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Department for Transport

# Lessons from cancelling the InterCity West Coast franchise competition

# 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.