

EXECUTIVE COUNCIL

RESTRICTED

Title of Report: Review of Partnering with Morrisons

Paper No: 162/09

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Report of: Director of Public Works

1.0 Purpose

- 1.1 To review and comment upon the performance of the partnering arrangement between Morrisons and Falkland Islands Government.

2.0 Recommendations

- 2.1 It appears appropriate at this stage to continue with commissioning major capital works through MFL subject to a review being undertaken of both performance during 2009/10 and work projections for 2010/11 onwards.
- 2.2 A further report will be required, in due course, on the sustainability of MFL's core team costs in the light of the currently projected capital programme.
- 2.3 A further report will be prepared in March 2010, once it is clearer what the future programme of works from 2010/11 onwards may be.

3.0 Summary of Financial Implications

- 3.1 There are no specific financial implications, the report is an information paper:

4.0 Background

- 4.1 The "Morrisons Partnering Agreement" followed an Executive Council consideration in 1999 of previous difficulties with major construction companies. The report at the time identified difficulties in procuring capital works:-
 - 4.2 inability to attract sufficient interest at tender stage
 - 4.3 inflated and non-compliant tenders
 - 4.4 non-compliance during the course of contacts
 - 4.5 poor workmanship
 - 4.6 problems with cashflows and payments to suppliers and sub-contractors
 - 4.7 late completion of contracts

- 4.8 The Original Memorandum of Understanding was signed in August 1999, committing FIG to covering certain core costs of a regional manager and staff, and paying 10% cost above the outturn costs of works.
- 4.9 Morrisons set up a locally registered company, Morrison (Falklands) Limited (MFL) but undertook to use and to encourage local business as suppliers. The original MOU was to last five years, but be reviewed periodically.
- 4.10 In August 2001 a Supplementary MOU was agreed to remove the need to place an individual Contract for each project, and to replace this with a Letter of Instruction for each project regulated by the previously agreed ICE Conditions of Contract.
- 4.11 It was agreed that the MFL Regional Management costs would be reimbursed at cost and all allowable project costs would be reimbursed at cost plus a 10% fee.
- 4.12 In November 2002 a proposal was put forward for the percentage fee to be adjusted in line with the relationship between the out turn cost and budget estimate. After consideration and detailed debate this proposal was rejected as it was felt that it did not provide a more cost effective way forward.
- 4.13 In November 2003 a proposal was put forward to introduce KPIs and adjust the fee based on annual turnover which would then be adjusted by $\pm 2.5\%$ depending on the KPI score. It was decided that this scheme would require additional administrative staff and was therefore not cost effective to implement on the levels of turnover anticipated. It would also require an increase in the basic fee percentage.
- 4.14 In 2004 a renewal of the Partnering Agreement was agreed with amended terms and conditions of contract, but still basing the contract on the cost plus arrangement that was previously implemented under the ICE Conditions of Contract based on a cost plus basis. The agreement was signed on 7th January 2005 and MFL continue to operate under the terms and conditions of this agreement.
- 4.15 Workload
- 4.16 In 1999, Morrisons had anticipated around £5-8million of construction works each year. In the event the workload has never reached this level (the peak being £4.75 million in 2001/02) and the figure has been reviewed downwards to £2 million from 2005 onwards. Even this figure has not always been sustained, and in 2008/09 the value was just below 1 million.
- 4.17 Projecting the likely value of work has proven problematic. For 2008/09 it had for instance been anticipated that the Dairy Paddock development would be progressed under the funding allocated for infrastructure development at a likely value in excess of £1 million, but in the event this did not occur and the total value of work, as noted above then fell below £1million.

- 4.18 The projection for 2009/10 is just over 2 million, even assuming that phases 2 and 3 of the abattoir project do proceed.
- 4.19 Morrison's have found it difficult cover skilled staff and supervisory costs at this level and although outturn on the abattoir project was not as it should have been, the need to apportion overhead costs at a higher rate than was assumed at the outset due to the low overall level of work has to be acknowledged as having contributed to this cost overrun.
- 4.20 That Morrisons undertake work locally for other parties assists in spreading overhead costs, but this is also variable and unpredictable. Morrisons currently employ a works team of 15, and an HQ and management staff of 5, with the balance of workload being delivered through local subcontracts.
- 4.21 The 2006 Internal Audit Review identified some strategic risks to the Agreement, namely that:
- 4.22 'The quantum of work remains low. MFL has accommodated a reduced quantum in previous years by undertaking significant work for other clients, notably large projects for SGSSI. MFLs capacity to sustain this will be tested as SSGSI work tails off from 2006/07.
- 4.23 In a worst case scenario, uncertainty and low quantum could lead MFL to withdraw. This would leave FIG with insufficient capacity (or higher costs) subsequently to undertake works. However for the avoidance of doubt, MFL voiced no threat of withdrawal during the audit.'
- 4.24 This situation has been realised, with a drop in work for both FIG and other clients, (although MFL have bid for other works for MoD and are currently bidding for works, at least one of which they believe will be gained by them shortly).
- 4.25 The company has clearly been sustained in no small part by works for other parties, most notably BAS, as although these works are not necessarily managed directly by the locally based team, the value of work is attributed to and taxed locally. The value of the tax take exceeds the local office costs and it could be argued that even if no work were taken for FIG there would still be positive value to the Islands in a presence being maintained. (see Appendix B)
- 4.26 Other Issues
- 4.27 Regional Managers Costs
- 4.28 The apportionment of Regional Managers Costs against projects is problematic, in that these can only be based on expected workload and this has over the past year and continues to be uncertain. For instance there is a projection of potentially £2.03 million of work for 2009/10, but £700,000 of this is for phases 2 and 3 of the abattoir, which is far from certain. At the £2million level, an assumption of approximately 9% can be made for the projected £190,000 overhead, but if the abattoir works do not progress, the

balance will then fall to other projects, unless works for others are sufficient to offset this. There is not, as there was in the first years of the partnering arrangement a separate vote code providing for these costs and the cost.

4.29 Staffing and Redundancy

- 4.30 As has been very publicly noted, staff were recently informed at little notice that they would be put on reduced pay, for a period of two months due to the downturn in work.
- 4.31 This was not particularly well handled insofar as staff were only notified a week in advance, but that was a call for the Regional Manager to make.
- 4.32 Allied to this however is the potential for redundancy costs to be sought under the Partnering Agreement.
- 4.33 There has been ongoing discussion on this and although the view taken if the contract documentation alone is considered is that this would only be applicable if work were aborted, it is very clear from written responses from both the then Director of Public Works and the Morrisons Director who negotiated the original package that the intent was that these costs would fall to FIG in the event that redundancies were effected, in proportion to the value of work done by individuals for FIG and others.
- 4.34 It could be argued that provision should have been made over the period of the partnering agreement, but the agreement essential provides only for those costs which have been met to be reimbursed, not for provision to be built up, in the form of an accrual, for potential liabilities.
- 4.35 It has not been possible to place a value on potential redundancy liability at this stage, but it is intended that this will form part of the March 2010 review.

5.0 Performance Review

- 5.1 Over the past year the financial performance of Morrison's against outturns has been judged by the cost overrun on the Abattoir and although this evidently was significant and very unsatisfactory, it was in no small part a result of lack of definition and control from the client side at early stages in the project, although compounded by inadequate estimating and planning.
- 5.2 Set out as Appendix A is the outturn against estimate for all projects over the period of the agreement:
- 5.3 This shows an overall outturn of projects at 1.05 times the final estimate (initial estimate plus variation orders (VO's)).
- 5.4 Excluding the Abattoir reduces this to 0.95.
- 5.5 Whilst this is broadly satisfactory, the abattoir highlights the need for more accurate estimating and more timely and accurate reporting of cost variations.
- 5.6 This has been reviewed and strengthened recently, with the production of a full resource based programme at estimate stage for Mink Park and this standard of submission is to be maintained.

- 5.7 This makes estimate review simpler and will also enable simpler cost tracking of specific work sections both of which should reduce the risk of significant variation from estimate and highlight variations at an earlier stage.
- 5.8 Turning to quality issues, the writer is of the view that there have been few instances of significant quality problems both over the whole period of the arrangement, or latterly, and that quality is an MFL: strong point.
- 5.9 There have been no contractual disputes.
- 5.10 MFL appears to continue to work well with and utilise local subcontractors. They largely employ locally resident personnel and one local engineer has been placed on secondment to the UK in order to widen their experience, which is seen as potentially having long term benefits to the Islands.
- 5.11 On performance, therefore, there is a broadly satisfactory delivery of service, generally close to estimate and at an acceptable quality.

6.0 Audit Review

- 6.1 An internal audit review of the Morrison's Partnering arrangement was carried out in October 2006, which found that the Key mechanics of the Agreement were working well, in that:
 - 6.2 There are rational procedures to monitor projects undertaken under the Agreement and to control the quality, timeliness and cost to FIG.
 - 6.3 MFL maintains clear audit trails to trace evidence of costs to projects
 - 6.4 MFL invoices on account and FIG pays promptly (the agreement anticipates a neutral cashflow position)
 - 6.5 MFL has established a track record of delivery within the agreed project budgets.
 - 6.6 The detailed monitoring arrangements appear to be working satisfactorily and both parties are acting within the agreement in material respects.
 - 6.7 There is ongoing audit carried out by the Contracts Engineer, in relation to costs, estimates and payments and these are periodically sample audited as part of external audit and no anomalies of any significance have been found.
 - 6.8 The systems in place when the full internal audit was done remain and have in some areas been strengthened, with closer monitoring by the contracts engineer and an improved budget estimating model having been recently introduced.

7.0 Continuing Value for Money

- 7.1 One of the key issues is that of maintaining sufficient pressure on MFL to perform to budget. There is no penalty on exceeding estimates and the key

measure used at present is ongoing pressure from PWD Staff to maintain or better estimated outturns. Budget estimating has been further strengthened which should reduce risk of overrun and hopefully avoid the lack of timely information which occurred in the abattoir project, but this will not absolutely guarantee Value for money.

- 7.2 A payment regime based on variable fee was agreed and implemented on a trial basis previously, which rewarded projects coming in below budget but penalised where they overran, but in practical terms they added more complexity, reduced flexibility and had little impact on outturn, provided that estimates were properly prepared in the first instance and a return was made to fixed fee in 2005.
- 7.3 A return could be made to this approach, but it is not seen as having added value in the past and at current PWD contract staffing levels is unlikely to be able to be adequately monitored (when last trialled there were in addition to the current staff of a Contracts Engineer a Quantity Surveyor and Projects Engineer):

8.0 Other Options

- 8.1 This review considered whether it would be appropriate to seek another Partner, instead of Morrisons.
- 8.2 In part, this was guided by the current low and possible further downturn projected in the Capital programme and it is not thought at all likely that (at £1-2m per annum) there will be many takers and it is most unlikely that they would accept the current 10% on-cost at that level of turnover.
- 8.3 Even for Morrisons at this level, there are serious questions about whether the Contractor can afford the costs of the “core team”. These include the MFL Regional Manager, projects Manager, Site Engineer and Office Clerk. FIG is currently committed only to funding a maximum of £190,000 per annum but this is high relative to workload projections.
- 8.4 The 10% fee has also to offset the relevant UK office overheads, which provide both engineering and logistical support and it appears that in real terms the margin is likely to be nearer 4 to 5%.
- 8.5 Equally, Morrisons may benefit from continuing to having a base in the South Atlantic, and being in a position to work to the south of the Falklands, although, as noted earlier, larger works in the Antarctic, although routed through the company are not managed through the local team.
- 8.6 It is not considered practical to propose a tendered approach to each and every large building project, given the uncertainty and length of tendering processed and the potential mobilisation costs.
- 8.7 There is no local company that can replace Morrison’s yet.

8.8 It is considered that the Partnership is not 'broken', although perhaps a little battered.

8.9 Direct Engagement of Equivalent Staff and Resources

8.10 Consideration was given to the concept of simply directly engaging an additional engineer and support staff and either managing subcontractors or directly engaging the balance of labour needed, but given that the Regional Managers costs are charged net, with no overhead and that the staffing costs would likely be no better, this seems most unlikely to result in lower costs and would also be a reversal of intentions and trends in terms of reducing the size of government.

8.11 Risk would not be lower and may well be higher and in the event of a project being badly underestimated, there would not be any recourse such as has happened recently with the Abattoir to negotiating the end cost downwards with the contractor on the basis of performance.

8.12 Last but by no means least, there would be a loss of engineering input and feedback from the company which is not a visible but is nonetheless very useful, given the very small team of engineers within PWD.

9.0 Conclusion

9.1 On balance the MFL Partnership has delivered.

9.2 Still to be resolved is whether in the short and medium term the level of capital works will continue to keep MFL busy, and sufficiently in profit to justify the retention of skilled and HQ staff on the Islands.

9.3 This is likely in part be dependant upon works of for others such as the Ministry of Defence being won and although it is known that they are bidding on such works the outcome cannot be guessed.

9.4 Account needs to be taken of the potential liability for redundancy payments in the event that the company does shed staff or cease to operate, although the principle of liability has not yet been agreed

9.5 There is need to review future work projections and to continue discussion with MFL on how workloads at current or similar levels might be sustained, should this prove to be necessary, as it is clear that there is still going to be need for works to be undertaken by contractors with more resources than the local builders can offer and that the partnering arrangement is the most effective way to achieve this at present.

10.0 Financial Implications

10.1 There are no specific Financial Implications as this is an Information Paper

11.0 Legal Implications

11.1 There are no specific Legal Implications, as this is an Information Paper

12.0 Human Resources Implications

12.1 There are not Human Resource Implications. This is an information Paper.

Appendix 'A'

Performance Against Budget Estimate

	Contract	LOI Value	Variations	Value including Variations	Outturn Cost	Variation	% Saving/Overrun
93089	Resite FIDF & Ammunition Bunker	1,064,229		1,064,229	1,193,999	129,770	12.2%
93092	East Stanley 5a	395,825		395,825	382,019	-13,806	-3.5%
93102	Infant/Junior School	2,106,974	560,464	2,667,438	2,669,509	2,071	0.1%
93116	Visitor Centre	338,000	9,761	347,761	355,467	7,706	2.2%
93149	Fisheries Estate	146,514		146,514	153,477	6,963	4.8%
93197	Glasgow/Kent Rd	215,351	12,396	227,747	189,822	-37,925	-16.7%
93264	East Stanley 6	2,503,443	-714,643	1,788,800	1,778,516	-10,284	-0.6%
93265	Rowlands Rise	132,151	7,860	140,011	145,153	5,142	3.7%
93295	East Stanley 7	913,283	135,490	1,048,773	969,558	-79,215	-7.6%
93992	East Stanley 5b	391,065		391,065	249,134	-141,931	-36.3%
94113	Incinerator/Lairage Building	209,790	45,207	254,997	251,731	-3,266	-1.3%
93104	Port Howard Jetty	37,054		37,054	19,334	-17,720	-47.8%
94873	Abattoir	998,030	214,780	1,212,810	1,237,002	24,192	2.0%
93162	FICS Improvements	22,000	684	22,684	24,768	2,084	9.2%
93205	Police Station	20,032		20,032	20,032	0	0.0%
93262	Sheltered Accommodation	957,984	22,076	980,060	918,981	-61,079	-6.2%
93296	FCO Plots	357,200	60,766	417,966	357,589	-60,377	-14.4%
93162	FICS Roof Repairs	385,308		385,308	367,475	-17,833	-4.6%
93125	Town Hall Roof	604,453		604,453	498,388	-106,065	-17.5%
94874	Pebble Island Jetty	205,721		205,721	196,880	-8,841	-4.3%
94874	Speedwell Island Jetty	62,000		62,000	61,540	-460	-0.7%
94874	Saunders Island Jetty	65,345		65,345	65,062	-283	-0.4%
94005	KEMH Upgrade	499,261	109,748	609,009	608,445	-564	-0.1%
94004	PSDS 1, 2 and 3	1,310,915	45,813	1,356,728	1,476,755	120,027	8.8%
94897	Sapper Hill	317,456	-56711	260,745	271,474	10,729	4.1%
93180	Water Treatment Works	1,379,923	42,168	1,422,091	1,326,684	-95,407	-6.7%
94001	Airport Road	160,000		160,000	146,866	-13,134	-8.2%
94015	Stanley Airport	20,000		20,000	12,489	-7,511	-37.6%
94874	George Island	196,696		196,696	205,881	9,185	4.7%
93180	JMA	152,810		152,810	163,237	10,427	6.8%
94874	Beaver Island	129,743		129,743	102,308	-27,435	-21.1%
94874	New Island	85,465		85,465	59,051	-26,414	-30.9%
93064	MPA Cinema	139,456	20,000	159,456	158,307	-1,149	-0.7%
93127	Lookout Phase 1	134,300	22,339	156,639	141,798	-14,841	-9.5%
93127	Lookout Phase 2	91,249		91,249	73,372	-17,877	-19.6%
93228	Eliza Crescent	87,730	13386	101,116	107,526	6,410	6.3%
93104A	New Haven	949,824		949,824	1,158,193	208,369	21.9%
93104B	P Howard Temp Term FIDC	293,726	14686	308,412	255,952	-52,460	-17.0%
	Abattoir	590,000		590,000	849,275	259,275	43.9%
93089	Police Station	935,955	46798	982,753	1,119,892	137,139	14.0%
93228	VPC Road	99,755	2494	102,249	97,709	-4,540	-4.4%
4874	Fox Bay Jetty	35,024		35,024	25,577	-9,447	-27.0%
	Totals Completed Projects only			20,356,602	20,466,227	109,626	0.5%