

House of Commons
Committee of Public Accounts

**PRIVATE FINANCE
INITIATIVE:
REDEVELOPMENT OF
MOD MAIN BUILDING**

Fourth Report of Session 2002–03

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*Report, together with
Proceedings of the Committee, Minutes of
Evidence and an Appendix*

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Contacts

All correspondence should be addressed to The Clerk of the Committee of Public Accounts, Committee Office, 7 Millbank, London SW1P 3JA. The telephone number for general inquiries is: 0207-219-5708. The Committee’s e-mail address is: pubaccom@parliament.uk.

Footnotes

In the footnotes of this Report, references to oral evidence are indicated by ‘Q’ or ‘Qq’ followed by the question number; references to the written evidence are indicated by the page number as in ‘Ev’.

TABLE OF CONTENTS

	<i>Page</i>
FOURTH REPORT	
Introduction and list of conclusions and recommendations	5
The extent of financial savings	7
The comparative costs of finance	12
The risks of being locked into a long-term PFI contract	13
PROCEEDINGS OF THE COMMITTEE RELATING TO THE REPORT	16
EVIDENCE (<i>Wednesday 26 June 2002</i>) (HC 1013-i, Session 2001–02)	
WITNESSES	
Sir John Bourn KCB, Comptroller and Auditor General	Ev 1
Mr Brian Glicksman, Treasury Officer of Accounts	Ev 1
Sir Kevin Tebbit KCB, CMG, Permanent Under-Secretary of State, Ministry of Defence, and Mr Jonathan Hoyle, Director, Main Building Development, Ministry of Defence	Ev 1
Mr Matthew Webber, Chairman, and Mr Les Mitchell, Managing Director, Modus Services plc	Ev 1
Mr Jeremy Colman, Assistant Auditor General, National Audit Office	Ev 1
APPENDIX	
1 Supplementary memorandum submitted by the National Audit Office	Ev 21

FOURTH REPORT

The Committee of Public Accounts has agreed to the following Report:

PRIVATE FINANCE INITIATIVE: THE REDEVELOPMENT OF MOD MAIN BUILDING

INTRODUCTION AND LIST OF CONCLUSIONS AND RECOMMENDATIONS

1. In May 2000, the Ministry of Defence (MOD) signed a deal costing £746 million over 30 years with the Modus consortium (consisting of Innisfree, Laing Investments, and Amey Ventures Ltd.) for the redevelopment of Main Building, MOD's London headquarters. The deal, procured under the Private Finance Initiative (PFI), is for the redevelopment of Main Building, and maintenance and facilities management thereafter until 2030.

2. On the basis of a Report by the Comptroller and Auditor General¹ the Committee took evidence from MOD and Modus on three main issues: the extent of financial savings from this deal; the comparative costs of financing deals under the PFI and conventional procurement; and the risks associated with the long term PFI contract.

3. Our key conclusions are:

- **Closer attention to financing costs would have been particularly helpful during the 16 months it took MOD to close the deal.** Reducing the length of that period, postponing the choice of finance to the end to get the cheapest form available, and a canny approach to the financing markets prior to closing the deal all might have helped to secure savings on this project. MOD's last minute negotiations formed the basis of the claim that this £746 million project is expected to yield savings of just £100,000. It would have been more productive for MOD to focus earlier on the pressures that increased the price of the deal by £99 million after Modus became preferred bidder, of which £60 million was attributable to financing costs.
- **Financing costs form a significant part of the cost of a long term project, and departments should ascertain how the costs of using private finance compare to other forms of procurement.** The Department could not tell us what the extra costs of private finance were in this deal. The value for money case for PFI depends on it bringing benefits that outweigh the extra costs of private finance, and can only be ascertained if those extra costs can be estimated.
- **Departments need to think through their future needs to avoid the extra time, and possibly costs, of arranging additional contracts for services excluded from a major PFI contract.** MOD had to enter into a separate contract for 500 additional staff when it found, shortly before completing the PFI deal, that these additional staff needed to be accommodated in central London. It also excluded from the PFI contract the provision of IT systems, as it was unable to identify the systems that its staff would require when the new accommodation becomes ready in 2004.
- **Where future requirements are genuinely uncertain, departments should assess which will be the more beneficial option for meeting them:** paying for flexibility within a long term contract, or using other forms of shorter contractual arrangements. In accommodation projects departments will need to assess the risks of being left with too much or too little accommodation. It may prove more

¹ C&AG's Report, *Ministry of Defence: Redevelopment of MOD Main Building* (HC 748, Session 2001–02)

expensive to seek additional accommodation in the market than to pay for this flexibility within a PFI contract.

4. Our detailed conclusions and recommendations are:

- (i) The public sector comparator gave a central estimate for the cost of a conventionally financed alternative to the PFI deal as £746.2 million, compared to an expected deal cost of £746.1 million. Such accuracy in long term project costings is spurious, and the small margin in favour of the PFI deal provides no assurance that the deal will deliver value for money.
- (ii) About £25 million of the £60 million increase in financing costs arose because Modus had planned when bidding to invest surplus cash from a bond issue at short term rates which would be higher than the long term cost of borrowing. The opportunity to invest cash at a profit will not arise now that the deal has been bank financed and may well not have been realised even if the deal had been bond financed in line with earlier proposals. It is imprudent to base the choice of bidder on essentially speculative aspects of financing proposals.
- (iii) MOD appears not to have been alert to the risk that it would be exposed to significant fluctuations in the finance costs during the closing negotiations. In similar circumstances departments should consider options for managing this risk.
- (iv) Bond finance may have been as much as £22 million cheaper at the time this bank financed deal was closed. Financing costs are a major component of the contract price and the prices of alternative sources of finance can fluctuate over time. Departments should therefore choose the method of financing as late as possible to ensure they can take advantage of the best sources of finance available.
- (v) The financing rates increased in the days leading up to closing this deal as the market knew that this large deal, and other PFI projects, were coming to the market at the same time. In successive sales by the Treasury of debt issued by former nationalised industries and of secondary tranches of shares in privatised companies the Treasury became skilful at reducing the scope for third parties to profit from the knowledge that large Government deals were being finalised. The Treasury should consider if this experience could be applied to PFI procurements.
- (vi) In addition, the Office of Government Commerce should consider ways in which the timetable for PFI deals reaching financial close can be better managed to avoid different large deals coming to the market at the same time. This would reduce the risk of increasing financing costs due to an excess demand for available long term funds.
- (vii) In this deal the MOD deferred full survey work until after Modus became preferred bidder. As our predecessors recommended, making full surveys available to each of the final bidders may help departments achieve more competitive prices for building work. It will also reduce the subsequent period for closing the deal during which departments are exposed to fluctuating financing costs.
- (viii) Modus said that it would be open to sharing some of any future refinancing benefits that may arise. MOD and Modus will need to ensure that a reasonable sharing of any refinancing gains is achieved.
- (ix) Transparency of financing costs is essential in comparing bids and in considering the merits of alternative forms of procurement. In this deal the way in which

financing costs are made up is not transparent and it is therefore not clear whether the returns being made are reasonable in relation to the risks being borne.

- (x) Although relative financing costs are crucial to decisions on PFI projects, the approach to investment appraisal normally used by departments does not enable a comparison to be readily drawn between the financing costs of a PFI deal and conventional procurement. The Treasury's investment appraisal approach does not result in the cost of public finance for conventional procurement being explicitly estimated. There is scope for the Treasury to clarify how the financing costs of alternative procurement approaches might be calculated.
- (xi) PFI brings some potential advantages, but, as currently practised, involves the disadvantages of extra financing costs compared to conventional public finance. It is not clear that current financing methods for PFI deals are the most efficient or the cheapest. Neither is it obvious why the improvements in risk allocation and management that are said to flow from PFI need necessarily involve expensive private financing.
- (xii) The Treasury should examine whether there are alternative financing methods for PFI projects, either collectively or individually, which would lower the cost of external financing. And the Office of Government Commerce should explore the scope for applying to public sector projects the best of the principles of risk management found in PFI deals to enable the taxpayer to benefit from the advantages of PFI whilst avoiding unnecessarily high financing costs.

THE EXTENT OF FINANCIAL SAVINGS

5. When assessing the value for money of a PFI deal departments are advised to produce public sector comparators (PSCs) to estimate the cost of an equivalent conventionally procured project. In this procurement MOD's final PSC showed a central estimate of £746.2 million. This compared to a deal cost of £746.1 million.²

6. MOD considered that the closeness of the comparison was due to the fact that in the final negotiations it only agreed to close the deal when Modus had dropped its price to a level which was less than the PSC. Modus had not known the PSC cost estimate and MOD considered it had got the maximum price reduction that could be negotiated.³ Even where there may be valid reasons for a PFI price being marginally less than a PSC there is still a risk that presenting figures with a high degree of accuracy, such that minor cost differences on large value projects appear important, may lead to a misinterpretation of the financial comparison. The appropriate conclusion is that the two routes are similar in cost terms. MOD considered that non quantified factors tipped the balance in favour of the PFI deal. These were the fixed price of the contract, the risk of overruns being passed to the contractor, incentives for the project to come in on time, the fact that the contractors' money is put at risk, and the incentive scheme for the contractor to perform.⁴

7. The inherent uncertainties in a financial comparison of this kind are highlighted by this deal. The MOD's central estimate of the PSC cost of £746.2 million included an adjustment for risk of £102.9 million or 17.2% (**Figure 1**). It is right to take differences in risk into account in these comparisons since it is not possible to predict conventional procurement costs with absolute accuracy. The outcome of the financial comparison was, however, very sensitive to the costing of risk. **Figure 2** shows that the decision on the extent of the risk adjustment for capital expenditure had a significant effect on the financial

² C&AG's Report, para 2.48. The total cash cost of the PFI deal is around £2.4 billion (Qq 88–89)

³ *Ibid*, paras 2.59–2.60; Qq 16–18, 75–81, 159, 162–163

⁴ C&AG's Report, para 15, Table 1, p 7; Q 2

comparison. For example, a change in the risk adjustment for capital expenditure from MOD's assumption of 29.5% to 29% reduces the PSC by £1 million. MOD's own calculations showed that, depending on the assumptions that were made for all the various risks, the costs of conventional procurement could fall anywhere within the range of £690 million to £807 million.⁵

8. MOD considered that its risk assessments were not excessive. It noted that its capital expenditure risk adjustment of 29.5% was lower than the risk factor of 35% that Treasury guidance at the time suggested should be applied to construction costs in conventionally procured projects.⁶ A more recent study of public building projects commissioned by the Treasury estimated a range for construction cost overruns of between 2 and 24% in standard building projects and between 4 and 51% in those involving non standard buildings.⁷ The extent of these ranges highlights how difficult it is to predict with certainty what the costs for a conventionally procured project might have been.⁸

Figure 1: The effect of risk assumptions on the main components of MOD's PSC

NPV (£ million at 2000 prices) Base costs	Base costs	Risk	Risk as % of base costs
	£ million	£ million	
Capital Expenditure	208.6	61.5	29.5
Capital replacements during contract period	95.2	22.2	23.3
Operating costs	202.4	8.0	4.0
Rent, contribution in lieu of rates, and leasehold risks	133.1	0.0	
Other	-2.5	17.7	
Total	639.9	109.3	17.2
Total PSC (base costs and risk adjustments)			

Source: C&AG's Report (Figure 9, p24)

Figure 2: The financial comparison with different risk adjustments for capital expenditure

Capital cost risk factor	Equivalent PSC cost
35%	£757.7 m
29.5% (MOD's central assumption)	£746.2 m
PFI price	£746.1 m
29%	£745.2 m
25%	£736.9 m
20%	£726.4 m

Source: National Audit Office⁹

⁵ C&AG's Report, para 2.47; Q 76

⁶ Qq 86–87, 124; Ev 22, para 13

⁷ Ev 22, para 13

⁸ C&AG's Report, paras 2.49–2.50; Qq 123–125

⁹ Ev 22, para 13

9. Given these uncertainties in estimating what a project might have cost under conventional procurement, a precisely calculated PSC should not be the main basis for making decisions on value for money. MOD told us that it had to abide by the rules set down by the Treasury that required a PSC using these techniques.¹⁰ We note that the Treasury's guidance specifically warns against the pursuit of spurious precision, and that it describes the PSC as an aid to judgement and not a pass or fail test.¹¹

10. The PSC was used by MOD as a negotiating tool to reduce the deal price by £4 million on the day of financial close. Knowing that the price had become higher than the PSC, MOD told Modus that MOD could not sign the deal unless the price was reduced. Modus did not know how much it needed to reduce its price by in order to offer a price lower than the PSC. MOD had given Modus certain information on base costs but had not disclosed the full PSC including risk adjustments. Modus eventually reduced its bid price to £100,000 below the PSC. MOD would still have signed the deal had the price been above the PSC because of the fixed price and other benefits the deal provided. MOD would be prepared to walk away from a project but would not normally do so on a PFI project once the initial evaluation and approval had been completed. It had only once walked away from a PFI project after it had reached the preferred bidder stage.¹²

11. In all deals there is a risk the price will increase if the deal is not closed quickly once the preferred bidder has been appointed following the bidding competition. In this deal MOD appointed Modus as preferred bidder in January 1999 after Modus had bid a proposed contract price of £647 million. It took MOD 16 months to finalise the contract. By the time the contract was let in May 2000 the deal price had increased by £99 million (15%). This was mainly due to increased financing costs and additional work required to Main Building that was only discovered during detailed surveys undertaken after Modus became preferred bidder. At the time it appointed Modus preferred bidder MOD had been expecting savings of £25 million compared with its PSC estimate of the cost of a conventionally procured project. These savings were not realised. It was only through the final negotiations on the day of closing the deal that MOD avoided the deal price being higher than its PSC.¹³

12. £60 million of the £99 million price increase was due to increases in the cost of financing the project. These were mainly due to interest rate increases and other movements in the financial markets (including a loss of income as an initial assumption that surplus funds could be invested at a profit could not be realised)¹⁴ (Figure 3). These factors caused an increase of close to 50% to the financing costs to £185 million.¹⁵ As is normal in PFI contracts the financing cost risk remained with the public sector. MOD was exposed to this risk during the 16 months it took to close the deal with Modus. The increase in financing costs added 10% to Modus's bid price. Commercial companies often employ hedging strategies when closing such large deals to avoid being exposed to such movements in financial markets. MOD did not hedge against movements in the financing markets as this is not government policy, but had also been advised that it would not have been possible to hedge the financing risk as there was no market in hedging instruments for a deal of this size at the time.¹⁶

¹⁰ Qq 86–87

¹¹ Treasury Task Force Private Finance, Technical Note No 5, *How to construct a Public Sector Comparator*, para 2.2.3 and p 67

¹² C&AG's Report, paras 2.58–2.60; Qq 77–80, 144–145, 160–161 (and footnote), 176–181

¹³ C&AG's Report, paras 2.24, 2.58, Figure 12, p 27; Qq 5–6, 75–79

¹⁴ C&AG's Report, para 2.24; Ev 22, paras 9–12

¹⁵ discounted at the Treasury discount rate of 6% real (Q 109)

¹⁶ Qq 57, 88–96 (and footnote)

Figure 3 Reasons for increase in financing costs

	£m
Increase in long term borrowing rates	27
Assumption that surplus funds could be invested at a profit not realised	25
Other factors (note 1)	<u>8</u>
	60
Note 1 : Other factors includes £2 million in respect of debt funding for additional work, £3 million additional equity costs and £3 million additional costs related to working capital and reserves.	

Source: *National Audit Office*¹⁷

13. MOD was exposed to increases in long term borrowing rates which occurred during the 16 months it took to close the deal. Part of this increase was due to the fact that MOD remained committed to a decision taken five months into this period that the deal should be bank financed. Long term borrowing rates in the bank financing markets then became relatively more expensive compared to those in the bond markets during the remaining eleven months MOD required to close the deal.¹⁸

14. MOD had asked its final bidders to provide two bids, one based on bank finance and one based on bond finance. At this stage, Modus's bond financed solution was expected to be £25 million cheaper than its bank financed solution (mainly due to an assumption that surplus funds from a bond issue could be invested, short term, at a profit). Modus kept the two financing routes open, but was concerned about the high costs of doing so, and in June 1999 pressed MOD for a decision on the method of financing. MOD considered it important to balance the cost of keeping the two options open against the potential benefit of having financing alternatives available. It did not, however, calculate what the costs and benefits might have been of keeping both financing options open.¹⁹

15. Movements in the markets meant that the expected difference in cost terms between bank and bond finance became marginal. Modus proposed that bank finance should be used to finance the deal. MOD considered that, in the absence of a clear cost difference, there were qualitative reasons for choosing bank finance. These included: greater flexibility to cope with any contract variations that would require changes to the financing; lower costs to MOD in the event of an early termination of the contract; concerns about the security issues attached to the disclosure levels of a public bond; and that the underwriters of a bond might not accept Modus being exposed to the same level of penalties for poor performance as could be applied in a bank financed deal.²⁰

16. In the subsequent eleven months up to the deal's financial close the markets moved so that the cost of bond financing became again generally favourable compared to bank financing. MOD stayed with its decision that bank finance should be used, however, as it could not see a clear case for change. It considered the movements in the relative costs of bank and bond finance were volatile, so any cost differential in favour of bond finance could not be certain to exist at financial close. It did not wish to delay the deal by changing

¹⁷ Ev 22, paras 9–12

¹⁸ C&AG's Report, paras 2.31–2.39; Ev 22, para 10

¹⁹ Qq 33–35, 68

²⁰ C&AG's Report, para 2.32; Qq 66–67, 69–70, 74, 88–89

the financing arrangements and it continued to prefer bank finance on qualitative grounds. There is evidence to suggest that when the deal was closed in May 2000 bond finance may well have been cheaper. Based on other bond financed PFI building projects signed around the same time, if a bond had been issued to finance the MOD deal the financing might have been up to £22 million cheaper.²¹

17. Given the fluctuations that can occur in financing rates it makes sense to make a final decision on financing as late as possible. MOD told us that, in the same circumstances, it would in future run a funding competition before closing the deal, like that used in the Treasury Building project. It considered that in 2000 it would, however, have been wrong to trial the use of a funding competition, which had not then been used before, on the large MOD Building deal. Since the financing markets had moved in favour of bond finance, and bond finance had been actively considered by MOD earlier in the procurement, the bond option might usefully have been reassessed before this deal was closed.²²

18. In a bond financed project funds are drawn down from the bond issue at the beginning of the deal and are placed on deposit to earn interest until they are required. Modus's bid assumed that, based on interest rates ruling at that time, monies from a bond issue could be placed on short term deposit at rates that would be higher than the long term interest rate payable to bondholders. In the event this benefit was not realised as short term interest rates decreased and MOD chose bank finance where funds are drawn down as and when required reducing the likelihood of there being surplus monies to place on deposit. These factors accounted for £24 million of the increase in financing costs after Modus became preferred bidder. At the time Modus was appointed preferred bidder MOD estimated that Modus's bid would achieve savings of £25 million compared with MOD's PSC estimate of the cost of conventional procurement. These estimated savings, which are not now expected to arise from the deal, were therefore largely based on the speculative assumption that surplus funds from a bond issue could be invested at a profit.²³

19. On the day of financial close, 4 May 2000, bank rates increased because the market knew that the MOD deal was coming.²⁴ MOD raised all the bank finance for the deal, some £500 million, on the day of financial close. In addition there had been a number of other large PFI projects that came to the market around that time. These factors increased the price that both MOD and other departments were charged for finance at this time. MOD agreed it would have been sensible if the large projects had sought finance at different times. To that end, OGC is now co-ordinating the PFI activities of different departments.²⁵

20. When MOD chose Modus as the preferred bidder in December 1998, bidders had only had access to high level surveys undertaken by MOD into the condition of the building.²⁸ MOD decided to wait until the preferred bidder stage to allow more detailed surveys of the building as it considered these would be unacceptably intrusive on the working environment, and would increase the bid costs if carried out before the selection of preferred bidder. Modem, the other bidder, had already threatened to pull out of the deal due to the cost of bidding. By deferring the detailed survey work until the preferred bidder stage, MOD was, however, exposing itself to the risk that further work would be required as a result of the surveys, which would be priced without competitive tension.²⁶

²¹ C&AG's Report, paras 2.40, 2.42, 2.44. The possible savings are based on the bonds used to finance the GCHQ and Treasury Building deals in June and May 2000 respectively.

²² Qq 9, 27–32

²³ Ev 22; para 11; Q 126

²⁴ C&AG's Report, para 2.39

²⁵ C&AG's Report, Figure 8, p 22; Qq 19–23, 44, 122

²⁶ Qq 126, 166

21. In the event, the detailed survey programme revealed that the building was in a worse condition than Modus had assumed in its bid. The detailed surveys identified problems with the water supply system, the quality of the roof and asbestos in the building. Modus asked for an additional £60 million to cover additional work to deal with these problems. To counter the lack of competitive tension in the pricing of this additional work MOD used its advisers, Bernard Williams Associates, to cost each element of the additional work. MOD then negotiated with Modus and reduced the price increase Modus was seeking from £60 million to £37 million. MOD considered the £37 million price increase for the additional work was fair. Nevertheless, if MOD had arranged these detailed surveys during the final bidding round the work would have been priced competitively and the period during which it was exposed to variations in financing costs would have been reduced.²⁷

22. As the deal is funded by bank finance, there is the possibility that it will be refinanced at some time in the future. As our predecessors found, refinancing can significantly increase the contractors' returns from a PFI project.²⁸ MOD does not have a specific contractual right in this deal to share any gain that might arise from a refinancing. However, Modus agreed with MOD that if Modus wanted to change its financing arrangements to effect a refinancing it would have to seek MOD's approval, thus enabling MOD to negotiate a share of the refinancing gains.

THE COMPARATIVE COSTS OF FINANCE

23. The financing costs are a key element within the pricing of a PFI deal. The rewards for those providing finance, as reflected in the finance costs, should be commensurate with the risks which have borne and successfully managed by the financiers. Information on the comparative financing costs of PFI deals and conventional procurement is, therefore, fundamental to assessing the comparative value for money of these alternative procurement approaches. The financing costs of this PFI deal were £185 million,²⁹ representing 25% of the contract price of £746 million.

24. It was not clear what the cost of funding would have been for a similar project using public finance. If the project had been financed under conventional procurement the Treasury would have provided funds raised at the Government borrowing rate, which is effectively a risk free rate since the lenders know that their money will be repaid. The methodology which the Treasury prescribes for a public sector comparator does not explicitly identify what the public sector borrowing costs would have been. The National Audit Office subsequently estimated that £100 million was a reasonable indication of the additional cost of using private sector finance for this project. This represents the cost associated with transferring risk to the private sector. The calculation assumes the cost of public borrowing would have been 6%. By comparison, Modus has entered into arrangements which fix the interest rates on their bank loans between 7.6 and 8.1% for either 25 or 27 years. In addition, when the deal was closed, Modus was forecasting that the rate of return for its equity investors would be about 20%. Modus told us this rate of return to equity investors was normal for deals concluded at that time.³⁰

25. Whatever the benefits may be of using the PFI approach, it certainly brings the disbenefits of a higher cost of finance than in conventional public projects. There is an important issue as to whether the benefits of the PFI approach could have been obtained using cheaper public finance. Modus said that, if one could maintain the disciplines that

²⁷ C&AG's Report, para 2.2.5; Qq 167–175

²⁸ 13th Report from the Committee of Public Accounts, *The refinancing of the Fazakerley PFI prison contract* (HC 995-I, Session 1999–2000)

²⁹ Q 109 (footnote). The finance costs are calculated relative to the Treasury discount rate of 6% in real terms when the deal was closed.

³⁰ C&AG's Report, Figure 8, p 22; Ev 21–22, paras 1–8; Qq 104–119, 137–138. The forecast rate of return to Modus's equity investors of 17.6% in real terms reflects their forecast returns on equity and subordinated debt taken together.

are generated through the PFI process, then where the finance comes from would not make a difference to contractors.

26. Simply substituting public finance for private finance might not get round the problem. Modus, for example, thought that separating the capital and ownership from the rest of the project might weaken the links with risk and reward. MOD doubted too that a contract could be devised which transferred the building risks to the contractor in the same way as a PFI deal, but with financing risks being borne in a different way. In the MOD Building deal, MOD considered there was risk transfer as the bank loans are not guaranteed by the Government. The Treasury told us that this risk transfer explains why the market charges Modus a higher rate for loans than it charges the Government. The Treasury would not permit the Government to lend money to private sector firms at the same rate as the Government was able to borrow, since there would be risks that the money would not be repaid if the contractor encountered difficulties.

27. Nevertheless, there is room for doubt as to the extent of real project risk borne by the banks or bondholders who currently finance PFI projects, and there is evidence that even where risks are low external financiers charge a premium for project-specific lending as opposed to general government borrowing. These considerations suggest that it would be worth exploring the scope for improving the established financing model for these deals.³¹

28. Further, the potential advantages of the PFI approach are said to depend on better risk allocation than conventional projects, better project management, encouragement for innovation and the use of output specifications. There seems no logical reason why these features should depend absolutely on the involvement of private sector financiers, particularly when those financiers are not themselves exposed to the risks of the projects they finance.

THE RISKS OF BEING LOCKED INTO A LONG-TERM PFI CONTRACT

29. The PFI deal that MOD has entered into is for 30 years. Modus must redevelop Main Building and provide maintenance and facilities management services at Main Building and the Old War Office until May 2030.³² MOD is tied to Modus for this period unless the quality of service provided by Modus is so poor that MOD would be permitted to terminate the contract. Departments face potential risks from such long term arrangements: the contract might not be sufficiently flexible to allow changes to the department's requirements to be accommodated; where changes are made it might be difficult in the absence of competition to demonstrate that the changes are value for money; or the contractor may perform to below the standard required by the department but not significantly enough to allow the department to terminate the contract.

30. MOD considers there are benefits from the long term deal it has entered into which offset the potential risks of a long term arrangement:

- Price certainty

The contract defines the annual unitary charge payable by MOD to Modus. MOD expects this to provide greater price certainty throughout the 30-year contract period than would be possible under alternative arrangements.³³

- The contract allows flexibility for MOD to reduce staff numbers in Main Building

³¹ Qq 186–203, 208–211

³² C&AG's Report, para 3

³³ Q 2

If MOD chooses to vacate a whole floor of Main Building its payments to Modus will be reduced. Modus may then sub-let the vacant floor but for security reasons MOD can veto incoming tenants. MOD sees its ability to vacate floors and to thereby reduce its payments any time during the 30-year contract as an important benefit. It is currently planning to reduce its Head Office staff numbers to 4,300 (Figure 4) but does not consider this to be a fixed figure. Although it does not expect to be able to leave London completely it will continue to bear down on Head Office costs. It therefore believes that it needs downwards flexibility in its accommodation requirements and has secured this in this contract.³⁴

- Payments linked to services in the long term

MOD's payments to Modus will be linked to the delivery of services at specified qualities and Modus is required by the contract to provide the same level of service in the final years of the 30-year contract as in the early years. Modus is also responsible for the design, build, maintenance, and operation of Main Building, and MOD expects both factors to incentivise Modus to provide high quality infrastructure throughout the 30-year period. If the building were not satisfactory Modus would have to rectify the problem and might face penalty charges.³⁵

Figure 4: Planned changes to MOD Head Office staff numbers in London

	1 April 1999	By 30 Nov 2004	% Change
Main Building	2,623	3,300	+26%
Other buildings (6 at 1 April 1999; 1—Old War Office—by 30 November 2004)	<u>3,397</u>	<u>1,000</u>	<u>-71%</u>
	<u>6,020</u>	<u>4,300</u>	-29%

Source: *Ministry of Defence*

31. Despite MOD's plans to reduce staff numbers it identified in April 2000, a month before the contract was signed, that a further 500 non Head Office staff needed to remain in London and would need accommodation after 2002. In January 2001 MOD approved a separate contract for the refurbishment of St. George's Court to accommodate these staff. MOD considers it will be cheaper to use St George's Court than to accommodate the extra staff in Main Building, as that would have required additional work with too much risk and cost. For security reasons MOD also values having an additional central London building available separate from Main Building.³⁶

32. Modus will provide IT infrastructure in the redeveloped Main Building, whilst MOD will provide the IT systems. MOD decided to exclude IT systems from the deal as its systems requirements evolve continually and could not be predetermined in the same way as its space requirement. It did not know what configuration it would require in 2004 on reoccupation of Main Building. The configuration would need to be linked to MOD's defence information infrastructure which is being developed separately. In the short term,

³⁴ C&AG's Report, para 1.16; Qq 4, 129, 133–137, 151–157, 204–207

³⁵ Q 2

³⁶ C&AG's Report, paras 1.21–1.22; Qq 4, 41–43, 130, 135, 212–213

MOD has contracted with third party suppliers for the relocation of systems to the decant buildings being used whilst Main Building is being redeveloped. When developing the PFI deal MOD had not known how many systems would need to be moved. There were around 200 different systems which were owned by various MOD agencies. Some had become time expired and MOD did not know if they would need to be replaced. In the event only 90 systems had to be moved into the decant buildings.

33. MOD did not consider that committing itself to deals which ran for 30 years would constrain its ability to be flexible in managing the defence budget in future. Commitments involving £2 billion of private finance had been entered into with a further £12 billion of private finance commitments being considered. If all these projects went forward, 8% of the defence budget would be committed to private finance arrangements. MOD considers the PFI arrangements it has entered into represent best value for money for delivering the services it needs to run the Armed Forces world wide and to execute defence policy.³⁷

³⁷ Qq 13–14, 81–83

MINUTES OF PROCEEDINGS OF
THE COMMITTEE OF PUBLIC ACCOUNTS

SESSION 2001–02

WEDNESDAY 26 JUNE 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr George Osborne
Mr Ian Davidson	Mr David Rendel
Geraint Davies	Mr Gerry Steinberg
Mr George Howarth	Jon Trickett
Mr Brian Jenkins	Mr Alan Williams
Ms Ruth Kelly	

Sir John Bourn KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

Mr Brian Glicksman, Treasury Officer of Accounts, was further examined.

The Comptroller and Auditor General's Report on Private Finance Initiative: Redevelopment of MOD Main Building (HC 748), was considered.

Sir Kevin Tebbit KCB, CMG, Permanent Under-Secretary of State, Ministry of Defence, was further examined; Mr Jonathan Hoyle, Director, Main Building Development, Ministry of Defence, was examined; Mr Matthew Webber, Chairman, and Mr Les Mitchell, Managing Director, Modus Services plc were examined; and Mr Jeremy Colman, Assistant Auditor General, National Audit Office, was further examined (HC 1013-i).

A division of the House being called, the Chairman suspended the meeting for ten minutes.

The Committee resumed.

The witnesses were further examined.

The witnesses withdrew.

The Committee further deliberated.

* * * * *

[Adjourned until Monday 1 July at Four o'clock.

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SESSION 2002–03

WEDNESDAY 15 JANUARY 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
 Mr Ian Davidson
 Angela Eagle
 Mr Frank Field
 Mr Nick Gibb
 Mr Brian Jenkins

Mr David Rendel
 Mr Gerry Steinberg
 Jon Trickett
 Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

Mr Rob Molan, Second Treasury Officer of Accounts, was further examined.

* * * * *

Draft Report (Private Finance Initiative: Redevelopment of MOD Main Building), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 3 read and agreed to.

Paragraph 4 postponed.

Paragraphs 5 to 33 read and agreed to.

Postponed paragraph 4 again read and agreed to.

Resolved, That the Report be the Fourth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order 134 (Select Committees (Reports)) be applied to the Report.

The Committee further deliberated.

* * * * *

[Adjourned until Monday 20 January 2003 at Four o'clock.]

MINUTES OF EVIDENCE

TAKEN BEFORE THE COMMITTEE OF PUBLIC ACCOUNTS

WEDNESDAY 26 JUNE 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Ian Davidson
Geraint Davies
Mr George Howarth
Mr Brian Jenkins
Mr Nigel Jones

Ruth Kelly
Mr George Osborne
Mr David Rendel
Mr Gerry Steinberg
Jon Trickett
Mr Alan Williams

SIR JOHN BOURN KCB, Comptroller and Auditor General and MR JEREMY COLMAN, Assistant Auditor General, National Audit Office, further examined.

MR BRIAN GLICKSMAN, Treasury Officer of Accounts, HM Treasury, further examined

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL: Ministry of Defence: Redevelopment of MOD Main Building (HC 748)

Examination of witnesses

SIR KEVIN TEBBIT KCB, CMG, Permanent Under-Secretary of State and MR JONATHAN HOYLE, Director, Main Building Redevelopment, Ministry of Defence, MR MATTHEW WEBBER, Chairman and MR LES MITCHELL, Managing Director, Modus Services plc, examined.

Chairman

1. Order, order, Welcome to the Committee of Public Accounts. Today we are looking at the redevelopment of MOD Main Building. We are delighted to welcome Sir Kevin Tebbit who is the Permanent Under-Secretary of State at the Ministry of Defence. We also welcome Mr Matthew Webber who is Chairman of Modus Services Limited. Do you want to introduce your colleague?

(Sir Kevin Tebbit) On my right is the Project Director, Jonathan Hoyle; Matthew Webber the Chairman and Les Mitchell the Managing Director of Modus as well.

2. May I start with you, Sir Kevin? We have a PFI contract here which is committing you to these arrangements with Modus for 30 years. What are the benefits which outweigh tying MOD to Modus for such a very long period?

(Sir Kevin Tebbit) As you have seen from the Report, the actual cost of going with a PFI partner as distinct from conventional procurement is about the same. The benefits are in other areas to which we attach a great deal of importance. The first is that we get greater price certainty throughout the period than would otherwise be the case. Second, the way in which the PFI contract is designed, means that there is a huge incentive on the contractor to complete on time. The penalties if he does not are very severe. Third, the payments under the contract are linked to delivering services at specified qualities based in terms of outputs of what we need and that covers the whole of the contract period. In other words, at year 29 and year 30 he is still having to deliver the same quality services to us as he is in year one. That is

actually quite important these days. As you know, many of our problems across Government now are the result of disinvestment in infrastructure and across the whole of the public estate we have clapped out systems which now require huge investment. This sort of thing sustains a constant level of investment throughout the project life. Finally, by putting the design, the build, the maintenance and the operation of the project under one contractor, we ensure that he is going to take a rigorous approach to the whole life of the project. In other words, he is going to want to put in high quality infrastructure, cabling, water, heating, because if he does not, he is the one who has to pay the price when it goes wrong. He has to rectify it and he may have to pay penalty charges. It is those broader considerations about price certainty, about timely completion and about quality which are really the ones which are driving us.

3. As you said, the costs compared with a conventional deal are very similar. You mentioned other benefits, but is it beyond the capability of your Department to deliver these other benefits without resorting to a PFI deal?

(Sir Kevin Tebbit) It is a matter of choice. It is a judgement. Most of the accommodation and building activities which are involved here are not core business for the Ministry of Defence, that is not what we do. They are core business for these people and therefore one goes to where it is most appropriately provided. It is not that we could not do this, it is a matter of choosing not to for the benefits which are here. There is no question that we had to do something because the present situation is simply untenable; we could not have stayed where we are. The Health and Safety inspectors would not give us

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Chairman Cont]

certification unless we guaranteed that we were doing these changes one way or the other. We judged that on balance this was a better way of doing it than by conventional procurement.

4. Let us examine some of these aspects of losing some flexibility. We already know from paragraphs 1.21 and 1.22 that there were non-Head Office staff for whom additional accommodation in central London had to be found. That just shows some of the dangers of tying yourself in for a long period in advance. Do you think you would have achieved better value for money if you had included this requirement in the Main Building PFI deal?

(*Sir Kevin Tebbit*) May I just comment on this flexibility point? The way the contract is drawn up does give us a lot of flexibility, flexibility to vary our numbers through the life of the contract. If we want less space as we go through, we can do that and the contract makes provision for that to happen and other tenants to come in and take over space. Flexibility is built into the arrangements. On the specific matter of the non-Head Office staff but nevertheless staff we need in London, we did look at whether it would be sensible to put them into the Main Building redevelopment, but judged that the number of changes which would have been necessary to the work, filling in the centre spaces or taking down walls and widening the building, would have just put too much risk and cost on the project. The solution we took was again taken on value for money grounds. It is a good deal to take the building we have taken in St Giles Court. If it were not value for money, we would not be doing that.

5. May I turn to the cost? You have agreed, and this is all set out in table 1 on page 7, that the cost is very similar to conventional procurement. I know that cost is not the only consideration; you mentioned other considerations. Can you tell us a bit more about why you were not able to generate any financial savings against the likely cost of conventional procurement?

(*Sir Kevin Tebbit*) We originally expected to be generating savings but in the latter stages of the project, the costs increased to bring them in at around the level of the public sector comparator. That is just how it came out. It would have been nice to have had slightly larger savings there, but in fact we were satisfied that this was the real cost of the project.

6. I am glad my colleague Mr Williams has come in, because I suspect this might be a question which would interest him. Here we have a public sector comparator of £746.2 million. You have a PFI deal of £746.1 million. That is very close, is it not? What you came out with at the end in your PFI deal was extraordinarily close to what is a public sector comparator. Some might think this was a fix.

(*Sir Kevin Tebbit*) I am sure you would not think that. I am sure this august Committee would not think that. The closeness is a virtue not a sin. I shall now illustrate, particularly for Mr Williams's benefit, why I say that. It came out a little higher and in order to negotiate as toughly as we could our negotiators said they wanted money off this price so that it was at least down to the public sector comparator and they shaved £4 million with tears running down the cheeks

of my colleagues on the left here in the final knockings. This was as a result of tough negotiation by the Ministry of Defence, which, as you know, is a tough negotiator in the market, rather than some accidental precision at £742 million. It is quite clear that the costs were greater than we had hoped, partly because of the state of the building which they found, which only underlines the importance of doing this work—when the more detailed surveys were done it required an awful lot more doing to it than we had hoped—and partly because of interest rate movements and the cost of raising capital in the markets which is one of these things; they can go up, they can go down. Unfortunately they were on a slightly rising trend.

7. I suspect that one of the reasons why you want to do this PFI deal is that you were hoping to save £100 million. It was not to be. We know from paragraph 2.24 that it took 16 months to close the deal from selection of preferred bidder during which the price increased by £99 million. What lessons have you drawn from this experience?

(*Sir Kevin Tebbit*) We were not hoping to save £100 million; it was not to be. We were hoping to ensure that we got the best value for money in a project which needed to happen and we believe that we still have that. That basically is the story of this Report. It would have been nice to have got a lower price, but there we are, this is the economic cost and we had it carefully validated and benchmarked by independent authorities to make sure that was true.

8. Let us leave that and let us go on to the price increasing by £99 million in the last 16 months. What lessons have you drawn from this experience?

(*Sir Kevin Tebbit*) It would be nice to say that you could do it in a shorter period than 16 months and that the time between best and final offers and finally closing the contract could have been reduced. I wondered at the time myself whether we could have done it faster and I wanted to push the negotiators. They always said to me that they could get it done now but they would pay more for it and that I should leave them to negotiate because it was going to be a 30-year deal rather than something which should happen fast before they had it fully thought through. I am satisfied more or less that 16 months was needed. One looks at some of these easier projects in the sense that they are template projects e.g. for hospital buildings. I noted that they take about a year. This was a one-off very complex project with three separate elements to it, so I do not think 16 months was unreasonable.

9. Let us look at what happened during that 16-month period. The deal was bank financed at a time when the Treasury building redevelopment, which we all visited last week and were very impressed by, and the new GCHQ were bond financed. We also note in paragraph 2.42 of the Report that bond financing might have saved you up to £22 million. Why was your approach to financing different to the Treasury and to GCHQ?

(*Sir Kevin Tebbit*) You are right in saying that it might have done; the Report says that is highly speculative. The GCHQ deal was later than ours; it came a month later. At the time we were operating, in June and July 1999, the largest bond which had been

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Chairman Cont]

floated was just over £100 million. Ours was £550 million, a very big loan indeed, bigger than the Treasury's £125 million, bigger than GCHQ's eventually which was £407 million. The view taken by our advisers was that there are diseconomies in very, very large bonds and that this was a better way to go. The other deals were also less complex. This one was first to operate the existing buildings, organise a decant of staff, then operate a new set of buildings; not a greenfield site project, therefore more risks associated with what was actually on there. A different contract period from the others, greater value here and higher risk. The judgement we took on the basis of the best advice we could have at the time was that this was the better way to go. There was also a feeling that bank finance gave us a bit more flexibility, a bit more control over some of the aspects of the project than would otherwise be the case. At the time we were all satisfied that it was the right decision to take.

10. What steps are you taking to ensure that you can share in refinancing benefits which may arise in the future?

(*Sir Kevin Tebbit*) We have clauses in the contract. There is a 15-year value for money review.

11. I should remind you that paragraph 1.32c says that the MOD does not have a specific contractual right to share refinancing gains.

(*Sir Kevin Tebbit*) I do not dispute that. We did not have a refinancing clause in there at the time. At the time of the deal, it was not the policy to have refinancing clauses in. What I am saying is that we have alternative means in the contract. One is the value for money review at the 15-year point, which could involve anything, including refinancing. The other one is that if the company wants to seek refinancing, we effectively have the right then to set conditions which include a share in the refinancing if there is a benefit.

12. Is that right, Mr Webber? If Modus want to refinance the project, can MOD share these benefits?

(*Mr Webber*) Yes, is the short answer. If we sought to replace the existing debt with more debt, because of certain clauses in the agreement, I am sure we would have to come to the Ministry of Defence and ask for their approval to changes in the contract. As seems to be the practice in other PFI projects at present, that would give us an opportunity to renegotiate that part of the transaction.

13. This Committee has often in the past expressed concern about refinancing. So you have this commitment to contracted expenditure for 30 years. You have an increasing number of these sorts of commitments. Will that constrain your ability to be flexible in managing the defence budget in future?

(*Sir Kevin Tebbit*) No, Chairman. At the moment we have about 43 PFI projects in defence with a value of about £2 billion of finance brought in. The servicing of that represents about 3% of our budget. Coming down the pipe are a similar number of projects which would add about £12 billion capital coming in, if they all happened. That would bring us up to about 8%. We are not at a silting up point.

14. We would not be in a position where you are in hock for 30 years and you cannot afford the ships and soldiers you need because you are paying for offices? Would you say that was an over-simplistic question?

(*Sir Kevin Tebbit*) I would not quite put it as being in hock either. I come back to the fundamental point: this represents best value for money for delivering the services we need to run the Armed Forces worldwide and to run defence policy.

15. Before I hand over, I should like to welcome the Financial Secretary to the Treasury to our proceedings, she is of course a member of this Committee, but I do not think she wants to ask any questions. She is here as a courtesy visit.

(*Sir Kevin Tebbit*) We are a supporter of her policies.

Chairman: She has other duties to attend to in the Treasury, so she will be having to leave us, but I do welcome you to the Committee. Thank you very much for coming.

Mr Rendel

16. You told us just now that the MOD is a very tough negotiator and as a result of this you managed to reduce the price by £4 million on the day of the contract by pointing out that otherwise the contract would not come in below the public service comparator. If you are such a good negotiator why had you not been able to bring down the price by £4 million even before then?

(*Sir Kevin Tebbit*) I did not personally negotiate it, but I think one would say that the pressure of the negotiation was at its greatest in that last day, as negotiating pressures usually are. We were not exactly up against a deadline but we made it clear that we were expected to come out of that with a solution.

17. Why did you not demand a greater reduction? They seem to have been perfectly happy to give you £4 million on the spot.

(*Sir Kevin Tebbit*) I think you will find that assumption unfounded. They were not happy to give us that £4 million; they are still talking about it today.

18. Are you convinced that £4 million was an absolute maximum you could get out of them at that time?

(*Sir Kevin Tebbit*) Yes, in that area of the negotiation. Of course there was a lot more in the negotiation than just that. There were all the various other conditions affecting performance, for example. In terms of the cash, I am satisfied our people got the maximum they could at that point.

19. My understanding is that the increase at the last moment was due to an increase in rates, not least because everybody knew that a big deal was about to be done, so the rates went up.

(*Sir Kevin Tebbit*) Yes.

20. What would have happened if rates had gone up at such a rate that you had gone £6 million over the public sector comparator? Would you have dropped the deal on the grounds that the public sector comparator was then better and if you could only get £4 million out of them it would still have been £2 million above the public sector comparator?

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Rendel Cont]

(*Sir Kevin Tebbit*) I cannot be that precise, but you are quite right, the on-the-spot rates were moving during that day and we were not the only Department which got caught by that increasing price. A number of other PFI deals got caught at the same time. Placing £0.5 billion of loan in the market does have that effect unfortunately.

21. So you are telling us that the Government decided to put a whole lot of contracts out to the market on the same day, in spite of the fact that this was likely to raise rates and therefore raise the price for the Government. Was that not a bit daft?

(*Sir Kevin Tebbit*) It was not actually the same day; another one came shortly after.

22. I am sorry, I thought you said the same day.

(*Sir Kevin Tebbit*) Around the same time. The trouble is that the markets are aware of what is happening within a week or two's timescale.

23. Even that is a bit daft, is it not? If the Government are going to put out these huge contracts and they are going to make a difference to market rates, you would think they had the sense to put them out at different times, so you do not suddenly have a huge amount of debt coming onto the market which was going to affect rates rather more?

(*Sir Kevin Tebbit*) That is a pretty sensible conclusion. This was the biggest loan that we had sought to raise in PFI. It was a pathfinder project. The one which came afterwards was a hospital. There are other considerations about when one needs to go to the market; that is not the only factor.

24. If on the day you discover that you are, for reasons of rates changing or whatever else, above the public sector comparator, do you then decide that you will not go ahead? Are you that tied by the public sector comparator that you cannot go ahead even if you are above it?

(*Sir Kevin Tebbit*) No, not at all, it is within a broad band. The public sector comparator has a wide range of about £100 million. There is no absolute magic about this, no. We used that figure in order to negotiate down the price. It was not otherwise absolutely critical.

25. So you were fooling them in saying that you had to get it down below the public sector comparator otherwise you would not go ahead.

(*Sir Kevin Tebbit*) It was a tactical point.

26. I congratulate you on fooling them because you got the price down.

(*Sir Kevin Tebbit*) It was a tactical point.

27. With the Treasury building we were told there was some sort of a funding competition to get the best way of funding the deal. Why did that not happen with this building?

(*Mr Hoyle*) The Treasury was the first project to run a funding competition and in fact they were trialing it with their project and we were running slightly ahead of them in terms of when we were going to sign the contract. It had never been done before. It would have been wrong to run a project with a £550 million placement as a trial of a funding competition. If we were starting now, we would learn the lessons from the Treasury and go down that route.

28. I am sorry, why was it the wrong project to start on?

(*Mr Hoyle*) Because it was just so big in comparison with the Treasury; the amount of money to be raised was about four times more.

29. So there was that much more to save than the Treasury.

(*Sir Kevin Tebbit*) The advice we had at the time in connection with the Treasury competition was that something of our size would bring diseconomies if we tried to do it by the same method and have that sort of competition. Theirs was £125 million: ours was £550 million. A much greater risk associated with a flotation of that size.

30. I am sorry, I do not quite understand. Are you saying that there would be a greater risk of running a competition than not running a competition? Are you saying that you would risk having to spend more by running a competition?

(*Sir Kevin Tebbit*) The advice we had was that it was much more sensible to go for a bank finance rather than a bond finance or a competition on bonds because the size of the financing for our project was so large that there would be diseconomies of scale if we tried to go for a bond.

31. That decision was what made all the difference to whether or not you would go for a competition. Had you gone the other way and gone for a bond you might have gone for a competition.

(*Sir Kevin Tebbit*) No, that was not why we did not go for a competition. We did not go for a competition because it was such a big flotation that the judgement was that this was not the right sort of size of thing to do as the experiment, whereas the Treasury was much smaller and therefore more susceptible to trialing.

32. I am not quite sure I understand the logic behind not trialing it just because it is big when you have greater potential savings when it is big. I can see you see some logic in it. If the difference between bank and bond financing is so marginal, do you always have to take a decision long before the moment of truth as you are signing the contract or can you go forward with the two potential methods of financing the deal and choose when you know which is better on the day?

(*Sir Kevin Tebbit*) We do use bond now rather more regularly as these things are becoming more normal. The choice between them varies according to project and varies according to market condition. There is no absolute rule as to whether to go for one or the other.

33. That was not the question I asked. What I asked was: do you leave it until the actual day to make that decision when you know which is going to be the cheaper?

(*Sir Kevin Tebbit*) You have to offset against that the extra cost of running two plans in parallel because you have to do the legal and the due diligence work for both and therefore there would always be a trade-off between those if you were trying to do it like that. I am not sure, I cannot say, whether the cost of running two routes together with the due diligence

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Rendel Cont]

associated with both would outweigh whatever benefit there was between bank or bond but that is the calculation one has to make.

34. In future you would always make that calculation.

(*Sir Kevin Tebbit*) We often do; I cannot say we always do.

35. Did you make it in this case?

(*Sir Kevin Tebbit*) No, I do not think we did. We knew that it would be very expensive to do due diligence for both routes and it was quite clear that those who would put the money up wanted clarity as to what we were intending to do. In this case it would have been very expensive to have tried to do both.

(*Mr Hoyle*) The risk of raising the finance actually rested with Modus. So strictly it was their decision as to whether at that time under policy we went bank or bond. They came to us with a recommended solution which we examined and decided in June 1999 that we would prefer bank for a number of reasons. To have gone beyond that point running both meant there was a strong chance that the bond arrangers would have walked away anyway because of the expense to them of employing lawyers to do the due diligence on the contract and technical due diligence on the project which would have cost them substantial sums of money unless we had been willing to recompense them.

36. My understanding is that in the end the bond probably would have been rather cheaper on the day as it turned out. Have you done any calculation of whether you could have saved money if you had gone through the necessary legal processes to make it possible still to go for a bond on the last day?

(*Sir Kevin Tebbit*) At the time of the decision it was the right choice. I do not know whether we did any subsequent calculations.

(*Mr Hoyle*) We have looked at what might have been, the hypothetical scenario. We think the saving, if we had managed to maintain the same terms and conditions we had achieved with banks, if we had managed to transfer those conditions to the bond arrangement, would have been a few million pounds. The NAO Report refers to the hypothetical scenario that if we had had the GCHQ terms and conditions the saving would have been of the order of £22 million. But that is a greenfield site with a different risk profile.

37. Turning now to paragraph 6, whose last sentence is, "In addition, there will be significant unquantified benefits to working efficiency arising from the improved accommodation", how do you judge a project if you have no idea of how great the benefits are going to be?

(*Sir Kevin Tebbit*) These were not benefits which we sought to bring into the value for money equation. They were just general efficiency benefits from co-locating staff in one building rather than more and working in more open plan environments for team working and shortening the distances between working areas and lifts and that sort of thing. We never attempted to put a financial value on that because it is a very soft concept. Nevertheless, I am very satisfied that we are going to have much more efficient use of the new building. We did not try

to capture it financially because it would have been impossible to justify any particular figure we put on it.

38. Let me turn to paragraph 1.26 where the sentence at the bottom of page 13 reads, "In addition, MOD did not transfer IT risk to Modus for the decant buildings as it did not know when procuring the contract how many different systems were extant". I do not know whether I have misunderstood this, but that seems to say that the MOD did not know how many computer systems it had. Is that right?

(*Sir Kevin Tebbit*) No. We have all the IT trunking and cabling up to the desks, as it were. What we have not done is decided precisely what type of system goes on the desktop, the hardware, the software. That is because that will need to be linked to our overall defence information infrastructure which we are developing separately. At the time the contract was crystallised, we had not got a clear enough view of that and with technology moving so quickly, we did not want to capture it at that stage. So we carried on doing that separately.

39. The IT systems you did not know were around, were future IT systems. Is that what you are saying? Or you did not know how many systems you had at that time.

(*Mr Hoyle*) At the time we were putting together the specification there were of the order of 200 systems in the Ministry of Defence headquarters. If we had specified that number to be moved, we would have lost money because in the end we actually only had to move 90 systems into the decant buildings because some became redundant.

40. Why did you not try to find out how many systems you had which would need to move?

(*Mr Hoyle*) They are owned by various agencies within the Department. Some of them are stand-alone system, some of them are wide area networks, some of them just became time expired and we did not know whether they would need to be replaced. We were looking at this in 1996–97 and with the way IT systems move forward, with technological change, it would have been a guess in the dark as to how many systems we would need to move in 2004.

41. I want to couple this with paragraph 1.21, where we are told "... a month before the contract was signed, MOD ... identified that there were up to 1,000 non-Head Office staff who should remain in London. Some of those, however, would have had no accommodation after 2002" had there not been some change to the plan. It does strike me that you were going ahead with this major project, without knowing exactly what IT you had, without knowing exactly what staff you had. There seems to be a dangerous lack of information on which to base a major project.

(*Sir Kevin Tebbit*) We knew what IT we had. The point was that we did not know precisely what IT configuration we would require in 2004.

42. But you could have discovered before going ahead.

(*Sir Kevin Tebbit*) No, we could not; not in 1997–98. We could not have predicted at that point the IT configuration which would be best for the

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Rendel Cont]

Department in 2004 so we decided not to incorporate that element. We are doing that separately as part of a wider defence information infrastructure because Head Office needs to be linked to all its operating agencies and budget areas. As far as staff numbers are concerned, the Report implies that we suddenly discovered these 1,000 people. They were always there. These were not Head Office people.

43. This is an agreed report and therefore presumably it is true, you accepted that you suddenly discovered the 1,000.

(*Sir Kevin Tebbit*) The word is not "discovered". These were not Head Office staff, these were staff where we decided at that point that we would keep them in London because that is the best place for them although they are not Head Office. It is mainly the Defence Export Services Organisation. It became cost effective to take St Giles Court, a third building on a different basis than before and cheaper than trying to build it into the Main Building contract.

44. Given what you have said about the number of Government contracts going ahead at the same time, what are you going to do in future to make sure there are not a large number of Government contracts going ahead more or less at the same date and therefore raising rates unnecessarily at the last moment?

(*Sir Kevin Tebbit*) That is not for me exactly. It is helpful that we now have an Office of Government Commerce that Peter Gershon is running which does co-ordinate the various activities which different Departments are engaged in, which helps a lot. I do have to come back to the point that the Project Director mentioned. At the end of the day, it is the contractor who is borrowing the money, not us, the PFI partner. This is also something which has to be borne in mind with them. The Office of Government Commerce does help in this area now.

Mr Howarth

45. Towards the end of paragraph 2.13 on page 18 it says, referring to advisers, "MOD reimbursed costs up to the phase cap, on the basis of pre-agreed hourly rates and actual verified hours worked, but subject to a 10% retention until the delivery of approved deliverables for each phase". What is that 10% of?

(*Sir Kevin Tebbit*) 10% of £6.82 million.

(*Mr Hoyle*) Split phase 1 and phase 2.

46. What I am trying to discover is, as all these fees went up during the course of the project, certainly in phase 1, whether it is 10% of the original sum or 10% of the amount it went up by.

(*Sir Kevin Tebbit*) I assumed it was 10% of the total cost but I shall have to check that for you.¹

47. On the subject of advisers there are two large advisers and then various sub-contractors, as stated in Table 6, first of all PricewaterhouseCoopers who

took £6.82 million and Herbert Smith, which as I understand it is entirely legal costs. What exactly is the function of PricewaterhouseCoopers?

(*Sir Kevin Tebbit*) Mainly financial advice in putting the project together with Herbert Smith doing the legal side of things.

48. Do they have any ongoing involvement?

(*Sir Kevin Tebbit*) Yes, they still do.

49. What is that?

(*Sir Kevin Tebbit*) There are still technical aspects which they are advising on.

50. Could you be a bit more specific about what those technical aspects they are still advising on are?

(*Sir Kevin Tebbit*) They are advising us, but I will ask the Project Director.

(*Mr Hoyle*) The contract has a range of completion tests through the course of each phase which the contractor has to achieve, many of which are engineering and quite technical as you would expect in a building. PricewaterhouseCoopers co-ordinate that technical advice to us from the advisers listed in table 6 through a construction engineer to make sure we are getting what we set out in the contract.

51. Let me get this clear in my own mind. If there is a technical problem with the project, and it needs advice on what the most appropriate solution is, PricewaterhouseCoopers will go out and, through these various sub-contractors, put together a piece of advice as to the best solution to the problem.

(*Mr Hoyle*) We would not wish to advise the contractor what the best solution to the problem was because then we would be taking the risk from the contractor. What they would do is advise me that what the contractor was proposing would probably not do the job come 2004 when we move back into the building.

52. This is the point I am trying to understand better. What is the relationship then between yourselves as the project manager and PricewaterhouseCoopers and the contractor? How do you manage that?

(*Mr Hoyle*) PWC are my advisers on technical aspects of the project to me direct. They have no direct relationship with Modus and their contractors.

53. To come back to the example I was using, if there were a problem, where do they fit into it?

(*Mr Hoyle*) They advise me that there could be a problem. I take it up with the contractor.

54. They are very much removed from the day to day conduct of the contract.

(*Mr Hoyle*) Yes.

55. It is said that two things are certain in this life, taxes and death and you can perhaps add a third to that: consultants of one description or another always cost more than the original estimate. I think that is probably an iron law, certainly in my limited experience. I know the NAO Report has a positive heading, "MOD appointed its advisers through a competitive process and controlled their costs", but in practical terms how did you do that? Do you accept that costs are bound to escalate because that is an iron law of consultancy, or do you try to keep them to the original sums?

¹ Note by witness: I can confirm that the 10% retention relates to the fees for PricewaterhouseCoopers (£6.82 million) for each phase of the Project. This was retained by the MOD until each phase was completed to the Department's satisfaction.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Howarth Cont]

(*Sir Kevin Tebbit*) We do keep a close eye on it. We can check the way in which we are being billed at any stage, whether it is through a PFI contract based piece of advice or whether it is from conventional procurement. These costs are broadly speaking in line with the sorts of costs which we traditionally find with major projects. It is about 1.2% in this case of the net present value of the contract which is pretty well at the lower end of the range you expect advisers to cost. If you compare this with other projects of a similar size or nature, you would find that these fees are well within what you regard as the norm, rather than the high end of the scale. That is the sort of measurement we make, as well as being able to drill down if we really need to, if we had some really serious doubts about the bills.

Mr Williams

56. We are told in the Report that Modus's bid of £647 million increased by £99 million over 16 months. We are told this was mainly due to additional building work and increased financing costs. We know that £37 million of it was additional work. Am I right in assuming that £62 million was additional finance cost?

(*Sir Kevin Tebbit*) Yes, that is correct.

57. 10% of the total cost of the whole project was the cost of the increase in finance alone. 10% of the total price of the contract of £647 million is the £62 million that the finance increased. It is incredible for one element in the whole project to increase in that short time by 10%. Do you not consider it slightly concerning?

(*Sir Kevin Tebbit*) I do, but it is a fact of life that you have to take interest rate risk as you go through any project.

58. That would be all right. Explain this then. If the £62 million was 10% of the total cost, what percent was it of the financing cost?

(*Sir Kevin Tebbit*) I cannot give you a quick answer to that. I will have to give you a written reply to that.

59. A written reply will not do for that because it is rather important for the rest of this hearing.

(*Sir Kevin Tebbit*) With respect, I am not sure that it is, because the total cost still came within the public sector comparator and is therefore still a valid project.

60. We shall come to the public sector comparator in a moment. All I can say is that I am astonished that you are unable to answer that question, but since you cannot, we have to move on. What it means is that the £62 million increase actually made even more beneficial the possibility of refinancing at a later date, did it not? If it went up 10% and if it came down 10% without having done anything at all, there was a potential £62 million windfall from refinancing, in addition to that which was already built into the contract.

(*Sir Kevin Tebbit*) It does not work quite as simply as that actually.

61. I am sure it is not quite as simple as that, but it is broadly as simple as that.

(*Sir Kevin Tebbit*) I do not think so.

(*Mr Webber*) The cost of interest rates for the project was fixed at financial close. In effect one locks into that cost for all time. The gains that the private sector had prospectively been making from refinancing of some of the early projects was where they took the risk and did not lock into long-term interest rates, they left them floating. That has not happened in this particular case, so there is not such an opportunity to benefit from refinancing.

62. This is one of the most dubious situations I have ever seen. Modus fixed its interest rates on the day the contract was finalised. Then bank rate increased on the rate of the final closure. What difference did this make? Does this account for the £62 million?

(*Mr Webber*) I believe the £62 million to which you refer is the difference in interest rates on the day we submitted our final bid, which was linked with a particular interest rate and then 16 months later we actually made a financial close of the transaction. At that point we locked into a series of fixed interest rates. That was the movement of the cost of interest in the economy over that time.

63. We have this potential enormous windfall but it was dependent on the bank rate movement, the movement of interest rates over the time of the construction when you were subsequently able to go to people with a cash flow and most of the risk gone.

(*Sir Kevin Tebbit*) Interest changes over an 18-month period.²

64. Yes, I am sure it does. My recollection is that it has been going down rather than up, but perhaps you do not live in the same world as we all live in.

(*Sir Kevin Tebbit*) I am just saying that this was nothing to do with this particular project, this was the way in which interest rates were moving.

65. It just happened on the day.

(*Sir Kevin Tebbit*) No, on the day is much smaller than that. On the day is not the £60-odd million, that is the interest rate movements in the economy over a 16 or 18 month period.

66. There is another coincidence. You had to choose between bonds and bank financing. Let us be clear. Is it not correct that bonds do not offer the possibility of refinancing deals?

(*Sir Kevin Tebbit*) That is correct.

67. We find that in December 1998 your bond finance bid was £25 million cheaper than the bank financed bid, so bond was better. In June you then pressed for a quick decision on the method of financing. Lo and behold, at that time, bond and bank financing were more or less equal, were they not?

(*Sir Kevin Tebbit*) At the time we took the decision it is generally accepted that we made the right choice. The bond one you are comparing is the specific GCHQ bond, which would not necessarily, and very unlikely, have been applicable in our case because of all the different factors I have mentioned.

² Note by witness: As the preferred bidder was selected in January 1999 and the contract was closed in May 2000, it was in fact a period of 16 months.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Williams Cont]

68. In that case why was Modus pressing you to reach a decision on the method of financing? They were forcing you to make a decision between bond and bank financing. Either it mattered or it did not. If it mattered enough to them to press for it, surely it mattered enough to you to get it right.

(*Sir Kevin Tebbit*) We did get it right, but we got it right at the time of the decision. The reason for being pressed to take a decision was because otherwise they would have to have run, and we would both have had to have borne the cost of, two separate processes of due diligence, one for one route, one for another. That would have carried its own cost. I should clarify this business about what happened on the actual day of closure. That was a movement of a few million, about £4 or £5 million, not the great £60-something million which was the movement of interest rates going on over 18 months.

69. I am still worried about the odd £20 million. We regard the odd £25 million as more than loose change.

(*Sir Kevin Tebbit*) So do I.

70. We have a situation where bond had been £25 million cheaper; according to the National Audit Office the bond deal had been £25 million cheaper.

(*Sir Kevin Tebbit*) I am afraid that is not correct.

71. National Audit Office, is that not what it says in paragraph 22 of your supplementary brief?

(*Sir Kevin Tebbit*) I think it would say it is hypothetical based on GCHQ's own bond which cannot be compared with the very different project we were running. That is the point.

72. Then I do not see why it was relevant to raise this. Was it or was it not £25 million cheaper and did it then not become £25 million cheaper some months after they had struck the deal?

(*Mr Colman*) We are necessarily in the world of hypothesis because the price of a bond is whatever it is on the day and it is extremely difficult to predict in advance what it will be. So Sir Kevin is quite right in saying that this particular £25 million relates to what this bond would hypothetically have cost if it had been possible to obtain it on exactly the same terms as the GCHQ bond.³

73. That is exactly what it says here and that is just what I said and I was told that it was not true, that it was not £25 million cheaper.

(*Mr Colman*) It is certainly £25 million on that hypothesis. The doubt and the debate is whether that hypothesis is valid.

74. They then press to get a deal at the one time when it so happens the bank financing is more or less equal to the bond financing and they wanted bank financing because the financial interest offered the opportunity of refinancing and windfall profits. Then having entered into their agreement, a few months later, lo and behold, it was back to virtually the same £25 million differential. This looks a bit suspicious.

(*Sir Kevin Tebbit*) I am afraid I do not follow your logic.

75. That is all right; other people will. Finally, let us look at the public sector comparator. When Modus became preferred bidder, it was estimated the price would be £25 million less than the public sector comparator.

(*Sir Kevin Tebbit*) Yes, that is correct.

76. That then converged until they became more or less the same if you take the average of the PSC, which was £746.2 and the final price which the PFI arrived at was £746.1, 0.01% lower than the average public sector comparator. That seems a slight coincidence, does it not?

(*Sir Kevin Tebbit*) As I have already explained, the reason for that being so precise is because of our own tactics on the last day of closure when we found the spot rate adding to the cost of the project when we were concerned to get the bank finance in place. We negotiated £4 million off the price in order to strike the toughest deal we could. That is why it is as close as you have just described. To all other purposes, it is purely coincidental that they came out close and the PSC comparator is within a very wide range of around £100 million. All one can say about this is that broadly speaking the two routes were about the same in terms of cost.

77. The point is that what we are told is that for negotiation and presentational purposes, MOD placed emphasis on the deal price of £746.1 million being slightly lower.

(*Sir Kevin Tebbit*) Precisely.

78. For presentational purposes.

(*Sir Kevin Tebbit*) Negotiation is the first word there.

79. In other words it would have been higher if it had not been that for presentational purposes you persuaded them to reduce it.

(*Sir Kevin Tebbit*) It would have been higher had we not negotiated that bit off at the end.

80. What comes through at the end of the day is that everything is done to cook the situation where the public sector comparator is never going to be playing on equal ground. We are then told that once you have negotiated for any length of time the public sector comparator becomes virtually irrelevant because it costs you too much to go back and start negotiations again.

(*Sir Kevin Tebbit*) We do not have a preference for one route or the other. We make judgements on the basis of value for money. We judged that in terms of cost, these were about equal, but we attached importance to those other factors I mentioned at the beginning which give us better value over the project. It is very useful to have a fixed price and know that is what we are going to be paying year on year and not more. You only have to look at this building itself to see what happens when you have cost overruns. We have been so used to cost overruns, so it is very good, I feel very pleased to be able to know that I am not going to be paying more than £55 million a year on this thing. It is also very good to know that it is going to come in on time. If it does not, these people lose a lot of money in payments. There are other qualitative factors which I have seen as I have gone round and these are the things which led us to make the decisive judgement. We have no instinctive

³ The figure of £25 million referred to is described in para 2.29 of the C&AG's Report. It is the estimate made by Modus in December 1998 of the potential saving from the use of bond finance.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Williams Cont]

affection for PFI as such, it is just that in some circumstances it offers us a better value for delivering the services we need.

81. It just so happens that never have we come across a case which has come before us where the public sector comparator has actually won the argument. This is a difference of 0.01%. I remember another case where the difference was just £1 million out of hundreds of millions of pounds, but in some miraculous way it always turns out that the elements which are quite nebulous which go into the public sector comparator always give an adverse public sector comparator. Can you think of a case where it has not?

(*Sir Kevin Tebbit*) The preponderant expenditure that the MOD makes is by conventional procurement not by PFI. PFI is a very, very small element in our overall capital and procurement spend. We only do this where it is value for money.

82. I do not suppose you buy a Eurofighter by PFI. It might be a good deal if you could get it there.

(*Sir Kevin Tebbit*) No, but we might buy a tanker service.

83. In that case what is the point of relating it to the entire Ministry of Defence budget. It does not have anything to do with building which is where most of these arise. I have finished now, Chairman, it is a waste of time.

(*Sir Kevin Tebbit*) Not in our case actually. We do use PFI for things other than accommodation. We are considering tanker services from aircraft to refuel others in mid air for example. We do look at it for other things as well. It is a small proportion.

Mr Bacon

84. I should like to start where Mr Williams left off with the public sector comparator. On page 24 it breaks it down by category and there is a list there with the base costs, then the risk, presumably at millions of pounds, then the risk as a percentage of the base costs. You will see in the first line it says capital expenditure £208.6 million, risk £61.5 million, risk as percentage of base costs 29.5%. Could you say how you came to 29.5%?

(*Sir Kevin Tebbit*) There is a range of possibilities. I think the method used is known as the Monte Carlo method. I am not an economist but if any of my colleagues can give us more detail on that.⁴

85. Do you mean it is like going into a casino and you just throw the dice and see what happens?

(*Sir Kevin Tebbit*) That is what the economic model is, but it is a way of trying to make sure there is a fair, open and, as far as one can judge, thorough way of looking at risk around these figures.

86. With buildings like this, these sorts of projects, and we looked at the Treasury building only yesterday, the public sector comparator always seems to come out just slightly less competitive so

that you go the PFI route. I have just calculated that if you changed that 29.5% to 29% it would swing it the other way. It would go from £61.5 million to £60,494,000, a difference of £1,600,000 the other way, just by changing that from 29.5% to 29%. It is a totally arbitrary figure. I see Mr Trickett nodding. He worked in the building trade. It says capital expenditure, but I am sure you could finesse more than half of 1% without too much difficulty. By just changing your figure from 29.5% to 29% I have suddenly switched more than one million pounds. You only had a difference of £100,000. I have already changed it tenfold the other way by flicking one figure by half of 1%. Do you agree with Mr Colman of the National Audit Office when he said, as was reported in the FT recently, that describing this public sector comparator as a basis for making decisions is really rather spurious?

(*Sir Kevin Tebbit*) I would not say it was the only basis for making the decision but clearly it is very important to do it.

87. It was an important basis for making the decision.

(*Sir Kevin Tebbit*) My Department has to abide by the rules which are set down by the Treasury, which we accept and that requires us to do a public sector comparator using these techniques. I have to say that I am slightly surprised. We have here an NAO Report, which is very positive about the way in which the Ministry of Defence has managed this project. It is a project we are proud of. It is going to give extremely good working accommodation for our people and I find myself under rather hostile attack implying that somehow we have cooked the books in order to do it by a route which members find unattractive. I am sorry, but that is just now how it feels.

88. Can I tell you why? I went to a seminar organised by the Chief Secretary quite recently at the Treasury to talk about PFI generally in a building analogous to this, the Treasury building. I asked a question which Mr Gershon, chairing the session, started answering not by talking about finance but by muttering about rats in the basement. It struck me as a little odd. If there were a sound reason related to the method of financing, he would have started with an answer related to finance and not one relating to rats. We went round the Treasury building yesterday. It is a fine building and I am sure your building will be too and will provide excellent accommodation. What we are interested in here, and I am sure this was the basis of Mr Williams's questions as well, is whether this is the best way of doing it. I tell you another reason why I am suspicious. I put down a Parliamentary Question to the Treasury and said: how much cash are you actually going to pay for this building? There is a term we use in PAC, 'COTD', cash out the door. They gave me an answer. I put down exactly the same question to your Department, I worded it the same way, and, as you know because I wrote to you subsequently, I did not get an answer. In fact the answer I got from the Minister, presumably drafted by a civil servant, said, following an explanation of the complexity of the project, that it was impossible to forecast the overall cash sum which would eventually be paid to Modus. If you could not forecast the eventual cash sum which would be paid,

⁴ *Note by witness:* The Monte Carlo method is a mathematical technique to calculate the overall risk to the project. It is a tried and tested 'best practice' approach to the modelling of multiple risks which uses a statistical approach to combine the probabilities of the various risks to provide a profile of likely risk distribution.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Bacon Cont]

how could you come up with £746.1 million as the net present value of that income stream? You could not have done. I thought that was a bit funny. I went back to you and I wrote to Sir John and I pointed this out and lo and behold, yesterday evening I received another letter from the Minister saying "When I wrote to you on 10 June I perhaps failed to make sufficiently clear the many factors which will influence the final cash figure by the end of the contract period". It goes on a bit and then finally says that the total cash sum, other things being equal, will be at or around £2,415,000,000 over the contract period. That was the answer I wanted, but the fact that it was not given to me initially, is one of the reasons why we get suspicious. Then we read in the Report that in December 1998 bond finance was £25 million cheaper and on page 23 that MOD always thought it was close to signing the deal. When you knew that it was £25 million cheaper, what hedging techniques did you buy in December 1998 or January 1999?

(*Sir Kevin Tebbit*) There are quite a lot of questions there. May I try to take them in the order you asked them?

89. I am sorry, but could you start with the last one.

(*Sir Kevin Tebbit*) I am sorry, I do not think I can because I am trying to hold in my head the answers to the questions as you went through. If I may answer you in order. First, and it is important to try to reassure the Committee against any charge of an uneven playing field, that the figures we used on the public sector comparator were on the conservative side rather than the reverse. The current Treasury guidance will say that for projects of £100 million and over we should use a 35% figure as the cost overrun risk allowance. We were using figures lower than that, so we were certainly not trying to make things look less favourable to the public sector comparator. We could have loaded higher figures in and still have been within the current Treasury guidance in their Green Book. We could go through this in some detail, but there would be no way of substantiating a charge that we were trying to go for higher figures to make it look less attractive. On the second point, we have already discussed the bond issue: the question of whether there was a point at which there was a bond which was £25 million cheaper is hypothesis based on a different case. On the third point about the reply from the Minister, the problem there was solely that the actual amount of cash that will go out over the whole 30 years of the project is dependent on a large number of different factors, none of which can be precisely identified. Since you pressed for an answer, we gave you an answer which said we will assume inflation is 2.5% over that period. It would gross up very easily and arithmetically to that figure. It has no greater validity than that. One has to make a judgement about what is value for money at a particular point in time. All the time we are facing those sorts of difficulties of forecasting into the future and making a judgement about a project. That is what we did in this case.

90. I know it was a very complicated question, but could I go to the last part of it about hedging. In January 1999, when the Report said you thought you were close to signing a deal, what hedging techniques did you employ at that time?

(*Sir Kevin Tebbit*) As a matter of policy, Government Departments do not hedge. That is the Treasury position.

91. It is Treasury guidance that you do not do it.
(*Sir Kevin Tebbit*) No.

92. You were basically exposed because you did not hedge. Did anybody advise you to hedge in January 1999?

(*Sir Kevin Tebbit*) I honestly do not know, but I presume not.

93. Could you find out?

(*Sir Kevin Tebbit*) I assume not.

94. I should like to know what it would have cost to hedge that risk at that time. It went £60 million the wrong way, which is a huge chunk.

(*Sir Kevin Tebbit*) This is over a 16 or 18 month period.

95. Yes, but what I want to know is what it would have cost you to take out a 12 or 24 month hedge in January 1999?

(*Sir Kevin Tebbit*) We are back to the basic point that the Government insures itself. It does not hedge.

96. I should love to know, if it is possible to get a comparator of what it might have cost. Could you also find out whether there was any advice? I should be very grateful.

(*Sir Kevin Tebbit*) I can tell you that there was no advice.⁵

97. I should like to ask Mr Webber about the refinancing. You said in an earlier answer that you were sure you would have to talk to the MOD. Is it right that the MOD do not have any rights until year 15? Is that the case?

(*Mr Webber*) There is no specific clause in this project which says we must share the refinancing gains we make. There is an overarching clause which would catch refinancing gains called a value for money clause which strikes after year 15. Notwithstanding that, if we were to try to replace the existing senior debt in this company, we would still have to go and ask for their approval and indeed make changes to the documentation. It is most likely, as other Departments are doing at the moment, that they will turn round to us and say that in consideration for allowing us to raise more money, they would like to receive some of the gains.

⁵ *Note by witness:* During the evidence I was asked by the Committee about hedging, in particular about techniques used in assessing the risk from January 1999 to May 2000 and about the advice, if any, that the department had received. In response, I said that it was not Government policy to hedge and I stand by that statement. I would however add that to have hedged against the financing risk associated with bank versus bond finance would have involved the purchase of an 'interest rate swap' option. This was not examined in detail at the time, as it would have been against Government policy because use of such financial instruments does not generally provide value for money. In any case, I understand that there was no market for a deal of this size at the time.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Bacon Cont]

98. Do you have any idea how that share would break down? Fifty/fifty would be good.

(*Mr Webber*) I think we need to be quite clear.

(*Sir Kevin Tebbit*) We should like to be bolder than that.

(*Mr Webber*) That has been under debate for some time between OGC and Treasury and the current market norm is expected to become 30%. Clearly that has not yet been established. I should say that this financing is a fixed rate financing. Just like the bond would have been a fixed rate term of the project, this bank debt is also a fixed rate. I should underline this point, that there is not as much refinancing upside as some people might perceive, because it is bank debt and still fixed so the amounts are not necessarily as significant as might be believed.

99. I want to ask about the fees. You said earlier that 1.2% of the net present value of the contract was typical.

(*Sir Kevin Tebbit*) Yes.

100. Did you mean by that for the whole gamut of fees across the whole project?

(*Sir Kevin Tebbit*) Yes, looking across the cost of PFI financed projects.

101. Was that more or less irrespective of the size of the contract, give or take? Or not?

(*Sir Kevin Tebbit*) No, it was not as precise as that. I would not like to start quoting the others. For these sorts of PFI accommodation projects.

102. I shall give you an example. The Treasury building bond was £140 million and the fees were nearly £10 million, about 4.7% in total. Even as a percentage of the net present value of the contract, which was £169 million, that is still a lot more than 1.2%. Is it possible that you could supply some comparators, small, medium and large, to substantiate that? I am not saying you are wrong.

(*Sir Kevin Tebbit*) I do not want to comment about any other Departments.

103. Especially not the Treasury. I should be interested to see some comparators across a range of projects, small, medium, large, perhaps public/private.

(*Sir Kevin Tebbit*) I could give you them for the Ministry of Defence.⁶ If you wanted them more generally, we should have to ask for the assistance of the NAO.

Mr Bacon: It would be nice to have a good range. Thank you very much. No further questions.

Jon Trickett

104. I am afraid I am going to ask more questions about the financing. It strikes me that the project itself is round about £550 million, the building costs, running costs, operating costs subsequently. Is that about right?

(*Sir Kevin Tebbit*) Yes, that is about right.

105. If the overall project is £750 million, am I right in saying that the costs of financing the £550 million amount to £200 million to use a round figure?

(*Sir Kevin Tebbit*) That must be about right.

106. So the £62 million difference is very easy to calculate: it is one third, an error of one third was made in the original estimate, or there was a change in the interest rates, because £62 million is one third of £200 million which was the eventual cost.

(*Sir Kevin Tebbit*) I think that must be right over that 18-month period, yes.

107. I do not think it was too difficult for somebody behind you to have calculated that. It came to me in an instant and I am sure it did to somebody behind you.

(*Sir Kevin Tebbit*) You probably find it a lot easier up here than I do.

108. Perhaps it is easier sitting where I am than where you are. The fact of the matter is that the financing of this scheme is not only conceptually distinct, it is also a totally different process in practice. This is why we are particularly interested in how this was financed and the £200 million costs of financing a £550 million scheme was obviously a very large proportion, probably about 40%. It is a huge proportion. I was intrigued about the public sector comparator. I passed a note to the Treasury, but they are unable to answer me. Perhaps somebody might be able to answer. The difference in cost had the money been provided through the Public Works Loan Board. What we have done, by the sound of it, is gone onto the market and borrowed the whole £550 million at a fixed rate of interest for 30 years, which must be about the most expensive way of borrowing money that one could devise. I do not know who made that decision, but the public sector comparator presumably, although I cannot see the figures here easily, must have calculated the difference in borrowing money from the Public Works Loan Board.

(*Sir Kevin Tebbit*) The point is that it is the company which was borrowing the money and the proposition which we accept is that it is the company which is putting its own money at risk, therefore it is the private sector partner who has the incentive to use the money that it has raised more efficiently.

109. With due respect, I am talking about the public sector comparator. I am predisposed to go with the public sector. I think that civil servants and the Government are predisposed to go with the private sector, so there may be an ideological difference between us. I accept eventually it is decided by the facts of the case. The facts of the case which we have been told are that the public sector comparator was £100,000 more out of £750 million than the private sector. An intriguing difference. What I am asking is this: of the £750 million £200 million were financing costs. If we had said to the builder, you get on with the building and running the building and we are going to finance it through the Public Works Loan Board, what would be the difference in cost? What would be the difference in cost? I know for a fact that there is a huge difference between long-term borrowing, everybody round the table must know, and Public Works Loan Board. What is the difference? Can anybody tell me?

⁶ *Note by witness:* Fees vary from one PFI project to another depending on the complexity and the in-house knowledge that has been gained. The average for a sample of MOD projects with a total value (NPV) of less than £25 million was 1.74%; for projects between £25–£50 million was 1.43%; and for projects over £50 million was 1.6%.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Jon Trickett Cont]

(*Sir Kevin Tebbit*) I am afraid I am not informed about the Public Works Loan Board. It is not a source of finance which is available to the Ministry of Defence. I do not know whether it is to anybody else.⁷

110. I just want to know how the public sector comparator was constructed? Do we assume the same financing costs?

(*Sir Kevin Tebbit*) 6% is the figure which is used in all cases for calculating the public sector comparator. That is the Treasury discount rate.

(*Sir John Bourn*) Perhaps we can help here.

(*Mr Colman*) This is a frightfully technical issue.

111. And huge amounts of money are involved.

(*Mr Colman*) Indeed there are. The fact is that the methodology which Treasury prescribe for the public sector comparator does not explicitly include the public sector borrowing costs. You might think the purpose of the calculation is to show whether the benefits of the PFI approach exceed the extra financing costs; you might think that is the purpose of the calculation. It is not in fact what that calculation does. The calculation uses a standardised discount rate of 6% which is not directly related to borrowing costs. To answer your question: the calculation could be done of the impact of financing this at a lower rate, but that is not what emerges from the public sector comparator.

112. Just so I understand. What is the finance cost which was eventually fixed at 6% then? What did you borrow on, Mr Webber?

(*Mr Webber*) We borrowed at an average of 7.8% or something like that.

113. You borrowed at 7.8%. You say it was an average but you fixed the price on day one. Who decided it should be fixed over a 30-year period? Why did you borrow long term on a fixed rate?

(*Mr Webber*) We were raising long-term funds for which we wanted to fix our risk on the interest rate.

114. You decided to borrow fixed over the long term.

(*Mr Webber*) We did and that is common practice.

115. It is also common practice to take advantage of market changes in the costs of borrowing money. Seven point 8% strikes me as quite high.

(*Mr Webber*) As we were discussing earlier, over the 16 months beforehand rates had gone up and that was precisely the problem.

116. What could you borrow it at today?

(*Mr Webber*) I suspect the rates have come down again slightly, but I do not know what the precise rate will be. This is the point: they are volatile and therefore with a long-term asset and long-term income it is best for companies such as ourselves with a high amount of debt in them, therefore quite fragile, to lock into the known cost of interest.

117. Just coming back to the Comptroller and Auditor General for a minute, the difference between 7.8% over 30 years on £550 million and 6% is an enormous amount of money. I am trying to understand where I can identify the difference in financing costs and whether we might well have done better from the public sector even though this Government may well be ideologically predisposed not to do such a thing.

(*Sir John Bourn*) That calculation could certainly be made.

118. Where would I find that calculation in this document?

(*Sir John Bourn*) The document is done by the Treasury rules for calculating the public sector comparator. The document brings out "Don't rely on the public sector comparator to determine your judgement", but if the Committee would find it helpful, we could certainly make the hypothetical calculation.⁸

119. We are talking about huge amounts of money, absolutely huge amounts of money. Whatever anybody else's ideological position round the table is, at the end of the day one's decisions are based on the facts rather than simply an ideological predisposition. I personally should be very interested to see how that calculation is done and what the difference in price might be. I want to move on to one other sub-set of questions around the same kinds of issues to do with the costing of risk. No, I shall come back to that. I shall change tack for a minute. Were the contractors aware of the public sector comparator prices, the £750-ish million?

(*Sir Kevin Tebbit*) No, no.

120. At no stage were they made aware of it?

(*Sir Kevin Tebbit*) No, not at all. That is why I said it was an accidental coincidence. They get the base costs but not the other. I think what you are actually arguing is that we should have raised this money by gilts at the price the Government can offer money rather than in the market. That is the basic proposition.

121. I am not arguing anything. I am predisposed to believe that would be the cheapest way of borrowing money.

(*Sir Kevin Tebbit*) What I am saying is that the company raising money in the market therefore took on the risk. The proposition is that the private sector partner, as a result of that risk, has to deliver efficiencies which more than offset the increased cost of borrowing by the route they take. That is the argument about better value for money.

122. With all due respect, I understand the argument that the public sector does not know how to build as efficiently as the private sector or to project manage, but this company took no risk at all with financing this debt because on day one they went to the market, borrowed the whole amount of money, affected the interest rate being charged in the spot market on that day by operating in a way which I regard as inept and secured the whole of the debt for the whole of the period. So the private sector took no risk at all. The price was fixed.

⁷ Note by witness: The total financing costs, calculated relative to the Treasury discount rate of 6% in real terms, amount to approximately £185 million of the total project cash flow. This figure reflects both the equity return and the interest cost that Modus pay to their third party funders and excludes the impact of interest paid on cash balances and the repayment of outstanding principal.

⁸ Ev 21-23

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Jon Trickett Cont]

(*Sir Kevin Tebbit*) But the ability to repay depends upon the stream of cash from the Ministry of Defence and if that does not come they will be —

123. The public sector took a hit of £60-odd million as a consequence of that decision. I should be interested to see how the figures we have asked for turn out. I want to move on to one other thing which is this business of risk taking by going to the public sector. You talked about the Monte Carlo simulation, but I rather think the reference to risk is in this Table 9, where we are adding millions of pounds to the public sector price to rig it effectively to put the job out to the private sector. In paragraph 2.50 it says that you were working to guidance partly laid down by The Cabinet Office Efficiency Unit, but in fact barely any data was available on which to base the risk calculations. There were only two MOD refurbishment projects on which to base any kind of estimate and there was a huge difference in the cost overruns between the two. It actually says, and you have agreed to this, that there was a lack of comparative data on redevelopments. So these figures here, which add up to £102 million loading the dice against the public sector, are based on inadequate information. Would you comment on that assertion of mine?

(*Sir Kevin Tebbit*) We did obviously look at whatever other comparators we had; certainly within the Ministry of Defence we had relatively few. We did use information from other Government Departments. As I have already explained, we did not use risk factors which were weighted heavily according to the Treasury Green Book. We were using pretty competitive risk factors, if you like. We did sample many projects, but one can always wish for more. At the bottom of all this, there is this basic issue of saying that if every project were done using Government finance we would end up essentially renationalising or nationalising the whole economy.

124. That sounds like a good idea to me, but that is another subject. It used to be in clause 4 of our Party at one time but somebody moved it. On reflection, I regret the fact that we took clause 4 out. The penultimate sentence in this paragraph talks about two MOD refurbishment projects, "... these had been subject to very different degrees of cost overruns". I think you said the Treasury were saying you should use a 35% overrun, which is really loading the dice against the public sector. You have gone for figures lower than that.

(*Sir Kevin Tebbit*) Lower than that.

125. Could you tell us what the variations were in the two projects which you were able to use?

(*Sir Kevin Tebbit*) I am not sure that I can. One was the Old War Office building which substantially overran. We have to be frank about this. The history of conventionally procured building projects in Government has not been marked with success. There was a large overrun in the Old War Office project which was finished in about 1992; several hundred %, I have to tell you. In the good old days of public finance we were not necessarily that brilliant at this. I come back to the proposition here. The contractor does have his money at risk. He depends on the payments coming from the Ministry of Defence which will only happen if he performs

well. He is incentivised in order to do it on time, so he gets the money when he needs it and he is fixed with all sorts of other performance criteria. Therefore he really does need to deliver efficiencies in order to make money on his contract. The proposition of going for the private finance route is that the efficiencies which flow from these incentives and risks on the private sector outweigh such additional cost of borrowing that might arise. Those additional costs of borrowing are often going to be there anyway, even if we use conventional procurement because you go to a contractor, you ask him to build you a building, he will still be borrowing money in the market and you will not know exactly how he has built that into his price.

Jon Trickett: I do accept some of the points you are making. Just reflecting on the debate about financing costs, it strikes me that there are three separate rates of interest: one is long-term fixed, which would be the highest, most expensive money you could borrow from the banks; one is the bank rate itself which is less; then—I was using the Public Works Loan Board simply because I am aware that is a publicly available figure—any way in which money might be available to the Department from the Treasury in the conventional way. It would be interesting if we could be shown the differences in the savings which might be made by using each method of borrowing, if we may?

Chairman: Perhaps the National Audit Office might advise us.

Jon Trickett: Building on the points we have already agreed.

Mr Jones

126. Sir Kevin, I share with you a little of the frustration that you are getting a rough time when if you look at the contents page of this Report it says, "The deal gives MOD what it set out to procure" and "After an effective procurement the benefits of this deal will be similar in cost to the forecast cost of conventional procurement" and the "Contract management has been good". It is a reasonable project from what I can see, but there are one or two issues I should like to take up. One is Table 12 on page 27, which we talked a little bit about earlier. I am looking at the graph in the middle where at the time Modus were made the preferred bidder their estimated price was £25 million less than the public sector comparator. In the negotiations which followed that £25 million disappeared and in fact another £4 million disappeared because their price on the final day initially was £4 million above the public sector comparator. Can you explain where that £29 million went? Is not one of the lessons we can take from this that the public sector will underestimate initially in order to become the preferred bidder and win the business?

(*Sir Kevin Tebbit*) First, of course the contractor did not know what the comparator was. What we are referring to here is the extra cost of work on the building which became evident when various surveys were undertaken. They showed in more intensive examination, once we got a preferred bidder and he could do more work, just how bad things were. We did not just leave it to him to tell us that these extra

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Jones Cont]

costs were there, we had them independently verified. They were involving things like the water supply system, which we were told was going to give us health and safety problems in a big order, things like the amount of asbestos which was found in the building, the overall quality of the roof, basically the structure which could not have been established without intrusive surveys which could only be done once you had a preferred bidder. Those are the main categories. I could give you a much more detailed breakdown: we do have them category by category of where the extra cost came from.

127. You have just said again that at no time did the bidder know what the public sector comparator was and yet you told us earlier that on the final day you had to get them to come down £4 million. Did you then tell them on the day?

(*Sir Kevin Tebbit*) On that very final day I suspect somebody must have said you have to come down by £4 million otherwise you could be over it. I think that was right in the very, very final moments of the negotiation.

Chairman

128. I can see a rueful smile on your left.

(*Mr Webber*) It was not a particularly pleasant experience. The sponsors had spent £10 million getting to that day and on the final day they were told to reduce their price otherwise the deal would not take place that day. It was a tricky morning.

Mr Jones

129. May I take you to page 11 of the Report and paragraph 1.16. It says, "MOD's staffing requirements are likely to change over time . . . it requires Modus to undertake an annual review of the use of accommodation. If MOD gives up complete floors, Modus is allowed to rent out whole floors of Main Building to others, subject to MOD's veto on who its co-tenants might be". Does that mean that each year Modus would look at what accommodation you were using, say that floor is empty, and then can they only lease that out to another organisation for one year?

(*Sir Kevin Tebbit*) No, they can lease that out indefinitely. The point here is that we have come down from about 13,500 people in London in the early 1990s to the figure we have now of about half of that. I do not regard the figure we are intending to come down to, 4,300 Head Office staff, as a fixed figure. This is going to continue to move and we shall need to sustain value for money throughout and bear down on Head Office costs. Hence the clause in the contract, which says firstly that we need to monitor very carefully just how much space people need and secondly as and when we can release chunks of space so we should do so, will reduce the cost we pay, less than the £55 million a year, and provide opportunities for somebody else to come in who will pay Modus. We would insist on security vetting to make sure that the people who came in were essentially Government Departments; that is what it will boil down to. That is why we have that flexibility into the contract. Each year this has to be looked at. If it is decided that there is ability to release a floor or

a particular defined area, then that can be done on an indefinite basis. We would not have any concerns as to whether it was five, 10 or 15 years or whatever was commercially advantageous. It is designed to continue to give us the flexibility to drive down our numbers in Head Office.⁹

130. Of course numbers may need to rise because of circumstances. We had the situation at GCHQ where numbers were trimmed back and now are beginning to rise a little.

(*Sir Kevin Tebbit*) It is not impossible, but I would hope we did not have to do that in Head Office. The whole way of networking information, the whole way in which IT is going, should enable us to put a cap on that. We do now have this third building. I should have said at one point that a further argument which has emerged in its favour is essentially a security argument. After 11 September, the idea that we might need to be somewhere else, not necessarily just in two buildings next door to each other, is a consideration. It is not an overriding consideration, but it is another factor which has occurred to us. The third building is quite useful for other purposes too.

131. You have just answered my final question relating to paragraph 10 on page 3. You rejected locating Head Office either elsewhere in London or on a greenfield site. I was going to ask whether that decision would have been the same post 11 September?

(*Sir Kevin Tebbit*) The fact that we do have that third building has been reinforced as a benefit since then.

Mr Jenkins

132. Coming so late in the proceedings most of the questions I had pending have already been asked.

(*Sir Kevin Tebbit*) But they may not have been answered. I can try again.

133. Mr Jones just mentioned a point which I have always found rather strange and no-one has come up with an answer yet. When you look at providing office space in central London, which is one of the most expensive and difficult places to refurbish anything, why do we do it and why have we not relocated something like this to Coventry or Plymouth or somewhere outside? Why are we still pouring money into central London when we know how expensive it is to get the work done in central London?

(*Sir Kevin Tebbit*) I take the point. We will always need our headquarters in central London as long as we need to have very close links with Number 10, the Foreign Office, central Whitehall buildings. We are an international department. A lot of visitors come to see us. We are having visitors either way, whether it is in the Department of State or whether it is in the Chiefs of Staff Headquarters which are in the one building, we are co-located. Also our crisis management facilities are in the basement of the building which are continuing throughout this

⁹ *Note by witness:* This means that Modus would be paid indirectly by the new tenant. In practice, under the contract, the new tenant would pay a rent to MOD who would in turn pay Modus.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Jenkins Cont]

period. Therefore it is not really an option for us not to be in central London. It is where we do need to be. However, you are quite right, 10 years ago we had 32 buildings in London; now we are coming down to three. We do deserve some marks for effort. We had more than 13,000 staff in central London; we are now coming down to 5,000. I see this as a moving picture. We have made major relocations outside London, Bath, Bristol, York, which was the most recent place. We are located throughout the country. We still have 91,000 civil servants; we used to have 100,000. With the change in the role of DERA, that has gone down to 91,000. The number in London, 5,000 of those 91,000, and they are just the civil servants. With the Armed Forces it is many more, so this is not a high proportion.

134. This is a break point, this is where you could have made the final decision. You still have the Old War Office building for your PR and your entertainment. I have a thing on my desk now which is quite marvellous. I switch it on and I receive a letter on the screen which has been typed in my constituency. I can adjust it, press a button and it is printed for me to sign and send off. I have this other thing on my desk as well which I can pick up and talk to somebody. I am in constant communication and they do not need to be here, in fact I would not want them to be here because I can get a much higher calibre of labour for the money I pay out of London than I could in London.

(Sir Kevin Tebbit) You are right; we are finding the same thing. We are doing it—we are doing it—but I am not able to promise that we shall be able to leave London completely, especially as Parliament is likely to be here for a while as well.

135. This was a point where you could have taken an extra building out of London and I think we could have got much better value for money, yet I see no figures to show you evaluated that possibility. Did you do the exercise?

(Sir Kevin Tebbit) We did an investment appraisal for that third building in St George's Court and we found that it was better value for money to stay where we are, as it happens in central London, but we got a very good deal on the building. That makes it worth while. Over a five-year period, we are getting £17 million value by staying in that building. It is a very, very advantageous renegotiation of the lease. The St George's Court building is there purely and simply because it is more cost effective to be there in London as it happens, notwithstanding the security argument I have also made, which helps. It is better value for money than it would be to have it anywhere else in the country.

136. So you did not actually do it for the Main Building.

(Sir Kevin Tebbit) No, not for the main headquarters. We could not move our crisis management facilities without major, major, very big cost implications. That is underneath the building. We need to have a central staff somewhere and central London happens to be where we need to be.

137. Are you refurbishing this underground crisis centre?

(Sir Kevin Tebbit) No, not as part of this project. We have done that separately. I really would not want you to get the impression that we have not been moving out of London. We have been doing it in a big way.

Mr Jenkins: Mr Mitchell has been sitting very quietly there at the end. I do not like anyone to feel they have wasted their time coming here. I bet you are quite glad you do not have to go through this on a regular basis. What would you think is an acceptable rate of return on a project like this one?

(Mr Mitchell) At the time this deal was entered into it was about 17%. That is about where the market was at that time.

138. 17% was the rate of return. Is that normal in this type of project?

(Mr Mitchell) It has probably dropped off a little bit since then, but it has been higher than that in the very early stages.

139. If it ran substantially over 17%, at what point would you feel you were in a position where you are totally embarrassed and you feel you would have to give some back to these people who negotiated this deal?

(Mr Mitchell) One does not embarrass very easily about these things.

140. I bet not.

(Mr Mitchell) It has been mentioned that there is this clause around year 15 that if the terms go up beyond a certain point then there is an automatic sharing with the authority.

141. If in the first 15 years you made 40% return, but after year 15, due to the refurbishment of the building, the return dropped to 20%, you would not be too embarrassed about that.

(Mr Mitchell) In year 15 one would recalculate the total return, taking into account the past as well, that is how the mechanics work.

142. So there are expectations then, hypothetically of course.

(Mr Mitchell) We would hope so and we would have to share it with you if we do make these super returns.

143. When you were beaten down on the last day by £4 million just to come under the figure already set, did you know that figure?

(Mr Mitchell) I was not with Modus on the day the deal was signed. I have joined since, so I cannot comment on that.

144. Did Modus have access to that figure before they got the price down to that level?

Chairman: There is a lady in the second row shaking her head.

Mr Jenkins: I am obviously talking to the wrong person here.

(Sir Kevin Tebbit) I am all in favour of you cross-checking what I said with the company. We did not share this information with them until that very, very last endgame moment.

(Mr Webber) I was there and did not know specifically what the figure was which we had to beat. We were told that unless we reduced our prices the deal would not close that day. We contemplated going away that day, but at that point the sponsors

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Jenkins Cont]

had spent four, five, six years working on the transaction and had spent at least £10 million if not more, therefore after four or five hours of discussion amongst the shareholders, we decided that although we did not particularly like that tactic, on the day, having completed all that work, we did give back some value to the MOD.

145. I ask because in the briefing paper we receive—and you probably do not have access to it—the NAO say that this emphasis enabled the MOD to negotiate a price reduction of £4 million on the day the deal was closed as they insisted the final price should be below the £746.2 million benchmark.

(Mr Hoyle) It was myself and the lady in the second row who engineered this. We did not actually give them a figure to beat. We just invited them to reduce their price on the final day. They made one offer after several hours. It was not quite sufficient and we thought we could get a bit more so we asked them to try again.

146. I can understand that you can give signals without intending to, but as long as they did not have access to that figure . . . We needed to clarify that and you have clarified it. The only other point I was to labour is the risk. I should like to identify what the risk is which you undertake. As has been established, you have borrowed all the money now, so there is no risk on borrowing the money for the next 30 years. He has put that in his bank account and he is going to pay it out as the project goes on. The cost of the building is a risk and there is a possible cost of overruns on the building. Are you familiar with the PFI deals which have been done in the Health Service?

(Mr Mitchell) Yes.

147. You are well aware that we almost have a PFI consortium now where builders get together.

(Mr Mitchell) I am not aware of that.

148. What it basically boils down to is that in the past when there was a contract, when you had a problem you sent for the architect and told the architect that it looked quite nice but if you had it wood panelled and gold plated it would take a little longer and cost a little more and of course the architect who was being paid a percentage of the final cost, said it was a good idea, he had not thought of that and the price went up and time went on. The more they could load on, the better. The architect nodded it through and off they went. Now you have to come in on time. All our PFIs are coming in on time because it costs the firm money if they do not make it. There is very little risk with regard to the overruns. Unless you have underestimated the structural elements, you are going to come in on time, are you not?

(Mr Mitchell) Yes, we would expect to come in on time giving that risk to our contractor and making sure that he manages that risk. That is where the change is from traditional procurement. The PFI contractor is able to manage the risk and it is his own responsibility to sort out the problems.

149. The contract runs over 30 years, so you have to maintain this for 30 years.

(Mr Mitchell) Yes.

150. We do not know what wage rates are going to be for 30 years, so that is a bit of a risk, is it not?

(Mr Mitchell) It is a risk.

151. You have to accept there is that risk. I understand that now. Technology changes, but technology changes normally result in the reduction of operatives in any location, so you may have some extra space and you are going to have to re-let that space.

(Mr Mitchell) Yes, if it is not required by the authority.

152. That is a good risk, is it not, to re-let space in a secure environment? Do you think you can let that space readily?

(Mr Mitchell) The only other prospective tenants are likely to be Government Departments, so it is not a free market letting situation because of the security impacts.

153. It is dependent on other Government Departments coming in.

(Mr Mitchell) The tenants would have to be approved and it is unlikely that the authority would wish to share its Main Building with people who are not secure.

154. May I suggest, hypothetically of course, that if I were in a position as your letting agent and I could let it to someone but the Department said no, I must let it to a secure individual such as a Government Department, I would hold my hands up and say it was not part of the original deal. This is a risk which was not my risk. It was not calculated. I could not calculate this risk. You have imposed this risk on me so I want compensation to accept that condition now.

(Mr Mitchell) That is highly unlikely. The contract is clear that we can only sub-let this to people approved by the authority. We entered into this contract with that clear in our minds.

155. So there is a definite risk on you.

(Mr Mitchell) Yes, there would be risk there.

156. This partnership has to work as far as you are concerned.

(Mr Mitchell) Yes.

157. If you mess them about in the early years, they can mess you about later on.

(Mr Mitchell) In order for this to work we have to trust each other, be open with each other and not mess each other around otherwise it becomes impossible.

Mr Davidson

158. You indicated unhappiness earlier on at getting a hard time on some points as though you wanted praise all the time. I see that you have a KCB and a CMG. You have had a fair bit of congratulation altogether. I am not sure whether that is a complete set or there are more to come if you do well?

(Sir Kevin Tebbit) I was not talking about me personally, I was talking about the project.

159. No, it was “I want a bit of a pat on the back”. As you know, the role of the PAC is a concept with which the MOD might very well be familiar, which is

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Davidson Cont]

to bayonet the wounded. We are here to pursue issues rather than simply hand out congratulations. I am sure you can understand why we are a trifle cynical when we discover that huge amounts of money have been spent, enormous investigations have been undertaken and it ends up that the private sector wins by £100,000. You can understand that looks a trifle suspicious at best, can you not?

(*Sir Kevin Tebbit*) Yes and I have just tried to explain throughout the hearing why that is unfounded.

160. Can you tell me whether or not the MOD, having gone through all this exercise and reached the final decision making day, have ever walked away from anything?

(*Sir Kevin Tebbit*) We do walk away from things, of course.

161. Can you tell me which PFI deals you walked away from?

(*Sir Kevin Tebbit*) This was the pathfinder, biggest PFI project we had. I am not aware of particular PFI deals which we walked away from. I have just been told that there is one called Project Waldorf.¹⁰

The Committee suspended from 17.50 to 18.00 for a division in the House.

162. May I return to the point about the anxiety many of us feel about the difference between the private sector build and the public sector comparator being only a handful of thousands? It just looks too good to be true, does it not?

(*Sir Kevin Tebbit*) It really is just that: it looks too close. May I come back very quickly with one or two simple points around that. This was a range, it is a benchmarking tool, it was never a real figure.

163. You agreed this Report.

(*Sir Kevin Tebbit*) Yes and I am not disagreeing and I am sure the NAO will bear this out. The competition was not actually between Modus and the public sector comparator, it was between a number of private sector companies and consortia who were vying with each other to provide and to win a competition.

164. There are two separate choke points then, are there not? There is a competition between the different contractors and Modus were successful there with a bid which was £44 million lower than their competitors and then later on it negotiated upward by some £37 million as a result of other things which were found.

(*Sir Kevin Tebbit*) All contractors would have found those costs.

165. The point was made that intrusive surveys could only be done when you had a single approved bidder. Why?

(*Sir Kevin Tebbit*) People were working in these buildings. The point here is that we were satisfied —

166. No, no, no. That is not the question I am asking you. I am asking specifically about intrusive surveys.

(*Sir Kevin Tebbit*) It costs money to do intrusive surveys. It cost the bidders lots of money to do intrusive surveys, so it adds to the costs.

167. Lots of money. After an intrusive survey £37 million of additional work was discovered.

(*Sir Kevin Tebbit*) Yes.

168. I should have thought that was fairly substantial. Do you not think that if competition is such a good thing, a bit of competition between the last two bidders about their bid before the intrusive surveys and after the intrusive surveys would have held the lid on the cost of work discovered after the intrusive survey?

(*Sir Kevin Tebbit*) These are perfectly normal techniques which would be true of a conventional procurement as well as a PFI. There is a hugely increased bid cost if you get both companies or consortia doing these surveys. There is also a great deal of dislocation to the building and disruption of work. It is perfectly normal to wait until you have a preferred bidder and then this is part of the process which goes between there and the final contract. The point I was making earlier was that I can demonstrate to you that those costs were absolutely genuine, were necessary and would have been found by any winning bidder at that stage. In other words it was not just Modus —

169. That is an interesting point. They would have been found by any bidder had they investigated. Presumably the advantage of competition is that it might have driven down the costs that the bidders estimated as being necessary to remedy that work. You must at one stage or another have taken your car along to a garage for a certain quote and suddenly found out later on that enormous costs were going to be incurred which they had never mentioned to you before.

(*Sir Kevin Tebbit*) In terms of meeting the specifications and in terms of cost, the lead this particular consortium had over the next one was sufficiently large for it still to be ahead anyway.

170. That is an interesting point. You are satisfied that you were still getting the cheapest bidder, but without competition for the additional work you cannot be satisfied that you were getting the cheapest possible bid.

(*Sir Kevin Tebbit*) I was still satisfied that we were getting value for money. The mathematics are very simple; they were £40-odd million lower.

171. Stop evading the questions I ask you. If I ask you a question about something, I prefer to have an answer to that question and not to a question I did not ask.

(*Sir Kevin Tebbit*) I am sorry, I did not answer your questions about my medals either. I shall try to remember that.

172. Now, now. No need to get upset. I did ask: how can you know that the additional £37 million was the keenest price available when nobody else was in a position to give a quote for that?

¹⁰ *Note by witness:* MOD would not normally walk away from any PFI once a project had achieved Initial Gate approval in the evaluation and approval process. As far as we are aware, MOD has withdrawn from one PFI competition after reaching the preferred bidder stage and this related to a recent project—Project Waldorf—for the provision of Service Family Quarters in Northern Ireland.

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Davidson Cont]

(*Sir Kevin Tebbit*) Because they claimed £60 million and we agreed to £37 million. In other words, we used an independent method of beating down the claim they put in and that is how we were satisfied that the £37 million was a fair and final figure.

173. How do you know that had there not been another bidder, that £37 million would not have been reduced further?

(*Sir Kevin Tebbit*) That is what we have our advisers for. That is why we have the technical team advising us.

174. Could you repeat that figure for me? The contractors were originally saying that the additional work cost how much?

(*Sir Kevin Tebbit*) Sixty million.

175. As soon as they discover that they are not under competitive pressures, their bids are overstated by quite a substantial amount. Do you understand why that gives me cause for some anxiety?

(*Sir Kevin Tebbit*) Not at all; it is perfectly normal to have non-competitive tendering in all sorts of areas and the way in which we make sure that value for money is achieved for the taxpayer is by having expert technical advisers who challenge those figures, which is what we did.

176. May I ask about the process of the final day, which is of some interest to all of us? Can you tell me whether or not at that stage the MOD had ever walked away from a PFI which had got to this stage, had got to the final day, or were you so locked in effectively, politically—with a small “p”—and everything else, that you tried to negotiate downwards but you were stuck with taking what was on offer?

(*Sir Kevin Tebbit*) No. The factual answer to your question is no, we have not walked away from a PFI on the last day like that. It is a bit of a tautologous thing because if it is the last day how do you know it is if you walk away from it? If you just walk away it would not have been the last day.

177. Yes, that is a good one. Have you ever walked away from anything? Can you tell me about a contract before that?

(*Sir Kevin Tebbit*) Yes, we often do. The point is we have —

178. How often? How often? How often?

(*Sir Kevin Tebbit*) Many times.

179. No; how many?

(*Sir Kevin Tebbit*) More times than I can possibly recount. The point is we have —

180. Could we have a note on that?

(*Sir Kevin Tebbit*) No —

181. What do you mean, “no”?

(*Sir Kevin Tebbit*) You must allow me to answer your question.

182. It is a fairly simple and straightforward question. I am seeking to clarify whether or not it was reasonable for the contractors to believe that there was a possibility of losing the arrangement by you finally saying that you were not accepting that and you were away.

(*Sir Kevin Tebbit*) Yes; indeed that is what they felt on that last day, that we would have walked away.

183. What evidence did they have for that on the basis of your past experience?

(*Sir Kevin Tebbit*) None. Our past experience which I was referring to was that we often fail to proceed with projects where our Investments Approval Board at an earlier stage says it is not worth doing it or we will not do it like this.

184. At an earlier stage.

(*Sir Kevin Tebbit*) Yes.

185. Once you had got to the stage we had reached here, there had never been an occasion when you actually said “No, I’m away”.

(*Sir Kevin Tebbit*) We only conclude deals when they are value for money.

186. Yes; quite. May I turn to the point which was made earlier on about the contracting work? It seems to me, looking at this, that a lot of the contracting work has been done far better than it could have been done elsewhere. The difficulty I have is with the cost of providing the finance. I do not quite understand why it was that we were not able in some way to marry the undoubted construction and technical and management skills of the contractors with the lower cost of money from the public sector, which would have been available through the Public Works Loan Board.

(*Sir Kevin Tebbit*) This was the company borrowing money to build a building. They had to borrow the money at market rates rather than essentially at Treasury rates, the rate the Government can borrow at, because they were taking on risk. That is the reason for the difference. The taxpayer would otherwise be bearing the risk. If the taxpayer provided the money at the lowest possible rate, at gilt rates, that would mean that the taxpayer was bearing the risk of this project instead of the company bearing the risk.

187. May I just clarify that? I can see that if the taxpayer provides the money, the taxpayer is then running the risk of interest movements and so on, but they are not necessarily bearing the risk of construction or similar things.

(*Sir Kevin Tebbit*) The great virtue of this to me is that we make one unitary payment of £55 million. If there is cost overrun that is the contractor’s problem. If they do not finish on time, that is the contractor’s problem. If they do not deliver the services to us, we deduct penalties according to the formula in the Report.

188. Fine; I am happy with all that.

(*Sir Kevin Tebbit*) That is the risk they are taking in the market.

189. I understand that.

(*Sir Kevin Tebbit*) They also have an incentive to be efficient and to build the thing on time, which often does not happen through other procurement methods.

190. I understand. Mr Webber, may I clarify whether or not, instead of going to the market at 7.8%, you would have preferred to have had money in some way from the Public Works Loan Board or whatever money was available at that time? Which one would you have chosen?

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Davidson Cont]

(Mr Webber) We are getting to the root of PFI here and that is a question of whether you want us to raise the money and take the disciplines of private sector money and the way in which it manages contracts. In abstract, I suppose if we can borrow the cheapest amount of money available, then we would. But we are not a gilts quality borrower, so there is no way we could do so.

191. But the Government are.

(Mr Webber) Yes.

192. Had you produced a profile of your spending plans, produced in some way an indication of how much money you wanted and when and then presented that to the Treasury and the Treasury arranged the borrowing for you so that the construction side of things, which you seem to have handled very well, was separated from the financing side of things, where you seem to have overpaid, would that not have been the best of all possible worlds?

(Mr Webber) In arithmetic terms, yes, but it would have de-linked the sense of capital and ownership and proper risk and return from the transaction and ultimately that pushes you back to an older fashioned method of procurement which is the Government using its own resources to pay for these things and facing the direct risk of overruns or errors or whatever.

193. Surely you as a construction firm and other things must on occasions take contracts which are not just simply cost plus, where you bear some share of the risks.

(Mr Webber) I am not a contractor, I am in effect a financier. I am a financial shareholder of this business.

194. Maybe I should ask Mr Mitchell?

(Mr Webber) He is a member of the management appointed by the shareholders to do it, so I am the wrong person to ask.

195. Fair enough. You deal with the money and he deals with the hard questions.

(Mr Webber) I raise the money to invest in these projects and he looks after my interests and the customer service.

196. Having made Mr Webber and his colleagues redundant and you able to get the money necessary from somewhere else at a cheaper rate, would that necessarily have imperilled the commercial running, the efficient running, the managerial disciplines that you and your colleagues were operating here?

(Mr Mitchell) If one could have maintained the disciplines as are generated through the PFI process, then where the money came from as far as the contractor was concerned, does not make that much difference.

197. Speaking of yourself as the person who is responsible for this, could you just clarify for me what difference it makes to your job on a day to day basis whether or not you have the discipline of having raised private money as distinct from having money at a much cheaper rate from the public sector.

(Mr Mitchell) The source of money makes no difference to what I do every day.

198. That is what I thought. Does it make any difference to what you do over a longer period, over the period of this whole contract?

(Mr Mitchell) Provided the same discipline is attached to both sets of money, it makes no difference.

199. So there was a way of financing this project which would have been a substantial saving to the public sector had the Treasury allowed it.

(Mr Mitchell) If the Treasury had allowed it, but I cannot —

200. Indeed you cannot. I think my point is made.

(Mr Webber) The Treasury would have to employ a lot of people to apply those disciplines to that pot of money.

(Sir Kevin Tebbit) The other way of putting it is: would the taxpayer be happy if there were cost overruns, in other words if those risks were borne by the taxpayer, just to fork out the extra money? That is the real issue.

201. I must confess I do not see that as being the alternative. It is not beyond the wit of our officers to devise a contract which means that the building risks, the construction risks continue to fall on the contractor and that the financing risks are borne in a different way.

(Mr Glicksman) We would not permit an arrangement whereby the Government, whether through the Department or through the Treasury or any other means, lent money to a private sector firm at the same rate of interest that the Government was able to borrow at. The Government are able to borrow at that rate of interest because it is a risk free loan as far as the people lending money are concerned. Government will not default on that loan. When people are lending to this company, they are charging a higher rate of interest because there is a risk associated with it and the risk is that the company will not be able to repay that loan. If the Government lent money to that company, then we would have to lend at a rate which also took account of the fact that the company may not be able to repay the loan because they may fall flat on their face in doing the construction work.

202. With respect, that is a statement of the Treasury view. It is up to politicians to decide whether or not that remains the Treasury view, is it not really?

(Mr Glicksman) It would not be value for money to the taxpayer to lend —

203. It is a political decision, is it not really, for us to take?

(Mr Glicksman) It is a value for money decision and one has to assess the likely cost to the taxpayer in the light of the returns.

204. May I turn to the point about the 4,000 or so civil servants whom you require to be in London? I understand the point about the need to be near to Downing Street and the need to be serving the Chiefs of Staff and so on. What independent assessment has been made of the need for there to be as many as 4,000?

(Sir Kevin Tebbit) It is 4,300 total; one quarter of those will be military officers and three quarters civil servants. It is an integrated headquarters. The

26 June 2002]

SIR KEVIN TEBBIT KCB CMG, MR JONATHAN HOYLE,
MR MATTHEW WEBBER AND MR LES MITCHELL

[Continued

[Mr Davidson Cont]

judgements about how many we need in Head Office are taken ultimately by me, using my management and organisation teams, looking at how we deliver outputs, how we run ourselves. We have been coming down pretty swiftly from a much higher figure.

205. You have PricewaterhouseCoopers and other accountants and advisers. Has anybody else externally ever examined the conclusions you have come to?

(*Sir Kevin Tebbit*) We do all the time look at our numbers and our processes. We usually do it in terms of outputs; 4,300 is an input figure and is not the best way of measuring it.

206. I asked whether anyone external had looked at this.

(*Sir Kevin Tebbit*) Yes. We have used and I have used over the last four years a number of different consultants and advisers in reprocessing various bits of the organisation, McKinsey for example when we were sorting out some of this.

207. Has anybody looked at the whole thing?

(*Sir Kevin Tebbit*) No, because that would not be an appropriate way of looking at it.

Geraint Davies

208. I just want to pursue Mr Davidson's point about risk management for a moment. The accepted wisdom on PFI is obviously that we transfer risk and therefore that risk is taken by the private sector and they pay for it and we pay a higher amount of money and if things go wrong, they pay. This situation is still slightly confusing. Mr Mitchell seemed to be saying that if he were given the money at a cheaper rate he could add the same business value. The issue for the Treasury would be in the PFI situation that we have a situation where we are paying a lot more money because Mr Webber has to borrow at a greater level and in the case where we borrow the money obviously we would be paying less and the difference between those two amounts would be a saving. I am just wondering whether the Treasury could say why it is not the case that we are committed in these PFIs to spend a certain amount of money, say over 20 years, and that is our commitment. We agree to do that and we bank that as the amount of money we are willing to risk and against that we have the smaller amount of money, the residue, as some contingency, would that not be a better way of managing things?

(*Mr Glicksman*) The difference between those two amounts is the risk that this company will not be able to perform in the way that it is planning to do, that if the costs overrun or the time overruns, the project turns out unsuccessful and it is unable to repay its loan. That is the reason why there is a higher rate being charged to that company for these loans than the market is charging the Government for its loans. For the taxpayer to lend money to the company at a rate which did not take account of that would not be value for money to the taxpayer. It would be risking not getting its money back. The proposal you are suggesting would pass further risks back to the taxpayer.

209. Yes. I suppose it is swings and roundabouts. What we are saying in the current case is that the risk which is judged by the market to be inherent in the

company is then factored into the cost of capital, so we pay for all that risk. So we are already paying for all that risk, are we not? In the case where we provided cheaper finance, we would still have in an insurance in the sense of that amount of value to cover that risk, would we not?

(*Mr Glicksman*) In the long run those two ought to work out the same because that is why the market values it at a certain rate.

Mr Steinberg

210. If he goes bankrupt tomorrow, who bales the project out anyway?

(*Sir Kevin Tebbit*) The banks. That is one of the reasons why the rate is the level it is. From the point of view of the Ministry of Defence, I simply have to say that we had no choice in the matter. We have to apply the rules. If I had a lower unitary payment to make each year as a result of this, there would still be a higher risk of a default and somebody else would have to pay the difference, which would be the taxpayer.

Chairman

211. Mr Bacon wants to ask whether the loan is guaranteed by the Government.

(*Sir Kevin Tebbit*) No. This is risk transfer.

Geraint Davies

212. You have these 4,300 people in London, you mentioned that one quarter are military. Was there a serious proposal to move the vast majority of these people to a cheaper location?

(*Sir Kevin Tebbit*) In the mid 1990s we did look at that and found that was not the most cost effective thing to do. If I find it to be cost effective to get the non-headquarters people who are in London out of London, then I will do it. At the moment the deal we have on St George's Court is cheaper. That would certainly be a chunk of staff we would move out if it becomes cost effective.

213. You could move them out and sub-let the building, could you not?

(*Sir Kevin Tebbit*) Yes; we would get rid of it, we lease it.

Chairman: That concludes our business. May I thank you and Mr Webber and your colleagues for coming this afternoon? I can understand some of the frustration felt this afternoon because, as Mr Jones quoted from the contents page, "The deal gives MOD what it set out to procure", "After an effective procurement the benefits of this deal will be similar in cost to the forecast cost of conventional procurement; other factors tipped the balance in favour of PFI". I am sure you will understand that we have to investigate these matters and no doubt we shall return to them in our Report. Thank you very much for coming. I know you wanted to get away for a royal occasion by six thirty. We do not want the PAC being accused of keeping you from a royal occasion, so we shall let you go now. Order, order.

26 June 2002]

[Continued

APPENDIX 1

Supplementary memorandum submitted by the National Audit Office

1. At the Evidence Session on 26 June 2002, the C&AG agreed that the NAO would submit to the Committee a note on two matters:

- (a) an analysis of the increased financing costs of £60 million which had occurred between the selection of Modus as preferred bidder and financial close of the deal;
- (b) an estimate of how the costs of the deal would have changed had it been possible to finance it at a cost of capital in line with public sector borrowing costs.

INCREASE IN COSTS OF FINANCE

2. Table 1 shows how the component costs of the deal changed between preferred bidder stage and financial close. It is clear that £54 million, that is almost all, of the £60 million increase was due to increases in the net discounted cost of debt finance.

TABLE 1: HOW THE COSTS HAVE CHANGED

	<i>Cost at selection of preferred bidder (£ million)</i>	<i>Cost at financial close (£ million)</i>	<i>Change in financing costs (£ million)</i>	<i>Increase (£ million)</i>
Project capital and operating costs	665	704		39
Financing costs				
—Equity	29	32	3	
—Debt	–63	–9	54	
—Cash	16	19	3	
Total change in financing costs				60
Total	647	746		99

3. In costing projects that involve expenditure spread over many years, it is standard practice to use a technique known as **discounted cash flow analysis**. This technique puts costs or revenues arising in future years on a common basis that takes account of the time value of money (that is the fact that £100 available for spending today is more valuable than £100 made available in one year's time). Accordingly, all the costs shown in Table 1 have been discounted in accordance with the principles laid down by the Treasury for use in public sector projects.

4. When discounted cash flow analysis is used, attention needs to be paid to the discount rate. The discount rate is supposed to be a measure of the time value of money and is akin to a rate of interest. During the negotiation of the PFI deal for Main Building the standard discount rate prescribed by the Treasury was 6% per annum in real terms.

5. Because the costings in Table 1 are discounted, the financing costs shown are a measure of the *difference* between the interest rate Modus expected to pay and the Treasury discount rate. So the figure of minus £63 million at preferred bidder stage indicates that at that stage Modus was expecting to obtain debt finance at a markedly lower cost than 6% in real terms; and the figure of minus £9 million at financial close indicates that at that stage the cost of debt finance was only slightly lower than the 6% rate.

6. We have examined why the cost of debt finance changed from minus £63 million to minus £9 million—an increase of £54 million. There are three factors:

- (a) £27 million from an increase in long term borrowing rates;
- (b) £25 million from a decrease in short term lending rates
- (c) £2 million arising from additional capital works to be financed.

INCREASE IN LONG TERM BORROWING RATES

7. The increase in the long term borrowing rates secured by Modus had two causes. One was generally increasing costs on long term borrowing in the financial markets. The other was MOD's decision to fund the deal using bank finance as opposed to bond finance. Long term borrowing in the bank financing markets became more expensive relative to that in the bond markets during the preferred bidder stage.

26 June 2002]

[Continued

DECREASE IN SHORT TERM INTEREST RATES

8. The increased cost of long term borrowing was exacerbated by a reduction in the short term interest rates that Modus could obtain on their cash deposits. In a bond-financed PFI project, funds are drawn down at the beginning of the deal and placed on deposit until they are required. These funds earn interest whilst on deposit. As short term interest rates decreased during the preferred bidder stage, and since MOD eventually chose bank finance, the benefit of funds on deposit in the project was greatly reduced, and consequently resulted in a higher financing cost.

ADDITIONAL FUNDING REQUIREMENTS

9. During the preferred bidder stage the capital costs of the project increased due to additional works identified in the detailed surveys. These additional works produced the need for a higher funding requirement, which in turn led to a higher overall financing cost.

IMPACT OF PUBLIC SECTOR FINANCING COSTS ON THE COST OF THE DEAL

10. The case for PFI rests on the benefits of the PFI approach outweighing the extra financing costs involved. The Committee were therefore interested in quantifying the extra costs in this deal arising from the use of private sector finance.

11. This calculation is not at all straightforward because the timing of the expenditure planned by Modus is likely to have taken into account the costs and nature of the external finance with which Modus would finance it. So, had Modus had access to debt at public sector borrowing rates, it is likely that the pattern of expenditure would have differed.

12. Subject to that very important reservation, some indication of the impact of private sector financing costs on the cost of the deal to MOD can be given by examining how the total cost of the deal is made up when discounted at a rate reflecting public sector borrowing costs. As pointed out above, in a discounted cash flow analysis the figures for financing costs reflect the difference between the costs of finance (in this case private sector finance) and the discount rate (public sector finance). Unfortunately the Treasury's standard discount rate on which Table 1 is based is not a good measure of public sector financing costs because the standard discount rate was set when public sector borrowing costs were much higher than they are now. That means that to make a fair comparison of public and private sector financing costs it is necessary to use a discount rate that is lower than the Treasury's standard discount rate of 6% in real terms: a discount rate of 3.5% is justified.

13. Table 2 shows the way the total costs of the deal are made up at the 3.5% discount rate. The total cost of the deal discounted at 3.5% includes some £160 million of financing costs relative to the 3.5% discount rate. The figure of £160 million is therefore an estimate of the impact of private sector financing costs on the price of the deal.

14. Because Modus may pay tax on profits arising from the deal, the net cost of the deal to the Exchequer could be less than £160 million. Table 2 suggests that the value to the Exchequer of tax revenues would amount to some £50 million (shown as £53 million in the Table). That figure is subject to some very important provisos: first that the deal generates profits to the extent assumed by Modus; and, secondly, that Modus actually pays the tax on those profits. The former would obviously depend upon Modus's success in managing the risks to which it is exposed. The latter would depend upon the scope for Modus and its shareholders to mitigate their overall tax liabilities. There would also be tax revenues to the Exchequer arising from the interest payments on public borrowing. Subject to those provisos, then, the extra cost to the Exchequer of private financing would be likely to be in the range of £110 to £160 million.

TABLE 2: THE IMPACT ON THE DEAL OF USING PUBLIC SECTOR FUNDING

	<i>Components of net present cost of the deal using a 3.5% discount rate</i>	
	<i>PFI deal</i>	
	<i>(£ million)</i>	
Project costs		897
Less Tax		- 53
Equity ⁽¹⁾	67	
Debt	78	
Cash	15	
Total financing costs relative to 3.5% discount rate		160
Total Discounted Unitary Charge		1,004

Note 1: Equity includes all equity and subordinated debt.

26 June 2002]

[Continued

Annex A

1. The Ministry of Defence have submitted a Note to the Committee that quotes a financing cost of £185 million. This amount is calculated by treating separately the effects on the cost of the project of draw-down and repayments of principal. It is wholly consistent with Table 1, as shown in the reconciliation below.

FINANCING COSTS SPLIT BETWEEN PAYMENTS TO FUNDERS AND CAPITAL MOVEMENTS

	<i>Cost at financial close (£ million)</i>	
Project capital and operating costs		704
Financing costs ⁽¹⁾		
—Interest and Dividends	185	
—Drawdown and repayment of principal	– 143	
		42
Total		746

Note 1: Interest and Dividends reflect the equity return and the interest cost that Modus pay to their third party funders. Draw down and repayment of principal relates to capital movements and reflects the benefit of funding being received at the start of the project but not being repaid until the end of it.

2. The figures shown in Table 2 are calculated, as explained in the Note, using a discount rate of 3.5%. As a result the total net present cost of the project appears to differ from the figure of £746 million in the C&AG's Report and in Table 1. For comparison, the table below analyses the component costs of the PFI deal using both discount rates.

COMPARISON OF THE DEAL AT DIFFERENT DISCOUNT RATES

	<i>Using a 6% discount rate PFI deal (£ million)</i>		<i>Using a 3.5% discount rate PFI deal (£ million)</i>	
Project costs	734			897
Less Tax	– 30			– 53
Equity ⁽¹⁾	32	67		
Debt	– 9	78		
Cash	19	15		
Total financing costs relative to 3.5% discount rate				160
Total Discounted Unitary Charge	746			1,004

Note 1: Equity includes all equity and subordinated debt.

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