

The Radiocommunications Agency's joint venture with CMG



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
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executive summary

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Introduction

- 1 The Radiocommunications Agency (the Agency) are an Executive Agency of the Department of Trade and Industry (the Department). They regulate the use of the civil radio spectrum in the United Kingdom (**Figure A overleaf**). Their work includes licensing the use of the radio spectrum, assigning frequencies over which users can transmit signals, monitoring use of the spectrum to confirm that there is no unauthorised use and investigating interference detected by their monitoring activities or in response to complaints from users.
- 2 In June 1998 the Agency entered into a partnership with CMG (UK) Ltd, the UK subsidiary of CMG plc, a leading European information technology (IT) services group, referred to in this report as CMG. The two parties established a joint venture company, Radio Spectrum International, owned 30 per cent by the Secretary of State for Trade and Industry, on behalf of the Agency because the Agency do not have the legal right to own shares, and 70 per cent by CMG. Radio Spectrum International provide the Agency with IT services and exploit commercially the Agency's skills by selling consultancy services and IT systems to overseas administrations.

The focus of our study

- 3 We examined:
 - why the Agency chose a partnership to meet their IT requirements;
 - how well the procurement of the partner was managed;
 - whether the foundations have been laid for a successful partnership; and
 - what benefits are likely to arise from it.

These four questions are analysed in Parts 1-4 and findings are summarised below. Our methodology is summarised in Appendix 1.

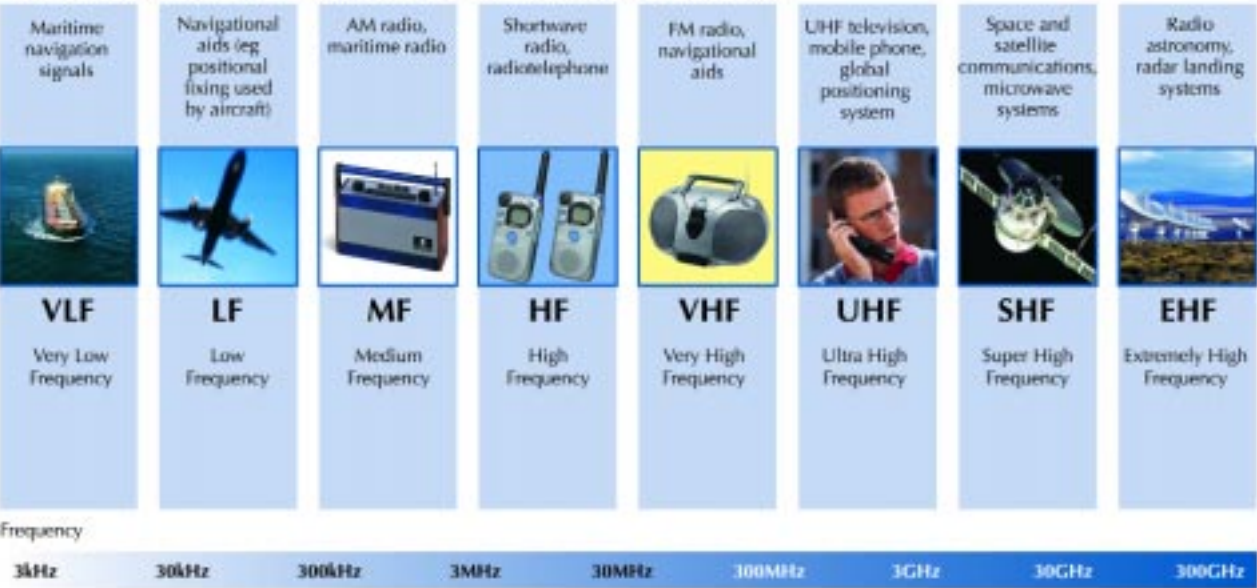
Paragraphs 1.5-1.22

Part 1: Why did the Agency choose a partnership for delivery of IT services?

- 4 IT is important to the Agency's business, impacting on practically every aspect of their work. For example, the Agency use large, sophisticated databases and bespoke applications developed in many cases by the Agency's radio engineers to model the impact of the allocation of frequencies on users. IT is also a key element in the Agency's research and development aimed at extending the usable radio spectrum. When first considering different ways of obtaining IT services in 1994, the Agency were unable to meet their requirement for IT services from in-house resources and were heavily reliant on the use of expensive individual contractors. The Agency were keen to achieve financial savings by bringing this reliance to an end.

A The radio spectrum

This figure shows the range of frequencies which make up the radio spectrum and the main user groups for specific points of the spectrum. The Agency manage the spectrum to achieve the most effective use of it and in accordance with domestic and international regulations. They license use by companies and individuals and monitor activity to prevent unauthorised use and interference to transmission.



Note: kHz = kilohertz, or 1000 Hz; MHz = megahertz, or 1000 kHz; GHz = gigahertz, or 1000 MHz

Source: National Audit Office

- 5 The Agency reviewed a number of options including outsourcing, which would have involved the transfer of IT staff and responsibility for delivering services to a private sector company. Concerned about transferring business-critical IT systems to a contractor, the Agency sought a solution that would give them more influence over the delivery and development of IT services than they considered could be achieved by outsourcing. The Agency regarded this influence as particularly important because they considered that their engineers needed to retain the flexibility to modify systems in response to new developments in technology and that this would not be easily accommodated in an outsourcing contract. The Agency also wanted to retain some in-house expertise in the delivery of IT services so that they could, if necessary, resume the provision of IT services in-house at some future date. In addition, they considered it important to retain sufficient in-house expertise to interact effectively with the private sector company. The Agency decided that they could best achieve these objectives through a long-term partnership with a private sector company. The partnership, moreover, would give the Agency access to a wider range of skills and resources than they had in-house, be available when needed and at a lower cost than their existing arrangements.
- 6 The Agency had, over a number of years, been receiving a large number of requests for assistance in spectrum management issues from overseas radio spectrum administrations. They considered that there was scope to exploit commercially their expertise in spectrum management through the provision of consultancy services and the sale of their spectrum management IT systems. They decided to link the delivery of IT services and commercial exploitation as one project. The Agency reasoned that the partner would acquire, through the delivery of IT services, a good understanding of the work of the Agency and their IT systems, and so would be in a strong position to sell these systems and the Agency's expertise in radio spectrum management. The commercial potential of these systems would also give the partner a clear incentive to concentrate on the efficient and effective delivery of the Agency's IT services.

- 7 After investigation of the options the Agency decided the partnership should take the form of a joint venture company and that this would provide them with the influence they sought over the provision of IT services. The idea of establishing such a company was an innovative approach to securing IT services in the public sector at the time. The Agency recognised that this approach would carry some risk as there was no existing model or guidance.
- 8 The Government is encouraging departments and agencies to exploit their skills and assets commercially through the Wider Markets Initiative which is aimed at improving the management of public sector assets. This partnership is an early example of an agency trying to exploit their intellectual skills base and property commercially with the assistance of a private sector partner.

Part 2: How well was the procurement managed?

Establishing the partnership overran the planned timetable and budget

- 9 The Agency originally envisaged that securing a partner would take 13 months, rather than the 32 months it eventually took. A number of factors contributed to the delay. Senior management in the Agency had other priority tasks including progressing the Wireless Telegraphy Act 1998, which allows fees for spectrum licences to be set based on the economic value of the spectrum, thus enabling auctioning for the first time. In addition, the emergency relocation of the Agency following the destruction caused by the London Docklands bombing in February 1996 made maintaining a service for customers and managing the spectrum priorities.
- 10 Through most of the procurement exercise the Agency took the view that the IT services operated mainly by contractors, rather than in-house staff, should be transferred first, thereby realising financial savings at an early stage. On this basis the Agency wanted to transfer the development work related to their bespoke IT systems first and to leave to last the transfer of the maintenance and management of hardware and non-business specific software. The Agency also did not want to guarantee the partner a minimum workload so that they could maintain pressure on the partner to keep charges competitive. The Agency considered that these measures would emphasise to potential bidders that what was on offer was not a conventional IT outsourcing contract but one which would require the supplier to add value in the development of systems. The Central Computer and Telecommunications Agency (CCTA) - then an Executive Agency of the Cabinet Office, now an Executive Agency in the Office of Government Commerce in the Treasury - advised that the Agency's proposed transfer order, the retention of an in-house capability and the absence of a minimum guaranteed workload would create uncertainty in the minds of potential bidders. They would be likely to assume that the Agency lacked commitment to the principles of partnership. An extended dialogue between CCTA and the Agency on the issue delayed the procurement. During final negotiations with CMG, when the Agency were satisfied that CMG understood the nature of the partnership on offer, the Agency agreed to a transfer similar to that initially proposed by CCTA.
- 11 With no similar previous public sector project to serve as a model the Agency underestimated the cost of securing a partner. Their original estimate was £550,000 including the cost of Agency staff working on the project. The decision to form a partnership through a joint venture company, which broke new ground in the relationship between the public and private sectors, increased costs significantly. By the time the contracts were signed with CMG in June 1998 the Agency had spent approximately £3.4 million. Of this sum about £2 million was paid to professional advisers and £0.5 million to CMG for

Paragraphs 2.1, 2.4-2.8, 2.19-2.36

work they carried out before the award of the contract. This work by CMG included analysing the work needed to establish Radio Spectrum International and auditing the Agency's IT systems to facilitate a rapid transfer of IT services.

Paragraphs 2.15, 2.18, 2.22-2.24

The proposed structure of the partnership reduced competition

- 12** Although the proposed structure and nature of the partnership represented a new departure in the relationship between the public and private sectors there were 56 expressions of interest in the project. In February 1996 the Agency drew up a long list of 12 potential bidders. Eventually in June 1997 two companies, CMG and Logica, submitted unpriced technical bids in response to the Agency's full specification for the partnership. Of the other ten potential bidders, nine withdrew and one was acquired by another potential bidder. The Agency rejected Logica's bid because Logica were reluctant to accept the Agency's proposal that the partnership, in the form of a joint venture company, should supply IT services and also exploit commercially the Agency's expertise in spectrum management. Logica wanted a direct contract with the Agency for the supply of IT services because Logica considered that there would be serious conflicts of interest within the Agency as they attempted to satisfy the roles of both purchaser and supplier of IT services. Logica were, however, prepared to form a joint venture with the Agency for the commercial exploitation of the Agency's expertise.
- 13** A factor that reduced interest amongst potential bidders was the Agency's proposal that the Agency should hold a controlling interest in the joint venture company. The Agency initially considered this necessary to secure the influence they wanted over business critical IT systems. Many potential bidders felt that this level of control created uncertainty about their freedom to add value to the delivery of services. Before commencing negotiations with CMG, the Agency reviewed their requirements and decided to take a minority (30 per cent) stake in the company. At this stage the Agency were satisfied that the influence they sought over business critical IT systems could be achieved through contractual provisions. In September 1997 the Agency effectively issued an amended full specification reflecting this change to those potential bidders who had received the original in April 1997. This approach did not generate fresh interest in the partnership.
- 14** Another factor that reduced interest was the apparent weight the Agency attached to the commercial exploitation of their expertise. Most potential bidders did not feel they had the knowledge to sell the Agency's expertise. Of the six potential bidders left in the competition when the Agency issued their full specification in April 1997, three were deterred from competing further because they considered that CMG had a commanding position through their



existing IT contracts with the Agency. The view was that CMG would have already acquired a good understanding of the consultancy services, systems and software that could be sold.

Part 3: Have the foundations been laid for a successful partnership?

Paragraphs 3.12-3.15, 3.21-3.26,
4.17-4.18

- 15** The Agency considered that the success of the partnership would depend on establishing and sustaining a co-operative relationship with their partner at both operational and managerial levels. They considered that the importance of IT to the Agency and the pace of technological change meant that the partner would have to work flexibly with the Agency as priorities and requirements changed. Early indications are that a co-operative and collaborative partnership has been achieved and that a trust-based relationship is emerging. Members of the Agency's staff report greater levels of satisfaction with the IT services being delivered. Developments and changes to IT services are coming on stream far more rapidly than prior to the partnership. The Agency's co-operative relationship with CMG is now the approach urged in Recommendation 20 of the Cabinet Office's report, "Review of Major Government IT projects, Successful IT: Modernising Government in Action" published in May 2000.
- 16** While seeking a trust-based relationship the Agency have secured contractual safeguards. To minimise the potential for disagreement over charges for services, the Agency have full access to the accounting records of the company. This openness extends to CMG, who have undertaken to provide long-term secondees to the joint venture company, Radio Spectrum International, at cost and have agreed to provide the Agency with all evidence required to verify that charges for such secondees do not include any element of profit. CMG have granted the Department the right to audit their files to verify compliance with the relevant contractual terms. The contract also provides the Comptroller and Auditor General with the right to access the books of the joint venture company. This access extends to CMG so far as is relevant for the purposes of examining and certifying the Agency's accounts and examinations to determine the economy, efficiency and effectiveness with which the Agency have used their resources.



Part 4: What benefits are likely to arise?

Paragraphs 3.17, 3.23-3.24, 3.27-3.29,
4.5-4.16, 4.19-4.21,
4.24-4.26, Figures 12-15

The partnership should improve the value for money of the IT services

- 17** Although the Agency and CMG agreed prices in the absence of competition, the Agency expected that the contract for the delivery of IT services, worth £51.5 million on the basis of discounting the cash flows to 1998 prices, would generate savings of £10.7 million compared to the Agency continuing with their existing arrangements. These savings were in the range of £10.3 million - £12 million targeted by the Agency before negotiations commenced. Financial savings arise mainly because the cost to Radio Spectrum International of IT staff is about 30 per cent less than the Agency were previously paying to contractors. These savings may be overstated because the Public Sector Comparator - the benchmark drawn up by the Agency on the basis that the IT services would continue to be provided in-house by the Agency and against which the cost of the partnership was compared - assumed the same high level of development work continuing throughout the period of the contract. CMG's bid, which was compared against the Public Sector Comparator, assumed that the demand for development work would decrease. We estimate that if, in CMG's model, the charges for development work are increased to reflect the level of work estimated in the Public Sector Comparator the potential level of savings reduce from £10.7 million to between £4.9 million and £8.0 million.
- 18** During the first two years of the partnership IT developments were implemented more rapidly and smoothly than prior to the partnership, including a successful relocation of the Agency's headquarters. The Agency attribute this to a co-operative working relationship with Radio Spectrum International. Reports from the Agency's monitoring unit suggest that the quality of service provided has improved significantly. Service improvements are difficult to quantify because detailed information about cost and service levels was not kept prior to the partnership. The Agency told us that this was a consequence of how the Agency's systems had evolved, often being developed in-house by their own staff and without the controls they now expect in terms of project definition and service delivery criteria. An important benefit of the partnership is that, with the setting of standards by the Agency for the levels of service to be provided, they are now able to measure improvements in service over time.
- 19** Radio Spectrum International made a profit after tax of £1.3 million (about seven per cent of turnover) in the first 18 months of operation from the delivery of IT services to the Agency. As a percentage of turnover this profit was higher than the six per cent estimated by the Agency in their business case for Radio Spectrum International. Concerned about this level of profit and that profits for later years would not reduce to the notional levels anticipated in the business case, the Agency entered into negotiations with CMG to reduce the level of desktop charges. The Agency were successful. CMG agreed to reduce the charges levied by Radio Spectrum International to the extent that the Agency should save on average about £1 million per annum, in cash terms, over the remaining five years of the contract.
- 20** The Agency were able to react to the higher than estimated profitability of Radio Spectrum International because the way the partnership deal was structured made Radio Spectrum International's profits transparent. In a typical outsourcing of IT services responsibility is contracted to the private sector and the profits made are not disclosed. The Agency also share in profits through dividend payments in proportion to their share ownership of 30 per cent. The Agency have so far received dividends of £241,000.

The partnership has not introduced new risks to the Agency

Paragraphs 4.22-4.24, 4.27-4.29

- 21** The establishment of the partnership does not expose the Agency to significant operational risks. The Agency had extensive experience of working with CMG and planned no new system development projects that might impede their ability to manage the radio spectrum in the most efficient manner. CMG have provided an indemnity against costs and liabilities arising from the provision of services by Radio Spectrum International.
- 22** The Agency have limited their financial commitment in Radio Spectrum International to the value of their share capital (£300). CMG have undertaken to provide all working capital needed by Radio Spectrum International, and to fund initial marketing expenditure of the international work. The Agency and CMG could have terminated the arrangement to exploit commercially the Agency's systems and expertise after two years, but, following a review of prospects in the summer of 2000, both parties have agreed to continue with the international business and to review its strategy annually.
- 23** For the period of the contract Radio Spectrum International have been granted an exclusive licence to use crown copyright materials and the Agency's intellectual property rights for the purpose of providing international consultancy services and to sub-license these rights to customers. The Agency recognised the risk to their name and reputation from the misuse of these rights and built appropriate safeguards into contractual agreements. These require, for example, Radio Spectrum International to inform the Agency of prospective customers and the consent of the Agency before agreements are entered into. Intellectual property rights arising from the development of IT services are vested in the Agency.



The Agency have not been able to retain an in-house capability at the level they wished (Paragraphs 1.12-1.13)

- 24** The Agency have a seven-year contract with Radio Spectrum International and can increase it to ten years, providing them with long-term stability in the provision of IT services. The Agency had intended to second staff to work in Radio Spectrum International so that they would retain a sufficient skills base to allow them to resume the provision of services in-house at the end of the contract or at termination if performance proved inadequate. But the Agency have been unable to retain or recruit IT staff to fill the posts open to their staff in Radio Spectrum International and are considering ways to improve the recruitment and retention of IT staff.



Radio Spectrum International have won a number of consultancy contracts (Paragraphs 4.33-4.42)

- 25** By March 2000 Radio Spectrum International had successfully tendered for four projects (in Russia, Greece, Egypt and India) and were at an advanced stage in negotiations for three contracts in the Gulf States. These primarily involve the provision of advice on a consultancy basis. Income has not so far been sufficient to cover the high initial start up costs for this new venture. The International Business Division of Radio Spectrum International incurred accumulated losses of £141,000 by January 2000 compared with projections by the Agency and CMG of pre-tax profits of £110,000. The Agency hoped that provision of consultancy services would lead to the sale of their systems. The original business plan forecasted at least one sale of the existing IT systems by the end of 1999 and this is where most profits would have arisen. No systems have as yet been sold. It has become clear that because much of the existing Agency software is designed to meet United Kingdom regulatory requirements its marketability internationally is limited. The Agency told us that Radio Spectrum International now has the capability to develop bespoke software for international customers and to evaluate systems in development for wider international use.



Lessons learned

The partnership entered into by the Agency demonstrates that public sector bodies can produce innovative solutions to traditional problems. The main lessons learned by the Agency which may be of benefit to other public sector bodies contemplating entering into partnerships are:

i. The need for clear objectives at the outset of the process

Uncertainty about the aims of the partnership, how it should be implemented and how the IT systems and services should be transferred to the partner delayed the procurement and contributed to the withdrawal of a number of potential bidders. Clear objectives understood by all those involved in the procurement would help minimise delay and encourage a positive response from potential bidders. (Paragraphs 2.4-2.11, 2.14-2.18)

The communication of clear objectives might have been helped by the appointment of a single responsible "owner" for the project. This is now recommended by the Cabinet Office in their report, "Review of Major IT Projects, Successful IT: Modernising Government in Action" published in May 2000. Two, and sometimes three, members of the Agency's management board supervised the Agency's procurement. (Paragraphs 2.25-2.36)

ii. Trying to maintain a competitive bidding process or, in the absence of this, ensuring adequate benchmarks exist to measure value for money

Wherever possible departments should enter into contracts following a competitive bidding process. In this case competition broke down before priced bids were available because all but two potential bidders withdrew and the Agency rejected one bid. Measuring the value for money from the deal was then made difficult because details of IT service levels were not available against which to measure the outcome of negotiations. When contemplating ventures such as that entered into by the Agency, organisations should consider, as part of the design of the project, establishing existing service levels so that subsequent changes in performance can be measured. (Paragraphs 2.15, 4.19-4.20)

iii. Considering the implications of linking projects where one element is novel and unproven

The Agency considered whether the commercial exploitation of their expertise should be linked with the new arrangements for delivering IT services as a single project. Their deliberations would have been reinforced by a detailed appraisal of the potential market for the Agency's systems and expertise. (Paragraphs 1.18-1.21, 4.34-4.36)



Commercial exploitation of the Agency's expertise was a new venture and this element of the project discouraged some bidders who were confident in their ability to supply IT services but not the sale of radio spectrum management expertise. Where deals break new ground in this way a robust supporting business case might provide assurance to prospective bidders, rather than relying on untested assumptions of market potential. (Paragraph 2.18)

iv. Recognising the importance of aspects such as alignment of business interests, trust-based relationships and effective collaboration but also building in contractual protections

The Agency developed a good understanding of the key elements necessary for a successful partnership and applied these successfully to the arrangements with their partner. While making the establishment of the partnership a priority, the Agency prudently agreed a contractual framework such that delivery of satisfactory services was not solely dependent on a collaborative relationship with CMG. (Paragraphs 3.1-3.2, 3.12-3.15)

As regards the key issue of the untested commercial exploitation of the Agency's systems and expertise, the Agency built in to the contract an opportunity on the second anniversary of the contract for either party to terminate the arrangement if the venture is unlikely to become profitable. (Paragraph 4.33)

v. Having a formal process for deciding on the percentage stake to take in a joint venture company

In many cases the private sector partner will be keen to take a majority holding in a joint venture company. If the public sector body is the majority shareholder the company will be subject to normal Government accounting policies and requirements, which potential partners may regard as incompatible with the pursuit of commercial enterprises. In this case the Agency initially wanted to take a majority holding but concluded that sufficient rights to protect Government interests could be achieved contractually with a minority holding. The Agency's legal advice was that a shareholding above 25 per cent and below 50 per cent was advisable. They decided that 30 per cent was sufficient to provide them with appropriate rewards. In coming to this decision they did not, however, carry out a detailed evaluation of each partner's contribution, something that we recommend should be done as a matter of good practice. (Paragraphs 2.22-2.24)

