

The PFI Contracts for Bridgend and Fazakerley Prisons



This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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*Aerial view of Bridgend
Prison*



*Aerial view of Fazakerley
Prison*



Preface

The contracts to design, construct, manage and finance new prisons at Fazakerley in Liverpool and Bridgend in South Wales were let as part of the Private Finance Initiative introduced by the previous Conservative Government. The Private Finance Initiative was announced by the former Chancellor of the Exchequer in his 1992 Autumn Statement. Its aim was to bring the private sector more directly into the provision of public services, with the public sector as an enabler and, where appropriate, guardian of the interests of the users and customers of public services. The most important objective was that Departments and Executive Agencies should benefit from appropriate private sector skills in the procurement and delivery of services, thereby improving the value for money of public sector projects.

Departments and Agencies were required to consider the Private Finance Initiative for all public sector capital projects. Two fundamental requirements for a Private Finance Initiative project were established: value for money had to be demonstrated and the private sector had to genuinely assume risk. The process by which contracts were let had to be competitive. Only if the project was unsuitable for private finance, or if the private finance option did not represent value for money, were traditional public sector procurement routes to be considered.

In the Autumn of 1993 the then Home Secretary announced that, as part of the strategy for further involvement of the private sector in the Prison Service, companies would be invited to design, construct, manage and finance six new prisons. The first two such contracts let by the Prison Service were for the prisons at Fazakerley and Bridgend.

Executive summary

1 In December 1995 and January 1996 the Prison Service awarded contracts to private sector contractors to design, construct and finance new prisons at Fazakerley and Bridgend and to operate them for a period of 25 years, with the buildings being transferred to the public sector at the end of the period. The contract for Fazakerley (now known as HMP Altcourse) was awarded to a partnership comprising Group 4 Securitas and Tarmac Construction Limited (Group 4/Tarmac); the contract for Bridgend (now known as HMP Parc) was awarded to a consortium comprising Securicor Custodial Services Limited, Costain Group plc, WS Atkins Limited, John Seifert Limited and Skanska International Building AB (the Securicor/Costain consortium). The procurement of custodial services was based on an output specification which set out the services to be delivered, and asked the private sector bidders to propose the ways in which the services would be provided. These contracts were the first under the Private Finance Initiative (PFI), which involved the construction of buildings.

Key facts about the contracts

Figure 1

| | Bridgend | Fazakerley |
|--|------------------------------|-------------------------|
| Date contract let | 4 January 1996 | 20 December 1995 |
| Number of prisoner places | 800 | 600 |
| Type of prison ¹ | Category B local prison | Category B local prison |
| Selected contractors | Securicor/Costain consortium | Group 4/Tarmac |
| Net present value of: | | |
| ■ Contract price | £266m | £247m |
| ■ Average annual cost of each prisoner place | £13,300 | £16,467 |

Note 1. These prisons will contain mainly Category B prisoners, for whom the highest conditions of security are not necessary, but for whom escape must be made very difficult. As local prisons they will hold prisoners on remand, awaiting sentence, serving short sentences or awaiting transfer to another prison. Both prisons are also designed as capable of holding Category A prisoners, for whom the highest conditions of security are required.

Source: The Prison Service, Lazards and the National Audit Office

2 This report examines the service to be provided, the obtainable PFI solutions, the comparison with traditional procurement and the letting of the contracts.

The service to be provided

3 The Prison Service are likely to receive a service which is consistent with the requirements they identified in 1994 and early 1995. By providing 1400 new prisoner places, the two prisons should make a significant contribution to prison accommodation at a time when overcrowding in prisons is occurring (paragraphs 1.2, 1.19 and 1.25).

4 A key feature of these PFI contracts is that the private sector contractors will be responsible for all custodial services. They will also be responsible for ancillary services such as catering, prisoner education and onsite medical facilities (paragraphs 1.21-1.23).

5 The Prison Service have sought to establish procedures with their chosen contractors which will ensure issues are resolved quickly and encourage opportunities for developing the projects in a mutually beneficial way to be identified and pursued. This partnering approach is an important feature, given that the contracts run for 25 years (paragraphs 1.29-1.30).

The PFI solutions

6 The PFI solutions required the Prison Service to pioneer new procurement processes in an emerging market with a view to achieving a competitive market for future projects. This influenced their handling of these first two contracts (paragraph 2.2).

The use of different contractors for each prison

7 The Prison Service let each contract to different bidders because they saw risks in letting two major PFI contracts to one bidder. This reflected the potential risks faced by a contractor in a new market using an untested prototype design which could adversely affect the service delivery at both locations. The Service also wished to avoid concentrating the market in one supplier to ensure a good level of competition in future PFI procurement projects (paragraphs 2.12 - 2.13).

8 The Service recognised that there would be an additional cost of £19 million as a result of not awarding both contracts to the lowest bidder. However, the lowest bidder for each contract, the Securicor/Costain consortium, told the Prison Service that additional savings could be delivered through economies of scale in the event of them being awarded both contracts, but the Service did not ask them, or other bidders, to quantify the additional savings that might be delivered. The Prison Service told the National Audit Office that it was a strategic decision not to let both contracts to the same supplier. The Service did not regard the argument that the savings foregone might have been greater than £19 million as relevant to determining whether they made a sound value for money decision (paragraphs 2.13 - 2.15 and 2.19).

9 The Prison Service's strategic decision not to let both contracts to the same supplier was finalised at the time they selected preferred bidders. Although it is not possible, after the event, to be certain about the additional savings that might have arisen the Securicor/Costain consortium say that for the prospect of working on both contracts they could have reduced their bids by up to five per cent. Our advisers, property consultants Chesterton, consider this a reasonable indication of savings that might have been achievable but the Prison Service and their civil engineers, Ove Arup, subsequently considered that such savings are more likely to have been at best in the order of 3 per cent. The additional costs of using two contractors would have increased by £5 million for each one per cent reduction in Securicor/Costain's bids (paragraphs 2.16 - 2.19).

10 By using two different contractors the Service hoped to encourage the developing market, leading to improvements in value for money on future PFI prison contracts. This strategy contributed partly to the lower unit price which the Service achieved when letting the third PFI prison contract for Lowdham Grange in November 1996 which has been recognised by the Private Finance Panel Executive. The Service also identified before letting the Fazakerley contract to Group 4/Tarmac that the Service's programme for producing additional houseblocks on the existing prison estate would also benefit from a new construction technique developed by Tarmac for the Fazakerley prison. Tarmac were subsequently awarded contracts for the construction of seven further houseblocks at various prisons using the new technique (paragraphs 2.20 - 2.21).

Innovation

11 The bids submitted by the Securicor/Costain consortium were based on a design which used much less space than that assumed by other bidders. The design, which was adopted at Bridgend, clearly reduced costs but as no other bidders had suggested using this design there were no competitive prices for this particular solution. **A feature of the PFI is that bidders are encouraged to provide, in competition, innovative solutions to a specification of required services. This may result in particular solutions which reduce costs but which have only been priced by one bidder. This contrasts with traditional procurement where there is less scope for innovation as the required solution is more tightly defined but the solution is then priced by each bidder** (paragraphs 2.24-2.26).

The contract terms

12 The extent to which value for money will be secured during the 25 year contract periods will depend on how the contractors' prices compare with charges by other providers for similar services. It is possible that unit prices on comparable projects may reduce through competition as a market for prisons procured under the PFI develops or through pressure on the Service to further reduce their costs. **There is no requirement, however, for the Bridgend and Fazakerley contract prices to remain in line with the charges of other suppliers during the contract periods. Bidders might have sought increases in their prices if this arrangement had been required but this issue was not tested by the Prison Service** (paragraph 2.42).

13 Parts of the contractors' charges are increased automatically each year by indexation formulae and the contractors can claim for other price increases arising from factors beyond their control relating to the operation and maintenance of the prisons. The contract terms relating to price variations are complex and, in some important areas, might be capable of more than one interpretation, particularly as to whether changes in costs such as utilities, bank interest, VAT and other taxation can trigger a price increase (paragraph 2.42).

14 In each contract the Prison Service are liable to repay part or all of the contractor's borrowings if the contract is terminated after the prison is complete because the original operator defaults and no replacement operator is willing to run the completed prison in the manner required. The Service's financial advisers, Lazard's, estimated that the maximum payable by the Service under this arrangement would be £68 million at Bridgend and

£84 million at Fazakerley but the actual amount payable would be less if any of the contractors' borrowings have been repaid or if the outstanding value of the contract is less than the borrowings. The Service would be allowed to deduct from the amount payable any additional expenses they expect to incur in obtaining the required level of service for the remainder of the original contract period. **After testing this in competition the Service came to the view that they were obliged to accept this arrangement in order to make the projects acceptable to bidders** (paragraphs 2.43-2.49).

Comparison with traditional procurement methods

15 The chosen PFI solutions should deliver a number of benefits compared to traditional procurement methods. These include a faster construction period, the introduction of innovative forms of design and operational methods and the transfer of some major risks to the private sector, relating to construction, maintenance and operations. In addition, the PFI solutions have enabled the Prison Service to start projects which would otherwise have had to be deferred. The Private Finance Panel Executive recognised the Prison Service's achievements in letting these contracts and the lessons for future PFI projects (paragraphs 3.2 and 3.5).

16 The Service estimate that the PFI solutions will deliver aggregate cost savings of 10 per cent when compared with building prisons using public finance and contracting out the operating to the private sector. The estimate is based on a number of assumptions relating to future events during the 25 year contract periods. Given this long contract period there is a risk that the actual outturn may be different from the estimate. All of the estimated savings relate to the Bridgend project; the Fazakerley PFI solution is estimated to cost approximately the same as the public sector comparator (paragraph 3.2).

Letting the contracts

17 Because the Prison Service were developing a new procurement approach the contracts were let nine months later than the original target date of 31 March 1995. The Service subsequently applied lessons learned from this process in their preparations for the Lowdham Grange PFI prison contract which was let in November 1996 (paragraphs 4.4 and 4.8-4.9).

18 The cost of advisers and consultants of £1.6 million reflected the work required for a new and complex method of procurement. The cost was more than double the estimate of £0.6 million because the Prison Service had no

previous experience of a major PFI contract, underestimated the amount and complexity of work that was necessary and did not expect to have to retender during the procurement. They did, however, establish procedures to monitor and cap expenditure on legal advice which amounted to £0.8 million compared to an initial estimate of £0.2 million (paragraphs 4.10 and 4.13-4.14).

19 The contract for the Service's financial adviser, Lazard's, was let without competition. The Service's reason for this was that Lazard's had been awarded a much smaller contract in competition to give advice on PFI matters and because of time pressures this was extended to the Bridgend and Fazakerley contracts. The Public Accounts Committee, however, have previously recommended that competition should be applied in all save the most exceptional circumstances and the principle of competition is included in guidance from the Treasury and the Private Finance Panel (paragraphs 4.11 - 4.12).

Recommendations

20 The National Audit Office identified the following key lessons for future projects:

Letting of multiple contracts

1. Where more than one contract is being let simultaneously, Departments should consider whether bidders would be prepared to reduce their proposed contract prices for the benefit of working on more than one contract. This would need to be balanced against other benefits which individual bidders could provide and the possibility that Departments might be exposed to a greater degree of risk where there is only one provider (paragraphs 2.15-2.18).

Linking the contract price to the prices of other suppliers

2. Where Departments are committed to very long term contracts they should consider including a facility for contract prices to be compared at periodic intervals with those charged by both public and private sector providers of comparable services and for contract prices to be adjusted if they are more expensive than the charges of other providers. In considering whether this is likely to improve value for money Departments will need to take account of expected changes in the market, the implications for competition and any variations to the pricing arrangements (including upwards price revisions) which contractors may require in return for agreeing to this facility (paragraph 2.42).

3. Departments should seek to ensure, before signing a PFI contract, that the contract unambiguously reflects their understanding of how risks are to be allocated between the signatories (paragraph 2.42).

Clarity of contract terms

4. Even where an adviser has provided preliminary advice on PFI matters, Departments should normally appoint advisers for PFI projects after competition. This would be consistent with public sector requirements on procurement and the recommendations of the Public Accounts Committee. It would enable Departments to demonstrate that both the quality and the price of alternative advisers were fully considered and that the best possible value for money has been secured (paragraphs 4.11-4.12).

Appointment of advisers through competition

5. Departments should gather information which will enable them to establish an accurate budget for each adviser's costs at the earliest practicable stage in a PFI procurement process. Particular care should be taken with the preparation of budgets for legal work as this is likely to be one of the major items of expenditure in connection with the letting of a PFI contract (paragraphs 4.10 and 4.13-4.14).

Setting budgets for advisers' costs

6. In a long term contract arrangement there are likely to be benefits from a cooperative relationship between the customer and the supplier. They may find it to their mutual advantage to collaborate closely in order to resolve issues quickly and deliver cost reductions, improved quality or innovative solutions. Departments should consider such partnering arrangements as they plan future PFI projects (paragraphs 1.29-1.30).

Partnering

21 Other recommendations on the handling of PFI projects were contained in the National Audit Office's reports on the Skye Bridge (HC5 Session 1997-98) and the Contract to Develop and Operate the Replacement National Insurance Recording System (HC12 Session 1997-98).

1. Service delivery under the contracts

1.1 This Part of the report considers the extent to which the Prison Service are likely to receive the service they require during the contract periods. It examines how far the Prison Service:

- took reasonable steps to identify their needs in respect of the new prisons at Bridgend and Fazakerley;
- communicated these needs clearly to bidders;
- ensured that the contracts they entered into are likely to deliver the service which they require;
- took account of the requirement for them to place increased emphasis on reducing costs; and
- have sought to adopt a partnering approach with their chosen contractors.

The Prison Service's identification of their needs

The need for new prisons was identified in an accommodation appraisal

1.2 The Prison Service identified the need for new prisons in South Wales and the North West in an accommodation appraisal completed in March 1992. Following the then Home Secretary's announcement in the autumn of 1993 that six new prisons would be built under the PFI the Service further assessed their need for prison accommodation in these two locations. By the end of 1994 they decided that, to meet current needs and to provide the greatest flexibility for meeting future changes in needs, they should commission:

- an 800 place Category B local prison at Bridgend, South Wales (holding prisoners on remand, those awaiting sentence, serving short sentences or awaiting a transfer to another prison), designed to be capable of holding juvenile and female prisoners and built to the standard of security necessary for accommodating a small number of Category A prisoners (those requiring the highest level of security); and

- a 600 place Category B local prison at Fazakerley, Merseyside designed to be capable of the same range of functions as Bridgend.

Further information on the Prison Service is set out in Appendix 2.

The Prison Service have subsequently sought to increase the available accommodation at Fazakerley

1.3 Since letting the 600 place Fazakerley contract in December 1995 the Prison Service have sought to build a further houseblock at Fazakerley for 118 prisoners to help reduce overcrowding in the Prison Estate. This is subject to obtaining planning permission. The Prison Service consider that at the time they planned this prison the need for extra accommodation could not have been anticipated as they saw no immediate major imbalance between the accommodation to be provided and the expected rise in the total prison population.

The PFI was considered the best option

1.4 The Prison Service decided to invite tenders from private sector contractors to design, build, finance and operate the Bridgend and Fazakerley prisons in line with Government policy under the PFI at that time because:

- a) they considered that procuring these prisons under the PFI would deliver benefits which they could not generate from traditional procurement methods; and
- b) having identified that these projects were suitable for private finance, the option of constructing these prisons using public finance could not be met from their budgets for capital projects.

1.5 Following their decision to procure these prisons under the PFI, the Prison Service had to ensure that the projects met the key PFI criteria set out in guidance from the Treasury and the Private Finance Panel that value for money must be demonstrated and the private sector partners must genuinely assume risk.

Aims were identified but objectives were not formally established

1.6 The Prison Service did not formally establish objectives for the two proposed PFI projects. The Service informed the National Audit Office that they took the following factors into account in their approach to the letting of these two PFI contracts:

- a) that new prison accommodation should be provided in South Wales and Merseyside consistent with their operational guidelines and their standards of care for prisoners;
- b) they would select the best available solutions having regard to:
 - the quality, innovation and safety of the design and construction work, and proposed operating regime;
 - value for money;
 - the adequacy and robustness of the providers' financing proposals; and
 - the deliverability of all stages of the projects;
- c) the projects would be required to deliver demonstrable benefits, including the transfer of risk to the providers, compared with traditional procurement methods; and
- d) they initially aimed to let the contracts by 31 March 1995.

1.7 The Service accept that a formal statement of objectives would have provided a clear reference point against which the projects could have been planned and evaluated and prior to this examination had prepared a formal statement of objectives for the subsequent PFI prison project at Lowdham Grange.

Planning the projects and letting the contracts was spread over three years

1.8 A chronology of key events is set out in Appendix 3. The Prison Service started to plan the projects in January 1993 and the processes leading up to the letting of the contracts were spread over the next three years.

The Prison Service's needs were developed into an output specification

1.9 The Prison Service acquired sites at Bridgend and Fazakerley and obtained outline planning approval; in the latter instance only after a public inquiry when the proposed new prison had been strongly opposed by the local planning authority. The Service developed their detailed needs for the new prisons and set these out in an output specification which was provided to bidders (Appendix 4). The specification covered both prisons.

The communication of needs to bidders

The Prison Service informed bidders of their requirements

1.10 At an early stage in the planning process the Service confirmed the level of market interest by discussing their requirements informally with private sector firms whom they considered might be interested in bidding for these projects. In November 1993, in accordance with EC procurement procedures, they published notices in the Official Journal of the European Communities (OJEC) inviting private sector expressions of interest.

1.11 In December 1993 the Prison Service held a one day conference for potential bidders. All the bidders told the National Audit Office that the conference was helpful in enabling them to clarify matters which would be relevant to the preparation of their bids.

1.12 The Prison Service also gave bidders an opportunity to submit written questions. As they had previously indicated to bidders, they circulated the questions and answers to all bidders, but without revealing the name of the party which had posed the question. The bidders' conference and the circulation of questions and answers were positive features which allowed the Service to clarify their needs to bidders while at the same time ensuring all bidders had equal access to information.

The initial invitation to tender resulted in non-compliant bids

1.13 In July 1994 the Prison Service issued invitations to tender. The documentation provided to bidders included:

- the output specification which set out the services required;
- an outline contract specifying the main terms and conditions; and
- a statement of the factors which would be taken into account in evaluating bids.

1.14 None of the parties invited to tender felt able to comply with all of the Prison Service's terms and conditions and as a result all bids were non-compliant. The bidders' concerns related mainly to the nature of the risks they were being asked to bear: principally that the occupancy of all available places would not be guaranteed and that no compensation would be paid to the banks providing debt finance if the contracts were terminated because of contractor default. Some of the terms which were rejected by bidders, including the suggestion that the contract price should be linked to occupancy rates, had been proposed by the Treasury in order to test the willingness of the private sector to assume risk.

The Prison Service revised their specification

1.15 In view of the bidders' concerns in the first round of tendering the Prison Service revised their specification, principally in respect of how risks would be allocated between them and the contractor, to arrive at what they believed would be transactions which would attract support from the contractors' banks while still meeting the PFI criteria of value for money and risk transfer. In making these changes they obtained advice from: Lazard's, their financial advisers, whom they appointed in June 1994; Coopers & Lybrand whom they appointed in November 1994 to provide project management support; and Freshfields, whom the Treasury Solicitors appointed in January 1995 to provide legal support on the commercial and financial aspects of the transactions which would supplement their work for the Prison Service and that of the Government Property Lawyers.

1.16 In addition, the Prison Service amended the output specification to include a revised performance measurement system, whereby the contractor can be penalised for a poor standard of service and also to reflect new security requirements. These arose from the December 1994 Woodcock Enquiry which

had been commissioned following the escape of prisoners from Whitemoor Prison. The Woodcock Enquiry's recommendations had significant implications for the design of maximum security establishments and for the day to day operations of their security and control procedures. Although Bridgend and Fazakerley were designated Category B prisons, they were designed to house all categories of prisoner, including Category A, and the Service had to reconsider their design and operational requirements for both prisons in the light of the Woodcock Enquiry.

1.17 The Service issued a revised invitation to tender in February 1995. Details of the revised specifications provided to bidders are set out in Appendix 4 and the factors which they told bidders they would take into account when evaluating bids are in Figure 2. This second invitation to tender, which added four months to the contract letting timetable, resulted in five compliant bids for each project.

1.18 The Prison Service's experience reflected the difficulties Departments can face in establishing acceptable terms for a deal when there is no precedent for the particular PFI project. The main lesson which the Service have identified is the need to consider carefully, before issuing an invitation to tender, the likely reaction of bidders to proposed terms and conditions, including the allocation of risks between the contracting parties. The early appointment of advisers is likely to be critical to this exercise, particularly where a Department or Agency have no previous experience of PFI contracts. The Service's success in letting a third PFI contract, for Lowdham Grange, within 11 months from issuing an invitation to negotiate, compared to 17 months for Bridgend and Fazakerley, indicates that lessons from the first competition have been learned and acted upon.

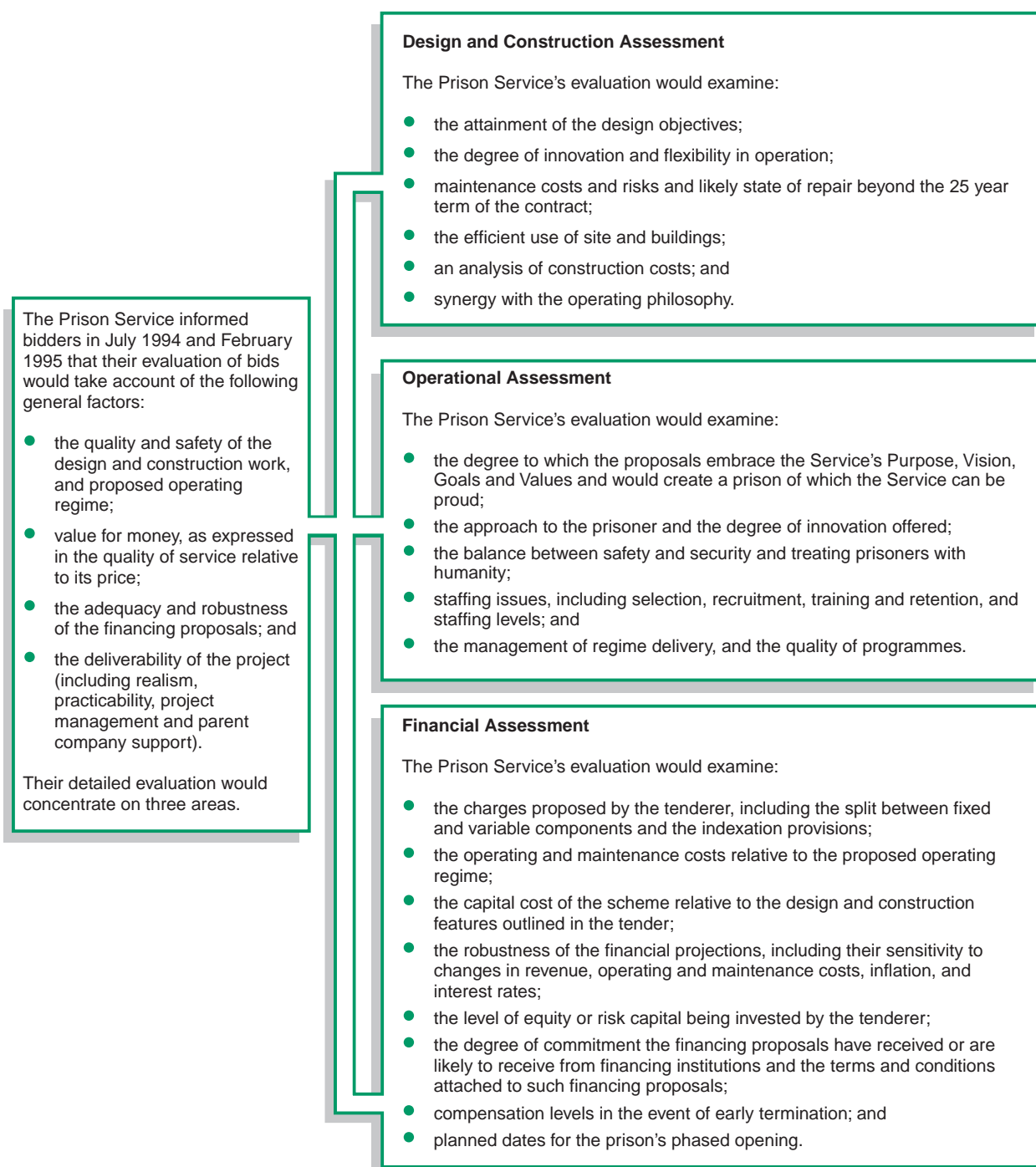
The form of the contracts and performance to date

The Bridgend and Fazakerley contracts are consistent with the specification

1.19 The Prison Service let a contract for Fazakerley prison to Group 4/Tarmac on 20 December 1995 and a contract for Bridgend prison to the Securicor/Costain consortium on 4 January 1996. The contracts require the contractors to build and deliver a standard of operating and custodial service over 25 years in a manner which is consistent with the Prison Service's needs, as defined in the specification which they prepared in February 1995 (Appendix 4). The designs will allow the Service flexibility to vary the mix of prisoners in each prison; for example, both prisons could accommodate female and Category A prisoners. To date there are no plans to hold female prisoners at either location but in January 1997 the Prison

Figure 2

Bid evaluation



Note: The method by which the Prison Service evaluated bids is described in more detail in Appendix 5.

Source: The Prison Service

This figure shows that the Prison Service's evaluation of bids concentrated on design and construction, operations, and financing.

Service announced that Fazakerley would be one of only seven of the Service's 37 local prisons where a high standard of modern security necessary to hold Category A prisoners is provided.

1.20 There is provision for the Service to request service changes during the contract periods. However, if these are significant, as defined in the contracts, the contractors would be allowed to renegotiate the contract price. Failure to agree proposed price changes can be settled by arbitration. The contractor can also propose changes to the design, operation or other aspects of the service which can be accepted or rejected by the Prison Service. This has happened where the Prison Service have accepted earlier than planned opening at both prisons and the proposal for a further houseblock at Fazakerley.

Custodial and ancillary services will be supplied by the private sector

1.21 A key feature of the PFI contracts is that both the prisons will be operated by custodial staff provided by the private sector operators (Securicor at Bridgend and Group 4 at Fazakerley). This builds on the Prison Service's strategy in recent years to make use of private sector custodial staff in new prisons; four new prisons built under traditional building programmes were contracted out to private sector management between 1992 and 1994.

1.22 The private sector operators are required to follow Prison Service procedures for the security of prisoners but were allowed to submit their own plans for the treatment of prisoners and how they proposed to deploy their staff within the prisons which they would also design.

1.23 The private sector operators are also responsible for the provision of ancillary services such as catering, prisoner education and onsite medical facilities. They are also responsible for the maintenance of the prisons throughout the contract periods.

There are controls to monitor the contractors' performance

1.24 The Prison Service have a number of controls designed to monitor the contractors' performance:

- they have appointed Mouchel and Ove Arup, as experienced engineers, to monitor progress on the building work and compliance with the terms of the contract. The contracts provide that payments to the contractor only commence when the prison is built and ready for occupation but in view of overcrowding in existing prisons it is important to the Prison Service that the new prisons become available on or before the contract target dates; and
- when the prisons become operational they will each have a Prison Service Controller, who will monitor service provision against the contract. The contracts set out financial penalties for lapses in operating performance by the contractor, for example related to security and the level of regime provided to prisoners. The penalties do not extend to non-custodial services such as facilities management although a failure to comply with the agreed maintenance provisions could result in some or all of the prison accommodation ceasing to meet the standards required by the contract. In this event the Service would not have to pay the relevant part of the contract fee to the contractor. If the Service were to incur additional expenses, for example through rehousing prisoners, they would seek legal action to recover these expenses from the contractors. In addition the contractor would lose their equity investment if the Prison Service were to terminate the contract as a result of a material default by the contractor.

The construction work is running ahead of schedule at both prisons

1.25 Since the contracts were let the construction work at both Bridgend and Fazakerley is running ahead of schedule so that new prison accommodation should become available at an early date to ease overcrowding problems. Bridgend will now take its first prisoners a month earlier than the original contract target of December 1997. Fazakerley is expected to take its first prisoners in December 1997 compared with the contract target of the end of May 1998.

The Prison Service's requirement to reduce costs

The two prisons are expected to contribute to the Service's aim to reduce unit costs

1.26 From its establishment as an Executive Agency the Service have placed increased priority on reducing its unit costs. They consider that the introduction of private sector operators at existing prisons whose operations have been contracted out, and the involvement of private sector operators in the prisons being built under the PFI, are contributing to a reduction in the Service's unit costs. Further analysis of the expected benefits from the PFI solutions for Bridgend and Fazakerley is set out in Part 3. The Service also consider that the introduction of private sector operators has provided a useful benchmark against which the costs of publicly operated prisons can be compared.

A third PFI contract has subsequently been let at a lower unit cost

1.27 Since the PFI contracts for Bridgend and Fazakerley were let the Service let a contract in November 1996 for the third PFI prison at Lowdham Grange at a cost per prisoner place which was 21 per cent lower than the cost per prisoner place at Bridgend and 36 per cent lower than the cost per prisoner place at Fazakerley (Figure 3). The specification for Lowdham Grange was not directly comparable to those for Bridgend or Fazakerley. It was less demanding in that it required a single function prison that, unlike Bridgend and Fazakerley, could not take Category A or unsentenced prisoners. Nevertheless, in the light of the Service's aim to reduce unit costs, the solution at Lowdham Grange showed that, having set a precedent by accepting a lower cost innovative solution at Bridgend, further unit cost savings could be achieved, compared with both Bridgend and Fazakerley, by using less demanding specifications and less expensive prison designs.

1.28 Securicor, a member of the consortium which was awarded the Bridgend contract, also told the National Audit Office that they would expect the pricing of PFI contracts to reduce in the future as contractors begin to establish a portfolio of PFI contracts. This will enable the contractors to accept a lower price on individual contracts as they will be able to spread the risk that an individual contract might yield a low level of return against other more successful contracts.

Comparative costs per prisoner place of the first three prisons to be built under the PFI

Figure 3

| | Bridgend | Fazakerley | Lowdham Grange |
|--|-----------------|-------------------|-----------------------|
| Net present value of total contract price | £266m | £247m | £131m |
| Number of places | 800 | 600 | 500 |
| Net present value of average annual cost of each prisoner place ¹ | £13,300 | £16,467 | £10,480 |

Note 1. These costs, expressed in net present values, are not comparable with information on costs per prisoner place in the Prison Service Annual Report which are calculated on a different basis and are expressed as cash costs.

This figure shows that in terms of net present value the new prison at Lowdham Grange will provide prisoner places that are 21 per cent cheaper than at Bridgend and 36 per cent cheaper than at Fazakerley. The specification for Lowdham Grange was, however, not directly comparable to those for Bridgend and Fazakerley, but shows that savings can be achieved by less demanding specifications and less expensive designs.

Source: The Prison Service and the National Audit Office

The Prison Service’s relationship with their chosen contractors

The Service have established various partnering practices which should produce benefits

1.29 While the Prison Service’s main objectives have been to secure value for money and risk transfer they have also sought to develop a close working relationship with their chosen contractors to ensure that issues are resolved quickly without the need to go to arbitration and opportunities for developing the projects in a mutually beneficial manner are identified and pursued. This is in line with guidance set out in both the Treasury’s “Setting New Standards: A Guide to Government Procurement” (1995) and “Private Opportunities, Public Benefit” (1995) issued by the Treasury and the Private Finance Panel.

1.30 Examples of how the partnering approach should benefit these projects include:

- the arrangement whereby the contracts provide for the Prison Service and the contractors to share in any benefits arising from new security technology;

- close onsite cooperation between the Prison Service, their contract monitoring engineers and the contractors;
- the contractual facility for the contractor to propose changes to the design, operation or other aspects of the contracts which can be accepted or rejected by the Prison Service; and
- agreed procedures for resolving any disputes.

In addition the Service consider that a partnering approach should help to identify and test new designs, technology and operational procedures which can be implemented across the prison estate.

2. How the PFI solutions were obtained

2.1 This part of the report considers the extent to which the Prison Service secured the best obtainable solutions under the PFI. It examines the following matters which were particularly critical to the outcome of the projects:

- to what extent the Service established competition between bidders and evaluated bids in a manner which was likely to produce the best possible deals;
- why they decided against awarding the contracts for Bridgend and Fazakerley to the same bidder who submitted the lowest bid for each contract;
- whether they could have taken further action to reduce the costs of the two contracts;
- whether the final contracts allocated risks to those who were best able to handle them and at a price which was reasonable to the Prison Service; and
- whether the financial position of the contractors was given due consideration in the evaluation process.

2.2 The PFI solutions that were obtained by the Prison Service, and the decisions that they took prior to letting the contracts, reflect the fact that these projects were the first prisons and also the first major buildings to be procured under the PFI. This required the Service to pioneer new procurement processes in an emerging market with a view to achieving a competitive market for future projects.

The establishment of competition and the evaluation of bids

The Prison Service established a good level of competition for the contracts

2.3 The Prison Service received 60 expressions of interest in response to their notice in the Official Journal of the European Communities. Ten consortia supplied the necessary pre-qualification information and six of these were invited to tender

for the two contracts in the first round of tendering. One of the bidders was disqualified during the first round of bidding; the other five bidders submitted bids for both the Bridgend and Fazakerley projects.

2.4 One of the benefits of the PFI competition organised by the Prison Service was that they succeeded in accessing overseas expertise in prison construction and operations. Three of the five bidders who submitted bids had overseas partners in their consortia (two from the United States and one from France). In addition, one of the preferred bidders, Securicor/Costain, added a Swedish construction partner, Skanska, prior to the second round of bidding and carried out research of American prison designs and operations which has contributed to innovative aspects of their proposals for the prison at Bridgend.

2.5 All the initial bids received were non-compliant (paragraph 1.14). After revising their specification the Prison Service invited all five initial bidders to retender for the two projects. They decided against re-advertising the two projects on the grounds that the first round of tendering had identified all likely bidders and that they did not wish to delay the procurement further.

2.6 The Service established a good level of competition for these contracts. Having five final bidders, however, meant that three of the bidders, who had prepared bids for both Bridgend and Fazakerley prisons, would not be awarded either contract. The costs incurred by unsuccessful bidders in preparing their bids could have been limited if the Service had been able to reduce the number of bidders invited to make final bids. The Service had considered reducing the number of bidders in the first round of tendering from six to three, but were advised by the Treasury Solicitor in May 1994 that their choice of the restricted procurement procedure under EC rules prevented them from doing this. When they retendered the projects they were further advised by the Treasury Solicitor that, if they did not wish to readvertise the projects and wished to use the EC negotiated procurement procedure, they were obliged to invite bids from all the original bidders. In the subsequent letting of the Lowdham Grange PFI contract, where the negotiated procurement procedure was used from the outset, the Service were able to reduce the number of contractors on the basis of indicative bids. They consider, however, that the larger number of final bidders in the first PFI competition was preferable at a time when their knowledge of the market and market sensitivities was limited.

The Prison Service carried out a thorough evaluation process

2.7 Both sets of bids were reviewed by four separate groups, each concentrating on a specific aspect of the bidders' submissions. The membership of the groups is shown at Figure 4. The methods by which the groups assessed the bids are set out in Appendix 5. The factors which the Service had told bidders would be assessed (Figure 2) were developed into four key evaluation areas:

- deliverability;
- financial (including the proposed contract price);
- quality; and
- innovation.

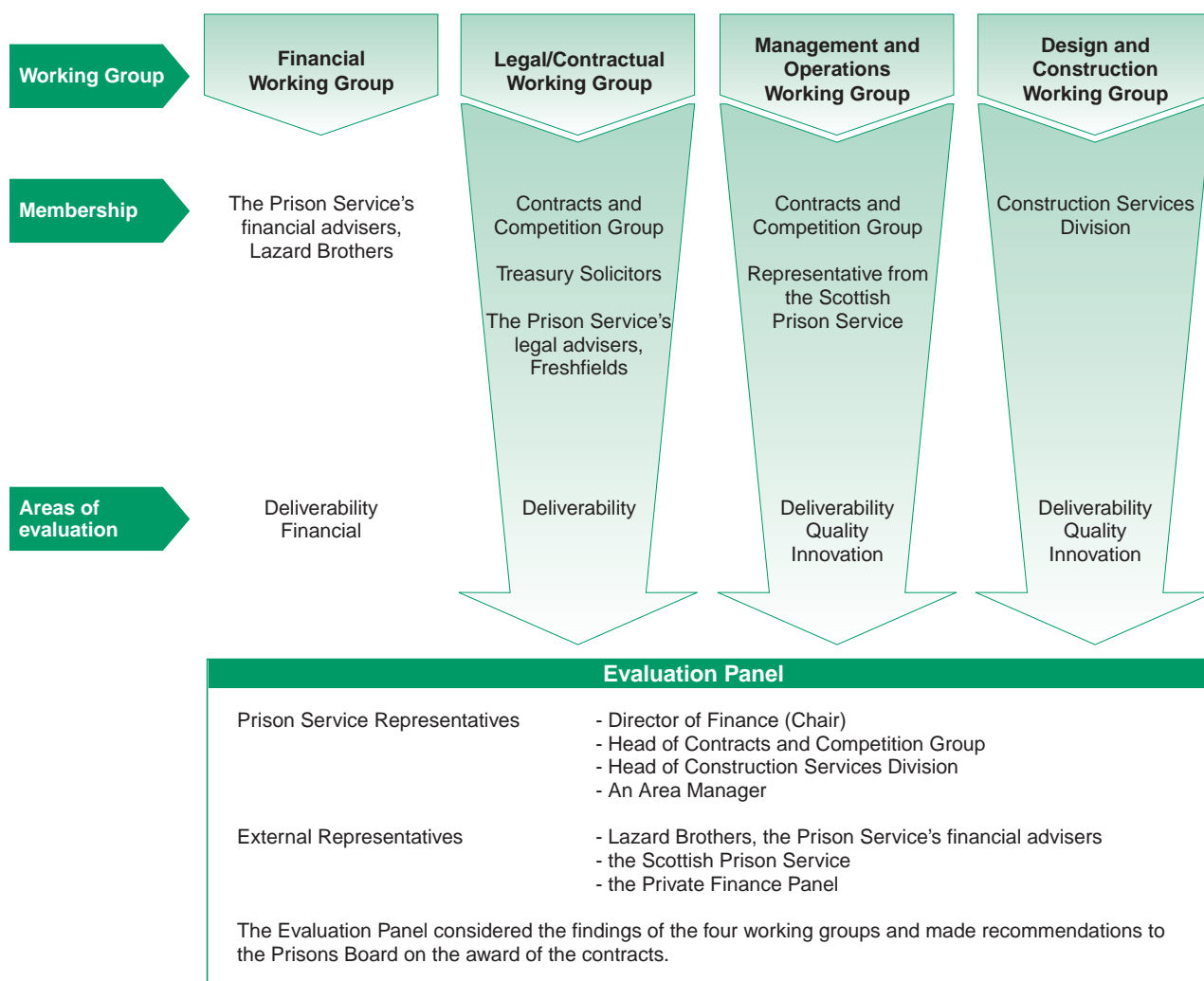
The groups discussed their assessments of the bids with particular emphasis on checking that the operational consequences of proposed design solutions were practical and feasible.

2.8 In the second round of tendering the views of the groups were summarised and considered by an evaluation panel, which included representatives of the groups and individuals from outside the Prison Service with relevant experience (Figure 4). The evaluation panel recommended preferred bidders for approval by the Prison Board which assists the Director General of the Prison Service with management of the Prison Service (Appendix 2).

2.9 The evaluation process was developed from, and is consistent with, the factors which the Prison Service had said they would take into account when assessing bids (Figure 2). There were, however, no guidelines as to how the evaluation panel would arrive at their final ranking of the bids when areas of the evaluation might be in conflict. Although the bidders had been told how their bids would be assessed, they did not receive guidance on how conflicting issues on quality and price would be resolved. Both bidders and evaluation panels are likely to find it helpful if they are informed in advance as to how the final ranking of bids will be determined. The Service issued guidelines on these matters when procuring the Lowdham Grange PFI prison.

Figure 4

The Evaluation Panel and Working Groups



Note: The detailed procedures for evaluating bids are described in Appendix 5.

This figure shows the membership and areas of evaluation of the Evaluation Panel and the four Working Groups.

Source: The Prison Service

2.10 In the Prison Service's bid evaluation, three of the bids for Bridgend and two of the bids for Fazakerley included contract prices which were much more expensive than the other bids and were rejected. The remaining bids were ranked as set out in Figure 5. Based on this ranking, the Service concluded that Securicor/Costain's prices were the most favourable for each prison, being over 10 per cent better than the next best bidder and, although they were ranked only fourth on quality for each prison, the quality scores of all bidders were relatively close. Securicor/Costain were initially awarded a relatively low score, however, for innovation compared to the other two leading bidders because the scoring system gave comparatively little weight to completely new design proposals which differed radically from the standard approach in recent years.

2.11 Before the final selection of preferred bidders the Service had discussions with Securicor/Costain about certain aspects of their proposals. Following these discussions the Service asked Securicor/Costain to make some improvements to their designs and proposed security arrangements. This led to a narrowing of the price gap between the top two bidders. The Service also satisfied themselves as to the operational implications of the innovative features of the Securicor/Costain designs. Only after concluding these discussions and reaching agreement over the design modifications were the Service confident enough to consider awarding a contract to the Securicor/Costain consortium. The final assessment of bids submitted to the Prison Board took account of these, and other discussions with bidders, and also considered innovation as part of the assessment of quality.

The Prison Service's decision not to award both contracts to the same bidder

The Prison Service considered that the risks of awarding both contracts to one bidder were too high

2.12 Although the Prison Service's final evaluation showed that the Securicor/Costain prices (after allowing for the agreed design changes) would be in aggregate just under 10 per cent better than the next best bid for both the Bridgend and Fazakerley projects, they decided against awarding both contracts to the Securicor/Costain consortium. Instead, in May 1995 they awarded the Securicor/Costain consortium the larger Bridgend contract and awarded the smaller Fazakerley contract to Group 4/Tarmac whose proposed contract price was the next lowest for the Fazakerley project, but who had achieved the highest quality and second highest innovation scores.

Figure 5

Summary of the Prison Service's initial evaluation of the three leading bids

| Bidder | Proposed contract price Net Present Value £ million | Ranking ² | | | Variation from the | | |
|-------------------------|---|----------------------|---------|-------------------------|--------------------|-----------------------|---------------------------------------|
| | | Cost | Quality | Innovation ³ | Cheapest Tender % | Best Quality Tender % | Most Innovative Tender ³ % |
| Bridgend | | | | | | | |
| Securicor/Costain | 254 ⁴ | 1 | 4 | 3 | - | 7 | 43 |
| Group 4/Tarmac | 286 | 2 | 1 | 2 | 13 | - | 14 |
| Premier Prison Services | 367 | 3 | 2 | 1 | 45 | 4 | - |
| Fazakerley | | | | | | | |
| Securicor/Costain | 221 | 1 | 4 | 3 | - | 8 | 50 |
| Group 4/Tarmac | 252 ⁴ | 2 | 1 | 2 | 14 | - | 14 |
| Premier Prison Services | 272 | 3 | 2 | 1 | 23 | 4 | - |

- Notes:
1. The evaluation working groups considered that the proposals of all bidders were deliverable.
 2. The ranking represents the relative position of the bid compared with all five bidders. The comparison was based on the method of evaluating bids set out in Appendix 5. A ranking of "1" relates to the most favoured bid in the particular 'category'.
 3. In the Prison Service's final assessment of bids innovation was assessed in conjunction with quality and this assessment reflected additional information gathered by the Service in their discussions with the contractors. (Further details are set out in paragraph 2.11 and Appendix 5).
 4. The net present value of the final contract price for Fazakerley was £247 million (Figure 1) due to a reduction in the contractor's financing costs. The net present value of the final contract price for Bridgend was £266 million (Figure 1) due to amendments to the contractor's proposals (paragraph 2.11) offset by a reduction in their financing costs.

This figure shows that Securicor/Costain submitted the lowest proposed contract price for both prisons, but other bidders were initially ranked more favourably on quality and innovation.

Source: The Prison Service

2.13 The Prison Service told the National Audit Office that it was a strategic decision not to award both contracts to the Securicor/Costain consortium which reflected:

- concerns, based on the Service's experience of opening new prisons, that the risks associated with the early stages of a new prison's operations would place too great a demand on Securicor who, although experienced in the provision of security services, did not have previous experience of managing a prison;
- the Service's wish to avoid the higher risks of time and cost overruns from awarding both contracts to one bidder using a prototype design. The Service were concerned that if the design, construction or operating plans of the contractor were faulty the Service would have an unsatisfactory service at both prisons;
- consideration that if the contractor's consortium or its members experienced financial difficulties this could affect the service delivery at both prisons. In considering this issue the Service took into account that Costain had been experiencing financial difficulties, which later led to the suspension of their shares (paragraphs 2.56-2.57); and
- the importance of having more than one service provider in order to develop a market in custodial services. This would ensure competition between bidders continued to be present on future PFI prison procurements.

Because of their concerns about using only one contractor, the Service decided to award the Bridgend contract to Securicor/Costain and the Fazakerley contract to Group 4/Tarmac.

This decision gave rise to additional costs which the Prison Service estimated to be £19 million

2.14 The Prison Service considered the cost savings which would be foregone by not awarding both contracts to the Securicor/Costain consortium. The design modifications which Securicor/Costain agreed to make increased their initial bids by about £12 million. The Service then estimated that the extra costs of not awarding both contracts to one bidder had reduced from £31 million (based on the original bids received) to £19 million.

There were possible additional savings foregone by using two contractors

2.15 Although they had informed bidders in March 1994 that both sites would not be awarded to a single contractor, this information was omitted when the projects were retendered a year later and bidders told us that they believed they could, if successful, be awarded both contracts. The Securicor/Costain consortium told the Prison Service in their bid that further cost savings could be made available in the event that they were awarded both contracts, but the Service did not ask them, or other bidders, to quantify savings that might be delivered through such economies of scale.

2.16 The Securicor/Costain consortium told the National Audit Office that further savings of up to 5 per cent of their aggregate proposed prices for the two prisons could have been made available to the Service in these circumstances. The Securicor/Costain consortium consider that some savings due to economies of scale could have been achieved in all the areas of the project, although the principal benefits would probably have been in design and construction costs.

2.17 Based on advice from Chesterton, we consider that it is not possible to know with complete confidence what level of savings would have been offered by Securicor/Costain if this had been tested in the competitive bidding process. We consider, however, that the range of additional savings which Securicor/Costain now say they could have offered is a reasonable indication of savings that might have been achievable. The Prison Service on advice from Ove Arup subsequently considered that the additional savings which could have been achieved are more likely to have been at best in the order of 3 per cent of the aggregate contract prices rather than the maximum level of 5 per cent which Securicor/Costain say they could have offered.

2.18 If such economies of scale had been offered before the contracts were let this would have increased the potential savings foregone from using two contractors by £5 million for each one per cent reduction in Securicor/Costain's bids.

2.19 The Treasury were informed about the Prison Service's strategic decision not to let both contracts to the same supplier which was finalised at the time the preferred bidders were selected. The Prison Service's consideration of the risks attached to awarding both contracts to one bidder was well thought through. They did not, however, obtain complete information about the cost savings foregone if they chose to use two different contractors. In view of the Prisons Board's opinion

that it would have been unsafe to award both contracts to one consortium in the first PFI prison procurement competition the Service say they would not have changed their choice of preferred bidders even if they had had a higher estimate of savings foregone by using two different contractors. Their strategic decision not to let contracts for both prisons to the same supplier would not have been affected by higher cost savings. Securicor/Costain acknowledge that there were good reasons for the Service's decision not to award both contracts to one consortium.

There were, however, other benefits from using two contractors

2.20 The Prison Service identified that there were other benefits from using the Group 4/Tarmac consortium as one of the contractors. By using two different contractors and encouraging a market to develop the Service hoped that it would enable them to achieve improvements in value for money on future PFI prison contracts which would not be possible without a range of competing contractors. This strategy contributed partly to the lower unit price which the Service achieved when letting the third PFI prison contract for Lowdham Grange in November 1996 which has been recognised by the Private Finance Panel Executive.

2.21 The Service identified, before letting the Fazakerley contract to Group 4/Tarmac, that Tarmac's proposed modular cell system of construction offered the prospect, once it had been fully tested at the contractor's risk at Fazakerley, of the much faster delivery of houseblocks in future. The new houseblock system was assessed to be capable of delivering concrete and steel category B modular cells (not available in England and Wales at the time the Fazakerley contract was let) between 6 and 11 months faster than using traditional methods. This assessment has proved to be accurate. The Service have subsequently awarded seven contracts to Tarmac to build additional houseblocks using the new technique at existing prisons capable of housing a total of 800 Category B prisoners.

2.22 Having encouraged a market to develop in these first PFI prison projects, the Prison Service now judge that, if there are not overriding operational risks or market development considerations, they will consider, as they gain more confidence in letting multiple contracts, whether to award more than one contract to a sole bidder, particularly if delivery can be in stages which both reduces risks and maximises savings.

Bidders thought that they might be awarded both contracts

2.23 Some bidders told us that they had submitted their bids in the expectation that they might, if successful, be awarded the contracts for both Bridgend and Fazakerley. They had formed this view because both the original and revised invitations to tender did not stipulate that the Prison Service would not award both contracts to one bidder. An earlier letter, however, which the Prison Service sent in March 1994 to the six prospective bidders short listed, had stated that “no consortium or group will win both competitions”. With hindsight, the Prison Service agree that they should have also indicated in the invitation to tender how they proposed to handle this issue.

Other factors affecting costs

The design solution adopted at Bridgend reduced costs significantly

2.24 The savings offered by the Securicor/Costain consortium arose from their plans to use considerably less floor space than other bidders and to concentrate the construction within fewer buildings and a comparatively smaller perimeter than rival bidders. These arrangements included the use of an appointments system for prison visits (thus reducing the space needed for the visitors’ room), the replacement of kitchen facilities with a catering service based on the delivery of cooked/chilled foods to the prison site, less unused space between houseblocks and other reductions in space utilisation. Although the savings were not quantified when bids were evaluated the Prison Service have since estimated that this approach to design reduced the cost of the Securicor/Costain bids by approximately 30 per cent.

There is tension between seeking innovation and requiring competitive pricing

2.25 The Securicor/Costain proposals for cost savings were not new techniques which were likely to be covered by intellectual copyright. They were solutions which had been used successfully in other countries, but had not been proposed by any other bidder in this competition or used previously in a British prison. The designs proposed by Securicor/Costain complied with the Prison Service specification, but they involved significant changes to the way the prisons would be

operated compared to other bidders' proposals. The designs which were adopted at Bridgend clearly reduced costs but, as no other bidders had suggested these designs, there were no competitive prices for this particular solution.

2.26 A feature of the PFI is that bidders are encouraged to provide, in competition, innovative solutions to a specification of required services. The competition may, therefore, produce an innovative solution which reduces costs, although that particular solution may only have been priced by one bidder. This contrasts with traditional procurement where there is less scope for innovation as the required solution is more tightly defined but the solution is then priced by each bidder.

2.27 To encourage innovation the Prison Service believe that there may be benefits from indicating in a PFI specification that significantly different designs will be acceptable to encourage bidders to put forward innovative solutions. In future competitions they also intend to discuss design features with prospective bidders and, as the Service gain experience of the possible solutions for meeting the service required, they may decide to define their required outputs in such a way that will encourage bidders to suggest and price a particular feature. Bidders are also likely to consider successful solutions from previous competitions when preparing future bids.

A fuller analysis of the leading bids may have identified other opportunities to reduce costs

2.28 Although the Service carried out certain preliminary comparisons of all bidders' cost structures to identify items that stood out as unreasonable or uncompetitive they did not examine whether the differences between the two leading bids from Securicor/Costain and Group 4/Tarmac related to:

- cost savings on common features of the two bids beyond a general analysis of construction costs per square metre for the prison as a whole, staffing numbers and conditions of service;
- the payback over 25 years of innovative design features assumed by Securicor/Costain leading to additional cost savings; or
- the additional costs of items that resulted in a better overall quality of service from Group 4/Tarmac.

2.29 The Service consider that their primary concern was to select contractors, whose bids, made in a competitive bidding process, best met the Service's aims for the two projects. A fuller analysis of the leading bids would, however, have enabled the Service to consider whether, without infringing intellectual copyright, they could obtain part or all of the additional cost savings offered by Securicor/Costain from the Group 4/Tarmac consortium, particularly where this may have simply reflected cost differences on features common to both bids. The Service agree that in future PFI procurements they may find it helpful to carry out further comparisons of the cost assumptions made by the leading bidders before the preferred bidders are selected.

The allocation and pricing of risks

Construction and certain other risks were transferred to the contractors and other risks were shared

2.30 The draft contract given to bidders set out the proposed allocation of risk between the Prison Service and the private sector contractors. This allocation was amended during negotiations with the preferred bidders. Appendix 6 sets out how risks were allocated between the parties in the final contracts and Figure 6 shows the major risks which were transferred to the contractors. The Prison Service transferred to the contractors the risk of time and cost overruns in construction (other than costs arising from a change of service required by the Prison Service or accepted by them following a proposal by the contractor). The contractors will not get paid until the prisons are completed and ready for occupation. The contractors are also responsible for the well-being and security of the prisoners as well as the maintenance of the prisons. A number of other risks, particularly relating to changes in operating costs, are shared between the Prison Service and the contractors.

2.31 Although the Prison Service had summarised separately their understanding of the main contract provisions and the allocation of risk, they had not related the risks to the contract terms in a single document. The Service agree that such an exercise would be helpful in future PFI projects.

2.32 The following paragraphs explain how certain significant risks were treated in the contracts:

- the risk that the prisons might not be fully used (paragraph 2.33);

- changes to the contractors' operating costs during the contract period (paragraphs 2.34 to 2.42); and
- events leading to termination of the contracts (paragraphs 2.43 to 2.49).

The main risks transferred to the contractors

Figure 6

| Nature of risk | Main outcome |
|---|--|
| Design and Construction | |
| Construction takes longer than expected | The contractor will not get paid until the prison is ready for use and is liable to pay the Prison Service liquidated damages. |
| Construction costs more than expected | The contractor bears these costs unless the Prison Service have asked for a change in the building programme that cannot be accommodated for a fixed price agreed in advance. |
| Operations and Maintenance | |
| Contractor fails to meet performance standards | The contractor's payments are reduced and persistent failure may result in contract termination with loss of the contractor's equity and possibly part of their bank finance. |
| Maintenance is required | The contractor is fully responsible for maintaining the prison in good condition; failure may result in contract termination with loss of the contractor's equity and possibly part of their bank finance. |
| Costs within the contractor's control increase in excess of amounts reimbursed through indexation provisions (Figure 7) | The contractor bears these costs. |

Source: The Prison Service and their legal advisers, Freshfields

This figure shows that some major risks have been transferred to the contractors.

Contractors are paid for availability of accommodation rather than actual usage

2.33 The Prison Service initially sought to transfer to the contractors the risk that the prisons might not be fully used. Their proposal was to pay contractors according to the occupancy of the prisons. This was resisted by bidders on the grounds that the Prison Service would remain wholly responsible for allocating prisoners to particular prisons. As a result, with the agreement of the Treasury, in the second round of tendering, bidders were asked to price their bids on the basis of payments by the Service for accommodation being made available to them for use.

The contract prices can be changed during the contract periods in a way which is intended to share risk between the Prison Service and the contractor

2.34 The Prison Service considered a number of alternative pricing mechanisms but formed the view at an early stage that value for money would be best achieved by a contract pricing mechanism which provided for:

- some costs, mainly relating to construction costs, to be fixed in absolute terms;
- some other costs, mainly relating to operating costs excluding salary costs, to be fixed in real terms;
- further costs, mainly relating to salary costs, to be increased annually by more than the movement in the Retail Price Index (RPI); and
- other price adjustments to be made for certain changes in costs that are beyond the contractors' control.

2.35 The Service considered that these pricing mechanisms would achieve a reasonable allocation of risk between the Service and the contractors and would fix, in absolute or real terms, the price for a substantial part of the costs within the contractor's control. The Service felt this would be an important factor in assisting the contractors to raise bank finance on satisfactory terms. The Service considered that if they had restricted further the scope for the contract price to be varied during the contract period this would have affected the contractors' ability to raise bank finance and would have increased the starting contract price proposed by bidders.

2.36 The contractors submitted their bids on the basis that these pricing mechanisms would be put in place. In their bids they specified how much of their costs would be allocated to each of the cost categories in paragraph 2.34, the rate of increase in real terms that they wished to apply to those costs which would increase annually by more than the change in the RPI, and the operating profit (the level of return) they expected to achieve during each year of the contract. Bidders were also asked to price the contracts on the basis that the average earnings index for the services sector would be used to increase the price in respect of salary costs rather than linking the price change for these costs to a specified rate in excess of the RPI.

2.37 The contracts incorporate the pricing mechanisms described above. In particular:

- the part of the price which will increase annually in real terms (mainly relating to salary costs) will, in both contracts, increase at two per cent above the increase in the RPI. This was the rate of increase proposed by the preferred bidders and the Service considered that their bids on this basis were preferable to their alternative bids based on the average earnings index for the services sector; and
- the other price variations which are permitted under the contracts are summarised in Figure 7 and detailed in Appendix 7.

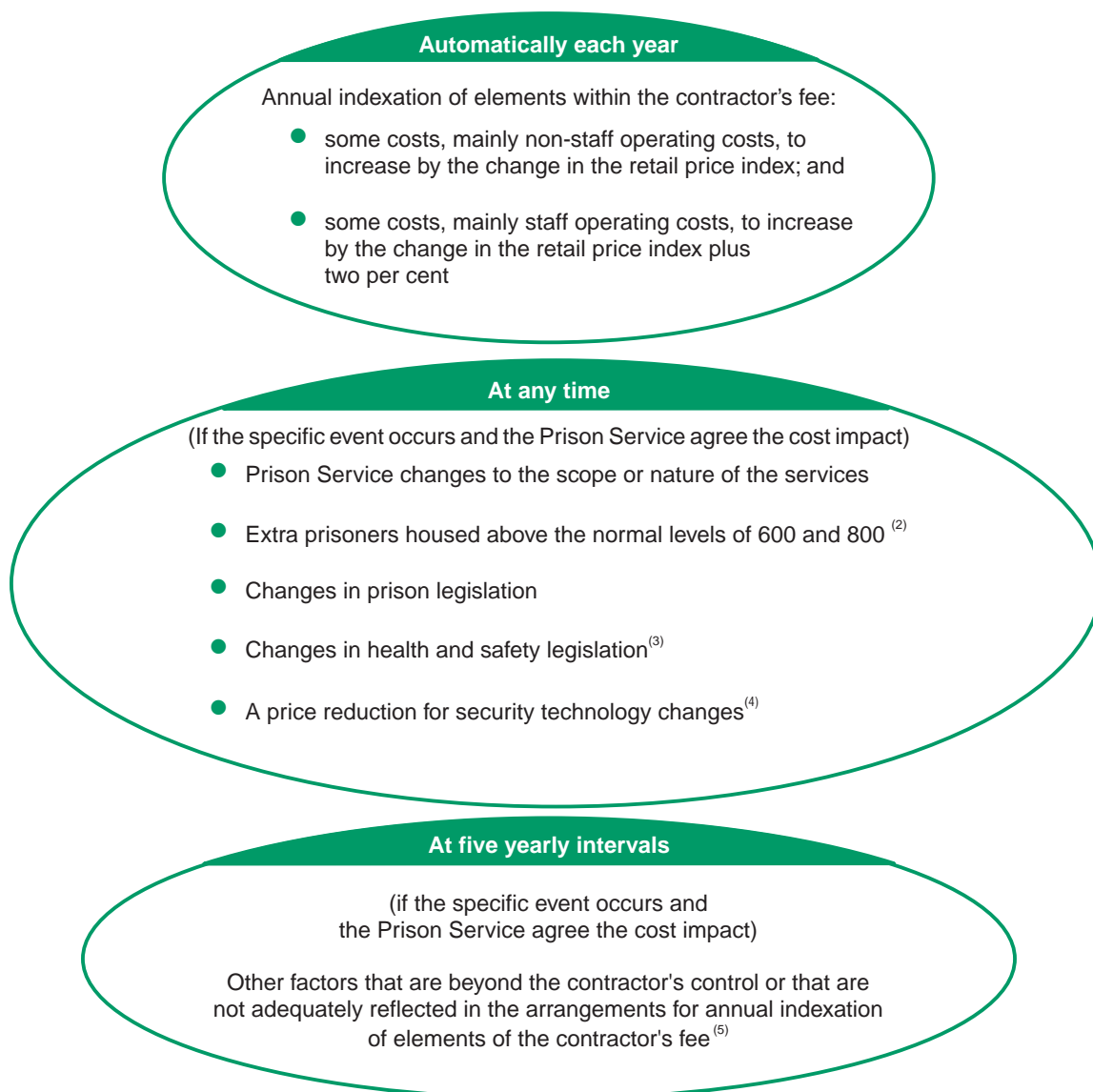
2.38 The effect of these pricing arrangements is that the contractor will receive a price increase for: certain costs through the annual indexation arrangements; for specific events (such as those arising from a change in prison legislation); or at five year intervals if costs beyond his control in operating and maintaining the prison have increased by more than 5 per cent in real terms and the increase has resulted in a significant change to his projected level of return.

2.39 The contractor will bear the risk of other cost increases, particularly if costs within his control relating to operations and maintenance increase by more than the amounts reimbursed through the annual indexation arrangements.

2.40 In the event that the contractor's level of return is higher than anticipated at the time the contract was let the Service can, in the following circumstances, obtain or seek a reduction in the contract price:

- if the contractor's increased profits are due to new security technology, at least half of the savings must be shared with the Service;
- if the contractor seeks a price increase for a change in health and safety legislation, the Service can claim a price reduction for any costs that have been less than expected when the contract was let; and
- in the Bridgend contract only the Service can claim a price reduction at five yearly intervals for decreases in costs beyond the contractor's control.

Figure 7 Variations to the contract price ⁽¹⁾



- Notes:
1. More detailed information on the circumstances in which the contract price can be varied is given in Appendix 7
 2. Each contract sets down the fee payable to the contractor for each extra prisoner
 3. Once the contractor has made a claim for such a price variation, the Prison Service can claim a reduction in the contract price in respect of any matters that have or should have reduced, or will reduce, the contractor's costs
 4. Each contract contains a formula, which sets down how cost savings arising from these changes are to be shared between the contractor and the Prison Service
 5. For an upwards price variation, the increase in the contractor's costs must have been more than five per cent in real terms and had a significant effect on his projected level of return. Examples of factors that are beyond the contractor's control were not specifically dealt with in the contracts. In the Bridgend contract only, the price variations may be downwards as well as upwards. For more details, see Appendix 7.

This figure shows the situations which will give rise to a change in the contract price.

Source: The Prison Service and Freshfields, the Prison Service's legal advisers

2.41 Over the life of the contracts the effect of these various price variation mechanisms is that the risk of cost changes (both upwards and downwards) will be shared between the contractor and the Prison Service.

In some circumstances the price variation mechanisms could compromise value for money

2.42 In the following circumstances features of the pricing arrangements could compromise value for money:

- if the prices or profit margins of other comparable providers, either private sector operators or the Prison Service, decrease during the contract period through competition or other market functions. For example, it is possible that unit prices may reduce through competition as a market for prisons procured under the PFI develops or through pressure on the Service to further reduce their costs. There is no requirement, however, for the contract price to be varied in line with market rates. The Service considered this might have led to higher opening contract prices or a requirement by the contractor for prices to be adjusted upwards as well as downwards but this issue was not tested by the Service during the bidding process;
- if the automatic annual price increase for certain contractors' costs, mainly salary costs, by two per cent above the increase in the RPI is more than the actual increase in these costs over the 25 years contract periods. Although public sector prison salaries have historically increased annually at RPI plus two per cent, the Service is under pressure to contain operating costs and the salary costs of private operators have previously been lower than those of the Service. These factors suggest that actual annual salary increases by private operators may be less than RPI plus two per cent in the future and that there has been a low level of risk transfer to the contractors on this aspect. A lower rate of annual increase at RPI plus 1.5 per cent was proposed by two of the bidders for these contracts (but not the preferred bidders whose overall solutions were judged by the Service to be the best) and was obtained by the Service in the Lowdham Grange contract;
- if the contractor is able to reduce his costs through efficiency savings the Service will not automatically receive any direct benefit except where these arise from new security technology; and

- if the Service is unable to reach agreement with the contractor over price variations which have to be the subject of claims by the contractor. Based on advice from our legal advisers Theodore Goddard, we consider that the price variation contract terms could be interpreted in different ways and the risk of this could have been reduced had these provisions been set out in more detail. For example, the contracts do not define costs which are beyond the contractors' control. But the contractors can seek a variation of the contract price, at five yearly intervals, if such costs in operating or maintaining the prison have increased. We consider that the possibility of future misunderstandings with the contractors could have been reduced (but not eliminated) if the contract had specified whether changes in certain major cost items, such as utilities, financing charges, VAT and other taxation could trigger a price increase. The Prison Service and their legal advisers Freshfields consider that it was not possible to define in the contract all the events that might need to be addressed by this arrangement. They believe, however, that cost increases from changes in interest charges or corporation tax are not costs associated with the operation or maintenance of the prison and are therefore risks which the contractor will bear. In the event of a dispute these price variation issues would be settled by arbitration.

The Prison Service may incur significant liabilities if the contract is terminated

2.43 If the contractor fails to meet his obligations prior to the prison's opening, no compensation will be payable by the Prison Service. The Service succeeded in transferring this risk although initially it was resisted by some bidders. But some compensation will be payable by the Prison Service to the contractor's lenders in the event of contract termination after the prison is available - even where the termination is through the fault of the contractor. The contractor will however lose his investment, except where the termination is due to the fault of the Service or, in the case of Bridgend, because of prescribed events outside the contractor's control.

2.44 The termination arrangements include a provision whereby if the original operator defaults and neither the Prison Service nor a replacement private sector operator choose to take over the operations of the prison then the Service must pay to the consortium the lower of:

- the consortium's outstanding bank borrowings and related termination costs; and

- the net present value of the unexpired part of the contract less any rectification costs which would be required to return the prison to an acceptable standard, the additional cost (if any) of providing alternative accommodation for prisoners while rectification takes place, and any projected additional operating costs incurred in fulfilling the remainder of the services required under the contract.

2.45 The intention of these arrangements is to provide some level of compensation to the contractor's bankers in the event of operator default but at a level which is projected to leave the Service no worse off than if the original contract had been fulfilled. If, however, the actual costs incurred in procuring the services required for the remainder of the original contract period are less than or exceed the costs projected at the time the termination payment is made, no subsequent adjustment would be made to the termination payments.

2.46 In return for making these termination payments ownership of the prison would revert to the Prison Service. The prisons are not expected to have a significant value until such time as any required rectification has taken place to enable them to be operated satisfactorily but the original contractor must carry out this work or have the value of the work deducted from the termination payment.

2.47 Lazard's calculated that the maximum amount that the Prison Service could be required to pay to the consortia under this arrangement would be £68 million at Bridgend and £84 million for Fazakerley which represented the expected maximum amounts of the contractors' outstanding bank borrowings at the end of the construction period. These amounts are, however, expected to decrease because the Service anticipate that the contractors' borrowings will be repaid early as the construction work (particularly at Fazakerley) is running ahead of schedule. In addition, the Service's liability would be reduced if the net present value of the unexpired part of the contract, calculated on the basis described in paragraph 2.44, is less than the contractors' outstanding bank borrowings. The Service's exposure could however be larger if they have authorised increases to the contractors' borrowings subsequent to the letting of the contracts. So far they have not been requested to authorise any additions to the contractors' bank borrowings since the contracts were let and would only do so to allow the contractor to finance negotiated changes in the service. The Treasury Officer of Accounts advised that, as the arrangements were in the ordinary course of business, these contingent liabilities need not be disclosed to Parliament under the Government Accounting rules.

2.48 The need for these compensation arrangements was driven by the requirements of the contractors' bankers who might not have been willing to fund these projects without such arrangements. As bidders were only asked to price their bids on the assumption that such arrangements would be in place, the Prison Service were unable to determine whether they had led to a reduction in the contract price.

2.49 The Prison Service's view was that, as Bridgend and Fazakerley were the first projects of their kind, the issue was not whether these arrangements led to a reduction in contract price. They considered that such provisions were essential if the projects were to be financed. However, they believe that it may be possible for the public sector to negotiate better terms in subsequent contracts, particularly if the number of contractors providing similar services increases which would make it easier for the banks to find replacement operators and thus avoid the need for termination payments to be exercised. The Service consider that in the Lowdham Grange contract they have simplified and capped more precisely their termination liabilities.

The Prison Service reviewed how some, but not all, of the major risks had been priced

2.50 The Prison Service asked bidders to price their bids on the basis of the proposed broad allocation of risks set out in the draft contract terms. This enabled them to assess all bids on a comparable basis. We believe that, in respect of major risks, Departments should compare the amount included in the bids for particular risks with the cost of managing those risks in the public sector. In these projects the Service did make a financial assessment of some individual risks: they asked bidders to provide alternative bids based on two different methods of indexation for salary costs and on assumptions of different rates of interest; and they assessed the financial effect of certain changes to the allocation of risk which occurred between the first and second tenders. They did not, however, consider the effect on the contract price of some other significant risks: for example, accepting the absence of a benchmarking arrangement to compare prices at periodic intervals with other suppliers, or agreement to the termination payment arrangements.

The financial assessment of the contractors

The evaluation of bidders included a financial assessment

2.51 Lazards considered whether the bidders would be financially capable of delivering the Prison Service's requirements. Their financial assessment of each bidder included:

- an initial assessment of the financial position of the bidding consortium and its members, based on their audited accounts, prior to the issue of the invitation to tender;
- a review of the financial information submitted by the bidder which showed their expected costs of providing the services;
- a review of the bidder's finance plans. As part of this review Lazards assessed the bidder's proposed contract price to see whether this would be sufficient to cover their costs, loan repayments and any contingencies which might arise. Lazards also carried out a sensitivity analysis varying the bidder's assumptions on revenues and costs to see whether the bidder would be able to service their debts in these circumstances; and
- an examination of the commitments to provide finance which the bidder had received from both their equity and debt funders. Equity funders had provided letters of commitment or had stated in the bid documents that they would provide the necessary investment. The banks providing debt finance had provided letters of support indicating that, although the full terms of the funding had yet to be finalised, they would expect to finance the projects. With the exception of one bid, which was not one of the preferred bids, these letters of support had been approved by the credit committees of the banks who would be required to authorise the final terms of the funding.

2.52 Lazards concluded that each bidder had presented a financial plan which would enable them to deliver the services required by the specifications. In addition, Lazards expected that each bidder would be able to conclude their financing on terms which would not be materially different to those proposed in the finance plans.

The Prison Service identified the rates of return payable to the parties financing the projects

2.53 Figure 8 sets out the rates of return payable to the various parties who are financing the Bridgend and Fazakerley projects. These rates of return are the reward which these parties receive for the risks which they bear in respect of their financial contribution to the projects.

2.54 Because few major PFI contracts have been let there are no clear indications of appropriate rates of return for finance invested in PFI projects. But based on evidence of other forms of project finance we consider that:

- the rates of return payable to the banks financing the projects are not significantly higher than the returns being earned by banks on comparable projects; and
- the projected rates of return to the equity providers of the projects of 12.8 per cent for Fazakerley and 19.4 per cent for Bridgend are within a range which the finance market would accept for this sort of project. It is not, however, possible to identify precisely why the two sets of equity providers have sought different levels of return although their required rates of return will have been influenced in part by the risks transferred to the contractors, the distribution of risk between the consortium members and the mix of finance for the project.

2.55 Lazards, and the Prison Service, considered that they should not seek to influence the bidders' financing arrangements as the contractors were primarily responsible for obtaining finance at the most favourable rates available and the procurement by the contractors of finance through a competitive process would encourage this. Lazards did, however, check the reasonableness of the interest charges arising from the arrangements whereby the contractors' variable rate loans were transferred into fixed rate loans (known as 'swaps') because these were arranged immediately prior to the contracts being let and Lazards were concerned that competitive tension might not operate in this situation. Lazards satisfied themselves that the interest charges arising from these 'swaps' (which would be indirectly borne by the Service through the contract payment structure) were reasonable. We consider that, in view of the material effect which financing charges have on PFI contract prices, such a review of the bidders' financing charges is important where there is any concern that the financing was not procured under full competition.

Figure 8

The rates of return payable to the parties who are financing the Bridgend and Fazakerley projects

| Type of finance | Amount £m | Interest rate/Rate of return | Term until |
|---------------------------|--------------|---|------------|
| Bridgend | | | |
| Base loan facility | 72.0 | 9.6235 per cent to the date the prison is operational, 9.4735 per cent for first five years of operations and 9.5735 per cent for the remainder of the loan term. ¹ | 15/11/2013 |
| Standby loan commitments | 5.0 | 1.65 per cent above the London Inter Bank Offered Rate (LIBOR) to the date the prison is operational, 1.5 per cent above LIBOR for the first five years of operations and 1.6 per cent above LIBOR for the remainder of the term of the commitments. | 15/11/2013 |
| Equity/Sub-ordinated debt | 15.6 | The projected rate of return, after taxation, to equity shareholders in real terms is 19.4 per cent per annum. | |
| Fazakerley | | | |
| Base loan facility | 92.5 | £82.6 million of the loan bears a fixed rate of interest of 9.0945 per cent to the date the prison is operational, then 9.5945 per cent to 15 December 2005 and a variable rate of 1.5 per cent above LIBOR thereafter. The balance of the loan up to the start of full operations bears variable rate interest at 1 per cent above LIBOR and 1.5 per cent above LIBOR thereafter. ² | 15/12/2015 |
| Working capital facility | 3.0 | 1.5 per cent above LIBOR. | 15/12/2015 |
| Equity/Sub-ordinated debt | 8.1 | The projected rate of return, after taxation, to equity shareholders in real terms is 12.8 per cent per annum. | |

Notes: 1. These interest rates are fixed for the respective periods of the loan. To enable the contractor to manage the risk of interest rate movements these arrangements replaced variable rate arrangements which the Securicor/Costain consortium had initially obtained whereby interest would be payable at 1.4 per cent above LIBOR to the operational date, 1.25 per cent above LIBOR for the first five years of operations and 1.35 per cent above LIBOR for the remainder of the loan term.

2. Both the fixed and variable rates of interest will be increased by 1 per cent if loan repayments are delayed. The fixed interest arrangement partly replaced the variable rate loan arrangement which the Group 4/Tarmac consortium had originally obtained whereby interest would be payable at 1 per cent above LIBOR to the operational date and 1.5 per cent above LIBOR thereafter.

This figure shows the financing arrangements for the two projects.

Source: The Prison Service

The financial position of the construction firms in the bidding consortia was an area of concern

2.56 Although the Prison Service are not required to pay the contractor until the prisons are built and available for use, they would encounter problems in accommodating prisoners if the construction phase is delayed. They were concerned that some of the construction companies in the bidding consortia had been incurring losses. Although they did not examine all the financial commitments of members of the bidding consortia, the Prison Service and Lazards were satisfied that their chosen construction firms, Costain and Tarmac, would have access to sufficient sources of finance to enable them to complete the construction of the prisons satisfactorily. They also drew assurances from the Securicor/Costain consortium's decision to appoint Skanska to assist on the construction work. Skanska would also take responsibility for all the construction work on the Bridgend project in the event that Costain became unable to fulfil their obligations although it is possible that this would lead to time delays and other difficulties in completing the projects.

2.57 In November 1996 Costain's shares were suspended for the second time in six months and in December 1996 the company announced proposals to realise assets and to restructure their senior management as part of a reorganisation required by the company's bankers. As at June 1997 these matters are being dealt with by Costain but their shares have not yet been relisted. Despite these concerns, the Prison Service have experienced no problems to date on the Bridgend project, and the construction work is running slightly ahead of target.

3. The benefits of the PFI solutions

3.1 This part of the report considers the extent to which the projects deliver benefits compared with traditional procurement methods.

The expected benefits which have been identified

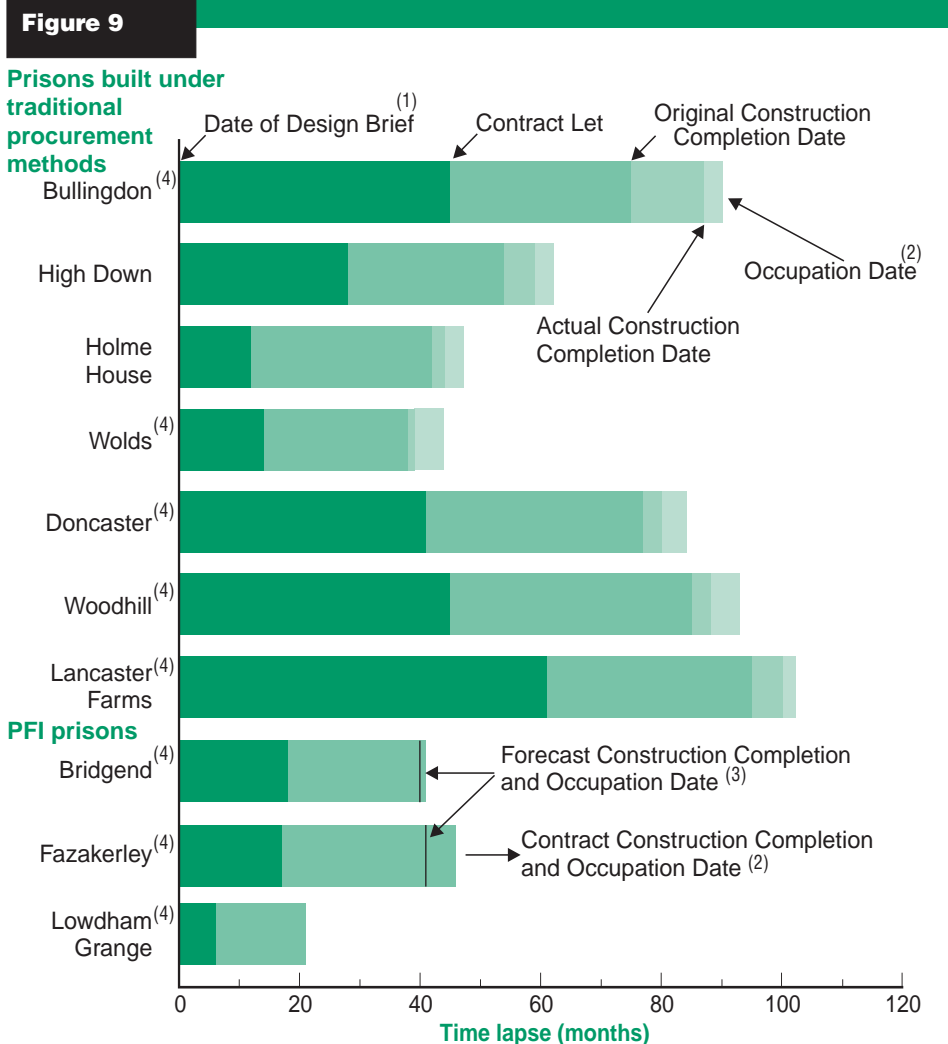
There are a number of benefits which are expected to arise from the PFI solutions

3.2 The Prison Service have identified the following benefits from the PFI contracts compared with managing part or all of the projects in the public sector:

- the current expected design and construction periods, 40 months at Bridgend and 41 at Fazakerley, are significantly shorter than many prisons built by the Property Services Agency on behalf of the Prison Service. Figure 9 shows that Bridgend and Fazakerley are expected to open 45 per cent more quickly than the average of a sample of prisons previously examined by the National Audit Office. The forecast time saving increases to 50 per cent if the comparison is made with those prisons in the sample which were based on prototype designs. The faster opening under the PFI is due to the overlapping of design and construction and the fact that there is no additional commissioning period, typically 3-4 months under traditional procurement, before the prisons are ready for occupation;
- the PFI solutions have enabled some innovative building design and operational methods to be proposed and implemented;
- the PFI solutions have enabled the building of these two prisons to start at a time when the Service were not able to use public finance for such projects;
- based on estimates prepared by the Service in May 1995, the PFI solutions for Bridgend and Fazakerley were expected to produce aggregate savings of 10 per cent compared with the most likely comparators of building the prisons using public finance and then contracting out the operations to the private sector (Figure 10); all of the estimated savings relate to the Bridgend project; the Fazakerley PFI solution is estimated to cost approximately the same as the public sector comparator;

Comparison of the forecast timescale for the first three PFI prisons with prisons built under traditional procurement methods

| Months to opening: | |
|-----------------------|----|
| Traditional (average) | 75 |
| Bridgend | 40 |
| Fazakerley | 41 |



- Notes
1. For the PFI projects, the date of the design brief is taken to be the same as the date of the issue of the invitation to tender to bidders
 2. The occupation date is the date that the first prisoners are accepted into the prison. On traditionally procured prisons, there was a period between the completion of construction and the occupation date to allow for the prison's commissioning. The PFI prisons will admit their first prisoners as soon as construction is complete.
 3. As at June 1997 the Prison Service forecast that the prisons at Bridgend and Fazakerley will open earlier than required under the contracts.
 4. These prisons were built using prototype designs and not designs used in previous prisons.

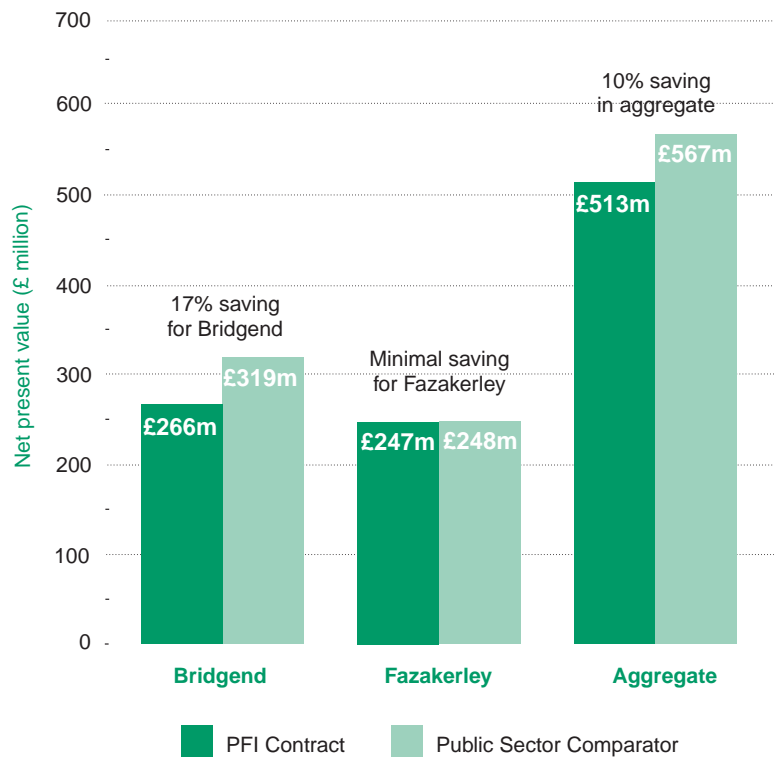
This figure compares the first three PFI prisons with seven prisons previously built conventionally by the Property Services Agency on behalf of the Prison Service and examined in the National Audit Office's report "Control of Prison Building Projects" (HC 595, 1993-94). It shows that Bridgend and Fazakerley are expected to open approximately 45 per cent more quickly than the average of these previous prisons. Further time savings are expected on the Lowdham Grange project. This is because the PFI prisons, unlike the traditionally procured ones, are being built using a fast-track strategy which overlaps design and construction and will accept their first prisoners as soon as construction is complete.

Source: The Prison Service

- further savings have been secured if the comparison is made with prisons operated by Prison Service employees; and
- there has been a transfer of some major risks to the private sector.

Comparison of expected PFI costs with public sector comparators based on publicly financed buildings and contracted out operations

Figure 10



This figure shows that the use of the PFI in these two projects is estimated to generate aggregate savings of ten per cent over comparators based on publicly financed buildings and contracted out operations. Virtually all of these savings, however, relate to the Bridgend project.

Source:
The Prison Service

3.3 The estimate of savings expected from the PFI solutions for Bridgend and Fazakerley is based on a number of assumptions relating to future events during the 25 year contract periods. If the assumptions prove accurate the estimated savings will be delivered; but, given the long contract periods, there is a risk that the actual outturn may be different from the estimate. The main assumptions on which the public sector comparators used in the savings estimate were based were that:

- the prisons would be built using public finance, but operated by the private sector;

- time delays and cost overruns during the construction period would occur at a rate consistent with other recent prison building projects identified in the National Audit Office report “Control of Prison Building Projects” (HC 595 of Session 1993-94);
- the private sector operator’s charges would reflect salary cost increases at a rate equal to RPI plus two per cent per annum, which is the same rate of increase allowed to the contractors for Bridgend and Fazakerley;
- there would be an additional increase in the private sector operator’s charges of 10 per cent at the end of the fifth year of operations. The Service considered this assumption appropriate in view of the fact that the private sector’s charges will, until that time, have been well below equivalent Prison Service costs, creating a risk that future price increases may be sought by the private sector;
- there would be no cost reductions as a result of efficiency savings; and
- the annual cost of public sector finance would be six per cent in real terms.

3.4 The cost savings attributed to the PFI solutions (Figure 10) also assumed that any price increases during the 25 year contract period arising from any claims which the contractors may be entitled to make, such as changes in prison or health and safety legislation or if costs beyond their control increase, would affect the PFI contracts and traditional procurement equally.

The Private Finance Panel Executive also considered there were noteworthy achievements

3.5 The Private Finance Panel Executive considered that, subject to the estimated savings being achieved over the life of the contracts, the achievements from the letting of these contracts were:

- the Service has in all likelihood secured prison places at good value compared with previous methods;
- innovative solutions have been incorporated that would not have featured previously in prisons;

- the expected timescales for asset and service delivery after contract are excellent; and
- in taking the decision to forego possible cost savings by awarding the two contracts to different contractors the Service took a long term view to position themselves strategically for future procurements. The terms they have subsequently achieved for Lowdham Grange appear to justify this decision.

Factors affecting the measurement of benefits

Before letting the contracts, construction and operational savings were not distinguished

3.6 Although the bidders were required to provide information on their expected construction costs and annual running costs they were not required to show how much of their proposed contract price related to these cost categories. The Service considered that the rates of return for the various elements of the service would reflect risk sharing within the consortium, which should remain commercially confidential. The Service believed that they should primarily be concerned to evaluate the contractors' service as a whole and not seek to analyse actual price allocation between the construction and operational sub-contractors, and the rest of the consortium.

3.7 The Service identified, however, before the contracts were let, that, although the construction costs were higher than at Bridgend, the method of construction at Fazakerley of pre-cast cell units provided an opportunity to develop a technique to reduce the construction time of individual concrete houseblocks at existing prisons with associated cost savings (paragraphs 2.20-2.22).

3.8 In future projects the Service may also find it helpful to ask the contractors to indicate, during the bidding process, how much of their proposed contract price relates to each of construction, operations and financing. This will help the Service to understand the economics of the bidders' proposals and to assess areas of proposed cost savings, and may identify aspects of individual bids which they would want to focus on during pre-contract negotiations. These cost categories are, however, to some extent interrelated in a PFI project and therefore a full evaluation of the total contract price is still of great importance.

The savings attributed to the PFI solutions are greater if compared with publicly operated prisons

3.9 The Service have identified that cost savings generated by the PFI solutions are greater if the comparison is made with publicly operated prisons. A Home Office review published in October 1996 indicated that privately operated prison unit costs were 11-17 per cent lower than those of comparable prisons operated directly by the Service (Appendix 2), depending on the measure chosen.

3.10 Charterhouse, the Service's financial advisers for the Lowdham Grange competition, recalculated the Fazakerley public sector comparator assuming both public sector operation and construction of the prison and also optimistic improvements in public sector performance (Appendix 2). The Fazakerley PFI project showed an estimated net present value saving of £2.5 million (1 per cent of the expected total project cost) compared with the revised comparator. This was a sensitivity test looking at the effect on the earlier comparator of a more efficient and economic public sector procurement process and long-term operation.

The contract unit cost and the comparator were lower in the third PFI project

3.11 As noted in paragraph 1.27 the Prison Service let a contract in 1996 for the third PFI contract at Lowdham Grange at a unit cost which was 21 per cent less than Bridgend and 36 per cent less than Fazakerley. The Service consider that the factors which contributed to the reduced cost at Lowdham Grange were: a less demanding specification, considerable competition between bidders to suggest lower cost solutions based on innovative designs (following the Service's acceptance of such proposals at Bridgend), an indication of how conflicts between cost and quality would be resolved, and pressure on the Service to secure a low cost solution in order to contribute to their new cost savings targets. These factors can contribute to lower unit costs in traditional procurement and were reflected in the Lowdham Grange public sector comparator.

There are a number of other factors which may affect the cost comparisons

3.12 It is difficult to estimate how the cost comparisons may be affected by future events. For example, if the contractor successfully claims a price increase for changes in costs beyond his control this may affect both the PFI price and costings assumed in the comparator. In addition, competition between private sector providers and the pressure on the Prison Service to reduce costs could also change

the cost comparisons. The Service did not test the sensitivities of their comparators for these factors and such a sensitivity analysis may be helpful when future cost comparisons are made on PFI prison projects. While, therefore, the Service's existing comparator provides a useful indication of possible savings for the first PFI prison competition it cannot be a precise forecast of the actual savings which will be generated over the life of the PFI contracts.

The Prison Governors and the Prison Officers Associations' observations

3.13 The Prison Governors and Prison Officers Associations each separately told the National Audit Office that they have reservations about the savings which the Prison Service have stated that they expect to achieve from the Bridgend and Fazakerley contracts compared to prisons built and operated by the public sector. Both Associations made very similar points:

- the Associations consider that, if their staff were given greater incentive to be innovative, they could generate many of the benefits attributed to the PFI in publicly managed prisons. They said that, as many employees of private sector security firms are former Prison Service employees, the innovation by the private sector has been derived largely from expertise that was previously available, and continues to be available, within the Prison Service;
- the reductions in operating costs of the Prison Service already planned for by the year 2000 together with further possible improvements in procurement procedures would, in the view of the Associations, make the cost of managing a prison in the public sector much more competitive compared with privately managed prisons;
- the Associations note that there are risks with a private sector management contract that the contractor will seek reimbursement for additional levels of service not covered by the original contract whereas, in the opinion of the Associations, Prison Service employees are more likely to take on extra responsibilities, such as looking after increased number of prisoners, without necessarily seeking further monetary compensation; and
- the Associations consider that there is a danger that in an effort to increase profits the private sector will reduce their operating standards which would affect the overall assessment of the benefits of PFI procurement compared with traditional procurement.

3.14 The Associations also noted that they were not asked to contribute to the preparation of the public sector comparators for Bridgend and Fazakerley and were not given an opportunity to comment on them despite requesting this facility. They considered that their experience of prison sector operations would be valuable to the preparation of future public sector comparators for prison contracts.

3.15 The Prison Governors Association were also concerned that the Prison Service's future operating budget would become less flexible because a proportion of the budget would be reserved for PFI contract payments which in part relate to capital and interest costs.

Prison Service response

3.16 The Prison Service view is that the longer term cost of managing a prison in the public sector will become more competitive when compared with privately managed prisons. This is because contracted prisons increasingly provide a benchmark for the costs that the Prison Service should achieve and the Service are able to adopt ideas and systems tested by contractors. Contractors have responded positively to changes of services required by the Service, with most, such as mandatory drug-testing, implementation of the new security manual and overcrowding, being introduced at no or comparatively little additional cost. The Service consider, however, that overcrowding is likely to result in slower convergence of private and public sector prison management costs.

3.17 The Prison Service carefully assess all operational proposals submitted by private sector bidders, and assured us that a bid would not be accepted if it was judged that the level of service did not reach the required quality threshold or if there was a risk that it could not be delivered. The Service gave the Prison Governors and the Prison Officers Associations the opportunity to comment on the methodology and terms of reference for the Coopers & Lybrand study which validated assumptions on which the Bridgend and Fazakerley public sector comparators were based.

3.18 The Service recognise that there is an impact on their future operating budget from expenditure under the PFI and have restructured their Vote to take account of this.

4. The management of the contract letting

4.1 This part of the report considers the following questions:-

- Were the processes leading up to the letting of the Bridgend and Fazakerley PFI contracts managed effectively?
- Were the costs of letting the Bridgend and Fazakerley contracts controlled satisfactorily?

4.2 In considering how well the Prison Service addressed these matters we recognise that the Bridgend and Fazakerley projects were pioneering large scale PFI projects for the Prison Service and that no comparable PFI projects had been carried out by other Departments which could be used as a model. A number of lessons have been learned from the Bridgend and Fazakerley projects. The Service have absorbed these lessons and have already acted on this by making changes to their procedures in the third PFI prison procurement for Lowdham Grange.

The processes leading up to contract letting

The letting of the contracts took more time than expected

4.3 Appendix 3 shows the timetable for letting the Bridgend and Fazakerley contracts.

4.4 The period between the advert in the Official Journal of the European Communities and letting the contracts was 25 months for Fazakerley and 26 months for Bridgend. The contracts were awarded in December 1995 and January 1996 respectively compared to an initial target of 31 March 1995.

4.5 The major factors which contributed to the higher than expected time in letting these contracts were:

- a) the initial invitation to tender produced non-compliant bids requiring a second revised invitation to tender (paragraphs 1.14 - 1.17);
- b) the finalisation of the contracts after preferred bidders were selected took considerably longer than expected;

- c) the need for the Prison Service to gain experience in managing a new method of procurement which required major complex contracts; and
- d) delays in appointing external advisers.

4.6 The Prison Service identified a need to strengthen their project management and in November 1994 appointed Coopers & Lybrand to act as project managers. The Treasury Solicitor appointed Freshfields to reinforce the Service's existing legal team of the Treasury Solicitor and Government Property Lawyers in January 1995. Both these appointments were made after the initial invitation to tender which was issued in July 1994 and resulted in non-compliant bids.

4.7 The Prison Service's decision in late 1994 to switch from the restricted to the negotiated form of EC procurement procedure added four months to the timetable. The first invitation to tender was issued using the restricted form of procurement procedure which is used for most forms of traditional Government procurement. The Service realised, however, that the negotiated form of procedure would give them greater flexibility to develop proposals with bidders and this form of procurement procedure was used in the second round of tendering and is now used in most PFI procurements.

A number of learning points have been identified

4.8 The Private Finance Panel published a report on the Bridgend and Fazakerley contracts in 1996 and identified a number of learning points relating to project management. These included:

- the benefits of the negotiated route over the restricted route for PFI contracts under EC procurement rules, enabling bidders and the public sector to develop and refine the private sector's proposals in discussion;
- the need to identify potentially non-transferable risks, such as volume risk, in these contracts as early as possible;
- the recognition that some Government procurement clauses, (for example the provision for a contract to be terminated in the event of corrupt gifts of any nature or amount), are not suitable in their standard form for PFI, and that these can be modified, still protecting the position of Government, while reflecting the commercial reality of raising finance;

- the need to appoint the right combination of advisers as soon as possible; and
- the need to discuss the implications of financing requirements with the private sector at an early stage.

4.9 In letting their third PFI contract for the Lowdham Grange prison, the Prison Service have aimed to absorb many of the lessons noted in this report and also those noted by the Private Finance Panel Executive in their report. The Lowdham Grange contract was let six months after the invitation to tender was issued which is approximately 65 per cent faster than the timescale required for Bridgend and Fazakerley (Figure 9).

The costs of letting the contracts

The initial estimates of costs significantly underestimated the actual costs which were incurred

4.10 Figure 11 sets out the external costs which the Prison Service incurred in letting the Bridgend and Fazakerley contracts compared with their initial estimates. Actual costs were nearly two and a half times the initial estimates because of the complexities of letting these first PFI prison contracts. The Prison Service monitored the costs of each consultant and adviser and approved increases before work was undertaken. As these were early PFI projects other Departments may benefit from the work carried out by the Service's consultants in helping to develop these projects.

4.11 The Prison Service's financial adviser Lazards were not appointed competitively for the Bridgend and Fazakerley contracts. The Service's reason for this was that Lazards had been awarded a much smaller contract in competition to give advice on PFI matters and because of time pressures this was extended to the Bridgend and Fazakerley contracts. There would have been merit in the Service also considering the expertise and costs of other firms before making the appointment for the larger PFI prisons projects. Before making the appointment, the Service were aware that Lazards had provided corporate advice to both Securicor and Tarmac, but were assured that Lazards would not be advising these firms on their bids for the PFI contracts.

Advisers' costs

Figure 11

| | Initial Estimate 1 £000 | Actual Costs¹ £000 | Increase | |
|--|--|--|-----------------|----------|
| | | | £000 | % |
| Legal advisers - Freshfields ² | 200 | 634 | 434 | 217 |
| Financial advisers - Lazards ³ | 145 | 333 | 188 | 130 |
| Project managers - Coopers & Lybrand ⁴ | 145 | 251 | 106 | 73 |
| Other legal advice - The Treasury Solicitor and Government Property Lawyers ⁵ | - | 187 | 187 | - |
| Construction compliance advisers - Mouchel and Ove Arup ⁶ | 119 | 119 | - | - |
| Insurance advice - Sedgwick | 27 | 27 | - | - |
| | <u>636</u> | <u>1,551</u> | <u>915</u> | 144 |

- Notes: 1. All amounts are inclusive of expenses but exclude VAT.
2. The initial estimate for Freshfields' work is the fee cap which was set for the first four month period 1995. No further overall estimate was set for this work at the outset.
3. Lazards were awarded an initial contract for £145,000 in June 1994 and two contract extensions in April 1995 and November 1995.
4. Coopers & Lybrand were awarded an initial contract for £145,000 in December 1994 and a further contract extension in November 1995.
5. The amounts paid to the Treasury Solicitor and the Government Property Lawyers arose from a call-off arrangement. No budget, however, was set for these amounts.
6. Mouchel and Ove Arup were paid a fixed monthly amount. The amounts shown above relate to services provided up to the letting of the contracts. Both firms have continued to provide construction compliance services to the Prison Service since the contracts were let. Their aggregate fees are expected to be £553,000.

Source: The Prison Service

This figure shows that actual costs were nearly two and a half times the initial estimates.

4.12 The Public Accounts Committee recommend in their report on the "Proper Conduct of Public Business" (8th Report, Session 1993-94), that full and open competition should be applied in all save the most exceptional circumstances, for example where no alternative supplier is available, in order to secure the best the market can provide at the most competitive price. The principle of competition is also included in the Treasury's guidance on procurement matters and in the

Private Finance Panel Executive's guidance of May 1996. The Prison Service agree that if they had sought competitive proposals before appointing their financial adviser they would be able to demonstrate more effectively that value for money and objectivity had been secured.

4.13 Freshfields were appointed as legal advisers by the Treasury Solicitor but the Service were involved in all aspects of the appointment of Freshfields and the operation of their contract. Although the Service monitored Freshfields' work and established financial limits, for each four monthly period, for Freshfield's fees they did not gather information to enable them to set a reliable initial budget for the cost of all legal work. The Service and the Treasury Solicitor doubt whether a meaningful budget could have been set because, at the time, there were no previous examples of similar PFI projects.

4.14 The costs incurred on all legal advice, including the Treasury Solicitor and Government Property Lawyers, was £821,000 for both contracts which was 53 per cent of total costs incurred. The Prison Service believe that their expenditure on legal advice in these first PFI projects will have long term benefits to their subsequent PFI projects and has contributed to a significant reduction in legal costs on the Lowdham Grange project. In view of the potential materiality of legal costs it is important that Departments should not underestimate the likely complexity of the work involved and hence establish an accurate budget for these costs even where they may not be able to draw on experience of directly comparable projects. They should also ensure that there are suitable arrangements to monitor and cap such expenditure.

4.15 The Prison Service did not calculate the total amount of time spent by their own staff working on the Bridgend and Fazakerley projects up to the time the contracts were let. As these were longterm projects there would have been some advantage to the Prison Service if they had recorded the amount of time required by each staff member for these projects at each stage of the procurement process. This form of time recording would assist the Service in planning for future similar PFI projects. The Service's procurement unit responsible for PFI work, the Contracts and Competition Group, have subsequently estimated the internal cost of PFI work as the basis for its annual budgetary forecasts.

Glossary of terms

| | |
|--|--|
| Category A prison | A prison containing mainly Category A prisoners, for whom the highest levels of security are required. |
| Category B prison | A prison containing mainly Category B prisoners, for whom the highest conditions of security are not necessary, but for whom escape must be made very difficult. |
| LIBOR | The London Inter Bank Offered Rate - a base rate of interest used in commercial borrowing. |
| Liquidated damages | Financial compensation payable by a contractor in the event of delays during a construction project. |
| Local Prison | A prison whose main function is to hold prisoners on remand, awaiting sentence or awaiting a transfer to another prison. |
| Negotiated form of EC procurement procedure | One of the forms of procurement procedure permissible under EC regulations which allows, in the circumstances defined in the regulations, the procuring body scope to negotiate the terms of the contract with tenderers (subject to the general rule that there must be genuine competition between the tenderers) in addition to the ability to clarify information. |
| Net present value of the contract price | The net present value of the contract price represents the amount that would have to be invested at the start of the contract to fund the expected future cash payments which the Prison Service will be required to make to the contractor. It is calculated as the total of the amounts payable by the Prison Service expressed in 1995 prices and discounted at 6 per cent per annum to the start of the contracts. |
| Outline planning permission | Formal consent in principle to a proposed development. |
| Planning permission | Formal consent of a proposed development based on detailed plans. |
| Private Finance Initiative | A policy introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services. |

| | |
|--|---|
| Restricted form of EC procurement procedure | One of the forms of procurement procedure permissible under EC regulations. There is no provision for the terms of the contract to be negotiated (as under the negotiated form of EC procedure) although discussions are allowed in order to clarify the requirement or the content of the tenders. |
| Sub-ordinated debt | Debt which has less favourable rights for repayment and security than other debt finance. |
| Swap | An arrangement whereby a loan which has a variable rate of interest (which will change in relation to market rates of interest) is exchanged for a loan which has a fixed rate of interest. |
| Training prison | A prison whose main function is to provide education and employment facilities for prisoners with medium and long sentences. |
| Volume risk | The risk that there are insufficient prisoners to fill all available cells. |

Appendix 1

Scope and methodology of the National Audit Office's examination

Scope

1 The National Audit Office examined to what extent the Prison Service met their objectives for these projects (paragraph 1.6).

2 The examination covered:

- Procedures: how the Prison Service went about the task.

The purpose of this part of the National Audit Office's examination was to assess the extent to which the Prison Service's procedures were well chosen and likely to give an outcome in line with their objectives.

- Outcome: how far the contracts are likely to enable the Prison Service to meet their objectives and the extent to which events since the letting of the contracts have impacted on the likely outcome.

This part of the examination involved assessment, and where possible quantification, of the eventual outcome of the Prison Service's work.

Methodology

3 The National Audit Office:

- collected and examined information about the deals from the Prison Service's records;
- discussed the projects with Prison Service officials, their advisers, winning contractors, unsuccessful bidders, and other interested parties;
- obtained advice from external technical experts to advise on specific issues;

- discussed their findings with the Private Finance Panel Executive (who were responsible for monitoring PFI activities and developing good practice guidelines); and
- evaluated the information and advice received.

The use of external technical experts

4 Following competitive tendering processes, the National Audit Office engaged the following organisations to provide specialist advice:

- Chesterton, property consultants, who were engaged to advise on aspects of the Prison Service's procedures for inviting tenders; their evaluation of bids and the sharing of risks between the Prison Service and the contractors; and the financing plans of the preferred bidders; and
- Theodore Goddard, solicitors, who advised on aspects of the contractual arrangements, including the arrangements which permit the contractor to seek a variation in the price of the contract, and the arrangements whereby the Prison Service may become liable for payments on termination of the contracts.

The external technical experts were chosen because they had experience of having advised on other large PFI projects.

Evaluation of the information collected

5 Our evaluation considered whether the Prison Service had followed good practice and how far the Prison Service's decisions impacted on the achievement of their objectives for the projects.

6 We considered how:

- the Prison Service devised the specification for the projects and how they invited tenders;
- effectively competition was brought to bear throughout the process;
- the Prison Service evaluated the bids;

- the Prison Service calculated the public sector comparator which they used to estimate whether savings would be generated by the proposed PFI solutions;
- the Prison Service sought to transfer risk to the contractors;
- the final contractual arrangements reflected the Prison Service's intentions for these projects; and
- events since the letting of the contracts have impacted on the likely outcome.

Appendix 2

Background information on the Prison Service

The status and organisation of the Prison Service

1 The Prison Service was established as an Executive Agency of the Home Office in April 1993. The Home Secretary is accountable to Parliament for the Prison Service. The Home Secretary allocates resources to the Prison Service and approves its Corporate and Business Plans, including its key targets. The Home Secretary will not normally become involved in the day-to-day management of the Prison Service but will expect to be consulted by the Director General on the handling of operational matters which could give rise to grave public or Parliamentary concern. The Director General is assisted by the Prisons Board, which is composed of the Service's senior management team and non-executive directors from outside the Service. Responsibility for the management of PFI and other private sector contracts rests with the Prison Service's Contracts and Competitions Group.

2 The Prison Service's statement of purpose is to serve the public by keeping in custody those committed by the courts. The Service's duty is to look after them with humanity and help them lead law-abiding and useful lives in custody and after release. In July 1997 the Prison Service held just over 62,000 prisoners in 132 prisons and employed 39,000 staff. Their budgeted expenditure for 1997-98 is over £1,750 million.

Relevant legislation

3 The Prison Act 1952 consolidated certain previous enactments. It includes a provision for a formal system of regulations, known as Rules, for the management of prisons, remand centres, detention centres and borstal institutions. The main set of regulations is the Prison Rules 1964 as amended by Statutory Instruments.

4 The Criminal Justice Act 1991 (subsequently amended by the Criminal Justice and Public Order Act 1994) provided for the power to contract out the management of prisons. Such contracts were made subject to the provisions of the 1952 Act and Prison Rules, except for specific exceptions related to the powers and duties of staff.

Operating standards

5 In April 1994, the Prison Service issued their Prison Service Operating Standards. These national standards, which all the Service's establishments must aim to meet over time, clarified and codified in a single document, for the first time, standards contained in the Prison Rules, Standing Orders and various management manuals and instructions to governors. Reference was also made to the European Prison Rules and best practice guidance.

Woodcock report

6 In December 1994 the Secretary of State presented to Parliament the report by Sir John Woodcock, CBE, QPM, into the escape by six Category A prisoners from the special security unit at Whitemoor Prison, Cambridgeshire in September 1994. The report made 64 recommendations for improvement in the security of both the design and operation of Category A prisons. Many of the recommendations require major physical improvements to the prison estate.

Learmont report

7 In response to the Woodcock report the Secretary of State appointed General Sir John Learmont, KCB, CBE, in December 1994 to conduct an independent review of physical and procedural security throughout the Prison Service. In January 1995 the Secretary of State extended his terms of reference to include an examination of the escape in that month of three prisoners, two of whom were Category A, from Parkhurst Prison, the Isle of Wight.

8 In October 1995 the Secretary of State published the Learmont report. It contained 127 recommendations. As well as criticising the general management of the Prison Service, the report made a number of detailed suggestions for the improvement of security.

Contracting out and the Private Finance Initiative

9 Between 1992 and 1994 the Prison Service contracted out the management of four new prisons - Wolds, Blakenhurst, Doncaster and Buckley Hall. The management contract for a fifth, Manchester, was won by an in-house bid. In total, over 2,000 prisoners places are currently contractually managed.

10 The statutory framework for contracted out management provides a framework of safeguards, controls and accountability, including: (1) the same degree of public scrutiny that applies to publicly managed prisons; (2) the presence of a Prison Service controller (an experienced and senior governor) on site to monitor the contract and undertake those functions reserved to state servants such as to adjudicate on disciplinary charges brought against prisoners and investigate allegations against the staff; (3) the vetting by the Prison Service of all prisoner custody officers; (4) arrangements for the Prison Service to take over all or part of the facility if there is a risk of a lack of control by the contractor; (5) arrangements for mutual support between contractually and directly managed prisons if there are disturbances; and (6) the prohibition of strikes amongst prison custody officers.

11 In September and October 1993 the Home Secretary announced plans for the private sector to finance, design and construct, and then to subsequently manage, six new prisons under the Private Finance Initiative.

Comparisons of public and privately operated prisons

12 A Home Office review of privately operated prisons published in October 1996 indicated that three privately operated prisons were on average cheaper by the following amounts than comparable prisons operated directly by the Service: 11 per cent based on cost per prisoner (calculated on historical average inmate levels), 16 per cent based on cost per baseline place (calculated by reference to the prison's certified uncrowded capacity level), and 17 per cent based on cost per in-use place (calculated by reference to the amount of the certified uncrowded capacity actually occupied).

13 The October 1996 review of privately operated prisons was used by Charterhouse to compute a revised public sector comparator for Fazakerley (paragraph 3.10). They made optimistic assumptions that the public sector would avoid construction delays and cost overruns (by learning from the PFI experience), would limit salary increases to RPI plus 1/2 per cent per annum, and would reduce total operating costs in line with the Service's target of a 5.7 per cent reduction in the three years to 1997-98. This was a sensitivity test looking at the effect on the earlier comparator of a more efficient and effective public sector procurement process and long-term operation.

Appendix 3

Chronology of key events

- 1993**
- January** The Prison Service started to meet private sector firms to gauge their interest in the possible use of private finance in the prison building programme, and began to seek advice on how this should be done.
- April** The Prison Service obtained a spending provision for two new prisons at Fazakerley and South Wales. They sent out a questionnaire to survey private sector interest in the use of private finance in the procurement and operation of new prisons.
- September** The Home Secretary announced that the design, construction, management and financing of two new prisons will be contracted out.
- November** The Prison Service published notices in the Official Journal of the European Communities (OJEC) inviting private sector expressions of interest in the provision of finance, design and construction, service operation and maintenance at Bridgend and Fazakerley.
- December** The Prison Service sent an information pack to the 60 firms and consortia who replied to the notice. They also held a conference to brief those interested.
- 1994**
- February** 10 consortia and firms replied and requested information.
- March** After a prequalification exercise, the Service established a shortlist of six consortia to be invited to tender.
- May** Outline planning permission obtained for the Fazakerley site.
- June** Appointment of Lazards as financial advisers.
- July** Formal issue of initial invitations to tender to six shortlisted consortia. Disqualification of one of the consortium invited to tender, due to change in its composition.
- August** The Prison Service started to define the evaluative process.

| | | |
|-------------|-----------------|---|
| | November | Receipt of initial tenders. Appointment of Coopers & Lybrand as project managers. |
| | December | The initial tenders received were non-compliant. In order to obtain compliant tenders, the Prison Service, on the advice of the Treasury Solicitor, changed from the restricted to negotiated procurement route. The bidders were informed of this. |
| 1995 | January | The Prison Service met with each bidder to discuss their proposals. They also re-examined the risk allocation proposed in the contracts and their requirements on design and operational matters, including the impact of the Woodcock report. Appointment of Freshfields as commercial solicitors. |
| | February | Formal issue of revised invitations to tender to the five consortia. |
| | March | Receipt of revised tenders. |
| | April | Report to the Prison Service Board on the evaluation of the tenders. The Prison Service hold further discussions with three bidders. |
| | May | Announcement of the preferred bidders - Securicor, Seifert and Atkins at Bridgend and Group 4 and Tarmac for Fazakerley |
| | June | Appointment of Mouchel Management and Ove Arup as Project Monitors. |
| | December | Contract for Fazakerley prison signed. |
| 1996 | January | Contract for Bridgend prison signed. |
| 1997 | December | Planned date for Bridgend to admit its first prisoners (but expected to be November 1997). |
| 1998 | March | Planned date for Bridgend to be fully operational. |
| | May | Planned date for Fazakerley to admit its first prisoners (but expected to be December 1997). |
| | August | Planned date for Fazakerley to be fully operational. |

Appendix 4

The operational specification for the prisons

Brief summary of aspects covered

| | |
|---------------------------------|--|
| A: The Prisoner | Each prisoner is to be treated as an individual with unique needs. Requirements arising from status, type, vulnerability and age were specified. |
| B: Security, control and safety | Eighteen specific requirements were identified, including the appointment of a designated security officer and compliance with the Prison Service Security Manual. Ultimate responsibility for security rests with the operator. |
| C: Good order and discipline | The features of the control environment to be delivered were specified. |
| D: Health and hygiene | The operator has to comply with health and safety legislation and meet general and personal hygiene requirements. |
| E: Accommodation | Each cell must be inspected and accepted by the Prison Service prior to occupation. Deadlines for completing repairs were specified. |
| F: Admissions and registration | Detailed procedural requirements for admissions, calculating sentences and handling grievances were set out. Bidders were asked to submit proposals for an induction process. |
| G: Release | The required procedures for discharge and transfer were summarised. |
| H: Legal matters | The assistance to be provided, including legal visits, was summarised. |
| I: Religion | All prisoners were to be enabled to observe their religious faith. |
| J: Health care services | The operator has to provide appropriate assessment, diagnosis, treatment and prevention of physical and mental disorders; and promote good health and harm minimisation. |

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| | |
|------------------------|---|
| K: Food service | The broad requirements were stated as to the number, quality, timing and variety of meals, and special diets. |
| L: Prisoner welfare | The operator was required to offer all necessary help, advice and facilities to prisoners to enable them to deal with their personal problems. |
| M: Outside contacts | Expectations for post, use of cardphones and visits were stated. Minimum visiting entitlements and the need for an active policy to inhibit the illegal entry and use of drugs were also specified. |
| N: Regime activities | The operator has to provide a balanced and integrated regime to maximise the time spent out of cells. Prisoners are to have a reasonable choice of structured and unstructured activities. A target was set for industrial activity and the broad requirements for other activities were given. |
| O: Incident management | The operator has to prepare response and contingency plans, including their use of emergency services. |
| P: Maintenance | The operator is to have total responsibility for the maintenance and general condition of the prison. |
| Q: Escort Work | The nature of the escort service required was specified. The handling of Category A prisoners was the subject of separate instructions. |

Note: There was one specification which covered both prisons; where requirements differed between prisons these were detailed in the specification.

Appendix 5

The Prison Service's method of evaluating bids

When assessing the bids, the Working Groups (Figure 4) grouped the evaluative criteria (Figure 2) into four categories. The results of each Working Group's assessment were summarised in a formal bid evaluation report to the Prison Board.

Deliverability

The Prison Service set a series of tests which the bidder had to pass. Failure on any test would preclude the bidder from winning. The Working Group simply assessed whether or not, in their opinion, the bidders' proposals met each of these tests and were deliverable.

Financial

The financial evaluation consisted of an assessment of:

- the robustness and deliverability of the bidders' financial plans; and
- the comparative costs of the bidders' proposals, as measured by their net present value.

Quality

The Prison Service evaluated bids against seven primary criteria, each of which was weighted to reflect their relative importance. The first five criteria reflect the first five principal goals of the Prison Service.

| Primary Quality Criteria | Weighting Per Cent |
|--|-----------------------|
| To keep prisoners in custody | 20 |
| To maintain order, control, discipline and maintain a safe environment | 20 |
| To provide decent conditions for prisoners and meet prisoners' needs including healthcare | 15 |
| To provide positive regimes which help address their offending behaviour and allow them as full and responsible a life as possible | 12 |
| To help prisoners prepare for their return to the community | 12 |
| To have in place adequate management systems, staffing arrangements and other matters | 15 |
| To demonstrate sensitivity to the local environment and to develop links with the community | 6 |

There were a number of secondary criteria which dealt with how the bidder proposed to achieve each primary criterion. The score for each of the primary criteria was then weighted to produce a total score for each bid. The maximum of this aggregate score was six.

Innovation

The Prison Service evaluated innovation as part of their quality assessment. Thus innovation was assessed against the same seven primary criteria used to evaluate quality. The Working Groups decided that if a bidder achieved a satisfactory score (4) or higher on quality and the proposal introduced innovative ideas, the bidder qualified for a further “bonus” score on innovation of up to 2 points. However, if the bidder did not deliver a particular quality criterion, they got a low score on quality and did not qualify for bonus points on innovation, even if their proposal was highly innovative. In this way the Prison Service expected that consortia would not benefit from proposing schemes which were innovative but intrinsically unworkable. They would, however, be rewarded for good and workable innovations.

Appendix 6

Allocation of risks

| Nature of Risk | Sector bearing risk: | Comments on Risk Allocation |
|--|----------------------|---|
| Design and construction | | |
| Construction lasts longer than expected. | Private | The contractor is not paid until construction is complete. He also has to pay the Prison Service compensation for any delay, except where the delay is the Prison Service's fault or in certain circumstances where the delay is not due to the contractor. |
| Failure to provide the prison to specification. | Private | As well as the above sanctions, the contractor has to meet the costs of rectifying defects. If the failure is significant, the Prison Service can terminate the contract without compensating the contractor. |
| The cost of housing prisoners elsewhere during delayed completion. | Shared | Costs are met from the compensation paid by the contractor for late completion. However there is a cap on the total amount of compensation payable (£5 million on Fazakerley and £10 million on Bridgend). If the cost of the temporary accommodation exceeds this, the Prison Service fund the excess. |
| Construction costs more than expected. | Private | The contractor will meet cost overruns unless the Prison Service is responsible for these. |
| Prison design causes operational difficulties or its operation requires changes to its design. | Private | The contractor meets the increase in operating costs, the costs of any changes to the prison design, and any Prison Service losses arising directly from the problems (subject to a cap - £5 million for any one incident or series of incidents and £20 million in total). If operations are so disrupted that the contractor defaults, the Prison Service can terminate the contract but will have to pay compensation. |
| Operation | | |
| Operating costs are more than expected. | Shared | The Prison Service will fund any increases resulting from agreed changes. There is also provision for a five-yearly review of the contract price, to be held if factors outside the contractor's control significantly increase his costs. |
| Operating costs are less than expected. | Shared | On Bridgend only, the five-yearly review of the contract price can be held if factors outside the contractor's control decrease costs significantly. |
| Contractor fails to meet performance standards. | Private | The contractor's payments are reduced. Persistent failure may result in the contract's termination, although the Prison Service have to pay compensation in this case. |
| Although no contractor default, the Prison Service terminate the contract. | Public | The Prison Service can terminate the contract at any point after the first five years of the contract, but have to compensate the contractor and his lenders. |

| Nature of Risk | Sector bearing risk: | Comments on Risk Allocation |
|--|----------------------|--|
| Intervention necessary due to loss of control over the prison. | Shared | The contractor has to meet the costs incurred by the Prison Service. |
| Re-instatement of prison if damaged. | Private | The contractor is liable for any loss or damage, except that caused by the Prison Service. |
| Building maintenance | | |
| The prison's condition is not properly maintained. | Private | The contractor has to maintain the prison in good condition and meet the cost of any repairs. After the first five years of the contract and then once every two years thereafter, the Prison Service can conduct their own condition survey. |
| Maintenance costs are more than expected. | Shared | If factors outside the contractor's control significantly increase his costs, this can trigger a five yearly review of the contract price. |
| Insurance | | |
| Insurance against damage. | Shared | The contractor must insure the prison and site to full replacement value. The Prison Service will be the insurer of last resort for malicious damage if insurance is generally unavailable (through no fault of the contractor's) at a commercial price. |
| Insurance against third party liability. | Private | The contractor must insure the Prison Service in respect of this liability up to a specified sum. If the insurance is not commercially available, the Prison Service can decide to allow the contractor to continue without the necessary cover. |
| Planning | | |
| Adherence to terms of planning permission. | Private | The contractor is responsible for complying with the terms of the detailed planning permission they obtained before the award of the contract. |
| Legislation/regulation | | |
| Changes in prison legislation increase costs. | Public | The Prison Service will meet any increases in the contractor's costs arising from changes in prison legislation. |
| Changes in health and safety legislation increase costs. | Shared | The contractor may seek a variation in the contract price due to increases in his costs from health and safety changes, but the Prison Service can then raise any other matters that may have reduced the contractor's costs. |
| Other legislation changes increase costs. | Shared | Such a change is a factor outside the contractor's control and can trigger a five yearly review of the contract price, if the effect of the change significantly increases the contractor's costs in operating and maintaining the prison. |

| Nature of Risk | Sector bearing risk: | Comments on Risk Allocation |
|--|----------------------|--|
| Availability | | |
| Less available places than contractually required. | Private | The contractor is only paid for the number of places available. |
| Volume | | |
| Insufficient prisoners to fill available places. | Public | The Prison Service originally asked bidders to price two options; one where they accepted no occupancy risk and one where they accepted some. The sharing of this risk, however, was not acceptable to bidders. |
| More places are needed due to increasing prison population. | Public | The prisons have to be able to provide a certain number of additional places above the usual number. However the Prison Service has to pay extra for each such place it uses, although at a reduced rate. |
| The mix of prisoners between categories in the prison, or the categories themselves, change. | Shared | The contract price can be varied if the change required significantly alters the prison's operational nature, as defined in the contract. |
| Technology/obsolescence | | |
| Improvements in technology make the prison design or operation obsolescent. | Private | Both the contractor and Prison Service can propose changes in security technology and both share in the resulting savings. |
| Residual value | | |
| The prison has little or no use at the contract's end. | Public | The prison reverts back to the Prison Service at the end of the twenty five year contract period. The prisons have a design life of sixty years, given proper maintenance. |
| Financial | | |
| Interest rate changes increase contractor costs. | Private | Under the contract the contractor bears the risk of interest rate movements on loans relating to the prison's construction to the extent that the contractor allocated these costs to the fixed cost part of the contract price. In any event, most of the contractors' borrowings bear fixed interest charges (Figure 9). |
| Inflation increases contractor costs. | Shared | The parts of the contractor's fee covering operating costs increase automatically each year. However the indices used are more generous to the contractor than the Prison Service originally proposed in the first round of tenders. |
| Changes in the tax regime increase contractor costs. | Shared | Such a change is a factor outside the contractor's control and may trigger a five yearly review of the contract price, if the effect of the change significantly increases the contractor's costs in operating and maintaining the prison. |

Appendix 7

Price variations permissible under the contract

| Event | Effect on the contract price |
|--|---|
| Events resulting in a variation to the contract price automatically each year | |
| Increases in the contractor's operating costs | The elements within the contractor's daily fee which cover these costs are automatically increased annually: certain costs, mainly staff costs, by the increase in the retail price index plus two per cent; others, mainly non-staff costs, by the increase in the retail price index. The contractor bears the risk that costs may increase at a greater rate than this where the costs are within his control. The Prison Service bear the risk that costs increase at a lesser rate and the risk of certain additional costs beyond the contractor's control (see below). |
| Events resulting in a variation to the contract price at any time | |
| The Prison Service change the scope or nature of the services that the contractor is required to provide | Once the change is agreed, the contract price is varied accordingly. The new contract price will include, if necessary, an element to allow the contractor to recover any capital expenditure incurred implementing the change. |
| The Prison Service require the prison to hold more prisoners than the total number of places that the contractor is contractually required to make available | The contractor is paid an extra fee for each additional prisoner place. The amount of this fee is set down in the contract. The contract also places a limit on the total number of additional places that the Prison Service can require. |
| A change in legislation specifically concerning prisons alters the contractor's costs | Once the effect on the contractor's costs is agreed, the contract price is varied accordingly. |
| A change in health and safety legislation alters the contractor's costs | Once the effect on the contractor's costs is agreed, the contract price is varied accordingly. However, when the contractor has made a claim for such a price variation, the Prison Service can claim a reduction in the contract price in respect of any matters that have or should have reduced or will reduce the contractor's costs. |
| A change in security technology reduces the contractor's operating costs ¹ | The contract price is reduced in line with a formula, detailed in the contract, which shares such cost savings between the contractor and the Prison Service. |

Event

Effect on the contract price

Events resulting in a variation to the contract price at five yearly intervals

Changes in the costs of operating or maintaining the prison arising from factors that are beyond the contractor's control or factors not adequately reflected in the provisions for the indexation of costs

Provided these factors result in an increase in the contractor's costs of more than 5 per cent in real terms and have a significant effect on his projected level of return, they can trigger the holding of a five-yearly review of the contract price. The parties are to agree a fair variation of the contract price which will provide the contractor thereafter with the level of return (being the contractor's projected operating profit year by year set out in the contract). The costs of operating or maintaining a prison which are beyond the contractor's control are not defined in the contract but the Prison Service's legal and financial advisers consider they would not include changes in corporation tax and interest rates. Under these provisions the Bridgend contract (but not the Fazakerley contract) would allow the contract price to be reduced if the relevant contractor's costs have decreased.

Note: 1. The cost savings must relate to security technology; the contract does not stipulate that other efficiency savings must produce a price variation.
