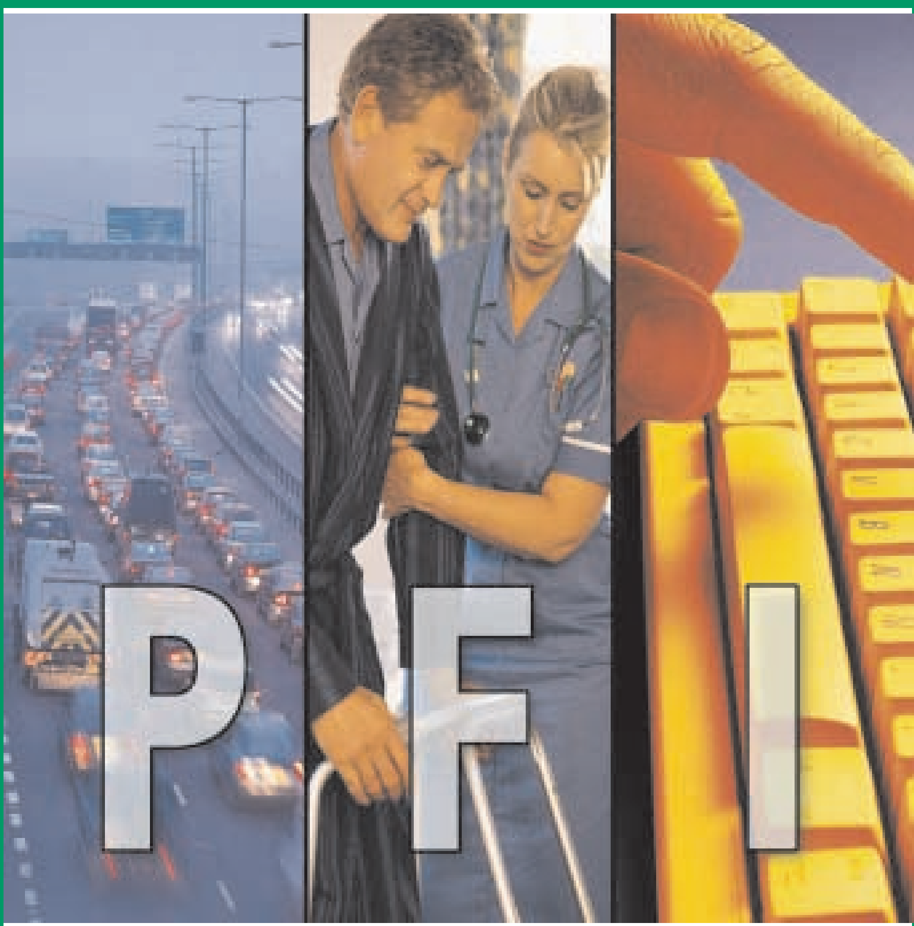
NAO
NATIONAL AUDIT OFFICE

Report by the
Comptroller and Auditor General

Examining the value for money of deals under the Private Finance Initiative



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Preface

The Private Finance Initiative was launched in 1992. Since then successive governments have continued to negotiate projects founded on the principle of drawing on private sector expertise, including finance raising, to provide services which traditionally would have been provided directly by the public sector. The Government have made clear their commitment to develop further this new approach across a wide range of services.

The private finance approach to providing services offers the prospect of better value for money than traditional publicly financed methods. But the private finance approach is both new and more complicated than the traditional methods. The new approach brings with it new pitfalls and new risks to value for money. This means that securing the potential benefits of the private finance approach is requiring new skills on the part of the public sector.

For this reason, I decided that the National Audit Office should aim to report to Parliament on the major privately financed projects. Since 1997, the National Audit Office have published eight reports on such projects, the Committee of Public Accounts have so far held hearings on six of these reports, and the Government have responded to the Committee's recommendations. The Committee have now published their report "Getting value for money from the Private Finance Initiative".

Based on this work, it seemed to me that the time was now right to report to Parliament the approach the National Audit Office are taking to the audit of deals under the PFI. This approach uses a comprehensive analytical framework combined with the detailed questions which have emerged from applying the framework to the particular cases the National Audit Office have so far examined.

I hope that the material in this report will also be of value not only to auditors of PFI deals but also to those whether in the public sector or not who are seeking to negotiate such deals.

John Bourn

Part 1: The National Audit Office analytical framework

Introduction

1.1 This report gives details of how we examine the **value for money** of deals reached under the Private Finance Initiative. It is important for the reader of this report to understand that our role is to report to Parliament on the value for money that Government departments have achieved. As auditors we examine what has happened in the past rather than what may happen in the future. We therefore are able to examine PFI projects as they are agreed between the public sector clients and the private sector suppliers and when they are therefore, in a sense, past events. In many cases, however, the projects envisage that the private sector supplier will provide services over many years, even decades, in the future. Our examination of these projects inevitably involves, therefore, taking a view on how well PFI deals are likely to succeed in meeting the public sector clients' requirements in the future.

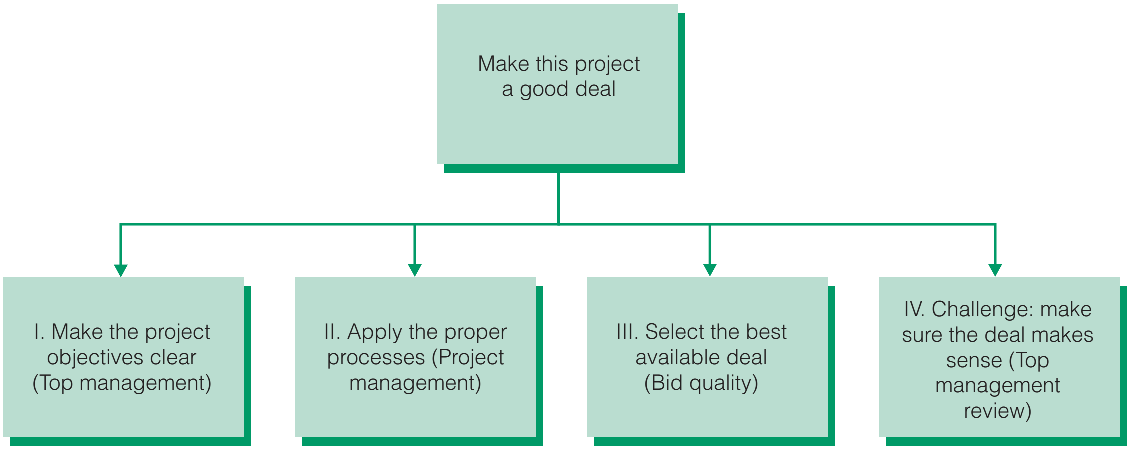
1.2 As experience grows in how PFI projects develop in practice, there may well be further lessons to be learnt. For that reason this must be seen as an interim report, showing how we view the value for money issues in the PFI now. This report concentrates on value for money and is not concerned with issues relating to the accounting for PFI deals.

1.3 In the course of our examination of PFI projects, we have developed an analytical framework which seeks to cover comprehensively the key value for money issues to which these projects give rise. We realise, however, that we may need to refine the framework further in line with any future developments in the PFI and in light of our own experience from examining more of these deals.

1.4 This part of the report comments on the principles underlying the achievement of value for money from PFI deals. These principles have emerged from the application of the analytical framework to particular cases. The framework takes the form of a hierarchy of statements expressed in terms of advice to the procurer. Starting from the most general, these statements become increasingly specific and detailed. The whole framework is shown in Appendix 1. Figure 1 shows the top level of the framework.

Figure 1

The National Audit Office's analytical framework



Overarching aim: to get a good deal

1.5 The aim of procuring departments should be to get a good deal for the taxpayer. This overarching aim needs constantly to be kept in view during what can be a very long drawn out procurement process. If it is not, two serious risks to value for money can arise. First, there is the risk that attention will be focussed on executing the process rather than on achieving a good outcome. Secondly, and this is a risk in private sector negotiations too, there is the risk that the department will focus on reaching agreement on a deal and not on getting a good deal.

The four pillars

1.6 The overarching aim of getting a good deal is supported by four pillars:

I: Setting clear objectives

Procuring departments need to think through, in advance of commencing the procurement, exactly what they are looking for from the proposed deal and how it can be expected to deliver that outcome. These are issues for departmental top management.

II: Application of the proper procurement processes

Procuring a PFI deal is usually a major project in its own right which needs to be managed as such. The choice of procurement process is of vital importance: the process must comply with the relevant law and regulations; and it must also be designed to maximise the prospect of achieving a deal which is good value for money. These are issues primarily for departmental project management to consider.

III: Getting the best available deal

To achieve this the department must ensure both that the procurement process delivers the best available deal in the market for the PFI project, and that that position is maintained during any period of exclusive negotiations with a preferred bidder. The prime focus here is on the quality of the bids which are received.

IV: Ensuring that the deal makes sense

This applies throughout the procurement. At any point in the process it may become clear that the market is not going to deliver a deal on the terms envisaged at the outset. That could be a sign that the project should be re-considered and either dropped entirely or re-tendered on a different basis. Applying this principle will mean that, at the moment before the procuring department become committed to the deal, they need to be satisfied that it is likely to deliver the service that they want on the best available terms, and that it provides the best way of meeting their objectives for the project. This issue is one that top management will wish to ensure is examined.

Make the project objectives clear

1.7 The essence of PFI deals is that the public sector and the private sector work together to deliver services. Good value for money from such working together depends upon structuring the PFI deal in a way which delivers to the public sector outcomes which meet the department's objectives, and which provides the private sector with the opportunity to apply their skills and expertise most effectively. A project which focuses on what the public sector wants, without regard to what the private sector can supply, is unlikely to be good value for money. Likewise, value for money will be compromised if the public sector's requirements take second place to providing an attractive opportunity for the private sector.

1.8 This means that, before a department embark on a PFI project, they need to think through most carefully how they hope to strike the necessary balance between public sector requirements and private sector capabilities. It is unlikely that they will know the full answer to striking this balance at the beginning of the procurement, so they will need to keep an open mind and be prepared to walk away from the procurement if it becomes clear that the project is unlikely to deliver good value.

1.9 In our analytical framework (Figure 2), there are four steps which need to be taken if the project's objectives are to be clear:

a) selecting the best projects to pursue

b) making clear what the project is expected to deliver

c) determining the best form of partnership with the private sector

d) producing an outline business case.

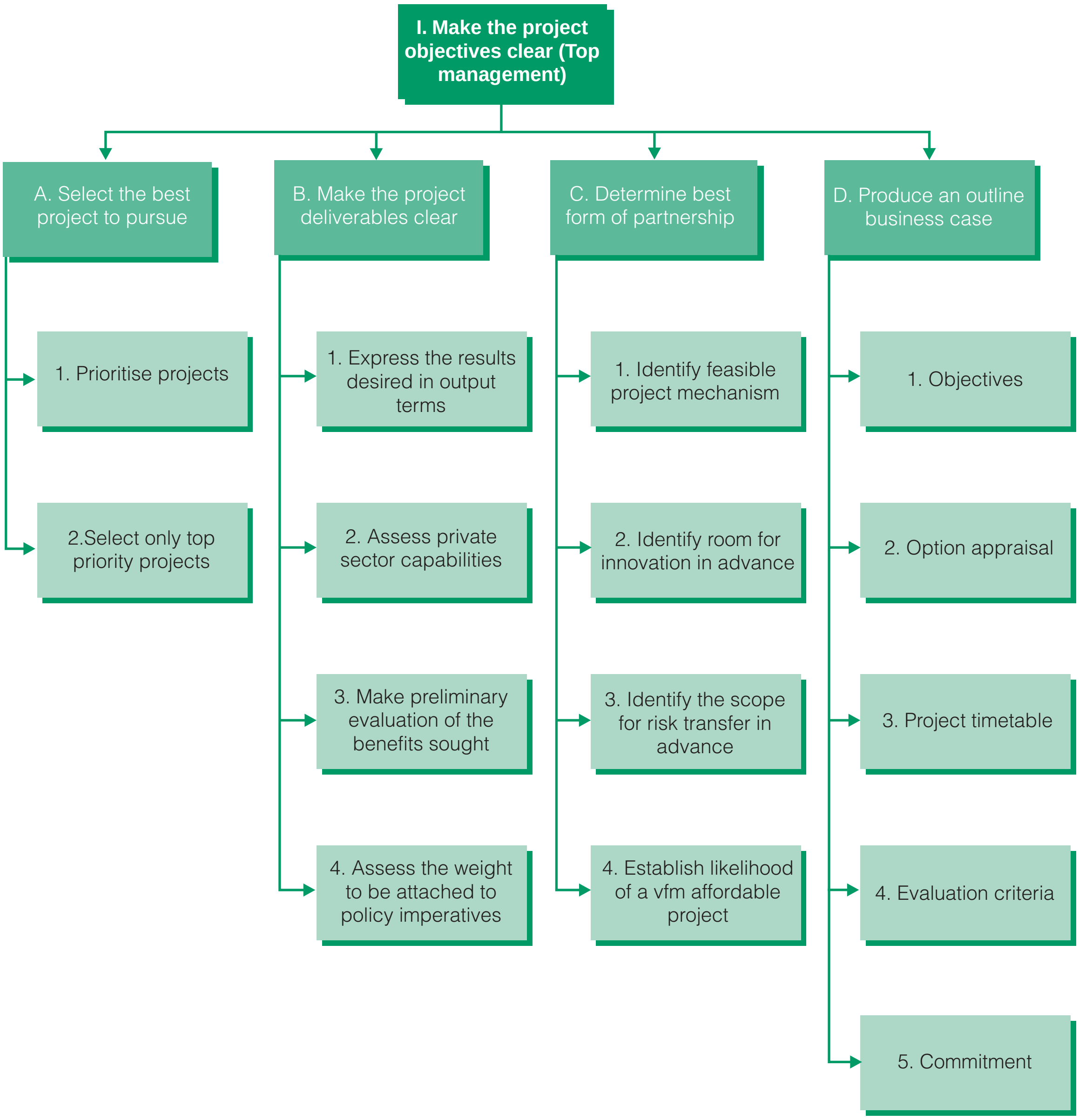
Selecting the best projects to pursue

1.10 The PFI approach can enable departments to undertake projects which they would be unable to finance conventionally. In many projects of the PFI type, the private sector finances the construction of a major physical asset, operates it, and recovers the cost over time through charges for services to a department. This means that the department does not need to find all the money for the capital asset up-front during its construction. For this reason, PFI projects can be very attractive to departments.

1.11 In this attraction, however, there lies the risk that departmental priorities may be distorted in favour of those projects which are capable of being run as PFI projects. A different set of distortions sometimes operated in the selection of projects to be procured traditionally as departments sometimes focussed on the capital costs involved in obtaining an asset and gave less attention to the on-going costs of operating it. Therefore, when selecting any project to be undertaken, departments need to establish some means of choosing projects by reference to wider programme objectives which offsets such potential distortions. They need to think hard about the volume and quality of services they require and the **full** costs of their provision over the long-term, regardless of the eventual method of procurement.

Figure 2

Make the project objectives clear



Making the project deliverables clear

1.12 The PFI approach offers the prospect of better value for money, in some cases, than conventional public procurement because it adds a wider range of private sector capabilities to those previously available to the public sector. For this to work, the private sector need to be given the greatest possible scope to apply their skills. This means that, in specifying what they want from a PFI deal, the procuring department need to be careful to avoid imposing unnecessary constraints on how the private sector can carry out the project.

1.13 The principles which need to be followed are therefore:

a) departments should focus on what outcome or output they really want, rather than on the inputs which the private sector may provide. Traditionally many departments have themselves been managers or providers of services and directly responsible for the construction of capital assets. This means that they have in the past necessarily focussed on inputs (numbers of staff, physical specifications of buildings and so forth). That historical approach can now make it difficult for departments to concentrate instead on outputs, but it is essential that they do so if the private sector are to be given the freedom they need to provide innovative solutions to departments' service requirements.

b) In determining how to express the desired outcomes, departments should have regard to private sector capabilities. In some cases, for example a payroll service, the private sector may be very familiar with the type of outcome likely to be required. In others, such as novel applications of information technology, the private sector may need more help in understanding what the requirements are. Departments need to take steps to understand, in each potential project, in what terms the private sector will best understand their requirements.

c) At these early stages a department will need to make a preliminary assessment of the benefits that they are seeking from the project. This will then enable them to set meaningful criteria for their later evaluation of tenders received.

d) In many areas of Government business, there can be policy or regulatory reasons which place constraints on how a particular service is to be delivered. Procuring departments need to understand fully the basis for such policy imperatives so that they can communicate them to the private sector.

Determining the best form of partnership

1.14 In some cases, it may be possible to leave open to the market exactly what form of partnership would best meet the procuring department's objectives. More usually, however, it will be impractical to seek bids on such an open basis: giving bidders complete freedom might unduly complicate their work and make it difficult for the department to make fair and thorough comparisons of one bid with another. This means that the department will have to limit the range of options before seeking bids. The key steps in doing so in a way which least compromises value for money are as follows:

a) Identify feasible project mechanisms

It may well be necessary to decide in broad terms what are the options regarding the nature of the deal which the market is to be asked to bid for. In the case of a road, for example, will it be a toll road, or a design, build, finance and operate project financed by shadow tolls, or design and build only?

b) Identify the scope for innovation

The best value for money from PFI projects is likely to arise when there is maximum scope for the private sector to develop innovative ways of delivering the services or outputs the procuring department requires. For this to be achieved, it is highly important for the department to ensure that any restrictions they may impose on innovation are justified.

c) Identify the scope for risk transfer

Likewise, one of the key ways in which the PFI approach can deliver better value for money than conventional procurement is by allocating risks to the parties best able to manage them. Procuring departments therefore need to think through in advance whether there are any aspects of the deal they are proposing to put to the market which are likely to stand in the way of allocating risks optimally; for example, by creating new risks which would fall on the private sector supplier.

d) Establish the likelihood of an affordable value for money project

It will be a waste of time and money to go out to competition for a project which could have been seen to be unaffordable or bad value for money even before bids have been sought. Although the procuring department might reasonably challenge the market by seeking novel approaches, including novel approaches to risk transfer, it is often possible, with appropriate external advice, to predict when the market is unlikely to be able to deliver a proposed requirement.

Producing an outline business case

1.15 In some central government organisations, it is a standard requirement to produce an outline business case before going to the market for a major project, whether of the PFI type or not. Irrespective of whether the procuring department has such a standard requirement for an outline business case, it is good practice to bring together formally the case for proceeding with a PFI deal. Without an outline business case, there is the risk that a deal will be done because it can be done rather than because it should be done.

1.16 The outline business case needs to set out the objectives of the project, an option appraisal showing that the PFI approach is most likely to be the best way forward, a timetable, evaluation criteria for examining bids, and indications of whatever financial commitment may be necessary to pay for the project once delivered.

Apply the proper processes

1.17 Once a decision has been taken to proceed with a PFI project, it will be the responsibility of the procuring department's project management team to set in place the appropriate procedures for procurement. It is their responsibility to satisfy themselves that the procedures they choose are consistent with the legal requirements applying to public sector procurement, and may be expected to give good value for money. Their procedures should also be fair to the bidders. Procedures which place unduly onerous requirements on bidders may result in these being unwilling to participate in future procurements, thereby weakening competition, and thus value for money, in the long term.

1.18 Crucial to getting good value for money will be a procurement process which is as fully competitive as possible throughout the whole period of the procurement. It is not good enough for the procedures to be competitive in form; they must be genuinely competitive in substance. For this to occur, it is essential to arouse and to harness the enthusiasm of several private sector bidders and to sustain that enthusiasm until agreement is reached on a contract. A PFI project is, or ought to be, not just a worthwhile but an exciting business opportunity for the private sector. It is the responsibility of the procuring department to ensure that the project is presented to the market as such an opportunity.

1.19 The principles (Figure 3) which should underlie the application of the proper procurement processes are:

a) thorough planning

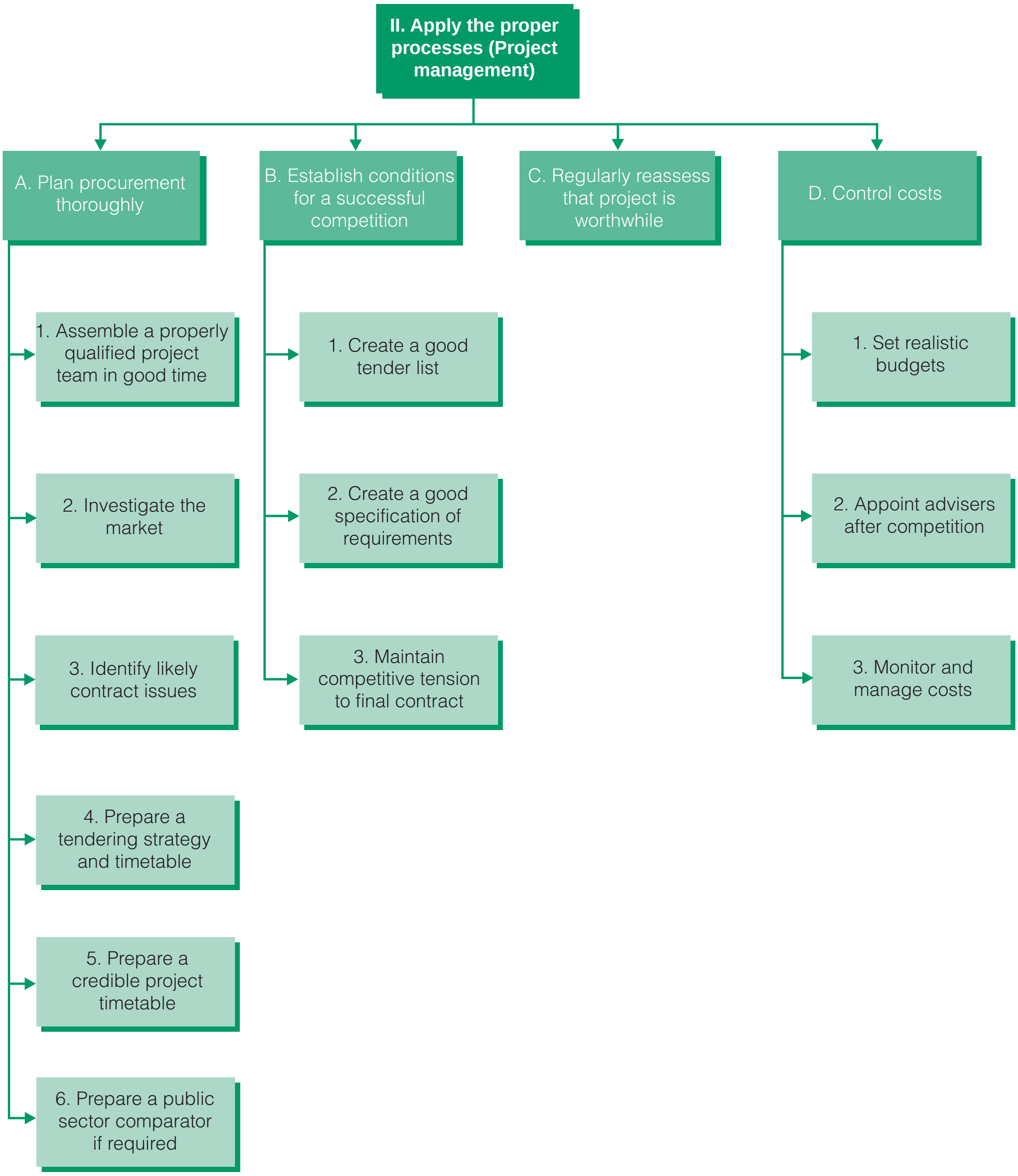
b) establishing conditions for a successful competition

c) regularly reassessing that the project is worthwhile

d) controlling costs.

Figure 3

Apply the proper processes



Thorough planning

1.20 The first step in the thorough planning of the procurement of a PFI deal is to assemble in good time a properly qualified project team. Wherever possible the internal members of the project team should include people with previous experience of negotiating PFI deals or privatisations. As regards external advisers, procuring departments should seek to appoint advisers with previous successful experience of PFI work. They should expect candidates for such appointments to be able to produce references from previous clients, and they should actively take up references.

1.21 With a team in place, the next step is to investigate the market for the services in question. The purpose of this investigation is to inform the way the project is presented to the market, so that potential suppliers will be able to appreciate the full extent of the business opportunity it offers. Within the legal constraints of the procurement regulations, it is nevertheless possible to discuss a potential project with potential bidders to discover what aspects of the project are likely to appeal to them and what may not be so attractive.

1.22 The outcome of the procurement will be a contract with the private sector partner. It therefore makes sense, in the planning stage of the procurement, to consider what issues are likely to arise in negotiating the contract, drawing where relevant on previous experience with similar PFI projects.

1.23 Competitive tension will be greatest when bidders are competing keenly with each other. However the private sector are unlikely to be willing to compete strongly if departments are asking an excessive number of firms to submit bids and commit the substantial resources that the preparation of a full bid involves. Normally there will need to be several rounds of bidding. It will therefore make sense for departments to limit the number of bidders expected to commit substantial resources to submitting full bids. Departments therefore need to think through their strategy and timetable for handling the number of bidders and bidding rounds, and also how much of the strategy should be revealed to bidders at each stage.

1.24 The principle which should govern the tendering strategy is to maximise competitive tension throughout so that tenderers will always feel under pressure to put forward their best possible bids. The timetable needs to be sufficiently brisk to maintain such tension, but it needs to be ample enough to permit the important contractual issues to be settled before the selection of the winning bidder. As regards revealing the strategy to bidders, there is much to be said for letting bidders know what is likely to be involved, because that enables bidders to make informed decisions on their own bidding strategy. At the same time departments must always ensure that they are free to vary their strategy in the light of changing circumstances and possibly at short notice if they believe that better value for the taxpayer will result. Departments should beware, however, of making it their general practice to vary their stated tendering strategy since this can work to their disadvantage. For example, if they routinely ask for further, unplanned rounds of bids, bidders are likely to anticipate this and take it into account when making their opening bids.

1.25 Finally, as part of the planning of the procurement, departments should establish a public sector comparator against which they will be judging the bids. The outline business case prepared earlier in the process will have set out the key basis for comparison. Departments should revise the detailed figures in this as the procurement progresses to reflect more up to date information on public sector costs, and revisit the assumptions underlying the comparator if necessary. They should aim to complete as much of the comparator as possible before the receipt of best and final offers if it is to help in their assessment of bids.

Establishing conditions for a successful competition

1.26 Competition is central to getting good value from PFI deals. The key conditions for a successful competition are:

a) A good tender list of firms invited to bid

Such a list cannot be expected to emerge by itself. Sponsoring departments need actively to stimulate interest in their proposed PFI projects, to publicise their procurement competitions in accordance with the relevant law and regulations, and to give all necessary guidance to potential tenderers on how to submit good bids. They may also need to assist the process through which firms can become aware of each other's interest and come together into consortia. All of this must, of course, be done in ways which are compatible with the relevant legal framework.

b) A clear specification of the department's requirements

Tenderers cannot submit good bids unless they know clearly what the procuring department want. It is a mistake, however, for departments to confuse clarity with excessive detail, particularly detail focussed on inputs rather than desired outputs or outcomes.

c) Competitive tension maintained throughout the procurement process

The need to maintain competitive tension cannot be over-emphasised. Competitive tension draws out of tenderers their best bids.

Regularly reassessing that the project is worthwhile

1.27 It is very important that departments do not lose sight of the original purpose of a project during the course of detailed negotiations. For this reason someone not directly involved in the negotiations should be responsible for considering as the negotiations evolve whether the expected outcome is likely to be fully consistent with the objectives originally set. In a number of cases, departments have appointed external consultants specifically to carry out this monitoring role. In other cases internal audit have carried it out.

1.28 Any important departure should be reported to senior management as soon as it is clearly established (or highly probable) and a decision should be sought on whether to change the project's objectives or abort the deal. Senior management should in any event keep in touch with progress on significant public/private partnership projects.

Controlling costs

1.29 As a major project in its own right, the procurement of a PFI deal often involves the procuring department in heavy costs. Departments should control these costs just as they should control any other of their running costs. The principles of controlling costs should be very well understood:

a) The procuring department should set budgets

Although it may be difficult to set a firm budget for external advisory costs at the outset of the procurement, that is no reason for failing to set an initial budget and revising it later when more is known about the work that needs to be done. Budgets should be set and controlled on a project basis, not just on the basis of the annual expenditure figures. It is good practice to set budgets for individual tasks to be performed by external advisers.

b) External advisers should be appointed only after a competition which takes full account of quality as well as of price

The principle of open competition for advisers is to obtain advisers who will provide the best value for money. They will not necessarily be the cheapest advisers, but that does not mean that there is no role for competitive pressure on the fees advisers wish to charge.

c) Costs should be monitored and managed

There is no excuse for failing to manage procurement costs in accordance with the budgets which have been set or as subsequently revised. We have seen indications that private sector bidders often impose stronger cost constraints on their advisers than do government departments, for example by ensuring that fees are capped and increased only for well-defined additional tasks.

Select the best available deal

1.30 The selection of the winning bid for a PFI deal will usually not be as straightforward as in conventional procurement. The reason for this is that normally in a PFI deal the criteria for evaluation will not just be price, or price subject to technical compliance with the service specification, but will be multi-dimensional. The procuring department will need also to take account of such matters as the degree of risk-taking by the potential suppliers, the extent of innovation, and trade-offs between price and quality.

1.31 This means that the method of evaluation should not be over-mechanical. It is highly likely that the exercise of informed judgement will be required. The two most important principles are that the method of evaluation should be consistent with the department's objectives for the project and with what tenderers have been told about the department's requirements. As shown in Figure 4, the key steps to selecting the best available deal are:

a) obtaining a good range of solutions

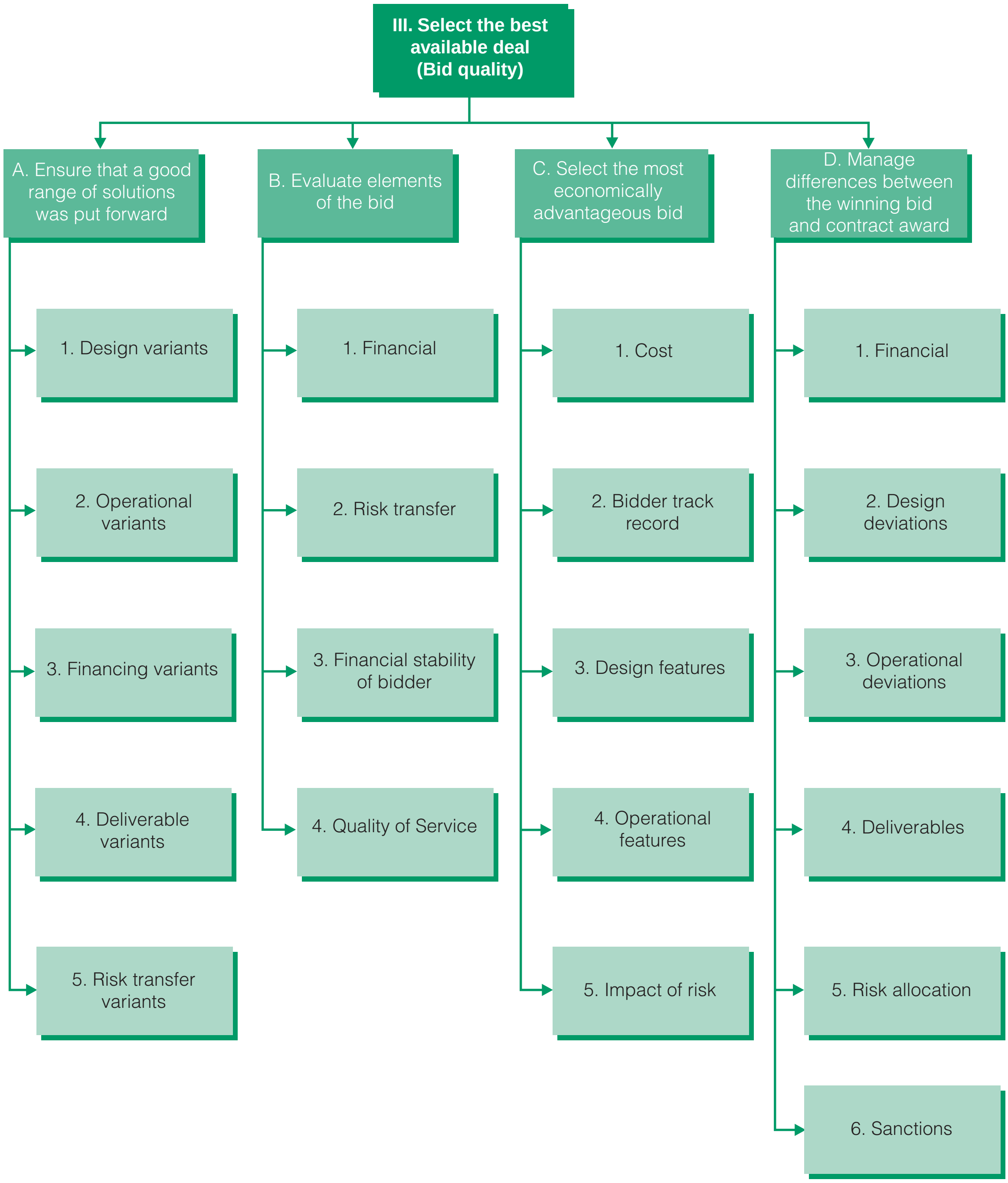
b) evaluating elements of the bid

c) selecting the most economically advantageous bid

d) managing differences between the winning bid and the final contract.

Figure 4

Select the best available deal



Obtaining a good range of solutions

1.32 A successful competition is very likely to produce a number of different solutions to the problem of delivering what the department wants. If there is not a good range of solutions, that will suggest that the department's specification has been expressed too much in terms of inputs, thus restricting the scope for innovation.

Evaluating elements of the bid

1.33 As noted above, the evaluation is likely to be multi-dimensional. The principle to be followed is to take full and fair account of all relevant financial and non-financial aspects of the evaluation. It may make sense to set up separate working groups in the department to examine each distinct aspect of the evaluation but the conclusions of any such groups need to be brought together to reach a comprehensive ranking.

1.34 It has often been traditional in public procurement to enforce a rigorous separation between the evaluation of the technical and commercial aspects of tenders. This is to avoid any risk that the technical evaluation might be unduly biased by knowledge of the prices. In the case of PFI, however, evaluation is likely to turn on the trade-offs between price and quality proposed by the bidders, and departments will therefore need to consider these explicitly. In such circumstances, while it may be helpful for the technical evaluation initially to be conducted in ignorance of pricing information, the full evaluation of bids should take account of both financial and non-financial factors and seek to identify the bid that offers the best combination of these.

Selecting the most economically advantageous bid

1.35 The final selection of the winning bid needs to balance all the criteria. Price alone is unlikely to be decisive and therefore departments will need to consider before the receipt of final bids how they intend in general to resolve any conflict between price and other evaluative criteria, such as the quality of service proposed. In attempting to address the trade-off between price and quality departments should be wary of blindly following some arithmetical scheme of weighting; it is very unlikely that such a scheme can accurately represent the value of differing bids in such a complex field as PFI. Evaluation schemes can provide a useful discipline in evaluation but they should not be used as a substitute for the necessary exercise of informed judgement. Departments should be prepared to be flexible and open to alternative, innovative proposals. For example, they should be careful not to exclude bidders' innovative ideas for payment mechanisms.

Managing differences between the winning bid and the contract

1.36 Because of the complexity of PFI deals, it has not been common for bidders to be able to make final bids which are unconditional. This means that even after final bids are submitted negotiations with remaining bidders are needed. It has also been common for there to be a period of exclusive negotiation with a preferred bidder.

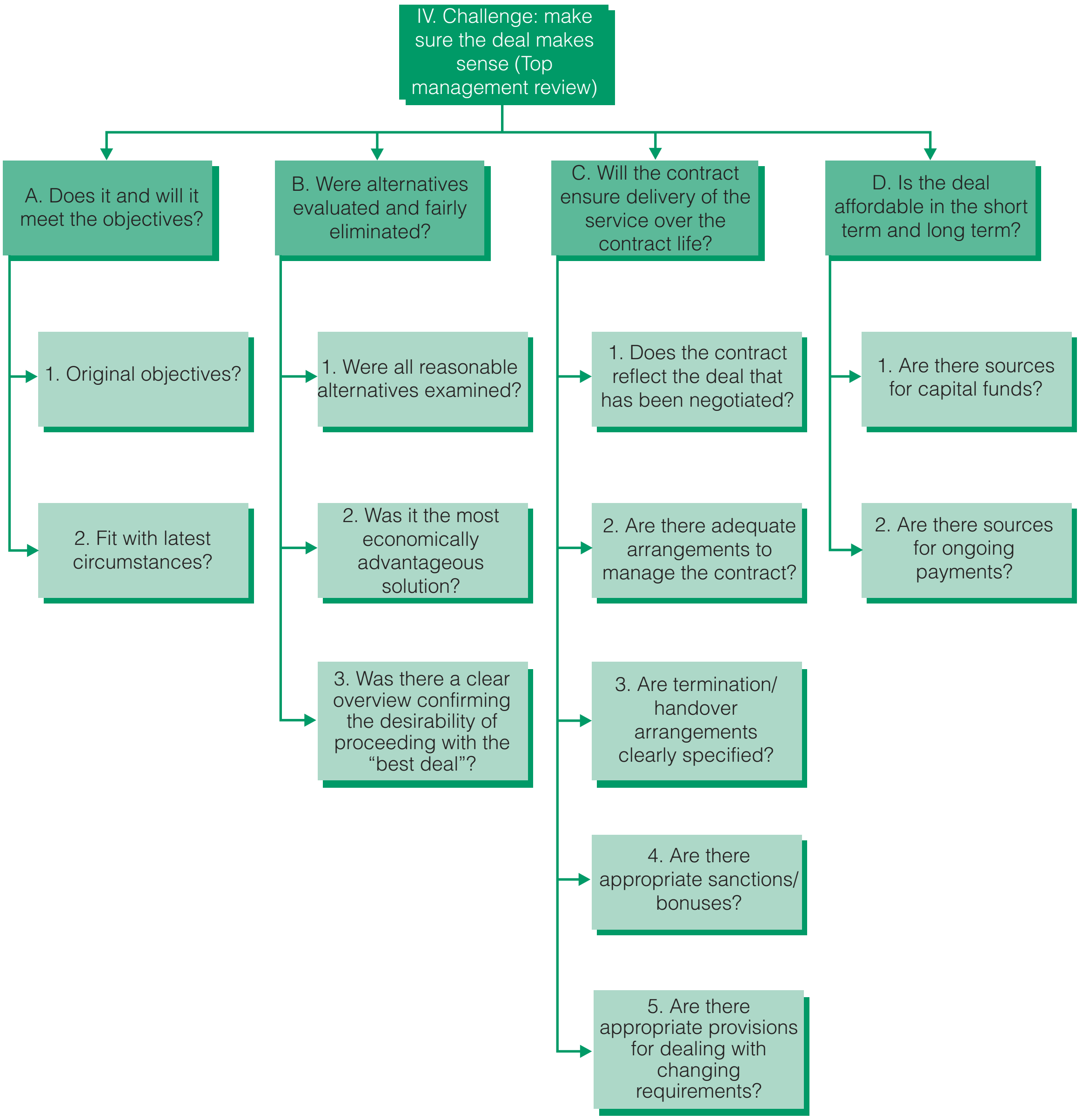
1.37 During such a period, it is hard to avoid some weakening of competitive tension. Unless the procuring department can keep a careful control on concessions to the preferred bidder, experience shows that there is a high risk of the terms of the deal changing so that they are less favourable to the department. This means that the scope for change during such a period needs to be tightly circumscribed and that the department should continually assess the impact on the value for money of the deal of any changes which are proposed or conceded during this period. The department should be wary of agreeing to changes which would put the winning bidder below the next best bidder. The department should also avoid conceding changes which would render the deal poor value for money as compared to an alternative option. Departments should be prepared to walk away from deals which would be poor value. It may be necessary at the start of negotiations to ensure that bidders understand this.

Make sure it makes sense

1.38 At the final stage, those responsible for the continuing review of the project (paragraphs 1.27 to 1.28) should make a report to senior management, comparing the deal on offer with the objectives originally approved and recording any decisions previously made to change those objectives. The questions that should be considered during this ongoing monitoring of the progress of negotiations and in the final report to top management are summarised in Figure 5.

1.39 These questions are also the questions that top management should ask before giving final approval for the project. In most cases, this final review should not delay the letting of the contract because the ongoing review process should have reduced the likelihood of problems at this late stage by previously providing assurance that it was worth continuing with the procurement.

Figure 5 Make sure the deal makes sense



Meeting the real objectives

1.40 There is no point in continuing with a deal which is unlikely to meet the department's objectives. This situation can arise if the terms available in the market are just not satisfactory or if the department's objectives have changed. Departments should be wary of changing their objectives in a way which might be seen by potential tenderers as fickle, as that will reduce the public sector's future prospects of getting good PFI deals. If a department is considering changing their objectives during the procurement, they should seek legal advice as to what changes they can make without exposing themselves to the risk of legal challenge by the bidders.

Eliminating alternatives

1.41 To establish that a deal is good value necessarily requires the procuring department to satisfy themselves that it is superior to their realistic alternative option or options. To do that they will need to carry out a systematic comprehensive and thorough comparison of the PFI option against the public sector comparator. Such a comparison will have begun in the outline business case, and have been worked up in more detail during the planning phase of the procurement. It needs to be maintained throughout the procurement process so that at the end the department can be sure that the contract they wish to sign is the best way of meeting their objectives.

1.42 The comparison needs to be accurate and sufficiently precise to provide a basis for sound decisions. The Treasury's guidance on investment appraisal "The Green Book" provides technical advice on how to carry out the comparisons which are needed. Experience shows that mistakes can easily be made when such comparisons are done by those not experienced in carrying them out. Departments should take the necessary steps to ensure that they carry out the comparisons correctly. In some cases departments have appointed external consultants to carry out the technical analysis or to review that performed by departmental staff.

1.43 Experience also shows that it is possible to construct over-elaborate financial and economic models to support the investment appraisal. It is a waste of money for these models to be more complex than is required or for them to provide spurious precision. Guidance from the Treasury Taskforce (Policy Statement 2: "Public Sector Comparators and Value for Money") makes it clear that greater detail is only required where such detail is likely to have an effect on the decisions made; for example, if there is not a great difference between the comparator and the PFI option.

1.44 In many cases there will be some uncertainty about the underlying assumptions which will limit the degree of precision it is sensible to seek from the financial or economic model. In such cases, it is good practice for the department to examine the sensitivity of the conclusions to variation in the key assumptions.

Ensuring delivery of the service over the contract life

1.45 Checking that it is sensible to proceed with the project must include an assessment of whether the contract has adequate incentives, remedies and safeguards to give the department a high level of confidence that the service will be delivered to a satisfactory standard throughout the contract period.

1.46 The procuring department should satisfy themselves of the following:

a) the adequacy of the arrangements to manage the contract

b) that the incentives provided by contractual sanctions and bonuses are appropriate

c) that the arrangements for compensation payable for poor performance by the contractor are appropriate

d) that satisfactory termination or hand-over arrangements are specified

e) that there are appropriate provisions for dealing with changing requirements

Affordability, short-term and long-term

1.47 PFI deals represent a contractual commitment by the procuring department to pay for services subject only to their being delivered. As such, these deals may reduce the future flexibility of the department to manage their expenditure within the parameters set down by Parliament. It would therefore be irresponsible for a department to enter into a PFI deal without verifying that they would have access to the funds needed to meet their contractual commitment. They need to consider both any capital costs, which might arise in the short-term, and long-term ongoing commitments to pay their private sector partners.

Part 2: Applying the framework: Points for auditors

Introduction

2.1 Our analytical framework for the examination of the achievement of value for money on a PFI deal takes the form of a hierarchy of statements expressed in terms of advice to the procurer. Starting from the most general, these statements become increasingly specific and detailed. Part 2 of the report covers the work that the auditor needs to undertake in order to gain reasonable assurance that a procuring department (the Department) has complied with each specific, lower level statement. If the Department has complied in this way, the auditor will then be able to take reasonable assurance as to statements higher up the hierarchy and, ultimately, that the project offered value for money and was therefore a good deal.

Section I: How the Department made the project objectives clear

Whether the Department selected the best project to pursue

The auditor should examine how the Department prioritised their projects and identify whether the Department selected only top priority projects.

2.2 Given that a PFI contract can commit the public sector to payments for services over a substantial number of years, the auditor should identify whether the Department established a clear need for the services eventually procured as part of their strategic planning process. Since it is possible that such planning identified many potential projects, not all of which could be met from the Department's resources, the auditor should check that the Department prioritised the projects identified. The Department should have carried out any such *prioritisation* in accordance with criteria which reflected their policy objectives and overall business strategy, thereby ensuring that their priorities were not distorted in favour of those projects which were capable of progressing under the PFI. The Department should then have *selected only the top priority projects for implementation*.

Whether the Department made the project deliverables clear

The auditor should examine whether the Department expressed the results they desired in output terms.

2.3 It is important for the successful delivery of any project that the Department stated their requirements clearly from the start. At these early stages it is not usually necessary for these requirements to be specified in detail. However the

Department should have formally established objectives for the project and the auditor should therefore examine whether they did so. As part of this examination the auditor will need to be satisfied that the Department's identification of their requirements was based on a *proper analysis of their needs*. This analysis should have covered not only their current needs but also some consideration of how these needs might change over time.

2.4 Having identified their needs, the Department should then have *specified these needs in terms of deliverables*. One of the main ways in which the PFI can achieve better value for money than traditional procurement is that it offers the private sector scope to offer innovation in service delivery. However the scope for such innovation is limited if the Department fail to specify their requirements in output terms and instead concentrate on inputs and the mechanics of delivery. The auditor should therefore examine whether the deliverables specified by the Department focussed on **what** was required and not on **how** they should be achieved.

2.5 Finally the auditor should check that, as part of their setting of objectives for the project, the Department *established cost limits* for the services to be procured. The Department should have attempted to form a view early in the project of its likely cost and whether they would have sufficient funds to meet this.

The auditor should review whether the Department made a preliminary assessment of the private sector's capabilities for delivering their requirements.

2.6 In determining how to express their desired outcomes, the Department should have had regard to the private sector's capabilities. The auditor should examine what initial soundings of the market the Department made in order to gain a better understanding of the terms in which the private sector would best understand their requirements and of the help that the private sector would need to gain such an understanding.

The auditor should identify whether the Department made a preliminary evaluation of the benefits that they sought.

2.7 The auditor should examine whether the Department established criteria for the evaluation of the benefits offered by bids prior to the project going out to tender. Figure 6 lists some of the criteria that the auditor should expect the Department to have used when identifying suitable firms to be invited to submit tenders and then when evaluating the bids received. The auditor should check that the Department had established the criteria early and should beware of criteria that were used at the end of the procurement process simply to justify the deal reached.

Figure 6

Evaluative criteria

- Value for money
- Bidder reputation and financial standing
- Bidder ability and technical capacity
- Degree of risk transfer
- Service start-up date

The auditor should review how the Department assessed the weight to be attached to policy imperatives.

2.8 Policy imperatives are objectives which need to be built into projects in order to ensure that the requirements of Government policy are met. The auditor should examine how the Department took account of these policy objectives when planning the project and what weight they gave to these.

Whether the Department determined the best form of partnership

The auditor should examine whether the Department identified a feasible project mechanism.

2.9 The auditor should review whether the Department examined the possible use of a range of alternative project mechanisms before they selected procurement using the PFI. Figure 7 lists the various mechanisms that the auditor should expect the Department to have considered.

Figure 7

Alternative project mechanisms

- Privatisation
- Contracting out
- Private finance initiative
- Joint ventures
- Partnering and framework agreements
- Traditional procurement
- Separate contracts for construction/development and operation

The auditor should review whether the Department identified the room for innovation in advance.

2.10 As mentioned in paragraph 2.4, one of the main ways in which the PFI can offer better value for money than traditional procurement is that it provides the private sector scope to offer innovation in service delivery. The auditor should examine whether the Department undertook a preliminary assessment of the scope for possible innovation and established a proper system for the evaluation of any such innovation proposed by bidders. Figure 8 lists the possible areas for innovation and what the auditor needs to be aware of in each.

Figure 8

Areas for innovation

Design and construction
The auditor should identify whether the Department laid down any design criteria which bidders were required to comply with and the Department's reasons for doing this.

Operation
The auditor should examine whether the Department specified any constraints on the bidders' proposals, such as the requirement for bidders to adhere to Departmental operating procedures, and the Department's reasons for this.

Financing
The auditor should investigate whether the Department or their advisers considered the scope for innovation in the funding of the PFI proposals.

The auditor should investigate whether the Department identified the scope for risk transfer in advance.

2.11 Appropriate risk allocation between the public and private sectors is a key requirement to the achievement of value for money on PFI projects. Without risk transfer the private sector receive the benefit of a very secure income stream, similar to a gilt-edged security, but may set their charges at a level which earns them a return far higher than is available on such a security. However, if the Department seeks to transfer a risk which the private sector cannot manage, then value for money will reduce as the private sector seeks to charge a premium for accepting such risks. The Department should therefore have sought to achieve not the maximum but rather the optimum transfer of risk, which allocated individual risks to those best placed to manage them. The auditor should check whether the Department identified at the start the risks associated with the project and the scope for their transfer to the private sector. On this latter point, the auditor should examine whether the Department made any initial soundings of the market in order to identify what risk transfer the private sector were likely to be willing to accept.

2.12 Appendix 2 gives more details of the risks likely to be involved on a PFI project. The auditor may need the help of an external consultant in assessing whether the transfer of risk that the Department initially proposed was reasonable. A good indication of whether the Department's original intentions were unreasonable would be if the actual risk transfer differed greatly from that they originally proposed.

The auditor should examine how the Department established the likelihood of a project that was affordable and offered value for money.

2.13 The auditor should examine whether the Department prepared an outline appraisal which demonstrated the project's value for money before they proceeded to go out to tender. This appraisal should have included the following elements:

- an estimate of the capital and operating costs of all feasible project delivery mechanisms (Figure 7), especially the costs of traditional procurement, the use of the PFI, and the options of doing either nothing or the minimum necessary;
- any other economic impacts on the public sector if the project were to proceed under the PFI; and
- the Department's likely project management costs.

The auditor will also need to check that at this same stage the Department confirmed that they could still afford to pay for the project (paragraph 2.5) and that it was likely that the private sector could provide the services required (paragraph 2.6).

Whether the Department produced an outline business case

The auditor should examine the Department's Outline Business Case.

2.14 The auditor should examine whether the Department produced an Outline Business Case before proceeding with the project. This Case should summarise the planning work which the Department had previously undertaken and which the auditor will have already examined in depth (paragraphs 2.2 to 2.13). Figure 9 lists the topics that the auditor should expect to see in such a case.

The contents of an Outline Business Case

Figure 9

Project Objectives

- Needs in output terms (paragraphs 2.3 and 2.4)
- Risk transfer sought (paragraphs 2.11 and 2.12)
- Budget limit and affordability (paragraph 2.5), including the limit on any public sector's initial contribution.

Option appraisal (paragraphs 2.9 and 2.13)

Procurement strategy

Project timetable

Evaluation criteria (paragraph 2.7)

Commitment

- Indications of commitment from the Treasury, sponsoring departments or other stakeholders.

2.15 The auditor should be aware that currently the Treasury Private Finance Taskforce are required to sign off the commercial viability of significant projects before they can progress. In doing this, the Taskforce will be reviewing a number of issues that also form the key features of any Outline Business Case. These issues include:

- the prospects for achieving value for money (compared with other realistic alternative procurement options);
- the services being purchased and how they will be paid for (public sector affordability, risk allocation); and
- the chances of negotiating a deal within a reasonable timescale (acceptance to bankers, suitability of the Department's advisers, and skills at the disposal of the Departmental project team).

Section II: How the Department applied the proper project management processes

Whether the Department planned the procurement properly

The auditor should examine whether the Department assembled a properly qualified project team in good time.

2.16 If the Department is to implement a PFI project successfully, it is essential that they have the right team in place in time to do this. Ideally they should set up this team once they have decided to proceed with the project's procurement. The auditor should check that, at the start of the project, the Department *identified their skill requirements*; that is, identified what skills they required at the various stages of the project's implementation in order to ensure its success.

2.17 Project management is particularly important to the successful completion of a PFI project. A project manager not only sets timetables for all stages of the project and monitors progress against these but also will be responsible for seeking to resolve problems as they arise so that they do not cause delay. The Department should therefore have appointed a project manager early in the project. They should also have included on their team at least one member with knowledge of and responsibility for ensuring compliance with EU and UK procurement rules.

2.18 Having identified whether the Department considered what skills they were likely to require, the auditor should check that they *identified the sources* of these skills. In a complex procurement like the PFI it is highly unlikely that all the necessary skills and expertise will have been available in-house. The Department therefore will have needed to appoint external advisers. Their appointment should have been early in the project as, without experienced advice, the Department could have developed the project in a way which was unattractive to the market or which contravened procurement legislation. Good legal and financial advice is particularly important and the auditor should therefore check whether the Department actively took up the references of prospective advisers.

2.19 Finally the auditor should examine the *planned reporting and decision making procedures* that the Department established to control the procurement. The Department should have designated a member of their staff to act as "Project Sponsor". The Sponsor acts as the Department's representative and provides the focal point for the day to day management of their interest in the project. The Sponsor's responsibilities will include the preparation of the specification and business cases, the management of the project budget and of external advisers, and the monitoring of progress. The appointment of a Sponsor is particularly important if the Department have appointed an external adviser to act as project manager. The Department should also have appointed a top management Project Champion to help the team cut through problems which could not be resolved by more junior staff. They should also have established clear levels of delegated authority within the project team and with users to ensure speedy decision-making.

The auditor should examine how the Department investigated the market.

2.20 The auditor should check whether the Department investigated the market sufficiently early in the project to ensure that there were suppliers who were willing and competent to bid for the work. This is particularly important where the project is of a new type. The auditor should be concerned that, if the Department did undertake detailed market consultation, they avoided conferring preferential treatment on any potential bidder or bidders. In certain cases where the number of potential suppliers was limited, the auditor should consider seeking external advice on how the Department might have structured the proposed project in order to stimulate greater competition.

The auditor should examine whether the Department identified the likely contractual issues.

2.21 The auditor should examine whether early in the project the Department identified the contractual issues that were likely to arise. Treasury guidance and past PFI contracts let by the Department should help them with this, although in the case of the latter the Department should have considered whether they should replicate the provisions of past contracts in their entirety, given possible changes in circumstances.

2.22 In particular the Department should have identified their preferred opening position on the following issues:

a) Length of contract

In determining the optimum length of the contract period, the Department should have given careful thought to their future service needs. In general the contract should be short enough to give the Department flexibility if their needs change but long enough to encourage serious commitment from the contractor. The length of contract will also reflect the way in which the underlying assets are to be financed.

b) Risk allocation

The aim of a PFI procurement is to achieve an allocation of the individual risks to those best able to manage them. Therefore, early in the project, the Department should have identified their proposed allocation of risk between the parties (paragraphs 2.11 and 2.12) and drawn up a draft contract to reflect this.

c) Payment mechanism and incentives

The payment mechanism is the primary means of achieving risk transfer. The auditor should check that the Department considered how they will ensure that the contractor's remuneration will be dependent on the satisfactory delivery of the required services. To this aim the contractor usually does not receive any payment until the completion of any assets required and the delivery of the services specified. Their payment will then be dependent on the availability of the services and the contractor's performance in meeting the agreed service standards. On some projects payment is also dependent on the usage made of the services. The Department should have sought advice on the design of the payment mechanism from their external consultants. If necessary, they may also have decided to leave it to bidders to suggest the mechanism, within parameters set by the Department.

d) Service levels and performance monitoring

The Department should also have considered early in the project how they were going to set and monitor service levels. Again they may have decided to leave it to bidders to come up with proposals. However they will have needed to ensure that any performance measures are objective and well-defined and focus on the most critical aspects of service delivery. In addition performance monitoring should be carried out not only once service delivery begins but also prior to this during the development or construction stage. Ideally the contractor should be responsible for monitoring their own performance with the Department having the right of access to their performance and cost records for verification purposes.

e) Covenant: customer to pay, supplier to perform

The auditor should identify whether the Department established early in the project that they had the authority to enter into the contract and the resources necessary to meet all of their obligations during the contract (paragraphs 2.5, 2.13 and 2.14). By doing this, the Department will have reassured the private sector supplier and their financiers that it was worth their while tendering for the project. In order to ensure continued delivery of the required services in the event of serious failure by the supplier, the Department's contract proposals should have allowed for the replacement of the supplier at as little cost as possible.

f) Change mechanisms

Change is inevitable as the Department's needs and priorities will alter over time. The Department should have attempted to accommodate within the scope of the original deal any changes to their requirements which they could foresee at the time. However it is not possible to foresee all change, particularly in the long term. The auditor should therefore examine the Department's contract proposals to ensure that they contain proper procedures for introducing and controlling changes to the services. The Department should also have outlined their proposed procedures for resolving disputes over changes as well as over other aspects of the contract such as service delivery.

g) End of contract: asset transfer & residual value

The auditor needs to ensure that, if the deal involves the transfer of valuable public sector assets to the private sector and their return at the end of the contract, the Department have considered how they will ensure that the contractor will maintain these to the required standards.

h) Sanctions

The Department will have needed to consider the sanctions that the contractor will face for late or unsatisfactory service. Minor breaches should be dealt with by means of the payment mechanism. Persistent service failures or material defaults should result in termination of the contract.

i) Clawback arrangements

The auditor should check that the Department considered whether they should put in place mechanisms to clawback part of any future windfall gains that the supplier may earn so that there is at least a sharing of such benefits. The auditor will also need to assess the potential effectiveness of any such clawback mechanisms included in the contract. Given that the agreement of effective clawback arrangements is highly complex, it is likely that the auditor will need the help of legal or property consultants in assessing these. This assessment should include not only a review of the mechanisms included in the contract but also the identification of any unusual omissions. The auditor should also be aware that the inclusion of such mechanisms requires careful evaluation and negotiation by the Department. Such clawbacks can help to avoid public criticism that the contract was wrongly priced if such windfall gains were to occur once the contract was let. However it is possible that, when faced with a proposed clawback arrangement, bidders may adjust their proposed contract price upwards to compensate for the possible loss of future income. The Department may therefore have needed to ask for prices from bidders with and without clawback to help them determine the value for money of such an arrangement.

j) External audit access

The auditor should check whether the Department consulted in advance with their external auditors as to what access they were likely to require to the contractor's cost and performance information for audit purposes. For bodies audited by the National Audit Office, the contract should require the contractor to maintain separate records of the costs of performing the services specified under the contract and to allow the Comptroller and Auditor General and his representatives access to these records.

The auditor should identify whether the Department prepared a tendering strategy and timetable.

2.23 The auditor should review the tendering strategy that the Department prepared for the procurement. This strategy should have included a *realistic tender timetable* from start to contract award and also a *communications strategy* detailing how the Department intended to make all reasonably probable and competent bidders aware of the project.

2.24 The auditor will need to check that in compiling their tender strategy the Department selected an *appropriate EU procedure* by which to award the PFI contract. For almost all PFI projects the negotiated or concession procedures are used because these provide greater scope for negotiations with bidders. The auditor should examine very closely the reasons for any use of the restricted procedure.

2.25 The Department's tendering strategy should also have detailed *the number of rounds of bidding* that the Department expected to require and the number of bidders left after each round. The auditor should check that, in drawing up this strategy, the Department did not unduly restrict their freedom of action in future. For example, if the Department provided bidders with details of their requirements for the number of bidding rounds and bidders, the Department should also have made it clear to bidders that they reserved the right to vary their requirements if necessary. However varying the tendering requirements will result in increased bidding costs for bidders and may also work to the Department's disadvantage (paragraph 1.24). The auditor should also be aware that requests for an extra bidding round could be a sign that the Department failed to specify their requirements properly or to make these clear to bidders.

2.26 In determining the number of bidding rounds and bidders the Department's aim should have been to encourage competitive tension for as long as possible during the procurement. However they will also have needed to be sensitive to the time and costs that bidders incur in preparing bids. If they ask too large a list of firms to submit bids, it is possible that the bidders will not commit themselves wholeheartedly to the competition since they perceive that their chance of winning the competition is low. Advice on the number of tender stages and the number of tenders that departments should invite at each tender stage is given in Stage 5 of the Treasury Taskforce guidance "Step by Step Guide to the PFI Procurement Process".

2.27 Finally the auditor needs to examine, in cases where a Department was letting more than one contract to a common timetable, whether the Department considered at an early stage *offering more than one contract to a bidder*. Awarding contracts in this way may result in lower prices as the contractor passes on savings arising from economies of scale. However the auditor should check that, where a Department have considered such an option, they sought legal advice to ensure their compliance with procurement regulations. The Department should also have examined whether bidders had the capacity to handle more than one contract simultaneously. The auditor should note that the Department may have made a policy decision to award their contracts to different bidders in order to strengthen the market for PFI if their initial soundings of the market had shown that it was weak in their particular sector.

The auditor should identify whether the Department prepared a credible project timetable.

2.28 The auditor should examine whether the Department updated the project timetable in their outline business case (paragraph 2.14) to take account of the detailed work to be done by their project team and the contractor before both the award of the contract and the start of service delivery. Where possible this timetable should have *identified useful milestones* against which the Department could measure progress and been consistent with the tender timetable they had prepared (paragraph 2.23). It should also have set out the *critical review points and analyses* which they needed to carry out to ensure the successful award of the contract.

The auditor should examine whether the Department prepared a public sector comparator and review the adequacy of this.

2.29 The Treasury in their policy statement "Public Sector Comparators and Value for Money", issued in February 1998, recommend that departments prepare such comparators in almost all PFI procurements. The auditor should therefore check that the Department have complied with this guidance and examine the reasons where they have not. Ideally the Department should have developed the comparator from the option appraisal prepared in the planning stage (paragraphs 2.13 and 2.14) and completed this before the receipt of best and final offers in order to help in their assessment of bids.

2.30 The auditor will need to consider the *amount of detail required in the comparator*. The level of detail required will depend on the impact that the comparator is likely to have on the assessment of value for money. For example, where private sector provision clearly offers much better value for money, there is less need for a precise calculation of the comparator's value (Treasury Taskforce Policy Statement 2: "Public Sector Comparators and Value for Money").

2.31 The auditor should concentrate their examination on reviewing the *assumptions underlying the comparator* and the *variables which will have most significant impact* on the total cost of traditional procurement identified in the comparator. Our experience has shown that variables likely to be important and therefore worthy of closer examination include:

- the completeness and reasonableness of the valuation of the possible financial impact of the various risks involved;
- the discount rates used; and
- the forecasts of the volume of services required.

The auditor may find it useful when examining the assumptions and variables to ask external consultants with the relevant technical or financial expertise to review these.

Whether the Department established conditions for a successful competition

The auditor should examine whether the Department created a good tender list.

2.32 To verify whether the Department succeeded in creating a good tender list, the auditor should first examine what action the Department took to *stimulate the market*. The Department's previous investigation of the market (paragraphs 2.6 and 2.20) should have identified the level of interest in their proposals and what, if any, stimulation was necessary. If some stimulation of the market were necessary, the Department should have undertaken this before they commenced the project's formal procurement in order to maximise the number of good quality bids submitted. Their stimulation could have involved direct mailing of potential parties, advertisements in the trade press, contacts with trade associations, and the holding of bidders' conferences.

2.33 The auditor should also examine whether the Department complied with the relevant procurement guidelines and *issued a notice in the Official Journal of the European Communities that was properly and widely phrased*. Too specific a statement of requirements in this notice could deter potential bidders and restrict the opportunity for innovation by the bidders during the competition. The auditor will need to review the *guidance on the quality and technical standards expected* that the Department provided to bidders. Clear guidance will aid bidders in the compilation of their bids. However if this guidance is too restrictive, then innovation could again be stifled. In reaching an opinion as to whether the Department's notice in the Official Journal and technical guidance were satisfactory and not unduly restrictive, it will be necessary for the auditor to canvass the views of those who bid for the contract. It may also be necessary to seek external advice in this area.

2.34 The auditor should check that the Department's *tender list did indeed provide enough competition*. They should verify the number of bids actually received, compare this with the number that the Department planned to receive (paragraphs 2.25 and 2.26) and seek explanations for any difference between the two. If the number of actual bids was less than expected, the auditor will find it useful to seek bidders' opinions as to why this was the case.

2.35 Other indications of the strength of competition are the quality of the firms who bidded and the quality of the bids themselves. To help in their assessment of these quality issues the auditor should firstly examine the exercise that the Department undertook, using the evaluative criteria in Figure 6, to identify firms that possessed the necessary technical quality and financial standing to participate in the tender exercise. The next step should then be to review the Department's evaluation of the bids received. The auditor should also ask the Department for their views on the quality of the tendering firms and the bids submitted.

2.36 *Debriefing of bidders* will help ensure that bidders submit better bids in subsequent tender exercises, thus improving future competition. Therefore, for the final part of the examination of whether the Department created a good tender list, the auditor should examine the adequacy of the Department's debriefing. In particular the auditor should seek the views of the bidders on this point.

The auditor should consider whether the Department created a good specification of their requirements.

2.37 In determining whether the Department created a good specification of their requirements, the auditor will need to examine how the Department developed this. They should examine how the Department *involved the users* in the identification of their requirements and controlled this input to ensure that users' expectations were realistic. For example the Department may have used value management techniques to ensure that the needs identified by the users were real. The Department should also have *discussed their requirements with bidders* to identify whether these requirements were practicable and whether there was scope for improvement.

2.38 This consultation should have resulted initially in the production by the Department of an *outline specification of requirements*. The auditor should verify that this specification was output-based and consistent with the project deliverables identified when the Department set their objectives for the project (paragraphs 2.3 and 2.4). The auditor should then check that this specification was incorporated into the Invitation to Tender.

2.39 Finally the auditor should check that the *Invitation to Tender was clear* so that bidders knew exactly what it was that they were required to price. The Invitation should have:

a) identified milestones, checkpoints and potential issues in order to lessen the risk of delays in the contract's award;

b) indicated the scope for innovation (paragraphs 2.10 and 2.33);

c) shown the criteria for the Department's appraisal of bids received in order of priority (paragraph 2.7), although without disclosing precise weightings; and

d) required bidders to submit a sensible number of options for the Department's evaluation.

2.40 In reaching an opinion as to whether the Department succeeded in creating a good specification of their requirements, it will be necessary for the auditor to canvass the views of all the firms which bid for the contract. It may also be necessary to seek external expertise in this area to review, for example, the Department's specification of requirements.

The auditor should identify whether the Department succeeded in maintaining competitive tension to contract award.

2.41 In evaluating the Department's success in maintaining competitive tension, the auditor will need to examine how the Department *maintained time pressure throughout*. The auditor should look for evidence that the Department issued bidders with the procurement timetable so that all parties were aware of the target dates that needed to be met. The Department could also have helped save time by issuing bidders with model frameworks for contracts and other guidance.

2.42 The auditor should check that the Department succeeded in the *creation of a competitive shortlist* of firms to be invited to submit final bids. They should verify the number of bids actually received, compare this with the number that the Department planned to receive (paragraphs 2.25 and 2.26) and seek explanations for any difference between the two. If the number of final bids was less than expected, they will find it useful to seek bidders' opinions as to why this was the case.

2.43 A particular useful indicator of a Department's success in maintaining competitive pressure is their handling of the *negotiations with the preferred bidder*. Most procurements of PFI projects end with negotiations between the Department and a single preferred bidder. Once the procurement enters this stage, competitive pressure effectively ceases. Given this, the auditor should examine whether the Department succeeded in minimising the scope for negotiation by keeping this period of exclusive negotiations short and by achieving as much improvement of the bid as possible before the preferred bidder was informed of their selection. The auditor should therefore be concerned if these exclusive negotiations took many months and/or there were changes during this period to the proposed price, scope of services, allocation of risk, or contractual terms.

2.44 In evaluating whether the Department did in fact maintain competitive tension to the final contract, the auditor should seek the views of the bidders on the Department's procurement process.

Whether the Department regularly reassessed that the project was worthwhile

The auditor should identify whether the Department regularly reassessed that the project was worthwhile.

2.45 The auditor needs to examine whether, after the preparation of the initial option appraisal in the Outline Business Case (paragraph 2.14), the project team regularly reviewed the project as the procurement progressed to identify whether it was still worthwhile. Such reviews are necessary to avoid continuing with a project that is no longer worthwhile and thus wasting management time and the incurring of unnecessary procurement costs. At certain key points in the procurement the Department's senior management should have sought particular assurance on this issue from the project team. These key points include:

- prior to the announcement of the preferred bidder;
- at the production of the Full Business case; and
- before the signing of the final contract (paragraph 2.77).

Whether the Department controlled their costs

The auditor should examine whether the Department set realistic budgets.

2.46 The auditor will need to examine how the Department set the budgets for their project costs. Departments have had problems in the past doing this because of their inexperience of the PFI and the amount of work that it involves. Ideally budgets should have been set as early in the project as possible and should have covered not only external but also internal costs. The budgets should cover the whole period of the project's procurement and not be restricted to just the preparation of estimates of annual expenditure each year.

The auditor should check that the Department appointed their advisers after competition.

2.47 The auditor will need to examine whether the Department appointed their advisers after competition since, despite clear guidance from the Treasury and the Public Accounts Committee, we have found examples of departments appointing advisers for PFI projects without competition. It is only acceptable for a department to appoint advisers on a project without competition if the appointment is made under a framework agreement. Even then the award of the original agreement should have been the result of a competition. Also the agreement should specifically cover the provision of advice on PFI or related matters and not be for advice in unrelated areas. The award of work under such an agreement to those without PFI experience can pose a risk to the achievement of a deal which provides value for money.

2.48 The auditor should examine whether, when choosing their advisers, the Department took into account not only the price but also the likely quality of advice. The auditor should also check that the Department monitored the performance of their advisers once appointed.

The auditor should review how the Department monitored and managed their costs.

2.49 The auditor should check that the Department regularly monitored all the costs associated with the project. Thus their monitoring should have covered not only their expenditure on external advisers but also the time spent by their own staff on the project.

2.50 As part of their examination of the Department's management of costs the auditor should also review the appropriateness of the basis that the Department chose for the advisers' remuneration to see whether it gave the advisers an incentive to meet the project's objectives and control their costs. If an adviser carried out a significant volume of work the auditor should check to see if the Department succeeded in obtaining a discount to the normal fee rates.

Section III: Whether the Department selected the best available deal

Whether the Department ensured that a good range of solutions was put forward

The auditor should examine whether the range of solutions proposed by bidders included design variants.

2.51 A good range of solutions usually demonstrates that the Department encouraged innovation, thereby contributing to a good deal. The auditor should therefore assess whether bidders suggested a variety of practical innovative solutions in a number of areas. Design is the area with the greatest such scope, not least because it has a large impact on the level of building and operating costs. The auditor should therefore be interested in how much freedom bidders had to suggest different designs. If the Department provided bidders with suggested designs, the potential for innovation may have been constrained. The auditor will also need to be satisfied that the Department did not reject innovative designs simply because they challenged presumptions or established practices used in their public sector comparator.

The auditor should review whether bidders put forward operational variants in their proposals.

2.52 Another area for possible innovation is how the eventual contractor will operate and deliver the required services. The extent of innovative service delivery will depend in part on the nature of the project. For example, PFI prison projects have required the contractors to take over the custodial services of the prisons but in hospital projects the clinical services continue to be provided by NHS employees. Where private sector proposals have been invited the auditor will want to assess that the Department had been open to new ideas while at the same time ensuring that these ideas were deliverable. The initial period of operations – for example, the opening of a new prison or the introduction of a new IT system – can pose particular risks. Therefore the auditor will need to satisfy themselves that the Department had sought sufficient information from the bidders as to how they would deal with these risks.

The auditor should investigate whether bidders' proposals included financing variants.

2.53 Financing charges are usually a significant part of a contractor's expected costs and new forms of financing PFI projects which offer reduced costs, such as the use of bond financing on hospital PFI projects, are gradually being developed. The auditor will therefore wish to be satisfied that the Department had sought bids which were based on obtaining finance through competitive procedures and which took into account the best sources of finance the market could offer. In assessing the value for money offered by the financing element of the winning bidder's proposals, the auditor will need to examine how the Department assured themselves that the proposed rates of return were reasonable. The auditor may also need to commission a financial consultant to undertake their own comparison of the financing of the deal with that in other deals.

The auditor should examine whether bidders suggested deliverable variants.

2.54 Although the Department should have clearly expressed the deliverables they were expecting to receive through the project (paragraphs 2.3, 2.4 and 2.38), bidders may have been able to add value by suggesting alternative deliverables. The auditor should therefore assess how the Department balanced the need to be open to innovative suggestions with the need to treat all bidders fairly. The auditor should note that, if the Department decided to pursue a bid which did not conform with the specification, they obtained appropriate legal advice to support their decision. This advice should have included consideration of whether the other bidders should also have been invited to bid on the alternative proposals.

The auditor should identify whether bidders offered risk transfer variants within their bids.

2.55 Value for money will be maximised where risks are allocated to the parties best able to manage them (paragraphs 2.11 and 2.12). The auditor will therefore need to assess whether the Department obtained solutions which clearly stated how risks would be allocated. The allocation should have been in a form which was likely to achieve value for money and unlikely to give rise to major renegotiations during the closing stages of the procurement process. Guidance available from the Treasury and individual departments on appropriate contract terms (Appendix 3) and early soundings of the market should have enabled the Department to seek bids on the basis of a risk transfer which would achieve value for money and be acceptable to bidders. The auditor will want to see whether the Department followed available guidance and their market intelligence. Evidence of lengthy negotiations on contract terms after the appointment of a preferred bidder should suggest either that the information on risk allocation previously requested from bidders could have been improved or that the Department had little success in agreeing the contract terms with bidders before this.

2.56 In certain circumstances where there is a particular risk which is unusual or where there is uncertainty about the allocation which will produce the best value for money, the auditor should identify whether the Department obtained information from bidders on the effect on prices of alternative risk allocations. This would have enabled the Department to evaluate whether it was worth transferring the risk to the private sector. However departments should avoid asking bidders to prepare a large number of alternative pricing calculations based on different allocations of risk as this will make large demands on the bidders' time and bidding costs.

How the Department evaluated the elements of the bid

The auditor should identify whether the Department assessed the financial ranking of bids.

2.57 The Department should have put in place previously an evaluation process which took account of all financial and non-financial factors which could have significantly affected the value for money of the services delivered (paragraph 2.7). Initially their evaluation of each of the individual factors should have been separate and paragraphs 2.58 to 2.63 contain guidance for the auditor on the examination of these separate strands of evaluation. However, in the case of PFI, the final choice of a bid is likely to turn on the trade-offs between price and quality proposed by the bidders. The Department should therefore have considered these trade-offs explicitly in their final evaluation of bids by taking account of both financial and non-financial factors and seeking to identify the bid that offered the best combination of these (paragraphs 2.64 to 2.68). Such a process should help ensure that the Department avoided awarding the contract solely on the grounds of cost. It would also have enabled them to clearly explain their reasons for appointing a particular bidder if an unsuccessful bidder had challenged their decision.

2.58 One of the most important factors affecting value for money is the financial impact of the bids received. In order to identify the financial ranking of the bids the Department should have converted bidders' proposed annual contract payments into a single net present value figure, using a discount rate of six per cent real in line with Treasury guidance on appraisal and evaluation. Because these net present values form a key part of the evaluation of alternative bids the auditor should satisfy themselves that the calculations have been correctly carried out. One common area of error is in the treatment of future inflation. The auditor should therefore check that the Department have discounted correctly any allowance for this built into the cashflows. Where these calculations have been prepared or checked by an experienced PFI adviser the auditor may be able to reduce the amount of detailed checking they perform.

2.59 The Department should not have confined their financial evaluation simply to an assessment of the overall price of the bids received. In particular the auditor should identify whether the Department and their advisers reviewed the financial models prepared by bidders in support of their bids, in order to gain assurance that these models accurately reflected bidders' proposals and that the bids could be financed. In one case we examined where the Department and their advisers had not reviewed this model before their selection of the preferred bidder, the bidder was subsequently unable to raise finance on the original terms. The financing the bidder actually raised proved to be more expensive and this increase was passed on to the public sector in the form of a higher contract price.

2.60 The auditor will also gain some benefit from carrying out their own review of the successful bidder's financial model. Such a review will, for example, help in the understanding of the bidder's approach to key areas of the deal, such as the bidder's identification of opportunities for third party revenues and their assumptions about the disposal of any surplus assets. It will also help in the auditor's assessment of a deal's value for money, especially where there has been little competition in the procurement.

The auditor should examine how the Department assessed the risk transfer ranking of bids.

2.61 Another significant factor affecting the value for money offered by a bid is the extent of risk transfer proposed. The Department should therefore have compared the extent to which the different bidders were prepared to assume risk. Where a bidder was prepared to accept different levels of risk the Department should have assessed what effect this had on the bidder's proposed pricing of the contract. In some cases individual bidders may have provided alternative prices for the contract assuming different levels of risk transfer. The auditor should check that the Department had appropriate procedures for evaluating the value for money of bids that were based on differing levels of risk transfer.

The auditor should check the Department's assessment of the financial stability of bidders.

2.62 The financial viability of a bidding consortium and its members will be critical to the success of a PFI project. The auditor should assess what steps the Department took, in addition to reviewing the bidder's financial model to assess its financeability (paragraph 2.59), to examine that each bidding consortium had obtained commitments of funding for the project and to check the financial viability of the members of the consortium. Particular emphasis should have been placed on the assessment of the financial position of those consortium members engaged in either construction or IT systems development work as a financial failure of such a member could result in serious delays to the provision of the required public service. The Department should not have assumed that big well-known firms would always be financially robust.

The auditor should assess the Department's evaluation of the quality of service proposed by the different bids.

2.63 The auditor should check what steps the Department took to evaluate the quality of service proposed by bidders. This evaluation should have included a technical assessment of whether a bidder's proposed solution would deliver the services the Department required. Given that this is an area where users of the service – such as the clinical staff in a proposed new hospital – may have been able to contribute to the evaluation, the auditor should examine how the Department involved these in this process. The auditor should also see whether the Department had established minimum levels of service quality required and how they assessed the merits of bids which proposed a higher quality service but at a more expensive cost.

Whether the Department selected the most economically advantageous bid

The auditor should review how the Department selected the most economically advantageous bid.

2.64 Since this is a critical phase in the procurement exercise, the auditor should be concerned to see whether the Department selected the best available deal using consistently applied evaluation criteria. The Department should therefore have clearly documented their assessment of each bid and their reasons for choosing their preferred bidder. Their aim should have been to select a bid which offered them the best combination of financial and non-financial factors (paragraph 2.57).

2.65 In checking whether the Department evaluated each bid consistently the auditor should obtain any internal guidelines which the Department issued for the evaluation of bids. These guidelines may have established weightings to be applied to certain evaluation criteria, minimum thresholds for quality, and maximum affordability limits. The guidelines may also have indicated how conflicts between different evaluation criteria such as price and quality would be resolved. There may, however, be certain circumstances where it would be acceptable for the Department to exercise judgement in selecting their preferred bidder in a way that would give a different result than would have been reached simply by following the evaluation guidelines. An example would be where the weightings applied to the various evaluation factors did not produce results which reflected the Department's current priorities.

2.66 A key consideration in the bid evaluation – but not necessarily the overriding consideration - will be *cost* (paragraph 2.58). However there will be situations where value for money and other objectives may be better achieved by the selection of a bidder whose proposed price is not the lowest – for example, where:

- non-financial factors, such as the quality of service to users, were considered to be very important; or

- there were doubts about the deliverability of a low price bid. In such cases the auditor should examine whether the Department assessed that bidders planned to devote sufficient resources to the project to enable it to be delivered to a satisfactory standard and on time.

2.67 Other factors which the Department should have taken into account in their bid evaluation include *the bidder's track record* (taking into account any problems which have arisen on other similar projects previously undertaken by the bidder) (paragraph 2.7), *design features* (which should have been subject to a separate technical evaluation), and *operational features* (paragraph 2.63).

2.68 The auditor should also be particularly interested in how the Department's evaluation of bids reflected the *impact of risk*. This should have been a feature of the evaluation process (paragraph 2.61) and the auditor should examine the results of the Department's consideration of the interrelationship between risk and value for money in each bid. Where a bidder had not been prepared to accept certain risks the auditor should check that the Department had taken into account the cost to the public sector of retaining and managing these risks.

How the Department managed differences between the winning bid and the contract awarded

The auditor should review how the Department managed any financial changes between the winning bid and the contract.

2.69 The period between the selection of the preferred bidder and the signing of the contract is crucial (paragraph 2.43). Once a preferred bidder is selected, competitive tension will inevitably slacken. The auditor should examine how the Department managed this phase of the procurement. In assessing the Department's performance the auditor will need to identify the extent to which the price or the terms of the deal changed in the run up to the award of the contract.

2.70 Changes may have occurred in a number of areas but one of the most important of these is the financial aspect of the deal. Provided there were no changes to the service specification, the tender price should not normally have changed after the preferred bidder has been appointed. An acceptable exception is for the effect of interest rate movements to be factored into the tender price up to the date of contract letting. The auditor should seek full explanations from the Department for any price changes which did occur after the preferred bidder had been appointed and obtain evidence that the Department assessed the value for money implications of the price variations.

2.71 The auditor should also assess whether the Department took adequate steps to minimise the risk of price variations after the preferred bidder was appointed. Such steps could include making it clear to final bidders that they would be seeking to finalise the contract with the preferred bidder within a short specified time period. The Department could also have asked one of the unsuccessful bidders to remain involved with the project until the contract has been let. However it will only be reasonable for unsuccessful bidders to remain involved in this way for a short period – in practice, longer than two months is unlikely to be acceptable to a reserve bidder.

The auditor should assess how the Department managed any changes in the risk allocation between the winning bid and the final contract.

2.72 Risk allocation is an area where the preferred bidder or their financiers might have sought changes in the closing stages. The auditor will be able to identify such changes by comparing the signed contract with the draft version current at the selection of the preferred bidder. If such changes have occurred, there will be implications for the deal's value for money because, even if the contract price had remained unchanged, there are likely to be additional costs to the Department if they agreed to bear certain risks which they had previously sought to transfer to their contractors. As with price changes the auditor will want to understand the nature of any changes in risk allocation which occurred and to see evidence that the Department correctly assessed the value for money implication of the changes.

2.73 The auditor should not rely on departmental explanations as to how the risks were finally allocated between the Department and their contractors. The auditor should examine the contract to verify how the risks have been dealt with and to identify any additional contractual risks which the Department may not have been aware of. In doing this the auditor may well need to obtain input from a legal adviser with PFI experience. As a matter of good practice the Department should have produced a summary showing how the major risks have been allocated with appropriate cross-references to the relevant contract clauses. The auditor should ascertain if such a summary exists before commencing this area of audit work.

The auditor should examine the Department's management of any other changes between the winning bid and the contract.

2.74 The auditor should assess the implications of any other significant changes to the project which occurred after the preferred bidder was appointed. If the Department made any changes to the *deliverables* they required, the auditor should ensure that the Department treated all bidders fairly and sought legal advice, if necessary. *Design changes* or *operational changes* should have been kept to a minimum at this stage of the project as these matters should have been fully dealt with before the appointment of the preferred bidder. Departments should have resisted any attempt by the preferred bidder to change the framework for *sanctions* but the auditor will also wish to see that all the main provisions for measuring performance and for dealing with shortfalls in performance quality were agreed and documented before the contract was let.

Section IV: How the Department made sure that the deal made sense

Whether the project meets and will continue to meet its objectives

The auditor should examine whether the deal meets the project's original objectives and the latest circumstances.

2.75 As procurement progressed the Department's senior management should have been reviewing at regular intervals whether the deal was still worthwhile (paragraph 2.45). It is especially important that they undertook such a review before they signed the contract since the Department will not be easily able to back out of a deal after this point.

2.76 The auditor should therefore check that, immediately prior to signing the contract, the Department's senior management reviewed the deal negotiated to ensure that it met its objectives. Usually these objectives will be those that the Department originally set for the project. However, since operating and financial policies can change, this senior management review should have taken full account of any policy changes that occurred during the procurement or were likely to occur in the foreseeable future.

Whether the Department evaluated and fairly eliminated alternatives

The auditor should review:

- **whether the Department examined all reasonable alternatives;**
- **whether their preferred option was the most economically advantageous solution; and**
- **whether they had a clear overview confirming the desirability of proceeding with the "best deal".**

2.77 In the early stages of the project's planning, the Department should have already examined a number of possible alternative ways of procuring the services required (paragraphs 2.9 and 2.13). The Department will also have previously identified the bid which offered it the most economically advantageous solution when choosing their preferred bidder required (paragraphs 2.64 to 2.68). However it is possible that important changes to the project could have been made subsequently during the tender process or negotiations with the preferred bidder. The auditor should therefore examine whether the Department confirmed again before they signed the contract that the preferred option was better than the other bids submitted and represented better value for money than other alternative procurement methods such as a traditionally procured option as represented by the public sector comparator (paragraphs 2.29 to 2.31).

Whether the contract will ensure delivery of the services over the life of the contract

The auditor should review:

- **whether the contract reflects the deal that has been negotiated;**
- **whether the arrangements to manage the contract are adequate;**
- **whether termination and handover arrangements are clearly specified;**
- **whether there are appropriate sanctions and bonuses; and**

- **whether the contract is capable of dealing with changes in the Department's requirements.**

2.78 It is important that the signed *contract reflects the deal that has been negotiated*. The auditor will therefore need to check that the contract clearly sets out the deal negotiated and contains no ambiguities or omissions. In order to do this it is likely that they will need to enlist the help of legal consultants to review the contract.

2.79 If the contract is to ensure the delivery of the services required, then the Department's *arrangements for monitoring the contract* will be crucial (paragraph 2.22d). The auditor should therefore assess the adequacy of these arrangements. If their performance monitoring is to be effective, they should undertake it not only once service delivery begins but also prior to this during the development or construction stage. The Department should also have put their monitoring arrangements in place prior to the award of the contract to ensure that the Departmental staff who will be responsible for monitoring the contract are familiar with them and can receive any necessary training.

2.80 The auditor will need to review the provisions in the signed contract for *termination and handover, and the payment regime*, to assess whether they provide the contractor with sufficient incentives, and the Department with adequate safeguards, to ensure that the services will be delivered to the required standards. In reaching an opinion on the adequacy of these provisions, the auditor may need to seek the advice of an external consultant.

2.81 Lastly the auditor should assess the contract provisions for handling any changes to the Department's requirements. The auditor should examine whether these provisions included adequate procedures for resolving any disputes over the pricing and any other aspect of proposed changes.

Whether the deal is affordable in the short term and long term

The auditor should identify whether there are sources for any capital funds required and for the ongoing payments payable under the contract.

2.82 Although the Department should have been reviewing constantly the affordability of their proposals as the project progressed (paragraph 2.45), the auditor will need to identify whether the Department made one last check, before they signed the contract, on the availability of any capital funds required and of the revenue funding needed to meet the payments under the contract once service delivery began. The auditor should also examine whether any problems with the project's affordability have arisen since the award of the contract. If problems have occurred, the auditor should establish the reasons for these and assess whether they were reasonably foreseeable at the time of the contract's award.

Section V: Sources of evidence when auditing PFI deals

2.83 Our main sources of evidence when auditing PFI deals have been interviews with the Department concerned and their external advisers, and reviews of the documentary evidence contained in the Department's records. Figure 10 lists the main documents that the auditor should examine on a typical PFI deal.

Documentary evidence

Figure 10

- Feasibility study
- Outline business case
- Procurement strategy
- Consultant commissioning strategy
- Tender documentation
- Draft contract
- Tenders received, including bidders' financial models
- Tender evaluation records and reports
- Full business case, including the financial model for the Public Sector Comparator
- Signed contract, including the direct agreement between the Department and the contractor's financiers
- Ministerial submissions
- Project management board minutes and papers
- Internal audit reports
- Post-project evaluation report
- Progress reports on development / construction of relevant asset(s)

2.84 We have supplemented the above evidence by seeking the views of other interested third parties on the deal. Depending on the number of parties involved, we have obtained their views either by direct interview or by surveying them using a questionnaire. These third parties fall into two categories:

- those who tendered either successfully or unsuccessfully for the PFI contract. Figure 11 lists the topics that we have discussed with these firms; and

- other interested groups. These have included those representing the end users of the new facilities (for example, general practitioners and community health councils on hospital projects, and road user groups on DBFO roads), local bodies such as local authorities, and representatives of staff providing the service prior to the PFI deal.

Topics discussed with bidding firms

Figure 11

- The scoping of the project and the objectives the Department set themselves
- The specification of the Department's service requirements and their willingness to discuss this with bidders
- The perceived attitude of the Department to private sector innovation
- The Department's stimulation of the market's initial interest in the project
- The information made available by the Department to bidders
- The Department's tendering requirements, including the number of tender stages, the number of bidders at each stage, the amount of time allowed for each stage, and the level of information required by the Department from bidders
- The evaluation by the Department of the bids received and their debriefing of losing bidders
- The Department's handling of the negotiations with their preferred bidder
- The extent of the bidding costs that bidders incurred
- The risk allocation initially proposed and that eventually agreed upon
- The bidders' willingness to tender for future PFI work

2.85 Because of the complexity and specialist nature of many of the areas involved in achieving a successful PFI deal, we have used external consultants to assist us in our examinations. Figure 12 lists the types of consultants that we have used and those topics we have asked them to examine. In seeking their opinion, we have sought to remind them that the PFI projects that we have examined to date have been among the first such contracts awarded in their relevant sector of government. Therefore we have asked our advisers when giving their opinion:

- to comment on the extent to which the Department's decisions were reasonable in the context of the project being one of the first PFI contracts;

- to consider, if they form the view that matters could have been handled differently, the Department's negotiating position and assess whether it was likely that the Department could have secured improvements on particular points without making other concessions which would have diminished overall value for money; and

- to identify how later PFI contracts in the sector could be developed differently in the light of the experience of the deal under review and other early PFI projects.

Possible consultants when auditing the PFI

Figure 12

Financial consultants

Value for money analysis

- Review of the validity of the assumptions made in the business case, including forecasts of likely demand for the services required
- Assessment of the reasonableness of the estimates of the financial impact of risks allocated in the deal
- Examination of the validity of any sensitivity testing undertaken
- Identification of reasons for any movement in the price of the PFI option

Financing of the deal

- Examination of bidder financial models, including reasonableness of assumptions made
- Assessment of the reasonableness of the rates of return payable to the banks and providers of equity and subordinated debt for the winning bidder, compared to similar PFI projects
- Review of the adequacy of the Department's own checks on these returns

Legal consultants

The contract

- The completeness of the contract provisions and any unexpected omissions
- The enforceability and appropriateness of important clauses such as contractual variations and the termination of the contract
- The allocation of risk in the contract

The tender process

- Compliance with EU and UK procurement rules
- Compliance with good procurement practice
- Realistic tender timetable and tendering requirements

Management of TUPE issues

Property consultants

Disposal of surplus property assets

- Examination of the reasonableness of the level of proceeds achieved, including the steps taken by the Department and the successful bidder before their disposal to increase their potential value
- Review of the Department's possible sharing of any future increase in the value of these assets through the use of clawback arrangements

Value for money analysis

- Assessment of construction costs in the PFI bid and the Public Sector Comparator

The Department's requirements

- Evaluation of the Department's construction or property specification

Technical consultants

In the past we have used consultants with different areas of technical expertise depending on the nature of the services involved. Thus we have used consultants to provide us with specialist advice in the areas of IT, telecommunications, and facilities management.

The Department's requirements

- Whether the Department's specification of their requirements was sufficiently output-oriented and receptive to private sector innovation
- The reasonableness of the quality of service targets and standards required

continued…

Performance measurement
- Comparison of the performance measurement systems and the associated payment regime against good practice

The tender process
- Compliance with good procurement practice
- Realistic tender timetable and tendering requirements

Value for money analysis
- Assessment of costs in the PFI bid and the Public Sector Comparator

2.86 Our experience has shown that the selection of such consultants should place at least as much emphasis on the individuals who will be providing the advice as on the firms. We have therefore tended to prefer those individuals with good prior experience of the PFI.

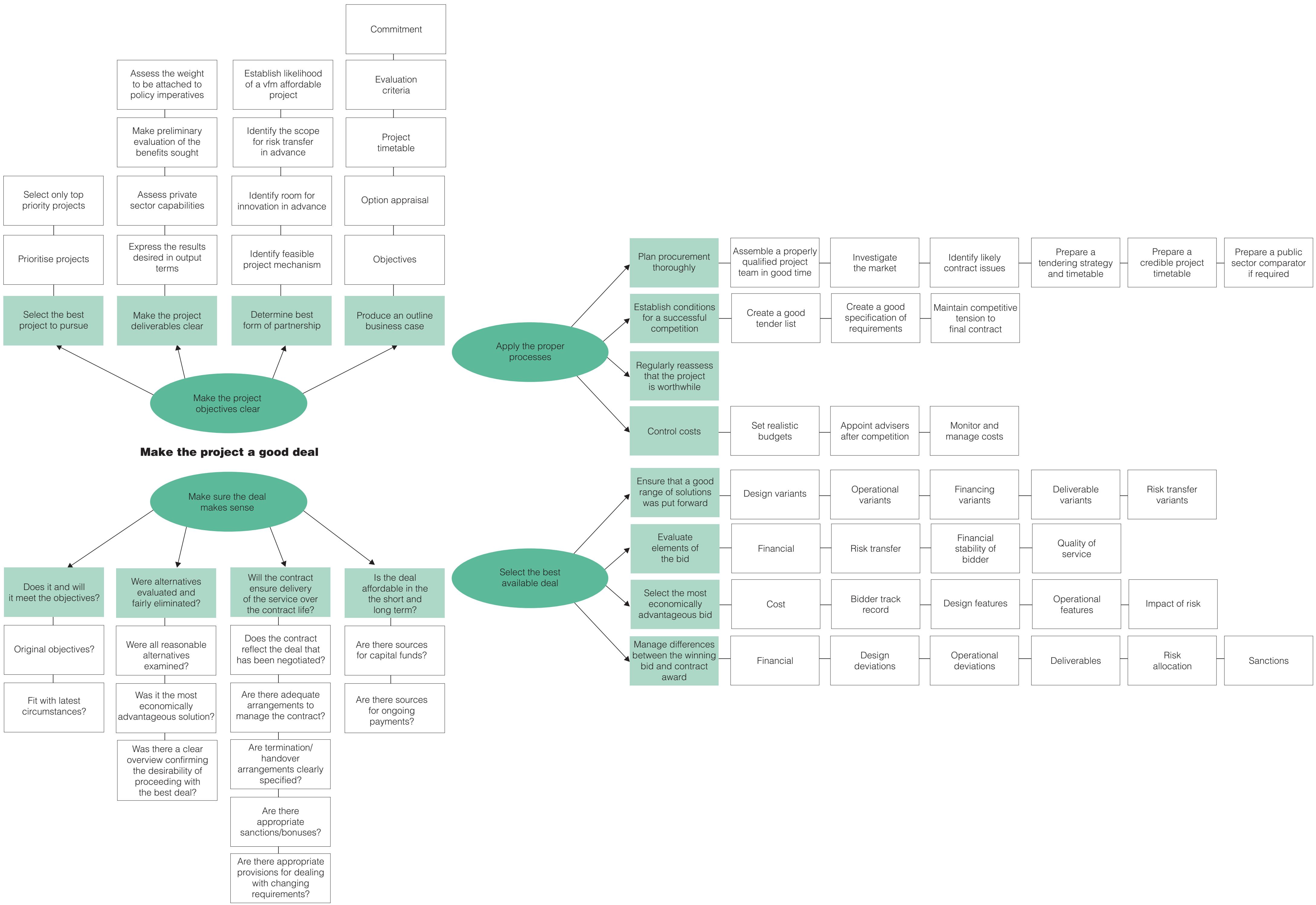
2.87 Finally our experience has shown that the auditor needs a good understanding of the large amount of guidance available on the PFI when auditing such deals. Appendix 3 lists the guidance produced. The auditor will also benefit from reading the reports that we have produced to date on the PFI (Figure 13).

Figure 13

National Audit Office reports on the PFI

- The Skye Bridge (May 1997)
- The contract to develop and operate the replacement National Insurance Recording System (May 1997)
- The PFI contracts for Bridgend and Fazakerley prisons (October 1997)
- The PFI: The first four Design, Build, Finance and Operate roads contracts (January 1998)
- The Immigration and Nationality Directorate's casework programme (March 1999)
- The PFI: The contract to complete and operate the A74(M)/M74 motorway in Scotland (April 1999)
- The PRIME project: The transfer of the Department of Social Security estate to the private sector (April 1999)
- The PFI contract for the new Dartford and Gravesham hospital (May 1999)

Appendix 1: The National Audit Office's Analytical Framework


Make the project a good deal
Make the project objectives clear
Select the best project to pursue
Prioritise projects
Select only top priority projects
Make the project deliverables clear
Express the results desired in output terms
Assess private sector capabilities
Make preliminary evaluation of the benefits sought
Assess the weight to be attached to policy imperatives
Determine best form of partnership
Identify feasible project mechanism
Identify room for innovation in advance
Identify the scope for risk transfer in advance
Establish likelihood of a vfm affordable project
Produce an outline business case
Objectives
Option appraisal
Project timetable
Evaluation criteria
Commitment
Apply the proper processes
Plan procurement thoroughly
Assemble a properly qualified project team in good time
Investigate the market
Identify likely contract issues
Prepare a tendering strategy and timetable
Prepare a credible project timetable
Prepare a public sector comparator if required
Establish conditions for a successful competition
Create a good tender list
Create a good specification of requirements
Maintain competitive tension to final contract
Regularly reassess that the project is worthwhile
Control costs
Set realistic budgets
Appoint advisers after competition
Monitor and manage costs
Make sure the deal makes sense
Does it and will it meet the objectives?
Original objectives?
Fit with latest circumstances?
Were alternatives evaluated and fairly eliminated?
Were all reasonable alternatives examined?
Was it the most economically advantageous solution?
Was there a clear overview confirming the desirability of proceeding with the best deal?
Will the contract ensure delivery of the service over the contract life?
Does the contract reflect the deal that has been negotiated?
Are there adequate arrangements to manage the contract?
Are termination/ handover arrangements clearly specified?
Are there appropriate sanctions/bonuses?
Are there appropriate provisions for dealing with changing requirements?
Is the deal affordable in the the short and long term?
Are there sources for capital funds?
Are there sources for ongoing payments?
Select the best available deal
Ensure that a good range of solutions was put forward
Design variants
Operational variants
Financing variants
Deliverable variants
Risk transfer variants
Evaluate elements of the bid
Financial
Risk transfer
Financial stability of bidder
Quality of service
Select the most economically advantageous bid
Cost
Bidder track record
Design features
Operational features
Impact of risk
Manage differences between the winning bid and contract award
Financial
Design deviations
Operational deviations
Deliverables
Risk allocation
Sanctions

Appendix 2: Risk Allocation

1 Appropriate risk allocation between the public and private sectors is the key to achieving value for money on PFI projects. If the private sector are asked to accept responsibility for a risk that is within their control, they will be able to charge a price for this part of the deal which is economically appropriate. However, if the Department seeks to transfer a risk which the private sector cannot manage, then the private sector will seek to charge a premium for accepting such a risk, thereby reducing value for money. The Department should therefore have sought to achieve not the maximum but rather the optimum transfer of risk, which allocated individual risks to those best placed to manage them.

2 The main categories of risk involved are dealt with in turn in more detail below. For each project, some risks are more relevant than others. In a road project, for example, the key risks will be demand, design, construction and maintenance, whereas in a prison project the key risks relate to availability, performance and operating cost. In an IT project, the Department should have addressed the risks arising from technology and its possible obsolescence.

Design and construction risk

3 The individual risks usually occurring under this heading are given in Figure 14. The private sector contractor should meet any cost increase arising from poor estimating, delays, and failure to meet the client's requirements, and should not be paid until the start of service delivery. The Department should have considered carefully how the contractor will be penalised for late completion. The options include: the delayed payment of the monthly contract fee and non-extension of the contract period by the length of the delay (the Treasury Taskforce's preferred option); payment of damages by the contractor; or a combination of both.

Design and construction risks

Figure 14

- Surveys and investigations fail to identify problems
- Construction lasts longer than expected
- Construction costs higher than expected
- Facilities are not provided to the required specification
- Alternative service provision is required during the delayed completion

Commissioning and operating risks

4 Figure 15 lists the individual commissioning and operating risks usually found on PFI projects. These include availability and performance risk.

Figure 15

Commissioning and operating risks

- Contractor fails to meet performance standards for service delivery
- Contractor fails to make assets available for use
- Operating costs are more than expected
- Operating costs are less than expected
- Assets underpinning service delivery are not properly maintained

5 The risk that operating costs will increase is usually shared since, if the Department were to ask the private sector to take a view on likely inflation over, for example, 30 years, they would take a conservative view on this and build a large cushion into their bid price, thereby reducing the deal's value for money. The risk sharing in this instance usually takes the form of an annual indexation of the contract price once the contractor begins to deliver the required services. Where the contract does allow provision for such indexation, the auditor will need to examine the choice of index to be used. If the index chosen does not closely relate to the type of costs that are likely to be incurred in providing the required services, the private sector will again build a cushion into their prices.

6 Even if there is indexation of the contract price, there still remains a risk in this case that the operating costs increase more or less than expected under this indexation arrangement. Again, on certain deals, this remaining risk can be shared if the contract allows for the periodic re-setting of the contract price after a benchmarking or market-testing exercise. The contract should allow the contract price to be adjusted up or down in these circumstances since the private sector will again build a cushion into their prices if such benchmarking or market-testing exercises can only result in a downward adjustment to their prices.

Demand risk

7 It is not always desirable to transfer demand risk since the level of usage required of an asset or service under PFI deals is usually not within the private sector's control. The level of usage either depends upon the Department or is within no one's control. Similarly a payment mechanism linked to volumes will create significant additional risk for both parties if the volumes are difficult to predict (such as certain road usages). Consequently the contractor may require a higher price for managing volume risk.

8 Thus volume risk is usually retained by the public sector or at best shared with the private sector. Situations where it may be reasonable to expect the contractor to bear some or all of the volume risk include:

- where the public sector does not directly influence the volume of usage of the service;
- where costs are volume related;
- where design may influence demand;
- where there are little or no competing services (for example, where there is only one hospital capable of providing health services to a locality); and
- where there is a relatively high degree of equity investment in the project (and accepting the risks and rewards attached to variable volumes is then in keeping with the nature of the investment).

On accommodation projects demand risk is usually transferred to the private sector through the use of break clauses/options.

9 The auditor will need to check that, if seeking to transfer some demand risk, the Department carried out at an early stage an appraisal of the likely demand for services before designing the specification for a PFI project. This appraisal should have included an assessment of the factors likely to influence demand for the services being supplied and an evaluation of the robustness of the Department's assumptions (paragraph 2.31). The Department would also have benefited if they had informal discussions with prospective bidders at the outset of a procurement to test the bidders' likely reaction to being asked to bear volume risk.

Residual value risk

10 This is the risk that is borne by the party taking over the capital asset underlying the project at the end of the contract. If the Department is to take the residual asset back, the risk that the contractor bears is simply that of handing the asset back in good condition (and the Department will need to set in place arrangements to ensure that this occurs). The Department will bear the wider risks involved with the ownership of the asset. On the other hand, if the contractor is to take the residual asset back and thus incur the greater responsibilities of ownership, the Department will wish to ensure that the contract is not unnecessarily prolonged to reduce the risk to the contractor.

11 When deciding whether or not they are to take the asset back at the contract's end, the Department should have considered a number of factors, including whether a secondary market exists for any asset within the project (as this will affect the residual value) and whether they are likely to need the use of the asset at the end of the contract period. The specialist nature of some assets and the lack of an alternative use may limit the Department's ability to transfer residual value risk.

Technology/obsolescence risk

12 The risk is that the quality of service delivery may be adversely affected if the equipment or other assets used in the service delivery become obsolete. Alternatively, there could be a need to make further financial investment in the project in order to introduce equipment or other assets which are based on new technology. This is an important factor in all long-term procurement projects and is likely to be particularly important in IT projects or those where services are dependent on other specialist equipment (such as medical equipment in hospitals).

13 Where there was a risk (as with an IT system) that an asset might become technologically obsolete by the end of the contract period, the Department should have included in the pricing structure a non-guaranteed transfer payment, which the contractor only becomes entitled to at the end of the contract period if the asset is still usable by the Department. This should result in the contractor bearing the risk of the asset becoming technologically obsolete by the end of the contract period.

Regulation risk

14 This is the risk that the balance of a deal may be affected by regulatory changes (such as in taxation type or rate), planning regulations, or other legal aspects. It is of particular concern in projects continuing over long periods of time. In the National Audit Office's view there is as yet no established good practice in the allocation of these risks. A major difficulty is that there are many different types of regulation which may affect a project. The allocation of regulatory risk should be guided by the general principle that the contractor assumes risk for all regulatory changes that apply to all industry, but may not do so for highly specific legislation or regulation applying to a small sub-set of industry. The Department should still, however, have ensured that the price they paid for the contractor assuming regulatory risk was reasonable. It is particularly important that they did not pay a contractor for bearing regulatory risks which in practice are not expected to affect the project. They should therefore have assessed what regulatory risks were likely to affect the project before negotiating with the contractor on these issues.

15 The auditor should be aware that the performance of the benchmarking or market-testing exercises referred to in paragraph 6 of this Appendix and the resulting periodic adjustments of the contract price can result in the sharing of legislative risk if these exercises are required to take account of any changes in law which have occurred since the last such exercise. However it is likely that the contractor will charge a premium for agreeing to a payment regime which does not allow for the sharing of this risk in this way.

Normal business regulations

16 As a general rule it is reasonable to expect that the contractor will bear the risk of changes to normal business regulation, such as changes to VAT, corporation tax or national insurance rates. However it is important that the contract deals clearly with these matters.

Industry-specific legislation

17 Contractors will generally resist accepting the risk of industry-specific regulation, such as changes to prison or hospital legislation, because such changes are outside the contractors' control but may have a fundamental effect on the requirements and economics of the project.

Planning permission

18 The Department should have decided in advance of the tendering process whether they would seek to transfer the risks of obtaining planning consents and public inquiries to their preferred bidder or whether they would manage these matters themselves. Giving the contractor responsibility for these matters may give bidders greater opportunity to suggest and develop their own design proposals. However it may also lead to time delays and an increased price as the contractor may include a premium in the contract price for managing these risks. The attitude of local authorities to applications by contractors and increasing requirements for planning gain can deter contractors from assuming planning risk. The bidder may well therefore be unwilling to submit firm price proposals until at least outline planning permission has been gained. In some projects it may be advantageous for the Department to work closely with the contractors to ensure the required permissions are obtained in the most effective manner. The Department therefore should have considered carefully how planning issues would be handled if they were to safeguard value for money.

19 The outcome of public inquiries and planning applications can lead to additional design and construction costs, which can be substantial. Where public inquiries and applications are dealt with after bids have been received, it is essential that departments agree with their contractors how such additional costs are to be dealt with in the pricing of the contract as this may affect conclusions about value for money and comparisons between bids.

Project financing risk

20 Project financing consists of two types; financing that is internal to the project, for example proceeds from the disposal of existing assets; and that which is raised from external funders. The risks differ in each case.

Disposal risk

21 This risk arises when the Department vacates existing property or assets, which can then be sold to help fund the new contract. Generally the Department should have sought to secure better value for money (in the form of reduced future payments) by transferring to the contractor surplus assets at a net present value. However they should have considered this carefully since some property may actually represent a liability due to a short remaining lease life with a rent above market levels and an expensive commitment to carry out outstanding repairs and maintenance before vacating the property.

External finance risk

22 This risk is concerned with the possible failure to raise funding for the project in the market. The Department should therefore have considered at an early stage whether external finance on acceptable terms was likely to be feasible at all for their proposed project. They should have ensured that their statement of requirements or proposed contractual terms and conditions did not make it unnecessarily difficult, expensive or impossible for potential contractors to obtain financial backing. As part of this preliminary assessment they should also have formed a view as to whether there was likely to be sufficient equity capital available from contractors and other investors to absorb the level of risk transfer being sought. Projects which are largely or wholly debt financed may involve insufficient risk taking by the private sector.

23 External finance risk also relates to interest rates. Contractors may argue that the contract price should be varied if interest rates move during the final negotiating period because the length of the negotiating period is partly outside their control. In these circumstances it would be good practice for the Department to have asked for bids priced on the basis of a reference market interest rate. Bidders could also have been asked to bid a price variation clause defining how movements in interest rates will be treated. If the Department accepted this risk, it is important that they quantified the possible effects since changes to the contract price could have affected value for money comparisons. The effect of this risk on the contract price should have been regularly reviewed up to the time the contract was signed.

Risk of contractor default

24 In many early PFI projects bankers refused to back contracts that did not include the payment of some compensation in the event of termination of the contract for contractor default. It is possible that banks will reduce their requirements for such arrangements as the market for PFI projects develops and contractors establish reputations for delivering projects. However the Department should have asked their financial advisers at the outset of the project whether the project was likely to be bankable without the inclusion of some compensation in the event of such termination. They should have also evaluated the risks attached to any arrangement which might require them to make such compensation payments. The evaluation should have included quantifying the compensation that might become payable and assessing the probability of this event arising. Before agreeing to such compensation arrangements, the Department should have sought appropriate advice from parties who had experience of other comparable PFI contracts.

25 Where the Department did agree to a compensation arrangement the amount of the compensation should have been set at a level such that, if the Department were to appoint a replacement contractor, the total cost of providing the service (including the compensation) would not become more than that envisaged in the original contract. The Department will have needed to pay careful attention in these circumstances to assessing the state of the project and making realistic estimates of the costs that they would incur to complete the project with another contractor. It is perfectly reasonable for the Department to have asked the private sector to bear at least part of the financial downside in the event of termination. This is particularly the case where the default has occurred because the contractor has underpriced the contract.

26 Other points to consider are:

- the contracts should be structured to ensure they eliminate all potential upside for the contractor and their lenders if the contract is terminated early through the contractor's default or through other action by the contractor other than where the public sector has been in breach of the contract. At all times the contractor and their lenders should be incentivised to continue to provide the services; and

- the Department should have set out their desired compensation arrangements in the beginning, and invited bids based on them, only making alterations if the bidders did not accept the terms.

Political/business risk

The auditor should be aware that departments cannot transfer to the private sector the risk of political embarrassment or the risk to the delivery of their core business should the contractor fail to deliver their contracted services.

Appendix 3: Treasury Guidance on the Private Finance Initiative and other Public/Private Partnerships

The Treasury Taskforce exists to promote the PFI and Public Private Partnerships, to act as enablers to projects proceeding through the PFI procurement process, and to develop a body of best practice guidance for providers.

The Treasury's main guide to the PFI is *Partnerships for Prosperity: The Private Finance Initiative* (November 1997).

Treasury Taskforce Guidance

General

"Partnerships for Prosperity" (November 1997).

"Step by Step Guide to the PFI Procurement Process" (April 1998)

"Standardisation of PFI contracts" (July 1999)

Policy Statements

No 1: "PFI and Public Expenditure Allocations" (October 1997)

No 2: "Public Sector Comparators and Value for Money" (March 1998)

No 3: "PFI and Public Expenditure Allocations for Non-Departmental Public Bodies" (August 1998)

No 4: "Disclosure of Information and Consultation with Staff and Other Interested Parties" (October 1998)

Technical Notes

No 1 (Revised): "How to Account for PFI Transactions" (June 1999)

No 2: "How to follow EC Procurement Procedure and Advertise in the OJEC" (June 1998)

No 3: "How to Appoint and Manage Advisers" (August 1998)

No 4: "How to Appoint and Work with a Preferred Bidder" (July 1999)

Case Study Material

"Private Finance and IS/IT case study: TAFMIS…and after" (March 1998)

"Colfox School Dorset - A Case Study on the First DBFO School Project" (March 1998)

Other Treasury Guidance

Appraisal and Evaluation in Central Government (Green Book) (August 1997)

PES (96)30 Public Expenditure Treatment of Finance Leases and Transactions that are in substance Borrowing

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Glossary

Term	**Definition**
Bench-marking	The process of comparing the time or cost of an operation, service or product against those of other organisations, preferably thought to be the best in the field.
Concession procedure	The concession procedure provides the maximum flexibility in negotiating with the selected parties on pricing the service to be delivered. It also, in practice, allows scope for further negotiation once preferred bidder status has been conferred. This route is only feasible if the concessionaire is able to exploit the concession. Where this procedure is not allowed, the **negotiated procedure** is the preferred option. Neither the **open** nor the **restricted procedures** are suited to PFI contracts as they are too rigid to allow for the negotiations required.
Conventionally financed	A construction contract in which the customer pays the contractor as the works are progressed. Such projects are fully paid for on completion. Maintenance is dealt with in separate contracts.
Core (technical) requirements	Technical details which must be satisfied by the design and construction and the operation and maintenance to meet the customer's requirements in the contract.
Cost of capital	The rate of return implicit in the sums repayable by an organisation to those providing it with funding.
Customer	The public sector body that will award the contract. Not necessarily a government department: might be an NHS Trust, local authority etc.
Deliverable	Indication of the possible ways of delivering a service, before contract award. After the contract's award, the agreed service specification.
Discount rate	The percentage rate applied to cash flows to enable comparisons to be made between payments made at different times. The rate quantifies the extent to which a sum of money is worth more to the Government today than the same amount in a year's time.
Financial models	Spreadsheets designed to show the financial outcome of a particular set of estimated costs, revenues and fixed and capital charges for delivering a service over time.
Framework agreement	A contract over a particular period where the consultant or contractor is guaranteed regular pieces of work without the need for competition, provided they can demonstrate that they provide value for money.

ITT-Invitation to tender	A formal communication to selected suppliers
Joint venture	Where the costs of a project are not met entirely through charges on the end user of the services but are subsidised from public funds. The public sector's role is limited to a contribution towards asset development, while operational control rests with the private sector.
Market testing	Discussions with industry and experts to see if there are organisations likely to bid enthusiastically to provide a proposed service before it is offered to the market. Also, after a contract has been awarded, the periodic re-offering of the service to the market.
Negotiated procedure	The negotiated procedure is 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.
Objective	General statement of service required. Comprises **deliverables**, cost limits, risk transfer and benefits sought.
Open procedure	One of the forms of procurement procedure permissible under EC regulations, which, unlike the **negotiated** or **restricted** options, allows all interested parties to tender. It is most applicable to the procurement of goods for which there is a clear and comprehensive specification and price is likely to be the key determinant.
Output specification	Specified aspect of the customer's service requirements or performance specification, for which the **customer** sets minimum quality standards to be met by bids.
Partnering	The situation where a public organisation and a private one work together to provide a service with some sharing of risk and reward, usually over a period of time
Planning risk	The risk that delays or increases in costs could occur due to procedures in the planning process, such as Public Inquiry.
Prequalification	The process by which organisations demonstrate their capability to tender for, and to carry out if selected, a project or class of projects.
Private Finance Initiative	A policy introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services.

Private Finance Initiative principles	The allocation of risk and reward should be clearly defined and private sector returns should be genuinely subject to risk; and the contracts should represent value for money, taking into account the benefits of transferring risk to the private sector and the cost of that transfer.
Privatisation	The transfer of assets from Government to the private sector.
Public Sector Comparator	An estimate of what the project would cost if traditional procurement methods were used. This is used to determine whether private finance offers better value for money than **traditional procurement**.
Reserve bidder	Second place short-listed bidder after the final bid stage. Reserve bidders may be invited to keep bids on the table in order to maintain competitive pressure on the provisional preferred bidder.
Restricted 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.
Risk	Hazard, danger, chance of loss or injury; the degree of probability of loss; a person, thing or factor likely to cause loss or danger.
Risk transfer	The passing of risk normally borne by the customer to the service provider
Sensitivity test	Test of the impact on the value for money of bids of changes in the key assumptions underlying the customer's main value for money assessment.
Shadow toll	Amount paid by the Government to the road operator for each vehicle kilometre travelled on the operator's roads.
Shortlisting	The first stage in selecting the successful bidder.
Statutory risk	The risk that the law will be changed in a way which specifically affects the operation of the service - for example the introduction of **user paid tolls**. The risk of general changes in law is borne by the operators as a normal business risk.
Traditional procurement	See **conventionally financed**.

TUPE	The Transfer of Undertakings (Protection of Employment) Regulations 1981, which aim to safeguard the rights of employees on their transfer to another employer, for example when their work is contracted out.
User paid tolls	Tolls paid by road users for road usage, otherwise known as "Real" tolls.
Value for Money (VFM)	The achievement of the optimum combination of whole life cost and quality to meet the customer's requirements.
Volume risk	The risk that service volumes (traffic, prisoners in cells) may be higher or lower than forecast volumes, thus possibly affecting the amount of payments.
Whole life approach	Taking a view of the construction, operation and maintenance of the road project over the whole life. Under **traditional procurement** the whole life cost is borne by the customer; under the PFI this is passed to the operator.

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Notes: Entries are to paragraph numbers for Parts 1 and 2, and also shown in parentheses after Appendix 2.