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REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

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

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.