PFI: strengthening long-term partnerships

March 2006

HM TREASURY

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ISBN-10: 1-84532-137-5
ISBN-13: 978-1-84532-137-6
Printed by The Stationery Office 03/06 330385

Cover images

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1 Introduction

Delivering value for money – the Government's commitment to PFI

"PFI: Meeting the Investment Challenge" set out how PFI has a strong track record of delivering investment in infrastructure that supports public services on time and on budget. That document described the Government's commitment to the appropriate use of PFI, choosing between PFI and other procurement routes only on the basis of value for money. It explained how the value for money benefits of PFI flow from the long-term focus it brings on whole-life costs, the private sector's risk management expertise incentivised by having private finance at risk, and the certainty for public services it provides of specified outputs being delivered at the cost contracted for. In this context, the Government introduced measures to reform the assessment of value for money, improve delivery in PFI procurement and ensure efficiency and flexibility in private finance.

"PFI: Strengthening Long-Term Partnerships" confirms that the Government sees PFI continuing to play a small but important role in the overall objective of delivering modernised public services. It will continue to be used only where it can demonstrate value for money and is likely to continue to comprise around 10-15 per cent of total investment in public services. **The total PFI deal pipeline over the next five years is around 200 projects worth £26 billion in capital value, one of the largest comparable programmes in the world.**

PFI is delivering in operation

As an increasing number of PFI projects enter their operational phase, the Treasury commissioned the most extensive survey of operational projects to date. Evidence presented in this document shows that PFI is now meeting public service needs across more than 500 operational projects. This research concludes that:

- **users are satisfied** with the services provided by PFI projects, with 79 per cent of projects reporting that service standards are delivered always or almost always;
- **public authorities are reporting good overall performance and high levels of satisfaction against the contracted levels of service.** Authorities report that the overall performance of 96 per cent of projects is at least satisfactory, and that in 89 per cent of projects, services are being provided in line with the contract or better;
- **the services contracted for are appropriate** with 83 per cent of projects reporting that their contracts always or almost always accurately specify the services required, with this result getting better the more recent the contract; and
- **the incentivisation within PFI contracts is working.** While payment deductions have been low reflecting the general levels of high performance, almost all projects report satisfactory levels of service after a deduction has been applied, and 72 per cent report good or very good performance.

Pursuing areas for further improvement

The evidence indicates areas where improvements can be made to strengthen PFI further. This document describes the measures the Government is taking to support authorities in getting consistent high performance from the operational phase of their projects, bolster public sector PFI procurement professionalism, and make sure authorities understand the long-term trade-offs about flexibility and value for money when designing projects. These measures are summarised in box 1.3.

INTRODUCTION

Overview

I.1 "PFI: Meeting the Investment Challenge", published in July 2003, explained the Government's approach to its PFI programme and its contribution to improving public services through increased investment and reform. The Government presented evidence of PFI's overwhelmingly strong record at delivering the construction of vital new facilities on time and at the cost contracted for. "PFI: Meeting the Investment Challenge" set out clear evidence based criteria for the areas where PFI was likely to deliver value for money and overhauled the process of assessing the value for money of PFI projects when compared against conventionally-procured investment. PFI remains one of a number of procurement options and "PFI: Meeting the Investment Challenge" set out the Government's systems for ensuring that there is no bias as to the correct procurement route. The Government also reconfirmed that value for money in PFI should not be obtained at the expense of employees' terms and conditions.

I.2 PFI's track record in supporting public service delivery means that the Government remains committed to using it as a procurement route, and this document sets out the ongoing pipeline of projects in procurement. PFI will continue to play a small but important role in modernised public services where it demonstrates value for money. Research presented in this document shows evidence that PFI is meeting the expectation of users and public sector managers in operation, service levels are being met, and the incentives are working.

I.3 "PFI: Strengthening Long-Term Partnerships" builds on the measures introduced since 2003, setting out further improvements to PFI to support its ongoing important role in delivering better public services. "PFI: Strengthening Long-Term Partnerships":

- proposes measures based on the Government's research to build on the operational and contractual flexibility under PFI, including increased support to public sector managers during this phase of the contract;
- sets out the measures that the Government is taking to improve the ability of the public sector to understand where PFI is likely to offer better value for money than other procurement routes. This will be achieved by assisting procuring authorities in understanding the value for money of key decisions within a project including strengthening the test for the inclusion of soft services;
- seeks to bolster the professionalism of PFI procurement to reduce procurement times. While improving, the Government believes that procurement times remain unnecessarily long and is introducing steps to improve the maturity of projects before they are tendered into the market, to reduce unnecessary uncertainty later in the procurement; and
- sets out how local decision making in PFI will be supported by central skills and capabilities and how changes to the existing framework will reinforce this so that approvals are given at the right points in the process.

I.4 The remainder of this chapter summarises the measures introduced since 2003, research undertaken and the steps that the Government is taking to improve continually the value for money and procurement of PFI. The policy proposals have direct effect only in England, as policy on PFI is devolved in Scotland, Wales and Northern Ireland.

CONTINUING TO MEET THE INVESTMENT CHALLENGE

Reforming public services

1.5 One of the Government's long-term objectives is to deliver world-class public services. To achieve this, sustained increases in investment and reforms to deliver efficient and responsive services, which meet public expectations throughout the country, are needed. Strong and dependable public services lay the foundations for a flexible, productive economy. They also promote opportunity and security for all, helping to tackle poverty and social exclusion and improving the quality of life. Since "PFI: Meeting the Investment Challenge", PFI has continued to deliver new or modernised infrastructure for public services on time and on budget. PFI has now delivered over 500 operational projects, including;

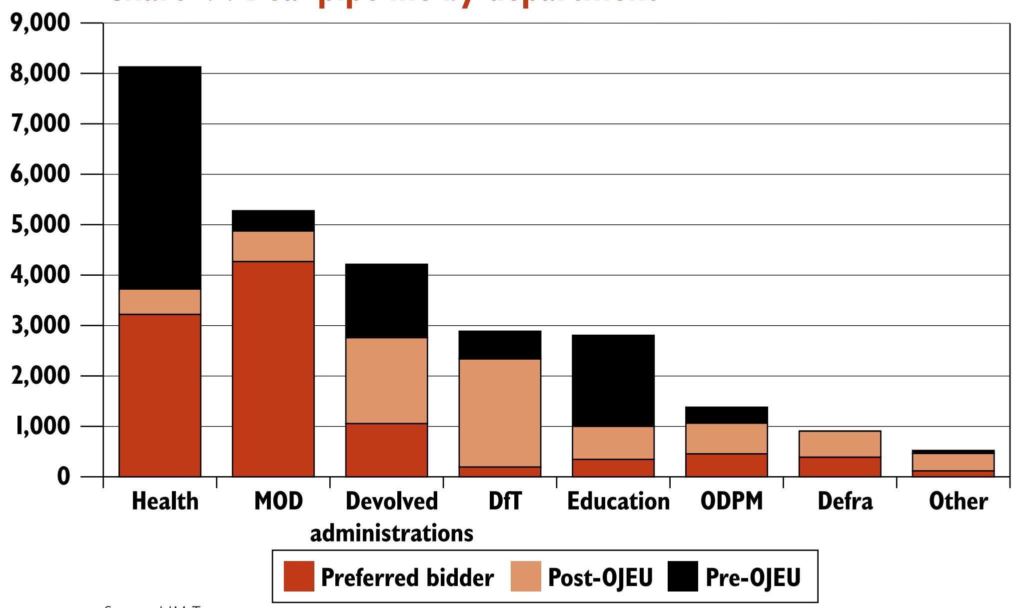
- 185 new or refurbished health facilities;
- 230 new or refurbished schools; and
- 43 transport projects.

1.6 Chapter 2 contains details of PFI's place within the Government's extensive programme of capital investment in public services. Whilst the vast majority of public investment remains conventionally procured, PFI consistently makes up 10-15 per cent of public sector investment. This proportion has remained at roughly this level since "PFI: Meeting the Investment Challenge" was published. Chapter 2 also explains why the balance sheet treatment of PFI is not relevant to the decision about whether to pursue PFI as a procurement option, as this is based purely on the assessment of value for money. Around 50 per cent of PFI projects by capital value are on the public sector's balance sheet.

Pipeline of projects

1.7 PFI's record of delivery means that the Government remains committed to using PFI as a procurement option where it is value for money to do so. There are currently around 200 projects with a capital value of £26 billion in the procurement pipeline to 2010. This represents one of the largest committed programmes of new investment in public service infrastructure through PPP and PFI projects globally. Chart 1.1 below shows the breakdown of projects in procurement by department.

Chart 1.1: Deal pipeline by department



Source: HM Treasury.

THE GOVERNMENT'S APPROACH TO PFI AND VALUE FOR MONEY

The Government's approach to PFI

1.8 PFI is only one of a number of procurement options that the Government can use to invest in public services. The Government only uses PFI where it can be shown to deliver value for money and does not come at the expense of employees' terms and conditions. PFI offers value for money for certain investments through: a long-term focus on whole life costs; risk management expertise; and greater certainty for the public sector that services will be delivered to the specified standard. Benefits are derived from PFI where the risks associated with a project are borne by the party that can best manage them.

1.9 Chapter 3 sets out the procurement options, including PFI, that should be considered as procuring authorities decide how to undertake major investment programmes. Options include: conventional design and build contracts, PFI, programme procurement vehicles such as are being used in Building Schools for the Future and NHS LIFT, and other approaches to partnering. Chapter 3:

- sets out the steps the Government is taking to improve the procurement of new PFI sectors; and
- sets out the Government's commitment to pilot a project delivery organisation involving the early involvement of the private sector in a project to work with the authority through the procurement process, while retaining the overall benefits that PFI brings.

Box 1.1: Measures introduced since "PFI: Meeting the Investment Challenge"

As a result of "PFI: Meeting the Investment Challenge" and the evidence presented of PFI's strength in delivery , the Government has introduced the following measures to strengthen the role which PFI plays in improving public services:

- **the "Value for Money Assessment Guidance"** published in August 2004 enables departments to maximise value for money from their investment programmes through the rigorous assessment of PFI compared with other procurement options. The Government has adopted a similar approach to the investment programmes of local authorities through the reform of the PFI credits system;
- **PFI is used where it is most appropriate** and where value for money can be demonstrated based on clear criteria. To achieve this, the Government no longer uses PFI for new IT projects and small projects because PFI did not represent value for money;
- **enforcement of the standard PFI contract** to bring about a unified approach to risk transfer and to reduce procurement times and costs;
- **enhanced use of strategic partnerships to coordinate procurement** such as in the Building Schools for the Future (BSF) programme that is now well established, with 12 projects currently in procurement that will modernise the country's stock of schools. The NHS LIFT initiative has delivered approaching £1 billion of investment in primary care infrastructure;
- **ensured value for money in PFI does not come at the expense of employees' terms and conditions.** Departments have continued to retain the right not to transfer soft service employees to a PFI project and, where employees are transferred, they are protected through the Retention of Employment (RoE) in the NHS and the Best Value Code of Practice; and
- **Credit Guarantee Finance (CGF) has been successfully piloted** on two PFI projects, producing a whole life saving of £70 million. The Government will further test the benefits of CGF before confirming its wider role.

IMPROVING THE VALUE FOR MONEY AND OPERATION OF PFI PROJECTS

Evidence on operational PFI projects

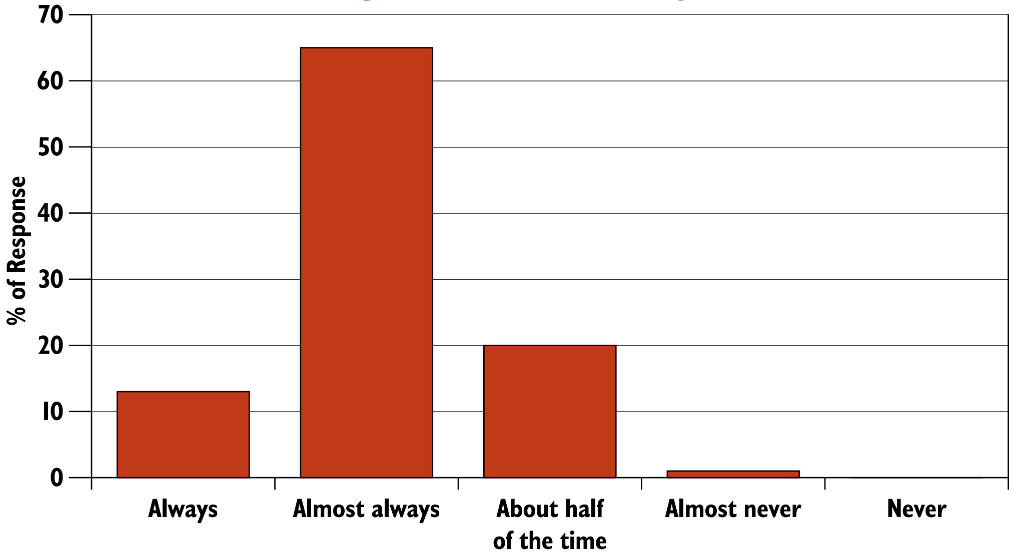
Research methodology

1.10 Chapter 4 reports the findings from research commissioned by the Treasury from Partnerships UK on operational PFI.[1] It also draws on evidence on the operational performance of PFI projects, including evidence from 4ps, the National Audit Office (NAO), the Audit Commission and other bodies.

Users are satisfied

1.11 Research shows that 80 per cent of all users of PFI projects are always or almost always satisfied with the service being provided. The evidence from this research is also consistent with other studies conducted by government departments and other bodies. For example, the KPMG and Business Services Association (BSA) study[2] found that users were satisfied always or most of the time in 81 per cent of cases.

Chart 1.2: Did the last user satisfaction assessment find that services were being delivered to an acceptable standard?



Source: Partnerships UK.

Meeting public sector requirements

1.12 Research also confirms that PFI contractors are delivering the services required under the PFI contract. Across all the PFI projects surveyed, 66 per cent of public sector managers believed that the service being provided was very good or good and 30 per cent believed the service to be satisfactory. Performance under PFI contracts has also been consistently high over time with around 90 per cent of PFI projects performing satisfactorily or better in every year since 1998.

[1] "Report on Operational PPP/PFI projects" Partnerships UK. Available on the Partnerships UK website.

[2] KPMG / BSA, (2005) "Effectiveness of Operational Contracts in PFI".

The partnership is working

1.13 An effective partnership between the public and private sector is central to a PFI project's ability to deliver the services required and meet the expectations of the public sector. Public sector managers believe that:

- they have developed an effective partnership with the private sector to deliver services. Over 70 per cent believe that their relationship with their private sector partners is very good or good; and
- the incentivisation within PFI contracts is working with around 80 per cent of public sector managers agreeing that the payment mechanism supports the effective contract management of the project. In just under 70 per cent of projects, levying payment deductions on the PFI contractor to reflect poor performance has led to improvements in the service being provided.

Improving the operational performance of PFI projects

Lessons from operational performance

1.14 While the research in general presents a positive picture of PFI in operation, the evidence points to a number of areas where PFI projects in operation could be improved further. These lessons, which are addressed in Chapter 5, can be grouped into two categories, where:

- operational performance and flexibility within PFI contracts can be improved to ensure that the public sector's requirements continue to be met in the future; and
- PFI could be refined to improve long-term value for money. Just as "PFI: Meeting the Investment Challenge" set out areas, based on experience, where PFI was less likely to offer value for money, the research into operational projects and recent experience has highlighted areas where the value for money of individual PFI projects could be improved further.

Improving the performance of PFI projects

1.15 The steps the Government is taking to improve the operational performance of PFI projects are split between measures to avoid issues arising in the future and improving the performance of older contracts that are now operational.

Flexibility under the PFI contract

1.16 PFI contracts are designed to allow the public sector to make changes in its service requirements, that become necessary after procurement, through the variation clause in contracts. Whether the asset is procured conventionally or through PFI, the costs of such change needs to be borne by the public sector. One of the key benefits of PFI is the requirement for the public sector to define accurately its requirement through an output-based specification and to consider and provide for mechanisms to change its requirements over time. This is a discipline that does not generally exist within conventional procurement.

1.17 While generally the contract accurately specifies the services required, public sector managers believe that the levels of flexibility built into (generally older) contracts to undertake minor variations could be improved. Evidence suggests public sector managers appreciate the long-term certainty over maintenance and service provision created by PFI, but want greater flexibility to make minor variations and greater alignment of incentives to agree and complete variations.

I.18 To ensure that variations can be undertaken more flexibly in future PFI projects, the Government will:

- **consult on a limited number of revisions to the standard PFI contract** to reflect the operational experience of variation mechanisms, including greater alignment of incentives to complete variations;
- **ensure that the flexibility required is adequately assessed** both when scoping the project's requirements and throughout the procurement process, in particular in the levels of flexibility offered by different bidders. This will be achieved through revisions to the "Value for Money Assessment Guidance"; and
- **improve the levels of support to contract managers.** The Government will create a PFI Operational Taskforce (described in Box 1.2) to support contract managers in undertaking variations and improving the flexibility of existing PFI contracts.

Improving incentives under PFI contracts

I.19 While payment mechanisms incentivise PFI contractors to deliver the services required, some respondents commented on the complexity of payment mechanisms. To ensure that payment mechanisms adequately incentivise contractors throughout the life of the contract, the Government will:

- consult on revisions to the standard PFI contract to improve the operational flexibility of payment mechanisms to ensure incentives remain aligned; and
- seek to create an acceptable mechanism for linking user satisfaction with payment under future PFI contracts to align the incentives of service providers more closely with user expectations.

Improving the transfer from procurement

I.20 In response to PFI contract managers believing that they would perform better if they had increased involvement during the pre-operation phase, the Government will require as best practice:

- the earlier involvement of contract managers during the procurement process to develop stronger relationships with the private sector;
- a more structured handover from procurement to operation, including a user guide to the PFI contract; and
- authorities to consider using a period of shadow-running to test key aspects of the contract in an operational environment.

Box 1.2: PFI Operational Taskforce

To provide the public sector with greater support during the operational phase of PFI projects and to bring consistency to the public and private sector's approach to the key operational issues, the Government will create a PFI Operational Taskforce (see paragraph 5.72). The Treasury will use Partnerships UK to establish a PFI Operational Taskforce that will work with departmental Private Finance Units (PFU), 4ps and the private sector to provide proactive support to project managers on key operational issues while also providing greater consistency across older PFI projects. Key priorities for the PFI Operational Taskforce will be:

- **improving the levels of guidance and support available to project managers who are approaching their first benchmarking or market testing periods;**
- **proactively assisting the public sector on all operational issues faced;**
- **considering a limited number of changes to the standard PFI contract that flow from an improved understanding of operational issues;**
- **implementing the Refinancing Code of Conduct; and**
- **collaborating with the Office of Government Commerce (OGC) on a pilot scheme reviewing operational performance, to provide advice to project teams to improve ongoing performance management.**

Improving the long-term flexibility of PFI

1.21 It is important that the public sector has the ability to reconfigure its asset base, more structurally than can be achieved within a PFI contract variation mechanism, to meet changing priorities. There will always be constraints on the public sector if its long-term requirements fundamentally change, whether the assets are procured conventionally or through PFI. The capital cost of constructing an asset to a particular specification will always have to be borne, even if the public sector's requirements fundamentally change. The PFI procurement process ensures that the cost, quality and outcomes of this flexibility are transparently understood and assessed. To ensure that PFI as a procurement option does not unduly constrain the public sector's choice of asset base required to deliver services, the Government will be:

- setting sector specific concession length caps to ensure that the length of the contract is appropriate to the nature of the services and assets being provided. For example, where a PFI project has a large service element, the value for money of a longer-term contract is diminished; and
- reducing the costs of terminating PFI contracts by changing its approach to certain aspects of the financial structure and the calculation of the payment made if the public sector wishes to terminate the contract.

1.22 The evidence presented in Chapter 4 shows a high level of satisfaction with the operational performance of PFI projects overall. Analysis of performance under the different elements of the contract emphasises the benefits that PFI brings in terms of the general availability of the underlying asset, and its maintenance. The evidence shows that soft services are performing satisfactorily. All of the PFI hospitals, in cleanliness data examined by Patient Environment Action Teams in 2004, are rated at least acceptable. Research presented in Chart 4.5, and backed up by interview evidence from the survey of operational projects, illustrates that while 100 per cent or just less of projects in that sample rated their projects adequate or better on both availibility and soft services, 91 per cent of those projects rated availability as good or very good, while 58 per cent placed soft services in the same catagories. The evidence shows therefore that soft services are seen as performing less well on average than the very high scores given to other elements of the PFI framework.

I.23 The Government's view is that the evidence on satisfaction with soft services does not demonstrate value for money as consistently as other elements of the framework, and that the analysis of service outcomes discussed in Chapter 4 suggests that while standards are no worse than in non-PFI structures, PFI has not led to a step change in soft service delivery. Therefore the Government is strenghtening its value for money test so that the public authorities must rigorously prove the case for including soft services in PFI projects. Chapter 5 of this document lays out the clear criteria which will form the basis for future decisions.

Market testing of soft services

I.24 Research showed that there was significant variation in the nature, and public sector understanding, of the soft service benchmarking reviews required in some PFI contracts. In future, where the public sector decides to include soft services, the Government will amend the standard PFI contract so that the soft services elements have greater flexibility. This will be achieved by requiring the provision of soft services to be actively competed and market tested at appropriate points during the PFI contract. This will ensure transparency and competition at the point service requirements are reassessed and repriced. Improving the guidance and support to public sector managers will be a key priority of the PFI Operational Taskforce.

CONTINUING TO IMPROVE THE PROCUREMENT OF PFI

Further improving procurement of PFI

I.25 A number of measures were introduced in "PFI: Meeting the Investment Challenge" to improve the Government's ability to procure PFI projects successfully, recognising that procurement skills were at a particular premium in PFI procurement. Evidence on PFI projects suggests that procurement times are still long, taking on average over two years from advertising in the Official Journal of the European Union (OJEU) to financial close. Although it is too early to analyse definitively the effect of earlier reforms on procurement times, there is initial evidence that the reforms have had some impact in increasing the number of projects that close in less than two years. Initial evidence also suggests that approaches such as NHS LIFT can have a significant impact in shortening procurement times.

I.26 The Government needs to ensure that the public sector has people with the appropriate skills and experience to develop and manage all procurement projects including PFI projects. Chapter 6 sets out the ways in which the Government continues to build and improve existing PFI procurement expertise. The chapter proposes that the Government should:

- develop a secondment model within the public sector so that public servants with experience of complex procurements can be retained and deployed on projects across the public sector;
- require procuring authorities to publish affordability limits that they have confirmed are sufficient to meet their requirement. This should assist in shortening the time taken from the OJEU advertisement to financial close;
- take steps in the forthcoming Comprehensive Spending Review to ensure that Private Finance Units (PFUs) are appropriately resourced to manage their PFI programmes; and
- develop individual and team procurement skills through formal qualification training.

I.27 The Government will also improve the way it monitors projects, building on the lessons learnt from the Project Review Group, including changing the points at which approval is required so that they better match the key stages of a procurement. This change will help the Government ensure that both central and local government projects are commercially deliverable before engaging the market.

1.28 The Government is also considering whether certain measures introduced into PFI procurement can be applied across other forms of conventional procurement. These measures include:

- extending the use of standardised contracts that articulate a defined risk transfer between the public and private sector;
- greater use of programme procurement vehicles where there is a sustained programme of investment required; and
- improving the support structures available to public sector procurers.

PRIVATE FINANCE

1.29 Since "PFI: Meeting the Investment Challenge", the market for private finance has continued to develop and debt financing terms have improved. The involvement of private finance is vital to ensuring that assets are delivered on time and on budget and that the procuring authority's requirement is met through the life of the contract.

Improving value for money

1.30 To support measures set out in Chapter 5 to improve the value for money of PFI, the Government will make a number of minor changes to the role that private finance plays in PFI. These steps include:

- measures to improve the flexibility on termination of bond-funded PFI projects and amendments to its approach to Authority Voluntary Termination; and
- forthcoming Treasury guidance for procuring authorities highlighting the different characteristics of the bank and bond markets and how these characteristics may affect them.

Supporting the flexibility of operational projects

1.31 To ensure that private finance supports the lessons and measures introduced on the operational flexibility of PFI projects, further guidance on assessing the impact of the financial structure of PFI projects will be provided in a revision of the "Value for Money Assessment Guidance".

Transparency of private finance

1.32 To improve further the transparency of private finance within PFI projects, the Treasury will require debt funding competitions (post the selection of preferred bidder) across all PFI procurements, except where the procuring authority believes that such an approach will unduly increase procurement costs and lengthen procurement times.

Increasing the efficiency of private finance

1.33 The Government wishes to ensure that funding markets continue to deliver optimum value for money, recognising the trade-off between price and risk transfer. To this effect, the Government will:

- monitor the use of equity funding competitions currently under consideration before consulting the markets on the implications for the Governments wider strategy;
- further test the benefits of its Credit Guarantee Finance approach before confirming its wider role; and
- consider alternative ways of optimising the risk and return of senior debt within PFI projects.

Box 1.3: "PFI: Strengthening Long-Term Partnerships" - key measures

To support public authorities in managing the operational performance and flexibility of PFI projects, the Government will:

- **create an PFI Operational Taskforce** to support the public sector on key operational issues including managing variations, benchmarking, payment and performance mechanisms, contractor distress and refinancing;
- **improve the transition to the operational phase** by encouraging the thorough handover of contracts between the procurement, construction and operational phases, and the shadow running of the prior to deal close;
- **determine sector specific caps on the length of PFI projects,** ensuring that they reflect the optimal period over which the authority wishes its services to be provided and do not unduly restrict long-term flexibility, and amend the "Value for Money Assessment Guidance" to help authorities choose an optimum level of contractual and financial flexibility in PFI proposals;
- **strengthen its value for money test for including soft services in PFI projects,** based on evidence that PFI projects are delivering soft services satisfactorily but not leading to a step change in standards. This document lays out clear criteria against which authorities will need to prove rigorously the case for inclusion; and
- **propose to the market revisions to the standard PFI contract** to reflect lessons from operational experience, including to make clear the advantages of market testing over benchmarking as a mechanism for ensuring the appropriate pricing of soft services where these are included.

To improve the procurement of PFI projects, the Government will:

- **develop a secondment model** so that public servants with experience of complex procurements are retained and deployed on projects across the public sector rather than their skills being lost;
- **require greater upfront investment by authorities in developing projects** before engaging the market, enforced through an enhanced project approvals process, and explore ways of getting the private sector involved earlier in the procurement process, piloting a project delivery organisation to help the procuring authority coordinate a complex PFI project; and
- **ensure that Private Finance Units (PFU) are appropriately resourced** to manage their PFI programmes through the forthcoming Comprehensive Spending Review.

To make sure that private finance continues to be available to PFI projects flexibly, efficiently and transparently, the Government will:

- **require authorities to use funding competitions for senior debt,** and monitor the use of equity funding competitions currently under consideration before consulting the market on the implications for the Government's wider strategy;
- **continue to innovate in the use of private finance,** considering with the market the use of structures like construction financing and partial debt underpinning. It will follow up the successful pilots of the Credit Guarantee Finance (CGF) model by testing its potential benefits in a project that has yet to select a preferred bidder before confirming its future wider role; and
- **consider methods for reducing the costs of authority voluntary termination** in the event of changing public service needs, including by making compulsory the use of a modified Spens formula.

2 Continuing to meet the investment challenge

The UK's public services have suffered from a sustained legacy of under-investment. PFI has played an important role in delivering part of the Government's programme of investment to deliver improved public services. "PFI: Meeting the Investment Challenge" set out:

- **the small but important role that PFI played in total investment in public services;**
- **PFI's strong track record in delivering public service infrastructure and services on time and on budget; and**
- **the areas of public services and parts of the country that have benefited from investment through PFI.**

This chapter reports on how Government is using PFI to continue to meet the investment challenge, where the:

- **place of PFI in total public sector capital investment remains stable. Investment under PFI is projected to continue to make up 10 to 15 per cent of total government investment in public services in 2005-06. While this has remained consistent since "PFI: Meeting the Investment Challenge", the majority of public investment is still carried out through conventional forms of procurement;**
- **number of PFI projects signed has continued to increase with over 700 projects with a total value of over £46 billion closed to date;**
- **investment through PFI is delivering extensive new and modernised public service infrastructure. Over 500 PFI projects have now completed construction across a broad range of sectors, delivering 185 new or refurbished health facilities; 230 new and refurbished schools; and 43 new transport projects;**
- **Government remains committed to using PFI where it delivers value for money with a further £26 billion of PFI projects planned across around 200 projects expected to reach financial close by 2010;**
- **decision to use PFI is taken on value for money grounds alone, but not at the expense of employees' terms and conditions. The accounting treatment of a PFI project is not relevant to this decision. Around half of PFI projects by value are reported on departmental balance sheets; and**
- **evidence suggests procurement times are getting shorter but remain unnecessarily long. The Government has seen a higher proportion of PFI projects reaching financial close within 2 years from advertising in the Official Journal of the European Union (OJEU), but remains concerned to reduce procurement times and costs further. Chapter 6 sets out measures to achieve this.**

BACKGROUND

2.1 This chapter focuses on the scale of the Government's investment plans for public services, and on the size and scope of the PFI programme within them. It illustrates the significant increases in public investment in the UK's public services, and the historical growth of the use of PFI in line with that increased investment. In reporting on the PFI programme, the Government excludes investment by the private sector in public services not undertaken under PFI projects. Where PFI continues to deliver value for money in the future, its place in the Government's investment plans remains stable.

Prioritising public investment

The UK's legacy of under-investment

2.2 The UK's public services have suffered from a sustained legacy of under-investment. The UK experienced a steady decline in public investment as a proportion of Gross Domestic Product (GDP) between the 1970s and 1990s with consistently lower levels than in other G7 economies. Public Sector Net Investment (PSNI) fell by an average of more than 15 per cent each year between 1991-92 and 1996-97, and represented 0.6 per cent of GDP in 1997.

2.3 This record of under-investment in the assets necessary for the effective delivery of public services produced a damaging backlog of repairs and maintenance, and hampered the ability of public servants to deliver high quality services to taxpayers:

- in 1997 the backlog of repairs in schools was estimated at around £7 billion;
- the backlog of maintenance in NHS buildings in 1997 was over £3 billion; and
- the transport sector had suffered from a highly damaging lack of investment in infrastructure.

Trebling of investment since 1997

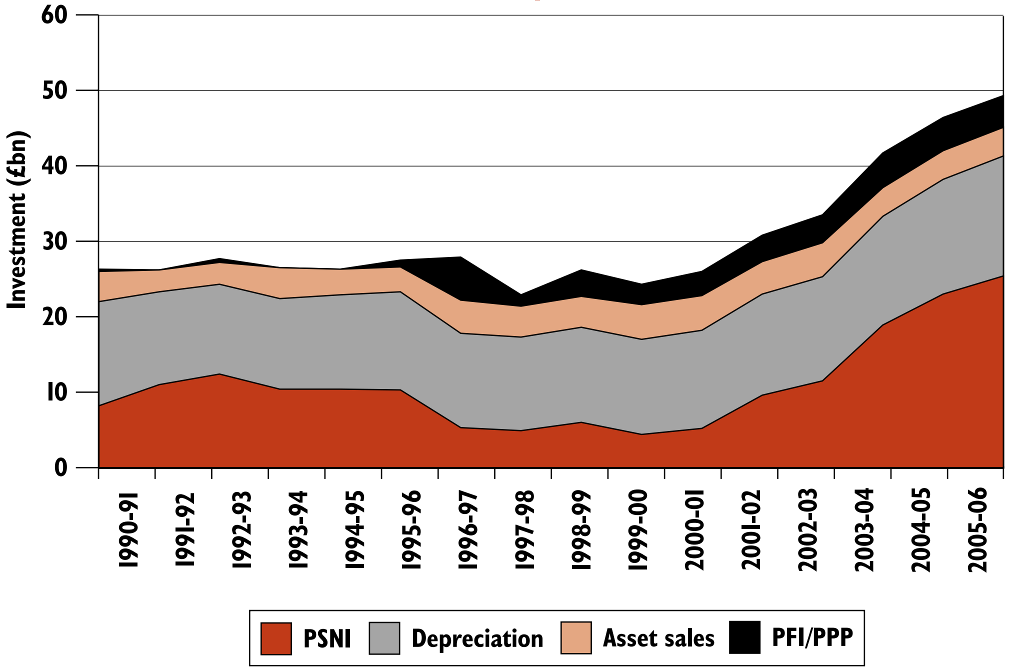
2.4 In order to secure the long-term future of the public services, the Government has significantly increased the total investment flowing into them. By the end of 2007-08, PSNI will be $2^1/_4$ per cent of GDP, more than trebling since 1997 as a proportion of GDP and funding sustained investment in the infrastructure of public services.

2.5 To ensure that this increased investment translates into the maximum improvement in public service delivery, it has been matched by reform of the budgeting framework to protect capital investment programmes and to give new incentives for managing the public sector asset base more effectively. PFI represents one option for infrastructure and facilities investment that enables the Government to secure value for money for the extra investment it undertakes.

PFI's place in public expenditure

2.6 Total investment in public services is around £50 billion in 2005-06, compared with £23 billion in 1997-98. Total UK investment in public services includes: PSNI reflecting conventional capital spending undertaken within departmental budgets; recycled proceeds from asset sales which are reinvested in capital on top of the capital budgets already available to departments; depreciation, to reflect the ongoing capital investment in existing assets to repair buildings and carry out maintenance; and investment carried out by the private sector on public service assets under PFI (including maintenance).

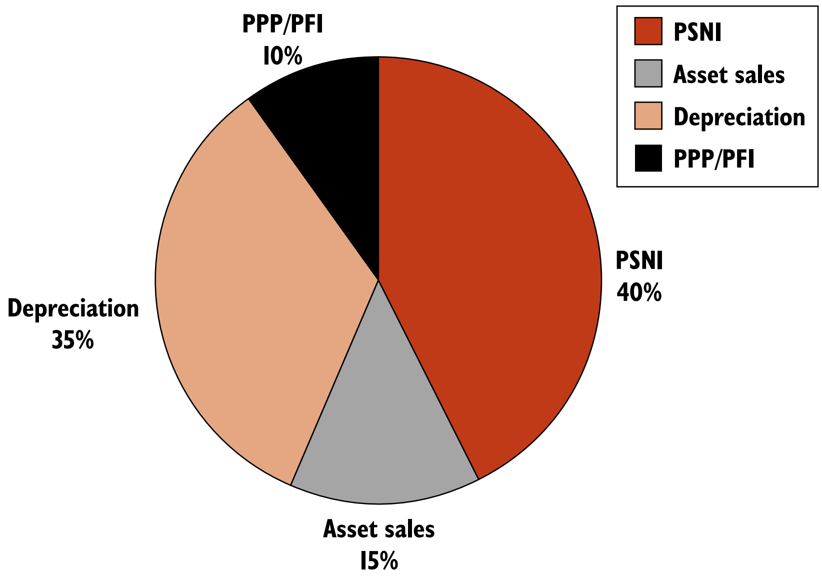
Chart 2.1: Total investment in public services



Source: HM Treasury.

2.7 PFI continues to play a small but important role in the Government's investment in public services. The Government has set clear criteria for where PFI is likely to provide better value for money than other forms of procurement. This means that the proportion of government investment in public services through PFI remains relatively stable at 10 to 15 per cent (see Chart 2.1) and PFI is expected to account for around 10 per cent of total investment in public services in 2005-06 (see Chart 2.2). The vast majority of increased investment in the UK's public sevices has been conventionally procured.

Chart 2.2: PFI as a proportion of total investment 2005-06



Note: PSNI excludes on-balance sheet PFI.
Source: HM Treasury.

Completed infrastructure

PFI's delivering public sector infrastructure

2.8 The delivery of public sector infrastructure on time and on budget is integral to the achievement of the Government's long-term objective to deliver world class public services that are value for money. PFI continues to play an important role in supporting this objective, with over 500 PFI projects currently in operation. These projects have delivered new public service facilities including:

- 185 new or refurbished health facilities;
- 230 new and refurbished schools;
- 43 new transport projects;
- 9 waste and water projects; and
- 180 other projects in sectors including defence, prisons, leisure, culture, housing.

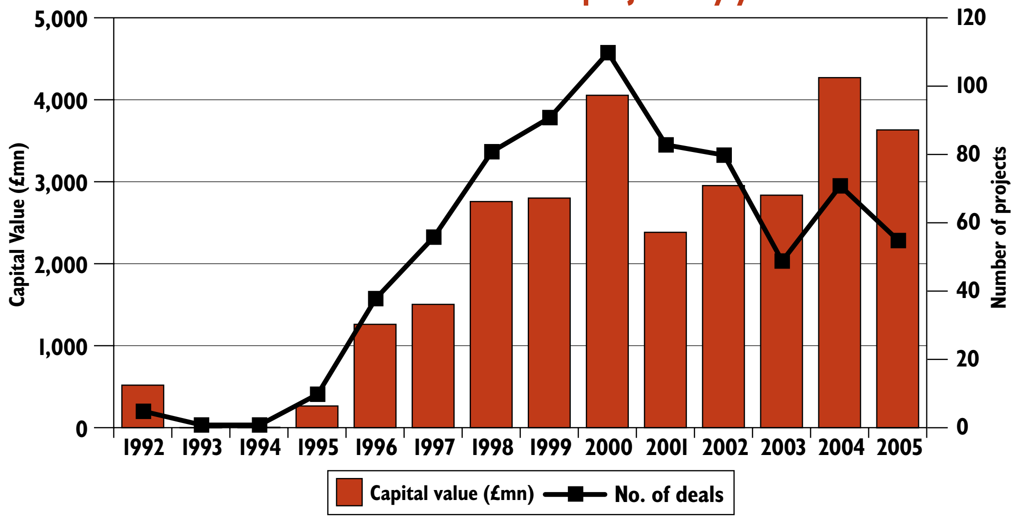
2.9 "PFI: Meeting the Investment Challenge" set out PFI's record in construction. 70 per cent of non-PFI projects were delivered late compared to only 20 per cent of PFI projects; and 73 per cent of non-PFI contracts ran over budget compared to 20 per cent of PFI projects (and these were due to the public sector changing its specification). As outlined in Chapter 4, the vast majority of operational PFI projects perform to a high level when assessed against contract specification and user satisfaction.

PFI's contribution to investment

2.10 PFI has grown in line with government investment in public services since 1997. As investment is projected to increase, it is anticipated that the use of PFI will rise accordingly. Chart 2.3 illustrates the capital value of PFI projects signed in each calendar year since the programme's inception.

2.11 Over 700 PFI transactions reached financial close by March 2006, with a total capital value of over £46 billion. Over £43 billion of this total has been signed since 1997. The number and total capital value of PFI projects has increased in recent years as the Government sought to reverse the historic under-investment. In 1995, projects amounting to £667 million were signed, whereas PFI investment from 1997 to date is between £2 to £4 billion a year.

Chart 2.3: Number and value of PFI projects by year



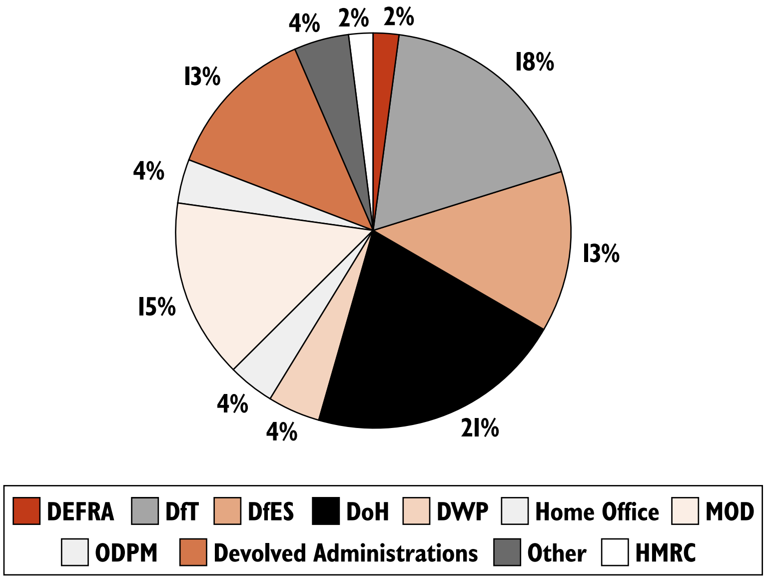
Source: HM Treasury.
Excludes London Underground PPP contracts.

Breakdown of projects

2.12 PFI investment has been used across all sectors. PFI contracts have been signed in over 20 different sectors, and by over one hundred different procuring authorities. Chart 2.4 shows that the largest users of PFI by value have been:

- the Department of Health (DoH), which has seen a total capital investment of £6 billion with 146 PFI projects signed to date;
- the Department for Education and Skills (DfES), with a total of 144 transactions worth a total capital value of £4.1 billion;
- the Department for Transport (DfT), with 41 projects and a total value of £4.7 billion; and
- the Ministry of Defence (MoD), with 53 projects and a total value of £4.5 billion.

Chart 2.4: Proportion of projects by capital value



Source: HM Treasury.

Geographical breakdown

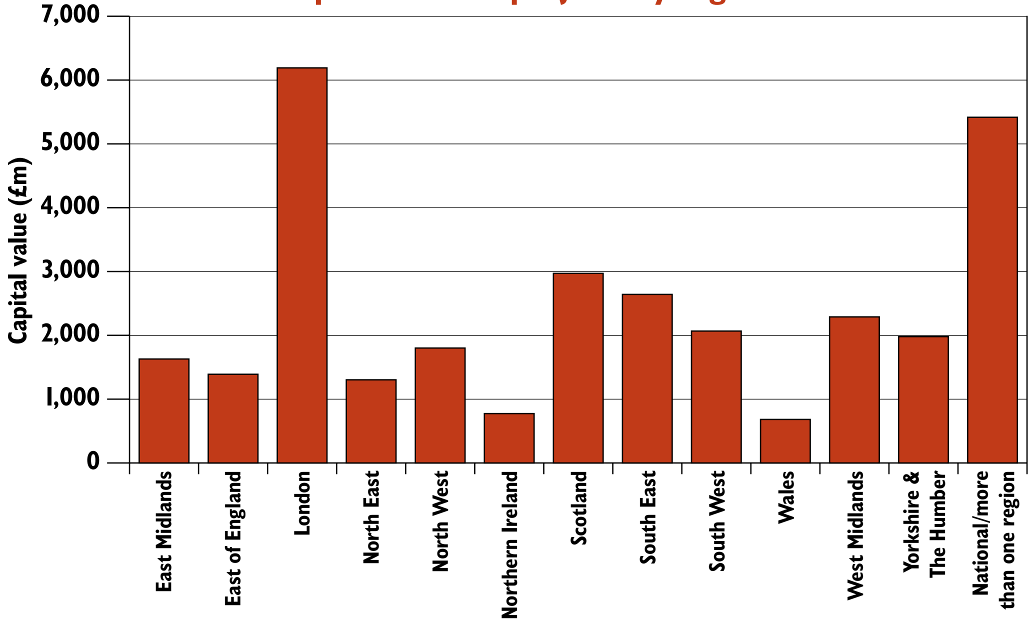
All regions benefit from PFI projects

2.13 Chart 2.5 shows PFI projects broken down by region. All the regions of the United Kingdom have signed at least 30 PFI projects. Every region will receive capital investment under PFI signed projects worth at least £600 million.

2.14 As Chart 2.5 shows, the devolved administrations are also seeing significant investment in public services through PFI, with over 170 projects signed worth a total capital value of over £4.4 billion where:

- Scotland has 98 signed projects amounting to a total capital value of over £3 billion. Signed projects include schools, waste management and healthcare projects;
- Wales has a total capital value of £600 million from 39 PFI projects signed. Energy management, healthcare and road projects are typical examples of the projects procured; and
- Northern Ireland has around 40 PFI projects with a total capital value of over £700 million. This involves projects in areas such as schools and health.

Chart 2.5: Capital value of projects by region to date



Source: HM Treasury.
Excludes London Underground PPP contracts.

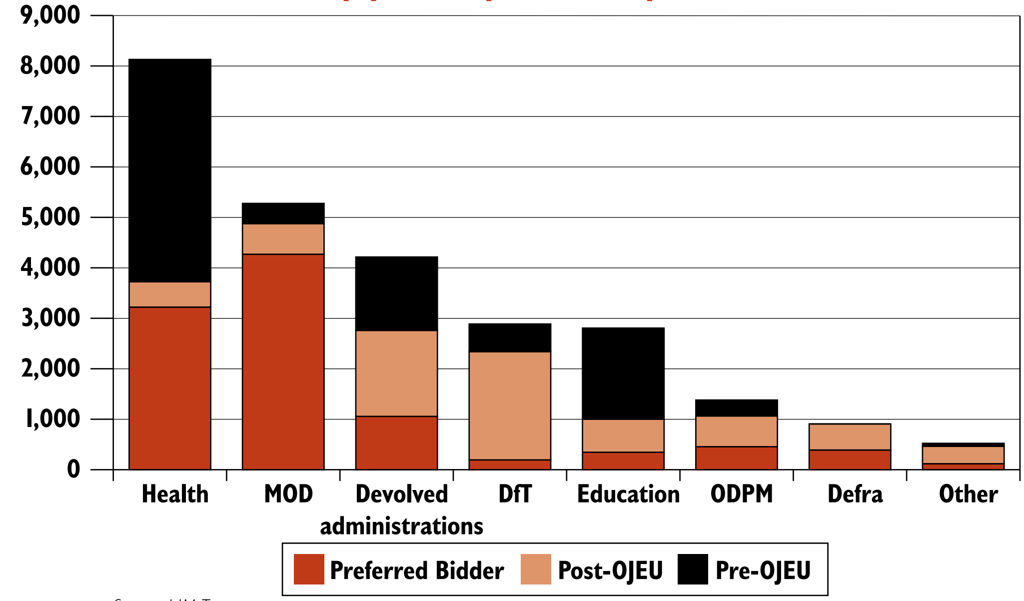
FUTURE PROJECTS

The future PFI pipeline

2.15 The Government is committed to securing value for money for all its investment programmes. Evidence shows that PFI has been successful in delivering high quality facilities for public services, with the benefit of on time and on budget delivery in key sectors of public investment. PFI will therefore continue to be used where it is expected to deliver value for money. To provide suppliers with greater certainty about the future of the PFI programme, set out below are PFI projects that have been tendered into the market and PFI projects at earlier stages of development:

- £26 billion of PFI investment across 200 projects is currently in the pipeline to close by 2010 (see Chart 2.6). This investment is expected to deliver significant new or refurbished public infrastructure over the next few years, including over 60 health facilities and 104 schools; and
- this includes the first, second and third waves of the Building Schools for the Future (BSF) programme which are in procurement or pre-procurement and will form part of the project pipeline. Beyond this, the subsequent waves of the BSF programme that contribute to the aim to provide 21st century secondary school facilities throughout the country are not included but will form part of the pipeline once they enter procurement.

Chart 2.6: Deal pipeline by sector department



Source: HM Treasury.

2.16 This does not include £600 million of PFI credits that the DfT has allocated to street lighting PFI, and a further £600 million of PFI credits that have been allocated to highways maintenance. DfT is currently seeking proposals from local authorities to use these credits in PFI projects and they will be included in the pipeline once allocated.

2.17 DoH recently announced steps to improve its capital investment programme (see Box 6.1). This announcement confirmed that the DoH:

- has asked NHS Trusts with capital development plans, including PFI projects, to take account of the current reforms to the NHS, specifically patient choice, a movement of services into primary and community settings, and the new financial regime of payment by results. As a result business cases will need to be assessed and reconfirmed. This process will help to ensure that plans are robust and viable in the context of the reformed NHS, and deliverable once they are put to the market; and
- would need to approve PFI projects before selection of a preferred bidder, rather than immediately prior to financial close as is currently the case. This step is consistent with the wider steps the Government is adopting for the approval of PFI projects as set out in Chapter 6.

2.18 After completion of this reappraisal, the NHS will remain the largest single user of PFI in government, with a programme valued at an estimated £7-9 billion.

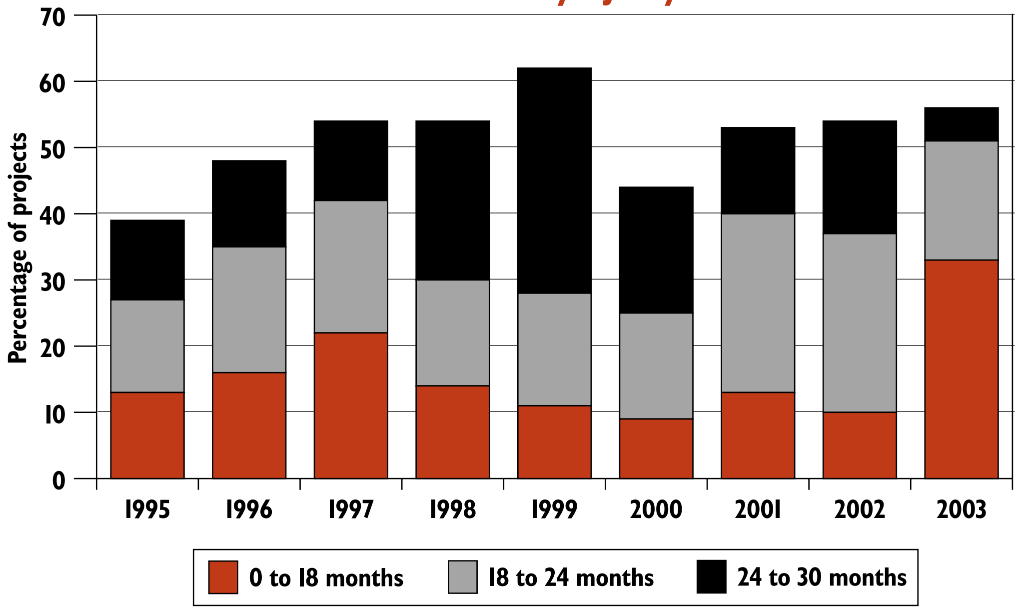
PROCUREMENT TIMES

Procurement times

2.19 The PFI procurement process can take longer than other types of procurement, as extensive due diligence is undertaken by the public and private sectors using legal, technical and financial advisers. This due diligence contributes to the overall value for money of PFI. Although some of this time is taken performing tasks that are highly beneficial to the overall project, in terms of shortening construction times and improving value the Government recognises that there are some aspects of the process that could be refined, to the benefit of both public and private sectors.

2.20 Evidence on procurement timeframes for a range of projects that were initiated in the mid-1990s was set out in "PFI: Meeting the Investment Challenge". This showed that the times taken from the point at which projects were advertised in the Official Journal of the European Union (OJEU) to financial close ranged from 13 months to 60 months for projects across different sectors. "PFI: Meeting the Investment Challenge" introduced measures to reduce PFI procurement timeframes, which included increasing contract standardisation to reduce legal negotiations, and improving the capacity of the public sector to act as a client to manage the procurement. The Government also introduced partnership vehicles such as the NHS Local Improvement Finance Trust (LIFT) initiative and Building Schools for the Future (BSF) to improve procurement.

Chart 2.7: Procurement times by OJEU year



Source: HM Treasury.

2.21 The evidence on PFI projects that have closed in the past year is that procurement timeframes are still unnecessarily long, taking on average over two years from OJEU advertisement to financial close. A project survey undertaken by the Major Contractors Group (MCG) published in 2005 found that the average procurement time was 27 months, compared with 29 months for a similar sample in 2003.[1] Many of the projects which have closed in the past few years will have begun procurement before the reforms detailed in "PFI: Meeting the Investment Challenge" were implemented. This is to be expected as the types of services and investment projects using PFI become more complex. It is likely that the trend towards larger projects will continue, as projects with a capital value of less than £20 million were found to be unlikely to provide value for money using PFI, and so are no longer considered.

2.22 Although it is too early to analyse definitively the influence of earlier reforms on procurement times, there is initial evidence that the reforms have had some impact in increasing the number of projects which close in under two years, suggesting that average procurement times are likely to decrease. Initial evidence shows that:

- more projects are closing in 18-24 months. 32 per cent of projects advertised in the OJEU in 2003 closed in under 18 months compared with only 11 per cent in 1999 and 9 per cent in 2000. 50 per cent of projects advertised in the OJEU in 2003 closed within 24 months compared with only 28 per cent in 1999 and 26 per cent in 2000 (see Chart 2.7); and

[1] Major Contractors Group survey 2005.

- the partnership procurement models are reducing procurement timeframes. The average procurement time for a project within the NHS LIFT initiative was 21 months for the first wave of the programme. This is much shorter than the average procurement time of almost three years. Thirty subsequent projects undertaken by LIFT companies have been procured in six to nine months. An advantage of the LIFT model is that the partnership contract is already in place. No BSF project has yet closed, but the first project took only 13 months to reach preferred bidder stage.

2.23 The Government recognises that there is still scope to reduce further procurement timeframes and eliminate inefficiencies during procurement, whether caused by the public or the private sector. Chapter 6 sets out the Government's proposed measures to continue to reduce procurement times.

FINANCIAL REPORTING OF PFI CONTRACTS

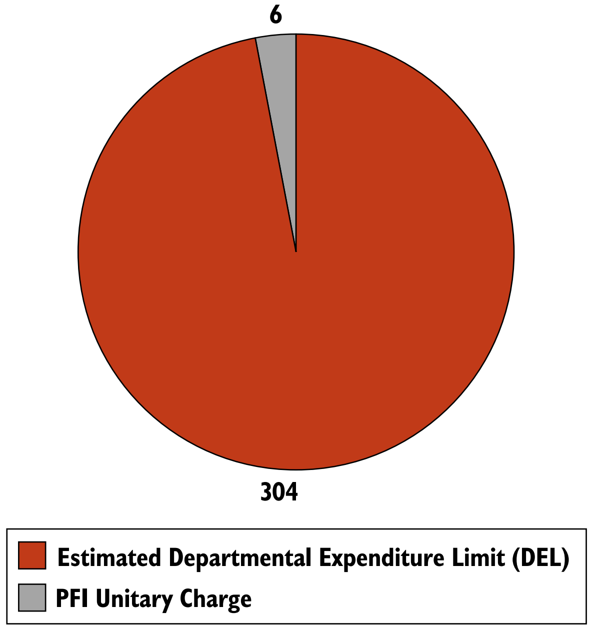
Publishing unitary charge estimates

2.24 The Government publishes its estimates of the unitary charge payments in the Financial Statement and Budget Report, and the Pre-Budget Report (see Chart 2.9). These statements show payments made by procuring authorities to the private sector which cover all the costs, both capital and service, of PFI projects, to be made under all signed PFI contracts. These payments represent the full price of the facility being made available to specified requirements, and cover all costs over the life of the contract while incentivising service delivery. These departmental commitments are monitored by the Government, included in consideration of future budgets, and therefore taken into account by departments in deciding how much PFI investment to undertake. This assesment should also improve confidence that individual projects are affordable when put into procurement.

2.25 PFI unitary charges include payments to cover the cost of capital expenditure, private finance, and the services needed to run and repair that asset. In a typical PFI hospital, payments for services make up 40 to 50 per cent of the unitary charge. For a typical PFI schools project, around 30 per cent of the unitary charge goes toward caretaking, maintenance and other services. If a project is built using conventional procurement, these future costs for services are not automatically covered, monitored or disclosed. Reporting estimated payments under PFI contracts therefore provides a fuller picture of future commitments than would be possible under conventional procurement, and provides better information for the management of future budgets.

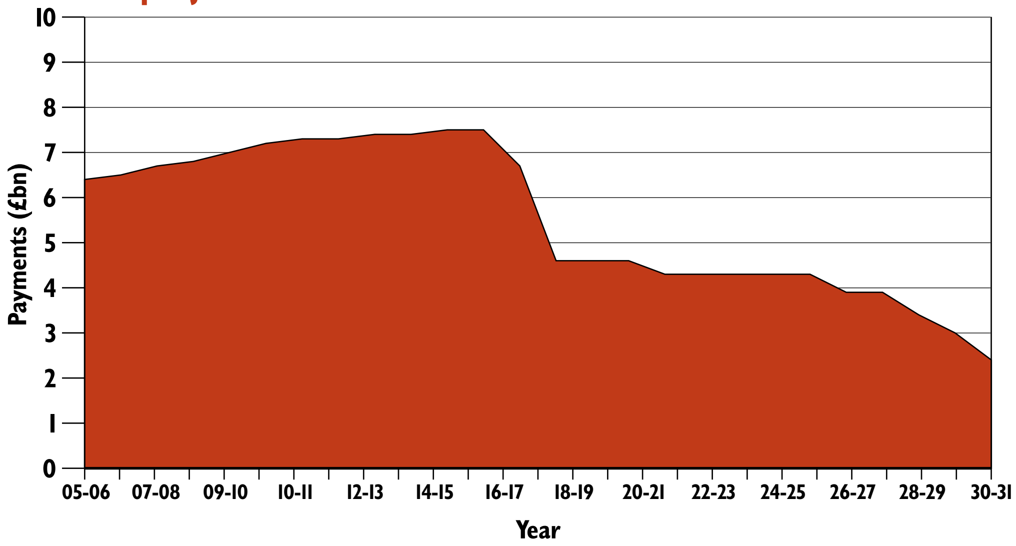
2.26 These annual payments under PFI unitary charges make up a very small proportion – under two per cent – of departments' total annual resource budgets (£6 billion out of £304 billion in 2005-06), as illustrated in Chart 2.8.

Chart 2.8: Estimated PFI unitary charge payments as a proportion of DEL (£bn) in 2005-06



Source: 2005 Pre-Budget Report.

Chart 2.9: Estimated payments in real terms under signed PFI projects



Source: 2005 Pre-Budget Report. These figures represent the estimated payments that the public sector expects to make to the private sector for services delivered under PFI. The payment mechanisms of PFI contracts contain provision for performance deduction – which reduce payment if the service is unavailable or to a poor standard to incentivise contractor performance – and may therefore be lower than these figures. These figures include estimates of the first 15 years of LUL PFI contracts as these contracts are reviewed periodically and payments also include tax payable by the private sector in respect of profits earned on the PFI scheme.

2.27 The accounting treatment of a PFI project on a departmental balance sheet, and its reflection as an asset in the national accounts, plays no part in the Government's decision about when to use PFI. That decision is based on value for money. Around 50 per cent of PFI projects by capital value are reported on departmental balance sheets. The accounting treatment follows rules set and audited by a series of independent national and international organisations.

OPENNESS AND TRANSPARENCY

2.28 It is the Government's policy that public services are accountable and responsive to the communities they serve. The Government seeks to ensure that PFI is as open and transparent as possible. As well as improving accountability, this approach leads to better management of programmes and projects, and helps the private sector plan its investments in PFI.

Publishing PFI information

2.29 Since 1997, the Government has introduced a number of reforms that have significantly increased the transparency of PFI and improved accountability for service users and service providers:

- an estimate of future payments contracted for by each PFI scheme is published biannually in the Financial Statement and Budget Report, and the Pre-Budget Report;
- the capital value of contracts signed to date and in procurement is published in the Financial Statement and Budget Report, and the Pre-Budget Report;
- an annual record of signed deals committed to in the previous year is published on the Treasury's website; and
- a published summary of the PFI pipeline by department.

2.30 In "PFI: Meeting the Investment Challenge" it was announced that an online database of PFI projects, managed and updated by Partnerships UK, would be introduced. The database is now publicly available on Partnerships UK's website. The Government also stated that it would investigate the feasibility of publishing further information on operational performance to improve the management of PFI programmes, and increase accountability and openness.

2.31 In order to improve further the transparency of future deal flows, departments will, from the 2007 Comprehensive Spending Review, publish all stage 1 value for money assessments that are undertaken in order to determine their likely PFI spend on programmes. This document reports back, in Chapter 4, on the Government's commitment to assess the operational performance of PFI projects and publish the results.

2.32 The Treasury intends to improve further overall accountability and transparency, by encouraging all departments to follow the example set by the Department of Health (see Box 2.1) so that:

- the outline business case for projects will be published on the website of the procuring authority within three months of final approval; and
- the strategic business case for projects (bar commercially confidential information) will be published on the website of the procuring authority within three months of financial close.

Box 2.1: Openness and transparency best practice - Department of Health's approach

The approach of the Department of Health (DoH) is set out in the "Code of Practice on Openness in the NHS." This document sets out the principle that the NHS should publish information and respond positively to requests for information, except in narrowly defined circumstances, such as where the information relates to patients' records.

In accordance with this Code, the DoH requires that procuring authorities publish an executive summary of every PFI project. In drafting this, procuring authorities follow a template that sets out the information that should be included. This information includes:

- **background details, such as the project specification, investment objectives and the expected timing of key dates;**
- **project details, such as the total capital cost, the scope of facilities management services included in the contract and details of the consortium partners;**
- **capacity details, such as demand assumptions and scope for future flexibility;**
- **staffing/TUPE details, such as the number and timing of any staff being transferred or seconded to the consortium;**
- **financial details, such as the unitary charge amount and the indexation basis; and**
- **other key details, such as derogations from the standard contract and the terms allowing deductions from the unitary charge.**

3 The Government's approach to PFI

This chapter sets out the Government's approach to PFI and its place in the choice of procurement routes open to the Government. The Government uses a range of procurement structures for complex investment projects and which route is chosen depends on which structure will offer best value for money given the particular characteristics of a project. The Government only uses PFI where it can be shown to deliver value for money, and where this is not at the expense of employees' terms and conditions. This chapter sets out the steps the Government has taken to continue to meet its committment to workforce protection.

As set out in "PFI: Meeting the Investment Challenge", PFI offers value for money benefits for certain complex investment projects, particularly through: a long-term focus on whole-life costs; risk management expertise; and much greater certainty for the public sector that services will be delivered according to specified outputs. These benefits are derived from the PFI risk-sharing structure, whereby the risks associated with a project are borne by the party that can best manage those risks.

Since "PFI: Meeting the Investment Challenge", the Government has emphasised that PFI would be used where it offered best value for money by:

- **publishing the "Value for Money Assessment Guidance" in August 2004 which must be followed by all Government departments wishing to pursue a PFI programme; and**
- **stopping PFI where it was not found to be likely to generate value for money as was the case for information technology projects and projects with a capital value of less than £20 million.**

Based on the evidence of PFI in operation and in procurement set out in this document, the Government will:

- **update the "Value for Money Assessment Guidance" to improve further the assessment of value for money of PFI; and**
- **refine the standard PFI contract guidance to reflect the lessons from the Treasury's operational performance research and further improve the value for money offered by PFI.**

The Government is committed to developing procurement vehicles that achieve value for money for investment through PFI in alternative ways. This chapter sets out two alternative approaches to delivering investment through PFI alongside other forms of procurement:

- **long-term partnership models; and**
- **the project delivery organisation model.**

Introduction

Overview **3.1** As set out in "PFI: Meeting the Investment Challenge" and the "Value for Money Assessment Guidance", the Government uses PFI only where it can be shown to deliver value for money and where this is not at the expense of employees' terms and conditions. This chapter sets out the Government's approach to PFI. The Government is developing alternative approaches to drive better value for money in PFI investment. Many of the drivers of value for money present in the PFI model and process would also create value for money for other procurement routes.

3.2 This chapter outlines:

- the procurement routes for complex public sector investment projects, of which PFI is one option;
- the drivers of value for money in procurement for complex investment projects;
- how the PFI structure and procurement process delivers value for money; and
- what the Government is doing to assess the benefits offered by PFI, and secure risk-sharing benefits in the standard PFI contract guidance.

3.3 This chapter also sets out how the Government is using other approaches to PFI procurement such as strategic partnerships, as being used in the Building Schools for Future (BSF) programme. Paragraphs 3.45 to 3.52 report on recent experience in the use of strategic partnerships and consider alternative approaches to delivering investment through PFI while reducing procurement times.

PROCUREMENT OF COMPLEX INVESTMENT PROJECTS

The Government's approach

3.4 As outlined in Chapter 2, the Government has established a significant and ambitious programme to improve public services. The objectives of this programme are to:

- improve outcomes including the achievement of higher standards, reduced inequalities and greater user satisfaction, the delivery of excellent, equitable and more personalised public services;
- ensure value for money so as to fulfil the Government's obligation to taxpayers and service users to employ resources efficiently and effectively; and
- strengthen accountability by ensuring that those delivering public services are responsive to the needs and preferences of the individuals and communities they serve.

3.5 Alongside its investment programme, the Government is committed to continuing improvement in the delivery of public services. The Government's public service reform programme, which is designed to help achieve the Government's objectives for public services, is based on four main elements including:

- setting clear goals and establishing national standards, through the Public Service Agreement (PSA) framework, and improved inspection, regulation and information to drive up standards and increase accountability;
- implementing devolved decision-making by increasing front-line operational freedoms and local accountability to deliver more responsive services, including through local government reform and provision of more autonomy to police and schools;
- increasing personalisation to deliver user-focused services. This includes providing greater choice in the services available and more opportunities for users to participate in their design, delivery and governance, equipping public service professionals to deliver more personalised services, and drawing on the voluntary and community sector's expertise in meeting diverse user needs; and

- securing efficiency improvements in the way public services are delivered through progress in implementing the 2004 Spending Review efficiency targets.

3.6 PFI needs to be viewed in the context of the Government's wider investment and procurement programme. PFI is one of the ways in which Government has been delivering the public services reform programme, to drive value for money and efficiency improvements.

VALUE FOR MONEY IN COMPLEX INVESTMENT PROJECTS

Overview

3.7 Government procurement totals well over £100 billion each year, across a vast range of goods and services. At one end of the spectrum this includes the bulk purchases of single commodities such as stationery, and the purchase of energy and other utilities for public buildings. More complicated are buying things like services to clean or maintain buildings, while at the largest end of the scale the Government procures assets and associated services such as schools, hospitals, roads or military equipment and major information technology projects. PFI is one of several procurement structures that the Government has developed to improve value for money at the largest end of the scale.

Defining value for money

3.8 Government Accounting defines value for money as "the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user's requirement".[1] As this definition makes clear, value for money in procurement should not be assumed to mean the lowest cost option, but understanding the whole-life benefits and costs of a particular procurement. This chapter lays out a broad framework for considering the drivers of value for money in procurement, drawing not just on experience through PFI but also in wider procurement.

The investment decision

3.9 Before assessing the value for money in procurement, the first decision is whether there is a strategic need for the Government to address and whether the benefits of the intervention would outweigh the costs. For any given project, it must be clear that this will be in line with strategic policy direction. Guidance on analysing the strategic need for a potential project is laid out in the Green Book.[2] As far as is practicable, the policy decision to invest funds should be separated from the decision to undertake a particular procurement route, and the value for money of both the strategic policy choice and the procurement choice must be explicitly and separately justified at the earliest stages of the project.

3.10 Once the strategic investment decision for a project has been outlined, the public sector will seek to ensure value for money is achieved when procuring the project. Achieving best value for money is at the heart of any procurement decision made across Government. This requires that for every procurement:

- sufficient preparation is undertaken. The preparation of a project before going to market can take significant amounts of time, and must be undertaken rigorously, irrespective of whether the structure is a conventional procurement, PFI or another type of procurement structure. Activities required to prepare a project for market include: setting clear objectives for the procurement; developing an authority's requirements and specifications

[1] "Government Accounting". HM Treasury, 2000.

[2] "The Green Book: Appraisal and Evaluation in Central Government". HM Treasury, 2003.

developing an appropriate procurement process; undertaking sufficient design work and stakeholder management; and assessing whether there is a competitive market for the project. Sufficient work in preparation is essential also to ensure that procurement times are minimised;

- the procurement process must be designed and managed effectively. The key goal of managing a procurement process is to maintain competitive tension while achieving the requirements laid out in the project preparation stage. The need to manage the procurement process effectively is also common across all types of procurement structure to achieve best value for money; and
- the appropriate procurement structure must be chosen to maximise value for money given the characteristics of the particular project. Over the past decade, the Government has increasingly developed a number of procurement options that use various contractual and organisational structures to work with the private sector to deliver value for money. The next section sets out what generates value for money in different complex investment project procurement structures.

DRIVERS OF VALUE FOR MONEY IN PROCUREMENT

Drivers of value for money

3.11 There are certain features of different procurement structures that can be harnessed to generate value for money. The procuring authority developing a project will need to choose the procurement structure that best creates value for money to reflect the characteristics of a particular project. For complex investment projects, the value for money drivers in different procurement structures are:

- an appropriate allocation of risks between the parties associated with the project;
- a procurement structure which optimises the whole life costs over the life of the project;
- an output based specification, reducing the complexity and risk for the public sector procurer by freeing the public sector of the need to plan the long-term detailed input requirement to deliver that service, and allows the bidders to develop innovative approaches or solutions which deliver value for money;
- sufficient flexibility to allow for changes in service requirements over time while providing sufficient certainty to bidders to innovate in delivery of the service;
- appropriate incentive structures for the private sector to deliver services in a timely and efficient manner; and
- risk management expertise provided through external due diligence or specialist risk management providers.

3.12 All of these value drivers will be present to a greater or lesser extent in all the procurement routes listed above. For example, all procurements should seek to consider and optimise the whole life value of a project. However, some procurement structures are inherently more likely to achieve whole life value, for example where the private sector partner is integrated into the project throughout the duration of the service and can therefore be properly incentivised to consider whole life costs throughout the project life. Public sector procuring authorities should understand the extent to which different procurement routes are able to meet the drivers of value for money.

WHEN DOES GOVERNMENT USE PFI?

Government's approach

3.13 The Government remains committed to the approach to PFI laid out in "PFI: Meeting the Investment Challenge" that:

- the choice of procurement route is based on an objective assessment of value for money;
- there is no bias between procurement options;
- value for money does not come at the expense of employee terms and conditions; and
- the use of PFI is consistent with the Government's wider public sector reform agenda.

3.14 The Government's approach to PFI is enforced through the "Value for Money Assessment Guidance". PFI offers value for money benefits, particularly through: a long-term focus on whole-life costs; risk management expertise; and greater certainty for the public sector. Box 3.1 explains the likely characteristics of a successful PFI project that will lead to these benefits.

Box 3.1: Value for money in PFI

PFI is likely to generate value for money where:

- **there is a major capital investment programme, requiring effective management of risks associated with construction and delivery;**
- **the private sector has the expertise to deliver and there is good reason to think it will offer value for money;**
- **the structure of the service is appropriate, allowing the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective, equitable and accountable delivery of public services in the long term, and where risk allocation between public and private sectors can be clearly made and enforced;**
- **the nature of the assets and services identified as part of the PFI scheme are capable of being costed on a whole-life, long-term basis;**
- **the value of the project is sufficiently large to ensure that procurement costs are not disproportionate;**
- **the technology and other aspects of the sector are stable, and not susceptible to fast-paced change;**
- **planning horizons are long-term, with assets intended to be used over long periods into the future; and**
- **robust incentives on the private sector to perform can be set up.**

Where PFI is not appropriate

3.15 The Government also recognises that there are areas where, based on an understanding of the drivers of value for money in procurement and on the basis of past experience, the PFI procurement structure is unlikely to deliver value for money:

- where the pre-conditions of equity and accountability in public service delivery cannot be met, as in most forms of frontline service delivery;
- where authorities require a significant degree of short-term flexibility due to fast-changing service requirements. It is for this reason and from the evidence of past projects that PFI is not used by the Government for information technology projects; and
- where the investment is small and the benefits of PFI do not justify the significant costs required during the PFI procurement process. For projects of less than £20 million in capital value, other procurement routes will be more appropriate.

Meeting challenges in new sectors

3.16 One of the sectors identified in "PFI: Meeting the Investment Challenge" as having potential for value for money through PFI was waste and recycling. Nine waste PFI projects have been signed to date, with a total capital value of £650 million. A further eleven projects are in procurement and will make a valuable contribution to diversion from landfill, increase recycling rates and promote a more sustainable approach to the treatment and disposal of waste. However, progress in the provision of PFI projects in the waste sector has been slow. Projects have experienced planning problems relating to facility construction, a constrained market of bidders for end-to-end services (encompassing collection, treatment and disposal) and affordability pressures relating to the costs of disposal. To address these issues the Department for the Environment, Food and Rural Affairs (DEFRA) has progressed the quality of business cases being produced by local authorities, increased engagement with the market, and stimulated levels of interest amongst private sector funders and contractors.

3.17 DEFRA is currently examining how best to deliver waste infrastructure through its waste strategy review. This will be informed by the findings, expected soon, of the Government's Kelly Market review led by the Office of Government Commerce (OGC) which is examining the waste sector under its remit of increasing competition and improving long term capacity planning in the government market place. The National Audit Office (NAO) will also publish a study shortly examining the extent to which actions are enabling England to meet the EU landfill targets for reducing biodegradable municipal waste sent to landfill. The Treasury, 4ps, Partnerships UK and OGC are working with DEFRA to consider the findings of these studies and explore the options for adjusting the current PFI model to achieve a better value for money solution for delivering waste infrastructure.

3.18 Another sector identified in "PFI: Meeting the Investment Challenge" as likely to benefit from PFI was housing, because:

- it involves the provision of capital assets where effective project management incentivised by appropriate risk-sharing would bring significant benefits; and
- assets, due to their long life, could benefit from design, construction and costing made on a whole-life basis by private sector parties incentivised to ensure best value.

3.19 There are a number of challenges facing PFI in the housing sector caused by issues such as the complexities in obtaining planning permission for multiple sites and difficulties in estimating costs for the refurbishment of properties at the outset of procurement. Some of these issues led to delays and cost increases in pathfinder housing projects. Based on experience the Government believes that PFI in housing represents value for money. Recent projects entering procurement have presented business cases that have learnt the lessons of pathfinder projects. The Office of the Deputy Prime Minister (ODPM), which is responsible for social housing policy and delivery is seeking to further improve procurement efficiency and value for money of projects by introducing further financial and legal expertise as well as centralising its Private Finance activities. As part of this work it is also assessing whether a partnership or project delivery model would be suitable for this sector.

3.20 PFI for the provision of social housing has received a substantial uplift in funding in recent spending reviews, receiving an allocation of £1.2 billion in 2004-05 financial year. PFI is making an important contribution to the Government's aim of bringing all social housing into a decent condition by 2010, and in the provision of additional social rented homes. The programme as it currently stands will deliver about 27,000 dwellings for the Decent Homes Standard, and almost 4,000 rented homes. The schemes will also deliver wider sustainable development of communities, and facilitate new build for sale or shared ownership. Nine housing PFI projects have been signed with a total capital value of £429 million, increasing the number of decent homes by 8,000. A further 15 projects are in procurement.

THE PFI PROCUREMENT PROCESS

3.21 Having a robust, efficient and well-managed procurement process is central to driving value for money from any procurement structure. At each stage, the public sector undertakes several different activities to ensure value for money. The current PFI procurement process generally comprises of the following stages:

- advertising in the Official Journal of the European Union (OJEU) which begins the formal procurement process;
- issuance of the Pre-Qualifying Questionnaire which is used to identify a short-list of contractors with which to proceed with in the procurement;
- issuance of Invitation to Negotiate (ITN) sets out formally the procuring authority's detailed requirement, the commercial conditions associated with project and how responses will be evaluated;
- submission and evaluation of bids where the procuring authority assesses the responses from bidders against the criteria set out in the ITN;
- selection of the preferred bidder is the point at which the procuring authority selects its preferred contractor following the evaluation; and
- commercial and financial close is the point when the commercial contracts are signed and finance raised by the PFI contractor.

3.22 EU procurement law governs the structure of the procurement process. Box 3.2 outlines the main features of EU procurement and how forthcoming changes are likely to change the PFI process.

Box 3.2: EU procurement law

The European law relating to public procurement, including PFI, recently changed. Rules implementing the revised public sector procurement directive came into effect from 31 January 2006. This directive introduced the competitive dialogue procedure for use in particularly complex contracts like PFI.

The main features of the competitive dialogue procedure are:

- **dialogue is allowed with selected suppliers to identify and define solutions to meet the needs and requirement of the contracting authority;**
- **the award is made only on the most economically advantageous tender criteria;**
- **dialogue may be conducted in successive stages, with the aim of reducing the number of solutions/bidders; and**
- **there are explicit rules on post-tender discussion.**

The competitive dialogue procedure supplements the existing competitive negotiated procedure and formalises the processes that are already undertaken in many PFI procurements. The Office of Government Commerce (OGC) recently published guidance for procuring authorities on running procurements under the competitive dialogue provisions and this guidance is available on the OGC website. Further guidance may be available on a sector by sector basis, for example Partnerships for Schools has published detailed guidance on their website.

ASSESSING VALUE FOR MONEY IN PFI

Government's approach

3.23 For the last Spending Review, the Government instituted a revised process for assessing the value for money of PFI projects. This process gives an indication at an early stage as to whether PFI is likely to represent value for money based on real evidence of PFI in practice, and enables an ongoing assessment of the project to ensure value for money is maintained during procurement. The value for money assessment process contains three stages:

- Stage 1: is an initial assessment undertaken by departments during the Spending Review of whether PFI is likely to provide value for money for a whole programme of complex investment projects;
- Stage 2: is a later assessment undertaken by project teams working on a project within the PFI programme to assess whether PFI is likely to provide value for money given the individual circumstances of a particular project; and
- Stage 3: is an ongoing assessment of the continued competitiveness of the market to ensure that value for money is not compromised once the assessment that PFI is the best route has been made and the procurement commenced.

3.24 An outline of the new process was provided in "PFI: Meeting the Investment Challenge" and following extensive consultation with all public and private sector PFI stakeholders, the methodology was formalised in the "Value for Money Assessment Guidance" published in August 2004. Some key features of this process are:

- a qualitative assessment: which gives a greater emphasis on assessing the likely value for money of PFI based on evidence from past projects. In the early development of PFI models, approaches to assessing value for money had greater reliance on quantitatively assessing the likely value of risk transfer. There is, in many sectors, sufficient evidence of PFI working in practice to allow an evidence-based assessment;
- a quantitative assessment with a simpler approach than the previous risk-adjusted Public Sector Comparator (PSC), as the initial value for money decision is taken earlier in procurement with a greater emphasis on qualitative factors. Eliminating redundant quantitative work reduces the costs of assessment and reliance on outside advisers;
- an emphasis on the need separately to make an assessment of the likely affordability of a project: project teams are expected to develop a model of what the PFI project will actually cost to judge affordability. Projects which appear to be unaffordable based on actual cost data will not receive approval to go to market;
- emphasis that value for money should not be achieved at the expense of workers' terms and conditions; and
- the decision whether to undertake PFI for a given project is made earlier in procurement, and only reversed if there is evidence of market abuse or lack of competition.

3.25 All departments with major PFI programmes have implemented the "Value for Money Assessment Guidance" processes. All local authority projects seeking approval from the Project Review Group must now complete Stage 2 assessments. Where appropriate, departments developed an initial Stage 1 assessment for the 2004 Spending Review period, and departments will be expected to produce a robust Stage 1 assessment for the 2007 Comprehensive Spending Review. Departments are expected to continue to build evidence bases on outcomes of PFI projects to support the qualitative and quantitative assessments. The experience of the process over the past two years suggests that this represents a major improvement in ensuring that PFI is used only when it represents best value for money. The Government will seek to improve and revise the "Value for Money Assessment Guidance" in advance of the 2007 Comprehensive Spending Review. The basic structure of the process, with three stages and qualitative and quantitative assessments, will not change.

Single bidder projects

3.26 One of the changes to the "Value for Money Assessment Guidance", as part of the Stage 3 assessment will be to clarify the circumstances when single bidder projects may be allowed to proceed. Policy is that there should be a strong presumption that single bidder projects will not be value for money, except under exceptional circumstances. This remains the position, and the Treasury will give greater clarity as what those exceptional circumstances will be and clarify the process for gaining approval for proceeding with a project when there is limited market interest in the project. Procuring authorities are required to consult the Treasury before proceeding with a project with a single bidder.

3.27 A challenge for the Government in coming years is to ensure that its procurement structures can meet adequately its changing needs for capital assets that support the delivery of public services. This is part of the work to be undertaken in the Comprehensive Spending Review. At present, the process of the "Value for Money Assessment Guidance" assesses only the value for money of the PFI procurement route against conventional procurement.

COMMITMENT TO WORKFORCE PROTECTION

3.28 PFI: Meeting the Investment Challenge" made clear that that whilst PFI has the potential to bring improved value for money in public services with greater quality and innovation, value for money achieved in PFI projects should not be at the expense of staff terms and conditions. The Government continues to pursue a strategy for enhancing worker protections and ensuring fair and reasonable treatment in PFI projects, based on:

- being open with staff;
- protecting terms and conditions for both transferees and new joiners;
- protecting staff pensions; and
- retaining flexibility in public service delivery, including through PFI.

3.29 Since 1997 the Government has been, and continues to be, determined to extend the protection of the terms and conditions for staff transferring to the private sector; address uncertainty and anxiety caused to the public sector staff in relation to a PFI project, as well as the potential disparity between the terms and conditions of new joiners and transferred. To this end a number of successful measures have been introduced:

- Fair Deal for staff pensions 1999;
- Cabinet Office Statement of Practice 2001;
- Retention of Employment Model for the NHS 2001; and
- Best Value Code of Practice.

3.30 More recently the Government has introduced further measures demonstrating the Government's commitment to the protection of new joiners and to ensure that the value for money achieved in PFI projects should not be at the expense of staff terms and conditions:

- extension of the Best Value Code of Practice to central Government departments, agencies and Non-Departmental Public Bodies (NDPBs);
- Agenda for Change agreement addressing the inequality between NHS staff on the Agenda for Change terms and conditions and those on standard contracts; and
- "Value for Money Assessment Guidance" issued in 2004 includes a quantitative model which does not allow for different assumptions for staff costs between the PSC and PFI.

Best Value Code of Practice

3.31 The Government's Best Value review in 2002 led to the publication of the Best Value Code of Practice, which came into practice in 2003. The Best Value Code of Practice applies to new joiners to workforces employed by contractors in areas covered by Best Value. These include local authority projects in a wide variety of areas, such as transport, education, police and fire services, waste management, and housing.

3.32 The Best Value Code of Practice protects both terms and conditions of employment and pensions. It requires that new joiners be offered terms and conditions that are "fair and reasonable" and "overall, no less favourable" than those available to transferees. The deal is designed to protect workers while maintaining the flexibility for employers to deliver quality public services. It does not prevent firms in tight labour markets from offering packages superior to those afforded by the public sector.

3.33 The terms and conditions should "offer reasonable pension arrangements", defined as either:

- membership of the local government scheme;
- membership of a "good quality" employer pension scheme (if it is defined-contribution, the employer must match employee contributions by up to six per cent); or
- a stakeholder pension (with the same matching requirement).

3.34 The Government subsequently announced that this standard should also be written into new TUPE regulations to apply to all compulsory transfers of staff in the economy. It will remain open to any employer to set out a standard for protection of transferees that exceeds this minimum standard and the government remains committed to maintaining its own standard of pension protection where TUPE applies.

Recent measures for new joiners

Extension of the Best Value Code of Practice

3.35 The Government has also announced the extension of the Best Value Code of Practice to central departments, agencies and NDPBs, with effect from April 2005. Like the Best Value Code of Practice for local authorities it requires that new joiners be offered terms and conditions that are "fair and reasonable" and "overall, no less favourable" than those available to transferees. The Best Value Code of Practice now covers all contracts undertaken by the Government where new joiners will be working with staff transferred from the public to the private sector.

NHS Agenda for Change Agreement

3.36 More recently the Government has announced a further deal in the NHS, beyond the existing measures of the Best Value Code of Practice and Retention of Employment Model (ROE), to remove the disparity between those staff that are transferred from the public to the private sector and new joiners. As part of the Agenda for Change programme a minimum rate of pay will be implemented on all outsourcing contracts. The agreement is only applicable to NHS in England. As PFI contracts are already covered by the retention of employment model, only a small number of PFI contracts will be affected.

Transfer of soft services staff

3.37 To ensure that value for money delivered by PFI does not come at the expense of employees' terms and conditions, departments already have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not essential for achieving the overall benefits of improved service delivery specified by the procuring authorities, and where not transferring staff is consistent with delivering the Prime Minister's commitment to flexibility in public service provision. Chapter 5 sets out the steps Government is taking to strengthen the value for money test for including soft services in a PFI project.

RISK TRANSFER IN PFI

Overview

3.38 The benefits of PFI flow from ensuring that the many different types of risks inherent in a major investment programme are borne by the party best placed to manage those risks. As set out in "PFI: Meeting the Investment Challenge", the Government does not seek to transfer risks to the private sector in a PFI project as an end in itself. Where risks are transferred, it is to create the correct disciplines and incentives on the private sector, which then drive value for money through more effective risk management. In general, the Government underwrites the continuity of public services, and the availability of the assets essential to their delivery, but the private sector contractor is responsible for its ability to meet the service requirements it has signed up to. Where it proves unable to do so, there are a number of safeguards in place for the public sector to ensure the smooth delivery of public services, but the contractor is at risk to the full value of the debt and equity in the project. The full value of that debt incurred by the project, and the equity provided by contractors and third parties, is the cap on the risk assumed by the private sector.

Risks transferred to the private sector

3.39 The risks that the Government seeks to transfer are specifically identified and limited. In PFI, the transferred risks are typically:

- meeting required standards of delivery. So if, for example, the project's design is unable to provide the required service needs, the private sector would need to pay the cost of rectifying the design to meet those requirements;
- cost overrun risk during construction. If, for example, ground conditions are discovered to be unstable after construction begins, and the building requires considerably more extensive foundations, the private sector would need to

cover those extra costs in order to complete the building to the required standard. There would be no increase in the public authority's unitary charge payments. In conventional procurement, the public authority would be forced to cover these costs;

- timely completion of the facility. If, in the example of unstable ground conditions cited above, the facility was completed and delivered late to the public sector, no payments would be made to the private sector until it was available;
- underlying costs to the operator of service delivery, and the future costs associated with the asset. For example, where the private sector takes on an existing building in a PFI project, it takes the risk of any latent defects in the building requiring remedy. The private sector would need to make these remedies, and cover the cost of them, to continue to receive payments for the building's availability;
- risk of industrial action or physical damage to the asset; and
- certain market risks associated with the scheme. For example, in some road schemes, the risk associated with actual traffic which uses the road.

Private sector risk allocation

3.40 With most PFIs, the risks transferred by the public sector to the private sector are then reallocated between the different private sector parties participating in the PFI project, using a central consortium company with subcontracts as a means of distributing these risks amongst the private sector participants.

3.41 One or more equity investors own the consortium company. Some of these shareholders may also be contractors to the central consortium company, although increasingly third parties are providing equity. The consortium will also raise debt finance, in the form of bank debt or bonds, to pay for the construction and operation of the project. This debt is at risk if the consortium is unable to meet its debt service obligations.

3.42 Within this structure, the private sector reallocates risk to the most appropriate parties. Typically:

- the construction contractor, under a subcontract with the consortium company, takes the design, construction, cost overrun and completion risk;
- the service provider, under a subcontract with the consortium company, takes the risk of timely and cost effective service provision;
- insurers provide protection for risks of damage and business interruption; and
- the consortium company, its lenders and investors are therefore left with a series of residual risks, some of which are risks on the subcontractors' performance.

3.43 The benefits of this consortium joint venture structure are that it permits different parties to become involved in the PFI scheme and share the risks effectively. It also permits the involvement of lenders who must assess the strength of the contractual arrangements and the level of support offered as they rely on these when it comes to repayment of their loans.

Risks retained by the public sector

3.44 Successful PFI projects aim for an optimal division of risk between the public and private sectors. There are certain risks that are best managed by the Government and to seek to transfer these risks would not offer value for money for the public sector. While the risks identified below are retained by the public sector, PFI contracts contain provisions to mitigate these risks. For example, the variation mechanism enables the public sector to vary the service being provided under the PFI project. Ultimately, if the public sector requires a fundamental change to its asset base it can terminate the contract. Chapter 5 sets out the steps Government is taking to improve to public sectors ability to mitigate risks in these areas. The risks that are usually retained by the public sector are:

- whether the service specified in the contract is required and adequate to meet public demand and expectations. This requires that, as for conventional procurement, the public sector invests significant resources upfront in assessing the long-term requirements of a project;
- the possibility of a change in public sector requirements in the future. As with conventional procurement, if the needs of public services change, the Government retains the responsibility to make alterations to the infrastructure base and the services provided. It is important that public authorities assess the need for future flexibility properly when making an assessment of the value for money of PFI and other procurement routes;
- in most cases, the extent to which the facility is used or not over the contract's life. For example, if the demand for school places in an area drops significantly, the Government would continue to pay the unitary charge for a PFI school, in much the same way as it would continue to pay for maintaining a conventionally procured school; and
- general inflation risk. Part of the unitary charge is typically linked to inflation, and so is subject to the same inflation risk as future maintenance or other costs in a conventional procurement.

PFI INVESTMENT IN ALTERNATIVE PROCUREMENT VEHICLES

Overview **3.45** PFI is just one procurement route, and the evidence shows that it is appropriate to use PFI for certain types of complex investment projects only. The Government is seeking to continue to use PFI procurement within wider procurement structures and potentially alongside other forms of procurement.

3.46 The Government also aims to develop procurement models that capture the benefits of PFI but can develop other benefits. Two models being developed are:

- strategic partnerships: where smaller investments in PFI and non-PFI projects are planned and managed by an organisation which is a joint venture between public and private sector, and has a long term, strategic relationship with the procurer(s). This has so far been used for programmes where there is a long-term investment plan that needs to be rolled out consistently across different regions or sectors, but, through its long term nature, cannot be fully specified and priced at the beginning; and
- a project delivery organisation model: where the public sector authority procures a "project delivery organisation" to manage the delivery of a project through procurement, construction and into operation. The organisation becomes the deliverer of the service to the public sector on completion of the procurement phase. The objective of this model is that through early contractor involvement, the procurement can be managed more efficiently whilst the potential PFI benefits through construction and operation can also be achieved.

Partnership procurement models

Recent experience

3.47 In the past few years, strategic partnership models have been developed which provide umbrella organisations to procure smaller PFI or PFI-like projects alongside other forms of investment such as information technology systems. The two main examples are in the health and education sectors:

- NHS: Local Improvement Finance Trusts (LIFT): This is a programme to deliver £1 billion of investment initially to refurbish GP practices and create one-stop primary care centres. Investment is delivered by local LIFT companies, which are a joint venture of the local Primary Care Trusts, a private sector partner and Partnerships for Health (PfH), itself a joint venture between the Department of Health and Partnerships UK. To support this joint venture PFH provides procurement expertise and direction. 40 local "partnership" LIFT companies have been created, and another 10 are in development, giving a private sector partner exclusive rights to undertake projects. To date LIFT has attracted £671 million additional investment into primary care facilities, and by the end of 2004 1510 one stop primary care centres were under construction.

- Education: Building Schools for the Future (BSF): This is a 15-year investment programme providing about £2.2 billion capital investment per year to upgrade the entire secondary education school estate. Local Education Partnerships (LEPs) are formed by the appointed private sector partner, working in conjunction with the Local Authority and Partnerships for Schools (PfS), to develop a strategy for upgrading the secondary education infrastructure in a particular area. The LEP contracts to deliver the investment, which will be a mix of conventionally procured projects and PFI. PfS is the national enabling body providing support to roll out the programme nationally whilst providing central expertise and direction to local authorities.

3.48 The broad shape and advantages of the partnership programmes in health and education are similar, although LIFT is a smaller programme with the focus on property development while the BSF programme is concerned with school construction and integrating the delivery of services associated with the running of schools. A key feature of both models is that they provide a strategic framework for planning and delivering investment over a long term. For an individual LIFT or LEP company, the public sector offers exclusivity over a large volume of work to the private sector partner. The private sector partner brings expertise and can apply that in a long-term partnership. For LIFT, the private partner brings in particular expertise in property development. For BSF, the private partner brings expertise to allow innovation in school design as well as the capability to integrate various services so that, for instance, information and communication technology and building infrastructure mesh well with one another, supply chain management, economies of scale, and faster delivery. The central co-ordinating vehicles such as PfS or PfH assist with procurement and knowledge transfer across projects.

Relationship with PFI

3.49 The individual projects undertaken by LIFT or LEP companies are structured in similar ways to PFI projects, and some of the companies entering into LIFT agreements are also involved in PFI projects. There are important differences, however, particularly that:

- the local partnership (the LIFT or LEP company) is not a single Special Purpose Vehicle, but rather a joint venture. The partnership takes strategic planning and procurement decisions, previously the sole responsibility of the public sector, without undermining the responsibilities of the public sector; and

- there is an overall national programme management organisation, with support given by PfS or PfH to the local partnership. Most PFI projects currently are single projects managed by local authorities with limited national support.

Box 3.3: the National Audit Office review of LIFT[3]

The NAO recently published a positive review of LIFT that found that LIFT was an effective route for securing improvements in primary and social health care provided that effective accountability and performance frameworks are put in place. By October 2005, fifty LIFT schemes had been developed covering almost half of Primary Care Trusts and about 70 per cent of the population. To date LIFT has attracted £671 million additional investment into primary care facilities, and by the end of 2004 510 one stop primary care centres were under construction. The NAO reports concludes that NHS LIFT will work – "at a national level NHS LIFT is an attractive way of securing improvements in primary and social care. The local NHS LIFT schemes [we] examined appear to be effective and offer value for money. But local management frameworks need to be strengthened".

The report found that for certain types of investment, LIFT offers advantages over other forms of procurement. The NAO found that LIFT:

- **appears to be an effective and flexible procurement mechanism;**
- **offers a faster delivery route than PFI, with shorter procurement timeframes;**
- **is a suitable procurement route for smaller projects which would be unsuitable for PFI. This is because transaction costs are lower for LIFT projects;**
- **encourages an integrated approach, through "the co-location of health and social care professionals in one building together with a more integrated approach to primary care"**
- **through the long-term partnership model will allow greater flexibility in investment and "help meet changing priorities". There were "encouraging signs of longer-term thinking".**

The NAO report noted that it was expected that the LIFT model can evolve from a PFI based structure to look more like that of a traditional property business, with a portfolio of properties, and in doing so to improve and expand on the services available.

The benefits

3.50 It is still early in the development of both the major strategic partnership programmes, although the early indications are that these are delivering expected advantages and offer a procurement model for Government's long-term investment needs. The benefits of the procurement models include that:

- the economies of scale in management and procurement allow smaller projects to be undertaken with a similar structure to PFI but with lower transaction costs;
- centralised bodies provide expertise and spread best practice across all the strategic partnerships;
- the private sector is brought into a flexible partnership arrangement, allowing a strategic approach to investment over the long-term, using private sector expertise. In the case of LIFT, for example, the private sector partner provides property development and project management expertise.

[3] "Department of Health Innovation in the NHS: Local Improvement Finance Trusts", National Audit Office, 2005.

- procurement times have improved. A recent NAO report on LIFT found Ashton, Leigh and Wigan LIFT completed negotiations on a bundle of projects in 13 months, which compares well to the very varied and unpredictable lead times which alternative routes for primary care development have taken to provide just one building. The first waves for LIFT closed in on average 21-22 months, and significant reductions are expected now that the model is developed. The LIFT partnership arrangement also reduces the need for future negotiations.

3.51 It is still early in the development of partnership models of procurement to understand fully the benefits and problems of these models of procurement. The initial evidence suggests, however, that partnership models offer a useful alternative procurement model harnessing private sector expertise. It may be that the partnership model is appropriate for other sectors, although these likely to be appropriate only where there is a significant programme of investment driven by a long-term investment strategy. The Treasury will monitor the continuing progress of these programmes. In particular, partnership models should be encouraged to ensure that the benefits of scale in saving procurement time and management costs are realised in any further waves of investment.

Extending Strategic partnerships

3.52 Work is underway in the Office of the Deputy Prime Minister (ODPM) to assess whether a partnership model similar to NHS LIFT initiative or Building Schools for the Future would be suitable for the social housing sector. This assessment will also consider whether the project delivery organisation model proposed in the following paragraphs would be suitable for this sector.

Project delivery organisation

Project Delivery Organisation

3.53 A key challenge as discussed in Chapter 6 remains to improve the procurement skills and capabilities of the public sector to manage complex investment projects, including PFI, to reduce procurement times over an investment programme. Building on the experience from the approach being developed as part of the Military Flying Training System Project, the Government will be looking to pilot a project delivery organisation. Unlike an individual project, the project delivery organisation will manage the procurement of the underlying assets and then integrate those assets together with necessary component services to provide an overall service to the procuring authority. This may be beneficial in projects where there is a long construction period or where the service requires significant investment in new capital assets during the life of the contract or where there is a significant likelihood of material change in requirements throughout the life of the deal. This means that PFI investment can be managed alongside other forms of investment which are not suitable for PFI while still achieving improvements in service delivery.

3.54 Some of the possible advantages of this model of procurement are:

- reduced procurement times, as the private sector organisation acting as the project delivery organisation will be incentivised to deliver on-time;
- improved procurement capability, due to the better procurement delivery management skills brought in by the project delivery organisation; and
- early private sector involvement in projects.

4 PFI: MEETING PUBLIC SECTOR REQUIREMENTS IN PRACTICE

With over 500 projects now operational, PFI has established a track record for the effective delivery of public services. The Treasury commissioned Partnerships UK to conduct research on the performance of operational PFI projects. This is the most extensive piece of research examining operational projects carried out to date with responses from over 100 projects. It reveals that they are working well, although there are some areas for improvement. Key conclusions from this research are:

- **overall performance: PFI is meeting the expectations of users. Public sector contract managers report that 96 per cent of projects are performing at least satisfactorily, with 66 per cent performing to a very good or good standard. Users believe that service standards are delivered always or almost always in 79 per cent of projects. Some issues raised include defects stemming from construction (snagging issues) and the effectiveness of soft services performance.**
- **payment and performance mechanisms: payment mechanisms are effective at incentivising performance to a good standard. Payment deductions have been relatively low as contracts are generally meeting the required service levels under the contract for most projects, but they have generally been effective in stimulating improved performance when levied. However, there is a need to reduce the complexity of payment mechanisms.**
- **benchmarking/market testing: most PFI projects have not reached the first benchmarking/market testing point. There is a need to clarify the process, to identify comparable data, and to ensure a value for money outcome. Public sector managers wanted further support and guidance and expressed concern at the cost implications for projects. The Government's preference for market testing to provide a fair and transparent outcome is discussed in Chapter 5.**
- **change and flexibility: 83 per cent of contracts are described as always or almost always accurately specifying the services required, which indicates that PFI contracts do reflect the services needed by the public sector during operational life. Most changes that have occurred within PFI projects have been relatively small and have had little impact on the unitary charge. The variation mechanism within some older projects is considered sub-optimal, and at times did not incentivise parties to work within appropriate timescales.**
- **public/private sector relations: 97 per cent of public sector contract managers rated the relationship with their private sector counterpart as satisfactory or better, with 72 per cent rating it as good or very good. Continuity of contract management personnel on both the public and private sector sides is an influential factor on performance. Few operational projects have used the dispute resolution procedure provided in the contract.**
- **contract management: The overall performance assessment of PFI projects reflects well on those charged with managing them. Feedback on relations also demonstrates a positive and pragmatic approach that is shared across the public and private parties to the contract. Contract management specialists are under-utilised by the public sector during the procurement phase. There is a demand from public sector contract managers for more specific PFI training and to be able to share experiences with other public sector contract managers.**

The steps the Government is taking to address the issues raised by the research are set out in Chapter 5.

BACKGROUND

4.1 Over 500 of the 700 plus signed PFI projects are now operational. In recognition of the need for further research in this area, the Treasury commissioned Partnerships UK to carry out a comprehensive assessment of the performance of projects that became operational before 1 April 2005 and to identify any issues that were believed to be impeding them from attaining optimal performance and therefore delivering value for money. Within this overarching framework, the research gathered data covering a range of topics related to operational PFI, including:

- overall performance of the project;
- user satisfaction;
- payment and performance mechanisms;
- benchmarking and market testing of soft services;
- the capacity for flexibility and change within projects;
- the effectiveness of the PFI contract;
- relations between the public and private sector;
- the contract management team; and
- areas where further advice and support could be provided.

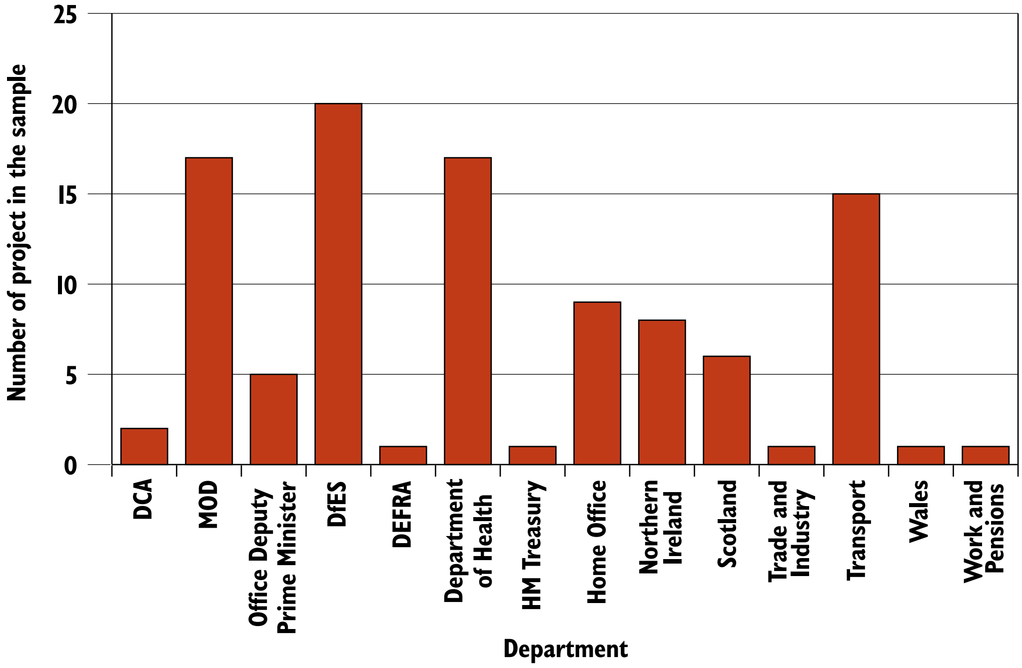
4.2 The research collected responses from 105 operational PFI projects, spanning a broad range of sectors (see Chart 4.1) and representing a population sample of over 20 per cent of all projects that are operational. It also included detailed interviews with 13 projects covering 10 sectors, and a review of the existing PFI research in this area. These different sources and techniques have generated a comprehensive report, published in parallel by Partnerships UK, on which the findings in this chapter are based.

Independent research

4.3 A number of other bodies, both public and private sector, have undertaken studies into PFI projects in operation. This includes research undertaken by the Department for Education and Skills (DfES), the Ministry of Defence (MoD) and Scottish Executive on their operational projects. Research has also recently been undertaken by 4ps and KPMG and the Business Services Association (BSA). The key constraint facing all studies conducted in this area is that operational PFI projects are still in their relatively early stages, with most projects still within the first five years of what could be 25-year contract periods. While this precludes the development of definitive conclusions in some areas of PFI, such as the effective delivery of long-term lifecycle maintenance, it does not inhibit the ongoing assessment of many others. This chapter seeks to draw together key findings both from the Partnerships UK study and from these other sources to provide a clear and comprehensive picture of PFI in operation.

4.4 Partnerships UK's research drew from a wide population of projects across the majority of PFI sectors. Chart 4.1 shows that this distribution and the number of responses broadly reflects the level of PFI activity in various sectors.

Chart 4.1: Research sample of operational projects



Source: Partnerships UK.

OVERALL PERFORMANCE

PFI is delivering in operation

4.5 Evidence on the overall performance of operational PFI projects reveals strongly positive results. It shows that the majority of PFI projects meet the required service levels, users are satisfied with the services being provided, and the benefits of partnerships are being realised. These results remain consistent when considered from a number of perspectives and across a number of studies, but are supplemented by a recognition that specific areas exist in which performance of PFI can be improved.

Performance assessed by the contract manager

4.6 A key measure against which to assess the performance of an operational PFI project is whether it is delivering the services stated in the contract to the standards specified. Partnerships UK research shows that contract managers report 96 per cent of projects are performing at least satisfactorily, with 66 per cent of projects performing either to a very good or good standard (see Chart 4.2). This finding is supported by the fact that 89 per cent of projects were reported to be achieving the contract service levels either always or almost always.

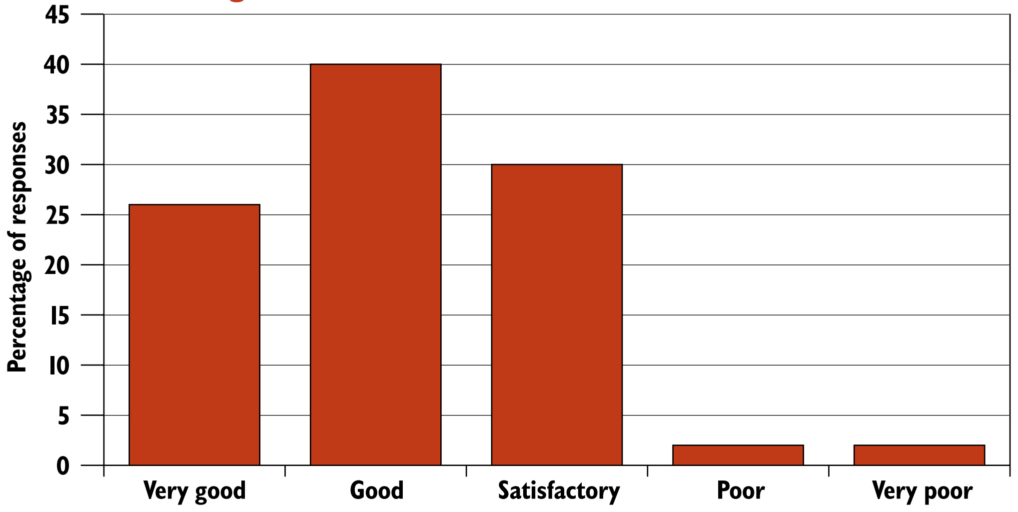
4.7 Other studies have revealed similar results. The 4ps study[1] into local authority PFI states that "service providers are in the main delivering the contracted services on time, to budget and within the specification". The study[2] carried out into Scottish PFI projects by Cambridge Economic Policy Associates (CEPA) on behalf of the Scottish Executive also found that most authorities thought that the standard of service met or exceeded expectations. The MoD study[3] found that all project teams surveyed reported performance as satisfactory or better.

[1] 4ps, "Review of Operational PFI and PPP Projects" (2005), Available online (20 November 2005) at www.4ps.co.uk.

[2] Cambridge Economic Policy Associates, "Public Private Partnerships in Scotland: Evaluation of Performance" (2005). A report for the Scottish Executive, available online at www.scotland.gov.uk.

[3] MoD "Review of MoD PFI projects in Construction and Operation" (2005).

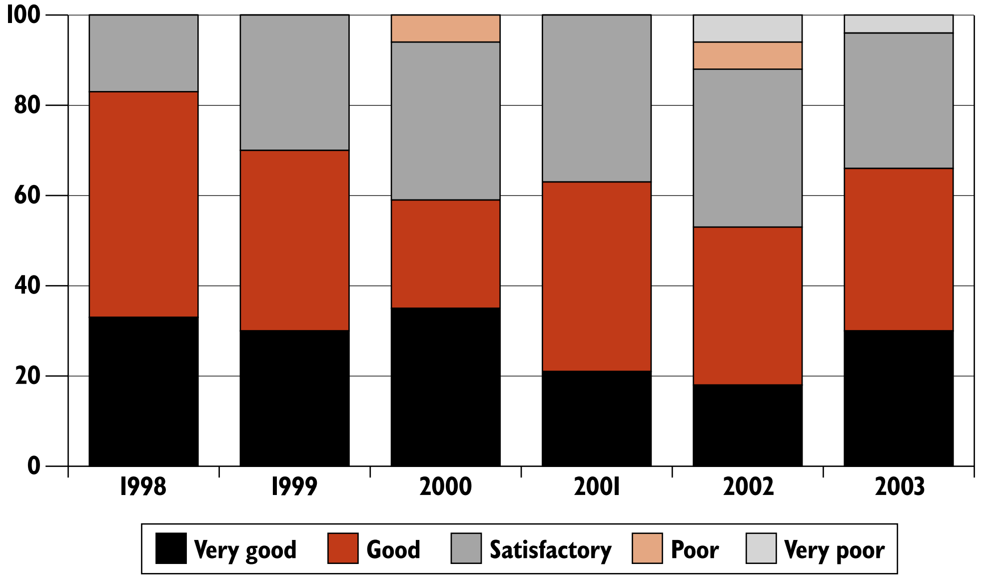
Chart 4.2: Rating the overall performance in terms of delivering the services stated in the PFI contract



Source: Partnerships UK.

4.8 A breakdown of the Partnerships UK performance results by the year in which projects became operational (see Chart 4.3) reveals that ratings are consistently strong over time, and potentially improve over time as projects mature. For example, of those projects that became operational in 1999, 70 per cent stated that the project was performing to a very good or good standard against the PFI contract. This compares with a figure of 63 per cent for those projects that became operational in 2001 and 65 per cent for those that became operational in 2003. This shows that a period of bedding in following commencement of service may initially lead to slightly lower levels of performance.

Chart 4.3: Breakdown of performance against the contract by the year that projects became operational



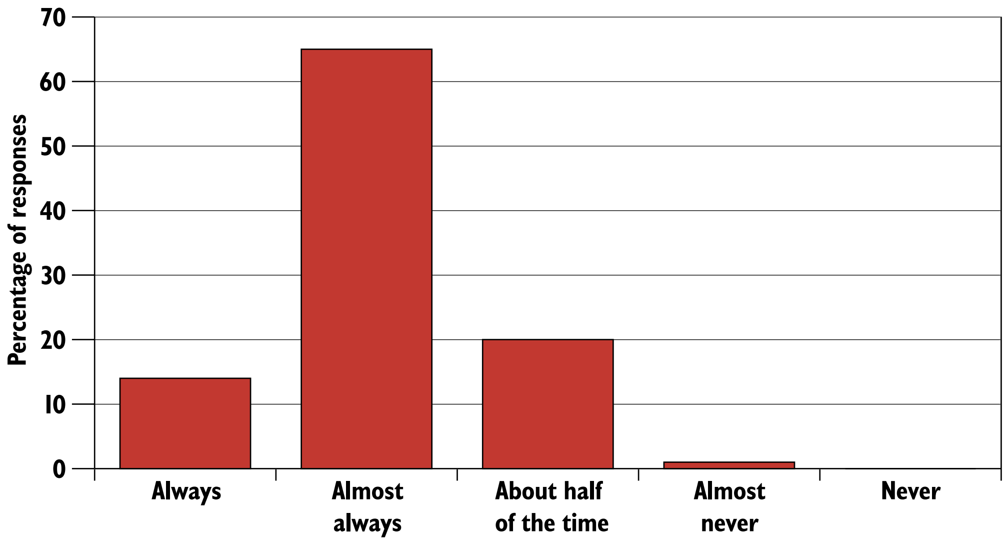
Source: Partnerships UK.

Performance assessed by the user

Performance assessed against contract

4.9 A consideration of the overall operational performance of PFI projects must also take account of the user's view. The definition of the term users can be subjective but broadly speaking, this refers to the end consumers of the services provided through PFI projects, for example pupils and teachers in schools. Partnerships UK's findings show that users believe service standards are always or almost always being delivered in 80 per cent of projects (see Chart 4.4). The information compiled on end user satisfaction was based on a range of surveys conducted by both the public and private sector partners in PFI projects. This is echoed in a study[3] carried out by KPMG and BSA in which the same question lead to 19 per cent responding 'always' and 62 per cent 'most of the time'. An Audit Scotland report[4] on PFI schools made the point that "councils, pupils and teachers generally welcome the improved accommodation and levels of service" and 4ps emphasised how "users and stakeholders are especially delighted with the new facilities and services now being provided. Such studies demonstrate a consistently high proportion of positive user views. When considered alongside the reported performance against the contract, these results suggest that PFI contracts reflect user expectations, which are in turn stimulating strong performance levels.

Chart 4.4: Did the last user satisfaction assessment find that services were being delivered to an acceptable standard?



Source: Partnerships UK.

4.10 Research is also generally consistent when identifying those areas in operational projects where users are most likely to raise issues. These relate to minor building defects that stem from the construction phase (often referred to as snagging issues) or the provision of soft facilities management services (soft services). Soft services typically relate to the day to day provision of the PFI service and often include catering, cleaning and portering. The prominence of these issues may be considered unsurprising given the age of most PFI projects and the visibility of soft services to the user.

[3] KPMG/BSA, "Effectiveness of Operational Contracts in PFI", (2005).

[4] Audit Scotland, "Taking the Initiative: Using PFI Contracts to renew Council Schools 2002", (2002), available online at http://www.audit-scotland.gov.uk.

4.11 It should be noted that user satisfaction is typically measured against individual expectations rather than contractual commitments. However, if such assessments are completed rigorously, regularly, and consistently, they can prove to be a vital source of information for both the public and private sector.

Performance of different services provided under PFI

4.12 Responses on overall performance indicate a positive view of the services provided under PFI projects. However, reliance on an aggregate view of performance does not always identify potential underlying issues. Some studies have sought to evaluate the constituent elements of operational PFI projects across sectors while others have tended to focus on the different services being delivered within a specific sector. The results of such studies are broadly positive but do serve to highlight some areas of PFI that are performing relatively better than others.

Services are being made available

4.13 Performance assessments of asset availability are typically among the most positive. A key element of a PFI project is generally the ability of the private sector contractor to make the service (for example a class room) available for use by the public sector. The Scottish Executive and CEPA study reported that 91 per cent rated availability as either very good or good. This represented the highest constituent score and is supported by the report "Schools PFI – Post-Signature Review",[5] conducted by Partnerships UK for the DfES, in which it found availability measures for schools projects to be working well.

4.14 Such strong performance is most commonly explained by the fact that availability often represents the single most influential factor upon the level of payment that the private sector contractor will receive. The relatively high level of payment deduction that can be levied for unavailability is reported to be an effective incentive on the private sector contractor to meet the service levels required. Conversely, in those projects where payment deductions have been levied for unavailability, this can sometimes be a source of strain in the relationship between the public and private sector.

4.15 Some issues were raised about availability. Contracting authorities sometimes come under pressure to keep an asset available that is operating below specified standards (under the label "unavailable but used") rather than declare it unavailable and lose the use of it completely until it is repaired. Some schools PFI projects also do not have sanctions for the unavailability of outdoor facilities. These are both considered to be issues that should be addressed through a contract variation and better defined output specification. They do not materially detract from the overall view that operational PFI projects are performing well in terms of their availability.

The benefits of hard FM are achieved

4.16 Hard facilities management (hard FM) services are activities that directly relate to the maintenance of the underlying asset (e.g. buildings maintenance and refurbishments). Research shows that hard FM services within PFI projects are working well. Difficulties in resolving snagging at the commencement of service delivery in a timely and effective manner can sometimes be a source of dissatisfaction for the public sector. The Scottish Executive and CEPA study highlighted the fact that most of the hard FM issues raised in their research related to snagging issues left over from the construction phase rather than to lifecycle maintenance. The Partnerships UK/DfES schools PFI report said that "…several authorities reported difficulty in incentivising contractors to close down snagging issues". While this is an issue that is just as, if not more, likely to occur in other forms of procurement, it is still one that PFI procurement and contract management teams need to consider proactively. The report also noted that hard FM repairs might take relatively longer to resolve, as they often required input from off-site staff.

[5] Partnerships UK, "Schools PFI – Post Signature Review", Report for the Department for Education and Skills, (2005) Available online at www.teachernet.gov.uk.

4.17 The Audit Commission report[6] into early PFI schools found that overall satisfaction was in line with those that were traditionally procured, and also noted that there had been service improvements in the responsiveness to day-to-day maintenance. Overall, such results seem clear that the PFI project needs to ensure that snagging issues are resolved in line with public sector requirements and timescales.

Soft services provision is satisfactory

4.18 The definition of soft services and the extent to which they are included in PFI contracts varies by sector. Whether soft services are included in a PFI project is a matter for the procuring authority. If their inclusion does not represent value for money, soft services should be excluded.

4.19 Research has shown that soft services within PFI contracts are performing satisfactorily though it also suggests that while standards are no worse than in non-PFI structures, PFI has not led to a step change in delivery in this area. The Healthcare Commission[7] concluded that "there is no clear pattern of cost and quality differences for FM services in PFI and non-PFI Trusts, other than higher costs of security, higher quality of linen laundry and lower quality of cleaning".

4.20 Analysis conducted by the Treasury on the annual scores on hospital cleanliness that are collected by Patient Environment Action Teams (PEATs)[8] shows[9] that out of 17 hospitals that, between 2001 and 2004, moved from non-PFI to PFI provision of services, eight showed an improvement, seven showed no change and only two a decrease in standards. It also showed that none of these hospitals received a score below acceptable in the latest assessment. Overall, analysis of PEAT scores for 2004 showed that PFI hospitals offered broadly similar standards to those for non-PFI hospitals (see Table 4.1). PEAT scores also indicate that a hospital's rating of its services appeared to remain consistent whether it was PFI or not. The same finding was drawn when such a comparison was conducted between the PEAT scores for catering in PFI and non-PFI hospitals.[10]

Table 4.1: Comparison of PEAT scores for hospital cleaning

2004	Unacceptable	Poor	Acceptable	Good	Excellent
All hospitals	**3 (0.5%)**	**24 (2%)**	**583 (49%)**	**456 (38.5%)**	**118 (10%)**
PFI hospitals	0	0	12 (46.2%)	11 (42.3%)	3 (11.5%)

Source: HM Treasury analysis of data collected by Patient Environment Action Teams (PEAT)

4.21 In other sectors the evidence on the inclusion of soft services within PFI contracts shows that they are seen as performing less well on average than other elements of the PFI project such as availability of assets and hard FM. Partnerships UK's study of schools PFI suggests that satisfaction is significantly higher for the buildings themselves than for the associated services. However, it also contrasted this with a number of strongly positive comments about catering in PFI projects. For example, a project in Cornwall stated that

[6] Audit Commission, "PFI in Schools: The quality and cost of buildings and services provided by early Private Finance Initiative schemes" (2003), Belmont Press, London, Available online at www.audit-commission.gov.uk.
[7] Healthcare Commission, "Acute Hospital Portfolio Review: Pathology, Facilities Management, Therapy and Dietetics, Information and Records" (2005), Available online at www.healthcarecommission.org.uk.
[8] Since 2000 Patient Environment Action Teams (PEATs) have reviewed standards at acute hospitals and checked that funding invested has produced the maximum benefit for patients. PEATs are independent teams that typically consist of NHS managers – including nurses, matrons, doctors, catering and domestic service managers, executive and non-executive directors, dieticians, and estates directors. They also include patients, patient representatives and people from patient organisations as well as members of the general public. They undertake yearly reviews of hospital services such as cleaning and catering.
[9] PEAT scores are published online at www.cleanhospitals.com.
[10] PEAT scores for hospital catering can be found at www.betterhospitalfood.com.

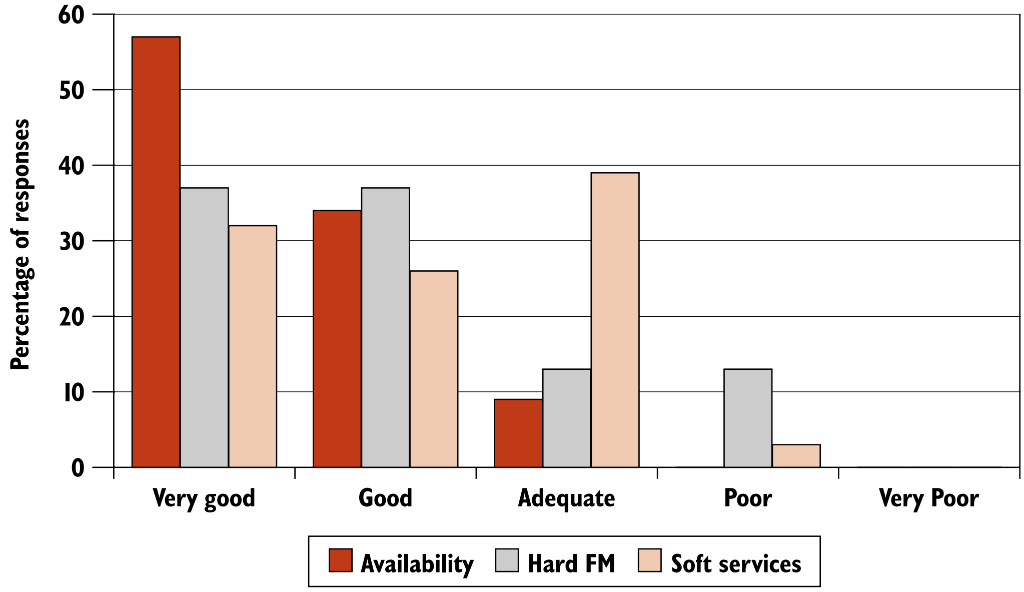
"school meals improved enormously immediately the PFI contract was in place". A school in Sunderland reported:

> "Facilities for catering in the past were very poor. The dining room was very small. Now 80–85% of children stay for dinner. Children now stay at lunch time because there are things to do. Before, children went out to the estate and a minority often caused trouble."

4.22 Research (in Chart 4.5) has shown that, while nearly 100 per cent of projects in the sample rated their projects adequate or better on both availability and soft services, 91 per cent of those projects rate availability as good or very good while 58 per cent placed soft services in the same categories.

4.23 In response to this, Chapter 5 (paragraphs 5.60 to 5.62) sets out a strengthened test to rigorously prove the case for including the inclusion of soft services in PFI projects.

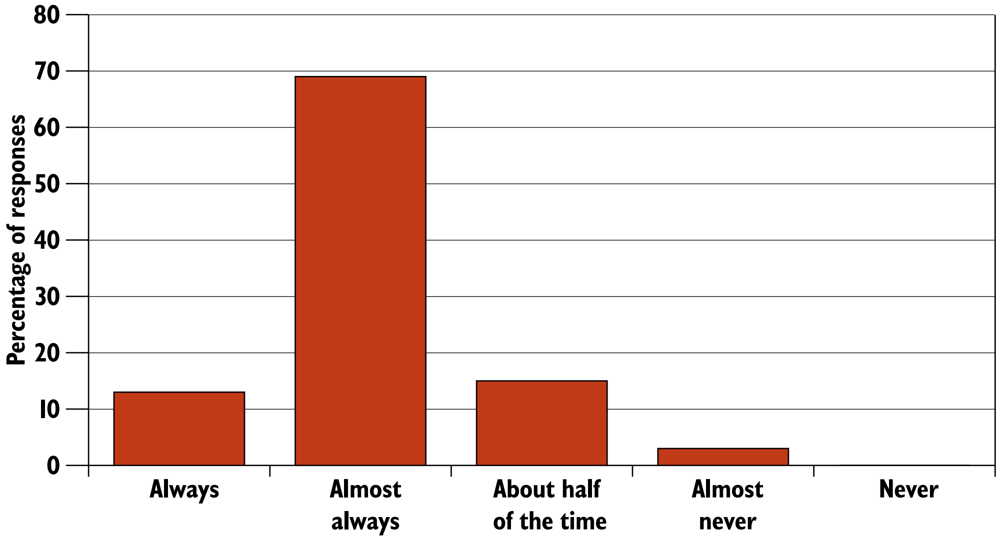
Chart 4.5: Standard of service under PFI contracts



Source: HM Treasury.

Rectification **4.24** The evidence collected by Partnerships UK suggests that, when operational problems occur in PFI contracts, the mechanisms in place to ensure timely rectification are proving effective. In 82 per cent of projects that responded, public sector contract managers confirmed that operational problems are always or almost always resolved within the permitted time period (see Chart 4.6). This is supported by findings that the levying of payment deductions often leads to a subsequent improvement in performance. Such results demonstrate that when operational problems occur the private sector is incentivised to resolve them.

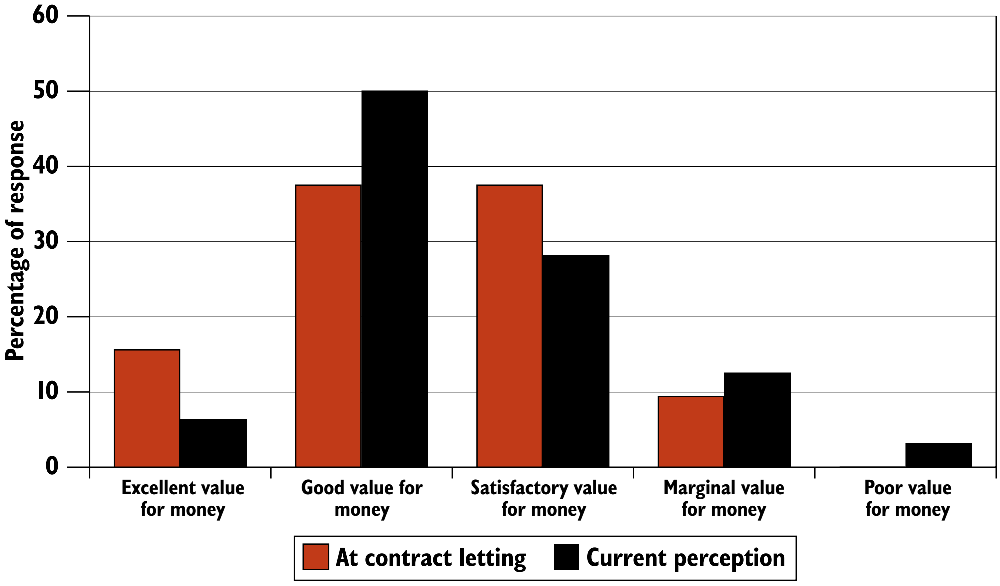
Chart 4.6 Are reported operational problems resolved within the time allowed under the contract?



Source: Partnerships UK.

Value for money **4.25** The Scottish Executive and CEPA study, which assessed authorities' perceptions of the value for money of their PFI projects, found that 84 per cent believed they were delivering value for money at a level that was satisfactory or better after a period in operation (see Chart 4.7). The NAO report in 2001 found that 50 per cent of authorities reported excellent or good value for money and 81 per cent said it was satisfactory or better.[11] The Treasury has published guidance which provides an objective framework for testing the value for money for PFI at a programme and project level. Though those studies are based on a different subjective assessment of value for money, the positive and consistent message provides some assurance that a good service level is being achieved.

Chart 4.7: Perceptions of the value for money the contract would deliver



Source: CEPA/Scottish Executive.

[11] NAO, "Managing the Relationship to score a Successful Partnership in PFI projects" (2001), TSO, London.

Box 4.1: Interview evidence – PFI in operation

The public sector contract manager for a PFI project to deliver and operate training and accommodation facilities describes overall performance as very good and that service levels were almost always being achieved.

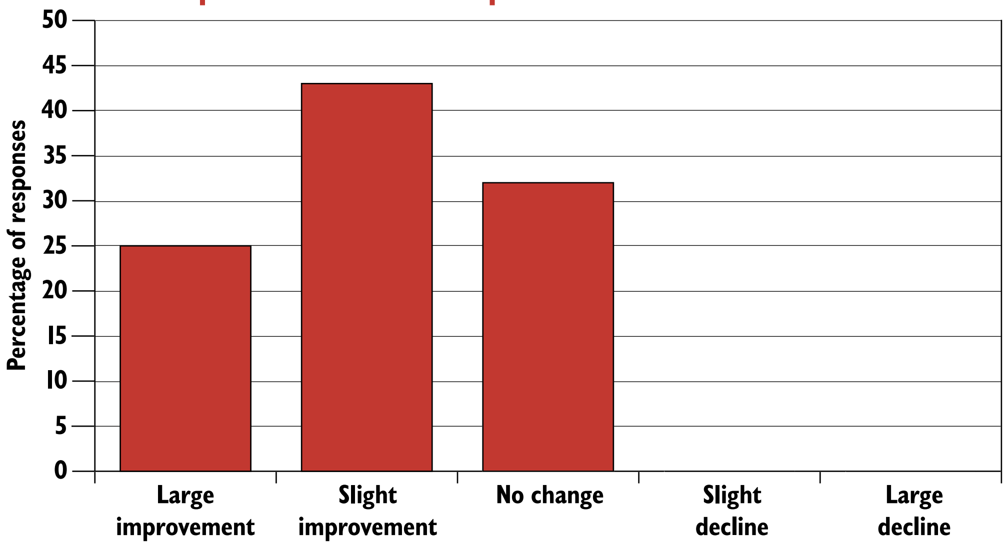
The contract manager explained that the contractor was delivering, and that service was particularly good in the stores area and in terms of availability (achieving over 99 per cent for all facilities). This area had originally been operating poorly but the contractor had taken positive action to resolve this by recruiting more professional and experienced staff. The public sector contract manager felt that the output specification was supportive of good performance, and that the performance requirements and penalties in the contract were clear. The only negative aspect raised in relation to the contract was the use of some outdated input specifications in relation to internal building regulations.

Public and private sector managers agreed that much of the project's success was attributable to individual personalities, and the development of strong working relationships between the most important parties. The two sides share the same mission statement and have mutual objectives in respect of delivering high quality training services to students.

PAYMENT AND PERFORMANCE MECHANISMS

4.26 Research indicates that the structure of the payment mechanism, and the performance levels underpinning it, act as an effective means of incentivising the contractor to deliver services in line with the contract. 4ps research identifies that 82 per cent of respondents believe the payment mechanism is working and the Scottish Executive and CEPA report says 61 per cent of payment mechanisms are working very well or well. Partnerships UK's research finds that payment deductions are almost uniformly low in relation to the overall unitary charge and, further to this, that payment deductions are generally effective in stimulating a subsequent improvement in those service levels that were not being met (see Chart 4.8). Where deductions had been made, 68 per cent of respondents reported an improvement in performance.

Chart 4.8: What is the impact of levying payment deductions on the performance of the private sector contractor?

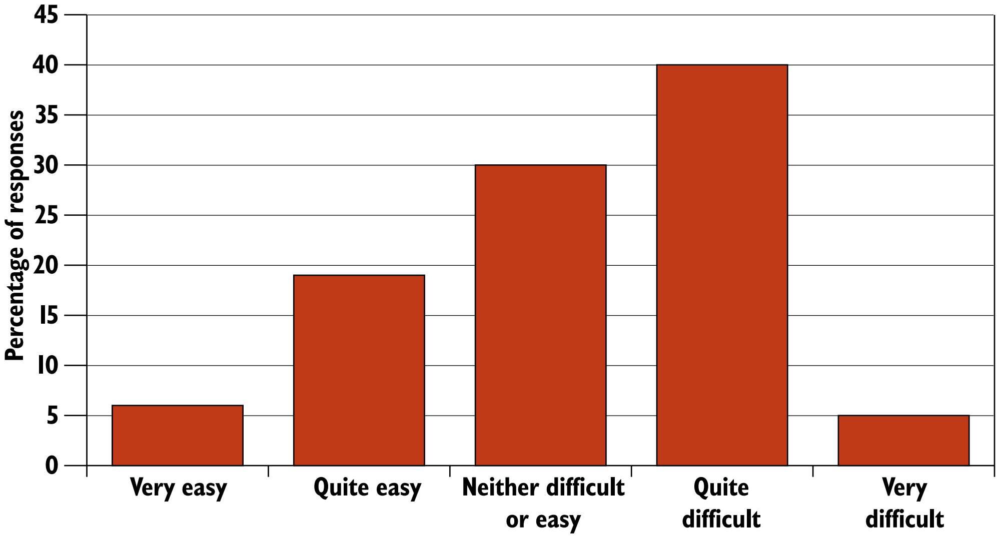


Source: Partnerships UK.

Reducing complexity **4.27** There are some areas in which there could be improvement in performance and payment mechanisms. For example, contract managers highlight the need to reduce complexity. Partnerships UK's research demonstrates that payment mechanisms are largely effective. However, some public sector contract managers find them relatively difficult to use (see Chart 4.9). This finding is supported by the Partnerships UK and DfES study into PFI schools, in which 47 per cent of respondents found the payment mechanism straightforward to use while 35 per cent rated it as difficult. Those respondents that rated it as difficult commented on difficulties with calculations, definitions and measurement of performance.

4.28 Such findings suggest that there is a demand for further consideration of how payment mechanisms can be made more user friendly. This might be achieved through simplification of the mechanism itself or through increased levels of training and support for those required to implement it. The NAO stated that, in the case of PFI prisons, they felt that "the number of targets could be reduced without reducing the effectiveness of the overall weighted scorecard performance measurement system". Conclusions such as these suggest that simplification of the payment mechanism may lead to better overall performance, reduced resource requirements, or improved contractor relations.

Chart 4.9: How easy or difficult do you find the payment mechanism to use?

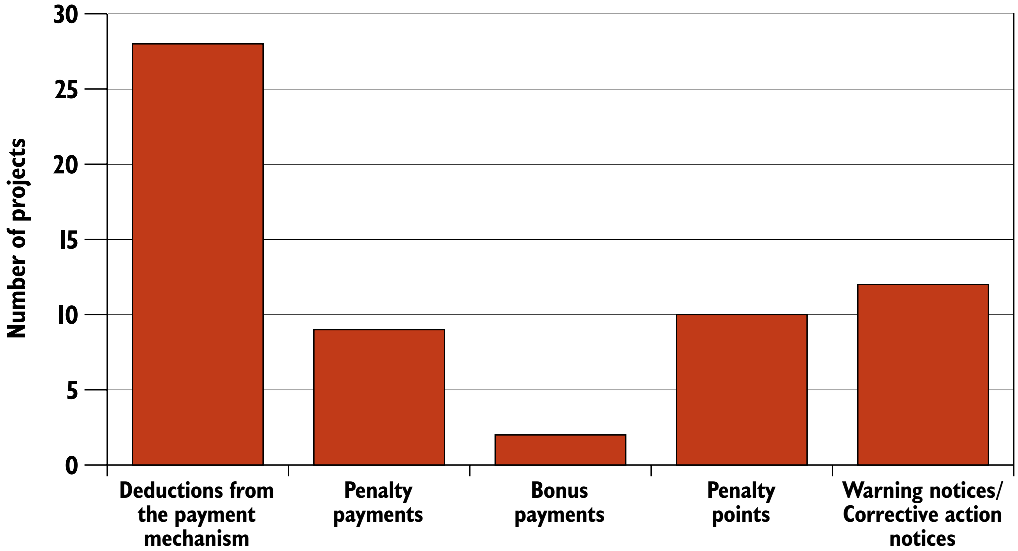


Source: Partnerships UK.

Incentives are effective **4.29** Research shows that payment mechanisms are proving effective in incentivising performance. 78 per cent of contract managers responding to Partnership UK's survey strongly agreed or agreed to some degree with the statement "the payment mechanism supports the effective contract management of this project".

4.30 Research also shows some challenges for the public sector. Some projects reported that payment and performance mechanisms motivate the contractor to focus primarily on avoiding payment deductions (by meeting the performance levels specified in the contract) and then, if possible, continuing to do so with a reduced cost base. There are also few incentives aimed at rewarding additional (a quantity above the minimum acceptable level in the contract) or exceptional (quantity above the specification stated in the contract) performance. The CBI report on prisons and the Scottish Executive and CEPA report had similar findings (see Chart 4.10). This has led some to argue that the public sector should change its view of incentive payments.[12]

Chart 4.10: Contract remedies used



Source: CEPA/Scottish Executive.

4.31 Payment mechanisms need to be correctly calibrated and specified to ensure that the public sector can effectively manage the contract. Some of the main functions of an effective payment mechanisms are:

- the service provider should be incentivised to correct the problem rather than suffer deductions;
- the level of deductions for major issues should be more significant than those for small or relatively unimportant ones;
- there should be a limited number of performance measures, serving to encourage full and accurate contract monitoring; and
- all important issues should be covered by payment deductions.

4.32 Chapter 5 (paragraphs 5.6 to 5.17) sets out the measures which the Government will introduce to improve payment and performance mechanisms.

[12] PriceWaterhouseCoopers, "Partnering in Practice – New Approaches to PPP Delivery" (2004). Available online at www.pwcglobal.com.

Monitoring of performance

4.33 An effective payment mechanism needs one or more forms of monitoring in place to support it. This may take the form of self-monitoring reports, feedback on helpdesk queries, regular progress meetings, and a right to sign off completed works. 4ps' research showed that monitoring reports were being prepared for each payment period in 85 per cent of projects, and that these reports contained sufficient information for the procuring authority to compute payment accurately in 84 per cent of cases.

4.34 Some public sector contract managers within the Partnerships UK research confirmed that not all of these monitoring processes are functioning when the project first becomes operational. As the value of such monitoring processes is often at its greatest during early operations, such problems need to be resolved quickly. Chapter 6 sets out the steps the Government is taking to improve the monitoring and scrutinising of project.

Balance between private sector reports and user feedback

4.35 Partnerships UK's research reveals that the public sector does not always audit the self-monitoring reports provided by the private sector in projects and instead relies on direct user feedback to assess performance. A balance between formal contract monitoring and direct user feedback needs to be struck if the benefits of both are to be realised. Formal contract monitoring mechanisms will always form the basis of assessing contract performance, and so the public sector must devote sufficient resource and expertise to ensuring they are accurate. However, users can often provide the most timely and relevant source of performance information, particularly with respect to their changing requirements, and so PFI contracts should provide sufficient incentives for contractors to collect and act upon user feedback in an effective and timely manner.

Box 4.2: Interview evidence – The payment mechanism in practice

The public sector contract manager for a housing PFI project explained that they were broadly content with the payment mechanism but that it was "…a little lumpy in places…". Some mechanisms were viewed as potentially punitive but acted as a good incentive on the contractor's performance. Significant authority resource is required to validate invoices and supporting information, but decisions on whether to make penalties are reviewed by a steering group before being applied.

The authority was generally happy with the performance indicators (PIs) and was content to maintain a degree of flexibility around them without necessarily invoking the change mechanism. There were some areas where the authority thought that PIs could be improved, for example none currently relate to keeping site areas clean during refurbishment work.

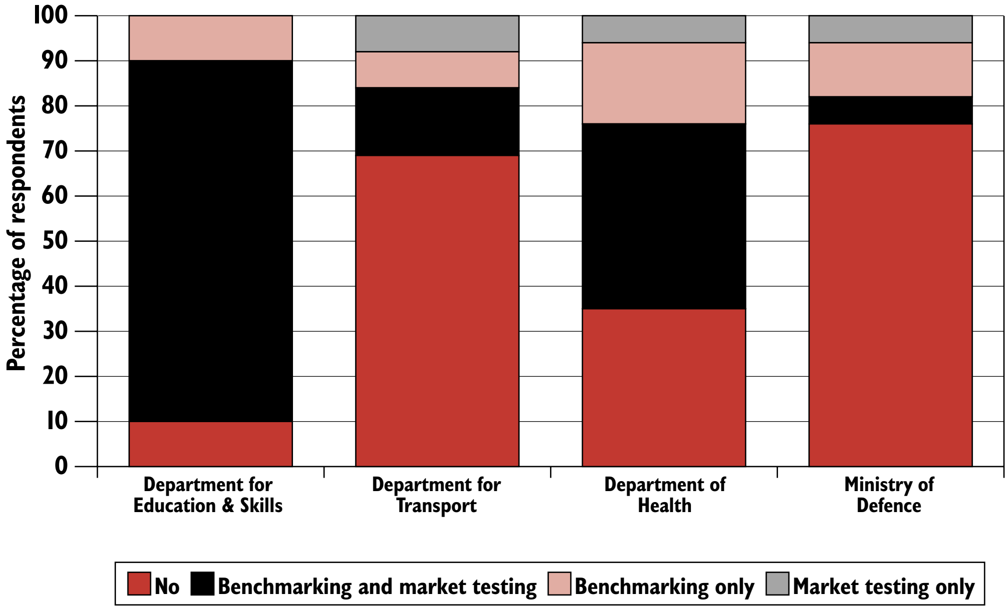
The contractor believed that the PIs were generally satisfactory but did feel that there were overlaps between some indicators and that some were ambiguous. Overall the contractor believed it was "kept on its toes" by the monitoring system. Improvements could have been made through greater sensitivity analysis of the impacts, thereby avoiding some punitive performance outcomes. There was also perceived to be a lack of proportionality with some measures. For example, availability measures failed to bite with a daily deduction of £3 per property but, conversely, failure to provide monitoring reports on time resulted in a £3,000 deduction. Finally, the contractor believed that the performance measurement system could be improved to allow it to share in over-performance benefits; for example there was no incentive to get ahead of rent collection targets.

BENCHMARKING/MARKET TESTING

4.36 Benchmarking and market testing provisions are embedded within many PFI contracts, making them a vital consideration for contract managers. Benchmarking is the process by which the PFI contractor compares either its own costs or the cost of its sub contractors providing soft services against the market cost of such serices. Market testing means the retendering by the PFI contractor of the relevant soft services. These provisions are used in some PFI contracts as a price variation mechanism for elements such as soft services. Of the projects in the Partnerships UK research, over 50 per cent confirmed that they included benchmarking and/or market testing provisions. However, the research did show differences across the main PFI sectors, in most cases reflecting the underlying nature of the assets and services typically included within their projects (see Chart 4.11).

4.37 The research also shows that most PFI projects have not yet reached the stage in their operational lives in which benchmarking or market testing is carried out. This is expected to change over the next two years, as the number of projects approaching their first benchmarking/market testing point increases significantly. A number of studies concur with 4ps when they say "…that benchmarking could become a contentious issue when it arises."[13] Such comments draw into focus a need for projects to work with the contractor to plan for such an event sufficiently in advance.

Chart 4.11: Does the PFI contract include a requirement to undertake periodic benchmarking or market testing?



Source: Partnerships UK.

[13] 4ps, "Review of Operational PFI and PPP Projects" (2005). Available online at www.4ps.co.uk.

4.38 The scheduled completion of benchmarking exercises every five years has become relatively commonplace in some sectors, though there is still a range of approaches. Greater consistency has been observed in more recent PFI projects, indicating that this may be an issue mainly relating to older contracts. Overall, benchmarking activity must be planned and managed effectively by contract managers.

Clarity on the benchmarking process

4.39 Partnerships UK's research reveals that 78 per cent of public sector managers felt that their PFI contracts clearly explained benchmarking/market testing processes. As 18 per cent said that their contracts did not clearly explain these processes and 4 per cent said that they did not know, more clarity on the benchmarking process may be required. Supporting qualitative research suggested that a number of contract managers had not yet looked at these contract provisions in detail (as the first benchmarking/market testing point was still some way off). The need for the public and private sectors to clarify the process is clear, and doing so well before the pressures of the exercise itself will help to ensure that it is achieved in the most efficient environment.

Availability of comparable data

4.40 Partnerships UK's research indicates that there may also be a lack of comparable data available from which to compile a benchmark. The Scottish Executive and CEPA study similarly stated that "interviewees commented that there had been issues around interpreting the provisions of the contract and in identifying suitable comparators". There is also a risk that the public sector engages in the process from a position of information asymmetry in relation to the private sector. In order to address this, Audit Scotland has recommended that PFI projects need to "…share information such as unit construction costs and operating costs actually experienced".

4.41 In the standard PFI contract, market testing is the fallback option if benchmarking fails to agree a price adjustment. There is some concern at the cost and complexity of market testing exercises and the potential for lack of competition.

4.42 Partnerships UK's research shows that there is a concern that any mispricing in the original contract may then result in the benchmarking or market testing exercise prompting a price increase. In the Scottish Executive and CEPA study "interviewees reported that the outcome of benchmarking exercises to date has been to increase the price paid by authorities." An effective partnership between the public and private parties should ensure that price changes are both anticipated and understood.

Resource and skills requirements

4.43 Early experiences of benchmarking and market testing exercises have suggested that they can be resource intensive relative to the typical contract management allocation within PFI projects. Partnerships UK's research suggests that PFI contracts do not always budget for additional resources and experience that may be required during this period of heightened activity. The public sector needs to budget and allocate resources to get the best value for money outcome from benchmarking and market testing.

4.44 In order to address concerns at the lack of comparable data available to conduct a benchmarking exercise and affordability pressures on the private sector, the Government believes there are advantages for future PFI projects in undertaking periodic market testing of soft services. This change of approach is explained in more detail in Chapter 5 (5.70 to 5.73).

CHANGE AND FLEXIBILITY

4.45 Research has found that one of the most important future challenges consistently raised by public sector contract managers is the need to cope with change. This was raised in the context of dealing with changes in public sector requirements and consequently the need for resources and experience to negotiate these changes with the contractor. It is also recognised that change in PFI projects can be attributed to drivers such as regulation, policy and standards, technology and demographics. Such drivers impact upon different PFI sectors in different ways.

4.46 Partnerships UK's research has shown that 83 per cent of contracts are described as always or almost always accurately specifying the services required, which indicates that PFI contracts reflect the services needed by the public sector during operating life.

Changes have been relatively small

4.47 Though there have been some large variations to PFI contracts, evidence gathered by Partnerships UK shows that most of the changes to date have been relatively small and have had little impact on the overall unitary charge. Estimates provided reveal that the number of variations completed within operational projects can differ considerably. The KPMG and BSA research found that 63 per cent of projects had completed 25 or fewer contract variations, but that 13 per cent had carried out more than 100. Partnerships UK research showed 73 per cent of projects have made 25 or fewer variations and 13 per cent have made more than 150.

4.48 One of the principal reasons quoted for these small contract variations taking place in the early stages of the contract is that the initial specification of services required revision. 4ps concluded that many of these changes were linked to interpretations of what the service requirement meant in practice, rather than a belief that it had been defined incorrectly. Such a finding would seem to support the need to introduce a contract manager's practical view during the procurement process. In many cases this may allow for the practical interpretation of the service requirement to have been considered and incorporated prior to operation commencing.

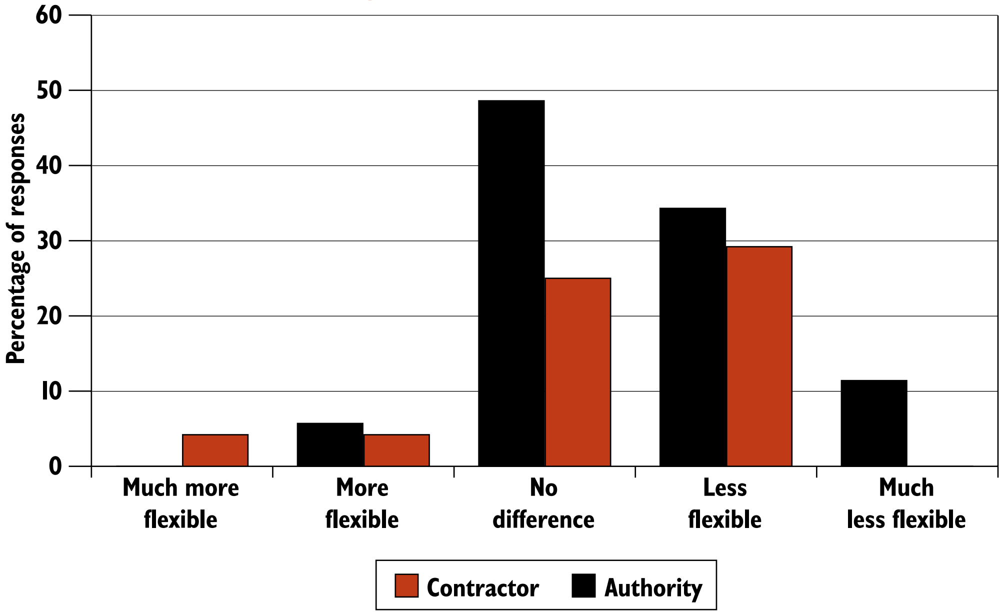
Flexibility in PFI

4.49 The Scottish Executive and CEPA research indicates that PFI contracts face challenges in terms of the ability to change service specifications, about relative certified flexibility between PFI and non-PFI contracts and also demonstrates a divergence of opinion between the public and private sector (see Chart 4.13). In contrast 4ps found that 64 per cent of respondents believed that the PFI contract (as originally negotiated) did offer sufficient flexibility, and a Ministry of Defence study[14] found that 85 per cent of their operational PFI projects believed that their contracts were "flexible enough to accommodate future change and to deliver on a sustained basis".

[14] Ministry of Defence "Review of MOD PFI Projects in Construction and Operation" (2005).

4.50 Further to this, Partnerships UK's research shows that contract managers believe PFI contracts for older projects (that have been operational for longer) are marginally less accurate, in terms of specifying the types and levels of services required, than for those that have become operational more recently. This may reflect the absence of a standardised contractual approach in older contracts.

Chart 4.12: Flexibility of PPP/PFI service delivery compared with non-PPP/PFI arrangements



Source: CEPA/Scottish Executive.

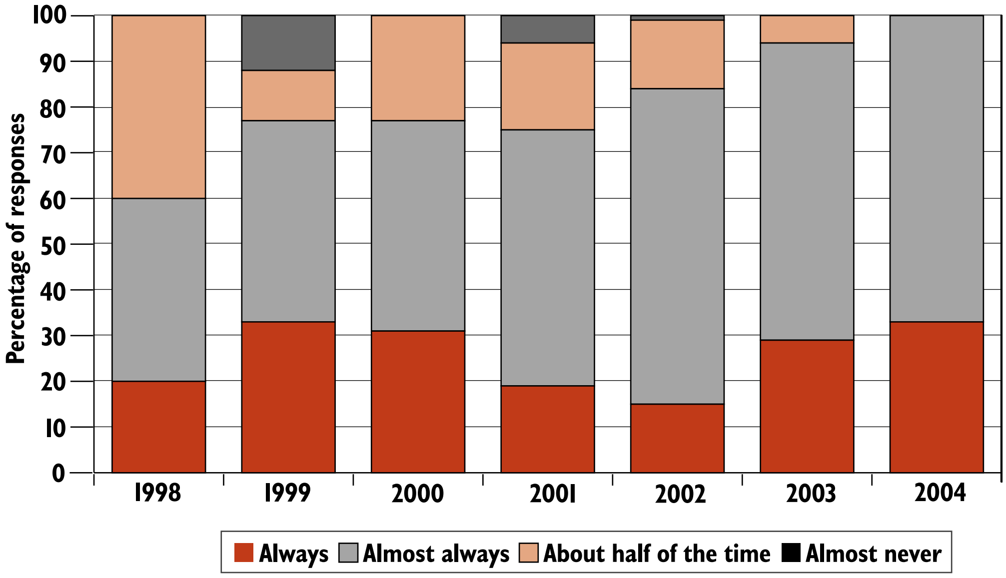
Variation mechanisms

4.51 The Audit Commission recognised in its PFI schools report how important it is that projects have a formal mechanism that allows for "streamlined, cost efficient and rapid processing of high volume, small-value transactions".

4.52 The variation mechanism in PFI contracts works effectively with research showing that over three quarters of projects have made changes to the contract. However, there are some improvements that can be made. The approvals process for large variations can be complex. Some, generally older, PFI contracts do not include contractual timescales or incentives to ensure that variations are agreed and completed to specific deadlines. This may serve to ensure that changes are only carried out when deemed absolutely necessary, but can also mean that when they are required the process does not always allow them to be implemented efficiently.

4.53 Some PFI contracts contain only one form of variation process, which does not cope well with small works provisions. The issue of a single change process is more common in older PFI projects, and a different approach for small and large variations has now been included within the standard PFI contract, thus ensuring that the impact of this issue has been limited.

Chart 4.13: The PFI contract accurately specifies the type and levels of service required



Source: Partnerships UK.

Informal change processes

4.54 Research also shows that additional (and often informal) processes have been developed by contract managers to make the management of changes easier. For example, the Scottish Executive and CEPA research identified measures including the bundling of changes, informal agreements for small changes, and making lump sum payments for changes which are then periodically incorporated into the PFI contract.

4.55 Although the application of such measures demonstrates a desire to put delivery first, it is important any changes agreed informally are recorded and monitored and that the value for money of an approach is properly assessed. Chapter 5 (5.28 to 5.31) sets out the steps the Government is taking in response to this evidence to improve the contractual flexibility of PFI projects.

THE PFI CONTRACT

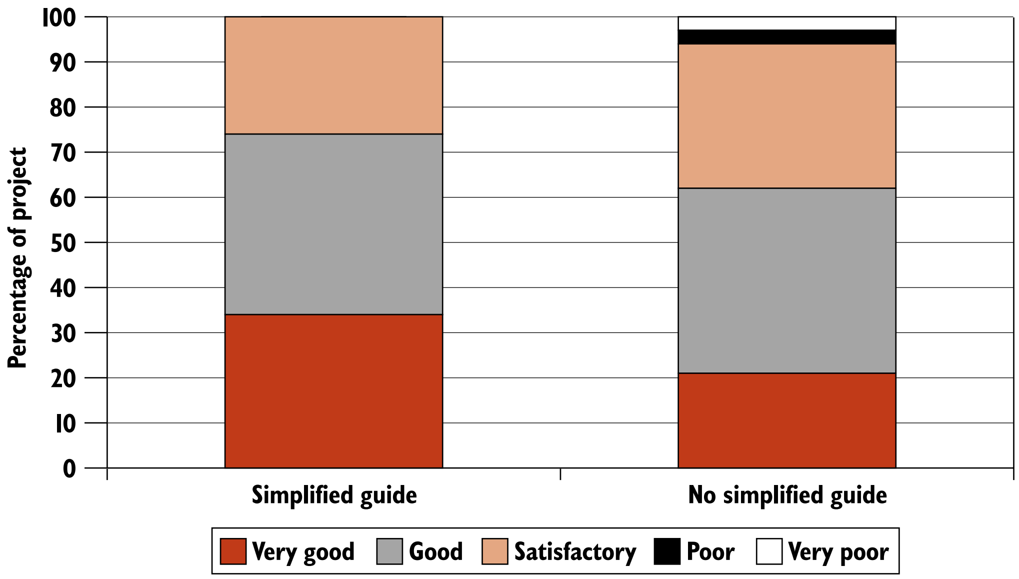
4.56 PFI contracts are detailed and comprehensive. This is necessary to ensure completeness and accuracy in specifying services required over a long time period. However, these characteristics can also make it difficult for operational staff to interpret and use contracts. The balance to be found, as the Audit Commission's PFI schools report states, is that "contract terms should not be so elaborate that the management time required to put arrangements in place and then monitor them outweighs the return in service improvement."

Value of a contract manual

4.57 A number of PFI procurement teams draft a supplementary, easy to read, contract manual to assist operational staff in using and understanding the full contract. Those projects that have a contract manual report, on average, a better level of project performance than those who do not (see Chart 4.14). However, Partnerships UK's research revealed that 65 per cent of those projects questioned did not possess one.

4.58 Chapter 5 sets out guidance the Government intends to publish to address a range of issues to improve the transition to the operational phase of projects. The production of a contract manual will be a requirement of that guidance.

Chart 4.14: Comparison of overall performance for those projects with a simplified contract guide against those without one



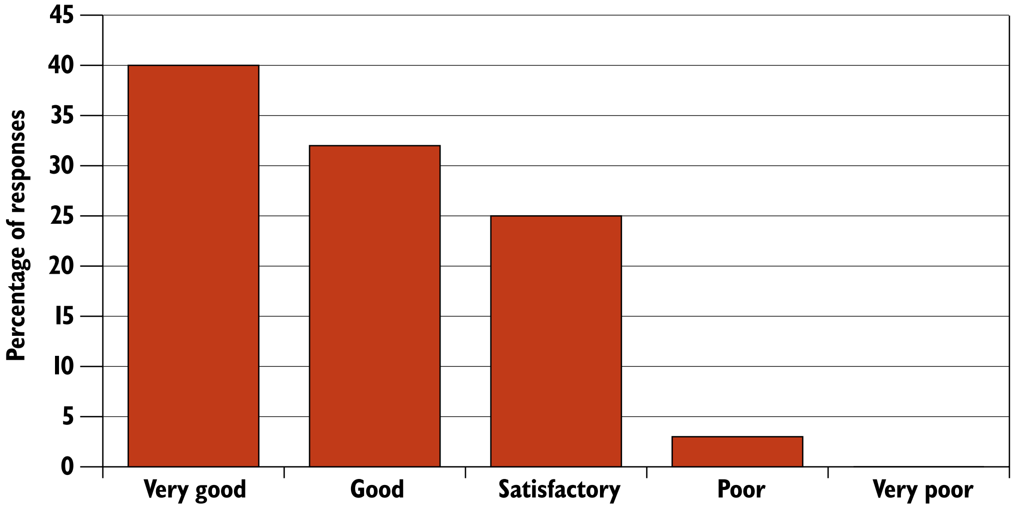
Source: Partnerships UK.

PUBLIC/PRIVATE SECTOR RELATIONS

4.59 Relations between the public and private parties to a PFI contract represent a key factor in influencing operational performance. Both Partnerships UK's research (see Chart 4.15) and the Scottish Executive and CEPA studies found evidence that public sector contract managers believed relationships between them and the contractor to be good. The KPMG and BSA study of PFI contractors found that relationships between most public and private contract management teams are good and 43 per cent of them also believed the relationship to be very good. The 2001 NAO report on managing relationships also found that 72 per cent of authorities and 80 per cent of contractors viewed their relationship as being good or very good.[15]

[15] NAO "Managing the relationship to secure a successful partnership in PFI projects" (2001).

Chart 4.15: Please rate the operational relationship between the public and private sector contract management teams



Source: Partnerships UK.

4.60 Such evidence does not mean that the public and private sector contract managers always agree, merely that disagreements have not been allowed to jeopardise the ongoing relationship. When asked what the main causes of strain in the relationship have been so far, public sector contract managers responding to Partnerships UK research put forward the following:

- different interpretations of the contract;
- performance issues (such as resolving snagging issues and helpdesk performance);
- belief that the contract was mispriced;
- one of the parties being under-resourced (in terms of contract management staff);
- high turnover of contract management staff; and
- changing public sector requirements.

4.61 One of the defining characteristics of PFI is the spirit of partnership espoused between the contracting parties. The need for such a partnership has long been recognised as key to successful performance, with the NAO stating clearly in its 2001 report that:

> "Authorities and contractors should always seek to understand each other's businesses and establish a partnership approach to each of their PFI projects based on a common vision of how they will work together to achieve a mutually successful outcome to the project."[16]

[16] NAO "Managing the relationship to secure a successful partnership in PFI projects" (2001).

4.62 Such a view has been reaffirmed in more recent studies, but is regularly coupled with a recognition that there is a balance to be struck between partnering and contract management and enforcement.

Effectiveness of making performance deductions

4.63 Partnerships UK's findings show that deductions for underperformance are effective in stimulating improvement (68 per cent of respondents indicated a large or slight improvement in performance following deductions), but that benefits from waiving such deductions (to promote the partnership) are much less clear. The recent research in this area suggests that where payment deductions are clearly enforceable under the contract then they should be levied. This finding is important because of anecdotal evidence that the public sector can sometimes be reluctant to levy deductions for fear of spoiling the relationship with the private sector.

4.64 A report by the New Local Government Network (NLGN)[17] suggests that the nature of such relationships should be clarified through the development of an agreed vision document, which can then act as the ongoing reference point for how they should operate. The Audit Commission echoes the demand for such a document in its report on operational PFI schools. It is believed that establishing such a reference point helps to neutralise the tendency for haphazard or adversarial relations. Measures to introduce this form of document are set out in Chapter 5 (paragraph 5.49).

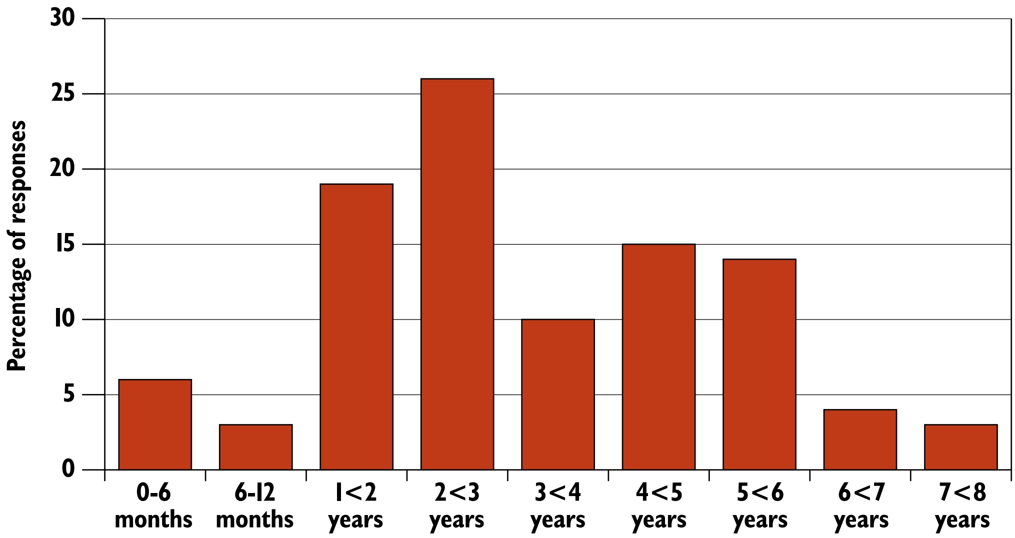
Continuity of staff

4.65 Partnerships UK's research finds that the continuity of contract management personnel on both the public and private sector sides is an influential factor upon the performance of operational PFI projects. Chart 4.16 shows that the majority of public sector contract managers have remained in post for a significant period.

Staff turnover

4.66 Both Partnerships UK's research and other studies go on to identify a broader perception of a relatively high rate of staff turnover on both sides. This suggests that such turnover may be down to other members of the contract management team rather than the main contract managers. All of the studies raise such changes as an issue, with 4ps emphasising the need for increased continuity and succession planning.

Chart 4.16: Time in post as public sector contract managers



Source: Partnerships UK.

[17] Hatter, W. and Reeve, S. "Beyond Contract – What makes a PPP successful?", New Local Government Network (NLGN), London (2004).

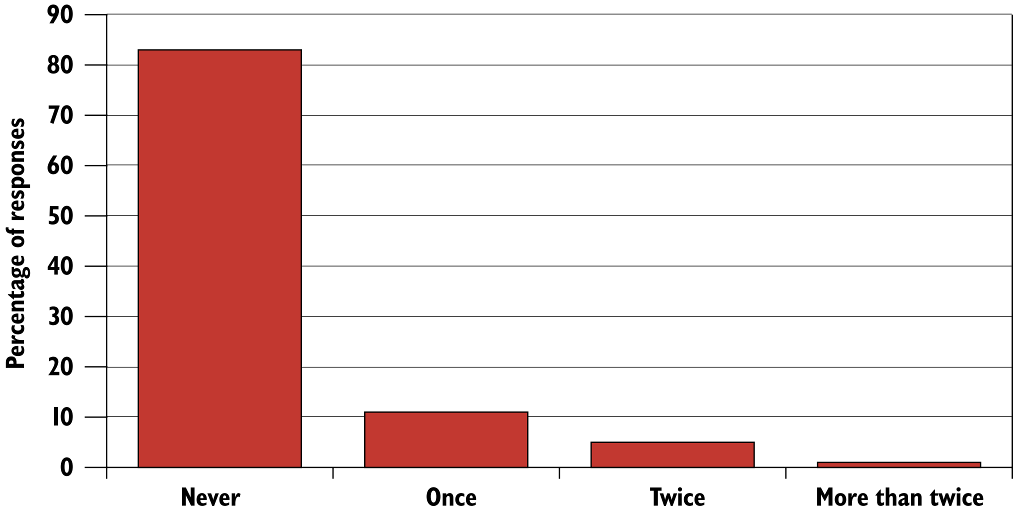
4.67 Partnerships UK's research confirms that communication plays a significant role in both the relations between the public and private sector parties and the performance of a PFI project. Overall it finds that communication structures and styles that have been adopted within operational PFI projects are conducive to developing a partnership including regular meetings and colocation of public and private sector teams.

4.68 For more information on these issues please see Partnerships UK's research available on their website. Measures to improve communication between the public and private sector are set out in Chapter 5 paragraph 5.48 to 5.50. The NLGN reaches the conclusion that staff from the different sides of the partnership should be colocated.

Dispute resolution

4.69 Partnerships UK's research also reveals that few projects have invoked the dispute resolution procedure (see Chart 4.17). This reflects positively on project performance and on the fact that relations are strong enough to be able to resolve issues without normally needing to resort to dispute resolution.

Chart 4.17: How many times has the contracts dispute resolution mechanism been used since the PFI project became operational?



Source: Partnerships UK.

Box 4.3: Interview evidence – Public and private relations in a PFI prison project

Partnerships UK's research into an operational PFI prison reveals that the public sector believes its relationships with the four contractors to be fair or good. There is generally perceived to be a reasonable amount of give and take between the authority and contractors. Changes in the governance structure about three years ago have also meant that the authority is more consistent in its approach to contract management across the portfolio of contracts. As a result contractors appreciate the more structured and consistent approach that is being taken.

The private sector contract manager confirmed that relationships with the authority were very good. They believe this to be because the culture of their organisation is about delivering high quality services and the authority recognises this. They also believe that the two sides share common objectives and that, even when there are disagreements about issues, both organisations are trying to achieve the same outcome. The disagreement is often more about the process of how things are being delivered. The contractor believes that another factor supporting good relationships is that the customer is an intelligent customer with professional procurement and contract management resources.

CONTRACT MANAGEMENT – STAFFING AND SKILLS

4.70 The overall performance assessment of PFI projects shows that public and private sector partners share a positive and pragmatic approach to the contract. Such findings portray a strong view of public sector contract management. However, there are some areas for improvement.

4.71 Partnerships UK's research revealed that the majority of contract managers had not been recruited into a project until after the procurement phase had been completed, though many were recruited within six months of the start of the operational phase. This was often the first involvement of contract management staff and reflected a common feeling that the project may have been improved (in relation to areas such as drafting the output specification and payment mechanism) if they had been involved in the procurement process.

Chart 4.18: A comparison of overall performance for those projects that completed a formal handover between construction and operational phases and those that did not

Source: Partnerships UK.

4.72 In order to deal with these issues the identification and limited introduction of the contract manager designate, or other contract management specialists, into specific elements of the procurement phase should be encouraged. Measures to address the issues are set out in Chapter 5 (paragraph 5.42).

Handover between procurement and operation

4.73 Findings from Partnerships UK's research reaffirmed the importance of completing a handover between the procurement and construction/operation phases of a PFI project. A comparison of overall performance scores of projects (as rated by the contract manager) between those that had a formal handover and those that did not gives some indication of potential benefits of a handover (see Chart 4.18).

4.74 Both Partnerships UK's and 4ps' research report instances in which either the public or private sector felt that they initially underestimated the level of contract management resource required, and had subsequently had to increase it. Such experiences suggest that the public sector should be cautious in estimating the required level of contract management resource when they are procuring a PFI.

4.75 It is also recognised within the Partnerships UK research that the level and type of contract management resource needs to be flexible over the operational life of the project. Periods such as very early operation, benchmarking, refinancing or other major project changes may all require either additional or specialist resource beyond that believed to be the norm.

Knowledge sharing networks

4.76 Partnerships UK's research also identifies a broad demand for knowledge sharing networks across PFI projects. The overall picture was one in which PFI contract managers were keen to share experiences and actively learn from one another.

Training and skills

4.77 A number of public sector PFI contract managers have undertaken training in valuable areas such as procurement, project management, and negotiation run by bodies such as the NAO. Partnerships UK's research further shows that most respondents have been in post as contract manager for their PFI project for more than two years, and so have attained significant experience (see Chart 4.16).

4.78 A number of public sector contract managers expressed an explicit desire for further training and guidance on how best to manage their PFI contracts. Measures to provide further support for the public sector are set out in Chapter 6.

Box 4.4: Interview evidence – Training and support in operational PFI projects

Schools project – the public sector contract manager had previous experience of managing non-PFI service contracts but did not receive any specific training for this contract. They stated that training would have been helpful.

Health project – the contract manager felt that it would be helpful to have a training package available to guides contract managers through the operational phase – what to look for, what you need to know, the payment mechanism etc. The need for a good "bible of documents" to be available to both sides at the commencement of the operational phase was also identified as important.

Housing project – the bid team moved across into the operational team but had no formal training in contract management. However, they did make use of the 4ps' training pack, 4ps' network meetings, and general conferences and seminars. Knowledge transfer had been achieved between the public and private sector through 'lessons learned' sessions. Both parties had drawn on external support occasionally, although this was not budgeted for. Legal advisers had been used to resolve some subcontractor issues, to examine an alternative ground rent model, and in working up a claim arising from statutory order delays. Financial advisers are used for six monthly updates of the financial model and clarifications of model assumptions.

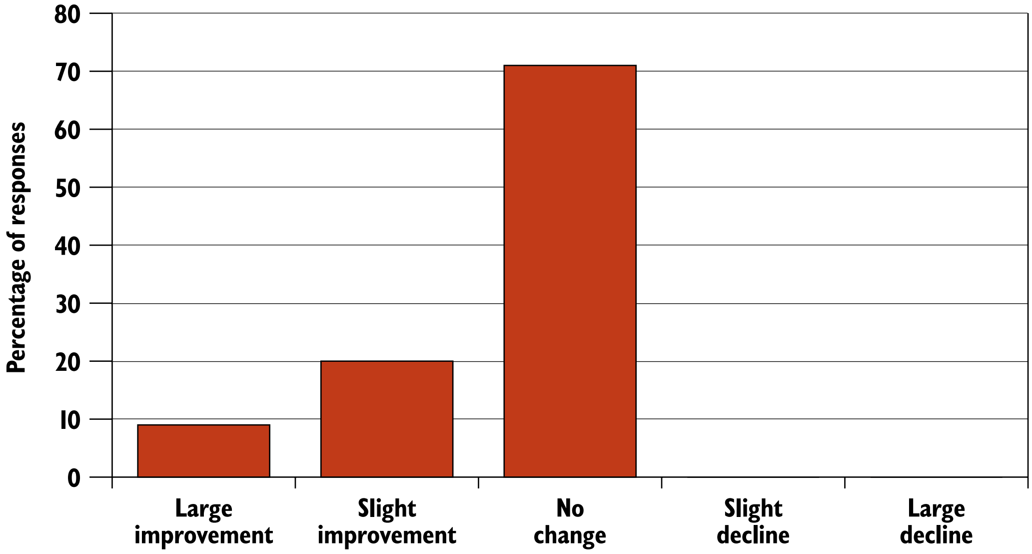
THE SPECIAL PURPOSE VEHICLE

4.79 Relatively early evidence is emerging on the dynamics within and between the parties to the PFI Special Purpose Vehicle (SPV). The SPV is the private sector body which operates the PFI project and is made up of a number of shareholding parties, some of whom will be delivering services under the PFI contract. These main contractors may in turn subcontract service to other providers who are not SPV shareholders. This evidence typically relates to the integration between private sector contracting parties in delivering the overall service, and in terms of the tendency of these parties to change over time. Research reveals emerging evidence showing that both equity owners and subcontractors circulate in and out of PFI projects effectively. The level of activity in projects to date is shown to have been at relatively low, but not insignificant, levels.

Change of shareholding

4.80 In the case of a change in the shareholding of the SPV, public sector contract managers have indicated that it has little impact on the operational performance of the project. In those instances where a subsequent impact is observed on operational performance it is found to be a positive one (see Chart 4.19).

Chart 4.19: How did the change of shareholding in the Special Purpose Vehicle impact upon the level of service received?



Source: Partnerships UK.

Box 4.5: The role of PFI in supporting frontline outcomes

Qualitative research across different PFI sectors reveals the part that PFI can play in delivering both an improvement in service outputs and overall policy outcomes.

- **Prisons: a Confederation of British Industry (CBI) study[a] found that private sector prisons led to a change in the management of prison staff and improvements in productivity. The NAO study[b] on PFI prisons found that prisoners "…felt that they were shown greater respect and were treated better than prisoners in public prisons". In addition, Partnerships UK's research quotes a commercial manager for PFI prisons stating that the contracts are "…contributing to the Government's aim of reducing re-offending by providing high quality and good value prison accommodation and management that addresses offending behaviour."**
- **Housing: Partnerships UK's research quotes a housing PFI contract manager as saying "Historically the estate has been a crime hotspot with a 25 per cent turnover of tenants" but that "the project has been very successful to the point where there is now a significant waiting list for tenants and crime has reduced significantly".**
- **Schools: Partnerships UK's research into PFI schools produced comments such as "The behaviour patterns of the children have changed and the children love the buildings – they respect them" and "Educational standards are up, attendance is up, the attitude to school has changed, vandalism has gone and the children appreciate the building." In relation to the benefits of PFI one authority explains how "In the past, the school hadn't spent much on building maintenance. Now school delegated 'building related' money is not siphoned sideways. The services are better than before, particularly on buildings maintenance."**
- **Street lighting: a street lighting project reports that there has been a "significant improvement in response times for repairing faults required by the contract, in comparison with the former operation directly managed by the Council".**

Evidence of this nature serves as a valuable acknowledgement that PFI is supporting the delivery of tangible benefits in frontline services.

[a] CBI, "Competition: A Catalyst for Change in the Prison Service – A Decade of Improvement" (2003). Available online at www.cbi.org.uk.

[b] NAO, "The Operational Performance of PFI Prisons" (2003), TSO, London.

5 Improving operational performance and flexibility in PFI

Research into operational PFI projects set out and reviewed in Chapter 4 has demonstrated a positive view from users and contract managers about performance in the delivery of services. Specifically:

- the majority of PFI projects are performing to a high level when assessed against contract specification. This finding is repeated across a broad range of recent research;
- performance ratings are high across projects at different stages of their contract life; and
- users believe that high service standards are almost always maintained in PFI projects. A range of studies show a high proportion of positive user views.

Chapter 4 also indicates some areas where the framework can be improved in order to support procuring authorities in meeting operational and flexibility challenges when designing and managing a PFI project. The Government is proposing to:

- **amend the Government's "Value for Money Assessment Guidance" and model** to help authorities choose an optimum level of contractual flexibility in any PFI proposals;
- **assess whether there should be changes to the standard PFI contract** to make variation procedures more flexible and efficient and payment and performance mechanisms more effective;
- **establish a PFI Operational Taskforce** to offer advice and assistance to the public sector and develop guidance and codes of conduct between the public and private sector;
- **improve the transition to the operational phase of projects** by introducing contract manager expertise during the procurement phase and develop shadow running of contractual structures prior to deal close or handover of the project;
- **set a framework for determining sector specific caps on the length of PFI contracts.** This is to ensure that the contract lengths reflect the optimal period over which the procuring authority wishes its services to be provided;
- **strengthen its value for money test for including soft services in PFI projects.** The "Value for Money Assessment Guidance" will be revised to set out the clear criteria against which authorities will need to prove rigorously the case for inclusion;
- **make clear that, where soft services are included in future PFI contracts, the Government believes there are advantages in undertaking periodic market testing of those services instead of benchmarking.** Through this approach the public sector can guarantee that it continues to get value for money in the provision of these services over the lifetime of the PFI contract through a transparent process; and
- **amend the standard PFI contract and "Value for Money Assessment Guidance" and increase support for procuring authorities to ensure that public sector safeguards in situations of contractor difficulties** operate as effectively as possible.

OVERVIEW

5.1 Maintaining operational performance and flexibility is a key factor in the long-term value for money of PFI. With PFI contracts typically running for 25-30 years there is a clear need for them to be able to respond and adapt to the inevitable changes that will occur in public sector requirements over that period of time while retaining private sector incentives to perform. Moreover, it remains essential for the public sector to manage effectively the PFI contract throughout its life so that the project continues to meet the public service requirements.

5.2 There are a number of different forms of flexibility which this chapter will look at:

- the effectiveness of the fundamental structure of PFI in responding to change in order to deliver value for money throughout the contract lifetime;
- the ability of the public sector to amend the PFI contract to reflect changes in its requirements or to recalibrate the contract to better reflect existing requirements; and
- the efficiency with which the public and private sector work together to provide high quality services on a day to day level.

5.3 This chapter:

- identifies the challenges which occur through a PFI project and impact on its operational performance based on evidence presented in Chapter 4;
- sets out the steps the Government is taking to strengthen the flexibility and value for money of PFI contracts at a strategic, contractual and operational level; and
- describes the steps being taken to improve the operational performance of existing and future PFI projects.

5.4 This chapter also explains what the Government has learnt from its experiences of contractor distress in its PFI programme and how the PFI model ensures the continuation and successful delivery of public services.

PAYMENT AND PERFORMANCE MECHANISMS

Key features of effective payment mechanisms

5.5 Effective payment and performance regimes are a key tool for ensuring that the public sector achieves long-term value for money in PFI projects, and they are central to incentivising the PFI contractor to meet the service levels specified within PFI contracts. The key features of an effective payment mechanism are:

- all the major elements of service delivery should be covered by the regime and given a weighting linked to their relative importance;
- no payments should be made until the contracted service is available;
- there should be a single unitary charge payment from the public sector for the service, which is not made up of separate independent elements relating to availability or performance;

- the single unitary charge should only be paid to the extent that the service is available (for example proportionate to the number of available places or units); and
- it should seek to make deductions for substandard performance so that the contractor is incentivised to rectify the problem. Deductions should reflect the severity of service failure.

Challenges to the effectiveness of payment regimes

5.6 Recent research by Partnerships UK and 4ps (see paragraph 4.26) indicates that the public sector receives a high level of delivery against service specifications and is generally satisfied with the way PFI contractors are incentivised by performance regimes in PFI projects. Partnerships UK's research also indicates that deductions for under-performance are effective is stimulating improvement (see paragraph 4.63).

Performance regime calibration

5.7 In order to ensure that the PFI contractor delivers a high standard of service and operational performance, the payment mechanism will need be:

- properly calibrated and straightforward to use so that the impact of performance on payment can be easily determined;
- thoroughly enforced; and
- able to adapt to changing public sector priorities.

5.8 The challenge for the Government is to continue to improve payment and performance mechanisms in PFI contracts and in other conventionally procured contracts. Some PFI contracts have set contractual mechanisms for performance deductions at a level that means that it is difficult for them to be triggered despite poor performance. This potentially weakens the incentives on the private sector to deliver the service levels desired. Although in most circumstances service levels are still being met, this can lead to an inflexible attitude by the private sector in meeting public sector requirements.

5.9 Research by Partnerships UK (set out in paragraph 4.30) also indicates some concern from public sector managers that the structure of the payment mechanisms does not incentivise the private sector contractor to exceed performance targets, but only to avoid payment deductions. This may lead to an environment where innovative ways of providing the services are not always identified or implemented. There are also concerns that performance measurement systems can occasionally incentivise the service provider to suffer deductions rather than correct a problem, and fail to focus on important areas of service delivery.

5.10 These factors show that setting stretching and well calibrated performance targets for the private sector partner at the outset of a contract is essential to effective performance and setting performance targets that are too easy to achieve undermines those incentives.

Additional high performance payments

5.11 Evidence and comments from public sector managers have raised questions about whether performance and payment mechanisms should contain flexibility for some form of additional payment if the private sector exceeds the service levels specified. While it is vital that the public sector correctly specifies its requirements in calibrating the performance and payment mechanism, the Government recognises that it is not possible to contractualise all aspects of the relationship between the public and private sector.

5.12 The private sector contractor has responsibility for the performance of staff it employs and is free to create mechanisms (financial or otherwise) to incentivise high levels of performance. However, the Government does believe that a constrained and budgeted level of additional payments to the private sector could potentially improve the incentivisation of PFI contractors without putting a meaningful financial burden on the public sector client.

Enforcing rights to make deductions

5.13 Many public sector authorities make payment deductions on a regular basis as a way to manage private sector performance (as set out in paragraph 4.30). However, Partnerships UK's research raises some concern that public sector managers can sometimes be wary of making performance payment deductions from the PFI unitary charge for fear of disturbing the long term partnership arrangement they have with the PFI contractor. The Government believes that procuring authorities should enforce all their rights under the PFI contract and that the relationship with the PFI contractor should be mature enough to withstand this.

5.14 Research described in Chapter 4 indicates that payment and performance mechanisms operate effectively. 4ps research shows 82 per cent of respondents believe that mechanisms are working to incentivise contractor perfomance. 78 per cent of contract managers responding to Partnerships UK's survey strongly agreed or agreed to some degree with the statement "the payment mechanism supports the effective contract management of this project". However, there are some challenges for the public sector. Partnerships UK's research indicates that 45 per cent of public sector respondents regarded the PFI payment mechanism as quite difficult or very difficult to use with only 25 per cent regarding it as very easy or quite easy. This indicates challenges for the public sector in efficiently using the PFI contractual mechanisms to manage the relationship with the private sector partner. It also indicates that there is scope to improve public sector training in managing PFI contracts.

Contracts need to adapt

5.15 It is inevitable with long-term contracts for public services that requirements for the delivery of those services are likely to change during the contract lifetime and that PFI projects should be able to adapt to those changes. Partnerships UK's research suggests that, in some instances, public sector managers want an easier process for changing the balance of incentivisation within a performance regime to reflect changing priorities or an incorrect initial calibration of the performance mechanism.

Clarity about required delivery levels

5.16 Greater flexibility could be provided in PFI contracts to adapt performance regimes. However, it is important that this should not disincentivise the public sector from attempting to set service levels correctly at the outset of the project.

5.17 Greater flexibility in performance mechanisms also has to be carefully weighed up against the additional risks created for the public sector in terms of renegotiation of the PFI contract and the ability to define an output based specification.

Improving performance and payment mechanisms

Payment mechanism revisions

5.18 In order to address these issues the Government will revise the price and payment mechanism chapter in the standard PFI contract to include guidance on how to set performance targets for the private sector contractor, which are easy for both parties in a PFI contract to understand and which will incentivise long term high quality performance. The Government will also assess whether stronger links can be made between user satisfaction and payment and performance mechanisms. If appropriate, it will also provide new contractual drafting on this subject. The Government will consult with the public and private sectors on the terms of this guidance and drafting which it intends to introduce before the end of 2006 (drawing on existing guidance such as that provided by the NAO).

5.19 This combined drafting and guidance will lead to better incentives for private sector contractors to provide an excellent level of service delivery while retaining value for money. It will also provide greater flexibility for the public sector to alter payment and performance mechanisms throughout the life of the contract.

Operational taskforce

5.20 Further support will be provided to projects through the establishement of a PFI Operational Taskforce. This unit will assist the public sector in making effective use of performance mechanisms, and will make sure it utilises its contractual rights and obligations to optimise value for money. This PFI Operational Taskforce is discussed further in paragraphs 5.34 to 5.37.

Improving the handover from procurement

5.21 Paragraphs 5.38 to 5.44 set out the measures that the Government is taking to improve the handover from procurement to construction and/or operation. A key aspect of this handover may be undertaking operational testing (or shadow running) of the payment mechanism to ensure that the public sector contract manager understands the running of the payment mechanism and that any operational issues can potentially be resolved before the PFI contract is signed or becomes operational.

Improving public sector skills

5.22 The Government will also assess how public sector skills in managing PFI contracts can be improved to manage more effectively the payment mechanisms associated with long term contracts with private sector partners. Chapter 6 contains more detailed measures on this subject.

CAPITAL WORKS AND CONTRACT VARIATIONS

5.23 The standard PFI contract contains guidance and standard drafting on how different types of contract variation should be handled. These are broadly distinguished between major variations (i.e. involving major capital changes) and small variations (involving minor day-to-day changes to the capital asset). Box 5.1 explains the different processes.

Box 5.1: Variation processes in the standard PFI contract

Small works changes: in any contract year the public sector may have to make several requests to the private sector contractor in respect of minor changes to the service. To facilitate efficient management of the contract, reduce costs, and ensure continued delivery of services, the contract should provide an efficient mechanism for dealing with public sector requests for small changes to the services.

Major variations: if the public sector requires changes that will result in capital expenditure (i.e. expenditure that will have the effect of increasing the contractor's financing costs for example, due to further construction work), a more detailed variation mechanism is required.

The contractor's financiers are likely to have a great deal of input and control over the ability of the contractor to agree to any changes if they impact on project and financial risk or projected equity returns.

5.24 Partnerships UK's research has shown that 83 per cent of contracts are described as always or almost always accurately specifying the services required, which indicates that PFI contracts do reflect the services needed by the public sector during operational life (see Chart 4.13).

Contract drafting 5.25 A number of contracts only have one change process which must be followed regardless of the size, complexity or risk involved in the change. This approach, mainly found in older PFI contracts, can restrict the ability for minor changes to be made relatively quickly and inexpensively. This can have a direct effect on user satisfaction with the service provided through the PFI contract.

Use of existing senior lenders 5.26 If funders' agreement is required for larger contractual variations, there is concern that the process for agreeing variations may be extended. Change mechanisms requiring funders' approval can increase the time and cost of approving a change. This sometimes leads to a side-stepping of the contractual process and ad hoc decision making on contractual variations. Though this may be the best course of action, the public sector must make a robust value for money assessment of whether to use public or private finance to fund such works.

Standard PFI contract drafting 5.27 The standard PFI contract does now specify that there should be separate provisions for small works charges and gives a detailed process for larger scale variations. As the use of the standard PFI contract is mandatory for all PFI contracts, the Government expects the benefits of this wording to flow through the system in coming years. However, this drafting is not all encompassing.

Revising the Government's approach to change mechanisms

5.28 The evidence presented in Chapter 4 (paragraph 4.45) shows some of the issues PFI projects face in ensuring contractual flexibility. The Government faces three main challenges in the approach to variations in PFI projects. These include:

- improving the value for money assessment of the flexibility required in a PFI contract to meet the public sector's requirements;
- increasing the contractual flexibility within the standard PFI contract to undertake variations; and
- supporting projects that are already in operation to make variations.

Update value for money guidance 5.29 The Government's current "Value for Money Assessment Guidance" will be updated to reflect specifically the balance between affordability and contractual flexibility in terms of increased costs for large and small changes in service. This will enable procuring authorities to understand the trade-offs they are making in the PFI project between the lowest cost solution and ensuring the project has sufficient flexibility to meet their operational requirement.

Amend standard PFI contract change provisions 5.30 The Government will consider amendments to the change in service provisions of the standard PFI contract to create a more robust and flexible process for considering variation requests. Specific issues which will be examined include:

- increasing the level of differentiation in the change mechanisms between small and large variations;
- clearly defining the responsibilities of the project lenders;
- imposing fixed timescales for different categories of change to maintain momentum, clarity, and focus in achieving that change; and
- introducing sanctions for not adhering to such timescales.

Establish a PFI Operational Taskforce

5.31 A PFI Operational Taskforce will be established to assist public sector contracting bodies facing contract variation issues in operational projects. This is to make sure that the public sector understands its contractual rights to optimise value for money.

PFI OPERATIONAL TASKFORCE

5.32 Throughout this chapter the Government recommends a range of measures to provide greater guidance and assistance to the public sector in managing operational PFI projects. This builds on valuable existing advice provided by departmental Private Finance Units (PFUs), private sector advisory firms and bodies such as 4ps, the Office of Government Commerce (OGC), the National Audit Office (NAO), and Partnerships UK. Specifically there needs to be more information and assistance available to public sector contract managers on:

- benchmarking;
- payment and performance mechanisms;
- contract variations; and
- contractor distress and refinancing

Main functions

5.33 In order to provide this information and assistance. The Government will establish a PFI Operational Taskforce. This will be a small unit acting on behalf of the Treasury and based in Partnerships UK. It will work with departmental (PFUs), local authorities and advisory bodies such as 4ps to provide proactive support to public sector project managers on key operational issues whilst also providing greater consistency across older PFI projects. Members of the Taskforce will have a range of skills relating to financial, legal and operational management. The Taskforce will be established over the next three months. Its main functions will be:

- providing a helpdesk facility with immediate effect, specifically resourced to help public sector managers on operational issues. This will include providing support to distressed projects and assistance to projects in dispute;
- developing specific guidance for the public sector on issues such as benchmarking improving the transition to the operational phase of projects, payment mechanisms and contractual variations and consider any potential changes to the standard PFI contract that might flow from this. Any guidance issued will be agreed with, and issued on behalf of, the Treasury;
- monitoring and maintaining a record of issues raised by the public sector and liasing with other departmental PFUs to ensure that best practice information is widely disseminated;
- undertake a pilot scheme of operational reviews of PFI projects working in collaboration with the OGC. These reviews will involve detailed discussions with both public and private sector partners involved in projects, with the primary aim of providing forward looking advice to project teams to improve performance;
- gathering information from market participants on trends in relation to issues that have been raised by the public sector and using this to inform guidance and best practice;
- negotiating any codes of conduct with the private sector that are required to provide a consistent approach across older contracts; and
- enforcing the refinancing code of conduct.

5.34 Some of the services available through the Taskforce such as the helpdesk will be free at the point of use, though procuring authorities will be expected to pay for more detailed work. The Taskforce will assist and advise public sector PFI contracting bodies on a range of issues, but will not seek to replace the primary decision-making role of those bodies in procuring and operating individual projects to ensure their success and continued value for money. The Government will also ensure that individual departmental responsibility for monitoring and supporting the PFI projects they sponsor remains intact.

5.35 The Taskforce will also be used to respond to any instances of contractor difficulties and provide advice and guidance to the public sector on specific problems experienced in projects. It will also gather information across PFI sectors on any potential issues which may give early warning of contractor difficulties.

IMPROVING THE TRANSITION TO THE OPERATIONAL PHASE OF PROJECTS

5.36 If PFI projects are to provide a high level of service to the public it is important that the transition from the procurement and construction phase of a project to its operational phase is handled efficiently and smoothly. The overall high performance assessment of PFI projects demonstrated by a range of research reflects well on the public sector management teams charged with delivery.

Timing of manager recruitment

5.37 Partnerships UK's research does indicate that there is room for improvement in the management of this transition. The research showed that the majority of contract managers had not been recruited into a project until after the procurement phase had been completed. Many of these began work within six months of the start of the operational phase.

5.38 The lack of involvement of contract managers in the procurement phase may mean that a range of operational issues are not identified during procurement. These then have to be ironed out in the operational phase causing early disruption to projects and tension between the public and private sector partners. Difficulties with the payment and performance mechanism can be exacerbated by a lack of involvement of contract managers during procurement.

Knowledge transfer

5.39 Knowledge transfer from the procurement phase to the operational phase of a project is important. Many staff involved in the procurement of projects do not move across to manage the contract. Therefore, it is important that there is comprehensive documentation to allow those taking over the project to effectively understand the project agreement and manage it. A simple and easy to use contract manual is essential in this regard.

Formal handover

5.40 Projects which have a formal handover at the beginning of the operational phase experience higher levels of overall satisfaction with the performance of the project than those who did not.

Resources and training

5.41 Some projects initially underestimated the amount of resource and experience that would be required for contract management. This imposed stresses on the management of projects and reduced the ability of the public sector to react flexibly during their initial operational phases. The need for additional resource at certain points in a contract life (e.g. if variations are required or benchmarking is taking place) also needs to be borne in mind.

Measures to improve the transition to the operational phase

5.42 Though operational PFI projects are performing to a high standard, recent research shows that there is a need to improve the consideration that teams procuring PFI projects give to the transition to the operational phase. To address this issue the Government will publish guidance through the PFI Operational Taskforce and make compliance with this guidance a requirement for central government approval of PFI funding. This guidance will embed the following principles:

- all projects should produce an easy to use contract manual at the point of contract signature and commit to undertaking a formal handover procedure;
- operational contract managers (both public and private sector) should be introduced into projects during the procurement phase to ensure that the project can be run effectively and that the rights and responsibilities of the PFI contract are properly understood and captured in the performance and payment mechanism;
- projects should consider implementing shadow running of the contractual structure where possible prior to contract signature to test its efficacy outside of a live environment; and
- consideration needs to be given to providing training and guidance to the public sector on specific PFI contract management. Proposals relating to this are explained further in Chapter 6.

OPERATIONAL FLEXIBILITY AND PUBLIC/PRIVATE SECTOR RELATIONS

Partnership approach and shared vision

5.43 A broad range of recent research has shown that there are strong relationships between the public and private sector partners. This is described in more detail in paragraph 4.59.

5.44 It is important that sufficient resources are put in place during the procurement phase of projects to ensure the effective management of the contract in the operational phase. The NLGN report (2004) "Beyond Contract, what makes a PPP successful" states how establishing an "original or agreed vision is hugely important as an ongoing reference point. It also establishes a common purpose". [1]

Communication and colocation

5.45 Partnerships UK's research (see paragraph 4.67) shows communication to be the most significant factor in ensuring successful relations between the public and private parties to the contract. Most projects surveyed approach communication between the public and private sector and the relationship as being in a spirit of partnership.

[1] New Local Government Networks (NLGN) "Beyond Contract What makes a PPP successful" (2004) Stephen Reeve with Warren Hatter

Transitional challenges **5.46** However, some projects have reported concerns in the early stages of operation in establishing effective communications between the public and private sector partners. This can lead to "delay in bedding in Special Purpose Vehicle (SPV) communications and the single service provider ethos"[2]. This is almost always a transitory issue that is resolved relatively quickly.

Ensuring performance incentives are not undermined **5.47** Any desire to ensure closer communication between the public and private sector parties should be balanced against a need to ensure that performance incentives are maintained. This is particularly relevant if there are concerns that the public sector is not making performance deductions from the unitary charge for fear of upsetting the long term relationship with the private sector contractor.

Improving the partnership

5.48 The Government believes that the relationship between the public and private sector in a PFI project must always ultimately be contractual but should be overlaid with partnership working to ensure that operations are effective. There is a genuine benefit in ensuring that the public and private sector have a clear understanding of how they should work together and communicate to manage the project effectively in a genuine partnership arrangement.

Partnership agreement **5.49** In order to encourage this approach the Government will promote the development of a partnership agreement or shared vision document that sits outside of the actual PFI contract. This would not be legally binding but would set out the parameters of the public sector and private sector working relationship and spell out in some detail how the contract will be managed in practice. The Government will work with the public and private sector to consider the main issues such a document should cover and decide on the best way to implement this approach.

Public sector skills **5.50** Issues relating to the experience and skills of public sector staff are examined in Chapter 6 on public sector skills.

CONTRACT LENGTH AND FLEXIBILITY

Overview **5.51** The duration of PFI contracts are based upon a variety of factors but should ultimately reflect the optimal period over which the procuring authority wishes its services to be provided, with reference to possible changes in service requirements. For PFI projects with major capital assets such as schools or hospitals, contracts are typically set for 25-30 years, though in some cases this can be longer. Preparatory work undertaken by the public sector before launching a procurement should identify an appropriate contract length based on these considerations prior to a decision to go to market. The long loan periods available from private financiers must not be a material factor in deciding an appropriate contract length.

Benefits of long term contract lengths **5.52** The wide variation in the nature of services procured through PFI would indicate that different contract lengths are appropriate for different sectors. Contract lengths over 30 years can offer value for money in the right circumstances. In particular, long-term contracts incentivise public authorities to think more strategically about the services they provide and the risks in relation to the whole-life cost of maintaining the asset that can be transferred to the private sector.

[2] Partnerships UK (2005) research.

5.53 Long-term contracts also allow for the development of a genuine partnership approach with the private sector therefore enabling more efficient and effective management of services. Shorter contracts have clear drawbacks such as desensitising the private sector from planning and managing the whole-life cost risk.

5.54 However, in a number of PFI sectors, it is not always clear in business cases that a 25-30 year contract length is a true reflection of the optimal period of service delivery, and therefore whether these contract lengths are likely to secure value for money. This is particularly the case if the overall value of the PFI project is skewed towards non-capital related costs. The Government is committed to ensuring that contract lengths are not driven by affordability requirements but by overall value for money.

Sector specific contract length caps

5.55 In order to address these issues the Treasury will consult with other Government departments and public sector bodies to establish appropriate sector specific caps for PFI contract lengths based on a detailed value for money assessment. This assessment will balance public authorities' need to manage their budget with a serious look at:

- projected future service requirements, to assess how far ahead there can be confidence of the need for the initial assets;
- the useful economic life of the assets procured and the balance between service and asset provision; and
- whether the inclusion of a second major refurbishment cycle within a PFI contract offers value for money for the public sector.

5.56 The Treasury will encourage government departments to publish the agreed caps before the end of 2006 with an explanation of the conclusions reached. These caps will only be applied to new PFI projects which begin procurement after the date of publication.

SOFT SERVICES AND THE IMPACT OF BENCHMARKING/ MARKET TESTING

5.57 Soft services are those services provided in a PFI contract that generally relate to the day to day provision of the service, which are not capital intensive in nature and do not materially impact the underlying asset. There is no single definition of soft services though typically these cover catering, cleaning, security and portering at a facility such as a school, office or hospital. However, the wide range of PFI projects currently in operation and procurement means that soft services can be very different in nature between sectors.

5.58 PFI contracts do not always include soft services provision where the decision has been taken on value for money grounds to either let separate contracts or to retain staff in house. Other PFI schemes do not include soft services because of the nature of the project (e.g. waste PFI). The Government's policy is that departments have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not essential for achieving the overall benefits of improved standards of service delivery specified by the procurer, and where not transferring staff is consistent with delivering the Prime Minister's commitment to flexibility in public services provision.

5.59 Though soft service providers are often part of the PFI private sector consortium they can also be subcontractors to the main concessionaire and may not have any shareholding in the PFI project company. For those PFI projects which do include soft services it is normal to provide for a periodic (every three to seven years) benchmarking or market testing exercise whereby the cost of these services is reset (up or down) and reflected in a new unitary charge. See Box 5.2 for a description of these alternative mechanisms. (paragraphs 4.36-4.38 provide more evidence on benchmarking and market testing). This adjustment does not protect the PFI contractor from the risk that it has incorrectly assessed the number of employees required to meet the service levels specified.

Box 5.2: Definitions of benchmarking and market testing

Benchmarking means the process by which the PFI contractor compares either its own costs or the cost of its subcontractors providing soft services against the market cost of such services. If the relevant costs are higher than market costs, a reduction in the price charged to the public sector should be made on an agreed cost sharing basis to reflect the differential. If costs are lower than market costs, any price increase must be justified by the PFI contractor.

Market testing means the retendering by the PFI contractor of the relevant soft service to test the value for money of that service in the market. Any increase or decrease in the cost of such service as a result of market testing requirements in the contract which results in the replacement of a subcontractor should be reflected by an adjustment in the price charged to the procuring authority.

Inclusion of soft services in PFI contracts

Soft services benefits

5.60 Including soft services within a PFI contract potentially creates a number of benefits that generate better value for money. These include:

- improving consideration of soft service requirements in the design and construction of the PFI asset. The integration of long-term service with design can reduce maintenance and operating costs over the contract life;
- more effective management. The private sector may have better skills than the public sector in management of soft services contractors where such an activity may be its core business. However, the value for money that PFI provides should not be achieved at the expense of staff terms and conditions;
- reduces interface issues between service providers and for the procuring authority. The authority can in effect procure a one-stop shop of serviced asset provision with a wide range of services included within one contractual regime, and with one partner ultimately responsible;
- creates flexibility benefits for users. This maintains a single point of contact for overall service provision and allows the PFI contractor to respond flexibly to user requirements; and
- creates wider financial incentives to perform if the performance of soft services is included within the payment and performance regime.

Challenges of including soft services

5.61 There is a number of issues that can erode the value for money benefits of including soft services during the operational phase of a project. Challenges include:

- the high visibility and significant effect on users of PFI facilities caused by failures in soft service provision. However, this risk may be difficult to reflect in the performance regimes of PFI contracts given the relatively small value of soft services contracts when considered against the value of the whole contract;
- the periodic benchmarking and market testing of soft services provisions are not currently well understood by public sector managers (see paragraph 4.39) and are a potential cause of friction in otherwise strong relationships between public and private sectors; and
- where service requirements change significantly and frequently, the incentive soft services within a PFI contract may erode value for money.

5.62 There may be positive benefits from letting soft service contracts outside of the main PFI contract in terms of direct control of this important set of services. Such an approach also gives the public sector more flexibility in setting service levels than would typically be the case in long term PFI contracts.

Benchmarking and market testing

Overview

5.63 Currently the standard PFI contract contains both benchmarking and market testing guidance. It states that market testing should generally only be undertaken where the parties have failed to agree any price adjustment following the results of a benchmarking exercise. Benchmarking (see box 5.2 for definition) is favoured over market testing because the latter approach is thought to be more disruptive and costly as it may require the replacement of a subcontractor. This is a particularly relevant consideration if there are a number of subcontractors providing soft services, each of which has to be market tested. It should be borne in mind that most PFI projects are only in their early years of operation and only a limited number have undertaken a benchmarking exercise.

5.64 Partnerships UK's and 4ps' research indicates that 78 per cent of public sector managers believed benchmarking and market testing provisions are clear. However 18 per cent felt these provisions were not clearly explained, indicating that benchmarking and market testing provisions could be contentious. 59 per cent of respondents in Partnerships UK's research do not know enough about these provisions in their contract in order to say whether they are clearly explained or not. This creates a significant challenge for the public sector to ensure that over the lifetime of a long-term PFI contract they will continue to get value for money for soft services provision.

Affordability pressures from benchmarking

5.65 The results of Partnerships UK's research also indicate that the public sector is concerned that affordability pressures on the private sector partner and lack of sufficient comparable data may mean that a benchmarking exercise results in price increases for soft service provision.

5.66 Where benchmarking exercises have been conducted respondents to Partnerships UK's survey reported a range of outcomes including increases in price or no overall change. Lessons have already been learnt from early PFI projects and more recent contracts have more robust and well understood benchmarking mechanisms. However, the lack of understanding and concern over benchmarking exercises is something the Government is responding to.

Improving the Government's ability to secure long-term value for money

Tougher test for inclusion of soft services within PFI contracts

5.67 The evidence set out in Chapter 4 indicates that soft services provided under PFI are of equivalent quality to those procured through other routes and that performance has been to the standard required of contracts. The evidence also suggests that while the soft services element of operational PFI contracts is judged to be performing satisfactorily on average, levels of performance are lower than the high levels expressed for the overall availability and hard FM provision in PFI facilities.

5.68 Soft services provision within long term PFI contracts can offer value for money through the integration of design with ongoing service provision and a single point of responsibility. However, it may also lead to a lack of public sector control and inflexibility in service delivery in certain situations. On this basis the Government believes that the value for money benefits of the inclusion of soft services within PFI contracts should not be taken as a given.

5.69 In order to strengthen the delivery and operation of PFI projects the Government will publish strengthened guidance on rigorously assessing the value for money benefits of including soft services within a PFI contract as part of its updated "Value for Money Assessment Guidance". This guidance will be used by public sector procuring bodies structuring their PFI projects. The broad principles set out in Box 5.3 will form the basis of the objective criteria for this assessment. In making this asssessment it will also be important to ensure that the public sector has sufficient data to compare accurately the provision of services through a PFI contract against provision outside of that contract either by the public or private sector.

Box 5.3: Principles for examining value for money of inclusion of soft services within PFI contracts

As a result of strengthening the "Value for Money Assessment Guidance" test for inclusion of soft services, public authorities will be asked to prove rigorously:

- **genuine integration benefits in terms of accurately assessing whole life operating costs of projects;**
- **that private sector management of subcontractors within PFI will be more effective than direct public sector management of a separately let soft services contract;**
- **that there will be a greater reduction in interface issues between service providers than if soft services contracts were let separately;**
- **flexibility benefits for end users with a single point of contact that could not be replicated with separate soft services contract;**
- **improved consideration of soft services requirements in design and construction of PFI assets leading to quantifiable reduction of maintenance and operating costs of project; and**
- **financial incentives to perform within a PFI structure that are significantly better than in a separately let soft services contract.**

Advantage of market testing

5.70 Where a decision is taken to include soft services in future PFI contracts the Government believes there are advantages in undertaking periodic market testing of those services instead of benchmarking. Through this approach the public sector can guarantee that it continues to get value for money in the provision of these services over the lifetime of the PFI contract through a fair and transparent process. The specific detail of this approach will be consulted upon in order to amend benchmarking and market testing provisions in the standard PFI contract.

5.71 The Government believes that the value for money benefits of a competitive and transparent process of market testing of soft services outweigh the cost and complexity of potentially changing service providers. Market testing also allows a more flexible approach to the provision of services by ensuring soft service provision for the project can be re-assessed to match public sector requirements at the time the exercise takes place. A move to market testing emphasises the importance of transparency and competition. It also acknowledges the benefits that can accrue from keeping soft services provision within the main PFI contract.

5.72 Market testing exercises are usually conducted by the PFI project company. This could cause conflicts of interest where soft services contractors are also equity providers in the project company. Where the soft services provider is also a shareholder in the PFI project company, the Government will also consider introducing contractual guidance to allow the public sector greater control of the process.

5.73 The PFI Operational Taskforce will assist public sector contracting bodies facing benchmarking exercises to make sure they understand their contractual rights and obligations to get the best value for money for the public sector.

CONTRACTOR DIFFICULTIES

5.74 The Government has had recent experience of the impact of contractor difficulties on PFI projects. In any major infrastructure project there is always a danger that private sector contractors may experience financial difficulties thereby causing problems for the project. This is just as likely with a conventionally funded project as with a PFI project.

5.75 However, with a PFI project the public sector has considerable additional safeguards to ensure that assets and services continue to be delivered without the public sector incurring additional costs. The Government believes that the structure of PFI projects and the contractual and financial incentives contained within them make them well, if not better, placed to cope flexibly with contractor difficulties. These safeguards ensure that value for money PFI projects can be delivered for the public sector and include:

- due diligence: senior lenders will scrutinise the financial robustness and ability of subcontractors to meet their obligations. They will also often require construction bonds and parent company guarantees from material subcontractors for their obligations to the PFI project company;

- service commencement and fixed term contracts: payment to the PFI project company does not start until the contracted service is delivered to the public sector and the length of the PFI contract is fixed. This means that delay in the commencement of service delivery directly impacts on shareholder returns and timing of the servicing of debt raised to finance a project. This means that shareholders and senior lenders are strongly incentivised to ensure the successful and timely commencement of services, and protects the public sector by ensuring no payment is made until the required service is delivered;
- equity risk: investors may lose their entire investment in a situation of project failure. They are therefore incentivised to manage subcontractors effectively;
- lender step-in rights: if a project experiences difficulties, senior lenders are incentivised to step in and take remedial action to rectify the problems. Failure by the senior lenders to rectify the problems could lead to the project being terminated with the likely consequence that senior lenders will fail to recover the whole amount they have lent to the PFI company; and
- authority right of termination: the public sector has the ultimate right to terminate a project if the PFI company fails to meet the public sector's requirements. If the project is terminated on this basis senior debt and equity is at risk of not being repaid, and the procuring authority can procure a new service provider to ensure that its service requirements continue to be met.

PFI structures have coped well with contractor difficulties

5.76 Since "PFI: Meeting the Investment Challenge" was published in July 2003 there have been a number of cases against which the robustness of the safeguards and the provisions of the PFI model and standard PFI contract for managing contractor difficulties have been tested. These have demonstrated that under the PFI model and standard PFI contract the public sector interests have been protected when contractors experience financial difficulties. Moreover, the levels of protection are greater than would have been the case had if the project had been procured conventionally.

5.77 The Government's experience during contractor difficulties has been that some delay in projects during construction did occur, just as any projects would following financial difficulties at a construction contractor in any situation. However, the strong financial incentives created under the PFI model, meant that shareholders and financial investors worked to ensure that work continued (if necessary with a replacement contractor) as smoothly and efficiently as possible in the circumstances with delays being minimised.

5.78 In all cases of contractor difficulties, projects have continued to progress through construction phases or in operation, working towards or already delivering value for money services to the public.

Learning the lessons from contractor difficulties

5.79 The PFI incentive structure has responded well to the recent instances of contractor difficulties. Drawing on this experience the Government is taking steps to improve further the public sector's ability to respond to these events.

Improving the assessment of financial strength of contractors

5.80 The evaluation of additional support provided to the PFI project company for the construction sub-contract through parent company guarantees and types of bonds needs to be considered carefully during bid evaluation. In the case of contractor distress parent company guarantees can be potentially difficult to call in quickly and over reliance on them can significantly increase risk to the public sector.

5.81 The public sector should ensure that it keeps good records of construction work that has been completed and properly certifies works undertaken by both contractors and subcontractors.

5.82 The benefits of a standardised contractual approach in PFI can assist projects in the speedy implementation of rectification plans.

5.83 The transfer of beneficial ownership of, or economic interest in, shares in a PFI project company can add to the complexity of negotiations in the event of difficulties being experienced by a contractor which is also an equity provider.

Maintaining lender and equity incentives

5.84 Upfront capital payments made during construction phase of a project can erode the overall incentives of lenders within a PFI project to deliver required outputs or, if necessary, step in to rescue a project in difficulty.

5.85 Given the pressure for public sector facilities to open on time, procuring authorities may be requested to make additional payments to assist with contractor difficulties. Making any such payments (or beginning partial payment of the unitary charge) erodes the risk transfer between the public sector and the PFI project company. Recent experience suggests that the incentives within the PFI contract are strong enough to incentivise the PFI project company to rectify the consequence of contractor difficulties.

5.86 The importance of maintaining effective communication between the public and private sector during all phases of a project is also apparent.

Improving public sector monitoring and coordination

5.87 There needs to be further development of the monitoring role of operational PFI projects across sectors by relevant central Government departments. This is to ensure that any emerging issues at a project or programme level (such as potential over-exposure to one contractor) which may lead to problems in the delivery of services under the PFI contract are identified early and effectively handled.

5.88 The public sector should ensure that it is well prepared to deal with events of contractor distress. In order to facilitate this process, the PFI Operational Taskforce will include within its remit the provision and coordination of advice to the public sector on issues relating to contractor difficulties.

The Government is acting to address issues relating to contractor distress

5.89 The Government is applying the lessons learned from its experience of contractor difficulties in its PFI programme to ensure that it is fully prepared to manage such situations effectively if they do occur and overall is able to limit the likelihood of it exposing itself to such risks. The Government has made, and is making, a number of improvements to both the procurement process and the standard PFI contract to deal with these issues as effectively as possible:

- the Government will increase the level of support provided to procurements. The details of this support will help facilitate a proper evaluation of the advantages and disadvantages of PFI structures prior to the appointment of preferred bidder;
- the "Value for Money Assessment Guidance" will be updated to assess:
  - the financial robustness of a PFI company and its sub contractors;
  - what further protections from contractor difficulties should be required by procuring authorities; and
  - the effectiveness of measures to provide protection from contractors.
- the Government will or has implemented changes to the standard PFI contract to:
  - provide additional rights for procuring authorities to be informed of, and where necessary, approve changes in PFI project company arrangements, such as transfer of beneficial economic ownership, This change was introduced into the standard PFI contract in December 2005;
  - provide additional rights to request information from the PFI project company and lenders relating to the projects and any potential financial difficulties of the relevant contractor;
  - restrict the ability of projects to make up front capital payments unless a clear and unambiguous value for money case is presented;
  - improve central support from departments for projects facing contractor distress. Proposals for boosting the capacity of central government departments to monitor and support PFI projects in procurement are discussed in more detail in Chapter 6. The PFI Operational Taskforce will also assist in providing this support.

6 CONTINUING TO IMPROVE PFI PROCUREMENT

In "PFI: Meeting the Investment Challenge" the Government set out measures to improve its ability to procure PFI projects. These measures included:

- **the enforcement of the standard PFI contract and the introduction of sector specific standard contracts which have contributed to reduced procurement costs and timescales and improved the quality of PFI contracts;**
- **the reform of the Project Review Group (PRG) for local authority projects from an inter-departmental group format into a panel of PFI specialists drawn from across government, and the introduction of a second stage review of projects prior to the appointment of a preferred bidder; and**
- **demonstrating the benefits of the development and retention of procurement expertise within the public sector as applied to a significant investment programme, through the work of Partnerships for Schools (PfS) and Partnerships for Health (PfH).**

The success of the above measures and the maturity of PFI mean that the Government can now look at ways to improve further public sector skills and procurement support, and to reduce procurement timescales and costs for both the public and private sectors. The Government is proposing to:

- **enhance the capacity of departmental Private Finance Units (PFUs) to ensure that they are appropriately resourced to provide support to procurement teams in departments and local authorities;**
- **develop a secondment model to ensure that public servants with experience of complex procurements can be retained and deployed on projects across the public sector;**
- **enhance individual and team procurement skills through formal training;**
- **improve the maturity of projects when they go to market by requiring procuring authorities to do more work upfront as part of the outline business case;**
- **increase the monitoring and scrutiny of projects, changing how certain central government projects and particularly complex projects are approved, and putting in place a mechanism to identify projects which develop problems during procurement;**
- **develop a best practice PFI project governance model; and**
- **facilitate the spread of procurement best practice to reduce procurement timescales and costs, including standardising the Government's approach to design issues across different sectors.**

BACKGROUND

6.1 The Government continues to place great importance on ensuring that the public sector develops strong procurement and project delivery skills across all of its procurement activities including, and as particularly addressed in this document, for PFI.

6.2 In "PFI: Meeting the Investment Challenge" the Government committed to:

- put in place the right skills and support mechanisms for the public sector to deliver reform and renewal of public services through PFI;

- address past difficulties in providing effective PFI procurement expertise to all projects; and
- help the public sector become a better client.

6.3 The Government emphasised the policy objectives of speeding the delivery of investment benefits by reducing PFI procurement timescales and improving value for money by reducing transaction costs for both the private and public sectors.

6.4 There are encouraging signs that the measures introduced in "PFI: Meeting the Investment Challenge" have had a positive impact on PFI, that procurements are becoming more efficiently managed, and procurement timescales are declining.

Enforcing the standard PFI contract

Standardisation of PFI contracts

6.5 In "PFI: Meeting the Investment Challenge" the Government announced that it would act to ensure more rigorous enforcement of the standard PFI contract, as the process of standardising PFI contracts helps articulate the Government's position on appropriate risk allocation between the public and private sectors, improves PFI procurements across the public sector, and is intended to reduce the length and cost of the procurement process.

6.6 In April 2004 the Government published version 3 of the "Standardisation of PFI Contracts" which was mandatory for all projects that had not reached commercial close by 14 May 2004. This has been supplemented by an addendum published in December 2005. In order to ensure compliance with version 3 of "Standardisation of PFI Contracts", all derogations from the core areas – both required drafting and key commercial principles where there is not specific contract wording – must be approved by the Treasury. Given the important benefits that flow from embedding standardisation, compliance with version 3 of "Standardisation of PFI Contracts" is also a prerequisite for approval of PFI projects at the Project Review Group (PRG) and the approval of full business cases. 4ps has also developed a local government supplement to the standard PFI contract.

Sector specific standard contracts

6.7 In order to embed further the implementation of the "Standardisation of PFI Contracts", and to recognise the inevitable differences that exist between sectors in which PFI operates, the Treasury also encouraged departments to develop sector specific standard contracts which are compliant with the core areas of version 3 of "Standardisation of PFI Contracts", where this would meet the overall aims of standardisation. All sector specific standard contracts are approved by the Treasury. Three sector specific standard contracts have now been approved and issued (for schools, housing and joint service centres) and four further sector specific standard contracts (defence, street lighting, housing and leisure) are due to be published this year, along with further guidance for the waste sector.

6.8 The Government believes that the enforcement of "Standardisation of PFI Contracts" has achieved real success in ensuring greater consistency across sectors and settling the risk allocation between the public and private sectors. Both the public and private sectors are achieving better quality contracts as a result. The focus of the debate is now more on the genuinely project specific areas of the contract. The list of derogation requests has decreased significantly as the Government's commitment to the risk allocation regime has embedded in the market, and greater certainty has been achieved as sector specific standard contracts have been developed. Feedback from sponsors suggests that legal costs incurred in bidding for PFI projects are decreasing. It is expected that there will be a discernable impact on procurement timescales and costs and that longer-term benefits will become apparent as projects that were launched subsequent to May 2004 progress through procurement.

Reforming the Project Review Group

Second stage review

6.9 The PRG was set up to test the deliverability of local PFI projects prior to entering procurement. The Government announced in "PFI: Meeting the Investment Challenge" that the PRG was developing new mechanisms to evaluate compliance with the requirements of the standard PFI contract guidance. In March 2005 the PRG announced a second stage review process that would be applied to a selection of projects and conducted immediately prior to the appointment of a preferred bidder. The purpose of the second stage review is to confirm a project's affordability, ensure compliance with the standard contract terms and conditions and identify and mitigate issues which may impede financial close, while the procurement is still in a competitive environment.

6.10 Where implemented, the second stage review has been successful in ensuring that all material commercial issues have been resolved before the competition is concluded. It is expected that this will result in projects achieving financial close more quickly following appointment of a preferred bidder, and is entirely consistent with the requirements of the new competitive dialogue regime (see Box 3.2) that is expected to apply to future PFI procurements and will require all material issues to be resolved prior to selection of a preferred bidder.

Panel of experts

6.11 In addition, in November 2005 the format of the PRG was reformed from an inter-departmental group into a panel of PFI specialists drawn from across government, selected on the basis of their collective PFI skills and experience. It is chaired by the Treasury with permanent representatives from the Office of the Deputy Prime Minister (ODPM) and 4ps. Procuring authorities, supported by the relevant departmental PFU, are now invited to discuss their projects directly with the panel to ensure that more in-depth scrutiny is possible.

Next steps in improving PFI procurement

6.12 The impact of these measures and the maturity of PFI procurement means that the Government can now look at ways to improve further the procurement of PFI and other complex investment projects. Chapter 2 showed that average procurement times are declining and that partnership programmes are helping to bring these down. However, the Government recognises that procurement costs and timescales remain unnecessarily long. This chapter sets out the steps the Government is taking to ensure procurement times are reduced further and to improve PFI procurement by:

- enhancing PFI procurement skills and increasing support to procuring authorities;
- increasing the frequency of monitoring and robustness of scrutiny of PFI projects, and reforming the approvals process; and
- ensuring that projects are better prepared before release to the market, such that authorities have a high degree of certainty about the scope of the project, service requirements, affordability and acceptability of risk transfer to the private sector before the procurement is started.

6.13 As set out in Chapter 3, the Government will also be exploring whether there is a role for creating vehicles to coordinate procurement and manage deal flow in sectors where there is a strong pipeline of projects.

6.14 While the Government acknowledges that the public sector has a pivotal role to play in continuing to improve PFI procurement, the Government expects the private sector to do its part to work with the public sector and to support the measures put in place to improve the efficiency of the process, so that both sides can benefit from quicker procurements and decreased costs.

Box 6.1: Improving capital procurement in the National Health Service (NHS)

In January 2006, the Department of Health (DoH) announced changes it was making to the process of procuring capital investment projects across the NHS. This was to reflect the significant reform to the NHS, that has impacted the clinical requirements from new capital projects, and the financial position of NHS Trusts over the medium term. This process will help to ensure that plans are robust and viable in the context of the reformed NHS, and deliverable once they are put to the market and meet the objectives of reducing procurement times.

The DoH has written to all NHS Trusts with capital projects in procurement stating that:

- **NHS Trusts should reconfirm that their investment plans remain consistent with clinical need, take account of the reforms to the NHS and remain affordable. The DoH is issuing further guidance on how NHS Trusts should assess affordability;**
- **in future, it will require NHS Trusts to seek approval for schemes before they appoint a preferred bidder. This means that greater scrutiny can take place before a project produces a final business case; and**
- **NHS Trusts with significant deficits will not be allowed to proceed to market with large capital investment schemes without agreed plans to deal with them before financial close.**

The DoH will also be piloting a project delivery organisation to seek to improve further the ability of NHS Trusts to procure specific types of capital assets where a different approach may lead to shorter procurement times and improved value for money.

The measures announced by the DoH are consistent with the approach the Treasury is taking across all PFI projects to reduce procurement times and costs and change the way in which projects are approved.

IMPROVING PROCUREMENT SKILLS AND SUPPORT TO PROJECTS

6.15 The Government recognises that good procurement, project management, project delivery and negotiation skills are essential to implementing projects and securing value for money in all public sector procurements, especially complex, capital intensive projects. In the past there have been difficulties in ensuring that PFI procurement expertise is retained within the public sector once it has been developed. In part this is because procurement expertise has been insufficiently valued within the public sector and, as a result, public servants have often been reluctant to pursue this as a career path. This problem has been exacerbated by the fragmentation of the portfolio of large and complex procurement projects across many procuring authorities, as a result of which there are rarely opportunities for procurement specialists to move to subsequent projects of a similar size and complexity within their existing employer.

6.16 PFI procurement advice may be provided to public sector project teams by departmental PFUs, Partnerships UK, 4ps and the Office of Government Commerce (OGC), as well as by external advisers. While each of these organisations is able to advise project teams, they are generally not currently resourced or set up in a way that enables them to adopt a more direct and leading role in projects. Advisers are not an adequate or appropriate substitute for an expert client function, and therefore it is critical for procuring authorities to engage experienced, full time procurement specialists, complemented rather than substituted for by specialist advice.

6.17 The Government believes more can be done to support procuring authorities more directly, to ensure the benefits of PFI are secured. In particular, the Government is determined to ensure that:

- departmental PFUs are appropriately skilled and resourced to directly support procuring authorities;
- PFI procurement expertise and experience is present in all frontline procurement teams, in terms of experienced project managers, negotiators, procurement experts and commercial management drawn from both the public and private sectors;
- an appropriate mechanism is put in place to facilitate the deployment of public sector procurement experts across sectors and projects, ensuring the retention of expertise within the public sector;
- all projects have an appropriate governance structure;
- appropriate training opportunities and qualifications are available to all public sector PFI procurers; and
- a system is established to facilitate the sharing of information and experience between procuring authorities, including information about advisers to the public sector.

Enhancing the capacity of departmental PFUs

Core PFU responsibilities

6.18 To emphasise the Government's commitment to improving the PFI procurement process and its priority of improving general procurement skills, the Treasury, supported by the larger departmental PFUs, has been considering the responsibilities, activities and competencies which should apply to all PFUs. This also builds on the MoD's experience of reforming its PFUs as part of the 2004 Spending Review.

6.19 As a result of this review, the Treasury intends to introduce a template of core responsibilities and competencies for departmental PFUs as part of the 2007 Comprehensive Spending Review. These measures are intended to enhance the capacity of departmental PFUs, to ensure a greater degree of consistency in the implementation of the Government's PFI programme and to complement improving frontline procurement skills. Similar standards ought, of course, to be applied to large non-PFI investment programmes.

6.20 It is anticipated that there will be certain key differences between the responsibilities and competencies of departments that run their own PFI procurement programmes, and those that sponsor locally-procured projects through PFI credits. Despite this, the key objectives of the core competencies and responsibilities will be:

- to ensure PFUs are adequately resourced with appropriate financial, commercial and, where relevant, technical expertise;
- to ensure consistency of approach to PFI procurement across Government, with greater emphasis on the sharing of best practice, and dissemination of central government PFI policy;
- better and more consistent market management across departments;
- more frequent and in-depth monitoring of projects in procurement; and
- to support projects in operation, in conjunction with the PFI Operational Taskforce.

6.21 The size and capacity of departmental PFUs will be driven by the size of the department's PFI programme or, where departments are sponsoring locally-procured projects, the value of PFI credits being managed by the department. As part of the Comprehensive Spending Review, departments will be required to commit sufficient resources to ensure they are able to meet the core responsibilities and competencies, commensurate with the size of their portfolio. Where departments are sponsoring locally-procured projects, the necessary resource funding commitment may be agreed in relation to the value of the PFI credits being managed by that department.

6.22 The Department for Education and Skills (DfES) is in a unique position in that new secondary school PFI projects are now delivered through Partnerships for Schools (PfS), a Non-Departmental Public Body, funded and managed through a joint venture between DfES and Partnerships UK. As a result, DfES' PFI expertise is now mainly held within the delivery vehicle, and the Government does not intend that this expertise should be duplicated. The size and capacity of the DfES PFU will reflect this.

Rationalise multiple PFUs

6.23 In addition, the Treasury will liase with departments to identify opportunities to make the implementation of PFI policy more efficient and effective. In particular, and prior to the Comprehensive Spending Review, the Treasury will require departments to rationalise multiple PFUs where these exist. This will result in a single PFU fully integrated with the policy requirements and objectives of each department, the elimination of duplicated effort and resource, and a consistent approach to policy implementation.

Box 6.2: Departmental PFU core responsibilities and competencies

The role of the PFU will be to provide policy and project support to individual project teams and key stakeholders, to act as the primary interface and focal point for liaison with the Treasury and other departmental PFUs on matters of PFI policy and to review, monitor and, where appropriate, approve individual PFI procurements. The key responsibilities and competencies will include:

- **a clear understanding of departmental strategy, and the role expected to be played by PFI in the achievement of departmental investment and service delivery targets, in accordance with the stage one value for money assessment;**
- **a clear strategy for market management in terms of assessing market capacity for projects, developing consistent deal flow and plans for releasing projects to the market, working with other departmental PFUs and the Treasury;**
- **a clear statement of what project teams can expect to get from the PFU in terms of guidance and direct assistance;**
- **appropriate sector specific guidance and contracts consistent with overall PFI policy;**
- **a set of criteria against which business cases will be scrutinised, with greater emphasis on improving the maturity of projects before release to market and confirming the affordability, value for money and viability of projects at the point of selection of the preferred bidder;**
- **a regular programme of monitoring and data gathering on projects, both in procurement and operation, with greater emphasis on learning from experience;**
- **provision of an appropriate range of staff expertise to include commercial, financial, legal and technical experts with direct transacting experience;**
- **protocols for inter-departmental sharing of best practice and market management strategies; and**
- **where relevant, an agreed view of the role expected to be played by local authorities in delivering the overall departmental strategy, and a clear policy for matching departmental investment strategies to PFI funding resources.**

Comprehensive Spending Review

6.24 The Treasury will require the reform of PFUs to meet the agreed competencies and responsibilities as part of the Comprehensive Spending Review. The Treasury will engage with departments to agree the review and implementation programmes, to ensure that reforms are completed ahead of the Comprehensive Spending Review. The Treasury will also provide support to departments to identify suitable candidates for key appointments to their PFUs where recruitment is considered necessary for departments to be able to meet the requirements of the core responsibilities and competencies. These disciplines mirror the emphasis that will be put on the management of the Government's whole investment programme through the Comprehensive Spending Review.

6.25 The Government recognises that not all central government departments have an active PFI programme and some departments may only ever embark on one or two PFI projects. As a result of a low level of deal flow it is unrealistic and uneconomic to expect these departments to provide and maintain the full PFU capacity outlined above. The Treasury will continue to ensure that those departments that undertake PFI projects on an infrequent basis are properly supported. In practice this support may be provided by the Treasury, another departmental PFU, or drawn from external resources, such as Partnerships UK. Any central government department which does not have an active PFI programme but is considering PFI as a form of procurement should speak to the Treasury at an early stage.

Improving frontline skills and support

Management of public sector procurement expertise

6.26 The Government is keen to continue to build on the procurement capacity of the public sector, and to ensure that expertise, such as project, commercial and procurement management is not lost to the private sector through poor management of experienced resource.

6.27 To help address the issue of retention of procurement expertise within the public sector, the Treasury is developing with departmental PFUs, Partnerships UK, the OGC and 4ps, how it can help public authorities actively manage the retention and deployment of experienced public sector PFI procurement skills. The Government is committed to finding a way to pool this key resource in a way that enhances the opportunities for PFI procurement experts and the talent available to procuring authorities. As a first step, the Government is developing a secondment model with its key partners, but is open to other mechanisms.

Improving public sector procurement capability

6.28 In addition, authorities will be required to demonstrate, as part of their outline business case, that they have properly resourced and adequately funded the public sector team. Going forward, departmental PFUs will be required to assess much more rigorously how the procuring authority proposes to deliver its project. They will assess both the overall governance structure of the project and the key appointments within that structure. Project directors and project managers will be required to demonstrate a proven track record in delivering complex procurements. These procurement experts may be drawn from either the public or the private sector.

6.29 The Treasury will publish guidance for the public sector on PFI project governance. The assessment of project governance structures and the capability of the project team will form a key part of the outline business case approvals process, and this will be included in the updated "Value for Money Assessment Guidance".

Upgrading procurement skills and training

Better and more focused training

6.30 As well as focusing on structural improvements to develop skills at the frontline, supported by adequately resourced and focused PFUs, the Government is committed to ensuring a more formal and structured approach to PFI procurement training. Currently training available for individuals and project teams is provided by a number of different organisations and institutions and there is not a recognised PFI procurement qualification.

6.31 The Treasury will therefore be working with departmental PFUs, Partnerships UK, the OGC, 4ps and existing providers of training to understand fully the array of training currently available, and to work with these parties to develop training appropriate for public sector participants in PFI procurement. Training must be available to cover all aspects of PFI procurement, from project appraisal and development, to project management and the commercial, financial, legal and technical aspects of the PFI procurement route. Whilst certain parts of the required training will be specific to PFI, this is just one form of complex procurement, and much of it will be generic across all forms of complex procurement. The Government is keen to see PFI training embedded more generally in the context of Professional Skills for Government and more specifically in the context of complex procurement training, rather than as something which is entirely bespoke.

6.32 It is important to ensure that appropriate training is available for the many different participants in the PFI process from senior responsible officers to the user and technical groups, as well as the commercial or project manager that wishes to follow a career in PFI or complex procurements. For the latter group it is currently envisaged that training should be developed on a modular basis, and be linked to an existing training qualification.

Pilot training course

6.33 In April 2006 the Treasury will pilot a PFI specific training course for departmental PFUs as a first step in ensuring consistency across departments. The course will be run by Partnerships UK.

Sharing information about public sector advisers

6.34 In "PFI: Meeting the Investment Challenge" the Government committed to establish a single information resource on the expertise and performance of private sector advisers to PFI projects in fields such as law, commercial structuring or finance. This was on the basis that poor advice contributes to slowing the procurement process, can inflate procurement costs, and impairs the ability of the public sector to identify value for money in options appraisal and negotiation. It was recognised that the public sector did not appoint advisors based on collective cross-government experience with those advisers, but rather the individual authority's or department's experience, and this hampered the public sector's ability to secure and make use of the best advice in a PFI project. The establishment of a single information resource would address these issues, reflecting the experiences of departments and public sector managers, providing recognition for the contribution of high quality advisers and reducing uncertainty over quality on the part of the public sector.

6.35 The Government remains committed to the principle of appointing advisers based on their quality and experience. There has been progress in how the public sector appoints and uses advisers, and a number of departments and PFI programmes have now established their own framework agreements. These allow the public sector to act more effectively as a single client for the purchase of these services. In addition, the OGC provides a service which advises public authorities on suppliers, including advisers.

IMPROVING MONITORING, SCRUTINY AND ACCOUNTABILITY

6.36 Alongside measures to improve public sector skills, the Government will introduce a package of measures to increase the monitoring and scrutiny of projects, and to change the way in which projects are approved. The Government wishes to ensure:

- better and more frequent scrutiny and monitoring of projects so that projects are properly developed before release to the market, and problems are identified early in procurement so that appropriate and timely action can be taken;

- more rigorous and consistent approval processes across departments, with greater emphasis on obtaining approvals earlier in the process; and
- a cross-departmental peer review of the viability, achievability, value for money and affordability of projects procured by central government departments that undertake PFI infrequently, and of particularly significant or complex projects, whether centrally or locally procured.

More frequent monitoring of projects in procurement and in operation

Project monitoring

6.37 The Government believes that procurement timescales remain excessive and that many projects slip from their published timetables. As part of the new and revised core responsibilities and competencies for departmental PFUs, the Treasury will look to formalise more frequent monitoring of projects by departments, both during the procurement and operational stages of projects. The objectives are:

- to ensure projects are sufficiently developed and mature prior to release to the market;
- to ensure that authorities invest time and resources upfront so that there is certainty of affordability before procurement starts;
- the early identification of potential problems, to enable issues to be considered in a timely and orderly manner;
- to ensure that only those projects which are value for money continue to proceed through procurement;
- to reduce procurement timescales and costs;
- to improve the ability of departments to communicate with the PFI market; and
- to capture the lessons to be learnt from projects in operation.

6.38 The primary responsibility for such monitoring will continue to rest with the departmental PFUs, but the Treasury will seek to ensure that projects proceed through procurement in line with their agreed timetables and, where issues or problems arise, these are dealt with in a timely and efficient manner. In the lead up to the Comprehensive Spending Review the Treasury will work with departmental PFUs to ensure they have the appropriate organisational architecture in place to agree an appropriate monitoring framework and the frequency of monitoring to be undertaken.

Gateway reviews

6.39 It is important to note that these reviews will complement the existing OGC Gateway process. All acquisition programmes and procurement projects in central government are subject to OGC Gateway reviews. In addition, 4ps runs a similar Gateway process for locally-procured projects.

Box 6.3: The Gateway process

Gate 0 Strategic assessment: this is applied at the start of a project or programme and is designed to consider the strategic assessment of the business need.

Gate 1 Business justification: this occurs once there is an outline business case in place. Its aim is to confirm that the business case is robust and make recommendations for improvements where necessary.

Gate 2 Procurement strategy: prior to the invitation to negotiate, this considers the project's potential for success and its ability to proceed.

Gate 3 Investment decision: this establishes whether the recommended investment decision is appropriate prior to the contract being awarded. It also examines the processes in place to select the supplier.

Gate 4 Readiness for service: this examines how the organisation will implement business change associated with delivery and how robust the solution is. It should also assess whether there is a basis for evaluating the projects ongoing performance.

Gate 5 Benefits evaluation: this ensures the delivery of benefits and value for money as set out in the initial business case.

6.40 The Treasury will support departments in their monitoring activities so that lessons drawn from this process are shared across departments, project teams and the wider public sector and to ensure this experience is recycled for the benefit of future projects. It will particularly be considering how it can support the monitoring requirements of departments that undertake PFI infrequently and as a result do not have the resources of programme-led PFUs.

Departmental business case approvals process

Reform of business case approval process

6.41 The Government sets out in this document its ongoing commitment that projects be properly defined and developed before they are formally released to the market (see paragraph 6.51). The Government is also concerned about the often long periods of time between selection of a preferred bidder and the financial close of projects, and changes that are occasionally agreed once competitive tension is lost. These issues are of course not unique to PFI, and indeed PFI makes them transparent in a helpful way. The same disciplines, described below, ought to be applied to complex projects whatever the procurement route.

6.42 To address these concerns the Government intends to change the business case approvals process, and wishes to ensure greater consistency in the business case approvals framework and criteria across departments, whilst recognising that there will continue to be important sector specific criteria. The particular changes that will be introduced are:

- more detailed scrutiny of the affordability, viability and deliverability of projects at the outline business case stage before projects are released to the market (prior to publication in the Official Journal of the European Union), and again before the invitation to negotiate where there has been a significant elapsed period of time following the outline business case. The Treasury will update the "Value for Money Assessment Guidance" to reflect this as part of the stage 2 and stage 3 assessments;

- greater emphasis on the examination of schemes prior to the appointment of a preferred bidder. The full business case and the checks more usually performed at this stage will therefore be brought forward; and

- there will be an approval immediately prior to financial close – the final business case – to confirm that the scheme remains within the parameters agreed as part of the preferred bidder appointment and approved in the full business case.

6.43 The Treasury will continue to approve projects that exceed departmental delegated authority levels.

Enforcement of the standard PFI contract guidance

6.44 The emphasis on greater scrutiny at selection of preferred bidder is also consistent with the requirements of the new competitive dialogue regime (see Box 3.2) which requires that there are no substantial modifications to a scheme subsequent to selection of a preferred bidder. To achieve this project teams will need to ensure that all commercial issues are resolved prior to selection of a preferred bidder. In order to facilitate this, the Treasury will require that all key derogations from the standard PFI contract guidance or sector specific contract, as applicable, are identified and considered as part of the full business case. This is not expected to make the process to preferred bidder more expensive or slower.

Approval of central government projects

Extending the Project Review Group

6.45 As outlined earlier (paragraph 6.25) the Government recognises that departments that do not have an active PFI programme will not have the full PFU capacity outlined in the new core responsibilities and competencies. The Treasury has, therefore, been considering how it can more appropriately support the PFI activities in departments that undertake PFI projects on an infrequent basis including monitoring and approving projects.

6.46 As a result of this assessment, and building on the success of the PRG for local government projects, the Treasury intends to extend the remit of the PRG to cover projects procured by central government departments that do not have an active PFI programme. A key difference is that the PRG will not be awarding central government funding, in the form of PFI credits, to these centrally procured projects. Notwithstanding this, recognising that these departments are unlikely to have the full PFU capability, it is appropriate that these projects should be subject to a cross-departmental peer review. It is anticipated that such projects should be subject to both a stage one review as part of the outline business case approval, and a stage two review immediately prior to selection of preferred bidder. This will give additional comfort to the sponsoring department and the PFI market that the project has been thoroughly prepared and is likely to succeed. A summary of the revised and extended role of the PRG is set out in Box 6.4. If this is successful the Government may look to extend the PRG's remit further to include non-PFI complex procurements.

Significant projects

6.47 The Government will also be considering the reintroduction of the concept of significant projects for locally and centrally procured schemes, in recognition of the increasing size and complexity of some transactions and the emergence of a strong pipeline in new areas such as waste and housing.

6.48 Significant projects would be determined by the Treasury and the relevant sponsoring department. In addition to the usual departmental approval processes, it is anticipated that these projects would be subject to additional expert cross-departmental peer review to provide additional challenge and support to particularly large, complex or novel projects. Particular emphasis would be placed on assessing these projects as early as possible in their concept development and strategic outline business case stages to ensure they are sensibly and appropriately structured from the outset, and carefully assessed to ensure they are value for money, commercially viable and deliverable. This additional level of scrutiny is likely to be provided by the PRG.

Box 6.4: Proposals for an extended Project Review Group

The Panel

The PRG is a panel of experts selected on the basis of their collective skills and experience drawn from across Government. The PRG is chaired by the Treasury with permanent representatives of the Office of the Deputy Prime Minister and 4ps.

Remit

The PRG currently oversees the scrutiny and approvals process for allocating PFI credits to local authority projects in England. In future, the PRG will also review projects procured by central government departments that do not have an active PFI programme and reviews significant projects that are particularly complex, large or novel.

Process

The 1st stage review, carried out at the outline business case stage of a procurement, assesses both the commercial deliverability and value for money of a project. This is mandatory for all local authority projects requiring PFI credit funding.

The 2nd stage review is conducted at the pre-preferred bidder stage of a procurement, on a selection of projects. The focus is on the affordability of the project and compliance with the standard PFI contract.

Projects that have been approved and subsequently undergo significant changes must be submitted to the PRG for re-approval.

IMPROVING THE PFI PROCUREMENT PROCESS

6.49 The Government is committed to eliminating inefficiencies in the procurement process which unnecessarily increase public and private sector side procurement costs, and procurement timescales. The measures the Government is implementing to improve public sector procurement skills and increase the monitoring and scrutiny of projects will have an impact on procurement timescales. In addition to these initiatives there are several other areas where the Government recognises it can make changes to remove inefficiencies in the procurement process.

Improving the maturity of projects before OJEU advert

Preparing the project for the market

6.50 There is continuing evidence that procuring authorities are allocating insufficient resources to adequately prepare and develop their projects, and test their requirements before formal engagement with the market. As a result it sometimes transpires that authorities' requirements are unaffordable or, following a period in procurement, the authorities make changes to the specification or requirement. Making changes to a project once the procurement has commenced is inefficient, adds to costs for both the public and private sectors and delays the introduction of important public services.

6.51 As part of the revised approvals regime outlined earlier in this chapter, the Government will be requiring the departmental PFUs to ensure that a much more thorough and robust assessment of the readiness of each project to proceed to market has been undertaken. In particular, procuring authorities will need to demonstrate that their requirements have been fully developed and tested so that a detailed analysis of the likely cost of the project can be prepared. This will establish the affordability of the authority's requirements so that they and the market can be confident that the requirements will not change once the project has entered procurement.

Approving the outline business case

6.52 To achieve this, authority project teams must be suitably funded and resourced. The Treasury will work with departmental PFUs to establish appropriate criteria to ensure the preparation of outline business cases is adequately funded. It will be a requirement, going forward, that authorities agree to commit the necessary funds to the preparation of the business case. This will be assessed by departments as part of the initial strategic outline business case. Where local authorities are seeking PFI credit funding, they will be required as part of the initial bidding round to confirm their commitment to properly fund the preparation of the business case should they be successful in securing an indicative PFI credit allocation. Departments will be required to look more critically at the overall quality of the business cases submitted. Outline business cases, which departmental PFUs consider have not been developed to an appropriate standard, will not be approved, irrespective of need.

6.53 The Treasury will update the "Value for Money Assessment Guidance" to reflect these changes.

Publishing affordability information

Ensuring authorities' requirements are affordable

6.54 In conjunction with measures to improve the maturity of projects prior to release to the market, and to ensure that the authority's resources are compatible with its requirements for the project, the Government is considering whether providing affordability information to bidders is likely to deliver better value for money.

6.55 Practice in this area is variable between sectors, with some projects providing affordability information, and others not. Publishing affordability information will reduce the chance that a project becomes unaffordable during the procurement process and will highlight potential problems earlier on. This needs to be balanced against the concern that bidders will simply treat this is a target cost, rather than delivering the optimum value for money solution against the authority's requirements. Publishing affordability limits is likely to be most appropriate in sectors where a number of projects have already been undertaken, there is good understanding of the likely costs of a project, and a vibrant competition can reasonably be expected.

6.56 Where affordability information is provided it will be important to ensure this sets a genuine affordability limit rather than a targeted or a tactical one, and must be signed off as affordable by the procuring authority. The procuring authority's bidding guidance should clearly state the evaluation methodology, including whether it will prioritise additional services over a reduced unitary charge where the bidder is able to deliver the specifications for below the affordability limit. This will not undermine value for money if there is a competitive procurement process and if a realistic assessment of the affordability of the project has been made.

Improving the design process

Developing a concept design and testing the design brief

6.57 The Government is aware that one of the major drivers of private sector bid costs is the design process. It also contributes to extended timescales where multiple redesigns are required as part of the bidding process. Often this is linked to the level of preparatory work undertaken by an authority prior to the release of the project to the market, and the issues outlined above. The Government's view is that authorities need to do a certain amount of design work upfront in order to test their requirements and the design brief properly. This also enables authorities to develop with sufficient confidence a realistic estimate of the likely outturn costs of the project and to inform the later evaluation of designs produced by the private sector.

6.58 Developing an initial design to allow for a realistic understanding of costs and improved design outcomes does not mean that the public sector undertakes all the design, nor should it mean that risk transfer is compromised. PFI achieves benefits in design and innovation because the public sector specifies the desired outcomes and the private sector has freedom to deliver those outcomes in the most appropriate way to achieve long-term value for money. The public sector should undertake enough upfront design work to get a good understanding of what the project is likely to cost, what design outcomes are possible and to get a good sense of what the market will be able to deliver within the authority's budget.

6.59 As well as improving the overall process, to remove inefficiencies, to speed the procurement process and reduce costs, and to improve overall value for money. The Government is also concerned to ensure that PFI is achieving good design quality and design outcomes for the user and the wider public. Design quality is not simply about aesthetic architectural value but is about functionality, fitness for purpose, build quality, sustainability and impact on the environment. Design will always be subjective, and different stakeholders will value certain aspects of design more highly than others. Given the long-term nature of the PFI procurement model and the rigorous focus on whole life value, PFI should be well-placed to deliver long-term build quality and functionality. The challenge is to ensure that every PFI project delivers quality across all aspects of design.

Consultation on the design process

6.60 Current practice on the approach taken to the design process varies between sectors and projects. The Government will consult key stakeholders in the private and public sectors with a view to publishing guidance on the design process for the public sector later this year. This will meet the objectives of removing inefficiencies in the process, securing good design quality and design outcomes, and improving overall value for money. At that time, Treasury Taskforce Technical Note 7 will be withdrawn.

Box 6.5: Summary of support and approvals infrastructure

The Treasury

The Treasury sets PFI policy, approves projects over departments' delegated authority levels, supports departmental Private Finance Units and chairs the Project Review Group.

Departmental Private Finance Units

Departmental Private Finance Units are responsible for the implementation of PFI policy in the context of the Departmental Investment Strategies, provide strategic management of the department's portfolio of PFI projects, are centres of expertise on PFI policy, best practice and implementation provides support to procuring authorities and, where appropriate, manage PFI credits for local authority projects.

The Project Review Group

The Government established the Project Review Group (PRG) as an inter-departmental body to test the deliverability of local authority PFI projects prior to entering procurement. It is responsible for approving the award of PFI credit funding to local authorities. No PFI project can be submitted to the PRG before the sponsoring government department has agreed: that it meets departmental policy objectives and priorities; is suitable for a PFI procurement; is value for money; affordable; and the department has approved the PFI credits being sought. More recently the remit of the PRG was extended to review a proportion of projects at the pre-preferred bidder stage, to evaluate project affordability, value for money and compliance with the standard PFI contract. The Treasury will now extend the remit of the PRG to include certain projects procured by central government, and complex, large or novel projects whether procured centrally or locally.

Partnerships UK

Partnerships UK was established in June 2000, and in 2001 became a public private partnership, incorporated as a private sector company. It was created out of the Treasury Taskforce to ensure continued access to procurement expertise for the public sector. Partnerships UK's primary objective is to provide the public sector with an improved client capability, and to be available to support all parts of the public sector, including local authorities and devolved administrations in implementing their PFI and PPP programmes and projects. Partnerships UK achieves its objectives in a number of ways: advising public sector clients; creating procurement joint ventures with the public sector for specific programmes, such as LIFT and BSF; and entering into development agreements with the public sector to procure PFI projects jointly. Partnerships UK reviews local authority projects on behalf of the PRG and leads on the contract derogations process on behalf of the Treasury.

The Office of Government Commerce

The OGC is an office of the Treasury and works with public sector organisations to help them improve their efficiency, gain better value for money from their commercial activities and deliver improved success from programmes and projects. The OGC takes the lead on the Government's policy of achieving value for money in public procurement, has overall responsibility for general procurement policy and for negotiating and implementing EU procurement directives in the UK.

The Public Private Partnerships Programme (4ps)

4ps was established in 1996 by the the Local Government Association to provide support to local authorities undertaking projects and procurements, including PFI. It also undertakes Gateway reviews for local authorities, provides training, skills development and procurement guidance, and assists several departments to prepare their sector specific standard PFI contracts for locally-procured projects.

7 PRIVATE FINANCE

Private finance plays an important part in the successful delivery of value for money in PFI. This chapter outlines the role of private finance in PFI and the improvements made since "PFI: Meeting the Investment Challenge". As the PFI market matures and develops, PFI policy also needs to adapt and develop to ensure that private finance continues to deliver the key criteria of flexibility, transparency and efficiency that contribute to value for money. This chapter sets out the measures the Government is pursuing to secure this.

Since "PFI: Meeting the Investment Challenge", the Government has:

- **successfully piloted two Credit Guarantee Finance (CGF) projects. This was done without disrupting the procurement process for either transaction and generated a whole-life saving to the Government of £70 million; and**
- **confirmed that framework funding can be used to provide faster and cheaper funding to PFI projects. Framework funding is being considered as a pilot for a subsequent Building Schools for the Future (BSF) wave.**

Based on the evidence from operational projects and its experience of PFI projects in procurement, the Government is:

- **ensuring that private finance does not impinge on the operational flexibility of PFI projects;**
- **improving the transparency of private finance; and**
- **continuing to improve the efficiency of all forms of private finance including senior debt and equity.**

To address the issues raised by market developments and experience from operational projects, the Government is proposing to:

- **improve the flexibility of private finance by ensuring that the PFI financial structure does not unnecessarily impede operational flexibility and reducing the potential costs of terminating PFI contracts;**
- **improve the transparency of private finance by providing guidance on funding competitions for senior debt so as to improve transparency and focus the competitive efforts of senior debt providers on funding the preferred bidder for a project. The Government will also monitor the use of the equity funding competitions currently under consideration before consulting the market on their implications for its wider strategy; and**
- **improve the efficiency of private finance by further testing the benefits of CGF in a project that has yet to select a preferred bidder before confirming its future wider role. The Government will also consider with the market the use of mechanisms like construction financing and partial debt underpinning.**

The Government will also update the "Value for Money Assessment Guidance" so that procuring authorities are able to ensure that flexibility and financial robustness are not compromised in the search for the lowest cost of funds.

BACKGROUND

7.1 The Government's approach to PFI, laid out in Chapter 3, sets out the benefits of PFI and where it is most likely to generate better value for money than other procurement routes. "PFI: Meeting the Investment Challenge" explained the benefits that private finance brings in PFI projects.

7.2 This chapter sets out:

- market developments since "PFI: Meeting the Investment Challenge";
- measures to improve the value for money of private finance;
- the impact of private finance on the operational flexibility of PFI projects and the steps being taken to improve flexibility;
- how the Government is seeking to support improvements in the transparency of private finance; and
- how the Government is continuing to improve the efficiency of private finance in PFI projects.

The role and source of private finance

The role of private finance

7.3 Private finance plays a number of different roles in a PFI project. At a high level, private finance is responsible for assuming, allocating and managing the risks inherent in a PFI project. The risks that are usually transferred to the private sector in a PFI contract are set out in paragraph 3.39. It is the management of these risks that contributes to better value for money for the public sector than under conventional procurement. The involvement of private finance contributes significantly to on-time and on-budget delivery and whole-life costing in a PFI project. As shown in Chapter 4, with appropriate incentives provided by private finance, changes in the public sector's requirements can be met throughout the life of a PFI project.

7.4 There is a premium for private finance over conventional procurement financing through issuing gilts for the risks transferred, but the risks in conventional procurement are instead paid for in full by the public sector if construction runs over budget, or projects are delayed, or whole-life costs underestimated. The Government ensures that the risk premium paid is commensurate with the value of the risks transferred to the private sector by carefully evaluating the value for money of PFI projects before procurement is launched.

Types and sources of private finance

7.5 There is usually a number of different sources of private finance in PFI projects including: senior debt, mezzanine debt, equity and sub-contractor finance. Each type of finance plays a different role in a PFI project and provides different benefits at different costs. The types of private finance, the risks they bear, the benefits they bring and their sources are described below.

The role of senior debt

7.6 Senior debt usually contributes around 80 to 90 per cent of the total capital required in a PFI project. Third party finance is required as the procuring authority does not generally begin to pay the PFI contractor until the service is available. Senior debt receives interest and repayments of capital in priority to equity but it takes the risk that it will not be paid due to unremedied failure by the PFI contractor to meet its obligations under the PFI contract. One of the benefits to the public sector of senior debt is the disciplined approach senior debt providers take in analysing and apportioning risk before they are willing to lend. To protect their loan, senior debt providers are entitled and incentivised to step in to remedy any significant failing by the PFI contractor under the contract with the procuring authority.

Sources of senior debt

7.7 PFI bidders have typically financed the senior debt required in PFI projects with a combination of all or some of the following:

- bank debt provided by PFI senior debt providers;
- debt raised in the capital markets with a financial guarantee from a monoline insurer[1] where the monoline insurer bears the project risks;
- debt raised in the capital markets without a financial guarantee (but rated by one or more rating agencies) whereby the investor takes the project risks associated with senior debt; and
- finance provided by the European Investment Bank (EIB), which may benefit from a guarantee provided by a bank or a monoline insurer.

7.8 As discussed in paragraph 7.19, whether the project is funded through bank debt or through the capital markets will provide differing value for money implications for the procuring authority given the potentially different requirements that exist in these markets.

The role of risk capital

7.9 Risk capital contributes around 10 to 20 per cent of the total capital in a PFI project for which it receives a return if the project performs as expected. The risk capital is the first to be affected by the under-performance of the project. It usually consists of a combination of shareholder loans that earn interest, and share capital that receives a dividend. Although different, these elements of the risk capital are often grouped together and referred to as equity. Equity mainly takes the risks associated with:

- failure to meet the general contractual obligations under the PFI contract;
- failure of a subcontractor to perform;
- life cycle costs including inadequate provisioning for future maintenance expenditure; and
- increases in insurance premiums.

7.10 Typically under PFI contracts, some of these risks are passed to subcontractors that are providing the services (e.g. the construction subcontractor) or shared with the procuring authorities, as is the case with insurance.

Sources of equity

7.11 As set out in paragraph 7.49, sources of equity have increased since the publication of "PFI: Meeting the Investment Challenge" with the advent of the primary and secondary institutional equity investors, which have complemented the traditional source of equity from the contractors bidding for PFI projects.

The role of mezzanine debt

7.12 Mezzanine debt lies between senior debt and equity in the transfer of risk. It is paid interest like debt rather than a distribution like equity. Mezzanine debt takes more risk than senior debt, in that its repayment is affected by poor performance before senior debt. As a consequence, it receives a return that is greater than that required by senior debt but less than that for equity.

[1] A monoline insurance company provides guarantees to bond holders to meet scheduled payments of principal and interest when they fall due if a project company fails to pay. The resources maintained by the monoline to pay claims are sufficient to be rated highly by the rating agencies, generally AAA/Aaa.

Sources of mezzanine debt 7.13 Banks, often the same ones that provide the senior debt, provide mezzanine debt. This is because the bank has become comfortable with the risks of the project through its due diligence analysis and is willing to take greater risk in return for a higher risk margin on a proportion of its loan. Mezzanine debt from third parties is not routinely used in PFI projects.

The role of subcontractor finance 7.14 The construction subcontractor funds its contractual performance obligations through a mixture of parent company guarantees; letters of credit from its banks; and performance and surety bonds. The construction subcontractor manages the risk that the project is delivered on time and on budget. If construction costs escalate or the project is delayed and penalties are incurred, the PFI contractor has assurance that the subcontractor has the necessary funds available to meet its contingent obligations up to the limit of any cap. The providers of these guarantees and letters of credit do not have a direct right to reclaim payment from the PFI project. Instead they have a guarantee of repayment from the subcontractor.

7.15 Paragraph 5.81 sets out the lessons and the role subcontractor finance played during contractor difficulties.

Market developments since "PFI: Meeting the Investment Challenge"

Overview 7.16 Since "PFI: Meeting the Investment Challenge" there have been a number of developments in the provision of private finance driven by increasing competition between PFI contractors, equity providers, and senior debt providers. The implications of this are that:

- PFI senior debt providers are increasingly prepared to provide senior debt to more highly geared financial structures and accept lower cover ratios. This is reflective of mature and competitive PFI and debt markets. This improves affordability through the reduced overall cost of capital, and may create a number of challenges that the Government will keep under review. These include the financial robustness of the PFI contractor and the consequential level of risk retained by equity compared to the risk taken by the PFI subcontractors, and the effect of these issues on operational flexibility and during a period of contractor difficulties;

- lending margins for senior debt have fallen. The reduction is due to increased competition between debt providers and other market developmentd. This, together with the willingness of senior debt providers to lend for nearly the full period of the PFI contract, has reduced the likelihood or necessity of refinancing projects later as the benefit has also been captured through the initial procurement process; and

- increasing competition may also be leading to senior debt providers reducing the levels of independent due diligence they would otherwise undertake. Such a development would be a concern for the Government, which gains some reassurance on the deliverability and robustness of PFI projects from lender due diligence.

7.17 The Government recognises there is a trade-off between the cost of private finance and the risk it wishes the private sector to bear. The Government is committed to maximising value for money through minimising the cost of private finance in the unitary charge while maintaining an appropriate level of risk transfer to private finance. The remainder of this chapter sets out how the Government is seeking to respond to market changes to continue to meet its overall objectives for the provision of private finance within PFI projects.

IMPROVING THE FLEXIBILITY OF PRIVATE FINANCE

7.18 Chapter 5 sets out the steps the Government is taking to improve the value for money of PFI so that the public sector is not constrained unnecessarily if its requirement changes significantly. This includes steps to ensure that contract lengths are appropriate to the service being provided under the PFI project. To support these measures, the Government is proposing to make minor changes to improve the value for money of private finance in PFI projects, including:

- improving the evaluation of different private finance structures;
- improving the evaluation of how macroeconomic risk is managed;
- revising the Authority Voluntary Termination (AVT) provisions; and
- requiring the use of a modified Spens formula.

Evaluating different private finance structures

Improved evaluation

7.19 The different requirements of lenders and investors in PFI bonds potentially changes the long-term value for money of private finance under different scenarios. For example:

- the bond markets provide fixed, floating or RPI[2] index-linked funding without the need to enter into a separate swap. However, a bond investor's requirement for a termination payment that provides compensation for decreases in interest rates and credit risk margin when a bond is terminated (the Spens formula) potentially increases the cost of voluntary termination; and
- in seeking to provide the procuring authority with predictable unitary charges, PFI contractors normally swap their LIBOR[3] based floating rate bank loan into either a RPI index-linked or fixed rate loan. Market practice is that the banks providing the interest rate swap charge the borrower an additional credit margin, representing the relative credit quality of the borrower. If the borrower, either independently or to meet an authority required change, wishes to terminate or reduce the swaps, the bank providing the swap contract normally requires the full payment of the swap credit margin over the whole life of the contract.

7.20 The Treasury will update the "Value for Money Assessment Guidance" to include the consequences for authority flexibility from various financial structures proposed by bidders. The guidance will incorporate current best practice procedures in use by departmental Private Finance Units and their major advisers.

Managing macroeconomic risk

The current approach for inflation and interest rate risk

7.21 The Government believes it is value for money to retain the risk of the impact of inflation increases on non-construction and non-refurbishment costs. Generally, other than for healthcare projects, the Government's approach is to pay a unitary charge partially indexed to RPI. The PFI contractor bids the portion of the unitary charge that it requires to be indexed based on its view of the likely impact of RPI on its underlying costs. This approach means the Government retains the risk of inflation, which otherwise would need to be priced by the PFI contractor.

[2] The Retail Price Index is a measure of inflation. It measures the average change in the prices of goods and services consumed by the vast majority of households in the UK. The financial markets are also able to offer interest rates linked to RPI.

[3] The London Inter Bank Offered Rate is the rate at which banks procure and supply funds in the inter-bank market. LIBOR is used as the benchmark to which an additional credit risk margin is added for PFI lending.

7.22 The Government transfers the risk of adverse movements in interest rates. The Government's approach is to pay a unitary charge that does not change with movements in interest rates, thereby transferring the risk of managing such changes to the PFI contractor. The Government will continue to monitor whether the current approach to interest rate exposure offers optimum value for money in the context of its wider PFI programme. For example, where it is necessary in exceptional circumstances to terminate a PFI contract, the cost of breaking the hedging contracts put in place by the PFI contractor is typically passed back to the Government.

Improved evaluation

7.23 It is unreasonable to expect each procuring authority to be able to evaluate expertly and fully the potential impact of the different financing structures proposed by bidders, for example when comparing an index-linked bond with an alternative funding structure such as LIBOR funding combined with an index-linked swap. The Treasury has produced detailed guidance that will be issued shortly to government departments highlighting the implications of interest rate risk policies for procuring authorities, and explaining the characteristics of index-linked swaps.

Managing inflation risk

7.24 If there is a mismatch between the impact of inflation on the PFI contractor's costs and its income from the unitary charge, the PFI contractor may seek to manage that risk through the use of RPI-linked funding. In practice the PFI contractor issues index-linked bonds or enters into RPI swaps on its bank debt to manage this mismatch in inflation risk. The incentive to match costs and income for the PFI contractor is a valuable discipline for the long-term success of a project, but taken to an extreme, over-indexation of the unitary charge changes the balance of the procuring authority's obligations by making the unitary charge lower in the early years and higher in the later years of the project. Recently, the increasing demand from investors for index-linked debt has driven down the cost of this type of finance, further exaggerating this characteristic. The Government believes that the use of index-linked debt in PFI projects increases longer-term liabilities and possibly reduces flexibility in later years. The Treasury will not encourage the use of over-indexed unitary charges. To help projects better understand the long-term exposure of index-linked obligations, the Treasury will be issuing guidance on hedging inflation rates.

Authority Voluntary Termination

Existing AVT provisions

7.25 Under the standard PFI contract the procuring authority retains the right to change its requirement as a consequence of significant changes to the public service it is providing. This could in exceptional circumstances mean that the authority needs to terminate the contract through the Authority Voluntary Termination (AVT) provisions in the standard PFI contract.

7.26 Compensation is payable if the Government decides to invoke its AVT option. Compensation includes repayment of senior debt and an amount for equity. It is expected that AVT will not occur other than in limited exceptional circumstances and PFI contractors have accepted compensation from procuring authorities on the basis that it leaves the contractor in a position that is no worse than it envisaged at the time of bidding. It is also currently possible that AVT could place the contractor in a position that is better than actual performance would otherwise provide. The Government will consider revising the standard PFI contract to ensure that AVT compensation includes adequate consideration of a PFI contractor's recent performance under the PFI contract.

Reducing the costs of AVT **7.27** The Government is also considering a revision to the standard PFI contract provisions to require periodic break points in the contract, where the termination sum at each break point is pre-agreed at the time of financial close. These would be in addition to the AVT regime above. When selecting private sector bids, procuring authorities will explicitly consider the cost attached to these break points. It would be for them to determine when and how frequently they would need break points.

Spens formula

The Spens formula **7.28** The Spens formula, which applies to listed bonds in the UK, provides for a termination payment that compensates the bond holders when a bond is redeemed before its maturity. In "PFI: Meeting the Investment Challenge" the Government expressed its concern that the Spens formula created an extra cost of termination for a PFI project over a project financed by a bank loan in the rare circumstances where it wanted to terminate voluntarily due to major changes in the public sector's requirements that could not otherwise be accommodated.

Modified Spens **7.29** Since "PFI: Meeting The Investment Challenge" PFI bond arrangers have launched several successful issues where an adjustment was made to the Spens formula. The Treasury will now require PFI contracts funded through the capital markets to contain such a modified Spens clause. The determination of which form of modified Spens is most appropriate will be a decision for each PFI project. The Treasury will issue guidance to procuring authorities to assist them in reaching that decision.

Improving the financial flexibility of future PFI contracts

How private finance impacts flexibility **7.30** Where projects are procured using PFI, the PFI contractor determines the type of finance it wishes to use during the bidding process. The choice of financing solution places different constraints on the PFI contractor as borrower. During the bidding process there is an incentive on the PFI contractor to ensure that it procures the most efficient source of finance. Generally, the emphasis on efficiency promotes the lowest all-in cost of finance and therefore a lower unitary charge for the procuring authority. This can be one of the most important evaluation criteria for the procuring authority.

7.31 It is often after selection of the preferred bidder that the financing solution (bank versus bond finance) is finally determined depending on the relative competitiveness of the alternative solutions at the time the contractual negotiations are complete. In deciding on the preferred funding solution procuring authorities need to evaluate gearing and the cover ratios required by senior debt providers. The proportion of debt to equity (the gearing ratio) and the senior debt providers' requirements for surplus cash to be retained to meet potential shortfalls in debt repayments (cover ratios) may have an impact on the financial flexibility of the PFI project to respond to unforeseen circumstances or changes in the public service needs during the operational period of a PFI project.

Gearing ratios **7.32** The Treasury will review what measures may be implemented to avoid the problems of reduced financial flexibility created by some of the more highly geared PFI financial structures. The Treasury will also consider whether the trend for senior debt providers to relax reduce their cover ratio requirements will have an adverse effect on service provision, particularly where projects are experiencing financial difficulties.

7.33 The Government recognises that artificially setting gearing levels may reduce the value for money of a PFI project as there is no additional risk transfer to the PFI contractor commensurate with the higher level of risk capital. In order to create greater flexibility for the procuring authority, gearing may have to decrease significantly to have an impact on the protections required by senior debt providers.

7.34 The Government also wishes to ensure that PFI contractors maintain reserves sufficient to provide an appropriate level of flexibility and liquidity if the project should enter a period of distress. The failure of a contractor is disruptive and not welcome to any party to the project.

7.35 In selecting the preferred bidder and their proposed financing solution, the procuring authority and its advisers should analyse the terms and conditions of the chosen funding source in an effort to strike a balance between the PFI contractor's cost of financing and financial flexibility.

7.36 As a project becomes more highly geared it also becomes less flexible, including reducing the opportunity for the senior debt providers to affect a restructuring in the event of contractor difficulties. It is the primary responsibility of the senior lenders, monoline insurers and rating agencies to satisfy themselves that the financial structure is sufficiently robust to withstand financial distress. The Government needs to satisfy itself that should a distress situation occur, services would continue to be provided at the standard required under the PFI contract. Chapter 5 sets out the Government's experience of contractor difficulties and the role played by private finance.

Flexibility in distress situations

7.37 The Government has provided senior debt providers with the flexibility to restructure their finance through the rescue refinancing regime in the standard contract adopted by all bidders. The standard PFI contract allows an increase in debt of up to 10 per cent above the level of debt at financial close. The Government is unwilling to allow debt to increase above this 10 per cent threshold as this is likely to arise as a consequence of excessive initial gearing or inadequate liquidity provisions in the subcontracts. It is therefore equally important to assess the financial robustness and any trade-off with a lower unitary charge.

7.38 The Government is also concerned that events following contract signature may weaken the incentives on the PFI contractor to perform over the long term. Specifically, these events might include a material underestimation of the whole-life operating and asset life cycle costs. Market practice is that the PFI contractor, normally at the insistence of the senior lenders, establishes major maintenance and refurbishment reserves to ensure sufficient funding is available to pay for at least a proportion of such costs in future. The procuring authority, through the unitary charge, effectively pays for this reserve. Should this reserve be insufficient to meet future major maintenance costs then equity returns, and subsequently senior lenders returns, are adversely impacted. The PFI Operational Taskforce will review a representative selection of mature projects to establish if adequate reserves are in place to ensure that agreed service levels will continue to be met.

7.39 The Treasury will update the "Value for Money Assessment Guidance" to include the consequences for procuring authority flexibility from various financial structures proposed by bidders. The guidance will incorporate current best practice procedures in use by departmental Private Finance Units and their advisers.

IMPROVING THE TRANSPARENCY OF PRIVATE FINANCE

The need for transparency

7.40 In PFI the Government has taken several steps to improve transparency in the contracts it enters into with private sector providers by increasing the availability of information about PFI. This means open competition, unambiguous risk transfer and the clearly distinguishable delineation of roles and incentives between the various parties to a PFI contract. The Government believes these issues are vital to the achievement of value for money and the Treasury is keen that it retains, and procuring authorities achieve, a suitable level of oversight on these issues.

Debt funding competitions

Debt funding competition evidence

7.41 The Government is committed to securing the benefits of private finance through open and transparent competition. Current PFI policy supports procuring authorities seeking open and transparent competition between providers of debt finance and also between the bank and bond markets. To date demonstrable savings have been recorded by procuring authorities running debt funding competitions between monoline insurers and bond arrangers on large bond issues in the months leading up to financial close on a number of PFI projects.

7.42 The current terms and conditions upon which finance is being offered to PFI contractors are evidence that bidders are securing efficient debt terms. The Government welcomes the ongoing improvement in funding terms secured through the PFI programme and recognises that as part of a bidding process the private sector bidders are incentivised to secure the most economically advantageous funding package.

7.43 Debt funding competitions serve the purpose of providing a well defined process to ensure that the selection criteria applied to the choice of debt providers are adequately developed, rigorous and based on a level of detail sufficient for the lenders involved to make an unambiguous commitment to lend. Debt funding competitions also ensure the terms on offer from the lenders are suitably tested as competitive, and reflect markets at the time of financial close rather than when committed funding offers were provided by senior debt providers.

Box 8.1: National Audit Office (NAO) funding competition studies

The NAO examined the funding competition held to finance the refurbishment of the Treasury building. The study was published in its 2001 report 'Innovation in PFI Financing: The Treasury Building Project', and concluded that:

"The success of the Treasury funding competition, where the financing was arranged through a separate competition after the other elements of the deal had been agreed, has shown that additional value can be generated by procuring the project funding in this way."

Commenting on the timing of introducing the funding competition in the procurement process, the NAO stated that:

"Financial institutions are likely to be more competitive if they are asked to bid for the financing after the contractor has become the preferred bidder and a commercially viable project agreement has been negotiated, allowing credit risks to be properly assessed and priced."

7.44 The Government also believes that greater efficiency and the deferral of cost until a more certain stage in the bidding process can potentially be achieved for certain projects by requiring debt funding competitions to take place after the selection of a preferred bidder. The Government's future presumption is for PFI projects to run funding competitions for the provision of senior debt after a preferred bidder has been selected for all projects over £50 million and the Treasury will issue guidance shortly on how to put these principles into effect. The Government recognises that in some circumstances the cost impact of running a funding competition may outweigh the benefits (for example in procurement time and loss of innovation). Procuring authorities should consult their departmental Private Finance Unit as to whether a funding competition is likely be beneficial and how lenders should be involved in the preparation of a bid for a PFI project.

Clarity as to the customer and contractor roles

Public sector equity in planning vehicles

7.45 Where the benefits can be clearly defined, the Government supports the concept of public sector equity invested into procurement and planning vehicles. Two partnership models have used public sector equity in this way (NHS LIFT and the BSF programme). Both these partnership models involve investment into joint venture companies by the private sector alongside public authorities. One of the key objectives of this model is to harness the procurement and planning expertise of the private sector partners.

Approach to public sector equity in risk capital

7.46 The Government sees no compelling case for public sector equity investments in the long-term risk capital of the PFI contractor in individual PFI projects. Where services are provided through long-term contracts, the Government believes that the inherent conflict between the procuring authority as a customer of services and as an investor in the service provider will normally outweigh any benefits that may arise from such an investment.

7.47 As part of the continuing effort to search for additional improvements in the alignment of provider and customer incentives, other approaches are considered by the Government such as those presently being developed in BSF. Such approaches are kept under review by the Government and will only be applied further if the benefits are proven. All proposals for public sector investments in the risks otherwise borne by the PFI contractor will require prior approval by the Treasury.

EFFICIENCY OF PRIVATE FINANCE

7.48 The search for efficient funding in PFI projects requires a continuing need to test the Government's approach to private finance to reflect continuing market developments. The Government continues to examine the role of private finance and ways to improve value for money from PFI and recognises the help and assistance provided by PFI practitioners as part of this agenda.

Equity

Equity returns

7.49 Since "PFI: Meeting the Investment Challenge" a deep and competitive secondary market has developed for the sale of equity in PFI projects. These secondary market equity investors are prepared to pay a premium for the equity of those projects that have passed a risk reduction threshold, such as following successful construction completion. The Government supports the development of the secondary equity market as this ensures primary investors in new PFI projects no longer need to charge a premium on their investment as compensation for the lack of subsequent re-sale opportunities. The development of the secondary equity market also allows the primary investors to reinvest their proceeds in PFI or in other parts of the economy.

7.50 From the work previously carried out by Professor Julian Franks in the PwC[2] study of equity returns and from the subsequent collection of equity return data, the evidence suggests that there has been an implicit premium for the lack of liquidity in the assumed equity returns of previously closed projects. The Government expects that primary equity returns will reduce further to reflect an appropriate risk premium over the prices being obtained in the secondary equity markets. The steps set out in Chapter 6 to improve procurement times also seek to reduce the risk of material changes to a procurement post selection of preferred bidder, which may affect equity returns.

Improving the efficiency of equity

7.51 Equity returns on distributions and sales are subject to the income tax and capital gains tax regimes. In addition, however, the Government remains committed to improving the efficiency and transparency of the equity market. To achieve this the Government is considering measures to:

- monitor transparent and competitive primary equity pricing. The Government will keep under review the efficiency of the primary and secondary equity markets. It will monitor the use of equity funding competitions currently being considered by procuring authorities and in light of any experience consult with the market how such competitions may fit within the Government's wider strategy for the use of funding competitions; and
- align long-term incentives. The Government will consult the market on appropriate qualification criteria for transferring shares. The Government wishes to ensure that new shareholders have the resources and capabilities to meet performance requirements under the contract. The Government's intention is that this will not have a significant effect on the shareholder's capacity to transfer shares.

Senior debt

7.52 To help ensure that the benefits of senior debt are achieved the Government remains committed to ensuring that the market for senior debt providers and financing structures is sufficiently diverse to be able to match the particular needs of a PFI project. To improve the overall value for money of senior debt this section explains:

- how the Government is using Credit Guarantee Finance (CGF) to improve the value for money of private finance;
- the Government's experience of setting up framework funding vehicles; and
- further measures being considered by the Government to improve the value for money of senior debt.

7.53 Through these measures the Treasury will develop a number of different structures through which PFI projects can be financed. This will enable procuring authorities to determine more easily the financing route that best generates value for money.

[2] "PFI: Meeting the Investment Challenge" Annex C – PricewaterhouseCoopers Rate of Return Study.

Credit Guarantee Finance

7.54 In "PFI: Meeting the Investment Challenge" the Government announced that it was pursuing a small number of pilot projects to test the practicality of an alternative means of funding the senior debt raised to fund some PFI projects, known as ICGF. The Government has completed two pilot schemes, the construction of a new £230 million oncology wing at St James' University Hospital Leeds (Leeds Hospital) and the £225 million reconfiguration of acute services and rationalisation of the hospital site at Queen Alexandra Hospital, Portsmouth (Portsmouth Hospital).

Box 8.2: How Credit Guarantee Finance works

The cost of borrowing for Government is naturally lower than the cost of borrowing for private sector financial institutions. The premium in the cost of borrowing paid by private sector financial institutions normally becomes a component of the funding cost of traditional PFI projects. CGF provides a means of reducing this funding premium and hence reduces the cost for the Government of financing PFI projects.

In CGF, the Government captures this benefit whilst also retaining the full risk transfer to the private sector that is otherwise inherent in traditional PFI, by lending to the PFI contractor the sums needed to finance the senior debt portion of the overall funding requirements and securing a guarantee for repayment of its lending from one or more major financial institutions. The Government's main risk in lending is therefore the credit worthiness of the guarantor, not the risk of default of the PFI project or the insolvency of the PFI contractor.

The lending rate is set at the prevailing market rate for PFI projects funded by private sector debt finance. The PFI contractor pays the Government the prevailing market rate, and after payment of the fee required by the guarantor the Government has a surplus that is larger than its cost of funding the loan through the issue of gilts. The surplus is a net cost saving for the Government.

The benefits of CGF

7.55 Inherent in the cost of raising private finance is the additional premium charged by the market, over and above the project risk premium, which reflects the higher credit risk of the private sector compared to Government. The use of CGF provides a means of reducing this finance premium and generating cost savings for the Government. The pilot projects have demonstrated that these cost savings can be achieved. The saving on Leeds Hospital is about 8 per cent of total financing costs (3 per cent of the unitary charge) and on Portsmouth Hospital is about 16 per cent of the total financing costs (3 per cent of the unitary charge).

CGF pilots

7.56 To test the applicability of CGF in different financing markets, one pilot obtained a bank guarantee while the other obtained a monoline insurer guarantee. The successful introduction of CGF in both pilots suggests that the Government's desire to ensure a mixed economy on financing PFI and the lower exposure to systemic market risk that comes with a wide spread of guarantors can be achieved. The Government has been further reassured that negotiations on CGF did not delay the financial close of either pilot.

7.57 The monoline guaranteed pilot generated a higher proportion of savings in relation to the total financing costs compared to the bank guaranteed pilot. This is due to a number of factors including the different time periods and market conditions that existed at the time the projects closed, as well as the different funding terms used. It is expected that, over time, as different market forces come into play the level of savings that will be generated in relation to both bank and monoline guaranteed CGF will change. However, the Government will continue to take an overall portfolio approach in assessing these savings and is keen to ensure a mixed market of private sector guarantors.

Further CGF pilot

7.58 The Government is now undertaking a further pilot to test CGF's potential benefits in a project that has yet to select a preferred bidder. This will enable a wider market based participation and acceptance beyond the bilateral discussions that have taken place on the earlier two pilots. This process will also enable the development of standardised documentation for the CGF programme with the aim of minimising the need for additional bilateral negotiations with the guarantee providers. The Government has selected the Knowsley Metropolitan Council BSF Wave 1 project as the next CGF pilot. The project was selected to demonstrate the applicability of CGF in a sector other than health, where the two previous CGF transactions were piloted, and the interest in the BSF programme will also allow the Government to engage with a wide range of market participants.

The future of CGF

7.59 The Government has already announced that it does not intend to use CGF for more than a limited proportion of its PFI programme, and will use a mixed market of private sector guarantors to ensure diversity in funding markets and to minimise exposure to systemic market risk. It is envisaged that CGF will be targeted on projects where savings can be enhanced by benefiting from the specific characteristics of the credit guarantee structure. An example of such opportunity is where monoline insurers can, under CGF, compete where the capital value of the project would otherwise have been too low for the debt capital markets.

Framework funding

7.60 The Government examined the potential of framework funding as a mechanism to provide a faster, cheaper funding solution that would maintain the benefits of third party finance whilst reducing its inherent inefficiencies when applied to smaller schemes. The pilot for this structure was the Partnerships for Church of England Schools (PfCS) initiative.

7.61 PfCS was subsequently absorbed into the BSF programme, but not before extensive development work on the framework funding initiative had been carried out, including the competitive selection of a bank to arrange the finance and a monoline insurer to guarantee repayment. The development work analysed the benefits of framework funding, including the potential value for money for the Government. It demonstrated that framework funding could have an application for projects where services are procured for small projects as part of a much larger and homogeneous programme. Partnerships for Schools is currently developing framework funding for a subsequent wave of the BSF programme.

Alternative mechanisms for improving the efficiency of debt

7.62 Currently, under the standard PFI project all senior debt within a PFI project is potentially at risk, subject to the performance of the PFI contractor. For this level of risk transfer senior debt providers charge a credit risk margin. However, recent research by Standard and Poors[3] suggests the likely recovery of outstanding senior debt in PFI projects, if the project were to be terminated, is high. This means that there is a value for money judgement for a procuring authority, balancing the pricing of senior debt and the risk transfer that the Government wishes to pass to senior debt providers.

7.63 There is evidence that the risk transfer to senior debt is least effective for very large PFI projects where:

- there may be a premium associated with the size of the financing requirement and the risk transfer necessary for the PFI project to be financed by senior debt providers; and
- the level of risk transfer to senior debt may be eroded within the PFI project.

7.64 Imposing a blanket restriction on very large projects would be an arbitrary solution to a perceived difficulty, and forcing large projects into traditional procurement would prevent the procurement benefits and risk transfer otherwise associated with PFI.

[3] Standard and Poors, April 2005: *"Recovery ratings for project finance transactions."*

7.65 To secure the value for money of senior debt in large projects the Government is exploring ways to refine the level of risk transfer to senior debt to achieve a lower cost of capital. The Government will explore these options so that the overall benefits provided by senior debt to achieving value for money can be retained, while reducing the cost of capital. The options that the Government is seeking to test are:

- an underpinned tranche. This may be structured as a fixed commitment to repay a predetermined proportion of the senior debt in the event of contractor default. Under this option the Government would transfer construction risk to the private sector but underpin a proportion of the senior debt at a set point in the operational phase of the project. To meet value for money criteria, the funding of this tranche should be very close to pricing of gilts; and
- construction financing. The Government will consider the use of piloting construction financing where short-term construction finance is put in place during construction, to be refinanced following construction to secure a lower cost of capital. The Government will consult the private sector on an appropriate risk sharing regime around the raising of the long term finance post construction completion.

7.66 To test the efficiency of these proposals and other alternatives the Government will trial a small number of partially underpinned financings to establish the strength of the value for money case. Until the pilots have been used to address any concerns that arise from all relevant parties in the public and private sectors, no other underpinned structures will proceed without prior approval of the Treasury.

Refinancing

The voluntary code of conduct

7.67 There have been a small but significant number of PFI projects that have amended their financial arrangements with their senior debt providers. This has been possible because the PFI contractor has passed a significant milestone in the satisfactory delivery of the project, usually after the contractor has satisfactorily completed the construction of the asset. The refinancing has often included a transfer from bank debt to bond finance, and an increase in the amount of debt borrowed in line with the reduced risk in the project.

7.68 The refinancing of all PFI projects is now subject to a gain sharing arrangement between the PFI contractor and the procuring authority. Gains are shared either subject to a voluntary code on refinancing gains put in place in 2002, or under the contractual arrangements required as part of Government's standard PFI contract. In total the Government has received over £130 million from these arrangements.

Current refinancing policy

7.69 The Treasury continues to support value for money refinancing of PFI projects and recognises the wish of PFI contractors to refinance their successful projects, and the interests of banks and equity that look to refinancing as an important element of liquidity to enable them to make funding available for new PFI projects.

7.70 The Treasury has issued additional guidance to procuring authorities to assist with their analysis. This guidance, "The Application Note – Value for Money in Refinancing" supports authorities in making a whole life value for money decision where they need to balance their share of the gains generated by the refinancing with any increased obligations they may face that might affect the long term flexibility of the contract.

The need to ensure value for money

7.71 The NAO have now reported on the refinancing of several PFI projects including two large district general hospitals, for the Dartford & Gravesham NHS Trust and the Norfolk & Norwich University Hospital NHS Trust. Those and earlier NAO refinancing reports have identified a series of issues for procuring authorities to consider when approving a refinancing. A key issue has been the analysis necessary for a procuring authority to undertake when making a value for money judgement on approving a refinancing that increases the Government's commitment to senior debt and equity providers' liabilities should certain termination events occur.

7.72 In paragraphs 7.30 to 7.36 a number of issues were raised as representative of the type of issues a procuring authority should consider as part of a future procurement. These issues are equally relevant for refinancing.

ISBN 1-84532-137-5

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