Examination of Witnesses

MR HAROLD MILLS CB, Secretary and Head of Department, and PROFESSOR JAMES INNES, Director of Roads, Scottish Office Development Department, examined.

MR J MORTIMER, Treasury Officer of Accounts, further examined.

Chairman

1. This afternoon we welcome Mr Harold Mills to the Committee to discuss the Comptroller and Auditor General's Report on the Skye Bridge. Perhaps Mr Mills, firstly, I could ask you to introduce your colleague before we start.

(Mr Mills) Yes, I would like to introduce Professor James Innes, who is Director of Roads in the Scottish Office Development Department.

2. Thank you, Mr Mills. Now before I start asking you questions, can I ask you to be reasonably brisk in your replies. I know it is a complex subject but we want to make some progress. My first question to you relates to paragraph 12 of the summary in the National Audit Report. "Competition is central to public procurement as a means of securing value for money". Yet the paragraph I just referred to states that "... the Department received fewer bids than it had good reason to hope for and were unable to bring competition to bear in making a deal". Why did you find yourself in this unpromising situation?

(Mr Mills) When we went out to tender first we had six firms showing an interest and as we went through the competition this reduced to three. When we received the three bids we found that one of them was very much better than the other two so we were left with one bidder who seemed to be likely to go forward to a successful completion. Basically it was the quality of the other two bids.

3. I see. At that stage?

(Mr Mills) At that stage. I could fill in more later if you wish me to.

4. I am sure others will come in on the questions. Paragraph 1.37 in the same report explains that in negotiating with the developer on risk transfers you compromised in three areas where risks subsequently crystallised and resulted in extra costs to you of £4.3 million. As a matter of good control should you not have quantified those risks before committing the Department to deal with the developer?

(Mr Mills) I think we have to look back at the history of this particular project. It was a very early privately financed project and at that stage there was no guidance of the kind which we have now. We set out, using competition, firstly, and secondly an attempt to transfer as much risk as we possibly could to the private sector to make it a good private project. As we went through the exercise we had to reassess the risk transfer on a number of things and they are detailed here. At the very end of the report there is a table showing what we intended the risk transfer to be. It is the table which is outlined, if I may refer to it, on page 51 which sets out intended allocation at tender stage and then the final column is the actual allocation in development and concession contracts. As the report notes, what we did at the end is broadly in line with good practice as it is at the moment. We regard it as a principle and the report makes the point that the risk should be borne by the party best placed to manage that risk and that the risks which we were looking at here for one reason or another at the end of the day were best managed by the Department, so the Department had to undertake costs associated with them.

5. Which meant that the taxpayer met the costs. You say it was an early pfi, which is quite correct, of course, but it is not the first time that there has been a major project with design risks and timetable risks, the sort of risks we are talking about here. Would it not have been sensible at that stage, even just on a common sense basis, to have asked for the bids to include costings of those sorts of risks within the original bid?

(Mr Mills) The risks in questions were the design risk and certainly the statutory processes delay risk. The design risk and the changes which occurred resulted from the public local inquiry and concerned meeting the points made by the reporter. At the early stage I am not sure that we could have quantified them. The statutory processes delay risk also arose at the late stage. I am not sure that we could have undertaken what you are suggesting. I think the conclusion we draw from it is that these are risks which the Department should carry because they are within the control of the Department and with hindsight I think we should have made that clear at the outset and carried these risks.

6. I think others may want to come back to that question later. Paragraph 1.41 explains the financial difficulties encountered by the developer as the preferred bidder from April 1991 and the steps needed subsequently to obtain the viable project finance. Why did you and your advisors not detect these difficulties sooner so you could have taken them into account before proceeding with the bidder, given that you went with just one bid I would have thought this would have been a sensible route to take?

(Mr Mills) At that time I think we saw the process as one of negotiation with the bidder on these particular points and the project would be taken forward in that way.

7. You did not foresee any risks to the finance package at that stage?

(Mr Mills) At that stage the finance package was difficult. It was a question of finding funders and as is brought out here the bid did not meet the objectives which we set for this project and the objectives which are summarised in the opening paragraph of the report in figure one, in particular the cost objective.

[**Chairman** *Contd*]

8. The report records "The Department did not establish budgets of price ceilings for their £2½ million expenditure on advisors and other overheads and various miscellaneous costs", that is paragraphs 19 and 1.18 to 1.20 and also figure nine on page 41, why was this?

(Mr Mills) Probably we did not realise at that stage that we should have done that. We had some ideas from previous projects, projects conducted in a different way of what the costs would be. We did not make an estimate. Of course we would now make an estimate on a project of this kind and I think it is worth noting also the outcome, that in many of these costs they compare very well with comparable projects, for example the costs of the consultants.

9. With hindsight would you say it was a serious oversight?

(Mr Mills) No, I do not think so because I think we managed it in other ways and the result at the end shows clearly we did manage that. I would accept that as a process point this is something we would do now in a project of this kind.

10. Part 4 contains a comparison of the price of the project with the benefits and paragraph 4.20 says you did not quantify the value to the Department of the risk transfer to the private sector. How did your Department assure themselves that the benefits were worth the price you were paying for them? How did you persuade yourself this was good value for the taxpayer?

(Mr Mills) As the paragraph points out we did not try to quantify the value to us of the risk transfer but I think we go back to the beginning of this part where if we could have we would have developed a public sector comparator but for the reasons set out in paragraph 4.4 we did not prepare a public sector comparator. When we set out on this project we addressed the issue of whether or not to compare a public sector comparator but because the Government were not considering this project going forward in the foreseeable future as a public project then a public sector comparator would have been false and misleading. What we decided then was in line with the guidance which came out in 1995.

11. Is this not something of a circular argument you have presented to us?

(Mr Mills) I do not think so. I think that a public sector comparator would have left the impression that we were considering seriously going ahead with a bridge of this kind from public funds. The choice was either to continue with the ferries and upgrade them or provide a tolled bridge. The exercise that we did on economic appraisal was to compare these two options. The answer to your first question is we did an economic appraisal which assessed the project against the ferries and secondly we had the objectives, which are set out at the beginning, of providing at an early date, a tolled bridge subject to the costs. We saw that as the objective which was setting out to deliver value for money.

12. On that basis, on the basis of those comparators, you believe this is a good value to the taxpayer, this project?

(Mr Mills) The taxpayer does not have very much money in it. The taxpayer's money is in the approach roads. The main investment in the bridge is the private sector.

13. I am sure some people will come back on that in a moment. My last question for you before I open the questioning up for the Committee relates to the negotiation over the financing. Paragraph 1.44 records the Department accepting in negotiation with developers an increase in the lifetime total of the tolls paid by the users to cover the risk of bridge traffic below even though users will still bear this increased cost in the event of high traffic growth; why was this? It is a technical question, have I made the question clear, what I am asking?

(Mr Mills) Could you repeat the question?

14. The point I am making—I will paraphrase it—since there was a risk perceived that the tolls would not meet the full requirement, the required net present value set up in your negotiation, the potential life was extended, that introduced extra costs which increased the net present value required.

(Mr Mills) Yes.

15. That was the case whether or not the lifetime was extended. In other words if it was a short life there was a large transfer of money from the toll payer to the equity holder. Why did you do that?

(Mr Mills) To secure the project. It was a question of negotiation with the concessionaire and behind him with his funders. They viewed the risk of this particular project as being very high related to the nature of the project. If we were going to secure the project, as we did, then we found it necessary to increase the RNPV by the amount you suggested as the means of securing the project.

16. Could you not have done that in a different way by having an option to extend if the required revenue was not met by a certain point in the lifetime and therefore not bring in the later costs until that condition applied?

(Mr Mills) I would like to ask Professor Innes if he could deal with this one. He was involved in the negotiations.

(Professor Innes) That was a possibility which we could have done which we did not pursue at the time, under the circumstances. In many ways it was an appreciation of if you take your loan over a longer period you end up paying more for that loan because you have more interest to pay because it is for a longer period. It is possible that we could have negotiated a possible deal, as you suggested, but the difficulty with getting the funders on board was extreme at that moment in time and we were given no encouragement and we did not perceive that a deal could have been achieved.

17. You do understand.

(Professor Innes) Absolutely.

18. The effect is to bring in some extra costs that the contractor may not face.

(Professor Innes) Yes, indeed.

[**Chairman** *Contd*]

19. The tollpayer pays that.

(Professor Innes) Yes and the alternative was that they paid higher tolls for a shorter period. If that had been the case we could have stuck with the original bid but to meet the tolls at the levels which we had set out to achieve, the period had to be extended and therefore with that extension of the period so too was the interest charge.

Mr Leslie

20. I am astonished actually, Mr Mills, about your response with regard to the public sector comparator because one of the things which leaps out to me in this report, although you did not undertake it, it seems the National Audit Office did a lot of work comparing how expensive the project would have been in the public sector to the private sector. Is it not the case that the equity finance aspects of the whole private finance package added significantly to the whole costs of the scheme? Would you say the equity finance represents good value for money?

(Mr Mills) I believe so for a number of reasons. The first one is that as we proceeded to negotiate with the preferred bidder we found that he was not going to secure the money without equity investment so that the equity investment became necessary to take the deal forward. This reflects what I said earlier that the way the project was viewed by the funders was that it was an extremely risky venture. So they took a very pessimistic view of various factors. I am not sure that we would have been able to find funders had we not moved to the equity investment. This was the advice of our consultants. As reported here we brought in Chartered West Bank and their advice was that we should be looking to have equity and we got the same advice from the Bank of America and we got the same advice when a loan from the EIB was first suggested. It was a necessity. The second point I would make is that one of our advisors has worked out the weighted cost of capital on the basis of no equity and the basis with equity. Without equity it was working out at 13.2 per cent, with equity it was more than that at 12.59 per cent. This compares with the weighted cost of capital for the Severn project of just over 14 per cent. The advice from our advisor was that introducing this equity would reduce the borrowing and could well be cheaper than proceeding with the more expensive borrowing but we will not be able to establish that clearly until we get to the end of the project when we find out what the return on equity is.

21. Thank you for that. Just tell me then how many other projects of this nature have had equity finance at this level?

(Mr Mills) I have no information on that. I do not know if you have?

(Professor Innes) The Severn Bridge does not pay equity and it is because the last payment on the Severn Bridge is to the Government because of the existing bridge.

22. Are there any others which have this degree?

(Professor Innes) The degree is small in so far as it is half a million pounds.

23. I know it is small, it is about two per cent of the total project.

(Professor Innes) It is indeed.

24. It seems small but what I am interested in is seeing whether this two per cent of the total capital cost in the end has been good value for money. What was the interest rate that the National Audit Office estimated?

(Professor Innes) 18.4 per cent.

25. That is what they estimate in real terms, that does not include the inflationary aspects. Is it not 26.4 per cent in cash terms.

(Professor Innes) As the National Audit Office said also and Price Waterhouse said on their behalf for an equity investment of this type in the power projects, which were going on at the same time, in actual fact the return was higher.

26. So anybody who put in—as was the case here—£500,000 at 18.4 per cent, that ends up at £10 million compound interest return at the end of 18 years but in cash terms it is £37 million. You put in your £500,000 at the beginning of the thing, 18 years later £37 million. Does that not sound to you like a licence to print money?

(Professor Innes) No, indeed, for the reasons that Mr Mills has said, firstly if we had not done that we would have been paying more in total interest to the package as a whole, the total weighted cost of capital went down by introduction of equity, and the other point is that the actual value that goes back to the equity of shareholders depends on how inflation and interests rates go in the interval. There is a risk they will get nothing.

27. What is so great then about this risk? It is a public sector project, it is going ahead, legislation is passed, what is the real risk for these equity investors here which justifies this £37 million pay off at the end of 18 years?

(Professor Innes) The other point which I think the report says is that as we looked at that at the time, these people if they had invested their half a million pounds in other activities they would have got a better return than they were getting on the Skye Bridge.

28. I think you could have built it probably as well on my Visa card with this equity business. The other point I want to raise is to do with the way the cost of the bridge inflated so much over the period of time. One of the things I want to pursue briefly is unforeseen land purchase costs and aspects, why did the Department under-estimate the cost of the land at £300,000 when you ended up forking out £784,000?

(Mr Mills) The estimate which we had of £300,000 came from the District Valuer at the time, the District Valuer being our advisor on these matters. When we moved forward to the negotiations to acquire the land the price was higher so that it reflected what the District Valuer was able to negotiate for us at the end of the day.

29. Did the actual acquisition of the land not take

[**Mr Leslie** *Contd*]

place rather late in the day in terms of when you purchased the land, when it went through?

(Mr Mills) That is correct.

30. Was that not as a consequence of the fact there were delays in the designing, in the public inquiry steps and so on? If it was so late in the day did it not really put the Department, the Government, over a barrel in terms of the price it had to pay for this land because you were so far down the road by the time you had to buy it no wonder you had to spend so much extra on it?

(Professor Innes) I do not accept that because the District Valuer does not negotiate the land. He puts the value on it and he is the person who undertakes that, in actual fact. We have no input into it. He has to reflect the land value at the time.

31. That was the £300,000 but you ended up paying £784,000?

(Professor Innes) Well perhaps that is a question for him to answer but in reality every job we do we end up buying the land probably later than when the deal for exchanging the land takes place. It is very seldom you have bought and paid for it, albeit the transaction has been done.

32. I would suggest in future you should look at the point at which you buy the land while your options are open so you can get land at a reasonable price. I think that is something you might pick up on, would you agree?

(Professor Innes) I would accept that the District Valuer always tries to get people a fair price for their land and if he can close a deal earlier it is always to the good, yes.

(Mr Mills) Can I just comment on that. I think we have to be careful about negotiating, getting the District Valuer to act in advance of need. £0.3 million was placed on it at an early stage. Until the contracts were signed then the Department was not committed to the project. I think we have to strike a balance between what you are suggesting, which I accept, and not finding ourselves acquiring in advance of need.

Mr Wardle

33. Chairman, I have listened with growing dismay. I have read this report, I recognise that you have a bridge, some people like it, some do not, some do not like the charges, the tolls. There has been a pretty horrendous overrun. Just listening to your answers, Mr Mills, the dismay grows. You say this was an early example of a private sector project, I find it impossible to believe you could not have gone to the City of London or any other financial centre and found somebody who could have built some sort of comparative model for you. The Chairman talked about design risk and some of these statutory risks. You say with hindsight lessons are to be learned. I find it hard to believe that your Department could not have concluded that if there was to be a public inquiry there would be some changes to the spec that would emerge and also there would be some delays. It is astonishing that none of those things was built in. To say there was no reason to have a public sector comparator frankly was a cop out. Let me dig a little deeper, let us get down to basics. Let me be—if you will forgive me—a little unkind here. Let us look at paragraph 1.14. Chairman, 1.14 says: "Three of the Department's four main external advisors were appointed on quality grounds". What on earth are quality grounds? Is this jobs for the boys, Mr Mills?

(Mr Mills) No.

34. What do you mean by quality grounds?

(Mr Mills) They were consultants with a track record.

35. Whose track record? Who measured it? Who set it up in competition or did you just sit up with your feet on the desk saying: "Well we know old Joe down the road"? Were they all Scottish firms? Easy to answer "yes" or "no".

(Mr Mills) Yes.

36. They were, so you did not have to think too long.

(Mr Mills) Apart from the last one.

37. The good old boys in Charlotte Square, what was going on here? You are going to arrange to spend large sums of money in a fairly complex project, a project in which you find yourself in next to no time weeding people out, choosing the likely contractor and then turning to your advisors, not chosen by competition but on the basis of this euphemism called "quality grounds" and using your advisors to tell the successful bidder how to structure his financing package. What was going on, Mr Mills, I repeat the question?

(Mr Mills) Could I start at the end and just go to paragraph 1.18 and that reads "The total advisors' fees in the Skye case were £1.7 million equivalent to seven per cent of the forecast of constructing the bridge ...".

38. What has that got to do with the price of anything?

(Mr Mills) My argument is that compares very well with comparable projects, road projects procured

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39. Mr Mills, answer the question please, Sir. What does choosing people on quality grounds mean other than saying: "I know a couple of firms, a couple of good Scottish firms, let us put them in the driving seat". What attempt was made to be scrupulous about this and to pick an advisor on the basis of competition?

(Mr Mills) As explained in figure five, there were reasons connected with each of the consultants. The first one, JMP Consultants were already associated with the project. They had been taking it forward from the mid 1980s and they had worked up the project and as explained elsewhere, we took the project over from the Highland Regional Council. We took it over on the basis explained there at agreed fee rates for staff working on the project.

40. In other words, you decided that because they had been involved it made sense for everyone, it was

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nice and convenient, they were there, they were warm with this project, let them run with it. I do not find that a satisfactory explanation, Mr Mills, and I wish to place that on record, Chairman. Just staying in criticism of the same vein, if Mr Mills will allow, let us look at pages 30 and 31. It seems you took the advice of the Royal Fine Art Commission, great, National Trust for Scotland, terrific, and the former Countryside Commission, just as you should have done, I am sure, but then when the tender has been settled the whole project has to go—as was predictable—out to public inquiry and at that point your own advisors expressed their own separate views. Now what could you have predicted from the start and what did this cost you and why was this not all thought through?

(Mr Mills) The advisers referred to in 30 and 31 were involved in the project almost from the outset. It was the Department who asked the tenderers to bring in the Royal Fine Art Commission and the project at various stages had their support. It was at the end of the project that the Royal Fine Art Commission in particular were critical of it and their views are recorded here. We set out on this course hoping that we would be able to reach agreement with all the parties concerned. We were trying to develop the project with support from the environmental groups mentioned here.

41. I can see why you had them there, but it seems as though no sooner have you put the whole thing together and decided on the preferred bidder and off you go to public inquiry and you find that the scenery has been shifted. Surely you could have predicted that. You are talking to these people.

(Mr Mills) I do not think we could have predicted it at the preferred bidder's stage. Would you like to take us through that period?

(Professor Innes) Yes. Before the bids came in all three bidders had to present their proposals to the Fine Art Commission and Countryside Commission and in actual fact they got a price on the project at that stage. It was later on down that line that the Fine Arts Commission in particular thought that they would take the advice of Professor Leonhardt and at that time they decided that they did not think that the bridge as proposed came up to an international standard.

42. So they did not work this out when they were first giving you advice on the final short-list of three when you were going to choose one preferred bidder from that, but later they decided to shift their advice and, hey presto, the Department finds itself and the taxpayer finds himself saddled with overruns and unbudgeted costs for statutory delays and for changes in the spec, as I put it.

(Professor Innes) That is absolutely right. Had this been a conventional piece of procurement that would have happened before we went to tender and these prices and these costs would have been built into the contract cost.

43. Is that not all the more reason that you should have tried to develop some sort of economic model that took all of these factors into account? To set that aside and say, "Well, we don't need one because if this is going to be public sector finance"—as Mr Leslie was saying and the Chairman, too—"then we are not going to have a project, we will forget all that, we will throw it out the window" seems to me to be rank carelessness. Let us just explore a little further how you came to pick the winner from the final short-list of three. Let us go back to the semifinal, as it were. You had six firms. Am I right in thinking two then dropped out of that six?

(Professor Innes) No. We put the six to the various environmental bodies and said, "This is our recommendation of the three that should go forward", and there was unanimous agreement that these three should go forward to the bidder stage.

44. But out of that you had one contender, the eventual preferred bidder, that you thought was the strongest candidate. What was this on? Was it on quality grounds or on the basis of a good old boy network in Edinburgh?

(Professor Innes) Absolutely not. These people came in with a firm tender price.

45. So firm that you hardly got a hundred yards down the road and they were saying to you, "Help, we can't put the equity finance in this package together", and you said, "There, there, we will get the Department's financial advisers to tell you how it is done." How can you have been so impressed if they had not thought that through?

(Professor Innes) In actual fact, when we compared the various tenders we had—the second person and the first person (ie the winner)—the winner priced both the box girder bridge and the cable stay bridge and the second bidder only the cable stay bridge. They knew the difference in price in the box girder and the cable stay in their tender. They knew that there was a significant difference in these two designs of bridges. So they were aware where they were in the bid list.

46. That is hardly a reason to pat yourselves on the back, the fact that these people could mark a distinction of that sort.

(Professor Innes) Yes indeed. We would have preferred to have seen a set of bids which gave us what we were looking for, i.e. nice and clean ferry tolls for the given period, but that is not how it worked out and the Department looked to see where it was that their bid had gone wrong because we believed that there was a possible proposal here which would fly and we investigated and saw that for instance they had not got EIB on board, which they could not have done at that stage anyway because it required government support.

Mr Wardle: Mr Mills, Professor Innes, I have heard what you have said. There is a slightly greater contrition creeping into what has been said. Chairman, I have got no further questions. I would just like to reiterate the comment that I think there has been sloppiness here and a smugness about who can be taken on as advisers and players in all of this without being nearly rigorous enough.

Chairman: Thank you, Mr Wardle. Phil Hope?

Mr Hope

47. My dilemma with this is the way that the catalogue of errors, starting with point one and ending at point 20, never seemed to be grasped and got hold of by yourselves. We see a project where there was no proper competition, no proper quantifiable risk, no proper test of the external financing arrangements, a very high return to equity investors, no systematic financial comparisons either in public sector projects or to maintain the ferry service and a failure to set budgets for price ceilings on various aspects of the project. It seems to me that in effect the Department and now the taxpayer have been turned over. Would you accept that description of the calamity of this scene before us?

(Professor Innes) No, I would not basically because the project as delivered delivered all its objectives insofar as it delivered a job which was within the toll structure and within the 20 years which we had anticipated. We believe, and the figures support us, that it will be 14 to 17 years until the job will be paid off. We did appoint the consultants on the basis of taking JMP on board because we did not wish that skill and that knowledge to be available to one of the tendering parties and not to us. They had a knowledge about the bridge and about the area which was far in excess of any of the other consultants which were around. So we chose them quite distinctly and quite definitely for that very reason. As far as the calamity of over-running is concerned, had this been a standard project these costs would have been in the project as well because we would have taken it through public inquiry as a design done by the Department. This was a design done by the developer and there is only one job in the country which has been done like that and that is the Birmingham Northern Relief Road. Every other job in the country has gone through its statutory procedures before and therefore these additional costs, as you see them, are built into the job. In effect the contractor had been asked to do something which no contractor in the country had ever been asked to do before. He was taking a risk that no matter what he put to the public inquiry it could have been changed and he would have had to pick up the tab.

48. If you take pages 19 and 20 it talks about the design risk and says that the Department had accepted responsibility for 1.6 million. On statutory processes, delay risk, the Department decided that they had to accept the risk of 2.2 million. In terms of the loan cost risk the Department decided that they accepted the risk. At each point in time, it seems to me, the taxpayer, the Department, was accepting the risk and the developer was getting away with a deal. Why was it that the taxpayer was continually on the losing side of all these negotiations?

(Professor Innes) He was not. On the delay cost position, in actual fact the cost of that was shared between ourselves and the developer. We were due to start the job on 1 April. The developer took the first two months of that delay and we took the second two months of that delay.

49. That is number one. What about the other matters? Why were you unable to negotiate a satisfactory outcome with the developer? The developer, it seems to me, is laughing all the way to the bank, as are the equity investors who are sitting there just looking forward to their windfall profits.

(Professor Innes) Again, I would say the windfall profits purely depend on the juxtaposition of interest rates and inflation and to date they have not gone to their favour. The windfall profit which they achieve may not be delivered. The position regarding the need for equity, it was not our choice that we had equity into it, it was the secondary debt providers and the EIB who insisted that the developers, as it were, committed themselves to this project so that they could not run away, they had a stake in it that they would lose. If these secondary investors were demanding the equity investment surely that shows the risk that they felt they were at. They did not want to be at the end of the chain, they had to have the developers in as the end of the chain to make this project viable.

50. But the buck passing that you have just been describing on page 21, for example, paragraph (c), describes "The Department and their advisers did not test directly whether the financing arrangements proposed by Miller-Dywidag were viable." Why not?

(Professor Innes) At that time we had Bank of America involved in two very major projects, the Severn Bridge and Dartford Crossing. They were, if you like, the leading financial investors in capital projects at that moment in time. Therefore, when they gave us a letter of comfort and said that this project would fly financially who else would we have gone to? They were the best people in the business to give us that assurance and that is what we relied upon. We would not rely upon them now.

Mr Hope: I certainly hope not, Chairman. That is all, thank you very much.

Maria Eagle

51. Gentlemen, I would like to pursue one or two points that have already been raised by the Chairman and a number of other Members of the Committee. First of all, just to point out that this Committee considers value for money and the National Audit Office says on page 43 in Part 4 "Value for Money", that "It is possible for departments to argue that good value for money has been achieved in a privately financed project where: the procurement process has been highly competitive .... and the resulting deal can be compared favourably with a public sector comparator..." Just to come to the second point first, I must say what on earth is wrong with preparing a public sector comparator as competition whether or not one intends to go ahead and build it in that way whatever the outcome? I understand there may have been some policy issues that said to you, the Department, from the Government "this has got to be done privately", nonetheless why can you still not have a public sector comparator so that the private sector is put to competition? Why was that ruled out because you were not going to build in that way? It may have been an illuminating comparison.

(Mr Mills) I think I have to go back to 4.4, that we

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considered a public sector comparator misleading. For the reasons you have just stated we decided not to do it. I repeat, the guidance in 1995 comes out with the same policy. What we are doing is broadly in line with that policy. We come back to the first leg which you mentioned ——

52. I will come on to that myself shortly. Perhaps you would like to tell me whether or not it would have been cheaper to prepare a public sector comparator than to stand for all the additional costs you have had to stand for in not having one?

(Mr Mills) I do not think it would be because the ——

53. Do you think having a public sector comparator and doing the work that would have been involved in coming up with such a thing would have cost millions and millions of pounds?

(Mr Mills) No, but the public money in this project was in fact the sum for the approach roads which we have touched on. The other part was going to be sustained by the toll fares in line with the objectives. It was that part which was concerning the private sector bidders. We did not do a public sector comparator for the entire project. Whether I would do one now, if that is what you are going to ask, I think I would seriously look at what could be done in this direction now.

54. Yes, well I am glad to hear that. Can I move on to the first part of paragraph 4.2 about the procurement process being highly competitive. Some of my colleagues have raised with you the question of competition in respect of your advisers, points which I fully endorse, points that have been raised that concerned me that they were not. I want to look again at the question of competition in respect of the bidders. You said at the beginning I think that there were six firms which showed an interest and that was reduced to three in the final bid. In fact, I think there were 54 organisations who indicated an interest and that came down to six consortia. Is that correct? You had considerable interest from individual organisations but they resolved themselves down to consortia, is that correct?

(Professor Innes) Yes, indeed. That 54 included students and all sorts of people who wanted to get a hold of our prospectus and that is what the 54 included.

55. So out of those 53 organisations who registered an interest, one assumes that is registered an interest in bidding, is it not?

(Professor Innes) No. Of the ones that actually came down and registered an interest in bidding there were ten companies in six consortia.

56. Ten companies and six consortia.

(Professor Innes) In six consortia.

57. So you only in fact had ten serious companies who were interested in bidding for that project?

(Professor Innes) That is quite right, yes.

58. Right. You then had six consortia arising out of those ten and that was brought down at outline bidding stage to three. You only asked three to prepare the full final bid.

(Professor Innes) Indeed. There was no bidding at that stage, it was done on aesthetic quality.

59. Aesthetic quality?

(Professor Innes) Absolutely.

60. In other words what the bridge was going to look like.

(Professor Innes) Correct. There was no price involved at that stage whatsoever.

61. Why would it not have been possible to ask all six consortia to bid? Six is not that many. Do you think it was sensible to rule half of them out at that stage without even looking at things like price?

(Professor Innes) The advice which we have for these expensive design and build projects is that it should be three, at a maximum four and no more. We had three international groups of companies.

62. Advice from who was that?

(Professor Innes) It is the current advice which is put out by the PFI Panel.

63. There was no such advice at the time, was there, because you were pioneers, were you not?

(Professor Innes) We were. We had also done a design competition for the Dornoch Firth Crossing several years prior to that and it was four companies we involved in that particular design and construct. We were doing St James' Interchange, another design and construct, at the same time and again it was a limited number of bidders. That collective wisdom, because the price of these bids is maybe five, six, seven, ten times more than the conventional tender and the PFI one where we have got to find finance is even more expensive, I would support the advice which is currently out that three or four is good wisdom. These are very expensive projects.

64. But six does not seem to be that many. Presumably the cost of preparing the final bids falls upon the bidders?

(Professor Innes) It does but if you take one of the more recent PFIs you could be talking about several million pounds for a PFI bid. That is a huge amount of money because it is passed on through the industry. These firms have got to recover these costs.

65. It is nice to hear that these firms were accepting some risk. I still do not see why you could not have had four. Perhaps six was too many but why not four?

(Professor Innes) It was a judgment at the time. Three was the advice and it was not advice that we took lightly.

66. At the end of the day you came down to having no satisfactory bids which met the criteria you laid down and you ended up putting yourself into what I would call a weak negotiating position and having to choose a preferred bidder at an early stage and then

[Maria Eagle *Contd*]

negotiate when you had the sword of Damocles over your head. Is that not a fair assessment?

(Professor Innes) Bear in mind the fact that in that price which we had we had a firm construction price which did not vary. What did vary was the financing terms under which that job was delivered, but the actual price which the bidder gave to us for building this bridge did not alter until we introduced the changes. So we did have a price which was fixed at the very outset in the competition amongst the three because they did not know at the time they bid that in actual fact the job was going to come so easily to them and so readily to them bearing in mind that Miller-Dywidag was one bidder. Trafalgar House was the other bidder, a very respected and major company in the country. Clearly they should have been able to give them a run for their money.

67. Mr Mills, I would like to take up the question of the additional payments that were made which you explained to the Chairman at the beginning of this hearing. You decided to take upon yourselves, because they were within the Department's control, the changes in respect of design. In terms of the delay caused by the public inquiry, you have said, and so does the report, that that was shared between yourselves and the developers because the developers took two months of the delay costs and you took one. Can you explain to me how that one month of delay cost £2.2 million?

(Mr Mills) Perhaps I could ask Professor Innes if he has these figures.

(Professor Innes) The £2.2 million is made up of various parts and there are three aspects of the delay. One is a month delay in actually starting the works. One is a month's delay because starting it at that point in time instead of starting it earlier meant the contractor had to suffer the weather in the autumn and the winter for his foundations rather than in the spring and summer months. So this four month programme for doing the foundations became five months. There was a third month associated with the changes brought about by the public inquiry to the shapings of the box. So the one month was actually three months.

68. I am not a civil engineer in any way, shape or form. Is it not the case when concrete structures like bridges are being built that some work can be done in advance, i.e. precasting elsewhere? Would that not have mitigated against this delay? Could not some of the basic building blocks be prepared and done in any event that would be the same however you built the bridge?

(Professor Innes) That is not quite right because if we did not get the approval of the public inquiry until 25 or 26 June there is no way that we could have allowed these people to proceed in advance of that, otherwise we might be sitting today with a different answer.

69. Can I ask a question in respect of the overall amount of money that has been given to the developers in respect of the tolls. I must say, as somebody who used to do negotiations, I used to be a lawyer in a past life, it does seem to me that you have come up quite badly in a number of respects, e.g. in respect of accepting risk which perhaps you could have spread. I accept that Mr Mills has said that you felt that these delays were within the ambit of the Department and you therefore probably felt that perhaps you should take them on board, although my view is you could have been harder given that design was a risk that the developer was supposed to take. Surely an element of design risk is whether or not the public inquiry would approve of the design. I cannot see why you could not have been a bit harder in negotiating. Could you tell me whether or not you think you had value for money at the end of the day taking into account what Mr Leslie said also about the equity financing? Do you believe you got a good deal out of this developer or do you believe you could have got a better one?

(Professor Innes) In hindsight one could always do better than what one achieved by going about it and ordering things perhaps slightly differently. The change insofar as the PFI project was concerned was from £21 million to £23 million, that is an increase of nine per cent. Projects which have been procured conventionally have had increases which are considerably in excess of that until recently when we began to bring down the tender to output overruns to within five per cent.

70. It seems to me that the Miller Group have done very well out of this. I am reading from the business supplement of *The Scotsman* dated Thursday 4 September: "Last year the mark of a milestone for the family run firm Miller Group returned to the black to the tune of £4 million after suffering pre-tax losses of £4.4 million the year before. For the six months to June this year the company enjoyed £133 million turnover with a further £34 million in the bank. PFI contracts, too, will continue to be an important part but it will not dominate us, said Mr Miller, although I expect that having come through the recession with £34 million in cash it does not surprise me to find that they are the preferred bidders on five other PFI contracts at the moment." Do you really think you have got the best deal out of Miller?

(Professor Innes) I think in actual fact the year they made their loss was the year they were building the Skye Bridge.

71. They are doing rather well now out of it, are they not?

(Professor Innes) Indeed, but they are also into mining activities and all sorts of other lucrative out-of-town developments as well. I think we will now have to examine these and see where their profits came from before I would agree that they have made significant profits from Skye. I am aware that they feel very sore that they have put more into this than they have got out of it so far.

Maria Eagle: Thank you.

Mr Maclennan

72. Mr Mills, Mr Wardle raised the question of the engagement of consultants and it is a point I think he made very effectively. It is not exactly a new point, is it, that consultants should be engaged by a competitive process?

[Mr Maclennan *Contd]*

(Mr Mills) I would agree with that, but I think we would have to remember that all this was done back in 1989. Sitting here in 1997 I certainly agree with what you are saying.

73. But it has been the view of this Committee for a very long time, reiterated in many reports, that consultants should be engaged by a competitive process and many of those reports go back beyond 1987.

(Mr Mills) All I can repeat are the reasons why in three of the four cases we adopted the procedure that we did, though, as I have agreed already, doing it now would certainly be going to competition.

74. It is a rule that has advanced almost as a rule in the conclusion of the National Audit Office's Report. What was so special about the circumstances which allowed you to think that it was sensible to depart from the rule? I know you have touched on this already, but I remain unsatisfied about the fact that you paid one particular firm of consultants £1.2 million, approximately, on what was evidently a treaty arrangement.

(Mr Mills) I regard JMP as a consultant who was closely associated with the project from its start and as Professor Innes has explained, they were very familiar with it. There was a desire to take the project forward as quickly as possible and it seemed as though the best way of doing that was to get the benefit of continuity of the consultants while at the same time ——

75. Not your consultants but the consultants of the council.

(Mr Mills) Yes, but in 1989 it was agreed that the Government would take the project on from the Highland Regional Council to make rapid progress with the project which was the wish of the Council. The Department took on the consultants, as explained in figure 5.

76. So speed is your alibi, is it?

(Mr Mills) No. I would say that we wanted to proceed as quickly as possible, but we still looked carefully at the agreed fee rates to make sure that it was reasonable to take them on.

77. Fee rates are not so much the question at issue, as I understand it, as whether or not the advice given was appropriate. In the outturn the projections do not all appear to have been well based.

(Mr Mills) I am not sure that one can lay that at the door of JMP Consultants. They were engineering advisers and managing consultants and they did proceed to provide the bridge which is there today.

78. I am not going to rehearse the arguments that have been put to you already by Mr Wardle but you seem quite deliberately to have gone against what is regarded as good practice by this Committee and now to be invoking some new doctrine that the urgency of a project will allow you to set aside good accounting practices and good consulting practices.

(Mr Mills) I can only repeat the judgment which was taken at the time.

79. Who took that judgment?

(Mr Mills) It would be officers within the Department.

80. Did you not think it appropriate to put it higher than that?

(Mr Mills) Can I ask Professor Innes to deal with what actually happened at the time.

(Professor Innes) At the time, going back to the point when the Highland Regional Council came to the minister and asked for the Department to take over the project, it was the taking over of the project which was seen as the activity. JMP had been involved with the Highland Regional Council since 1975 making analyses of the problem at Skye. They did a report in 1986 and they did a report in 1988. As I said before, they were the people who had the up to date knowledge of the territory, they knew all the circumstances surrounding the various activities, they had spoken to the various advisory bodies and to us it appeared at the time that in actual fact if they were to team up with one of the contractor's outfits there would have been a significant, as it were, imbalance in the period leading up to that bid. Plus the fact that we wanted the best advice. We believed that they had the best advice to offer to us at the time.

81. I am really rather puzzled by your deployment of what sounds like a "heads I win, tails you lose" argument. On the one hand you say this is a totally novel project, the first time we have had a PFI operation of this kind and therefore your practices are in a sense groping in the dark, and on the other hand this is a project which you were "taking over" as though you knew your way.

(Professor Innes) The difference is between the engineering of the project and the financing of the project: the JMP people were not financing the project, they were not giving us advice on finance, they were purely the structural and highway engineers who knew the job much better than anyone else.

82. But the argument has been deployed in respect of all the consultants against competition.

(Professor Innes) If we take the Quayle Munro situation, the Quayle Munro situation was tendered of a sort in so far as four firms were approached. They were asked to provide a bid as to what their prices would be for advising the Department. Two of them decided that they would not reply to us because the value of the commission was seen to be small at the time. We got two bids, one from Noble Grossart and one from Quayle Munro. We took the cheaper of these two prices by some 20 per cent. So there was competition in our financial advisers. We did not have competition in the Chartered West situation because Chartered West were brought in at a very small fee to do a very specific task, some £35,000.

83. Can I turn to another issue. It is stated in Appendix 3 of the report of the NAO that the secondary objective of the Department was to deliver a toll no greater than the ferry fare linked to inflation paid off in 20 years. At paragraph 3.4 of the report on page 37 it is reported that: "....tolls were lower than the ferry fares in September 1995, immediately

[Mr Maclennan *Contd*]

before the bridge opened, for example a single car fare was then £5.40." But the report goes on to say, "This was because the bridge tolls were uprated by inflation for the period between 1991 and 1995, while the ferry operator had increased fares above inflation in this period." Is it not the case that these increases by the ferry operator had to be authorised by the Department?

(Mr Mills) No. The increase in the fares by Caledonian MacBrayne is a matter for them.

84. Not a matter that the Department influences?

(Mr Mills) Not directly, no.

85. What does "not directly" mean?

(Mr Mills) We set the overall external financing limit for Caledonian MacBrayne within which they work.

86. Is that not how, in fact, you decide that Caledonian MacBrayne is obliged to decide how to operate the tolls?

(Mr Mills) No, because inside that EFL there are many factors at play, including Caledonian MacBrayne's level of investment in new vessels. The company works inside that and take a view on what their policy on fares should be.

87. Are you suggesting that governments have no influence over the level of Caledonian MacBrayne's fares?

(Mr Mills) I am saying that they are set within the EFL.

88. And within that?

(Mr Mills) Within that the government has an interest. Obviously it knows what they are, what the company announce. As you know, following this year's increase in fares the government has asked Highlands and Islands Enterprise to look into the effect of the fare increases on the economy of the islands. Yes, the government has expressed an interest in the link between fares and the economy of the islands.

Mr Maclennan: Thank you.

Jane Griffiths

89. I want to return to the concessionary period which was extended to 27 years although the original tender had a 20 year maximum as a mandatory condition. Do you think that is fair tendering given that there may well have been bodies which might have wished to tender on a 27 year basis but did not feel able to on a 20 year basis? Does this not amount to moving the goal posts?

(Professor Innes) In actual fact, if I can answer this, the 20 year period was not offered in the tenders by any of the three bidders. The bid was put in at 25 years and that was another area where it did not comply, if you like, with what we were seeking in our bid. The 27 years was the consequence of needing to extend the period to recover the reduced income because the tendered toll level went down. That we saw as a matter of negotiation. The belief we had, and the belief we still have, is that 14, 17 or 18 years will in actual fact be the duration of the tolls. It was a comfort element to the secondary lenders.

90. I see what you are saying but it does seem, forgive my naivety, a little strange to say "this is the period that we wish to see in the tenders", that they all come in over that but you then increase it to beyond what they have all come in at and say that your personal belief is that these will actually be less. I just wonder where ——

(Professor Innes) Let me explain if I can please. The length of the period is wholly dependent on the traffic flow. The developers were so risk averse in this project, or their financiers were so risk averse in this project, they assumed that there would be no growth whatsoever from 1990 onwards and that was the basis of their bid. We clearly believed that that was wholly unrealistic, albeit that the crossing was very susceptible to the tourist traffic and the tourist traffic was what really concerned them. The base level traffic for Skye was then about 250,000 vehicles a year. As I tried to explain before the inquiry that is about a day and a half across the Kingston Bridge in Glasgow. It is doubled by the fact that there is a tourist element which brings it up to half a million or thereabouts, as then was, and it is very susceptible to that tourist trade. Therefore, the job was very risky. It is like us trying to put a tender price in the document and saying, "We want you to give us the price of X for this job." In actual fact the tender was the level of the tolls and the duration. We tried to press down our advice to the bidders in order to achieve a sensible bid which was that we thought 20 years was the limit on the basis of our analysis of risk and traffic and we actually believe that is still the case.

91. Can I just take a slightly different line. Following the public inquiry it appears that costs were 48 per cent more in real terms than the target contribution of £6 million (p43, fig 14). Could the Department not have anticipated that level of increased costs given that it is not unusual for a public inquiry to result in something which does increase costs?

(Professor Innes) There are certain areas where one could have anticipated that. The Otters is a good example. The design which we thought we had agreed with the conservation body was that there be a fence erected. In actual fact we had to convert that to a wall and that caused us a significant amount of money over the length of the job. They also wished that the secondary bridge crossing, which was a small three-span crossing, be enhanced and it became a seven-span crossing. That cost us a significant sum of money as well. There was a design change to the external look of the bridge and that is the area where we led evidence at the public inquiry in that we did not think that was necessary. The Reporter did not find in our favour and we accepted that as a consequence the changes would be made. In hindsight we could have foreseen many of these, but this was a very public project by this time and there was pressure to be sure that we complied with all the environmental aspects, which we duly did.

[**Jane Griffiths** *Contd*]

92. What you have done is outline what aspects came up at the public inquiry which had to be changed and therefore resulted in the increased costs. That is fair enough. That is information, though, it is not an explanation. If it is a high profile, public project which is facing a public inquiry people know about it. Is that not all the more reason to be aware of what cost increases there might be?

(Professor Innes) The timing must come into this equation as well. That pressure began to build after the tenders had been submitted, not prior to the tenders being submitted. When the tenderers took their designs to the Fine Arts Commission and the Countryside Commission and the National Trust there was an acceptance of what they were proposing at that time. The bid was on our desks and it was subsequent to that that the pressures came through for change. So I think at that moment in time we would have been right in assuming that we could have delivered it for the design as proposed.

Mr Clifton-Brown

93. Would the normal way of proceeding not have been to have appointed consultants to have designed one or more designs and then put it out to public inquiry long before you actually went in for a tender whatever system you were going to use to actually build the bridge?

(Professor Innes) That is the normal way. As I tried to explain, there are only two projects in the UK which have been designed using the New Roads and Street Works Act; one is Skye Bridge and the other is Birmingham Northern Relief Road. What was offered to the private sector was the maximum degree of flexibility for them to come through with their ideas and their experience and their ingenuity to devise how this project should be delivered. We did not specify it should even have gone along the route that it actually ended up going along. It could have gone in a different alignment. What we asked for was a project taking us from Kyle to the roundabout where it now stops. We were being told at the time, and we still are, that the private sector had better ideas than we had and that we should give them the maximum availability to develop these ideas and to put them forward in a bid and that is what this job offers.

94. It seems as though you have almost wet a finger and put it up in the air and seen which way the wind was blowing. This whole thing is open-ended and it is riddled with extra costs. Do you think as a Department you really have managed this thing properly either on behalf of the taxpayer or, much more importantly, on behalf of the tollpayer who is now going to have to bear these much higher tolls than if the thing had been managed properly?

(Professor Innes) Bearing in mind what you asked me in the first question, I do not accept that. If we had taken this through the process we would have ended up with a bridge of the same cost because the public inquiry design might have been a more expensive design than what we actually delivered, but it would have included the various pressures that came to bear upon this at the public inquiry. We would have had that built in before we went to tender. So the end cost of the job may well have been the same, if not more.

95. I think, if I may say so, that is a highly questionable assertion. May I ask you whether the National Audit Office has seen the full contract or only significant elements of it?

(Professor Innes) They have seen all of the contract. Every document has been made available to the National Audit Office.

96. Have they seen the Fraser of Allander Report 1991 and any other critical evidence available to the Department?

(Professor Innes) The Fraser of Allander Report we were aware of through press releases, but I am not aware that it came into the Department during the currency of the job. It was not in our files for the NAO to find.

97. Did the Department determine at any stage that this whole thing was going so wildly wrong that you considered abandonment of the PFI and taking it down a normal tendering route?

(Professor Innes) The answer to that is no, because we believed, and we still do, that they would have ferry fares for less than 20 years. We are going to achieve that.

98. Would you agree that the two main reasons for having a PFI process rather than a normal public procurement process would be the private sector would manage risks more effectively and reduce costs?

(Professor Innes) Yes.

99. Do you think this project succeeded on either of those two counts?

(Professor Innes) I think what we did get was a very competitive tender. As I explained to your colleague, the construction price of this job did not vary from start to finish.

100. You might have had a very competitive tender eventually, after you had gone through a series of alterations and re-thinks, as it were.

(Professor Innes) The re-thinks came in the financing of the job which in effect was the skill in the private sector that the bankers and financiers were bringing to the PFI. The engineering and the construction we changed as a consequence of the public inquiry. I was saying to you that had we gone to public inquiry with that design as our design we would also have changed it.

101. May I refer you to page 51, figure 14, and the passing of risk to the private sector. It does seem to me that anybody managing this project would have tried to reduce the amount of risk because surely this is the whole object of PFI, before you put it out to PFI tender you, as the Government office, should try to manage those risks. And clearly from a number of things that my colleagues have already mentioned, land acquisition, inquiry costs, design changes, even the increase in the Department's own costs, you have not managed either the risks or the costs before putting it out to the PFI process effectively.

[Mr Clifton-Brown *Contd*]

(Professor Innes) I think what the report also points out is that where the risk ended up in this project is where the PFI recommended it should be in the first instance. What we were trying to do was to squeeze the very best we could out of the private sector and we asked them for an extreme position on, for instance, taking the PLI risk. As I said, there are only two jobs ever to have had that PLI risk associated with the contract and this was the very first. The business world out there was not prepared to accept that risk. They were not ready for it.

102. I accept it was the first and I accept that inevitably there is a learning curve to be overcome, but it does seem to me that some of the risks that you asked the contractor to accept were unreasonable risks. A risk always has a cost and therefore if the risk is unreasonable there is no point putting it in. Why did you put in some of the risks that are within the Government's control, namely the namely, the cost of the inquiry which was largely within your Department's control and, referring to that table, changes in the corporation tax. It seems to be an unacceptable risk to put into a PFI tender.

(Professor Innes) If I could take the first one first, the PFI. In the document it says that the normal cost of the PFI risk is one which —— I am sorry, I have lost the theme. Could you repeat the question?

103. Yes. Why put risks into the PFI tender which were largely within the government's control? In other words, the cost of the inquiry was within your Department's control, changes in corporation tax are within the control of the Treasury. You are asking the contractor to take a risk that government has a control over.

(Professor Innes) In the first instance we set that out as our bargaining position, if you like. We deliberately went to the left-hand side of the equation, if you like, knowing that we may well have to move to the right during the currency of that. We would have been delighted if the contractor had been able to build in sufficient contingency to take care of all the eventualities that might have occurred. We might have had to pay very dearly for that if that in actual fact had been the position. There was an indication during the period that they were unwilling to take that risk and we accepted, as in fact the PFI now recommends, that that risk should not be with the developer but should be with the government.

104. Lessons have been learned?

(Professor Innes) Yes.

105. Can I finally ask one other technical question. Were all other sources of external finance exhausted, in particular European Objective 1 funding?

(Mr Mills) If I may deal with that. The European Objective 1 funding did not exist when this project was being developed. European Objective 1 funding did not come in until 1994 and it was in 1992 that this project was started, so these funds postdate the development of this project.

Mr Clifton-Brown: Thank you. It seems to me, Chairman, that the poor toll payer is having to pay more than he necessarily needed to.

Mr Love

106. This report described the competitive tendering round as "inconclusive", yet following that you, the Department, chose a preferred bidder and arising from that you entered into negotiations, in part of which you assisted them to provide new finance through the European Investment Bank which they would not have got otherwise. There was, as has already been mentioned, the nine per cent increase to toll fares over the whole period, there was the £3.8 million additional costs, all of which have had to be added to that original tender price. Two questions. First, would you describe that whole process as competitive tendering and the way that it was supposed to operate? Do you think, even accepting that the original tender price was, as you have judged it, competitive, that you have actually got value for money at the end of the process?

(Professor Innes) Yes. I think I have tried to answer the value for money question already in so far as we have rerun the net present values at the request of the NAO during the currency of the investigation and the job still stacks up as a very good value for money contract. In securing the finance, at the end of the day again the Price Waterhouse analysis is that the money, the cost of the money, is a reasonable cost of the money which would be anticipated and was better than some projects which were dealt with later in the power industry. On the financial side of the equation, according to the report and investigations that have been done, we got a reasonable deal on funding. It might have been done better. You are always able to go back and rethink and do it again and get possibly a better round of negotiations. In the circumstances at the time from the bid to the closure of the deal, the financial markets had changed their perspective, we had the Gulf War in that period, there was a whole variety of things happening in the financial markets at that time. The report seems to have accepted that what we got in financial terms was a reasonable deal. As I said, on the construction side I do believe we got a very good price for the bridge. It was very close to the tendered estimates which JMP put out in the first instance and the variances which were brought in later would have been variances which would have occurred had we gone down a traditional route. If you take the approach roads price and compare that with the approach roads of a project that is just down the road from here at Dornie where we had a bridge similar to the secondary bridge and a length of road associated with that which did not include rock excavation the cost was more than the approach roads at Skye. Yes, I do believe that the construction aspect of this project was a good buy.

107. Can you hold your hand on your heart looking at the construction cost and if you tried to build in those risks at the tender stage that came on afterwards, if you tried originally, do you believe that the tender price would have gone up to the extent of the additional costs that you had to accept?

(Professor Innes) I cannot say it would have, no, because, like you, I do firmly believe that every price, every part of the deal, should be tendered for as much as possible. We do not like, and we do not encourage, if you like, untendered extras if at all possible.

[**Mr Love** *Contd*]

108. Can I move on then to the evaluation of alternatives to building a bridge. You mentioned earlier, I think it was you, Mr Mills, that there had been some sort of economic evaluation between the current ferry and the bridge way back at the beginning of this whole process.

(Mr Mills) Yes.

109. I wonder if at any time you sought to evaluate the possibilities, perhaps even of PFI, to allow Caledonian MacBrayne to develop the types of ships that would allow them to overcome the problems that were undoubtedly occurring for which the bridge was built? I accept that you could not have done a public sector alternative to bridge building for the reasons you have given but surely there were other alternatives that you could have looked at that would have given you at least some comparator with which to compare the final bridge costs?

(Mr Mills) No, we did not do what you are suggesting. Appendix 4 sets out what we did. I am advised that there would be difficulty in providing a ferry service which would compete in terms of convenience for the person crossing over to Skye with the bridge. As the analysis sets out, with the waiting time and the effect of the weather on the ferry and all that kind of thing, it was very likely that any kind of appraisal of the kind you suggest would have ended up with results which are broadly similar to Appendix 4. I believe that Caledonian MacBrayne did give some thought to larger ferries and so on but they advised that it would be difficult to operate more than two ferries across this very short length of water, they would have got in each other's way going backwards and forwards and to overcome that one would have had to develop additional berthing space at Kyleakin and Kyle of Lochalsh and there would have been costs associated with that as well as being quite intrusive to the communities they serve. If we had tried to develop a ferry service which could deliver the same economic value as the bridge then there would have been other difficulties and complications.

110. I do not think one needs it for that purpose because we are now in a position where the bridge has a monopoly and people do not have any context in which to compare the benefits that they are receiving from that monopoly. I accept that the other alternatives, improved shipping and whatever other necessities, that would need to be changed to allow that to occur may not have been as good a solution but at least they would have been able to compare one with the other and they would have been able to make a cost benefit analysis. What we have now is in a sense the worst of all possible worlds because we have a bridge built we are told, and this report seems to confirm it, relatively cost effectively but there is still enormous controversy over the way that the tolling is working at the present time.

(Mr Mills) I accept there is controversy, but I would say that the Government and the Department set out on the project with a very clear prospectus that what was being discussed was a toll bridge with tolls no higher than the ferry fares, and that was what was being discussed in 1986 and in 1988/89 Highland Regional Council agreed that the project should go ahead and asked the Department to take it on and that is what was put very clearly at the public inquiry which Professor Innes attended.

(Professor Innes) We also took the report back to the Highland region at various stages and they consulted with the community councils as well, whether they wished the bridge albeit with the toll. With the exception of one community council out of about 17, they preferred the bridge with the toll to carrying on with no bridge. So the district council, the vast majority of the community councils and the regional council all wished a solution, albeit would have preferred not to have tolls, but that was not on offer.

111. I have to say, I did note that in the report it said that the tolls had been agreed and that may come as a surprise to everyone else but I do not think it would come as a surprise to politicians to find that the concern arises when they actually receive the charge. Can I then move on to deal briefly with the costs that arose from financing charges without wishing to get into too much of the complication because I know this is a very complex area. On the original financing deal the tender was based on The Bank of America giving some indications that they would meet the tender in terms of the financing. That did not then occur, yet you do not seem to have shown the scepticism that I would have thought that that would create in your mind when the further tender bid came in. In order words you seem to have accepted what the financial experts told you rather than perhaps been a little more critical. Would you accept that?

(Professor Innes) Bear in mind that Bank of America were taking £8 million or thereabouts of the actual funds and Prudential Insurance were taking another major part and EIB were coming in with another lump of the money. When Bank of America initially said that they could raise that money they were the people who had the expertise in the business of Severn and Dartford. We had no reason to question it. These were the people who had done most of these kind of deals in the transport scene in Britain. When it did not happen, by that time we had already got involved because EIB—and this is common for all the road schemes—do not get involved until the latter stage. In the M6 bids which we have just concluded and in the M8 bids which are on our desks just now the same principle applies. Once they are there the EIB then are prepared to look at dealing with the winner, as it were, and coming forward with a proposal at that later stage. They do not come in early on. Therefore, we facilitated the interface between the EIB and the preferred bidder. That in itself helped the financing, but it took the intervention and the re-assessment of the traffic —— If I can try to explain it. In the early stages of this job when the Miller-Dywidag advice was the traffic might not grow, that is what the people that they went to had in their mindset in the city. When we then had to try to show to these people that it was not going to be like that, that in actual fact the traffic was more robust, that there was far greater likelihood of traffic growth and continued traffic growth on this route, that had to be got across with some authority and the advisers to Miller's had already given their decision. We had to

[**Mr Love** *Contd*]
come in with other advice to show that there was a different approach to the traffic volumes and that is again the interface that we had with the city and with the financing, and Chartered West were our tool and our means of effecting that.

112. Can I just ask about the traffic implication because obviously that is critical to the whole issue and I was interested to read that the second report had been more optimistic. We have heard from a number of members of the Committee some concern expressed about the rate of return that the equity investor has in this, but of course that is based on the prediction of your traffic projections. If those traffic projections are better than expected then not only will there be a shorter number of years before the pay-off but presumably the equity investor will do even better than is expected. One wonders whether in some senses you have been dictated to by the financiers in relation to the equity investor. Obviously they want an equity investor long term that is involved with the bridge, one can understand that, but they seem to have dictated the terms on which that equity investor is involved and you seem to have accepted the terms that they have put to you. They are saying, "We will reduce our interest rates to keep your weighted costs of capital down if you involve an equity investor." Should you not have been more critical about the issues that you were saying to them, i.e. we want a lower rate of interest and we do not need an equity investor because there has not been one involved in other projects of a similar nature?
(Professor Innes) Initially that was the position that we took. It was one which we could not sustain.

113. Is this not brinkmanship?
(Professor Innes) Always.

114. You mentioned earlier on that the deal could not be achieved, there was high risk and you were concerned about the project. They knew you were concerned about the project. Have they forced you into something that is not in the best interests of the project?
(Professor Innes) If we could have got the interest rates which we got without an equity slug at the end then the job would have been that much better, but one negotiates with what one can and managing to get the costs of capital down from where it started to where it finished we perceived as a good deal overall. It could have gone the other way. It could have gone worse. The pressure was both from EIB and from the Prudential Insurance Company and if these two players had walked away because there was no equity then there was no deal.

115. You mentioned earlier about the additional costs for the delayed start and the contractor had allowed two months. The additional costs were something in the region of £2.2 million. That seems quite a large cost when you compare it to the overall cost of the project. Did you look at that seriously and make sure that you were not being overcharged at that stage in order to make up for perhaps some of the competitive tender that they had submitted previously?
(Professor Innes) Very much so. There was a great deal of negotiation centred round that, as you can imagine. As it was the very first PFI I do not think we were under any illusions that we would be sitting here today talking to you about it and this number clearly was a number which we would negotiate very heavily on and we pressed very hard to make sure that nothing in that number was not justifiable.

Mr Davidson

116. I wonder if I could follow up the point about the public sector comparator. You said that you decided not to seek a public sector comparator because a policy decision had been taken even if you were going to go down the public sector route. Is that correct?
(Professor Innes) That is right.

117. So you deliberately decided not to have something to compare it with in order to make sure that you were getting value for money in case the result was embarrassing.
(Professor Innes) No. In actual fact we did do an economic evaluation of this project and we proved that this project would deliver value for money because of its greater return vis-à-vis carrying on with ferries and in that analysis of how the ferries would compare with the bridge we accepted that the ferries would have to be replaced at certain stages during the assessment period, which is 30 years.

118. I am sure at the time—I do not want you to go round the houses—the ferries were not the only public sector comparator that could have been sought?
(Professor Innes) We could have done a public sector bridge.

119. And you did not.
(Professor Innes) We did not, no, because that was not on offer. We did not wish to give the impression that it was on offer.

120. Fine, I understand that. Can I turn to the question of the land cost. The District Valuer, as I understand it, valued the land at £300,000 and had you gone for compulsory purchase it would have been on the basis of the District Valuer's opinion, would it not?
(Professor Innes) Yes.

121. Instead you went down the route of negotiations and you managed to negotiate instead of £300,000 a price of £784,000. Why did you go down the route of negotiation rather than compulsory purchase?
(Professor Innes) Could I say that the Compulsory Purchase Orders were all published. That is standard practice. The District Valuer undertakes a negotiation whether we negotiate or whether there is compulsory purchase. The valuation of the land has nothing to do with the compulsory purchase. If the person you are giving the bid to does not accept it then it goes to the Lands Tribunal. If the DV and the seller cannot agree it goes to the Lands Tribunal. That would have been

[Mr Davidson *Contd]*

the process. The District Valuer was persuaded by the wisdom of the seller, or his agents, that the value of the land was greater than he had initially estimated. We had no currency in that negotiation, the District Valuer in actual fact undertakes that on our behalf in all circumstances.

122. This was not a negotiated settlement, this was established by the District Valuer?
(Professor Innes) Absolutely, yes.

123. Are the costs of the legal and other charges publicly available in this whole arrangement out of the £784,000? Are all the costs of the individual packets of land publicly available?
(Professor Innes) Yes, they are. All of the costs of all of the individual pieces of land are available. There was one which was not and that was Mr Farmer but Mr Farmer then agreed to reveal his price. All the rest of them are publicly available.

124. It did strike me that when the Kyle Request Group got £30,000 for nine acres and Mr Farmer got £127,000 for three acres there did seem to be somewhat of an imbalance. My knowledge of Scottish football is not exact but I cannot remember whether Tom Farmer owned Hibs at the time.
(Professor Innes) Probably

125. I was not sure whether or not this was an indirect way of the Scottish Office subsidising Scottish football! I would have thought a more direct way could have been found if that was the objective. Certainly that does seem to be a rather surprising discrepancy, it started off at £300,000 and then jumped to £784,000. Can you clarify for me why you think that was? Was the initial valuation so outrageously wrong?
(Professor Innes) The initial value was low but bear in mind that the island has a house on the island, a house which could have been readily restored and upgraded.

126. Readily?
(Professor Innes) Yes. It needs the roof fixed and some interior work done to it. In actual fact it is being proposed as part of the assets of the Trust which has been set up for Eilean Ban. It has a property on it. It also was an island and I think islands around Scotland come at a price.

127. Islands with bridges over the top of them!
(Professor Innes) It was not valued at a price with a bridge, it was valued at a price without a bridge.

128. Let me move on to the question about the ferry and ferry prices. I was intrigued by the responses you were giving to Mr Maclennan's points about the rise in ferry prices. You seemed to indicate that the Scottish Office had absolutely no influence in these matters at all. I always thought that the Scottish Office, if not all powerful, at least did have some influence in these sorts of matters. Are you seriously saying to me that you had absolutely no control whatsoever over the external financing limit of Caledonian MacBrayne, no influence whatsoever on how they applied the rises in fares on one route as distinct from another and that you had absolutely nothing whatsoever to do with the fact that the fares were rising consistently year on year and by coincidence they provided a favourable comparator for a PFI project on the cost of tolls?
(Mr Mills) On the first point, we do set the EFL, the minister sets the EFL, as part of the public expenditure round and that caps everything that Caledonian MacBrayne does through its operations and its revenues.

129. So do you actually control the fares effectively?
(Mr Mills) No.

130. I thought you said yes.
(Mr Mills) You asked me whether we set the EFL and yes, we do set the EFL. Inside that Caledonian MacBrayne take a view on what their fare policy should be. Up until recently the government has not intervened in that fare policy. As I was explaining to Mr Maclennan, in the last month following the announcement of this year's fare increase the government asked Highlands and Islands Enterprise to look into the effect of the fares on the economy of the islands. In a sense, yes, the government has taken an interest in them and we will see how that develops.

131. By controlling the financing limit of Caledonian MacBrayne the government effectively knows that the fares will go up rather than down?
(Mr Mills) I think that would be right, yes. I must qualify whether or not by the rate of inflation, which they have done for many years, or by more than that will be for the company.

132. Quite. Could I ask you about the sale of the ferries. The sale of the ferries was expected and was built into the calculations. How much did you get for the sale of the ferries?
(Mr Mills) It was not built into the calculations. The expectation was that when Caledonian MacBrayne was given permission to go ahead and build new ferries in 1990, that was after the bridge was proceeding, the ferries built for that route would be transferred to other routes and they would cascade down to routes and hence avoid further capital investment on these routes. In practice the vessels gave operational difficulties for Caledonian MacBrayne. They were indeed designed for the Kyle-Kyleakin route but they had some difficulty operating there due to the tidal conditions, the squalls which develop there ——

133. I get the picture.
(Mr Mills) And the open ramps. They were quite large ships with large flat sides.

134. They did not work basically?
(Mr Mills) They did. They served that route until the bridge was opened. Caledonian MacBrayne decided in view of their experience that they wished to sell the vessels and they proceeded to try to do so. In fact, they have not achieved the sale at the kind of the price that they were looking for and they have now

[**Mr Davidson** *Contd*]

decided that it is better in value for money terms to retain the vessels and make alterations to them and to the ports which they serve.

135. But that in turn has implications for the external financing of Caledonian MacBrayne?

(Mr Mills) It will indeed have implications for a time, yes.

136. Could I ask about the question of the appointment of advisers and in particular the appointment of Quayle Munro. Quayle Munro were clearly controversial in their privatisation but at this stage we are told in paragraph 1.17 there was indirect process and so on and so forth. I thought I heard you say that there were actually two bids and Noble Grossart were 20 per cent more. Did I pick you up wrongly?

(Professor Innes) No, you did not.

137. These two things cannot both be true then.

(Professor Innes) That was the indirect arrangement. What we did not do was publish in the press saying we wanted a financial adviser. What we did do was we went to the people who were advised by those who bid for the Scottish Bus Group privatisation and we sought bids for Skye from ——

138. So there was a clandestine bidding arrangement?

(Professor Innes) It was not clandestine.

139. It was open then, was it not? It was not open.

(Professor Innes) It was not advertised, you are quite right.

140. So it was secret. There was a secret bidding arrangement for financial advisers, is that right?

(Professor Innes) If you wish to put it that way. What we would have said was we selected those who we were aware of could offer us a price ——

141. It is either open or it is secret. It was not open so I presume it was actually secret. Bids were secretly invited to which no other financial adviser who was not approached by yourselves could tender and of the two who secretly bid one was selected.

(Professor Innes) Yes. We went to the two ——

142. I just really wanted to point out whether it was secrecy or not secrecy. Could I just clarify the question of whether or not there is any cap on the profit that there could be to the equity investors?

(Professor Innes) The profit to the equity investor is dependent on how long the duration of the job goes forward. I suspect the shorter it is maybe the less they will get rather than the more they will get. 143. I understand all of that. I understand it is complicated and it is a byproduct of a whole number of other things.

(Professor Innes) What there is is a cap and that is on the actual rate of return, ANPV, the Actual Net Present Value and that is set at £23-something million. When that figure is achieved then the income from the crossing discounted to the base year ——

144. That is the whole thing finished, I understand that. But that involves a variety of other factors, does it not?

(Professor Innes) The answer to your question then is no.

145. So there is no cap whatsoever on the profits that can be earned by the equity investors on this?

(Professor Innes) Nor is there a bottom ceiling either.

146. I think we both know which is more likely, do we not? You mentioned that the Gulf War had affected the financial provision of the whole project. Maybe you can clarify for me exactly why that is because I think there are a number people looking for excuses to blame Saddam Hussein for a number of things and if this is one of them then something useful might have come out of today!

(Professor Innes) Shall we say that that was an excuse that was given to us.

Mr Davidson: Thank you very much.

Chairman

147. The Prime Minister might be having words with you, Mr Davidson! Gentlemen, you will have detected a degree of concern about the bidding and negotiating process. I am going to ask for some responses from you in documentary form to clarify for the Committee precisely what happened. The first one relates to the last matter that Mr Davidson raised which was the question of contingency arrangements and the concessionary period. I asked you at the beginning whether it would have been better to build in a contingency arrangement later in the project rather than making the tollpayer meet the net present value based on the costs the contractor might have faced. Could you let us have a note describing the options you considered when negotiating the final deal on the concessionary arrangement to deal with the prospect of a shortfall?[1] Deputy Comptroller, could I ask you if the NAO will do an analysis of the financial effect of the concessionary period deal in the event that the predicted traffic volumes were met?

(Mr Le Marechal) Yes.[1]

Chairman: It has been presented as a risk reduction for the investors. It does look a little like a profit increase at the expense of the tollpayer and I want to know which of those turns out to be the case. Secondly, you said you were advised to confine the final round to three bidders. This has turned out to be rather important in the final analysis. Could we have documentary evidence of that advice, whatever the contemporary written advice was on that, please?[2] Thirdly, virtually everybody on the Committee has expressed concern over the lack of competition for the appointment of three of the consultants. You say this was because of quality and I must admit, after listening to today, I have doubts which are largely focused on the quality of the advice you have been given rather than the cost. So presumably there was a memorandum, since this is an important decision and it was outside the normal rules of government,

[1] Note: See Evidence, Appendix 1 page 20 (PAC110).
[2] Note: See Evidence, Appendix 1, page 20 (PAC110).
[3] Note: See Evidence, Appendix 1, page 20 (PAC 110).

[Chairman *Contd]*

explaining the reasons at the time. Can we see the contemporaneous written evidence on the selection of those consultants?[1] Finally, you mentioned a letter of comfort you received from the financing arm of the Bank of America on the financing arrangements. Could we see that letter of comfort, please?[1] If you have it on file, if we could have the judgment from your legal advisers on the value of this letter of comfort to you at the time. Gentlemen, thank you for your time and the evidence you have given.

[1] Note: See Evidence, Appendix 1, page 20 (PAC 110).

[1]Note: See Evidence, Appendix 2, page 25 (PAC 75).

APPENDIX 1

MEMORANDUM FROM THE SCOTTISH OFFICE DEVELOPMENT DEPARTMENT THE SKYE BRIDGE (PAC 97–98/110)

1. This memorandum deals with the points raised by the Chairman at the end of the Committee's hearing on 17 November, when additional information was requested from the Department on four points. It also provides the Committee with information on the agreement between the Secretary of State for Scotland and Skye Bridge Ltd (SBL) on the new discount tolling arrangements, which were announced by the Secretary of State on 11 December.

Contingency arrangements in the Concession Agreement

2. The Department was asked for "a note describing the options [we] considered when negotiating the final deal on the concession arrangement to deal with the prospects of a [traffic] shortfall" (Question 147).

3. The tolling arrangements as finally agreed incorporate two mechanisms designed to protect the concession company. These are an extension of the maximum concession period to 27 years, and a provision for tolls to increase by up to 30% if traffic falls below 1990 levels. In 1991, neither of these provisions was expected to bite. That remains the Department's view and is supported by actual traffic levels in the two years since the crossing opened. The increase in the required net present value (RNPV) between the initial bid and as finally agreed was part of the negotiations with SBL under which the company accepted tolls no higher than 1991 ferry fares—a key Departmental objective—rather than the much higher level in the initial bid, and is not a mechanism to protect the company from a traffic shortfall.

4. It is important to set the identification of options and the negotiation with the preferred bidder in their wider context, and the following paragraphs seek to do this. In addressing the degree of exposure for the company, the options assessed centred on those that provided sufficient comfort to enable the sale of the main element of the debt required to fund the project and thus achieve the toll objectives. These options were set out for Ministers in June 1991 and were:–

(a)to provide additional Government support by increasing the £6 million payment for the approach roads to £9 million (at 1988 prices) from the outset;

(b)to accept toll levels higher than ferry fares at the time of opening;

(c)to agree to allow the toll levels to rise in the event that a sustained fall in traffic from 1990 levels occurred over a three year period from date of opening; toll levels would be permitted to increase in real terms only after 1998 up to a maximum of 30% above existing ferry fare levels sufficient to recover the 1990 position; any such increase would be removed instantly if the cumulative traffic recovered sufficiently;

(d)As with (c) but rather than increasing the toll above inflation, the Government would provide an interest-bearing subordinated loan up to a maximum value of £3 million; again on sufficient recovery of traffic volumes, the loan would be instantly repaid.

5. The option of an agreement with provision for deferred changes in the RNPV or concession life was not separately considered. The concession structure already transferred a very high degree of traffic risk back to the users, by the operation of the RNPV formula, resulting in a weighted average cost of capital which varied very little in response to variation in traffic, and it was not considered appropriate to reduce that variation further by shortening the concession period at high levels of traffic. The exchanges with Miller/Dywidag's advisers gave no indication that there was room to reduce aggregate toll income collected, and hence reduce the cover available to protect lenders in the event of adverse movements in costs, whatever the traffic level.