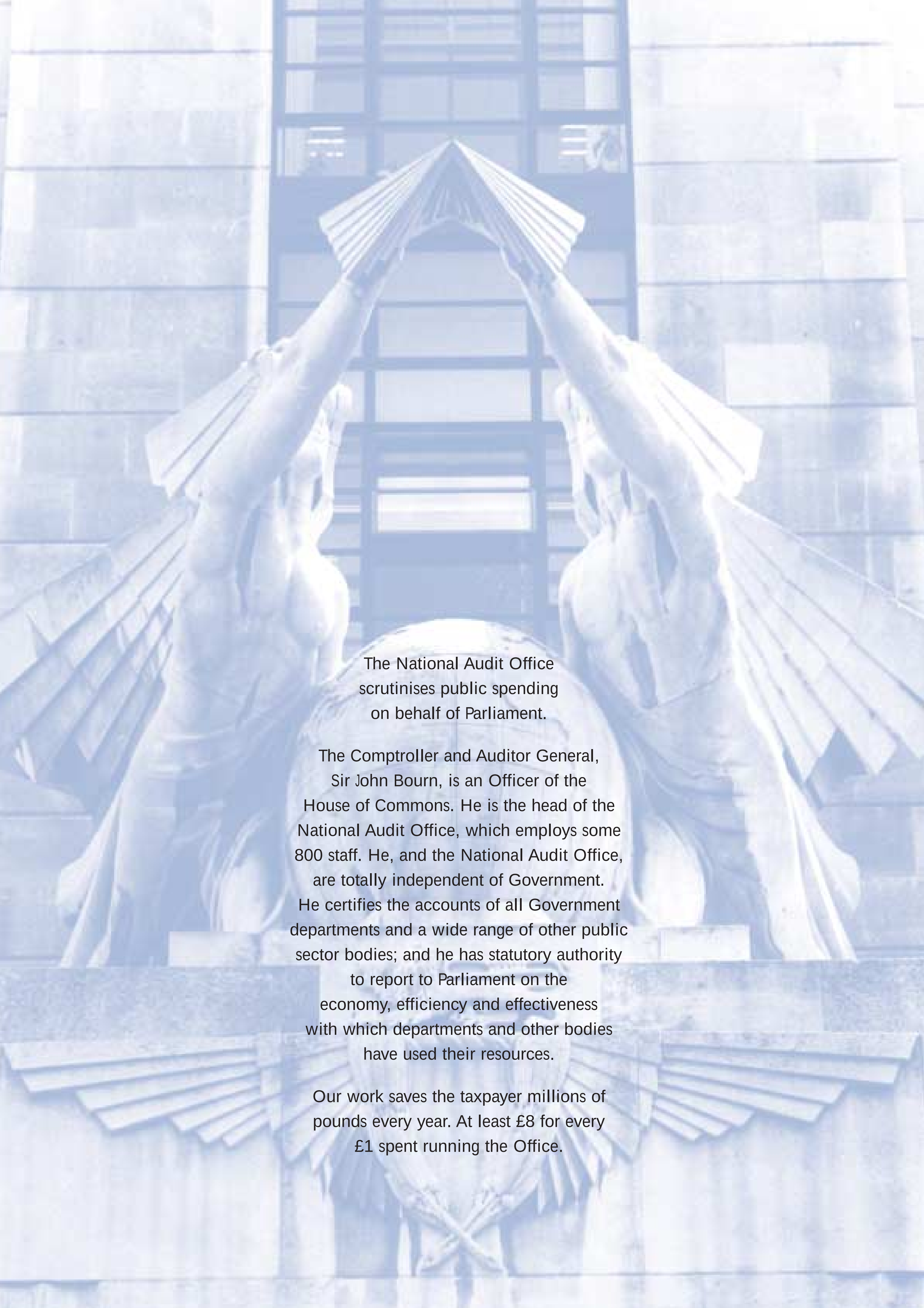
NATIONAL AUDIT OFFICE

PFI: The STEPS Deal

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 530 Session 2003-2004: 7 May 2004



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Comptroller and Auditor General

National Audit Office
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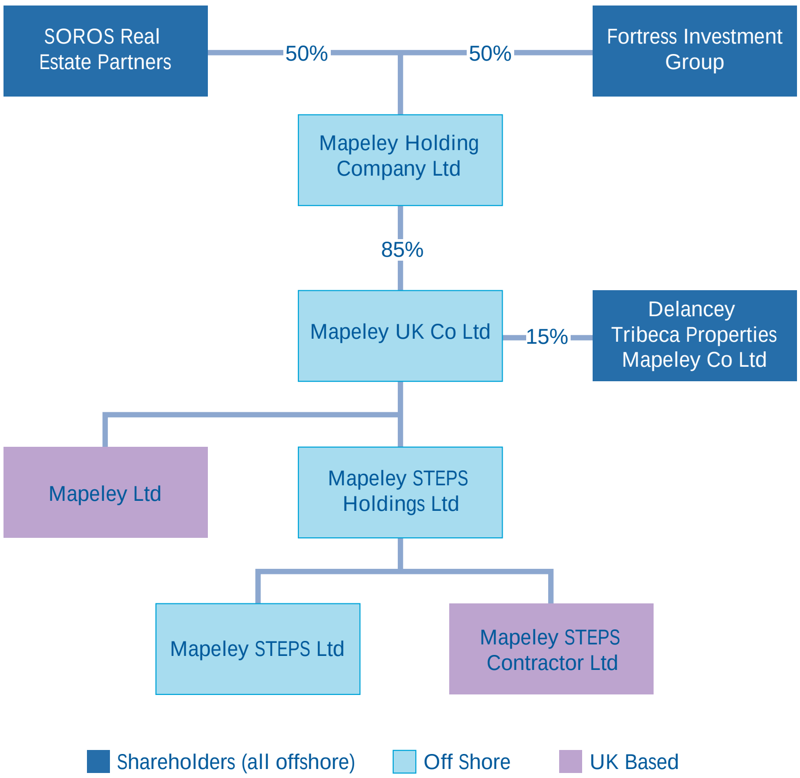
Summary

1 This report examines the value for money of a property and services outsourcing deal by the Inland Revenue, HM Customs and Excise and the Valuation Office Agency (the Departments) known as STEPS (the Strategic Transfer of the Estate to the Private Sector). In March 2001, the Departments signed the contract to transfer ownership and management of the majority of their estates to a private sector consortium of companies within the Mapeley Group, hereafter referred to as Mapeley STEPS.[1] The contract commenced on 2 April 2001.

1 The structure of the Mapeley Group



NOTE

1 Delancey Tribeca Properties Mapeley Co Limited was formerly called Delancey East Limited.

Source: National Audit Office

1 For the purposes of this report, the term Mapeley STEPS will be used to describe Mapeley STEPS Limited and Mapeley STEPS Contractor Limited. Where necessary, in later parts of the report, specific legal entities within the Mapeley Group are identified.

2 STEPS was similar to a deal signed in December 1997 by the Department of Social Security (now the Department for Work and Pensions). That deal (called PRIME[2]) was expected to reduce costs by some £560 million over 20 years. Over the 20-year life of the STEPS contract, when compared with the Public Sector Comparator, the Departments expect to save £344 million (in net present values), with an estimated first year saving of some £27 million. In 1998, as part of a Comprehensive Spending Review, the Departments considered ways of increasing efficiency and effectiveness in the management of their estates and how to work more closely together across the range of their responsibilities. These factors pointed towards the joint procurement of a PRIME-type estate management deal that would produce substantial cost savings.

3 The STEPS deal will last for 20 years and comprises the following key elements:

a) the transfer for £220 million of the Departments' freehold and long leasehold buildings to a subsidiary of Mapeley (Mapeley STEPS Limited). The remaining estate comprised liabilities under short-term leases, which were transferred to both Mapeley STEPS Limited and Mapeley STEPS Contractor Limited, a different subsidiary of Mapeley **(see figures 2 and 3)**;

b) in return for operating the estate and taking responsibility for rental and other costs, the Departments will pay Mapeley STEPS Contractor Limited an average annual charge of £170 million,[3] equating to some £1,500 million[4] over the period of the contract.

c) At the end of the contract, the Departments will not own the estate, but will retain a right to occupy the buildings that they wish to remain in, with leases based on market terms obtaining at the time.

4 We examined the extent to which the STEPS deal is likely to deliver value for money. The methodology for the study is outlined at Appendix 1. In summary, we found that:

a) the deal has delivered benefits and more are expected;

b) the Departments got a good price; and

c) good risk management will be essential.

The deal has delivered benefits and more are expected

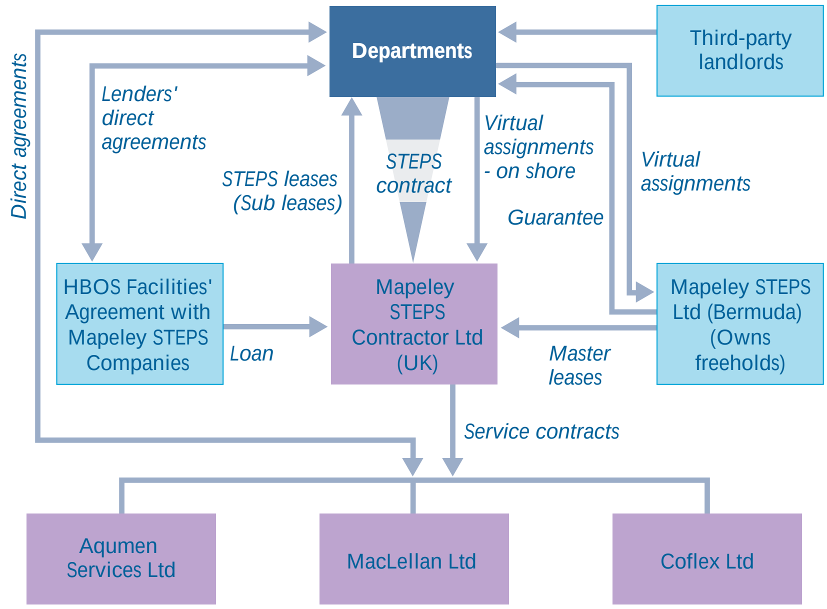
5 Before STEPS, the Departments employed approximately 300 staff on estate management. By late 2003, this number had been reduced to 160 and is expected to fall further as the contract beds in. Contract management has also been rationalised and consolidated. Instead of dealing with numerous service providers, the Departments now deal just with Mapeley STEPS and with a small number of service providers for the parts of the estate that were not transferred under the STEPS deal. As is often the case in the early months of such complex contracts, there were problems with service delivery. These problems were compounded by the fact that Mapeley STEPS was a new company and the Departments added a number of new properties early on. In response, Mapeley STEPS re-organised its regional structure and appointed a new service director in October 2001.

2 C&AG's report: The PRIME Project: The transfer of the Department of Social Security estate to the private sector (HC 370, session 1998-1999); PAC Report, The PRIME Project: The transfer of the Department of Social Security estate to the private sector, Committee of Public Accounts, Forty-first report 1998-1999.

3 This charge reflects the Departments most likely requirements for accommodation and may increase or decrease as their accommodation requirements change.

4 This is the present cost at 2001 prices of the payments amounting to £3,400 million over the 20 year contract, discounted at 6 per cent real to April 2001.

2 STEPS stakeholder relationships



Source: National Audit Office

3 Properties transferred to Mapeley STEPS

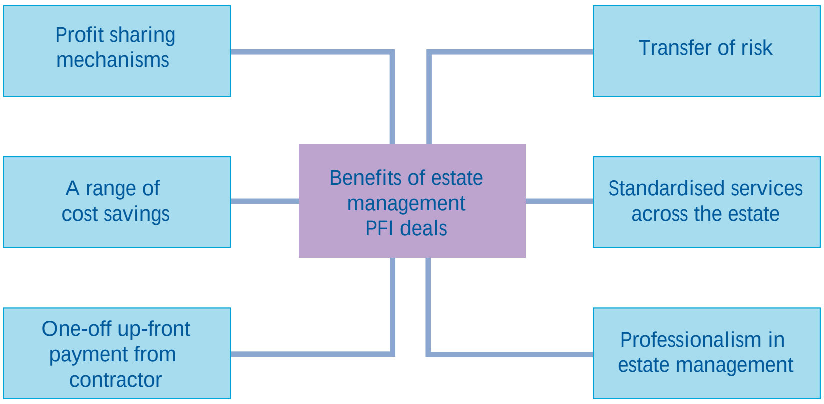
Property type	Number of buildings	Space (m²)
Transferred to Mapeley STEPS:		
■ Leasehold	415	775,000
■ Freehold/historic leaseholds	159	581,000
Service only (ownership not transferred)	124	87,000
Total	**698**	**1,443,000**

Source: STEPS Final Business Case

6 Unlike conventional property leases, the contract allows the Departments to vacate a certain proportion of the estate over the duration of the contract, without incurring further costs in the year of vacation. This flexibility can be applied irrespective of the residual lease terms on properties vacated. As the cost of providing this level of flexibility has been transferred to Mapeley STEPS, maximum value for money depends on the Departments making appropriate use of the available flexibility. A change mechanism built in to the contract also allows the Departments to obtain additional space if needed. To cope with extra demand for office space, over 30 additional buildings and other facilities have been acquired by Mapeley STEPS since the contract went live in April 2001. In addition some 300 projects have been completed by the contractor. These include provision of buildings for new call centres, removal of asbestos and provision of new lighting.

7 STEPS also puts the Departments in a strong position to react to Government-wide initiatives such as the recent review of public sector relocation (the Lyons review). The Departments now have the flexibility to relocate without having to meet the in-year costs of breaking leases or finding alternative tenants and could bring other Departments into new or existing buildings managed under the STEPS contract.

4 Operational and financial benefits from estate management PFI deals



Source: National Audit Office

8 There are wider benefits available to the Departments as a result of the STEPS deal. To support the implementation of Government policies such as the "One Stop Shop" initiative (aimed at providing the public with as many Government services as possible from one location), Mapeley STEPS have permitted the Departments to establish two sublets to local authorities with the option to negotiate others on an individual basis. Staff from both Departments have worked on the STEPS procurement team and the Estates and Contract Management Unit and are examples of the benefits of closer working across Departments. The deal has also encouraged wider joint working between the Departments' internal audit teams, with joint reporting on the STEPS deal.

The Departments got a good price

9 The Departments secured a very competitive price from Mapeley STEPS, a new entrant to the market. In doing so, the Departments applied lessons learned from PRIME, established clear criteria for evaluating bidders' proposals and recognised that there were risks in going ahead with the deal. Mapeley STEPS offered the lowest price by some £500 million. Its bid was also some £300 million lower than the best alternative to a PFI deal.

10 The pricing of the winning bid was based on returns over a 20-year time horizon and operating profits were expected to be minimal. Mapeley STEPS also assumed that it would win other business and that its central overheads would therefore be spread over a number of contracts. In order to evaluate whether Mapeley STEPS could deliver the deal at the price proposed, the Departments tested the robustness of Mapeley STEPS' financial model and examined some of the key assumptions that underpinned the deal in more detail. This analysis showed that the funding structure was robust under most scenarios examined, but that it might be vulnerable to increases in life cycle and annual maintenance costs.

11 Mapeley STEPS was selected as the preferred bidder in 2000 and, following detailed negotiations, the contract was awarded in March 2001 to Mapeley STEPS Contractor Limited (registered in the UK) which would provide the services, and Mapeley STEPS Limited (a property holding company registered in Bermuda). There was no material increase in the bid price between selection of preferred bidder and financial close. This was facilitated by a Memorandum of Understanding (MoU) agreed between the Departments and Mapeley STEPS which set out how outstanding issues would be resolved between the two parties.

12 At contract signature Mapeley STEPS was owned by Fortress Investment Group (incorporated in Delaware USA), Soros Real Estate Partners CV (a Limited Partnership formed in the Netherlands), and Delancey East Limited (resident in the UK at the time, but now offshore). As the STEPS freehold and long-leasehold properties were transferred to a company based outside the UK, tax on any gain made by a sale by this company will not be captured under the current UK tax regime. Furthermore, as the shareholders of Mapeley STEPS are non UK resident, they are not liable to pay UK capital gains tax if they sell their shareholdings since it is generally only payable on capital gains realised on the disposal of an asset by UK resident individuals and companies.

13 The location of Mapeley STEPS Limited in Bermuda has no material effect on the overall value for money of this deal to the UK taxpayer. Mapeley STEPS estimated that if it had been required to bring the STEPS properties onshore, its bid price would have had to increase by £55 million to cover the extra UK tax that might have been due.[5] This is not a material figure in terms of a £1.5 billion deal or in the difference between the Mapeley STEPS bid and the nearest bidder and was not therefore a deciding factor in selecting Mapeley STEPS.

14 The Departments followed procurement law throughout the process. The Government has responded to the tax issues raised in this deal by suggesting a new clause for future PFI contracts that limits the ability of contractors to go offshore. It remains to be seen how it will work in practice.

Good risk management will be essential

15 In December 2001 (seven months into the deal), the contractor indicated to the Departments that it faced a serious cashflow problem arising from errors in the pricing of its bid, variations to the contract since signature and claims arising out of the procurement process. Mapeley STEPS asked for a substantial cash payment from the Departments for the variations and claims. The Departments rejected that request. Instead, they set up a working group to investigate the position and make recommendations on how best to proceed. The group was chaired by Partnerships UK (PUK), and included NM Rothschild & Co., who had no previous involvement in the deal, as independent commercial advisers to the Departments.[6] Rothschild's view was that the Departments had obtained a good deal in terms of the original contract price and that it was in their interests to continue. The Departments accepted this but also recognised the risks of a Mapeley STEPS collapse and asked the working group to consider possible fall-back scenarios.

16 A number of factors have since combined to improve the contractor's financial position. Property management income has increased, largely as a result of changes in the property and financial markets, and Mapeley STEPS' financial management has been strengthened by putting in place new systems and processes and by recruiting key individuals including a director with specific responsibilities for finance. Its shareholders have injected additional short-term funding of £8 million with an annual ongoing commitment of £2 million to £3 million. The Departments recognise that the deal is always likely to be finely balanced and will need to be managed carefully if the contract is to deliver the underlying benefits of the deal.

5 This estimate was provided to the National Audit Office by Mapeley STEPS. It represents the net present value, at a 6% real discount rate, of the additional unitary charge needed to offset the potential tax liability if Mapeley STEPS had not been based offshore. The figure reflects Mapeley STEPS own views on prospective increases in commercial property values over the 20 years of the contract and assumes no changes in current UK tax legislation. Given the inevitable uncertainties surrounding forecasts up to 20 years into the future, it can only be a very approximate estimate. This figure has not been agreed with the Inland Revenue and HM Customs and Excise since the Departments cannot comment on the tax affairs of individuals in public.

6 Rothschild's involvement ended in January 2003.

17 Like other PFI deals, the STEPS contract includes a performance measurement system (PMS) that is intended to incentivise the contractor to perform as required by reducing the contractor's income in the event of poor performance. The system was developed by the Departments and their advisers and supplied to all three shortlisted bidders for their consideration and input. The IT to support the operating system was developed by Mapeley STEPS and it was not practical to fully test it prior to implementation. Neither the contractor nor the Departments could therefore be certain how it would operate in practice.

18 Shortly into the operation of the full system, it became clear to both parties that the PMS was not correctly incentivising Mapeley STEPS. The system was driving all the contractor's resources towards fixing faults at the expense of preventive activity to avoid further problems from occurring. Mapeley STEPS also considered that the system was punitive in certain areas. The Departments disagreed, taking the view that as in other PFI deals the contractor needs to fulfil certain agreed criteria in order to receive its payment. The Departments have told us that the revised version of the PMS that is currently being negotiated would lead to an average monthly deduction of around £121,000. Mapeley STEPS is challenging these potential deductions, but it has made an interim payment for the period April 2001 to September 2003 and has agreed to further monthly deductions on a without prejudice basis, pending the outcome of the review.

19 In any long-term contractual relationship of this kind, a partnership arrangement is essential if a deal is to be a success. In STEPS, a number of key staff members moved on to other jobs very soon after contract signature, leaving only one key member of the original STEPS team still involved in the deal. However, the Departments were aware of the prospective personnel changes for some time before they happened and ensured continuity through succession planning. In the case of the Project Director, a replacement was in post six months before contract signature. There were also a number of senior management changes at Mapeley STEPS shortly after the contract was signed. The deal is still bedding in and, while there have been moves on both sides to work in partnership, this has not yet been fully achieved.

RECOMMENDATIONS

Recommendations to the Departments

A **If the deal is to be successful in the long term, the Departments and Mapeley STEPS should conclude the current negotiations, and incorporate agreed variations to the contract as soon as possible, and move towards a partnership approach to managing the deal.**

There is some evidence that both parties are working together to achieve this objective. Examples of partnership working that are beginning to emerge include: the development of a longer-term estate strategy; the redevelopment and improvement of the governance structure; and attempts to improve the monitoring of Mapeley STEPS' performance.

B **Mapeley STEPS' pricing and business model mean that its finances are likely to be finely balanced for the foreseeable future. Good risk management will be essential if the Departments are to secure the full value of the deal.**

The Departments have built on their existing risk management arrangements, but they need to ensure that comprehensive risk management processes are in place and review these regularly as deal risks change.

C **The Departments and Mapeley STEPS need to develop a single business focus that will involve the Departments developing an understanding of how their own decisions impact on the contractor, and the latter continuing to provide access to its income and forecasts.**

The Departments and Mapeley STEPS are addressing this issue, in part through the development of commercial and estates strategies, to understand the possible impact on the contractor of the Departments' vacations of parts of the estate. Both parties will also have to be willing to change the contract where necessary.

D **The performance measurement system should balance both rewards and reductions in payments, in order to incentivise Mapeley STEPS to carry out the day-to-day activities that are necessary to prevent future problems from occurring.**

The performance measurement system can only function effectively when all parties are agreed on the criteria for, and the value of, deductions under the performance regime. In STEPS, the system is currently being reviewed and will not be fully effective until the outstanding issues are resolved.

Recommendations for other PFI deals

E Where there is a lack of data, and therefore certainty, bidders may reflect this in their prices and so it is in a department's interests to have the complete and appropriate data that the bidders require to price their bids. If such data on an estate cannot be assembled in good time, a joint survey with the bidders should always be considered. This ensures that all bidders are working to common assumptions and reduces bidding costs. Even then, material uncertainties may remain ahead of selecting a preferred bidder and, in such cases, an adjustment mechanism could be incorporated, based on strictly factual data such as area and title. In the STEPS deal, the Departments realised early on that they did not have high quality estate data and they therefore commissioned a joint survey from their property advisers.

When considering a deal involving the transfer of a large number of freeholds and leaseholds, departments should assemble appropriate and high quality estate data based on bidders' pricing requirements.

F Ahead of signing the contract, the Departments had not given a high priority to analysing the possible termination scenarios. This weakened their position in the face of Mapeley STEPS' stated financial situation. The Departments took further advice to clarify their position in the light of the particular circumstances which faced them and have subsequently assigned roles and responsibilities in the event that termination should occur.

Departments must always have a business continuity plan to cover termination (whenever it might arise) and its impact. This understanding must encompass how termination would be effected, where key responsibilities would lie, and what continuity arrangements would be in place.

G In STEPS, the performance measurement system was not tested fully before implementation although a three month period was created to allow the system to bed down. However, early on in the deal Mapeley STEPS considered that the performance measurement system was not providing sufficient incentives and it is currently under review.

Performance measurement systems are an important element in the risk transfer of a PFI deal. Where possible, therefore, performance measurement systems should be agreed before contract signature and tested prior to implementation. Both the contractor and the department should have the ability to review progress after an initial bedding in process, as in the STEPS deal.

H Key staff in both a department and a contractor can move on shortly after deal signature. As was demonstrated in the STEPS deal, the corporate knowledge of a deal must be retained in a department until a contract has bedded in.

Alongside a well developed succession plan, key staff should be retained as far as possible for the contract bedding-in period.

I The joint procurement of STEPS has demonstrated a number of benefits both for departments and for bidders, for example, reduced costs and a more attractive portfolio of properties.

Other Government departments should consider joining together to enhance the value for money achievable in any future procurements of this type.

J Mapeley STEPS' bid was based on returns over a 20-year time horizon with operating profits expected to be minimal. Mapeley STEPS also assumed that it would win other business on the back of this deal. This approach makes the deal high risk for Mapeley STEPS and it therefore included a much higher level of equity than is commonly found in PFI deals. This has helped to tie in the shareholders and reinforced their commitment to the deal.

The capital structure of a deal must be consistent with the risks involved in the project.

Part 1

The deal has delivered benefits and more are expected

This part of the report examines the rationale for the STEPS deal and the benefits that have been secured so far. It shows that the Departments have rationalised the management of their estates. Other benefits, such as flexibility of occupancy, are not due to become fully available until later in the deal, or have not yet been realised because of ongoing contractual negotiations.

There is a strong commercial basis for this type of deal

1.1 There are strong commercial reasons for the public and private sectors to enter into deals such as STEPS. These were highlighted in the National Audit Office's and Public Accounts Committee's reports on the PRIME deal.[7]

It makes sense for departments

1.2 This kind of deal makes sense for Government departments, as there are both operational and financial benefits **(Figure 5)**.

They are attractive to the market

1.3 This type of deal is attractive to private sector investors, because it provides a relatively secure long-term revenue stream from Government tenants and a large estate on which they can earn revenue from efficient property and facilities management. These factors will also make the deal attractive to other investors should the investor decide to sell the contract.

1.4 At the time that STEPS was being procured, the market for such deals was relatively new. Since the first major deal, PRIME, there have been several similar deals. Abbey National, BT and Bradford and Bingley have all outsourced their property management. There are also other deals in the pipeline. For instance, Bradford Council is tendering for a private sector asset management partner and other local councils are considering similar projects.

STEPS is expected to reduce estate running costs

1.5 As part of a Comprehensive Spending Review in 1998, the Departments decided that they needed to reduce the cost of running their estates. Just as the Departments were considering how to do this, the PRIME deal was close to being signed and was expected to cost £560 million less over the 20-year contract period than continuing with the existing arrangements. This was mainly due to lower capital expenditure, lower facilities services costs and extra property income.[8]

1.6 Over the 20-year life of the STEPS contract, when compared with the Public Sector Comparator, the Departments expect to save £344 million (in net present values), with an estimated first year saving of some £27 million. These savings are estimates because of the inevitable difficulties in accounting for changes to the size of the estate, rent increases, and assumptions on contract letting.

7 *C&AG's report: The PRIME Project: The transfer of the Department of Social Security estate to the private sector (HC 370, session 1998-1999); PAC Report, The PRIME Project: The transfer of the Department of Social Security estate to the private sector, Committee of Public Accounts, Forty-first report 1998-1999.*

8 *The PRIME project: the transfer of the Department of Social Security estate to the private sector. (HC 370 Session 1998-1999).*

5 Benefits of estate management PFI deals

Operational benefits

Flexibility: These deals give departments flexibility in their occupation of estates, allowing them to vacate a large proportion of their estates without charge and to occupy additional space as required by evolving business strategy.

Focus on core business rather than estate management issues: Reduced staff numbers in estate related functions are expected. Staff may also be transferred to the private sector contractor.

Facilitating strategic thinking: Promoting a long-term focus on business need and how the estate can best be used to serve that need.

Transfer of risk: Risks transferred usually include rent increases, costs exceeding budgets, losses on property development, costs associated with vacation of flexible properties, compliance with health and safety regulations and service delivery below set standards.

Consolidation and rationalisation with a single service provider: Prior to these deals, departments had to deal with fragmented service contracts. These estate management deals consolidate these to a single contract with one service provider who deals with sub-contractors.

Standardised services across the estate: A single point of access for service delivery issues is usually created via a helpdesk, often available 24 hours a day, 7 days a week. Helpdesks generally deal with reported faults such as replacement of lightbulbs, emergencies such as a broken lift and service requests for porterage and room bookings.

Incentivising performance: A payment mechanism that makes deductions for poor performance is used to incentivise the contractor to maintain standards of service delivery.

Professionalism in estate management: Experts in estate management are brought in. They are best able to take advantage of the property cycle, deal with estate management risks and bring cost effective management of the property portfolio. This frees the public sector from dealing with rent reviews, lease negotiations and disposal of surplus property with multiple landlords.

Other Government departments: There may be opportunities for other government departments to occupy space within the estate and share the benefits of the deal.

Financial benefits

Cost reduction: Cost savings are to be expected through reduced facilities management (FM) and maintenance costs, lower capital expenditure, receipts from the disposal of surplus property, and potential savings on utility charges and the purchasing of items such as furniture.

Up-front payment: A capital release from the sale of the properties can be made in the form of a one-off up-front payment from the contractor at the start of the contract.

Profit share: There are opportunities for further gain by including profit-sharing mechanisms in the contract.

Source: National Audit Office

Some anticipated operational benefits are emerging

1.7 STEPS has been operating for three years. While some problems have occurred, some of the anticipated benefits are being realised.

The Departments have rationalised management of the estate

1.8 Prior to STEPS, estate management in the HM Customs & Excise was organised through 18 Estate Management Units and in the Inland Revenue through 10 regional property centres responsible for managing and maintaining properties, seeking rationalisation opportunities and providing advice to local managers on estate issues. Estate managers employed over 200 contractors providing a range of facilities management services. Under the STEPS contract, Mapeley STEPS is now responsible for the negotiation of rents, lease renewals and the disposal of surplus property. Before STEPS, approximately 300 staff in the Departments worked directly on estate management. By Spring 2004, this number had been reduced to 160, and is expected to fall further as the contract beds in.

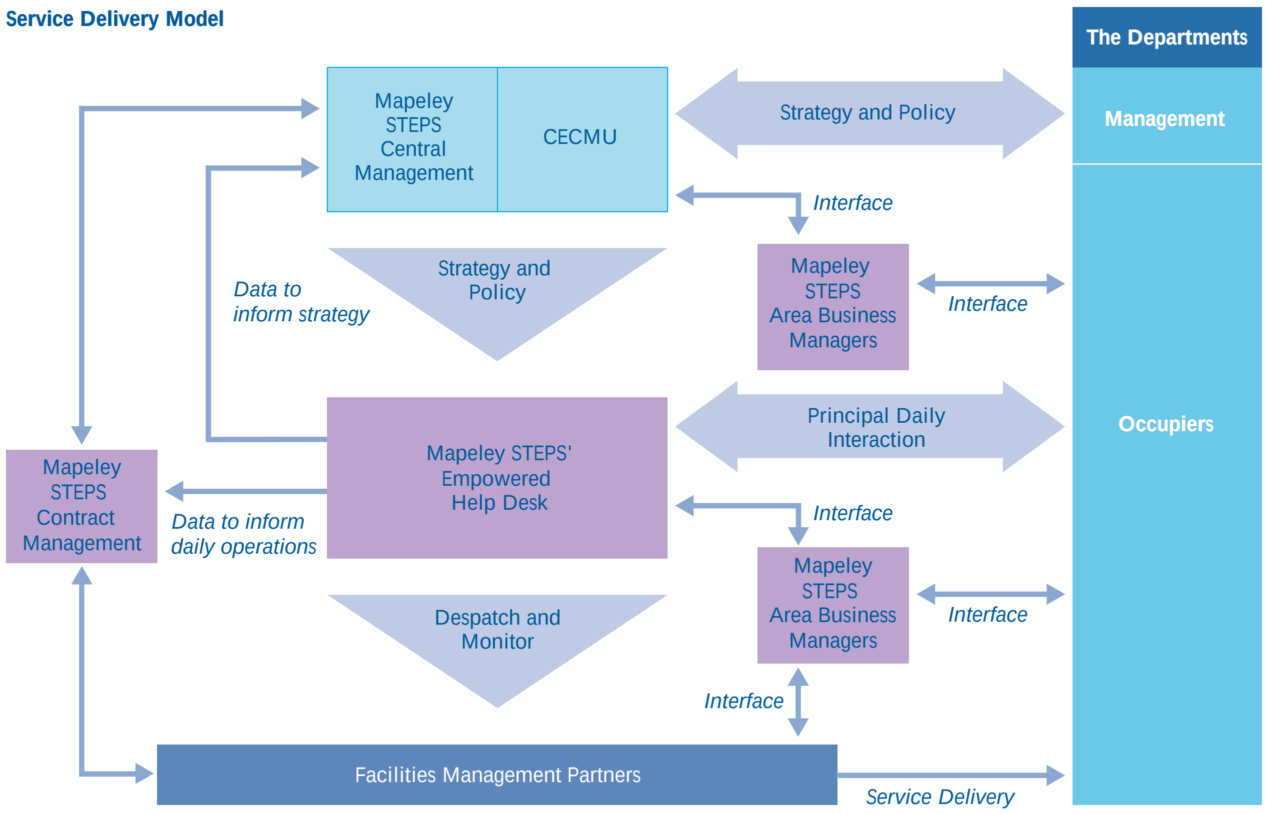
A single service point has been created for facilities management issues

1.9 The quality and availability of facilities management services was variable across the estates. STEPS has provided a standardised service with a single service provider for the majority of the Departments' accommodation. All staff have access to the service provider via a helpdesk. This helpdesk acts as a single point of contact between the Departments' staff and Mapeley STEPS and provides the contractor with a direct link to its maintenance teams. The system is designed so that staff can call the helpdesk directly to report problems, request services and make bookings. The phone operatives then prioritise the call and a work order is generated automatically and sent to the appropriate service provider or sub-contractor to deal with **(Figure 6)**.

Mapeley STEPS has provided additional facilities

1.10 To meet demand for extra office space since the start of the contract, Mapeley STEPS has acquired over 30 additional buildings and facilities for the Departments and is providing facilities management in them. Eleven of the buildings are about to be covered by the contract, while the others are in the process of being incorporated.

6 The Mapeley STEPS Helpdesk



Source: Mapeley STEPS

The Departments anticipate further benefits

1.11 As well as the benefits already secured, there are further benefits that have yet to emerge. Some of these benefits, such as greater flexibility, are not intended to be available until some time into the contract. Others, for example, focusing on core business, have not yet been fully realised, in part because of ongoing contractual negotiations since contract signature.

Both upward and downward flexibility of the estate is available for the future

1.12 Based on the Departments' own projections of need, the contract provides a high level of flexibility, most of which starts to become available from year four of the contract. The Departments can if they wish vacate up to 60 per cent of their estate over 20 years without additional costs. A change mechanism within the contract has also allowed the Departments to obtain additional space. The contract is intended to allow the Departments to respond more flexibly to changing demands for space (in terms both of staff numbers and of location) than they have been able to in the past. The Departments have classified their estate into three categories - core, intermediate and flexible - according to the likelihood of their future occupation **(Figure 7)**.

There are wider benefits available as a result of the deal

1.13 There are a number of wider benefits available to the Departments as a result of the STEPS deal:

A One stop shops

Mapeley STEPS has authorised the Departments to establish two sublets to local authorities in Bradford and East Kilbride and will consider others on a case by case basis to support the implementation of Government policies such as the "One Stop Shop" initiative. This initiative is aimed at providing the public with as many central and local Government services as possible from one location.

B Savings for other Government departments

As part of the STEPS deal, other Government departments are entitled to occupy space. Before STEPS, other Government departments occupied approximately 10 per cent of the Departments' estates. Under the contract, Mapeley STEPS charge the Departments for this space and the Departments pass on the charges to the other Government departments. This will enable other Government departments to benefit from the expected cost reductions under the STEPS deal.

C Experience of departmental joint working

Both the STEPS Project Team and the Estates and Contract Management Unit are examples of closer working. The Departments have benefited from the interchange of knowledge and skills and the management of a joint estate. In addition, STEPS has also promoted joint working between the Departments' internal audit teams, with joint audit reporting on the STEPS deal. On 17th March, the Chancellor of the Exchequer announced the re-organisation of the Departments into a single organisation. Any accommodation aspects that emerge during this process will be facilitated by the STEPS deal.

7 Flexibility allowances in the contract

Category	Area	% of total estate	Vacation allowances per year (square metres)	Period
Flexible Vacation at nil cost within specified allowances	175,000	13	2,500 5,000 6,000-15,000 Nil	Year 1 Years 2-5 Years 6-15 Years 16-20
Intermediate Primary focus on first 5 years. No cost if vacation takes place on or after the date specified. Payment of unavoidable costs if early vacation.	212,000	16	Varies	Year of transition (varies from property to property)
Core Occupancy is expected for the full 20 years of the contract but can still vacate within specified allowances	969,000	71	Nil 15,000 (at no cost) + 15,000 (must pay Overhead Compensation) Overall cap of 450,000m^2 Nil	Years 1-3 Years 4-18 Years 19-20

NOTES

Annual allowances operate on a cumulative basis, so any part not used can be carried forward to the following year.

Unavoidable costs

Unavoidable costs are costs that the contractor may expect to face as a result of the Departments vacating the facility - for example, the costs associated with subletting or re-assigning the lease, or a payment to the landlord for early surrender of the lease. Under the STEPS contract (schedule 14), the Departments will not have to pay any unavoidable costs, where properties are vacated within the contractual allowances.

Overhead compensation

Where Departments decide to vacate core facilities beyond agreed allowances an overhead compensation amount becomes payable.

Source: Inland Revenue and HM Customs and Excise

Part 2

The Departments got a good price

The Departments created a competitive environment for the deal, applied lessons learnt from PRIME and secured a highly competitive price. The evaluation of Mapeley STEPS' bid identified a small risk that it might not deliver but the Departments decided to accept this risk in order to benefit from Mapeley STEPS' pricing, which was well below not only the other bids but also the best available alternative to a PFI deal.

There was an effective competition

2.1 One of the underpinning features of value for money in any deal is a good quality competition. When the Departments set out to procure the STEPS deal they faced a marketplace where there had only been one deal to date and where there was only one provider with any experience. The Departments therefore had to ensure that they created enough interest from the marketplace to ensure that new consortia would bid for the deal and create an effective competition.

The Departments planned the procurement thoroughly

2.2 The Departments undertook a high level appraisal of the main options. These options were:

- do nothing
- a business improvement option that would introduce efficiencies and savings into the current system of estate management
- a PFI asset transfer deal similar to PRIME.

2.3 The Departments rejected a "do nothing" option, as they wanted to make improvements to, and reduce the cost of, running the estate. The second option considered was based on running the estates as they currently stood but making incremental improvements to the estate management system. While this might achieve the Departments' requirements to improve value for money, they considered that it did not transfer the risk of running the estate to, nor utilise the skills of, the private sector. The third option, a PFI scheme, was likely to satisfy all of these criteria.

2.4 During the early stages of the project, the Departments examined the possibility of a joint procurement. They considered that a joint procurement would be more complex and require careful handling and co-ordination. It would however enable closer working, reduce procurement costs both for the Departments and for bidders, achieve better prices through increased buying power and eliminate any risk of competing for market interest and expertise. The Departments sounded out these ideas in the market and concluded that the project would be well received. Bidders have told us that two projects coming to market at the same time would almost certainly have driven up prices, but that individually the Departments' estates would have been of sufficient size to generate market interest.

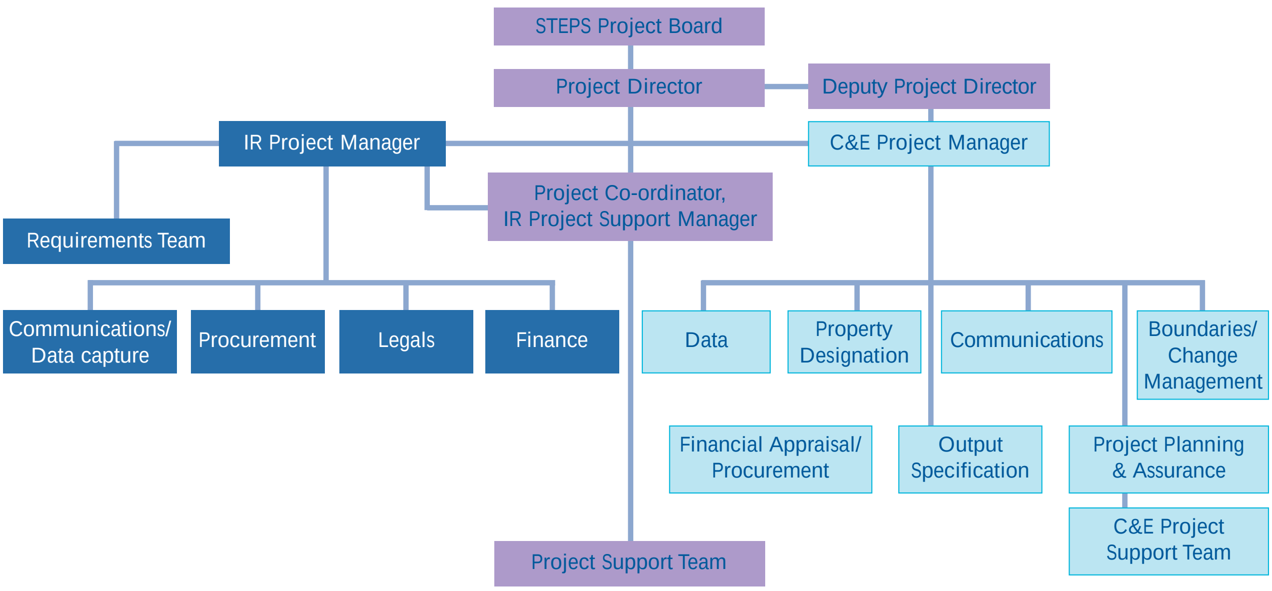
2.5 A joint project board and a joint project team were established, supported by working groups on specific issues (**see Figure 8**). As the PRIME deal was close to financial close at this time, the STEPS team had regular meetings with the PRIME team to learn from their experiences. A timetable and budget encompassing all the procurement stages was developed, based on the experience of PRIME. The STEPS team also followed Treasury guidance available at the time, both from the "Green Book" and the active participation of the Treasury Taskforce (later Partnerships UK). The procurement costs for the Departments were £10 million against an original budget of around £12.5 million. Appendix 2 gives a chronology of the deal.

Conditions for a successful competition were established

2.6 The project was well marketed in advance of the competition. Pre-marketing meetings were held in New York and London in early 1999 and attended by the Project Director and the project's financial advisers, Deloitte & Touche. An advertisement was placed in the Official Journal of the European Communities in March 1999 and around 230 interested parties attended a briefing day held in London in April 1999. Several of the companies present were familiar with the PRIME deal and so had a general understanding of the issues involved. The response confirmed earlier expectations that a sufficient number of credible consortia would come forward to maintain competitive tension at each stage of the procurement.

2.7 Ten submissions were received at Pre-Qualification Questionnaire stage. The project board endorsed the selection of five consortia to go forward to Invitation to Submit an Outline Proposal stage. At this stage, the Departments considered that all the bidders were of sufficient quality, they were all backed by big institutions, and were investing heavily in the competitive process. The assessment panel recommended that three bidders go forward to the Invitation To Negotiate (ITN) stage. These were all strong consortia, which the Departments considered could deliver a value for money bid **(Figure 9)**.

8 STEPS procurement teams



Source: Inland Revenue and HM Customs and Excise

9 The three bidders at ITN

Consortia	Property Management Expertise Provider	FM Expertise Provider	Funders
Mapeley STEPS	DTZ Debenham Thorpe, Grubb & Ellis Management Services, Delancey Estates.	Grubb & Ellis Management Services, Dalkia Symonds, EDS, Aqumen Group Ltd, MacLellan International Ltd, Coflex.	Bank of America, HBOS, Fortress Investment Group, Soros Real Estate Partners.
Trillium	Trillium team experience from PRIME.	Trillium. Service partners are Sutcliffe Catering, MITIE, ISS, George S Hall, Drake & Scull, Chubb, Regus.	Goldman Sachs, Whitehall Street Real Estate Limited Partnership, MyChand Central Limited Partnership.
Servus	Jones Lang Lasalle Ltd, Healey and Baker, Grosvenor Estates Holdings, London & Regional Properties.	SERCO, with back-up from Servus internal staff.	Wholly owned by Nomura, National Westminster Bank.

Source: National Audit Office

The lessons from the PRIME deal were applied and generally worked well

2.8 Our report and that of the Committee of Public Accounts on the PRIME deal made recommendations for future deals. The STEPS procurement team were keen to ensure that any lessons from PRIME were taken on board. They identified three areas that they considered key for the STEPS deal:

A Up-front payment

An up-front payment by the private sector may be desirable for a number of reasons. It ties in private sector funders, since they have capital invested in the project and can only earn this back over time through the Unitary Charge. It also ensures that risk is transferred, and will bring in debt providers whose monitoring of the deal to protect their investment is aligned with the departments' interests. For these reasons, bidders were required to include an up-front payment in their bids for PRIME. In STEPS, bidders were required to include an up-front payment of £220 million but could also offer variant bids with lower or nil capital payment, as long as they provided equivalent security for the transferred assets and better value for money. A figure of £220 million was used, as this was a similar proportion of the estate valuation[9] to that used for the up-front payment in the PRIME deal. The market had also indicated to the Departments that it was content with this figure. When the bids were analysed, there was only a marginal difference in the net present cost to the Departments under the two scenarios. The £220 million up-front payment option was chosen.

B Joint survey

Where there is a lack of data, and therefore certainty, bidders may reflect this in their prices and so it is in a department's interests to have the complete and appropriate data that the bidders require to price their bids. If such data on an estate cannot be assembled in good time, a joint survey with the bidders should always be considered. This ensures that all bidders are working to common assumptions and reduces bidding costs. In the STEPS deal, the Departments realised early on that they did not have high quality estate data and they therefore procured a joint survey from their property advisers Insignia Richard Ellis.[10] The costs of the survey were split equally between the Departments and each of the three shortlisted bidders. The bidders were given the opportunity to provide input into the scope of the joint survey and signed up to the final specification. The joint survey of the Departments' estates was necessarily a major logistical challenge. Although it was delayed by four months, this did not delay the deadline for ITN submissions. A number of errors in the data were discovered and bidders were made aware of this.

C Variant bids for different levels of flexibility

In the PRIME deal, we recommended that departments should obtain variant bids based on different levels of flexibility to vacate properties, allowing the options to be costed in the light of different staffing projections. Whereas PRIME categorised buildings into two groups - those that would be vacated and those that would be retained - STEPS added a third "intermediate" category of buildings. Intermediate buildings are generally expected to be vacated within the first five years of the operating period. This category was developed to avoid the Departments having to pay for flexibility that they were unlikely to use, but also to avoid paying costs if the buildings were vacated before the end of the operating period. Bids were received that allowed various vacation scenarios to be costed. Bidders also had a clearer idea of the Departments' needs and this extra certainty will have been reflected in their pricing. The first three years of the contract provide the Departments with 12,500m^2 of flexible space. At 31 October 2003, 8,096m^2 of this allowance had been utilised. If the balance is not allocated before the end of the financial year, the contract allows it to be carried forward into 2004-05.

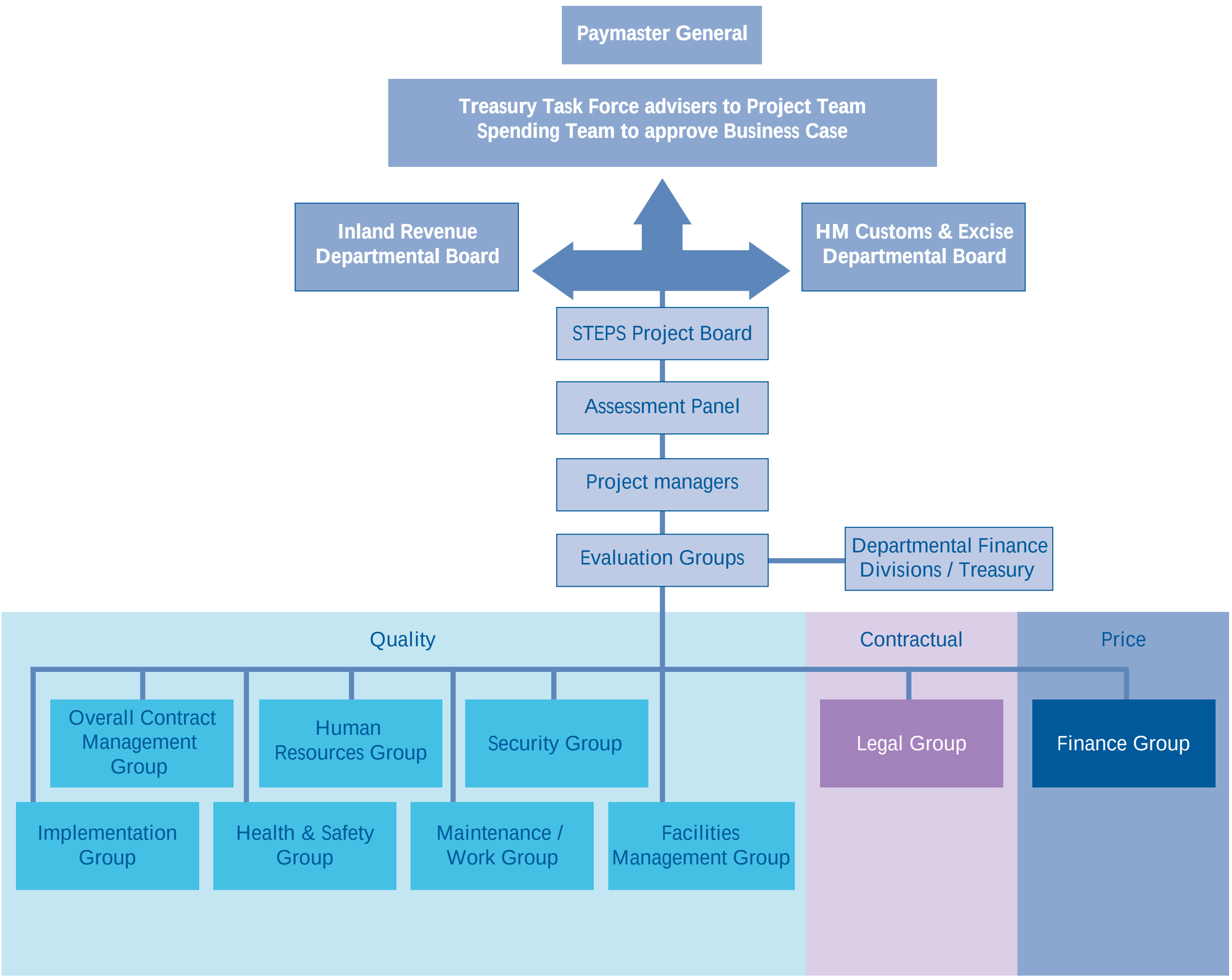
A clear evaluation process was established

2.9 The Departments set out a clear organisational structure for bid evaluation **(Figure 10)**. Seven Quality Review Groups were set up to evaluate the bids and assess whether the Departments' business requirements were met. A Legal Review Group assessed whether the bids complied with the Departments' mandatory requirements and advised on any variations proposed by the bidders. A Financial Review Group evaluated the value for money of the bid, the affordability and robustness of the proposed funding structure and the commitment of the financiers. The evaluation teams were kept separate, to avoid them influencing each other, and each group was given a set of criteria for evaluating the proposals. A project evaluation team then pulled all the findings together to form a final evaluation for each bidder.

9 *The STEPS estate was valued at £370 million. In addition to the upfront payment of £220 million, the balance of the value of the estates (£150 million) will be received by the Departments through a reduction in the unitary payments over the term of the contract.*

10 *Now called CBRE.*

10 Structure of evaluation teams and accountability framework



Source: National Audit Office

Mapeley STEPS was the clear winner

2.10 Mapeley STEPS was the clear winner in terms of quality, conditionality and price.

Highest quality

2.11 The seven Quality Review Groups evaluated the bids in 18 different categories, awarding a score of between zero to three for each category. The scores were then weighted according to their overall importance to the Departments and a total score was calculated for each bidder. Mapeley STEPS scored consistently across all categories, with no individual category scoring below two. Its overall score was 273, with the next highest bidder on 234. The evaluation teams also marked it as the highest scorer in 17 of the 18 categories. The Departments considered that it not only demonstrated an understanding of the technical issues but a partnership approach and an appreciation of the Departments' requirements.

Lowest level of conditionality

2.12 When bidders respond to a tender document, they may attach conditions to their bid. The STEPS Legal Group assessed the bids to establish the level of conditionality, or the amount of change to the draft contract, that each bidder was requesting. Mapeley STEPS had only one comment that the Departments considered to be a material change to the risk allocation proposed in the draft contract. The Departments expected that this condition could be eliminated during the course of the preferred bidder stage. As the other bidders had a much greater number of comments on the draft contract, the Legal Review Group therefore concluded that Mapeley STEPS' bid was the clear winner.

11 Bids at selection of preferred bidder

Bidder	NPC with £220 million up-front payment	NPC with nil up-front payment
Mapeley STEPS	£1,427 million	£1,464 million
Trillium	£1,982 million	£2,104 million
Servus	£1,920 million	Late bid considered non-compliant.

Source: Financial Review Group Evaluation Report

12 Mapeley STEPS bid versus the best available alternative

Option	Base Case NPC	Minimum Likely NPC	Maximum Likely NPC
Business Improvement (PSC)	£1.83 billion	£1.729 billion	£1.976 billion
PFI Scheme with Mapeley STEPS	£1.486 billion	£1.43 billion	£1.542 billion

Source: STEPS Final Business Case

The lowest price

2.13 A comparison of the Net Present Cost (NPC) of the bids showed that, with or without an up-front payment, Mapeley STEPS was some £500 million cheaper than the other bidders **(see Figure 11)**. This remained the case when NPCs were compared across a wide range of scenarios for different levels of flexibility. The main areas where it was cheaper were in the pricing of flexibility, central overhead costs and reduced life cycle costs.

Cheaper than the best alternative to the deal

2.14 In order to evaluate whether the deal that is being procured is the best available, departments must always be aware of their best available alternative. This can act as a useful comparator when key decisions need to be taken. The best alternative to the STEPS deal was a business improvement option, which retained the estate in-house, but reduced costs over time through better management of the buildings. The costing of the best alternative in this deal was used as a Public Sector Comparator (PSC).

2.15 The PSC had an inherently high level of uncertainty attached to it as a result of the difficulty of forecasting not only the level of the Departments' accommodation requirements over 20 years, but also the associated running costs and potential income realisable from the estate. To take account of some of these uncertainties, the PSC was prepared for different scenarios. Across the range of scenarios, the price bid by Mapeley STEPS was some £300 million below the PSC **(Figure 12)**. Appendix 5 gives more details of the PSC.

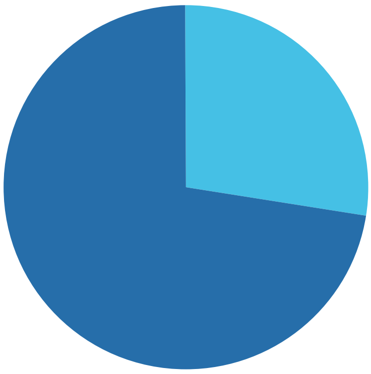
The Departments knew that Mapeley STEPS' low bid had risks attached

2.16 Throughout the procurement, the Departments were aware that Mapeley STEPS was a new company and that it had put in a low bid in order to win business in what it saw as a promising market. The Departments identified risks associated with its bid, but considered that they could be managed. In addition, its shareholders demonstrated their commitment by investing £80 million of equity in the deal, about 28 per cent of the overall funding (**Figure 13**). A more typical level of equity in a PFI deal is around 10 per cent or less.

Mapeley STEPS was a new company and its desire to enter the market was reflected in its low bid

2.17 At the time that the STEPS deal came to market, there was only one contractor in the market, Trillium, with experience of the sector. Throughout the bidding process, Mapeley STEPS had stated that its bid was highly competitive since it wanted to use the deal to gain a foothold in what it saw as a developing market. It planned to use the STEPS deal as a platform to win other business and stated that the pricing of its bid was based on returns over a 20-year time horizon and therefore had kept its operating margins in the bid very tight. The bid also contained assumptions that it would win other business in due course and that its central overheads would therefore be spread over a number of contracts.

13 Mapeley STEPS funding structure



Source: STEPS financial evaluation

The Departments tested the robustness of Mapeley STEPS' bid and decided to accept the risks identified

2.18 The Departments were concerned by the fact that Mapeley STEPS' bid was significantly cheaper than the other bids, as well as the PSC. In order to evaluate whether it could deliver the deal at this price, the Financial Review Groups tested the robustness of its financial model and examined in more detail some of the key assumptions that underpinned the bid. This analysis showed that the funding structure was robust under most scenarios examined, but that it may be vulnerable to increases in life cycle and annual maintenance costs. Assuming the most extreme variances in these costs over the life of the contract suggested that there was an 11.5 per cent probability that Mapeley STEPS would breach the terms of its debt repayments. The Departments' property advisers, Insignia Richard Ellis, reviewed Mapeley STEPS' costs in these areas and stated that they had no concerns about the life cycle costings but that some caution needed to be taken as to the robustness of its bid in the area of maintenance. The Departments calculated that the level of variance suggested by their property advisers would result in a reduced probability of 1.3 per cent that Mapeley STEPS would breach the terms of its debt repayments.

2.19 The Departments were also concerned about the assumptions made on property disposal income in the first year of the contract. The Departments commissioned work from their property advisers, who stated that the annual figure of some £6 million for disposals did not cause them concern, but that, if the timing of the receipts was critical to the robustness of Mapeley STEPS' bid, the property advisers would have concerns about its ability to achieve this receipt in the first year. Another area of the bid that varied significantly from the other bids as well as the PSC and historical data was that of security costs. Mapeley STEPS included an annual cost of £1.26 million in its bid, whereas the other bidders allowed an average of £6.8 million. The Departments were aware of this costing and took the view during negotiation that this was partially offset against a possible overpricing (some £2.2 million) of the amounts that Mapeley STEPS had allowed in its bid for payments of rent to landlords.

2.20 Mapeley STEPS was selected as the preferred bidder in 2000 and, following detailed negotiations, the contract was awarded in March 2001 to Mapeley STEPS Contractor Limited (registered in the UK) which will provide the services, and Mapeley STEPS Limited (a property holding company registered in Bermuda). There was no material increase in the bid price between its selection as preferred bidder and financial close. This was facilitated by a Memorandum of Understanding (MoU) agreed between the Departments and Mapeley STEPS which set out how outstanding issues would be resolved between the two parties.

Mapeley STEPS hold the freehold and long-leasehold properties offshore

2.21 At contract signature Mapeley STEPS was owned by Fortress Investment Group (incorporated in Delaware USA), Soros Real Estate Partners CV (a Limited Partnership formed in the Netherlands), and Delancey East Limited (resident in the UK at the time, but now offshore). As the STEPS freehold and long-leasehold properties were transferred to a company based outside the UK, tax on any gain made by a sale by this company will not be captured under the current UK tax regime. Furthermore, as the shareholders of Mapeley STEPS are non UK resident, they are not liable to pay UK capital gains tax if they sell their shareholdings since it is generally only payable on capital gains realised on the disposal of an asset by UK resident individuals and companies. Mapeley STEPS Limited is liable to pay UK income tax only on any profits made from renting the properties back to the Departments.

2.22 The location of Mapeley STEPS Limited in Bermuda has no material effect on the overall value for money of this deal to the UK taxpayer. Mapeley STEPS estimated that if it had been required to bring the STEPS properties onshore, it would have had to increase its bid price by £55 million to cover the extra UK tax that might have been due.[11] This is not a material figure in terms of a £1.5 billion deal or in the difference between the Mapeley STEPS bid and that of the nearest bidder and was not therefore a deciding factor in selecting Mapeley STEPS.

2.23 Even to the extent that the location of Mapeley STEPS Limited in Bermuda might have affected UK tax revenues, the 'Green Book' stipulated that tax flowbacks or savings should not be counted as part of the microeconomic impact of projects.[12]

2.24 The Departments followed procurement law throughout the process. The Board of the Inland Revenue only became aware of the tax arrangements late in the procurement. At that stage, the Board concluded in the light of legal advice that it would not have been lawful to exclude Mapeley STEPS on the basis of its tax arrangements. The Board of HM Customs and Excise only became aware of the tax arrangements after contract signature. The Government has responded to the tax issues raised in this deal by suggesting a new clause for future PFI contracts that limits the ability of contractors to go offshore. It remains to be seen how it will work in practice.

11 *This estimate was provided to the National Audit Office by Mapeley STEPS. It represents the net present value, at a 6% real discount rate, of the additional unitary charge needed to offset the potential tax liability if Mapeley STEPS had not been based offshore. The figure reflects Mapeley STEPS own views on prospective increases in commercial property values over the 20 years of the contract and assumes no changes in current UK tax legislation. Given the inevitable uncertainties surrounding forecasts up to 20 years into the future, it can only be a very approximate estimate. This figure has not been agreed with the Inland Revenue and HM Customs and Excise since the Departments cannot comment on the tax affairs of individuals in public.*

12 *Green Book (1997), paragraph 4.20.*

Part 3

Good risk management is essential in this deal if value for money is to be fully realised

Some risks have crystallised very early in the STEPS deal. The Departments took some time to respond to these but sought good advice and now have a much clearer view of the risks involved. Measures are also being taken to improve the governance of the contract. However, effective risk management will be essential if the Departments are to realise full value.

3.1 Our report *Managing the Relationship to Secure a Successful PFI Deal* highlighted the importance of good risk management in a PFI deal and the ways in which this can be achieved. Good risk management will result from a thorough appraisal of all the possible risks attached to a deal and the development of contingencies should the risks crystallise. Our report also highlighted the importance of developing a successful partnership-based relationship between an authority and a contractor. This relationship is assisted by the right contractual framework, which includes allocating risks appropriately, establishing clearly defined quality of service and value for money mechanisms, and building in arrangements to deal with change. It is also essential that both parties to the deal understand their respective objectives, assess the prospects for a partnership, and make efforts to understand each other's business. As a deal progresses, the risks inherent in it will change and risk management arrangements must be reviewed regularly as deal risks change over time.

A number of risks crystallised very early in the STEPS deal

3.2 In any deal, it is possible that risks will crystallise at any time. The key to a successful deal is how risks are dealt with when they crystallise and the level of contingency in place. STEPS is a very complex and dynamic deal, involving the management of some 700 buildings for 20 years.

Seven months into the deal, Mapeley STEPS made a number of financial claims

3.3 Mapeley STEPS first raised with the Estates and Contract Management Board (ECMB) the possibility that it was facing financial pressures in November 2001. The ECMB asked for more information to get a better understanding of the problem. Following the request, it gave a presentation to the Departments in December 2001. Mapeley STEPS believed it faced a serious cashflow problem, with an annual shortfall of some £27 million, based on errors in the pricing of its bid, variations made to the contract since contract signature and claims arising out of the procurement process. The presentation carried a request to the Departments for a one-off payment with an additional yearly contribution. The Departments rejected this proposal as they believed the contractor's claims were based on projected figures which were not robust and were open to challenge.

It took time to establish the nature and extent of the problem

3.4 Having rejected Mapeley STEPS initial proposals, the Departments acknowledged that there was an issue to be resolved and agreed to work with the contractor to understand the extent of the contractor's financial problems and to consider what options were available.

3.5 The Departments set up a working group to analyse the situation and appraise the available options. The working group was chaired by Partnerships UK and comprised Deloitte & Touche (financial advice), Lovells (legal advice), and the Departments' Estate and Contract Management Unit. The group reported to the Inland Revenue Board in January 2002. At that meeting the Board asked for further work to be done to gain a better understanding of Mapeley STEPS' finances and the protections the Departments had if the contract did not continue.

3.6 The Departments subsequently appointed Rothschild to report on the situation alongside the working group. The appointment was made to help prevent any conflicts of interest arising within the existing working group, all of whom had advised on the original deal. Rothschild's report concluded that the original deal, signed in April 2001, was at a good price and that it was in the Departments' interests to continue with the deal. Although Rothschild was unsure how robust the contractor's figures were, it was clear that without significant injections of capital or additional support, there was a risk of Mapeley STEPS Contractor Limited becoming insolvent. The report recommended that the Departments should look for solutions that kept the senior debt provider (HBOS) in the deal, since the bank brought a monitoring role to the deal. Rothschild also recommended that the Departments should develop a full understanding of Mapeley STEPS' underlying business dynamics and conduct a thorough review of the implications of termination, and of the management of the STEPS deal, in order to be clearly forewarned of any further problems.

3.7 Following a meeting of the Departments' Chairmen on 1 May 2002, further work was commissioned from the working group. The Chairmen recognised the risks of a Mapeley STEPS' collapse and the operational reasons why the working group should continue to investigate the prospects of reaching a successful conclusion. The Departments considered that, without a settlement, there was a risk that Mapeley STEPS might fail financially. This would result in operational difficulties, litigation, and the loss of the expected cost savings in the deal. The Chairmen also believed that it was crucially important to get a better understanding of the consequences of the contract coming to a premature end and that contingency work should be carried out to explore exit options.

3.8 At this stage Mapeley STEPS approached the Departments seeking reassurance about the likely outcome of discussions with the aim of sharing this with the bankers and auditors. The Departments sent two letters to Mapeley STEPS on 27 June and 24 July stating that negotiations were ongoing and that any final settlement would be subject to approval. These letters were accompanied by a draft memorandum of understanding that would form the basis of the ongoing negotiations. The Departments were subsequently advised by the Treasury Officer of Accounts that the letters may constitute letters of comfort. No money was paid over to Mapeley STEPS as part of this process and there is no contingent liability.

Mapeley STEPS' position has since improved

3.9 Since Mapeley STEPS first stated that it had financial problems, a number of factors have combined to improve its financial position. Principal among these is the fact that it has been able to improve its property management income, largely as a result of changes in the property and financial markets, and its recruitment of a financial director. It told the Departments that its shareholders had also injected additional short-term funding of £8 million with an annual ongoing commitment of £2 million to £3 million.

3.10 One of the principal reasons for undertaking a property deal such as PRIME or STEPS is that the risk of managing property in line with general movements in the economy and the financial and property markets is transferred to the private sector contractor. In its original bid, Mapeley STEPS had expected to realise £6 million in the first year from efficient management of the STEPS estate. It took longer than expected to realise this income and it achieved only £1 million in the first year.

3.11 Since the first year, however, Mapeley STEPS has strengthened its management team and has been able to improve the company's estate management. Furthermore, changes in the property market and more general changes in the financial markets, have allowed the contractor to begin to realise value from the estate. As returns on equities have been weak in recent years compared to returns on property, property has become a more sought after investment in the market. The most marketable property is currently that with a lease in excess of 15 years remaining and with a good quality tenant. Much of the STEPS estate fits into this category, particularly since Government departments are the tenants. Mapeley STEPS has therefore been able to lengthen some of its leases in return for a premium cash payment from landlords.

3.12 In November 2002, Mapeley STEPS submitted revised cash flows that took account of its improved financial position. While its short-term position had improved, its business model has a high degree of fixed costs and is therefore very sensitive to any future shortfalls in forecast income. The Departments recognise that, even with the current improved health of the contractor's finances, the STEPS contract will always be finely balanced and they remain alert to the risks that this creates.

Negotiations are ongoing

3.13 In our report on the PRIME deal, we stated that the Department should not adopt an inflexible approach to negotiations that would damage the long-term partnership with the contractor and benefit neither party. Both parties should be willing to trade variations in the contract over its 20-year duration and manage their contractual relationship in a spirit of partnership. This recommendation is of particular relevance to the STEPS deal, where there are still a number of issues surrounding payments to Mapeley STEPS that form part of ongoing negotiations with it. These negotiations fall into two areas, financial and contractual. Although it is inevitable that the two areas overlap the Departments have been able to ensure that, for the most part, it has been possible to progress day-to-day contractual issues independently of the financial negotiations. The financial negotiations fall into two distinct categories:

- Variations clearly within the contract, that can be priced within the contract, such as additions of new buildings and changes to service specifications.
- Claims that arise primarily out of the procurement process such as the specification of pricing of security services and discrepancies in property information.

3.14 In December 2002, the Departments decided to open negotiations with the contractor to seek an overall settlement of the outstanding claims covering both Mapeley STEPS' contractual claims and any other areas where there have been unforeseen results due to developments since contract signature. The financial negotiations are under the supervision of a steering group that comprises two board-level Departmental representatives and the Head of the Private Finance Unit at the Treasury. The Departments' position is that, if any additional payments are to be made to Mapeley STEPS in respect of claims they must be to meet contractual liabilities or be in return for tangible benefits. In respect of variations any additional payments must offer quantifiable value for money. Negotiations are still ongoing and this has prevented some key senior management staff from focusing on core business and the Departments have not yet been able to focus as much on core services as was envisaged.

The Departments and Mapeley STEPS now have a clearer view of the risks involved

3.15 The STEPS deal is a large and complex PFI project with both typical and atypical risks. While it has similar operating risks to those displayed in many other PFI deals, the fact that the financing is secured on existing assets means that the risk profile is different from other more standard PFI deals.

3.16 In a standard PFI deal, the financing is raised by the private sector and is secured on the future cashflows of the project. Since those cashflows are dependent on delivery of the service to the public sector, investors will only recoup their investment and make a return if the project is successful. This helps to align the interests of the public and private sectors. It also brings the due diligence processes of the private investor to bear on the project. In the STEPS deal, the private finance provided is secured on the Departments' estates. This gives the private sector investors a much higher degree of security than is traditionally the case in PFI.

3.17 At the time that Mapeley STEPS went to the Departments in November 2001, stating that it had serious financial problems, the Departments had not worked through all the consequences which would arise should the deal collapse in the particular circumstances which then faced them. Nor did they have a fully developed view on the implications of the options available to them to move forward in those circumstances. As a result of the work done in response and effective use of their advisers, the Departments now have a clearer view of the risks inherent in the STEPS deal. They have a clearer understanding of Mapeley STEPS' business model, its finances and investors, and its business focus. They also have a clearer view of the effects of termination and the costs involved. The Departments have taken comfort from Rothschild's view that they got a good deal with the Mapeley STEPS contract and that it is in their interests to continue. They also recognise the operational reasons for seeking a successful conclusion to negotiations. However, as part of their risk management activities, the Departments have assigned roles and responsibilities in the event that termination should occur.

Contract management mechanisms are not yet fully functional

3.18 If a PFI deal is to deliver the service required over the full length of the contract, it is essential that effective contract management mechanisms and partnership working are in place early on.

Governance arrangements were put in place to manage the contract

3.19 The STEPS contract is managed for both Departments by an Estate and Contract Management Unit (ECMU). This lies outside the Departments' traditional line management structure and manages the estate as a single entity. The ECMU is held accountable by the Estate and Contract Management Board, whose role is to provide assurance to the Departments that the outcomes planned from the deal are delivered.

3.20 The Departments intend to manage the contract through a partnership approach. Mapeley STEPS do not form part of the Board but is required to attend meetings as appropriate. The chair of the Board is rotated between the two Departments. It was originally envisaged that the Board would meet quarterly, and that over time this would reduce to bi-annually, although to date it has met more regularly because of the ongoing negotiations with the contractor.

3.21 As the contract has progressed, the governance structure that was set up has been restructured and a number of new initiatives have been put in place to ensure that communications and management of the project are more effective. These include:

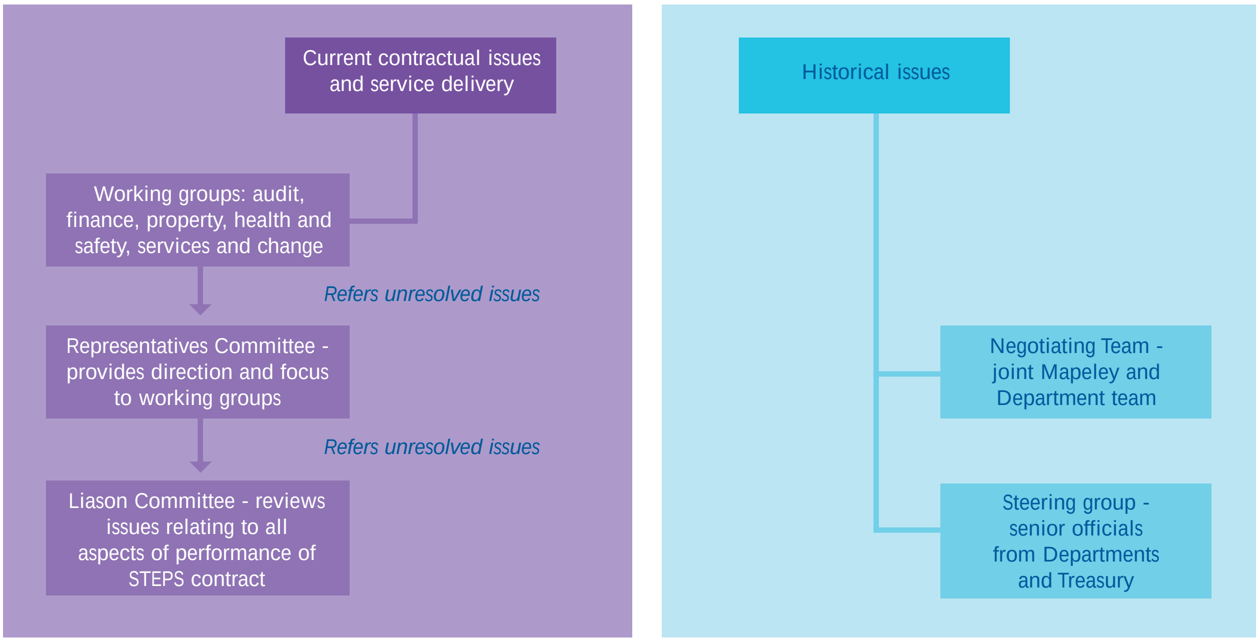
- The decision to recruit a professional contract manager who has extensive private sector experience to provide more effective management of the contract.
- A review of estates roles and responsibilities to remove duplication and ensure clear processes and accountabilities.
- The strengthening of the Estates and Contract Management Board by the appointment of a Non Executive Director, who has extensive experience in estates and facilities management.
- A revised STEPS committee structure to facilitate better communications between the Departments and Mapeley STEPS and to resolve issues.

A review was undertaken by external consultants of the contract management and the recommendations are currently being implemented. These are aimed at ensuring that clear processes and lines of communication are in place between the in-house support teams. Additionally, the STEPS committee structure has been reorganised into two lines. One is charged with resolving current contractual issues and for managing service delivery, the other is responsible for the historical issues under negotiation **(Figure 14)**.

A performance measurement system was put in place, but this is currently not working satisfactorily

3.22 The STEPS contract has a performance measurement system (PMS) that is intended to incentivise the contractor to perform well and to make deductions for poor performance. This is a typical feature of a PFI deal. The STEPS PMS as envisaged in the contract was built around five Key Performance Indicators (KPIs) that are measured in every building **(Figure 15)**. The contractor is responsible for generating the performance information against each of these indicators and the Departments are responsible for verifying the accuracy of performance reporting by reference to Mapeley STEPS' own records.

14 Governance arrangements



Source: National Audit Office

3.23 The PMS mechanism was developed by the Departments and their advisers and supplied to all three shortlisted bidders for their consideration and input. The IT to support the operating system was developed by Mapeley STEPS and it was not practical to fully test it prior to implementation. Neither Mapeley STEPS nor the Departments could therefore be certain how it would operate in practice. Because both parties accepted that it would take a few months for service delivery to bed in, a three-month review period was created at the start of the contract (April-June 2001). Under this arrangement, the contractor would still pay a full year's deductions but these would be calculated on the level of deductions in the other nine months of the year. The bedding-in period was subsequently extended to six months, as a result of problems encountered in generating reliable information from Mapeley STEPS' software system and insufficient understanding of systems by Mapeley STEPS' subcontractors. Using the contractual provision that allows the PMS to be revised, a version of the full system was implemented in October 2001.

3.24 Shortly into the operation of this version of the system, Mapeley STEPS considered that the PMS was not sufficiently incentivising it and that it was punitive in certain areas. At the time, part of KPI 1 and KPI 3 were the only ones being used in the PMS reports, KPIs 2 and 4 were not being measured at all, and the use of KPI 5 had been deferred altogether. It was clear that even the revised PMS was not operating as intended, particularly in terms of incentivisation and prioritisation for Mapeley STEPS. The result was that the PMS would reward it for being reactive in dealing with problems, rather than incentivise it to carry out the day-to-day activities that would help to prevent problems. Since May 2003, KPIs 2 and 4 have been operating as part of the PMS; KPI 5 is still not being measured.

3.25 Mapeley STEPS argues that the charges are punitive and therefore an unfair contract term. The Departments do not share this view. To try to resolve this dispute, the contractor and the Departments have commissioned a joint review in an attempt to devise a way forward that is acceptable to both parties. The Departments have told us that the revised version of the PMS that is currently being negotiated would lead to an average monthly deduction of around £121,000. Mapeley STEPS is challenging these potential deductions, but it has made an interim payment for the period April 2001 to September 2003 and has agreed to make further monthly deductions on a without prejudice basis pending the outcome of the review.

There were some early problems with service delivery

3.26 During the course of the study, we found evidence to suggest that there have been difficulties with service delivery, such as delays in rectifying faults, particularly in the first few months of the contract. In response to these early issues, Mapeley STEPS has re-organised itself and appointed a new services director, and considers that service quality and timeliness is now improving. For example, the time taken to complete reactive maintenance and top priority tasks has improved.

15 Key Performance Indicators

- **KPI 1 measures compliance with the required outputs** (i.e. service levels). Each service is broken down into products (or sub-products) and scored against the required outputs set out in the contract. Points are set for meeting these levels and eroded if they are not met. Points can also be eroded for not doing maintenance work within the required times. Only top priority jobs feed into this KPI.
- **KPI 2 records performance against planned tasks** (e.g. planned preventive maintenance). This is calculated from the numbers of tasks completed against those specified in the Methods Statements and the Facility Output requirement.
- **KPI 3 reflects adherence to response times for reactive tasks.** The helpdesk allocates response times for action and completion of reported tasks according to the times specified in the contract. The contractor's performance is measured against a percentage target, which must be achieved. There are three stages to each task: Investigate, Temporary Fix and Permanent Fix. Each stage is worth one point, which can then be won or lost.
- **KPI 4 measures changes in the number of incidents reported.** This is measured against the average monthly number of incidents in the previous year (although Mapeley STEPS has now asked to have the incidents taken as an average over three-monthly periods). Increases in the number of incidents incur a score of less than 100 per cent. The contractor is obliged to report any incidents that are not reported by the Departments or other parties.
- **KPI 5 is a customer service measure.** This measures any change in monthly customer satisfaction compared to an average calculated from all previous months. Any increase in customer satisfaction gives a score of 100 per cent. At contract signature, the Departments and Mapeley STEPS had not agreed a method for measuring customer satisfaction (This KPI has never been operated).

Source: National Audit Office

3.27 Managing staff expectations may have played a role in these early difficulties. The deal was not intended to raise service standards across the estate but to ensure a consistent level. However, the Departments have told us that this may not have been effectively communicated to Departmental staff, resulting in poor expectations management.

Mechanisms to allow changes to the contract are not being used

3.28 Governance arrangements and procedures for agreeing changes will be critical if a PFI deal is to continue to deliver the services required. The STEPS contract has mechanisms to deal with change. However, although governance processes are in place, there are a number of changes that have been made outside the contract.

3.29 Shortly after Mapeley STEPS' financial problems came to light, the Departments agreed to change the Unitary Charge payment date. Since the contractual monthly payment to Mapeley STEPS fell a few days after its payments to landlords, the Departments decided to pay the Unitary Charge earlier in the month to ease the burden on Mapeley STEPS' cashflow. The change in payment date was not dealt with in the contract and the Departments are returning the payment date to its original month end position.

3.30 To cope with extra demand for office space, the Departments have had the use of over 30 new facilities since the contract went live and are receiving services from Mapeley STEPS for most of them. Apart from the first 11 of these, the Departments are currently paying rent directly to landlords and paying the contractor for services, as the remaining 19 have not yet been incorporated into the contract. Mapeley STEPS and the Departments are still negotiating the Facilities Unitary Payment of these facilities. In addition some 300 projects have been completed by Mapeley STEPS. These include provision of new call centres, removal of asbestos and provision of new lighting.

A proper partnership is not yet in place

3.31 In our report *Managing the Relationship to secure a successful partnership in PFI Deals,* we found that a successful outcome for both parties to a deal can only be achieved if they are prepared to approach projects in a spirit of partnership.[13] The STEPS deal is still bedding in and, while there have been moves on both sides to work in partnership, this has not yet been fully achieved. If the deal is to be successful in the long term, the Departments and Mapeley STEPS will have to conclude the current negotiations and move towards a partnership approach to managing the deal.

Since the start of the contract there have been staff changes on both sides

3.32 Following the signing of a deal, there may well be staff changes in both the contract management function and the contractor. This may be a natural progression, since the skills required on the contract management side for negotiating a deal differ from those required to manage a deal and a department's negotiating staff may be asked to use their skills to procure another PFI deal for the department. The *Managing the Relationship* report noted that a number of departments and contractors said that they had experienced difficulties because of a lack of staff continuity within contract management teams.

3.33 The Departments have told us that, in order to manage this situation, they put in place succession planning arrangements. However, a number of key staff members moved on after the deal was signed. These included the Project Board Director and Deputy Director. Three of the four most senior procurement staff moved on very soon after contract signature, leaving only one key member of the original STEPS team still involved in the deal. There were also a number of management changes at Mapeley STEPS shortly after the contract was signed. The finance director was not appointed until nearly a year into the contract, in January 2002, and there were four services directors within seven months of the contract going live. The current Deputy Chairman (former CEO) of Mapeley STEPS has been involved in the deal from the start and continues to be so, thus providing some continuity. But overall, the loss of key senior staff in all parties means that the Departments and the contractor potentially lost valuable knowledge of the purpose of the contract. While the contract can be read by those new to the deal, such subsequent interpretation may not fully capture the intention of those who originally wrote it.

Other characteristics of a partnership are not fully evident

3.34 **Figure 16** lists some of the features cited in our report as important for a partnership and describes the STEPS contract situation alongside these.

13 *C&AG's report: Managing the relationship to secure a successful partnership in PFI projects (HC 375 Session 2001-2002).*

16 Partnership working in the STEPS deal

Open communication, share information and work together to solve the problem

- Earlier consideration of the offshore nature of the company may have enabled the Departments to develop a communications strategy to deal with any resulting negative publicity.
- Rothschild's report noted that, at the start of their financial problems, the contractor presented its figures in such a way that it took time for the Departments to clarify Mapeley STEPS' financial position, thereby delaying their response to the problem.
- There was some confusion over whether Mapeley STEPS would break any of its financial covenants during its period of financial difficulties. It stated that there was a risk that it would breach its obligation to repay its working capital on 31 March 2002, but subsequently injections of shareholder capital ensured that it would not be breaking this obligation.

Co-location helps to improve communication

- Co-location can help to improve communication and lead to a good relationship. Mapeley STEPS is not co-located with the Departments at the moment and there may be benefits in moving towards this.
- There is some form of local co-location, as the contractor's mobile Area Business Managers move between the Departments' offices.

Roles and responsibilities must be clearly defined

- The Departments are taking the opportunity to redevelop and improve the governance structure.

Continuity of staff to build relationships

- There is a large turnover of Mapeley STEPS and Departmental staff. Succession planning was undertaken for go-live and this will continue to be essential, given the ongoing negotiations.

Open and honest environment

- The relationship has been affected by the financial negotiations. The Departments and Mapeley STEPS have maintained the relationship on the service delivery side by keeping this separate from the financial negotiations.

Appropriate monitoring of contractor's performance

- The PMS is not fully implemented (in the case of KPI 5) and is subject to disagreement. The Departments and Mapeley STEPS are working to develop an alternative.

PMS incentivises

- Mapeley STEPS claims that the PMS penalises rather than incentivises it. The Departments do not agree, but wish to work with the contractor to improve incentivisation.

Change procedures are important and good change procedures help the relationship

- There are frameworks for change in the contract, but the detailed procedures that make up the change processes have not been yet been fully used - for example, it is taking longer than expected to incorporate new facilities into the contract.

Source: National Audit Office

Glossary

Authority	A public sector body which lets a PFI contract. This may be a government department, or an agency of a department.
Capital structure	The make up of the funding employed in a business project. It usually refers to the proportions of debt to equity or senior debt, subordinated debt and equity.
Core facilities	Facilities that the Departments do not expect to vacate. The Departments will bear the costs of early vacation of core facilities if they exceed the agreed vacation allowance.
Efficiencies	Monetary adjustments to the public sector comparator base costs and the risk adjustments to reflect the extent to which management can reasonably foresee being able to deliver the infrastructure services in the public sector at a lower cost in the future.
Equity	The value of a company or project after all liabilities have been allowed for. The equity is owned by the shareholders.
Facilities management	Management of services relating to the operation of a building. It includes activities such as maintenance, security, catering and external and internal cleaning.
Flexible facilities	Facilities that the Departments expect to vacate at some point during the twenty year contract. Mapeley STEPS bears the costs of early vacation of core facilities if the Departments exceed the agreed vacation allowance.
Governance	System of joint working and responsibility for running the contract.
Interest	An additional amount that a bank charges on a commercial loan over and above its own cost of providing the loan. The margin serves to provide the bank both with a profit and compensation against the risk of not having the loan repaid.
Intermediate facilities	Facilities that the Departments expect to vacate at a specified time during the twenty year contract. The Departments bear the costs of early vacation of core facilities if they exceed the agreed vacation allowance for an initial period but then this responsibility passes to Mapeley STEPS.
Invitation to negotiate (ITN)	A document giving detailed information about the services to be provided and the proposed PFI contract and inviting bidders to submit bids for the contract.
Invitation to submit outline proposals (ISOP)	An invitation to bidders to submit outline high level bids.
Key Performance Indicators (KPIs)	The detailed standards of performance a department requires a contractor to provide.
Net present value	The net present value of the contract price represents the amount that would have to be invested at the start of the contract to fund the expected future cash payments which an authority will be required to make to the contractor.

Overhead compensation	Where the Departments decide to vacate properties over and above either the core or flexible vacation allowances, the STEPS contractors' reasonable "Changes in Costs" would have to be met by the Departments. Such costs include a negotiated amount for overhead compensations which the Departments expect to amount to six months Facility Unitary Price.
Performance Measurement System (PMS)	A system to measure the contractor's performance against specified criteria. Deductions from payments to contractor can be made if performance falls below set levels.
Preferred bidder	A bidder selected from the shortlist to carry out exclusive negotiations with the department.
Present value	The discounted value of a series of payments occurring over time taking into account the extent to which a sum of money is worth more to the Government today than the same amount in the future.
Private Finance Initiative (PFI)	A policy introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services, while reducing the impact of public borrowing.
Public sector comparator (PSC)	A benchmark against which value for money is assessed. It is typically a cost estimate based on the assumption that assets are acquired through conventional funding and that the procurer retains significant managerial responsibility and exposure to risk.
Risk transfer	The passing of risk under the contract between the public sector and the private finance provider.
Senior debt	The debt that is ranked highest in terms of claims on project cashflows and therefore carries the lowest risk that it will not be repaid.
Termination	The ending of the contract before its contractual duration. It can be triggered by a department or a contractor.
Unavoidable costs	These are the costs that the contractor may expect to face as a result of the Departments vacating the property - for example, the costs associated with subletting or re-assigning the lease, a payment to the landlord for early surrender of the lease. Under the STEPS contract (schedule 14) the Departments will not have to pay any unavoidable costs, where properties are vacated within the contractual allowances.
Unitary payment	The periodic payment that the public sector agrees to pay for the provision of services by the PFI contractor.
Value for money	Achieving the optimum combination of whole life cost and quality to meet customer requirements.

Appendix 1 Study scope and methodology

Study scope

The objective of the study was to examine value for money issues of this high profile PFI deal to transfer the ownership and management of the C&E and IR estates to the private sector. We used an issue analysis approach to design the scope of the examination and the nature of the evidence required. For this methodology, we set a series of high level audit questions that we considered necessary for assessing whether or not the deal had been value for money. These questions were:

- Were the project objectives clear?
- Did they apply the proper processes?
- Was the best available deal selected?
- Will the contract ensure delivery of the service over the contract life?
- Is the deal delivering the expected benefits?
- Are changes to the deal being well managed?

Study methodology

We collected evidence from a variety of sources to enable us to answer the questions set out above. These included:

- An extensive review of documentation held by HM Customs and Excise and Inland Revenue
- Semi-structured interviews with key members of staff within the Departments and their advisers
- Semi-structured interviews with the other bidders, including Mapeley STEPS.
- An analysis of the financial models constructed by the Departmental project team and the bidders
- We engaged the legal firm Berwin Leighton Paisner for taxation advice
- We did work shadowing at Mapeley STEPS' telephone helpdesk in Milton Keynes.

Appendix 2 STEPS chronology

July 1998	Comprehensive spending review
October 1998	First meeting of STEPS project board
March 1999	OJEC notice published
April 1999	Briefing day for contractors
June 1999	Longlist bidders announced
August 1999	ISOPs submitted
October 1999	Shortlist of 3 bidders (Mapeley STEPS, Trillium and Servus) announced
Jan 2000	Invitation to Negotiate (ITN) issued
April 2000	Bidders submit ITN
August 2000	Departments announce award of contract to Mapeley STEPS
March 2001	Contract signature
April 2001	Property transferred from Departments to Mapeley STEPS Limited
Nov 2001	Mapeley STEPS tells the Departments' project board that the company is in financial difficulties
June-July 2002	Letters of comfort sent to Mapeley STEPS' shareholders
Dec 2002	The Departments tell Treasury Select Committee that Mapeley STEPS' financial position has improved

Appendix 3 Possible termination routes

Possible termination routes

Event: Termination by Departments

Reason: One of the following default events

STEPS contractor is insolvent or involved in insolvency proceedings

STEPS contractor is in breach of certain of its contractual obligations
or
commits a material breach of its obligations under the agreement which materially or adversely affects the provision of the operations

STEPS contractor fails to comply with statutory IR requirements
or
is no longer authorised or licensed as necessary to carry out its obligations under contract

STEPS contractor has received a certain number of warning notices about services levels in any 12 month period

STEPS contractor fails to meet contractor obligations in relation to first charges on the property transferred

STEPS contractor is in default of any payment owing to one of the Departments for more than two weeks

STEPS contractor fails to comply with certain of the benchmark agreements or ratios set out in the facilities agreement

Departments entitled to remain in occupation of each site occupied by them.
Rent charged at the prevailing market rent in line with the arrangements for the end of the operating period.

There is no provision of ownership of the estate, or any part of it, to return to the Departments should the contract terminate early.

The banks have first charge on the buildings.

Payment of "deferred consideration" to be paid by STEPS contractor to the Departments if termination occurs in first 10 years of the contract. The amount to be paid reflects the residual value of the estate, taking into account the transfer payment and the proportion of the remaining value of the estate which the Departments will have received through the lower unitary charge in the years preceding termination.

To give the Departments security to cover any failure of Mapeley STEPS to pay the relevant payment on early termination, first charges are delivered to the department on 'charged properties'. The legal charge on these properties is to transfer to Mapeley STEPS on the tenth anniversary of the commencement date, as the Departments' view is that it will have recovered the full cost of the estate from the reduced fees charged by Mapeley STEPS.

The Departments would not be liable to make any compensation payments if the contract terminates early as a result of one of the default events.

They would be liable for the NPV of any *capital* payment streams from the Departments to the contractor which are outstanding at date of termination.

Event: Termination by Mapeley STEPS

Reason: Breach by Departments of their obligations covering the transfer of the estate to Mapeley STEPS which substantially frustrates the STEPS contractor performing its obligations for 90 days or more

Reason: Departments default on unitary payments or other payment which in aggregate total over £14m

Outcome: Departments pay compensation.
NPV of compensation: NPV of projected net cashflows which STEPS contractor would have received if termination had not taken place.
The relevant cashflows are as follows:
Aggregate facilities payment for remainder of operating period
less projected net cashflow which STEPS contractor is reasonably likely to receive
less projected costs and overheads of providing the services
plus any other costs which would have been incurred had termination not taken place.

Payment of "deferred consideration" to be paid by STEPS contractor to the Departments if termination occurs in first 10 years of the contract. The amount to be paid reflects the residual value of the estate, taking into account the transfer payment and the proportion of the remaining value of the estate which the department will have received through the lower unitary charge in the years preceding termination.

To give the Departments security to cover any failure of Mapeley STEPS to pay the relevant payment on early termination, first charges are delivered to the department on 'charged properties'. The legal charge on these properties is to transfer to Mapeley STEPS on the tenth anniversary of the commencement date, as the Departments view is that it will have recovered the full cost of the estate from the reduced fees charged by Mapeley STEPS.

Departments entitled to remain in occupation of each site occupied by them.
Rent charged at the prevailing market rent in line with the arrangements for the end of the operating period

Appendix 4 STEPS profit share on sale of business

Departmental rights in the event of sale

Sale of the contract (assignment) at any time	The contractor must seek and obtain Departments' permission if the contract, or part of the contract, is to be sold on
Sale of control by sale of shares in first *three* years of contract signature	The contractor must seek and obtain Departments' permission which is at the Departments' absolute discretion
Sale of control by sale of shares *three* years after contract signature	Departments may withhold permission under certain limited circumstances, for example, if the new shareholders are based in a country which is subject to economic sanctions imposed by the UK government

Departmental rights to share profits in event of a sale

Sale of the contract (assignment) at any time	Departments are not contractually entitled to any profit share from the sale but as they must give consent for a sale to occur they can negotiate the terms of that consent
Sale of a controlling share in first *five* years after contract signature	If Fortress, Soros or Delancey sell more than 51% or float more than 25% of the net cashflow, the Departments are entitled to a 20% share of any windfall gain element
Sale of a controlling share *five* years after contract signature	The Departments have no right to share any profits

Structure of the PSC

The PSC in the STEPS deal was used by the Departments as the baseline when evaluating the value for money of the private sector bids. The comparator was based on an assumption that the Departments would continue to own and manage the estate in house, but run the estate more efficiently than in the past (for example, through greater efficiencies in facilities management costs such as cleaning and security and through reductions in the number of staff needed the manage the estate).

To enable comparison with the bids the PSC was constructed on a common basis with them;

- The same properties, range of services and standards to those in the bids were used in the PSC.
- Services excluded from the deal were similarly excluded from the PSC.
- The PSC assumed that the estate will not be static and therefore identified income from sale freeholds and income from letting and subletting to private tenants.
- New properties were excluded from the PSC since the value for money of these is evaluated on a case by case basis. The bids similarly excluded new properties.
- The PSC was modelled for different levels of flexibility and could therefore be compared to the bids, which were also examined on different flexibility profiles.

The Departments' financial advisers provided technical advice and support to develop the model and ran it to provide the information. The Departments' property advisers also provided technical advice and undertook specialist costings. The assumptions and workings of the model were refined and validated at a series of workshops using Departmental staff. The team also obtained assurance from a financial modelling company that the structure of the model was valid.

Finalisation of the PSC involved de-constructing the individual sections of the model to test that they performed as anticipated. Each test was cross-referenced to the appropriate section of the model and the assumptions that lay behind that section. Following finalisation the model was tested for sensitivities. Results of the sensitivity testing are given below with a breakdown of the PSC costs.

Risk in the PSC

The PSC had an inherently high level of uncertainty attached to it, as a result of the difficulty of forecasting not only the level of the Departments' accommodation requirements over 20 years, but also the associated running costs and potential income realisable from the estate. Risks were modelled in the comparator by using Monte-Carlo simulation and the final output of the final PSC was expressed as a range.

The risks modelled in the PSC covered uncertainties in predicting future income in areas such as subletting and sales and uncertainties in future costs such as ongoing rent payments. Since the STEPS deal differs from a standard Design, Build, Finance, and Operate (DBFO) PFI deal in that there is no construction of an asset, the STEPS PSC had no risk adjustment for construction time or cost overruns. This risk is usually the largest risk adjustment in a standard PSC. The overall risk adjustment in the PSC can be taken as the difference of £101 million between the minimum likely cost and the mean cost to compare the PSC with the PFI bid.

Minimum likely cost (Low level of risk)	£1,729 million
Mean cost	£1,830 million
Maximum likely cost (High level of risk)	£1,976 million