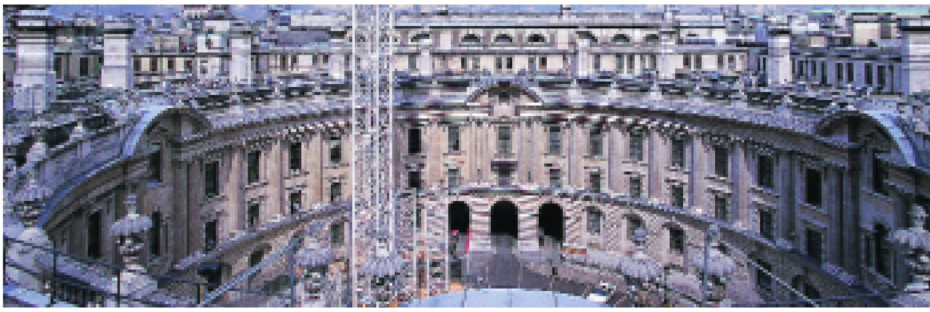
executive summary

1 The Government Offices, Great George Street is a grade II* listed building, constructed about a century ago. It forms an important part of the Government's freehold estate, occupying a prominent position in Whitehall close to the Houses of Parliament and overlooking Parliament Square and St. James's Park. By the early 1990s, after many years when only essential maintenance had been undertaken, the fabric of the building required extensive remedial work. In May 2000 the Treasury completed a deal with Exchequer Partnership[1] to refurbish and then maintain the building for a period of 35 years. Once the Treasury is able to occupy the refurbished building it will pay Exchequer Partnership an annual unitary payment of £14 million (in March 1999 prices). The total net present cost of the unitary payments over the lifetime of the deal is £170 million.

2 Exchequer Partnership was selected as the preferred bidder for the project in September 1996, after a competitive procurement process. Subject to final negotiations, the key terms of the deal had been agreed and funding commitments from financial institutions had been agreed in principle by Exchequer Partnership, as is usual in PFI deals. Following the 1997 General Election, however, negotiations were terminated. The Government considered it inappropriate to go ahead with this major project at a time when all departments were undertaking comprehensive spending reviews.



3 The Treasury reviewed the project to re-assess the extent of the remedial work required and the priority of the project in relation to other expenditure demands. The review confirmed that the building was in need of substantial refurbishment if it was to become a flexible and efficient office, suitable for the future needs of the Treasury. On the basis of a revised specification, Ministers agreed that the project should go ahead.

4 The Treasury decided to retain Exchequer Partnership as its preferred bidder rather than hold a second competition for the entire project. However, when negotiations were resumed in October 1998 thinking had advanced and a fresh element of competition was introduced into the process. Negotiations were re-opened with Exchequer Partnership on the condition that the external project funding was obtained via a separate competition. This was to be the first time

1 *A consortium consisting of Bovis Lend Lease Holdings Ltd, Stanhope plc and Chesterton International plc*

that project funding had been secured this way in a public sector procurement. The Treasury had two objectives in requiring such a competition:

a) to persuade banks and other project funders to accept standard contract terms for future PFI projects

Whilst the Treasury was negotiating the project agreement, the Treasury Taskforce[2] was developing a set of standard terms and conditions for future PFI contracts. This was intended to streamline the procurement process and reduce costs for both the public and private sectors. The Taskforce agreed with the Treasury PFI project team that the project should be used to test how the standard terms and conditions worked in practice. It was hoped that this would lead to their general acceptance by PFI project funders.

b) to obtain the best available price from a transparently competitive process

The Treasury recognised that the suspension of the project and the subsequent renegotiations with Exchequer Partnership after such a long delay would raise doubts whether the deal in its entirety reflected the best value the market had to offer. Holding a funding competition was seen as a way of getting the best price for the project funding and demonstrating that this was the case.

5 This report is about the funding competition. It examines whether the Treasury achieved its objectives and how such competitions might be run effectively in the future. Our methodology is summarised at Appendix 1.

The Treasury achieved its objectives

6 Although there were good reasons for holding a funding competition, the full benefits would not be achieved unless the process was well managed by all the parties and their advisers. Before embarking on the competition, the Treasury and Exchequer Partnership signed an agreement that detailed how the competition was to be run and set out the roles that all parties were to play during the competition process. Appropriately qualified advisers were appointed separately by the Treasury and Exchequer Partnership and prospective bidders in the funding competition were provided with clear information. These arrangements facilitated a strong competition in which 19 financial institutions submitted initial offers and six final bidders provided detailed credit terms. In the final outcome, the Treasury achieved its objectives.

The standard terms and conditions were accepted by bidders

7 A large majority of the financial institutions that submitted initial offers also accepted the standard contract terms and conditions without amendment.

The funding was obtained at a good price without any adverse effect on the agreed allocation of risk

8 The allocation of risks between Exchequer Partnership and the Treasury remained unaltered during the competition. The final capital structure of the deal was also within the range of possibilities envisaged at the start of the competition. The funding was obtained at a fair price and savings of £13 million over the lifetime of the deal were achieved compared to the unitary payment offered prior to the funding compeition.

2 The projects and policy teams of the Taskforce were set up within Treasury to support Departments on PFI transactions and to develop PFI guidance. All future references to the Treasury or the Treasury project team, unless otherwise stated, can be assumed to include the Taskforce from whom close assistance and support was received.

The role of funding competitions in future PFI projects

9 One of the key advantages of the PFI is that the potential for private sector innovation can be maximised through a single competitive process in which bidders submit proposals covering all of the elements that make up a typical bid, often described as design, build, finance and operate. 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. This suggests that funding competitions may have a role to play in future PFI deals.

10 While the synergies between the design, build and operate parts of a deal are clear, the advantages of arranging the financing at the same time may not be always so obvious. When a contractor is selected as the preferred bidder the commercial elements of a deal should have been agreed. The complete cost of financing, however, is usually only finalised at financial close for a project financed transaction. Financial institutions are likely to be more competitive if they are asked to bid for the financing after a contractor has become the preferred bidder and a commercially viable project agreement has been negotiated, allowing credit risks to be properly assessed and priced. The potential benefits of a funding competition are the likelihood that the most appropriate form of financing will be arranged at a competitive price.

11 There are, however, significant risks in running a funding competition. These risks include the project not attracting competitively priced funding and the deal taking longer than expected, leading to increased procurement costs and a delay in realising the project benefits.

Recommendations

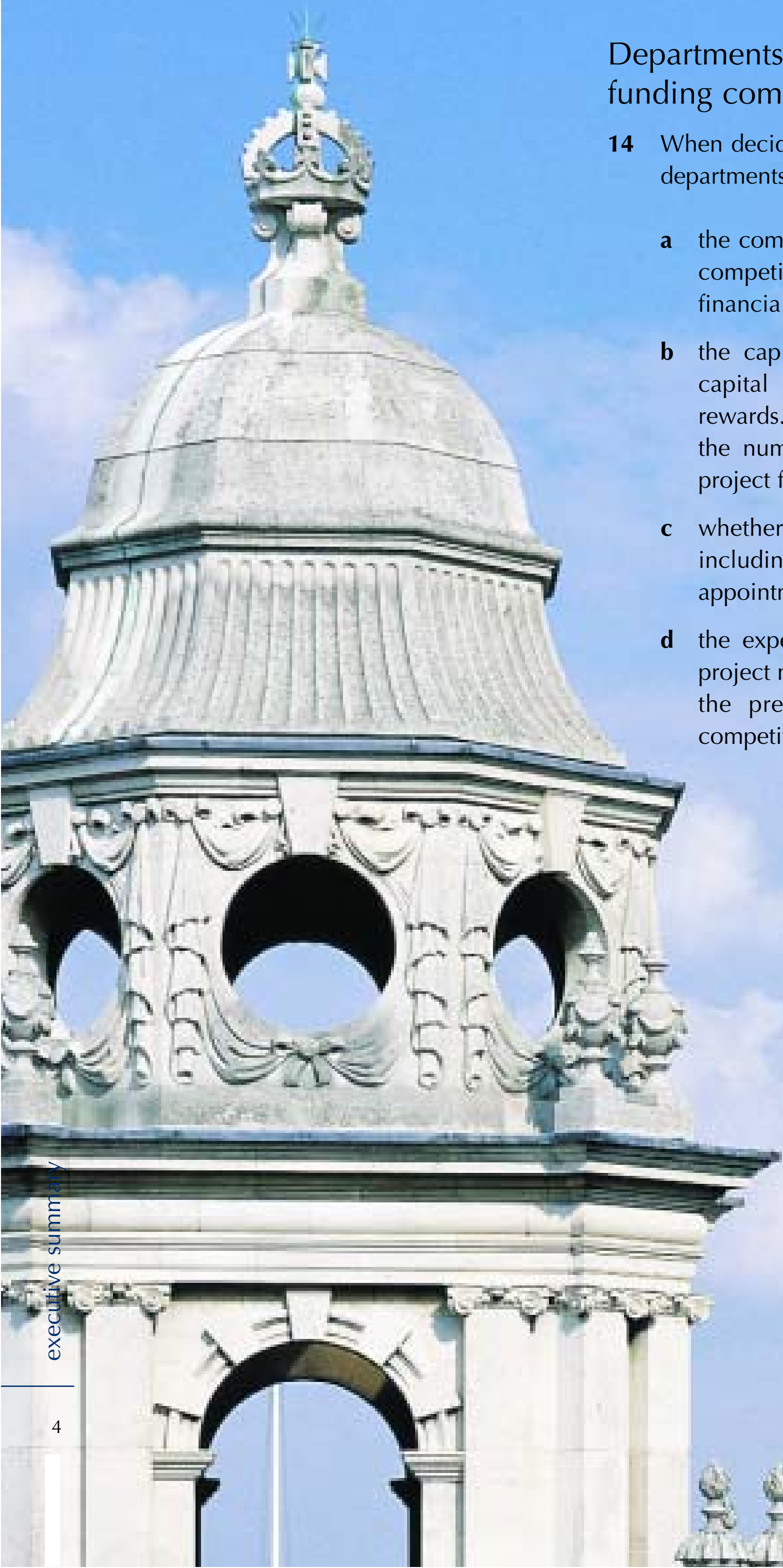
12 Running a funding competition is a complex undertaking that requires experienced and qualified project managers and advisers on the public and private sector sides of the deal. In many cases the complexity of the competition process and the risks involved will outweigh the potential benefits. In other cases, however, significant benefits may accrue if running a funding competition is a credible option. By reserving the right to require a preferred bidder to run a funding competition, departments can ensure that the financing package supporting the preferred bidder's solution is highly competitive.

13 In the light of the benefits obtained from the funding competition for the Treasury building, we make the following recommendations for future PFI deals:

Departments should always consider the option of using a funding competition

14 When deciding whether a funding competition will improve value for money, departments need to consider:

- **a** the complexity of the project - it will be easier to run a funding competition for a simple well-understood project, but the financial rewards for a complex project may be greater;
- **b** the capital funding requirement - projects with a significant capital expenditure element offer the potential for greater rewards. The size of the funding requirement will also impact on the number of potential funders interested in providing the project financing;
- **c** whether the PFI procurement process was competitive, including a consideration of the elapsed time between the appointment of the preferred bidder and financial close;
- **d** the experience and qualifications of the public sector project management team, the department's advisers and the preferred bidder who will be conducting the competition.



In the absence of competitive tension a funding competition may be essential

15 For a number of reasons a department may find itself in the position where the PFI procurement process does not produce a competitive environment. This may occur because there is only a single bidder or because of the time taken between selection of preferred bidder and financial close. In these circumstances, a funding competition is the best way of ensuring that the funding of the deal represents good value for money.

In deciding to hold a funding competition, departments must pay careful attention to the structure of the deal and how the competition is run

16 For a funding competition to be successful, departments must carefully consider the following aspects:

a The project agreement must be commercially viable. Without a commercially viable agreement there is a risk that the subsequent due diligence by funders will result in changes being made to the project agreement during the competition and a probable delay to financial close. The use of standardised contract terms, which are known to be acceptable to financiers, should help departments to negotiate commercially viable contracts and to attract greater competition in sources of finance.

b High quality advice is essential. When appointing advisers, departments need to consider whether an adviser has sufficient commercial experience, specifically in the PFI market, and suitable experience of raising finance.

c The competition must be planned in advance. Early planning will help to avoid cost increases and any potential delays to the completion of the project. Departments will also need to judge carefully the number of potential funders asked to bid.

d The evaluation criteria must be well thought through. In particular, departments and their advisers need to consider carefully the appropriate funding structure in relation to the risks transferred and recognise that the lowest cost does not always represent the best value.

e The capability of the department's own project management to take on the additional responsibilities inherent in a funding competition.

Departments should take a close interest in bidders' funding arrangements even when there is not a separate funding competition

17 If a separate funding competition is not to be used departments should ensure that they understand and monitor bidders' funding arrangements. Departments and their advisers will need to consider ways in which bidders can be incentivised to obtain the best priced and most appropriate form of financing. This might include:

a The traditional approach of relying on competitive tension in the overall procurement process to incentivise bidders to include the most attractive finance as part of their bids.

b Allowing bidders to suggest running a funding competition and to ensure that the bid evaluation process takes account of this.

c At an appropriate point during the procurement, benchmarking the expected funding costs.

18 We understand that, having considered the issues set out above, the Office of Government Commerce intends to issue guidance to departments on when, in future PFI projects, it may be appropriate for funding to be obtained through a separate competition.