Report by the
Comptroller and Auditor General

The Contributions Agency

The Newcastle Estate Development Project

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Executive summary

1 In January 1998, the Contributions Agency, (the Agency), let a Private Finance contract for the redevelopment and maintenance of the Newcastle estate of the Department of Social Security (the Department). The Contributions Agency were one of the Department's agencies and, with three other agencies (the Benefits Agency, the Child Support Agency and the Information Technology Services Agency), they occupy most of the Newcastle estate. In letting this contract, they acted on behalf of the Department as a whole. Since 1 April 1999 they have been an Executive Office of the Inland Revenue, called the National Insurance Contributions Office.

2 The Newcastle estate housed over 13,000 of the Department's staff and comprises over 2.5 million square feet, 627,000 square feet of which comprised single storey buildings at Longbenton, on the outskirts of Newcastle, which had been constructed as temporary accommodation during the 1940s.

3 To replace the ageing premises at Longbenton, the Department was advised by the Treasury to explore the Private Finance approach, under which a private sector supplier would contract to design, build and finance new buildings and to operate them and the remaining buildings for a period of years. It was a pioneering Private Finance project in the office sector. Acting on Treasury advice, and in order to increase the attraction of the project to the private sector, they included the whole Newcastle estate, which comprised both freehold land and buildings owned by the Department and leased premises.

4 The contract was awarded to a consortium formed for the purpose called Newcastle Estate Partnership, (NEP). The shareholders in NEP are AMEC Developments Ltd, a subsidiary of a UK-based international construction and engineering group, and Building and Property Group, a facilities management company.

5 From January 1998, NEP took over the ownership of elements of the Department's freehold estate in the Newcastle area and are responsible for redeveloping it during the following five years. The contract requires them to provide offices for the Department over a period of 31 years from 1998. In return, the Department will pay NEP at a predetermined price according to the availability of the space. At the end of the contract, the Department have various options, including renewing it, occupying the buildings on a traditional lease arrangement at a predetermined rent, or moving elsewhere. The expected net present cost of the deal is £241 million.

6 We examined whether:

a) the contract will deliver the accommodation service sought;

b) the Contributions Agency's conduct of the procurement was satisfactory; and

c) the contract would achieve the objective to provide the best value for money to the taxpayer and the Department.

The methodology for this examination is described at Appendix 1 of this report.

The contract should deliver the accommodation service sought

7 The Contributions Agency sought to negotiate a contract on behalf of the Department which would:

a) provide good quality accommodation in the Newcastle area, which will provide an adequate working environment for staff;

b) reduce escalating maintenance costs;

c) provide accommodation which is adaptable both in terms of movement between business units and future reductions in staffing;

d) reduce the number of sites housing business units;

e) provide accommodation which is IT-friendly and capable of further IT expansion; and

f) harness private sector skills and innovation.

8 Many of the existing premises are old and in very poor condition. This means that new accommodation will almost inevitably yield major operational benefits. The contract provides for the number of sites to be reduced from 12 to 5. Some flexibility if staff numbers fall is given by providing for the Department to vacate up to 20 per cent of the accommodation free of charge over the 25 years that the buildings are occupied. The Department can also request construction of a further new building during the first seven years of the contract should that be necessary.

9 The Contributions Agency sought to allocate risks to the party best placed to manage that risk, because such an allocation of risk is most likely to provide value for money. The contract does allocate the major risks appropriately and in accordance with this principle.

10 The Department have transferred to the private sector the risk that the Department might vacate up to 20 per cent of the office space available under the contract. This decision was informed by:

a) the known and possible major changes affecting the Department and its staffing levels;

b) discussions with the three bidders about the likely level of flexibility which they would be able to fund at a reasonable price, before asking all of them to include such flexibility in their final bids; and

c) historical movements in staffing levels since the early 1970s.

11 The Department were aware that a number of major changes were under consideration, such as the introduction of major IT systems and possible greater use of outsourcing, including (for example) Child Benefit work which accounted for some 1,850 staff on the Newcastle estate. The Department therefore felt that the future was very uncertain and all business units felt unable to make realistic long-term forecasts of their requirements for office space. Because of this uncertainty the Department saw flexibility as mandatory. The Contributions Agency also saw flexibility as inherent to their understanding of the Private Finance Initiative. They did not, therefore, ask bidders how much it was adding to their prices. This approach means that the Agency did not know, with certainty, whether the Department were likely to need the flexibility over the life of the contract – it was a matter of judgement – and they did not know how much it would cost the Department.

The procurement took longer than planned

12 When the Contributions Agency began work on the project, there was no precedent for seeking to use the Private Finance approach to provide office space. This absence of direct precedents was a factor in planning and managing the procurement.

13 The Contributions Agency set up an appropriate team to manage the procurement and sought to use what wider Private Finance precedents they had to conduct the procurement effectively. By including the whole Newcastle estate in the project, they responded to earlier advice that a Private Finance solution was not viable for the Longbenton site alone. They issued an output or performance specification that gave bidders an opportunity to offer innovative solutions to the Department's requirements. They achieved some significant advances in Private

Finance Initiative practice including better approaches to dispute resolution, and a clause that allows the Department to occupy space free of charge when temperature limits are breached.

14 The procurement took three years from the Contributions Agency inviting interest to signature of the deal, compared to an initial timetable of nine months which they acknowledge, with the benefit of hindsight, was too short. The effect of this was to involve bidders and the Agency in much higher procurement costs than they had expected and to delay the start of the redevelopment. The preferred bidders, and others, were concerned about the costs they had to bear, although six of the eight bidders stated that they would still be interested in bidding for future Private Finance projects.

15 The length of the procurement left little time between the award of the contract and the expiry of the leases on some existing buildings. The Agency and NEP worked together to minimise the operational consequences of the delayed start and NEP decided to begin detailed design work before the contract was awarded, with the confidence of having agreed commercial terms. At the time of writing, construction of the new buildings is progressing well and the National Insurance Contributions Office do not expect to have to renew any of their current leases for this reason.

16 In a ground-breaking procurement such as this one, it is inevitable that issues will arise for the first time and the tackling and resolution of these issues will extend into the procurement period. The main issues to arise during procurement were:

a) important requirements developed after the start of the formal procurement process;

b) difficulties of inter-agency co-operation within the Department, principally obtaining information on the conditions of existing buildings on the estate;

c) moving to negotiate with a preferred supplier while there remained important areas for negotiation. However, the National Insurance Contributions Office believe that the preferred supplier was appointed at an appropriate time and after a rigorous evaluation process;

d) the Contributions Agency continuing negotiations until satisfied with both the deal and the contract details; and

e) following commercial agreement, NEP took five months to conclude its external funding arrangements.

The Department consider that the deal represents value for money and is within probable budgetary allocations

17 The Department's main financial objective was to provide a solution which offers best value for money to the taxpayer and the Department. The Department took assurance on value for money through what they considered to be a competitive process and a comparison of the costs and benefits of the deal with those of remaining in the existing, dilapidated estate.

18 This comparison showed that the direct cost to the taxpayer of the Private Finance deal of £241 million (in present cost terms) was £51 million more than remaining in the existing premises. But the Department estimated that efficiency improvements of only three per cent of annual running costs would enable them to contain this extra cost within their budgetary allocations. There are a number of benefits arising from the replacement of the dilapidated estate, including improved working practices and working environment, and freeing the Department from the risks of property ownership. As a result, the Department concluded that the extra cost of the Private Finance deal was justified by the operational and risk transfer benefits it offered.

19 The Department decided not to prepare a full Public Sector Comparator, which would have estimated the costs of publicly financing a redevelopment of the estate. As a result, we are unable to say whether the deal is likely to deliver better value than a conventionally financed redevelopment of the estate. The Department's decision not to use a Public Sector Comparator was consistent with Treasury guidance extant at the time, which did not require the preparation of a Public Sector Comparator. The guidance has subsequently been withdrawn,[1] and the use of a Public Sector Comparator to demonstrate value for money of Private Finance deals is now standard.

1 This guidance was contained in *Private Opportunity, Public Benefit* (published by HM Treasury in November 1995). This guidance was subsequently replaced by new general guidance from the Treasury PFI Taskforce: *Step by step guide to the PFI procurement process* (first issued in July 1997 and revised in April 1998); *Partnerships for Prosperity* (November 1997); and specific guidance dealing with the preparation of public sector comparators *Public Sector Comparators and Value for Money (March 1998)*.

Recommendations

Preparing for procurement

1 It is important that departments considering the potential for Private Finance projects think sufficiently widely about their requirement.

This project demonstrates how, in accommodation projects, departments can improve the feasibility of their projects by applying an output specification, and by including a wide portfolio of property to enable the private sector to make innovative proposals.

2 Departments should undertake a comprehensive strategic review of the fundamentals of the service they require before they begin formal procurement.

In this project, in line with the Contributions Agency's understanding of the negotiated procedures, many fundamentals of the deal were developed after the Contributions Agency issued a notice inviting private sector interest. This is because they were concerned that the private sector were becoming aware of the project and that they needed to issue the notice quickly to preserve fairness between bidders. The contract notice reflected all requirements known to them at the time and provided the flexibility to develop key requirements as the procurement progressed. This approach reflects the ground-breaking nature of the project and the negotiated procedures procurement route followed by the Agency.

3 Where large projects are undertaken involving the accommodation of several executive agencies, they should have the appropriate level of corporate management and support. This should help reduce the scope for dispute and poor co-ordination between the participating bodies.

This project was managed by the Contributions Agency on behalf of other parts of the Department, although other users, the Department's central administration function, and other parts of government were represented on the project board. The project team encountered some co-ordination difficulties during the procurement, but such difficulties may be encountered by any team procuring a service on behalf of a number of autonomous agencies.

4 Departments should exercise caution when setting project procurement budgets and timetables. Using budget and timetable data from other projects can be helpful but sufficient attention must always be paid to differences between projects.

> The Contributions Agency initially set too short a timetable and too small a budget, largely because of the lack of useful precedents to guide the estimates. They adjusted their timetable and budget as soon as they realised that their initial estimates were overly ambitious.

5 The risk that business requirements, such as the way space is used or staffing levels, may change is one of the most important risks facing departments when they enter into Private Finance contracts for office accommodation over a long period. Departments must adopt the same approach to this risk as to any other: identifying the most likely outcome, considering who is best placed to manage that risk, and considering how to mitigate any residual risk remaining with the public sector.

> In this case, the Department considered that the staff numbers and known and possible changes to the business were the key drivers of accommodation requirements. To inform their judgements about this risk, the Agency sought to obtain staffing projections from all business units using the accommodation, but, given uncertainties affecting the Department's overall business strategy, considered that any staff projections beyond a five-year horizon would be speculative and unrealistic. But, after discussions with bidders, they concluded that the private sector could manage an overall level of flexibility at 20 per cent of total office space, and requested bids on this basis.

6 Departments should consider inviting variant bids from suppliers in key areas of accommodation deals, such as flexibility to vacate space without payment and whether to require a capital payment for property transferred to the supplier. On flexibility, variant bids would enable departments to assess the price they would pay in higher basic charges in order to reduce the risk of having to pay for surplus space. On capital payments, variant bids would enable departments to assess the amount they would pay in higher basic charges if they require an up-front capital payment from the supplier.

> The Department considered flexibility as a mandatory requirement and therefore saw no need to request variant bids. However, they will receive discounts from accommodation charges should they not use, or surrender

their rights to, flexibility. On capital payments, the Department obtained variant bids showing the additional cost of requiring an up-front payment and decided on that basis not to require one.

Managing the procurement

7 It is vital that client departments eradicate major uncertainties from suppliers' bids before awarding one preferred bidder status.

The Agency appointed NEP as preferred supplier having identified uncertainties relating to NEP's bid, principally concerning the proposed design for the new buildings they planned to construct. The Evaluation Panel considered that these were negotiable at a cost which would still mean NEP provided best value for money. The Agency was successful in limiting the cost of resolving these uncertainties during negotiations with NEP to a level below that assessed by the Panel. This also reflected their wish to limit bidders' costs.

Achieving value for money and a sound deal

8 Where, as in this case, the Private Finance option has a higher direct cost to taxpayers, departments should, before signing the deal, consider carefully the indirect benefits in terms of risks reduced or transferred to the private sector and the value to their operations of higher service quality. If quantification is not possible, they need to set out clearly and comprehensively how they have arrived at the conclusion that the unquantifiable benefits outweigh the quantifiable costs.

In this case, and in accordance with then-extant guidance, the Agency took assurance on value for money through competition. Comparisons conducted by the Department showed that the Private Finance deal had a higher direct cost than the alternative of remaining in existing accommodation. But they considered that the extra direct cost of the deal was justified by the operational benefits they expected it to bring.