Ministry of Defence

# Redevelopment of MOD Main Building

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# executive summary

1 The Ministry of Defence (MOD) requires secure, modern and efficient working accommodation in central London, close to Downing Street, from which to direct Britain's defence operations. MOD had recognised since 1990 that the number of its Head Office staff in London could be reduced. This would create opportunities for reducing the number of London buildings used by MOD and save accommodation costs. In addition, MOD had identified that improvements were necessary to the accommodation and working environment available in its principal office building in Whitehall known as Main Building. It therefore decided to redevelop Main Building.

2 This is a large and complex project. It involves moving over 3,000 staff into other central London accommodation (a process known as decant), carrying out an extensive redevelopment of Main Building, disposing of surplus properties and then moving staff back into Main Building.

3 In May 2000, MOD let a PFI contract with a net present value of £746 million (at 2000 price levels) to a consortium called Modus **(Figure 1)**. The 30-year contract covered the redevelopment of Main Building and limited refurbishment and provision of support to other buildings needed to accommodate staff while redevelopment is undertaken, followed by the provision of maintenance and facilities management services at Main Building and the Old War Office until May 2030.

**1 Members of the Modus consortium and its main contractors**

| | % shareholding |
|---|---|
| Innisfree PFI Funds[4] | 40.1 |
| Laing Investments | 40.0 |
| Amey Ventures Ltd | 19.9 |
| | **100.0** |

**NOTES**

1. Hyder Investments Ltd and Macquarie Infrastructure Projects Ltd were both initial shareholders in Modus but subsequently sold their respective shareholdings.
2. The construction contractor is Skanska Construction (who took over Kvaerner Construction who had been allocated responsibility for the provision of construction services).
3. Facilities management services are to be provided by Amey Whitehall.
4. Innisfree have two PFI funds: PFI fund 1 has a 13.4 per cent shareholding, PFI fund 2 has a 26.7 per cent shareholding.

*Source: National Audit Office*

**4** We examined the extent to which the PFI contract for the redevelopment is likely to deliver value for money and the effectiveness of MOD's management of this major project. The methodology we adopted to undertake the study is set out in Appendix 1. In summary, we found:

- the deal gives MOD what it set out to procure, namely rationalisation of its central London Head Office accommodation, through a PFI deal in standard form;
- after an effective procurement, the benefits of the deal will be similar in cost to the forecast cost of conventional procurement, other factors tipping the balance in favour of PFI;
- the management of this project, which is proceeding ahead of plan, has been good.

**5** Key features of the deal and how it compares to conventional procurement are set out in Table 1 on page 7.

# The deal gives MOD what it set out to procure

## The contract requires Modus to deliver MOD's physical requirements

**6** As a result of letting this contract, MOD is likely to secure significant benefits. MOD expects to achieve its objective of accommodating a reduced number of Head Office staff, with staff numbers falling by 29 per cent **(Figure 2)**, in two buildings. Following the rationalisation, MOD will be able to dispose of five of its seven existing central London sites resulting in annual operating cost savings of £18 million. The improved usage of floor space should enable MOD to increase the number of staff working in Main Building by 26 per cent (Figure 2). In addition, there will be significant unquantified benefits to working efficiency arising from the improved accommodation.

**2** **Planned changes to MOD Head Office staff numbers in London**

| | 1 April 1999 | By 30 Nov 2004 | % change |
|---|---|---|---|
| Main Building | 2,623 | 3,300 | +26% |
| Other buildings (six at 1 April 1999; one, Old War Office, by 30 November 2004) | 3,397 | 1,000 | -71% |
| | **6,020** | **4,300** | **-29%** |

*Source: Ministry of Defence*

## The project has the appropriate features of a PFI deal

**7** The deal provides incentives to Modus to complete this major project on time, without varying the cost to MOD, and then to provide the specified standards of service. Only once the new accommodation is provided in accordance with the contractually specified standards will Modus be entitled to its full average annual fee of £55 million. If Main Building cannot be fully reoccupied by MOD by 30 November 2004 then Modus will lose £1 million in revenue for each month of delay and it will have to pay the additional costs of keeping MOD staff in alternative accommodation. MOD is not required to pay Modus for accommodation that does not meet the specified availability standards even if it chooses to use the space. And MOD may deduct Modus' entire fee if 90 per cent of the accommodation falls short of the required availability standards. In addition, up to 20 per cent of Modus' facilities management costs

are at risk if its standard of service provision is not satisfactory. A major benefit of the PFI as a form of procurement is that it has enabled MOD to achieve an appropriate allocation of risk between itself and its private sector contractor.

**8** A risk inherent in any long-term accommodation project is that requirements may change over time. MOD's contract with Modus allows MOD flexibility on reducing the space it occupies. In April 2000, a month before letting the PFI contract to Modus, MOD identified, however, that there were a further 1,000 non-Head Office staff who should remain in London. It subsequently approved a separate deal whereby London and Regional Properties will refurbish one of MOD's other London properties to accommodate the additional staff.

## After an effective procurement, the benefits of this deal will be similar in cost to the forecast cost of conventional procurement; other factors tipped the balance in favour of PFI

**9** In assessing the value for money to be expected from a PFI deal, a number of factors need to be considered together: the strategic justification for the deal; the competitiveness of the procurement process, including analysis of any movements in the price of the deal during exclusive negotiations with the preferred supplier; and the forecast costs of the deal alongside any qualitative factors which differentiate the deal from other options. In this case:

- the PFI deal emerged as the most promising from a wide range of options;
- the selection of Modus was competitive, but the price of the deal changed during exclusive negotiations with Modus, in particular as a result of further building work identified from surveys and increases in the cost of finance for the project;
- the costs of the deal were similar to those of a public sector comparator and, by the time the contract came to be signed, other factors were decisive in giving the deal advantages over the alternatives then open to MOD.

### The PFI deal was selected after a review of a wide range of options

**10** MOD rejected relocating its Head Office either elsewhere in London or on a greenfield site because of the cost of moving the Defence Crisis Management Centre (DCMC), and the need for Ministers to remain at the heart of Whitehall. Potential problems in operating the DCMC and anticipated planning permission objections to Main Building given its grade 1 listing also led it to reject demolition and rebuild options. MOD rejected a 'do minimum' option of refurbishing Main Building's systems because of its poor physical state. In addition, this option would not have given the required working environment and rationalisation benefits. A PFI procurement was chosen because MOD thought it could achieve savings with strong incentives for the contractor to complete on time and without varying the cost to MOD.

### After a competitive procurement the price of the deal increased due mainly to survey work and increased financing costs

**11** MOD ran a competition amongst UK companies; the final stages of the competition were between Modus and the Modem consortium led by Taylor Woodrow. MOD selected Modus as preferred bidder in January 1999 as its price was £42 million lower than that offered by Modem, its solution complied more closely with the output specification, and more closely met MOD's commercial requirements.

**12** The deal was closed in May 2000, 16 months after Modus became preferred bidder. During this period the price increased by £99 million (at 2000 price levels). As has been normal PFI practice interest rate risk rested with the public sector until contract signature. Because of interest rate increases, an increased funding requirement as a result of additional capital expenditure and other movements in the financial markets the price increased by around £60 million during this period. £37 million of the price increase arose mainly because further extensive surveys by Modus showed that additional building work would be required as the building was in a poorer condition than anticipated. MOD wanted to resolve the building issues to ensure that Modus would agree to price certainty but took steps to satisfy itself that the additional work was necessary and the price for the work was reasonable.

**13** In June 1999, based on discussions with Modus, MOD expected the deal to be closed within four months and accepted that Modus needed to make a final decision on the type of financing to be used if the timetable was to be achieved. As there was little to choose at that time between the likely costs of bank and bond finance, MOD agreed with Modus' proposal that, on qualitative grounds bank finance should be used. These included some uncertainty by MOD as to whether it would be possible to arrange bond finance for such a large deal on terms which would represent value for money at a time when the bond market for PFI deals was less developed than the PFI bank finance market. It also preferred bank finance for a number of other qualitative factors including that it provided greater flexibility to cope with any necessary contract variations.

**14** The deal was not closed in October 1999 as MOD had expected. Between this date and the actual signing of the deal in May 2000, MOD chose to continue with bank finance as the method of financing in the absence of a clear case for change. In hindsight, following price movements in the markets, bond financing may have provided a less expensive financing cost at the time of closing the deal in May 2000. Bond finance might have been between £1 million and £22 million cheaper at that time. But, because of uncertainties surrounding these estimates[1] and how the markets at the time would have priced a bond for this deal, such an outcome from using bond finance, in respect of the pricing and timing of the deal, cannot be viewed with certainty. At the time, MOD saw no durable advantage from changing the financing arrangements. Despite the delays, MOD always believed it was close to signing the contract and did not wish to risk further delays. It continued to have reservations about various aspects of bond finance including the terms on which it could have raised bond finance for such a large deal and therefore whether bond finance would be deliverable. MOD also took into account that the possible cost differential in favour of bond finance was not certain to continue until the contract was ready to be finalised and considered it unlikely that the same degree of risk transfer would have resulted. It also considered that bank financing continued to offer other qualitative advantages.

*1 As explained further on page 23, the upper end of this range is based on the saving that would have been achieved had it been possible for MOD to arrange a bond on the same terms as that achieved in the GCHQ Building deal in June 2000. The terms of the Treasury Building bond in May 2000 would also have produced a similar outcome but the terms were obtained on a considerably smaller redevelopement project. There are uncertainties about whether these terms could have been achieved for the MOD Building deal. The lower end of the range would have arisen if the pricing of the deal had had to be amended in a number of ways from the pricing achieved on the GCHQ and Treasury building deals due to the complexity, size, and length of contract.*



## The cost of the deal is similar to the forecast cost of conventional procurement; other factors tipped the balance in favour of the PFI deal

**15** The price of the 30-year deal as contracted with Modus is £746.1 million at 2000 price levels. In comparison, MOD estimated that the cost of a conventionally procured project would fall in the range £690 million to £807 million. Given the uncertainties inherent in comparing 30-year forecasts of project costs, the appropriate conclusion from these figures is that the deal will cost a similar amount to a conventional procurement.

**16** MOD drew this conclusion but also took into account other factors which it considered favoured the PFI deal over conventional procurement. For negotiation and presentational purposes MOD placed emphasis, however, on the deal with Modus being priced slightly below £746.2 million, MOD's estimate of the average expected cost of a conventionally procured project. This emphasis enabled MOD to negotiate a price reduction of £4 million on the day the deal was closed as it insisted the final price should be below the £746.2 million benchmark.

**17** The comparison with a public sector comparator shows that there was a decline in savings from the £25 million savings expected when Modus became preferred bidder. But in the late stages of procurement such a comparison with a public sector comparator may not be the soundest basis for the business decisions needed at that point. For example, it may no longer be practicable at that stage to start the procurement again as a conventional procurement. A comparison of the costs and benefits of the proposed PFI deal with the best alternative option available will best inform the decision as to whether to close a PFI deal. MOD recognised this and compared the option of proceeding with the deal with alternatives including: (i) aborting the deal and arranging a new conventionally procured deal at some future date or (ii) scaling down the project to one which would just involve essential building maintenance without a major redevelopment. MOD concluded that, compared with the alternatives, there were clear benefits from finalising the deal with Modus.

## Contract management has been good

**18** The decant of staff out of Main Building was completed in August 2001 three months ahead of schedule and building work has since started. MOD has been pleased with the progress made to date and has been building an effective relationship with Modus and their principal contractors. In particular, MOD has conducted a series of partnering workshops, adopted a joint mission statement with Modus, maintained continuity of well-trained and appropriately skilled staff and adopted appropriate change procedures. It is too early to predict whether the redevelopment will be successfully completed by the required deadline of 30 November 2004 but the early progress is encouraging. As a result of the acts of terrorism targeted at prominent buildings in America on 11 September 2001 MOD is reviewing its security needs at Main Building but has not yet decided if further work will be needed to address security needs.

# Recommendations

**19** As a result of this examination we make the following recommendations:

A The extensive experience which the MOD Building project team has built up of managing a large complex PFI building procurement should be disseminated more widely across central government. The project team should summarise the lessons it has learned and make this available to other departments. These include the importance of the commitment from senior officials to the project's success and of negotiating objective performance standards for the availability of all types of serviced accommodation.

B Departments should bear in mind that, although the expected price is important there are also, as MOD recognised, other important strategic factors which may influence the choice of procurement. If, as was the case in this deal, there is a reasonably foreseeable long-term need for accommodation, it makes sense to consider a long-term contractual arrangement for it to be supplied. And arrangements, such as those included in PFI contracts, which incentivise the contractor to complete on time, which minimise the risk of cost variations to the department and which provide specified service standards, may be an important consideration in the choice of procurement.

C Departments should recognise the importance of survey work on the physical state of their buildings to the pricing of bids for redevelopment projects. Departments should consider the merits of making a detailed survey available to all bidders to enable redevelopment building risks to be priced competitively by all bidders.

D Departments should be aware they may be exposed to fluctuating financing costs if there are extended negotiations with the preferred bidder. Costs may go up or down. Where possible the need for negotiations after a preferred bidder is appointed should be minimised and a decision on the choice of financing (which may be affected by fluctuations in the rates obtainable for alternative sources of finance) should be made as late as possible in the procurement timetable.

E There are significant uncertainties inherent in any public sector comparator. The actual costs of a conventionally procured project may fall within a wide range of possible costs. Departments should recognise this in making cost comparisons. In particular, they should be careful not to conclude that a PFI deal becomes better value for money if it is marginally less than a single figure estimate of the cost of conventional procurement. Given the uncertainties in the comparison, a more reasonable conclusion in that situation may be that the cost comparison shows there is little to choose between PFI and conventional procurement in cost terms.

F As the MOD team did in this deal, departments should compare a proposed PFI deal with the best alternative option available before proceeding with the deal. Conventional procurement as modelled by a public sector comparator may not represent a true fall-back solution when closure of the deal approaches. But there may be other realistic alternatives, such as carrying out an alternative project with a reduced scope, which should be compared with the proposed PFI deal.



## Table 1: Key aspects of MOD redevelopment deal

| | PFI deal as contracted | Conventional procurement alternative |
|---|---|---|
| Final deal cost at 2000 prices (discounted at 6% over 30 years) | £746.1 million | Most likely estimate £746.2 million within a range of £690 million to £807 million |
| Cost profiles | Unitary charge of £55 million spread evenly over years 5 to 30 of the contract (Unitary charge is reduced in first 4 years until Main Building is fully redeveloped) | Full capital cost of £351 million in first 4 years followed by ongoing facilities management and maintenance costs only |
| Risk allocation: | | |
| ■ remaining with public sector | Delivery of MOD operational objectives<br>Information Technology Systems | Most risks retained by Public Sector |
| ■ passed on to private sector | Construction<br>Latent defects<br>Meeting specified performance standards and operating cost risk over the contract period<br>Design<br>Programme | |
| Cost of advisers used in procurement (actual prices) | £9 million | MOD consider that cost would be broadly the same under conventional procurement |
| Original estimate of deal cost (2000 prices) at: | | |
| Invitation to negotiate | £659 million | £693 million |
| Selection of preferred bidder | £647 million | £672 million |
| MOD assessment of the additional benefits of its chosen procurement route over conventional procurement | Greater price certainty | Cost overruns passed on to public sector body |
| | Incentivises contractor to complete redevelopment on time as full payment only starts once the building is ready for use and occupied | |
| | Payment linked to delivery of service which incentivises the PFI contractor to deliver the quality of service which is specified over the entire contract period | Service delivered on cost plus basis |
| | Same contractor designs, maintains and operates building under one contract and is therefore incentivised to adopt whole-life costing | Design, maintenance and operation of building is dealt with under separate contracts |
| Milestones | Contract start - May 2000 | May 2000[1] |
| | Decant complete - November 2001 | April 2002 |
| | Recant complete - November 2004 | August 2005 |
| | Deal end - May 2030 | |

**NOTE**

1. Assumes a conventional procurement process would have commenced in January 1999 leading to contract signatures in May 2000.

*Source: National Audit Office*