



House of Commons
Committee of Public Accounts

**Department for
Transport: Lessons
from cancelling the
InterCity West Coast
franchise competition**

Thirty-first Report of Session 2012–13

*Report, together with formal minutes, oral and
written evidence*

*Ordered by the House of Commons
to be printed 4 February 2013*

HC 813
Published on 26 February 2013
by authority of the House of Commons
London: The Stationery Office Limited
£11.00

Committee of Public Accounts

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The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the internet at www.parliament.uk/pac. A list of Reports of the Committee in the present Parliament is at the back of this volume. Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee is Adrian Jenner (Clerk), Sonia Draper (Senior Committee Assistant), Ian Blair and James McQuade (Committee Assistants) and Alex Paterson (Media Officer).

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Summary

On 3 October 2012, the Department for Transport (the Department), cancelled its decision to award the InterCity West Coast franchise to First Group due to errors in the procurement process. The Department's failure to properly manage the competition will directly cost taxpayers at least £50 million, the majority of which will be spent on compensating bidders. There is also a significant opportunity cost resulting from delays in investment in the franchise. The Department spent £1.9 million on staff costs and external advisers to run the franchise competition—significantly less than the estimated £10 million each bidder spent on their bids. The Department's attempt to make cost savings in running the competition, for example by not employing external financial advisers, ended up costing the taxpayer tens of millions of pounds. These figures relate only to the West Coast Franchise. It is not yet clear whether other franchise competitions will be affected.

The InterCity West Coast competition failed because the Department did not get basic processes right and had failed to learn from mistakes made in previous projects. Recommendations made in our 2010 report *The failure of Metronet* to prevent a lack of oversight and information were clearly not applied in this competition. We are concerned the Department could yet again fail to apply basic processes, which could affect its future projects, including HS2 and Thameslink.

The Department made a number of mistakes when identifying the amount of risk capital (called the subordinated loan facility) it required from bidders to balance the riskiness of their bid. It failed to include inflation in its calculation and also applied discretion in deciding the amount it asked from bidders which was not allowed in the stated process. These errors led to the Department asking First Group for a lower subordinated loan facility than was needed to protect itself from the recognised additional risk in the bid. A higher subordinated loan facility was requested from Virgin Trains. This opened the Department to the risk of legal challenge and ultimately led to the cancellation of the franchise competition.

There was a lack of line management and leadership on the project. This project had no single SRO (Senior Responsible Owner) who was responsible for the project from beginning to end. The Department divided responsibility between developing the policy and implementing the competition. Confusion in the handover between the SROs at the policy and implementation stages, which was meant to happen when the invitation to tender was issued, led to a situation where no SRO was in place for three months. Lack of leadership was made worse by the Department's unique application by General Counsel and others of anonymity for bidders in the franchise competition. As a consequence, the Permanent Secretary was deliberately not allowed to see the details of the competition and commercially confidential information. Despite warning signs, including from industry, the Department's senior management did not sufficiently probe the information provided by the project team. They failed to apply common sense and challenge the outcome of the

competition.

On the basis of a report by the Comptroller and Auditor General,¹ we took evidence from the Department for Transport on the cancellation of the InterCity West Coast franchise competition.

1 C&AG's Report, *Lessons from cancelling the InterCity West Coast franchise competition*, HC 796, Session 2012-13

Conclusions and recommendation

- 1. This competition failed because the Department did not apply basic processes properly.** This is not the first time we have come across this situation. Our predecessor Committee's recommendations relating to *The failure of Metronet* are relevant to this competition, as they address the need to improve oversight and information to protect taxpayer's interests. We are concerned that the Department seems to have ignored the lessons from past failings. The Department had documented processes, but staff failed to follow them during this competition. The Department needs to put adherence to basic principles and processes at the core of how it does its business. We expect to see this has been done when we look at HS2, Thameslink and the other rail franchises.
- 2. The Department's senior managers failed to apply common sense and missed clear warning signs, including from the industry, that there were serious problems with the competition.** We would have expected the Department to thoroughly investigate the significant differences in forecast passenger growth, premiums and the subordinated loan facilities of the two leading bids. Instead, the Department's decision makers were too reliant on assurances from technical advisers and its evaluation processes. Senior management should use their common sense and challenge the answers that they get from staff and specialist advisers in order to discharge their ultimate responsibility to protect the taxpayer.
- 3. The Department's protection against risky bids failed due to a number of errors.** The Department began the franchise competition without knowing how it would calculate the level of risk capital (the subordinated loan facility) it would request from bidders to protect itself against risk in bids. It later provided misleading advice to bidders about this process and made errors in how the subordinated loan facility was determined. These errors resulted in the Department requesting a significantly lower subordinated loan facility than was required to counteract the recognised risk in First Group's bid and a higher loan facility than was necessary from Virgin. The Department needs a greater understanding of its risk appetite and of risk transfer to the industry, including the likely cost of any risk capital, so that it can identify when it has made errors. It needs to have the tools in place to calculate the risk before starting a competition and to be clear consistent and transparent with the advice given to bidders.
- 4. The Department's misguided attempt to make cost savings by cutting corners on the competition resulted in significant additional costs to the taxpayer.** The Department incurred £1.9 million in staff costs and external advisers on the competition compared to bidders who spent an average of £10 million on their bids. Despite the franchise having a value to the taxpayer of £5.5 billion the freeze on the use of consultants meant that it did not use external financial advisers on the competition. The amount the Department spent is paltry when compared to the £50 million it will now incur, at a minimum, as a result of cancelling the competition and the significant unquantified opportunity cost due to the delays in investment on the line. We are astonished that there was no senior civil servant in the team despite the

critical importance of this multi-billion pound franchise. We are astonished that the Permanent Secretary did not have a detailed understanding and oversight of the competition. We support the Department's commitment to train, nurture and reward staff with the specialist skills it needs. The Department should put in place the right internal resources and external support. Where it needs external support it should robustly argue its case for this with the Cabinet Office. The Department must ensure appropriate oversight of major projects by the Permanent Secretary and his management team.

5. **The Department's blinkered and rushed approach meant the competition was not run properly.** Key risks and issues were not escalated as a result, including the risk of legal challenge. External advisers who flagged these concerns did not have direct communications with the top of the Department. The unique way the Department applied anonymity in the competition meant that the Permanent Secretary did not know the details of the competition and did not sufficiently probe the information that they were given by the project team, and the new Accounting Officer did not challenge the approach when he arrived in April 2012. We expect the Accounting Officer to set the tone for the Department, establish a strong professional culture and set out clear expectations for the Department's leadership team including high levels of accessibility and willingness to hear and act on warning signs.
6. **It was a mistake not to have a single person responsible for the project from beginning to end.** This meant that no single person had to live with the consequences of delivering their policy decisions. It is unacceptable that for three months no SRO (Senior Responsible Owner) was in place, due to the failure of the Department's planned handover between SROs when moving from the policy to the delivery stage. We expect a single individual who will be held accountable to be responsible throughout a project, implementing his or her decisions. The Department should review all its SROs to make sure they have the right seniority, experience and expertise for every project for which they are responsible.

1 The failure of the franchise competition

1. The InterCity West Coast is one of the largest franchises the Department for Transport (the Department) lets. It was last awarded in 1997 to Virgin Rail Group. In January 2011, the Department began re-letting the contract, but in May 2011 delayed the competition by nine months as it needed more time to consult on proposed changes. In January 2012, the Department issued the invitation to tender with the intention of starting the new contract on 9 December 2012. On 15 August 2012, the Department announced its plans to award the contract to First Group who had offered to pay the Department £5.5 billion to run the franchise—Virgin then launched legal proceedings to challenge the decision. The Department initially stood by their original decision but cancelled the competition on 3 October 2012 when in preparation to defend its case in court it realised that there had been serious errors in its procurement process. The Department had not properly calculated the subordinated loan facility and so did not ask for enough funding to protect the taxpayer adequately against the risks identified in First Group’s bid.² The subordinated loan facility is capital provided by the bidder’s parent company, and is used to cover operator losses, protect the Department against default and guarantee premium payments.³

2. The Department accepts it made a serious mistake by not doing enough thinking during the planning and preparation stages of the competition, in particular about how it would implement its policy of requiring a subordinated loan facility from bidders. When the Department issued the invitation to tender, it had not established how it would calculate the subordinated loan facility.⁴ This insufficient planning caused confusion among its staff about the main purpose of the loan.⁵ The Department rightly sought to maximise the premiums offered by bidders, but intended the loan to be its main protection against the winning bidder making an overoptimistic bid and later walking away from the contract.⁶ The Department had intended that the size of the subordinated loan facility for each bidder would be correlated to the nature of risk in the bid, with a riskier bid requiring a larger loan.⁷

3. There was an error in the Department’s calculation of the level of subordinated loan facility required. Instead of developing a bespoke tool to calculate the amount, the Department tried to adapt a tool designed for another purpose to perform this task, but did not realise that this tool did not take account of expected inflation over the life of the contract. As a result the Department significantly underestimated the amount of subordinated loan facility it should have requested from bidders. For example, the loan it calculated of £252 million for First Group should have been over £350 million. It also gave

2 Qq 17, 57-59; C&AG’s Report, *Lessons from cancelling the InterCity West Coast franchise competition*, Session 2012-13, HC 796, paragraphs 1.2-1.3.

3 Q 132, C&AG’s Report, paragraph 4.4

4 Qq 109, 131

5 Q 131

6 Qq 42, 76-77

7 Q 72

bidders misleading advice about the amount of subordinated loan facility the Department might require from them because this did not include inflation either.⁸

4. A further source of error was that the Department's Contract Award Committee, which was the body that set the amount of subordinated loan facility required from each bidder, applied discretion to its decision rather than following the set process which the Department had told bidders it would use.⁹ This resulted in the Department not only requesting a subordinated loan facility from both First Group and Virgin that was different to the amount that it had calculated using the process it told bidders it would follow, but it also treated them unequally. 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.¹⁰ This use of discretion was not made known to the more senior decision makers in the Department who endorsed the project team's contract award recommendation.¹¹

5. The Department told us these mistakes had been "extremely expensive, very serious, deeply concerning and extremely regrettable".¹² The decision to cancel the competition has resulted in considerable cost to the taxpayer, the total amount of which is not yet known but is expected to be in excess of £50 million, as shown in Table 1 below.¹³ Further costs may arise if other franchise competitions that have been put on hold in the wake of the cancellation do not proceed, while there will be as yet unquantified opportunity costs because benefits arising from investment in the InterCity West Coast franchise have been delayed by at least two years.¹⁴

Table 1: Estimated costs to the Department of cancelling the InterCity West Coast franchise competition

Description	Estimated cost
Compensation for costs incurred by bidders on the franchise competition	£40 million
Compensation for costs incurred by First Group in preparing to take over the franchise	£5 million
Staff and advisers costs for running the competition	£1.9 million
Professional fees related to preparing for the legal challenge	£2.7 million
Cost of external advisers for reviews commissioned following the cancellation of the competition	£4.3 million
Costs of contingency plan preparations for Directly Operated Railways to take over the franchise	£1 million

8 Qq 76, 146; C&AG's Report, paragraph 4.17

9 Q 44

10 Qq 47, 54, 148-149; C&AG's Report, paragraph 4.25

11 Qq 42-43, 95-97

12 Q 64

13 Qq 58-63, 69

14 Qq 62, 69

6. The Department acknowledged that, had it spent a small amount more on running the competition, these other costs are likely to have been avoided as the competition would probably not have been cancelled.¹⁵ The Department's costs for running the competition were about a fifth of the estimated average £10 million that each bidder spent on trying to win the franchise. While the Department considered it would not have needed to match bidders' costs to run the competition effectively, it accepted that it should have spent more to secure the right resources both within the Department, including recruiting and nurturing commercial expertise and developing the ability to act as an effective client, and buying in necessary external expertise, particularly financial advice.¹⁶ Instead, the Government's moratorium on using consultants combined with the Department's overoptimistic view of its own capacity to undertake complex financial analysis were significant contributory factors in the failure of this project.¹⁷

15 Q 58

16 Qq 110-111, 166-171

17 Q 145

2 Preventing such a failure from occurring in the future

7. The events which led to the Department cancelling the Intercity West Coast franchise competition demonstrate that it did not have proper management control and oversight in place. There are a number of safeguards against making poor decisions, which are basic management processes, which were either missing or were not operating effectively in this case. We and our predecessor committee have made recommendations which the Department failed to apply to this competition. For example our report *The failure of Metronet* recommended that the Department needed to be more proactive in overseeing risks which requires it to have the right information.¹⁸ The Department will need to ensure that the lessons from the failure of the competition are infused in the whole organisation.¹⁹

Challenge by senior management

8. We asked what the Department's senior management, through the committees which approved the decision to award the contract to First Group, had done to confirm that its bid was deliverable. This is because we were concerned that the Department was seduced by its technical models rather than using common sense to question whether the passenger growth forecast by First Group was too good to be true.²⁰

9. The Department told us that the evidence that it had, including from its expert advisers Atkins, was that the bid from First Group was technically deliverable. That is, that there was capacity to carry the number of passengers forecast, and that First Group would be able to market the service to generate the number of passengers it expected and manage the resulting level of service.²¹ Key factors in the Department's assessment were a subjective view of whether marketing proposals would encourage passengers including business travellers to change their travel patterns to less crowded trains.²²

10. We believe that the different sizes of the subordinated loan facility the Department asked the two leading bidders to provide, of £40 million and £190 million, should have acted as a warning light to those at the top of the Department. This is because the size of the subordinated loan facility reflects the relative risk in each bid. We do not understand why the Department did not dig into the information which would have allowed it to identify the mistakes that were made.²³

18 Committee of Public Accounts, Fourteenth Report of Session 2009–10, *Department for Transport: the failure of Metronet*, HC 390, paragraphs 1-3

19 Q 113, C&AG's Report, paragraph 6

20 Qq 4-5, 33-35

21 Qq 17,34

22 Qq 35, 38

23 Qq 73,76, Q 79, C&AG's report, paragraph 4.25

Management and information flow

11. The risks the Department was exposed to on the project franchise were not properly escalated which has caused serious reputational damage to the Department and Ministers.²⁴ The Department told us that the project team had been aware of a gap in the invitation to tender in relation to how it would calculate the subordinated loan facility. The consequential legal risk this raised for the Department reached its Rail Refranchising Programme Board but senior officials and Ministers were not informed. Bidders' concerns about how the amount of subordinated loan facility would be worked out were also not raised higher than director level.²⁵ The Committee also asked why concerns raised by Eversheds, external legal advisers on the project, that the Department may not have been able to apply discretion in deciding the amount of subordinated loan facility it required from bidders did not go further up the chain. The information was not reported to the Department's most senior lawyers or the top of the Department.²⁶

12. The Department told us that its risk management documents and processes are clear that the risk should have been reported to more senior officials. However, it admitted that the project team did not have the right leadership. With effective line management the risks would have been escalated through the natural flow of information.²⁷ The independent review the Department commissioned from Sam Laidlaw also identified a cultural pressure that the team was under to complete the project which may have led them to decide to ride the risk they had recognised because completing the task was uppermost in their minds.²⁸ The Department said that the team was ultimately trying to do their best and deliver value for the taxpayer. We were surprised that the project team did not include anyone from the senior civil service given the project's complexity and value.

13. The way the Department applies its practice of anonymising information from bidders means that no commercially confidential information is available to senior management. The Permanent Secretary was simply told he could not see all the information which might have enabled him to challenge the processes and the judgement. Elsewhere in Whitehall, Departments maintain the integrity of procurements without making the same separation of those who have access to all information to evaluate bids and senior decision-makers.²⁹ The Committee asked why the Accounting Officer had not challenged the Department's practice when he joined the Department in April 2012, even though he found it surprising.³⁰ We also asked why he had accepted advice from the Department's general counsel that he had to remove himself from the decision-making process when he discovered the identity of some of the bidders from letters Virgin wrote to the Department in late July 2012.³¹ The Department agreed that its anonymisation was one of the most

24 Qq 120-121

25 Qq 109, 133-135, 150, 152-153

26 Qq 117, 136

27 Qq 155, 161

28 Q 154; Department for Transport, Review of Laidlaw Inquiry: Inquiry into the lessons learned for the Department for Transport from the InterCity West Coast Competition, HC (2012-13) 809 available at <https://www.gov.uk/government/publications/report-of-the-laidlaw-inquiry>

29 Qq 85, 91

30 Qq 1, 80-83, 90, 121

31 Qq 87-88

significant causes of failure on the project and that it has already changed the practice. It also agreed that the Accounting Officer should have full access to all relevant information in future.³²

The Senior Responsible Owner

14. In late 2010, the Department split responsibility for rail franchising policy and the delivery of franchises between two Director Generals, as part of a wider restructuring.³³ As part of its new structure, the identity of the SRO (Senior Responsible Owner) was meant to change when the franchise project moved from policy development to implementation, which would occur when the Department issued its invitation to tender to bidders.³⁴ The Department admitted that there had been a period of confusion, from the issue of the invitation to tender in January to March 2012, when it was not clear who the SRO was. This is because one individual thought he was no longer the SRO, while the other individual would not take responsibility because the invitation to tender was incomplete.³⁵

15. The Department told us that it had put this structure in place to increase transparency but admitted that, in retrospect, it had not been a wise move to have two SROs responsible for different phases. It agreed with the Committee that the tasks of developing a policy and delivering it successfully are closely linked.³⁶ The Department for Work and Pensions defines the role of SRO as the person who has to live with the consequences of a policy. By splitting the role, the Department had removed the alignment between policy making and implementation.³⁷

16. Going forward the Department told us that it will have an SRO at director level for the whole franchising programme and individual franchise competitions will have more clearly identified responsibility than occurred on the Intercity West Coast. The Department has made a single Director General responsible for all major issues to do with rail, except HS2 where it has appointed a new Director General.³⁸

32 Qq 83, 89

33 Qq 20-24

34 Q 24

35 Q 139

36 Qq 27-28

37 Qq 26-27

38 Qq 30-31, 172

Formal Minutes

Monday 4 February 2013

Members present:

Margaret Hodge, in the Chair

Guto Bebb
Chris Heaton-Harris
Meg Hillier
Fiona Mactaggart

Austin Mitchell
Nick Smith
Ian Swales
Justin Tomlinson

Draft Report (*Department for Transport: Lessons from cancelling the InterCity West Coast franchise competition*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 16 read and agreed to.

Summary agreed to.

Conclusions and recommendations agreed to.

Resolved, That the Report be the Thirty-first Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report (in addition to that ordered to be reported for publishing on 14 January 2013).

[Adjourned till Wednesday 6 February at 3.00 pm]

Witnesses

Thursday 13 December 2012

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Philip Rutnam, Permanent Secretary and **Clare Moriarty**, Director General (Corporate), Department for Transport

Ev 1

List of printed written evidence

1 Department for Transport

Ev 22

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2012–13

First Report	The Government Procurement Card	HC 1915
Second Report	Mobile Technology in Policing	HC 1863
Third Report	Efficiency and reform in government corporate functions through shared service centres	HC 463
Fourth Report	The completion and sale of High Speed 1	HC 464
Fifth Report	The Regional Growth Fund	HC 104
Sixth Report	HM Revenue & Customs: Renewed Alcohol Strategy	HC 504
Seventh Report	Immigration: The Points Based System – Student Routes	HC 101
Eighth Report	Managing early departures in central government	HC 503
Ninth Report	Preparations for the London 2012 Olympic and Paralympic Games	HC 526
Tenth Report	Implementing the transparency agenda	HC 102
Eleventh Report	Improving the efficiency of central government office property	HC 288
Twelfth Report	Off-payroll arrangements in the public sector	HC 532
Thirteenth Report	Financial viability of the social housing sector: introducing the Affordable Homes Programme	HC 388
Fourteenth Report	Assurance for major projects	HC 384
Fifteenth Report	Preventing fraud in contracted employment programmes	HC 103
Sixteenth Report	Department of Health: Securing the future financial sustainability of the NHS	HC 389
Seventeenth Report	Department of Health: The management of adult diabetes services in the NHS	HC 289
Eighteenth Report	HM Treasury: The creation and sale of Northern Rock plc	HC 552
Nineteenth Report	HM Revenue & Customs: Annual Report and Accounts 2011-12	HC 716
Twentieth Report	Department for Energy and Climate Change: Offshore electricity transmission—a new model for infrastructure	HC 621
Twenty-first Report	The Ministry of Justice's language service contract	HC 620
Twenty-second Report	British Broadcasting Corporation: Off-payroll contracting and severance package for the Director General	HC 774

Twenty-Third Report	Department for Work and Pensions: Contract management of medical services	HC 744
Twenty-Fourth Report	Nuclear Decommissioning Authority: Managing risk at Sellafield	HC 746
Twenty-Fifth Report	Funding for local transport: an overview	HC 747
Twenty-Sixth Report	The Department for International Development: The multilateral aid review	HC 660
Twenty-Seventh Report	HM Treasury: Annual Report and Accounts 2011–12	HC 659
Twenty-Eighth Report	Department of Health: The Franchising of Hinchingsbrooke Health Care NHS Trust and Peterborough and Stamford Hospitals NHS Foundation Trust	HC 789
Twenty-Ninth Report	Tax avoidance: tackling marketed avoidance schemes	HC 788
Thirtieth Report	Excess Votes 2011–12	HC 959

Oral evidence

Taken before the Committee of Public Accounts

on Thursday 13 December 2012

Members present:

Margaret Hodge (Chair)

Mr Richard Bacon
Guto Bebb
Chris Heaton-Harris
Meg Hillier

Mr Stewart Jackson
Fiona Mactaggart
Austin Mitchell
Justin Tomlinson

Amyas Morse, Comptroller and Auditor General, National Audit Office, **Gabrielle Cohen**, Assistant Auditor General, NAO, **Geraldine Barker**, Director, NAO, and **Marius Gallaher**, Alternate Treasury Officer of Accounts, were in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

Lessons from cancelling the InterCity West Coast franchise competition (HC 796)

Examination of Witnesses

Witnesses: **Philip Rutnam**, Permanent Secretary, Department for Transport, and **Clare Moriarty**, Director General (Corporate), Department for Transport, gave evidence.

Q1 Chair: Thank you very much for coming. Can you both just tell us how long you have been in post? When did you arrive, Philip?

Philip Rutnam: I arrived on 11 April 2012.

Q2 Chair: Clare, you have been in the Department for Transport for a long time. Just take us through the last couple of years when this was an issue where you were.

Clare Moriarty: I have been in the Department for Transport since September 2009 and have been in the post of director general for corporate group during that time. In that role, I chair the Board Investment and Commercial Committee, which is my principal involvement with the west coast franchise.

Q3 Chair: So you chaired the committee that looked at this.

Clare Moriarty: Yes.

Q4 Chair: Right. That is very helpful.

It is probably unfair to turn to you, Philip; we will try and defend you, but when I first came across this, which was before the Department had decided to withdraw the award to FirstGroup, I looked at FirstGroup's bid and it had this 10.4% compound revenue growth throughout the contract—on the back of a double-dip recession. It was also clear that Virgin had only achieved just over 10% gross over 10 years with an investment of £9 billion in upgrades during that period. So that profile of growth looked questionable, to put it politely.

The other thing that I looked at was the proposed payments to Government and the skewing of the payments towards the end of the contract in FirstGroup. It is £26 million in 2014 and £739 million in 2026—I hope I have got my figures right, but that is as I remember it—so surely, just looking at that bid,

without any of the analysis afterwards, which we will come to later, it looks too good to be true. If it looks too good to be true, it most likely is.

Philip Rutnam: Would you like me to answer that?

Q5 Chair: No, I think it is really for Clare. I accept your accounting officer responsibility, but she chaired the committee. It belies common sense in a way. That is what I felt. I am not a great expert in transport, but looking at all those things, it seemed too good to be true and it therefore probably was.

Clare Moriarty: At the stage when the proposition came to the Board Investment and Commercial Committee, it had been through a very rigorous process of evaluation by the various teams. It had been looked at by the Contract Award Committee. The Board Investment and Commercial Committee probed quite hard into what lay behind the presumption about the level of growth that could be delivered. We probed into how FirstGroup was proposing to go about marketing in a different way from what had been done before, how it was proposing to use much better real-time information about both supply and demand and how it was proposing to use extra capacity effectively to spread passengers over a wider range of services. We asked those questions, and we were told that it had been very thoroughly looked at by the technical advisers who support the evaluation process, that they had risk-adjusted and taken account of the inevitable questions that you have to ask about deliverability. They were satisfied that this was a technically deliverable bid.

Q6 Chair: We will come to the technical appraisal—you can get lost in the technical stuff—but it is not technical; it is just common sense. We are in a second-dip recession and goodness knows what will happen to the economy. Whoever you are, you are not deeply

optimistic about the economy for the foreseeable future. You look at that profile of money back to the Government, and FirstGroup had already pulled out of a previous franchise. Am I wrong about that?

Philip Rutnam: They had a contractual option that they chose to exercise, which was not pulling out. They exercised a contractual option to bring forward the date at which their franchise for Great Western would have ended. It was not pulling out; it was not the situation as with National Express four or five years ago.

Q7 Chair: You call that a contractual option; I call that pulling out. They pulled out at the point at which they would have started paying the Government more money back. This was a completely similar thing. Forget, in a way, about technical appraisals, but you could not have thought that there was credibility in those growth projections and you would have been jolly suspicious of anyone putting in a bid that is so backloaded, given their record. We will come to the judgments that you did later on. There were judgments that you made on other issues, such as the loan, yet on that very basic assessment of the viability of the bid, you just didn't get it.

Clare Moriarty: I can assure the Committee that we asked those questions. It is worth bearing in mind that rail passenger numbers and rail revenues have held up during the recession much better than anyone expected. We expected to see—

Q8 Chair: That is not the east coast main line, because we had to nationalise it. The revenues went down—that is what we were told in this Committee. We were told that on the east coast—I accept it was the '08 recession, but the revenues went down and that created the problems in East Coast. I don't even accept that argument, really, but that was what we were told at the time, wasn't it?

Clare Moriarty: Generally speaking, rail revenues have held up better than expected across the board.

Q9 Chair: But they did go down; you have got to accept that. You have got to accept that the reason East Coast failed was because they had been over-optimistic about passenger growth and revenue income, and they claimed it was because they were hit by the recession. You had that knowledge in your head.

Clare Moriarty: We did, and that drove the sort of questions that we asked about the process. However, we have been in an environment where the system through which we have protected train operating companies has disincentivised investment; it has disincentivised them from doing things that will increase revenue. In moving to the new system of franchising, we were looking at longer franchises and a way of specifying franchises that gave them greater freedom and greater incentive to invest, with a compensation mechanism that provided—as we thought—the right incentives for train operating companies to make sensible decisions that would allow them to grow the business.

I personally tested this quite hard, because I could see it was a question that was likely to be asked. The

bid that they were putting forward seems to hold up against those—

Q10 Chair: Let me just probe this a bit further, because I am just astounded. At the moment, as I understand it, there are three trains per hour on that line and at peak times they are full. That's right, isn't it? That's what I'm told.

Philip Rutnam: No. I don't think that's right on the west coast main line. I think there are 13—

Q11 Chair: Well, that's what my research tells me.

Philip Rutnam: The figure that is in my mind is that I think there are 13 fast services per hour on the west coast main line—certainly more than three or four.

Q12 Chair: At peak times, could you run more trains? Could you put more trains on?

Philip Rutnam: More trains are indeed being put on. As from the timetable on 9 December, we have additional fast hourly services to Glasgow.

Q13 Chair: On the track? So you can put more trains on.

Philip Rutnam: There are additional—because of the very significant upgrading on the west coast main line, on which the Government and Network Rail spent several billion pounds—

Q14 Chair: £9 billion.

Philip Rutnam: There is additional capacity, which has been used to run additional services.

Q15 Chair: When did that open? When did that happen?

Philip Rutnam: I think it was completed in 2009—2008, 2009. But that's from memory.

Q16 Chair: But if you look forward—we are now in 2012—could they put more capacity on?

Philip Rutnam: The infrastructure was completed. However, the services continue to be upgraded, so we have just had the final delivery of 106 additional Pendolino carriages, allowing additional services on the enhanced infrastructure. So the upgrade in the services has been continuing. It didn't all come in just when the infrastructure was switched—

Q17 Chair: But can that absorb the passenger growth that you are talking about? FirstGroup—can it absorb it? Or is it right that there isn't the capacity and you have extended all the platforms and—?

Philip Rutnam: No. I will just go back to the deliverability issue, to add to what Clare said. The Department did a thorough analysis, with expert advisers Atkins, of the deliverability of the different bids that we received. We did not conclude that the First bid was undeliverable. Indeed, we concluded that—on what we could see—it was deliverable.

Just to be clear, nothing—nothing—in terms of the process that has happened since, in the judicial review brought by Virgin or the conclusions that the Department has reached, has meant that we have concluded that that bid was not deliverable. Nothing in that has said that it was not deliverable. There may

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be different views in the industry as to deliverability—there may be different views even in this room as to deliverability—but there was a thorough testing of deliverability, including by technical advisers who looked at the marketing initiatives and engineering capacity solutions that First was planning to adopt, and the answers that came back to those questions were essentially that the bid was deliverable. So, it passed the deliverability test.

The reasons why the competition failed, and we had to do this extraordinary thing of cancelling the competition, were not to do with the deliverability assessment of passenger growth or the ability to carry those passenger numbers. They were all to do with the way in which we estimated—or rather, failed to estimate properly—the amount of risk capital that the bidders should put up.

Q18 Chair: Well, that is interesting, because that is not the view in the industry.

May I just ask you another question, because in reading this document what hits you—and I keep thinking about all my years of experience as a Minister—is that this was one of the biggest things you were doing in the Department this year. It is the first of the large franchises, the first of the extended franchises to 10 years. I know that you have other big projects around—HS2, for example, and we might come on to how you are managing that one—but this was a massive project. So what I just don't get is how on earth you had a project like this without a senior director general in charge. I don't get it.

Philip Rutnam: First, I agree completely it was a very large project. We had a number of other very large projects, but this was certainly one of them. The whole refranchising programme was an even larger project, but this was the first example of that. We did have a director general in charge.

Q19 Chair: Who was the director general? The report seems to suggest—correct me if I am wrong, Geraldine—the report says there is no senior manager in charge.

Geraldine Barker: There was no one senior responsible owner throughout the duration. It was handed over during the procurement process.

Q20 Chair: My understanding was the director general post that you had in charge of franchising: he/she went—I have no idea who the individual is—after the election, in your cuts, when you tried to do the administrative cuts. You then divvied it up between two or three people and you have now decided to bring that post back, which is a good thing for the future but a bit of a waste of money for the public purse.

Philip Rutnam: I think there are several different issues here. The first is an organisational issue to do with the structure of responsibilities for the rail industry. In late 2010/early 2011 those were split—

Q21 Chair: Which was mad; do you accept now that was mad?

Philip Rutnam: Between different directors general.

Q22 Chair: Do you accept that is mad?

Philip Rutnam: I don't intend to carry on with that structure in the future.

Q23 Mr Bacon: Can you describe how they were split?

Philip Rutnam: They were split so that we had one director general responsible for policy—so policy towards rail franchising, policy towards the development of the rail network; and another director general responsible for the delivery, specifically through design, development, implementation of major projects and the award of franchises and the contract management of franchises. So the idea was you had one DG within the organisation who was responsible for policy—effectively the client within the organisation—and then another DG within the organisation responsible for delivery.

Q24 Mr Bacon: When was that split?

Philip Rutnam: It was decided upon, as I understand it, at the tail end of 2010 and implemented properly in the very beginning of 2011.

Chair: Okay; so you split the job, which you now accept was wrong, and you are putting that together again. I am just trying to find my copy of the Report, and I can't find it, but my understanding from looking at the Report was that there was not a senior manager in charge.

Geraldine Barker: The point we were trying to make was that we don't think there was a senior person—a programme manager or project manager—overlooking the whole process: the policy and the procurement side of it.

Philip Rutnam: Actually, I agree with what Geraldine has said. I described the organisational structure in terms of responsibilities for rail within the Department: two DGs. Then, for major projects, we have a policy of having senior responsible owners for major projects, who are personally responsible for securing the successful delivery of that project. In this case, consistent with the philosophy that I have outlined in terms of organisational structure, the Department had decided definitely to have a senior responsible owner for the project, but that the identity of the senior responsible owner should change at the point when the project essentially moved out of the policy development phase and into implementation. So there was a senior responsible owner up to the point of issuing the invitation to tender, or thereabouts, in the early months of this year, and another senior responsible owner thereafter.

Q25 Mr Bacon: We have looked at this often. What is your definition of a senior responsible owner?

Philip Rutnam: My definition is that it is the individual whom we hold to account for the successful delivery of a major project; and I expect that individual to be active and engaged in all the major dimensions of the project—not to be a figurehead but to be actively engaged and taking personal responsibility for making sure that that project comes to a successful fruition. If the individual identifies risks which they are personally not able to manage because of the constraints within which they are

operating, or because they are too large, or because the timetable is unrealistic, then they have equally an expectation of escalating that risk so that the very top of the Department and Ministers are aware of it. That is my definition of the responsibility of an SRO.

Q26 Mr Bacon: The Department for Work and Pensions will tell you that the senior responsible owner is the person who has to live with the consequences of a policy. That is, in a way, a much more succinct definition. It means that the person who is driving the policy is also the person who has to live with the consequences. So you make sure that the two—the driving of the policy and whether it is implementable or not—are aligned at the top. And you split them.

Philip Rutnam: There are several different points there. First, you asked about the definition of the role of the SRO. I have to say that while the DWP definition may be more succinct, I prefer mine, because all of us have to live, typically, with the consequences of a policy. The person responsible for securing a successful outcome from a project is what I see the SRO as being.

Q27 Mr Bacon: I am quoting from the DWP, and I think it was your colleague, Robert Devereux, who made the point. He was simply saying that not everyone has to live with the consequences of the policy in the same way. The person who ends up being responsible for implementing that area, who directly has to live with the consequences—that is what I am talking about.

Philip Rutnam: What I would agree with is that I do not think in retrospect it was a wise move to separate the role of SRO into, first, a policy development phase, and second, into an implementation phase. That is for precisely the same sort of reason as Robert Devereux would identify, which is that the tasks of developing a policy and delivering it successfully are absolutely, inextricably linked.

Q28 Mr Bacon: Since this is not a new point, why was the decision taken to split them?

Philip Rutnam: I am afraid that goes back to before my time.

Chair: Maybe Clare can help, because she was there.

Clare Moriarty: I think it was a consequence of creating the structure that we had. As the Report sets out, there was a reason behind creating the separation, which was about creating transparency and avoiding a situation in which the whole process became vested in one person who wasn't able to stand back and look at the moment when possibly things need to be changed. So there was a reason behind the separation; we can agree that, when put to the test, it didn't stand up, and that is why we are changing that. But in a situation where there is policy to be developed and then to be implemented, there is a clear responsibility, and the initial SRO had the responsibility to create a deliverable policy that could then be implemented by somebody within the rail contracts—

Q29 Chair: I think transparency is an odd—given the lack of transparency over this contract, that seems a

really weird justification of a rather odd structure, which we are glad you are dropping. At what level was the SRO?

Philip Rutnam: The SRO for the first phase of the project was at director level, and the SRO for the second phase of the project was at director general level.

Q30 Chair: And going forward—if we were to look at this for HS2 or any of them?

Philip Rutnam: For HS2, the SRO is at director general level going forward. For rail franchising going forward, the Government have issued a response to the Laidlaw report which includes some details on this point, and we will be having an SRO at director level for the rail franchising programme. Individual awards beneath the wider programme will have much more clearly identified responsibility than existed in this case. But the director who will be the SRO for the rail franchising programme will report to the DG responsible for rail, who will, as I said, be the DG responsible for all major issues to do with rail in the Department.

Q31 Mr Bacon: So will the post of director general (networks) be recreated?

Philip Rutnam: I would see it as director general (rail). I think director general (networks) included the strategic road network, and I am not intending to include that in the post.

Q32 Mr Bacon: But Mike Mitchell's job was mainly rail, wasn't it?

Philip Rutnam: I think he also had responsibility for national road networks. He had a rail background though.

Q33 Chair: May I just go back to one issue? I am very sceptical about the growth that was suggested could be achieved both in income and in numbers. When you put the submission to Ministers, were they aware of those growth projections against the performance of Virgin, as the current operator of the line—the 10.2 against the 10.4—were they aware of the growth assumptions on GDP, and were they aware of FirstGroup's record on the First Great Western franchise, where they had pulled out—sorry, terminated the contract before the end of the contract? Were they aware of all those things? Was it in the submission that went to them?

Clare Moriarty: I am speaking from recollection because I didn't see the submission at the time, but the submission was similar to the papers that came to the Board Investment and Commercial Committee. From recollection, I think that the information about the relative growth in the bid compared with the achieved growth in recent years wasn't in the submission.

Chair: That was in?

Clare Moriarty: That wasn't in.

Chair: Was not in or was in?

Clare Moriarty: Was not, as far as I recall.

Q34 Chair: Goodness.

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Philip Rutnam: Ministers rightly asked a number of questions about the deliverability of the bid that was being put in front of them for award. They rightly asked a set of probing questions around that. They were assured by the Department, on the basis of the detailed work that had been done, including by Atkins our technical advisers, that we had no evidence that the First bid, notwithstanding views to the contrary in the industry, was not technically deliverable.

You say that there are different views in the industry. I think that if you had Virgin here in front of you, you would hear one view in terms of the deliverability of the First bid, and if you had First here in front of you, you would hear quite a different view in relation to the deliverability of the bid. What we did was to go through an independent and impartial process of testing deliverability, and the evidence that we had was that First's bid was technically deliverable. When I use the word "technically", I mean being able to carry that number of passengers, being able to market the service in a way to generate that number of passengers, and being able to manage the service level that would follow as a consequence.

Q35 Chair: My understanding is this, and do correct me if I am wrong. Given that the platforms had already been extended, and that the trains, particularly between London and Manchester—I think that's where I got my only three trains an hour figure from—at peak times are full but might not be full beyond that, and the control of the stations, including parking at the stations on the route, all that stuff suggested that even if FirstGroup were right about the increase in passengers that they could obtain from marketing and very good economic conditions, the capacity on the line was simply not there. That is why I am so bewildered (a) that you believe the figures in relation to GDP growth and (b) that you thought it was deliverable. I am just bewildered on a common-sense basis. What I feel happened—if I may just put this to you—is that you sort of got seduced by technical models, and in that technical complexity you lost common sense.

Clare Moriarty: May I just come back on the point about the capacity of the system? That was something that we tested in discussion in the Board Investment and Commercial Committee. There is a huge variation in the loading of trains at different times of day. There are trains that are full to bursting, but there are many times of day when we transport large numbers of empty seats around the country.

Chair: We know that.

Clare Moriarty: We did ask the critical question. The things that First were doing were significantly designed to get people on to trains that they were not currently travelling on. So the marketing strategies that they had, and the way in which they were planning to use counting equipment on carriages, were designed to give them a much more sophisticated basis for targeting passengers, in the same way that a Tesco's does, so that you could get people travelling on a wider range of trains and make better use of the network and the capacity.

Q36 Chair: I worry about your analysis, then, because these inter-city lines are mainly used by business people, which is why they are so sensitive to what happens in the economy. That is the main use. You can perhaps entice someone going to see their relatives over the weekend to go on a different one, but the main use is business use and the idea that a bit of a cheaper fare is going to encourage business users on the whole to change their plans is, I think, pie in the sky.

Philip Rutnam: May I add one point to what Clare said? First, I would say that I don't actually agree with your analysis of the impact that marketing, including fares policy, can have on generating travel.

Q37 Chair: On business users.

Philip Rutnam: Certainly on more price-sensitive segments—leisure users—they have a very significant impact.

Chair: I agree with that, but that's not the main thing on inter-city.

Philip Rutnam: It is a very significant proportion of traffic and a significant proportion of revenue. The other point I was going to add, though, was that First's plan also included bringing in new rolling stock from 2016, which could also be accommodated within the infrastructure that we have delivered on the west coast main line. That additional rolling stock was a very important part of enhancing the service offer and the level of traffic. Different views are possible, I understand that. None the less, there was a thorough assessment of the technical deliverability of what First had put on the table, and nothing that came back out of a quite detailed review of that technical deliverability suggested that it could not be done, both through marketing and significant additional investment—hundreds of millions of pounds of additional investment.

Amyas Morse: Just on a point of clarification, nothing we found in our work indicated that you had not made the assessment properly. We are not trying to say that. However, it is fair to say, as you will notice we do in paragraph 4.21—I think this is factual—that the passenger volume projections for the two bids were very comparable up to 2016–17, and after that that they parted company materially, with much higher growth being predicted in one bid than another. I think it would be fair to characterise it as a quite long-term view. That is when the differential return comes as well. Is that reasonable? What am I trying to make out of it? Just that if you are thinking about comparing the two bids from a risk and immediacy point of view, they were really quite broadly comparable until the later years of the contract. Is that fair?

Clare Moriarty: I think that is fair, and I think that is where the assessment that we made of the bid interacts with the flaws that were subsequently found, which were to do with identifying how much capital companies needed to be asked to put at risk. We tested, and we asked exactly the questions that you are rightly identifying. The answer, substantially, was that there was greater risk towards the end of the contract, and that was mitigated by the risk capital that we had asked for from the companies. That is the element of the process that turned out to be wrong,

but within the context that we had at that time, we tested very hard and, as Philip says, we asked the questions about the deliverability. It was not nonsense to think that these things could be delivered. With hindsight and the benefit of understanding what went wrong with the subordinated loan facility, we now understand that the risk attached to them was higher than we were being told by the mechanisms we were working with.

Chair: That is a very useful point, but I have to say that the judgment, given FirstGroup's record of walking away from another contract, leaves me astounded.

Q38 Guto Bebb: That was the point I was going to make, actually. You gave us assurances that the technical feasibility was there in the figures, but when the explanation was offered, it was basically a subjective view of the marketing proposals of FirstGroup—

Philip Rutnam: No, I do not think that is fair. I also have to say that I really do not think it would be fair to characterise FirstGroup as having walked away from a contract. They had—

Q39 Chair: Well, they've got a contractual right. I think that says you write your contracts a bit—

Philip Rutnam: I think it is important to characterise this fairly. Sometimes companies have options to extend and sometimes companies have options to shorten the term. That is a standard feature of major contracts.

Q40 Chair: Come on. I am not going to have this, because it is ridiculous. In that contract that they walked away from, they walked away at the time they would have to pay back more money to Government—the taxpayer—right? It may seem like just a little contract to you, but I think it is a device that you should be aware of in determining who gets a contract.

Philip Rutnam: No, it certainly does not seem like a little contract to me. These are all major contracts—very important contracts—and proper management of them is very important.

Q41 Chair: But when you judge a contract, if they backload the payments to Government, that is hugely important. If they have a record of walking away from one, you have to have regard to that when you are considering whether to give them another.

Philip Rutnam: I think there is a separate issue about how we ensure that the design of these contracts does not encourage overbidding, whether in this case or any future case. That is a very important issue. I just want to make it clear that I do not think that any negative judgment should be applied to First's decision to exercise a perfectly fair contractual option that they had—

Q42 Chair: Well, I have to say, I find that quite a worrying comment. In protecting the taxpayers' money, which is your job as accounting officer, looking at the profile of repayments to Government and the way in which they are used by contractors has

to be a key element in your judgment as to who you give contracts to.

Philip Rutnam: Some contracts will be of fixed term, with no flexibility to vary their length, and some contracts will have a fixed term with the option to extend, and that can sometimes make perfectly good sense in the interests of taxpayers.

Amyas Morse: I don't think we disagree, so I am saying these things to elucidate. I think, however, that it is not unreasonable to take account—without disqualifying anyone—of prior actions or decisions that companies have made. I do not think that you disagree with that at all. So, to be clear, we were very dependent on the subordinated loan capital as the main protection against walking away, which is why you naturally asked questions when people were exercising discretion on how much subordinated loan capital would be required, and apparently there was rather less required from FirstGroup than from others. It is worth understanding, so can you take us through that bit of logic as well?

Clare Moriarty: There was no knowledge—at the time when the Board Investment and Commercial Committee considered the issue and when Ministers considered the issue, it was not known that there had been an exercise of discretion in setting the amount of the subordinated loan facility.

Q43 Chair: Why was it not known? Why?

Clare Moriarty: It was not known because the papers that came to the Board Investment and Commercial Committee set out the process, which did not involve the exercise of discretion.

Q44 Mr Bacon: When you say it was not known that there had been an exercise of discretion, can you translate that into English for the benefit of our viewers at home?

Clare Moriarty: What I mean is that the subordinated loan facility should have been calculated according to a clear set of instructions—the guidance had been given to the bidders, they understood how it was to be done.

Chair: They did not really understand, that was one of the problems—but go on.

Clare Moriarty: In the process of setting the subordinated loan facility, discretion was exercised, so another committee—the Contract Award Committee—took a view about the levels of subordinated loan facility to set, believing that it had the discretion to set levels other than what came straight out of the calculation.

Q45 Mr Bacon: What I am trying to get to is what it was you were asking bidders to do, so that our viewers at home can understand this—indeed, so that members of this Committee can understand it. When you say repeatedly “the exercise of discretion”, it is not clear on the face of it, from what you say, what bidders were actually asked to provide on the subordinated loan facility. Can you say what actually happened?

Clare Moriarty: What happened is set out in a good deal of detail in the Laidlaw inquiry report—

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Q46 Mr Bacon: Our viewers at home do not have the Laidlaw inquiry report in front of them. I do, but they do not.

Clare Moriarty: Exactly. What happened was that bidders were asked to put up an amount of capital that would be available as risk capital in the event that they did not achieve the revenue they expected.

Q47 Mr Bacon: Once again, the exercise of discretion mattered here because?

Clare Moriarty: Because the amount they were asked to provide was not the amount that would have been the case if we had followed the guidance correctly.

Q48 Mr Bacon: And was the amount that they were asked to provide the same in each case, for each bidder?

Clare Moriarty: No.

Q49 Mr Bacon: Right. So it was that that was the exercise of discretion, was it not?

Clare Moriarty: Yes.

Q50 Mr Bacon: Right. That is the bit that I wanted you to say.

Clare Moriarty: Okay, I apologise—

Q51 Mr Bacon: Just to be clear, what you are saying is that the exercise of discretion meant that one bidder was asked to provide a certain amount for the subordinated loan facility and that another bidder was asked to provide another amount for the subordinated loan facility. Is that right?

Clare Moriarty: To be precise, the exercise of discretion taking account of factors that should not have been introduced led to—

Q52 Mr Bacon: Let us do one thing at a time. Is what I have just said correct or not?

Clare Moriarty: The exercise of discretion in itself simply led to a committee asking for numbers that could not readily be tracked back to the guidance—

Q53 Mr Bacon: Right. I am trying to get to the point of my question. Did the exercise of discretion mean then that one bidder was asked for one amount and another bid was asked for another, different amount?

Clare Moriarty: The exercise of discretion, in itself, did not produce that effect. The exercise of discretion, with different factors played in, had that result.

Q54 Mr Bacon: The net effect was that you asked one bidder to contribute less and another bidder to contribute more. Correct?

Clare Moriarty: We are quite clear about that, yes.

Philip Rutnam: May I just add to this? The rules of the competition allowed for different bidders to be asked to provide different amounts of risk capital. But the rules of the competition also said that the amount of risk capital should be worked out in a certain clearly prescribed way. The Contract Award Committee did not pay attention to the rules of the competition, as it should have done.

Mr Bacon: It ignored them.

Philip Rutnam: Instead, it worked out the amounts of risk capital that should be provided by each bidder in a different way.

Q55 Mr Bacon: Yes. Am I correct in thinking that it didn't tell each of the bidders what each bidder was being asked to provide?

Philip Rutnam: No, it did tell each of the bidders the amount—

Q56 Mr Bacon: I'm sorry. It didn't tell each of the bidders what the other bidders were being asked to provide.

Philip Rutnam: No. It just told one bidder, "You would be required to provide this amount of risk capital," and another bidder, "You would be required to provide this amount of risk capital." It didn't tell them the way in which those had been worked out, though of course bidders would naturally assume that the rules of the competition had been followed. Sadly, they had not been.

Q57 Mr Bacon: That is why there was a very serious risk of a legal challenge.

Philip Rutnam: Very serious. We concluded that we could not defend the legal challenge.

Q58 Mr Bacon: Well yes you did, on the contrary. You say that you didn't defend it, but what blew Fiona Mactaggart's mind when we were talking about this earlier—there are still bits of her mind splattered across this page as a result, but fortunately, she is so brainy that there is still plenty left; and it blows my mind too—is that you spent £1.9 million on staff and advisers' cost of running the competition, which ended up being cancelled, and significantly more than that, £2.7 million, on preparing to defend your decision in court. To say that you wouldn't defend it—actually, you spent £2.7 million preparing to defend it.

Philip Rutnam: It is a prime example of how one can be penny wise and pound foolish. If we had spent a small amount more on running the competition and had run it properly, we would have got to a result—

Q59 Mr Bacon: You have taken the words out of my mouth, Mr Rutnam, and I haven't even got to the £4.3 million on the advisers' costs for the review commission since the cancellation, which presumably you are going to have to fund. That is the third item in that list. You have the £1.9 million for your costs of running the competition, the £2.7 million for your costs of preparing to defend your decision in court, which you subsequently decided that you couldn't do, and the £4.3 million for the advisers' costs. Presumably you will have to fund those advisers.

Philip Rutnam: Those are the costs of the external reviews—Laidlaw and the other. Of course we will be paying those costs.

Q60 Mr Bacon: Do you know what the cost is going to be? In the newspapers, it has been put as high as £100 million, but I don't know whether that is accurate or not.

Philip Rutnam: In addition to those three items that we have already been through, the principal cost I am

presently expecting we will have to pay is the bidders' costs of putting together their bids for this failed competition.

Q61 Mr Bacon: How much is that?

Philip Rutnam: We have estimated those at around £40 million.

Q62 Chair: What about the other bids, the other franchises that you have put on hold? Have you had any claims in for those?

Philip Rutnam: We haven't had any claims in for those that I am aware of.

Chair: Yet.

Philip Rutnam: It will depend on what we do in relation to those competitions. That in turn depends on the outcome of another review that we have under way at the moment by Richard Brown into the future of the franchising programme.

Q63 Mr Bacon: £40 million for the bidders' costs—

Philip Rutnam: Around.

Mr Bacon: Plus this 4, 5, 6, 7 or 9 million pounds mentioned here. It is getting on to £50 million. Are there any other costs on top of that?

Philip Rutnam: I can't say that there won't be. If we had to cancel other competitions, we would have to consider—I can't say what the conclusion would be—whether there was any case for bidders' costs in relation to any of those. There may be other costs. We will keep Parliament fully informed of other costs as they emerge.

Q64 Mr Bacon: This is thousands and thousands of pounds—

Chair: No, millions.

Mr Bacon: I'm sorry, I haven't finished my sentence. This is thousands of individual taxpayers on average earnings paying many thousands of pounds each. That is how you get to £40 million or £50 million.

Philip Rutnam: I can only say that these mistakes are—

Mr Bacon: Expensive.

Philip Rutnam: Extremely expensive, very serious, deeply concerning and extremely regrettable.

Q65 Mr Bacon: That is why how you run your Department—whether you have the right directors general in place and the fact that, as it says in paragraph 11, you have had four permanent secretaries in two years—is so important. It suggests that your organisation isn't properly run, and that as a result of that, you are making expensive mistakes.

Philip Rutnam: I could not agree more that it shows how important it is that the Department is run properly. I beg to differ on the claim that the Department is not properly run as a whole.

Mr Bacon: Well, I hope it is now.

Philip Rutnam: We have had a very expensive and completely unacceptable mistake in this area. There are many other areas of the Department's business that I could talk about which have actually done very well over the past couple of years.

Q66 Mr Bacon: Yes, I am sure that is right. In any large organisation, there will always be bits that run better than others, one would hope. We are not suggesting it is all a complete Horlicks, although I think that might be a good characterisation of this particular bit of it. But surely you will agree that an organisation that has had four permanent secretaries in two years is not an organisation in good health.

Philip Rutnam: Obviously, it is not desirable to have such rapid change at the top. It is worth bearing in mind why the tenure of Lin Homer in particular was so short. It was because of the tragic death of Dame Lesley Strathie, chief executive of HMRC, that the head of the civil service concluded that she needed to move at relatively short notice, in order to provide leadership to that organisation. Clearly, it is not a desirable state of affairs to have such rapid turnover, but when one looks beneath the surface at what the reasons actually were, I think it is a little bit more understandable.

Q67 Chair: I want to bring in Geraldine, and then Stewart.

Geraldine Barker: I was just going to add, on the point about costs, that paragraph 5.7 identifies seven areas where there are likely to be costs.

Chair: Will you take us through them? What page?

Geraldine Barker: Page 40, paragraph 5.7. There are the costs that you have already discussed: staff costs, professional fees for the judicial review, fees for external advisers, the refunding of costs to bidders and the costs of directly operated railways preparing a contingency plan to take over the intercity west coast franchise, which is not going to happen now. Then there are the major opportunity costs from lack of investment in the franchise.

Q68 Mr Bacon: By when do you expect that all these costs will have come through the system and you will know what they are?

Geraldine Barker: I don't think it will—

Q69 Chair: What about Mr Rutnam? When are you expecting to be able to tell us?

Philip Rutnam: Thank you, Geraldine, for running through the other bullets. The fifth bullet down is the costs of directly operated railways preparing a contingency plan. We estimate that those are likely to be a bit over £1 million. The costs FirstGroup incurred in getting ready to take over the franchise before we aborted the competition we estimate at a bit under £5 million or thereabouts. That takes us down to the seventh bullet, which I have already talked about.

The sixth bullet, the opportunity cost, is the most difficult to estimate. As you may know, the Department concluded a contract with Virgin last week for the operation of intercity west coast services for a further 23 months from December 2012. During those 23 months, we intend to award a new long-term franchise for the west coast, which will take us beyond 2014. The point I am getting at is that the opportunity cost, in a sense, depends ultimately on the terms of that award.

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Q70 Mr Jackson: I was going to ask if it is possible for you to send us a detailed breakdown, particularly on the legal costs and the £1.9 million of staff and advisers' costs, by way of a note.

You have alluded to the first six bullet points. On the final one, about the paused competition tendering, would you be able to give us a more detailed note about your estimates of any likely existing or future costs for those three franchises?

Philip Rutnam: We can certainly give you a note on the first six bullets. I am not sure how much. In a sense, it will depend on what decisions we make about those paused competitions, and also on what costs bidders have incurred. I will see what information we can provide on that bullet, as well as the others.

Q71 Mr Jackson: It is quite important, because we do not want to be in a position where you are saying, "We don't know what the costs will be," and then you come back in year and say what the costs have actually been. We need to have a picture of the cumulative impact of this disastrous maladministration and mismanagement in your Department, and that will extend to looking at the three franchises that you have paused.

Philip Rutnam: Understood. We will provide what we can.

Q72 Chair: Can I go back to the loan for a minute? However much the loan was—what was the word you used?—changed or manipulated, to anybody looking at the loan that was required from FirstGroup, as compared to the loan that was required from Virgin, it demonstrated the massive risk with the FirstGroup tender. Yes?

Philip Rutnam: Indeed. If you look at it in terms of the net risk to the taxpayer, the risk to the taxpayer attached to the bid plus the loan, one of the intentions behind setting the loan at that level, according to the rules of the competition, anyway—not necessarily according to the way in which they were applied—was that the size of the loan would be correlated to the nature of the risk in the bid. So you take the two things together and the taxpayer is in the same position, only better.

Q73 Chair: If I were a decision maker—particularly because you reduced the size of the loan, as a matter of judgment or in the way that you chose to manipulate it—I would see a red light. I understand that officials lower down the food chain have been held responsible. Mr Rutnam, you were there by then and this is the biggest thing on your desk at that time, in my view, or one of the big things on your desk. You were in charge of the committee that was vetting it. I simply cannot understand how you did not dig down into the information you were given to uncover the mistakes that were made.

Q74 Chris Heaton-Harris: On that point, can you tell us what information you were given? Paragraph 4.26 correctly describes the Chairman's point. It is surprising that these things were not escalated up the line. It would be interesting to know what you were given.

Q75 Chair: And what you weren't. And why you did not ask for what you weren't given.

Philip Rutnam: Before I come to that, I hope you will forgive me for bringing out just one point, which is that the bid from First also included significantly more value for the taxpayer—hundreds of millions of pounds of additional net present value.

Q76 Chair: I understand that, but the risk was enormous and the risk, somewhere in your internal food chain, had been diminished a bit, because they had reduced the loan. If I had seen figures with £50 million on one and £350 million, not having regard to inflation, on the other—I do not understand how you did not get that. I do not understand why you did not dig down into it. That is your jobs, both of you.

Philip Rutnam: I will come to the question you asked in a moment, but if we had chosen, without good reason, to reject a bid that offered the taxpayer hundreds of millions of pounds more NPV—

Chair: That is not the question we are asking you. We are asking you why you did not do due diligence.

Q77 Mr Bacon: Can you finish your point?

Philip Rutnam: If we had rejected a bid without good reason that had offered the taxpayer hundreds and hundreds of millions of pounds of additional value, you would rightly have criticised us for that. The objective—

Q78 Mr Bacon: I thought you were going to say that if you had done it without good reason you would have been open to legal challenge. But of course you had a good reason and the reason was, it was unlawful. And there were people in your Department who knew that it was unlawful because Eversheds told them, as paragraph 4.26 says, but they didn't tell you; they didn't tell the people on the committee making the decisions—

Philip Rutnam: Indeed, and I will come to all that in a moment.

Q79 Mr Bacon: That is the thing we cannot understand. How was it that Eversheds, though not at the meeting, raised concerns with the Department that the Department might not have been entitled to apply discretion, and that did not get raised up the chain?

Philip Rutnam: Can I come to that in a moment? The point that I was simply trying to make is that, deeply flawed and wholly unsatisfactory though this process was, what the team down in the organisation was trying to do was, ultimately, to deliver value for taxpayers. They may have gone about it in a thoroughly misguided way, but that is the objective that they were trying to achieve.

You asked what information I knew. I arrive in the Department in April. This process, or course, was already well under way. It had begun in early 2011, the invitation to tender had gone out in January 2012 and exchanges were already under way in some detail with bidders. One important point to observe is that, under the policy that the Department had of anonymising information from bidders, and the practice that it had in relation to the circulation of information within the Department, no commercially

confidential information was available to me or, indeed, to other members of the Board Investment and Commercial Committee. No commercially confidential information was intended to be available to us until the end of July—before contract award.

Q80 Chair: Why?

Philip Rutnam: Because that was the practice that the Department—

Q81 Chair: Why did you not challenge that?

Philip Rutnam: I was told that that was the established practice—

Chair: You are the boss. You are the top person at the Department.

Philip Rutnam: I was told that that was the established practice of the Department, and the Department had given undertakings to bidders about the anonymisation—*[Interruption.]* Undertakings had been given to bidders in the January 2012 invitation to tender that this was the way in which it was going to work

Q82 Chair: Why?

Philip Rutnam: I think it was because there was a long-standing view in the Department, or at least within this part of the Department, that in order to maintain the integrity of the procurement process, you need to separate the process of evaluating the bids, which is conducted within a relatively small team that has access to all the information, and the process of making decisions about the award on the basis of the evaluation of criteria.

Q83 Mr Bacon: That might be a reasonable argument, but it did not protect the integrity of the bidding process; it undermined it, because you did not have key information.

Philip Rutnam: You are absolutely right. It was one of the most significant causes of failure in my mind, and it is a policy that we have changed forthwith and that I found surprising even then.

Q84 Meg Hillier: I dealt with ID cards. As a Minister, I knew more in broad terms about who was bidding for what than you did as the permanent secretary. So you are saying that this was a one-off bit of decision making in the Department for Transport, and it is not right across Whitehall.

Philip Rutnam: The Department for Transport has historically taken—

Q85 Chair: Who decided that?

Meg Hillier: Can we just be clear? Was it just the Department for Transport?

Philip Rutnam: First, the Department for Transport's anonymisation of bids is, I believe—

Meg Hillier: Unique?

Mr Bacon: Unique.

Philip Rutnam: I understand that it is not practised elsewhere in Whitehall.

Q86 Mr Bacon: You are not selling it as a franchise around other parts of Government.

Philip Rutnam: Unique is a strong word. I do know that it is not practised elsewhere in Whitehall. The further level of confidentiality that, in practice, was adopted and applied around rail franchising was additional even to the practice elsewhere in the Department. I could not agree more that it was a source of failure.

Q87 Chair: Mr Rutnam, I know that you are halfway through your explanation, but I have to say that you came from the Treasury. It is such an obvious thing that I do not understand why you did not change that. It might have been the old convention—

Philip Rutnam: Can I answer? I was given legal advice that, as soon as I had commercially confidential information specific to particular bidders, I had to recuse myself from the decision-making process.

Q88 Mr Bacon: Which lawyer? Was this the Department for Transport lawyer or was it external?

Philip Rutnam: The general counsel in the Department. From 20 July onwards, Virgin, knowing that they were not the preferred bidder, started writing letters to the Secretary of State, which I saw, that contained commercially confidential information. I was therefore unable to attend the Board Investment and Commercial Committee on, for example, 2 August, which concluded what advice to give Ministers on the award.

You also asked about what information I had access to in the Department following my arrival. Of course, I did take steps to assure myself that, across the Department's portfolio of activities, which is very extensive, these things were, as far as I could tell, being properly conducted. I got assurances in relation to the rail franchising programme and this award, but this was outside of the commercially confidential information, which I was far from having.

Q89 Mr Bacon: You said that you were barred from having it because the general counsel in the Department for Transport told you that you needed to recuse yourself. Not only did you come from the Treasury, but you worked in an investment bank, I think—Morgan Stanley in the far east?

Philip Rutnam: Yes.

Mr Bacon: And it is common in investment banks that somebody has to sit on top, looking over the Chinese wall and knowing everything that is going on. That person is surely the top guy. That was you. You were the person who had a duty to inform yourself as to everything that was going on and keep it confidential, but somebody had to have a controlling mind and an understanding of all the factors at play.

Philip Rutnam: Let me just say that I regard the idea that I should not have access to commercially confidential information—it is very clear, henceforth, that this is not a practice that—

Q90 Mr Bacon: Surely, when you got that information from the general counsel—we have a bit of experience of general counsels of Departments in this Committee, and they do not always give advice that is necessarily of the highest calibre—the obvious question is, why did you just accept the advice? Since

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it was so strange, why didn't you question it there and then and say, "Get another lawyer to give me some other advice"? I had a conversation once with a Cabinet Minister who got a piece of advice that said he could not do something because it was illegal. He said, "I wrote 'Bollocks' all over it and I got completely different advice back a few days later." This is what the people at the top are supposed to do if they do not see that things make sense.

Philip Rutnam: If we are talking about lessons that might be learned, maybe that is a lesson I can learn myself.

Amyas Morse: I just want the Committee to be sure of the motivation for this. Why was this policy in place? Presumably because of concern about leaking of the details of bids. I assume that when you asked—you must have asked—they explained it to you somehow, and they must have said, "We're nervous about leaking of bids." I am not justifying it; I am just saying, so that it makes sense to the Committee, that that was the reason why, I guess.

Philip Rutnam: I believe that was.

Clare Moriarty: I think it was partly about leaking but partly also about being able to give assurance to bidders that nobody was applying any prior knowledge or making assumptions about whether this company would be better than another. It was intended to ensure the objectivity of the process, so that people were looking just at the information that came out of the bids, the evaluation of the bids and all of that without applying extraneous factors.

Amyas Morse: Which of course means that any flaws in that process are even more damaging because people are not in a position to correct them by judgment, but I can understand, and I just wanted to make sure the Committee understood, what lay behind it all.

Q91 Chair: We may understand it. Fiona wants to come in. Can I just hear from Clare Moriarty, because you did have the info, didn't you? You were not covered by this—not allowed to see the necessary information to make a sensible judgment.

Clare Moriarty: The information that I saw was a paper that came to the Board Investment and Commercial Committee. It was still anonymised, so at the stage when the information came forward, the bidders were identified by codenames. So it did not say, "First's bid says this. Virgin's bid said this." They were identified in terms of codenames.

Q92 Chair: You knew.

Clare Moriarty: By the end of the process, I knew, because there was sufficient—

Chair: Of course—pathetic.

Clare Moriarty: Press coverage that—

Q93 Chair: Everybody else knew. Anyway, why didn't you dig down to question some of the data you were getting, or the information? Why didn't you? I can't understand it. I can't understand why you didn't do it. I can understand Mr Rutnam—

Philip Rutnam: We—

Q94 Chair: No, can we hear from Clare Moriarty? Why didn't you actually dig down into what you were given?

Clare Moriarty: I dug into what I had, so, as I say, we went through—I questioned people about the realism of the proposition that we had in front of us, about whether or not there was really the capacity. We talked quite a lot about the technical deliverability. We asked people about the subordinated loan facility, which, as we have said, was the critical balancing factor. It was the way in which bids with different inherent risk profiles could be put into a position where we could compare them. We asked, in the committee, about the subordinated loan facility. We were given a very clear explanation that it came from following a process that had been set out which was designed to deliver a particular level of default rate, looking across a whole range of economic scenarios. That was a change that had been introduced following the comments that this Committee made about the east coast main line bid. As Philip says, we can all learn lessons, and asking yet more questions is one of the lessons that I have learned, but it wasn't for want of asking questions. I asked questions; I got reassurances.

Q95 Mr Bacon: You were aware that discretion had been used.

Clare Moriarty: No, I wasn't.

Q96 Mr Bacon: You were not aware.

Clare Moriarty: No. The paper that came to the Board Investment and Commercial Committee said, "This is how the subordinated loan facility has been worked out. It has been worked out by essentially an arithmetical method to deliver 4.4% default rates."

Q97 Mr Bacon: So you were not aware that discretion had been used. Were you also not aware that Eversheds had found out that discretion had been used and had said that the Department may not have been entitled to apply discretion? Were you also unaware of that?

Clare Moriarty: I was unaware of that.

Q98 Mr Bacon: In the NAO Report, on the subordinated loan facility—which involves the GDP resilience model—it says, in paragraph 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." Then it says that Eversheds went on to say that the Department "may not have been entitled to apply discretion".

The Laidlaw report talks about the way in which the GDP resilience model was calculated. It states, in paragraph 3.10, that the Department "used an elasticity factor"—the factor that governs the relationship between GDP and revenue—"of 1.4 in the DfT's model. However, the DfT advised bidders it would use a...factor...of 1.8". As the report says, "The guidance may have created an impression in the minds of bidders that the model would be calibrated by reference to 1.8." That is perhaps not surprising if

that is what bidders were told. Were you unaware that bidders had been told that an elasticity factor of 1.8 would be used?

Clare Moriarty: May I make two points? One is that I was unaware of what the bidders had been told about the elasticity, but secondly, what the bidders were told about elasticity related to the risk adjustment of their revenues, and there was a different elasticity applied in calibrating the model that was used—

Q99 Mr Bacon: From what the bidders had been told?

Clare Moriarty: Well, there were two different places where elasticity was used. The bidders were told one thing about one elasticity, but the elasticity used in the model, as far as I know, was not a piece of information that was given to bidders. It is undoubtedly another source of the problem that we found ourselves in that two different elasticities were used.

Q100 Mr Bacon: You said that the bidders weren't told, but the DfT did advise bidders that it would use an elasticity factor of 1.8. That is what paragraph 3.10 says—

Clare Moriarty: It advised bidders that it would use an elasticity figure for revenue risk adjustments.

Q101 Mr Bacon: I am reading from Laidlaw, which says, "the DfT advised bidders it would use a different elasticity factor (of 1.8) to carry out revenue risk adjustments." When it says "different", it means different from the first sentence of the paragraph, which says that an elasticity factor of 1.4 was used. I take it that all this is factually correct, so, trying to be clear, I am asking whether you were unaware that bidders had been told that a factor of 1.8 was to be used. That is right, isn't it?

Clare Moriarty: May I take you back to the precise words of the Laidlaw report? "The DfT used an elasticity factor...of 1.4 in the DfT's model"—which was the model that was originally developed to calibrate the compensation mechanism. It continues, "the DfT advised bidders it would use a different elasticity factor (of 1.8) to carry out revenue risk adjustments", which is a different part of the process. So there were two different elasticities being used. I think it—

Q102 Mr Bacon: But, and I am reading again, "Since the DfT's model was calibrated using an elasticity factor of 1.4, this was inconsistent with the elasticity used in the guidance the DfT had given to bidders. The guidance may have created an impression in the minds of bidders that the model would be calibrated by reference to 1.8." What I am simply trying to get to is what you were unaware of. First of all, you were unaware that the bidders had been told that the revenue risk adjustments would be carried out using an elasticity factor of 1.8—yes?

Clare Moriarty: Yes.

Q103 Mr Bacon: Okay. Were you also unaware that the DfT used an elasticity factor of 1.4 in its model?

Clare Moriarty: I was aware that the GDP Mechanism was calibrated with a 1.4 elasticity.

Q104 Mr Bacon: You were?

Clare Moriarty: Yes.

Q105 Mr Bacon: But you were not aware that the guidance had "created an impression in the minds of bidders that the model would be calibrated by reference to 1.8." You were unaware of that?

Clare Moriarty: I was unaware of that.

Q106 Fiona Mactaggart: Mr Rutnam, earlier you used the phrase that you thought that there might have been points where the Department had been "penny wise, pound foolish." I was struck by a particular figure that I thought I heard: that the process had cost you, as we know from the figures at the beginning, £1.9 million, but the costs for bidders, which you may have to recompense, sounded like £40 million.

Philip Rutnam: Around £40 million, yes.

Q107 Fiona Mactaggart: It strikes me that we are talking here about a process where the public purse is not geared up in the same way as the private purse, and where decisions being made about the public pound are unclear. For example, who signed off on spending £2.7 million on legal advice that then had to be thrown away? I would quite like to know who signed off on it and I would quite like to know why you think that the public are well defended by a process that costs so much less than the private end of the process?

Philip Rutnam: May I deal with the £2.7 million first, because I don't think it is right to say that that advice then had to be thrown away. What happened when Virgin's legal challenge arrived was that we started a forensic process within the Department of examining exactly how this competition had been conducted. It was that forensic process, including the use of external lawyers and counsel and other professional advice, that cost £2.7 million. It was because of what we found through that forensic process that the Secretary of State concluded that we had no alternative but to cancel the competition. If you like, that was the cost of discovering what mistakes we had made. It was a significant cost but it wasn't as though it was wholly fruitless.

Q108 Fiona Mactaggart: A lot more than the process in the first place.

Philip Rutnam: Indeed, and we talked about that earlier. Can I go to your wider point?

Q109 Guto Bebb: Can I just come back on that point first? You said that the spending of £2.7 million identified the fact that there were problems; but the Laidlaw report says that the Department for Transport was aware in the first quarter of 2012 that it could be open to legal challenge as a result of decisions made.

Philip Rutnam: Yes. That is a rather different point. In the first quarter of 2012, shortly after the invitation to tender had been issued, officials working on the project identified that they needed to do more to provide bidders with guidance on how the

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subordinated loan facility would be calculated, and also to do more work inside the organisation on how it would be calculated. That was a sort of missing hole, a gap in the way in which the commercial offer described in the invitation to tender had been put together. I have to say that it was a very serious missing hole. They did some work on that and found what they thought was a solution but they identified that it was not a solution without risk, hence the reference to identifying the risk of legal challenge in the first quarter of this year. What they did not do—rather consistent with the earlier exchange—was to escalate awareness of that either to Ministers or to the top of the Department.

Q110 Guto Bebb: But they were aware.

Philip Rutnam: They were aware. If I could go back to Ms Mactaggart's wider point, I think you are right that there is an asymmetry here. We have out there relatively well resourced, powerful bidders that have very strong commercial interests in winning competitions like this. For those good reasons, they put a lot of resource into preparing their bids and thinking about exactly how they can position themselves for the competition. They are also not subject, of course, to any of the constraints that we are subject to in terms of civil service pay or the ability to use external advisers. There is an asymmetry there.

I don't think that the sort of resource we need to put in in order to manage our side of the process is the same as the very most that a bidder would put in in order to manage its side of the process. If we take the average, if you like, of bidder costs as being around £10 million, my instinct is that somewhere between £1.9 million and £10 million would be an appropriate amount for us to invest in order to make sure that we are properly prepared for running a competition like that.

To my mind, a key part of that, as well as getting the right resources inside the organisation, which I don't think we quite did in this case, is proper professional external advice, not least on the financial dimensions of a complex contract.

Q111 Chair: So you made a mistake not getting financial advice.

Philip Rutnam: I think with hindsight, yes. Going forward, I think getting proper financial advice—I was surprised, putting it mildly, that we did not have external financial advice on a—

Q112 Chair: You were the boss, Mr Rutnam.

Philip Rutnam: I was the boss, Mrs Hodge, from April, by when I am afraid these decisions were all—

Mr Bacon: You were already looking at a big hole.

Q113 Fiona Mactaggart: If I may finish, one of the things that I am really concerned about is that you are telling us that you have learned the lessons from these things, but I have a kind of feeling that this Committee has been here before with the Department for Transport telling it that it has learned the lessons. I was not a member of this Committee when, for example, it produced a very critical report on the London Transport process. I cannot see where the

evidence is that the Department learns lessons. If I look at the beginning of this Report, I do not see a very sophisticated description of the lessons about management. It is very simple. We all know it. To manage a process, you need clear objectives, you need strong project and programme management, you need senior management oversight, you need effective engagement with stakeholders and you need a proper assurance process. Anyone at the first session not even of their MBA but of their BA in management learns that. It is very, very basic.

I am really scared that we have a process here where you come and tell us, "We have learned the lessons and I was not the person in charge at the beginning," and actually there isn't any string through the Department that can ensure that there is a process whereby each time there is a muck-up like this—and this is not the first one—those lessons are properly infused into the organisation of the Department. I want to know how you are going to tell us that you have done it, because I do not believe that previously it has been done.

Philip Rutnam: I think there are a number of points in there. First, I agree that the basics of running any major project are quite simple, and one needs to keep focused on whether those relatively simple elements are there to the right standard.

Q114 Fiona Mactaggart: But they were not.

Philip Rutnam: No, they were not, in this case. I completely accept that. But you are quite right: the basics are quite simple. We need just to recognise—I hope the Committee will allow this—that this was quite a complicated project, being done in a way where there was a real challenge about the time scale. Part of the complexity comes because this was about taking a new approach to franchising—longer-term franchises; a new Government's policy approach to franchising—and turning it into practice. Now, we didn't get it right in this case, and we didn't get it right because, in a sense, we got the basics wrong. But when you go beneath the basics and think about things like exactly what level of risk we should be transferring to the private sector, how we should avoid the risk of over-bidding and how we should manage the capital structure element of it, it does get quite complicated. It is at that level, not least, that we fell down.

Q115 Fiona Mactaggart: Did you get the basics wrong because you were told that you had to cut spending—that you could not have the right resources to do this? Is that one of the reasons why you got the basics wrong?

Philip Rutnam: No. I think that those were—

Fiona Mactaggart: Because we have shown that you haven't got the resources that you need.

Philip Rutnam: This is discussed, to some extent, in Laidlaw's report and also in the NAO's Report. Those were background factors, which contributed and created an environment which made it more challenging for us to do this successfully. But fundamentally, I have to say that I see this as a matter of proper, effective management and leadership and,

not least, creating the right environment in which information flows up to the top of the organisation.

If we had had the right kind of management and leadership on this programme, we would have identified earlier that we needed external advice. We would have identified that we needed to put more resource into it. We might have done all those things later than we really should, but if we had had those two key things—really effective management and leadership and proper flows of information—I think we could have achieved this successfully, notwithstanding the wider environmental issues to do with the spending review and the challenges of the new policy.

Q116 Fiona Mactaggart: Let us just take one of those points—proper information flows. Part of the point of the Report on London Transport was a failure properly to flow information through the Department of Transport—information that had come from the NAO. So why was there not put in place a process that made sure that the information flowed? Is it not the point of the civil service that when it has a system that goes wrong, it re-engineers the system? What I do not understand is why that was not put in place following a previous muck-up. If we cannot expect it to happen, what is the point of what we do? Why are we expending this energy?

Philip Rutnam: We have the processes. I could show you on our intranet guidance documents to project managers and guidance documents to senior responsible owners of projects, which say exactly the right things about the need to identify and escalate risk.

Fiona Mactaggart: But they are ignored.

Philip Rutnam: We have the processes in place in terms of governance. We have a committee structure that is intended to provide a second line of defence for major projects and programmes to provide additional assurance on them. We have got the processes in place. It is not fundamentally a matter about process; it is about people using them.

That comes back to my points around management and leadership, and also about, to be honest, individual responsibility. There is an element of this, which we haven't touched on so far, that is essentially about the responsibility of individuals and whether they did their job in the way that was properly expected of them. I don't want the answer to this in the Department to be designing lots more processes, because, to be honest, that is not the heart of the issue; the heart of the issue is about taking responsibility for things and creating an environment in which people who know that they are dealing with difficult issues, with risks that they cannot necessarily manage, put their hand up and say that they need help.

Q117 Chris Heaton-Harris: You have said that individuals have responsibility, and I would like some more detail on your legal advisers, Eversheds. Who did they report to and why did the information not flow up the chain? That is the kind of key trigger, isn't it? Surely, when you have external legal advisers telling you something is fundamentally wrong, I would have liked to have thought that it would have

gone further up the chain than it obviously did. Is there a time line of how that flowed up? What level did Eversheds report to?

Philip Rutnam: They reported to the Department's internal legal team, which was responsible, with Eversheds, for legal advice on the transaction.

Q118 Chris Heaton-Harris: Where did the information go exactly?

Philip Rutnam: The exchanges with Eversheds immediately following the Contract Awards Committee on 27 June came to the internal legal team. They were not escalated within the internal legal team to the most senior lawyers in the Department or to the top of the Department.

Q119 Chair: Why?

Philip Rutnam: That is a very good question.

Q120 Mr Bacon: So the same general counsel who told you that you had to recuse yourself from the board meeting—the committee that you could not go to—was himself not told by his own more junior lawyers that Eversheds had told the Department that what it was trying to do was unlawful?

Philip Rutnam: That is correct. There was not the right escalation within the Department of the information that we had about the risks that we were running, whether on the legal side or on the other, non-legal side.

Q121 Mr Jackson: I suggest that it would be sensible to look at your protocols in terms of legal advice, both to get a second opinion from the Department's general counsel, because clearly the opinion that you were given had a massive impact on decision making, and to consider the receipt of legal advice from external legal representatives. That should be looked at as a matter of urgency. The narrative on this case seems to get worse as we go along. You have established a new civil service precedent that, essentially, you cannot trust the Permanent Secretary with any commercial information. That is the culture you inherited, and you did not seem to challenge the culture when you came into the Department. Particularly, as we have heard from someone from the Treasury, that is something that you need to look to.

The other thing, of course, is that that caused significant embarrassment to Ministers. The fact that you were effectively out of the loop on this meant that Ministers were also out of the loop, which caused them really serious reputational damage, as well as your Department.

Can I ask about Virgin particularly? Let me go back to the tender. Are you specifically saying that the fact that the Permanent Secretary should be precluded from knowledge of that commercial information was written into the tender? Was it an informal agreement? Or was it just assumed?

Philip Rutnam: No, it was not specifically in the tender. The invitation to tender said that the way in which the Department dealt with bids was on an anonymised basis and that the way in which the Department applied that practice within the

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organisation was such that commercially confidential information was essentially down the organisation, held by the team responsible for working on the project. The sequence of events was such that the information went to the Contract Awards Committee, which was effectively the first senior review committee to consider the matter, in June. Later, it went to the Board Investment and Commercial Sub-Committee, on which the Permanent Secretary sits, at the end of July.

Q122 Mr Jackson: But was who gets to know that information about Virgin's business? I know it has got into banking, health and all those things, but I did not know it was into civil service HR. Virgin, it seems, had a perverse effect on this. It seems to me, from reading the Report and from what you have said today, that their pressure resulted in the fact that you were kept out of the loop; then their letters, perversely, made the situation worse, because they entrenched that position, which meant the people lower down the chain were carrying on doing things, and people like yourself, the sub-committee and the Major Projects Authority were all kept out of the loop.

Philip Rutnam: Perhaps I could clarify: the pressure from Virgin of which I became aware was at the very time that they sent in letters to the Secretary of State and then to others as well—from around 20 July onwards. So it was actually right towards the back end of the process, just before this was intended to come to the Board Investment and Commercial Committee.

Q123 Mr Jackson: But you, as the most senior official—the accounting officer—were forced to accuse yourself in the process, because of those letters.

Philip Rutnam: I was advised that because I had seen the exchanges with Virgin, in which they had raised a whole range of points and had therefore broken the ring of confidentiality, I should not attend the Board Investment and Commercial Committee—specifically, the one on 2 August.

Q124 Mr Jackson: One more question: we learn in the Report, on pages 36 and 37, that various different bodies and committees were given reassurances that were factually incorrect—not, I would think, deliberately, I hasten to add. On page 37, paragraph 4.36 tells us that Treasury Ministers were reassured—this is after the contract was signed on 29 August—that everything was fine, after they had sought assurance from the Department that “Virgin's concerns were not justified”. Who actually advised the Ministers of that? Adjacent to that question, were the Transport Ministers involved in that decision and that communication with the Treasury?

Philip Rutnam: Transport Ministers concluded what they were minded to do, by way of awarding the contract, in early August, and, because this is a contract outside our delegated authority, they wrote a letter to the Chief Secretary seeking the Chief Secretary's endorsement of the award, which was received. Then the award was announced.

Q125 Mr Jackson: So that was a letter from the Rail Minister to the Chief Secretary?

Philip Rutnam: I think it would have been from the Minister of State, yes. DFT Ministers sought assurance that the proper process had been followed, that this was a robust contract award and that concerns such as whether the bid was deliverable had been taken into account. Both Transport Ministers and, I believe, Treasury Ministers sought those assurances.

Q126 Chair: Did the people who had actually done the work ever appear before the Minister? Who took the decision to the Minister?

Philip Rutnam: Yes, members of the team were involved in meeting the Minister. There were several meetings with the Minister of State—

Q127 Chair: With the members of the team?

Philip Rutnam: Various members of the team, yes.

Q128 Austin Mitchell: I would have thought the thing would have been to keep information from getting to the Minister, not to keep it from you. The Minister likes to ask you for assurances that it is all going well; you can't give them, because you don't know.

Philip Rutnam: I was not actually asked for assurances from Ministers that all things were going well until the very point at which the Secretary of State and I both had the letter from Virgin in front of us, towards the back end of July, and jointly interrogated the team as to whether there was any substance in it.

Q129 Austin Mitchell: But if you had been, you could not have answered?

Philip Rutnam: No, I would not have been able to answer.

Q130 Chair: If you had not had the letter from Virgin to challenge it, you would have acted unlawfully and awarded the contract. If you had not had the letter from Virgin, and if you had not had the judicial review challenge, you would have gone ahead, and you would then have acted unlawfully.

Philip Rutnam: I accept that if the judicial review had not come from Virgin, then, on these matters, we would not have gone through the forensic process of investigating what happened, because we had multiple assurances from within the Department that the proper process had been followed, including assurances at quite senior levels. That is, of course, completely unacceptable.

Q131 Austin Mitchell: I am puzzled by the subordinated loan facility. I do not understand what it is about, and I see from the Report that the Department did not see what it was about or what it was for. It says on page 7: “There was considerable confusion among staff about the primary purpose of the subordinated loan facility”. Why was that and what was it for?

Philip Rutnam: Why was there confusion? Because essentially the aspects of how to implement the new policy of longer franchises with more risk transfer

were developed too late. There was not enough thinking in the planning and preparation phase for the project about that issue. That is why there was confusion. In particular, it was a serious mistake to issue the invitation to tender in January without having thought those issues properly through.

It does not accord with good practice on large commercial projects to issue an invitation to tender without having thought, "What is a key dimension of the commercial offer to business?" That is why there was confusion. These things were being thought about too late. What was it actually for? The term is rather misleading—subordinated loan facilities. It is a technicality. It is really about requiring bidders to put up a certain amount of capital, which is at risk in case their business is at risk of going bust.

Q132 Austin Mitchell: Not if they care to skip or dump the contract.

Philip Rutnam: No, it is so that, if they earn less revenue and have higher costs than expected so that they are facing a position whereby there is a significant risk of insolvency and then the franchise would come back to us, and we would have to pick up the pieces, they have to call down this bit of capital that provides additional cash into the business and which can be used up to help keeping it running for longer. That is what it's about. It reduces the risk of insolvency, of default. That is invaluable for us because it means that the risk that we will need to step in to pick up the pieces is reduced.

Q133 Austin Mitchell: But surely it is a major problem. It is pretty daft that a large financial consideration will be required from the bidders, but they cannot be told what it is, and what it's for. Even the Department doesn't know. I see from the report that, "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)".

We see at paragraph 4.3 that "The Department had not developed a tool to calculate the subordinated loan facility value" at the time the tender was decided. It had not thought through, on a major financial consideration, how it would provide bidders with information to predict the likely size of their subordinated loan value. That is crazy, isn't it?

Philip Rutnam: I agree. It was not the way to be doing things.

Q134 Chair: Austin, before you go on, Philip Rutnam is agreeing all that.

You were part of the process. Didn't you notice any of these things along the way, Clare?

Clare Moriarty: I wasn't aware at the time.

Q135 Chair: Shouldn't you have been?

Clare Moriarty: The Board Investment and Commercial Committee agreed the ITT. We had quite a lot of discussion about how the GDP Mechanism—the compensation mechanism—would work. We weren't aware that there was a gap in the ITT around the subordinated loan facility.

Q136 Chair: Why not?

Mr Bacon: And you weren't aware that your lawyer had said that it was probably unlawful.

Chair: That was later on. This is the early stage. I agree with you. When you look at the early stage, why on earth were you not clear what the objectives were? You had not clearly defined them. You hadn't got a proper tool to assess them? Nothing was ready. Meg might agree. As a Minister in a previous Government, I am astounded that those questions are here today. I am astounded by it. You should have been aware, and actually you should have then put it up the chain, so that Ministers were aware. You should have done.

Philip Rutnam: I would say, in particular, that the individuals who were responsible for the project should have identified this and brought it to the attention of the Department.

Q137 Chair: We will come to those individuals. There is a management responsibility here within the civil service, as well. I don't know your structure. I don't know where Clare sits in it, and I don't know who sits underneath it. Presumably, you have taken action against those individuals. I don't know. You will come to that. It is just wrong. You can't say you have the processes there. The culture is just awful.

Philip Rutnam: I am not disagreeing that it was a very serious mistake. I am not disagreeing with that at all. The individuals were trying to do the best they could.

Q138 Chair: Why didn't they feel that they had to tell their managers?

Philip Rutnam: They should have thought about this issue earlier and planned it better. This is not to say that this is the sole cause by any means, but if we had had proper financial advisers, as we should have done, on what is a multi-multi-billion pound contract with quite significant complexities as to capital structure, they would have said, "You have to sort this." I have worked on transactions like this before and they have said and we have said, "Don't issue the ITT until you've thought this through."

Q139 Austin Mitchell: The confusion did go on. Paragraph 4.14 states: "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." It indicates that there was no corporate owner from January to March. Is that correct?

Philip Rutnam: There was indeed a period of confusion—it pains me to say this—during which it was not clear who was the SRO for this particular project. That lasted until the back end of March. One individual thought that he was no longer the SRO once the ITT had been issued. The other individual said, "I am not taking responsibility for being the SRO until the issues have been resolved, because the ITT is not complete."

Q140 Austin Mitchell: Is that anything to do with the heavy turnover of staff, because of the requirement to cut your staff down?

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Philip Rutnam: I think that that is part of the background to this. We need to face—these are individuals. Every individual at senior level involved in this was trying to do multiple things at the same time, often things that were, to be honest, at least as challenging or more challenging than this. Serious mistakes may have been made along the way, but they were trying to do their best.

Q141 Austin Mitchell: In very difficult circumstances.

Philip Rutnam: One has to have some sympathy.

Q142 Chair: Did you not get financial advisers because of the cuts?

Philip Rutnam: I am afraid I have not been able to identify exactly why financial advisers were not retained on this transaction.

Q143 Chair: Do you know, Ms Moriarty?

Clare Moriarty: No. We had—

Q144 Chair: Was it because of the moratorium on consultants? Was it something to do with that? It seems to be crazy. I agree that it was crazy.

Clare Moriarty: As part of the wider context, there was a moratorium. We had a stringent controls basis for looking at the requirement. Prior to this contract, the Department had created an in-house team that was capable of dealing with what are called long form reports. For one of the stages of valuation, which had historically been done externally, the Department created a team to do that in-house. That is slightly different from financial advice on—

Q145 Chair: So why were there no financial advisers? Was it cuts? Was it oversight? Was it a moratorium on consultants? What was it?

Philip Rutnam: If you want my interpretation, I think it was a combination of those things. The environment in relation to using external advisers after the election was clearly to avoid them if you can. I think the Department had an overly optimistic view of its own capacity to do the kind of complex financial analysis required on a transaction such as this. Those two things together led us down a path, and then we did not, as we went down that path, pause and take stock and think whether it was sensible to continue in that way.

Q146 Austin Mitchell: Thank you. Another triumph for the Osborne cuts, it seems to me. I have a couple of final questions while my voice lasts. Appearing at La Scala, Milan is a bit difficult.

The loan facility was calculated on 2010 prices, with significantly lower requirements. Why was that?

Philip Rutnam: This is another issue, I am afraid. During this period, in late 2011 and the first few months of 2012, as the team was thinking, “We need to work out how we can determine the subordinated loan facility and the amount of risk capital. How can we do it? What can we use to work it out in a robust way?” they identified that there was a tool that they could use, which had been developed for another purpose—another purpose to do with franchising, this

franchise included. It was known as the GDP Resilience Model. It was a tool that was, essentially, intended to work out how sensitive the finances of franchises were to changes in GDP. That was the purpose of that tool. And they worked out that if you made a few tweaks to that tool, you might be able to use it to work out the amounts of this loan facility. That was the approach that they took.

Unfortunately, however, there was an error in the model. The whole model was constructed in constant prices, in 2010 prices, and what was not realised—in a sense, it was not an error in the model but an error in the way in which the model was then going to be used for this purpose—was that while using constant prices was fine for working out the sensitivity of franchises to changes in GDP, it was not fine for working out the amount of a loan facility, which is, literally, an amount of cash; it is a nominal thing. So there was a confusion between real and nominal terms in the way in which that model was used for the purposes of the SLF. The result of that, I am afraid, was that we underestimated the amount of the SLF that would be required, and that was true in all the later processes up forward into the summer.

We also gave bidders misleading advice—not intentionally, but unintentionally—on the likely amount of the subordinated loan facility, because in February we issued them with a note that was not binding as to the amount but included something called a Ready Reckoner. We said, “This Ready Reckoner cannot tell you exactly how much you will have to provide by way of SLF but it gives you a guide,” and that Ready Reckoner suffered from that real/nominal confusion. As a result, all the amounts for the SLF were understated.

Q147 Austin Mitchell: A final question. Was the subordinated loan facility set higher for Virgin than for FirstGroup?

Philip Rutnam: No, the subordinated loan facility was set lower for Virgin than for First—

Q148 Chair: But higher than the model.

Philip Rutnam: But higher than the output from the model, yes. So discretion was used to increase the amount of the subordinated loan facility for Virgin, compared with what it should have been, and discretion was used to reduce the amount of the subordinated loan facility for First, compared with what it should have been.

Q149 Austin Mitchell: So how did they finish up relatively?

Philip Rutnam: At £40 million for Virgin and £190 million for First—those were the figures that were given to them.

Q150 Guto Bebb: I just want to go after the uncertainties surrounding the issue of the SLF guidance back in the first quarter of 2012. One of the key issues is the information flows within the Department, which were clearly faulty. To what extent were the concerns about those issues in the first quarter of 2012 fed up the food chain? More importantly, to what extent did the outside bidders

contact you in relation to their concerns about the transparency of the process in the early stages?

Philip Rutnam: My understanding is that the concerns in relation to how to work out the SLF, the point about the fact that there was a legal risk involved in it and so on, reached something called the Rail Refranchising Programme Board and no further within the Department. The Rail Refranchising Programme Board was chaired at director level, so two levels below me and one level below the level of director general.

Q151 Guto Bebb: So the owner of the project who was on board when you became part of the Department, was that individual aware of these concerns?

Philip Rutnam: He would not have been at the meeting of the Rail Refranchising Programme Board. I am afraid I can't tell you whether or not he made himself aware of those concerns.

Q152 Guto Bebb: This is quite a serious issue, because if those concerns had been highlighted by bidders in the process, obviously the subsequent tarnishing of the reputation of some of those bidders in the media was undoubtedly unfair.

Philip Rutnam: To be clear, concerns continued to be expressed by bidders. Certainly concerns were expressed by bidders in March, that they were not really clear how the amount of the SLF would be worked out. It is probably fair to say that those concerns—I cannot remember the exact details in terms of telephone conferences and e-mails and so on—continued to be expressed by bidders during the spring of this year about how the amounts of the SLF would be calculated.

Q153 Guto Bebb: And those concerns turned out to be accurate.

Philip Rutnam: They turned out to have real force, yes. Those concerns—in terms of within the Department—again reached the level of the team responsible for the procurement and certainly no higher than director level in the Department.

Q154 Guto Bebb: Is there any explanation as to why they did not go any further?

Philip Rutnam: This is a very good question. Laidlaw talks about two different things. He looks at this question of why information was not escalated, but he does not come to a conclusion. He talks about two different things: one is, were individuals in some cases wary of raising it with their line managers—with more senior people in the Department—because they thought that those concerns might be dismissed: that there was not a receptivity to those concerns?

He also asks whether there was a culture of completion at all costs on the project—whether, because the team was under a lot of pressure to get this done: they thought it had to be done and the contract had to be awarded in August because the franchise was coming to an end in December, and even that is not very long for a handover, and there was no opportunity to extend it, so it had to be done, the culture within the team was, “Well, okay, there are

risks, but we will ride those risks. What we have got to do, above all, is to complete the task.” I have to say that that has echoes. If you look at the accounts of industrial accidents—of things that go wrong—where you have teams working on problems, often they know that things are wrong but they decide to ride the risk, because completing the task is the thing that is uppermost in their mind.

Q155 Guto Bebb: Absolutely. The only question I would ask is, to what extent did they have an obligation to inform people higher up the food chain that there was a risk and that that risk was significant?

Philip Rutnam: They did, and if you go back to the documents that I described earlier, which we have in the Department, saying how you manage risk, of course they should have escalated. To be honest, if the line management had been as effective as it really should have been, those risks would have been escalated because of the natural flow of information.

Q156 Chair: So what are the things you have changed, Mr Rutnam?

Philip Rutnam: What have I changed?

Q157 Chair: Yes. A lot of things are emerging from this hearing, but one is that there is a culture in the Department whereby people don't see a responsibility to share information upwards; and your managers clearly, I think, don't see a responsibility for properly understanding all the things under their control. That appears to me this morning to be the culture. What have you changed?

Philip Rutnam: I don't think it is right that that is a culture within the Department; I think it is right that that was a culture in this area of the Department.

Q158 Chair: No, because it comes out in the lawyers: the lawyer didn't give the information up, so that is one bit of it. It comes out in two or three bits of the Department.

Philip Rutnam: It is very clear in relation to this project and the people who worked on this project, whether they—

Q159 Chair: But the lawyers—

Philip Rutnam: The lawyers were part of the project team. Let me assure the Committee that, in the few months I have been in this Department, we have had many other difficult projects, which we are dealing with in real time. I have seen plenty of evidence of the rapid escalation of problems and the rapid escalation of information. Information comes into the Department about some difficult issue, and within a few hours people can be sitting in my office, and we can be talking about exactly how we handle it. So I do not accept that this is a generic cultural issue. I think that this dreadful episode is one from which the Department as whole can learn, but I have not seen, so far, evidence of the same cultural issue—the lack of escalation, and an inability, unwillingness or anxiety about sharing problems—in other parts of the Department that we have clearly had here.

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Q160 Mr Bacon: You are making it sound as if, in this particular area, there were managers who might have been fearful of passing the information up the line, in case they encountered the culture of completion—“Don’t give me problems. Get it done!” “B-b-but it’s unlawful.” “Just get it done!” Is that a cartoon?

Philip Rutnam: No. I don’t think—well, I only gave you a description—Laidlaw has looked at why this problem of lack of escalation occurred, and I just gave you the two reasons he offers without his actually reaching a conclusion. If you want my own hunch—

Q161 Chair: Yes, you’re the manager.

Philip Rutnam: If you want my own hunch, in this particular case it was more to do with the fact that the team did not have the right leadership. I think this is in the NAO Report; it is certainly in the Laidlaw report: of the people who were living and breathing this project, day in, day out, often working crazy hours to get it done, there was nobody actually in the senior civil service.

Q162 Mr Bacon: Good Lord, there was not a single member of the senior civil service?

Philip Rutnam: In the project team. There was a senior responsible owner responsible for the project who was in the senior civil service, certainly.

Q163 Mr Bacon: Who was doing lots of other things?

Philip Rutnam: But in this project, which has an NPV of £5.5 billion—that was the amount of premium that First offered—there was no senior civil service. That is another significant learning point.

Q164 Guto Bebb: I just want to go back to an earlier question. One of the issues that the Chair alluded to was, where was the common sense in all this process? I asked about that. In response, you said that on a technical valuation the figures provided by FirstGroup were satisfactory, but when we asked for an explanation of the technical availability of places on trains, we then started talking about marketing, which I would say is subjective. Can you explain how you would describe the evaluation of the marketing offer of FirstGroup as a technical issue? Surely that is a subjective viewpoint.

Philip Rutnam: May I read out from a note that I have in front of me? This is the advice that I have. “Technical assessors carefully considered FirstGroup’s initiative-driven growth”—so management-action driven growth—“in the early years of the franchise, including the introduction of significant additional rolling stock”—

Guto Bebb: That is the technical side; I agree with that.

Philip Rutnam: Yes, but technical is a rather broad term here. It is looking at, is the bid credible? Is the bid deliverable in terms of—

Guto Bebb: Capacity.

Philip Rutnam: In terms of capacity; in terms of whether or not, based on experience elsewhere, this kind of marketing activity is likely to generate the additional demand. They looked at all those dimensions and came to the conclusion that the bid was deliverable.

Q165 Guto Bebb: On the issue of marketing, can you specifically quote?

Philip Rutnam: We can perhaps come back to you on that. Specifically on marketing, what I am told is that there is a lot of expertise in the rail industry about marketing initiatives and the impact they can have, and an assessment was done by people who have expertise in marketing. Beyond that, I am afraid I cannot go at the moment.

Q166 Meg Hillier: You have made recommendations and you have had a lot of reports on the news. It seems that one of the recommendations that we need to make is about specialism in the Department—we have been talking about that around Whitehall generally. If you agree with that view, what key specialist posts should be created in the Department for Transport to ensure that this sort of thing does not happen again?

Philip Rutnam: The central issue in relation to skills that is on my mind is that we have a very significant programme of big projects that involve difficult commercial—judgments, ultimately, but essentially, you need to have sufficient commercial expertise to know how to run a big project such as this or a big project such as our procurement of the Thameslink rolling stock, or any number of other—

Q167 Meg Hillier: So, commercial expertise?

Philip Rutnam: Essentially, it would be commercial expertise. The ability to act as an effective client is the other skill set.

Q168 Meg Hillier: So, a tough negotiator?

Philip Rutnam: Yes, which comes with the first point, and then project and programme management, which is linked into the point I was making about leadership.

Q169 Meg Hillier: What about finance skills? You mentioned that earlier as being a weakness in the team.

Philip Rutnam: Well, it is corporate finance.

Q170 Meg Hillier: So you would buy that in rather than have it in-house?

Philip Rutnam: In order to be an effective client, you need to know enough about what you are buying. That means that you need to be able to test what the external advisers are providing. So you need to have some corporate finance capability in-house in order to be an effective client of an investment bank or an accountancy consultant.

Q171 Meg Hillier: So, you are suggesting that there should be more recruitment from the private sector into the civil service, or maybe a bit of backwards and forwards. Or would you develop that expertise?

Philip Rutnam: Yes, that would be part of it. I would also pay attention to the development of our own people—the people that we already have. We have many very capable, talented and energetic individuals. They may not have done those sorts of things. When I joined the civil service 25 years ago, I had not done those sorts of things, but then I got exposure to them and worked on projects and programmes and starting filling those roles. So, there is an element of bringing in talent, but an element also of growing our own talent—giving people the opportunity to learn and to do.

Chair: We agree with that strongly as a Committee. We think you have got it in-house; it just needs nurturing, training and rewarding.

Meg Hillier: Sticking with the project.

Q172 Chris Heaton-Harris: You mentioned that there were no senior civil servants attached to this. Can you give us some assurance about HS2 and about how maybe you have learned some lessons from this for the biggest project you have on the go for the future?

Philip Rutnam: I hope this is not too long an answer, but I think about these things in terms of three lines of defence. Do we have the right management and leadership? Do we have the right sort of scrutiny and challenge within? And do we have the right kind of quality assurance without?

Taking management and leadership first, in both the Department and HS2 Ltd we have a very significant amount of management and leadership. In HS2 Ltd, which is a body the Department is ultimately responsible for, we have Doug Oakervee as chair, who is one of the world's—certainly one of the country's—leading experts in building and delivering mega-projects. We have a strong team of senior managers there, again, people who have real experience of having done these sorts of things in the past.

In the Department, I have some of my most capable people working on HS2, and I have recently announced the appointment of an additional director general, David Prout, who is a very senior and experienced DG in Whitehall, with lots of experience that can be brought to bear on this, to be a DG dedicated specifically to HS2 as the programme gears up and we get ready for delivery of the hybrid Bill, and ultimately for the start of construction. So there is a very significant amount of management and leadership.

Then we have a strong structure with high levels of transparency and visibility to the very top of the Department. I am talking here about boards and committees, and I sat myself in the High Speed Rail board yesterday, with people from both the Department and HS2 Ltd reviewing key aspects of the project. So we have no problem in terms of the flows of information on HS2.

Q173 Chris Heaton-Harris: And legal counsel?

Philip Rutnam: Legal counsel are heavily involved in issues around the production of the hybrid Bill and managing the property compensation scheme.

Q174 Chair: In-house? Are they in-house, all these wonderful counsel who told you that you couldn't have the detail?

Philip Rutnam: It is a good question. I think in-house and some external. Of course, we also have judicial reviews under way at the moment. In fact, I think today may be the last day on which they are being heard, in which, of course, our own lawyers and external lawyers are heavily involved. I will go away and look at what exactly the arrangements for legal advice on HS2 are.

Q175 Chair: And franchising—have you got a good team on franchising?

Philip Rutnam: Franchising—the truth is, we need to rebuild our team. This has been a very significant blow for the Department overall, but particularly in relation to rail franchising. We need to recalibrate the programme—we are waiting for Richard Brown's report on that—and we need to rebuild the team. We need to make it stronger and we need to make accountability much clearer than it has been.

Q176 Chair: I am going to ask two questions, Richard has one, and then I think we are done. How have you held the individuals to account?

Philip Rutnam: In parallel with the Laidlaw inquiry, I also commissioned an independent investigation into the HR aspect of this, which was conducted by Bill Stow, a very experienced former director general at DEFRA who also had previous experience of similar exercises that he has had to conduct elsewhere. He delivered a report to me last week, which looked at the role and conduct of individuals. That is, of course, a confidential report that will not be published. Following receipt of it earlier this week, I began disciplinary proceedings in relation to a number of individuals. I am afraid I am not going to give you any further detail on those, because that is a confidential staff matter.

Q177 Chair: Not the number?

Philip Rutnam: No.

Q178 Chair: Okay. Are you confident that extending the franchise to Virgin without a competition has not left you open to legal challenge?

Philip Rutnam: Yes. Well, almost anything in life can be the subject of legal challenge. Do we think we have made a decision that is lawful, can be defended robustly and is also in the public interest? We certainly do. We had looked at this matter very carefully, and also had extensive discussions with the European Commission, and I am confident in the decision that we have made.

Q179 Chair: And you didn't think of giving it to the directly operated company, which, from what I can see, is doing a rather good job on the east coast?

Philip Rutnam: We did consider that. Following the cancellation of the competition on 3 October, we considered whether it would be right to use Directly

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Operated Railways, or whether we should have a new contract with Virgin. The Secretary of State's very clear conclusion was that the right answer was to proceed—

Q180 Chair: Because?

Philip Rutnam: Because we are talking here about decisions by mid-October for a franchise where the contract was about to expire on 9 December. The issue is to do with securing continuity of service. The Secretary of State has a statutory duty to secure continuity of service and the challenge of doing so on what is one of the country's most complex and most important railways, given the very short time frame from mid-October to 9 December, meant that the right course was to proceed with a single tender action with Virgin.

Q181 Mr Bacon: Do you think that any judge would have found, if it were challenged, that that was the lawful and correct thing to do in the circumstances, taking account of the statutory obligation?

Philip Rutnam: I cannot speak for any judge. As I say, anything can be subject to legal challenge, but was it a lawful decision that was strongly in the public interest? We consider that it was.

Q182 Chair: A very final question. The Secretary of State said that there was nothing in the Laidlaw report that suggested that there was anything wrong in the other competitions. Do you agree with that view?

Philip Rutnam: Yes. There is nothing in the Laidlaw report to suggest that how we have gone about other competitions and other procurements suffers from the same failings. Immediately following the decision to cancel the competition, I initiated a series of actions to review other major procurements, and I am grateful for the co-operation of colleagues across Whitehall. I brought in reviewers from a number of different Whitehall Departments with no previous involvement in the matter to review the procurement processes that we adopted on a number of major transactions, or are adopting, for example, on search and rescue helicopters—the competition on that is live at the moment—the Thameslink rolling stock and our shared service centre award process. The results of those reviews were positive and assured us that there was no evidence of failures in our procurement processes.

Q183 Mr Bacon: 20 years ago, I used to represent the consulting industry, and one of the common complaints from the consulting firms that I represented was that when they were dealing with public sector organisations, it was quite difficult to get engagement with the top of the office; that the services—we are talking about intellectual services of a variety of kinds—were bought at too low a level.

There are lots of surprising things in this Report, but one of the most surprising is that an external legal adviser could tell the Department for Transport that what you were doing was unlawful, and that that didn't make it to the top of the office. It didn't even make it to the Contract Award Committee. That is really quite extraordinary. Among the various changes that you have implemented and are implementing, you

mentioned something to do with professional legal advice and making sure that it got to the top. Will that be universally the case? Will senior managers take more interest, as a matter of routine, in the content of external legal advice, so that that type of idiotic mistake cannot happen again?

Philip Rutnam: They certainly will be, I think. Let me just go back to the point I made about our documentation in relation to the processes that should be followed. The documentation basically is fine. It says, if you get that kind of information coming in, don't sit on it; escalate. The issue is about practice—making it real. In relation to the legal advisers in the Department, we are already reminding them thoroughly—although, to be honest, they have all observed these events—and they will go through refresher training.

Q184 Mr Bacon: It is an interesting answer, but it is not as reassuring as I was hoping, because what you are talking about is that when the information comes in down here, you are telling the people over there, "Make sure you push it up there—to the top of the office." What I am talking about is these people being able to talk up there. I had an example in a different area, in the IT area, where an adviser was desperate to talk to the very top of the office—to the permanent secretary—and eventually, because they felt that they were getting nowhere, to the Minister. And they said so; they said so down here. And within 10 minutes, I was told, the permanent secretary was on the phone saying, "We talk to Ministers; you don't talk to Ministers."

Now, that is what I am talking about, and what you have just said suggests that the issue is for the people lower down the office to read the guidance even more thoroughly and to be sure, if something comes in that says, "Guys, you are acting unlawfully," that they pass it up. What I am talking about is a high-level conversation. It is routine in the private sector, when successful, large, private organisations are buying consulting and advice of all kinds, that the very top of the office—the CEO and the finance director—are talking to the external advisers in a conversation all the time. So that there would have been no question of Eversheds not talking to you—except that you were being kept out of the process. That couldn't have arisen. In what you have just said, you have described an architect. You are just trying to make the scaffold—if that is probably the right word—just a bit stronger.

Philip Rutnam: Can I try to give an answer that I think will be more reassuring? Of course, I would expect the senior lawyer in, for example, Eversheds to have a relationship with and to be regularly in touch with, for example, my general counsel. I would expect, and indeed it is already the case, that on complex financing transactions that we are trying to achieve at the moment, I would expect the senior partner in the relevant advisory firm to have a relationship, if it is a particularly big deal, with me. Indeed, that is the case, I can assure you. I have, in the past month, spent quite a bit of time sitting around the table with the most senior advisers on some of our most difficult transactions, saying, "Right, what do we do?"

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Mr Bacon: “Hello, I am Philip.” That is very reassuring.

Philip Rutnam: Things can always be improved but rest assured: I completely recognise the point you are making.

Chair: Thank you very much for the openness with which you have approached this morning.

Philip Rutnam: Thank you.

Written evidence from the Department for Transport

During my appearance before the Public Accounts Committee on 13 December on the cancellation of the West Coast Mainline competition, I said I would write on a number of issues.

EVALUATION OF MARKETING INITIATIVES IN WCML BIDS

1. The evaluation of the Marketing Initiatives was conducted in accordance with the requirements set out in sections 3 and 4 of the ITT and subsequent instructions and clarification responses. Bidders are required to provide appropriate and definitive evidence to substantiate any proposals within their bids. Because the bidders have to provide this evidence themselves, the onus is on bidders to convince the assessors rather than DfT or its technical experts being required by the process to carry out independent research or seek new external evidence during the time-limited bid evaluation process. Bidders would be expected to provide particularly convincing evidence if they were anticipating higher than normal growth.

2. In the West Coast competition there was a specific Delivery Plan focusing on Marketing & Fares (DP4).

3. As is the case for all Delivery Plans, the evaluation was undertaken according to the European Foundation for Quality Management (“EFQM”) guidelines adopting the ADAR elements of the EFQM RADAR approach. More detail can be found in the note at Annex A.

HS2 AND LEGAL ADVICE

4. Lawyers currently advising on HS2 include:

- an in-house team of five DfT lawyers (some of whom have broader portfolios and also advise on other policy areas);
- four solicitors from the Treasury Solicitors Department (TSol) advising on the current HS2 judicial reviews;
- a team of four barristers (including one Queen’s Counsel) from Landmark Chambers who are currently advising on and representing DfT in the HS2 judicial reviews;
- a joint team of Parliamentary Agents from Winckworth Sherwood and Eversheds advising DfT and HS2 Ltd on the preparation of the phase 1 hybrid Bill; *and*
- legal advisers from Eversheds and Bircham Dyson Bell (BDB) advising HS2 Ltd directly

5. In addition, HS2 Ltd will be employing a small team of in house lawyers in 2013; and the team of barristers is soon to be expanded to also advise on the phase 1 hybrid bill.

COSTS

6. You asked for a break down of the costs mentioned in chapter 5 of the NAO report. Please see the detail in Annex B.

Philip Rutnam
Permanent Secretary

20 December 2012

Annex A

EVALUATION OF MARKETING INITIATIVES IN WCML BIDS

7. As is the case for all Delivery Plans, the evaluation was undertaken according to the European Foundation for Quality Management (“EFQM”) guidelines adopting the ADAR elements of the EFQM RADAR approach.

- Approach—the Department was looking for evidence the Approach proposed is sound and integrated and includes evidence of a clear rationale; defined processes; focus on stakeholder needs; is supporting of policy and strategy; and is linked to other Approaches as appropriate.
- Deployment—the Department was looking for evidence the Approach can be implemented and deployed in a systematic and structured way, with the method used for deployment being planned and executed soundly; this is especially relevant where innovation or improvement was proposed in the Approach.

- Assessment & Refinement—the Department expected to see evidence of regular measurement of the effectiveness of the Approach throughout its Deployment as planned and thereafter through clear identification of best practise and continuous improvement opportunities.

8. The evaluation involved DfT and Atkins (technical advisers). The Atkins evaluators undertook a more detailed technical analysis, which was based on a framework of issues that Bidders' Delivery Plans should answer. This considered a range of factors including:

- the proposed size and organisation of the marketing team;
- the level of resource to deliver the initiative;
- evidence of “similar” previous campaigns;
- evidence of analysis of marketing trends;
- verification of the predicted “decay” of the impact of marketing initiatives;
- how identified marketing initiatives would be implemented;
- details of how the initiative would target specific passenger groups; *and*
- how identified risks would be mitigated.

9. Individual evaluators prepared their views on the strengths and areas for improvement and entered scores into the AWARD system. Questions were raised with Bidders to clarify specific issues. The individual views and scores were then moderated.

10. In addition to this evaluation, the team considered the level of risk the proposed marketing initiatives presented. This was particularly important where the proposed size of the marketing effect on revenue was significant. An adjustment fed into the sizing of the Subordinated Loan Facility to reflect the industry experience on the rate of return of the marketing initiatives.

11. The fact that a bid that includes ambitious revenue growth from an initiative such as marketing has won a franchise competition does not mean that the Department has accepted or agreed with the revenue attached by the bidder to the initiative. The policy has been that bids can be accepted with projections which exceed DfT's projections, as long as they provide suitable capital to cover the risk which has been identified during bid assessment. If the DfT projections are correct, capital has been contracted that mitigates the risk. The Laidlaw report provided a comprehensive review of the SLF issues.

Annex B

COSTS

The NAO Review at paragraph 5.7 set out seven areas of costs. A further analysis of those costs, where available, is provided below under each bullet point heading.

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 breakdown for these costs is as below:

	<i>Forecast costs for 2012–13 as at end of October 2012 £'000s</i>	<i>Costs as per NAO Report £'000s</i>
Internal		
Staff costs	637	
External		
Agency Staff	238	
Other costs	25	
Legal Advisers	500	
Technical Advisers	471	
Total External	1,234	
TOTAL	1,871	1,900

The Department estimates the cost of professional fees related to the judicial review as £2.7 million

The breakdown for these costs is as below:

	<i>Forecast costs for 2012–13 as at end of October 2012 £'000s</i>	<i>Forecast costs as per NAO Report £'000s</i>
Internal		
Staff costs	0	
External Legal		
Legal Advisers	2,122	
Total Legal	2,122	
Financial		
Financial Advisers	600	
TOTAL	2,722	2,722

In November 2012, the forecast costs of legal Counsel's advice reduced by £187,000, reducing the overall forecast cost to £2.535 million.

The Department forecasts that external advisers on the reviews it commissioned will cost £4.3 million

The breakdown for these costs is as below:

<i>External Advisers</i>	<i>£000s</i>	<i>Forecast costs as per NAO Report £000s</i>
Legal Advisers	2,440	
Technical Advisers	164	
Financial Advisers	1,684	
TOTAL	4,288	4,300

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

The Department has invited bidders to claim refunds of their reasonable direct costs incurred. Each of the bidders has submitted their claims, which in total amount to £45.8 million. However, claims are subject to close scrutiny and detailed assurance processes to ensure their validity, and, under the rules set out in "Managing Taxpayers' Money" payments must be approved by HM Treasury. The Department is preparing to pay on validated items shortly. The Department's estimate of total costs remains around £40 million.

Parliament will be kept informed of the costs of these reimbursements.

In addition, the Department has received a claim from First Group for contractual costs incurred by them in mobilisation. The assurance process on the claim is well advanced and the Department will also be making a payment in respect of the validated items.

There are costs of Directly Operated Railways preparing a contingency plan to take over the Intercity West Coast franchise

The breakdown for the costs incurred by DOR Ltd during the period up to the award of the short term franchise agreement with Virgin Group in early December is as below:

	<i>£000s</i>
DOR Ltd Staff	282
Legal Advisers	163
Financial Advisers	364
Technology and Revenue Management	160
Property, Offices, IT and Other	127
Uniforms	230
TOTAL	1,326

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 West Coast Mainline has received significant investment in recent years with £9 billion invested in the infrastructure upgrade, and the 106 new Pendolino coaches.

The Department decided to lengthen the duration of franchise agreements, in part, to offer an incentive to Train Operating Companies to increase their capital investment in the railways. Commonly, Train Operating Companies will deliver net investment in the earlier stages of the agreement in order to start to receive the benefits of their investment thereafter soon as possible. While there is a short term opportunity cost forgone in the arrangements to extend franchises, the Department's aim remains that future franchising arrangements will deliver net benefits to the tax payer over the longer term.

The Department may incur internal and bidders' costs if it chooses to cancel competitions it has paused—on Great Western, Essex Thameside and Thameslink

The Department has not yet made any decisions on this matter. What happens to the paused competitions will depend in particular on the outcome of the Brown Review. The position in relation to the costs bidders have incurred in the event that any of these competitions is cancelled will depend inter alia on the nature of the Department's legal obligations.

ISBN 978-0-215-05439-5



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