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HM Revenue & Customs' estate private finance deal eight years on

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

30 November 2009

In 2001 HM Revenue & Customs signed the 20-year STEPS contract with Mapeley, aiming to reduce its estate costs and obtain more flexibility to vacate properties. This report is our second review of the contract, and concludes on whether the Department has obtained value for money eight years into the deal.

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Contents

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Summary

1 In 2001 the Inland Revenue and HM Customs & Excise, now HM Revenue & Customs (the Department), signed a 20-year contract with Mapeley STEPS Contractor Limited, one of several companies within the Mapeley Group involved in the contract. In this report references to Mapeley mean the companies involved in the contract; and Mapeley Group the wider group. The Department transferred ownership and management of around 60 per cent of its estate, including the estate of the Valuation Office Agency. The remainder of the Department's estate consisted of private finance initiative deals on specific buildings, properties rented from other departments, and properties at ports.

2 Under the STEPS deal (the Strategic Transfer of the Estate to the Private Sector), the Department sold 132 freehold properties to Mapeley and now leases them back. Mapeley manages these, and 459 properties the Department leases from third-party landlords, and provides facilities management and maintenance services on these and other service-only properties in return for fixed monthly payments from the Department (**Figure 1**).

3 The Department based the contract on the Department for Work and Pensions' PRIME contract, the largest Government estates outsourcing private finance initiative deal, and learnt from its experience. The Department expected to reduce running costs during the contract compared with continuing to manage the estate itself, and it has the flexibility to exit up to 60 per cent of the estate, with costs of breaking lease terms borne by Mapeley. **Figure 2** summarises the deal's main features.

4 Mapeley's bid was some £500 million cheaper than other bids (2001 net present value) over the life of the contract, and some £300 million cheaper than the Public Sector Comparator, the Department's estimate of the cost of continuing to manage the estate itself. The National Audit Office (NAO) and the Committee of Public Accounts (PAC) reported on the deal in 2004 and 2005. They concluded that the Department achieved a good price for the contract, but good risk management would be essential as Mapeley was a new company entering the market and had put in a low bid to establish itself. It based its bid on speculative returns from increases in property values over the 20 years, and expected minimal operating profits.

Figure 1
Properties transferred in 2001

Type	Number of buildings	Space (square metres)
Freehold and historic leasehold	132	437,300
Leased and licensed	459	917,700
Total	**591**	**1,355,000**

Source: National Audit Office analysis of Departmental information

Figure 2
Main features of the deal

At contract start	The Department sold freehold buildings and assigned responsibility for managing leased buildings to Mapeley for a £220 million up-front payment, and £150 million in reduced payments over the contract.
During the contract	The Department makes monthly payments to Mapeley to cover rent, facilities management, maintenance and debt costs. Mapeley provides fully-serviced accommodation and bears the associated risks. The Department manages the relationship and payments to Mapeley, passing on charges to the Valuation Office Agency and other occupiers.
Benefits for the Department	Benefits include the opportunity to: • exit up to 60 per cent of the estate and the flexibility to manage its accommodation according to business needs rather than fixed lease terms; • transfer day-to-day management of services; • transfer property-related financial risks such as increased rents; • obtain professional estate management expertise; • reduce costs through lower capital and facilities management expenditure; • obtain capital through an upfront payment; and • share in windfall gains.
At contract end	The Department will not own the estate but retains a right to occupy buildings, with leases based on market terms.

Source: National Audit Office analysis of Departmental information

5 At contract signature Mapeley was owned by Fortress Registered Investment Trust, Soros Real Estate Investors and Delancey Estates Limited. Mapeley obtained £262.5 million of funding for the contract, comprising £42.5 million of initial equity, a £30 million loan from shareholders and £190 million of commercial debt. Seven months into the contract, Mapeley approached the Department with cash flow problems. By 2004 its position had improved, largely as a result of changes in the property and financial markets, which enabled Mapeley to obtain income by entering arrangements with landlords to extend leases in exchange for upfront payments. In 2002 Mapeley estimated that it would receive £70 million from these deals. Shareholders also injected £8 million in short-term funding, with an annual ongoing commitment of £2-3 million.

6 This report considers how the contract has operated, including how it has enabled the Department to adapt to efficiency targets and economic changes. Appendix 1 describes the methodology. We also report the Department's progress against the Committee of Public Accounts' previous recommendations (Appendix 2). We examine the:

- **performance of the contract** – costs of the contract, service delivery and gain-sharing (Part 1);
- **Department's management of accommodation changes** – its use of property vacation allowances, and inclusion of additional buildings into the contract (Part 2); and
- **Department's management of contract risks** – how it is managing risks from the economic downturn, and whether it has an effective partnership with Mapeley (Part 3).

Key Findings

7 The Department secured a competitive deal from Mapeley, but there were significant risks involved requiring careful management. By 2009 the Department had paid Mapeley £312 million more than forecast (2009 prices), £138 million relates to payments to reimburse Mapeley for unrecoverable VAT costs arising from the complex lease arrangements. The remainder relates to changes in specification, inflation, and use of vacation allowances. While there has been some improvement in service delivery, with Mapeley responding to 92 per cent of maintenance calls on time in 2008-09 and completing 98 per cent of planned tasks on time, Mapeley has not met all service requirements, and in 2008-09 the Department deducted an average of £56,000 a month from facilities payments. A benchmarking exercise with 16 other Government departments indicates that in 2005-06 the Department's STEPS estate costs were lower than many other departments' costs at £157 per square metre. This figure reflects the Department's high presence in regional areas where accommodation costs are lower, and the reduced contractual payments arising from the transfer of freehold properties. The Department now expects to pay £570 million (2009 prices) more than originally estimated over the life of the contract.

8 The contract's existence meant that the mechanics of the estates merger went smoothly following the merger of Inland Revenue and Customs & Excise in 2005, as the Department managed the contract as a single entity. The contract provides the opportunity for the Department to vacate up to 60 per cent of the estate, to help it achieve savings and efficiency targets. By March 2009 it had saved £52 million out of an available £151 million. At the start of the contract, the Department had the potential to save £1.1-1.2 billion (2009 prices) over the life of the contract, but it has not recognised the contract as a major strategic asset and the total possible savings now available have fallen to £900 million. The Department now has plans to vacate large numbers of properties, but did not adequately consider the impact on Mapeley. This programme creates financial pressures for Mapeley, further exacerbated by the economic downturn and falling property values. The Department could incur significant costs in the event of Mapeley default, including one-off costs of £40-110 million for unpaid rent and suppliers. There would also be substantial ongoing costs relating to estates management and increased rent liabilities.

9 The Department has taken some measures to improve its management of the contract since 2007, although there is not yet a fully effective partnership in place. It has not committed appropriate commercial and legal skills to managing the contract, and has generally reacted to risks and issues as they arise rather than strategically managing the contract. In applying Treasury guidance on refinancing, it was able to negotiate successfully a windfall gain share of £900,000. It has also obtained £4.5 million as a share from Mapeley's sale of properties and has recently undertaken additional work to understand its liabilities in the case of contractor default. But under the contract it does not have full visibility of all Mapeley's gains and losses, particularly on renegotiated leases that ultimately may affect its liabilities in the event of contractor default. There remain outstanding claims that have yet to be resolved, and there have been significant delays in adding new properties into the contract, which directly affects the cost to the Department of vacating buildings. The Department is taking steps towards identifying outstanding issues, preparing a consolidated negotiation with Mapeley, and developing an estates strategy.

Value for money conclusion

10 Eight years on the Department has not achieved value for money on the contract so far, as it has not realised all the benefits available from the deal. Nor will it achieve value for money over the 20 years of the deal unless it strengthens its management of the contract. The property vacation provisions are key to the value of the contract but the Department had no long-term strategy for using them, and has not obtained all the savings available. It now has plans to vacate a significant number of buildings up to 2011, but it does not yet have an agreed way forward with Mapeley, or clarity about how the Mapeley Group would manage the financial effects, or the costs it will incur on the vacations and the likely funding available. To devise plans for the remainder of the contract that achieve value for money, the Department should deploy relevant commercial and legal expertise to obtain a full understanding of Mapeley's financial position and the profitability of the contract, and for any proposals that would alter the terms of the deal, the potential costs, benefits and liabilities for each party.

11 The Department considers that this conclusion does not fully recognise the value it has obtained from the contract since the merger of the two departments in 2005.

Recommendations

Recommendations for the Department

These recommendations apply to the Department, but may have relevance to other similar deals.

Understanding Mapeley's profitability

a **The Department has limited access to information under the contract, reflecting current practice when the contract was signed in 2001. It has not assessed the benefits realised by Mapeley from the STEPS deal nor the profitability of the Mapeley Group.** The Department should seek full access to Mapeley's financial information, and that provided to Mapeley's bankers in line with the Treasury's 2007 guidance on standardised private finance initiative contracts. It should establish ongoing processes to assess Mapeley's financial position and profitability, including an independent expert assessment of Mapeley's return on its original investment. Full disclosure from Mapeley should be a prerequisite for any negotiations on varying the terms of the contract.

Undertaking negotiations

b **The Department has performed poorly in bringing negotiations on a number of issues to a conclusion. It has a programme under way to make greater use of the vacation allowances which may require further negotiations.** The Department should consider carefully any proposals for changes to the contract or changes that will affect its use of the vacation allowances. It must not offer any concessions without corresponding benefits, and it should reassess whether it has the right commercial and legal skills to undertake these negotiations.

Setting a strategy

c **The Department has no long-term strategy enabling it to balance business needs and savings potential, and lacks a shared strategy with Mapeley.** The Department and Mapeley should develop a joint annual estates strategy and set up a joint strategic committee, separate to the estates management function, to establish objectives for the next five and 10 years, and for the end of the contract. These should include cost and space targets at key points, aiming to maintain space utilisation of between 10 and 12 square metres per person in line with standards recommended by the Office of Government Commerce.

Maximising value

d **The opportunity to vacate 60 per cent of the estate is a significant benefit but there are also opportunities for the Department to benefit by committing to retaining some buildings.** In developing its strategy, the Department should also identify buildings it wishes to retain longer term. It should examine opportunities to share in the benefits Mapeley can obtain on deals that increase property values.

Understanding value for money

e **The Department does not monitor the overall cost of the contract against initial models to understand whether it is achieving value for money, and it has not undertaken analysis on the potential savings available. Until recently it had a limited understanding of its liabilities in the event of contractor default.** The Department should prepare an annual value for money assessment on the contract for its Board, including an update on costs versus forecasts, potential liabilities and risks, and available benefits.

Contract ownership

f **There needs to be active management of the contract at Board level to ensure the contract represents good value for money. Current engagement is at operational level.** The Department's senior management should work directly with the Mapeley Board to resolve outstanding issues, agree strategies, and manage risk.

Managing Data

g **The Department uses a number of property databases which do not reconcile. It has no shared database with Mapeley.** The Department and Mapeley should establish a common database, to include a complete estate inventory and specifications, and information on properties that it plans to vacate.

Managing risks

h **The Department recognised that it would need strong risk management processes. It has generally reacted to risks as they materialise and has no shared risk register with Mapeley. It only began to develop a detailed business continuity plan to manage the risk of Mapeley default in January 2009.** The Department should set up a comprehensive risk register that it shares with Mapeley. It should formally document its response to recommendations from commissioned reviews, and update its business continuity plan to manage the risk of contractor default.

Recommendations for HM Treasury and the Office of Government Commerce on guidance for departments

Understanding implications of contractor default

i **The potential cost to the Department in the event of default is likely to be significant. The Department carried out some analysis in 2002 but has not kept this up to date, and before undertaking further work in January 2009 did not understand its liabilities in the case of Mapeley default.** Departments undertaking these types of deals should maintain an up-to-date understanding of the costs and consequences of contractor default.

Understanding downside risks

j **The Department did not fully appreciate the risks arising from the downturn in the property market. In January 2009 Mapeley approached the Department with concerns about financial pressures resulting from the vacations programme in the current economic climate.** Departments should carry out robust scenario testing of downside risks to ensure they have a full understanding of the implications and risks to the taxpayer.

Sharing gains in property deals

k **Mapeley has concluded deals with landlords to extend leases and reduce its risk profile in exchange for up-front payments. The Department does not share in the payments and there may be increased liabilities in the event of Mapeley default, particularly from lease extensions.** As in refinancing arrangements, departments should ensure that they have full visibility and approval rights on such deals, and consider whether it is appropriate to put in place gain-sharing provisions.

The STEPS contract is a Government asset

l **The Department is seeking to reduce the size of its estate, but in the current economic downturn this creates financial pressures for Mapeley.** There are opportunities for the Office of Government Commerce to engage with central and local government agencies to fill space the Department is vacating or, where the Department has partially vacated a property, for it to relocate to other government properties.

Part One

Performance of the contract

1.1 This part examines:

- the contract costs;
- the service delivered; and
- payments under gain-sharing mechanisms.

The costs of the contract

1.2 The 2004 NAO report found that the Department secured a competitive price from Mapeley, but that good risk management would be essential as Mapeley was a new company entering the market, and had put in a low bid to establish itself. It based its bid on speculative returns from increases in property values over the 20 years, and expected minimal operating profits. The Mapeley bid was some £500 million (2001 net present value) cheaper over the life of the contract than other bids, and some £300 million cheaper than the Public Sector Comparator, the Department's estimate of how much it would cost to continue managing the estate itself.

1.3 Mapeley's bid was £3.19 billion in 2009 prices.[1, 2] Following further negotiations on the accepted bid, Mapeley prepared a revised financial model which was included in the contract. This estimated the total cost at £3.3 billion (2009 prices). The increase was due to the inclusion of an additional 16 buildings and five service-only properties, and changes to Mapeley's debt structure. The first year cost increased by £30 million (2001 prices) to £181 million: £6 million for additional buildings, £17 million for debt costs, and £7 million for maintenance work found to be the Department's responsibility following surveys. The debt costs relate to the loan Mapeley took for the initial investment. The original debt structure assumed no charges in the first two years. Although the Department paid more in debt costs in the early years of the contract, overall it benefits from the change.

1 Previous NAO and PAC reports quoted net present cost of £1.50 billion in 2001 prices.
2 All figures expressed in 2009 prices are adjusted using March RPI figures from 2001-2009, and future cash flows are discounted at 3.5 per cent.

1.4 In 2008-09 the Department paid Mapeley £206 million for rent, facilities management, estate maintenance, and debt charges (**Figure 3**). This includes a proportion recharged to the Valuation Office Agency and other occupiers. £157 million related to estate occupied by the Department, representing about 35 per cent of its total estate costs of £450 million. By the end of 2008-09 the total cost was £1.88 billion (2009 prices), £312 million (20 per cent) more than the contract model price. **Figure 4** overleaf shows the reasons for the increase.

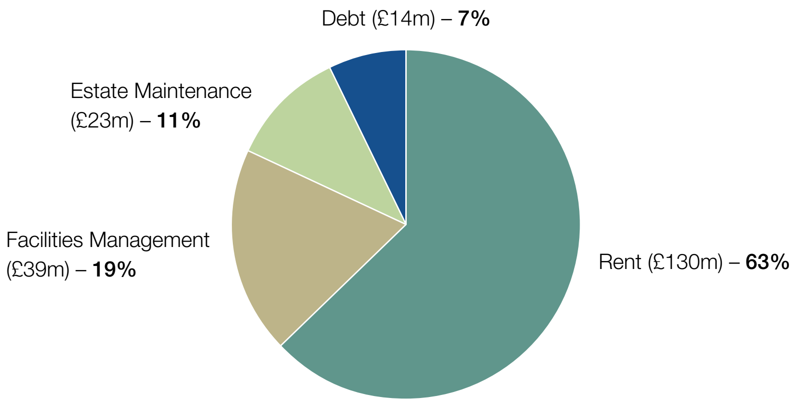
1.5 In addition to the payments made, Mapeley has lodged a £12 million claim for a number of services for which it had not previously invoiced the Department, dating back to December 2002. The Department is negotiating the amount it will pay.

1.6 While the Department has paid more for the contract than modelled, the NAO's 2007 report, *Improving the efficiency of central government's office property*, found that the Department's office costs were at the lower end of the range for 16 Government departments. Its cost was £157 per square metre in 2005-06, whereas the range was £123 to £636 per square metre.[3] The STEPS estate also cost £157 per square metre in 2005-06. In 2008-09 the STEPS estate cost around £160 per square metre. The cost reflects the reduced contractual payments arising from the transfer of the freehold properties (Figure 2) and the Department's presence in regions where accommodation costs are lower.

1.7 The Department has not had strong processes to monitor the overall cost of the contract and whether it is achieving value for money. It calculates the expected cost annually and checks monthly invoices, but does not compare figures against initial models. In June 2009 it estimated that over the contract it will pay Mapeley £3.87 billion in 2009 prices. The final cost will depend on how much space the Department vacates (Part 2).

Figure 3

Breakdown of the £206 million payment to Mapeley in 2008-09



Source: National Audit Office analysis of Departmental information

3 HC 8 Session 2007-08, November 2007. These costs were the mid-value when the cost per square metre for each building was ranked in order.

Figure 4

Differences between contract model costs and actual costs (total cost April 2001 to March 2009)

Reason	Total cost incurred (2009 prices) (£m)	Explanation
VAT indemnity	138	Under the contract the Department pays an indemnity for the VAT Mapeley pays to landlords but cannot recover on leases which are virtually assigned as described in Part 3. The Department would have had to pay these costs whichever bidder won the contract, and it did not include them in its comparison of bids or in its assessment against the Public Sector Comparator.
Additional buildings	40	The Department has paid for 11 additional buildings between 2003 and 2005, and 10 since then, although it has not formally incorporated these buildings into the contract.
Additional payments	40	In 2005 the Department agreed an extra annual charge of £4 million (2001 prices) up-rated each year, relating to specification errors in original information and changes to service requirements.
Modelled price increases	22	The contract increases the price annually by the Retail Price Index, a normal pricing mechanism in such deals. The model assumed standard annual inflation of two per cent, but on average inflation has been higher over the eight years of the contract. However, it is less than zero for 2009-10.
Use of vacation allowances	72	The model assumed the Department would use vacation allowances more extensively than it has done to date (Part 2).
Total	**312**	

Source: National Audit Office analysis of Departmental information

The service delivered

1.8 The Department paid around £62 million in 2008-09 for facilities management and estate maintenance. It can make financial deductions for poor service delivery through the performance measurement system. We previously concluded that the system did not provide appropriate incentives, and recommended that the Department and Mapeley agree a system balancing rewards and reductions in payments. The Department and Mapeley introduced a revised system in 2005, but have yet to formally incorporate it into the contract. The revised system uses two key performance indicators measuring Mapeley's performance in reactive and planned maintenance.

1.9 Mapeley has improved its performance in reactive maintenance, reducing by 50 per cent the number of calls to its helpdesk that it does not respond to in the required time from an average of 1,200 calls a month in 2005-06 to 600 in 2008-09 (8 per cent of total calls). It has also improved its performance on planned maintenance, completing 98 per cent of planned tasks in March 2009.

1.10 The level of financial deductions has decreased as a result of improvements (**Figure 5**). Using a three-month rolling average, deductions have decreased by 55 per cent since June 2006 to £56,000 in March 2009. The Department's ambition is zero deductions.

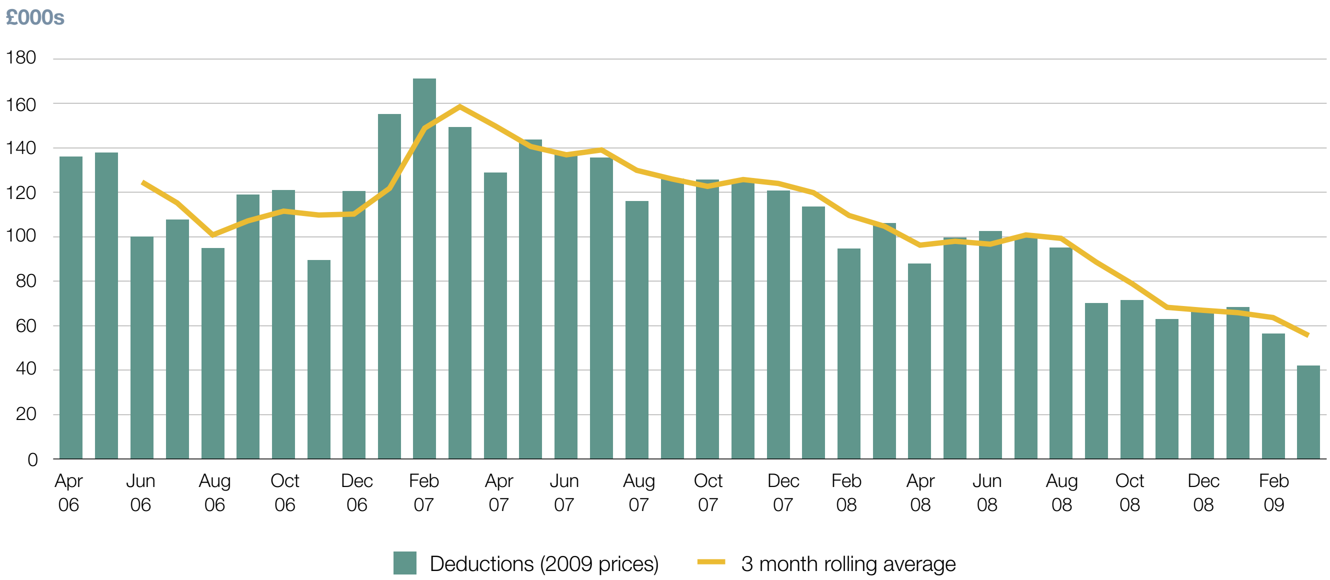
1.11 In 2007 the Department commissioned an independent review to benchmark maintenance and cleaning costs against property portfolios of a similar size, which concluded that its costs were lower than the average costs of comparators.

1.12 If a breakdown occurs in a critical aspect of a building for over two hours (for example, no running water), the Department can classify the area as unavailable and claim a reduction in the facilities price for that space. By March 2009 the Department had received an unavailability credit for £8,000 covering two incidents since the start of the contract. It was also reviewing with Mapeley its outstanding claim of over £1 million for 144 other incidents recorded since 2001.[4]

Payments under the gain-sharing mechanisms

1.13 The contract provides for the Department to share in one-off financial gains Mapeley achieves through its property and financing deals.

Figure 5
Financial deductions April 2006 to March 2009



Source: National Audit Office analysis of Departmental information

4 Mapeley put forward proposals to settle the matter in March 2009. Discussions between the parties continue.

Development gain

1.14 Development gain arises when Mapeley sells properties at a profit. It is the difference between sale proceeds and the price agreed by Mapeley in 2001 adjusted using an established property index, less qualifying expenditure. By April 2009 the Department had received £4.5 million from the sale of 16 properties for £34 million. Mapeley made a loss on five of these buildings. The Department does not share losses. It employs an independent agent to check the value of sold properties. **Figure 6** shows how the Department's share is calculated.

1.15 The thresholds used in calculating the gain should change in line with an established property index. Mapeley provides the calculation, which the Department should check to agree its share. Mapeley did not adjust the thresholds, so the Department's share on the sale of two buildings was overstated by £191,000.

Windfall gain

1.16 The Department was entitled to receive a 20 per cent share of financial gains made by Mapeley's shareholders through the sale or flotation of the whole or part of the business if it occurred within the first five years of the contract and met certain ownership, internal rate of return, and cash flow criteria.

1.17 When the contract was signed Mapeley was privately owned by Fortress Registered Investment Trust (Fortress) (42.5 per cent), Soros Real Estate Investors CV (42.5 per cent), and Delancey Estates Limited (15 per cent). During 2004 Fortress acquired the other shareholders' interests. In June 2005 it listed Mapeley on the London Stock Exchange, issuing new shares which diluted its shareholding to 65 per cent. A further share issue in January 2006 diluted its shareholding to 55 per cent. These transactions did not trigger the gain-sharing mechanism. The five-year deadline passed in April 2006. Under the contract the Department should have then received a certificate from Mapeley confirming that it was not eligible to share in windfall gain. The Department has not yet obtained this certificate.

Figure 6
The Department's share of development gains

2001 development gain thresholds (these are adjusted by an agreed property index at the time of sale)	Percentage share
Under £1,000,000	30
£1,000,000 – £4,999,999	40
£5,000,000 – £9,999,999	50
Over £10,000,000	60

Source: Departmental information

Refinancing gain

1.18 As an early private finance initiative deal, the contract did not provide for the Department to share in Mapeley's financial gains if it refinanced its debt and achieved better terms. In 2002 the Office of Government Commerce issued guidance recommending that future contracts should include provisions for equal sharing of refinancing gains. It also introduced a voluntary code of conduct for departments to share 30 per cent of refinancing gains arising in earlier contracts.

1.19 In early 2005 Mapeley sought the Department's approval to refinance its debt. The Department employed an external adviser to undertake due diligence to ensure the arrangements did not expose it to new or additional risk. It secured a share in the gain, and complied with the Office of Government Commerce code of conduct. It did not accept Mapeley's initial proposals, but worked with Mapeley to reach an agreed position, and the refinancing took place during 2006. Mapeley's objectives in refinancing were to reduce the cost of debt and loan administration. There was no cash payment to shareholders. The Department received £894,900, 30 per cent of the gain. The Department and Mapeley incorporated provisions into the contract in September 2006 entitling the Department to receive 30 per cent of future gains.

Part Two

The Department's management of accommodation changes

2.1 This part examines:

- flexibility to vacate properties;
- the Department's rationalisation of its accommodation;
- including additional buildings in the contract; and
- implications of the Department's plans to vacate buildings.

2.2 It covers only the properties managed by the Department. The Valuation Office Agency manages its properties separately and has its own strategy.

Flexibility to vacate properties

2.3 It is usual for organisations to seek some flexibility to exit properties in long-term contracts, for example through break clauses in traditional leases. There are two methods of purchasing this flexibility in private finance initiative contracts. If the occupier is reasonably certain it will no longer require particular buildings, it can specify allowances to vacate specific areas over a specific period. The costs of such allowances are incorporated into the contract price. If it is uncertain, it can negotiate the additional costs it would pay if it were to vacate properties.

2.4 In negotiating vacation allowances, the Department classified its buildings as flexible, intermediate or core, and negotiated different vacation arrangements for each type (**Figure 7**).

- **Flexible (12 per cent of the Department's STEPS estate):** it designated as flexible those buildings which it wanted the option of vacating. It has annual allowances enabling it to vacate 99 per cent of flexible space, which it can use at no additional cost by giving 12 months' notice.[5]
- **Intermediate (13 per cent of the Department's STEPS estate):** intermediate buildings have specified dates for exit, which are the earliest the Department can vacate without additional cost. If missed, there is a two-year lock-in period after which it can vacate by giving 12 months' notice.

5 The Department asked bidders to price two levels of flexible vacation allowances, 10,000 or 15,000 square metres each year in years six to fifteen. Mapeley bid the same price for both, effectively providing the Department with an additional 50,000 square metres of flexible allowances at no extra cost.

- **Core (75 per of the Department's STEPS estate):** the Department designated buildings it expected to retain in the longer term as core, and invited bidders to price the cost of exiting these buildings, which it would only pay if vacated. Mapeley offered allowances of 225,000 square metres over the life of the contract at no cost. The Department can use these allowances by giving 12 months' notice and unused allowances accumulate. The Department also has 225,000 square metres of further core allowances, which it can use with 12 months' notice and payment of compensation.[6]

2.5 The vacation allowances are a significant benefit for the Department, enabling it to manage its accommodation according to business needs rather than to fixed lease terms. At the start of the contract, the Department had the right to vacate 764,900 square metres, 60 per cent of the STEPS estate. 42 per cent was at no additional cost, and 18 per cent attracted compensation.

2.6 We estimate that at the start of the contract the Department could have made savings of around £1.1-1.2 billion (2009 prices) on ongoing estates costs over the life of the contract if it fully used the vacation allowances, including further core allowances, as soon as they became available.[7] Excluding allowances for which it has to pay compensation, it could have saved around £800-870 million.

Figure 7
Available vacation allowances

Building designations	Contract year	Annual vacation allowance (square metres)	Total vacation allowance (square metres)	Cost of vacation
Flexible	Year 1	2,205	152,121	Paid for in contract price. No additional cost on vacation.
	Years 2-5	4,409		
	Years 6-15	13,228		
Intermediate		Variable based on transition date	162,791	Paid for in contract price. No additional cost on vacation.
Core	Years 4-18	15,000	225,000	No cost.
	Further core Years 4-18	15,000	225,000	Compensation paid when allowances are used.
Total			**764,912**	

Source: National Audit Office analysis of Departmental information

6 Compensation, designed to reduce Mapeley's losses resulting from vacations, is calculated by a complex formula.
7 The Department would have to pay compensation to achieve these savings.

The Department's rationalisation of its accommodation

2.7 In 2004 the O'Donnell review recommended that the Inland Revenue and HM Customs & Excise should merge, to improve effectiveness, customer service and compliance costs, and achieve efficiencies through economies of scale. They merged in 2005. Our interviews with the Department and Mapeley confirmed that the mechanics of the estates merger went smoothly. The contract's existence meant that the Department had considerable estates information available, and it already managed the contract as a single entity.

2.8 Until the merger in 2005, the two departments managed their estates plans separately. From 2003 uncertainty over a possible merger hindered development of combined estate plans, and following the merger in 2005 there was further delay as the Department established its structure and responsibilities. Under the Government-wide efficiency agenda, the Department has been expected to make efficiency savings by reducing staff numbers and relocating posts out of London and the South East. It currently has a target to reduce total expenditure by five per cent a year to 2011-12. The contract's vacation allowances have enabled the Department to respond to these targets and reduce the size of its estate. The contract has also facilitated other changes, such as the creation of the Revenue and Customs Prosecution Office (2005), and the Serious Organised Crime Agency (2006). These organisations and the Department confirmed that the contract, along with protocols developed by the Office of Government Commerce, enabled reasonably easy transfers.

2.9 In 2007 the Department developed its estates plans to March 2012 under its Workforce Change and Estates Consolidation Programmes. The Workforce Change Programme involved business areas identifying their optimal staffing and accommodation needs to achieve their targets and transformation, resulting in buildings being earmarked for closure. The Estates Consolidation Programme is the operational programme to accommodate staff in fewer buildings through closures identified by the Workforce Change Programme.

2.10 As part of the Estates Consolidation Programme, the Department plans to use space more efficiently. The Office of Government Commerce's High Performing Property initiative recommends an average space allocation of 10 to 12 square metres per person.[8] The NAO report *Improving the efficiency of central government office property*[9] found that the Department's space utilisation in 2005-06 was 16 square metres per person – at the lower end of the range of 13 to 22 square metres per person across 16 departments. The Department initially planned to improve space utilisation to 12 square metres per person by 2012, but in March 2009 revised its estimate to 13.8 square metres following reductions in the space it plans to vacate.

8 The Office of Government Commerce launched the initiative in 2006 to improve efficiency of the civil estate. It sets good practice guidelines for achieving efficiency, and milestones for departments.

9 HC 8 Session 2007-08.

2.11 Figure 8 shows the Department's actual and planned use of vacation allowances to 2011-12. Prior to the launch of the Estates Consolidation Programme in 2007, it had vacated 90,000 square metres using 34 per cent of available cumulative allowances of 264,000 square metres. Due to a lack of consistent data, we have been unable to calculate actual savings achieved back to 2001, but our modelling, based on an average cost per square metre, indicates savings of £23 million out of a possible £75 million. By March 2009 it had vacated 181,000 square metres, using 51 per cent of available cumulative allowances of 356,000 square metres, achieving savings of £52 million out of a possible £151 million.[10] Savings achieved are proportionally lower than the allowances used because of the timing of vacations: vacating buildings at the earliest opportunity would have saved the cost of that space over future years.

Including additional properties in the contract

2.12 The Department can add properties to the contract to keep its own estate management costs low. Since contract signature, the Department has taken on 238,000 square metres of new space including 59 offices, car parks, storage, and specialist operation areas, to accommodate new responsibilities such as tax credits and changes in work practices towards centralised processing and call centres. Since 2003 it has been paying Mapeley the facilities price for 11 properties with the intention of bringing them into the contract (it vacated and stopped paying for one of these properties in 2005). It has not formally incorporated them into the contract due to issues over offshore ownership.

Figure 8
Buildings vacations April 2001 to March 2012

Period[1]	Event	Cumulative allowances (square metres)	Actual cumulative vacations (square metres)	Percentage of available allowances used	Savings available (2009 prices) (£m)	Savings achieved (2009 prices) (£m)	Percentage of available savings realised
April 2001 to March 2005	**Pre merger**	163,000	48,000	29	26	8	31
April 2001 to March 2007	**Post merger**	264,000	90,000	34	75	23	31
April 2001 to March 2009	**Estates Consolidation Programme**	356,000	181,000	51	151	52	34
April 2001 to March 2012 (Planned)[2]		495,000	404,000	82	313	164	52

Source: National Audit Office analysis of Departmental data

NOTES
1 Vacations analysed in periods to show how the allowances and possible savings accumulate over time.
2 Planned vacations may not be achieved in full.

10 Lost savings are higher than the £72 million in Figure 4. The contract model assumed that the Department would use only some allowances. The modelled £151 million is based on using all vacation allowances.

2.13 At contract signature, the Department transferred the freehold properties to Mapeley STEPS Limited. The company was registered offshore in Bermuda, enabling it to reduce its tax liabilities under UK laws. Any gains made on sales of these properties are not subject to UK tax. The Board of the Inland Revenue became aware of the tax arrangements late in the procurement, and the Board of Customs & Excise only after contract signature. The Inland Revenue concluded that it would not have been lawful to exclude Mapeley from the bidding process because of its tax arrangements.[11] In response to a Committee of Public Accounts recommendation, HM Treasury issued guidance in 2003 stating that departments generally should not use tax avoidance schemes.

2.14 Mapeley estimated that it would have had to increase its bid price by £55 million (in 2001 prices) to cover additional UK tax had it kept ownership of the buildings in the UK. Our previous report concluded that this was not a material figure in a deal of this size. Given inevitable uncertainties surrounding forecasts of property sales 20 years into the future, this figure was approximate. Mapeley estimates that it has saved approximately £2.6 million in tax on gains made through the sale of properties to date.

2.15 During negotiations to include the first 11 additional properties in the contract, in June 2006 a company in the Mapeley group, registered offshore, purchased the freehold of one property as part of its Direct Property Investment portfolio. Because of concerns around offshore ownership, the Department requested that Mapeley transfer ownership into the UK. Mapeley agreed to do so once the properties were included in the contract, but in the current climate this could entail losses. The Department therefore considered it should exclude this property from the contract, but it now intends to seek its inclusion.

2.16 As a result of these delays, the Department has been paying the facilities price for the additional properties since 2003 without obtaining the benefits of inclusion in the contract. The Department can designate the category of any buildings included in the contract, and for core buildings it immediately receives equivalent space as core vacation allowance. The Department plans to designate seven of the buildings as core, increasing core vacation allowances it can use at no cost by 21,800 square metres. If it brings these buildings into the contract before using further core allowances, it would save compensation it would otherwise have to pay. The Department and Mapeley are currently negotiating the basis on which the buildings will be included in the contract, and the interpretation of the compensation clauses in the contract.

2.17 The Department's delays in concluding negotiations on the initial group of properties means it has not started negotiations on other properties which could be brought into the contract. It has identified approximately 115,000 square metres of space it is considering for inclusion. While they remain outside the contract it continues to bear the costs of estates management functions for these properties.

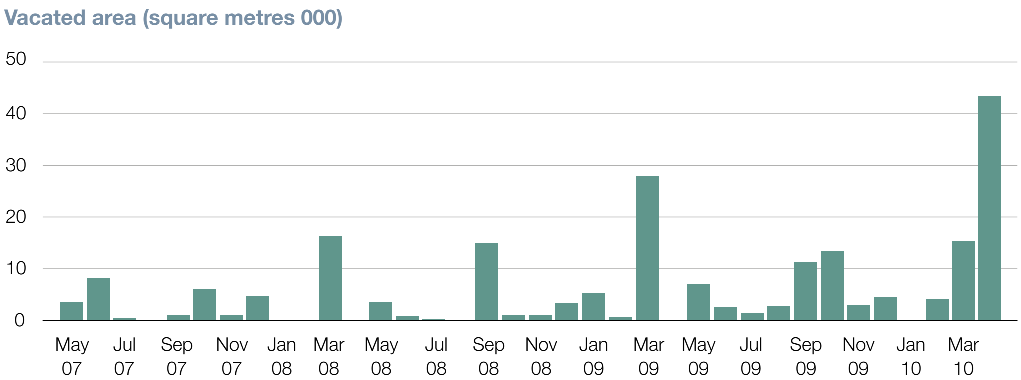
11 See previous NAO report, *PFI: The STEPS Deal* HC 530 2003-04, for details.

Implications of the Department's plans to vacate buildings

2.18 In April 2008 the Department estimated it would make savings of £250 million through the Estates Consolidation Programme by vacating properties from the STEPS and non-STEPS estate. It estimated that the Programme would cost £99 million, including the cost of closing buildings (15 per cent) and reconfiguring buildings (85 per cent). In early 2009 the Department reduced the funding available for the Programme. In addition, the Department has a policy of avoiding compulsory redundancies as far as is reasonably practical. Because of the cost of compulsory redundancies, and the funding the Department has available, in some areas it has taken longer than planned to work through the implications of buildings closures. In some cases the Department is only partially vacating buildings until staff redeployment or redundancy can be managed. By early 2009 the estimated savings had fallen by £20 million to £230 million as a result of these issues.

2.19 The Department's plans to vacate buildings have implications for Mapeley. The Department included Mapeley in its regional consultations to select individual buildings to vacate, but only provided full details of its plans towards the end of 2008. In January 2009 Mapeley approached the Department with concerns about financial pressures resulting from the programme in the current economic climate, particularly as planned vacations peak in March or April each year to maximise savings in the financial year (**Figure 9**). This puts Mapeley under pressure to find tenants for large amounts of space at the same time. Mapeley informed the Department that in the economic slowdown it is harder to re-let property and particularly difficult to re-let partially vacated properties or renew partial leases.

Figure 9
Pattern of vacations from April 2007 to April 2010



Source: National Audit Office analysis of Departmental data

2.20 The Department should not make any concessions to Mapeley without corresponding benefit, however it may be able to ease the pressure on Mapeley by:

- **Committing to buildings:** Mapeley proposed identifying several buildings that the Department would retain beyond the life of the contract, allowing it to undertake deals that increase the buildings' value. It offered to share payments with the Department, or invest in improving the facilities. The Department did not accept this proposal as it did not consider the range of likely benefits was sufficient.
- **Working with other bodies:** the Department cannot sublet property under the contract, but can allow other central government bodies to occupy space. In February 2009 the Department had 40 minor occupiers in 80 STEPS buildings, occupying 86,000 square metres (seven per cent). There are opportunities for the Department and Mapeley to work more closely with other organisations to fill vacated space. The Department considers space vacated in regional areas is unlikely to meet the needs of central government departments, but may meet local government requirements. The Department can only accept central government bodies as minor occupiers, and it is time-consuming to make the legal arrangements to sublet to other bodies although there are examples where this has happened. HM Treasury's Operational Efficiency Programme reported in early 2009 on opportunities to use Government estate more efficiently, and recommended creation of a body to manage use of estate across the whole public sector.[12]

2.21 The Department's Estates Consolidation Programme covers planned vacations of properties up to 2012 but there remains significant potential for savings from further vacations to the end of the contract in 2021. The Department achieved £52 million in savings by the end of 2008-09. We estimate that it will save a further £281 million by 2020-21 on buildings already vacated by the end of 2008-09, and that it could save a further £295 million over the same period if it achieves its planned vacations under the Programme. If it fully uses all remaining allowances as they become available from 2012-13, it could save an additional £269 million. In total, it now has the opportunity to save around £897 million over the life of the contract, compared with the £1.1-1.2 billion available at contract inception.

2.22 To make the most of these opportunities the Department should have an over-arching estates strategy. Its current estate plans are operational rather than strategic, and negotiations with Mapeley tend to be building-by-building. In comparison, the Department for Work and Pensions has separate estates strategy and operations functions, which it considers essential for managing the PRIME contract. This enables strong governance and engagement by its Board. The Department now needs to start identifying buildings for future vacation. At present it has no plans for vacations beyond 2010-11. In 2011-12 it will accrue a further 44,000 square metres of allowances in addition to any allowances remaining unused at the end of 2010-11. Given budgetary restrictions and ongoing negotiations with Mapeley over compensation payable for its use of further core allowance, the Department may not be able to make full use of the vacation allowances available to it by the end of 2010-11.

12 HM Treasury launched the Operational Efficiency programme in 2008 to review five areas of spending including property and estate costs. It reported the results in Budget 2009.

Part Three

The Department's management of contract risks

3.1 There are various risks inherent in the contract requiring careful management. Part 1 covered the Department's management of risks to cost, service provision and gain-sharing. Part 2 covered risks associated with the vacation allowances and including additional buildings in the contract. This part examines:

- risks posed by the economic slowdown;
- how the Department is managing these risks; and
- progress in developing a partnership with Mapeley.

Risks arising from the economic downturn

3.2 Throughout the procurement the Department was aware that Mapeley was a new company which had put in a low bid to win future business. It priced its bid based on potential returns from increases in the value of properties transferred, rather than profits from managing the estate. In November 2001 Mapeley told the Department it faced serious cash flow problems as a result of errors in the pricing of its bid, variations made to the contract since contract signature, and claims arising out of the procurement process, and asked for additional money. Following favourable movements in the commercial property market, the injection of further funds by its shareholders, and settlement of an outstanding claim relating to specification errors in the original information and changes to service requirements, Mapeley's financial position improved. The Mapeley Group has now secured other lines of business including a 20-year contract with Abbey National (now Abbey) and a contract with the Identity and Passport Service. In 2004 it also began to build its own portfolio of properties (Appendix 3).

3.3 We previously concluded that Mapeley's pricing and business model was such that its finances would continue to be finely-balanced for the foreseeable future, and that it was essential for the Department to undertake good risk management to secure the full value of the deal. Our analysis of the 2006 refinancing cash flow model suggests that operating profits from the contract have been minimal, and will continue to be low over the life of the contract. Mapeley needs to supplement operational cash flows with disposals of surplus freeholds and through making deals on leases.

3.4 The economic slowdown that began in 2007 affects Mapeley in several ways:

- **Slowdown in the property market:** the value of commercial property has fallen, reducing the opportunity for Mapeley to benefit from selling freehold property vacated by the Department and affecting the value of assets held. The value of the STEPS portfolio decreased by nine per cent between December 2007 and December 2008 to approximately £470 million.[13]
- **Difficulty re-letting vacated properties:** to maintain its income Mapeley needs to re-let vacated buildings, which is more difficult in the current climate, particularly for partially vacated properties and properties in more remote areas. As part of its loan arrangements with banks, Mapeley is required to maintain certain levels of income in relation to interest costs. The Department’s plans to exit buildings could adversely affect Mapeley’s income levels.
- **Difficulties obtaining debt finance:** the collapse of the credit market in 2008 affects Mapeley’s opportunities to refinance debt. This has not affected the part of the group that owns the contract, which has no short-term refinancing requirements and its loan is secured on the freehold property. However, it has affected the Mapeley Group, which had a short-term loan fall due in April 2009 and could not get new debt to cover it. It raised cash to pay off the loan through the issue of 20 per cent convertible bonds underwritten by Fortress. As a result, Fortress owns more than 75 per cent of the company and it de-listed Mapeley Limited from the London Stock Exchange in April 2009.
- **Economics of the deal:** the combined effects of decreasing revenue flows and asset values may affect the long term profitability of the deal. The Department does not have a good understanding of the profitability of the deal, the Mapeley Group, or the benefits realised over the contract life.

3.5 The contract contains clauses that protect the Department in the event of Mapeley default, including rights to continue occupying buildings and to take over the service contract. However, a default would have cost implications for the Department. In the first year, it might have to cover unpaid rents, utilities, and suppliers. These one-off payments could total £40-110 million. The Department would incur substantial additional ongoing costs on estate management and administration, for negotiations with landlords for rent, maintenance, managing tenants, and increased rent liabilities.

3.6 The arrangements by which the Department transferred leases to Mapeley contribute to the Department’s liabilities in the event of Mapeley default. The Department recognised that landlords would be unlikely to accept Mapeley as tenant, as a Government tenant increases the value of a property by providing a low risk income stream. The Department virtually assigned its leases to Mapeley through the contract, meaning that the Department remains the legal tenant but granted Mapeley power of attorney to act on its behalf (a concept used in the PRIME deal).[14] The contract

13 Mapeley also sold some properties during the period.
14 A court decision (Natwest versus Clarence House 23 January 2009) has ruled that, in the absence of consent from the landlord, virtually assigned leases may be in breach of the property lease and that damages may be payable. The Department is currently assessing the likely impact of the decision.

requires Mapeley to endeavour to re-negotiate leases into its own name, but it has been able to do so in a limited number of cases. In the event of Mapeley default, the virtual assignments cease to exist and, as the legal tenant, the Department would resume responsibility for the leases, including areas of the estate remaining in its name which it has already vacated. If Mapeley had sublet vacated properties the Department would have tenants to manage, but if property remains vacant the Department would be liable for rental costs. Failure of the contract would also mean the Department would lose the opportunity to vacate a significant part of the estate at minimal costs, which would undermine its ability to achieve efficiency savings targets (Part 2).

3.7 The Department's liabilities would also be higher because of lease extensions Mapeley has negotiated with landlords. Mapeley entered around 70 deals, mostly during 2003 and 2004, and obtained an up-front payment in exchange for lease extensions, and in some cases increased rents. Landlords are keen to enter these deals as they obtain the benefit of a valuable Government tenant for a longer period. In December 2002 Mapeley estimated the total value of these deals would be £70 million on 131 properties. It notified the Department of each deal but it does not have to provide details of the payments received, and Mapeley has not confirmed the total amount realised. Such arrangements are normal for property companies and were part of Mapeley's bid model. Mapeley entered into these arrangements on buildings that it considered the Department would require for a significant period. Having a longer lease protects Mapeley from the risk of landlords refusing to renew leases, in which case it would have to arrange alternative accommodation for the Department. In many cases Mapeley negotiated flexible re-letting provisions within its lease with the landlord, reducing its risk if the Department vacates the building.

3.8 These property deals are conceptually similar to refinancing deals, where contractors refinance their debt on better terms resulting in a benefit for the contractor and potentially increased termination liabilities for the department. HM Treasury guidance is that departments should share in gains realised on refinancing, but there is no similar guidance for these types of deals.

How the Department manages risks of the contract

3.9 Over the life of the contract the Department has sought to improve its understanding of risks and assess options for the future using legal, property management, and economic advisers to advise on risks, the implications of contract termination, extended lease and rental deals, use of flexibility provisions, and Mapeley's solvency. It has not always been clear whether the Department has considered the recommendations and taken action where necessary. For example, several advisers have recommended that the Department should have in place a full business continuity plan to cover the risks of Mapeley default. The Department carried out some work in 2003 but did not keep it up to date. In January 2009 it began to construct a full revised business continuity plan to cover the risks of Mapeley default.[15] The Department has not always provided advisers with complete information or sought data from Mapeley that may have informed the reviews.

15 It has plans for individual buildings to cover risks such as fire and flood.

3.10 The Department has also sought to manage risk by monitoring Mapeley's position and performance. It has set up a Commercial Stability Analysis Function to monitor and report on the financial viability of all its estates contractors. While the Department has access to Mapeley STEPS Contractor Limited's accounts, the contract does not include provisions for access to Mapeley's full financial information and financing arrangements. It monitors Mapeley through publicly available information such as annual accounts, movements in share price, and press articles. Under Treasury guidance for standard private finance initiative contracts, revised in 2007, departments should obtain full access to financial information.

3.11 The contract sets out the circumstances in which the Department or Mapeley could terminate the contract. The Department has no right to voluntarily terminate the contract. Voluntary termination rights were not included in the original PRIME contract, but the Department for Work and Pensions negotiated them as part of the expansion. Voluntary termination rights would give the Department more flexibility to respond to changing circumstances, although negotiating these rights would come at a significant cost.

The Department's partnership with Mapeley

3.12 We previously recommended that the Department and Mapeley should develop a single business focus, recognising that a partnership arrangement was essential to the success of the deal. Our discussions with the Department and Mapeley indicated that there is not yet a fully effective partnership in place, although there have been improvements since 2007.

3.13 The Department considers that the negative publicity at the start of the contract about Mapeley's offshore ownership put a strain on the relationship which has influenced the handling of issues such as changing the contract, adding new buildings, and agreeing the revised performance measurement system.

3.14 The two organisations do not share key information in a consistent manner, such as having a shared database of the properties and a joint understanding of the vacation allowances used. Our focus group indicated that the organisations do not have a good understanding of each other's objectives and strategies. There is also no shared risk register, although discussions on risks take place regularly.

3.15 Since 2007 there have been improvements in the relationship. The Department identified the need to have appropriately skilled staff to manage the contract as an intelligent customer, and appointed staff with property experience. Mapeley considered this has improved the partnership. In 2008 the Department and Mapeley ran joint road shows to obtain staff feedback on the service provision, and introduced a joint Service Improvement Plan, targeting key aspects of performance such as cleaning and health and safety. The Department monitors progress through joint performance meetings and a Liaison Committee. The impact of the vacations programme and the falling property market has also led to improved communications.

Appendix One

Methodology

Our main research methods are outlined below. Further details are on our website.

Method	Work carried out
Document review	We reviewed the contract, contract amendments, previous reviews, and other documents to identify the key contractual terms, focusing on gain-sharing provisions, the performance measurement system, vacation rights, assigned leases, and termination arrangements.
Semi-structured interviews	• HM Revenue & Customs and Mapeley • Office of Government Commerce and the Operational Efficiency Programme • Partnerships UK • Serious Organised Crime Agency, Revenue and Customs Prosecution Office, and Department of Health • Department for Work and Pensions, the Northern Ireland Office, and National Savings and Investments
Analysis of financial, estates, and cost information	Analysis of: • costs, predicted prices, and actual amounts paid; and • the size of the estate and vacation plans. With PricewaterhouseCoopers, we created a financial model to calculate potential savings from the vacation allowances. We based this on the estate originally transferred to Mapeley, assuming a constant average cost per square metre.
Focus group	HM Revenue & Customs and Mapley attended to validate our findings, particularly on the operation of the partnership in relation to strategic alignment, innovation, and managing risk.
External expertise	We engaged PricewaterhouseCoopers to enhance our expertise covering the Department's: • use of the vacation allowances; • understanding of the risks to Mapeley; and • the tax impact of Mapeley's corporate structure.
Review of comparator contracts	We reviewed the Department for Work and Pensions' PRIME contract, the National Savings contract, and the Northern Ireland Office Workplace 2010 Project (terminated in February 2009) to understand others' experience in estate management, gain-sharing mechanisms, managing key risks, and estate efficiency.

Appendix Two

Previous PAC recommendations

We summarise below the Department's progress on implementing recommendations in the Committee of Public Accounts report on The STEPS deal, Twentieth Report of Session 2004-05, June 2005.

PAC Recommendations	Progress	Reference
Negotiations between the Department and Mapeley on outstanding claims arising from the procurement process have still to be concluded. It is important that they should meet their objective of concluding negotiations by Spring 2005.	The Department concluded negotiations on outstanding claims in December 2005.	Part 1
They should aim to agree a performance measurement system that balances rewards and reductions in payments.	The Department and Mapeley began operating the revised performance measurement system in April 2005. It has not yet been incorporated into the contract.	Part 1
It was a very serious blow for the Inland Revenue to have entered into a contract with tax avoiders. Departments should as far as possible discount gains from tax avoidance that may be factored into a PFI bid, since any price advantage to the Exchequer is likely to be offset by lower tax revenue.	HM Treasury guidance is that generally tax avoidance schemes should not be used.	Part 2
Departments need to ensure that they retain a real option to terminate a deal in the event of contractor default.	The Department has sought to understand its termination rights. There are also implications from potential contractor default that the Department began assessing at the end of 2008.	Part 3

Appendix Three

Key events for the Mapeley Group

2000	• Mapeley wins the HM Revenue & Customs contract and a similar contract for Abbey National's (now Abbey) UK property.
2001	• STEPS contract signed in March.
2004	• Fortress purchases the shares of Delancey and Soros, and takes control of the Mapeley Group. • Mapeley begins building its own portfolio of properties (Direct Property Investment).
2005	• Fortress lists Mapeley on the London Stock Exchange, raising £133 million to expand its Direct Property Investment business. • Mapeley pays dividends of £17 million from group profits.
2006	• Mapeley wins a three-year contract with options to extend, to acquire, fit out and deliver serviced accommodation for 69 offices of the Identity and Passport Service. • Mapeley raises £197 million from retail investors for its Direct Property Investment business. • Mapeley pays dividends of £41 million from group profits.
2007	• Revenue from HM Revenue & Customs is now 50 per cent of Mapeley's overall revenue. 23 per cent comes from the Direct Property Investment portfolio, a quarter of which are Government and Local Authority tenants. • Mapeley pays dividends of £55 million from group profits.
2008	• Mapeley pays dividends of £14 million from group profits.
2009	• Mapeley raises £45 million through the sale of convertible bonds to finance the repayment of a short-term loan, which it is unable to renew due to the collapse of the credit market. Fortress underwrote the sale. It now owns more than 75 per cent of the group. • Mapeley delists from the London Stock Exchange.

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