

NATIONAL AUDIT OFFICE

**REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL**

The Market Test of ED5

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John Bourn
Comptroller and Auditor General

National Audit Office
6 March 1996

The Comptroller and Auditor General is the head of the National Audit Office employing some 750 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

Contents

	Page
Part 1: Introduction and background	1
Part 2: Preparations for market testing	3
Part 3: The selection process	7
Part 4: The outcome of the market test	12
 Appendices	
1. Consultants and other firms assisting the market testing unit	18
2. Key dates in the market test of ED5	19
3. The cost of the market test	21

Part 1: Introduction and background

Introduction

- 1.1 This report deals with the market testing by the Home Office (the Department) of the administrative information technology services provided by ED5 Computing and Pay Services Division (ED5). These include:
- a) mainframe services to the Immigration and Nationality Department, the Prison Service, and the Home Office's personnel, finance, accounting, statistical and administrative divisions;
 - b) the maintenance of a back-up facility for the police national computer;
 - c) general support for desk top computers.
- 1.2 Following a comprehensive market testing exercise, Sema Group were awarded a contract which lasts for an initial three year period from 1 November 1994. By mutual agreement, this may be extended to a total of up to 7 years. The contract is estimated to be worth £51.9 million over the 5 years to 31 October 1999 at forecast workloads and 1994 prices.

Background

- 1.3 In November 1991, the Government published the White Paper "Competing for Quality", which required Departments and Executive Agencies to set targets for testing new areas of activity in the market to see if alternative sources would give better service and value for money. The targets were to be informed by studies, undertaken with private sector help, to determine the most promising new areas for market testing and contracting out. The studies would identify the priorities for action and the areas to be explored in a rolling programme in later years.
- 1.4 The Department therefore commissioned a review of their activities to identify areas where rapid progress could be made in extending competitive tendering for the provision of services. This review, which was conducted jointly by the Department's Market Testing Unit and consultants Coopers and Lybrand, identified ED5 as a suitable candidate because of its potential for service improvements and cost savings. At that time, ED5 employed around 580 staff, mainly at the Bootle Data Centre.

- 1.5 The Department recognised from the outset that external assistance would be required in conducting this market test. Appendix 1 lists the consultants and other firms who provided professional advice. Appendix 2 provides a chronology of main events.

Objectives of the market test

- 1.6 The underlying objectives for this market test were those set out in the "Competing for Quality" White Paper: the achievement of improvements to service quality and value for money through the introduction of competition. Ministers approved a programme prepared by officials which included a target date of April 1993 for completion of the market test of ED5. Ministers subsequently agreed to defer the completion of this test until June 1994. This allowed the Department to refine the arrangements for the market test to ensure that the scope for improvements to service quality and value for money were maximised. It also gave ED5 the opportunity to appoint a private sector partner for a possible in-house bid.
- 1.7 The Department did not set itself any other explicit objectives at the outset but it is clear that whilst seeking to meet the timetable approved by Ministers, the Department also had regard to protecting the interests of the tax-payer; providing a continuous and high quality service to users; and protecting the interests of staff.

Methodology

- 1.8 The National Audit Office examined:
- a) the measures taken to prepare ED5 services for market testing;
 - b) the market testing process, including the marketing and evaluation of bids;
 - c) the main elements of the contract;
 - d) the cost of the market test.
- 1.9 The National Audit Office examined departmental papers and interviewed key Home Office staff. We sought to establish whether the Department had taken appropriate professional advice; had consulted ED5 customers where appropriate; had applied clearly defined evaluative criteria linked to service quality and delivery; and had treated bidders with parity. We also examined the terms of the contract.

Part 2: Preparations for market testing

Defining the scope of the market test

- 2.1 Following the announcement in June 1992 that ED5's activities would be subject to market testing, the Home Office established a Project Board to oversee the arrangements. The Project Board subsequently asked ED5 to produce a report to determine the scope and arrangements for the market test.
- 2.2 The draft report submitted by the ED5 scoping team in December 1992 was not accepted by the Project Board, primarily because the recommendations for market testing were not considered sufficiently robust and covered only small areas of ED5. A revised report, produced in January 1993 by the Market Testing Unit, recommended that all ED5 Information Technology functions, with the exception of new large scale information technology development work, should be market tested.
- 2.3 The scoping study report had also recommended that the market testing of the payroll should be deferred, because the changes required for the introduction of performance pay and the possible integration of pay and personnel systems made their specification difficult. The pay service has been the subject of a separate market testing examination which was taken forward in 1994-95.
- 2.4 New large scale information technology development was excluded because the Department considered that retaining a choice of supplier would give it greater control of costs and enable it to respond more readily to events. The ability to select the supplier proposing the best solution for a particular project offered the prospect of significant value for money benefits. The exclusion of this area of work also allowed the Department the possible option of retaining significant in-house expertise to provide continuing technical advice; and it avoided the situation where the Department would be locked into one major supplier for a long period of time.
- 2.5 Following consultations with the private sector, the Department decided that all ED5 Information Technology services, excluding payroll and new large scale IT development, should be offered under a single contract which should last for at least five years. It was felt that this would help to generate an adequate level of interest in the market test.

Managing the risks posed by the market test

- 2.6 Following the completion of the scoping study the Department concluded that:
- a) an assessment of the risks associated with the market test should be carried out to enable the Department to take whatever measures might be necessary to safeguard the taxpayers' interests;
 - b) there was a need for a full, separate and independent review of the arrangements for contract control and for the management of information technology following the market test.
- 2.7 The subsequent risk assessment in June 1993 identified six broad areas of risk to be addressed. These were the current timetable, which was seen as too demanding; the time allotted to contract negotiations and the level of expertise needed within the Home Office to undertake such complex negotiations; a lack of firm requirement in the period leading up to detailed contract negotiations; customers' lack of experience in drafting service level requirements; the transition period between award of contract and the start of a new service agreement; and unclear definitions and responsibilities relating to the market test.
- 2.8 The Department responded to this assessment with measures to address the identified risks. It increased the time allowed for detailed contract negotiations; introduced additional expertise through the appointment of experienced contract negotiators and accountancy advisers; and ensured that there were adequate procedures for guiding and liaising with ED5 customers and satisfactory arrangements to cover any transitional period.
- 2.9 The relationships between users and service providers were defined further by CCTA (the Government Centre for Information Systems) in their review of the arrangements for post market test contract control and information technology management. CCTA is part of the Cabinet Office, and is responsible for promoting business effectiveness and efficiency in Government through the use of information systems. The CCTA report, which was published in July 1993, concluded that the ambiguity of ED5's combined roles as purchaser and provider must be sorted out to remove potential conflicts of interest. The report also concluded that a core role for a central advisory division was to help users develop their "intelligent customer" role.
- 2.10 The Department accepted the conclusions of the CCTA report and implemented its recommendations by separating information technology strategy from service delivery, with ED5 responsible solely for the latter. The Department also strengthened control over service quality and customer liaison by putting in place contract management and service control arrangements.

Customer liaison and the development of service specifications

- 2.11 The Department began work on the service specifications for the market test in February 1993. It recognised that these had to be underpinned by appropriate service level definitions for each ED5 customer. Customer liaison arrangements were developed that involved discussions with all customers across the Department to identify and document their service requirements.
- 2.12 To ensure that this aspect of the preparatory work went as smoothly as possible, the customer liaison arrangements made named individuals on the market testing team responsible for co-ordinating the preparation of customer requirement specifications. The broad basis of customers' requirements was documented in advance of the issue of the Request for Proposals and completed in August 1993. This was later than originally planned, primarily because of the extension to the project timetable to enable the in-house team to seek a commercial partner.
- 2.13 In April 1993, the Department further developed its customer liaison arrangements and formed a market test customer board. This provided ED5 users with a forum within which wider issues of common interest, such as the procurement and evaluation strategies, could be discussed.

The procurement strategy

- 2.14 On the basis of advice from CCTA, the Department decided to adopt the negotiated procedure route for this procurement, because of the complexity of the services subject to the market test and because some technical issues had still to be resolved. Many issues, such as the handling of assets, staffing arrangements, and accommodation requirements would have to be resolved by contract negotiations. The final specification and associated workloads could only be drawn up at the end of the negotiations.
- 2.15 The procurement strategy followed published CCTA guidelines and was planned in six phases:
- a) the issue of a "Request for Information" document to approximately 20 Facilities Management Companies in February 1993. The purpose of this exercise was to assist the preparation of the Statement of Service Requirements and to ensure the requirement was pitched to attract the best possible response from the trade;
 - b) the advertisement of the market test in the Official Journal of the European Community;

- c) the issue of the "Request for Proposals" document. This invited potential bidders to submit more detailed proposals, from which a short-list of approximately three would be taken forward to the contract negotiation stage;
- d) detailed contract negotiations with each bidder;
- e) the submission of Best and Final Offers;
- f) the evaluation of Best and Final Offers and the award of the contract to the lowest technically acceptable tender.

Employee issues

- 2.16 The Department recognised the importance of staff and related issues within the market test. It consulted the Trades Unions on these matters and took account of bidders' experience of integrating staff into their organisations when evaluating the bids.
- 2.17 Transfers of staff from one organisation to another are governed by the Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE). It is a matter of law in any individual situation whether or not TUPE applies. Where it does, with the exception of existing pension rights which are protected by separate employment legislation, staff transfer to the new employer on their existing terms and conditions of service. The Department decided that it would be for individual bidders to determine whether TUPE should apply and to take this into account in putting their proposals together. The Sema Group subsequently concluded that TUPE would apply.
- 2.18 The Department was advised that there would be practical difficulties in making any surplus staff redundant before ED5 was transferred. It concluded that any redundancies would be a matter for the winning bidder to determine and responsibility for financing them would be for that bidder. There was no question of the Department accepting responsibility for these redundancies through the contract negotiation. All that would be at issue would be the extent to which the supplier explicitly allowed for the expected reconstruction (including redundancy) costs in their bid.
- 2.19 If a private firm won the market test, ED5 staff would cease to be civil servants and would have to leave the Principal Civil Service Pension Scheme. To protect staff pension rights, fulfil its obligations as a good employer and avoid potential claims for constructive dismissal, the Department stipulated that the winning contractor must offer ED5 staff a pension scheme which gave broadly comparable benefits to those offered by the civil service. Benefits accrued up to the market test could be left with the Principal Civil Service Pension Scheme or transferred to the employer's new scheme.

Part 3: The selection process

Initial expressions of interest

- 3.1 The market test was launched in February 1993 with a Request for Information sent to 20 IT facilities management companies. This was followed by the advertisement in the Official Journal of the European Community. The Department subsequently received 16 expressions of interest in May 1993, including one from the in-house team.
- 3.2 To evaluate these expressions of interest the Department formed an evaluation working group which included procurement specialists from CCTA and the market testing branch, an accountancy specialist, the Departmental Security Officer and ED5 customers. Expressions of interest were examined by the panel through a formal tender board to ensure parity of treatment.
- 3.3 The evaluation of all initial expressions of interest, including that from the in-house team, focused upon the applicants' ability to provide the relevant services by examining their:
 - a) financial standing;
 - b) technical expertise;
 - c) experience of providing similar services elsewhere and integrating staff into their organisation;
 - d) quality control procedures.
- 3.4 In June 1993, the in-house team announced that they wished to form a partnership with a private sector company and the Department extended the timetable for the completion of the market test to enable them to do so. Three companies who submitted initial expressions of interest then withdrew to allow them to compete for the in-house partnership. Following a competition, the in-house team appointed Hoskyns Plc as their partner.
- 3.5 From the remaining expressions of interest the Department short-listed Sema Group, EDS-Scicon, CSC Limited, Bull Data Sciences, CFM Limited and the in-house/Hoskyns Plc partnership to be taken forward to the request for proposals stage.

Requests for proposals

- 3.6 Requests for Proposals were sent to the short-listed candidates in August 1993. Three proposals were received in October 1993 from the in-house/Hoskyns Plc bid, Sema Group and CFM Limited and these were subsequently supported by detailed presentations to the Department.
- 3.7 To evaluate these proposals the Department established an evaluation team which included the negotiation team leader (who had recently transferred from CCTA), the project manager (from the Home Office market testing unit), a contracts specialist from CCTA, a Home Office accountancy adviser and representatives from ED5 customers, including senior officials from the Immigration and Nationality Department, the Prison Service, and Home Office Pay and Statistics functions.
- 3.8 The evaluation team dealt with all the responses to the Request for Proposals through a second tender board, which confirmed that the following matters were adequately covered by the bidders:
- a) the candidate was prepared to provide the full range of services required;
 - b) the candidate was prepared to provide a formal undertaking to comply with the Department's security requirements;
 - c) the candidate agreed to all the statutory requirements relating to employment practices.
- 3.9 Once the evaluation team had satisfied itself that the proposals met these requirements, it concentrated on the following key elements:
- a) service provision and quality;
 - b) assets;
 - c) service control management;
 - d) staffing issues;
 - e) the quality of the response.
- 3.10 The evaluation of responses was intended to identify those bidders who appeared to be able to provide the necessary services and with whom the Department expected to be able to conclude contract negotiations. The main purpose was to shortlist bidders to be taken forward to the next stage under the negotiated procurement procedure. The Department considered that none of the indicative costs put forward by the bidders were so obviously out of line with expectation as to cause undue concern, but told the National Audit Office that they would have considered indicative costs in more detail had that been the case.

- 3.11 In November 1993, the evaluation team recommended to the Project Board that two of the bidders (the in-house/Hoskyns Plc partnership and the Sema Group) should be invited to the detailed contract negotiation stage. The CFM proposal was considered less certain to meet anticipated service requirements.

Detailed contract negotiations

- 3.12 Contract negotiations began in November 1993 and covered all aspects of the contract, including service levels and quality, forecast workloads and likely tariff charges, cost estimates, staffing arrangements, the use of office services and the handling of assets. This work culminated in invitations to submit Best and Final Offers on the basis of draft contracts and was intended to ensure that both bidders had a clear understanding of the Department's requirements and that arrangements for future delivery of the service would ensure best value for money. The negotiation process included:

- a) agreeing the detailed definition of the services required (the Services Schedule);
 - b) negotiating a charging structure with each supplier which could be directly related to the Services Schedule (the Charges Schedule);
 - c) developing and issuing in draft a workload profile based upon the definitions of services contained in the Service Schedule and in units compatible with the Charges Schedule of each supplier.
- 3.13 By following this sequence, suppliers were able to commence preparation of their business plan whilst other schedules were being negotiated.

- 3.14 Following these lengthy negotiations, the Department were satisfied that bidders did have a clear understanding of their requirements and that the draft contracts agreed between the parties represented a sound basis from which to formulate Best and Final Offers. The Department told the National Audit Office that bidders had been heavily involved in all aspects of the negotiations and had not objected to the timetable for submitting Best and Final Offers - which were invited only after contract negotiations had been completed and when the Department was satisfied that the proposed contracts would provide the services required from either bidder. No comments had been received from the bidders to suggest that the Department's forecast of likely workload was inaccurate.

Best and final offers

- 3.15 The in-house/Hoskyns Plc team and Sema Group both submitted Best and Final Offers in June 1994. The in-house/Hoskyns Plc team were also asked to submit a business plan with their offer. The Department wished to be assured of the commercial viability of their bid, given that it would be liable to meet any shortfall in revenue over the life of the contract.

- 3.16 The Department's evaluation team reviewed both candidates' Best and Final Offers in detail using a third tender board to deal with the administrative arrangements. The evaluation team concluded that both bids were technically capable of meeting the Department's requirements and that the award of contract rested on the financial evaluation of the offers.
- 3.17 The cost of each bid was defined as the cumulative net present value (using the 6 per cent discount rate recommended by HM Treasury) of the full cost of each bid over a 5 year period. The evaluation was complicated by the fact that the Best and Final Offer from the in-house team included an estimate of the income arising from the projected workload that was £12.2 million less than their forecast costs. The reasons for this shortfall, and potential sources of additional revenue, were not discussed in their business plan.
- 3.18 The Department asked the in-house/Hoskyns Plc team as to the reasons for this shortfall and where the additional revenue was to come from to ensure viability. The in-house team replied that they believed:
- a) actual workload was likely to be 23 per cent higher than that forecast by the Department;
 - b) they would win other Home Office contracts;
 - c) their costs could be reduced through secondments to Hoskyns Plc.
- 3.19 The evaluation committee considered this explanation carefully. However, they noted that no additional work of this magnitude was planned and, even if it were, the in-house/Hoskyns Plc team would be unlikely to win all of it, given the need to put this out to competitive tender. They estimated that the in-house/Hoskyns Plc team would need to tender for about £60 million of work over the five years to generate the income needed to cover their shortfall of £12.2 million.
- 3.20 The evaluation committee therefore decided to take the "worst case scenario" and add this shortfall to the cost of the in-house bid. The results of the comparison of the costs of each offer are given in Figure 1 opposite.
- 3.21 At the same time as the in-house team's Best and Final Offer had been received, Hoskyns Plc wrote to the Head of the Department's central IT Division, offering to take up to 60 secondees a year from ED5 over the first five years of the contract. For this period, this represented up to 185 staff years more than had been assumed in the Best and Final Offer and, if taken into account, would have significantly reduced the cost difference between the in-house and Sema Group bids.
- 3.22 The Department told the National Audit Office that it would not have been proper to treat the separate, non-contractual, letter from Hoskyns Plc as part of the in-house bid - which it would not now be permissible to alter. The evaluation committee had received clear legal advice that although it might seek clarification of the bid, it would not be appropriate for the bidder to change the

Figure 1: Comparison of Best and Final Offers		
	In-house/Hoskyns PLC Offer	Sema Group Offer
	£m	£m
Cost of providing the specified services (including reconstruction costs)	53.4	61.0
Revenue adjustment (to cover additional costs)	12.2	-
Less discounting adjustment at 6 per cent	(10.3)	(9.1)
Total Net Cost	55.3	51.9

Source: Departmental Records

This figure shows the final cost to the Department of each Best and Final Offer.

terms of the bid. To have done so would have been to disregard the parity of treatment required under the procurement rules. The Department told the National Audit Office, in the light of the letter, that clarification of the in-house bid had later been sought and this had confirmed a lower number of secondments to Hoskyns Plc reducing over the years from a maximum of 33 per year. Accordingly, the cost of the in-house bid used in the evaluation was based upon these lower numbers.

- 3.23 The Department therefore decided that the Sema Group should be awarded the contract as their bid was £3.4 million lower than that of the adjusted in-house bid.

Part 4: The outcome of the market test

The final contract

- 4.1 In July 1994, the Department announced the award to Sema Group of a contract to supply information technology services from 1 November 1994. The contract lasts for three years and may, by mutual agreement, be extended to a total of up to 7 years. Over the five years to 31 October 1999, the contract is estimated to cost £51.9 million at forecast workloads and 1994 prices. As part of its Best and Final Offer, Sema Group had specified certain minimum workload levels over the first three years. To safeguard the taxpayers' interests, these workload levels were set in the contract below the service users' forecasts of likely demand.
- 4.2 Prior to the start of the contract the Department negotiated transitional arrangements, from 1 August to 31 October 1994, which were set out in Schedule 3 to the contract. During the transitional phase, and after staff had transferred to them under the TUPE Regulations, Sema Group undertook a business review of ED5 to determine future staffing levels, re-organised ED5, and arranged for the move of former ED5 staff and removal of equipment to new premises. Their costs for each phase of this period, which were fully taken into account in the evaluation of Best and Final Offers, were finalised when the contract was signed and set out in an accompanying letter.
- 4.3 Following their business review, and the transfer of staff under the Transfer of Undertakings (Protection of Employment) Regulations 1981, Sema Group asked for voluntary redundancies. 130 staff at Merseyside applied and 92 of these applications were accepted. Subsequently, all 42 staff at the Corby Data Preparation Centre took voluntary redundancy packages because Sema Group had stated in its Best and Final Offer that it wished to subcontract this work. They were later re-employed by the new contractor; but on different terms and conditions of employment.
- 4.4 The reconstruction charges contained in Sema Group's Best and Final Offer contained a variable element towards the costs of redundancies on which the Home Office had a cap. The cost of making staff on Merseyside redundant exceeded this cap by 23 per cent, the company funding the balance. All redundancy costs for Corby staff were met by Sema Group. The payments made by the Home Office under the terms of the contract for transition did not, therefore, prove to be excessive.
- 4.5 Contract prices for the specified services under the main contract are fixed for the first three years of the contract. Thereafter, they may be adjusted using a capped price variation formula contained in the contract. The contract also

contains provisions for ensuring the security of information and documents and provides for redress should the contractor fail to fulfil any obligation specified in the services description within the contract. These measures include:

- a) making good identified failures at the contractor's cost;
 - b) the recovery of costs incurred by the Department in rectifying poor performance;
 - c) the use of "service credits" (or refunds) should performance fall below pre-set standards;
 - d) the removal of particular services from the contractor;
 - e) in exceptional circumstances, the right to terminate the contract.
- 4.6 The Department has estimated, in accordance with Efficiency Unit guidelines, that the contract with Sema Group will save approximately £23.6 million, excluding the cost of the market test, over the first five years of the contract; a reduction of 32 per cent on the cost of providing ED5 services prior to letting the contract.

Conclusions on the achievement of objectives

On protecting the tax-payers' interest

On the setting of objectives

- 4.7 The Department's strategic objective for this market test was consistent with Government policy in the Competing for Quality White Paper. In seeking to meet the timetable approved by Ministers, the Department also had regard to the need to achieve value for money, to provide a high quality service to users, and to protect the interests of its staff.

On the timing of the market test

- 4.8 The Department met the revised timetable approved by Ministers of submitting final recommendations to them by 30 June 1994.

On the preparations for the market test

- 4.9 The National Audit Office note that the Department took professional advice, commissioned scoping and risk assessment studies and established clear customer liaison arrangements to ensure that the market test proceeded as smoothly as possible. For future market tests, the National Audit Office recommend that scoping studies should not be undertaken by the organisation subject to the market test and should be broadened out to include a risk analysis, technical assessment and business review.

On the choice of procurement route

- 4.10 The negotiated procedures route was adopted following professional advice. This approach was justified by the complexity of the services being market tested; the need to resolve key technical and other issues such as the handling of assets and staffing arrangements; and the fact that the final specifications and workloads could only be determined after consultation with the shortlisted bidders.
- 4.11 The Department told the National Audit Office that the fact that so few bids had been received was due:
- a) to the withdrawal of three firms early in the procurement process, following the competition for partnership with the in-house team;
 - b) to the fact that at least two major companies, who would normally have been expected to tender, were bidding for other, much larger information technology contracts at around the same time.
- 4.12 In view of these difficulties, it would probably be helpful for future market tests if questions relating to an in-house team's links with a commercial partner could be resolved at the start of the procurement process. The timing of the market test should also have regard to what else may be happening in the market.
- 4.13 Under the negotiated procedure adopted for the procurement, the final and detailed costs and revenues associated with each bid only became available at the Best and Final Offer stage, when the negotiations were complete and the bids were effectively frozen. The Department told the National Audit Office that inviting indicative offers before the conclusion of detailed negotiations could have given rise to difficulties in relation to the propriety of the procurement arrangements. It might have led to the belief that the indicative offer could be used as a mechanism to influence the final costs in a manner which could favour a particular bidder and thus the outcome of the competition. By opening up this possibility, the Department would then have found it extremely difficult to reject any subsequent challenges that indicative price information had been misused in such a way. The Department said that under the procedures it had adopted, which it regarded as consistent with Treasury and CCTA guidance on the conduct of procurements, it would have been possible to have invited all bidders to re-submit if none of the Best and Final Offers had met its requirements.

On the evaluation of Best and Final Offers

- 4.14 Detailed contract negotiations successfully ensured that both offers were technically capable of providing the required services. Although the in-house Best and Final Offer envisaged selling the mainframe computers to Hoskyns Plc four months after the sale date rather than the six months agreed with the Department, the financial consequences would not have been significant and, having taken legal advice, the Department therefore decided to treat the bid as being fully compliant.

- 4.15 The Best and Final Offers were made up of a number of elements, including tariff charges, accounting adjustments and transitional costs. The in-house team submitted the lowest tariff prices for the services to be provided under the contract, but the total cost of their bid exceeded tariffed income by £12.2 million because it was based on workload assumptions that far exceeded the Department's forecasts.
- 4.16 Since the Department would have been liable for any unrecovered costs, they decided that the in-house bid would have to be adjusted to reflect this shortfall. As this adjustment was more than the difference between the bids, the extent to which the contract awarded to the Sema Group represented best value for money depends both on the need for and size of that adjustment.

On the need for a revenue adjustment

- 4.17 In the National Audit Office's view, the revenue adjustment was clearly necessary to put the two bids on a comparable basis. The Department had no reason to assume that the in-house team would be able to generate the extra work needed to cover their costs because:
- a) the lower workload figures on which the Department conducted its evaluation were based upon estimates of demand prepared by ED5 customers;
 - b) there was likely to be insufficient revenue from other Home Office contracts to cover the whole of the shortfall;
 - c) the in-house business plan did not specify the source or extent of the income to be won from other clients;
 - d) Hoskyns Plc did not underpin the in-house Best and Final Offer with a guaranteed minimum extra contractual work.

On the size of the revenue adjustment

- 4.18 The National Audit Office reviewed how the revenue adjustment had been calculated. We conclude that while it was broadly the right size, there were a number of items that were not fully reflected in it. Some would have increased the adjustment while others would have reduced it. They do not, however, invalidate the Department's decision to award the contract to the Sema Group.
- 4.19 At the end of the contract, it is possible that most, if not all, of those who would have been seconded to Hoskyns Plc would have been made redundant. However, the Department did not take these costs into account when evaluating the in-house team's Best and Final Offer. The Department told the National Audit Office that it had been advised against including these costs on the grounds that:
- a) the gap between the two bids was already too wide to make such an adjustment necessary;

- b) the calculation of future redundancy costs would have been extremely complex and difficult, not only because such calculations are grade and salary dependent but also because they are highly age sensitive. The Department's accountancy advisers therefore believed that any attempt to forecast the redundancy liabilities would provide estimates of spurious accuracy. Only if the costs of the two bids had been closer might they have advised that probability theory should be applied.

On other factors influencing the cost of the final offers

i) The technical capability of the in-house bid

- 4.20 The Department's information technology specialists did not consider that the in-house Best and Final Offer devoted sufficient resources to Desk Top Management Support and two other services. The Department did not take this into account when evaluating Best and Final Offers.
- 4.21 The National Audit Office note that leaving such issues to post contract negotiations could have adverse effects. The extra costs that might subsequently have to be incurred could result in a contract not being awarded to the bidder who actually put in the cheapest offer. The Department told us, however, that it would not have postponed this issue to post contract negotiations: had the bids been closer, the in-house team would have been approached for clarification before a decision was made between the bids.

ii) Training costs

- 4.22 As part of the in-house bid, Hoskyns Plc offered to provide £1 million of free training to ED5 staff. This offer was a function of the relationship between the in-house bid team and Hoskyns Plc. Training was not a bid cost but was a matter for the in-house bid team to take into account. Nevertheless, the inclusion of free items complicates the comparison of Best and Final Offers and these should be avoided wherever possible. Bidders should be required to cost each item separately and include any proposed subsidies in their Best and Final Offer. This will help to ensure parity of treatment between the bids received and assist the Department to assess whether the proposed cost structure is consistent with the proposed service delivery. Where free items are unavoidable these should always be written into the contract to ensure that the promised facility is delivered.

iii) Removal costs

- 4.23 The in-house team stated that, should their bid be successful, they would wish to move out of St Johns House to alternative accommodation in Liverpool. However, these removal costs were not separately identified and the in-house team confirmed that these were subsumed within other costs.
- 4.24 The costs of removal were likely to be sizeable; Sema Group estimated them to be around £1 million. The National Audit Office recommend for the future that Best and Final Offers be required to distinguish between operational and

overhead items and that all costs and revenues be separately disclosed. In the absence of such disclosure it is difficult to take a fully informed view on all key issues.

(iv) Discounting techniques

- 4.25 When calculating the net present value of the bids, the Department assumed that payments would occur at the end of each year. This favoured the in-house bid, which had lower transitional costs and higher annual running costs. This treatment is inappropriate when payments are incurred evenly throughout the year, although in this case it was not significant to the outcome. Discounting cash flows to a mid rather than end point in each year would have increased the difference in net cost between the Best and Final Offers by £129,000 in the Sema Group's favour.

Conclusions

On protecting the taxpayers' interests

- 4.26 The Department took appropriate steps to ensure that there was parity of treatment between the two bids. In the light of the legal advice received and the Department's workload assumptions, which are broadly consistent with actual workloads since the contract was let, the need for and size of the adjustment to the in-house bid seems justified. The Best and Final Offer from Sema Group therefore represented better value for money to the Home Office.

On the provision of a continuous service

- 4.27 The National Audit Office were satisfied that ED5 continued to provide an adequate service in the period prior to the market test, that sufficient attention was given to standards of service during the evaluation stages, and that there are sufficient controls over service quality built into the contract (paragraphs 2.11 to 2.13 and 4.5).

On protecting staff interests

- 4.28 The application of the TUPE regulations protected staff terms and conditions of employment. Pension arrangements were adequately protected by the new Sema Group pension scheme which the Government Actuaries Department confirmed offered broadly comparable benefits to those available in the Principal Civil Service Pension Scheme (paragraphs 2.16 to 2.19).

On the cost of the market test

- 4.29 The cost of the market test was £1.565 million (see Appendix 3), around 3 per cent of the estimated contract value. No overall budgets were set for this market test at the outset, but costs were controlled by the Project Board and Market Testing Unit: all expenditure was approved in advance and contained within Departmental budgets.

Appendix 1

Consultants and other firms assisting the market testing unit

Information technology advisers

CCTA	Main advisers on information technology and provided advice on contract negotiations and market intelligence
Touche Ross Consultants	The valuation of information technology assets - March 1995
P.A. Consultants	The specification of contract services

Negotiations advisers

Brian Farrington Ltd	The provision of contract negotiation training
Kermon Consultants	The provision of specialist advice during the contract negotiations

Legal advisers

Theodore Goddard	Advice on the legal aspects of the market test
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Other advisers

David Cronin	Risk analysis of the market test procedures
Government Actuaries Department	Actuarial advice on staff pensions
Ken Worthy Associates	Advice on individual service tariff structures
KPMG Peat Marwick	Independent accountancy advice for the evaluation of Best and Final Offers

Appendix 2

Key dates in the market test of ED5

1991

November Competing for Quality White Paper published.

1992

March ED5 identified by Coopers & Lybrand as a candidate for market testing.

June Home Office market test programme announced. ED5 is included in the list of services to be market tested.

July Project Board established and a scoping study is commissioned from ED5.

December Project Board consider the ED5 scoping study. This is rejected because it only recommends small areas of ED5 for contracting out.

1993

January Market Testing Unit issue revised scoping study recommending that all, except the new large scale development work, ED5 Information Technology functions be subject to market testing. The market test of pay services should be deferred.

February Requests for Information sent to facilities management companies.

April Advertisement placed in Official Journal of European Community (OJEC).

May Deadline for responses to the OJEC advertisement.

August Request for Proposals sent to companies that were short-listed following the evaluation of responses to the OJEC Advertisement.

October Deadline for responses to the Request for Proposals document.

November Two candidates, Sema Group and the in-house bid, invited to proceed to detailed contract negotiations.

1994

June	Best and Final Offers received and evaluated and submission to Ministers made.
July	Decision by Ministers to offer contract to Sema Group.
August	Transition period begins.
November	Handover to Sema Group. Start of main contract.

Appendix 3

The cost of the market test

Home Office Administration	
	£
Staff costs	708,508
Travel and subsistence	21,291
Accommodation	421,147
Expenditure on Consultants listed at Appendix 1	368,187
Other costs	45,935
Total Cost	1,565,068