National Audit Office

Report
by the Comptroller
and Auditor General

Department of Health & Social Care

Investigation into the rescue of Carillion's PFI hospital contracts

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Key facts

	Midland Metropolitan	Royal Liverpool
The project	669-bed hospital in Sandwell, West Midlands, replacing two existing hospitals	646-bed hospital in central Liverpool to replace the existing hospital
Expected benefits	Modernised services in a single site acute hospital	Reduced risk to services from current hospital's poor condition, meeting changing healthcare demands
NHS Trust	Sandwell and West Birmingham Hospitals	Royal Liverpool and Broadgreen University Hospitals
Original opening date	October 2018	June 2017
Status when Carillion collapsed in January 2018	Around two-thirds complete, structure largely built	Construction and fit-out almost complete
PFI termination	No payment to lenders	£42 million payment to PFI lenders
Procurement of contractor to replace Carillion	Bidding process under public procurement rules, only one bidder	No public procurement process. Main contractor appointed by the PFI company, transferred ('novated') to the Trust
Delay until major work recommenced	22 months	18 months
New contractor	Balfour Beatty Construction Limited	Laing O'Rourke
Current forecast opening dates	July 2022, 3 years and 9 months late	Completion planned for autumn 2022, more than 5 years late. Opening date not yet set
Key risks remaining to the Trusts	Balfour Beatty has agreed a target price for finishing the hospital, but the Trust will pay for any unforeseen costs arising from problems with Carillion's work	There is no cap to the price of the remaining work, the scope of which is being finalised, and there are risks of further cost rises and time delays
Original expected cost to build and run	£686 million	£746 million
Current expected cost to build and run	£988 million (+44%)	£1,063 million (+42%)
Of which, amount public sector will pay	£709 million (+3%)	£739 million (-1%)
Estimated losses on the projects borne by private sector	£279 million	£324 million

What this investigation is about

1 This report is about what happened to Carillion's two major public sector construction contracts after it collapsed and how the Private Finance Initiative (PFI) operates in these circumstances. Carillion plc went into liquidation on 15 January 2018. In June 2018 we reported how government worked to ensure continuity of the public services operated by Carillion during the liquidation. But Carillion's construction contracts stopped. At the time, Carillion was the main construction contractor for two new hospitals, both being built under PFI:

- the Midland Metropolitan Hospital in Sandwell, West Midlands (Midland Metropolitan). This is to be used by the Sandwell and West Birmingham Hospitals NHS Trust (referred to in this report as 'the Sandwell Trust' or 'the Trust' as appropriate); and
- the Royal Liverpool University Hospital (Royal Liverpool). This is to be used by the Liverpool University Hospitals NHS Foundation Trust, which was formed on 1 October 2019 through a merger between the Royal Liverpool and Broadgreen University Hospitals NHS Trust (referred to as 'the Liverpool Trust' or 'the Trust' as appropriate) and another NHS trust.

2 Under the original PFI arrangements, dedicated private companies – The Hospital Company (Sandwell) Ltd and The Hospital Company (Liverpool) Ltd (both referred to in this report as 'the PFI company') – were responsible for the delivery of each hospital and held the finance. These companies were to be financed by £57 million from shareholders (including Carillion), £395 million loans from investors (mainly banks) and £215 million of government funding. The PFI companies had contracts with Carillion to deliver the hospitals to an agreed price.

3 The principle behind PFI is that the PFI companies are responsible for the provision of the asset over a period of around 30 years. The PFI companies, and hence the PFI investors, are only paid for the hospital if it is built and available for use. This works by spreading the Trust's payments for the cost of building and maintaining the hospital over the period of the contract, through a monthly 'unitary charge'. The Trust receives ownership of the hospital after the contract has ended.

4 The projects were at different stages of construction when Carillion stopped work. The Royal Liverpool was nearing completion and the Midland Metropolitan was about two-thirds complete. But both hospitals were already behind schedule and Carillion's costs were rising. PFI companies are designed with little spare contingency funding as they pass the risks to their contractors. They are reliant on the financial strength of the contractor to deliver the buildings to the agreed price. But in this case this was not viable because of Carillion's collapse. By autumn 2018 it was clear that both PFI companies could not replace Carillion with another contractor using the remaining money left in the projects.

5 HM Treasury, the Cabinet Office, the Department of Health & Social Care, and NHS Improvement (the Departments) collectively agreed to replace the two PFI schemes with public financing. Work then restarted at Royal Liverpool, with a new main contractor addressing problems with Carillion's work. At Midland Metropolitan, the contract to complete the work was awarded to Balfour Beatty in December 2019.

6 This investigation is thus a case study on what happens to a PFI construction project when it goes wrong. The PFI companies were expected to replace the construction contractor and carry on. But they could only do that until the point at which the cost to complete grew larger than the funds available to the project. On the one hand fixed-price contracts, like PFIs, can ensure that contractors are both incentivised to manage costs and bear the brunt of cost rises. On the other hand, some risk ultimately remains with the public sector; when things go wrong beyond a certain tipping point, the public sector will bear the consequences. For these projects the tipping point was reached through a combination of high cost overruns on the construction and the failure of the contractor who had been expected to pay for them.

7 The investigation focuses on the role of central government and the Trusts in relation to the two hospital projects before, during and after Carillion's failure in January 2018. It sets out:

- the construction problems on each project (Part One);
- how the government and the Trusts dealt with the effects of the collapse of Carillion (Part Two); and
- the impact on the schedules and costs of the two projects (Part Three).

8 To prepare this report we have relied on information from the Departments and the Trusts. This is because many of the private organisations previously involved, including Carillion and the PFI companies, are in liquidation or have had their contracts terminated. We have not assessed the actions of Carillion, its directors or its advisers.

9 The Department of Health & Social Care and the Cabinet Office agree with the facts and findings of this report, but have asked us to note that our approach to presenting the costs of the two hospital projects is not the one that they would have chosen. We have expressed costs in real terms, to make them easier to understand, and therefore have not included the time value of money.

Summary

Where are the hospital projects now?

10 **The hospitals are currently due for completion several years late, meaning local patients have to use the existing facilities.** Under current plans by the Sandwell and West Birmingham Hospitals NHS Trust (the Sandwell Trust) and the Liverpool University Hospitals NHS Foundation Trust (the Liverpool Trust):

- The Midland Metropolitan Hospital (Midland Metropolitan) is now expected to open in July 2022. This would be a delay of three years and nine months from the original planned opening date, October 2018 (paragraph 3.2).
- The Royal Liverpool University Hospital (Royal Liverpool) is now expected to be completed in autumn 2022. The Trust has not yet set an opening date, but this will be more than five years after the originally planned opening of June 2017. Further work to demolish the old hospital and create a new underground car park and public plaza, was not included in the PFI project and is currently unfunded (paragraphs 2.40 and 3.5).

11 **The currently expected total cost to all parties of building the two hospitals has risen 98% since the Private Finance Initiative (PFI) contracts were signed.** The construction of the Midland Metropolitan is now expected to cost at least £663 million compared with £350 million in the original business case. This includes £315 million still to be spent to complete the construction, including the Trust's contract with Balfour Beatty and other costs. The construction of the Royal Liverpool is now expected to cost at least £724 million compared with £350 million in the original business case. This includes a currently estimated £293 million for remedial work to the structure and to complete the construction. The cost of maintaining both hospitals has also risen due to changes in the market since the PFI contracts were signed, and the delays have also led to cost increases on other projects (paragraphs 3.9 to 3.13 and Figures 7 and 10).

12 **The use of PFI means that the private sector will end up paying most of the cost increase, and the public sector is only expected to pay 1% more in real terms across both projects than was originally expected.** Collectively the investors, their insurers and Carillion have lost at least an estimated £603 million across both hospital projects. Once the increased cost of maintenance and the impact of the delay on other projects are taken into account, the currently expected total cost to the public sector of the Midland Metropolitan hospital has risen by 3% and the currently expected total cost to the public sector of the Royal Liverpool has fallen by 1%. The public sector's costs are higher than they otherwise would be because the public sector contribution to the projects was higher than was usual for PFI, in order to reduce the amount of private finance necessary and make the projects more affordable (paragraph 3.14 to 3.18 and Figures 7 and 10).

13 **The Trusts now face higher early costs, but will receive additional support from the Departments, so will pay an estimated net £155 million less than planned under the PFIs.** The costs above do not take account of when the money will be paid. The new arrangements require the Trusts to pay the construction costs sooner, over the course of the rest of the construction, instead of spreading the costs of the construction over the 30-year operational period of the PFI contracts. However, they have received additional support from NHS England and NHS Improvement (NHSE&I)[1] and the Department of Health & Social Care, including additional public dividend capital which acts as a permanent loan, which compensates for having to pay more upfront (paragraphs 3.19 and 3.20 and Figures 9 and 12).

14 **Both Trusts will pay for any further costs arising from problems with Carillion's work and there are particularly significant risks of further cost increases and delays at Royal Liverpool.** Both Trusts are now directly managing the contracts with new construction firms:

- Balfour Beatty has agreed a 'target price' for its work to complete the Midland Metropolitan, but the Trust may have to pay more for extra work caused by defects in Carillion's work that could not have been foreseen during Balfour Beatty's pre-contract due diligence.
- Laing O'Rourke is acting as a managing contractor and is paid a fee to manage other contractors to complete the Royal Liverpool. Laing O'Rourke has no contractual incentives to manage cost. Some issues which are not yet resolved could increase costs.

NHSE&I has worked with the Trusts to put additional oversight arrangements in place on costs and the Trusts are using an independent construction consultancy to advise on the appropriateness of costs. Both Trusts have also sought warranties from Carillion's subcontractors for work already done (paragraphs 2.29 to 2.40).

1 NHS England and NHS Improvement, previously two organisations, merged from 1 April 2019.

What went wrong with the construction of the hospitals?

15 Both hospital projects had significant difficulties before Carillion's collapse and their openings had already been delayed. Both projects were running around a year late by January 2018:

- At Midland Metropolitan, construction was originally expected to be complete by July 2018. By late 2017, the structure was complete but delays to the designs for the mechanical and electrical fit-out had delayed the completion date by 11 months to June 2019 (paragraphs 1.12 to 1.15).
- The Royal Liverpool's construction had been delayed due to problems including asbestos discovered on the site and issues with the power supply. During 2017 Carillion was investigating the cause of some cracks in structural beams, while work continued. By late 2017 the hospital was at a late stage of construction and Carillion expected to complete it in April 2018, some 13 months late (paragraphs 1.16 and 1.17).

16 Carillion stopped work on both sites when it collapsed on 15 January 2018, which created more delay on both projects. The Cabinet Office provided funding to the Official Receiver to enable the Trusts and the PFI companies to secure the sites, retain key staff and maintain essential services such as ensuring water pipes were used to avoid bacteria building up (paragraph 2.2).

17 The PFI company and the Trust discovered further construction issues at Royal Liverpool following Carillion's collapse. Initially, the Trust and the PFI company thought only modest remedial work was necessary, but in April 2018 the PFI company commissioned the engineering consultants Arup to review the structural design and perform a fire safety review. Arup reported that major work was needed to strengthen the structure at multiple points, which required the new fittings, piping, wiring and heavy plant and equipment to be stripped out across three floors of the building. Further work identified other construction problems, including shortcomings in internal fire protection and the fire safety of external cladding (paragraphs 1.17 to 1.20).

18 It is not clear why the design problems at both hospitals occurred. PFI arrangements are meant to lead to better design and performance by transferring the risk to the most appropriate party. The Trusts require the PFI companies to build the hospitals to the required specification. The PFI companies and their investors are meant to be able to rely on their contractors to manage the design of the projects. The investors' payments to the PFI companies are made in line with technical adviser reports that track progress against plan and provide no assurance over the design. We have not looked at the detail of what went wrong with the design process within Carillion and its subcontractors. NHS England and NHS Improvement and a few individuals involved in the construction projects told us that one of the causes may have been that Carillion's original pricing was too low to meet the required specification (paragraphs 1.5 and 1.21).

How did the Trusts and Departments deal with Carillion's failure?

19 The Departments and the Trusts assumed that the PFI companies would complete the hospitals, as contractually required, by replacing Carillion. As we reported in June 2018, government had contingency plans for the collapse of Carillion, but focused on operational service contracts to ensure that services to the public continued, and not Carillion's construction projects. The PFI companies' plans assumed work would pause while they found a new construction company (paragraphs 1.8 to 1.10).

20 Following Carillion's collapse, the PFI companies assessed the status of the projects and found that they did not have enough money to complete them. In line with the usual PFI model, both PFI companies would have been relying on Carillion to absorb the rising cost of completing the hospitals and had been designed with very little contingency funding of their own. They thus found that with Carillion no longer guaranteeing to deliver the hospitals at the set price, and large costs to correct and complete the hospitals, that they had insufficient funding from investors to complete the projects. At Midland Metropolitan, the PFI company notified the Sandwell Trust in January 2018 that it could not complete the hospital without additional money from the Trust. At Royal Liverpool, which the Liverpool Trust believed was within a few months of completion, the project seemed deliverable with the money available from the investors until July 2018, when the extent of the problems with the structure, internal fire protection and cladding emerged (paragraphs 2.3 to 2.6).

21 The Departments wanted to hold the private sector to its contractual liabilities and avoid any 'bailout' that would set a precedent. The Department of Health & Social Care, the Cabinet Office and HM Treasury were concerned that additional public funding would not be value for money and would set a precedent for similar bailouts of other PFI contracts, by breaking the principle that PFI investors bear the risk of their projects. It also feared that a bailout could lead to not only the two hospitals but all the government's PFI debts being reclassified as National Debt. In May 2018 the Departments rejected the Sandwell Trust's proposal to rescue the Midland Metropolitan PFI company through additional government funding, although the Trust believed this could have led to the completion of the hospital 18 months earlier than under public financing. In September 2018 the Departments also rejected a similar rescue package proposed by the PFI investors for Royal Liverpool (paragraphs 2.7 to 2.12, 2.18 and 2.19).

22 The Departments explored whether new PFI schemes could be set up but found no interest from potential investors or construction contractors. The Department of Health & Social Care worked with NHS Improvement, the Infrastructure and Projects Authority in the Cabinet Office, and HM Treasury in a 'recovery group' to coordinate work to restart the hospital projects. The group contacted potential private investors in a new PFI scheme for Midland Metropolitan, while the Sandwell Trust researched whether construction contractors would be interested. They found that potential investors and contractors would not accept any financial risk of a problem later arising due to Carillion's work, which made a PFI scheme or any normal fixed-price contract impractical (paragraphs 2.11 and 2.13 to 2.15).

23 **The Departments were left with terminating the PFI schemes and using public finance to complete the hospitals with new contractors.** The Sandwell Trust terminated the Midland PFI company's contract in July 2018 and, following discussions about the extent of the structural problems at Liverpool, the Liverpool Trust terminated its PFI company's contract in October 2018. This avoided any 'bail out' of the PFI companies or reclassification of other PFI debt. The Departments agreed to provide additional public funds to the Trusts to finish the hospitals instead. HM Treasury approved the new business case for Midland Metropolitan in October 2019 (paragraphs 2.12, 2.22 and 2.29).

24 **The Department of Health & Social Care funded the Trust to pay £42 million compensation to Royal Liverpool's lenders to terminate the contract**. PFI contracts are not well designed for a termination during the construction stage. The contract required the Trust to pay compensation to the PFI company's lenders, based largely on the estimated cost to complete the hospital, before the actual cost to complete the hospital was properly known. It also allowed the lenders the option to delay construction for several months while compensation was negotiated. The Departments decided to reach a quick consensual settlement with the lenders for the compensation payment, so that the Trust could take over the site quickly and continue the work of the PFI company's construction contractors. This avoided the lengthy contractual termination process that may have led to a lower compensation payment but would have led to more delay and its associated cost. But going for a quick settlement meant the Departments had to rely on the available estimate of the cost to complete, provided by the PFI company, its lenders and their advisers (paragraphs 2.20 to 2.27).

25 **Had the Departments better understood the cost to complete the Royal Liverpool, they may not have funded the Trust to pay any termination payment to the lenders.** At the time of the settlement in September 2018, the Departments used an estimate of the cost of completing Royal Liverpool of £117 million present value based on information provided by the lenders and their advisers, but this was subject to a lot of uncertainty. By January 2019 further work on site led the Trust to increase this estimate by £47 million to £164 million, which was sufficiently high to mean no termination payment would have been due under the contract. The current estimate of the cost to completion is £293 million (paragraphs 2.25 and 2.26).

26 **To restart the projects, the Liverpool Trust agreed contracts with several new suppliers without a public procurement process, while the Sandwell Trust ran a public procurement which only attracted one viable bidder.** This meant that new suppliers for both the hospitals were chosen without competition. The Liverpool Trust transferred contracts from the PFI company without going through a procurement exercise and has then appointed further work to smaller contractors without competition to prevent further delay to the project and to maintain warranties. The Trust told us that it estimated the costs of delay at more than £2 million per month. Its board was advised that some of the contracts could be subject to legal challenge because they were not properly procured or advertised, but given there was no market for the work that the likelihood of this was low. The Sandwell Trust signed a construction contract with Balfour Beatty in December 2019. Balfour Beatty was the only viable bidder and had started work on site under an 'early works' contract while the Sandwell Trust was putting together a business case for completing the hospital and running a public sector procurement for a new contractor (paragraphs 2.29 to 2.40).