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Department for Culture, Media & Sport

The rural broadband programme

Key facts

£1.2bn	£0.5bn	9
total public funding to private sector supplier for rural infrastructure expansion	central government contribution to the rural broadband programme	of 44 broadband projects projected to reach their 90 per cent superfast coverage target by May 2015

4.6 million premises which the Department currently estimates will benefit from access to superfast broadband as a result of the Programme

44 individual broadband projects managed by local bodies

26 rural broadband contracts signed by June 2013, all awarded to one supplier

March 2017 Department's current projection for completing the Programme (original target May 2015, new target to "secure delivery by December 2016")

23 per cent average proportion of private sector funding in contracts signed to date, compared with 36 per cent modelled in the Department's 2011 business case

Summary

The rural broadband programme

1 The government has made broadband internet provision a key public policy priority. In many predominantly rural areas, covering almost one third of UK premises, commercial providers have no plans to invest in the enhanced infrastructure required to deliver improved broadband speeds because these areas will yield lower returns. The government has therefore decided to intervene in the market and make subsidy available to stimulate investment.

2 The Department for Culture, Media & Sport (the Department) is responsible for government's broadband policies. Its objective for the UK is to have the best superfast broadband network in Europe by 2015. Before June 2013, the government aimed that by 2015, 90 per cent of premises in each area of the UK would have access to superfast internet speeds of above 24 Megabits per second (Mbps) and for all premises to have broadband speeds of at least 2 Mbps. In June 2013, it announced its intention for 95 per cent superfast coverage by 2017.

3 A unit within the Department – Broadband Delivery UK (BDUK) – is responsible for the £530 million rural broadband programme (the Programme). The Department gives grant funding to local bodies (a local authority or group of authorities, devolved government, or Local Economic Partnership), which procure the superfast broadband services for their areas. The Department has developed a framework contract for local bodies to use and also offers them support in negotiating with suppliers to provide the local infrastructure required to fill in the gaps in commercial coverage. Local bodies have generally been required to provide matched funding to the central government grant and can also put in additional money if, for example, they wish suppliers to reach a higher level of superfast broadband coverage.

4 The Department designed the Programme with three sets of safeguards intended to work together to achieve value for money, recognising that each would not be sufficient alone:

- Establishing a procurement framework for potential suppliers, promoting competition.
- Providing assurance that bids made by suppliers are appropriate through a call-off process and contract provisions.
- Providing in-life contract mechanisms to ensure that payments reflect actual costs and to clawback or reinvest revenue if actual costs or uptake differs from that anticipated.

We consider each of these sets of safeguards in turn and conclude on the overall assurance offered.

5 This report examines how well the Department designed the rural broadband programme and the extent to which the operation of the combined set of safeguards provides assurance over value for money for the subsidy. It also considers whether the Department is making sufficient progress in rolling out superfast broadband to rural areas. It does not consider wider aspects of UK broadband policy. Our audit approach is summarised at Appendix One. Our evidence base is summarised in Appendix Two.

Key findings

Promoting competition through a procurement framework

6 **The Department's market analysis concluded that BT had a strong market position in the provision of superfast broadband, but with competitors also intending to invest it opted for a competitive framework approach.** It stated that BT's advantages included its size, and its established market position as the only end-to-end provider with full geographic reach of wholesale local access infrastructure (between homes and a local exchange) as well as being a retail internet service and telephone line provider. The Department's market analysis indicated competition in the market to be weak. However, several of BT's competitors expressed an intention to invest in the market. The Department ran a competitive process in accordance with UK procurement regulations and European Commission guidelines on state aid (which aim to ensure that government funding does not distort competition within the European Union). The Department believed a centrally-supported but locally led delivery was the best approach to delivering value for money and designed a national procurement framework with call-off contracts between suppliers and local bodies (paragraphs 2.2 to 2.7).

7 **The design of the framework had advantages of ensuring affordability and transferring risk, but together with state aid conditions, this led to limited competition.** Compared to alternative funding models, the gap funding model favoured by local bodies reduced public cost and risk to government. However, stakeholders told us that the design of the Programme, including the gap funding model, the local nature of procurement contracts, the qualification requirements for prime contractors and the unattractive commercial conditions created by current regulatory and state aid conditions, were all factors leading potential suppliers to withdraw from the bidding process (paragraphs 2.6 to 2.9).

8 **There has been limited competition to BT within the Programme and, currently, no prospect of competition for the remaining framework procurements.** Nine companies pre-qualified to submit tenders for the national framework, but only three submitted final tenders and only two suppliers – BT and Fujitsu – were appointed to the framework. In March 2013, Fujitsu announced it did not intend to submit any further bids for contracts, leaving BT the only active participant in the framework. All local projects operating outside of the national procurement framework which have chosen a supplier have chosen BT. By June 2013, 26 of the 44 local bodies had signed contracts and all 26 had selected BT as their supplier (paragraphs 2.10 to 2.13).

Providing assurance that supplier bids are appropriate

9 In order to have assurance that supplier bids were appropriate, the Department needed:

- transparency over BT forecast costs (both at framework contract and local procurement stages); and
- benchmarking of the unit costs of deploying superfast broadband (paragraphs 3.2 and 3.3).

10 The Department has secured limited transparency over forecast costs. The Department required each supplier's framework bid to include a reference cost book intended to show costs at the call-off stage. BT chose to provide output unit costs from its own internal model due to the commercial sensitivity of its detailed data. On the Department's initial evaluation of BT's draft bid, its score for cost transparency indicated it had not yet reached the minimum threshold that would be required at final bid stage. In response, BT's final bid provided limited further information on cost drivers but the data still did not clearly identify input variables and corresponding unit costs. BT also contractually committed to ensure the costs in its bids would be internally consistent and consistent with its commercial investment case although the Department is reliant on self-certification from BT as it was not able to negotiate inspection rights. The Department concluded that BT's improved approach was sufficient to reach the minimum score acceptable for inclusion on the framework (paragraphs 3.4 to 3.6).

11 The Department has compared tender prices between local bids, which has helped local bodies. A key control during local procurement is the comparison of supplier bids to other costs. Most local bodies did not have competitor bids to compare. The Department instead provides local bodies with comparisons to other local bids and the financial model from the framework bid. Such comparisons have identified a few errors in BT bids, resulting in financial savings for local bodies, but the analysis is limited, as it does not link bids to unit costs or to wider benchmarks (paragraphs 3.7 to 3.10).

12 The Department commissioned analysis to benchmark unit costs through building a 'should cost' model but was hampered by lack of detailed data. The framework required suppliers to submit to a cost benchmarking study, as part of which the Department commissioned a consultancy firm to develop a 'should cost' benchmark model. A first draft of the report was completed in late May 2013, by which stage half of local body contracts were already finalised. The benchmarking report indicated that one supplier bid is in line with market expectations but has so far been unable to conclude on a second bid due to limited transparency over its complex technical solution (paragraphs 3.11 and 3.12).

13 The Department does not have strong assurance that the level of contingency included in BT's bids is reasonable. BT is required in the contracts to bear the risk of overspends. This arrangement limits public risk but may incentivise BT to include contingency in its bids. During the project, BT may only claim payment for evidenced expenditure. For 36 per cent of the costs BT has included in its bids, there is a range of benchmarks available against which the reasonableness of BT's bids can be assessed. But these benchmarks would lead to different conclusions about the amount of contingency included. For a further 41 per cent of costs, there is only limited benchmarking available and there are indications that there may be contingency in some of these amounts. For 23 per cent of costs, there is no benchmarking available (paragraphs 3.13 to 3.16).

14 The project funding contributed by suppliers has so far been lower than that modelled in the Department's 2011 business case. The Department's business case estimated that to reach 90 per cent superfast coverage, supplier contributions might be 36 per cent of the Programme's total projected funding of £1,547 million. Following the negotiation of contract conditions, the Department now expects suppliers to provide only 23 per cent of overall funding, £207 million less than it modelled in its 2011 business case. Contributions have varied between 38 per cent and 15 per cent of funding for each local area. Local bodies have provided greater contributions than expected, with total coverage slightly increasing to an estimated 92 per cent (paragraph 3.17).

In-life contract controls over costs and profit levels

15 The Department has secured in-life controls such as analysing actual costs in invoices. But no open book procedure is perfect and some risks remain. The process that the Department and local bodies will operate appears robust and should allow local bodies to validate that all equipment has been correctly costed and is separate from BT's commercial programme. However, BT's labour and project management costs, likely to comprise around 40 per cent of total costs, will be more difficult to fully assure. The Department is working with BT to introduce detailed assurance procedures, and is helping local bodies to focus invoice checking on the key risk areas (paragraphs 4.4 to 4.9).

16 The Department has transferred much of the downside risks to BT although BT would benefit from some upside risks. BT bears the risks of costs being higher, or revenues being lower than modelled, including the risk of future price regulation. The public sector will benefit from capital costs being lower than modelled. However, BT would benefit in full from any efficiencies it can make in operational costs. If take-up, and therefore wholesale revenue, is higher than expected, the public sector would share the benefits from volumes being higher than expected for the ten years of the contract. After that point, all wholesale revenue will go to BT. Experience to date suggests a possibility that BT's take-up assumption of 20 per cent may be conservative. The Department has not modelled the upside and downside risks that BT faces to determine whether the price paid for the balance of risk is reasonable (paragraphs 4.13 to 4.15).

17 **Securing value for money from the Programme will depend on scrutiny of hundreds of thousands of invoices and follow-up analysis on take-up rates.** The success of such a safeguard will partly depend on the level of skill and resource available in the Department and local bodies during implementation and beyond. The Department has begun developing processes and information to support local teams' scrutiny. Some local bodies told us they may not be well-resourced at the end of implementation to enforce clawback arrangements. The Department has stated it intends to monitor local bodies' capacity to manage contracts effectively (paragraphs 4.5 to 4.9).

Prospects for meeting targets and the future broadband market

18 **The Department currently estimates that the Programme will reach its target 22 months later than initially planned.** Only nine local projects are estimated to meet the Programme's target of supplying 90 per cent of premises with superfast broadband access by May 2015. The delay in roll-out is partly because of an extended negotiation to gain EU approval under state aid rules, which took six months longer than expected. In June 2013, the Department announced a revised target to "secure delivery by December 2016" in its business plan. The Department projects the Programme will reach 4.6 million premises in total, completing its roll-out in March 2017. At this point estimates show 92 per cent of premises in areas covered by the Programme would then have access to superfast broadband, although four local areas are not predicted to reach the 90 per cent target (paragraphs 5.2 to 5.5).

19 **All of the assets and infrastructure created using the £1.2 billion public sector investment in the Programme are likely to be owned by BT although there will be some additional wholesale access conditions.** The Programme's primary objective was to deliver value for money to the taxpayer within the existing regulatory framework, not to increase the competitiveness of the wholesale broadband market. BT's asset base will benefit from the significant public sector investment. Whether the additional access conditions secured by the Programme will have any significant impact in encouraging competition is as yet unknown. The EU's target of universal access to 30 Mbps by 2020 is much faster than the Programme's current aim of universal access to 2 Mbps, and plans for reaching this target are not yet clear. If reaching the EU target requires additional infrastructure or public sector funding, BT is likely to be in a strong position (paragraphs 5.6 and 5.7).

20 **The sector regulator, Ofcom, identified BT's dominant position in wholesale line access provision, and has taken some regulatory action to encourage greater competition.** Ofcom last reviewed the wholesale broadband market (separate from the competitive retail market) in 2010. Ofcom introduced regulatory remedies to encourage further competition in infrastructure deployment. Superfast broadband was in its infancy at the time and Ofcom did not, therefore, seek to impose any price controls on it. It is undertaking a further review later in 2013 (paragraphs 1.15 to 1.18).

Conclusion on value for money

21 The Department is seeking to deliver the government's rural superfast broadband objectives in a market dominated by one supplier. The Department is relying on a combined package of value-for-money safeguards to provide assurance. However, competition was limited and assurances over costs and take-up assumptions have been hampered by the complexity of the solution and lack of cost transparency. The Department does not have strong assurance that costs, take-up assumptions and the level of contingency in supplier bids are reasonable. Ensuring value for money for the £1.2 billion public investment now relies heavily on whether the Department can effectively implement the in-life contract controls it secured for the Programme.

22 The Department is currently forecasting that it will complete the programme 22 months later than originally planned, reaching 90 per cent of premises 12 months later than originally planned. Experience from similar projects suggests that government is not strong at taking remedial action to guard against further slippage. At the end of the Programme, BT's wholesale infrastructure is likely to have benefited from £1.2 billion of public money. Active involvement from Ofcom and the Department will be required to monitor the impact of the Programme on BT's position in the sector in the longer term.

Recommendations

23 The following recommendations are designed to help the Department use its available levers to achieve value for money from the rural broadband programme and lessons for future government projects. The recommendations are all the more important given the June 2013 announcement that the Department's programme will be extended, with a new target to reach 95 per cent of premises by 2017.

For the rural broadband programme

a **The Department should review all the reasons for the delay in roll-out to date, and guard against further slippage.** The Department's current projections suggest that the Programme will complete 22 months later than it originally planned. The Department should identify all the reasons for the slippage and then work with BT to establish where constraints exist and how to guard against further slippage.

b **The Department should seek greater assurance that BT's bid prices are reasonable and do not contain excessive contingency.** Analysis to date has not been able to give a clear picture of the extent to which the prices at bid stage include contingency. The Department should seek:

- an explanation from BT on the differences between the actual costs of a previous programme and costs included in tender bids;
- further information in bid responses on cost drivers, unit costs and reasons for cost variations to enable 'should cost' models to be applied;

- assurance from BT about how economies of scale are being passed to the public sector; and
- more detailed analysis on key risk items such as project management.

c **The Department should implement the procedures it is developing to thoroughly monitor in-life contract costs, placing additional emphasis on ensuring staff expertise.** In particular, the Department and local bodies should:

- evaluate the implementation of payment processes to inform later projects;
- carefully monitor operational costs and, if BT makes significant efficiencies over the bid costs, examine the scope for sharing in these;
- consider the long-term need for sufficient financially skilled staff to support invoice checking and clawback arrangements; and
- take steps to assure itself that local authorities are appropriately staffed to carry out robust checks.

d **The Department should consider evidence on take-up rates outside of the Programme and discuss with BT whether its modelling assumptions are still valid.** Take-up rates are a key assumption in determining investment levels and profits and can generate clawback for local bodies. If BT's assumptions appear conservative, the Department should support local bodies to use the clawback mechanisms as early as possible, and to consider whether there are ways of extending them.

For future projects

e **The Programme contains lessons which could be applied to the Department's other programmes and to wider government.** The Department sought to deliver a complex programme in a challenging time frame and designed a range of value-for-money safeguards aimed to work together to provide assurance. But there are some lessons which could be learned:

- Programme design and safeguards should be directly linked by the number and quality of market players as indicated by robust market analysis.
- If competition is weak, the Department should require a sufficiently high standard of financial transparency to be able to assure the reasonableness of unit costs.
- External benchmarking of prices to industry standards or a 'should-cost' model should be done early in the process to inform the assessment of all supplier costs.