

## REPORT OF THE COMPTROLLER AND AUDITOR GENERAL ON THE 2016-17 ACCOUNTS OF HIGH SPEED TWO (HS2) LIMITED

### Introduction

1 High Speed Two (HS2) Ltd is a company limited by guarantee, controlled and funded by the Department for Transport (the Department). The Department established the company to develop, build and operate a high speed rail network to link London, Birmingham, Leeds and Manchester, and onwards to services on the existing rail network. The company is classified as a Non-Departmental Public Body (NDPB) by the Cabinet Office and is part of the central government sector.

2 The Department is responsible for setting the framework under which HS2 Ltd operates. This is principally reflected in a framework document<sup>1</sup>, drawn up by the Department with the agreement of HM Treasury, and signed by the Department and the company.

### My qualified opinion on regularity in respect of HS2 Ltd's redundancy schemes

3 During the year, HS2 Ltd spent outside the agreed framework, and did not comply with HM Treasury rules, by running a redundancy scheme at enhanced terms without the necessary approvals. Relevant commitments of £2.76<sup>2</sup> million were, I estimate, £1.76m in excess of the amounts payable on the statutory rates authorised by the Department.

4 HS2 Ltd's framework document and subsequent agreements give the company exceptional flexibilities on its rates of pay, so that it is properly equipped for its role, given market conditions in the rail sector.

5 However, the company's framework imposes certain constraints in light of these freedoms, and to protect the taxpayer's interest. These constraints include the following clause.

*Any proposal by HS2 Ltd to ... pay any redundancy ... above statutory requirements ... requires the prior approval of the Department ... any proposals for extra-contractual payments of any kind to staff must be cleared with the Department and HM Treasury<sup>3</sup>.*

6 In March 2016 the company sought formal permission for a relocation and redundancy scheme. The Department gave written permission, which included a clear restriction that redundancy terms should be at statutory levels. In April 2016, HS2 Ltd asked the Department to enhance the terms of upcoming schemes beyond this, to a level comparable with the Civil Service Compensation Scheme then operating, but more generous than the new terms for the CSCS on which the Cabinet Office were publically consulting at the time.

7 A senior official at the Department then instructed to a senior executive at HS2 Ltd that

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<sup>1</sup> *High Speed Two (HS2) Ltd Framework Document*, December 2014, available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/389375/High\\_Speed\\_Two\\_HS2\\_Ltd\\_framework\\_document\\_December\\_2014\\_.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389375/High_Speed_Two_HS2_Ltd_framework_document_December_2014_.pdf)

<sup>2</sup> These include amounts paid by year end, and provided or accrued for in the financial statements, as well as £0.59m included in contingent liabilities where notices have been issued but departures remained uncertain at the year end. The contingent amounts are included here since the company has received advice that if these individuals cannot be found permanent roles and their redundancies go ahead, it is contractually committed to pay compensation using the unapproved enhanced terms.

<sup>3</sup> *Ibid.*, 6.8-6.9.

no enhancements would be approved. No evidence has been presented to me suggesting that this instruction was passed on within the company.

**8** HS2 Ltd made commitments based on enhanced terms despite the absence of an approval to do so. In addition, the enhancements the company actually made were well in excess of those it requested from the Department, or those that would have achieved parity with the CSCS.

**9** It is clear to me, and should have been clear to HS2 Ltd as it made commitments, that:

- explicit approval from the Department was required for any departure from statutory levels;
- the Department rejected the company's request to enhance schemes to civil service rates;
- additional enhancements had been made well beyond civil service rates – for example, where individuals would be due lump sums in excess of the £95,000 CSCS maximum, they were offered 'gardening leave' to work around this constraint; and
- in the absence of unequivocal written approval from the Department, the company did not have the authority for any of these enhancements.

**10** Retrospective approval has not been given either by the Department or HM Treasury.

**11** I therefore conclude that these transactions do not conform with the authorities which govern them, so have qualified my opinion on regularity. The remainder of my report describes my detailed findings, the actions taken to date by HS2 Ltd and those required of it in the future.

## **Detailed findings**

### *Background*

**12** During the year, HS2 Ltd decided to run both compulsory and voluntary redundancy schemes, as it needed to restructure its workforce. There were a number of reasons for this. These were the transfer of the company's Head Office to Birmingham; the grant of Royal Assent to the High Speed Rail (London – West Midlands) Bill, moving into the design and construction stage for Phase 1 of the route; as well as HS2 Ltd's decision to reorganise some areas of its business.

### *HS2 Ltd needs Departmental and HM Treasury approval to enhance redundancy payments*

**13** The rules covering HS2 Ltd's finances are set out in its framework document, described above. This document, agreed with HM Treasury, makes clear<sup>4</sup>:

- a. that the benefits package authorised includes only statutory redundancy pay – a condition built into HS2 Ltd staff contracts – with any proposals for extra-contractual payments requiring authorisation by the Department and HM Treasury; and
- b. that the salaries allowed at HS2 Ltd are higher than those that would normally be allowed in the public sector, because of market conditions and the restrictions to wider benefits<sup>5</sup>.

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<sup>4</sup> *High Speed Two (HS2) Ltd Framework Document*, pp23 and 40.

<sup>5</sup> Additional flexibility on salaries is provided by HM Treasury's agreement in November 2014 to remove the restriction for HS2 on pay awards, and to allow 65 posts at HS2 Ltd with salaries above £142,500. HM Treasury noted that these freedoms reflected 'the fact that HS2 is a highly exceptional time-limited project, like the Olympics and Crossrail' and the need to

**14** HS2 Ltd therefore has bounded flexibility on salaries, but is authorised to make only statutory redundancy payments. Approval is needed from the Department for any departure from this rule, and (assuming the Department is content) from HM Treasury. The Department reiterated the restriction to statutory terms in March 2016, at the point of approving HS2 Ltd's request to run compulsory and voluntary redundancy schemes.

*HS2 Ltd's request to enhance redundancy terms was above revised terms for the Civil Service*

**15** In April 2016, HS2 Ltd made a further request to the Department to enhance the terms of its planned schemes. HS2 aimed to secure the required redundancies whilst encouraging staff to delay their departures until key dates, to support programme delivery. The proposed enhancements were as follows.

<b>Scheme design</b>	<b>Pay per year of service</b>	<b>Minimum service</b>
Statutory	1 week (dependent on age)	2 years
As proposed	1 month	1 year
CSCS (revised)	3 weeks	Discretionary for voluntary schemes; 2 years for compulsory schemes.

**16** HS2 Ltd argued that the terms proposed were reasonable since they were similar to those of the Civil Service Compensation Scheme (CSCS) operating at the time. However, the Cabinet Office changed CSCS terms in November 2016, before HS2 Ltd finalised any redundancies, from one month to 3 weeks pay per year's service. HS2 Ltd should have been aware of this change as the Cabinet Office consulted on the proposed changes in February 2016 and publically responded to the consultation<sup>6</sup> in September 2016.

*HS2 Ltd committed to unapproved redundancy packages at these enhanced terms*

**17** I have seen evidence that the Department rejected HS2 Ltd's request, via an e-mail from a senior official at the Department and a senior executive at the company. No evidence has been presented to me suggesting that this was passed on within the company. There were some further communications between HS2 Ltd and Departmental officials which made reference to the payment of an enhanced scheme, without any indication at working level that the request had not been approved. Regardless, I would have expected HS2 Ltd to be conscious of the Department's previous rejection, and in any case to await explicit written approval before taking action.

**18** In rejecting this request, Departmental officials emphasised the significant flexibilities in pay and benefits granted by the Department and HM Treasury to HS2 Ltd over Civil Service levels. These allow the company to offer higher pay to compete for high quality rail industry staff, but were granted in the context of wider benefits having been intentionally limited.

**19** HS2 Ltd negotiated exits based on their unapproved proposal. The company also further enhanced redundancy packages well beyond the level of the CSCS scheme (both older and revised versions) using mechanisms described below. Taken together, these

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'ensure HS2 Ltd is equipped to deliver the best possible value for money for the taxpayer more widely'.

<sup>6</sup> Cabinet Office, *Civil Service Compensation Scheme – Response to consultation on proposed reform*, September 2016, available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/555286/civil\\_service\\_compensation\\_scheme\\_response.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/555286/civil_service_compensation_scheme_response.pdf)

factors had the effect of commitments being made significantly in excess of the statutory rates mandated in HS2 Ltd's framework document.

*The company's actual scheme terms remained unapproved and were further enhanced beyond civil service rates*

**20** 27 staff received offers on the **voluntary scheme**, with a total value of £1.844 million. Extra-contractual enhancements which increased this figure included the following.

- a. Redundancy compensation was, as HS2 Ltd had proposed, paid at 1 month's salary per year's service, in line with the CSCS terms which had been superseded in November 2016, before any redundancies were finalised. Several constraints in the CSCS scheme, such as a cap on the salary multiplier, were not applied.
- b. All individuals received a lump sum payment in lieu of notice (PILON) based on their full notice period, despite in many cases significant notice having been given and worked.
- c. Under CSCS terms, exit packages are capped at £95,000 per individual, and Cabinet Office approval is required for payments above that level. To ensure that lump sums payable did not exceed the £95,000 cap, HS2 Ltd paid, for those whose compensation and PILON calculated as above would have exceeded £95,000, additional salary for a period of 'gardening leave', during which individuals were paid, but asked not to work. In substance this allowed exit packages of more than £95,000 to be paid.

**21** The following table contrasts key terms between statutory entitlement, CSCS rates, and the actual voluntary scheme.

<b>Scheme design</b>	<b>Pay per year of service</b>	<b>Minimum service</b>	<b>Cap on salary multiplier</b>	<b>Period on which PILON payable</b>	<b>Overall cap</b>
<b>Statutory</b>	1 week (age-dependent)	2 years	None	Notice period not worked	None
<b>CSCS (revised)</b>	3 weeks	Discretionary	£149,820 <sup>[1]</sup>	Notice period not worked; capped at 3 months	£95,000
<b>Actual</b>	1 month	1 year	None	Full notice period regardless of time worked after notice	'Gardening leave' <sup>[2]</sup> paid where compensation and PILON would have exceeded £95,000

[1] 9 individuals in the scheme earned over this level.

[2] 9 individuals agreed gardening leave as part of their exit packages. Of these, 8 received a total exit package of more than £95,000.

**22** The financial effect of these enhancements is summarised below. In total, the rate payable was double the statutory terms allowed for in HS2 Ltd's framework document. Applied in full, CSCS terms would have been less than statutory entitlements, primarily as a result of the CSCS cap on notice periods on which PILON is payable.

<i>All figures £, rounded</i>	<b>Compensation</b>	<b>PILON</b>	<b>Salary for 'gardening leave' period</b>	<b>Total</b>
Statutory terms (NAO estimate <sup>[1]</sup> )	43,000	875,000		<b>918,000</b>
CSCS (revised) terms (NAO estimate)	389,000	363,000		<b>752,000</b>
Actual HS2 Ltd offer	679,000	602,000 <sup>[2]</sup>	563,000	<b>1,844,000</b>

[1] NAO estimates on what would have been payable under statutory and CSCS terms are based on the rules prevailing in November 2016, and draw on a review of all 27 cases. In a small number of cases, we have made assumptions to compensate for incomplete data. These uncertainty in our estimates in these cases is not significant.

[2] The total for PILON actually paid is lower than statutory terms because HS2 Ltd reduced PILON in cases where paying the full amount would breach the £95,000 CSCS cap measured across all elements of the exit package. As described, a 'gardening leave' feature was introduced in these cases. In all voluntary scheme cases, PILON and gardening leave payments taken together exceed contractual entitlements. PILON was not payable in the compulsory scheme.

**23** Under its **compulsory scheme**, HS2 Ltd made 28 staff redundant at a cost of £323,000 and these individuals left before the year end.

**24** 39 further staff were given notice of redundancy before the year end at a potential total cost of £593,000. Many of these individuals subsequently found temporary roles and their exit dates have been extended. If they find a new permanent role they will not be made redundant. If they cannot find a permanent role HS2 Ltd are legally obligated to pay compensation at the enhanced rates set out in notice letters.

**25** I have estimated the amount that would have been payable under statutory terms for a compulsory scheme. My estimate, below, assumes that the enhancement to statutory compensation terms would be similar to the ratio I found in analysing the voluntary scheme, since the terms on this element were the same.

<i>All figures £, rounded</i>	<b>Compensation</b>	<b>PILON</b>	<b>Salary for 'gardening leave' period</b>
Statutory terms (NAO estimate)	Between 55,000 and 115,000	Nil	Nil
Actual HS2 rate	916,000	Nil	Nil

### **Action taken by High Speed Two Limited and the Department for Transport**

**26** Although the majority of redundancy packages formally agreed by HS2 Ltd were not paid during 2016-17, HS2 Ltd have been advised that they have a legal obligation to honour exit packages agreed with or notified to individuals. The company will honour these obligations.

**27** The Department has asked HS2 Ltd not to agree any further redundancy packages under these terms, where the point of obligation has not passed.

### **Further actions required on overall control environment**

**28** The sequence of events I describe suggests a weakness in HS2 Ltd's control environment, and provides an example of ineffective communication both between the company and the Department, and within the company. Whilst deriving from a single redundancy scheme, these findings highlight the need for improvements in the company's general control environment, where the company has itself acknowledged areas of weakness.

**29** This is a critical stage in HS2 Ltd's lifecycle. The company has, with the Department, achieved a significant milestone in securing Royal Assent for the London – West Midlands Bill. Since then, the company has taken on significant additional delivery responsibilities, including key land and property transactions. The company expects to award the first tranche of civil engineering contracts later in 2017 which will signal the start of a new phase for the company.

**30** I acknowledged this progress in my report of June 2016<sup>7</sup>, whilst highlighting cost and schedule pressures faced by the project, and noting<sup>8</sup> the key challenges faced by the company in building its capacity – both in terms of people and systems – to keep pace with programme developments. My findings here suggest further work is required in this area.

**31** This should focus not only on the company's systems and processes, but also its culture and behaviours, which should support HS2 Ltd's role as a delivery body with commercial and engineering expertise, operating within a defined public sector framework. Behaviours here fell short of the level required, in my view, on two counts.

**32** Firstly, HS2 Ltd proceeded with several redundancy scheme enhancements beyond its allowed framework, without recognising a breach of that framework. This suggests an insufficient familiarity among HS2 Ltd staff with the framework document. Secondly, the Department responded in writing on a one-to-one basis, and HS2 Ltd did not treat this, or the lack of a more widely-disseminated formal response, as a barrier to progress. This suggests a need for the Department and company to consider whether the balance between ad hoc or informal interactions, and those at arm's length based on clearly understood roles and responsibilities, is right.

**33** A robust control environment, both within HS2 Ltd and in respect of interactions between the company and the Department, is essential to ensure that delivery risks for the new rail line are appropriately mitigated, and that taxpayer's money is protected as the programme forges ahead. I therefore welcome and endorse HS2 Ltd's identification in its 2016-17 Governance Statement of the need for significant improvement in the general control environment. This work must be given a high priority if the company is to properly support the imminent step change in the scope of its financial responsibilities. I also welcome a joint commitment from the Department and company to review the failure of controls in this area, and determine the appropriate actions.

**34** Given the duration and value of the HS2 project, I expect to report again on the programme during this Parliament. I will report on the progress made in response to the issues identified at an appropriate point.

**Sir Amyas C E Morse**  
**Comptroller and Auditor General**

**Dated 11<sup>th</sup> July 2017**

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<sup>7</sup> National Audit Office, *Progress with Preparations for High Speed 2*, HC 235 of Session 2016-17, available at: <https://www.nao.org.uk/wp-content/uploads/2016/06/Progress-with-preparations-for-High-Speed-2.pdf>

<sup>8</sup> *Ibid.*, p30 in particular.