The Department for Culture, Media and Sport

The Re-negotiation of the PFI-type deal for the Royal Armouries Museum in Leeds

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
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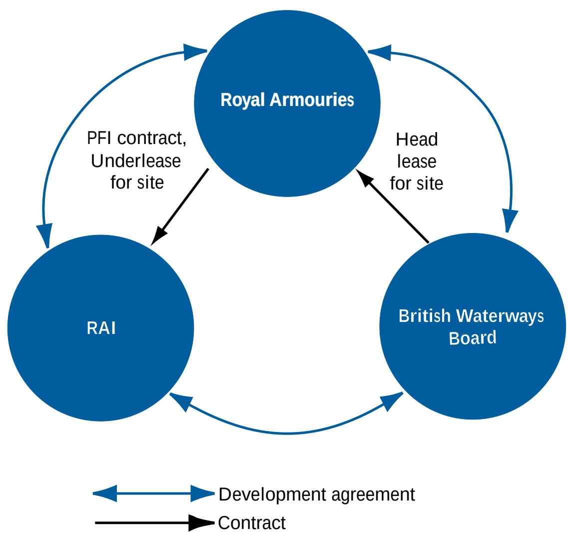
executive summary

In this chapter

1 In December 1993 the Royal Armouries ("the Armouries"), then based principally in the Tower of London, signed a contract with a private sector company, Royal Armouries (International) plc ("RAI"), for a new museum in Leeds to display more of its collection. Under the contract RAI were to build and operate the new museum. In return it would retain all the income the museum generated from visits by the public. The contract structure for the deal is shown in **Figure 1**. However the new museum never made enough money to meet its operating costs and the servicing of RAI's debts. Consequently in July 1999, after previous warnings from RAI's bankers, the Bank of Scotland, that it would not be able to make additional funding available to RAI after that month if RAI's financial problems persisted, the Armouries revised its agreement with RAI. Under the revised agreement the Armouries took over responsibility for the running of the museum, while RAI retained responsibility for the provision of some services, such as catering, to visitors to the museum. RAI is to use its income from these activities to pay off its debt with the Bank. A chronology of events is at Appendix 1.

2 The deal with RAI in 1993 was one of the very first PFI deals signed. At the time there was no guidance available to the Armouries and its sponsoring department[1] (the Department) on how to structure such deals nor was there much experience within government and in the private sector. We therefore considered whether current guidance on good practice on PFI deals would have strengthened the Armouries' and the Department's position in coping with RAI's financial problems and the threat which these posed to the museum's continued operation. We also examined whether, despite the existence now of comprehensive guidance on the PFI, there were any lessons which could be learned from this particular deal for future contracts. The methodology we adopted is set out in Appendix 2.

1 Contract structure 1993-1999



Source: National Audit Office

1 *The Armouries' sponsoring department was the Department of Environment until 1992 when the newly created Department of National Heritage took over responsibility. In 1997 this department was renamed the Department of Culture, Media and Sport.*

The deal for the establishment of a new museum in Leeds

3 The Armouries decided to proceed in 1990 with the establishment of a new museum as it considered that this would help it to meet its statutory duties by allowing it to put more of its collection on display. The profits from the new museum would also allow it to meet its strategic business objective of becoming more financially self-sufficient by reducing its need for grant-in-aid from the Department (paragraphs 1.9 to 1.11).

4 The agreement the Armouries signed with RAI in December 1993 generally met the specific objectives that the Armouries set for the project. For example, it enabled both the public and private sectors to make a financial contribution to the project and share in its returns. RAI met over £14 million of the £43 million cost of constructing the new museum, with the Armouries contributing £20 million and Leeds City Council and Leeds Development Corporation £8.5 million. While RAI was to retain, in most instances, any profits the museum made, the deal also provided the Armouries and RAI with a share of any future development gain from the redevelopment of the surrounding Clarence Dock site. The Armouries also consider that the deal maximised the private sector's contribution as its financial advisers, Schroders, told it that, in their opinion, the deal with RAI was the best that could have been achieved in the market at the time, given the project's parameters. The competition for the deal, however, elicited little response. Despite the Armouries' marketing of the deal to the private sector, it received only one serious proposal, from RAI (paragraphs 1.17 to 1.24).

5 The deal involved a major transfer of risk to the private sector. RAI was to build the museum in accordance with the Armouries' design and then operate it for 60 years. During the museum's operation RAI would receive no further public funding except for the free provision by the Armouries of its curatorial staff and a contribution by the Armouries to the museum's marketing and promotion costs. RAI was to meet all other operating costs from the income generated at the new museum and retain any profit made. This was a significant commercial risk for RAI as the museum was a new attraction with no proven track record of visits by the public and this was RAI's only source of income. RAI accepted this risk by heavily discounting the projections of visitor numbers and by engaging Gardner Merchant to manage the early launch phase. For its part, the Armouries retained ownership of the collection and full responsibility for its maintenance and preservation (paragraphs 1.25 to 1.31).

6 The museum was delivered on time in March 1996 and to budget. Once opened it won a number of national and international awards and achieved high levels of visitor satisfaction. However, it also immediately began to incur losses and by early 1999 RAI's cumulative losses were estimated at £10 million. These losses arose as visitor numbers were much less than previously estimated **(Figure 2)**. Delays in the development scheme for the surrounding Clarence Dock site also contributed to RAI's financial problems as these delays, in turn, meant delays in its receipt of its share of the development gains and a lack of passing trade for the museum (paragraphs 1.33, 1.35, and 1.41 to 1.45).

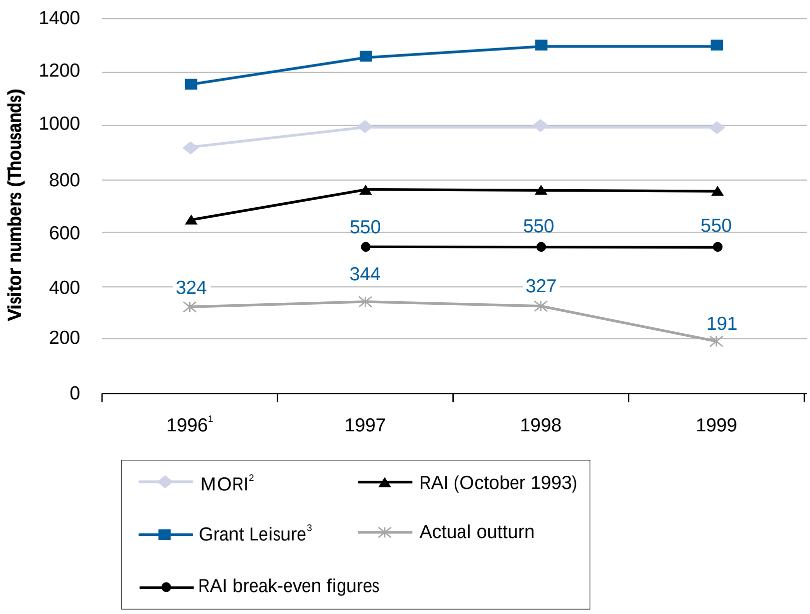
7 In the face of these financial problems, RAI's steps to increase its income and reduce its expenditure resulted in some disagreements with the Armouries over RAI's actions and performance. The early settlement of these disagreements could not be informed by an agreed operating specification which lay down the agreed requirements and standards of performance in operational areas, such as income generation and the maintenance of the museum by RAI. Under the 1993 contract the Armouries and RAI were to agree the specification before the museum opened but in 1994 they agreed to defer this until after the opening as they believed that they would need to acquire some experience of operating the new museum first. In fact the specification was never agreed and the settlement of the disagreements proved more difficult because of the financial difficulties in which RAI found itself and the unpredictability of visitor numbers (paragraphs 1.29 and 1.46 to 1.50).

8 In response to its financial problems RAI undertook two refinancings with the support of both its shareholders and its lenders, the Bank of Scotland. However, as part of the second refinancing in 1998 the Bank said that it would not be able to make additional funding available to RAI after July 1999 if its financial problems persisted (paragraphs 1.52 and 1.54).

9 Both the Armouries' and RAI's ability to deal with the problems at the museum was limited by some of the terms of the 1993 deal. The lack of an agreed performance regime with pre-agreed service standards, monitoring arrangements and provisions for the contract's termination in the event of RAI's poor performance made it difficult for the Armouries to address effectively those areas of RAI's performance, such as income generation and the maintenance of the museum, which were in dispute. However there is no evidence that this had any significant effect on visitor numbers. RAI's ability to cut certain operating overheads was limited and, due to Treasury's stipulations, no additional funding was available to the Armouries to make further contributions to the museum's operating costs beyond those contributions to, for example, marketing and promotion costs agreed as part of the original deal.

2 **Visitor numbers**

Visitors numbers were much less than expected.



Notes: 1. April to December 1996.
2. Excludes school visits and foreign tourists as the estimates are based on a survey of the UK adult population.
3. Includes school visits and foreign tourists.

Source: Royal Armouries

Because RAI was a private company the Armouries also faced great difficulty in getting timely information on the true extent of RAI's financial difficulties as, under the contract, it had no access to RAI's underlying financial records (paragraphs 1.51 and 1.55 to 1.61).

10 The provisions of the 1993 contract also meant that, in the event of RAI going into receivership, the Armouries could not immediately terminate the contract and take possession of the museum. If it wanted to take over the museum's operation without a period of delay it would have to come to a financial arrangement with RAI's main creditor, the Bank of Scotland. As no attempt was made to negotiate on this basis, it is not clear as to the size of the payment that the Bank would have required. However the size might well have been affected by the fact that, under the terms of RAI's sub-lease of the museum from the Armouries, the buildings could only be used as a museum and had to be kept open to the public at all reasonable times (paragraphs 1.66 to 1.71).

11 The Armouries and the Department considered a number of options for dealing with the financial crisis. The most expensive option was to persist with the 1993 contractual structure with the Armouries funding RAI's continuing losses from increased grant-in-aid. The cheapest options involved the closure or partial closure of the museum after RAI went into receivership. However the Armouries' evaluation of non-financial factors scored these options poorly. The Armouries' preferred option was for it to take over all the museum's operations with RAI remaining in a shell company role, although this would have required the agreement of RAI and its principal lender, the Bank of Scotland. On the basis of advice from the Armouries' legal advisers, the Armouries and the Department considered that, if RAI was to go into receivership, it was unclear whether and to what extent the receiver would keep the museum open, notwithstanding the restrictive covenants in RAI's sub-lease of the museum. If the museum were to close, then the Armouries' compliance with its statutory duties would be adversely affected, as far fewer items of the collection would be on display. The Clarence Dock development scheme would also be adversely affected. Also, if the museum were to close, the Armouries might need extra grant-in-aid either to pay for new accommodation to display the collection elsewhere or to pay off RAI's creditors in order to gain immediate access to the existing buildings. Another important factor was that the political impact of the loss of a national museum, particularly one in the north, would have been considerable (paragraphs 1.70 and 1.74 to 1.81).

12 Following consultation with the Bank of Scotland, RAI made a late proposal under which the Armouries would take over responsibility for the museum, with RAI providing certain services to the public at the museum. The Department supported these proposals. It considered that this was the only arrangement which was certain to keep the museum open as this was the only option that RAI's bankers would support. It also considered that RAI's proposals offered better value for money; they were marginally cheaper than the option the Armouries preferred, which involved no role for RAI and the Armouries taking over total responsibility for the museum and all the services there, and offered a similar level of non-financial benefits. Finally, the Department preferred these proposals as RAI would retain responsibility for the repayment of its loans with the Bank of Scotland of almost £21 million (paragraphs 1.85 to 1.88).

13 Consequently, in July 1999 the Department told the Armouries that RAI's proposals were the only ones for which the Department was willing to make extra funding available (paragraph 1.89).

14 Under the revised deal reached in July 1999 the Armouries has taken back certain risks which were previously allocated to RAI. The Armouries now operates the museum and meets its operating costs, in the first instance, from the income the museum generates. The Armouries has therefore assumed the demand risk that visitor numbers are insufficient to ensure the museum's future survival. In addition to the income from the museum, the Armouries also receives from the Department extra grant-in-aid of £1 million a year. However this has been insufficient to meet all the extra costs that the Armouries now incurs from running the museum and the Armouries has had to make efficiency savings of almost £2 million a year. In addition the Armouries and Department have identified measures which could help to increase visitor numbers (paragraphs 1.90 to 1.92, and 1.101).

15 RAI has retained responsibility for the provision of catering, car parking and corporate hospitality at the museum. It is possible that it may get enough income from visitors from these activities to ensure, once it has paid off its debt with the Bank of Scotland, that its investors will see some return on their investment. Should, however, RAI go into receivership, the Armouries' position in the new museum is protected (paragraphs 1.93 to 1.94, and 1.97).

16 The revised deal has brought the Armouries benefits. The museum has remained open with a fully trained operational workforce. The revised deal has also ensured the survival of the Clarence Dock development scheme, from which the Armouries will receive a number of benefits such as the free provision of further storage space for its collection. The museum's continued operation retains and, through the Clarence Dock development, creates a number of benefits for the local economy and community (paragraphs 1.107 to 1.110).

Comparison with current practice

17 The Armouries' deal was one of the very first PFI projects and took place when there was no guidance available on how to structure such deals. Since the signing of this deal in December 1993 the PFI has developed greatly. Many more such contracts have been signed and there is a large body of guidance now available to public bodies who want to enter into such deals. Consequently developments in the PFI have made a similar outcome on other PFI projects less likely. The Armouries cannot be criticised for any failure to follow subsequent guidance as the issue is whether current best practice would have led to a better outcome if it had been available at the time.

18 For example, it is unlikely that a similar project would be approved now without a clearer demonstration of value for money. The importance of an effective competition when awarding a PFI contract is now emphasised. On this project there was little interest in the market place (paragraph 4). There is also now a requirement that a public sector body prepare a public sector comparator, showing the cost of providing the required services using public funding, and compare this with the PFI option before signing any contract. No such comparator was prepared for this deal as the Department had decided in 1991 that the new museum should not be totally funded by the public sector but that some funding should come from the private sector (paragraphs 2.3 to 2.4).

19 Had this project been concluded in line with guidance which became available subsequently, it seems likely to us that the Armouries would have been better able to tackle the problems on this project. For example, guidance now recognises the need for an agreed performance regime which was lacking on this project (although there is no evidence to suggest that the lack of this specification here had a material effect on the number of visitors). Greater rights of access to the private sector party's financial records, as is now standard, might have helped the Armouries to determine the extent of any financial problems being encountered by the contractor on this project. The existence of a direct agreement, as recommended in current guidance, would have placed the Armouries in a better position to discuss with RAI's bankers RAI's financial problems as such an agreement would have established a direct contractual relationship between the Armouries and the bankers. More significantly, current guidance, if followed, would have given the Armouries the right to terminate the contract and take possession of any assets provided under the contract immediately the contractor went into receivership, again unlike on this deal (paragraphs 2.8 to 2.10, 2.12, and 2.17 to 2.20).

20 The incorporation of the elements of current good practice in the original 1993 contract would probably not have saved this deal in the face of a collapse in visitor numbers. However, in our opinion, it seems likely that these elements would have allowed the Armouries to intervene more easily and at an earlier stage. This earlier intervention may have opened up more opportunities for saving the deal as options which were not considered to have been feasible in 1999 may have been in 1997 (paragraphs 2.28 to 2.29).

Recommendations

Extent of market interest

1 When procuring PFI projects, it is important that departments should gauge the level of market interest. If, as on this project, the project is inherently risky, because of the lack of proven demand, and there is very little interest in the project as currently structured, departments should consider whether to continue with the project or to restructure it to make it more likely that a greater number of private sector firms will compete for the contract. A department could amend the scope by seeking a deal for the delivery of serviced accommodation, where payments to the private sector party are dependent on the accommodation's availability. Alternatively, a department could revise the risk allocation and share demand risk, by agreeing, for example, to a revenue guarantee mechanism whereby the department will provide some financial support to the private sector party if demand falls below an agreed level.

Completeness of contractual documentation

2 Departments should ensure that the contents of all contract documentation, such as the operating specification as well as the contract itself, are agreed before the contract is actually signed. Agreements to agree provisions after contract signature severely weaken the public sector's negotiating position when it comes to agree these terms subsequently. After contract signature the public sector body will not easily be able to walk away from the project if it seriously disagrees with the private sector party's proposals in the areas under negotiation as it will have to comply with any provisions contained in the contract regarding the contract's termination.

Compliance with current good practice

3 Departments should seek to comply with current good practice and guidance when procuring PFI contracts. The experience on this deal demonstrates that the availability of such guidance when this contract was awarded would have improved the Armouries' and the Department's position when faced with the financial difficulties of its private sector partner and the possible closure of the museum.

Termination in the event of contractor insolvency

4 When faced with the possible insolvency of a private sector partner on a PFI project, departments should, as was done in this case, consider all options open to them, including the possibility of not intervening and allowing the insolvency to occur. As in this case, departments should be absolutely clear what their position is legally under the contract should the private sector partner actually become insolvent. They should establish what rights they have to terminate the contract and take possession of any related assets, and their consequent liability to the payment of any compensation sum.