Report by the
Comptroller and Auditor General

Ministry of Defence

The Private Finance Initiative: The Contract for the Defence Fixed Telecommunications System

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Executive summary

Introduction

1 In March 1995 the Ministry of Defence ("the Department") invited tenders for the provision of a new Defence Fixed Telecommunications System for the whole of the Department including the three Armed Services. The Department's main aims were to rationalise and improve the efficiency of their existing fixed telecommunications services, to ensure continued telecommunications services and to deliver financial savings of around £30 million a year (some 20 per cent of their annual fixed telecommunications costs).

2 The Department's fixed telecommunications capability at that time consisted of 46 distinct services (Figure 1), provided by four separate organisations. The new system will consist of six services (Figure 2) managed, largely through a contract for the Defence Fixed Telecommunications System, by one organisation, the Defence Communications Services Agency (Figure 3).

3 In July 1997, after a competition, the Department let a ten year contract for this project to BT. The Department estimate that the project will cost them £782 million (present value), consisting of £612 million in payments to BT, and £170 million in other costs remaining with the Department. The Department estimate that their contract with BT, together with cost reductions they had made before letting the contract, will achieve the 20 per cent savings target they had established in 1995.

The focus of our study

4 We examined whether the Department went to the market for the right project, whether they contracted for the services at a good price, the extent to which they protected their interests over the life of the contract and whether they managed the procurement process effectively. Appendix 1 outlines our methodology for the study.

The scope of the project may not have maximised value for money

Paragraphs 1.5 to 1.13.

5 Before developing the project the Department had carried out a strategy study of all their communications requirements until 2010. This had identified the implementation of a single fixed telecommunications system as the keystone of the

Department's future communications strategy and the savings which this would produce would be an important factor in enabling their other plans for improving communications to be achieved. There are, however, interrelationships between the Department's various communication systems and rapidly changing technology requires fast and frequent reassessment of the most effective form of service delivery. But, having decided to procure a new fixed telecommunications system, the Department did not assess the potential advantages and disadvantages of expanding the project to seek synergies from including other services, or reducing the scope to generate competition for a number of smaller projects.

6 The Department consider that the project involved considerable risk because it was large and novel, and that expanding the project would have added further to its complexity. They say this would have prolonged the competition and led to delays in the achievement of identified savings they expected to secure through rationalising the delivery of fixed telecommunications services. BT, the winning bidder, supports this view. We consider, however, that the Department should have carried out a strategic review of the project scope to assess the extent to which restricting the project to fixed telecommunications would have limited their future options for pursuing the best possible savings on other communication services and how this should be balanced against the risks of a project with a different scope.

Paragraphs 1.16 to 1.20

7 The project started out as a conventional public sector procurement of assets, but became a privately financed project when the Department rejected two publicly financed bids. They assessed one of these bids as not technically feasible. They were keen to pursue a privately financed solution, they rejected the other publicly financed bid due to technical non-compliance and decided that the final stages of the competition would be most effective if this was between the two privately financed bids they had received.

Paragraphs 1.23 to 1.27

8 After considering other contract periods, the Department chose to let the contract for ten years. Although contracts for many privately financed projects are much longer than ten years, the length of Private Finance Initiative contracts for information technology and telecommunications services has generally been between five and ten years due to rapid technological changes in these sectors, with the current trend being towards ten year contracts. The Department decided that ten years would deliver the greatest savings, would reduce annual charges as bidders would have longer to recover the costs of their investment, and retain some flexibility that would be lost by being locked into a longer term contract. The length also reflected the fact that the project is complex, requiring a three year implementation period before the new system is fully operational. A ten year contract period, however, entails a number of risks for the Department arising from the rate of change and increasing competition in the telecommunications industry. How effectively the contract deals with changes will therefore be an important element in ensuring value for money. The Department and BT meet regularly to consider jointly whether service changes are desirable and the contract contains mechanisms aimed at ensuring that BT's services continue to offer value for money throughout the ten year period (paragraphs 3.10 to 3.17).

The Department obtained the contract at a good price

Paragraphs 2.12 to 2.14, and Figure 8

9 Both final bids complied with the Department's quality and technical criteria, and the Department estimated that BT's final bid was £121 million (expressed in present values) less costly than the other final bid from Racal. BT's final bid also produced non-financial efficiencies and innovations compared to the previous form of service delivery.

10 Bids from GPT and Nortel on the basis of public finance initially appeared to offer more savings than the two privately financed bids from BT and Racal. GPT's bid initially offered £48 million more savings than the BT bid, but the Department reduced this estimate of additional savings to £12 million after adjusting aspects of the GPT bid which did not meet the specification. The Department nevertheless rejected GPT's bid, because they considered it was not technically feasible.

11 The Nortel bid was assessed to be technically feasible despite some technical non-compliances. This bid initially offered £27 million more savings than BT's. After adjusting for aspects which did not meet the specification, the Department estimated, however, that it would be £26 million more expensive than BT's bid, but still £30 million cheaper than Racal's bid over a ten year period. Although the Department chose a ten year contract period, and Nortel had offered substantially greater savings than Racal over this timescale, the Department did not invite Nortel to participate in the final bidding rounds. They decided to have only two final bidders, were keen to pursue a privately financed solution and considered that the Racal bid would offer more credible competition to BT with fewer technical non-compliances than Nortel's bid. Racal's bid would also have offered greater savings over a 15 year period.

Paragraphs 2.6 to 2.9 and 4.7

12 The Department followed a procedure which limited bidder negotiations until they selected a preferred bidder. We consider that this contributed to the need for bidders to put in three Best and Final Offers rather than the preferable one, thereby increasing the length of the competition and increasing costs to bidders. There was an awareness within the Department and in the private finance market at that time that the European Union negotiated procedure was appropriate for privately financed deals although the Department's project team told us they had not been advised to follow this procedure. In our view, better external advice may have led to the Department following the negotiated procedure.

Paragraphs 2.3 to 2.5, 2.29, 2.32 to 2.34, and 2.37 to 2.44, and Figure 11

13 The Department did well to sustain competition between BT and other suppliers. BT had advantages in the competition because they already provided much of the Department's fixed telecommunications requirements, so they had a greater knowledge of the Department's requirements than any other supplier. The Department maintained competitive pressure until selection of preferred bidder and secured a late reduction in the final bid from BT which reduced the total project costs by some £60 million (discounted).

14 The expected payments to BT rose, however, by £77 million as a result of negotiations after they became preferred bidder. This was largely a result of BT agreeing to provide additional services and to advance the date for taking over responsibility for some services. There were, therefore, compensating reductions of £40 million to costs which the Department would otherwise have borne directly. This resulted in a net increase to the overall project costs as a result of the negotiations of £37 million. The Department's ongoing cost reduction programmes had reduced other telecommunications costs which they would bear directly by £35 million. As a result their estimate of the total project cost increased at this time by £2 million. The Department consider that their negotiations with BT provided a small improvement in value for money as around 90 per cent of the additional payments to BT were for additional services purchased at tariffs determined in the competition and there was also a cost reduction for UNITER, a secure system.

15 We have carried out benchmarking which has confirmed that the prices of services are generally reasonable. The Department are paying around the same amount for two high security services as they were before the contract, despite the fact that these are now being provided by cheaper civilian staff. BT are now responsible for maintenance risks and for replacing obsolescent equipment. While this may explain the difference we consider the Department should have quantified this risk transfer to demonstrate whether the price paid was value for money.

The Department are generally protected by the contract but we have some concerns

Paragraphs 3.3 to 3.5

16 During the first three years BT are responsible for operating the existing fixed telecommunications services whilst preparing their systems to take over the service at dates agreed in the contract. The process of transferring service delivery to BT systems, known as migration, is scheduled to be completed by July 2000. The new services are to be introduced at specified dates in stages, referred to as milestones. BT are paid for providing the existing service and for the achievement of the milestones. Virtually all milestones defined in the contract have been achieved by the due dates. The contract allows for new services and technology to be incorporated during the contract period and the Department can ask other suppliers to provide such services if they are not satisfied with BT's proposals.

Paragraphs 3.10 to 3.17 and 3.26 to 3.28

17 Prices for the various services are adjusted periodically in line with price movements in agreed price indices. The Department are allowed, within certain limitations, to challenge BT's prices, and have established arrangements for monitoring BT's ongoing prices against those of other suppliers. The Department are content with the price challenge arrangements. The contract terms, which were initially drafted by BT, limit, however, the risks transferred more than in other privately financed contracts we have examined. As a result the contract is closer to a traditional outsourcing than a private finance contract. Prices for the telecommunications elements of services, which are expected to fall, are adjusted annually, whereas prices for other elements, which are expected to rise, are adjusted quarterly. The effectiveness of the price challenge mechanism may be limited because the contract only allows it to be used in exceptional circumstances, without defining what these are. In addition, although the challenge is to allow a value for money review to be undertaken, the contract does not indicate how value for money is to be measured. The Department receive volume related price discounts for three of the telecommunications services only.

Paragraphs 3.18 to 3.22

18 Our analysis also suggests that, although the Department consider that the performance standards and compensation arrangements for poor performance meet their requirements, in many respects they are not as stringent as those applied in other large contracts for telecommunications outsourcing, facilities management and privately financed services. For example, higher than normal service failures are allowed before BT must pay compensation, and the level of compensation the Department receive can be no more than 50 per cent of BT's payments for a particular service, whereas payments of up to 100 per cent are not uncommon in other contracts. The Department consider that more stringent conditions would have led to increased prices.

Paragraphs 3.31 to 3.39

19 The contract provides for a further competition to provide the services at the end of the ten year contract period. BT are once again likely to have advantages over other bidders, though the scope of the contract may change, which may encourage other suppliers to bid.

The Department should have made better use of external advice

Paragraphs 4.2 to 4.7

20 The Department spent some £4.4 million on external advice during the competition. The largest parts of this were £1.8 million for ongoing specialist support to the project, and £1.7 million for site surveys to inform the Department's asset database for the invitations to tender. They spent relatively little (only £220,000) on strategic, financial and legal advice as they considered their in-house experience of procurement and the delivery of telecommunication services gave them sufficient expertise to address most issues that would arise.

21 The Department did not supply bidders with the draft contract terms the Department required. Instead they asked BT and Racal to submit their own draft contracts with their final bids. The Department did not appoint their own legal advisor, Burges Salmon, until after BT had been selected as preferred bidder. The Department chose Burges Salmon, after taking advice from their internal legal section, from a panel of approved legal advisors. The Department did not seek competitive tenders from other firms and only sought input from Burges Salmon on limited areas of the contract and negotiations. In other areas the Department negotiated the contract based on the terms initially proposed by BT without Burges Salmon. We consider that this contributed to some aspects of the contract being more favourable to BT than we would have expected (paragraphs 17 and 18).

22 In our view the Department's interests could have been better protected if they had brought their legal team together at the outset, if they had considered which legal firms had relevant experience, had sought competitive tenders from those firms, and if they had sought bids based on a set of contract terms developed with input from their legal advisors. The Treasury's guidance on the standardisation of Private Finance Initiative contracts published in July 1999 will help departments and their legal advisors to develop acceptable terms for privately financed contracts.

Recommendations

23 As a result of this examination we have identified the following key learning points for future projects, a number of which are reflected in the Department's current guidance:

Paragraphs 1.6 to 1.8

1 Where there are interrelationships and potential synergies between different services departments should appraise their strategy for delivering all such services before developing a long-term project for any of them. They should also be open to suggestions from bidders as to how to draw the boundaries of a project to maximise value for money. After letting a contract a department should reassess the scope of the project at periodic intervals during the contract period and prior to any further competition.

The Department's 1998 guidance "Private Finance Initiative Guidelines in the Ministry of Defence" emphasises the need for those procuring a Private Finance Initiative project to consider how possible solutions to their service requirements fit in with wider departmental needs and strategy and where exactly the boundaries of these requirements should be drawn.

Paragraphs 4.4 to 4.6

2 Even where departments have in-house staff with expertise in traditional forms of procurement, they should still consider at the outset what additional skills external advisors can contribute to a privately financed project. It can be a false economy not to make use of external advice. Advisors should be appointed through competition.

The 1998 guidance stresses the importance early in a project of identifying what outside skills might be necessary. To this end the Department have established a framework of contracts with a range of consultancy companies and lawyers who can offer advice on Private Finance Initiative projects.

Paragraph 4.6

3 Departments should, with their advisors, make use of the Treasury's new guidance on contract terms to develop a set of proposed contract terms. They should then ask contractors to price their bids on the basis of these terms. This will enable departments to obtain competitive bids based on terms which meet the departments' requirements and should help avoid protracted negotiations once they have appointed a preferred bidder. Departments should review how the contract terms work in practice to inform their negotiations of future deals.

The 1998 guidance recommends that the Department should, with their advisors, draft contract terms and conditions and invite bidders to comment on these. The Department are also preparing guidance on Private Finance Initiative terms relevant to the defence sector to supplement the Treasury's guidance.

Paragraph 2.7

4 Departments should reserve the right to modify the bidding process in any way which seems likely to improve value for money. In this project, for example, the Department obtained significant price reductions by asking the final bidders to reassess their bids before selecting the preferred contractor. Departments should be careful, nonetheless, to avoid making a general practice of asking for further rounds of bids as bidders would be likely to anticipate this and take it into account when making their opening bids. They should also try to avoid increasing bidding time and costs unnecessarily.

The Department's guidance contains advice on the advantages and disadvantages of asking for an extra round of tenders.

Paragraphs 2.36 and 3.14

5 Departments should consider whether benchmarking prices before contract signature can help their position in negotiations. In a field like telecommunications, where prices change frequently, they should also regularly benchmark contract prices against prices charged by other suppliers for comparable services. This is common industry practice to assess the value for money of services provided, and is being followed by the Department in this contract. Benchmarking also assists discussions about prices, where the contract allows prices to be adjusted if they are uncompetitive.

There is no reference in the Department's guidance to the use of benchmarking techniques before contract letting.

Paragraph 3.15

6 Where a contract provides for regular price adjustments departments should ensure that they are able to receive the benefit of downward price adjustments at least as frequently as they bear upwards price adjustments.

Although the 1998 guidance deals with price variation issues, it does not deal with the frequency with which indexation formulae should be applied.