

House of Commons
Treasury Committee

**THE HANDLING OF THE
JOINT INLAND
REVENUE/CUSTOMS
AND EXCISE STEPS PFI
PROJECT**

Fourth Report of Session 2002–03

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

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Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) from Session 1997-98 onwards are available on the Internet at: www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_reports.cfm. A list of Reports of the Committee published in the present parliament is on page 22 of this volume.

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Footnotes

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by the page number as in 'Ev 12'.

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FOURTH REPORT

The Treasury Committee has agreed to the following Report:

THE HANDLING OF THE JOINT INLAND REVENUE/CUSTOMS AND EXCISE STEPS PFI PROJECT

Introduction

1. The Treasury Committee established a Sub-committee in July 2001 to scrutinise the work of the various bodies for which Treasury Ministers are accountable. As part of this work we decided to undertake a short inquiry into the handling of the joint Inland Revenue and HM Customs and Excise STEPS PFI project. We heard oral evidence on this from Sir Nicholas Montagu, Chairman, Inland Revenue, and Mr Richard Broadbent, Chairman, HM Customs and Excise on 11 December 2002. We also received written evidence from the STEPS contractor, Mapeley, which we publish with this report.

2. In March 1999 HM Customs and Excise, the Inland Revenue and the Valuation Office Agency, an agency of the Inland Revenue, (collectively “the Departments”) announced the start of a joint procurement to establish a long-term partnership with the private sector for the provision of serviced accommodation to meet their needs for a period of 20 years. Following a competition, in August 2000, the Departments announced that the Mapeley consortium had been selected as the preferred bidder.¹

3. The Strategic Transfer of the Estate to the Private Sector (STEPS) contract, signed in March 2001, was structured so that in return for the transfer of ownership and responsibility for some 600 properties to the Mapeley Group, the Departments received an up front cash payment of £220 million, together with a further £150 million in the form of discounted service prices. Under the contract, the Departments pay Mapeley a “Facilities Payment” in return for the provision of fully serviced accommodation.²

The contract award

4. The Departments told us that standard EC procurement arrangements were used to identify the supplier of the STEPS project. An advertisement was placed in the Official Journal of the European Commission in March 1999 inviting expressions of interest for the supply of serviced accommodation to the Departments. Following the short-listing of three contractors, tenders were received in April 2000 from Mapeley and two other bidders: Trillium and Servus. The Mapeley tender identified the owners of Mapeley as Fortress Registered Investment Trust (incorporated in Delaware USA), Soros Real Estate Investors CV (a Limited partnership formed in the Netherlands), and Delancy Estates Ltd (a company which was resident in the UK at the time the contract was signed) whose shares were subsequently acquired by Tribeca Properties Mapeley Ltd (a company registered outside the UK). Bids were received from the other consortia, each of which included at least one non-resident wanting to invest in the UK. The Mapeley consortium was chosen as the preferred bidder in August 2000 and contracts were exchanged in March 2001.³

¹ Ev 4, paras 2.1, 3.1, 3.9

² Ev 5, paras 4.1, 4.4, and Ev 26, para 3

³ Ev 2, para 2, and Ev 4, para 3.6

5. The Departments told us that an appraisal of the proposed contract demonstrated that over its lifetime there would be a significant benefit to the Departments. The benefit was not only lower costs. Risk has been transferred to Mapeley in areas such as the flexibility in the vacation of properties, and increases in the cost of maintenance and the provision of other services. The contract also contains a formula that allows the Departments to share in development gains achieved by Mapeley.⁴ Sir Nicholas Montagu told us that he was “absolutely confident that we have got a really good deal for Government.”⁵

6. In this short inquiry we have examined the way the STEPS project was handled administratively by the Departments. We have not sought to examine the STEPS contract in detail and we have not come to any conclusions as to its merits for the Departments. The National Audit Office has indicated in its forward programme document that it proposes to examine the STEPS PFI project and we look to its report to determine whether value for money was obtained for the taxpayer.

Mapeley’s offshore structure

7. We asked the Departments for details of the identity and place of registration of the principal companies involved in the STEPS contract. The Departments told us that: the company which tendered was Mapeley Limited, registered in the UK; the main contracting party is Mapeley STEPS Contractor Limited, also registered in the UK; and that the majority of the assets are held by Mapeley STEPS Limited, registered in Bermuda.⁶

8. Mapeley told us that in PFI contracting the private sector contractor is “typically a special purpose, bankruptcy remote, corporate vehicle. In the case of STEPS, that vehicle is Mapeley STEPS Contractor Limited,”⁷ a UK company. Mapeley advised the Departments’ project team that the valuable freehold and long leasehold properties would be transferred to its investment company, Mapeley STEPS Limited, a Bermuda registered company. Non-valuable leasehold properties and properties that were to be disposed of in the short term were transferred to Mapeley STEPS Contractor Limited. Both Mapeley STEPS Contractor Limited and Mapeley STEPS Limited have appointed Mapeley Limited, a UK company, to manage the STEPS Contract and the STEPS estate. Mapeley Limited is a management company with approximately 150 employees.⁸ Mapeley STEPS Contractor Limited and Mapeley STEPS Limited are both subsidiaries of Mapeley STEPS Holdings Limited, also registered in Bermuda. The relationship between these companies, Mapeley Limited and their shareholders is illustrated in a structure chart provided by Mapeley (shown at Figure 1 below).⁹

⁴ Ev 5, paras 4.2, 4.3

⁵ Q 4

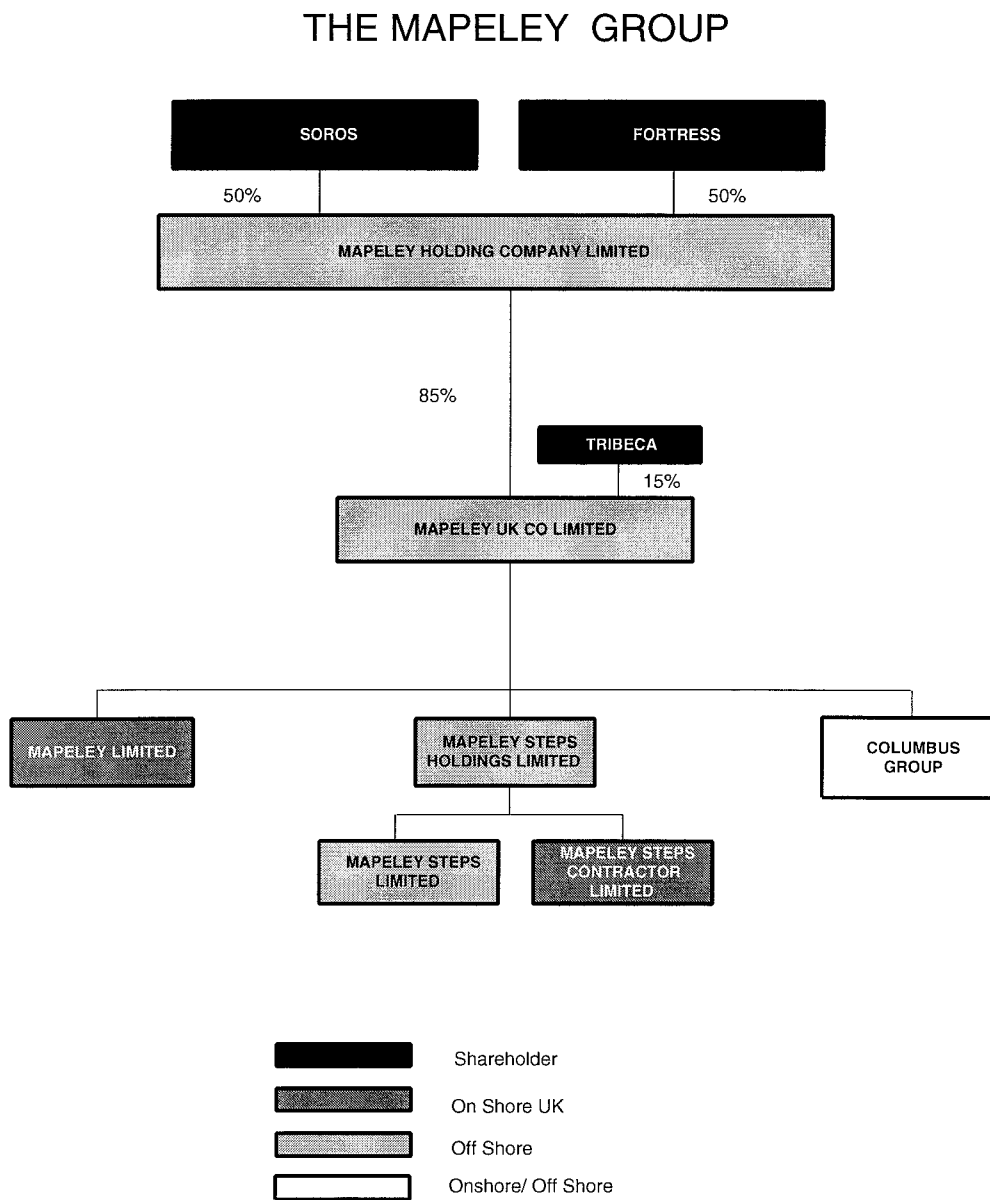
⁶ Ev 2, para 7

⁷ Ev 27, para 16

⁸ Ev 26, paras 1, 19, 21

⁹ Ev 28, para 23 and Ev 30, Annex 2

Figure 1: The Structure of the Mapeley Group



Tax avoidance

9. Mapeley noted that approximately 90 per cent of its capital for STEPS was provided by overseas investors and that, regardless of Mapeley's structure, Mapeley's investors are subject to their respective taxation regimes for any benefits arising out of their investment in the Mapeley Group.¹⁰ Mapeley also told us that on an operating basis the economics of the contract are marginal for the company. As a result, Mapeley shareholder returns rely upon capital gains on the valuable properties towards the end of the STEPS contract term. Accordingly, Mapeley "structured its tax affairs to minimise exposure to Capital Gains Tax and thereby reduce the charge to the Departments. This is absolutely standard in the investment world where offshore investors own property in the UK. Mapeley has operated entirely within both the letter and spirit of the law."¹¹

10. The Departments told us that the STEPS procurement followed standard arrangements which provide "for the exclusion of bidders where they have not paid their tax or are (or have been) involved in tax evasion. There are no other grounds on which bidders can be excluded. The procurement process was ... subject to three community law provisions and one WTO agreement:

- Article 83 of the EC Treaty (freedom of establishment),
- Article 49 of the EC Treaty (freedom to provide services),
- Public Services Contracts Regulations 1993 (SI 1993 No.3228), which implemented an EC Directive on public procurement,
- Under the auspices of the World Trade Organisation, the Government Procurement Agreement 1994.

Following advice from leading Counsel, Inland Revenue lawyers (who were not involved in the procurement process) have recently asserted that the practical effect of these measures prevented the Departments including a provision in the procurement process to outlaw the use of an offshore tax structure by bidders."¹²

11. Government policy is to reduce tax avoidance.¹³ We asked the Inland Revenue whether the structure adopted by Mapeley for the STEPS contract involved tax avoidance. Sir Nicholas Montagu told us that "... lawful [tax] avoidance, in other words avoidance within the scope of the law, cannot under European or World Trade Organisation rules be taken as a reason for discriminating against a bidder. That is a rule which applies right across Government procurement"¹⁴ and "... for us to have discriminated against the Mapeley bid because the properties were being transferred to a company in Bermuda would have been unlawful."¹⁵ He also told us that he did not think it was correct to describe it as tax avoidance in this case,¹⁶ noting that "if you are an overseas company you have no liability for UK Capital Gains Tax. Therefore these are companies without a liability."¹⁷

12. The Inland Revenue was not able to tell us whether Stamp Duty had been paid by Mapeley on the purchase of these properties as it does not comment on the affairs of individual taxpayers.¹⁸ Mapeley subsequently stated that "... Stamp Duty was paid on the

¹⁰ Ev 27, paras 16, 18

¹¹ Ev 28, paras 24, 25

¹² Ev 4, paras 3.3, 3.4

¹³ Q 51

¹⁴ Q 17

¹⁵ Q 20

¹⁶ Q 43

¹⁷ Q 44

¹⁸ Qq 5–64

transaction in accordance with the relevant legislation. The amount paid was subsequently approved as a matter of routine by the Stamp Office.”¹⁹

13. We also asked the Inland Revenue why the advice they had obtained from Counsel, on whether procurement law prevented excluding bidders from using an offshore tax structure, had not been obtained before the contract was signed. Sir Nicholas Montagu told us that “... it was not necessary ...Government lawyers right across Whitehall tell their departments that the European procurement law and World Trade Organisation rules do prohibit discrimination on the grounds of lawful tax practices. When interest in the Mapeley contract was evident in the media and more widely, and it became clear that your Committee would take an interest, we thought that it was wise ... on belt and braces grounds to seek advice from leading Counsel, which confirmed the view of Government lawyers across Whitehall.”²⁰

14. The project team did not explore with Mapeley whether the consortium was prepared to own the properties through a UK company in the Mapeley Group.²¹ Sir Nicholas Montagu admitted that the project team could have explored this option, but noted that “they were working within European regulations, which say that an overseas structure is no reason for discrimination”²² and that “even if the properties had been transferred to a UK based company, at the point of transfer nothing in the contract could have prevented a restructuring of the consortium to transfer them before any point of disposal to an offshore company.”²³

15. We note the Inland Revenue’s view that it is not correct to describe the offshore structure adopted by Mapeley for the contract as tax avoidance. But on the basis of Mapeley’s own evidence to the Committee it had “structured its tax affairs to minimise exposure to Capital Gains Tax ...” Tax avoidance was clearly one of Mapeley’s objectives in the way the deal was structured.

16. We accept both that Mapeley was entitled to minimise its tax liabilities and the evidence that the avoidance of tax in this case was legal. However, we consider that the Inland Revenue, responsible for implementing the Government’s policy of reducing tax avoidance, should of all departments have been alert to the difficulties of being party to a deal that transferred ownership of its properties to an offshore company. We are concerned that these difficulties were not recognised at the time. We regard the fact that the project team did not explore with Mapeley the possibility of an alternative structure to the deal that might have avoided them as a failure in the way the project was handled.

17. We were told that even if the properties had been transferred to a UK based company, nothing in the contract could have prevented a subsequent restructuring of the consortium to transfer them to an offshore company. While this may be the case, this argument ignores the tax liabilities that could arise for a company resident in the UK transferring assets offshore.

18. The Departments maintain that procurement law prevented them excluding bidders from using an offshore tax structure and that this was confirmed recently by advice from leading Counsel. We recommend that procurement guidance be reviewed to ensure that it contains comprehensive advice on this matter.

¹⁹ “Statement re Treasury Sub-committee Hearing”, Mapeley, 13 December 2002, www.mapeley.com

²⁰ Q 38

²¹ Ev 5, para 5.3

²² Q 46

²³ Q 51

19. We also recommend that further advice is sought and published so as to clarify whether it is possible to exclude bidders using an offshore tax haven in similar circumstances, and to restrict final beneficial ownership to companies registered in countries that have signed the agreement on Government Procurement. In particular, advice should be sought as to whether specifying this exclusion in the tender advertisement makes it lawful. We further recommend that the Treasury explores whether adjustments should be made to contract bids to reflect loss of tax revenue as we believe is the practice in the United States.

Project management

20. The Departments told us that Mapeley disclosed its intention to adopt a corporate structure with some of its companies resident outside the UK in a letter in November 2000 to the Departments' legal advisers that was forwarded to the Departments' procurement team. The first reference to a company registered in Bermuda was in an e-mail sent by Mapeley's lawyers to the Departments' lawyers on 7 December 2000 which also referred to plans for the Departments' freehold and long-leasehold properties to be held in another Mapeley company also to be incorporated in Bermuda.²⁴ The corporate structure of Mapeley was an item on the agenda of a meeting attended by officials from HM Customs and Excise, the Inland Revenue, their legal and financial advisers (Lovells and Deloitte & Touche), and Mapeley and its legal advisers. The Departments' representatives on the project team subsequently said that "they saw no reason to mention the offshore arrangements to more senior colleagues as they were legal, and not prevented by the procurement rules."²⁵

21. The Board of Inland Revenue learnt of the offshore structure a few days before contracts were due to be signed. The Departments' financial advisers, Deloitte & Touche, who had been asked to explain Mapeley's tax arrangements, reported on 1 March 2001 that "the structure was familiar to the commercial world and that it was the kind of arrangement which they would expect from professional overseas investors. They said that they had not seen anything to create alarm. Specialists in the Department looked at the structure and confirmed that it was a conventional arrangement used by non-residents that could not be challenged under tax law. The Board took the view that there were no grounds in the established procurement process for refusing to sign the contract."²⁶ Mr Broadbent told us that the Customs and Excise Management Committee were not informed of Mapeley's offshore structure before the contract was signed.²⁷ Similarly, at the time the contract was signed, the Paymaster General had not been told that Mapeley STEPS Limited was registered in Bermuda.²⁸

22. We asked how the Board of the Inland Revenue came to learn of the offshore structure a few days before the contract was signed. Sir Nicholas Montagu explained that "at the point where the Board of Inland Revenue were preparing to give their agreement and to sign, at that point we asked (to be precise my deputy on the policy and technical side asked), knowing that arrangements of this sort were common, what the structure of the Mapeley companies was."²⁹

23. We questioned whether the joint project team had kept senior management sufficiently well informed on the negotiations and the form of the proposed contract. Sir Nicholas Montagu told us that the project team had been focussing very much on operating

²⁴ Ev 5, para 5.1, 5.2

²⁵ Ev 5, para 5.3

²⁶ Ev 5, para 5.4

²⁷ Q 24

²⁸ Ev 5, para 5.4

²⁹ Q 28

within the procurement rules laid down by the Treasury and that “at worst the charge against them is one of naivety in not ... [flagging up Mapeley’s offshore structure] as something which could be presented against ... [the Departments] at a later stage.”³⁰ He also told us that if the exercise was repeated he “would expect the outcome of the procurement to be the same because it was conducted in an exemplary way in accordance with the rules.”³¹ The failure to inform the Minister was “a pure and simple oversight. I have apologised to the Paymaster General ... we should have warned the Paymaster General because again it was something which could be misrepresented. Had we told her, again it could not have made any difference to the ultimate outcome.”³² Mr Broadbent told us that he thought the project team should have told the Customs and Excise Management Committee about the offshore structure of the contract and that “... it is regrettable that they did not.”³³

24. A joint Inland Revenue and Customs and Excise press release of 9 March 2001 announcing the signing of the contract referred to the estates being transferred to Mapeley Ltd, a UK registered company, rather than Mapeley STEPS Ltd which is registered in Bermuda. The information was subsequently corrected in an Inland Revenue statement issued in September 2002. The Annual Report and 2000-01 Resource Accounts of the Inland Revenue refer to the transfer of buildings to a UK incorporated company, Mapeley STEPS Contractor Ltd, instead of Mapeley STEPS Ltd. The Customs and Excise Annual Report also refers to the signing of a contract with Mapeley Ltd. The Departments told us that they “regret that incorrect company details were shown in the original press release, accounts and report. It seems the officials producing these documents focussed on Mapeley as a consortium or Mapeley Ltd, the bidding vehicle, rather than individual companies in the group.”³⁴ Sir Nicholas Montagu characterised these events as pure mistakes “for which we have apologised and set the record straight ...”³⁵

25. The Board of the Inland Revenue was not informed by the project team that, under the contract, the Revenue’s properties would be transferred to a company registered in Bermuda. The Board appears to have discovered this fact a few days before the contract was due to be signed only because one of its members, knowing that arrangements of this sort were common, asked what the structure of the Mapeley companies was. The Customs and Excise Management Committee and the relevant Minister, the Paymaster General, were not told of the offshore structure of the contract before it was signed. We reject the proposition put forward by the Chairman of the Inland Revenue that at worst the charge against the project team is one of naivety, a view we believe is complacent. We view with great concern the fact that such failures in briefing senior management and the Minister have occurred. We expect the Departments to have identified exactly where and how things went so seriously wrong and to have taken the necessary steps to prevent a recurrence.

26. A joint Inland Revenue and Customs and Excise press release in March 2001 announcing the signing of the contract, and the Revenue’s Annual Report, wrongly refer to the transfer of the estate to a UK incorporated company rather than one registered in Bermuda. These errors were not corrected until September 2002, some 18 months after the initial mistake. Customs and Excise’s Annual Report refers to the wrong company as the STEPS contractor. Parliament and the public rightly expect information provided by Government departments to be accurate. In this case errors have been made in describing the contract on several occasions. While we

³⁰ Q 29

³¹ Q 30

³² Q 32

³³ Q 31

³⁴ Ev 5, paras 5.4, 5.5

³⁵ Qq 52–55

acknowledge that the Departments have corrected their previous statements, this standard of performance is not acceptable.

Financial difficulties

27. Mapeley first raised concerns about financial issues in November 2001. In December 2001 Mapeley pointed to a serious cash flow problem and asked the Departments for a substantial cash settlement. This proposal was rejected, but the Departments agreed to work with Mapeley to get a better understanding of the extent of its financial problems, and to consider what options were available. The Departments “recognised that whilst most of the financial pressures arose from areas where risks had been transferred to Mapeley, changes in the Departments’ requirements and the bedding down of the contractual arrangements could also adversely affect Mapeley’s cashflow ...”³⁶ Mapeley’s view was that it had “suffered significant economic detriment compared to its expected bid case on the STEPS contract ...[and that] the economic strain ... [resulted] from inaccuracies in the data provided by the Departments and changes in the Departments’ requirements under the contract.”³⁷ However Mapeley accepted that “in some measure the strain also results from Mapeley’s own errors, for which it takes full responsibility. For example, it under-estimated the overall costs of service delivery. It has therefore re-engineered the way it manages service delivery and reduced its costs significantly.”³⁸

28. The Departments appointed an investment bank, Rothschilds, who had no previous involvement in the deal, to report on Mapeley’s financial position, and the options for going forward. Rothschilds concluded in March 2002 that the Departments had negotiated a good deal in terms of the original price and that it was in the Departments’ interest to reach a settlement with Mapeley if possible. They recommended that more work be done on Mapeley’s financial projections, and how the contract would operate in the event of a termination.³⁹ In May 2002 the Chairmen of the Departments met “to agree how best to move forward with the involvement of all stakeholders. While not wishing to pay out money in respect of risks that had been transferred to Mapeley, they recognised that without a settlement there was a risk that Mapeley might fail financially. That could involve the Departments in more expenditure, costly litigation and real operational difficulties. Those operational difficulties would be particularly serious for the Inland Revenue. They agreed, therefore, to commission further work to determine how the financial issues could be settled. They believed that it was crucially important to get a better understanding of the consequences of the contract coming to a premature end and that contingency work should be carried out to explore exit options ...”⁴⁰

29. In July 2002 the Inland Revenue Board asked the working group set up to examine and advise the Departments on this issue to discuss with the Treasury, the Office of Government Commerce and the National Audit Office how best to keep to a minimum the risks to the Departments, and the payments to Mapeley. The working group was asked to consider a package that might involve:

- obtaining greater security for the Departments in the event of termination;
- getting Mapeley’s shareholders to inject extra money into the group;
- increasing the facilities payment to Mapeley for three years or, spreading the equivalent amount over the life of the contract;

³⁶ Ev 5, para 6.1

³⁷ Ev 28, paras 33, 34

³⁸ Ev 28, para 35

³⁹ Ev 6, paras 6.3, 6.4

⁴⁰ Ev 6, para 6.8

— a guarantee to Mapeley’s bankers which would provide for part of the facilities payment to Mapeley to be paid by the Departments direct to the bank if the guarantee was triggered.⁴¹

30. Mapeley had approached the Departments in May and June 2002 seeking reassurances about the likely outcome of discussions on their financial issues, with the aim of sharing this with their bankers and auditors. A letter setting out on a “without prejudice basis” the shape of a possible settlement with the Departments, but emphasising that any deal would be subject to the approval of Treasury officials and Ministers, had been sent in June 2002. A further letter on the same lines was sent in July 2002 to provide reassurance to Mapeley’s shareholders. This letter was accompanied by a draft Memorandum of Understanding, “which might have formed the basis of the further agreement between the Departments and Mapeley. The letter again made it clear that any arrangement would be subject to approval by Treasury officials and Ministers.”⁴² These letters are considered further in paragraphs 36 to 42 below.

31. The draft Memorandum of Understanding was subsequently withdrawn as changes in the stock and property markets had enabled Mapeley to improve its income from asset management of the STEPS estate. Mapeley has put a revised proposal to the Departments which “focusses on resolving the outstanding contractual issues. The Departments are considering the proposals with their advisers. Once the analysis is complete the proposals will be referred to Treasury officials and Ministers.”⁴³

32. We asked the Departments how a 20 year contract had run into difficulties after only seven months. Sir Nicholas Montagu told us that at the time when the Departments had signed the deal they had undertaken all the due diligence that you would expect on the robustness of the financial position. At the point of signing the contract neither Mapeley, the Departments, nor their advisers had foreseen Mapeley’s cash flow problems.⁴⁴ “At the point where Mapeley came to us, having identified their financial difficulties, and in the succeeding months there was a real danger that the contract could collapse. If it did so it would have involved ... [the Departments] in very substantial additional costs if we had taken the estates back, which would not have been a good deal for the taxpayer. So what we wanted to explore was, was there a way in which we could preserve the partnership and in which we could help Mapeley over these problems. ... This was a complex negotiation involving not just their cash flow problems but various contractual issues of the sort that you do expect during the first year of a complex contract.”⁴⁵

33. We questioned what risk assessment of the dangers involved in early termination of the contract had been undertaken before the contract had been signed and what the position would be if Mapeley failed. The Departments told us that they and their advisers had undertaken full due diligence work on the financial, legal and technical aspects of the bid⁴⁶. If Mapeley failed “an intrinsic part of the contract [was] that the freeholds to the estates were passed on ... what we retained as a result of that was the right of occupancy and the ability to buy essentially a services package ... in practice the freeholds and leaseholds would actually revert to the lending banks because Mapeley is indebted to banks and they have a first charge over the property. The structure of the contract gives us a right of tenure in the properties for at least twenty years after the contract terminates. So we would have the right to occupy the buildings at no more than the market rent ...”⁴⁷

⁴¹ Ev 7, para 6.13

⁴² Ev 7, paras 7.1, 7.2

⁴³ Ev 8, para 8.1

⁴⁴ Qq 7–10

⁴⁵ Q 8

⁴⁶ Q 10

⁴⁷ Qq 12,13

34. Sir Nicholas Montagu told us that since Mapeley's first approach for financial assistance "movements in the stock market and the property market respectively have enabled Mapeley substantially to improve their cash flow position and that is why the negotiations that we are in with them now are very different from those that we entered into earlier in the year."⁴⁸ These ongoing negotiations, which the Departments hoped to conclude "reasonably early" in 2003⁴⁹ limited the information that could be made available to the Committee in public.⁵⁰ The Departments have agreed to provide the Committee with a memorandum on these negotiations when they have been concluded.⁵¹

35. It is clearly a matter of concern that only seven months after the twenty year contract was signed the Departments had been asked to provide a substantial cash settlement to alleviate Mapeley's cash flow problems. This must cast doubts on the robustness of Mapeley's bid and the standard of due diligence work undertaken by the Departments and their advisers before the contracts were signed. We are also concerned that the Departments' negotiating position with Mapeley appears to have been weakened by the concern that there would be serious operational difficulties and very substantial additional costs for the Departments if Mapeley failed financially. We consider this to be a matter that should have been addressed and resolved before the contract was signed. We look to the National Audit Office to examine these aspects of the project as part of its value for money study.

36. We note the Departments' view that most of the financial pressures arose from areas where risks had been transferred to Mapeley. But the Departments' evidence was also that changes in their requirements and the bedding down of the contractual arrangements had affected Mapeley's cash flow. We are concerned that this state of affairs indicates weaknesses in the original contract which will have to be addressed in the ongoing negotiations with Mapeley. The fact that these may result in a more satisfactory settlement for the Departments than at first seemed possible appears to have been the result of fortuitous movements in the stock and property markets. We look forward to learning the outcome of these negotiations which we will report to the House.

37. We are concerned that the financial crisis faced by Mapeley so soon after entering the contract, and the potential consequences of the company going bust, undermines one of the key stated objectives of this deal—to transfer risk to the private sector.

Letters of comfort

38. In Minutes in March and July 2002 the Paymaster General expressed "strong reservations about paying increased amounts to Mapeley."⁵² However, in June and July 2002 letters and a draft Memorandum of Understanding were sent to Mapeley (paragraph 29 above refers) "as part of the continuing attempt to identify recommendations to make to Ministers, and they were not, in consequence, brought to their attention at the time ...it was made clear throughout the discussions that any changes to the contractual arrangements would be subject to approval by Treasury officials and Ministers. Our legal advice was at the time, and remains, that, because of this strong and unequivocal proviso, the letters do not create a contingent liability for the Departments."⁵³

⁴⁸ Q 81

⁴⁹ Q 85

⁵⁰ Q 78

⁵¹ Q 153

⁵² Ev 7, para 6.13

⁵³ Ev 8, para 7.3

39. The financial statements of Mapeley STEPS Contractor Limited for the period ended 31 December 2001 were lodged with Companies House in August 2002. They contain a note entitled “Going Concern” which states:

“The directors note that the company has net liabilities of £23,656,000 as of the balance sheet date. The directors have prepared these financial statements on a going concern basis following their review of the current cash flow forecasts for a period of no less than twelve months from the date of approval of the statements. These cashflows assume a successful outcome to current negotiations with the Departments in relation to the restructuring of certain aspects of the STEPS contract, including additional revenues, and changes to the financing arrangements and contract structure. The Directors have received a signed letter of the intent from the Departments in relation to these key proposals and therefore consider that the outcome to these negotiations will be successful. In addition, as part of these negotiations, the ultimate shareholders have agreed to provide certain additional funding to support the ongoing contract to 2005 if required.”⁵⁴

40. The Departments told us that this “going concern” note “might be taken to imply a greater degree of certainty about a possible settlement than the provisos in the letters sent to them warranted. Three members of the working group, including a representative of the Inland Revenue, were sent a draft of the proposed “going concern” note ... but they did not recognise the significance of the note and so it was not considered further in the Departments before publication of the accounts.”⁵⁵ The Departments also informed us that they had been advised subsequently by the Treasury Officer of Accounts that the letters sent to Mapeley may constitute letters of comfort within the meaning of ‘Government Accounting’. Accordingly, they had brought the letters to the attention of the Chairman of the Public Accounts Committee and had apologised for not doing so earlier.⁵⁶

41. Government Accounting states that “departments should approach any request for a letter of comfort with a strong predisposition to reject it. While letters of comfort are not generally legally binding, they may lead to a moral obligation: a public sector body, which is ultimately dependent on government credit, is unlikely to be able to issue such a document without effectively committing government credit and having to meet the obligation if it should materialise. Moreover, the existence of a letter of comfort could lead to threats of legal action, which might have implications for government credit. Proposals to issue a letter of comfort should therefore be exceptional and should be cleared in advance with the Treasury. If the Treasury agrees to the proposal then the Department should follow the parliamentary reporting procedures.”⁵⁷

42. We asked the Departments why, when Government Accounting says that departments should approach any request for a letter of comfort with a strong predisposition to reject it, they had issued two letters of comfort without realising it. Sir Nicholas told us that they had been strongly advised to provide the assurances so that Mapeley could show them to its auditors, bankers and shareholders. The letters had been cleared by the Departments’ legal advisers to ensure that they did not create any contingent liabilities for the Government and on that basis they had been sent. Mr Broadbent accepted that the requirements of Government Accounting had been overlooked when the letters were sent which he thought was regrettable.⁵⁸

⁵⁴ Note 21 to the financial statements for the period ended 31 December 2001 of Mapeley STEPS Contractor Limited (formerly Shelfco (No.2013) Limited).

⁵⁵ Ev 8, para 7.4

⁵⁶ Ev 8, para 7.5

⁵⁷ Government Accounting, para 26.3.1

⁵⁸ Qq 86–89

43. The letters of comfort were not brought to the attention of the Inland Revenue Board or the Customs and Excise Management Committee before they were sent⁵⁹. Mr Broadbent told us that in relation to the July 2002 letter “I received an e-mail I think the day before the letter was issued saying that this was proposed. I responded and questioned the wisdom of doing that but we were subsequently told the letter had then been sent the following day.”⁶⁰ Mr Broadbent agreed that the working group should have recognised that the letters issued were letters of comfort and he considered that the Boards should have been informed about them.⁶¹ “This was a situation where we had no reason to doubt at certain points that Mapeley might pull out, collapse, and there were some very important tactical decisions to be taken to keep this thing going to enable the Boards to fully understand the situation and to consider all the options. In doing that, I think the working group did one or two things (of which probably this is the main example) which perhaps went beyond tactical and they should have informed the Board.”⁶²

44. We questioned why the members of the working group that had received a draft of the “going concern” note that Mapeley STEPS Contractor Limited intended to include in its financial statements had not recognised its significance. Sir Nicholas Montagu told us that this was an oversight and that, with the benefit of hindsight, where they went wrong was in not reacting to it.⁶³

45. Despite the Minister’s “strong reservations about paying increased amounts to Mapeley” the Departments sent two letters to Mapeley to reassure Mapeley’s auditors, bankers and shareholders about the state of negotiations regarding a financial settlement. These appear, from the financial statements of Mapeley STEPS Contractor Limited, to have been fundamental to the company being viewed as a “going concern” despite net liabilities of over £23 million at 31 December 2001. We are surprised that the officials who saw a draft of the relevant “going concern” note in advance of these financial statements being published did not appreciate its significance. This was a serious failure.

46. Government Accounting requires departments to approach any request for a letter of comfort with a strong predisposition to reject it. Following the Treasury Officer of Accounts advice, it appears that the Departments have issued two letters of comfort to Mapeley without realising it. We note the Departments’ view that their letters have not created any contingent liabilities for the Government, but we are concerned, as Government Accounting itself points out, that the letters may have led to a moral obligation and could lead to threats of legal action.

47. The letters of comfort were not brought to the attention of either the Board of the Inland Revenue or the Customs and Excise Management Committee before they were sent and the requirements of Government Accounting were also overlooked. Again the Minister responsible was not informed. We are astonished, and extremely concerned, that such failures can have occurred. We consider these to be serious lapses in the standards required from officials and we expect the Departments to have identified exactly where and how things went so seriously wrong. We expect them also to have taken all necessary steps to prevent a recurrence.

48. We are concerned at the evidence from this project of officials repeatedly failing to inform or seek Board level approval at appropriate times. Similarly, the responsible Minister was not informed of key events before they took place and she

⁵⁹ Q 95

⁶⁰ Q 115

⁶¹ Qq 118, 119

⁶² Q 118

⁶³ Qq 111, 113

has, in our view, the right to be deeply disappointed by the service she received. This is not the first time that we have encountered such problems in the course of our work and we recommend that a review be undertaken of the relationship between Treasury Ministers and the bodies for which they are accountable to ensure appropriate standards of governance and accountability are met.

LIST OF CONCLUSIONS AND RECOMMENDATIONS

- (a) In this short inquiry we have examined the way the STEPS project was handled administratively by the Departments. We have not sought to examine the STEPS contract in detail and we have not come to any conclusions as to its merits for the Departments. The National Audit Office has indicated in its forward programme document that it proposes to examine the STEPS PFI project and we look to its report to determine whether value for money was obtained for the taxpayer (paragraph 6).
- (b) We note the Inland Revenue's view that it is not correct to describe the offshore structure adopted by Mapeley for the contract as tax avoidance. But on the basis of Mapeley's own evidence to the Committee it had "structured its tax affairs to minimise exposure to Capital Gains Tax ..." Tax avoidance was clearly one of Mapeley's objectives in the way the deal was structured (paragraph 15).
- (c) We accept both that Mapeley was entitled to minimise its tax liabilities and the evidence that the avoidance of tax in this case was legal. However, we consider that the Inland Revenue, responsible for implementing the Government's policy of reducing tax avoidance, should of all departments have been alert to the difficulties of being party to a deal that transferred ownership of its properties to an offshore company. We are concerned that these difficulties were not recognised at the time. We regard the fact that the project team did not explore with Mapeley the possibility of an alternative structure to the deal that might have avoided them as a failure in the way the project was handled (paragraph 16).
- (d) We were told that even if the properties had been transferred to a UK based company, nothing in the contract could have prevented a subsequent restructuring of the consortium to transfer them to an offshore company. While this may be the case, this argument ignores the tax liabilities that could arise for a company resident in the UK transferring assets offshore (paragraph 17).
- (e) The Departments maintain that procurement law prevented them excluding bidders from using an offshore tax structure and that this was confirmed recently by advice from leading Counsel. We recommend that procurement guidance be reviewed to ensure that it contains comprehensive advice on this matter (paragraph 18).
- (f) We also recommend that further advice is sought and published so as to clarify whether it is possible to exclude bidders using an offshore tax haven in similar circumstances, and to restrict final beneficial ownership to companies registered in countries that have signed the agreement on Government Procurement. In particular, advice should be sought as to whether specifying this exclusion in the tender advertisement makes it lawful. We further recommend that the Treasury explores whether adjustments should be made

- to contract bids to reflect loss of tax revenue as we believe is the practice in the United States (paragraph 19).
- (g) **The Board of the Inland Revenue was not informed by the project team that, under the contract, the Revenue's properties would be transferred to a company registered in Bermuda. The Board appears to have discovered this fact a few days before the contract was due to be signed only because one of its members, knowing that arrangements of this sort were common, asked what the structure of the Mapeley companies was. The Customs and Excise Management Committee and the relevant Minister, the Paymaster General, were not told of the offshore structure of the contract before it was signed. We reject the proposition put forward by the Chairman of the Inland Revenue that at worst the charge against the project team is one of naivety, a view we believe is complacent. We view with great concern the fact that such failures in briefing senior management and the Minister have occurred. We expect the Departments to have identified exactly where and how things went so seriously wrong and to have taken the necessary steps to prevent a recurrence (paragraph 25).**
- (h) **A joint Inland Revenue and Customs and Excise press release in March 2001 announcing the signing of the contract, and the Revenue's Annual Report, wrongly refer to the transfer of the estate to a UK incorporated company rather than one registered in Bermuda. These errors were not corrected until September 2002, some 18 months after the initial mistake. Customs and Excise's Annual Report refers to the wrong company as the STEPS contractor. Parliament and the public rightly expect information provided by Government departments to be accurate. In this case errors have been made in describing the contract on several occasions. While we acknowledge that the Departments have corrected their previous statements, this standard of performance is not acceptable (paragraph 26).**
- (i) **It is clearly a matter of concern that only seven months after the twenty year contract was signed the Departments had been asked to provide a substantial cash settlement to alleviate Mapeley's cash flow problems. This must cast doubts on the robustness of Mapeley's bid and the standard of due diligence work undertaken by the Departments and their advisers before the contracts were signed. We are also concerned that the Departments' negotiating position with Mapeley appears to have been weakened by the concern that there would be serious operational difficulties and very substantial additional costs for the Departments if Mapeley failed financially. We consider this to be a matter that should have been addressed and resolved before the contract was signed. We look to the National Audit Office to examine these aspects of the project as part of its value for money study (paragraph 35).**
- (j) **We note the Departments' view that most of the financial pressures arose from areas where risks had been transferred to Mapeley. But the Departments' evidence was also that changes in their requirements and the bedding down of the contractual arrangements had affected Mapeley's cash flow. We are concerned that this state of affairs indicates weaknesses in the original contract which will have to be addressed in the ongoing negotiations with Mapeley. The fact that these may result in a more satisfactory settlement for the Departments than at first seemed possible appears to have been the result of fortuitous movements in the stock and property markets. We look forward to learning the outcome of these negotiations which we will report to the House (paragraph 36).**

- (k) **We are concerned that the financial crisis faced by Mapeley so soon after entering the contract, and the potential consequences of the company going bust, undermines one of the key stated objectives of this deal—to transfer risk to the private sector (paragraph 37).**
- (l) **Despite the Minister’s “strong reservations about paying increased amounts to Mapeley” the Departments sent two letters to Mapeley to reassure Mapeley’s auditors, bankers and shareholders about the state of negotiations regarding a financial settlement. These appear, from the financial statements of Mapeley STEPS Contractor Limited, to have been fundamental to the company being viewed as a “going concern” despite net liabilities of over £23 million at 31 December 2001. We are surprised that the officials who saw a draft of the relevant “going concern” note in advance of these financial statements being published did not appreciate its significance. This was a serious failure (paragraph 45).**
- (m) **Government Accounting requires departments to approach any request for a letter of comfort with a strong predisposition to reject it. Following the Treasury Officer of Accounts advice, it appears that the Departments have issued two letters of comfort to Mapeley without realising it. We note the Departments’ view that their letters have not created any contingent liabilities for the Government, but we are concerned, as Government Accounting itself points out, that the letters may have led to a moral obligation and could lead to threats of legal action (paragraph 46).**
- (n) **The letters of comfort were not brought to the attention of either the Board of the Inland Revenue or the Customs and Excise Management Committee before they were sent and the requirements of Government Accounting were also overlooked. Again the Minister responsible was not informed. We are astonished, and extremely concerned, that such failures can have occurred. We consider these to be serious lapses in the standards required from officials and we expect the Departments to have identified exactly where and how things went so seriously wrong. We expect them also to have taken all necessary steps to prevent a recurrence (paragraph 47).**
- (o) **We are concerned at the evidence from this project of officials repeatedly failing to inform or seek Board level approval at appropriate times. Similarly, the responsible Minister was not informed of key events before they took place and she has, in our view, the right to be deeply disappointed by the service she received. This is not the first time that we have encountered such problems in the course of our work and we recommend that a review be undertaken of the relationship between Treasury Ministers and the bodies for which they are accountable to ensure appropriate standards of governance and accountability are met (paragraph 48).**

MINUTES OF PROCEEDINGS OF THE COMMITTEE AND THE SUB-COMMITTEE RELATING TO THE REPORT

Main Committee

THURSDAY 6 FEBRUARY 2003

Members present:

Mr John Mcfall, in the Chair

Mr Nigel Beard
Angela Eagle

Norman Lamb
Dr Nick Palmer

The Committee deliberated.

Draft Report from the Sub-committee [The handling of the joint Inland Revenue/Customs and Excise STEPS PFI project] brought up and read.

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

Paragraphs 1 to 48 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 Appendices to the Minutes of Evidence taken before the Sub-committee be reported to the House.—(*The Chairman.*)

* * * * *

[Adjourned till Monday 10 February at a quarter-past Nine o'clock.

Sub-committee

WEDNESDAY 5 FEBRUARY 2003

Members present:

Mr Michael Fallon, in the Chair

Mr Nigel Beard
Mr Jim Cousins
Angela Eagle
Norman Lamb

Mr John McFall
Dr Nick Palmer
Mr David Ruffley

The Sub-committee deliberated.

Draft Report (The handling of the joint Inland Revenue/Customs and Excise STEPS PFI project) proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 48 read and agreed to.

Resolved, That the Report be the Second Report of the Sub-committee to the Committee.

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

Several Papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Sub-committee be reported to the Committee.—(*The Chairman.*)

[Adjourned to a day and time to be fixed by the Chairman.]

LIST OF WITNESSES

WEDNESDAY 11 DECEMBER 2002

Sir Nicholas Montagu, KCB, Chairman of the Board, Inland Revenue and
Mr Richard Broadbent, Chairman of the Board, HM Customs and Excise Ev 9

LIST OF DOCUMENTS INCLUDED IN THE MINUTES OF EVIDENCE

1. Letter to the Paymaster General from the Chairman of the
Sub-committee Ev 1
2. Letter to the Chairman of the Sub-committee from the Paymaster
General Ev 1
3. Letter from the Chairman of the Inland Revenue and from the Director
General of HM Customs and Excise to the Paymaster General Ev 2
4. Memorandum from the Chairman of the Inland Revenue and the
Chairman of HM Customs and Excise Ev 3

LIST OF APPENDICES TO THE MINUTES OF EVIDENCE

1. Memorandum submitted by the Mapeley Group Ev 26
2. Letter from the Chairman of the Inland Revenue to the Chairman
of the Sub-Committee Ev 31

LIST OF REPORTS PUBLISHED BY THE TREASURY COMMITTEE

SESSION 2002–03

First Report: National Statistics: The Classification of Network Rail (HC 154)

Second Report: The 2002 Pre-Budget Report (HC 159)

Third Report: Split Capital Investment Trusts (HC 418-I)

First Special Report: Government Response to the Committee's Seventh Report, Session 2001–02: Parliamentary Accountability of Departments (HC 149)

SESSION 2001–02

First Report: The 2001 Census in England and Wales (HC 310)

Second Report: Budget 2002 (HC 780)

Third Report: The Office of Government Commerce (HC 851)

Fourth Report: Appointment to the Monetary Policy Committee of the Bank of England of Mr Paul Tucker and Ms Marian Bell (HC 880)

Fifth Report: Banking, the Consumer and Small Businesses (HC 818)

Sixth Report: The Financial Regulation of Public Limited Companies (HC 758)

Seventh Report: Parliamentary Accountability of Departments (HC 340)

Eighth Report: Inland Revenue: Self Assessment Systems (HC 681)

Ninth Report: Appointment of Sir Andrew Large as a Deputy Governor of the Bank of England and Member of the Monetary Policy Committee (HC 1189)

Special Reports:

First Special Report: Government Response to the Committee's Fifth Report, Session 2000–01: Banking and the Consumer (HC 198)

Second Special Report: Responses by the Government and the Bank of England to the Committee's Ninth Report, Session 2000–01: The Monetary Policy Committee—An end of Term Report (HC 199)

Third Special Report: Government Response to the Committee's Eighth Report, Session 2000–01: The Royal Mint (HC 266)

Fourth Special Report: Government Response to the Committee's Seventh Report, Session 2000–01: The Government Actuary's Department (HC 267)

Fifth Special Report: Government Response to the Committee's Sixth Report, Session 2000–01: HM Customs and Excise (HC 315)

Sixth Special Report: Government Response to the Committee's Tenth Report, Session 2000–01: Equitable Life and the Life Assurance Industry: An Interim Report (HC 316)

Seventh Special Report: Government Response to the Committee's Fourth Report, Session 2000–01: International Monetary Fund: A Blueprint for Parliamentary Accountability (HC 379)

Eighth Special Report: Government Response to the Committee's Third Report, Session 2000–01: HM Treasury (HC 429)

Ninth Special Report: Government Response to the Committee's First Report, Session 2001–02: The 2001 Census in England and Wales (HC 852)

Tenth Special Report: Government Response to the Committee's Second Report, Session 2001–02: Budget 2002

Eleventh Special Report: Government Response to the Committee's Third Report, Session 2001-02: Office of Government Commerce (HC 1217)

Twelfth Special Report: Government Response to the Committee's Fifth Report, Session 2001-02: Banking, Consumers and Small Businesses (HC 1218)

Thirteenth Special Report: Government Response to the Committee's Sixth Report, Session; 2001-02: The Financial Regulation of Public Limited Companies (HC 1219)

Fourteenth Special Report: Government Response to the Committee's Eighth Report, Session 2001-02: Inland Revenue Self Assessment Systems

MINUTES OF EVIDENCE

TAKEN BEFORE THE TREASURY SUB-COMMITTEE

WEDNESDAY 11 DECEMBER 2002

Members present:

Mr Michael Fallon, in the Chair

Mr Nigel Beard
Mr David Laws

Mr John McFall
Kali Mountford

Letter to the Paymaster General from the Chairman of the Sub-committee

The Sub-committee has asked me to write to you about a subject that was raised with you recently when we took evidence on the Inland Revenue's expenditure plans, namely the joint Inland Revenue and Customs and Excise STEPS PFI project.

Richard Broadbent provided some information on the STEPS project in a letter to me of 15 March 2002 in connection with Customs and Excise's Spring Supplementary Estimate. However, the Sub-committee would be grateful if you could provide a fuller note of the project that includes details of:

- the competition and the criteria used that led to Mapeley being selected as the private sector partner;
- the checks undertaken to ensure bidders, and Mapeley in particular, were capable of delivering the service required, and whether where the company and any parent company was registered was a factor in this assessment;
- the full name and place of registration of the company contracted to deliver the STEPS project at its commencement and now, if different, and of the companies having ultimate control of these companies, if different;
- what control the department has over the contractor transferring the contract to another subsidiary or separate company; what criteria are applied in exercising that control; and whether any such transfer has taken place, and if so, when; and
- the way the contract was implemented, what performance targets the contractor is required to meet and whether these have been achieved.

It would also be helpful if you would set out any significant changes to the contract that have been proposed or accepted since it was signed.

I am copying this letter to Sir Nicholas Montagu at the Inland Revenue and Richard Broadbent at Customs and Excise.

2 July 2002

Letter to the Chairman of the Sub-committee from the Paymaster General

Thank you for your letter dated the 2 July 2002 and I apologise for the delay in replying.

I enclose a copy of a letter from Sir Nicholas Montagu, Chairman of the Inland Revenue and Mike Eland, Director General of Customs and Excise to me that responds to your questions.

15 October 2002

11 December 2002]

[Continued

Annex

Letter from the Chairman of the Inland Revenue and from the Director General of HM Customs and Excise to the Paymaster General

1. Further to the letter of the 2 July, from the Treasury Sub Committee, we set out below the responses to the Committee's questions.

COMPETITION AND CRITERIA USED

2. Standard EC procurement arrangements were used to identify the supplier of the STEPS project. An advertisement was placed in the Official Journal of the European Commission (OJEC) in March 1999 inviting expressions of interest of the supply of serviced accommodation to Customs and Excise, the Inland Revenue and the Valuation Office Agency (VOA), agency of the Inland Revenue. A shortlist of three contractors was announced in October 1999. The Mapeley consortium was chosen as preferred bidder in August 2000 and contracts were exchanged in March 2001.

3. The key selection criterion used throughout the procurement process was value for money taking account of price and ability to deliver the Departments' requirements for serviced accommodation.

Checks undertaken to ensure bidders were capable of delivering the service

4. The Departments prepared a contract requirement that specified what they wanted from the STEPS project. This was then used to compare the three bids under three heading—legal, financial and technical.

LEGAL

Whether the proposals complied with what the Departments had specified in the STEPS contract and, if not, what was the effect of any alternative being offered.

FINANCIAL

Did the bidders' proposals offer value for money compared to the Public Sector Comparator?

Were the bidders funding proposals sufficiently robust to assure they could deliver the contract?

Would the required funding be delivered within the required timescale?

Was the bid financially robust?

TECHNICAL

Were the bidders' implementation proposals realistic and achievable, particularly in relation to staff, continuity of service and property transfer?

Were the bidders' proposals for providing services and managing the properties likely to provide an effective, efficient and seamless service to the Departments?

In particular, were they going to match the Departments' requirements and would those requirements be delivered in a way that was acceptable to the Departments?

Would the bidders' proposals ensure that highest standards on health and safety issues.

5. The Departments were assisted by various specialists throughout the competition. Deloitte & Touche provided expertise on financial aspects, Lovells were the Departments' lawyers and Insignia Richard Ellis were technical advisers on property considerations.

6. The place of registration of the company or any parent company was not a separate criterion in the assessment of the service delivery capability of the bidders.

Names and place of registration

7. We can provide you with the following information about the identity and place of registration of the principal companies involved in the contract:

*11 December 2002]**[Continued*

Company which tendered;	Mapeley Ltd Registered in UK
Main contracting party;	Mapeley STEPS Contractor Ltd UK throughout
Majority of assets held by;	Mapeley STEPS Ltd Bermuda throughout

8. The Mapeley companies are owned by a consortium comprising:

Fortress Investment Corporation, Soros Real Estate Partners, Bank of America, Halifax, DTZ Debenham Thorpe, Grubb and Ellis Management Services, EC Harris, Delancy Estates, Morgan Stanley and Co Ltd, Electronic Data Systems Ltd (EDS), Aquamen Group plc, McLellen International Ltd, Sulzer-Infra CBX.

9. This information was provided by the Inland Revenue and Customs and Excise press releases of August 2000 announcing Mapeley as the preferred bidder, and 9 March 2001 announcing the awarding of the contract to Mapeley.

CONTROL OVER THE CONTRACTOR

10. The STEPS contract provides a number of safeguards in relation to change of control:

- The STEPS contractor cannot assign (other than by way of security) the contract without prior written consent of the Departments at their absolute discretion;
- No change of control is permitted within the first three years of the contract without prior approval of the Departments, again at their absolute discretion;
- Prior consent of the Departments for a change of control is required from the Departments after the three year period referred to above but can only be withheld where:
- The new shareholders have their main controlling office in a country that is subject to economic sanctions imposed by the UK Government; or
- The new shareholders commit a material breach of any law relating to the Departments' businesses.

IMPLEMENTATION OF THE CONTRACT

11. Mapeley agreed to start preparing for implementation of the contract once they were appointed preferred bidder (August 2000). The Departments were closely involved in the planning for implementation.

12. Standards have been set for each of the services provided by Mapeley and these are monitored regularly in every building. Some delivery problems have arisen in the first year, but a service improvement plan has recently been put in place. On the other hand Mapeley have been successful in a number of areas, for example,

- reducing the cost of utility services to the Departments by more than £1million per annum;
- the completion of 20 high value projects on time and within initial budget; and
- significantly improved arrangements around the purchase and repair of furniture, ensuring better use of discounts and warranties.

13. We have written to the Chairman of the Public Accounts Committee explaining the current contract status.

15 October 2002

Memorandum from the Chairman of the Inland Revenue and the Chairman of HM Customs and Excise

The Handling of the Joint STEPS PFI Contract

1. INTRODUCTION

1.1 The Committee has asked for a comprehensive memorandum on the STEPS project before taking oral evidence from the Chairmen of Customs and Excise and the Inland Revenue on 11 December 2002.

1.2 This memorandum sets out the background to the contract, the procurement process, contract structure, and final approval. It also discusses the offshore structure of the Mapeley Group, and the financial issues surrounding the contract that led to "letters of comfort" being sent to Mapeley in June and July 2002. As explained in the final paragraph, changes in the markets have enabled Mapeley recently to reduce considerably the financial pressures they were experiencing.

11 December 2002]

[Continued

2. BACKGROUND

2.1 As part of the 1998 Comprehensive Spending Review the Departments were asked to look at ways of improving the efficiency and effectiveness of their estate management. Following this, a single PFI solution was proposed to enable Customs and Excise, the Inland Revenue and the Valuation Office Agency (an agency of the Inland Revenue) to outsource their accommodation requirements. The STEPS project follows the approach taken by the then DSS in its accommodation PFI project known as "PRIME", which started in 1996.

3. PROCUREMENT PROCESS

3.1 On 30 March 1999 the Departments announced the start of a joint procurement to establish a long-term partnership with the private sector for the provision of serviced accommodation to meet their needs for a period of 20 years.

3.2 A Project Board made up of representatives of the Treasury, Treasury Task Force (and subsequently Partnerships UK), the Inland Revenue and Customs and Excise was set up to oversee the project. John Yard, Director of Business Services in the Inland Revenue, and Richard Allen, holding a similar position in Customs and Excise, chaired alternate meetings. The Departments also engaged external legal, financial and property advisors (Lovells, Deloitte & Touche and Insignia Richard Ellis) to provide advice during the procurement process.

3.3 The procurement followed standard arrangements. Amongst other matters, these provide for the exclusion of bidders where they have not paid their tax or are (or have been) involved in tax evasion. There are no other tax grounds on which bidders can be excluded. The procurement process was advertised in the Official Journal of the European Communities, and was subject to three community law provisions and one WTO agreement:

- Article 83 of the EC Treaty (freedom of establishment),
- Article 49 of the EC Treaty (freedom to provide services),
- Public Services Contracts Regulations 1993 (SI 1993 Number 3228), which implemented an EC Directive on public procurement,
- Under the auspices of the WTO, the Government Procurement Agreement 1994.

3.4 Following advice from leading Counsel, Inland Revenue lawyers (who were not involved in the procurement process) have recently confirmed that the practical effect of these measures prevented the Departments including a provision in the procurement process to outlaw the use of an offshore tax structure by bidders.

3.5 On 21 October 1999 the Departments announced that three consortia had been invited to go forward to the invitation to negotiate stage of the STEPS project. (The invitation to negotiate stage was designed to establish a preferred bidder). Mapeley was one of the consortia.

3.6 On 25 April 2000 tenders were received from Mapeley and two other bidders: Trillium and Servus. The Mapeley tender identified the owners of Mapeley as Fortress Registered Investment Trust, (incorporated in Delaware USA), Soros Real Estate Investors CV (a Limited partnership formed in the Netherlands), and Delancey Estates Ltd (a company which was resident in the UK at the time the contract was signed. Following a reorganisation the Mapeley shares previously owned by Delancey were acquired by Tribeca Properties Mapeley Ltd, a company registered outside the UK). Bids were received from the other consortia, each of which included at least one non-resident wanting to invest in the UK.

3.7 Three groups were formed by the Departments to evaluate the bidders. Each group focused on a specific theme—financial issues, legal matters and technical issues. The work of the evaluation groups was brought together in a single report covering all bidders and on 15 June 2000 these reports were submitted to a panel (comprising the STEPS project director and deputy director, and representatives from the Departments operational areas) for assessment.

3.8 A recommendation to proceed with Mapeley as the preferred bidder was submitted to and approved by the STEPS Project Board. The recommendation was approved at Board level in Inland Revenue and by the Management Committee in Customs and Excise in July 2000.

3.9 On 3 August the Departments announced that the Mapeley consortium had been selected as the preferred bidder.

*11 December 2002]**[Continued*

4. CONTRACT STRUCTURE AND FINAL APPROVAL

4.1 The contract was structured so that in return for the transfer of their properties to the Mapeley Group, the Departments received an up front cash payment of £220 million, together with a further £150 million in the form of lower service prices. Under the contract, the Departments pay Mapeley a “Facilities Payment” in return for the provision of fully serviced accommodation.

4.2 An appraisal of the proposed contract demonstrated that over its lifetime there would be a significant benefit to the Departments. The benefit is not only lower costs. Risk has been transferred to Mapeley in areas such as flexibility in the vacation of properties, and increases in the cost of maintenance and the provision of other services. The contract also contains a formula that allows the Departments to share in development gains achieved by Mapeley.

4.3 At the end of the life of the contract, or if it is terminated early, the Departments can select the properties they wish to continue occupying and Mapeley must then provide them with a lease at market rates on those properties (subject to the constraints of any superior lease).

4.4 During 2000 the business case was considered by Treasury officials who recommended it to Treasury Ministers in early 2001. On the basis of that recommendation, the Chief Secretary approved the business case. The contract was signed by the Departments on 6 March 2001.

5. MAPELEY OFF-SHORE STRUCTURE

5.1 Mapeley was funded through equity and debt provided mainly by overseas shareholders. As often happens where the majority of the shareholders are overseas, Mapeley adopted a corporate structure with some of its companies resident outside of the UK. They disclosed their intentions to the Departments’ legal advisors, Lovells, in November 2000 in a letter that was forwarded to the Departments’ procurement team.

5.2 The first reference to a company registered in Bermuda was in an e-mail sent by Mapeley’s lawyers to Lovells on 7 December 2000. They explained that Mapeley UK Company Limited (the Group holding company) had been incorporated in the British Virgin Islands (BVI), but, because of the “black-listing” of BVI companies by the OECD, the company was in the course of migrating to Bermuda. The note also referred to plans for the Departments’ freehold and long-leasehold properties to be held in another Mapeley company also incorporated in Bermuda.

5.3 The corporate structure of Mapeley was an item on the agenda of a meeting held on 11 December 2000 with attendees drawn from Lovells, Mapeley, Customs and Excise, Inland Revenue, Mapeley’s legal advisors, and Deloitte & Touche. The Departments’ representatives on the project team have recently said they saw no reason to mention the offshore arrangements to more senior colleagues as they were legal, and not prevented by the procurement rules. The project team did not explore with Mapeley whether the consortium was prepared to own the properties through a UK company in the Mapeley Group.

5.4 The Board of Inland Revenue learnt of the offshore structure a few days before contracts were due to be signed. Deloitte & Touche were immediately asked to explain Mapeley’s tax arrangements. On 1 March 2001 they said the structure was familiar to the commercial world and that it was the kind of arrangement which they would expect from professional overseas investors. They said they had not seen anything to create alarm. Specialists in the Department looked at the structure and confirmed that it was a conventional arrangement used by non-residents that could not be challenged under tax law. The Board took the view that there were no grounds in the established procurement process for refusing to sign the contract. A joint Inland Revenue and Customs and Excise press release of 9 March 2001 announcing the signing of the contract, inadvertently referred to the estates being transferred to Mapeley Ltd, a UK registered company, rather than Mapeley STEPS Ltd which is registered in Bermuda. A press statement on 23 September 2002 corrected this. At the time the contract was signed and the March 2001 press notice was issued, the Paymaster General had not been told that Mapeley STEPS Ltd was registered in Bermuda.

5.5 The Annual Report and 2000–01 Resource Accounts of the Inland Revenue inadvertently refer to the transfer of buildings to a UK incorporated company, Mapeley STEPS Contractor Ltd, instead of Mapeley STEPS Ltd. The Customs and Excise Annual Report also inadvertently refers to the signing of a contract with Mapeley Ltd. The Departments regret that incorrect company details were shown in the original press release, accounts and report. It seems the officials producing these documents focussed on Mapeley as a consortium or Mapeley Ltd, the bidding vehicle, rather than individual companies in the group.

6. STEPS CONTRACT FINANCIAL ISSUES

6.1 Mapeley first raised concerns about financial issues at the STEPS Estate and Contracts Management Board in November 2001 (This Board oversees the operation of the Mapeley contract on behalf of the Departments). A meeting was set up between the contract management team and Mapeley to increase understanding of Mapeley’s financial position. Following that meeting in December, Mapeley gave a detailed presentation to a finance sub-group of the Estates and Contract Management Board. They pointed to a

*11 December 2002]**[Continued*

serious cash flow problem and asked the Departments for a substantial cash settlement. This proposal was rejected but the Departments agreed to work with Mapeley to get a better understanding of the extent of their financial problems, and to consider what options were available. The Departments recognised that whilst most of the financial pressures arose from areas where risks had been transferred to Mapeley, changes in the Departments' requirements and the bedding down of the contractual arrangements could also adversely affect Mapeley's cashflow. Difficulties of this sort often occur in a contract of the size and complexity of STEPS.

6.2 The Board of Inland Revenue and Customs Management Committee were alerted to the potential problems. Partnerships UK (PUK) were asked to co-ordinate and chair a working group to ensure a careful and professional analysis of Mapeley's position was undertaken as a pre-cursor to identifying options available to the Departments. This working group was made up of representatives from Deloitte & Touche, Lovells, PUK and the Departments' Estates and Contract Management Unit. It was felt that the support of Deloitte & Touche, Lovells and PUK would be particularly helpful in providing a team which could give the Departments a financial evaluation of the options, advice on PFI policy as it affected STEPS, and in any negotiations which might subsequently be necessary.

6.3 The working group was asked to prepare a report to inform an Inland Revenue Board meeting in January. At that meeting the Board asked for further work to be done, including a detailed analysis of the protection the Departments had if the contract did not continue. They agreed to talks continuing with Mapeley to test the Departments' understanding of the problems. Following similar discussion, the Customs Management Committee came to the same conclusion.

6.4 The Inland Revenue Board met again at the end of February and after discussion with Customs and Excise, further work was commissioned. The Departments agreed to appoint an investment bank, with no previous involvement in the deal, to review the proposals developed by the working group. Rothschilds were selected and were asked to report on Mapeley's financial position, and the options for going forward, by 25 March. On 5 March the two Chairmen gave Ministers an overview of the financial issues and discussions with Mapeley.

6.5 Rothschilds reported to the Departments towards the end of March. They concluded that the Departments had negotiated a good deal in terms of the original price and that it was in the Departments' interest to reach a settlement with Mapeley if possible. They recommended that more work should be done on Mapeley's financial projections, and how the contract would operate in the event of a termination.

6.6 The Rothschilds report was discussed at an Inland Revenue Board meeting at the end of March with a member of the Customs Management Committee present. The Boards agreed that the working group should undertake the work recommended by Rothschilds. They also raised a number of other questions and asked the working group to resolve them. They agreed that discussions with Mapeley should continue, without commitment. They were insistent that any potential cash settlement with Mapeley should include significant improvements for the Departments.

6.7 Rothschilds provided a further report on 19 April setting out their view of the options available to the Departments. They suggested further work on re-financing, and on ways to keep the existing bank group in the deal. They also stressed the serious consequences for the Departments of the contract coming to a premature end. This report was considered at an Inland Revenue Board meeting on 22 April. The Board agreed the work should be done, including setting up discussions with Treasury officials.

6.8 The Chairmen of the Departments met on 1 May to agree how best to move forward with the involvement of all stakeholders. While not wishing to pay out money in respect of risks that had been transferred to Mapeley, they recognised that without a settlement there was a risk that Mapeley might fail financially. That could involve the Departments in more expenditure, costly litigation and real operational difficulties. Those operational difficulties would be particularly serious for the Inland Revenue. They agreed, therefore, to commission further work to determine how the financial issues could be settled. They believed that it was crucially important to get a better understanding of the consequences of the contract coming to a premature end and that contingency work should be carried out to explore exit options. The Chairmen recognised that once the work was completed, a report with recommendations would have to be put to Treasury officials and Ministers.

6.9 Discussions and meetings took place in early May involving representatives of Inland Revenue and Customs and Excise, PUK, Rothschilds and Treasury officials. This resulted in a draft report being prepared by the working group setting out the position on Mapeley and the options. This was sent to the Treasury officials by PUK on behalf of the working group on 28 May.

6.10 Following on from the joint departmental meeting in May, the working group held a series of meetings with Mapeley. The objectives of the meetings were to explore the options for a settlement between the parties that

- gave Mapeley a realistic chance of dealing with their current financial issues and would provide more confidence to their bankers and shareholders about their ability to continue fulfilling their obligations under the contract;

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- did not weaken the Departments' position in this and future PPP contracts;
- would provide significant improvements for the Departments and confidence in Mapeley's ability to deliver the required level of services in the future.

Given the Departments' concerns about increasing the amounts payable to Mapeley, the working group considered whether a potential settlement could be reached which involved no change in payments, or alternatively would minimise the amount of any cash settlement for the early years.

6.11 On 17 May Mapeley told PUK that their shareholders had injected further short-term funding. This money is in addition to funding already provided by shareholders over and above the original equity commitment to STEPS. Mapeley saw this as evidence of the shareholders' intentions to make STEPS work.

6.12 Following discussions between the Inland Revenue and Customs and Excise, the Inland Revenue Board met on 25 June to discuss available options following the discussions with Mapeley. Three options were considered

- do nothing and let Mapeley sort the problems themselves;
- agree a financial settlement which would result in an increased payment from the Departments for three years;
- agree a change in the profile of any additional payments to Mapeley so they were spread over the remaining term of the contract.

The Board asked for a further paper on these options for their July meeting.

6.13 The Inland Revenue Board met on 23 July. Mindful that in minutes of 5 March 2002 and 18 July 2002 the Paymaster General had expressed strong reservations about paying increased amounts to Mapeley, but not yet certain that they fully understood Mapeley's financial position, they asked the working group to discuss with Treasury, OGC and NAO how best to keep to a minimum the risks to the Departments, and the payments to Mapeley. The working group was asked to consider a package that might involve:

- obtaining greater security for the Departments in the event of termination;
- getting shareholders to inject extra money into the group;
- increasing the facilities payment for three years or, spreading the equivalent amount over the life of the contract;
- a guarantee to Mapeley's bankers which would provide for part of the facilities payment to Mapeley to be paid directly by the Departments direct to the bank if the guarantee was triggered.

6.14 Two meetings were held in August at which PUK and Rothschilds, on behalf of the working group, met with Treasury officials to discuss the issues before the Departments prepared advice for Ministers on how to go forward.

7. LETTERS OF COMFORT

7.1 Initially in May and again in June 2002, Mapeley approached the Departments seeking reassurance about the likely outcome of discussions on their financial issues, with the aim of sharing this with their bankers and auditors. A first draft of a letter, setting out on a without prejudice basis the shape of a possible settlement with the Departments, but emphasising that any deal would be subject to the approval of Treasury officials and Ministers, was produced by PUK. This was then reviewed and amended by Lovells to ensure that no contractual commitment was given. The rest of the working group reviewed the letter to ensure it made commercial sense. The draft letter was then sent to the Departments for approval. They agreed to issue it, and it was sent on 27 June.

7.2 A further letter on the same lines was sent on 24 July 2002 to provide reassurance to Mapeley's shareholders. This followed a letter to the Departments from Mapeley, on behalf of the shareholders, requesting further comfort on the state of the negotiations. The working group concluded that Mapeley's shareholders were not convinced that the Departments were serious about the negotiations and agreed that there was a compelling need to send a signal that the Departments were still trying to reach a settlement. A precipitate withdrawal of the shareholders' backing could have presented the Departments with heavy costs and real problems in maintaining their businesses, and done so before the situation had been fully analysed and options prepared for Ministers. This letter was accompanied by a draft Memorandum of Understanding, which might have formed the basis of the further agreement between the Departments and Mapeley. The letter again made it clear that any arrangement would be subject to approval by Treasury officials and Ministers.

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7.3 The letters and draft Memorandum were sent as part of the continuing attempt to identify recommendations to make to Ministers, and they were not, in consequence, brought to their attention at the time. Copies of the two letters are attached.¹ As noted above, it was made clear throughout the discussions that any change to the contractual arrangements would be subject to approval by Treasury officials and Ministers. Our legal advice was at the time, and remains, that, because of this strong and unequivocal proviso, the letters do not create a contingent liability for the Departments. The Inland Revenue Board and Customs and Excise Management Committee had authorised John Yard to act generally for them in relation to discussions with Mapeley and relying on that authority he signed and issued the letters of comfort.

7.4 A note to the accounts of Mapeley STEPS Contractor Ltd lodged with Companies House in August 2002 might be taken to imply a greater degree of certainty about a possible settlement than the provisos in the letters sent to them warranted. Three members of the working group, including a representative of the Inland Revenue, were sent a draft of the proposed note to the accounts of Mapeley STEPS Contractor Ltd, but they did not recognise the significance of the note and so it was not considered further in the Departments before publication of the accounts.

7.5 We are now advised, by the Treasury Officer of Accounts, that the letters sent to Mapeley may constitute letters of comfort within the meaning of 'Government Accounting'. In the light of that advice, the Chairmen of the Departments brought the letters to the attention of the Chairman of the Public Accounts Committee, as soon as practicable after getting the Treasury Officer of Accounts' views. The Departments have apologised for not doing so earlier.

8. FURTHER PROPOSALS FROM MAPELEY

8.1 Changes in the markets have enabled Mapeley recently to improve their income from asset management of the STEPS estate by negotiating extension to some existing leases in return for up front premiums. The draft Memorandum of Understanding has been withdrawn. Mapeley have now put a revised proposal to the Departments which focuses on resolving the outstanding contractual issues. The Departments are considering the proposals with their advisers. Once the analysis is complete the proposals will be referred to Treasury Officials and Ministers.

3 December 2002

Annex

**Letter to Mr Robin Priest, Chief Executive, Mapeley Ltd, from
Mr John Yard, Director, Business Services, Inland Revenue**

PROJECT STEPS

At the end of 2001, Mapeley made Inland Revenue and HM Customs and Excise (the Departments) aware that, for a variety of reasons the projected cash flows for Mapeley meant that in the foreseeable future Mapeley may be placed under considerable financial stress.

The Departments set up a Working Group, chaired by the Partnership UK, to consider the financial information supplied by Mapeley, and Mapeley's proposals for easing its potential cash flow difficulties.

With the full knowledge of the Departments Boards, the parties have engaged in meaningful discussions towards resolving the potential financial difficulties identified by Mapeley and these discussions have resulted in a draft, non-binding Memorandum of Understanding (MoU) being drawn up.

Based on the discussions over the last month, the non-binding MoU, and assuming no further information comes to light, it is the Departments present expectation that the parties will reach a value for money settlement that is satisfactory to all the key public sector stakeholders. Obviously, the principles in the MoU need to be developed, and much of the detail remains to be agreed, but the Departments are at present confident that this can be achieved. It should also be noted that both HM Treasury and Ministers will need to approve any settlement before proceeding.

The Departments understand that Mapeley has kept its financiers informed as appropriate, and may wish to provide its financiers with a copy of this letter. Whilst the Departments have given this letter in good faith, the Departments cannot accept any liability to Mapeley, its financiers or other third parties for the content of this letter.

27 June 2002

¹ See Annexes below.

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[Continued

Annex

**Letter to Mr Robin Priest, Chief Executive, Mapeley Ltd, from
Mr John Yard, Director, Business Services, Inland Revenue**

PROJECT STEPS

At the end of 2001 Mapeley made the Departments aware that for a variety of reasons the projected cash flows for Mapeley meant that in the foreseeable future they may be placed under considerable financial stress. Since that time, and with the full knowledge of the Department's Boards, the Working Group established by the Departments and Mapeley have engaged in meaningful discussions towards reaching a value for money settlement between us to resolve issues of mutual interest in respect of the STEPS contract. These discussions have resulted in the attached, non-binding Memorandum of Understanding (MoU), which is, in all material respects agreed in principle (subject to contract).¹

Based on the MoU, and assuming no further information comes to light, the Departments anticipate that the parties will be able to formally document a settlement that is satisfactory to all the key public sector stakeholders. Obviously, the details arising from the principles in the MoU need to be negotiated and documented. Irrespective of the Departmental position, it should also be noted that both HM Treasury and Ministers will need to approve any settlement before execution of legally binding documentation.

This letter is provided expressly for the shareholders of Mapeley, and is not to be shared with any other party without the express consent of the Departments.

24 July 2002

Examination of Witnesses

SIR NICHOLAS MONTAGU, KCB, Chairman of the Board, Inland Revenue and MR RICHARD BROADBENT, Chairman of the Board, HM Customs and Excise, examined.

Chairman

1. Sir Nicholas, welcome to the Committee. Could you formally identify yourself and your colleague for the shorthand writer, please.

(Sir Nicholas Montagu) Yes. Thank you, Chairman. I am Nick Montagu. I am the Chairman of the Inland Revenue and on my left is Richard Broadbent, who is my opposite number, the Chairman of Customs and Excise.

2. Thank you. Sir Nicholas, we are here to enquire into the STEPS contract with Mapeley. Could you briefly set out the main features of that contract?

(Sir Nicholas Montagu) Yes. It is a deal under which Customs and Excise and the Revenue transferred our properties, sold our properties to the Mapeley consortium for a period of twenty years. It is not quite a conventional sale and leaseback but they then manage the facilities and receive payment from us for doing so, so that essentially it was a major PFI deal disposing of the Customs' and Revenue's estate.

3. What did they pay?

(Sir Nicholas Montagu) They paid £370 million, £220 million in an up front payment and the remaining £150 million through reductions in the facilities payment over the initial years of the contract.

4. Eighteen months on are you satisfied you got a good deal?

(Sir Nicholas Montagu) Yes, I am satisfied that we got a good deal. At the time of the contract the Treasury Task Force, the predecessor of Partnerships UK, described it as an exceptional PFI

deal. I think it still is. As you would expect, during the early months of any major partnership of this sort there are issues which need to be resolved. That has been happening but I am absolutely confident that we have got a really good deal for Government.

5. When you say there are issues to be resolved in the first few months like any other deal, in fact according to your memorandum just seven months after the contract started Mapeley came to you saying they had "a serious cash flow problem" and asked you for a substantial cash settlement?

(Sir Nicholas Montagu) That is correct.

6. How can that have been a good deal if it all went wrong just seven months later?

(Sir Nicholas Montagu) I do not think it did all go wrong, Chairman. That does not seem to me quite the right way of putting it. What our memorandum makes clear is that Mapeley seven months into the deal encountered a cash flow problem which they regarded as threatening. What they wanted to discuss with us within the framework of the partnership was how we could work together to get over that problem and to enable the partnership to proceed for its full term.

7. But how could you sign a twenty year deal with somebody who just seven months later said they had a cash flow problem in executing it?

(Sir Nicholas Montagu) At the time when we had signed the deal we did all the due diligence that you would expect on the robustness, on the financial position, etcetera. Our memorandum, I think, shows that Mapeley unexpectedly encountered cash flow problems. I am not quite clear—and there are issues which it is obviously difficult to air publicly—why

¹ Not printed.

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SIR NICHOLAS MONTAGU, KCB
AND MR RICHARD BROADBENT

[Continued

[Chairman Cont]

this should be. They did encounter cash flow problems. The concerns of Richard's Management Committee and of my Board was that we should work constructively to help overcome these problems, to provide a good chance of the contract proceeding successfully and at all times—again I think our memorandum makes clear—we were concerned that if there were to be any additional payments by the Departments that we should get extra for those payments.

8. But if both sides to this contract entered into it with their eyes open why are you asking the taxpayer to provide extra money to bail you out of this mess?

(*Sir Nicholas Montagu*) What I think needs to be recognised is that at the point where Mapeley came to us, having identified their financial difficulties, and in the succeeding months there was a real danger that the contract could collapse. If it did so it would have involved Richard's and my Department in very substantial additional costs if we had taken the estates back, which would not have been a good deal for the taxpayer. So what we wanted to explore was, was there a way in which we could preserve the partnership and in which we could help Mapeley over these problems. But I should also make clear, Chairman, that we are not just talking about Mapeley coming and saying, "We've got financial problems. Can you give us some more money?" This was a complex negotiation involving not just their cash flow problems but various contractual issues of the sort that you do expect during the first year of a complex contract.

9. You do not expect—you keep calling it a partnership—your contractor to have serious cash flow problems within seven months of starting, do you? Did you foresee that?

(*Sir Nicholas Montagu*) Obviously at the point of signing we would not have foreseen, nor indeed would Mapeley have foreseen the cash flow problems. The issue, I think, has to be, what do we do when this actually happens? Do we contemplate with equanimity the prospect of this deal, which provides excellent value for Government, collapsing with consequent extra financial costs and, particularly for my Department, operational difficulties, or do we work with our partners in the property deal to try and find a way around these problems?

10. But in that case Mapeley would always have had you over a barrel, would they not? They would always be able to say, "Well, it will be far worse if the thing collapses." Did you not do any risk assessment of the dangers involved in early termination of this?

(*Sir Nicholas Montagu*) Yes, certainly. As I have indicated, we did full due diligence on the bid on various aspects—on the financial aspects, on the legal aspects, on the technical aspects. In all of this we were advised by professional advisers, and again I think our memorandum makes this clear. We had Lovells as legal advisers, we had Richard Ellis as property advisers and we had Deloitte & Touche as accountancy advisers. Obviously at the point where we signed the deal neither we nor Mapeley foresaw the difficulties with which they came to us.

11. Nor did your advisers?

(*Sir Nicholas Montagu*) Nor did our advisers.

12. Had Mapeley failed who would then hold the freeholds and the leaseholds involved in the properties that you occupy?

(*Sir Nicholas Montagu*) I think I am right in saying that they would revert to us if the contract completely failed. Richard has corrected me. We retain the right of occupancy in that event.

(*Mr Broadbent*) In practice the freeholds and leaseholds would actually revert to the lending banks because Mapeley is indebted to banks and they have a first charge over the property. The structure of the contract gives us a right of tenure in the properties for at least twenty years after the contract terminates. So we would have the right to occupy the buildings at no more than the market rent irrespective, but the freeholds are substantially owned by Mapeley and if Mapeley became insolvent they would be part of the assets of Mapeley and would be available for those banks who were the other parties to this financial position.

13. I find that extraordinary. So the public assets, the buildings you used to own, which you transferred to Mapeley for this contract would then be lost to the taxpayer for ever and would go to Mapeley's banks if the contract collapsed?

(*Mr Broadbent*) It was an intrinsic part of the contract that the freeholds to the estates were passed on, that is correct, yes. What we retained as a result of that was the right of occupancy and the ability to buy essentially a services package.

14. But the assets would revert to Mapeley's bank?

(*Mr Broadbent*) the assets are owned by Mapeley, not by the Government or Customs and Excise or Inland Revenue.

15. I see. Could you just tell us a little about the standard procurement arrangements that you followed in this case. How did you determine whether or not the various bidders had paid their taxes properly in the UK?

(*Sir Nicholas Montagu*) We would always do this, Chairman. European procurement law provides unequivocally that non-compliance with tax obligations or any tax fraud is a valid reason for discriminating against a bidder. It also provides that lawful tax practices are not such a reason.

16. Does that cover the intermediate area of tax evasion?

(*Sir Nicholas Montagu*) Tax evasion is unlawful avoidance of tax obligations. Anybody who was found to be evading tax could lawfully be excluded.

17. Does that include placing their tax arrangements within offshore tax jurisdictions?

(*Sir Nicholas Montagu*) Chairman, I think there is a critically important distinction here. Avoidance is escaping tax duties within a legal framework; evasion is unlawfully doing so. Evasion is a good legal reason for discriminating against a bidder. Lawful avoidance, in other words avoidance within the scope of the law, cannot under European or World Trade Organisation rules be taken as a reason for discriminating against a bidder. That is a rule which applies right across Government procurement.

18. So a consortium which had taken over the properties of the Revenue could itself quite happily be involved in tax avoidance?

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[Continued

[Chairman Cont]

(*Sir Nicholas Montagu*) It is perfectly possible. In this case, if it would help the Committee to get specific, Mapeley is a consortium which at the time of the consignment of the contract was 85% overseas owned; it is now 100% overseas owned. Overseas concerns do not have any obligation to pay Capital Gains Tax. On the other hand, overseas landlords, under the non-resident landlord scheme, do have an obligation to pay tax on income generated in this country.

19. But do you think it encourages the rest of us if the Revenue's own property company avoids tax?

(*Sir Nicholas Montagu*) Chairman, I think that it is not altogether helpful, if I may say so, to talk in terms of avoiding tax here. Mapeley was, as I have indicated, 85% overseas owned; it is now 100% overseas owned. It is entirely normal for consortia, where the ownership is overwhelmingly overseas, not to locate itself in this country. At the point where the Bermuda structure of one of the Mapeley companies became clear Deloitte & Touche, our accountancy advisers, said in terms that this was entirely a normal arrangement and the kind of arrangement that you would expect from a consortium which was overwhelmingly owned by overseas concerns. I also have to emphasise, it is an entirely lawful arrangement.

20. You do not see anything unfortunate about the Revenue's own property company being based in an offshore haven?

(*Sir Nicholas Montagu*) Chairman, I have to come back to the point that I made. The Inland Revenue exists to implement the policies of Ministers within the framework of the law, domestic and international law. For us to have discriminated against the Mapeley bid because the properties were being transferred to a company based in Bermuda would have been unlawful.

Mr Beard

21. What happens after the end of twenty years?

(*Mr Broadbent*) At the end of the contract, at the end of twenty years, we have the right, if we wish, to occupy any of the buildings in the estate for a further twenty years on market rent terms.

22. But they are still in the ownership of STEPS?

(*Mr Broadbent*) Absolutely. The nature of this contract is that the ownership of the properties has passed and we cannot—

23. So it is effectively a contract which goes on for forty years if you want it to?

(*Mr Broadbent*) At the end of that further twenty years we are then in an absolutely straightforward commercial position of any tenant and landlord; there are no further contract obligations.

24. Mr Broadbent, Mapeley advised the Departments' project team in December 2000, three months before the contract was signed, that the valuable freehold and long leasehold properties would be transferred to its investment company, namely Mapeley STEPS Limited, a Bermuda registered company. The Board of the Inland Revenue "learnt of the offshore structure a few days

before contracts were due to be signed." Were the Customs and Excise Management Committee informed of this before the contract was signed?

(*Mr Broadbent*) They were not.

25. Why was there the lag between the project team being told and the Board of the Inland Revenue being told?

(*Sir Nicholas Montagu*) I think the answer here, Mr Beard, is that the project team, remember, was a project team consisting of our specialists together with the outside advisers. With hindsight I think it is easy to say that they were politically naive in not alerting the Boards, but it was no worse than that. These were people engaged in an intensive negotiation to get a good deal and advised by professional advisers who took the view that this was an entirely normal arrangement.

26. Were the Customs and Excise Management Committee informed of this before the contract was signed?

(*Mr Broadbent*) No, they were not, but I was going to go on to say, as Sir Nicholas has said, this was a situation where we were working jointly and we have discussed closer working a number of times in this Committee. To make closer working work you do have to have joint teams and particularly if you are in negotiation, a very complex negotiation and a very complex contract situation, you frequently have to rely on them to come to decisions and implement them. In this case I think because the team judged it was not a material issue they informed, as it happened, the Revenue Board, I suspect because it was a Revenue tax issue, but they did not see it as a contract issue so they did not come formally to the Customs' Board as partners to this contract.

27. When did you, as the heads of the two organisations, review the negotiations? Were they given entirely carte blanche to go away and conclude the negotiations without further reference?

(*Mr Broadbent*) No, negotiation was carried over actually a period of many months and there were many review periods from the invitation to tender stage, to a shortlist, to the selection of a preferred bidder, to negotiations with the preferred bidder and then a very intensive series of reviews before the case was put to the Treasury because of course this contract exceeded our delegated limits. There was then a review by the Treasury and finally the contract was signed in March, probably 15 months after a whole series of reviews and interventions after the process started.

28. But why did they eventually tell the Inland Revenue a few days before the contract was signed then? Why did they eventually recant and spill the beans?

(*Sir Nicholas Montagu*) No, I do not think it was a question of recanting, Mr Beard. At the point where the Board of Inland Revenue were preparing to give their agreement and to sign, at that point we asked (to be precise my deputy on the policy and technical side asked), knowing that arrangements of this sort were common, what the structure of the Mapeley companies was.

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[Continued

[Mr Beard Cont]

29. So you are saying that no one in this project team on either side or the other partnerships were sensitive enough to the issue that it would be strange at least to have the two tax gathering organisations of the country dependent upon a landlord which was registered in a tax haven? Nobody was sensitive to all this?

(*Sir Nicholas Montagu*) Mr Beard, I have to come back, if I may, to the point that I made in reply to the Chairman. This was a project committee, made up as Richard has described, working within the rules laid down by the Treasury reflecting European procurement law. The fact that it could be presented as paradoxical that the properties were being transferred to a company in Bermuda could not be allowed to affect the procurement process which had to be carried out in accordance with European and WTO rules. I think that the project committee were focussing very much on operating within those rules. You could say they were over-focussed. They were certainly right that they had to operate within those rules. At worst the charge against them is one of naivety in not saying, "Look, there's no option other than to proceed in this way, but we ought to flag it up as something which could be presented against you at a later stage."

30. This question is really to both Sir Nicholas and Mr Broadbent. If you were doing the exercise again would you do the same again? Would you expect to see this team go off, negotiate an arrangement like this and really never inform anybody until the last minute?

(*Sir Nicholas Montagu*) I would expect the outcome of the procurement to be the same because it was conducted in an exemplary way in accordance with the rules. If you are asking me with the benefit of hindsight do I now wish that they had alerted me to the possible presentation difficulties the answer is, yes, but in terms of the substance it could not have been allowed to make a difference.

31. Mr Broadbent?

(*Mr Broadbent*) Yes, I think they should have told us. I think it is regrettable that they did not. I have a degree of understanding for them. When you go into these very large scale, complex procurement exercises you do have to have very clear guidelines and if you do not follow guidelines you very rapidly get lost. Certainly I would be open, and probably rightly so, to quite material criticism if I had tried to make up the rules as I went along. It is a very difficult task when you are conducting a complex negotiation and you are trying to stick to the guidelines, which was very clearly done in this case. It was signed off by all the appropriate people in Treasury, and so forth. It is very difficult to know what is outside the guidelines but you ought to tell people about, and I think it is regrettable in this case that they did not tell us. I have a little bit of sympathy for them but I would wish they had done.

Mr McFall

32. Why was the Minister not informed before the contract was signed?

(*Sir Nicholas Montagu*) A pure and simple oversight. I have apologised to the Paymaster General in terms for this. Again, if I might repeat the point I have made to Mr Beard, we should have warned the Paymaster General because again it was something which could be misrepresented. Had we told her, again it could not have made any difference to the ultimate outcome.

33. Sir Nicholas, you exist and Mr Broadbent exists in the interface between the public and the private; you are part of Government. When one is part of Government sometimes perception is reality. So I would charge you with a less insensitive, in fact a naive approach to this situation where you did not for a minute think that there was anything wrong with this, where the general public would look at it and say, "Look, this is registered overseas." You are coming at us with a strictly legalistic framework. I would say to you, you are maybe not in touch with reality in terms of what people regard as the issue here.

(*Sir Nicholas Montagu*) I think I plead guilty to that charge, Mr McFall, in the sense, as I have said, that we should have warned the Minister of the way in which it could be presented. You accuse me of being legalistic. I have to operate as a civil servant within the law. It is for Parliament and not for the Civil Service to change that law.

34. I agree with that entirely but what I am saying is that you should have had some foresight, you should have had some feel for the issue, which seems not to have happened, and that is the charge. Inland Revenue and Customs do not have a great reputation for foresight and what we are saying to you is, have you learned something now and what checks and balances are in place now so that something like this will not happen again?

(*Sir Nicholas Montagu*) When you say "so that something like this will not happen again", Mr McFall, if you are talking about the procurement, it would happen again. I come back to the point about the law. If you are asking me about Richard's and my failure to alert the Paymaster General at that point, what I have learned—and it is certainly something which I was old enough in sin as a civil servant to know already—is to have my antennae waving a bit more actively, to have warned her. But what I would have been warning her of would have been of possible presentational difficulties ahead and the need to have her arguments ready to counter them. I do emphasise, Mr McFall, we are talking of presentation and not substance here. But in terms of did I give my Minister the service she was entitled to expect, no, I did not and that is why I have apologised to her.

35. So your antennae and Mr Broadbent's antennae will flap more vigorously in future?

(*Sir Nicholas Montagu*) You bet!

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[Continued

Mr Beard

36. Under what circumstances would you expect people who were at the level of the project team to report to you on any other issue and under what circumstances would you expect to report it to the Minister—not this issue but what sort of issue would you expect to have brought to you and what sort of issue would you expect to take to the Minister?

(*Mr Broadbent*) If I can start by saying I think that is a very good question and I think it is a very difficult one to answer because the point has been made that there should have been more sensitivity shown to an issue which might have created, as you rightly say, an issue of perception. There are many of these in the public sector, as I have learned, and actually they change over time as well. It is very difficult. You can have a green book or a red book, whatever it is called, which sets out all the guidelines for letting a contract and every letter of that guideline was followed and, as you point out, we are in a situation where we (at least in perception terms) stand accused of doing something which people do not find easy to understand. So we then have to find another set of—they cannot be rules or guidelines, can they?—behaviours which, if you like, protect us from this happening again. What are those behaviours? Well, you come down to words like “awareness” and “political sensitivity” and what you actually get down to is, who do you trust? It gets down to a very basic management issue and coming in to the public sector I have to say that the issue is made more acute when the very high majority of people working in the Civil Service have had no outside experience, so it is quite difficult sometimes. So I think you have asked the right question. I do not think I would claim to have a ready answer. I believe that you cannot do more than write guidelines; beyond that you are in a management issue of how do you encourage the right attitudes and behaviours which—and I recognise that criticism has been made by the Committee—cannot be one-sided. I would have to make the point that I think Sir Nicholas and I would stand open to very severe criticism if we had not signed the contract, which is probably saving us something in the order of £30 million a year at the moment and providing us with professionally serviced accommodation and taking future risks off us about how to use that accommodation, because we did not like the smell of this. I understand there is an issue there which might have been considered but your question is a very hard one to answer, I think.

37. Was the Government Office for Commerce involved in these negotiations through Partnerships UK? Did they not ring any alarm bells?

(*Mr Broadbent*) Partnerships UK were the sort of leaders for the centre, as it were, and they were not only fully engaged but at points they were leading the process.

(*Sir Nicholas Montagu*) To answer your question, Mr Beard, the Office of Government Commerce were not a party to the negotiations. It was more appropriate, as Richard has indicated, for Partnerships UK and their predecessor, the Treasury Task Force, to be. But certainly the Office of Government Commerce and Peter Gershon were well aware of what was going on and indeed over

recent months Richard and I have been keeping Peter in very close touch with further discussions with Mapeley.

38. You say in your memorandum that you have recently taken advice from counsel which has confirmed that the practical effect of the EC procurement law that applies in this case prevented the Departments including a provision in the procurement process to outlaw the use of an offshore tax structure by bidders. Why was this advice not sought at the time?

(*Sir Nicholas Montagu*) Because it was not necessary, Mr Beard. This is essentially belt and braces. Government lawyers right across Whitehall tell their Departments that the European procurement law and World Trade Organisation rules do prohibit discrimination on the grounds of lawful tax practices. When interest in the Mapeley contract was evident in the media and more widely, and it became clear that your Committee would take an interest, we thought that it was wise, as I say, on belt and braces grounds to seek advice from leading counsel, which confirmed the view of Government lawyers across Whitehall.

(*Mr Broadbent*) I just have one comment on the EU position. I am not sure it is right. I think perhaps the thing that I would be more troubled by is that when you set out to negotiate there is a very important term about negotiating in good faith. We have set out our store in this process and Mapeley, which was the preferred bidder, certainly by the end had invested two years' time and effort and money in the contract and I think there would have been some quite material dangers if we had just turned around and shifted the goalposts. Whatever the EU process says, I think we would probably have been in some danger of being accused of bad faith at that point and possibly damages.

Mr Laws

39. Sir Nicholas, did the other two bids use the same sort of overseas tax structure?

(*Sir Nicholas Montagu*) Mr Laws, I am in some difficulty here. The nature of the other two bids and the structure is an issue which is covered by commercial confidentiality. I think the other point I should make is that once Mapeley had been selected as the preferred bidder would be the stage at which—Richard has got far more commercial experience than I and may want to add to this—they would naturally have thought of their structures. I do not think that probably Trillium or Servus (the two other short-listed consortia) would have got to that stage by the point at which they dropped out of the competition.

40. That was not an issue that you investigated then?

(*Sir Nicholas Montagu*) It is not an issue that we are allowed to investigate, Mr Laws. As I have indicated, all that we can legitimately investigate is evasion and non-compliance.

41. Sir Nicholas, could I bring you back to the memo which you jointly did for this session?

(*Sir Nicholas Montagu*) Surely.

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[Continued

[Mr Laws Cont]

42. Paragraph 5.3, which says: “The corporate structure of Mapeley was an item on the agenda of a meeting held on 11 December, when the Departments’ representatives on the project team obviously realised that there was this offshore element involving tax avoidance.” At the end of the paragraph it says: “The project team did not explore with Mapeley whether the consortium was prepared to own the properties through a UK company in the Mapeley group.” Is that not quite extraordinary?

(*Sir Nicholas Montagu*) No, I do not think it is really, Mr Laws. Again, if I may, as I did with the Chairman, I have to take issue with tax avoidance. What we are talking about is a consortium owned by overseas companies who do not, as they are based overseas, have liability for Capital Gains Tax. What they do have, as I have indicated, is liability for income gains made in this country.

43. So you are indifferent to whether there is tax avoidance involved in the transactions you enter into or not?

(*Sir Nicholas Montagu*) What I am saying, Mr Laws, is two things. One, I do not think it is correct to describe it as “tax avoidance” in this case.

44. It is tax avoidance compared with this structure, which you told us was not even investigated by the project team. One would involve paying more tax than the other: tax avoidance in an offshore tax centre like Bermuda versus the UK structure. Why did you not even investigate that?

(*Sir Nicholas Montagu*) If you are an overseas company you have no liability for UK Capital Gains Tax. Therefore these are companies without a liability.

45. Your team did not even bother to find out whether the transaction could be structured in a way which was consistent with Government policy. You know yourselves, both of you, that the policy of the Government is to reduce tax avoidance and your project team did not even bother to find out whether this deal could be structured in a way which was consistent with that?

(*Sir Nicholas Montagu*) As I have indicated, Mr Laws, our project team was working within European procurement—

46. No, there was nothing within European law to prevent the project team exploring with Mapeley whether the consortium was prepared to own the properties through a UK company?

(*Sir Nicholas Montagu*) No. That is perfectly true, but I would make two points. First, they were working within European regulations, which say that an overseas structure is no reason for discrimination.

47. I am quite well aware of that. There is nothing to stop them doing what is in the last paragraph—

(*Sir Nicholas Montagu*) If I might be allowed to respond to that second point. Of course they could have investigated that. What we are talking about here is a structure at the outset of a contract, a contract which is going to run for twenty years. We are not talking about avoidance, we are talking about the application of liability. What we are talking about is a putative Capital Gains Tax liability on a putative value, extra value, of the property at the end of the twenty years. Whatever the structure—

48. Sir Nicholas, you are not answering the question.

(*Sir Nicholas Montagu*) I am sorry, Mr Laws, I must be allowed time to do so. What I am saying is that whatever structure had been agreed to at the time of signing—and this is true of all contracts—there is nothing to stop a change of location or a change of control.

49. So they are going to voluntarily repatriate some of this to the UK, are they, so that they can pay more tax? Is that the assumption this is based on?

(*Sir Nicholas Montagu*) That is not my point, Mr Laws; it is the other way around. Even if there had been a UK based company at the outset of the contract there would be absolutely nothing, there could be nothing, to prevent the consortium from transferring the properties to a jurisdiction in which there was no Capital Gains Tax liability at the time of disposal.

50. But the project team did not even discuss whether it was prepared to use that model?

(*Sir Nicholas Montagu*) No.

51. It did not even try to be consistent with the Government’s policy of reducing tax avoidance?

(*Sir Nicholas Montagu*) The Government’s policy is, as you say, to reduce tax avoidance. I have indicated that I think it is very doubtful whether the Mapeley arrangement, given the overseas ownership of the consortium, is properly describable as avoidance. But the other point again that I come to is that even if the properties had been transferred to a UK based company, at the point of transfer nothing in the contract could have prevented a restructuring of the consortium to transfer them before any point of disposal to an offshore company.

52. Sir Nicholas, are you not deeply unhappy that the background revealed in your memo here is that the project team did not explore the issue of an alternative structure, that people apparently on the project team did not brief you and the Board adequately, that you then, in spite of that background, forget to tell the Minister and then, following all of that and the sensitivity of this issue, in three separate places—the press release in March 2001, the annual report of the Inland Revenue, the annual report of Customs and Excise—all misdescribe the nature of the entity that you had been in the transaction with to give the impression that it was a UK based entity, not an offshore entity? Is that not either a cock-up or a conspiracy?

(*Sir Nicholas Montagu*) It is cock-up, certainly.

53. It is a cock-up?

(*Sir Nicholas Montagu*) What is a cock-up is this: I have already said in reply to Mr McFall and Richard has said in reply to Mr Beard that with hindsight we would have wished the project team to have alerted us and certainly we should have alerted our Minister. The references in the various reports and press release are pure cock-up. I think they were drafted—

54. Three cock-ups?

(*Sir Nicholas Montagu*) Three cock-ups.

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[Continued

[Mr Laws Cont]

55. There are two separate companies described in that cock-up. You did not use the same company both times. You described two separate Mapeley companies that you got wrong.

(*Sir Nicholas Montagu*) Pure cock-up, for which we have apologised and set the record straight. It was a cock-up, but again I come back to—

56. Are there normally this number of cock-ups in your Department relating to single individual transactions because virtually everything seems to have gone wrong here?

(*Sir Nicholas Montagu*) No, on the contrary, that is just not true.

57. Well, everything we have been talking about—

(*Sir Nicholas Montagu*) No. We have got an excellent deal in commercial terms, described—and again I come back to it—as an exceptional PFI deal by the Treasury Task Force, the experts on the subject, against the background of a scheme, a partnership of this nature with the savings which it provides to our Departments agreed as part of the 1998 spending review. The cock-ups which you have mentioned are certainly cock-ups but they are hardly major cock-ups.

58. Well, we will leave others to judge that. Sir Nicholas, was stamp duty paid on the purchase of these properties by Mapeley?

(*Sir Nicholas Montagu*) I am sorry, Mr Laws, that is not a question I can answer.

59. Hang on a second, I am not asking how much was paid, I am asking whether stamp duty was paid on these properties?

(*Sir Nicholas Montagu*) Chairman, I am very sorry. I want to be helpful to the Committee. Chairman, I cannot discuss properly whether any individual, corporate or otherwise, paid or did not pay a direct tax. I am prevented by my duty of confidentiality.

60. Sir Nicholas, let me tell you what one of your officials told the House of Commons Library today when the House of Commons Library contacted one of your senior officials in the Stamp Office of the Inland Revenue and was asked by the House of Commons Library whether on this type of transaction you would have to pay stamp duty and the answer was “You certainly would” and they referred to paragraph 1.29 of the Inland Revenue Stamp Taxes manual and to Section 14 of the Stamp Act 1891. I am not asking you how much they paid, I am asking you to tell us here today that there is not another element of tax avoidance in this scheme and that this company did not also avoid paying the tax on the property transaction?

(*Sir Nicholas Montagu*) Mr Laws, I will be as helpful as I can. I am not going to answer you directly.

61. Well, that is not very helpful.

(*Sir Nicholas Montagu*) If you keep in interrupting me I am not going to be able to be helpful. Chairman, I must ask for indulgence to answer the questions put to me. I am not going to answer the question “Did Mapeley pay stamp duty?”

62. Why not? Your official can answer that question. He says they are liable to.

(*Sir Nicholas Montagu*) My official has not commented on any—

63. He has to the House of Commons Library.

(*Sir Nicholas Montagu*) He has not commented on whether a particular taxpayer did or did not pay stamp duty. I am quite happy, Mr Laws, to tell you what the rules are. I am quite happy to tell you that the rules in this transaction would be applied to Mapeley on the same basis as to any other taxpayer.

64. But Mapeley may have taken advice, which you may have been aware of and your officials, that they structured this deal in a way that avoided paying stamp duty and you are aware that in the Budget 2002 the Chancellor himself announced that he was concerned about stamp duty avoidance on precisely these types of transaction, that he thinks it is penalising unfairly compliant taxpayers and he wants to clamp down on it and now you cannot give me any undertaking that this deal has not had a double avoidance element, not only the capital taxes but the stamp duty as well? You are trying to evade answering that question?

(*Sir Nicholas Montagu*) No, I am not, Mr Laws. I am refusing, as I always refuse, to answer questions about whether or not a particular taxpayer of whatever sort paid any tax.

65. Well, we will want to follow this up and we will want to follow it up with Ministers to find out what sort of job you have been doing.

(*Sir Nicholas Montagu*) Mr Laws, you are very welcome, of course, to follow it up with Ministers but, as I say, if I try to answer your question, the structure of the property deal with Mapeley was a typical deal of this sort—

66. A typical tax avoidance?

(*Sir Nicholas Montagu*) That is simply not so. The Department would never connive in tax avoidance, nor I think would the Treasury approve a deal—

67. Well, that is what you say.

(*Sir Nicholas Montagu*) I have to come back for the record. I have not conceded that the Bermuda arrangement was tax avoidance and certainly I can give you an assurance that in signing the deal with Mapeley the Inland Revenue did not connive in any kind of tax avoidance.

68. Sir Nicholas, you must be the only person in the country who does not think this is tax avoidance.

(*Sir Nicholas Montagu*) I think not, probably, Mr Laws. At any rate, you and I are agreeing to differ.

Mr Laws: Yes, and many others.

Chairman

69. We are going to leave the tax side of it there. Could we turn now to the financial difficulties which this contract, which you have described again as an excellent deal, got into just seven months after it was signed. In their memorandum Mapeley have told us, in paragraph 34 of their evidence to us, that the economic strain under the contract also results from the inaccuracies of the data provided by the Departments and changes in the Departments' requirements. So that was your fault?

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[Continued

[Chairman Cont]

(*Mr Broadbent*) One of the points which I think it is worth making at the outset is a comment about the scale and complexity of this contract. I am not going to labour the point but it is a very large and complex contract. I say that because when you deal with a transaction of this size you negotiate in good faith, both parties supply information to each other and incidentally in that process you try generally to raise the minimum number of new issues because you are trying to negotiate—that is possibly one reason why the tax structure is not explored—and you get to a point where essentially you are going to do or not do a deal and people must take a view. We took a view and Nick took a view. As with any contract of this size and scale where you have a continuing service relationship you do try in good faith, even after signing, to go on working at some of the issues. But at the point the contract was signed Mapeley took a view and they signed.

70. But why was the data they were supplied with inaccurate?

(*Mr Broadbent*) I am not in the slightest bit surprised that the scale of the data which you require—and indeed Mapeley's own note makes this clear—to do a deal of this complexity, which not only involved 700 properties but all the services, facilities and security which go with them, might be inaccurate at points. Mapeley's own memorandum says, I think in paragraph 31, that it is impossible to freeze at a point in time all data. It is a sort of Heisenberg principle; you just cannot get a perfect snapshot in time.

(*Sir Nicholas Montagu*) Mapeley were given comprehensive data and they carried out their due diligence exercise. This is standard in assessing and costing risk, and they did carry it out. Based on their findings when we questioned them about the robustness of their bid, they expressed their confidence that they could deliver the required serviced accommodation at bid price and certainly our procurement teams were not aware of any material facts that were not disclosed to Mapeley.

71. So there is disagreement here. They say in paragraph 34 that the strain under the contract results from inaccuracies in the data you provided. You are now contesting that?

(*Mr Broadbent*) No, I am sorry, I was not contesting that.

72. You told us the data were complex and comprehensive, and so on. Were the data provided accurate or not?

(*Mr Broadbent*) No, I think it was paragraph 13, not 31, I am sorry—

73. Let us stick with paragraph 34, which I have quoted to you: "The economic strain under the Contract also results from inaccuracies in the data provided by the Departments . . ."

(*Mr Broadbent*) Some of the data was inaccurate.

74. Why was that?

(*Mr Broadbent*) It is not unusual. I think it would be inconceivable that every single individual item of a contract on this scale would be accurate. The issue here is how material it is. Mapeley's own paper, as I say in paragraph 13, recognises that data will always be a bit inaccurate at a point in time.

75. All right. What about their other charge that there were changes in the Departments' requirements under the contract? Is that true?

(*Mr Broadbent*) That is certainly true. Certainly I speak for my own Department but I think both Departments' property needs are significant, major and constantly changing. That is actually one of the reasons why we wanted to have a contract with a property provider rather than to try and be our own property company.

76. Yes, but anybody looking at this from outside sees a twenty year contract which just seven months after it started is in serious economic difficulties. Were things changed in the seven months after the signing?

(*Mr Broadbent*) Well, certainly things can change quite quickly. In this situation I think two things changed. One is that Mapeley took a view at the time of signing the contract, as they were entitled to do and had to do, about a set of issues, some of which transpired to be different from the view they took at the time they signed the contract and clearly market conditions worsened.

77. All right. You have told us that one of the objectives in exploring the option for resolving all these difficulties was to reach a settlement which "did not weaken the Departments' position in this and future PPP contracts". How would a settlement actually weaken your position in this contract or a future contract?

(*Mr Broadbent*) I think in relation to this contract if you are engaged (as clearly is the nature of this or any other PFI contract) in would be a long term partnership with somebody you have to recognise it is a long term partnership and your behaviour at all times must contribute to the future of that partnership and if Mapeley had come to us and said "We're short of money" and we had rolled over and said "Here's some more" it would not have strengthened our position for the future of the contract and we did not do that. More generally, of course, we are quite a large procurer of services and we have other PFI contracts so our behaviour as a procurer, as a giver of PFIs, is also scrutinized by our other suppliers.

Kali Mountford

78. You have told us that the contract was a very good deal for Government—I assume by that you mean there were significant savings for the Government—and yet at the point where there were financial difficulties for Mapeley, further cash was sought and further improvements sought, which makes me question whether it was such a good deal in the first place. What were those improvements and why could they not have been sought sooner?

(*Sir Nicholas Montagu*) Again, Ms Mountford, Richard will, I think, want to answer that but may I ask for the Committee's forbearance in one particular, which is that although, as we have indicated, the position has changed because of the state of the property market and we are not now talking in terms of the kind of cash injection that was the subject of discussion earlier in the year, we are nevertheless still in negotiation with Mapeley. So

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[Continued

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again I hope that is something the Committee will understand but, Richard, I think, would like to answer Ms Mountford's question.

(*Mr Broadbent*) If I could just go back one step. The goals of this contract certainly were partly to do with efficiency. We were trying to save money and that is one of the things we always have to have regard to. One of the reasons we chose this area was because as organisations one of the challenges we face is that our activities are constantly changing as the economic map of this country changes and as a result our property requirements keep changing. Historically we have sought to manage our own property essentially by often entering long leaseholds or buying freeholds and certainly I have found—I think Nick has as well—that this is making it increasingly difficult to manage our businesses because every time there is a change in move, we need to move people or move an office, we find ourselves with these long leases and freeholds. It is expensive and difficult. So there is certainly a goal to save money, which I think is proper, but a very major part of the purpose of this contract was also to improve the way we manage our property, to get more flexibility, to effectively pass the management of the property to somebody who is a professional in the field, who would run the asset management side of it better and take away from us quite a lot of the risk we currently carry that if there is a movement of companies we cannot move our staff, we have got an expensive long lease in place. The Mapeley contract does that very effectively because we did in fact get a good price for the properties, I believe, and that was externally verified but the contract includes very, very substantial provisions in two areas. One is the flexibility it gives us to change our use of property, to exit buildings, and the other is that instead of us having to buy all our services for a building—buildings are very complicated, this one is very complicated—we just paid Mapeley one cheque and they provided everything from the security guard to the window cleaner, to the heating, to the lights, which is an enormous relief to us in terms of the cost and in an area we are not very expert at. I go through all of that because that is why the contract is not just a few hundred pages with a set of a hundred properties, it is thousands and thousands of pages specifying, for example, the quality of the lights we have, how many security guards, whose responsibility is it to change the locks if there is a break-in and about clearing the snow. It took nearly two years to get to the point of signing this contract and I find it actually unsurprising in the first year or two of a twenty year contract to find that we are spending time with Mapeley saying, "We want this bit done a bit better or a bit differently." When we came to the issue of money with Mapeley we certainly said, "We're not going to just pay you more money. However, there are certain things we want which we had not fully understood at the time of signing the contract and perhaps we can talk about that." That would have been, for example, in things like the degrees of flexibility in occupation of property, levels of service, whether this is working well for us or not. That is not unusual in a commercial negotiation of this sort.

79. So you are telling us that you handed over a significant amount of cash to a company without securing first any appropriate improvements to the deal?

(*Mr Broadbent*) No, they handed over a significant amount of cash to us. They paid us over £200 million.

80. Yes, but you had to bail them out after seven months?

(*Sir Nicholas Montagu*) No.

(*Mr Broadbent*) No, we have not bailed them out. We have not bailed them out in any way at all. There is a commercial negotiation in progress at the moment which hangs around effectively a set of unresolved contractual issues. We have not bailed them out.

81. So how have you helped their cash flow problems?

(*Mr Broadbent*) We have not.

(*Sir Nicholas Montagu*) Their cash flow problems, I think, Ms Mountford, if I can put it this way, have helped themselves. At the point where Mapeley approached us they had the cash flow problems for the kind of reasons that Richard has described. Since then movements in the stock market and the property market respectively have enabled Mapeley substantially to improve their cash flow position and that is why the negotiations that we are in with them now are very different from those that we entered into earlier in the year.

82. But if it was only a matter of changes in the stock market why would they have come to you?

(*Sir Nicholas Montagu*) I think again we need to look at this in the context of almost a snapshot, if you like. It is undoubtedly true that at the point when Mapeley approached us, seven months in, or whatever it was, they had problems with cash flow which they believed were threatening their position and that was why they wanted to talk to us about what we could do within the terms of the contract, and so on. At that point I do not think that anybody could quite have foreseen the respective movements of the property and equities market. At the moment I am told that the property return on equities is in the region of minus 17.3% and the annual return on property is 9.5%. What that means is that property investment is now in demand from institutional investors who are attracted to properties with long income plans and that has made Mapeley's position very much more favourable because large investors are looking for alternative homes for their money. So, for example, landlords are now looking to grant an extension of leases. Government leases are low risk, the Government-backed income stream, and they are prepared in this case to make one-off payments to Mapeley. So what they have benefited from is a significant development in those two markets since they first approached us.

83. That answer makes me query your answer to Mr Fallon at the very beginning of this session. When he asked you what happened at the seven month stage you said at that point you were able to secure some significant improvements. You have said so in your memorandum to us. You are now not able to tell us what those significant improvements are. I have to say I am not understanding what the relationship is between the cash flow problems, the

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[Continued

[Kali Mountford Cont]

relief of those problems and the significant improvements of which you are able to tell us nothing.

(*Mr Broadbent*) If I could put it this way. I think the answer to your question “Did the market just change?” is slightly different. I think Mapeley originally came to us because they hoped that we would stump up. When they came to us it was pretty clear, as you would expect with a contract of this size, there were some contractual issues and actually legally there is some doubt; we also had to have regard not just to the law but to good faith and to the fact that we have had a relationship with these people over many years. So there is a very valid area of discussion to have there. There is another area where there may be contractual issues but we actually think they are invalid. There is another area where Mapeley say, “Actually it is not a contractual issue at all. We would like some help.” Each of these sort of components of the negotiation progressed. The last bit is off the table and one of the reasons it is off the table is, I think, because we have been very unwilling to get drawn into that. The other areas are still on the table and if we are going to resolve contractual issues then obviously from our point of view we want to make sure we resolve our contractual issues as well as Mapeley’s and of course we have a set of issues as well. Is this particular service being provided in exactly the way we thought it was going to be provided? That is the nature of any debate. Both sides have issues which hinge around what exactly this contract means, what does it provide for, and the reference to improvements is we want to get what we want out of the contract what we thought we were going to get out of it and raise areas of certainty or doubt just as Mapeley do. If that negotiation goes well, which is not necessarily a foregone conclusion, we will get to a result. But this has been going on for quite a long period of time and that is not an unusual thing.

84. How soon do you think we might have an answer?

(*Mr Broadbent*) I would hope quite soon, although—and this is not in any sense meant to be a criticism—it is actually very difficult to conduct a negotiation in public and this process has been, I think, somewhat slowed down by the publicity now attached to it. You cannot negotiate in public; it is very difficult.

85. I appreciate you cannot negotiate in public but I would quite like to know what these significant improvements are, so would it be possible for us to have a note?

(*Mr Broadbent*) I am quite hopeful that we will be able to conclude at least provisional discussions with Mapeley and put advice to Ministers reasonably early in the new year.

Chairman: All right. Could we turn now to the letters of comfort. Nigel Beard.

Mr Beard

86. Your joint memorandum to us for this meeting refers to Mapeley approaching you in May and June this year seeking reassurance about the likely outcome of discussions with the aim of sharing this

with their bankers and auditors and indeed you issued a letter accompanied by a draft memorandum of understanding which might have formed the basis of the agreement between the Departments and Mapeley. Then your account goes on to say: “A note to the accounts of Mapeley STEPS Contractor Limited lodged with Companies House in August 2002”—August this year—“might be taken to imply a greater degree of certainty about a possible settlement than the provisos in the letters sent to them warranted. Three members of the working group, including a representative of the Inland Revenue, were sent a draft of the proposed note to the accounts of Mapeley STEPS Contractor Limited, but they did not recognise the significance of the note and so it was not considered further in the Departments before publication . . . We are now advised, by the Treasury Officer of Accounts, that the letters sent to Mapeley may constitute letters of comfort within the meaning of ‘Government Accounting’.” “Government Accounting”, when you look at paragraph 16.3.1, says: “. . . a public sector body, which is ultimately dependent on government credit, is unlikely to be able to issue such a document”—a letter of comfort—“without effectively committing government credit and having to meet the obligation if it should materialise. Moreover, the existence of a letter of comfort could lead to threats of legal action. . .” So Government Accounting says that the Departments should approach any request for a letter of comfort with a strong predisposition to reject it. So how did you manage to issue two letters of comfort to Mapeley without realising it?

(*Sir Nicholas Montagu*) The working group looking at Mapeley’s position and reporting to the two relevant business directors in our two Departments was chaired by Partnerships UK, successor body to the Treasury Task Force. They were approached by Mapeley and essentially were told that in the first case the banks and auditors and in the second case the shareholders were essentially looking for an assurance that the Departments were still serious about doing business with Mapeley, which we were. On the basis of that Partnerships UK, who chaired the working group, advised strongly that we should issue letters of comfort to Mapeley to be able to show their auditors, bankers and their shareholders, which would give them the assurance they were seeking; and Partnerships UK then drafted the letter. It was cleared—and this is, I think, an important point—by Lovells, our legal advisers, on the basis that it most certainly did not create any contingent liabilities for Government; and on that basis it was sent. You have quite rightly, if I may say so, Mr Beard, quoted Government Accounting on that. We could have an interesting discussion on whether the letters of comfort (which undoubtedly were letters of comfort) fall within the description that needs to be reported to Parliament. But equally, once attention focussed on them, we were also aware that if in doubt err on the side of reporting, which was why at that point we wrote to the Chairman of the Public Accounts Committee.

87. But were there no lawyers on the negotiating team who gave a warning about this and was there no foreknowledge of what the Government Accounting

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[Continued

[Mr Beard Cont]

rules said about this before these letters were drafted because we are also dealing with not just the first letter but also the note to the accounts of Mapeley STEPS Contractor?

(*Sir Nicholas Montagu*) We are indeed and, as I have indicated, on the working group in addition to representatives of the two Departments and Partnerships UK in the chair, Lovells, our legal advisers, and Deloitte & Touche were also represented, and it was Lovells who cleared the letter of comfort very, very specifically to ensure and to be able to confirm that it did not create any contingent liability for Government, because at all times it was made clear in both letters that any decision was subject to approval by the Treasury at both official and Ministerial level and therefore there was no contingent liability created.

88. Therefore there seems to be a conflict between the advice which you have here from the Treasury Officer of Accounts and Lovells?

(*Sir Nicholas Montagu*) I do not think there is. If I am honest, I think it is a shading in the sense that, if you read Government Accounting word for word, you could argue on the fine detail, was that a reportable or not a reportable letter of comfort. Once we had talked to Brian Glicksman, the Treasury Officer of Accounts, he thought that on balance it could be and certainly Government Accounting essentially says "If in doubt, report", so we did.

89. Mr Broadbent, have you anything to add to that?

(*Mr Broadbent*) I feel there are certainly some tensions between Government Accounting, Government policy—because we had an earlier discussion as to whether we should have taken into account Government policy in letting a major contract but there is no reference to that in Government Accounting—and commercial demands, how do you negotiate and get best value for money in the public sector. Whether this triangle meets perfectly I think is an interesting question. Certainly the working group at the sharp end, properly and well advised by good external legal and other advisers, were trying to take sets of decisions to get to a conclusion on a commercial negotiation and they did. They certainly overlooked at that point in the process a requirement of Government Accounting and that, I think, is regrettable but I think there are some questions as to how easy it is when you are working on the ground in those circumstances to apply the framework, the demands of the situation and Government policy. That is one of the complexities, I think, of negotiating these contracts in the public sector.

90. What this amounts to is that this team, without reference to you, without reference to Ministers or without reference to Parliament effectively committed the Government through these letters of comfort to financial obligations had they been—

(*Sir Nicholas Montagu*) No.

91. Well, that is what the Treasury viewpoint is and that is what is implied by the Government Accounting—

(*Sir Nicholas Montagu*) No. I am sorry, Mr Beard, I have to make the position absolutely clear. That is why I said that it is a question of interpretation not

of whether there were liabilities created, but of what constitutes a reportable letter of comfort. The Treasury Officer of Accounts certainly recognises, and he has told me so, that no contingent liabilities on Government were created by those letters because the position of the Treasury at Ministerial and official level was explicitly and in terms reserved.

Chairman

92. If I could just interject here for a moment. What possible comfort to the Mapeley shareholders can a letter of comfort provide which does not imply any contingent liability?

(*Sir Nicholas Montagu*) I think the assurance, which I mentioned before, that we were serious about wanting to continue in negotiation with Mapeley. What we were essentially saying was, "Look, we are conducting these negotiations in good faith." The kind of approach, taking the point at which the letters of comfort were written is, "The point which we have reached is where we think there could be a way forward on these lines, but we do have to enter the proviso that it is a way forward which is subject to agreement by the Treasury at Ministerial and official level."

Mr Beard

93. But Mr Montagu, that does not square with your memorandum quoting the Treasury Officer of Accounts, where it says: "The letters sent to Mapeley may constitute letters of comfort within the meaning of Government Accounting" and "within the meaning of Government Accounting" is what I quoted. In answer to Mr Fallon's question, that implies there is some contingent liability developing under these letters?

(*Sir Nicholas Montagu*) I do not think that is right, Mr Beard. As I say, Brian Glicksman has accepted all along there is no contingent liability. Brian's advice to us was that although the letters did not create a contingent liability they may nevertheless constitute letters of comfort within the meaning of Government Accounting, but again—

94. But that means then that there is a contingent liability because that is what these phrases mean. Let me read them again.

(*Sir Nicholas Montagu*) It does not, and we have the explicit understanding of the Treasury Officer of Accounts confirming what our lawyers have confirmed, that no contingent liability was created. If I say to you, "Look, I will enter into this agreement with you but if and only if such a circumstance obtains", then that reserves my position. In this case the circumstance was the approval of the Treasury at Ministerial and official level, which could not be taken as a foregone conclusion; and because of that we have unequivocal advice from the lawyers and the concurrence of the Treasury Officer of Accounts that no liability was created for Government.

95. Were these letters brought to the attention of the Inland Revenue Board and the Customs and Excise Management Committee?

(*Sir Nicholas Montagu*) No, not at the time. They were not.

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[Mr Beard Cont]

96. Mr Broadbent?

(*Mr Broadbent*) No, the letter in June was not and the letter in July, there was effectively a contemporaneous discussion. We were informed at the time it was sent.

97. So you had no influence over it?

(*Mr Broadbent*) No.

98. Again, does this not call into question the criteria by which people are reporting to these two Boards?

(*Sir Nicholas Montagu*) I do not think so. Again, let me go over the structure of this group. This was a working group of experts chaired by Partnerships UK and with them strongly advising that the letter should be sent and indeed drafting the letter. The group reported to two very senior directors, one from Richard's Department and one from mine, who were operating with the implicit delegated authority of my Board and Richard's Management Committee. It was on that basis that the letters were signed.

99. It seems the delegated authority was a sort of infinite delegation. Nobody had to report anything back, nobody had to have any sensitivities which ought to be aired with Ministers; they were operating freelance?

(*Sir Nicholas Montagu*) No, that is not so, Mr Beard. As I have indicated, the working group reported to the two very senior directors in both Departments, who in turn were operating with the authority of my Board and Richard's Management Committee.

100. But neither of them spotted the difficulties in these letters of comfort, despite having been asked to comment on this qualification—

(*Sir Nicholas Montagu*) There is no implicit difficulty in the letter of comfort except in the procedural point, which I acknowledge should probably—and I say “probably”—have been reported to Parliament, but certainly they had got explicit confirmation from our lawyers that the letters did not create any contingent liability.

101. Why did you put that phrase in your memorandum then if that is the case?

(*Sir Nicholas Montagu*) Which memorandum?

102. In the memorandum to us. You said: “We are now advised, by the Treasury Officer of Accounts, that the letters sent to Mapeley may constitute letters of comfort within the meaning of ‘Government Accounting’.” That is what was sent to us.

(*Sir Nicholas Montagu*) Yes. This is the point we have been over, Mr Beard. The Treasury Officer of Accounts thinks that they may have been reportable to Parliament but he does not believe for one moment that they created contingent liabilities. It does not follow that if it is reportable to Parliament, clearly from what Brian Glicksman has told us, that automatically a contingent liability is created. Brian has explicitly taken those two positions with us.

Mr Beard: I think we had better leave it there. Thank you.

Mr Laws

103. Can we just clarify this point, Sir Nicholas. Are you saying that this group was basically sending out these letters of reassurance to Mapeley's shareholders without your approval?

(*Sir Nicholas Montagu*) I am saying that the letter of comfort was signed by a senior director in the Revenue operating implicitly with the delegated authority of my Board.

104. But without your approval?

(*Sir Nicholas Montagu*) With my delegated authority; without my explicit approval. The director in question is probably the most senior, the most experienced handler of public private partnerships in Government and within the Revenue we delegate authority to our senior directors.

Chairman

105. On this point, you are aware in both letters the phrase is used “With the full knowledge of the Departments' Boards”?

(*Sir Nicholas Montagu*) Yes.

(*Mr Broadbent*) That refers to the state of the negotiation, of which both Boards did have full knowledge. The nature of the proposals being discussed, the contractual issues had been discussed both in the Customs Management Committee and the Revenue Boards. So the issues being discussed and the state of the negotiation was something within the full knowledge of the Boards. What was not within the full knowledge—

106. But the letter says “With the full knowledge of the Departments' Boards the parties have engaged in discussions and these discussions have resulted in a non-binding memorandum of understanding.” So you cannot say the Boards did not know about it.

(*Mr Broadbent*) No, I am not. The Boards did know about the negotiations and were fully aware of the state of discussions. The point, as I understand it—

Mr Beard

107. But in reply to my question, when I asked had these been brought to the attention of the Inland Revenue Board and the Customs and Excise Management Committee, your answer was “No.”

(*Mr Broadbent*) Yes. The letters of comfort were not drawn to the attention but the reference to the negotiations, the negotiations were in the full knowledge of the Board.

(*Sir Nicholas Montagu*) What the letter actually says is: “With the full knowledge of the Departments' Boards the parties have engaged in meaningful discussions towards resolving the potential financial difficulties identified by Mapeley.” That was absolutely true. Richard's Management Committee and my Board were kept in touch with how the negotiations were going and the direction that they were taking.

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[Continued

Mr Laws

108. You had full knowledge that there were negotiations but you just did not know what was actually going on or that letters were being sent out of reassurance to Mapeley's shareholders on your behalf?

(*Sir Nicholas Montagu*) We knew that discussions were going on, we knew what direction the negotiations were taking. We did not know in terms that the letters recommended by Partnerships UK—

109. Is that not pretty important for you to know, Sir Nicholas? It is fine to have discussions but the critical issue here was when a letter went out which was being taken as a reassurance to Mapeley's shareholders and I cannot understand how you can fully understand and be fully aware of without being aware of that most critical element of it. Do you think in retrospect you would like to have been told?

(*Sir Nicholas Montagu*) It is always terribly easy simply to say "Yes" in retrospect now, and obviously if I could say "Yes, we were told" in a way it brushes off the subject. What I am trying to do is to look back and say the Boards knew that these negotiations were going on. The Boards had delegated authority to the two senior directors to whom the working group reported and who kept them in touch with the direction of the negotiations at the point where this expert working group, chaired by Partnerships UK, said, "Look, we need to reassure the shareholders and the banks that balls are still in play. It would be a good idea to write to them." I think that that was a reasonable decision.

110. Sir Nicholas, is this process not very bizarre? Could I refer you again to 7.3 of your memorandum to us. It says here: "The letters and draft Memorandum"—the ones we were just talking about—"were sent out as part of the continuing attempt to identify recommendations to make to Ministers, and they were not, in consequence, brought to their attention at the time. . . ." So in this process instead of having a discussion internally about what you were willing to send out, what you were not, what undertakings you were prepared to make with Mapeley's shareholders, you did not know about it, the Minister did not know about it and these letters and draft memorandum are being sent out in order to identify recommendations to make to Ministers. Is that the way normally things happen?

(*Sir Nicholas Montagu*) No, we knew. As I have indicated, Alex Fraser on Richard's side and John Yard on mine were keeping us in regular touch with the direction that the negotiations with Mapeley were taking. These were real and they were tough negotiations to try to come up with a series of realistic options which we could then put to Ministers. What Mapeley's shareholders, bankers and auditors required was an assurance that the Departments were indeed serious in engaging in these negotiations with Mapeley and that is what the letters of comfort gave.

111. Let me take you on to the note then, 7.4 in your paper: "A note to the accounts of Mapeley STEPS Contractor Ltd lodged with Companies House in August 2002 might be taken to imply a greater degree of certainty about a possible

settlement than the provisos in the letters sent to them warranted. Three members of the working group, including a representative of the Inland Revenue, were sent a draft of the proposed note to the accounts of Mapeley STEPS Contractor Ltd, but they did not recognise the significance of the note and so it was not considered further in the Departments before publication of the accounts." Is that not another cock-up basically?

(*Sir Nicholas Montagu*) It is certainly an oversight, yes.

112. Not a cock-up?

(*Sir Nicholas Montagu*) If you like, but again let us look at it in the scale of things. I think that Mapeley's assertion was an over-confident one in the note to the accounts. I do not think, particularly with the way that things have panned out, that in the greater scheme of things anything has resulted from it to the detriment of either Department or to Government in general.

113. Before Mr Beard comes in, could I just ask you for one bit of clarification. The three members of the working group who were sent that draft took a decision which turned out to be a mistake to actually approve it and let it go in to the accounts. Was that with advice from Lovells as well?

(*Sir Nicholas Montagu*) I cannot honestly remember who the other two members of the working group were but again they did not approve it. Where I think, with the benefit of hindsight, they possibly went wrong was in not reacting to it. They were sent the draft and they did not comment on it. They did not write back and say, "Yes, this is okay."

Mr Beard

114. Mr Laws just read out the same passage I read out: "Three members of the working group, including a representative of the Inland Revenue, were sent a draft of the proposed note to the accounts of Mapeley STEPS Contractor Ltd, but they did not recognise the significance of the note. . . ." If the note was not expressing some contingent liability why was it significant?

(*Sir Nicholas Montagu*) Because it could have been taken as implying that there was no contingent liability. It could have implied, as we say in our memorandum, a greater degree of certainty about a possible settlement than the provisos (which were what protected us from contingent liability) warranted. My colleague tells me that one of the other to whom it was sent was a representative of Deloitte. I do not know who the third one was.

Chairman

115. Could we just be clear about this. When you say the full Board was not told, was any member of either Board shown these letters of intent?

(*Mr Broadbent*) In relation to Customs and Excise, in the case of the June letter, no. In the case of the July letter, I received an e-mail I think the day before the letter was issued saying that this was proposed. I responded and questioned the wisdom of doing that but we were subsequently told the letter had then been sent the following day.

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116. Was any member of the Revenue Board?

(*Sir Nicholas Montagu*) No, we were not. As I have indicated, we had delegated the authority to our senior director, to whom the working group reported, and who acted on the strong advice of Partnerships UK and the working group.

(*Mr Broadbent*) Could I offer one perspective on this?

117. Perspective?

(*Mr Broadbent*) Yes.

118. I think we are in need of that.

(*Mr Broadbent*) I think we should have been told about these letters of comfort but the perspective I want to offer is that the Boards, I think, were quite properly trying to manage these negotiations in the sense of understanding the financial situation, what the contractual issues were, where our negotiating boundaries might lie. They were not trying to micro-manage the tactics of it. The working team were trying to micro-manage the tactics of it and that is a proper split of responsibilities. A Board cannot micro-manage negotiations. This was a situation where we had no reason to doubt at certain points that Mapeley might pull out, collapse, and there were some very important tactical decisions to be taken to keep this thing going to enable the Boards to fully understand the situation and to consider all the options. In doing that, I think the working group did one or two things (of which probably this is the main example) which perhaps went beyond tactical and they should have informed the Board. That is a judgment a responsible person when in negotiation always has to have in mind. In this case I think they got it slightly wrong, but again the perspective I want to offer is that people are under a lot of pressure in a very real commercial situation, trying to preserve actually the value of public assets and protect the public purse and probably in a situation which many of them have not had a great deal of experience of before and the fact that on one or two of these points they did not quite get that judgment call right, "Do we tell the Board or do we not tell the Board?" I think is regrettable but I do not find it wholly reprehensible.

119. If you are writing letters of intent on behalf of two major Government bodies you might tell the Boards?

(*Mr Broadbent*) It was letters of comfort which they had clear and good legal advice created no liabilities, but I agree they should have recognised that they were letters of comfort—

Mr Laws

120. The other perspective, Mr Broadbent, is that given you knew all of this was going on you might have expected to know the most important part of the equation, which was that these undertakings were being sent out to the Mapeley shareholders, but I am interested that you take a different view to that of Sir Nicholas. You are now saying to the Chairman that you think it would have been sensible if you had been consulted on this before the letters had been sent out, is that right?

(*Mr Broadbent*) Just to comment, I do not actually think the letters were the most important part of this negotiation. I think the Boards were focussing on what was the most important part of the negotiation, which was, what is the trade off here between the risk of this contract not going forward, possibly collapsing, getting contractual issues sorted out and possibly having to pay money or not pay money to keep it going.

121. But you think in retrospect it would have been sensible if you had been consulted?

(*Mr Broadbent*) On the issue you particularly raise, as I have said, I would have wished to have been consulted.

122. When would you have wished to tell Ministers?

(*Mr Broadbent*) About the letters of comfort or about the negotiations?

123. About the letters of comfort.

(*Mr Broadbent*) It is a very difficult question to answer in the hypothetical because it depends what the situation was.

124. Well, in this situation.

(*Mr Broadbent*) Would I have told Ministers if I had known?

125. Yes.

(*Mr Broadbent*) I find that hard to answer without knowing, in a sense, all the facts. I doubt it. Let me try and give you a sort of conditional answer to a hypothetical answer. If I was satisfied in all the circumstances that it was the right thing to do to send the letters of comfort, which amongst many other things would mean being satisfied that they created no liability and it was essential in order to enable the negotiations to continue, it is quite possible I would not have told Ministers.

126. Do you think it was a sensible process that the letters and draft memoranda could be sent out to the Mapeley shareholders as part of a continuing attempt to identify recommendations to make to Ministers, so you make the undertaking to the shareholders in order to decide what to put to Ministers?

(*Mr Broadbent*) The letters of comfort were not an undertaking. I am afraid we have to sort of correct this every time it is said because we are in a commercial negotiation and I cannot allow you to say things which may imply a view I do not hold because we are in a negotiation. I do not believe that the letters of comfort were pivotal to the options we were trying to develop for Ministers. The options we were trying to develop for Ministers were, should we be effectively taking a very hard line here in just saying "Well, you've signed the contract and if you go belly up we don't care", should we be trying to work with our partners? In essence you have to understand somebody's position very closely in order to develop options.

127. But under Government Accounting guidelines a letter of comfort is not something you should give in normal circumstances. It is a very serious undertaking which potentially implies liabilities for the taxpayer. It may have been one of a number of important elements here but it was not an unimportant element, was it?

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[Mr Laws Cont]

(*Mr Broadbent*) I think all these issues are important. In this case I think the working group quite rightly took advice, which has since been confirmed, that the letters do not create liabilities.

Chairman

128. The letter of intent in the note to the accounts was fundamental to the directors' definition that the company was still a going concern?

(*Mr Broadbent*) Yes—

129. This was not one of a number of issues, it was the letter of intent that enabled the directors to say that even though they had liabilities of £23 million they were still a going concern, so it was the key document.

(*Mr Broadbent*) I think it was the fact that the discussions were going on but certainly the directors took the view—and it is only their view under the Companies Act and only a view they can take—that that letter was something which was worth mentioning in their accounts alongside actually in the same paragraph a reference to support from their own shareholders in coming to their going concern view, which is a sort of overall view. But that is their judgment, not our judgment.

Mr Laws

130. Without breaching commercial confidentiality, what is the latest situation in relation to the Mapeley position? Has it now been stabilised? Are negotiations on-going? Are there any other letters of comfort being sent out?

(*Sir Nicholas Montagu*) There will be no other letters of comfort going out. As I indicated earlier, I think in answer to Ms Mountford, the position has changed. Mapeley are in a much happier position as a result of the changes in the equity and property markets and, yes, discussions with them are continuing on a number of the kind of issues which frankly, as Richard has indicated, you would expect to fall out during the early years of a major contract and as we have found with other major partnerships.

131. Sir Nicholas, could I just ask for one final point of clarification, coming back to the Mapeley contract before it was signed. Did the Revenue's deputy chairman seek advice about the Mapeley contract from the Department's own special investigation section and from Mr Shaw?

(*Sir Nicholas Montagu*) He did seek advice from Dave Shaw, yes.

132. What was Mr Shaw's advice?

(*Sir Nicholas Montagu*) Dave Shaw's advice was that he had flagged up the point which we have talked about a lot in this hearing, that it could indeed give rise to presentation difficulties, but he also gave unequivocal advice that we could not, because of that, stop it going ahead; in other words Dave Shaw recognised that a perfectly legitimate and legal arrangement of Mapeley's structure would not be a legal reason for the Revenue to act other than award the contract.

133. So is it untrue, as is reported this week in a magazine, that Mr Shaw was consulted (as you have described he was) and that Mr Shaw's unsurprising response was that the Revenue should not touch the transaction with a barge pole?

(*Sir Nicholas Montagu*) It is utterly untrue, Mr Laws. I saw the article myself. As a result of that, I looked at the exchange of e-mails and Dave Shaw never said that.

134. Could you send us a copy of the e-mail, please?

(*Sir Nicholas Montagu*) I am not sure. I would need to take advice on that.¹

135. Why not?

(*Sir Nicholas Montagu*) Because again I am not sure of the detailed content and whether there are any commercially confidential issues, but subject to that—

Mr Laws: I would not have thought there would be. This is a policy recommendation.

Chairman: Well, we will hear.

Mr Laws: We look forward to it.

Chairman

136. When you were summing up the negotiations with Mapeley and the happy upturn in Mapeley's fortunes, do we take it from that that they are not now seeking a substantial cash settlement from you?

(*Mr Broadbent*) There is still quite a considerable number of issues between us and Mapeley, which centre around the interpretation of a large and complex contract. Those discussions are continuing. They are going to be quite difficult, I think, but I think that we will be seeking to bring them to a close because we have to move forward.

137. But are the taxpayers going to have to fork out?

(*Mr Broadbent*) There is no proposal on the table for money to be paid to Mapeley in return for nothing. The discussions are around contractual issues, "What is implied here in terms of this service level?" or "What is implied here in relation to this payment?" There is no bail out being discussed.

138. There is no bail out being discussed?

(*Sir Nicholas Montagu*) The sort of thing that we are talking about, Chairman, is facilities payments to take account of new buildings brought into the estate and a number of contractual issues of the sort which, as I say, are routine in the early years of a major partnership.

139. All right. We are drawing towards the end now. In the memorandum you do refer to the creation of the Project Board and a number of Ministers and so on being involved. Could we just be clear about this whole structure. The joint Project Board reports to whom, Mr Broadbent?

(*Mr Broadbent*) The joint Project Board reports to both Boards but the structure was deliberately designed to create a single unitary structure to conduct the negotiations rather than having, if you

¹ Ev. 31.

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like, twin channels. So you have a project group which comes to a head, there is a unitary body and the reports of that group go to both Boards.

140. Right. Is there anybody from Board level, Revenue or Customs, actually on this joint Project Board?

(*Sir Nicholas Montagu*) No. The Project Board was chaired alternately by my director of Business Services, John Yard, and his then opposite number in—

141. There is nobody at Board level actually on this Project Board?

(*Sir Nicholas Montagu*) No.

142. Fine. There are references in the memorandum to various Ministers; there are references to the Chief Secretary, to the Paymaster General, the Economic Secretary. Who is actually the responsible Treasury Minister for the Mapeley STEPS contract?

(*Mr Broadbent*) The Paymaster General is the Minister responsible for Inland Revenue affairs.

143. I know that.

(*Mr Broadbent*) The Economic Secretary is the Minister responsible for Customs and Excise affairs.

144. I know that.

(*Mr Broadbent*) So they have, if you like, rather like the Customs and Revenue Boards, the twin strands of responsibility. Since this contract was above the delegated limits of either Department to sign it is actually the Treasury and the Chief Secretary who had finally to approve the contract.

145. So the three Ministers are copied in on everything?

(*Mr Broadbent*) Yes.

146. And none of them is in charge?

(*Mr Broadbent*) I think it is fair to say that given the fact that at the time the contract negotiation began the Paymaster General was the Minister for both Customs and Revenue, she has taken the lead in this matter.

(*Sir Nicholas Montagu*) Indeed, but in terms of being in charge it is clearly Richard and I as accounting officers who are formally accountable for the Mapeley contract and its operation.

147. That is why you are here.

(*Sir Nicholas Montagu*) Exactly so.

Mr Beard

148. There appear to have been many mistakes which we have rehearsed. There were errors in the press releases, which were repeated in the Revenue's accounts and Customs and Excise's annual report and those have had to be corrected. Letters of comfort were issued inadvertently, as we have been rehearsing, and the Board of Inland Revenue, Customs and Excise Management and Ministers were not kept informed as they should have been of the developments in this complicated negotiation. Given this catalogue of errors, what have you done to ensure that similar errors are not made in future?

(*Sir Nicholas Montagu*) I think that the big lesson for us will be possibly to have more rigorous and regular reporting arrangements from, if I can put it

this way, the detailed project or negotiating bodies. One of the initial difficulties was the one which I talked about very early in this session when I mentioned naivety. The people who are maybe your property specialist or your commercial negotiating specialist may not have the degree of political savvy—it comes back to Mr McFall and antennae—that other officials would have, and I think that were I to re-run I would certainly institute probably more formal project reporting arrangements. So far as things like the wrong references in the press notices and the Boards' reports are concerned, I am afraid these things happen. It was quite genuinely an unfortunate coincidence of mistakes that they happened around this. Obviously we are as tight as we can be on it but I do not think that there is any obvious remedy there. One cannot crawl over, checking and double checking every reference on every occasion, but to me it would be probably a more rigorous reporting arrangement within our project control.

(*Mr Broadbent*) I do not think we yet know what are the full lessons to be drawn. I agree that the really central issues are around communication and the balance of what should be, if you like, pre-cleared with a very busy Board which is trying to run an organisation of 25,000 people and what should be left to the team in a fast moving, intense negotiation. Some of the things that we are beginning to look at would include, for example, recruiting a contract manager from the private sector. We have to ask whether we have fully the skills for this sort of thing. Yet when we look at that we also come back to the fact that that person has even less knowledge about Government Accounting, for example, than was exhibited in this case. So I am not yet ready to come to conclusions. I feel the issues here—and I agree these are the main areas—are quite complex. We do not let many contracts of this scale and I suspect the next one we let we will give quite considerable thought not just to how the Government Accounting and procedures are implemented but how we get this balance right between a sensible commercial negotiation, which is actually in the interests of the public sector to get value for money—you cannot just follow the rule book because you do not get value for money that way—but something which recognises not just the rules but also some of the wider sensitivities of the public sector which we have touched on in this hearing. But that is, I think, a complex question and I do not think we are quite ready yet to draw conclusions.

149. Do you believe that you have got people of adequate understanding of commercial type negotiations like this because there are stages in this where it appears they were out of their depth?

(*Mr Broadbent*) Yes. We certainly, I think, have very good people and all the time we are getting more and more people who have experience of this sort of negotiation. These contracts over the last few years have become more common. I am sure, as with all organisations, in a world where talent is in short supply we could do with more, but we do have good people and they are learning.

(*Sir Nicholas Montagu*) I would go along very strongly with that so far as the Revenue is concerned. We have some very strong commercial negotiators,

11 December 2002]

SIR NICHOLAS MONTAGU, KCB
AND MR RICHARD BROADBENT

[Continued

[Mr Beard Cont]

commercial managers, contract managers. Again, at the risk of tedium, I do have to say that although there were the errors which the Committee has not been slow to point out, overall the deal which they negotiated was one which provided really good value to Government. In terms of the negotiation, I would still regard it as a considerable success.

Mr Beard: Thank you.

Mr Laws

150. If you have to negotiate another such deal again in the future and if it does turn out—which you will not tell me, Sir Nicholas—that there is a double avoidance of taxation here on stamp duty and capital taxes neither of you would learn any lessons from that or do anything differently in the future? You would still be happy for the Inland Revenue and Customs and Excise to be parties to a deal in which the counterpart was involved in major tax avoidance?

(*Sir Nicholas Montagu*) What we would do, Mr Laws—I have to repeat, for the sake of the record, you cannot keep implying that the Revenue has been a knowing party to double tax avoidance. I am going to get this point on to the record. I have refused to answer questions on stamp duty because I do not answer questions about any individual taxpayer. What I have said to you is that Mapeley were treated in exactly the same way in accordance with the law as passed by Parliament as any other taxpayer and we would certainly, once again, aim to conduct all our negotiations and our procurement, as we did this, within the framework of the legislation by which we are bound.

151. The view of your official, who told the House of Commons Library this afternoon, your official in the Stamp Duty Office of the Inland Revenue, was

that this type of transaction should certainly have stamp duty paid on it. You are not bothered about that?

(*Sir Nicholas Montagu*) Mr Laws, what I have said is that the law on stamp duty applied to this transaction as it would to any other transaction. It should not be beyond, I think, the ability of the Committee to put together the statement that stamp duty should apply to a transaction of this sort—and as I have said, I am happy to talk about where stamp duty applies—and my assurance to the Committee that the law in relation to stamp duty would apply to this transaction as it would to any other taxpayer. As I say, without breaching my duty of confidentiality, those two statements ought to give the Committee a good deal of confidence.

Chairman

152. All right. Thank you very much. We are going to draw a halt there. You have promised us, I think, to see whether that e-mail is available?

(*Sir Nicholas Montagu*) I will see what we can do on that.

153. I would also like you to supply us when these negotiations are concluded, if you would, with a memorandum—without the commercial bits you may wish to excise—letting the Committee know where you have got to and where things stand.

(*Sir Nicholas Montagu*) Yes. We will be very happy to do so, Chairman.

154. We may well return to this. In the meantime, thank you both very much.

(*Sir Nicholas Montagu*) Thank you.

APPENDICES TO THE MINUTES OF EVIDENCE

APPENDIX 1

Memorandum submitted by the Mapeley Group

Throughout this paper, the term Mapeley is used to describe the Mapeley Group in general. Where necessary, specific legal entities within the Mapeley Group are identified.

EXECUTIVE SUMMARY

Mapeley, as the STEPS contractor, is pleased to have the opportunity to assist the Treasury Sub-Committee in its review of the handling of the STEPS Contract. Mapeley has been asked specifically to address in this paper certain aspects of the Contract, namely:

- how it was awarded;
- how it is structured;
- experience to date; and
- proposed changes to the Contract.

The conclusions of the paper are that:

- the Contract was properly and fairly awarded;
- Mapeley's structure is standard for an overseas investor in the property industry;
- the Contract is highly complex, but is operating effectively;
- the economics of the Contract are strained, but Mapeley and the Departments are working together to address this; and
- the commercial decision making processes on the Contract need improvement.

A tremendous amount has been achieved through the STEPS Contract and the Departments and Mapeley are working in partnership in order to ensure its continuing success.

INTRODUCTION

1. Mapeley STEPS Contractor Limited (MSCL), a UK company, is the private sector contractor under the Strategic Transfer of the Estate to the Private Sector (STEPS) Contract, signed in March 2001.

2. The STEPS Contract requires MSCL to meet the accommodation needs of Inland Revenue, HM Customs and Excise and the Valuation Office (an Agency of the Inland Revenue) (collectively the Departments) for a period of 20 years from April 2001 in return for a fixed all inclusive payment, which is indexed relative to RPI.

3. As part of the Contract the Departments transferred ownership of and responsibility for some 600 properties. Approximately 200 of these are freeholds or long leaseholds and approximately 400 are short leaseholds (ie liabilities). The Departments transferred assets valued by Mapeley at £350 million in return for:

- a payment by MSCL of £220 million;
- a discount of approximately £14.5 million per annum on the all-inclusive payment from the Departments for the first 10 years of the Contract; and
- absorption of substantial leasehold liabilities by MSCL.

4. MSCL is responsible for delivering to the Departments, for a fixed price, a range of accommodation-related services, such as cleaning, security, maintenance, catering and landscaping. Some of the services on the leasehold properties are delivered by landlords and charged to MSCL through the Landlord's Service Charge. MSCL also takes the risk of cost increases on these services. The services are delivered to the transferred estate and to a further 125 properties comprising HMCE's Frontier Estate.

5. The STEPS Contract has enabled the Departments to reduce operating costs and to transfer all property and service related risks to MSCL. The Contract will also enhance the efficiency of the Departments' accommodation and related services and facilitate the introduction of the Government one-stop shop and new ways of working for Departmental staff.

THE AWARD OF THE CONTRACT

6. Mapeley was appointed Preferred Bidder for the STEPS Contract in August 2000 following an exhaustive and highly competitive procurement process. Mapeley believes the competition was well run, fair and conducted in accordance with EU procurement rules. A summary of the process is attached as Annex 1.

7. Consideration for the acquisition of the property assets and liabilities was set by the Departments at £220 million. Tenderers were required to price the delivery of serviced accommodation to the Departments over the twenty-year term of the Contract, including the cost of absorbing the leasehold liabilities transferred, and reflecting the difference between £220 million and the value of the property in a lower charge to the Departments.

8. Mapeley's bid, as required, delivered "the most economically advantageous" (source: STEPS Invitation To Negotiate (ITN)) solution to the Departments. The key tests of economic advantage were the first year aggregate Facility Unit Prices (FUPs)—the fixed all-in annual cost to the Departments for each property—and the net present cost of the 20 years' aggregated FUPs. Importantly, Tenderers were also required to attach minimum conditionality to their bids and to demonstrate that the quality of service required by the Departments would be met.

9. Tenderers had to show clearly that they had both the technical and financial wherewithal to deliver the STEPS Contract.

10. Mapeley bid at ITN stage so that its price, the minimum conditions attached to its bid, and its service quality would leave "clear blue water" between itself and the other two finalists. Mapeley accepted modest overall returns and minimal operational profitability. It saw the STEPS Contract as an opportunity to create an operating business through which other contracts could be won and managed.

11. Tenderers were asked to price very substantial risk in the STEPS competition. The key elements are:

<i>Risk</i>	<i>Summary</i>
Lease Liabilities	The STEPS Contractor is responsible for all future rent payments to third party landlords and absorbs all future rent increase risk, void costs and dilapidations. It also has service charge risk.
Life Cycle Maintenance	The STEPS Contractor has to maintain all buildings to a required standard for the term of the Contract.
Service Delivery	The STEPS Contractor has to deliver a highly specified suite of services for a fixed price for the term of the Contract and is subject to a penal performance measurement regime.
Legislative Change	The STEPS Contractor generally has no recourse to the Departments for increases in costs caused by change of law.

12. In order to price these risks accurately, the Tenderers needed substantial and correct information. During the procurement, vast amounts of data and documentation were provided to the Tenderers. The Departments' project team's task of collating disparate sources of information across the Departments, a widespread estate, and fifteen different lines of service, was immense.

13. It also has to be borne in mind that the estate and the Departments' needs are constantly changing: at no point is it possible in reality to freeze data and data previously supplied can quickly become out of date. When this is occurring across such a large number of property interests and varied lines of services and service requirements, it is impossible to have an entirely accurate picture. This difficulty was compounded by the very limited due diligence possible.

14. It is inevitable in such a complex, changing and voluminous suite of data that information gaps occur. Mapeley had to assume that the information was complete. However, it transpired during the Preferred Bidder stage and post go-live that some of the information gaps were significant. For example, the specification of the manned security guarding that was to be included in the STEPS Contract did not include the number of guards required at a site, nor was the frequency of patrol specified.

15. One of the cornerstones of the information was the Joint Condition Survey (JCS) prepared by Insignia Richard Ellis, the property advisory firm. This was a building survey of the estate to be transferred to the successful Tenderer. The survey was delivered late to bidders and was of limited value in enabling Mapeley accurately to assess the risk of life cycle maintenance of the buildings.

THE STRUCTURE OF THE CONTRACT

16. In order to protect both parties, in PFI contracting the private sector contractor is typically a special purpose, bankruptcy remote, corporate vehicle. In the case of STEPS, that vehicle is MSCL.

17. The STEPS Contract is effectively the legislative framework for an operating business. Accordingly, the capital required to support the contract on the part of MSCL is more substantial than is generally found in PFI projects. Mapeley's shareholders have contributed in excess of £80 million of equity capital, representing approximately 30% of the total capital structure for the contract. This compares to the 3% to 10% equity capital usually seen in support of PFI projects.

18. Approximately 90% of Mapeley's capital for STEPS is provided by overseas investors. Regardless of Mapeley's structure, Mapeley's investors are subject to their respective taxation regimes for any benefits arising out of their investment in the Mapeley Group.

19. As an overseas company, Mapeley advised the Departments' project team that the valuable freehold and long leasehold properties would be transferred to its investment company, Mapeley STEPS Limited (MSL), a Bermuda registered company. Non-valuable leasehold properties and properties that were to be disposed of in the short term were transferred to MSCL.

20. The Departments require one monthly invoice for the accommodation outsourcing services they receive. MSCL is responsible for the provision of all services supplied to the Departments. To enable this and to give the Departments a direct relationship with MSCL in respect of all the properties, MSL leases all its properties to MSCL under a master lease arrangement. MSCL in turn sub-lets them to the Departments.

21. MSCL and MSL have appointed Mapeley Limited, a UK company, to manage the STEPS Contract and the STEPS estate. Mapeley Limited is a management company with approximately 150 employees.

22. MSL is not a party to the STEPS Contract, but guarantees to the Departments the full performance by MSCL of its obligations under the Contract. It has given the Departments legal charges over some of the properties with an initial aggregate value of some £145 million to secure the discount provided to the Departments inherent in the FUPs charged by MSCL derived from the value of the transferred properties.

23. MSCL and MSL are both subsidiaries of Mapeley STEPS Holdings Limited, also registered in Bermuda. The relationship between these companies, Mapeley Limited and their shareholders is illustrated in the Mapeley STEPS Group structure chart attached as Annex 2.

24. The STEPS Contract economics are marginal for Mapeley on an operating basis. Mapeley shareholder returns therefore rely upon capital gains on the valuable properties towards the end of the STEPS Contract term. Accordingly Mapeley structured its tax affairs to minimise exposure to capital gains tax and thereby reduce the charge to the Departments.

25. This is absolutely standard in the investment world where offshore investors own property in the UK. Mapeley has operated entirely within both the letter and spirit of the law.

26. The Mapeley Group has significant UK tax losses arising mainly from the up-front investment by its shareholders of more than £30 million in bid costs, technology and infrastructure to support the provision of services to the Departments. As a result of these losses and not Mapeley's tax structure, no UK tax is likely to be payable for some years.

27. Mapeley shared its corporate structure with the Departments' project team prior to the signature of the STEPS Contract. This structure was considered by the Departments' professional advisors, Deloitte and Lovells, and was found to meet the terms of the Contract.

EXPERIENCE TO DATE

28. The STEPS Contract is extremely complex. It is unlike a standard, single building PFI contract in that it has to legislate for day to day activity across a nationwide estate of some 725 buildings and a wide range of services. It is thus challenging to operate. Both Mapeley and the Departments have had to be flexible and have generally worked collaboratively to ensure that the Contract works in the real world.

29. Mapeley achieved successful mobilisation of the Contract despite not having been allowed on site to any significant degree prior to "go live". Inevitably Mapeley did not get everything right. However, it has always sought to correct its errors and to be focused upon delivering a quality service to the Departments.

30. Since go live, Mapeley has restructured its service delivery and introduced a number of key personnel and processes that mean on a day-to-day basis service delivery is good and improving. Performance statistics bear this out. However, there are still areas for improvement and these are being addressed.

31. Mapeley has delivered a number of significant capital projects on time and to budget and has provided 24 new facilities for the Departments since April 2001. It has significantly reduced the cost of utilities to the Departments and also is substantially lowering expenditure on furniture.

32. Though the Departments' Contract Management Unit has worked effectively with Mapeley at an operational level, the Contract has been hampered by slow commercial decision-making by the Departments. The Departments and Mapeley are now addressing their respective contract management structures to ensure there is a mirrored and joined-up process for the appropriate escalation and resolution of commercial issues. The Departments have assured us that in future decisions will be made with greater efficacy.

SIGNIFICANT PROPOSED OR ACCEPTED CONTRACT CHANGES

33. Mapeley has suffered significant economic detriment compared to its expected bid case on the STEPS Contract.

34. The economic strain under the Contract also results from inaccuracies in the data provided by the Departments and changes in the Departments' requirements under the Contract. Mapeley is working with the Departments to address these.

35. It made a formal presentation to the finance sub-committee of the STEPS Contract Management Board in December 2001. This presentation outlined the reasons why Mapeley was suffering economic strain:

- errors resulting from inaccurate and incomplete data; and
- changes in contractual requirements which have not been settled.

In some measure the strain also results from Mapeley's own errors, for which it takes full responsibility. For example, it under-estimated the overall costs of service delivery. It has therefore re-engineered the way it manages service delivery and reduced its costs significantly.

36. The Departments appointed a team to investigate Mapeley's financial position and to make recommendations as to how to proceed. This team comprised representatives from the Departments' project team, Partnerships UK, Deloitte and Lovells. January and February of 2002 were spent in reviewing of Mapeley's position and the findings were that Mapeley's depiction of the Contract economics was broadly accurate.

37. In the spring of 2002, Rothschild was then appointed to advise the Departments. Negotiations ensued that culminated in the issue of a Memorandum of Understanding (MoU) between the Departments and Mapeley as to how to resolve both the economic strain faced by Mapeley and a number of other contractual issues raised by the Departments. This was issued in July 2002.

38. Mapeley's financial position is such that it had to rely on undertakings from the Departments for the Directors of the Mapeley Companies to be able to make going concern representations. It was always made clear that the MoU was subject to Treasury and Ministerial approval and was not legally binding.

39. Mapeley was informed in October 2002 that the MoU as it stood had been withdrawn by the Departments. Mapeley was invited to submit an alternative proposal, which it has now done and which it understands is now under consideration. The proposal is for Mapeley to be paid for changes in the requirements of the Departments and for its claims under the Contract.

40. The dynamics of the property and financial markets have enabled Mapeley to bring forward asset management income derived from property trading activities to support operating losses. However, in the medium term this is not sustainable and it is important that settlement is reached with the Departments in respect of outstanding contractual issues as soon as possible.

41. The summary position is that there has been no amendment to the STEPS Contract to date. The Departments and Mapeley are working towards a mutually acceptable resolution of the financial position. Both are confident that this can be achieved.

Annex 1

THE PROCUREMENT PROCESS

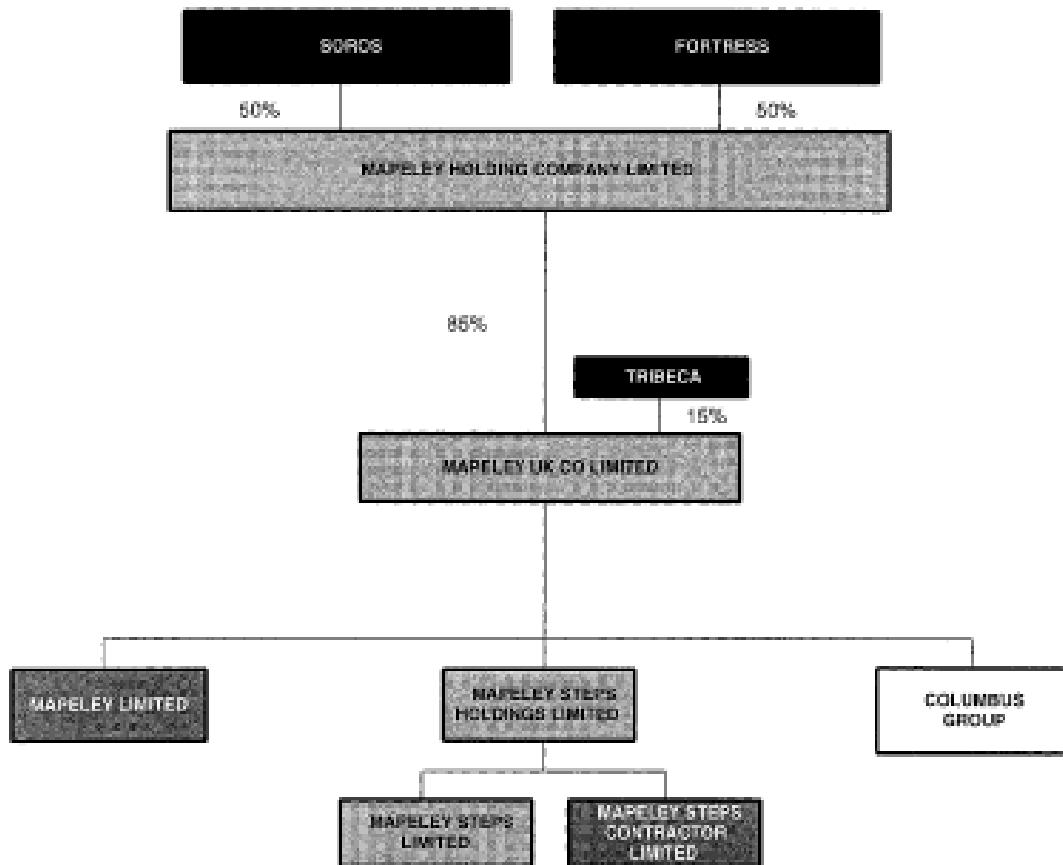
<i>Date</i>	<i>Event</i>
April 1999	OJEC published
May 1999	Pre-Qualification Questionnaire (PQQ) issued. The objective of the PQQ was to determine if the consortia, prima facie, had the technical and financial strength to compete in the procurement.
June 1, 1999	Approximately 11 consortia submitted PQQ responses.
Late June 1999	Long List of five consortia selected to proceed.
July 1999	Invitation to Submit Outline Proposals (ISOP) issued. The ISOP required a reasonably detailed exposition of how the consortia would manage and operate the STEPS Contract.
August 1999	Four of the five Long List consortia submitted ISOP responses. It is understood that the fifth consortium elected not to do so because of the high costs of bidding and the strength of the other four consortia.
October 1999	A short list of three consortia was selected to proceed to the Invitation to Negotiate (ITN) phase of the procurement: Mapeley, Servus and Trillium. Each of the three was backed by overseas investors.
October 1999	The Draft ITN was issued. The final ITN could not be issued at that time, because not all of the necessary data to support the bids was available and the Draft STEPS Contract was still being prepared.
February 2000	The Final ITN was issued. The objective of the ITN phase was primarily to determine which of the consortia would offer the "most economically advantageous offer to the Departments". The Tenderers were told that there were three main criteria for selection of Preferred Bidder: value for money; conditionality of the offer; and the quality of the service offering.
April 2000	The Tenderers submitted their ITN responses.

<i>Date</i>	<i>Event</i>
May—June 2000	Written clarification questions were sent to each Tenderer and meetings were held on specific aspects of the procurement (eg the performance measurement system). Mapeley was selected as Preferred Bidder. STEPS Contract negotiation and Mapeley's own mobilisation
August 2000	
August 2000—March 2001	

2 December 2002

Annex 2

THE MAPELEY GROUP



- Shareholder
- On Shore UK
- Off Shore
- Onshore/ Off Shore

APPENDIX 2**Letter from the Chairman of the Inland Revenue to the Chairman of the Sub-committee**

When Richard Broadbent and I appeared in front of your Committee on 11 December, I replied to questions from David Laws about an e-mail sent by Dave Shaw in my department to my Policy and Technical Director General. You asked me if I could make the e-mail available to the Committee, and I said that I would first have to look again at its detailed content.

I have done so, and I am afraid that I cannot make it available—not because of commercial confidentiality, but because it refers directly to policy advice given to Ministers, which by convention is not disclosed to Select Committees. I can, however, confirm the thrust of the answer which I gave to Mr Laws: I think it is fair to describe Dave Shaw's clearance of the structure as unequivocal, but that is implicit rather than explicit. I should also perhaps add that Dave Shaw said in terms that he was "... very much guessing in the dark. INT [our International Division] are the experts in this field"; and that we did indeed consult our International specialists, who confirmed that the legality of Mapeley's structure was beyond challenge.

20 December 2002

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