purpose (to protect the taxpayer against the franchisee failing to pay the contracted premiums) it needed to be calculated using bidders' risk adjusted costs and revenues (Paragraph 4.21) but the Department had to decide on the level of risk transfer it was comfortable with. This process was important, as were the Department to transfer a small amount of risk to the bidder and request a subordinated loan facility which was too low, it would provide inadequate protection to the taxpayer. Conversely, if the Department transferred a large amount of risk and requested a loan which was high then the provider would respond through higher margins and lower premiums. We are unclear whether the Department fully appreciated the impact its decisions on the level of elasticity factor in the GDP mechanism and the target default rate would have on the size of the subordinated loan facility. The Department informed bidders of the new policy on the subordinated loan facility but not its method for calculating it.

15 The performance bond is additional to the subordinated loan facility and is designed to cover the cost to the Department of running services and reletting a franchise if the operator defaults.

16 Comptroller and Auditor General, *Department for Transport: The InterCity East Coast Passenger Rail Franchise*, Session 2010-11, HC 824, National Audit Office, March 2011.

4.7 The Department could learn from the approach taken by bodies elsewhere in the public sector, such as economic or financial services regulators, which have to form judgements on capital structure, cost of capital and capital adequacy. In these cases there are formal processes of consultation and dialogue with industry that follow well-established practice. The regulator scrutinises and challenges the private sector's proposals sceptically and supplements private sector analysis with its own. In contrast, the Department relied on its own analysis to support its judgement. This created a risk of insufficiently reviewed and challengeable assumptions and analysis, which subsequently occurred.

4.8 The Department appointed Grant Thornton in November 2011 to help analyse the impact of the GDP mechanism and how the size of the subordinated loan facility would change under various scenarios. Grant Thornton's report illustrated that the size of the subordinated loan facility was sensitive to the parameters the Department set and the margin bidders sought. It is not clear how the Department used this report when it received it in March 2012.

4.9 The Department did not have a method to calculate the subordinated loan facility when the Tender was released, and decided to use its GDP resilience model as it did not have time to develop a bespoke tool. At that time the Department had no standard quality assurance arrangements for models used in procurement decisions. The Department should have carried out additional quality assurance checks. It was using the tool to calculate a subordinated loan facility that could have ruled bidders out of the competition due to its size and was therefore open to challenge.

Lack of information

4.10 Given the cost and difficulty in raising capital, bidders had a strong interest in understanding how their subordinated loan facility would be calculated and given there had been a change in the method they sought more information. In response to bidders' requests for transparency, the Department issued guidance on 24 February stating that the subordinated loan facility would be calculated using the GDP resilience model. The Department did not give bidders the model because it simplified cost and revenue models and contained assumptions about operators' behaviour which it did not wish to share.

4.11 Instead it issued a generalised set of results from the GDP resilience model that set out the likely size of the subordinated loan facility under various circumstances, called a 'ready reckoner' (**Figure 7**). This provided some more information, but bidders still could not calculate their subordinated loan facility as they did not know the risk adjustments the Department would apply.

4.12 It is unclear where and when the Department decided to use the GDP resilience model to calculate the subordinated loan facility and issue the guidance including the 'ready reckoner'. This is concerning given the significant commercial implications of these decisions. Stronger management oversight of the franchise may have allowed the Department to foresee and manage the risk that the lack of transparency around the methodology for calculating the subordinated loan facility created.

Figure 7
The Department's 'ready reckoner'

This is the table the Department gave to bidders for illustrative purposes and was intended to clarify how much financial support might be required

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

Source: Department for Transport

4.13 Bidders used clarification questions to ask the Department about a range of issues including how the subordinated loan facility would be calculated. We could not confirm that all bidders' enquiries received a response, or that the replies were consistent. The Department maintained a log of 'clarification questions' received from bidders, not all of which appear to have been answered. In addition, the Department communicated with bidders individually. During a conference call, Virgin sought further clarification on the Department's purpose for the subordinated loan facility and it was informed that the Department did not require 'skin in the game', if the Department's assessment did not require one, that is for Virgin to have their money at risk should they default. If Virgin had a margin of at least 5 per cent and its bid revenue and costs were not risk adjusted then it would not be required to provide a subordinated loan facility.

Lack of ownership

4.14 Under the governance arrangements for the franchise the senior responsible owner was due to change from policy to delivery staff when the Tender was issued. It is unclear that this change occurred as intended, which left the project without a clear senior responsible owner from January to March.

4.15 In March 2012 the Major Projects Authority identified an issue with the governance for the whole refranchising programme. The key changes it recommended were introduced during the competition but were not fully implemented on this franchise:

- A single senior responsible owner should be accountable for the entire franchise programme including individual franchise projects.
- A programme office, led by a programme director, to be responsible for managing the programme and supporting the senior responsible owner.

Problems leading to the cancellation

4.16 Further problems with how bids were evaluated that have come to light leading to the competition being cancelled are how the Department:

- calculated the subordinated loan facility value using the tool;
- applied the results of the evaluation tool, and
- approved and assured the decision.

Problems with the evaluation tool

Inflation

4.17 The subordinated loan facility should be adequate to protect the Department against potential losses in any given year by considering the effects of inflation across the whole contract (nominal terms). However, the GDP resilience model (and hence the 'ready reckoner') calculated the subordinated loan facility in 2010 prices (real terms). This had a significant effect on the size of the loan that the Department requested. For example the loan of £252 million which the Department calculated for First Group would have been around £355 million in nominal terms.[17]

Choice of elasticity factor

4.18 There was inconsistency in the use of elasticity factors in the bidding process. The Department used the latest data to derive a factor of 1.4 in the GDP mechanism and in sizing the subordinated loan facility. This reduced the risk it would overcompensate bidders in a downturn and that the subordinated loan facility would be unaffordable to bidders. However, it risk-adjusted bids using a passenger demand elasticity factor of 1.8. In sizing the subordinated loan facility, if the Department had used an elasticity factor of 1.8, instead of the 1.4 actually used, and retained the 5 per cent target default rate and corrected for inflation, the subordinated loan facility would have increased by over 250 per cent for one bidder. We are not commenting on what size the subordinated loan facility should have been, but illustrating the model's sensitivity to these factors and the inconsistency in the Department's use of the elasticity factors.

Problems applying the results of the evaluation tool

4.19 From May, a small departmental team, supported in respect of specific aspects by external advisers, Atkins and Eversheds, evaluated the bids to ensure they were compliant with the Department's guidance, and to identify a preferred bidder following four stages:

- **Compliance with guidance** – Bids which had incorrectly interpreted guidance would have been disqualified.
- **Deliverability** – Each bid contained ten delivery plans which two evaluators from the Department and two from its technical advisers, Atkins, scored before agreeing an overall mark. Any bid judged undeliverable would have been disqualified. Some internal evaluators ran out of time and not all plans received the intended level of assessment.
- **Net present value of premiums** – This was the main criterion the Department used to select the preferred bid. For this franchise the Department took 100 per cent of premiums for the core period of 13 years four months and 50 per cent of premiums for the optional 20-month extension period.

17 The £252 million was calculated by the Department using its 'ready reckoner'. PwC calculated the £355 million using the Department's GDP resilience model and adjusting for inflation.

- **The subordinated loan facility** – The higher the risk in a bid the greater the subordinated loan facility a bidder would have to provide. Atkins adjusted revenues and costs in each bid based on their forecasts and assessed deliverability. They also adjusted bids so that they contained the same external assumptions. The Department used the risk-adjusted revenue and costs to calculate the subordinated loan facility over the core franchise only, as it decided it would not require bidders to raise capital for a contract period they may not be awarded.

The risk adjustment process

4.20 Grant Thornton had previously confirmed that if the Department applied a significant risk adjustment the resulting subordinated loan facility might not be commercially viable. For example, if the Department thought that 2 per cent of annual revenue projections were undeliverable, this could require a subordinated loan facility increase of at least £296 million to achieve the Department's target default rate (paragraph 3.7).

4.21 Atkins applied significant risk adjustments to the revenue growth that both Virgin and First Group forecast from initiatives such as marketing and improving products and services. The two leading bids showed similar profiles of passenger revenue up until 2016-17, at which point First Group's revenue diverged significantly from Virgin's, driven by higher expectations of growth in passenger journeys reflected in higher costs.

Agreeing revenue projections

4.22 Before selecting a preferred bidder the Department needed assurance from bidders that they could guarantee the subordinated loan facility the Department had calculated. On 19 June 2012 the contract award committee agreed indicative levels which the two leading bidders, Virgin and First Group, were told. These indicative levels were based on an initial assessment. On 27 June, the committee approved final values for all bidders.

4.23 Bidders' models were complex and were derived using different methodologies, making assessment challenging. Between 19 and 27 June 2012, Atkins identified that First Group had increased passenger demand figures in 2012-13 because actual demand was higher than that predicted in the Department's assumptions. This had the effect of increasing passenger revenue in all subsequent years. Atkins told us the scale of the change was not detected earlier due to the lack of clarity in First Group's record of assumptions and model, and because Atkins prioritised examination of other parts of the model which were thought more likely to require large risk adjustments.

4.24 After seeking clarification from First Group, Atkins advised that there was evidence to apply an increase to passenger numbers but did not accept the full amount calculated. Based on Atkins' analysis, the Department decided to apply two-thirds of First Group's assumption to the bids, which reduced Virgin's subordinated loan facility requirement but increased that for First Group. It is unclear whether this complied with the evaluation process outlined in the Tender, which implied that the Department would either wholly accept alternative assumptions and apply them to all bids, or reject the alternative assumption.

Applying discretion in deciding the subordinated loan facility

4.25 When it approved the final values of the subordinated loan facility on 27 June 2012 the contract award committee applied discretion, which it thought it was entitled to do, to the numbers produced by the 'ready reckoner'.[18] This led to the unequal treatment of the two leading bidders. The Department asked Virgin for a subordinated loan facility of £40 million when its calculations showed none was required, while it reduced the total capital required from First Group from £252 million to £190 million, after taking account of £10 million equity included in the bid.

4.26 While the tender stated that the Department would 'determine' the size of the subordinated loan facility, the guidance it subsequently issued stated that it would use the GDP resilience model to do this. Although not at the meeting, Eversheds, its legal advisers, subsequently raised concerns with the Department that it may not have been entitled to apply discretion when it found out that this had occurred. This advice was not escalated to members of the board investment and commercial subcommittee, the Permanent Secretary or ministers. Nor were they informed that discretion had been applied. Eversheds' concerns were also not fed back to the contract award committee.

Problems with assurance and approving the decision

4.27 The Department's evaluation criteria stated that, if all bids were judged to be deliverable, it would choose the winning bid primarily on the value of premium payments. It would only consider delivery scores further if the premiums of two or more bids were within £200 million. The evaluation team proposed awarding the contract to First Group because the net present value of its premium, at £5.5 billion, was £600 million higher than Virgin's who had a higher overall deliverability score (Virgin had a deliverability score of 64.5 compared to 60.9 for First Group). The evaluation team presented this information, anonymously, to the contract award committee which approved the award decision in July 2012.

Assurance

4.28 Two internal audit reports identified issues with governance arrangements relevant to the franchise. Against the defined scope of work, both received a substantial rating, which meant that systems were well-established and working effectively with minor weaknesses found. But these assurances seemed at odds with some of the specific findings contained within the reports:

- In May 2012, an internal audit report on rail governance found there was no standard governance route and individual projects were determining their own approval routes. This risks insufficient oversight and challenge of projects by decision-makers.
- A review of the contract award committee identified that, while its terms of reference were defined, the minimum number of decision-makers was unclear, as was how far in advance of meetings they should be given information.

18 The 'ready reckoner' produces different results to the GDP resilience model. However, these are small in comparison to the other issues with the subordinated loan facility size, such as inflation. The Department chose to calculate the subordinated loan facility from the 'ready reckoner' because it had been provided to bidders.

4.29 The Department's internal audit was not invited to review the franchise competition while it was underway as management felt there was sufficient assurance around the project. Internal audit was encouraged to do a lessons learned review once the contract had been signed. Our report *The effectiveness of internal audit in central government*[19] found that, across government, internal audit does not consistently focus on key risks and its senior customers are not clear on what they should expect from an effective internal audit.

4.30 On 18 July 2012 the Major Projects Authority carried out a three-day review of the project. This was a standard review on the investment decision, which is normal practice on a major project approaching contract award, using a scope agreed with the Department. It comprised document review and interviews, and sought to gain assurance by giving those involved with the project a confidential environment to raise any issues. It was not designed to provide independent assurance on the modelling and the calculations. Based on the evidence provided, it gave the project a green rating, stating that the Department was well placed to award the contract. Senior management in the Department took comfort from this review.

4.31 There are limitations in the assurance that can be taken from gateway reviews given their timescale and scope. In *Assurance for high risk projects*[20] we reported on several limitations to gateway reviews, including that they tend to be opinion based. The review team relies on the Department's evidence including its own assurance processes. Such reviews are intended to provide a high level, external overview of a project at key decision points, principally to identify whether there are any concerns about its readiness to progress to the next stage. They are not designed to provide a detailed audit of past decisions.

4.32 Senior managers took too much comfort from various assurance processes and reviews with clearly defined but limited scope which are not a substitute for good line management.

Approval

4.33 The board investment and commercial subcommittee queried the process by which the preferred bidder had been selected when it considered the contract award on 31 July. At the start of the meeting they were informed that the Department had received correspondence from a bidder raising questions about the process that had been followed:

- Between 22 June and 23 July, Virgin wrote several times to the Department raising its concerns with the franchise process. On 30 July it wrote again requesting information and raised the possibility of judicial review.

19 Comptroller and Auditor General, *HM Treasury: The effectiveness of internal audit in central government*, Session 2012-13, HC 23, National Audit Office, June 2012.
20 Comptroller and Auditor General, *Assurance for high risk projects*, National Audit Office, June 2010, available at: www.nao.org.uk/publications/1011/project_assurance.aspx

- The subcommittee sought and received assurance about the process. It did not consider initiating an independent review of the procurement process at this stage, but asked for further information from the project team and held a follow-up meeting two working days later where it endorsed the contract award decision. There were significant changes in the attendance of committee members between the two meetings, with minutes showing only the Chair and one other member attending both. We question the effectiveness of the assurance obtained at the second meeting because there was a lack of continuity between members.
- The senior responsible owner, Permanent Secretary and others became aware of the identity of the preferred bidder as a result of Virgin's letters. As they would no longer be making an anonymous decision, they were advised not to take part any further in the contract award decision.

4.34 The events leading to cancelling the franchise highlight the importance of having a clear governance framework to select the preferred bidder. There were issues with how the contract award committee and board investment and commercial subcommittee operated:

- Individual project teams provide the secretariat for the contract award committee. On the franchise this resulted in confusion over who should attend the meetings, with only two members attending all meetings, and papers for the meeting considering the size of the subordinated loan facility circulated too late for members to consider them. There is no guidance on the content of papers and information project teams submitted to the Committee.
- There is confusion within the Department about how the board investment and commercial subcommittee makes decisions, and its role. For example, it was not clear to the project team that the subcommittee's role was not just to endorse decisions but also to independently scrutinise them.
- The project team had significant influence over the minutes of meetings of both committees, either writing them or being given first opportunity to comment. On this project documentation was poor as there are multiple and contradictory versions of minutes for key meetings.

4.35 The Department's use of anonymity had a perverse effect once Virgin started to raise complaints. Individuals were unable to participate as decision-makers once they knew the identity of the preferred bidder. But we do not consider that this should have prevented them from scrutinising the project processes.

4.36 On 15 August the Department announced it intended to award the contract to First Group and to sign the contract on 29 August following a standstill period. Treasury ministers approved the Department's decision, having previously sought assurance from the Department that Virgin's concerns were not justified.

Part Five

The Department's actions since 15 August 2012

5.1 This part of the report explains how the Department is seeking to learn lessons and understand the costs of cancelling the competition.

Preparing for legal proceedings

5.2 Virgin launched legal proceedings on 28 August, the day before the Department had been due to sign the new franchise contract with First Group. As a result, the Department did not sign and began preparing to defend its case in court.

5.3 The Department cancelled the franchise competition on 3 October because its analysis had identified flaws in the procurement and decision-making process that it had followed to reach the value of the subordinated loan facility. These flaws included an undetected error in the model, which was highlighted in work the Department had commissioned from PricewaterhouseCoopers (PwC) in preparation for its legal defence.

5.4 PwC examined how a number of factors would have influenced the size of the subordinated loan facility that Virgin and First Group were asked to provide, including:

- an alternative assumption for passenger demand (based on a revised starting point in 2012-13) applied by the Department in evaluating all bids (paragraphs 4.23 to 4.24);
- the choice of elasticity factor used to size the subordinated loan facility (paragraph 4.18); and
- whether the subordinated loan facility was calculated based on the core contract period of the 13 years and four months, or the core and extension period (paragraph 4.19).

PwC did not advise the Department on what decision it should have made concerning these factors. Its work was intended to inform the Department's preparation to defend the legal challenge by Virgin.

Reviews

5.5 It is commendable that once uncovering the problems the Department has sought to be open about what has happened, investigated further and is seeking to learn lessons.

5.6 The Department is also undertaking a number of other reviews to identify whether any systemic weaknesses might affect its other projects and programmes:

- It is contributing to a government-wide review of quality assurance processes for business critical Government analytical models led by HM Treasury. Immediately after the competition cancellation, the Department asked the Chief Economist from the Department for Business, Innovation and Skills to do a rapid, high-level review of its quality assurance processes of models.
- The Department asked reviewers from other government departments to examine the procurement processes for the Thameslink and Intercity Express Programme rolling stock, Search and Rescue helicopters and the sale of the shared service centre. The objective of the reviews was to provide confidence, through assurance, that the procurements had been conducted appropriately. Overall, the substantial findings were that the procurement processes, controls and measures were consistent with common public sector practice.
- Internal audit reviewed the quality assurance and governance procedures for the Thameslink rolling stock model and commissioned PwC to review the quality assurance and governance procedures over the rail business models for High Speed 2 and certain aspects of Thameslink's.

We will follow up these findings on High Speed 2 and Thameslink in our reports on these programmes in 2013.

Costs

5.7 The Department has initiated a project to identify the costs of cancelling the competition so that it can correctly account for them. The Department will not know the full cost until it has decided its response to the findings of its reviews and concluded negotiations with bidders. It has identified that costs may arise in seven areas, which we will review as part of our financial audit of the Department's 2012-13 accounts:

- Staff costs and the cost of external advisers working on the cancelled competition are £1.9 million. This comprises £0.9 million internal and agency staff costs and £1.0 million for external advice on the competition.
- The Department estimates the cost of professional fees related to the judicial review as £2.7 million.
- The Department forecasts that external advisers on the reviews it commissioned will cost £4.3 million.
- The Department will need to refund the costs that bidders incurred on the InterCity West Coast competition including costs First Group incurred between August and October to prepare to take over the franchise. This is likely to be the most significant cost for the Department from cancelling the competition.
- There are costs of Directly Operated Railways preparing a contingency plan to take over the Intercity West Coast franchise.[21]
- A potential major opportunity cost to the Department is the lack of investment in the franchise while it runs another competition. The Department is also contemplating negotiating extensions to a number of franchises, including the InterCity West Coast franchise while competitions are suspended.
- The Department may incur internal and bidders' costs if it chooses to cancel competitions it has paused – on Great Western, Essex Thameside and Thameslink[22] – following the findings of the Brown review.

21 Directly Operated Railways was established by the Department in July 2009 to fulfil the Secretary of State's requirements under the Railways Act to secure the continued provision of passenger railway services should an existing franchisee not be able to complete its full term.

22 The Department has paused two franchise competitions that were underway and a third, Thameslink, which had not reached the invitation to tender stage.

Appendix One

Our audit approach

This study examined the process the Department went through and reasons for the cancelling the InterCity West Coast franchise competition. It also considered how effectively the Department's safeguards against making poor decisions operated in this case. We reviewed:

- the events and the Department's process between May 2010 and October 2012 when the Department announced it was cancelling the franchise competition;
- the flaws and the contributory factors which led to cancelling the franchise competition; and
- the Department's actions after cancelling the competition.

Our audit approach is summarised in **Figure 8** overleaf. Our evidence base is described in Appendix Two.

Figure 8
Our audit approach

Objective of government

The Department for Transport is responsible for the oversight of passenger rail franchising. Its objective is to obtain value for money by incentivising operators to: invest in the network; work in partnership with Network Rail to deliver better services, rolling stock and stations; and tackle costs.

How this will be achieved

The Department is responsible for the specification and procurement of each franchise. Franchises are run by privately owned train operating companies, which are given the rights to run passenger services for a specified period on a specified part of the network. Train companies bid for franchises on the basis of the Department's specification, service quality and the amount of subsidy they require or the premium they would be prepared to pay to run these services.

Our study

The study examined the process the Department went through and reasons for the cancellation of the InterCity West Coast franchise competition. It also considered how effectively the Department's safeguards against making poor decisions operated in this case.

Our key questions

What happened between 2010 and October 2012 when the Department announced the cancellation of the competition?

What were the flaws and contributory factors which led to the cancellation of the InterCity West Coast franchise competition?

What were the Department's actions following the cancellation of the competition?

Our evidence (see Appendix Two for details)

- We reviewed departmental documents to **establish the events during this period**.
- We attended interviews **to understand staff roles**, **process followed during the period and decisions made**.

- We reviewed **previous NAO work.**
- We reviewed the **Department's** and **Major Projects Authority's documents**.
- We analysed the **Department's model** used in the InterCity West Coast competition. For aspects of this we placed reliance on work carried out by Grant Thornton and PricewaterhouseCoopers.

- We reviewed the Department's **financial information** on the costs of cancelling the competition.
- We reviewed the **terms of reference for the two independent inquiries** led by Sam Laidlaw and Richard Brown CBE.

Our conclusions

The Department's conduct in the InterCity West Coast franchise competition was not value for money and is likely to result in significant cost for the taxpayer, the full value of which is not yet known. The Department lacked:

- clarity of objectives;
- strong project and programme management;
- senior oversight to act as a sense check;
- effective engagement with stakeholders; and
- internal and external assurance.

Their failure to operate effectively in this case inevitably raises wider questions, since each area is a product of the broader management approach of the Department.

Appendix Two

Our evidence base

1 Our independent review of the cancellation of the InterCity West Coast competition was completed following our analysis of evidence collected between October and November 2012. Our audit approach is outlined in Appendix One.

2 We reviewed what happened between May 2010 and October 2012 when the Department announced it was cancelling the competition.

- We examined the majority of documents the Department provided to the Laidlaw inquiry and the Department's published documents to **establish the events during this period**.
- We attended interviews organised by the Laidlaw inquiry with the Department's officials, legal advisers, technical advisers, HM Treasury and the Major Projects Authority involved in the InterCity West Coast franchise competition **to understand staff roles, process followed during the period and decisions made**.
- We undertook semi-structured interviews with the Department's officials, Eversheds law firm, Association of Train Operating Companies, Virgin Trains, First Group, Keolis, Abellio, HM Treasury and the Major Projects Authority **to understand staff roles, process followed during the period and decisions made**.

3 We reviewed the flaws and the contributory factors that led to cancelling the InterCity West Coast franchise competition.

- We analysed the **Department's model** used in the InterCity West Coast competition to understand its purpose, how it was developed, the quality assurance it received and the decisions it was used to support. For aspects of this we relied on work carried out by Grant Thornton and PricewaterhouseCoopers.
- We examined the **refranchising programme delivery plans; board and committee minutes and papers; and Major Projects Authority reports** to understand the governance structures and programme timetable.

- We drew on evidence from **previous NAO work**, particularly *Reducing costs in the Department for Transport*[23] and *The InterCity East Coast passenger rail franchise.*[24]

4 We reviewed the **Department's actions after cancelling the competition.**

- We reviewed the **Department's financial information** on the costs of cancellation.
- We examined the **terms of reference for the two independent inquiries**.

23 Comptroller and Auditor General, *Department for Transport: Reducing costs in the Department for Transport*, Session 2010–2012, HC 1700, National Audit Office, December 2011.

24 Comptroller and Auditor General, *Department for Transport: The InterCity East Coast Passenger Rail Franchise*, Session 2010-11, HC 824, National Audit Office, March 2011.

Appendix Three

Chronology of events

Date	Details
July 2010	The government launched a consultation on rail refranchising policy. It considered alternative mechanisms for managing risk within a revised franchise contract.
June to September 2010	The Department considered but declined an offer from Virgin to extend its franchise by two years from March 2012 to 2014.
11 January 2011	The Department put a notice in the *Official Journal of the European Union* inviting train operating companies to express an interest in running the franchise.
19 January 2011	The Department launched a consultation to inform stakeholders of the franchise award process, the aims and objectives and the proposed franchise specification.
24 March 2011	The Department announced the four train operating companies it had shortlisted to bid for the franchise: • Abellio InterCity West Coast Limited (NV Nederlandse Spoorwegen); • First West Coast Limited (FirstGroup plc); • Keolis and SNCF West Coast Limited (Keolis SA and SNCF); and • Virgin Trains Limited (Virgin Group Holdings Limited).
20 April 2011	A Major Projects Authority review of the rail refranchising programme highlighted problems in resourcing and lack of programme management. An amber rating was given.
10 May 2011	The Department delayed the competition to launch a second consultation.
October 2011	The Department agreed an extension of the franchise with Virgin Rail Group from March to December 2012, as the consultation impacted on the competition timetable.
November 2011	The Department carried out a ‘hostile review’ of the franchise specification including the GDP mechanism over three sessions to test its readiness to go to tender. The review contained extensive recommendations.

December 2011	The contract award committee and rail refranchising programme board approved the letting of the Tender. This decision, including the parameters for the GDP resilience model, was endorsed by the board investment and commercial subcommittee and ministers.
January 2012	HM Treasury approved the Tender as a pilot which would inform the Department's development of future franchises. HM Treasury raised concerns about the risk profile of the franchise programme and the potential implications on its affordability.
20 January 2012	The Department issued the Tender, setting out the InterCity West Coast proposition for which it was seeking bids, with a response deadline of 1 May 2012.
January to March 2012	It was unclear whether the handover between the two senior responsible owners responsible for policy and delivery of the project respectively occurred as intended. This left the project without a clear senior responsible owner from January onwards. The Department did not finalise a method for calculating the subordinated loan facility from bidders when it issued the Tender and there was no time to develop a bespoke tool. The Department decided to use the GDP resilience model to calculate the subordinated loan facility. On 24 February the Department gave supplementary guidance to bidders on how the subordinated loan facility would be calculated using the GDP resilience model. The Department issued a generalised set of results which set out the likely size of the subordinated loan facility under various circumstances called a 'ready reckoner'. The Department commissioned Grant Thornton to review the GDP mechanism. Its report in March 2012, provides a suggested level of subordinated loan facility, more in the region of what it should have been if it had been correctly calculated in nominal terms. Bidders raised issues with the Department about the guidance and lack of transparency of the process. The first was sent on 2 March.
Early 2012	Franchising policy was changing. The Department decided a minimum subordinated loan facility would be required from all future franchisees for Great Western and Essex Thameside franchises.
29 March 2012	The Major Projects Authority examined the rail refranchising programme. Its report noted significant concerns with resourcing and management. A amber-red rating was given. The Department changed its governance structures as a result by introducing a single senior responsible owner and a programme management office.
4 May 2012	The bidders submit their bids, extended from the original deadline of 1 May.
May to June 2012	A small team at the Department and Atkins evaluated and risk adjusted the bids.
13 June 2012	The Major Projects Authority completed a follow up review of the rail refranchising programme. It gave an improved rating of amber.

19 to 27 June 2012	The contract award committee agreed indicative levels of the subordinated loan facility for the two leading bidders based on an initial assessment by Atkins. The bidders were informed on the same day, so that they could confirm if they could get the funding in place. On 22 June Virgin wrote to the Department querying the level of indicative loan. Atkins identified a difference in the assumptions First Group used to forecast passenger revenue compared to those used by the Department. Atkins and the Department decided to accept two-thirds of the assumptions and apply these across all bids. On 27 June the contract award committee approved the final subordinated loan facility values for the bidders.
29 June to 2 July 2012	The Department was advised by its external lawyers that the contract award committee's actions on 27 June may not have been in line with guidance the Department had issued on the subordinated loan facility. This advice was not escalated to the Department's committees.
3 July 2012	The contract award committee approved negotiations with leading bidders.
18 July 2012	A Major Projects Authority report examining the investment decision for the InterCity West Coast franchise gave it a Green rating.
23 July 2012	Virgin wrote to Secretary of State, copying in the Prime Minister and Chancellor of the Exchequer.
25 July 2012	Contract award committee approved the award of the franchise to First Group.
31 July 2012	Board investment and commercial subcommittee convened to approve contract award committee decision to award to First Group, but asked for more information.
2 August 2012	Board investment and commercial subcommittee reconvenes and endorses the decision to award the franchise to First Group.
August 2012	The Department started to prepare for legal challenge to its decision.
3 to 7 August 2012	Briefings were sent by the Department to the Minister of State, requesting approval of award and on 7 August the Treasury spending team provided advice to the Chief Secretary to the Treasury.
10 August 2012	Virgin wrote to the Department, including ministers, with a report written by consultants raising issues about the subordinated loan facility.
14 August 2012	Officials briefed the Minister of State on the consultants' report and gave reassurance that the assertions did not affect the decision to award the franchise to First Group.

15 August 2012	The Department announced its intention to award the franchise to First Group. The contract was expected to be signed on 29 August 2012, following an obligatory standstill period.
28 August 2012	Virgin Rail Group started high court proceedings demanding a judicial review into the decision to award the contract to First Group.
29 August 2012	The contract was not signed as a result of the judicial review.
3 October 2012	The Department cancelled its provisional decision to award the franchise to First Group. It announced two independent reviews and put three outstanding franchise competitions on hold.
15 October 2012	The Department announced that it is in negotiations with the Virgin Rail Group to extend the franchise for around 9–13 months, while it runs a competition for an interim franchise agreement. The interim agreement, which will be open to any bidders, is to run the franchise until a new long term franchise is agreed.

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