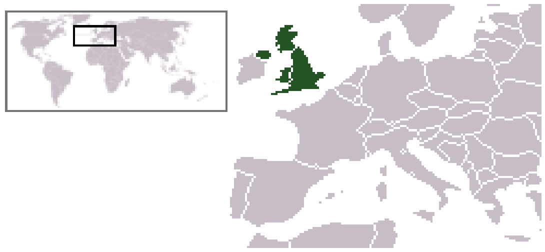
UK Project Management Round Up



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INTRODUCTION

As the euphoria of the summer of sport wanes, business in UK is getting back to normal. While there is plenty to discuss on the success of the Olympics and the role project, programme and portfolio management played, the major stories now concern procurement and related processes. Traditionally, Government procurement, especially in Defence, has been a focus for criticism even though it is rather like shooting fish in barrels. However the whole process of Government procurement has become the focus of serious concern. Beyond procurement troubles, there are also major problems facing the construction of new nuclear plants and the progress of a major merger is under threat. So this month the focus of this report is on the West Coast Mainline Franchise, new nuclear contracts and the BAE/EADS merger.

RAIL FRANCHISE BID PROBLEMS

Last month the results of the bidding battle between First Group, who run rail routes in the west of England, and Sir Richard Branson's Virgin Group for the right to operate the lucrative West Coast Mainline franchise were announced. Predictably, Branson complained bitterly that the contest was not fair, citing what he saw as biases that led to significant advantages to First Group. In response, First Group stated that the bid conditions had been established 2 years ago and had not been challenged.

Just as the public was getting used to the idea of new operators running the franchise, the Transport Secretary has announced that the whole bid process is flawed and the contest will be re-run. Furthermore, the process cost bidders as much as £15 million each to contest and the Government will refund this to all bidders.

The franchise is for the right to operate the West Coast Mainline for 15 years. The duration of the franchise has been a bone of contention for years because there are powerful arguments for awarding longer term contracts, mainly so that any successful bidder has an incentive to invest significantly in rolling stock and other infrastructure needed to improve safety, reduce journey times and increase passenger carrying capacity.

However, long contract durations require accurate forecasting of passenger numbers and costs for the period in question. Most project managers know that all cost estimates require careful assessments of the underlying assumptions; in this case, bidders would need to make assumptions concerning the growth of passenger numbers and growth in passenger numbers of a significantly longer period than most financial models operate. As **Robert Peston**, the BBC's finance Editor noted, 'a healthy scepticism needs to be attached to forecasts of the health of the economy and of the relevant public service over a time period as long as three parliaments.' Without such scepticism, the government would tend to demand too little in the way of guaranteed money for taxpayers from bidders who are particularly optimistic about long-term prospects. In other words, risk appetite was a key factor that was ignored. Some would also think that the basics of Cost Benefit Analysis were also ignored.

Critics might also feel that any errors in assumptions would become more significant towards the back end of the franchise period so that would make the financial model unreliable. Virgin's case, and one that they took to court, was that the effect was to make First Group's bid seem significantly more attractive, because First Group took a much more optimistic view of passengers and revenues growth after 2021 than did Virgin.

Claims that the Department of Transport unfairly discriminated against the incumbent, Virgin, by attaching far too great a probability to the projections by the rival bidder First Group seem unreasonable. The decision may have lacked some logic but that alone seems poor grounds for deciding that one bidder was unfairly treated. More pertinent is that the government demanded too little guaranteed money for taxpayers from the winning bidder. The complaint that the Department insisted on contract award according to its published schedule is also difficult to sustain. Virgin has been complaining about the flaws in the bidding process since it lost the franchise but that was only to be expected. The process was only halted after Virgin demanded a judicial review that the Department was forced to investigate its assessment method and then to acknowledge that their model has serious shortcomings.

Currently, three department officials have been suspended and heads may roll. Many would expect more senior heads to be on the block, in particular of the permanent secretary, **Philip Rutnam**, and the previous transport secretary, Justine Greening, who left office last month in a Cabinet reshuffle, to explain how they came so close to awarding a contract worth around £5bn on such a flawed basis.

In awarding any contract to run a public service, such as a railway, or procure other items such as rolling stock, a balance must be struck between making the contract long enough to encourage necessary investment and yet short enough so that the forecasts built into bids for the contract remain valid. There are already demands for all sorts of procurement decisions to be reviewed and for many to be reversed.

NEW NUCLEAR PROJECTs

Photo courtesy Daily Telegraph

Energy supply in UK has faced major problems with aging reactors and coal power plants due to come off line in the near future, leaving a huge energy gap to be filled. New energy generating methods such as wind, wave and other renewable have yet to scale up to meet demand and have attracted comparatively little investment. It had been hoped that new nuclear reactors could meet demand.

The whole new nuclear effort is facing problems. The Government had planned for up to 12 new reactors, but rising costs and a lack of overseas investment are likely to mean that the scale of new projects is reduced. It is currently expected that 6 reactors will be built.

The Horizon project is to build new nuclear reactors at Wylfa in Anglesey and Oldbury, in Gloucestershire. The project is owned by German energy giants, E.ON and RWE. Following the Fukushima disaster in Japan last year the project has been under review, partly on political grounds in Germany after politicians in Berlin decided to scrap domestic nuclear power production. As a result, the project was put up for sale in March.

Implementation bids were required to be placed at the end of September. A Franco-Chinese consortium failed to make a bid for the multibillion-pound project before the final deadline, leaving the consortium led by Toshiba and a rival Japanese offer from Hitachi in the running. According to *The Times* Toshiba-Westinghouse is seeking to quit the nuclear industry altogether and is struggling to raise finance for the joint venture.

The Horizon project is economically important to the Government as about 20,000 jobs would be created if it goes ahead. However, worries about price and construction costs have dogged the programme. Horizon was to have built six reactors in Gloucestershire and Anglesey but its German owners, RWE and Eon, put it up for sale.

The Horizon venture is less well advanced than EDF Energy's £14 billion project to build two reactors at Hinkley Point in Somerset. The French group has promised to decide by the end of 2012 whether to build what would be Britain's first new reactors for decades. The decision is likely to be heavily influenced by the availability of generous government subsidies. The new owners of Horizon may not make a final investment decision on whether to go ahead and build reactors on their sites until 2015.

Late last month it was announced that a Franco-Chinese consortium did not bid for the Horizon, leaving the consortium led by Toshiba and a rival Japanese offer from Hitachi in the running. According to The Times Toshiba-Westinghouse is looking to quit the nuclear industry altogether and has not been able to raise finance for the joint venture.

The Toshiba Consortium problems leave the remaining group, Hitachi and SNC-Lavalin, the Canadian engineering group, as the front-runner. However, Hitachi's reactor design has not been assessed by British regulators and could take up to four years to gain approval. It was noted that SNC-Lavalin is under investigation police in Canada and Switzerland over $56 million of payments allegedly made to agents for construction contracts that did not exist.

There is considerable interest in China regarding investment in UK's new nuclear programme. The Chinese state-controlled group, State Nuclear Power Technology Corporation (SNPTC), which had formed part of the Toshiba-led consortium with Exelon, the US generation company, had committed to provide almost half of the costs of the project but recently pulled out.

The unexpected withdrawal last week of a third consortium, formed by France's Areva and Guangdong Nuclear Power Corporation, a rival Chinese state-controlled group seems to have influenced SNPTC's exit. According to *the Times,* Guangdong would prefer to buy a 20 per cent stake in EDF Energy's £14 billion Hinkley Point project in Somerset and is making negotiations with the French company a priority while Areva believes it would be overstretched by being involved in two new-build programmes. Areva and Guandong are also reported to have also fallen out over a similar venture to build new reactors in China.

The outlook is looking bleak from the UK Government perspective and concern has been expressed in Union circles, too. Mike Graham, national secretary of Prospect, the largest union in the British nuclear industry, said: "We have reached a critical three-week period for the future of the UK's nuclear new-build ambitions. We can only hope for early contract closure on the sale of Horizon to ensure that the momentum behind the UK's plans for a new fleet of nuclear power plants does not get lost. "The Horizon venture still has the potential to be a major contributor to achieving a secure low-carbon energy supply for the future."

BAE /EADS MERGER

This merger would marry BAE's defence industry prowess with EADS-subsidiary Airbus' passenger jets to create a defence and aerospace giant to rival Boeing of the US. Despite the financial issues faced by the two firms, the merger is not simply aimed at cutting costs and employee numbers, according to recent statements by the two companies' bosses.

The merger would also achieve the union of the French, German and British defence industries that was originally mooted as long ago as the 1990s. However, many obstacles have emerged since the plan was leaked to the press in mid-September. At governmental level, the French and German governments have become involved while the UK parliament has announced a review. Shareholders, too, have raised concerns.


Photo courtesy Flightglobal

It has also been reported that Downing Street has threatened to veto. Opposition is also likely in US as any challenge to their contractors have elicited legal and commercial challenge in the past.

The different players have widely differing commercial reasons for the merger. BAE seem to be attempting to lessen the impact of the current massive squeeze by the UK and US on defence spending. They may also be seeking to help EADS to improve the profit margins on its own smaller defence business and secure access to the billions of euros in EADS's coffers (the combined group would have €18bn net cash, according to reports) for deployment in research and development.

EADS, seem to be seeking to de-politicise the company - by getting the German and French governments to end their control over the company and behave like normal investors.

Opponents of the merger fear a sprawling, complicated and bureaucratic global monster will be created. Political interference by profit-destroying French and German ministers is seen as a major weakness and sharing British intellectual property with competitor economies is seen as a threat to UK jobs, while Britain's defence would become dangerously dependent on overseas suppliers.

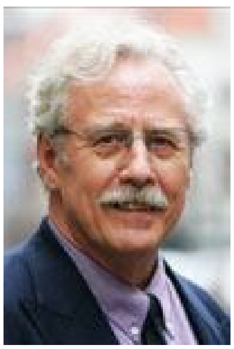
In the perception of Robert Peston, the BBC Economics Editor, it is impossible to adjudicate definitively between these views, because much depends on whether the French and German governments are ultimately prepared to let EADS/BAE evolve into as normal a commercial business as is possible for a company in defence and thus dependent on government contracts. He believes the outlook is finely balanced. The French and German governments seem prepared to abandon their formal agreements that give them direct control over EADS. But their insistence on shareholdings of at least 9% each in the enlarged group, and perhaps more, speaks to a reluctance to let go.

Observers believe that if France and Germany are not prepared to give the new company its freedom, the US government, which is BAE's biggest customer and would also be the biggest customer of EADS/BAE, would block the merger by making it clear that it would no longer be prepared to award sensitive contracts to the new company.

Conclusion

The news has been dominated by major commercial issues that affect projects, programmes and portfolios. It is disappointing that such basic errors as estimation evaluation and risk appetite have been ignored. Similarly, the bid process for new nuclear is bedeviled by escalating costs and consequent withdrawal of bidders. The outcome of the BAE and EADS merger will be of considerable interest to contractors as well as project managers at many levels.

ABOUT THE AUTHOR



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