NAO
NATIONAL AUDIT OFFICE

Report by the
Comptroller and Auditor General

National Savings

Public-Private Partnership with Siemens Business Services

HC 493 Session 1999-2000
25 May 2000

Report by the
Comptroller and Auditor General

National Savings

Public-Private Partnership with Siemens Business Services

Ordered by the
House of Commons
to be printed 22 May 2000

LONDON: The Stationery Office
£0.00

HC 493 Session 1999–2000
Published 25 May 2000

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

John Bourn
Comptroller and Auditor General

National Audit Office
6 April 2000

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

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020-7798 7400

email:enquiries@nao.gsi.gov.uk

Web site address: www.nao.gov.uk

Contents

Front cover photograph by Doug Neal (National Audit Office)

Executive summary

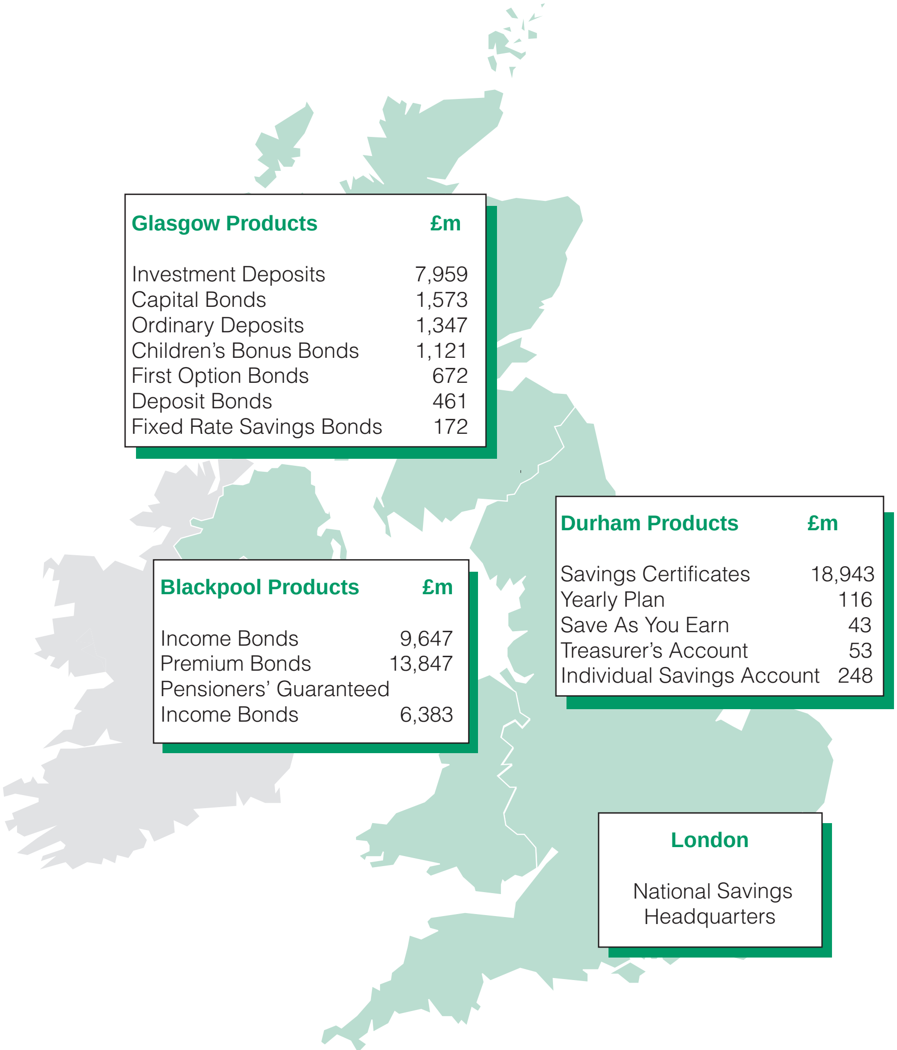
1 The Department for National Savings (National Savings) is an executive agency of the Chancellor of the Exchequer which helps to fund central government borrowing by offering savings products directly to the public. In March 1997, National Savings invited expressions of interest from potential bidders to run the operations required to process product transactions and provide a customer service (the operational service). Following a competition, National Savings transferred all of its operational staff and assets to Siemens Business Services (SBS) from 1 April 1999. Within a partnership framework, SBS will service all of National Savings' products for up to 15 years. The partnership forms a vital part of a programme of modernisation and transformation which aims to provide better value for the taxpayer and National Savings' customers. An intensive investment programme should enable National Savings to be competitive and relevant in the highly competitive and fast moving retail savings market.

2 National Savings has about 12 per cent of the retail savings market and at 31 March 2000 around 30 million customers had invested a total of £62,500 million in a range of products which include Premium Bonds, Savings Certificates and Investment Deposits. These products are serviced by SBS at three operational sites - Blackpool, Durham and Glasgow. National Savings is located mainly at its London headquarters (Figure 1). Business is conducted through agents and directly with customers by post and by telephone. During 1999-2000, the operational service processed over 50 million transactions resulting in sales of £10,200 million and repayments of £11,100 million. Although National Savings has a number of computer systems, many of the processes used for product transactions are paper based. Prior to April 1999, National Savings employed some 4,200 staff and incurred running costs of some £180 million a year.

3 We examined the value for money likely to be obtained by National Savings from the partnership with SBS, whether the contract underpinning the partnership will be an effective framework for managing the relationship and how the procurement process was handled. Our methodology is summarised at Appendix 1.

Figure 1

Amounts invested in National Savings' products at 31 March 2000



Source: National Savings

The partnership with SBS is capable of delivering significant benefits

The need for private sector involvement was based on a business strategy

4 The partnership with SBS arose from a strategy review which concluded that, although National Savings created significant added value for the taxpayer, it would be seriously eroded unless operational delivery was modernised to compete with private sector participants in the retail savings market. To meet the challenge, savings products needed to be designed and marketed more effectively, running costs had to be cut and customer service enhanced. This led to two key decisions.

5 First, a core of some 130 staff would be responsible for the design, management and marketing of products and for liaison with the Treasury on annual funding requirements. The remaining 4,100 staff would provide the operational service required to process transactions and deal with customers. Second, the private sector could provide the substantial investment needed to transform operational processes, design and implement supporting IT systems and create new jobs through the development of third party business.

Performance to date has been encouraging

6 Although it is impossible for us to reach a conclusion on the eventual success of this project at such an early stage, it is apparent that performance since the partnership began has been better than that of National Savings in the preceding period. In the first six months of the partnership, SBS has played a key role in the launch of three new products, along with five product variations. In comparison, only three new products had been introduced in the previous eight years.

It is a high risk project but SBS considers it is taking a low risk approach

7 With 30 million customers, a major failure of the operational service would be a matter of grave public concern. To meet National Savings' requirements and to achieve its expected returns on the project, SBS will have to transform the existing business processes, combined with a significant advance in information technology. These tasks involve a high degree of risk.

8 Two factors mitigate this risk. First, in contrast with SBS' existing contracts with the Passport Agency and the Immigration and Nationality Directorate, SBS is wholly responsible for new operational processes, supporting IT systems and their use by former National Savings' staff who have transferred under the deal. SBS therefore has more control over this project than on previous occasions, including the cultural change required from its new workforce. If SBS is unsuccessful, it will bear the financial consequences of failure. Second, as there is a system that works and can continue to work until new systems are up and running, SBS plan to change the business processes and supporting IT systems gradually, rather than taking a "big-bang" approach. Each stage, for the most part involving proven IT packages, is to be rolled out well in advance of contracted target dates, and small groups of operations staff will check usability and identify potential improvements.

9 As the transformation of business processes is central to the success of the partnership, National Savings is monitoring progress through an agreed governance structure and working-level contacts. Alongside this, National Savings has employed independent IT consultants to help it act as an intelligent customer when assessing SBS's proposals and progress.

Running costs will be lower

10 The estimated net present cost of running the operational service in-house was £793 million over 15 years, while the net present cost of the partnership with SBS is expected to be £635 million. The principal reasons for the difference are that SBS can invest cash in transforming operations more quickly than National Savings and can create new jobs through the development of third party work. National Savings' scope for investment was constrained by annual cash budgets, which were planned to decline in real terms at an annual rate of 2.5 per cent and it could not create new jobs for surplus staff. SBS and other bidders were not subject to such constraints and could plan to incur losses in the first years of the contract to realise efficiency gains more quickly than National Savings could.

The contract underpinning the partnership appears to be robust

The contract aligns the interests of both parties

11 SBS saw the acquisition of the operational service as a strategic asset which, with skilled and experienced staff already in place, provided an opportunity to develop services for other customers. Its bid was therefore priced to reflect the creation of at least 1,200 jobs on such third party work. If SBS is not successful in creating these new jobs, it will bear the costs of any potential redundancies.

12 Although SBS plans to use at least 1,200 staff on third party work, the contract price included a time-limited contingency of £45 million in the event that SBS was not as successful as expected in winning third party work. Any part of this contingency provision which is unused will be shared in a ratio of 70:30 between National Savings and SBS. Where SBS uses staff and other assets which remain employed on National Savings' business for third party work, National Savings will share in profits and receive rebates on running costs.

13 Within the contract price SBS is required to facilitate the introduction of four new products in each of the first two years and two new products in each subsequent year. But SBS is not guaranteed all the additional work needed to introduce new savings products. If National Savings enters new areas of business through the introduction of fundamentally different products or develops

fundamentally different sales channels, SBS is required to assist National Savings in their design and development. However, to preserve the ability to use competition to get good value, the contract allows National Savings to go out to tender for the operations needed to deliver and maintain such products and channels. In addition to detailed sharing mechanisms covering specific aspects of the partnership, National Savings is also entitled to receive 50 per cent of the amount by which SBS's annual net profit margin exceeds an agreed percentage in the contract and will not share in losses.

The contract allocates risks properly

14 Although SBS has accepted significant risks, it considers that the transfer of the entire operational service under a long-term contract provides the power and necessary incentives to manage those risks. For instance, SBS is responsible for operational errors. If an overpayment is made to a customer, SBS has to reimburse National Savings and take action to recover the overpayment. If an underpayment occurs, National Savings bears no cost risk for any SBS errors but SBS will have to pay compensation to customers if sums due have been paid late and may, if too many underpayments are made, incur performance deductions. SBS must also bear the cost of all staff fraud and any customer fraud in any one year in excess of £250,000. There are, therefore, powerful incentives for SBS to limit the number of operational errors.

There is machinery to manage the contract

15 National Savings and SBS have established a joint governance structure for the contract. To help monitor the contract at a strategic level and on a day to day basis, National Savings has established a relationship management unit which includes professionally qualified senior staff who negotiated the contract. The unit has developed a manual of new business management processes and has introduced new business reports to help ensure that management of the partnership is effective.

16 In addition to the transformation of operations and the introduction of new products, SBS has to meet and exceed 42 key performance indicators spread across eight areas of operational services, designed to measure accuracy, timeliness and quality of service to customers. To monitor SBS's reporting of performance satisfactorily, National Savings has increased the resources it devotes to these tasks and plans a further small increase.

17 The contract includes a comprehensive list of events which can lead to default. In particular, poor performance by SBS can lead to default and termination of the contract. National Savings may also terminate the contract for any reason after the first two years but must give 12 months notice and pay compensation if SBS is not at fault.

18 In such a long contract it is inevitable that there will be constant changes as the business environment, market place and technology move forward. Formal change processes have been put in place to manage and control this. Accordingly, both partners have agreed roles and responsibilities within their respective organisations to facilitate the agreement of contract changes. It is also essential to include clear arrangements to apply at the end of the contract period or earlier termination, so that National Savings are free to choose an alternative supplier through a competitive process. In a pre-handback period, one year before expiry of the contract, SBS cannot alter the terms of employment of staff, dispose of any assets or alter key contracts with suppliers. During the contract, where assets are shared, SBS and National Savings must jointly agree the appropriateness of third party business proposals and maintain the transferability of assets at the end of the contract.

19 Nevertheless, to the extent that SBS succeeds in winning significant amounts of third party business, a proportion of staff and assets may well be employed on both National Savings and third party work. Without proper control, the detailed handback procedures which are included in the contract may not work well. It is therefore important that the contract should be varied (using agreed change procedures) to ensure that the handback provisions remain workable.

The procurement process was handled well

The procurement was properly planned

20 As a substantial part of its operations would be transferred to the private sector, senior National Savings' management committed a large amount of time to planning the project. Bidders were consulted to establish the likely benefits from a partnership and how the procurement could best be implemented. To maximise the potential for efficiencies, National Savings agreed that the operational service should be transferred as a single package to a single private sector provider under a long-term contract.

21 To protect itself from being reliant on a single partner in a long-term contract, National Savings sought firm prices for each year of the contract, depending on forecast transaction volumes. During the life of the contract, costs and quality would be benchmarked at regular intervals with the outcomes limited to downward only price movements and/or improvements in quality of service. In addition, National Savings required a partner to share equally any higher than expected profits.

The detailed requirements of the project were well specified

22 National Savings clearly defined the scope of its own responsibilities and those of a private sector partner. A private sector partner would be responsible for service delivery and development, support services and database management. In setting a detailed output specification, National Savings paid particular attention to the handling of volume risk and the use of a performance measurement regime to provide appropriate incentives for high service quality.

There was competition at each stage of the process

23 Ninety companies responded to an advertisement published in the Official Journal of the European Communities in March 1997. National Savings selected four companies to receive an Information Memorandum setting out the scope of the project in greater depth. Following evaluation of the bidders' proposals, SBS and Electronic Data Systems (EDS) were invited to negotiate on detailed terms. National Savings considered that taking forward two rather than three or all four of the bidders would provide the optimum balance between the maintenance of competitive tension in the final stage of bidding and the significant costs for both sides in formulating and evaluating final bids. National Savings maintained competitive pressure on SBS and EDS by negotiating a draft contract with each of them before recommending a preferred bidder to the Treasury. At each stage of the procurement, pre-determined criteria were used to evaluate bids. SBS provided better value for money than EDS on the basis of price and the extent of risk transfer. This was most apparent in the higher limits of liability and level of performance deductions SBS was prepared to accept.

Lessons learned

24 Although it is too early to conclude whether the key outcomes envisaged in this partnership will be achieved, it is apparent from our examination that National Savings secured a very good deal with SBS. In doing so, a range of complex issues had to be addressed and National Savings' experience underscores some important lessons which should be borne in mind in negotiating public-private partnerships.

Take a pragmatic approach

a) **There are advantages in transferring not only the risk of business process re-engineering involving IT solutions to a private sector partner but also the staff who will be responsible for implementing those solutions.**

SBS is responsible for new IT systems and their use by staff who have transferred under the deal. SBS therefore has more control over this project than on previous projects, including the cultural change required from its new workforce (paragraphs 1.23 to 1.26).

b) **In transferring staff to the private sector in circumstances where they may otherwise be made redundant, departments should encourage bidders to make proposals for alternative work for their new employees.**

SBS saw the acquisition of the operational service as a strategic asset which provided an opportunity to develop services for other customers. Its bid was therefore priced to reflect the creation of at least 1,200 jobs on such third party work (paragraph 2.2(a)).

c) **It is unwise to rely solely on risk transfer and appropriate incentives for the private sector party to ensure that the required services will be delivered.**

As the transformation of operational processes is central to achieving the benefits expected by each partner and the ultimate success of the partnership, National Savings is monitoring progress by SBS and has engaged independent IT consultants to help it act as an intelligent customer (paragraphs 2.9 and 1.28).

d) **Departments should ensure that poor performance by a service provider will put the contract at risk of termination**.

National Savings has avoided being "locked-in" to the contract and can terminate the partnership if performance standards agreed with SBS are not achieved (paragraphs 2.11 to 2.13).

Maintain and monitor the contract terms

e) **Departments should ensure that they have appropriate management resources to monitor the performance of a private sector partner.**

SBS has to meet and exceed 42 key performance indicators spread across eight areas of operational services, designed to measure accuracy, timeliness and quality of service. National Savings has increased the resources it devotes to monitoring SBS's performance and aims, through effective business judgement, to incentivise performance improvement rather than apply a mechanistic formula of penalties (paragraph 2.10).

f) **In entering into a long-term partnership, departments must ensure that the underlying contract reflects changes which will occur over time.**

Detailed procedures have been agreed to facilitate the agreement of changes and incorporate them in the contract. Nevertheless, if SBS succeed in winning significant third party business, a proportion of staff and other assets may well be employed on both National Savings and third party work. It is therefore important that the contract should be varied using these agreed procedures so that the provisions for handing back staff and assets remain workable (paragraphs 2.16 to 2.18).

Managing the procurement process

g) **Senior departmental management should be closely involved.**

As a substantial part of its operations would be transferred to the private sector, senior management within National Savings took control of the project and, with the support of professional and experienced staff, committed a large amount of time to planning the procurement and agreeing the terms of the contract with SBS (paragraphs 3.2 and 3.3).

h) **Departments will be in a much stronger negotiating position if the content and scope of the deal is made clear to bidders**.

National Savings clearly defined its own responsibilities and those of a private sector partner at the Invitation to Negotiate stage of the procurement process. There were considerable benefits in sending out a properly constructed Invitation to Negotiate and it is questionable whether National Savings would have got such a good deal if the document had been issued on the date originally intended. Throughout the procurement, pre-determined criteria were used to evaluate bids. To avoid any drift on price, risk transfer and value generally, competitive pressure was maintained on two final bidders by negotiating a draft contract with each of them before recommending a preferred bidder to the Treasury (paragraphs 3.8 to 3.16).

Part 1: The partnership with Siemens is capable of delivering significant benefits

This part of the report shows that the partnership with SBS was based on a business strategy and that the performance of SBS in the first six months of using the current systems has been encouraging. Nevertheless, National Savings and SBS will only gain significant benefits if new working practices and up to date IT systems are successfully introduced across the operational service. Although the development and implementation of these new systems is a high risk project, both partners consider they are taking a low risk approach which will result in better customer service at lower cost.

The need for private sector involvement was based on a business strategy

1.1 Before considering the deal itself, the strategic considerations which led National Savings to seek a partner to run its operational service need to be understood. In 1996, National Savings commissioned a strategic review to clarify its role and purpose, to identify how value to Government should be measured and to recommend how that value could be maximised.

1.2 The Treasury is responsible for financing the Central Government Net Cash Requirement through sales of gilt-edged securities (gilts) and National Savings' products in such a way as to minimise cost while ensuring consistency with the objectives of monetary policy. This responsibility is delivered through two executive agencies. The Debt Management Office manages the sales of gilts to participants in the wholesale capital markets and the sale of savings products to retail investors is handled by National Savings. The funding task for National Savings is set a year at a time in the form of a remit agreed with the Treasury.

The strategic review recommended that the involvement of the private sector could add value

1.3 National Savings has for many years provided savings products for UK citizens, even for those with very little money to save. National Savings might, therefore, be thought to serve a socially useful function. Although in the past National Savings had been a very important source of funding for Government, in its recent history the Treasury had not regarded it as playing a critical part in

Government funding. If the prime role of National Savings was its social functions, then its future strategy might be based on providing those functions at minimum cost, but if there were also financial arguments for retaining National Savings, then a different strategy might be appropriate. The strategic review therefore needed to consider the ways in which National Savings might be regarded as a source of value to the taxpayer.

1.4 The review, completed in January 1997 by Corporate Value Associates, concluded that the added value of National Savings for the taxpayer could be measured by the extent to which funds are raised at lower yields than the alternative of issuing gilt-edged securities, taking account of the administration costs and tax foregone on some National Savings' products (Appendix 2). National Savings expects to achieve some £300 million of added value during 1999-2000.

1.5 In the light of the strategic review, National Savings decided to base its business strategy not on cost minimisation but on maximising value creation. This has meant pricing products competitively both in relation to gilts, to provide value directly to taxpayers, and in relation to other savings institutions, to provide value to customers and thereby ensure the continuing loyalty on which sustainable taxpayer value depends. Seen in that light, control of costs became just one way of improving the value National Savings could add. The review considered that there were areas in which further value could be added:

a) Particular products are administered at each of the three sites. As there was no common computer system for all savings products, customers who hold a range of investments could only complete transactions or make enquiries about different products by going to separate contact points. In addition, National Savings could not collate and analyse customer information to help market products as effectively as it might. Against a background of fragmented information on its customers, National Savings had in the past been slow to react to changes in the market.

b) National Savings' operations were too dependent on paper-based systems requiring high staffing levels and, where systems had been automated, the technology had become out of date. Investment in operations would reduce costs and improve service.

1.6 In 1995, National Savings had started to address these issues through a Business Process Re-engineering project designed to improve customer service while reducing the cost of managing the business. This would be achieved through a fundamental re-design of operational processes, supported by the implementation of new IT systems.

1.7 As a result of the strategic review, however, National Savings took two key decisions. First, if it was to compete within an increasingly competitive financial services market, strategic and commissioning functions needed to be separated from operational services. A core of 130 staff based mainly in London were made responsible for liaison with the Treasury on funding requirements, the design and marketing of products to deliver the required level of funding, and the management of the operational service. The remaining 4,100 staff would provide the operational delivery of sales, payments and after-sales along with supporting transactions and a customer service.

1.8 Second, National Savings considered that the private sector could help to enhance added value to both taxpayers and customers by improving operational delivery. A private sector partner could provide substantial investment to deliver the benefits expected from the business process re-engineering project, improve customer service and consolidate the fragmented database of customer information such that National Savings would be in a better position to market products sooner and more effectively. A key difference was that the private sector also offered the prospect that staff could be re-deployed on third party work. In March 1997, National Savings launched a search for a private sector partner, which resulted in the appointment of SBS to take on and run the operational service.

However, a PFI deal for office accommodation was already in the process of procurement

1.9 In 1996, before the appointment of a new Chief Executive, National Savings had identified excess accommodation at the three sites and that this excess would increase on completion of the business process re-engineering project. Following a competition, discussions were held with three property companies for a PFI solution where the private sector would provide serviced accommodation for National Savings' requirements and would be free to redevelop the sites. These discussions were underway at the time a separate competition for the operational service was launched.

National Savings pragmatically combined the two deals

1.10 In running separate operational service and accommodation projects, National Savings faced the complexity of managing two interrelated deals where the eventual partner running the operational services would dictate the nature and scale of accommodation needed. National Savings recognised this and discussed the inclusion of accommodation in the operational services project. However, bidders either rejected or showed little enthusiasm for the inclusion of accommodation at the Information Memorandum stage of the project. National Savings considered that to insist on its inclusion would have risked bidders withdrawing from the competition, especially as only one of the four bidders had a property arm. On the other hand, bidders for a separate accommodation deal may have provided an acceptable solution as they were specialist property companies, so National Savings allowed both projects to progress in parallel.

1.11 In the event, National Savings received only one bid for the accommodation deal. At a price of £136 million, this was inferior to the expected costs of £63 million involved in managing the three sites under existing arrangements. Accommodation proposals were therefore requested as part of the Invitation to Negotiate which was the next stage of the operational services project. National Savings judged that it was likely that SBS and EDS, the two final bidders at that stage, would see accommodation as a relatively small part of a much larger operational services deal and would therefore be prepared to include it in their proposals. To provide bidders with a degree of flexibility, National Savings gave SBS and EDS the choice of either purchasing or leasing some or all of the sites for the duration of the contract. Both bidders proposed to purchase or lease the sites. To ameliorate the impact on local communities in Blackpool, Durham and Glasgow, SBS offered to keep a presence at each of the three locations for at least five years. National Savings has also retained a right of veto over the relocation of all or any part of the operational service outside the UK. In the event, SBS has leased the properties for the duration of the contract.

Performance to date using the current systems has been encouraging

1.12 We compared National Savings' performance in the period before the contract took effect with the first six months under the new arrangements. Although there have been some positive results, it is impossible for us to reach a conclusion on the eventual success of this project at such an early stage in the life of a contract which could last for 15 years.

New savings products and product variations have been successfully introduced

1.13 SBS has demonstrated partnership working by introducing a new savings product (an Individual Savings Account) by a tight target date of 6 April 1999. SBS started work on the new product after being selected as preferred bidder in December 1998. This involved the implementation of a new IT system and was achieved on time. SBS has also demonstrated that it can bring other new products and product variations to the market quickly. At National Savings' request, two more new products were introduced, along with five product variations, between April and October 1999. In comparison, National Savings had introduced only three new products in the previous eight years.

SBS has improved efficiency

1.14 Under the terms of the partnership, SBS is free to innovate in ways which will improve efficiency and effectiveness. Through more efficient working practices, SBS has, at 1 March 2000, reduced the number of staff required to run the operational service by some 600. In addition, SBS has put in place a voluntary early retirement scheme.

SBS has met and exceeded key performance indicators with one major exception

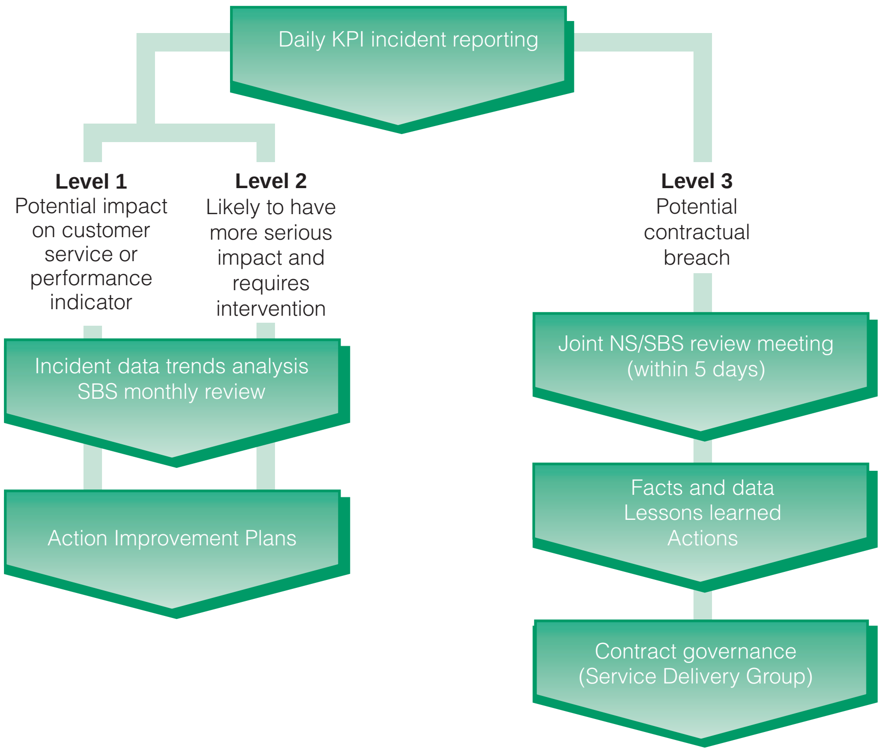
1.15 We compared SBS's performance in the first six months of the contract with the six months immediately prior to the start of the contract. The contract has provided effective incentives for SBS, performance has improved and measurement has become more open and rigorous. During the first six months of the contract, if National Savings had performed against the key performance indicators as it had done in the six months prior to the commencement of the contract, it would have faced performance deductions of up to £3.8 million. National Savings considers it now has greater control over the business through a clearer definition of outputs and that SBS's performance is better because of the disciplines on it to deliver against key performance indicators embedded in the contract.

1.16 SBS has failed one important key performance indicator during the first six months of the contract. On this occasion, receipts of £600,000 out of a total of £15.8 million were not transferred to the Bank of England on the day they were received. As the money was not available to the Exchequer for one day, interest foregone amounted to £108. National Savings and SBS reviewed this failure through their agreed performance improvement process, illustrated at Figure 2.

Performance review process

Figure 2

This figure shows the processes and actions National Savings and SBS take to review performance and apply lessons learned



Source: National Savings

1.17 National Savings has the power to decide the level of performance deduction to apply (Figure 3), which in this instance ranged from £0 to £426,000. The review concluded that the performance deduction should be £43,000. National Savings reached this figure taking into account that:

a) It was an opportunity to emphasise that achieving continual improvement is of more value than extracting financial penalties for failure.

b) The consequential loss involved and the potential damage to National Savings' reputation and brand were small.

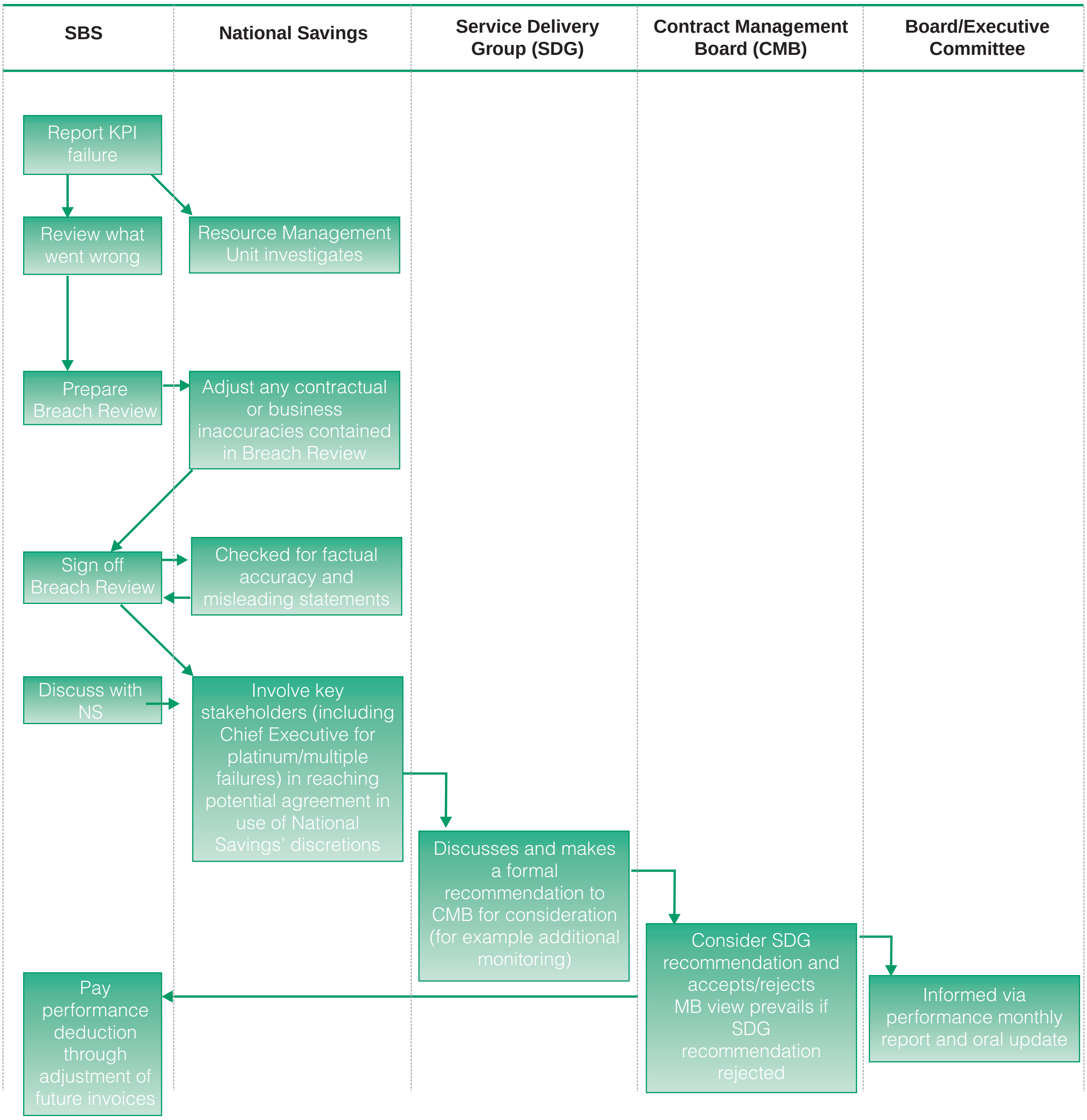
c) The primary cause of the failure was a third party failing to inform SBS of system changes.

d) It was early in the life of the contract when SBS had not had sufficient time to build successful relationships with its new suppliers.

Figure 3

Performance deduction process

This figure shows that National Savings and SBS have agreed a process for determining performance deductions



Source: National Savings

e) Achieving a balance between the minimum and maximum deduction would encourage openness and continual improvement. On the other hand, it would also reinforce the need for SBS to achieve consistently excellent performance.

SBS has now implemented improved operational processes and more effective controls at all three sites for the transfer of funds to the Bank of England.

1.18 Although SBS has recorded other breaches of key performance indicators, National Savings has chosen to regard them as "technical incidents" which do not merit performance deductions, as losses have been negligible. For instance, there have been five breaches of a banking indicator due to a small number of low value cheques not being banked on the day of receipt. National Savings considers that such "technical incidents" have always occurred from time to time and will continue to occur. In National Savings' view, it is preferable for them to be reported and subjected to lessons to be learned reviews rather than hidden, which could be a consequence of imposing performance deductions in every instance.

Millennium compliance was achieved

1.19 National Savings was aware of the potential problem that the new millennium could bring and a project was initiated in 1996 to assess the impact on all systems and services and correct the computer systems. The project was over 95 per cent complete by January 1999, shortly before SBS took on the operational service. SBS accepted the risk and responsibility of ensuring that National Savings' computer systems would be millennium compliant. At the turn of the year, SBS experienced two minor system faults caused by the change of date which have since been rectified.

Arrangements have been introduced to cover accurate financial reporting

1.20 In 1997, the Committee of Public Accounts took evidence from National Savings on weaknesses in financial accounting systems for Ordinary and Investment deposits. The Committee concluded that National Savings had failed to apply basic accounting controls and there was a risk that fraud had been a factor in the discrepancies identified. In February 1999, the Committee took further evidence on progress made in resolving the weaknesses and the implications of the planned contracting out of the operational service. The Committee concluded that National Savings had made significant progress but must continue to enhance the financial and business skills of staff at the core of its organisation and meet a revised target for the production of audited accounts across all of its activities from 1998-99 onwards.

1.21 SBS now has a qualified financial controller in place at each site, one of whom is responsible for ensuring proper controls are exercised over transaction accounting across all three sites. In addition, National Savings has strengthened its own Finance Directorate with three qualified accountants now responsible for quality assuring SBS transaction accounting processes. This team can also call upon additional resources under an internal audit contract with Deloitte & Touche.

1.22 Audited product accounts have been produced for 1998-99 for the first time ever. National Savings' management are accountable for the accuracy and timeliness of the accounts. Draft accounts are prepared by SBS from data held on their systems to a specification set by National Savings. The specification requires compliance with National Savings transaction accounting requirements and generally accepted accounting procedures, as applicable in the public sector. National Savings exercise quality control over the preparation of the drafts and produce the final accounts for audit.

It is a high risk project but both partners consider they are taking a low risk approach

1.23 Although performance to date using existing systems has been encouraging, National Savings and SBS will only gain significant benefits if new operational processes and IT supporting systems are introduced alongside changes in staff culture.

This is a high risk project

1.24 With 30 million customers, a major failure of the operational service would be a matter of grave public concern. To improve the operational service and achieve its expected returns on the project, SBS will have to implement a major transformation of the operational service combined with a quantum leap in information technology.

The project differs from previous deals

1.25 In examining how SBS propose to transform the operational service and National Savings' role, we took into account the key lessons the Committee of Public Accounts identified in its 23rd Report[1] of Session 1998-99 and 1st Report[2] of

1 Getting Better Value for Money from the Private Finance Initiative (HC 583)

2 Improving the Delivery of Government IT Projects (HC 65)

Session 1999-2000. The Committee's key lessons are summarised at Appendix 3. We consider that SBS and National Savings have incorporated those lessons in this deal.

1.26 This project differs from SBS's contracts with the Passport Agency and the Home Office Immigration and Nationality Directorate. In those deals, SBS is responsible for the development of IT systems to be used by staff who remain employees of the Home Office. In this partnership, SBS is responsible both for the development and implementation of new IT systems and their use by staff who have transferred. SBS therefore has more control over this project than on previous occasions, including the cultural change required from its new workforce to provide the quality of service required by National Savings and its customers. If SBS is unsuccessful, it will bear the financial consequences of failure.

SBS is not taking a "big-bang" approach

1.27 SBS plan to put new IT systems in place gradually, as shown at Box 1, rather than attempting to transfer all savings products to one new system in one go. Each stage, comprising proven IT packages seen to work elsewhere and some bespoke software where necessary, is to be rolled out well in advance of contracted targets, and experienced operational staff will test usability and identify potential improvements. Alongside new IT, SBS is conscious of the human resource consequences of what is proposed, especially the need for cultural change and adequate training of staff. Staff training will be incremental, involving small groups at the start, who will champion the changes and train their colleagues.

1.28 As transformation of operational processes is central to the success of the project, National Savings is monitoring progress through an agreed governance structure, joint plans and formal business reporting, in addition to working level contacts. Alongside this, National Savings has employed independent IT consultants to help it act as an intelligent customer when assessing SBS's proposals and progress. The consultants have indicated that that they are impressed by SBS's technical solutions but that it is still early days and there will need to be ongoing monitoring of SBS's plans and controls. SBS is using IT experts from other parts of the SBS organisation including the parent company, Siemens AG. Both partners will share the conclusions of their respective experts. National Savings has defined the outputs required from the operational service and will not become involved in the design or development of new IT systems or specify the project management methodology, thereby avoiding the transfer of risk back to itself. National Savings will, however, monitor progress in a critical and positive way.

Box 1

SBS's gradual approach to the development and implementation of IT and human resource solutions

Jan - Mar 2000	Apr - Jun 2000	July - Sept 2000	Oct - Dec 2000

New organisation grows - transfers by product

Release 1: Pilot
- Installs core infrastructure.
- Sufficient functionality to allow migration of products to new systems.
- (Image, Call Centre).
- Minimum new organisational structure.
- Review post-live with users and 'tune'.

Old organisation
- 8-10 products running on old system.
- Support services unchanged.

Release 2: New & migrated functionality
- Delivers second phase of infrastructure (wide area network, desktop and other hardware infrastructure) and starts product migration.
- Staff moved to new organisation.
- New products/variations delivered direct into new organisation.

Old organisation
- Branches closed down.
- Case management work transferred progressively to new organisation.

Release 3: New & migrated functionality
- Migrates more products, with accompanying branch moves.
- Builds second Call Centre, Imaging Centre, etc.
- Adds further new products and/or variations.
- Majority of contractual and internal requirements complete.

Old organisation
- Most functions transferred.

Release 4: Contingency
- Migrates last 'active' products.
- Remaining capacity held in reserve for functionality that fails to meet previous release dates.

Old organisation
- Remnant of old organisation handles inactive products.

'Current' organisation reduces - transfers by product

❇ Migration of products to new systems in four tranches.

Source: SBS

1.29 SBS's approach to dealing with the processing of applications for Premium Bonds is an example of how it is using the expertise of other subsidiaries of its parent company and new technology. Premium Bond sales have continually risen in recent times with National Savings receiving a record 300,000 applications in July 1999. To process the applications, staff at the Blackpool site have had to sort and check each one before manually keying the information into a mainframe computer. This resulted in inevitable data entry errors, onerous checking procedures to ensure accuracy and difficulties in achieving same-day banking of applicants' cheques. The growing popularity of Premium Bonds indicated to SBS that it needed a radical technical innovation if performance standards were to be met, including the need to bank all cheques by 1pm on the day they are received.

1.30 To speed up the process and improve accuracy, a system that could scan incoming documents, avoiding information being manually keyed, would have to be designed. Following a feasibility study by a subsidiary of Siemens AG specialising in high volume transaction processing systems, a new character-recognition system was installed in November 1999 to read and store automatically information from applications and then transfer that information to a customer database.

Running costs will be lower

1.31 The purpose of a Public Sector Comparator is to inform a department's decision on whether a proposed PFI deal offers value for money. As part of its value for money appraisal of the project, National Savings prepared a comparator which estimated the cost of continuing to manage the operational service in-house. The estimated net present cost was £793 million over 15 years, while the estimated net present cost of the proposed deal with SBS was £635 million. The Public Sector Comparator used by National Savings was a sound basis on which to make a value for money decision (see Appendix 4). The principal reasons for this significant difference are that SBS can invest in transforming the operational service more quickly than National Savings and can create new jobs through the development of significant levels of work for third parties.

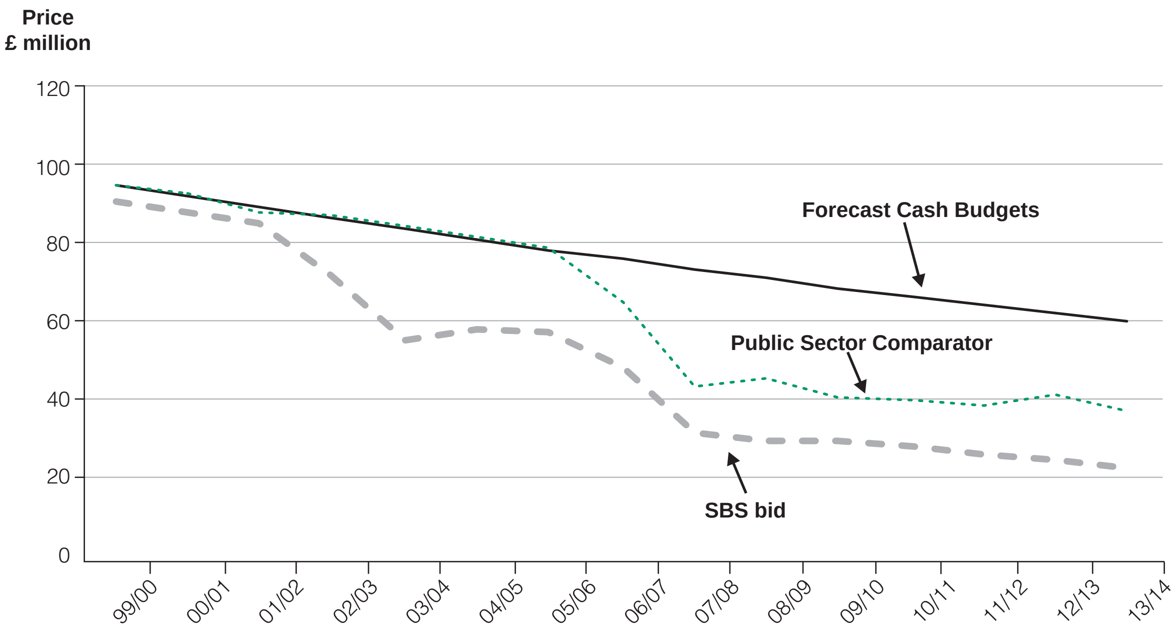
1.32 SBS expects to employ fewer staff on the operational service than National Savings would have done if it had remained in-house. There were both technical and generic reasons for this difference. SBS assumed a greater use of imaging and automated decision-making than the in-house solution had assumed. SBS also planned for additional savings from an extension of its business transformation project to other parts of the business, rather than just transaction processing, and envisaged a greater degree of flexibility in the use of staff.

1.33 SBS also expects to re-deploy staff more quickly than National Savings. National Savings' ability to release staff was constrained by annual cash budgets, which would decline in real terms at an annual rate of 2.5 per cent. This acted as an expenditure ceiling for National Savings and a charging limit for bidders. National Savings therefore required SBS and EDS to keep their proposed charges at a level which permitted National Savings to remain within its expected budgets. SBS's bid and the Public Sector Comparator price are compared with the cash budgets at Figure 4.

Figure 4

Comparison of National Savings' forecast cash budgets, the Public Sector Comparator and SBS's bid

This figure shows that SBS's bid was superior to the Public Sector Comparator, and that both were within National Savings' forecast cash budget



Source: National Audit Office

1.34 As SBS and EDS were not subject to such a budgetary constraint they planned to incur financial losses in the first years of the contract and realise efficiency gains more quickly than National Savings could. Because it lacked sufficient cash to fund necessary severance payments, National Savings could not immediately release surplus staff through redundancy or early retirement. As a significant number of surplus staff would remain on the payroll in the early years of the project, the productivity benefits of business process re-engineering would not feed through to running costs savings immediately.

1.35 SBS will make a profit from the partnership if the business transformation allows staff to be re-deployed and alternative employment for staff is secured. SBS's bid was priced on the basis that at least 1,200 jobs would be created for former National Savings staff on third party work. By January 2000 SBS had agreed contracts with third parties which should secure some 500 jobs.

Part 2: The contract underpinning the partnership appears to be robust

Before proceeding with a PFI deal, departments must ensure that the contract underpinning any partnership contains adequate incentives, remedies and safeguards to give a high level of confidence that the service required will be delivered throughout the contract period. This part of the report shows that this contract aligns the interests of both parties, allocates risks appropriately and that there is machinery to manage the contract.

The contract aligns the interests of both parties

2.1 National Savings wants SBS not only to succeed in delivering a more efficient and effective operational service through transforming the business, but also to develop third party business. In developing third party business, SBS will maximise the use of staff, IT systems and office space. If this is successful, National Savings and SBS will share the benefits from such work directly or through an overall profit sharing arrangement.

Both parties are incentivised to act in their joint best interests

2.2 National Savings and SBS are incentivised to act in their joint best interests through the sharing of specific profits and cost savings:

a) **SBS is incentivised to win third party work.**

SBS saw the acquisition of the operational service as a strategic asset which, with skilled and experienced staff already in place, provided an opportunity to develop services for other customers. Its bid was therefore priced to reflect the creation of at least 1,200 jobs for former National Savings' staff on such third party work. The unitary charge negotiated with SBS reflected this and was some £37 million less than it would otherwise have been. If SBS is not successful in creating these new jobs, any potential redundancy costs will be for its account.

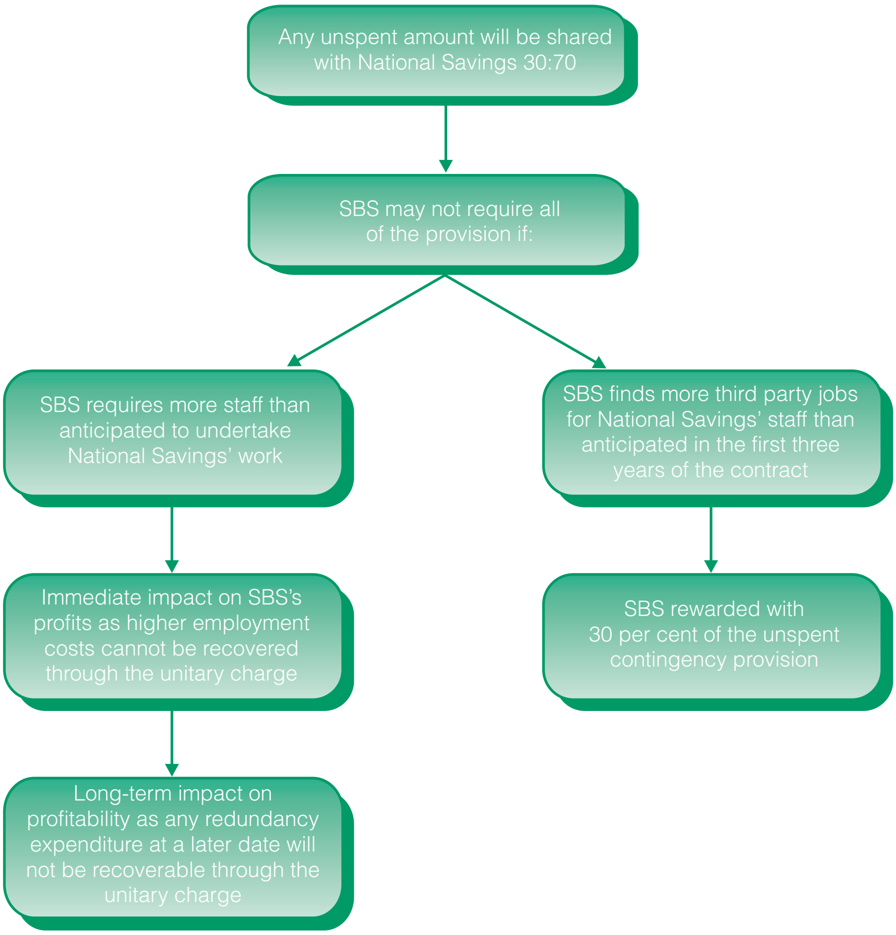
b) National Savings will share in SBS's success in winning third party work.

Although SBS plans to use at least 1,200 staff on third party work, the contract price included a time-limited contingency of £45 million in the event that SBS was not as successful as expected in winning third party work Any part of this contingency provision which is unused will be shared in a ratio of 70:30 between National Savings and SBS. The reasons why an amount may remain unused and the impact on SBS are explained at Figure 5. This arrangement acts as an incentive for SBS to complete its business transformation programme by a target date of 31 December 2000 and to re-deploy staff who would otherwise be required for National Savings work. To allow SBS time to develop third party

Sharing of contingency provision

Figure 5

This figure shows the likely reasons why SBS may not require all of the contingency provision in the unitary charge and the potential impact and rewards



Source: National Audit Office

work and in recognition that many staff cannot be released until the appropriate stage of the transformation programme is complete, National Savings agreed to defer taking a share of any unused contingency provision until the end of the first three years of the contract.

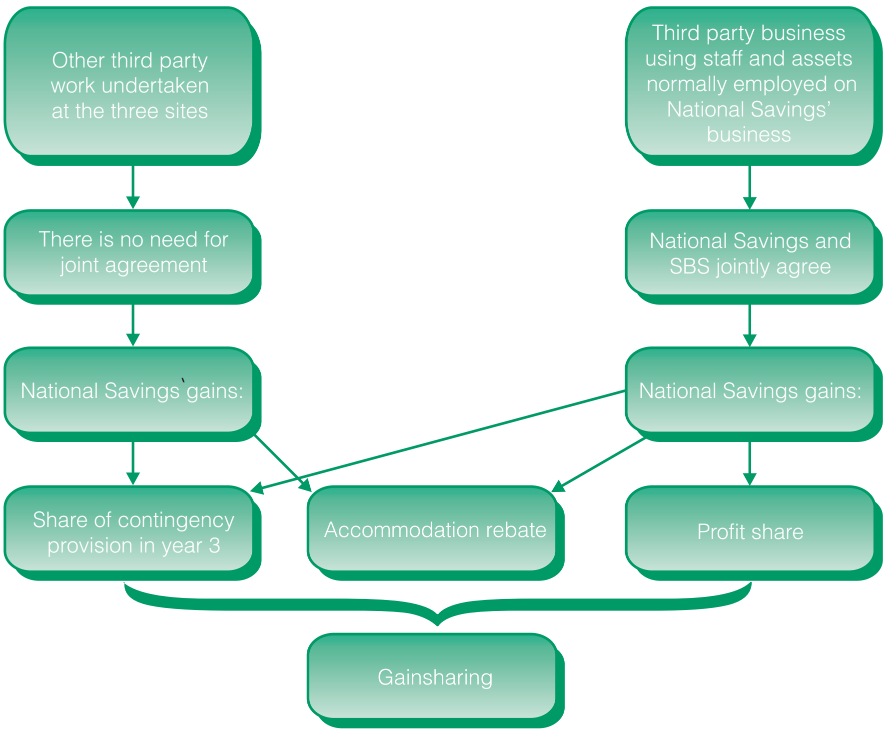
c) National Savings will share in SBS profits from some third party business.

Where SBS uses staff and other assets which remain employed on National Savings business for third party work, National Savings will share in profits and receive rebates on accommodation and redundancy costs included in the unitary charge. National Savings will not be liable for any losses. SBS profits on other third party work undertaken at any of the three sites will not be shared, although National Savings will be entitled to rebates of accommodation costs and the contingency provision (Figure 6).

How National Savings may gain from the development of third party business

Figure 6

This figure shows that there are mechanisms which allow National Savings to gain from SBS development of third party business



Source: National Audit Office

d) National Savings will share savings on the costs of introducing new products.

Within the contract price SBS is required to facilitate the introduction of four new products in each of the first two years and two new products in each subsequent year. SBS and National Savings have agreed a maximum price for new products. If costs are higher, SBS will carry the risk. However, both partners are incentivised to drive costs down to the lowest commercial level: SBS through the direct impact on its profit margin and National Savings via direct gain sharing if costs are below the maximum agreed price.

e) But SBS is not guaranteed additional work from the introduction of fundamentally different products or new sales channels.

In the future, National Savings might enter new areas of business through the introduction of fundamentally different products (such as a pension product) or develop fundamentally different sales channels (such as digital television). Under the terms of the contract, SBS is required to assist National Savings in the design and development of fundamentally different products and new sales channels. However, to preserve the ability to use competition to get good value, the contract allows National Savings to go out to tender for the operations needed to deliver and maintain such products and channels.

f) National Savings will share with SBS any net profits from rental income.

Under the contract, the running costs of the sites chargeable to National Savings will fall in line with the expected reductions in office space needed by SBS. This is another incentive for SBS to reduce the number of staff required to run the operational service, as it will not be able to recover accommodation running costs in excess of the levels detailed in the contract. In addition to third party work, SBS is allowed to recover running costs by sub-letting space to other employers, including other Siemens AG entities. In such circumstances, National Savings will receive 50 per cent of both the net profit from rental income and the amount by which the running costs of space occupied by the operational service fall below stated levels in the contract.

National Savings will also share in any gains made by SBS above those stated in the contract

2.3 In addition to detailed sharing mechanisms covering specific aspects of the partnership, National Savings is entitled to receive 50 per cent of the amount by which SBS's overall net profit margin exceeds an agreed percentage in the contract but will not share in any losses. SBS expects a profit margin equivalent to 8.7 per cent a year over the life of the contract (based on 15 years). The calculation of any excess profit will be on an annual basis, after deduction of any amounts receivable by National Savings under other sharing arrangements.

The contract allocates risks appropriately

2.4 The allocation of risks to the parties best able to manage them is a key requirement in achieving value for money in PFI projects. Without risk transfer, the private sector partner will receive a secure income but may set their charges to earn a far higher return than would be appropriate. However, if the public sector partner seeks to transfer risks which the private sector cannot manage, then value for money will be impaired as the private sector will look to charge a premium price for accepting such risks. In this partnership, the practical implications of the risks involved were analysed thoroughly before the risks were allocated to the parties best able to manage them.

SBS accepted appropriate but extensive risks

2.5 Although SBS has accepted significant risks (Box 2), it considers that the transfer of the entire operational service under a long-term contract has given it the power and the necessary incentives to manage those risks.

Box 2

Allocation of major risks under the contract

Risk	National Savings	SBS
Operational risks: Failure to meet key performance standards.	National Savings has discretion to waive performance deductions.	SBS faces substantial performance deductions for failing to meet KPIs.
Post Office Counters Automation		SBS will bear the risk of POCA not being achieved by its expected target date.
Failure to implement business transformation by the dates specified.		SBS will have to employ more staff than expected and cannot recover those costs in the contract price. It will also have to pay National Savings 70 per cent of the contingency provision it has not used.
Failure to further improve KPIs if business transformation programme not in place by December 2000.		SBS still has to meet the improved KPIs even if it has not completed the programme by the required target date.
Year 2000 compliance		SBS has indemnified National Savings for all loss or damage resulting from breach of this obligation. Contract can be terminated and SBS will pay the cost of a third party to undertake the work. SBS will be penalised through failure to meet KPIs, but can gain relief from such penalties if third party computer systems non-compliance leads to poor performance.
Euro compliance	National Savings gave only very broad indications of what it wanted for Euro compliance. SBS may charge up to £9 million for meeting this requirement once National Savings has decided what it wants in more specific terms.	SBS is responsible for development of a suitable Euro Compliance Plan. If SBS misses a Key Date in the plan, it must take steps at its own cost to fulfil that Key Date. If it fails to do so, National Savings can arrange for a third party to carry out the work and SBS shall reimburse costs incurred.
Fraud	National Savings will bear the first £250,000 cost of fraud in any one year.	SBS will bear higher losses resulting from fraud and will indemnify National Savings in respect of any claim and loss of any person arising out of operational error.
Commercial risks:		
Product variations		SBS implements at own cost except where an adjudicator judges the change is necessary because of negligence by National Savings.
New National Savings products and channels		SBS will not be able to charge National Savings more than it bid and National Savings can share in lower costs below a given threshold.
Transaction volumes		The unitary payment is adjusted if transaction volumes fall outside a nil adjustment band. SBS bears the risk that the cost of additional transactions exceeds the price for those transactions.
Change of law risk:		SBS will bear all this risk unless the change of law is only directed at National Savings.

The contract gives SBS incentives to minimise operational errors and fraud

2.6 SBS is responsible for operational errors. For instance, if an overpayment is made to a customer, SBS has to make good National Savings' funds and take action to recover the overpayment from the customer. In the case of underpayments, National Savings bears no cost risk for any SBS errors. SBS may, if it makes too many underpayments, incur deductions from the unitary charge under key performance indicators for quality of service. SBS is also responsible for compensation to customers, for example, where sums due have been paid late. This, together with discretionary performance deductions for failing to meet key performance indicators, acts as a powerful incentive for SBS to limit the number of operational errors.

2.7 SBS accepted that it should bear the cost of all fraud by its staff and any customer fraud in excess of £250,000 in any one year. Over the last eight years National Savings has experienced customer fraud totalling an average of £287,000 a year, within a range of £204,000 to £405,000. Fraud levels were, however, significantly higher in the 1980s, reaching levels in excess of £4 million a year. In sharing this risk with SBS, National Savings aimed to protect itself from a very high level of fraud in any one year while incentivising SBS to identify how frauds are perpetrated and develop innovative ways to prevent them. SBS and National Savings have set up a joint working group to take this forward.

There is machinery to manage the contract

2.8 If the partnership is to continue to deliver the services required, then the arrangements for monitoring the long-term contract and agreeing changes to it will be crucial. National Savings has put in place a number of mechanisms to achieve this.

A contract governance structure has been established

2.9 National Savings and SBS have established a joint governance structure for the contract. The structure comprises three partnership boards, as shown at Figure 7. To monitor performance against the contract on a day to day basis, National Savings has also established a relationship management unit, which includes professionally qualified senior staff who negotiated the contract with SBS and carefully selected people with extensive knowledge of the operational service. The unit has developed a manual of new business management processes and has introduced new business reports to help ensure that the partnership is managed effectively.

Figure 7

Governance of the contract

This figure shows that a formal governance structure has been defined for the contract

National Savings	Board	SBS
Economic Secretary to the Treasury	**Annual Meeting**	Siemens AG Chief Executive Officer

↑

National Savings	Board	SBS
National Savings Chief Executive, National Savings Board Treasury	**Partnership Development Board** Meets six monthly	SBSUK, SBS Siemens plc, Siemens AG

Terms of reference
General topics, future improvements

↑

National Savings	Board	SBS
National Savings Chief Executive, Executive Committee	**Partnership Management Board** Meets quarterly	SBS senior management

Terms of reference
Future strategy of the partnership, National Savings' plans and their potential impact, people and processes, performance against objectives, developments within National Savings, SBS's proposed major delivery charges, developments within SBS which will affect National Savings, gainsharing and benchmarking, communications, internal and external and dispute resolution.

↑

National Savings	Board	SBS
Sourcing director, commercial director, head of relationship management	**Contract Management Board** Meets at least 6 times a year	Business development manager

Terms of reference
SBS's performance in delivering the contract, agreeing and managing major variations to the contract within prescribed financial limits, changing service standards and key performance indicators, monitoring of SBS's performance on third party business and resolution of disputes outstanding from lower levels of the structure.

↑

National Savings	Group	SBS
Head of relationship management unit	**Service Delivery Group** Meets at least monthly	Business development manager

Terms of reference
SBS's performance against key performance indicators and application of performance deductions, agreeing and managing variations to the contract within prescribed limits, reporting bi-monthly to the Contract Management Board on SBS's performance, resolution of issues with other service providers, management of the relationship and dispute resolution.

↑

National Savings	Group	SBS
Commercial director	**Commercial Development Group** Meets at least monthly	Business development manager

Terms of reference
Provision of a forward-looking view to SBS, outline of charges in the remit and government policy that have occurred and their implication for Siemens, presentation of changes to the marketing programme and the potential impact that they have on SBS, feasibility of new proposals and agreement on the priority of the development work being performed for National Savings, commissioning feasibility studies, customer service standards for the contract, commissioning of minor variations to the contract, maintenance of brand values.

Key: National Savings (dark green) | SBS (light green)

Source: National Savings

National Savings is monitoring SBS performance and has increased resources to do so more thoroughly

2.10 National Savings expects SBS to run the operational service on the basis of 100 per cent performance. In addition, National Savings has specified 42 key performance indicators spread across eight areas of the operational service to measure accuracy, timeliness and quality of service. To monitor SBS's reporting of performance satisfactorily, National Savings has increased the resources it devotes to these tasks and plans a further small increase. The majority of the indicators have been designed to measure customer service and satisfaction. Details of the indicators are shown in Box 3. Accuracy indicators are expressed as, for example, 97% of payments must be 100% accurate and timeliness indicators as 97% of documentation must be despatched within a specified number of working days. Timeliness indicators will become tougher on the target date for the completion of business transformation whether or not SBS has been successful in implementing it. In addition, customer satisfaction indicators will increase by 0.5 per cent a year. National Savings expects key performance indicators to evolve over time. For instance, National Savings and SBS have agreed in principle the introduction of a new key performance indicator for the preparation of product accounts each year.

Poor performance can lead to termination of the contract

2.11 The contract between National Savings and SBS includes a comprehensive list of events which can lead to default. These include such events as the insolvency of SBS's parent company, a change of control of SBS or its parent company and any fundamental breaches of obligations. Fundamental breaches include abandonment of the contract by SBS or a failure to take action which results in the standing or reputation of National Savings or the Government being adversely affected to a significant extent. In particular, poor performance on the part of SBS gives National Savings the option to terminate the contract when performance deductions of 40 per cent or more of the unitary charge are made in a month or any platinum graded key performance indicator is failed two or more times in any six month period. National Savings can also terminate the contract for any reason after two years from the start of the partnership but would have to give 12 months notice and pay compensation if SBS was not at fault. SBS has agreed to a limit of £250 million on aggregate liability for all defaults during the contract period. On the other hand, SBS may terminate the contract if National Savings fails to pay any sums properly due or is unable to perform its obligations.

Box 3

Key performance indicators

Area of Coverage	Broad Description	Number of KPIs and Grading			Date of Introduction	Measurement	Frequency of Reporting
		Platinum	*Gold*	*Silver*			
Treasury Management	Banking of receipts and transfer from local banks to Bank of England. Transfer to and from National Loans Fund and National Debt Office	2	3	-	4 at 1/4/99 1 to be decided	Timeliness and accuracy of money movement	Daily
Product Delivery – Sales	Despatch of customer documentation sales queries and updating of records	-	-	5	4 at 1/4/99 1 at 1/10/99	Timeliness of despatch and response to queries and accuracy in compliance with customer's instructions	Daily or weekly monitoring with results reported monthly
Product Delivery – After Sales	Replies to queries, despatch of statements of interest	-	-	7	4 at 1/4/99 2 at 1/7/99 1 at 1/10/99	Timeliness of despatch Accuracy of replies to customers	Daily monitoring with results reported monthly. Quarterly for ISAs Annual
Product Delivery – Payments	Despatch of payments and customer documents, queries	-	2	2	3 at 1/4/99 1 at 1/10/99	Timeliness of despatch and accuracy in compliance with customer's instructions	Daily monitoring with results reported monthly
Product Delivery – Premium Bond Prizes	Informing major winners, despatch of high value claim forms and of prize warrants, and automatic reinvestment of prizes	-	1	4	5 at 1/4/99	Timeliness of despatch and accuracy	Monthly
Product Delivery – Customer Service	Customer enquiry calls	-	-	7	3 at 1/4/99 2 at 1/7/99 1 at 1/10/99 1 to be decided	Speed of answering and duration of calls Accuracy of fulfilment	Daily monitoring with results reported monthly
Customer Service – Research	Customer satisfaction with the service provided and customer complaints	-	5	-	5 at 1/10/99	Percentage of satisfaction	Continuous sampling with quarterly reporting of results. Daily monitoring with results reported monthly
Management Information	Delivery of standard and ad hoc management information reports specified by National Savings	-	-	4	4 at 1/10/99	Timeliness and accuracy	Daily, weekly and monthly
		2	11	29	23 at 1/4/99 4 at 1/7/99 13 at 1/10/99 2 to be decided		

Note: National Savings did not introduce all of the key performance indicators at the commencement of the contract. Those not introduced immediately are in areas where National Savings had not previously measured performance or are for new processes introduced under the contract, for example the provision of management information by the private sector partner to National Savings. SBS wanted to gain experience of these measures before they became subject to performance deductions.

2.12 In the event of a fundamental breach of contract, National Savings will receive compensation for any losses after deduction of the “value inherent” in the assets of the partnership at termination. Under force majeure, SBS would be entitled to compensation equal to its net investment from the start of the contract to the termination date. However, as the nature of service delivery was likely to alter out of all recognition over the life of the contract, National Savings and SBS could not agree a definition of “value inherent”.

2.13 Where assets are to be returned or transferred to another private sector partner in such circumstances, it is essential for departments to have unfettered access to the private sector partner’s accounts for the business. SBS is required to provide monthly auditable financial statements for the operational service and will show on an open book basis all cost components, cost levels and profit margins in relation to National Savings and third party work. Along with assisting the monitoring of profit sharing and benchmarking arrangements, National Savings consider that this arrangement will help any future negotiations on “value inherent” and, if agreement cannot be reached, both parties have access to agreed dispute resolution procedures.

National Savings has also sought to ensure that quality and continuity of service will be maintained

2.14 Specific requirements were placed on SBS to maintain quality and ensure continuity of service. SBS is obliged to manage the business in accordance with internationally recognised quality management and quality assurance standards. By the end of 2000, SBS also has to achieve registrations in accordance with ISO 9000 and install a fully functioning quality management system before the end of 2001. To ensure continuity of service, SBS has to develop a business continuity plan in consultation with National Savings, update the plan annually and periodically test it.

Appropriate dispute resolution procedures are in place

2.15 National Savings and SBS have agreed a liaison procedure between selected representatives within their respective organisations to discuss any disagreements. If the liaison procedures do not work, National Savings and SBS aim to resolve disputes through further discussion at the partnership boards. If a dispute cannot be resolved through this joint governance structure, a senior partner of an independent firm of chartered accountants will act as an arbiter.

Handback arrangements are clearly specified and should be capable of being managed successfully

2.16 In a long contract it is essential to include clear arrangements for the return of assets at the end of the contract period or on earlier termination, so that National Savings is free to choose an alternative supplier through a competitive process. SBS has to ensure that assets, supplier contracts and employee terms and conditions are maintained in an agreed condition to allow continuity of service with a new provider. In the pre-handback period, one year before expiry of the contract, SBS cannot alter the terms of employment of staff, dispose of any assets or alter key contracts with suppliers without the agreement of National Savings. SBS will bear the costs of complying with the handback requirements, and must provide information for National Savings to use in re-tendering the services. Following termination, SBS is also required to co-operate fully over a maximum period of six months to achieve a smooth, orderly and efficient transfer.

NS will have to ensure that the development of third party business will allow handback arrangements to run smoothly

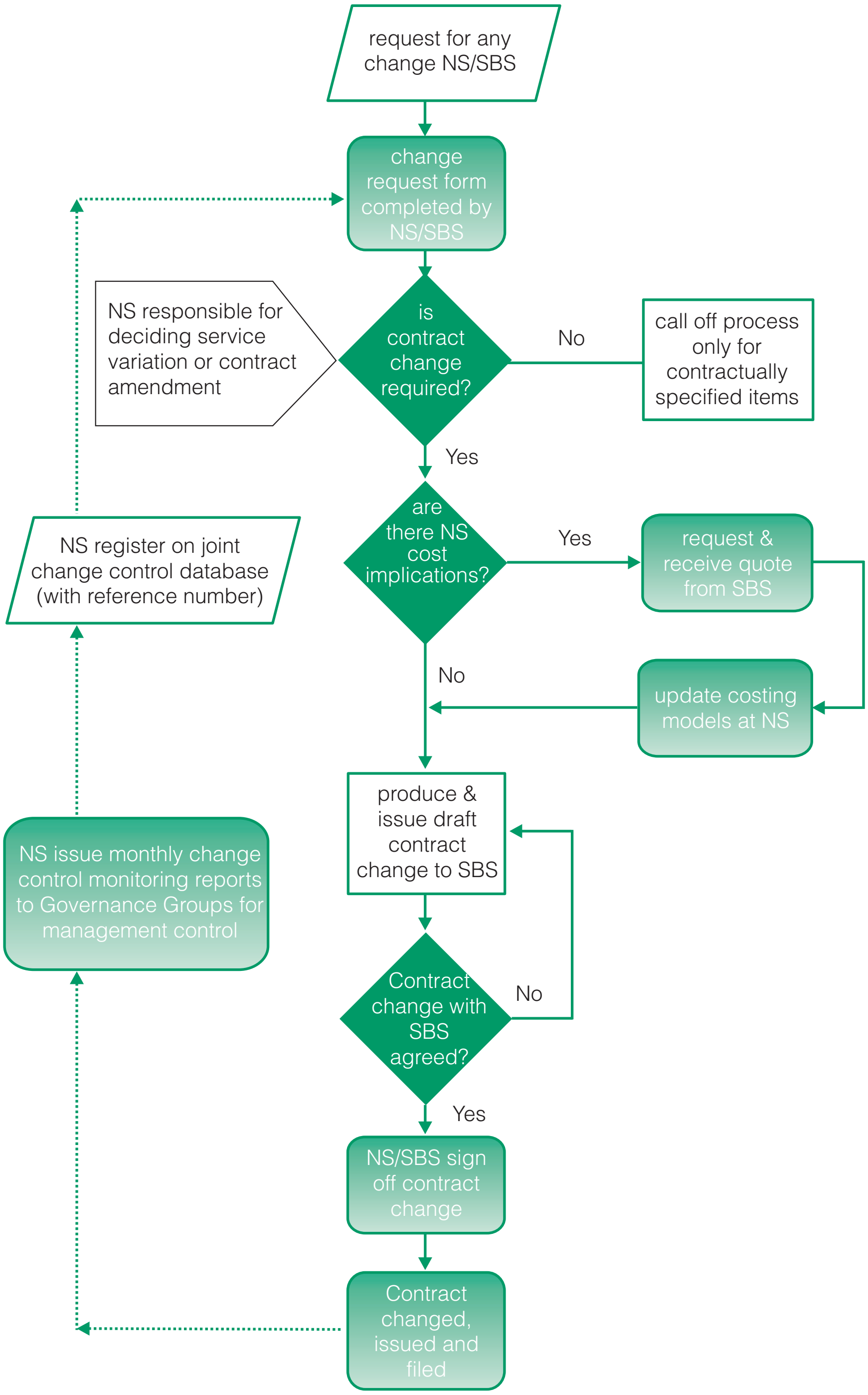
2.17 The handback arrangements envisaged in the contract assume that SBS's physical assets, software, and staff used for National Savings work will be identifiable and transferable back to National Savings when the contract comes to an end. Contractual provision exists for National Savings to retain a register of staff and assets used in the delivery of the operational service. All third party business to date has not required the use of any shared assets and this is likely to remain the case with most or all future third party work. The possibility exists, however, of third party business requiring the use of shared assets. In such circumstances, National Savings and SBS will jointly agree any proposals before they can proceed and it will be important for National Savings to satisfy itself as to the transferability and handback arrangements prior to giving its agreement.

2.18 Contracts for complex partnerships should be dynamic documents capable of being maintained and changed to suit changing circumstances. The maintenance of this contract will be in the interest of both partners. National Savings wish to keep the contract up to date so that there is as much clarity as possible as to what is expected of both partners. It will also help to ensure that disputes with SBS are avoided and enable National Savings to be in a position to re-tender for a new private sector partner at any point during the life of the contract. Detailed procedures are included in the contract and both parties have agreed roles and responsibilities to facilitate the agreement of changes, which can then be incorporated into the contract. These are shown at Figure 8.

Contract maintenance at National Savings

Figure 8

This figure shows that National Savings (NS) and SBS have agreed a process for updating the contract after the agreement of contract changes



Source: National Savings

Note: Solid line indicates the process and the dotted line indicates updating of information

Part 3: The procurement process was handled well

As shown in the previous parts of this report, the National Savings Public Private Partnership with SBS appears likely to deliver value for money. This part of the report examines the procurement process which led to that outcome. It shows that the procurement was properly planned, the requirements of the deal were well specified and that the process was competitive throughout, which gives assurance that the price being paid by National Savings was the best obtainable in the market.

The procurement was properly planned

3.1 If a PFI project is to be implemented successfully, it is essential that the public sector have the right team in place in time to investigate the market and prepare a tendering strategy. Figure 9 shows the progress of the procurement through its main stages.

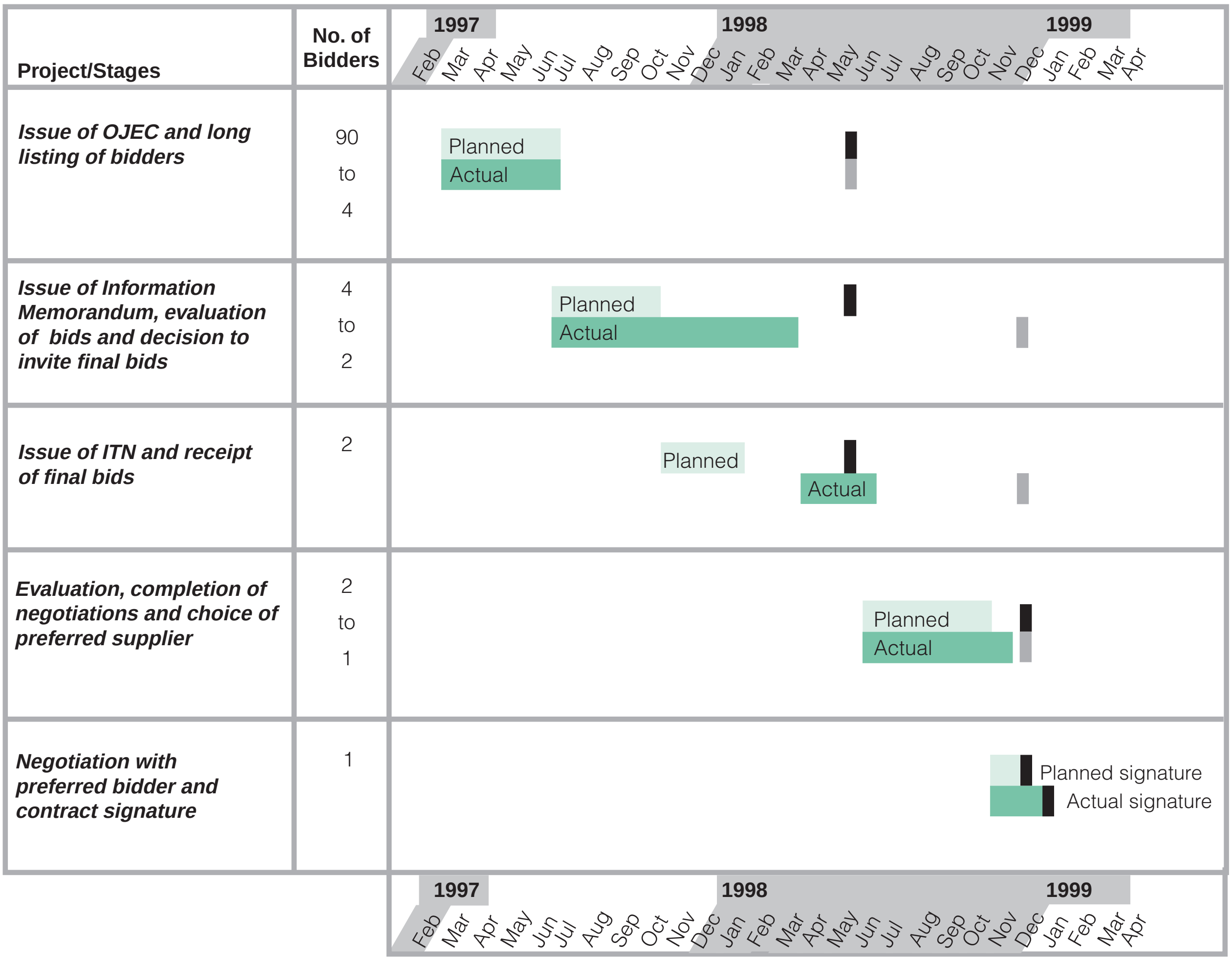
The project was managed from the top down

3.2 Senior National Savings management committed a large amount of time to the project. This is essential, especially where a department is proposing to transfer a substantial part of its operations to the private sector. The organisational structure for the project is shown at Figure 10

3.3 National Savings benefited from the input of the Treasury. Both the Debt and Reserves Management Division, the sponsoring division for National Savings, and the PFI Task Force regarded this deal as a significant project which they wished to see run smoothly. Along with staff from National Savings, Treasury officials were members of the Sourcing Strategy team from November 1997, prior to bidders' responses to the Information Memorandum.

Figure 9

Comparison of project timetable with outturn



Key

Planned duration at the start of each stage

Actual duration

Planned contract signature date at start of this stage

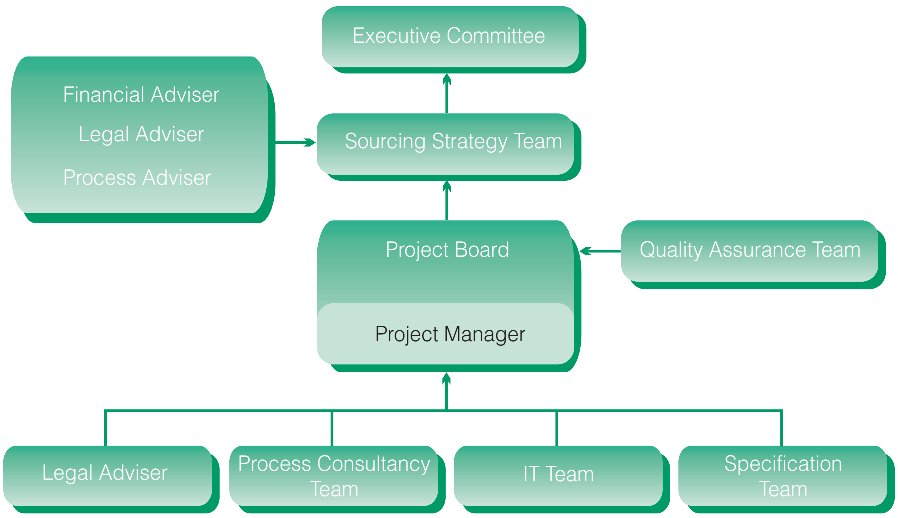
Planned contract signature date at end of this stage

Source: National Audit Office

Project organisation

Figure 10

This figure shows that National Savings adopted a formal project management organisation



Source: National Savings

Advisers were appointed in good time and costs were controlled

3.4 National Savings appointed advisers in good time following competitions in which success depended on the quality of advice on offer, having regard to price. Budgets were prepared to monitor advisers' fees against actual costs (Figure 11). The overall budget for both the original accommodation project and the partnership to run the operational service was exceeded by 14 per cent. This included unplanned expenditure on the accommodation project of £253,000. The scope of the accommodation project was extended beyond initial expectations and took longer than expected to define. This resulted in the need for a greater level of professional advice. When extra spending was proposed, however, National Savings' project board and finance directorate scrutinised the proposals and authorised further spending so that budgets were never exceeded without authority.

Cost of National Savings advisers

Figure 11

This figure shows that National Savings exceeded its budget by 14 per cent

Adviser	Budget £000s	Actual £000s	Variations £000s
Operational Services			
PA Consulting	1,519	1,609	90
Herbert Smith	722	902	180
Dresdner Kleinwort Benson	325	280	(45)
Other	139	102	(37)
Total	2,705	2,893	188
Accommodation			
Herbert Smith		200	
Richard Ellis		187	
Dresdner Kleinwort Benson		109	
Other		105	
Total	348	601	253
Overall Total	3,053	3,494	441

Notes: 1. These figures exclude VAT.
2. Other operational services advisers: Corporate Value Associates; Arthur Andersen; Central Computer and Telecommunications Agency and Government Actuary's Department.
3. Other accommodation advisers: Edmund Kirby; PACE and Burness.
4. Expenditure shown under accommodation represents 86 per cent of the cost of advisers for the separate accommodation deal before it was incorporated into the main operational services PFI deal.

Source: National Savings

National Savings investigated the market

3.5 Prior to the Information Memorandum stage, National Savings consulted its advisers and potential bidders on how the deal could best provide value for money. At the Information Memorandum stage, National Savings sought to establish, in detail, from the four remaining bidders their thoughts on the likely benefits of a public-private partnership and how the project could best be implemented to maximise those benefits. The Information Memorandum was designed as an open-ended document to encourage creative proposals and National Savings regarded it as a consultative process, although indicative prices were required as part of the bids. Following this process, National Savings judged that there were a number of key commercial drivers affecting the ability of the private sector to deliver a high quality and value for money operational service. The commercial drivers were:

a) to maximise the potential for efficiencies and economies of scale, a single integrated package of services comprising all of National Savings' current operational processing should be transferred to a single private sector provider, along with all of the staff and other assets of the operational service;

b) the private sector's ability to use surplus capacity for third party work could help to minimise the human and financial costs of future reductions in staff and offered the prospect of additional income for National Savings if such work was profitable; and

c) the private sector would require a long-term contract to allow time for the management of change, the development of third party business and to payback the investment made, while keeping within National Savings' annual budgets.

A tendering strategy was prepared

3.6 National Savings, however, identified two potential risks in such a deal. First, in transferring the entire operational service to a single private sector provider, it would be dependent on the selected partner for a service that is central to its success in achieving its objectives. This would create risks if the relationship with the provider faltered or the partner became unwilling to develop the operational service in a cost-effective manner and in the direction National Savings' strategy required. Second, a long-term contract raised the prospect of the cost and quality of the service diverging over time from the best available in the market.

3.7 National Savings, therefore, sought to protect itself from being reliant on a single partner in a long-term contract. To ensure future affordability, the Invitation to Negotiate sought firm prices for the specified operational service for each year of the contract, depending on forecast transaction volumes. To maintain a service equivalent to that available elsewhere, costs and quality would also be benchmarked at regular intervals during the life of the contract against the best available in the market. The outcome of these benchmarking exercises would be limited to downward only price movements and/or improvements in quality of service.

The detailed requirements of the project were well specified

3.8 The PFI approach offers the prospect of better value for money than conventional public procurement because it adds a wider range of private sector capabilities including risk management to those previously available to the public sector. For this to work, the private sector needs to be given the greatest possible scope to apply its skills. In specifying what would be required from a PFI deal, National Savings needed to avoid imposing unnecessary constraints on how the private sector could carry out the project.

National Savings set out clearly what was wanted from a private sector partner

3.9 The Invitation to Negotiate set out the objectives for the deal and what would be expected from a private sector partner (Box 4). In providing such a detailed output specification, National Savings was careful to avoid setting out what was required in input terms, so that bidders' ability to innovate would not be restricted. The outcomes expected from the successful development and implementation of business process re-engineering were made clear but bidders were not told how to achieve them.

Box 4

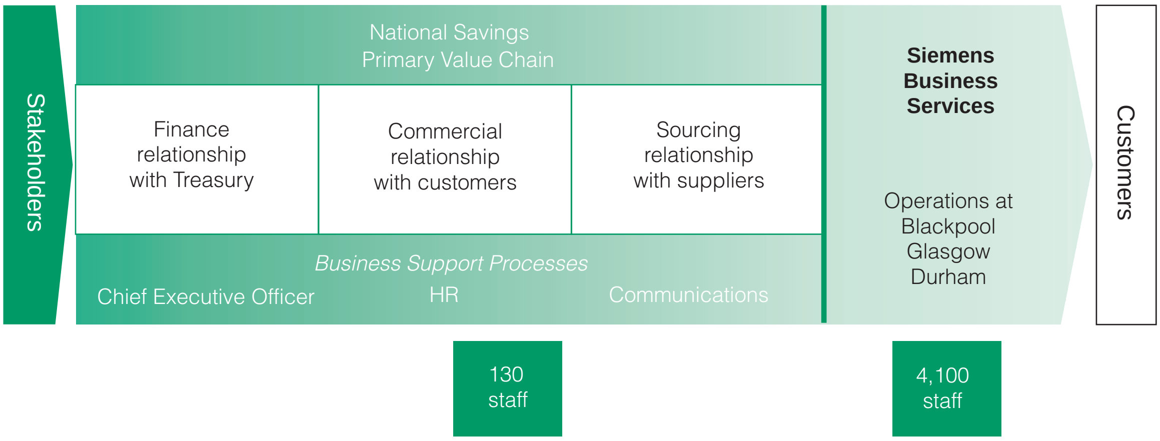
National Savings' objectives for the deal and its requirements of a private sector partner to meet those objectives

Objectives	National Savings required a private sector partner to:
a) The transfer of responsibility and the risk for the delivery and enhancement of an integrated operational service.	■ substantially increase operational efficiency through business process re-engineering; ■ meet detailed product and customer quality standards as measured by specified key performance indicators; ■ accept progressive reductions in the fee if key performance indicators are not met; ■ develop a link with the planned Post Office Counters Automation system; ■ be responsible for transaction accounting; ■ accept all risks associated with the year 2000; ■ take on the risk of the impact of future legislative changes on the operational service; ■ take operational responsibility for implemention of the first National Savings ISA product.
b) Cost reduction to the most competitive levels achievable throughout the contract.	■ charge a declining fixed fee based on a "middle case" volume transaction scenario with a pre-determined free band of volume variations around the "middle case"; ■ charge a different fee for each band of transactions above or below the "middle case" volume and free band; ■ benchmark services and costs throughout the contract and offer downward only price movements and/or improvements in quality of service; ■ share in higher than expected profits from National Savings work; ■ share in profits and cost savings made from third party business using National Savings assets; ■ agree that severance costs above an agreed cap will be at the provider's risk.
c) A collaborative and flexible contractual relationship with a provider incentivised to support National Savings strategies.	■ allow National Savings the right to audit all aspects of service delivery and key performance indicator calculations; ■ maintain complete transparency of accounts relating to the performance of the National Savings contract and the third party work conducted from the transferred undertaking; ■ allow National Audit Office access; ■ supervise, on a day to day basis, the processing services provided by Post Office Counters Ltd; ■ ensure that the entity performing the National Savings contract remains an identifiable and separable undertaking at all times enabling National Savings to be able to regain control at any time; ■ not charge for variations which are simply regular amendments; ■ provide new products at no additional cost, with a marginal increase or decrease in cost if National Savings requires more or fewer of such products.
d) An equitable commercial relationship.	■ take a long term view of investing in a partnership with National Savings; ■ agree that where new products or channels are fundamentally different, National Savings retains the right to tender more widely; ■ agree to a 12 or 15 year contract term with both parties able to terminate five years before contract end; ■ assume responsibility for staff, operational assets and liabilities from National Savings.
e) The transfer and protection of staff.	■ maintain Investors in People accreditations; ■ retain a significant presence at all three sites for at least the first five years of the contract; ■ apply Transfer of Undertakings Protection of Employment rules to the transfer of staff; ■ provide redundancy and pension terms which are broadly equivalent to the Principal Civil Service Pension scheme.

3.10 In addition, National Savings clearly defined the scope of its own responsibilities and those of a private sector partner. It required a private sector partner to be responsible for actions involved in, or supporting, the delivery of products. Such actions would encompass service delivery, service development, support services to National Savings and database management and information. The roles and responsibilities of each party are given in greater detail at Boxes 5 and 6 respectively.

Box 5

National Savings' role and responsibilities



Source: National Savings

Box 6

SBS's responsiblilities

Service delivery	The actual provision of products to customers. It involves performing three generic processes: **Sales:** A sale is the investment by customers of money in a National Savings' product. This involves creating appropriate records, providing the customer with appropriate documentation and associated processes, such as dealing with enquiries and despatching appropriate literature. **After sales:** All aspects of maintaining records, issuing statements and dealing with customer queries and problems. **Payments:** A payment involves any one of the following: a) returning the customer's investment, with or without interest; b) making a regular payment of interest or dividend; c) paying a Premium Bond prize. There are a number of ancillary services which are involved in delivering the products: a) transaction accounting and reporting; b) treasury management; c) forms printing and distribution (according to National Savings design); d) distribution of brochures; e) operational liaison with other National Savings agents including Post Office Counters Limited.
Service development	SBS will be expected to advise National Savings on the operational and technical impact associated with the design of brands, channels and products and the effect this will have on operational efficiency. SBS will be expected to implement new brands, channels and products within demanding timescales.
Support services to National Savings	National Savings requires SBS to provide some support services including: a) IT services (including voice and video conferencing); b) records management and archiving services; c) office services.
Database management and information services	SBS will manage the data that it collects via the new operational IT system which it is required to develop. Management of the data in the database will involve the use of sophisticated data warehousing techniques to allow National Savings' Directorates to exploit all of the information held about National Savings' customers. National Savings requires SBS to provide information concerning its service delivery performance. Such information will take two forms: a) regular reports to be delivered to National Savings on a daily, weekly, monthly or annual basis; b) ad hoc reports which may cover any aspect of information about customers, products or service standards. SBS will provide an easy to use report writing facility that will allow National Savings to interrogate the database and financial systems.

3.11 In setting an output specification, National Savings paid particular attention to the handling of volume risk and the use of a performance measurement regime to provide appropriate incentives for high service quality.

Volume risk was transferred

3.12 National Savings closely defined the transactions on which a unitary charge by a private sector partner would be based. Although individual products may encounter sharp fluctuations around their launch and anniversary dates, the overall volume of transactions each year tends to be stable. Moreover, even in the event of declining financing requirements, the Treasury would normally expect National Savings to plan on the basis of a steady state of funding. This is to assist business planning, in a competitive market, over the medium term and also because the gilts market is normally better placed to cope with changing financing requirements.

3.13 In 1998, at the time of the Invitation to Negotiate, some 55 million transactions were processed annually: 19 million sales, 30 million payments and 6 million after-sales transactions. Of the sale and payment transactions, 21 million represented the automatic processing of transactions such as the re-investment of Premium Bond prizes and monthly interest on Income Bonds. National Savings therefore based the pricing mechanism on 28 million manual transactions, of which some 20 million were directed via Post Office Counters Limited. After-sales transactions such as customer enquiries were excluded from the payment mechanism as a private sector partner could influence the number of such transactions by improved performance. Their exclusion provides SBS with an incentive to minimise them through handling transactions correctly and avoids the transfer of risk back to National Savings.

3.14 The Invitation to Negotiate included four forecasts of transaction volumes, prepared in consultation with the Treasury, based on a combination of transactions on existing products and those expected to be generated from new and replacement products. The forecasts are shown at Figure 12. The four funding scenarios were:

Upside: assumed no Treasury restrictions on funds to be raised from year to year;

Middle: a steady improvement in sales of existing savings products;

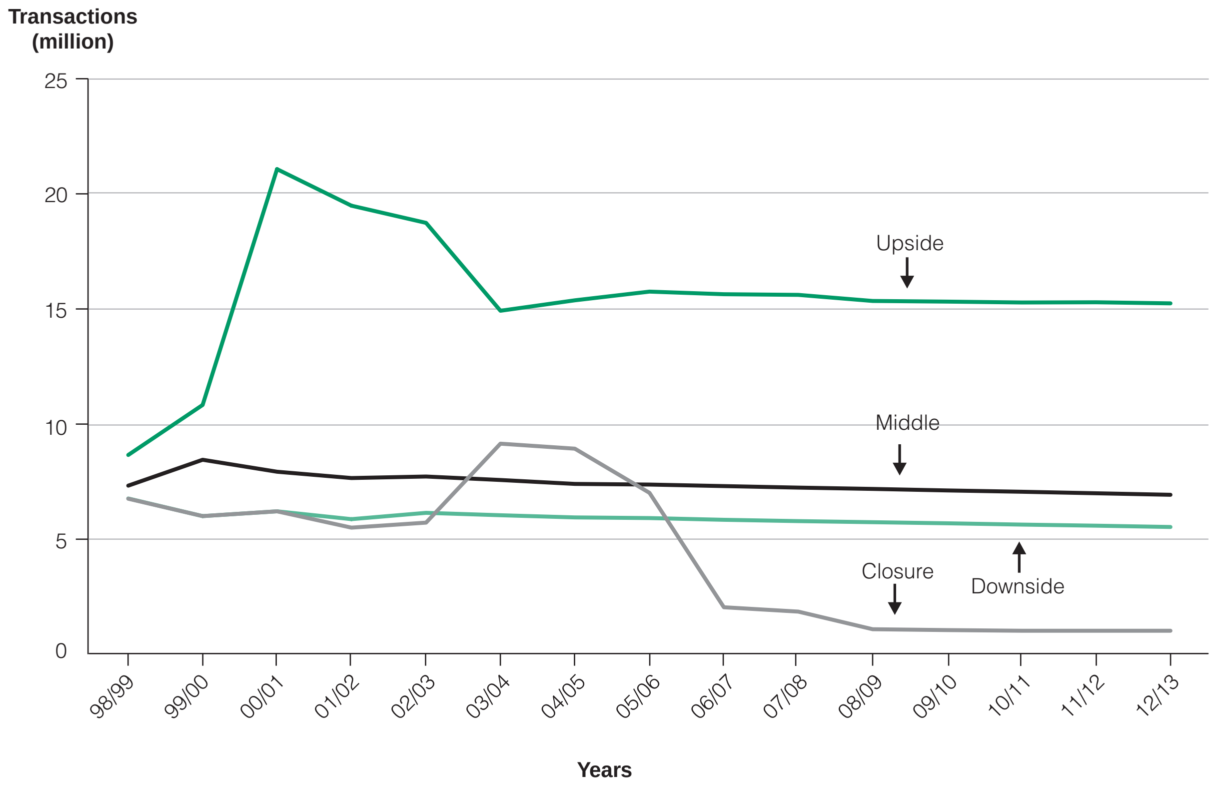
Downside: assumed Treasury restrictions on funding levels and non-participation in new opportunities in the retail savings market;

Closure: the downside scenario during the first five years of the partnership, followed by no product sales thereafter.

Figure 12

Projected transaction volumes by funding scenario

This figure shows projected transaction volumes under the four funding scenarios agreed with the Treasury



Source: National Savings

3.15 For manual transactions directed through Post Office Counters, National Savings assumed there would be some 20 million in the first year but that the number would decline and ultimately disappear by 2002/03, as the Post Office Counters Automation project came on stream. As the Post Office project was not within National Savings' control, SBS and EDS were asked to put a price on the risk of delays in its implementation.

3.16 Final bidders had to propose a base unitary charge for each year of the contract covering the fixed and variable costs of the operational service for the volume of transactions assumed in the middle funding scenario. To avoid contract price variations from normal changes in volume and allow for forecasting errors, National Savings also required the unitary charge to cover a "nil-adjustment" band of one million more and 200,000 fewer transactions a year. Bidders also had to price volume fluctuations outside of the "nil adjustment" band. For transactions directed through Post Office Counters Limited, bidders had to bid a marginal cost for transactions in excess of the 20 million currently processed.

Performance standards were set

3.17 The Invitation to Negotiate set out the standard of performance expected from a private sector partner and a range of potential deductions from the unitary charge if the standards were not met. National Savings considered that a persistent failure to meet the levels of customer service expected would merit severe performance deductions. The limits of any deductions are determined by the frequency of failure and grading of key performance indicators. For key performance indicators graded platinum, gold or silver, National Savings proposed maximum deductions from the monthly volume adjusted unitary charge of 10 per cent, 1 per cent or 0.7 per cent respectively. As SBS and EDS considered that such large deductions would represent an unacceptably high risk, they proposed lower levels of performance deductions in their bids.

3.18 There is no evidence that SBS and EDS inflated their bids to offset the risk of the performance deductions proposed by National Savings. There was a high degree of competition between the two and their prices, based on the middle funding scenario and lower levels of performance deductions, were similar. During the course of negotiations with the final bidders, National Savings reached agreement with SBS on the scale of performance deductions after SBS had reduced the overall margin expected over the life of the deal by £70 million. Although the agreed performance deductions were higher than those proposed by EDS, they were a level 50 per cent lower than National Savings had originally proposed.

The original timetable to completion was extended

3.19 Putting together and agreeing such a comprehensive set of output specifications took longer than expected. National Savings planned to complete the project in 15 months, from inviting expressions of interest in March 1997 to the signing of a contract in June 1998, leading to a private sector partner taking over the operational service from September 1998. In the event, the contract was awarded in January 1999 and SBS formally took over the service on 1 April 1999. Key dates are shown in Figure 13.

Figure 13

Comparison of National Savings' planned timetable and actual dates achieved

This figure shows that National Savings completed the project six months later than originally planned but that slippage was only 20 days against the planned target for completion after issue of the Invitation to Negotiate

	Original plan	Planned at issue of Invitation to Negotiate	Actual dates achieved	Slippage from original plan (days)	Slippage from dates planned at issue of Invitation to Negotiate (days)
Issue OJEC	01.03.97	-	01.03.97	0	-
Longlist bidders	07.07.97	-	07.07.97	0	-
Issue Information Memorandum	28.07.97	-	28.07.97	0	-
Receipt of bidders' responses	10.10.97	-	10.10.97	0	-
Completion of Invitation to Negotiate	28.11.97	-	06.03.98	70	-
Decision to invite final bids	24.11.97	-	15.04.98	102	-
Receipt of final bids	02.02.98	16.07.98	15.07.98	117	(1)
Completion of negotiations and recommendation of preferred bidder	19.06.98	03.09.98	06.11.98	100	(47)
Economic Secretary to the Treasury choice of preferred bidder	19.06.98	27.11.98	30.11.98	116	1
Award and contract signing	24.06.98	09.12.98	05.01.99	139	20

Source: National Savings

3.20 The major reason for missing the original targets was a delay in issuing the Invitation to Negotiate caused by the time needed to refine the requirements of the project, reach a final decision on whether the project should proceed and select the final bidders. The Treasury and PFI Task Force were aware of the need to have a well constructed Invitation to Negotiate and they challenged National Savings and its advisers on the content. Following the issue of the Invitation to Negotiate, the project only slipped by 20 days against a revised timetable.

3.21 There were considerable benefits in sending out a properly constructed Invitation to Negotiate and it is questionable whether National Savings would have got such a good deal if the document had been issued on the date originally intended. In clearly specifying the benefits expected, the payment mechanism and the roles of both partners, National Savings avoided disagreements at later stages in the project, enhanced the comparability of final bids and reduced the risk that the preferred bidder might make unreasonable demands prior to taking over the operational service.

The procurement was competitive

3.22 Competition throughout the procurement process is essential to getting good value from a PFI deal. Although competitive tension will usually draw the best bids out of tenderers, it is also essential that departments are in a position to select the best deal available through a systematic evaluation of the costs, benefits and risks of each bid.

There was competition at each stage of the process

3.23 Ninety companies responded to an advertisement published in the Official Journal of the European Communities in March 1997. After an initial sifting of the responses, National Savings invited 35 interested parties to respond to a questionnaire which evaluated their suitability for the deal and whether they could provide a range of options. Six respondents were interviewed and four were selected to receive an Information Memorandum setting out the scope of the project in greater depth. As a consultative document, SBS told us that the Information Memorandum afforded it an opportunity to be highly expressive and creative. A formal decision about whether and how to proceed with the procurement process would be made on the basis of the bidders' responses to the Information Memorandum, as would the shortlisting of the companies to be asked to respond to an Invitation to Negotiate.

3.24 After evaluating the four bidders' responses to the Information Memorandum (Figure 14), National Savings recommended to the Treasury that SBS and EDS should be taken forward to the Invitation to Negotiate stage. Both final bidders had submitted the best prices and had scored highest against non-financial criteria used in the evaluation. National Savings considered that taking forward two rather than three or all four of the bidders would provide the optimum balance between the maintenance of competitive tension in the final stage of bidding and the significant costs for both sides in formulating final bids and evaluating them. The final bidders told us that their costs ranged from £1.25 million to £1.73 million.

Figure 14

Comparison of prices offered by the four bidders at the Information Memorandum Stage of the Procurement

This figure shows that SBS and EDS offered the lowest prices

	SBS	EDS	Bidder 3	Bidder 4
Price offered £m	443	572	577	607
Ranking on non-financial criteria	1	2	4	3

Note:
1. The prices offered are shown in net present cost terms.
2. Bids were invited on the basis of a ten year contract.
3. Non-financial criteria were Business and Contractual Strategy, Technical and Service Quality and Management Environment and Staff acceptability.

Source: National Savings

Competitive pressure was maintained on the two final bidders

3.25 National Savings maintained competitive pressure on SBS and EDS by negotiating a draft contract with each of them before recommending a preferred bidder to the Economic Secretary to the Treasury. In negotiations, National Savings sought clarification from bidders by asking them to respond to position statements in the form of the project objectives, National Savings' understanding of each bidder's position and any gaps which needed to be closed. This approach, which was aided by clear specifications in the Invitation to Negotiate, allowed National Savings to lead in negotiations rather than the bidders doing so.

3.26 National Savings negotiated reductions in the prices of both final bids. Neither bidder had included all the requirements of the Invitation to Negotiate in their first bids in July 1998 and were asked to improve their bids. Following the receipt of the improved bids in October, National Savings considered there were a number of issues where both bids needed to be made comparable with each other and the Public Sector Comparator. Both bidders were therefore asked for a final reconciliation of their bids by November 1998. The differences between the bids, based on the middle funding scenario, are shown in Figure 15.

3.27 EDS did not change the price of its bid between July and October but did take the opportunity to make a reduction in November. The reduction of £68.5 million was accounted for by a fall in forecast redundancy costs, savings in postage, a reduction in expected profit margin and lower charges for dealing with manual transactions if the Post Office Counters Automation project was delayed.

Figure 15

Comparison of SBS and EDS bids

This figure shows that SBS's bid for operational services was £21 million lower than that of EDS and that its bid for accommodation was £36 million lower

	SBS			EDS		
	Operations £m	*Accommodation £m*	*Total £m*	*Operations £m*	*Accommodation £m*	*Total £m*
July	641	4	645	622	68	690
October	592	35	627	623	68	691
November	604	31	635	625	67	692

Notes: 1. All values are shown in net present terms at 1998/99 prices.
2. SBS's initial bid for the accommodation elements of the deal was an error and was corrected in October.
3. Both SBS and EDS were prepared to purchase or lease the accommodation. National Savings negotiated a leasehold option with SBS and a purchase option with EDS as these represented the best value for money solutions offered.

Source: National Savings

3.28 The fall in SBS's bid between July and October resulted from a substantial reduction in central services costs and expected profit margin, partly offset by a number of cost increases as a result of a greater understanding of National Savings' requirements and the correction of an error in the accommodation element of the bid. However, the price of the bid increased in November for items SBS had not previously included and an erroneous assumption that the use of 1st class pre-paid envelopes in communications with customers at a cost of £37 million over the life of the contract could be withdrawn.

Bids were evaluated systematically

3.29 At each stage of the procurement National Savings used pre-determined criteria and selected teams to evaluate bids:

a) After sifting responses to the advertisement in the Official Journal of European Communities, National Savings interviewed six potential bidders and evaluated them against four headline criteria: service delivery experience, organisational capability and cultural fit, financial and service capability and commitment to National Savings' objectives for the project.

b) At the Information Memorandum stage, an evaluation panel co-ordinated the process and assessed results on the basis of pre-determined evaluation criteria used by four specialist groups: Business and Contractual Strategy; Service and Technical Quality; Management Environment and Staff Acceptability, and Financial.

c) At the final stage of bidding, National Savings established a management structure for evaluation and negotiation, roles and responsibilities for each specialist group and used the pre-determined criteria set out in the Invitation to Negotiate to measure the potential of the final bids to achieve project objectives.

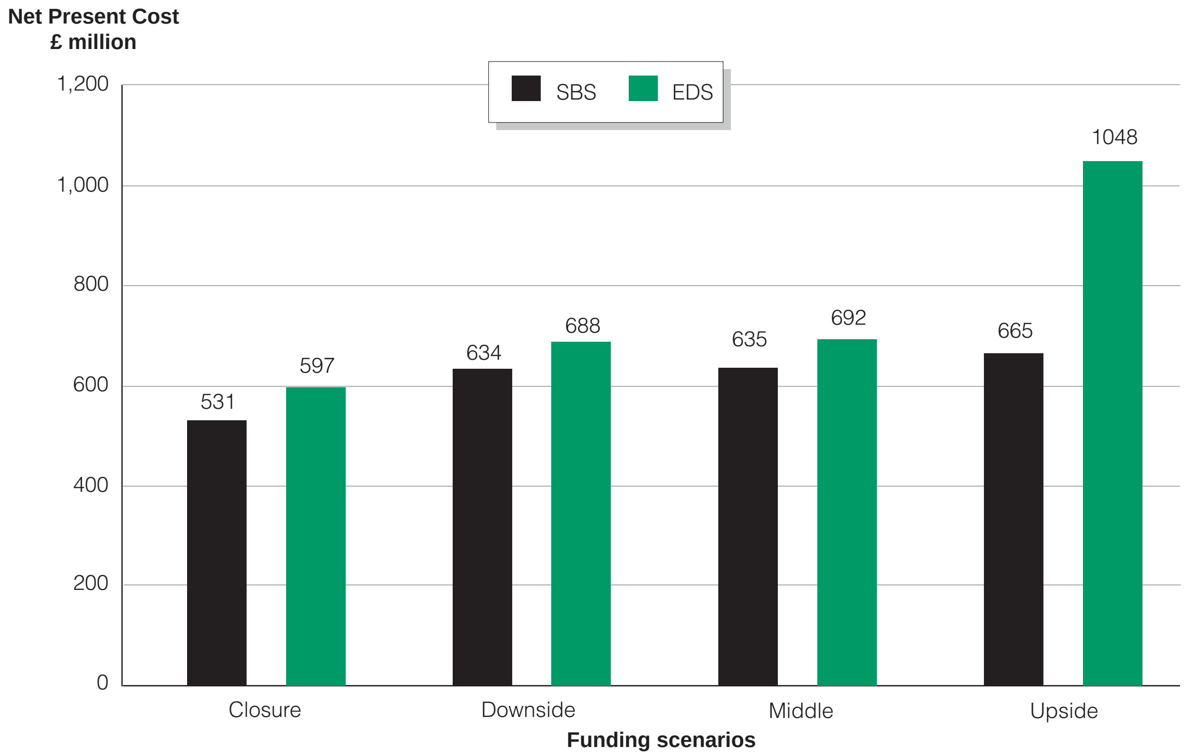
The best bid was selected

3.30 The SBS bid was superior on price to that of EDS on all four transaction scenarios, as shown at Figure 16. The significant difference between the two bids on higher transaction volumes is explained by the much higher price EDS quoted for each additional transaction of £4.82 (plus 72p postage) compared with SBS's price of up to 40p (plus 21p postage). For a lower number of transactions, EDS

Figure 16

Comparison of SBS and EDS charges over the four funding scenarios

This figure shows that SBS's projected charges were lower than those of EDS on all funding scenarios



Source: National Savings

proposed a rebate of 34p a transaction, compared with 10p from SBS. However, as SBS's price of £31.3 million to take over accommodation at the three sites was half that of EDS's at £67.2 million, the higher rebate from EDS at lower transaction volumes was insufficient to bring its price below that of SBS for the downside and closure scenarios.

3.31 The prices of the final bids at the middle volume scenario were close, as were the estimates of the number of employees each bidder would need to run the operational service. The major difference between the two bids was the inclusion in EDS's bid of a charge for the possible failure of the Post Office Counters Automation project. In negotiation, SBS indicated to National Savings that it had made an error in calculating the charge for additional transactions, which it had priced at 10p plus postage. In exchange for being allowed to change its price for additional transactions, SBS agreed to remove the potential charge for failure of the Post Office project from its bid.

3.32 The arrangement reached with SBS on the accommodation element of the deal was superior to that proposed by EDS on both price and other terms. SBS has taken leases on the whole estate and will pay a market rent of £4.1 million a year, recovered in the unitary charge, leaving National Savings with a saleable asset. Surplus land has been excluded from the leasing arrangements and retained for future sale. To date, National Savings has sold surplus land at the Glasgow site for some £200,000 and is seeking improved planning consents at Blackpool before considering a sale.

3.33 Aside from price, SBS was prepared to accept more risk than EDS. An example of this is the higher level of performance deductions SBS accepted. The difference between National Savings' proposed performance deductions, what SBS proposed and then accepted and the levels proposed by EDS are shown at Figure17, which also shows that both bidders accepted escalating deductions for frequency of performance failure.

Figure 17

Maximum performance deductions

This figure shows that SBS was prepared to accept higher maximum performance deductions than EDS and that after negotiation it moved closer to the levels specified by National Savings

	Platinum				Gold				Silver			
Number of months key performance indicator not achieved	*NS proposal %*	*SBS proposal %*	*Agreed level %*	*EDS proposed level %*	*NS proposal %*	*SBS proposal %*	*Agreed level %*	*EDS proposed level %*	*NS proposal %*	*SBS proposal %*	*Agreed level %*	*EDS proposed level %*
First month in any six months	10	0.61	5	1	1	0.13	0.5	0.5	0.7	0.09	0.35	0.1
Two or more in any six months	15	1.03	6	3	3	0.13	1.5	1.5	1.6	0.09	0.80	0.3
Four or more in any six months	15	1.44	7	6	10	0.13	5	3	4	0.09	2	0.6
Six or more in any 12 months	20	1.91	8	10	20	0.13	7	5	10	0.09	5	1

Notes: 1. Each 1 per cent deduction is equivalent to £85,163 of the unadjusted volume monthly fee in the first contract year.
2. The performance deductions are maximum deductions. The actual deduction applied is at National Savings' discretion and will take into account any loss suffered and the circumstances giving rise to the KPI failure.

Source: National Savings

3.34 SBS did seek, however, to mitigate potential performance deductions where the degree by which a target was missed could be measured in percentage terms. National Savings accepted that in such instances only a proportion of the maximum performance deduction should be made, as shown at Figure 18. There were other significant differences in the bids in favour of SBS, as shown at Appendix 5. There were no increases in the price agreed with SBS after its selection as the preferred bidder.

Variations in maximum performance deductions

Figure 18

This figure shows that SBS proposed and National Savings agreed that performance deductions should be lower where it was possible to quantify the relevant failure in percentage terms

SBS proposals		Agreed levels	
Percentage by which performance falls below target	*Proportion of performance deduction to be made %*	*Percentage by which performance falls below target*	*Proportion of performance deduction to be made %*
0 to 1	20	0 to 1	20
1 to 2	40	1 to 3	60
2 to 3	60	3 plus	100
3 to 5	80		
5 plus	100		

Note:
1. None of the platinum KPIs can be graded; eight of the gold and 25 of the silver can be graded.
2. 20 per cent and 60 per cent of a first failure of a gold KPI are £8,516 and £25,549 respectively and for a first failure of a silver KPI they are £5,961 and £17,884.
3. The level of deduction increases with the frequency with which the Key Performance Indicators are not met.
4. The performance deductions are maximum deductions. The actual deduction applied is at National Savings' discretion and will take into account the loss suffered as a result of the KPI failure and have regard to the circumstances giving rise to the KPI failure.

Source: National Savings

Glossary of Terms

Benchmarking The process of comparing the cost and/or quality of an operation, service or product against those of other organisations, preferably thought to be the best in the field.

Change of law risk The risk that future changes in legislation, for example, employment law, may lead to higher costs for the provider of the services.

Force majeure Events over which the parties to the contract have little control, but which could have serious impacts on performance of the contract. These may include war, rebellion, nuclear explosion and earthquakes.

Information Memorandum A formal document written and supplied by National Savings to bidders, which included financial and other information about the operational service, inviting them to provide their views on how the private sector could provide best value for money in delivering the operational service and costed responses.

Invitation to Negotiate A formal communication to selected suppliers.

Key Performance Indicators (KPIs) The detailed standards of performance National Savings requires SBS to provide in eight areas of the operational service.

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.

Public Sector Comparator An estimate of what a project would cost if traditional public sector procurement methods were used.

Risk transfer The passing of risk under the contract between the public sector and the private sector service provider.

Volume risk The risk that service volumes (transactions) may be higher or lower than forecast volumes, thus possibly affecting the amount of payments.

Appendix 1

Scope and methodology of the National Audit Office's examination

Scope of this study

1 We examined how National Savings was likely to achieve its objectives through the project. At the time of the examination in 1999 SBS had been providing National Savings' operational service for some ten months. Therefore, we were able to examine performance during the very early stages of the contract, although much of our work focused on the signed deal, and in particular the way it addresses the following aspects:

- The achievement of operational objectives - particularly the extent to which the contract provides for the sustained provision, to specified quality standards, of National Savings' operational service.

- Value for money - the extent to which the partnership with SBS is likely to be a more economical, efficient or effective solution than National Savings' continuing to run the operational service in house, taking account of the transfer of risk to the private sector.

Main aspects of the National Audit Office's methodology

2 The examination covered:

- **The conduct of the procurement:** how National Savings went about the task.

The purpose of this part of the examination was to assess whether National Savings' approach was well planned and implemented and likely to produce an outcome in line with its objectives. The process impacts on:

- **Outcome:** how far the outcome should meet the objectives.

  This part of the examination focused on the extent to which the signed deal should meet National Savings' operational needs within a price that provides value for money. It also encompassed SBS's performance in providing the operational service in the early stages of the contract.

3 In undertaking this examination we followed the approach laid out in our published report[3] on our methodology for examining private finance deals. In particular, we:

- designed the examination using experience acquired on our earlier studies of Private Finance Initiative deals;
- collected information about the procurement process and the deal;
- used an external firm and individual expert in aspects of the Private Finance Initiative to advise on specific issues;
- evaluated the information and advice received; and
- evaluated National Savings' performance against the key lessons from two recent reports by the Committee of Public Accounts (Appendix 3).

Collection of information

4 We collected information from the following sources:

- a review of National Savings' papers, bidders' submissions and of the legal agreements underpinning the deal;
- interviews with National Savings senior management, officials and advisers, on how they handled the negotiation of the deal;
- a questionnaire sent to the four bidders involved from the Information Memorandum stage of the procurement; and

3 Examining the Value for Money of Deals under the Private Finance Initiative (HC739 Session 1998-99)

- discussions with the two final bidders.

Use of external expertise

5 We engaged Theodore Goddard, a firm experienced in acting as legal advisers on Private Finance projects, to examine the contract and advise on how well it protected National Savings position. We also engaged Professor Andrew Davies of Cranfield University, School of Management to advise on project management.

Response to the National Audit Office Survey of Bidders

We surveyed the four entities who took part in the procurement process from the Information Memorandum stage. All four responded to our survey.

Initial Information on the Project

1. How did your interest in the National Savings' project arise? Please indicate the most important.

OJEC	Consortium member	Press and media	Other contact by HMG
2			2

2. How do you rate the initial information made available to prospective bidders by National Savings in the OJEC notice, oral briefings, questionnaire and the briefing pack issued to OJEC respondees?

Excellent	Good	Adequate	Inadequate	Poor
1	3			

3. Were you aware of the evaluation criteria National Savings proposed to use to shortlist bidders at this stage?

Yes	No
4	

4. How would you describe the time taken by National Savings from the issue of the OJEC to shortlisting for the consultation stage?

Too long	About right	Too short
2	2	

The Consultation Stage

5. To what extent was innovation encouraged in National Savings' consultation exercise?

	Greatly Encouraged	Encouraged	Neutral	Discouraged	Greatly Discouraged
Partnerships	1	3			
Staffing issues		3	1		
Business Process Re-engineering		4			
Contract length		2	2		
Performance measurement		2	2		
Risk allocation	2	2			
Profit and gain sharing		3			
Third party business		3	1		
Other					

6. How would you describe National Savings' attitude towards any innovations suggested by you in the following areas?

	Very receptive	Receptive	Not receptive	Opposed	Not applicable
Partnerships	1	2	1		
Staffing issues	1	3			
Business Process Re-engineering		3	1		
Contract length		4			
Performance measurement		3	1		
Risk allocation		3	1		
Profit and gain sharing		3	1		
Third party business		4			
Other					

7. How would you describe National Savings' requests for information at the consultation stage?

Very excessive	Excessive	About right	Too little
		4	

8. Do you think that National Savings provided sufficient information at the consultation stage?

	Excessive	About right	Too little
Information Memorandum		4	
Visits to sites		3	1
Access to staff		2	2

9. How clear to you were the criteria by which bidders were assessed at the consultation stage?

Very clear	Clear	Unclear	Confusing
1	2	1	

10. How would you describe the time taken by National Savings from the issue of the Information Memorandum to shortlisting for the Invitation to Negotiate stage?

Too long	About right	Too short
3	1	

11. What were your consortium's full costs after completion of the consultation stage?

up to £300,000	up to £500,000	up to £750,000	up to £1,000,000	up to £1,250,000
2		1		1

The Invitation to Negotiate Stage

12. To what extent was innovation encouraged in National Savings' Invitation to Negotiate in the following areas?

	Greatly Encouraged	Encouraged	Neutral	Discouraged	Greatly Discouraged
Partnerships	1	1			
Staffing issues	1		1		
Business Process Re-engineering		1	1		
Contract length		1	1		
Performance measurement		2			
Risk allocation		2			
Profit and gain sharing		1	1		
Third party business	1			1	
Accommodation		1	1		
Other					

13. How would you describe National Savings' attitude towards any innovations suggested by you in the following areas?

	Very receptive	Receptive	Not receptive	Opposed	Not applicable
Partnerships		1	1		
Staffing issues		1	1		
Business Process Re-engineering		1	1		
Contract length		2			
Performance measurement		1	1		
Risk allocation		1		1	
Profit and gain sharing		1		1	
Third party business		1		1	
Accommodation		1	1		
Other					

14. In your view, how should risk be allocated so that it is with the party best able to manage it?

	Wholly with NS	Mostly with NS	Shared	Mostly with Private Sector	Wholly with Private Sector
Legislative/ regulatory changes		1	1		
Post Office Counters Automation	1	1			
Business Process Re-engineering				1	1
Staff redundancies				1	1
Operational error and fraud			1		1
Year 2000 compliance			1		1
Accommodation			1	1	
New National Savings products and channels			1	1	
Transaction volumes		1			1

15. How would you best describe the allocation of risk proposed by National Savings in its Invitation to Negotiate?

	Wholly with NS	Mostly with NS	Shared	Mostly with Private Sector	Wholly with Private Sector
Legislative/ regulatory changes				1	1
Post Office Counters Automation			1		1
Business Process Re-engineering					2
Staff redundancies					2
Operational error and fraud					2
Year 2000 compliance					2
Accommodation					2
New National Savings products and channels				1	1
Transaction volumes			1		1

16. How would you describe National Savings' requests for information from you at the Invitation to Negotiate stage?

Very excessive	Excessive	About right	Too little
		2	

17. Do you think that National Savings provided sufficient information at the Invitation to Negotiate stage?

Excessive	About right	Too little
	1	1

18. How clear to you were the criteria by which bidders were assessed at the Invitation to Negotiate stage?

Very clear	Clear	Unclear	Confusing
	1	1	

19. How would you describe the time taken by National Savings from the issue of the Invitation to Negotiate to the award of the contract?

Too long	About right	Too short
1	1	

20. What were your full costs after the Invitation to Negotiate stage?

up to £1,250,000	up to £1,750,000
1	1

21. How would you describe the quality of National Savings' debriefing?

Excellent	Satisfactory	Unsatisfactory	Poor
1		1	

22. As a result of this procurement exercise, how interested would you be in bidding for other similar Government projects?

Very interested	Quite interested	Not very interested	Not very interested
2	2		

23. How would you describe your views of the PFI procurement process on this project?

No changes required	Minor changes required	Major changes required
2	1	1

Appendix 2

How National Savings adds value for the taxpayer

1 In 1996, Corporate Value Associates conducted a strategic review of National Savings to determine whether its business added value for the taxpayer and how such value might be maximised in the future. The review concluded that National Savings adds value for the taxpayer through being an attractive source of funds to government. This appendix provides a brief explanation of how this added value arises and how it can be measured.

Retail savings can be an attractive source of funds relative to gilts

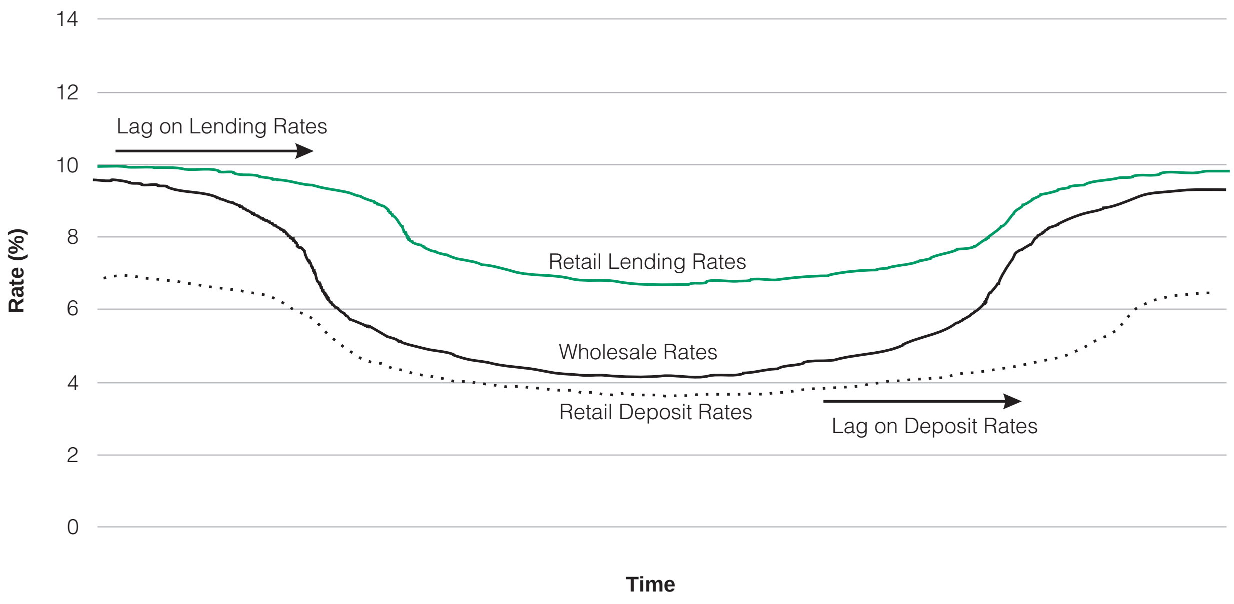
2 Private sector retail savings and lending institutions such as banks and building societies will create value in the form of profits from lending to borrowers at higher rates of interest than they pay to investors who deposit money with them. The interest rates charged or paid by banks and building societies will change in line with changes in wholesale money market rates (typically the rates at which the London clearing banks are prepared to lend and borrow).

3 The Government's borrowing requirements are funded largely by issuing gilts to participants in the wholesale capital market. As the payment of interest and repayment of capital on gilts is backed by the Government, they are usually regarded by investors as risk free if held to maturity. The yield on gilts is therefore lower than wholesale market interest rates for other types of securities, where there may be a risk that an investor will not be paid interest or repaid capital in the future.

4 To maximise profits when wholesale market interest rates are declining, banks and building societies will try to reduce the rates of interest paid to savers quickly and slow the reduction in lending rates charged to borrowers. On the other hand, when wholesale interest rates are rising, they will raise lending rates quickly but slow any increase in savings rates. This behaviour is illustrated at Figure 19. As National Savings only takes deposits, involvement in the retail savings market provides the Government with an option to borrow funds at lower rates than gilts.

Figure 19

Retail funding over an economic cycle



Source: Corporate Value Associates

However, the pricing of National Savings' products is crucial

5 Value added will be enhanced for the Government when wholesale interest rates are rising as the retail sector attempts to maximise margins by lagging behind changes in wholesale rates. Retail savings, however, will be less attractive if retail institutions are reducing savings interest rates in line with wholesale interest rates. As a result, the value added by National Savings will vary substantially with wholesale interest rate changes over an economic cycle. Accurate pricing is therefore critical to ensuring that money is raised throughout a cycle at competitive interest rates with gilts. Accurate pricing is also critical if National Savings is to compete effectively with other institutions and maintain a loyal customer base.

National Savings can add value over a complete economic cycle

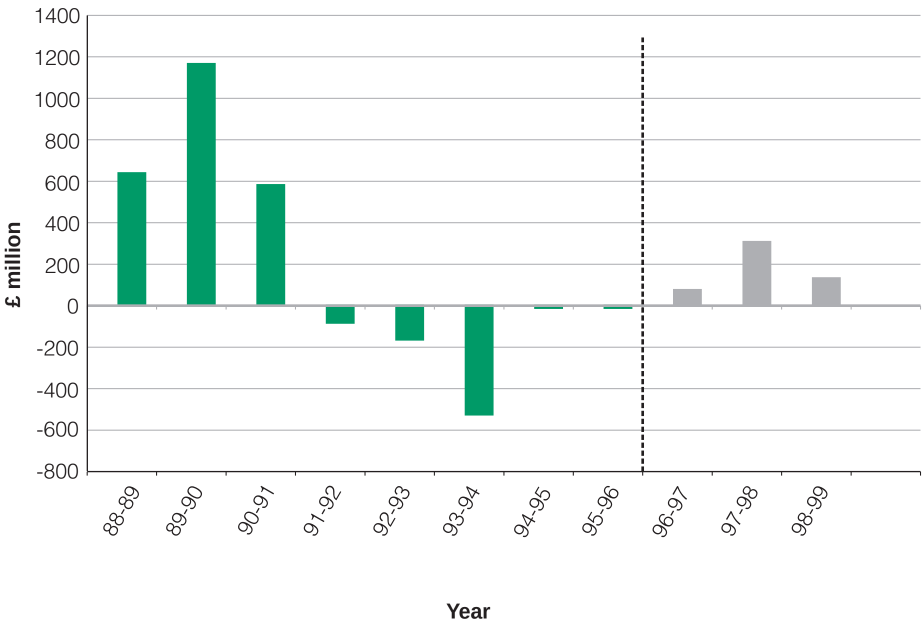
6 Raising money through retail savings will add value over a complete cycle, whether or not the Government needs to borrow on both the wholesale and retail markets. In practice, the gilts market is normally better placed to cope with changing financing requirements compared with National Savings through the retail market. Therefore, to provide the basis for efficient operations and business planning in a competitive market, the Treasury expects National Savings to plan on the basis of at least maintaining its real level of deposits even in the event of declining government financing requirements.

In the economic cycle1988/89 to 1995/96 National Savings added value of £1,600 million

7 As part of the strategic review, Corporate Value Associates calculated that National Savings added value of £1,600 million during the period 1988/89 to 1995/96 (Figure 20), after taking account of running costs and tax foregone on some savings products. The profile of value created demonstrates the characteristics of retail funding described earlier. Value is created mainly in periods of rising interest rates: 1988 to 1990 was a significant period of value creation. In contrast, value was reduced in 1991/92 to 1993/94, a period of falling interest rates. Variable rate products created some £500 million of value and fixed rate products £1,100 million over the cycle.

National Savings added value from 1988-89 to 1998-99

Figure 20



Sources: Corporate Value Associates and National Savings

The methodology for measuring National Savings' added value

8 In developing a prototype methodology to measure value added, Corporate Value Associates used particular gilts as comparators, based on the characteristics of National Savings' fixed and variable rate products. Fixed rate products last for a period of, typically, five years and Corporate Value Associates considered that the value of these funds should be compared to a five-year gilt.

9 National Savings' variable rate products are priced flexibly, typically, on a ninety-day notice period before an investor can withdraw funds without paying a penalty. Most of these products, however, provide funds that are very long lasting. In the retail savings market customers pay, through a lower interest rate, for an option to remove their funds at short notice but in practice they do not exercise this option. For example, Premium Bonds have an average life expectancy of over 13 years and National Savings Investment account would take over five years to empty even if there were no new deposits. Corporate Value Associates considered, therefore, that a five-year floating rate gilt would be the most appropriate comparator. Since 1997, National Savings has undertaken further work to refine the value added methodology first developed by Corporate Value Associates.

A broad appraisal was made of the future value of National Savings

10 Corporate Value Associates also calculated, on the basis of a seven year cycle, that National Savings could add net value of £1,400 million, an average of £200 million a year after deducting running costs. Such added value will equate to a pound for pound reduction in public expenditure and, if National Savings' operational costs could be reduced, the amount of added value would increase.

Appendix 3

Key lessons from previous deals

The partnership with SBS aims to enhance cost effectiveness through a transformation of business processes across all areas of the operational service. There is, however, a small but significant IT element which, if not implemented by the target date, will delay the delivery of the business benefits required by National Savings and have a major impact on SBS profits from the partnership. In this appendix, we indicate how National Savings has performed against some of the key lessons in two recent reports by the Committee of Public Accounts:

a) getting better value for money from the Private Finance Initiative;

b) improving the delivery of Government IT projects.

A: Getting better value for money from the Private Finance Initiative

1: Managing the procurement

a) **For private sector suppliers to put together good quality bids they need to know as clearly as possible what a department requires of them.**

- National Savings specified the service standards to be achieved and provided as much information as possible on likely volumes of activity and any constraints which the private sector needed to be aware of.

b) **By specifying requirements in output terms departments will permit innovation in how services are delivered.**

- National Savings specified its requirements in output terms. For example, it specified a data warehouse and the data that should go in it but not how SBS should do it.

c) **Departments should allow adequate time for procurement of the project.**

- National Savings extended the procurement timetable to allow it to develop a comprehensive set of output specifications for the Invitation to Negotiate.

d) **It is common to choose the short list of bidders following a pre-qualification competition. In such cases, the choice should be based on the ranking of bidders in the pre-qualification.**

- National Savings chose the four bidders for the Information Memorandum stage of the procurement in accordance with their ranking in pre-qualification.

e) **Departments need to strike a balance between proceeding with too few competitors and too many. If there are too few, there is the risk that competition could be weakened, especially if one or more bidders were to drop out prematurely.**

- National Savings considered that it had to balance the maintenance of competitive tension in the final stage of bidding and the significant costs for both sides in formulating final bids and evaluating them. In this instance, competitive tension was maintained between two final bidders by negotiating a draft contract with each of them before recommending a preferred bidder.

f) **In principle, departments should seek to finalise all fundamental aspects of the contract prior to contract award.**

- National Savings agreed all fundamental aspects of the contract with SBS before selecting it as preferred bidder after which final negotiations took two weeks without any changes in the price agreed.

g) **Departments should set and monitor budgets for their likely resource costs (both internal and external) after careful consideration of the likely expenditure.**

- National Savings set budgets for advisers and closely monitored expenditure as the project progressed.

h) **Save in exceptional circumstances, departments should always appoint their external advisers after competition.**

- National Savings appointed advisers following competitions.

2: Obtaining the best available deal

a) Contracts should allocate the risks associated with a project to the parties best placed to manage them.

- The contract with SBS allocates risks to the parties best placed to manage them.

b) Departments should identify all the significant risks associated with the project and understand the implications of such risks for their businesses.

- National Savings identified all the significant risks involved in transferring the operational service to the private sector.

c) Departments should recognise that, although they can, and should, transfer the financial consequences of certain risks, it is unlikely that all of the business risk can be transferred. Departments remain accountable for these business risks and should ensure adequate contingency plans exist to manage these risks.

- National Savings is monitoring progress through an agreed governance structure, joint plans, formal business reporting and working level contacts. SBS is obliged to manage the business in accordance with internationally recognised quality management and quality assurance standards.

- If things go wrong, National Savings can re-tender for a new private sector partner at any point during the life of the contract. In such circumstances, the contract requires SBS to continue to provide the operational service for six months after termination, while National Savings finds a new partner.

3: Demonstrating the achievement of value for money

a) Departments should establish adequate arrangements for monitoring the contractor's performance in delivering the required services.

- National Savings is monitoring SBS's performance and has secured additional resources to do so thoroughly.

b) Contracts should provide for compensation to be paid in the event that the supplier fails to meet the required performance standards.

- The contract includes a range of performance deductions if SBS fail to deliver. If SBS has to employ more staff than expected, it cannot seek a higher price from National Savings. SBS has agreed a limit of £250 million on aggregate liability for all defaults during the contract period.

c) However the setting of compensation levels is a matter of judgement. If levels are too high, then prices offered by bidders may be increased as bidders seek to cover themselves against the risk of their having to pay such compensation.

- There is no evidence that the bidders inflated their bids because of the level of the maximum performance deductions National Savings required.

d) Public sector comparators provide a useful indicator of whether value for money is likely to be delivered by a PFI contract by comparing the expected cost of the deal with that for the same services using more conventional procurement methods.

- The Public Sector Comparator prepared by National Savings was a sound basis for making a value for money decision.

B: Improving the delivery of government IT projects

1: The inception and design of IT projects

a) Departments should ensure that they analyse and understand fully the implications of the introduction of new IT systems for their business and customers.

- National Savings based its requirements for new IT systems on a clear business need.

- National Savings clearly defined roles and responsibilities for SBS, its chosen private sector partner, to develop and implement IT systems to deliver the business benefits identified by National Savings.

b) Departments must consider carefully the scale and complexity of projects to assess whether they are achievable.

- SBS and EDS based their proposals on National Savings' projected timetable and SBS is taking an incremental, as opposed to "big bang", approach.

c) Delays in implementing projects place them at risk of being overtaken by technological change.

- SBS is introducing systems in phases and is incentivised to use technological advances in delivering the operational service through profit sharing mechanisms over the life of the contract.

d) The project specification must take into account the business needs of the organisation and the requirements of users.

- SBS is making use of the staff transferred to it to assist in the development of new systems and to assist in the training of other staff when those systems are implemented.

2: Managing projects

a) Senior management in all public bodies have a crucial role to play in championing the successful development of IT systems.

- National Savings senior staff recognised that better information technology could improve the operational service and provide other business benefits, as identified in the strategic review.

b) It is vital that departments pay attention to the management of risks and have contingency plans in case projects are not implemented as planned.

- There is a system that works now, which can be used if the new system is not implemented successfully. SBS will bear any additional costs in providing the operational service until a new system is successfully introduced.

3: Relationships with suppliers

a) Relations between the department and the supplier will have a crucial effect on the success of the project.

- National Savings is maintaining a close relationship with SBS through their joint governance structure for the contract.

- Both partners have a clear understanding of their roles and responsibilities, and a shared understanding of key terms and deadlines.

- National Savings has liaised closely with the SBS contract management unit to ensure it is familiar with all the requirements of the main contract and how they should feed through to SBS's sub-contractors.

b) Contracts between departments and suppliers must be set out clearly.

- Change procedures are included in the contract and National Savings and SBS have agreed a methodology to agreeing changes to be incorporated into the contract so that it remains an up to date document.

4: Post-implementation issues

a) Sufficient time and resources should be spent on ensuring that staff know how to use the IT system. And proper consideration should be given to the possible effect the new system may have on productivity in the period following implementation.

- SBS based its staff needs on the basis of new systems and a transformation of business processes. If more staff are needed than planned, SBS will bear the costs.

- SBS has responsibility to train its staff to deliver the operational service to the required standards.

Appendix 4

Technical aspects of the Public Sector Comparator

In examining the Public Sector Comparator we benchmarked the processes used by National Savings against good practice published by the Treasury Task Force, and experience gained from our previous examinations of PFI deals. We consider that the Public Sector Comparator used by National Savings was a sound basis for making a value for money decision for the following reasons:

- **In the absence of a PFI deal, the comparator was a real business option**

  The PSC was akin to an in-house bid against competition from external service providers rather than a costing of an existing or lower level of service delivery. As such, the proposal was a real business option in the absence of a PFI deal. It was aligned to, and acted upon, the strategic objectives of the business. This alignment provides assurance that the comparator was a reasonable tool for a value for money case because it embodied real assumptions about likely alternative courses of action. National Savings based the comparator on a business plan prepared by the Operational Services Directorate, which reflected the conclusions of the strategic review. The business plan assumed successful delivery of the business process re-engineering project, the plans for which depended on the use of known and successful technologies, such as modern interactive databases and IT systems to support call centres. It was also based on the output specification and transaction volumes bidders were required to use.

- **It was prepared and reviewed by professional advisers and approved by National Savings' senior management**

  The comparator was prepared by PA Consulting and reviewed by KPMG, Dresdner Kleinwort Benson, National Savings' Operational Services Directorate and the Treasury. Throughout the procurement process, National Savings' senior management challenged the assumptions made. Such a degree of senior management involvement is unusual and indicates that the preparation of the comparator was subject to an appropriate level of internal as well as external review.

- **It was used as a value for money benchmark throughout the procurement process**

National Savings used the comparator as a value for money benchmark throughout the procurement process. It was first prepared in outline form in May 1997, when National Savings started to consider how the private sector might help to run the operational service. The first full version coincided with the issue of an Information Memorandum to bidders in July 1997. The comparator was developed further during 1998 and a new version was complete when an Invitation to Negotiate was issued to bidders in April. Senior management within National Savings approved it in July 1998, prior to receipt of bids from SBS and EDS.

- **The comparator did not overestimate the costs of the in-house option**

To avoid distorting a value for money decision in favour of a PFI option, departments should not overestimate costs within a Public Sector Comparator. We did not detect any evidence of this. With hindsight, costs may have been underestimated in the comparator for two reasons. First, SBS considers that National Savings' plans for business process re-engineering were ambitious. This implies that the comparator may have understated re-engineering costs and overstated the likelihood of successful completion within the time expected. Second, the comparator assumed the implementation of a project underway at Post Office Counters to automate systems for handling transactions on savings products. Successful completion of the project would have reduced National Savings' staffing requirements. In the event, Post Office Counters decided to abandon the project.

Appendix 5

Other significant differences between the final bids from SBS and EDS

Area	SBS	EDS
Open book accounting	Unfettered access.	A comprehensive list of reports available for National Savings' scrutiny audited by EDS's auditors.
Benchmarking	Regular benchmarking on both service levels and its underlying cost base against best practice. Reductions in costs would go directly to the unitary charge.	Periodic future benchmarking of the service but related to average market service levels as opposed to best practice. Any reductions in cost would be shared through the profit sharing mechanism.
Profit sharing	50:50 over base margin requirement calculated annually. An element of the deal reported separately for profit sharing. Any savings in contingency provision would be shared 30:70 with National Savings.	50:50 share over base margin requirements calculated cumulatively over time and across cost areas. EDS would give National Savings a credit note to be offset against additional and/or changed EDS services. Savings in redundancy costs would feed through to the profit sharing mechanism.
Telephone call centre	Capacity: 2 million Additional calls: 80p each	Capacity: 2 million Additional calls: £1.80 each
New products	Cap of £600,000 for each product even outside the number contained within the unitary charge. Rebate of £600,000 for each new product not introduced within the unitary charge.	Not clear. Cost of additional new products not capped.
Fundamentally different products	Accepted National Savings' definition.	Proposed a more restrictive definition. Potentially National Savings would have difficulty classifying products as new as opposed to fundamentally different and thus have them included within the unitary charge. EDS also reserved the right to refer National Savings' decision on a new product to the dispute resolution procedure.
Accommodation	SBS has taken leases on the whole estate and will pay market rent of £4.1 million a year, recovered in the unitary charge, leaving National Savings with a saleable asset. SBS will keep a presence at each of the three locations for at least five years.	EDS proposed to transfer purchased properties to another company and lease them. It also proposed to sell the Durham site within 2 years of contract commencement. EDS proposals required National Savings to underwrite a 10 year lease on required accommodation. Weak clawback provisions included, leaving National Savings little chance of sharing in windfall gains from property development.

Area	SBS	EDS
Third party business	At least 1,200 jobs underwritten. Indicated a greater potential for job growth. Contingency provision £45 million spread over three years.	At least 1,900 jobs underwritten. Contingency provision £31 million spread over four years.
Limits on liability	£250 million with a cap of £120 million for any 2 contract year period. Includes banking losses, value added losses, customer compensation and customer overpayments.	£50 million. Excludes banking losses, value added losses and customer compensation.
Fraud	Accepted responsibility for all internal fraud and any customer fraud in excess of £250,000 in any one year.	Accepted responsibility for internal fraud but not for customer fraud.
Post Office Counters Automation project	No additional charge if the project was not implemented.	Additional charge of £60 million if this project was not implemented during the life of the contract.
Millennium compliance	Took the risk on all systems.	Would not accept the financial risk of failure of legacy system.
Unitary charge	All of the monthly unitary charge would be at risk for poor performance.	Required a guarantee of 20 per cent of monthly unitary charge.