Cayman Islands

REPORT OF

THE AUDITOR GENERAL

on the

Government Office Accommodation Project's Private Finance Initiative (PFI)

Report 1: Has the Ministry made the project objectives clear?

Cayman Islands Audit Office

October 2003

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TABLE OF CONTENTS

Auditor General's Comments

01. Successive Governments of the Cayman Islands have generally been prudent in their management of public sector borrowing. There has been a long-standing informal rule of thumb that annual debt service cost should be limited to no more than 10% of annual revenues. Indeed this is now mandated in law, and I take this opportunity to underscore my support for the legislature's commitment to the five principles of responsible financial management [1]. Earlier this year the Government refinanced most of its existing public debt with a 15 year US$163 million fixed interest rate bond. This arrangement is beneficial in several respects. It has locked into historically low interest rates and removed the risk of future interest rate rises; matched the period of financing more closely to asset lives; and it has helped to reduce the annual debt service ratio from 8.8% to a projected 6.4% of operating revenues.

02. However, there are upward pressures on the 10% debt service ratio that the Government has to manage. The law measures borrowing limits over the entire public sector, and not just against central government. In the past, the policy preference was for statutory authorities to borrow directly, usually backed by government guarantee, so that long-term debt could be excluded from the Statement of Public Debt – this could be viewed as a forerunner of off balance sheet financing. As a result statutory authorities and government owned companies (e.g. Cayman Airways Ltd) have higher debt levels than core central government. Added to this, new accounting rules that take effect in 2004 will reduce the revenue base because only external revenue can be counted. The Government of the day is facing a number of critical capital investment pressures and choices – the need for improved Government accommodation; for three new schools; for seaport and airport infrastructure, being the major challenges. Given the magnitude of the capital investment required, it is unlikely that all the above projects could be financed within the 10% debt service ratio.

03. When Private Finance Initiative ("PFI") schemes were first introduced in the UK over a decade ago, the objectives were to promote efficiency, to improve services and to stimulate fresh investment. Later the objectives were redefined to provide an opportunity for the private sector to bring a wide range of managerial, commercial and creative skills

[1] The Public Management and Finance Law, 2001, section 14

to the provision of public services.[2] The present interest in PFI in the Cayman Islands is being driven by accounting standards, which offer the opportunity to have the transaction treated as "off balance sheet". In other words, the proposed PFI's will not be counted in the 10% debt service ratio limit. The accounting rules can be complex and it depends how a PFI deal is structured whether it is on or off balance sheet. Often the accounting treatment can only be assessed once the final contract terms are known and agreed. What must not be overlooked in the accounting debate is that a PFI deal commits the purchaser to substantial commitments over a project's life. For example, should the government accommodation project proceed under PFI, the rolled-up cost of building, financing and operating this project could be in the region of CI $250-$275 million. In my professional opinion, the accounting treatment issue is secondary to project affordability, project priority and value for money. I would expect that the final decision to go ahead with a PFI procurement should be on the basis of it being demonstrated as affordable and good value for money.

Wider Issues

04. The Cayman Islands Audit Office supports well thought-out innovation and risk-taking in the provision of public services. We recognise that PFI schemes present an opportunity for benefits but are likely to be much more complex than traditional procurement. Our subsequent work has confirmed that a PFI project usually involves a wide range of issues that need to be carefully thought through if the project is to be successful.

05. I have identified two Government-wide issues that require further work to improve the likelihood that the Government will receive value for money from the Government Office Accommodation Project ("the GOAP") and other PFI projects. Readers of this report should recognise that these issues transcend the responsibilities of the Ministry of Planning and the GOAP PFI scheme.

06. Staffing costs are by far the largest operating expense of central Government, approximately 55% for fiscal 2002. Civil service staffing levels have more than doubled since the early 1990s. I regret to report that there is no Government-wide strategic policy for the future "size and shape" of the public service. In my opinion, this should have been an essential pre-requisite of any long-term accommodation policy, as it could reduce the risk that the GOAP may not align with the future needs of the public service. I

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[2] Smith, C. *Making Sense of the Private Finance Initiative*, 1999

observe that GOAP has factored in a space requirement for a 30% staffing increase over the seven year period 2003 to 2010. This now forms part of the invitation to negotiate (ITN). It should be noted that the growth forecast was developed from information provided by heads of departments and was not part of the Ministry of Planning's project task. I make no direct comment on the affordability or sustainability of further substantial increases in the size of the public sector. Ultimately that is a policy decision. However I am concerned that the (ITN) makes no provision for Government to transfer the risk of excess accommodation to the selected service provider, as I would have expected from my understanding of PFI projects in the UK. In my professional opinion, Cabinet should review the estimate for future GOAP space requirements to ensure that it is consistent with their vision of the future size and shape of the public service.

07. From my overview of the government budget process over these past 11 years, it is evident that the linkages between the Government's strategic policy objectives and capital investment decisions have at best been weak. In hindsight, it is unfortunate that the role of the Public Sector Investment Committee (PSIC) was not encouraged and supported during the early 1990s. It is important that the Government prioritises all capital investments to ensure that priorities are not distorted in favour of those projects that are capable of progressing under PFI. We were not able to identify a formal cross government prioritisation process, that included PFI and non-PFI capital projects, and that included a prioritisation process that rated projects to a predetermined criteria. As an immediate step, we suggest that in future all major capital projects should be referred to the recently reactivated PSIC.

Progress on the PFI GOAP

08. The Ministry of Planning has achieved significant progress on the GOAP within a relatively short period of time.

- Overall the Ministry has dealt professionally and ably with the PFI learning curve. A strong in-house project team has been assembled and the Ministry has hired experienced financial and legal advisors to assist it in its quest to deliver the project. The Ministry also organised an excellent PFI conference earlier this year that was attended by potential PFI proponents as well as civil service managers.

- The Ministry has adopted the UK PFI framework set out as the "Government Accommodation Project – Step by Step Guide" albeit in amended format apparently to accommodate timeline pressures. Provided the framework is

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CAYMAN ISLANDS

followed and complied with, in general terms I am satisfied that it should provide assurance of whether or not the PFI route will deliver value for money.

- The framework at step 4 "Development of User Requirements and Reference Project" should include formal approval of the affordability of the project. As the project scope changes through the later subsequent steps the affordability must be revisited. Ernst & Young's Forecast Annual Costs Report dated 12 September 2003 presents an analysis of the source of funding required to cover the shadow unitary charge. It estimates the additional cost to Government above current expenditures as $5.5 million. In further communication with Ernst & Young it was confirmed that $657,000 for electricity and water would have to be added back for a total unitary charge of approximately $6 million.

- During the course of our review the timetable for the steps and the scope of the project were subject to frequent change.

- The GOAP makes no provision for the Cayman Islands Law School, which will probably require in the region of 5,000 – 6,000 square feet at a site to be decided. On the credit side, so far there has been no formal consideration of future use of the Tower Building site. Timely disposal of this surplus asset post 2006 would help the GOAP to be more affordable. I expect that the public sector comparator will continue to be evolved over the next 4 – 6 months so that all relevant costs are included.

09. I wish to acknowledge and thank all those who assisted and cooperated with my Office to gather the information for this report – the Ministry for Planning, Communications, Works and Information Technology, Public Works Department, Economic Research Unit and Ernst & Young. I would also like to acknowledge the efforts of my own staff in the production of this report.

N K Esdaile
Auditor General
George Town, Grand Cayman
Cayman Islands *31 October 2003*

Executive Summary

Review Purpose and Scope

10. This report, Report 1 is the first of four reports of our review of the GOAP. The four reports are:

- Report 1: Has the Ministry made the project objectives clear?
- Report 2: Has the Ministry applied the proper project management process?
- Report 3: Has the Ministry selected the best available deal?
- Report 4: Was this a good deal?

11. Over four reports the Audit Office will examine the process being followed for PFI and whether the Government is likely to receive value for money from the GOAP.

12. Our review was performed in accordance with the UK's National Audit Office's analytical framework[3] for assessing the value for money issues which are likely to determine how successful a particular PFI contract will be. The entire framework for the four reports is included at Appendix A.

Overall Conclusions

Has the Government selected the best project to pursue?

13. The Government should carry out cross-government prioritisation of capital projects in accordance with criteria that reflect its long-term policy and strategic objectives and ensure that its priorities are not distorted in favour of those projects that are capable of progressing under a PFI initiative.

14. Given that the annual payment (unitary charge) is estimated at CI$8 to $8.5 million, this financial commitment may limit Government's ability to execute other important projects in the future. The Government should select only the highest priority projects, within affordability.

[3] Examining the Value For Money of Deals Under the Private Finance Initiative, National Audit Office, UK HC 739 Session 1998-99, 13 August 1999.

Has the Ministry made the project deliverables clear?

15. The Ministry has conducted a detailed survey of Heads of Departments to identify the future requirement for government accommodation.

16. A Government wide strategic policy for the future size and shape of the public service is required for there to be a proper analysis of accommodation needs and to reduce the risk that the GOAP will not align with the future needs of the public service.

17. The Cabinet should analyse and approve the detailed estimate for the future demand for government accommodation and ensure that the estimate is consistent with its vision of the future size of the public service.

Has the Ministry determined the best form of partnership?

18. The Ministry did consider traditional procurement and the possibility of contracting out for office accommodation through an estimation of lease costs. The Government entering into a joint venture with a private sector firm, and separate contracts for development and operation were not considered.

Has the Ministry prepared an Outline Business Case?

19. The Ministry had a Public Sector Comparator (PSC) and Forecast Annual Costs Report prepared by Ernst and Young.

Accounting Treatment

20. The final accounting treatment can only be assessed once the final contract terms are known and agreed. At this stage the proposed contract terms and in particular the allocation of risk is still developing. As noted in Ernst & Young's letter of 11 April 2003 to the Chairman of the PFI Committee a detailed accounting assessment should be completed shortly before financial close, which is scheduled for April 2004. The accounting treatment of the Office Accommodation Project will be addressed in our Report 3 "Has the Ministry selected the best available deal?"

Summary of Recommendations

Strategic policy for the size and shape of the public service

21. A Government wide strategic policy, for the long-term size and shape of the public service is required to reduce the risk that the GOAP will not align with the future needs of the public service. (page 21)

22. Cabinet should approve the ITN estimate for future staffing and ensure that the estimate is consistent with their vision of the future size and shape of the public service. (page 21)

Affordability Decision

23. The Cabinet should formally approve the Reference Project for affordability at Step 4 "Development of User Requirements and Reference Project" before further resources are committed to PFI projects to confirm that an investment option exists which should be affordable. (page 14)

Assumptions in Financial Models

24. The PFI Steering Committee should review and approve at the detailed level all assumptions in the financial models with particular emphasis on affordability and value for money. (page 15)

Timetables

25. At the time of our interviews in June and July 2003 the Timetable for the procurement was ,"Step 1 Establish the Business Case" June 2002 through to "Step 11 Contract Close and Award" 1 April 2004. As of October 2003 "Step 11 Contract Close and Award" is June 2004. The timetable should be revisited with the project team to ensure that the time allocated is realistic when compared to completed PFI projects. (page 16)

Cross-government Prioritisation of Capital Projects

26. The Government should carry out prioritisation of capital projects in accordance with criteria that reflected their strategic policies, thereby ensuring that its priorities were not distorted in favour of those projects, which were capable of progressing under PFI. (page 19)

Cost Limits

27. The Cabinet should establish cost limits for the services to be procured. The Ministry should have attempted to form a view early in the project of its likely cost and whether it would have sufficient funds to meet this in future years. (page 19)

Evaluation of Innovation

28. The Ministry should make a preliminary assessment of the scope for possible innovation and establish a proper system for the evaluation of any such innovation proposed by bidders. (page 24)

Part 1: Introduction

Private Finance Initiative (PFI)/Public Private Partnership (PPP)

29. The objective of PFI/PPP is to secure improved value for money for the public sector in the procurement of services. One way of achieving this outcome is to apportion risk optimally between the public and private sectors.

30. PFI Principles

- Public sector purchases service not assets
- Public sector specifies service outputs required
- Private sector commonly provides the design, build, operation and possibly finance
- Risks are identified and placed with the party best able to manage
- Private sector is paid according to performance
- Improved value for money

Economic Appraisal of the Proposed Office Accommodation Project

31. Following the draft report of the Economic Research Unit (ERU) titled Economic Appraisal of the Proposed Office Accommodation Project 20 June 2002, it became apparent that Government had to take immediate and proactive steps to formulate a plan to deal with the need for Government office accommodation. The report listed in some detail the problems that existed with the Government Administration Building (GAB) and the Tower Building, as well as documenting the annual amounts that Government is currently paying to rent accommodation for Government office employees.

32. Amongst the problems that were identified with the Government Administration Building and Tower Building were;

- The Tower Building, which was built in 1984, has a very limited remaining useful life due to major structural and mechanical defects. Based on a BCQS report it is anticipated that the cost of renovation of the Tower Building plus adding much needed additional parking space has been estimated to be in the region of $17.2 million, and would take in excess of 12 months to complete.

- In light of these costs the Executive Council made the decision to demolish the Tower Building, once alternative office accommodation is available to house the Government employees.

- The (GAB) was built in 1975 and requires extensive refurbishment to bring it back to an acceptable standard. The structural integrity of the building needs to be brought up to hurricane standards, which means the replacement of external windows and metal banding elements with stronger graded material.

- The ERU report details the amount that Government pays for rented accommodations to house Government employees and statutory authorities. In 2002 the figure was \$3.34 million for annual rentals and \$62,400 for management of leases.

Cabinet

33. As government needed to take affirmative action to address these matters, Cabinet in meeting 83/02 held 13th August 2002, gave approval for the development and implementation of new Government Office Accommodations and applicable infrastructure (i.e. roads and parking) at the Racquet Club site.

34. The strategy policy statement of Government stated that "There would be no more Government Borrowing" so a way needed to be found whereby the GOAP could proceed while at the same time keeping within the guidelines of the Strategic Policy Statement. Based on the foregoing and the experience of the U.K. and other countries the Government decided to pursue the PFI/PPP financing route.

35. On 13th August 2002 Cabinet requested a senior project manager be appointed to Public Works to be the exclusive PFI/PPP project leader. A steering committee chaired by the Honourable Minister for Planning, Communications, Works & Information Technology was established to oversee the project. The first meeting of the committee was held in August 2002.

36. A detailed study was completed to establish the office size requirements to accommodate not only those departments presently in rented premises but also staff in the GAB and Tower Building. This lead to a detailed project definition document, which showed that 180,000 square feet of office accommodations, would be needed.

37. In October 2002 the PFI/PPP Project Manager placed advertisements locally and internationally inviting expressions of interest from developers, who wished to bid on the construction of the project under a PFI/PPP scheme. By the deadline of 6th December 2002 expressions of interest were received from nine groups. The selection committee reviewed the submissions and eight companies were identified as potential bidders. Over the next few months two other bidders withdrew their submissions leaving six groups. After a further selection process the final number of short-listed proponents was four.

38. In March 2003 the Ministry engaged the services of PricewaterhouseCoopers to present a PFI/PPP conference in Grand Cayman. Invitees to this conference included representatives from all the proponents bidding on the contract and it was also well attended by senior Government employees.

Financial and Legal Advisors

39. Between the 17th March and 21st March 2003 interviews were conducted in London for the services of both Financial and Legal advisors.

40. On 28th March 2003 the Central Tenders Committee approved the recommendations based on the interviews to engage the services of Ernst & Young as financial consultants, and Masons as the legal consultants. The contract included terms that should the detailed analysis undertaken by Ernst & Young and Masons reveal that Government could not get "value for money" under a PFI/PPP scheme, when compared to a more traditional finance scheme, then there would be no further obligation to continue the contract. It was planned that Executive Council would at that time be able to consider the best value for money option that is open to Government.

Part 2: Timescales

Government Accommodation Project – Step by Step Guide

41. As with all PFI contracts, time scales are most important, and the Ministry prepared a Step-by-Step PFI Procurement Process. Traditionally UK PFI step-by-step procurement guides have a 15-stage process, however the European Economic Community (EEC) requirements of The Official Journal of the European Community (OJEC) notifications is not required within the Cayman Islands PFI scheme.

42. **Exhibit A** illustrates a comparison of the PFI Procurement Process of the UK Treasury Task Force with the Cayman Islands' GOAP Step by Step Guide.

43. The first stage in the UK Treasury Task Force process is "Establish Business Need". The first step in the CI GOAP is "Establish Business Case".

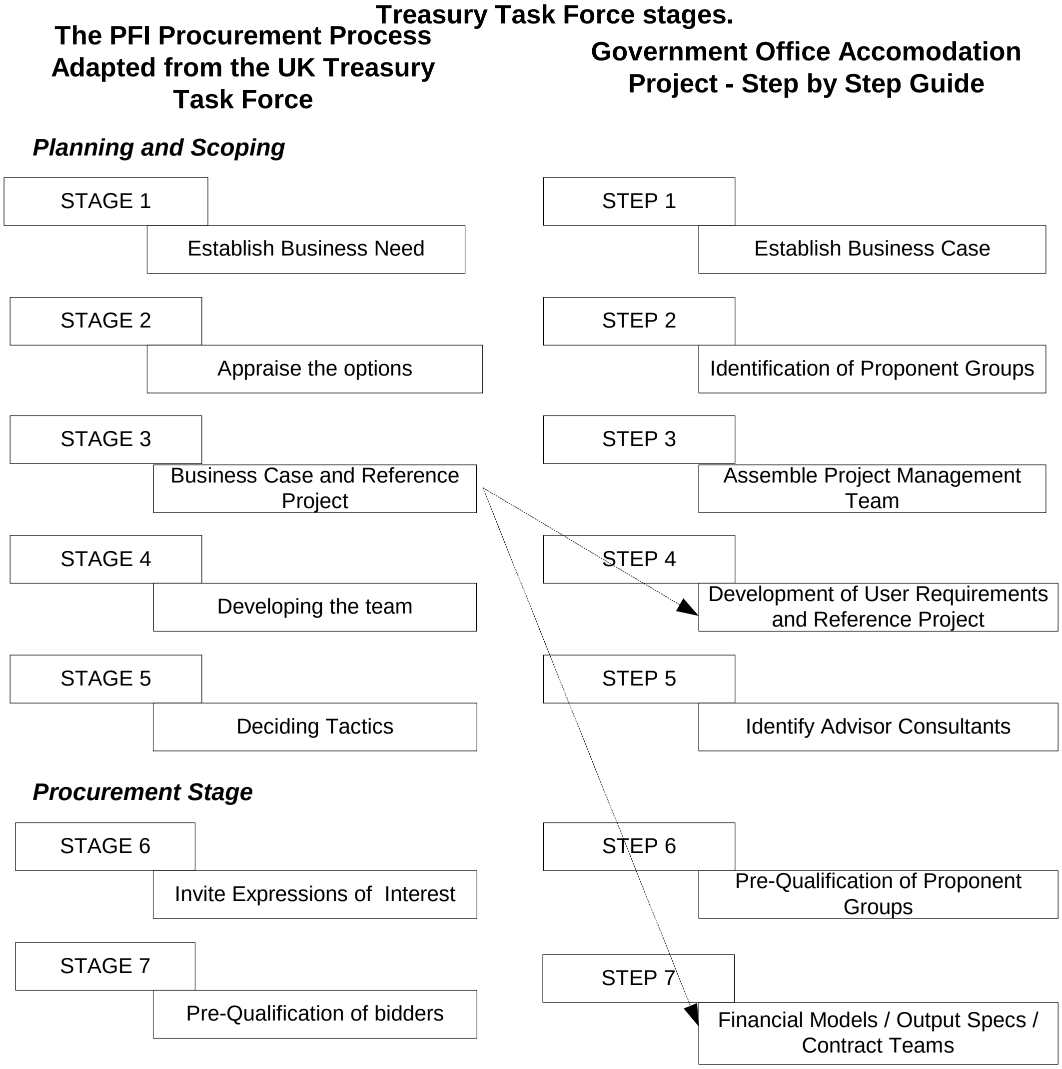
44. The second stage in the UK Treasury Task Force process is "Appraise the Options". At this stage, if the business need is established, a strategic examination identifying and assessing the options should be carried out. The scope of the project should be correctly drawn. It is also important to consider whether the investment is consistent with the Government's Strategic Policy Statement. The Ministry should think about the service it needs to procure and the best means of getting it. Affordability should always be borne in mind.

45. The options to be appraised for the project are limited by not including any consideration of the existing Tower Building site and specifying that the Government office accommodation will be at the Elgin Road property. The tight timeline encourages bidders to follow the possible design for the buildings and car park in the ITN.

46. The second step in the GOAP is "Identification of Proponent Groups". This step was conducted far earlier than in stage 6 of the UK Treasury Task Force model. To conduct this step early was most likely an extremely prudent change because the market for PFI in the Cayman Islands was undeveloped and unknown. It was quite feasible that the project might have required substantial marketing.

47. The third stage in the UK Treasury Task Force process is the "Business Case and Reference Project". If the outcome of "Appraise the Options" is that there is a strong case for investment, which is expected to be cost-effective, then the possibility of a PFI solution should be explored. This requires the preparation of an Outline Business case or equivalent appraisal, involving a clear definition in terms of service delivery of what is being sought: the output specification. The Outline Business case should be a realistic assessment of what is possible and incorporate a Reference Project.

Exhibit A
Comparison between the Government Accomodation Project steps and the UK Treasury Task Force stages.



48. The Reference Project is a possible solution to the output requirement whose purpose is to demonstrate that an investment option exists, which should be affordable. Proceeding beyond this stage without a clear indication that the process will produce an affordable project in the end can lead to wasted time and money. The Reference Project needs to be costed with sufficient reliability that the service appears affordable on a year-by-year basis. This level of reliability requires a comprehensive estimation of whole life costs and an identification of the risks inherent in undertaking the investment.

Affordability Decision

49. The affordability decision examines the financial implications of projects before expending resources on a procurement of accommodation services, which cannot be afforded[4]. In summary:

- the business case establishes need and priority within the strategic context;
- a net present cost is established for the preferred public sector option;
- if the project is affordable on this basis a PFI procurement can proceed;
- if it is unaffordable, need and priority are revisited, the project may be re-engineered to improve affordability or additional resources will be found from other projects or services, and
- if the project is still unaffordable and is not of the highest priority it may be abandoned or put on hold.

50. The fourth step in the Government Office Accommodation Project is "Development of User Requirements and the Reference Project". A BCQS cost estimate, based on the scope of the project at that time, estimated the cost to be $60 million.

51. We have not been able to identify that Cabinet formally decided that the Reference Project was affordable at step 4. If the project were decided affordable at this step the process would proceed. If it was unaffordable, the priority may be revisited, the project may be re-engineered to improve affordability, or additional resources would be found from other projects or services. At this step the Minister approved the project.

52. **Affordability Decision.** Cabinet should formally approved the Reference Project for affordability at Step 4 "Development of User Requirements and Reference Project" before further resources are committed to PFI projects to confirm that an investment option exists which should be affordable.

[4] PFI in Government Accommodation, Private Finance Panel, HM Treasury, p5.

Proceeding with Procurement Steps Concurrently

53. There is substantial benefit in arranging the procurement plan over the shortest practical timescale and to encourage concurrent activity on a number of fronts.[5] This approach focuses the activities of the project team. The approach also requires a level of attention that precludes the sidetracking of key staff into other tasks.

54. In the minutes of the PFI Steering Committee of 2nd April 2003 it was noted that given the tight timetable set by the Minister for the project, certain procurement steps would have to run concurrently, such as the financial analysis, to ensure Affordability and Value for Money were being carried out at the same time as due diligence on the proponents and the preparation of the ITN.

55. Progressing on steps concurrently allowed the project team to continue progress while financial information proved difficult and time consuming to obtain. For example, there was a lack of historical data on the soft facilities management costs of the Tower Building and GAB.

56. The commitment of resources to procurement steps past the point of 'determining affordability'; stage 3 in the Treasury Task Force model; tends to present a risk that the project will develop pressure or momentum to precede because of the resources already expended to date. With affordability held to step 7 in the Government Office Accommodation step by step guide, there is a significant risk that the analysis will be recalculated until it encourages the approval of the project.

57. **Assumptions in Financial Models.** The PFI Steering Committee should review and approve at the detail level all assumptions in the financial models with particular emphasis on affordability and value for money.

Timetable for Procurement Stage

58. The timescale for completing a PFI project will depend on a number of factors, most notably, the size and type of project, the complexity of the project, the resources of the project team, the quality of advisors and the award procedure adopted.

[5] Making Sense of the Private Finance Initiative, Developing Public Private Partnerships, Courtney A Smith p177.

59. The first lesson learned from the experience in the UK on the procurement and implementation of PFI projects[6] is to allow ample time for planning and procurement. It is clear from the timetables from the procurements and implementations studied that a period of at least two years should be allowed for the PFI procurement from the point of agreeing to a strategy to the date of implementation. This is a minimum requirement from experience of a relatively straightforward procurement that received priority at all stages of its existence.

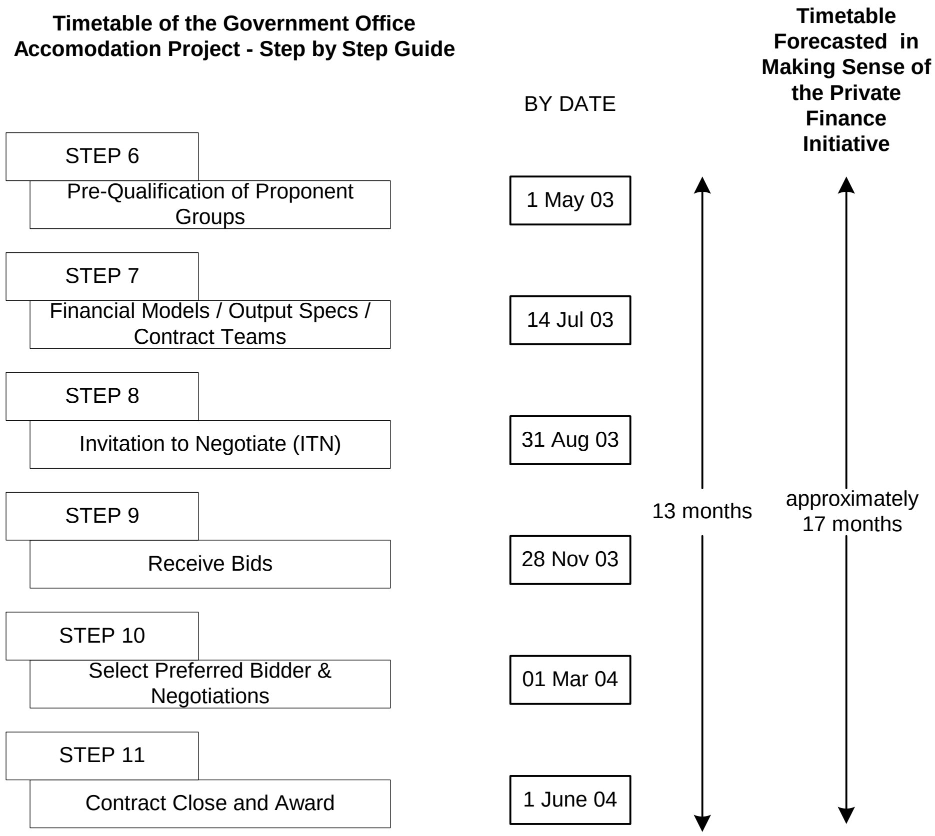
60. The GOAP Step by Step Guide starts with "Step 1 Establish the Business Case" June 2002 through to "Step 11 Contract Close and Award" 1 April 2004. This timetable provides only 20 months rather than the 24 months required. Based on the experience referred to above this timetable appears rushed and may not be realistic.

61. **Timetable Step 1 – 11.** At the time of our interviews in June and July 2003 the Timetable for the procurement was "Step 1 Establish the Business Case" June 2002 through to "Step 11 Contract Close and Award" 1 April 2004. As of October 2003 "Step 11 Contract Close and Award" is June 2004. The timetable should be revisited with the project team to ensure the time allocated is realistic when compared to completed PFI projects.

62. The Ministry has greatly compressed the timeline. The following steps in **Exhibit B** are outlined to take 13 months rather than the approximately 17 set out in the PFI procurement process from the Treasury Task Force.

[6] Making Sense of the Private Finance Initiative, Developing Public Private Partnerships, Courtney A Smith p176.

Exhibit B
Timetable for the Procurement Stage
(Dates as Forecasted in June 2003)



63. **Timetable Step 6 to 11** The Timetable for the procurement steps 6 to step 11 should be revisited with the project team to ensure the time allocated is realistic when compared to completed PFI projects.

Part 3: Issue Analysis

64. The issue analysis framework sets out a series of questions, which should be capable of being answered "yes" or "no". This issue analysis gives us a means of examining PFI deals, which is rigorous, comprehensive and logical. It reflects the issues that arise in most PFI projects although there may of course be additional issues, which may be relevant to certain individual projects.

Has the Government selected the best project to pursue?

Has the Government prioritised their projects and selected only top priority projects?

65. A PFI contract can commit the Government to payments for services over a substantial number of years. The Government should identify a clear need for the services eventually procured as part of their strategic planning process. Since it is possible that such planning would identify many potential projects, not all of which could be met from the Government's resources. The Government should carry out any such prioritisation in accordance with criteria that reflected its policy objectives and overall business strategy, thereby ensuring that its priorities were not distorted in favour of those projects, which were capable of progressing under the PFI. The Government should then have selected only the top priority projects for implementation.

66. In the Strategic Policy Statement for the financial year ending 30 June 2004 in the section 2. Outcome Goals and Strategic Priorities there are Key New Policy Initiatives. Under Broad Outcome Goal 8 "Open, efficient and accountable Government" there is Construction of the new Government Administration building using a Private Finance Initiative (PFI).

67. In the Budget Address 2003/4 "Charting Our Course For The Future" delivered to the Legislative Assembly on 17 June 2003, in the Strategies and Key Policy Actions: Improving Government Performance, it states "The Government is continuing to advance the construction of a new Government accommodation building. The Budget includes $800,000 to cover legal and consulting costs related to the development of the Public Finance Initiative specification and contract for the building."

68. Included in the ERU report Economic Appraisal of the Proposed Office Accommodation Project 20th June 2002 there is included under the sub-title Prioritisation of Projects "*The Office Accommodation Project must be placed within the context of a broader economic plan. This means that there must be a process by which projects are prioritised within a Public Sector Investment Programme in order to achieve broader strategic objectives with the available resources. This point cannot be over-emphasised,* *given the potential size of this project, which may limit Government's ability to execute other important projects in the future."*

69. After a lapse of several years the Public Sector Investment Committee (PSIC) resumed its work in March 2002. Prior to the setting up of the PSIC, the Ministry of Planning, Communications Works & Information Technology had asked the ERU to undertake an economic evaluation of options for the office accommodation project. The ERU used background material from the project to illustrate the framework for project appraisal to the PSIC. The presentation made on 27 March 2002 had the participation of the Permanent Secretary and Assistant Secretary of the Ministry. The PSIC Annual Report noted that the office accommodation project highlighted the importance of two key areas in project preparation. Firstly the identification of the core problem and evidence to support its existence and secondly an assessment of all feasible options to address the core problem.

70. **Cross-government Prioritisation of Capital Projects.** We were not able to identify in Government any formal documented prioritisation process for top projects that included a prioritisation process that rated projects to criteria that reflected the Government's strategic policy.

71. **Cost Limits.** The Cabinet should establish cost limits for the services to be procured. The Ministry should have attempted to form a view early in the project of its likely cost and whether they would have sufficient funds to meet the financial commitment in future years.

Has the Ministry made the project deliverables clear?

Has the Ministry expressed the results they desired in output terms?

72. It is important for the successful delivery of any project that the Government state its requirements clearly from the start. At these early stages it is not usually necessary for these requirements to be specified in detail. However the Ministry should have formally established objectives for the project.

73. The Ministry prepared an analysis of its needs in the report "Valuation and Technical Analysis Relative to the Feasibility of Government's Office Project March 2002". Also a Project Manager from the Public Works Department went to every department and worked out the space allocation.

74. The Ministry of Planning prepared a Briefing Document outlining a Government Office Accommodation Project described as 180,000 square feet of office and office related accommodation, car parking for 800 cars and the widening and upgrading of approximately three miles of access roadways. The preliminary construction budget was identified at approximately CI $60 million.

75. The Briefing Document states the project is required because the Government Financial and Administrative functions are located in the Tower Building, the GAB, and in several locations in private sector rental properties scattered throughout George Town.

76. The Tower Building has technical problems beyond economic renovation. The rental costs in the private sector are high and subject to increase. The GAB is overcrowded and in need of total renovation. There are also security issues with the present locations including concerns with regard to ease of intrusion and poor hurricane resistance. The new Office Accommodation will consolidate the Governments Administration and Financial Services in one secure location.

77. The briefing document states that after embarking on various feasibility studies and considering alternatives the Government has decided on a Design, Build, Operate and Finance (DBOF) delivery using the Private Finance Initiative procedures.

78. Government officials have prepared a feasibility study including project costs however, they recognize further and more detailed study will have to be carried out with regard to the risks and economics of the project.

79. Having identified its needs, the Ministry should then have specified these needs in terms of deliverables. One of the ways in which the PFI can achieve better value for money than traditional procurement is that it offers the private sector scope to offer innovation in service delivery.

80. The Ministry considers that the June 2002 report of the Economic Research Unit (ERU) made it apparent that Government had to take immediate and proactive steps to formulate a plan to deal with the need for additional office accommodations. The report listed in some detail the problems that existed with both the Government owned office accommodations, (GAB and the Tower Building), as well as documenting the large annual amounts that Government is currently paying to rent accommodation for Government office employees.

81. The ERU report Economic Appraisal of the Proposed Office Accommodation Project 20th June 2002, notes under the sub-title Future Size and Growth of Civil Service *"Any decision on the course of action must consider, whether the future demand for space is estimated accurately. This is particularly important if there are any policy decisions to be undertaken regarding the size of the service."*

82. The ERU report states that in recent years the civil service has grown at unprecedented rates, largely due to the creation and expansion of existing services. For example between 1995-2000, the civil service grew on average by 6.6 percent per year to a total of 4,046 employees in 2000. This growth decreased in 2001 and 2002 as a result of the following measures: moratorium on established posts; release of returning graduates; and overall expenditure reductions. In a schedule titled "Department List with Staffing, existing and projected" included in the ITN, the staffing level goes from 828 in 2003 to 1,080 in 2010, a growth of 30% over a 7 year period. In volume 3 page 17 item 2.9.8, there is no specific provision that permits the government to reduce the space and unitary charge in future years.

83. **Strategic Policy for the Size and Shape of the Public Service.** A Government wide strategic policy for the long-term size and shape of the public service is required to reduce the risk that the Government Office Accommodation Project will not align with the future needs of the public service.

84. Cabinet should approve the ITN estimate for future demand for space and ensure that the estimate is consistent with their vision of the future size and shape of the public service.

Has the Ministry made a preliminary assessment of the private sector's capabilities for delivering their requirements?

85. The Ministry thoroughly considered the private sector's capabilities. The Ministry initiated early soundings of the market to gain a better understanding of the terms in which the private sector would best understand the Government's requirements and the help that the private sector would need to gain such an understanding.

86. In October 2002 the PFI/PPP Project Manager placed advertisements locally and internationally inviting expressions of interest from developers, who may wish to bid on the construction of the project under a PFI/PPP scheme. Initially they received expressions of interest from nine groups by 6th December 2002, which was the deadline for submissions of those expressions of interest. The selection committee reviewed the submissions and eight companies were identified as potential bidders. Over the next few months two bidders withdrew their submissions leaving six groups.

87. The selections committee reviewed the submissions, and a scoring system was established to review the submissions, with weighting being given to local groups.

88. In March 2003 the Ministry engaged the services of PricewaterhouseCoopers to present a PFI/PPP conference in Grand Cayman. Invitees to this conference included representatives from the private sector bidding on the contract.

Has the Ministry made a preliminary evaluation of the benefits that they sought?

89. A Selection Committee was formed on the instructions of the Accommodation Steering Committee to review the proponents. An assessment system with an objective scoring system was constructed by the Selection Committee who assessed the Groups on the information provided including technical ability and financial capability and identified a short list of 3 proponents. The Selection Committee then passed the information on the Proponents Groups to their financial and legal consultants Ernst and Young and Masons to carry out their due diligence. Ernst & Young and Masons confirmed the Committee's selection but proposed a fourth bidder. The Selection Committee considered this addition and confirmed the Consultants recommendation.

Has the Ministry assessed the weight to be attached to policy imperatives?

90. Policy imperatives are objectives, which need to be built into projects in order to ensure that the requirements of Government policy are met.

91. The Ministry, when planning the project, did not have a formal process for identifying and weighting the Government's policy objectives.

Has the Ministry determined the best form of partnership?

Has the Ministry identified a feasible project mechanism?

92. The Ministry should have examined the possible use of a range of alternative project mechanisms before they selected procurement using the PFI. The various mechanisms that could be expected to be considered are:

- Contracting Out
- Private finance initiative
- Joint ventures
- Traditional procurement
- Separate contracts for construction, development, and operation.

93. Of the above mechanisms the Ministry did consider traditional procurement in step 4 "Development of User Requirements and Reference Project". Also contracting out for office accommodation was estimated for leases. Joint ventures with the private sector and separate contracts for construction, development and operation were not considered.

Has the Ministry identified the room for innovation in advance?

94. One of the main ways in which the PFI can offer better value for money than traditional procurement is that it provides the private sector scope to offer innovation in service delivery.

95. In the PFI Steering Committee minutes of 7 May 2003 the following was included, *"It was noted that although the Public Works Architects had created a reference scheme it was proposed in the ITN that encouragement would be given to the private groups to be innovative in all aspects of design, construction and operation to give the best value for money to Government."*

96. The Ministry determined that the new building would be on the Elgin Avenue property and the project would include a multi-story car park and road works and land acquisition. The minutes of the PFI Steering Committee noted that selling the Tower Building and land was not at this time being factored into the project. The refurbishment of the GAB was to form part of the project. Later it was decided to leave refurbishment or demolition of the GAB to the bidders.

97. **Evaluation of Innovation.** The Ministry should make a preliminary assessment of the scope for possible innovation and establish a proper system for the evaluation of any such innovation proposed by bidders.

Has the Ministry identified the scope for risk transfer in advance?

98. Appropriate risk allocation between the public and private sectors is a key requirement for achieving value for money on PFI projects. Without risk transfer the private sector receive the benefit of a secure income stream, but may set their charges at a level which earns them a return far higher than is available on such a security. If the Ministry tries to transfer a risk that the private sector cannot manage, then value for money will reduce as the private sector seeks to charge a premium for accepting such risks.

99. The Ministry should therefore have sought to achieve not the maximum but rather the optimum transfer of risk, which allocated individual risk to those best placed to manage them.

100. The financial advisors Ernst & Young utilised a Risk Analysis model written in Microsoft Access. The model started with over 90 risks which Ernst & Young and the Project Manager and CFO for the Ministry paired down to approximately 33 risks that were relevant to the GOAP. The Risk Analysis model categorises the risks and for each risk estimates the risk retained by the Government under the Public Sector Comparator (PSC) as versus under the PFI initiative and the length of time there is exposure to the risk. Then the associated driver for the risk is identified and the impact and probability in a best, medium and worst case scenario. The dollar value of the risk at a discount rate of 6% is identified and the expected value of the risk per annum along with the net present value (NPV) under PFI, PSC and the dollar value transferred.

101. The Ministry identified at step 7 Financial Models / Output Specs / Contract Terms the risks associated with the project and the scope for its transfer to the private sector. The Ministry did not conduct any initial soundings of the market to identify what risk transfer the private sector were likely to accept.

Has the Ministry established the likelihood of a project that was affordable and offered value for money?

102. The Ministry contracted with the financial advisors, Ernst & Young for the preparation of the PSC and the Affordability Analysis. *"The PSC may be defined as a hypothetical risk-adjusted costing, by the public sector as supplier, to an output specification produced as part of a PFI procurement exercise"*[7] Ernst & Young is preparing the PSC based on the conventional public sector method of procurement whereby the Government raises the finance for the capital costs of the project, the construction and refurbishment work is put out to competitive tender, and the required facilities management services procured directly at the end of construction.

103. Ernst & Young have included the following input costs:

- Design and construction costs of the office accommodation, multi-story car park, land acquisition and highway improvement works;
- Lifecycle replacement costs so as to achieve the output specification for the project over the concession period, e.g. Replacement of air conditioning units;
- Facilities management costs e.g. electrical installation (hard facilities management) and janitorial services (soft facilities management).

104. In Ernst & Young's PSC also takes into account the procurement costs and the risk that additional costs may arise, which under PFI would fall to the private sector rather than the Government. A discounted cash flow of the estimated total cost of the project is calculated using a real discount rate of 6% and deflating the nominal costs by the assumed consumer price index to express the expected cost of the PSC in NPV terms over the life of the project.

105. In determining the value for money the PSC is compared against the expected total unitary charge payments that the Government would make to the private sector under the PFI option over the concession period in NPV terms to assess which approach is better value for money. The Ernst & Young analysis estimated that the PFI scheme is $1.3 million less expensive than traditional delivery over a 30 year term.

[7] Treasury Task force guidance How to Construct a Public Sector Comparator (Technical Note No. 5)

106. The purpose of Ernst & Young's Affordability Analysis dated 30 June 2003 Draft 2.0 was to set out the initial assessment of the affordability position of the project. This document was renamed in the 12 September 2003 Draft 3.0 version to Forecast Annual Costs Report and its purpose changed to "set out the initial assessment of the forecast annual costs of the office accommodation project". The draft at this point in the section Financial Implications sets out that the project will cost Government an additional circa $5.5 million. Further correspondence with Ernst & Young on 8 October 2003 raised the estimate to $6.0 million.

107. Cabinet should formally approve the affordability.

Has the Ministry prepared an Outline Business Case?

108. The Ministry contracted with the financial advisors, Ernst & Young for the preparation of the PSC and the Forecast Annual Costs Report (FAC). A draft PSC report was presented on 1 July 2003 and it was subsequently revised on 5 September 2003. A draft FAC report was presented on 12th September 2003.

109. The Public Sector Comparator may be defined as a hypothetical risk-adjusted costing, by the public sector as supplier, to an output specification produced as part of a PFI procurement exercise.[8]

110. The Forecast Annual Costs Report simulates the methodology a private sector bidder would use to develop the unitary charge for the provision of serviced accommodation over the concession period.[9]

111. In the second draft the scope of the project was amended with the removal of the Road Works and Land Acquisition cost of CI$6.1 million. The Public Works Department will require funding for this phase of work.

112. There were reductions in Lifecycle Replacement Costs, which included engineering services repairs and replacements cost for the new building decreased by

[8] Ernst & Young Public Sector Comparator, September 05, 2003

[9] Ernst & Young Forecast Annual Cost Report, September 12, 2003

CI$9.2 million (57%) and total lifecycle replacement cost for the new building decreased by CI$15.68 million and increased by CI$619,000 for the Glass House.

113. The annual cost for Planned Preventative Maintenance and Emergency Repairs for the New Office Building has increased by CI$126,000 (153%), and has increased by CI$30,000 (176%) for the GAB. The increase of these annual costs for Planned Preventative Maintenance and Emergency Repairs results in a total increase in Hard Facilities Management Cost of CI$6.1 million over the life of the project.

114. There were reductions in Facilities Management Costs that included the annual energy and utilities cost for the new building and GAB (CI$1.334 million & CI$336,000 respectively). The exclusion of these annual costs for energy and utilities results in a total reduction in Soft Facilities Management Cost of CI$97 million over the life of the project. These cost were excluded from the PSC on the premise that Government would be responsible for the energy and utility costs.

115. The Chairman of the PFI steering committee stated that the initial Quantity Surveyor reports on lifecycle costs, etc were prepared by a UK based firm as there was no one in Cayman qualified, who was not aligned with a proponent company. The initial Quantity Surveyor’s report was carefully analysed by the government’s PFI project team and Ernst & Young, after which a number of changes were made to the submitted costs to bring the estimates more in line with reality.

116. The FAC Report prepared by Ernst and Young is only indicative of the final unitary charge. The final unitary charge will be determined through negotiations with the preferred bidder on the project. The bidder’s costs, financial package and perceptions of risk will dictate the final unitary charge.

117. The financial implication section of the FAC Report presents an analysis of the source of funding required to cover the shadow unitary charge. The analysis shows that the funding available for the project would be partially sourced through savings from rental accommodation (CI$1.3million), life cycle cost (CI$651,000) and facilities management expenditures and insurance (CI$1.15million). The most significant amount comprising energy cost facilities management expenditure is electricity cost (CI$623,000). This amount relates to the savings from energy cost currently being incurred for the GAB and Tower Building. There is however no factoring of the electricity cost that will be saved from the termination of leased premises.

118. The inclusion of the electricity cost in the source of funding analysis suggest that the cost currently being incurred will be saved as they are provided for in the unitary charge. However as mentioned above, the energy and utility cost that was previously included in the original PSC report (CI$1.67million/ annum) was removed from the revised PSC, suggesting that this cost would be retained by Government. If the private entity is responsible, the energy and utility cost should be included in the PSC, thereby impacting the shadow unitary charge. If Government is responsible, the amount being included in the source of funding analysis as a saving is incorrectly presented, as Government would need to source additional funds annually to cover the increased utility cost.

Part 4: Ministry Response

119. A draft report was presented to the Ministry of Planning, Communications, Works and Information Technology on 10 October 2003. A response was received from the Chairman of the PFI steering committee, and the relevant sections of the report were amended to reflect these comments.

120. The Audit office held a briefing meeting with the Honorable Minister, The Permanent Secretary and the Senior Assistant Secretary for the Ministry on 27th October 2003 to discuss and confirm factual information presented in the report. The Ministry did not wish to submit a substantive response for inclusion.

Appendix A

Cayman Islands Audit Office Methodology

121. The Cayman Islands Audit Office examined the Government Office Accommodation Project in accordance with the audit framework of the NAO as outlined in “Examining the value of money of deals under the Private Finance Initiative” [13 August 1999].

122. The framework employs a technique known as Issue Analysis to determine a detailed approach to the review. This technique is designed to structure issues in a clear, logical and hierarchical fashion, based on the principle that identified issues should be collectively exhaustive and mutually exclusive.

Report 1

1. Make the project objectives clear (Top management)

- 1.1. Select the best project to pursue
  - 1.1.1. Prioritise projects
  - 1.1.2. Select only top priority projects
- 1.2. Make the project deliverables clear
  - 1.2.1. Express the results desired in output terms
  - 1.2.2. Assess private sector capabilities
  - 1.2.3. Make preliminary evaluation of the benefits sought
  - 1.2.4. Assess the weight to be attached to policy imperatives
- 1.3. Determine best form of partnership
  - 1.3.1. Identify feasible project mechanism
  - 1.3.2. Identify room for innovation in advance
  - 1.3.3. Identify the scope for risk transfer in advance
  - 1.3.4. Establish likelihood of a VFM affordable project
- 1.4. Produce an outline business case
  - 1.4.1. Objectives
  - 1.4.2. Option appraisal
  - 1.4.3. Project timetable
  - 1.4.4. Evaluation criteria
  - 1.4.5. Commitment

Report 2

2. Apply the proper processes (Project management)

- 2.1. Plan procurement thoroughly
  - 2.1.1. Assemble a properly qualified project team in good time
  - 2.1.2. Investigate the market
  - 2.1.3. Identify likely contract issues
  - 2.1.4. Prepare a tendering strategy and timetable
  - 2.1.5. Prepare a credible project timetable
  - 2.1.6. Prepare a public sector comparator if required

- 2.2. Establish conditions for a successful competition
  - 2.2.1. Create a good tender list
  - 2.2.2. Create a good specification of requirements
  - 2.2.3. Maintain competitive tension to final contract

- 2.3. Regularly reassess that project is worthwhile

- 2.4. Control costs
  - 2.4.1. Set realistic budgets
  - 2.4.2. Appoint advisors after competition
  - 2.4.3. Monitor and manage costs

Report 3

3. Select the best available deal (Bid quality)

- 3.1. Ensure that a good range of solutions was put forward
  - 3.1.1. Design variants
  - 3.1.2. Operational variants
  - 3.1.3. Financing variants
  - 3.1.4. Deliverable variants
  - 3.1.5. Risk transfer variants
- 3.2. Evaluate elements of the bid
  - 3.2.1. Financial
  - 3.2.2. Risk transfer
  - 3.2.3. Financial stability of bidder
  - 3.2.4. Quality of Service
- 3.3. Select the most economically advantageous bid
  - 3.3.1. Cost
  - 3.3.2. Bidder track record
  - 3.3.3. Design features
  - 3.3.4. Operational features
  - 3.3.5. Impact of risk
- 3.4. Manage differences between the winning bid and contract award
  - 3.4.1. Financial
  - 3.4.2. Design deviations
  - 3.4.3. Operational deviations

3.4.4. Deliverables
3.4.5. Risk allocation
3.4.6. Sanctions

Report 4

4. Challenge: Make sure that the deal makes sense (Top management review)

4.1. Does it and will it meet the objectives?
4.1.1. Original Objectives?
4.1.2. Fit with latest circumstances?

4.2. Were alternatives evaluated and fairly eliminated?
4.2.1. Were all reasonable alternatives examined?
4.2.2. Was it the most economically advantageous solution?
4.2.3. Was there a clear overview confirming the desirability of proceeding with the "best deal"?

4.3. Will the contract ensure delivery of the service over the contract life?
4.3.1. Does the contract reflect the deal that has been negotiated?
4.3.2. Are there adequate arrangements to manage the contract?
4.3.3. Are termination handover arrangements clearly specified?
4.3.4. Are there appropriate sanctions / bonuses?
4.3.5. Are there appropriate provisions for dealing with changing requirements?

4.4. Is the deal affordable in the short term and long term?
4.4.1. Are there sources for capital funds?
4.4.2. Are there sources for ongoing payments?