NATIONAL AUDIT OFFICE

Report by the Comptroller and Auditor General

A New Ship for St Helena

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Comptroller and Auditor General

National Audit Office
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Report

Introduction

1. St Helena, a dependent territory of the United Kingdom, is an island in the South Atlantic Ocean with a population of some 5,500. It has no airport and since 1977, when commercial shipping lines stopped calling, it has relied almost entirely on a secondhand passenger/cargo ship, *RMS St Helena*, for transport links with the United Kingdom and South Africa; and with its two dependent islands of Ascension and Tristan da Cunha. The *RMS St Helena* is on charter to St Helena Shipping Line Ltd, a company controlled by the Government of St Helena.

2. In May 1986 the United Kingdom Government announced its intention to provide a new ship to replace the *RMS St Helena* which was 23 years old and reaching the end of its operational life. The cost of purchase was estimated at £19 million. In addition the Government agreed to provide an annual operating subsidy for 20 years, expected to total £25 million. The cost was to be borne on the Overseas Development Administration's Overseas Aid Vote.

3. The client for and the owner of the new ship is the Government of St Helena. The Administration handled all the the negotiations on behalf of the Governor of St Helena. The ship was launched in October 1989 and is scheduled to enter service in August 1990. The total cost of providing the ship is now estimated to be £32 million, 66 per cent more than the original contract price. Some £11 million is in effect being provided by the Scottish Office from their own programme.

4. This report summarises the arrangements made for the selection of contractors and the reasons for the cost increases. It also explains the involvement of the Industry Department for Scotland and draws attention to four general principles for project assessment and management.

Justification

5. In 1983 the Administration began an investigation of the shipping service to St Helena, including the frequency and standards of service and capital and operating costs. For a number of reasons this work proved inadequate and the appraisal was re-examined by the Administration's economic and engineering advisers. The House of Commons was informed in May 1986 that a new ship would be built in a British yard. At this stage the re-assessment had not been completed but the Administration recognised that the existing vessel would need to be replaced.

6. In the event the economic, financial and technical appraisals predicted a replacement requirement by no later than 1992 with a need to order a new ship by 1989. Nevertheless the Administration decided to proceed ahead of that deadline. They were concerned that the old ship did not meet the current safety demands for twin engines and that the risk of breakdown was greater than with a new ship. They also

pointed to the fact that, if replacement costs were to rise by more than 5 per cent a year above inflation, there would be no economic advantage in deferral. In addition the Foreign and Commonwealth Office were anxious that the Islands, whose expectations had been raised by the May announcement, should not be disappointed. The Department of Trade and Industry attached great importance to the order for the shipbuilding industry. The Treasury found the argument finely balanced: they expressed concern that expenditure would be incurred on the Aid Programme earlier than necessary but approved the project. In December 1986 the House of Commons was informed of the decision to proceed.

The Tenders

7. The Administration, with the advice of the Department of Transport, sought tenders from marine consultancy firms to provide a comprehensive technical service for design and construction, including advice on procurement. The appointed consultants designed the ship and in August 1987 they obtained tenders from five shipbuilders. Three of these, with yards in Aberdeen, Clydeside and Lowestoft, were shortlisted for more detailed review.

8. The consultants' technical recommendation was to award the contract to Hall Russell Ltd of Aberdeen. This company had also submitted the lowest tender but, unlike the two other tenderers, was unable to provide a financial guarantee which the Administration considered to be of sufficient value to cover the construction and post-delivery periods. On the Administration's instructions the marine consultants asked financial consultants to examine the bid and to review the company's business prospects. In October 1987 the financial consultants advised, on the assumptions that the company would complete its order book to schedule, win additional orders and achieve a ten per cent productivity increase, that it would just be able to survive with the St *Helena* contract. However, given more pessimistic assumptions, the financial consultants considered that the company would have to close the shipyard before the launch of the vessel.

9. In November 1987 the financial consultants advised that, as Hall Russell had not won any of the three orders used in its projections, should there be no other orders the company would require a further injection of capital within a year if it was to complete the ship, either to a launch condition or for final delivery. They also advised that if Hall Russell secured a £4 million order for the conversion of a ferry, for which it was then negotiating, it should be able to deliver the St *Helena* ship. The consultants did not speculate as to whether the company might secure further orders which would be necessary to enable it to remain in business during the warranty period.

10. In the light of the financial consultant's report the marine consultants advised that they saw the alternatives as:

(a) the additional order or an equivalent contract — which they considered a less favourable position than in their previous report;

(b) an injection of more capital;

(c) an increase in the price of the ship — which would reduce the differential between the tenders and reduce the reasons for taking the risk of placing the contract with Hall Russell.

They stated that if this situation were to arise in the private sector, they would advise the purchaser to set out specific financial terms; if these were not substantially met, negotiations should be suspended and alternative tenders considered. They advised that Hall Russell did not appear to have a reasonable chance of remaining in business without an additional order (which it later obtained — paragraph 16); their overall view on whether to proceed with the company was dependent on the Administration's required terms and whether Hall Russell could meet them.

11. The Administration remained concerned that on certain assumptions the company would go out of business before the ship was built and that on certain more optimistic assumptions, it would not survive the warranty period. They had already consulted the Department of Trade and Industry and the Ministry of Defence in view of these Departments' expertise of shipping contracts and guarantees; following these latest developments they sought their further advice. The Ministry of Defence expressed the view that the guarantees of £2.4 million offered by Hall Russell Ltd amounted to about a half of those which they might have expected. The Administration concluded that the advice about Hall Russell's financial condition was decisive against awarding the contract to them, regardless of guarantees. They favoured the third lowest tenderer, at an additional cost of £1.9 million, whose bid was technically superior to and only marginally higher than the second lowest.

12. The Industry Department for Scotland had been monitoring the situation and told the Administration that they were not convinced that there were adequate grounds for setting aside Hall Russell's tender given that it was cheaper and technically superior. The Department were aware of the company's financial instability and the likelihood of imminent receivership without further orders. Nevertheless they considered that the Administration were unduly pessimistic about the productivity gains likely to be achieved and the yard's prospects of securing further orders including the ferry conversion. They felt that the guarantees being sought by the Administration were too stringent and thought further orders were likely to follow once the *St Helena* contract was awarded.

13. The National Audit Office were unable to find documentary evidence to support these views. However, the Department explained that they based their opinion on the established good reputation of the yard, the standard of its facilities, the good track record of the new yard manager, and the fact that there were a number of potential orders, which the yard were pursuing actively, for vessels to which the yard's expertise was particularly suited.

14. The Department noted the Administration's view that it was impossible to be certain of the additional costs which would be incurred if Hall Russell failed and another yard had to complete the

St Helena. They also noted that the Administration's estimate, based on professional advice, of the minimum guarantee which should be sought from Hall Russell up to the time of the launch, was £4.5 million to cover nugatory advance payments and realistic disruption costs. The Department concluded that the net risk to public funds in the event of Hall Russell's receivership should not exceed £0.2 million — taking account of Hall Russell's £2.4 million guarantee and the £1.9 million difference between the Hall Russell and the Administration's preferred tender.

15. The Department took the view that this relatively small financial risk was justified, given the likelihood that the yard would fail if it did not secure the *St Helena* order and the associated social and economic consequences. The Department told the National Audit Office that, in advising the Administration that the order should be placed with Hall Russell, they also took into account the wider economic difficulties in Scotland at the time in the shipbuilding, steel and offshore oil and gas industries, in the last case bearing particularly heavily on Aberdeen. The Administration, however, maintained their preference for the third lowest tender. The Scottish Office therefore proposed to transfer to the Administration any amounts required to meet the costs of completing the *St Helena* above their preferred tender and after allowing for the £2.4 million Hall Russell guarantee. The Treasury approved this unusual arrangement subject to the costs being found from the Administration's and, if necessary, the Scottish Office's existing Public Expenditure Survey provisions.

16. Ministers agreed on 26 November 1987 that, subject to negotiation, the contract should be awarded to Hall Russell. To facilitate securing the ferry order (paragraph 10), a notification of award, subject to contract, was issued to Hall Russell. The company obtained the ferry order on 3 December and the Administration placed a fixed price contract for the *St Helena* on 17 December in the sum of £19.5 million. The company's bank provided a performance guarantee of £2.4 million; although the Administration were not aware of the fact at the time, this guarantee was secured against the £2.4 million advance payment provided on contract signature which was being held by the bank. The contract included clauses requiring Hall Russell to provide quarterly management accounts and other financial information. This is not typical of fixed price shipbuilding contracts but the provisions were introduced by the Administration because of the company's delicate financial position.

17. Following the placement of the contract the Department invited the Scottish Development Agency to assist Hall Russell in reviewing and if necessary improving its financial and organisational structures. In February 1988 the Agency commissioned an accountancy firm to examine Hall Russell's financial systems; however because of the need to preserve client confidentiality, the Agency were unable to make available the results of the firm's work to the Administration or to the Department.

18. From February 1988 the marine consultants monitored the promptness of payments being made by Hall Russell to its suppliers and sub-contractors. Because the £2.4 million advance payment was not available to the company (paragraph 16) it had increasing difficulty in meeting its commitments. These problems were discussed on several occasions at meetings between Hall Russell, its bankers, the Administration and the marine consultants. In September Hall Russell made proposals to revise the stage payment schedule to alleviate its financial problems. Whilst these were being considered steps were taken in mid-October to obtain improved financial information.

Receivership

19. Towards the end of October 1988, the marine consultants became concerned that Hall Russell was failing in its contractual commitments to maintain payments to suppliers and was using stage payments to settle old debts and had insufficient funds to pay sub-contractors and suppliers. At the end of October they advised Hall Russell that it would have to resolve the problems of payment to one particular supplier before they could clear the next payment. Before this situation was resolved, Hall Russell's financial situation deteriorated. The company was put into receivership by its bankers at the beginning of November, with debts of several million pounds owed to over eighty creditors. At this time the *St Helena* was one-third complete, up to schedule and technically satisfactory. The Administration had paid £7.2 million in stage payments.

20. To provide time to consider the options available, the Administration, on behalf of the Governor of St Helena, negotiated with the Receivers to continue financing construction in receivership on a short-term basis at a labour cost of some £140,000 a week plus essential materials. Payments were made to the Receivers under an agreement with them designed to protect the rights of the Government of St Helena whilst enabling work to proceed. The work carried out, which eventually totalled £4.1 million, was restricted to essentials to allow the ship to be completed at another yard, should it become necessary. By this means the Administration hoped to ensure that the vessel itself and any future work would remain distinct from the problems of the shipyard.

21. During this period of financing in receivership the Administration found that a number of firms which had provided or were in the process of producing materials for Hall Russell were pressing for payment and threatening to cease work. In some cases, claims were for work invoiced prior to receivership and it was not evident to what extent this work had already been covered by stage payments. In other cases firms refused delivery or were not prepared to continue production without payment. In a few cases where materials had been delivered it was not wholly clear whether ownership had passed. However, in order to protect their future position, minimise disruption to the construction schedule and the additional costs of completion of the ship, and to facilitate the continuation of work, the Administration decided, in consultation with the Industry Department for Scotland, to settle a number of outstanding claims, either through the Receivers or direct under separate new contracts.

Re-tendering

22. On 23 December 1988 the Administration asked the marine consultants to invite tenders for the completion of the ship. Two categories of company responded: four incorporating offers to the Receivers for the purchase of the shipyard and wishing to complete the vessel in situ; and three proposing completion of the vessel in their own yards. In assessing the tenders, the Administration and their consultants considered a range of criteria relevant to the successful completion of the ship in addition to the cost factor. In consultation with the Industry Department for Scotland and the Receivers the Administration narrowed the choice to Zenta Engineering Ltd, ship repairers with yards on the Clyde and the Tyne, and A&P Appledore International Ltd — a major international shipbuilding and marine consultancy and a subsidiary of the A&P Appledore Group — having yards at Falmouth, on the Tyne and elsewhere in the UK. Both proposed completion in the Hall Russell yard at Aberdeen which they would purchase from the Receivers.

23. The consultants evaluated the technical and managerial background of the two companies, their ability to withstand unexpected technical, managerial or financial problems during the construction period, and their ability to attract new contracts. They also examined the likelihood of each retaining key personnel and took account of their record on industrial relations. On several key issues the consultants judged Appledore as a significantly better risk than Zenta. They also had reservations about the performance bond of £2 million offered by Zenta compared with Appledore's offer of £3.7 million and a recommended bond of £5 million. Consequently, they regarded Appledore's bid as preferable, even though the tender was £1.5 million higher.

24. The Industry Department for Scotland took a different view. They recognised that Zenta was smaller and less experienced but considered the company's technical and business expertise was more than adequate to complete the *St Helena* on time and within budget. On balance they concluded that ownership of the yard by Zenta offered the better long-term prospect for shipbuilding and marine employment in Aberdeen. In the Department's view, the advantages identified by the consultants of employing Appledore were insufficient to offset its additional £1.5 million tender. Bearing in mind their acceptance of responsibility for additional costs (paragraph 15), the Department recommended on 26 January 1989 that the Administration should attempt to negotiate a satisfactory contract with Zenta.

25. Zenta's original offer proposed a number of deviations from the invitation to tender, one being the omission of a warranty covering work done or materials already provided or selected. This became an issue of particular concern to the Administration when, during negotiations, the company declined to improve the warranty — effectively negating any meaningful warranty on the ship as a whole. The company also indicated that it wished to negotiate separately for any remedial work which it considered necessary — effectively undermining the fixed contract price. On 13 February the Administration, with the agreement of the Industry Department for

Scotland, therefore re-opened negotiations with Appledore, who had previously agreed to provide a full warranty. At the same time the Administration also offered Zenta the opportunity to reconsider the warranty issue.

26. In subsequent negotiations Zenta offered a better warranty though at an extra cost of some £350,000. To take account of work done in receivership both firms offered a reduction in price: Appledore one of some £500,000 and Zenta £300,000. The net effect of these revised offers was to reduce the gap between the tenders to about £900,000.

27. On 16 February Zenta made an offer to the Receivers, available until 17 February, to purchase the shipyard which was not dependent upon obtaining the contract for completing the ship. The Administration were concerned that if the Receivers accepted this offer, there would be little alternative but to accept the terms offered by Zenta for the completion of the vessel.

28. Meanwhile the Administration had negotiated a contract with Appledore for the completion of the ship, subject to the company's acquisition of the yard. In the light of Zenta's offer, Appledore also submitted a formal bid for the shipyard but it was £200,000 lower. As it is a receiver's statutory duty to accept the best offer available the Receivers agreed to sell the Hall Russell yard to Zenta.

29. However, after discussion and negotiation between the parties concerned, on 19 February Appledore made an offer that Zenta withdraw from the agreement for a consideration of £500,000. Appledore was prepared to pay Zenta this sum and to increase its bid for the shipyard to a figure slightly higher than Zenta's offer provided the Administration would accept a £0.6 million increase in its tender price for completing the ship. The Administration, after consulting the Industry Department for Scotland and taking legal advice, concluded that the safest way to protect the Government's position would be to agree to accept the increase in the contract price. They received an assurance from Appledore that it would not use its position as owner of the yard to re-negotiate the contract terms. The Receivers accepted Appledore's revised offer on 20 February and the following day the contract to complete the ship was signed.

Project completion

30. The ship was launched on 31 October 1989 and is scheduled to enter service in August 1990, eight months later than originally planned. The total cost of the ship is now estimated at £32.3 million (net of the £2.4 million guarantee for Hall Russell called in by the Administration), an increase of £12.8 million (66 per cent) on the initial contract price of £19.5 million. The Scottish Office liability arising from their indemnity is some £11 million. The 1989 Winter Supplementary Estimate for the Overseas Development Administration's Overseas Aid Vote (Class II Vote 5) included an additional £9.3 million to cover the increased costs expected in 1989–90. The Scottish Office took account of the requirement to make corresponding savings in planning adjustments to their programmes before putting forward their own Winter Supplementary Estimates.

Conclusions

31. The Administration adopted their normal procedures for this aid project. They used specialist departmental advice where appropriate and engaged consultants to advise on procurement and construction matters. The Administration concluded that the project should proceed and that the contract should be awarded to the third lowest tenderer.

32. However, to take account of the views of the Industry Department for Scotland, supported by the Scottish Office's financial guarantee, they agreed to accept Hall Russell's tender. The Industry Department for Scotland believed, on the basis of the consultants' advice, that there were reasonable prospects of the yard securing further orders which would allow completion of the *St Helena*. They also believed that the financial risk was unlikely to exceed £200,000 which they considered acceptable when set against the technical superiority of the lower bid and the consequences for Aberdeen of the yard failing to win the order. Although the company secured a further order it was put into receivership before completing the ship.

33. This report is naturally not concerned with the policy decision by ministers to put work in Scotland. As a result of the decision to accept the Hall Russell tender, an additional £11 million has been committed from Government funds, and continued employment was provided to the workforce of 500, of whom 475 remain employed at the yard, with associated employment effects on the local economy.

34. Given the decision to accept Hall Russell's bid and the subsequent receivership it appeared to the National Audit Office that the Administration took steps to minimise the further costs. Nevertheless this case shows the importance of four general principles for project assessment and management:

(a) ensure that assumptions as to a potential contractor's viability are realistic (paragraphs 8 to 14);

(b) not to place contracts with firms at risk of insolvency without special safeguards — safeguards which do not prejudice the purchaser's position under company law (paragraphs 9 to 12 and 18 to 21);

(c) take special care with a contractor in financial difficulties to ensure that claims for stage and other payments reflect payments already made to sub-contractors or suppliers (paragraphs 16 to 21); and

(d) establish clear lines of responsibility which preserve the interests of the Aid Programme when the concerns of other Government Departments may be different, and to allow project managers to manage (paragraphs 22 to 24).