

## **NHS Lothian**

Finance & Resources Committee  
25 July 2018

Director of Finance

### **SUPPLEMENTARY BUSINESS CASE TO SUPPORT PROPOSED COMMERCIAL AGREEMENT FOR COMPLETION OF RHSC/DCN PROJECT**

#### **1 Purpose of the Report**

- 1.1 The purpose of this report is to present to the Committee a update on the proposed Settlement Agreement for completion of the disputed capital works required for completion of the new Royal Hospital for Children and Young People/Department of Clinical Neuroscience/Child and Adolescent Mental Health Facility.

Any member wishing additional information should contact the Executive Lead in advance of the meeting.

#### **2 Recommendations**

- 2.1 The Committee is recommended to:

- approve £10m capital contribution towards disputed works required for completion of the facility, subject to availability of funding from the Scottish Government Health and Social Care Division (SGHSCD);
- approve a £1.6m contribution towards the shortfall in funding available to IHSL, under the enhanced early access element of the agreement; and
- approve the Director of Finance and / or Interim Chief Executive to act as signatory to the Settlement Agreement.

#### **3 Discussion of Key Issues**

- 3.1 This business case is intended to be supplementary to the 'Financial Case' section of the original Full Business Case (FBC). It considers two potential approaches to deliver completion of the project, and compares estimated costs for both before assessing overall affordability. The document focuses on the Financial Case as there are no material changes in the Strategic Case, Economic Case, Management Case or Commercial Case as presented as part of the approved FBC.
- 3.2 Following a series of delays and disputes, IHSL and the Board team have negotiated a potential solution to provide certainty over programme and specification of the completed facility.
- 3.3 This solution covers the **capital cost of all outstanding works** (£17.61m) and the **project financing and additional contractor costs** (£5.77m).

- 3.4 The proposal is for the Board, funded by SGHSCD, to make a capital contribution of £10m towards the capital costs. Although this is the greater share of the £17.61m estimated cost, it is equivalent to the 'risk adjusted' cost of an alternative Dispute Resolution Process (DRP) but brings significant additional benefits.
- 3.5 Recognising that this remains a live construction site, as at the date of the agreement, the proposed capital contribution provides certainty on programme; certainty on specification of key areas of dispute; avoids a protracted and reputationally damaging DRP / court process; and represents value for money against the potential costs of an unfavourable DRP / court outcome.
- 3.6 The project financing and additional contractor costs were originally proposed to be funded through an 'Enhanced Early Access' Fee provided by the Board, to allow NHS Lothian to undertake additional commissioning activities in advance of formal handover. However the recent water damage throughout the lower half of the construction site, caused by a pipe breaking, is likely to limit the level of early commissioning that the Board could expect to undertake and this element of the proposal requires further negotiation. We have estimated that £1.6m would be an appropriate contribution towards the overall funding shortfall.
- 3.7 IHSL have indicated that they are able to cover the remaining shortfall via additional borrowing, although servicing such borrowing would reduce the level of surplus available to the public sector. As such, the value for money and affordability of such an approach requires further assessment.
- 3.8 Any NHS Lothian / SGHSCD funding for this would come from currently available budgets to cover the Annual Service Payment, which has not yet become payable, or from surpluses that would be returned to Scottish Government.

#### **4 Key Risks**

- 4.1 This is a complex and uncertain negotiation, and there are a number of risks with the proposal:
- the programme to completion to 31<sup>st</sup> October is challenging, particularly given additional work caused by water damage from the burst pipe;
  - failure to agree the details of all outstanding works to be included in the Settlement Agreement may leave the project open to further dispute;
  - any additional commissioning works may be difficult to manage while construction works are ongoing; and
  - any requirement for additional borrowing by IHSL may result in reduced surpluses for the public sector, as anticipated through the NPD model;
  - it is a live construction site with a high degree of works undertaken out of sequence to foreshorten the programme and sub contractors pressured. This may give rise to other problems in construction, new programme delay or operational deficiencies being identified post completion.

## **5 Risk Register**

- 5.1 The project's existing risk register is kept updated and reported through the Programme Steering Board. The key deliverability risk has been escalated to the corporate risk register.

## **6 Impact on Inequality, Including Health Inequalities**

- 6.1 An impact assessment was carried out as part of the business case for the project. No additional impact assessment has been completed.

## **7 Duty to Inform, Engage and Consult People who use our Services**

- 7.1 No further engagement has been carried out for this supplemental business case, but publication of the outturn programme milestones (e.g. migration and operational start) will be undertaken.

## **8 Resource Implications**

- 8.1 The resource implications are a £10m capital contribution, anticipated to be funded by SGHSCD, and a £1.6m contribution towards the shortfall in funding available to IHSL, under the enhanced early access element of the agreement.

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24 July 2018  
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## **List of Appendices**

Appendix 1: Supplemental Business Case to Support Proposed Commercial Agreement for Completion of RHSC/DCN Project

**NHS Lothian**

**SUPPLEMENTAL BUSINESS CASE TO SUPPORT PROPOSED COMMERCIAL  
AGREEMENT FOR COMPLETION OF RHSC/DCN PROJECT**

**1 Background**

- 1.1 NHS Lothian (the Board) and its private sector partner, IHSL, are nearing completion of the new Royal Hospital for Children and Young People/Department of Clinical Neuroscience/Child and Adolescent Mental Health Facility (the Project), being delivered under the Scottish Government's NPD Programme.
- 1.2 As discussed last at this Committee in May 2018, the project has experienced significant delays for a variety of reasons – the facility should have been handed over to the Board in July 2017. The delays have resulted in significant losses to the construction contractor, Multiplex (MPX). In addition to this, a number of areas of dispute have arisen that the parties have been unable to resolve.
- 1.3 Of these areas of dispute, one of the most significant is the provision of ventilation to patient rooms to the Board's requirements, which have been interpreted in different ways by the Board and contractor. The Special Purpose Vehicle, IHSL, believe that the Board should bear the cost of these works, whereas the Board hold the opposite view – both views are supported by contradictory QC opinion.
- 1.4 Under the Project Agreement, all delay and associated construction risks lie with IHSL who pass these down to MPX. This is stated by MPX and IHSL as an unsustainable position to deliver to our required programme and specifications. The Board had been prepared to take Court action to enforce its view, but has continued to seek a negotiated settlement on the basis that such a solution would offer more certainty in terms of cost and timescale.
- 1.5 The Board team has now negotiated with IHSL a potential solution that could overcome these points of dispute and assist in the completion of the facility by October 2018. The Board's Finance and Resources Committee gave its support to the principle of the proposed settlement at its meeting in May.

**2 Proposed Settlement Agreement**

**2.1 Agreement Structure**

- 2.2 The proposed solution falls into two parts, summarised in the table below, which together would allow for a target date for patients to begin moving into the facility in early March 2019.

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Expenditure Description £m		Funding Source £m		Paragraph Ref
<b>Cost of Completion</b>		<b>NHS L</b>	<b>IHSL / MPX</b>	
Completion of ventilation works	£4.66m			
Completion of remaining disputed items	£6.48m			
Liquidated damages during extended construction period	£2.27m			
MPX on-site costs during extended construction period	£4.20m			
<b>Total</b>	<b>£17.61m</b>	<b>£10.00m</b>	<b>£7.61m</b>	See 2.7 – 2.11
<b>'Early Access' Fee</b>				
Funding required to cover IHSL financing obligations during construction June – Oct, with some access for NHSL commissioning.	£5.77m	£1.60m	£4.17m	See 2.12
<b>Overall Total</b>	<b>£23.38m</b>	<b>£11.60m</b>	<b>£11.78m</b>	

- 2.3 The table above demonstrates a roughly even split between the parties of the estimated cost to complete the facility.
- 2.4 A Settlement Agreement has been jointly drafted by the Board and IHSL that sets out all the remaining tasks required to complete the facility, set out in a technical schedule, a detailed programme to delivery and an allocation of responsibility for each task, including all of the disputed items.
- 2.5 The Agreement will be signed upon fulfilment of all specified conditions precedent, Scottish Government approval being one of these. The key deliverable is the workable programme including Board activities and any early enhanced access.
- 2.6 Recognising that the Settlement Agreement involves compromises and addressing derogations from the Board's stated requirements, the Programme Steering Board has requested that an assessment be made of those elements that may need operational mitigation and will be managed through the payment mechanism. Once this work is complete, it will form part of a further engagement with IHSL prior to the operational phase.

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2.7 The Case for Capital Injection

2.8 The Board, with IHSL and MPX, has sought to agree a negotiated settlement between the parties where the parties themselves agree the allocation of responsibilities and costs as opposed to pursuing Dispute Resolution Process (DRP) or court action. A balance has been assessed between potential costs of pursuing action against the SPV and contractor, assessment of the likely success factors, and time involved versus the capital injection costs to avoid such steps.

2.9 The solution would be enacted by a legal Settlement Agreement that will set out the responsibilities of each party in relation to all actions to be carried out to allow the anticipated actual completion of the facility by the end of October 2018, including costs. In particular this will include a commitment to a completion date, which until now has been absent from both IHSL and MPX.

2.10 The first element of the solution is a capital injection provided by the Board to IHSL that would represent the Board's capital share of the cost to complete the facility, including the disputed items. This sum is a fixed amount of £10 million, anticipated to be funded from an additional Scottish Government capital allocation.

2.11 The update to this Committee in May 2018 noted that two funding options – for the sum to be provided either as a loan or as a capital injection – were being explored in parallel. The loan option is not currently considered viable due to concerns over potentially breaching state aid rules, as well as contractual issues arising from incorporating a loan within the Project Agreement. The £10m contribution is therefore anticipated to be an SGHSCD capital injection.

2.12 The Case for an Enhanced Early Access Fee

2.13 In May, this Committee considered a paper which recognised the shortfall of £5.77m in the financing during the period of disputed works and put forward a proposal for providing the Board with 'enhanced access' in return for Board funding in the form of an Enhanced Early Access Fee. The proposal would facilitate the Board in undertaking certain commissioning activities sooner than envisioned under the Project Agreement.

2.14 However, on 7<sup>th</sup> June a significant area of water damage throughout the lower half of the construction site was caused by a pipe breaking. The area affected includes the imaging suite where some Board / specialist equipment had already been installed. The detailed cause and insurance report has not yet been shared by IHSL with the Board, but a direct impact on the commissioning programme and potentially also on the operational dates have been identified. In turn, this impacts on the approach to the Settlement Agreement, as the level of enhanced early access anticipated is now likely to be delayed and be of a more limited nature than previously expected.

2.15 Consequently, it is not considered appropriate for the Board to provide an Enhanced Early Access Fee to the same level as previously envisaged. This would create a shortfall in the funding required to complete the facility.

2.16 It is proposed that the Board would make a contribution towards this shortfall to a maximum of £1.6m against the budgeted Annual Service Payment, which would

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reflect a realistic reflection of the level of access that would be obtained under the revised programme.

- 2.17 IHSL have confirmed that it is in a position to access additional borrowing to cover the remaining shortfall. This would come in the form of either additional shareholder funds or further debt to be provided by senior funders, or a mixture of the two. Such borrowing would come at a cost that would reflect commercial lending rates. The cost of servicing such debt would reduce the level of surplus produced by IHSL.
- 2.18 Because of the nature of NPD projects, where the surpluses present are distributed to the public sector and not to private investors, any action by IHSL to introduce further debt or equity would result in the projected surpluses being eroded, which may be to the detriment of the public sector.
- 2.19 The Settlement Agreement and financial case has to consider the desirability of preservation of the levels of surplus in the project, which could be achieved by providing a capital injection, compared to the injection of debt recovered, in effect, from lower surplus payments to the public sector.
- 2.20 Discussion is ongoing with Scottish Government to consider the effect that such borrowing would have on the surplus levels and the effect that this would have within the wider context of capital and revenue budgets and to assess potential alternative approaches that might offer better value or affordability within the constraints of the surplus available and the Annual Service Payment budget.
- 2.21 Settlement Agreement – Risks and Benefits
- 2.22 The risks and benefits of the Settlement Agreement are set out in the table below.

<b>Benefits</b>	<b>Risks</b>
The cost to the Board is fixed – the £10m million payment in full and final settlement of all known works required to complete the facility	The programme to completion is challenging, particularly given the issues arising from the burst pipe, but has been robustly assessed and deemed deliverable. As IHSL will cease to receive funding from the Board past the October date, there is a strong incentive to complete the facility on time
The timescale to completion is clearly defined and agreed as 31 October 2018	The Board will experience difficulty in managing its commissioning programme while construction works are ongoing. The mitigation for this is as above, and via the Protocol agreed
The Board may be able to access the facility and commence commissioning earlier than would be the case were it to wait until Actual Completion or until after litigation or dispute resolution has been completed	The Agreement is subject to a range of conditions precedent, including approval of Scottish Government and funders
A mutually acceptable settlement preserves the good relationship that the	The Agreement will define all works to be carried out. This work has not yet been

Benefits	Risks
Board has built with IHSL	concluded. Failure to agree all details will leave issues outstanding that are not catered for within the agreement, leaving open the risk of further dispute
The completion of the sale of the present RHSC site is conditional on vacant possession being provided by the Board by September 2019. The process of full decommissioning may take several months, so the handover that the proposed solution would allow reduces the risk of missing this deadline significantly	
A settlement avoids a protracted, resource intensive and reputationally damaging process via the Courts or DRP	

### **3 The Financial Case for the Capital Cost of Completion of the Facility**

3.1 The financial case has been carried out in the context of three factors, namely:

- An assessment by IHSL of the losses incurred by MPX to date and the need to sustain a viable construction project for all the parties.
- The cost of completion versus the risk of court action prolonging the programme even further.
- MPX commitment, from 9<sup>th</sup> June 2018 when agreement in principle to a settlement was agreed (without prejudice), to undertake work to clear the disputed items.

3.2 For the settlement sum to be acceptable to the Board, it must be demonstrated to offer

- a fair and balanced share of the cost of completing the facility; and
- a better option in value for money terms than pursuing DRP or Court action.

3.3 Analysis of the estimated construction cost has been undertaken by the project team which identifies that a normal market estimate would indicate a lower cost might be expected. However, when this has been compared to the potential cost of dispute and risk of losing, the premium is justifiable.

3.4 While it may be assumed that a fair and balanced solution would offer a 50:50 split of this cost, or £8.8m, the weighting towards the Board in cost terms is deemed appropriate because:

- MPX have already commenced works in a number of areas, including ventilation, at its own risk, offering a benefit to the Board in terms of timescale.
- Provision of these sums will allow IHSL to cover their shortfall in cash flow created by the dispute and protect the financial position of the project, the stability of which could be threatened without the entire shortfall being addressed.



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- Should the Board seek to provide a sum lower than £10m, for example by pursuing a solution whereby the cost to complete is evenly split, then IHSL would need to obtain further funding from other sources (see 2.18 – 2.20), which would further erode the surplus.
- The settlement would avoid the risk of significant additional cost falling entirely to the Board should the outcome of DRP or Court action not be in the Board's favour. This is assessed in more detail below.

**4 Cost and Risk of Litigation or DRP**

4.1 The alternative to agreeing the settlement would involve the Board undertaking a formal process, either through Dispute Resolution or Court, that would in effect entail each party setting out its position and presenting evidence, with a third party deciding upon the outcome and allocating responsibility and costs for resolution of the disputed items.

4.2 The risks and benefits of this option are set out in the table below.

<b>Benefits</b>	<b>Risks</b>
Clearly defined outcome	The time it would take to complete such a process is unknown. During this period, the contractor would be reluctant to undertake works, notwithstanding the requirement under the contract to do so. If only be carried out once the outcome is known, there would be further extension of the timescale to completion
Outcome is enforceable on both parties and as such offers certainty of implementation once the outcome is known	Resorting to this approach would likely result in a range of other issues being included in the overall dispute by both parties, this increasing the exposure to cost risk significantly
The Board's position in relation to the dispute would be maintained, even if ultimately not accepted by the third party	There is no certainty of success – the existence of contradictory QC opinions suggests that both parties have a strong chance of success. The Board's QC placed an estimate of 60% chance in favour of the Board, based on the original areas of dispute
The process would follow a clearly defined and understood route	The cost of taking such action in terms of legal and advisory fees and management time would be high
	The process could result in significant reputational damage for all parties
	An adversarial approach could damage the partnership relationship between the Board and IHSL during the 25 year contract period

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4.3 In terms of the costs relating to this option, these are largely uncertain. However, the Board has worked with its advisors to identify the potential costs as set out in the table below.

<b>Cost heading</b>	<b>Value £m</b>
Cost of carrying out all works to completion	17.61
Cost of DRP proceedings – additional advisor fees	0.90
Other (project costs, additional staff, double running)	6.50
<b>Total</b>	<b>25.01</b>

4.4 The total potential exposure to the Board is, therefore, £25m. On the basis that the Board, in its view and based on the advice received to date from the Board's QC and solicitors, would have a 60% chance of success were the dispute to be taken to Court, then the risk adjusted value of this option would be just over £10m, marginally higher than the Settlement figure, but would avoid all of the risks and disadvantages of going to litigation as set out in 4.2.

4.5 The losses sustained by MPX should also be considered within this assessment. It is understood that additional costs borne by MPX significantly exceed the margin included by MPX in their pricing of the contract and as such constitute a direct loss that, although not currently quantifiable, should be considered in the overall context of assessing how the actual cost of completion is being shared among the parties.

## **5 Conclusion**

5.1 The settlement agreement route:

- Offers a solution that avoids the risks and potential cost of taking Court action or of following the DRP route
- Provides the benefits set out in the table at 2.21
- Represents a fair and balanced financial solution for the Board

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24 July 2018

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