PFI: The STEPS Deal

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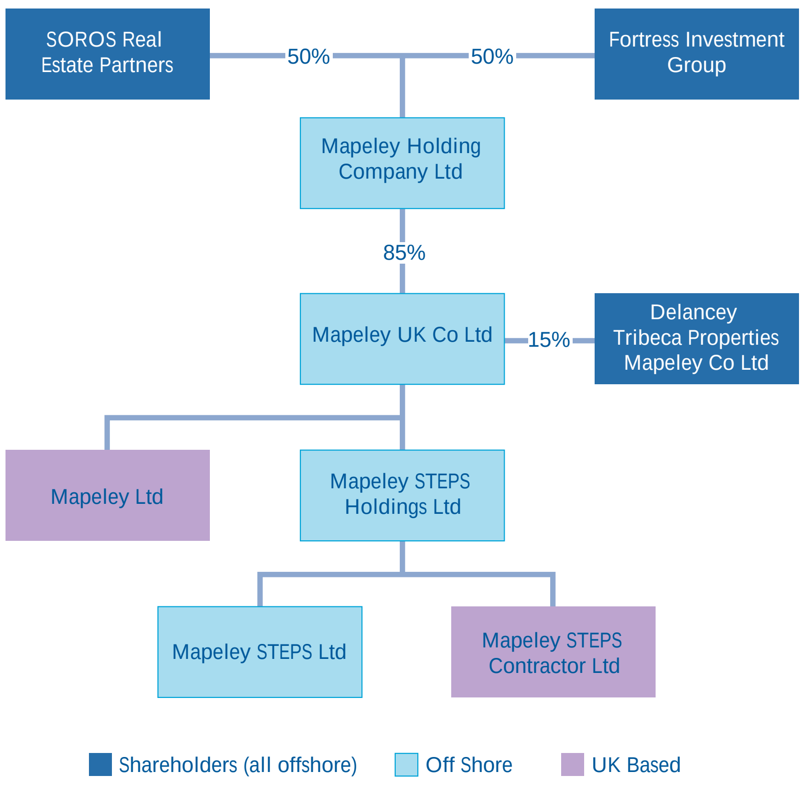
Summary

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

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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.

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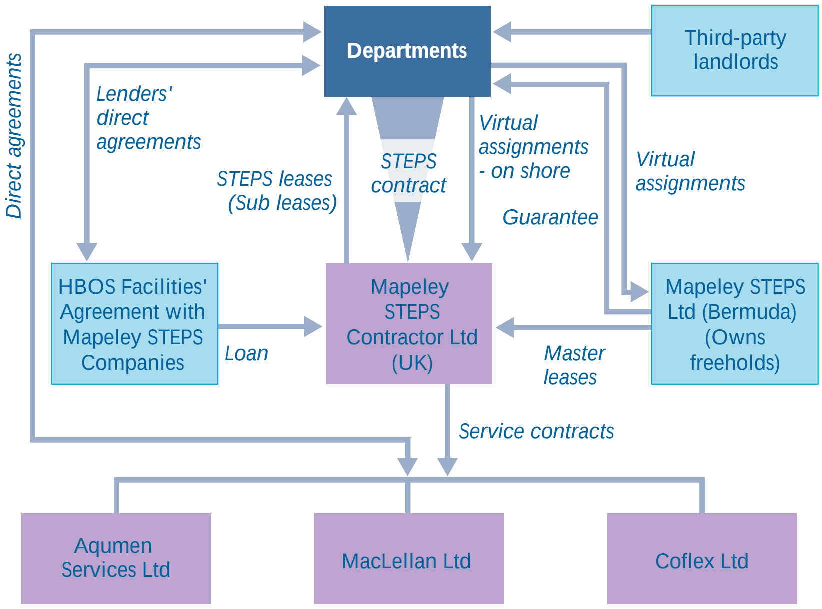
2 *C&AG's report: The PRIME Project: The transfer of the Department of Social Security estate to the private sector (HC 370, session 1998-1999); PAC Report, The PRIME Project: The transfer of the Department of Social Security estate to the private sector, Committee of Public Accounts, Forty-first report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

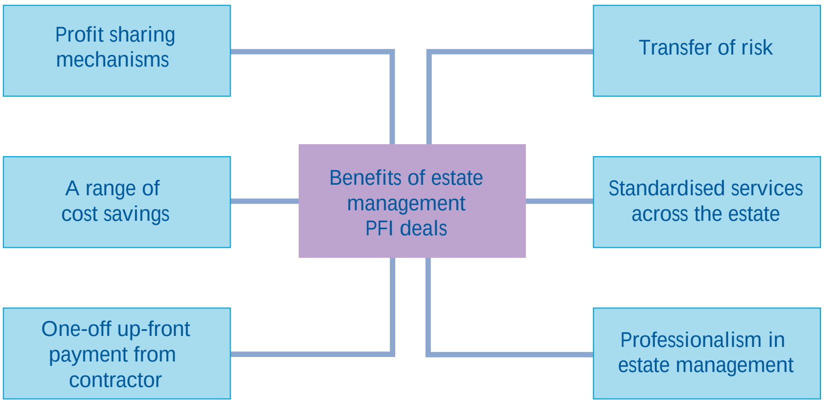
Property type	Number of buildings	Space (m^2)
Transferred to Mapeley STEPS:		
■ Leasehold	415	775,000
■ Freehold/historic leaseholds	159	581,000
Service only (ownership not transferred)	124	87,000
Total	**698**	**1,443,000**

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).*