



National Audit Office

Benchmarking and market testing the ongoing services component of PFI projects

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John Bourn
Comptroller and Auditor General
National Audit Office

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The National Audit Office study team consisted of:

Mark Simpson, Mark Wynniatt, David Jackson, Hannah Payne, Michael Prest and Sean Clayton, under the direction of David Finlay

This report can be found on the National Audit Office web site at www.nao.org.uk

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

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SUMMARY

1 Around 500 Private Finance Initiative (PFI) projects out of the 600¹ that have been let, are now in the operational phase. At least half of these projects have provisions in their contracts that require the value of certain services, such as catering and cleaning, to be tested at intervals, typically every five to seven years. The services that are subject to this value testing are often a significant part of the total cost of a PFI contract (**Figure 1**) and so the process of value testing is an important aspect in seeking to achieve value for money from a PFI contract which may run for 25 or 30 years or more. Value testing may involve comparing information about the current service provider's

provision with comparable sources [benchmarking] or alternatively, inviting other suppliers to compete with the incumbent in an open competition [market testing].

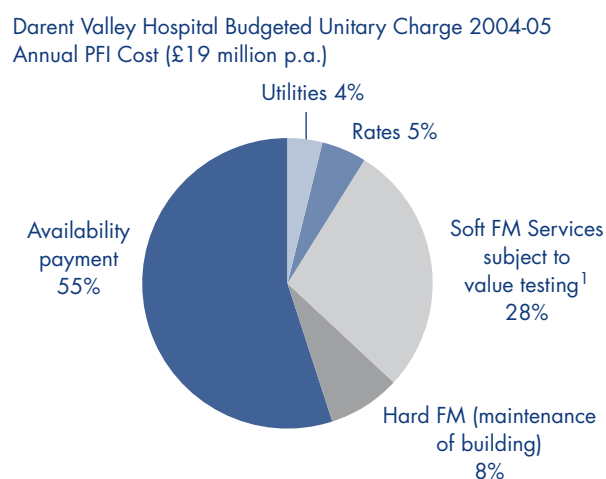
2 We examined the contractual provisions for value testing within a sample of 34 PFI contracts in order to assess their expected effectiveness. We also examined the early experience of the 11 PFI projects in England that had carried out value testing at the time of our study in summer 2006. We found that in some of these initial cases the value testing had demonstrated that value for money was being achieved, but in other cases the outcome was uncertain. Our methodology is set out in Appendix 1.

¹ As of April 2007 the list of PFI projects published by HM Treasury has been updated and reduced from over 750 signed PFI deals to 600. This reflects the large data validation exercise HM Treasury has carried out as: some projects had concluded or been terminated; some projects had changed their contractual structures that meant they were no longer classed as PFI; some projects had been contractually merged; and departments have stopped collecting data on some very small projects in order to reduce reporting burdens.

Summary text continued

3 Although the projects examined were all those that had used value testing up to summer 2006, the number of projects is only around two per cent of all PFI projects in operation. In addition, there have, over time, been improvements in contract terms for value testing since some of the contracts we examined and there is now detailed Treasury guidance to supplement the previous guidance about value testing in the Treasury's Standardisation of PFI Contracts (SoPC). For these reasons the results of our examination of the early examples of value testing are not necessarily indicative of how the arrangements will work in future in other PFI projects. Nevertheless, we considered it important to examine these initial examples to highlight lessons drawn from the first practical experiences of applying value testing. These lessons will help the many projects that will be using benchmarking or market testing in the coming years.

1 Example of the proportion of the total annual costs of a PFI contract which are subject to value testing



Source: Darent Valley Hospital and National Audit Office

NOTE

1 The value testing relates to the facilities management services such as catering, cleaning and portering ("soft FM services") which have been subject to benchmarking. These services are 28 per cent of the total annual cost of the PFI contract.

4 The Treasury issued new guidance in October 2006² which took account of our initial findings and additional research conducted by Partnerships UK (PUK) on behalf of the Treasury. Current best practice as set out in Treasury guidance addresses issues described in our study and gives the prospect of improved value for money in the future. Our other main findings were:

The mechanics for carrying out value testing in the early PFI contracts

i) The early PFI contracts, let before the start of contract standardisation in 1999, contain a range of provisions for benchmarking or market testing. Lawyers, Nabarro, examined on our behalf a sample of 34 contracts and found that the value testing terms were often expected to have limited effectiveness, although these have yet to be tested in practice. Some of these contracts, where value testing would be appropriate, have no contractual provisions. Where contract clauses are absent, or are expected to have limited effectiveness, it may nevertheless be possible for the parties to carry out effective and value for money value testing if they develop suitable processes.

ii) Projects will now benefit from the Treasury's 2006 guidance which is more detailed than that available in previous versions of Standardisation of PFI Contracts. We agree with the Government's view expressed in the new guidance that, because of the potential benefits of competition, transparency, and flexibility for re-assessing the service provision, market testing, if it can be applied successfully, is generally the mechanism most likely to give a better outcome on value for money grounds.

iii) Although only three market tests had been completed at the time of our study, which does not allow wide-ranging conclusions to be drawn about this process, these first three market tests were competitive processes and produced beneficial outcomes. Although not necessarily indicative of future experiences, one was won by an in-house bid and the other two by the incumbent supplier. External suppliers bid but were not successful in these competitions. To maintain the competitive benefits of market testing, suppliers must continue to be interested in bidding against incumbent suppliers. The Treasury is seeking to facilitate a market in benchmarking and market testing through publishing details of ongoing services that will be put out to competition. The Treasury intends to make this available on PUK's website.

2 Operational Taskforce Note 1: *Benchmarking and market testing guidance*, HM Treasury, October 2006.

The application of the processes

- iv)** In projects where ineffectual or vague contract clauses were identified, authorities and their private sector counterparts have had to work together in order to produce an effective project plan to manage the process.
- v)** Value testing can be a lengthy process. We found that where projects had completed the process it had taken nine to 25 months; similar to the time taken to re-let service contracts in conventional procurement. But one project examined had yet to complete the process, having taken, up to March 2007, 37 months. Agreeing how the process will be conducted can be time consuming and there have often been detailed negotiations before a final price adjustment has been agreed. In particular, projects have experienced difficulties in finding suitable benchmark data with which to compare the services. The Treasury is liaising with departments to draw up a central database of benchmarking and market testing information.
- vi)** By allowing prices to be renegotiated in line with market rates these processes enable the public sector to benefit if market prices fall and they also limit the uncertainty faced by the private sector by giving them an opportunity to obtain a price rise when costs increase.
- vii)** The two telecommunication projects which had completed value testing had achieved value for money through price reductions of 19 per cent and 37 per cent after using benchmarking to take account of falling prices in the very competitive communications sector.

viii) In the seven building projects we examined, five of which were hospitals, where value testing had been completed the final price adjustments were mainly -2 to +6 per cent (**Figure 2**) although in one school project the final price increase was 14 per cent. The authorities had been involved in negotiations to arrive at these price changes after the value tests initially suggested that, in most cases, upward price changes would be required, with the changes mainly in the range -1 to +19 per cent (**Figure 2**).

ix) These price changes were separate from the contractual arrangements allowing the private sector an annual price increase for general inflation. The price changes initially proposed reflect various market factors, including salary costs that had risen more than had been expected since contract letting and that some initial contracts may have been priced competitively at below normal market rates. These projects were the first PFI building projects to use value testing processes and the price changes reflect cost changes in the market for facilities management services up to 2006. The resulting price changes are not, therefore, indicative of the price changes that may arise in future uses of value testing in PFI building projects.

x) The negotiations, initiated by the authorities, were a significant factor in arriving at the final price changes. As part of the negotiations, in three of the seven projects, the authorities made minor reductions to their service specification in order to keep the price affordable.

2 Price adjustments arising from value testing the seven PFI building projects¹

Final price change after negotiations

In the range -2 to +6%

(with the exception of Debden Park High School which was 14%)

The price change for each project also took account of any reductions to service requirements which the authorities had requested as part of the final negotiations.

Price change arising from the initial outcome of the value test proposed to the authority

In the range -1 to +19%

(with the exception of Debden Park High School which was 26%)

To arrive at a like-for-like comparison, the price change for each project was based on the services subject to value testing which the authority had been procuring immediately prior to the value testing but before any changes to service requirements made at the time of the value testing.

Source: National Audit Office

NOTES

¹ The price changes shown above exclude the effect of further salary increases which NHS Trusts in five of the seven projects will be obliged to take on arising from the NHS Agenda for Change². Other than the NHS Trust at Queen Elizabeth Hospital, Greenwich, where the impact on the final price adjustment was to increase it from +6 per cent to +37 per cent, the impact of the Agenda for Change salary increases was still being discussed by the other four NHS Trusts at the time of our study.

² Agenda for Change is the new NHS grading and pay system for NHS staff other than doctors, dentists and some managers which became effective in September 2005. Staff working for PFI contractors are affected by this either because, in some cases, the staff remain NHS employees or because they are private sector employees covered by similar salary arrangements as a result of the Joint Statement on Workforce Matters published in October 2005 by the Department of Health, NHS Employers, the CBI, the Business Services Association and Trade Unions. It would also affect in-house services.

These authorities considered that the service levels were previously over-specified and do not expect the reductions in specifications to compromise the service delivered to the public although it is too early to judge the outcome conclusively.

xii) The price changes which have arisen from these value testing exercises should not be viewed in isolation but are part of the overall cost of procuring facilities services to the standards specified in the PFI contracts over an extended period. The Treasury requires project teams to make a value for money decision on whether to include or exclude these services from the contract before embarking on a PFI procurement. We are not, however, aware of any systematic overall comparison to date between the cost and quality experiences of facilities services procured under the PFI with conventional outsourcing. There are difficulties in making these comparisons as the conventional examples may not be comparable to the PFI deals in terms of the required services or standard of performance. There is also limited experience to date of the price changes arising from using the value testing arrangements in PFI contracts.

xiii) We considered the value for money of the completed value tests by reference to the resulting changes to the price and service specification, and the effectiveness of the value testing (Figure 3).

3 National Audit Office assessment of the value for money of the nine completed value tests¹

Type of Project	Number of Projects	Value for money has been achieved	The value for money outcome is uncertain ²
Telecommunications	2	2	–
Buildings	7	3	4
Total	9	5	4

Source: National Audit Office

NOTES

1 The outcomes of two projects of the 11 projects examined by the NAO were uncertain at the time of our examination as one had not completed their price adjustment negotiations following value testing and one had not yet quantified the outcome from value testing. Further information on the NAO assessments of the 11 projects examined is set out in Figure 15 and Figure 16.

2 Uncertainty was due to various factors including whether the best price had been secured where there had been price increases, weaknesses in the comparator data and authorities identifying that they would make changes to their value testing processes in future to achieve better outcomes.

Lessons learned as a result of the early applications of benchmarking and market testing

xiii) The projects that have completed benchmarking and market testing have learned important lessons such as: the need for realistic timescales, the benefit of the early engagement of the private sector, the need for an effectively designed project plan, access to good comparable benchmarking information and the effective role that advisors can play in the process. These lessons have been incorporated into the Treasury's 2007 Standardisation of PFI Contracts version 4 (SoPC4) and Operational Taskforce Note 1, Benchmarking and Market Testing guidance.

Recommendations

1 Departments should ensure that their PFI project teams are familiar with, and adopt, the new Treasury guidance on benchmarking and market testing. Project teams should take appropriate advice including consulting their Private Finance Units, the Treasury Operational Taskforce managed by Partnerships UK, and other projects which have already undertaken these processes. Project teams should also consider the skills they will need and seek to identify who in their departments or agencies might have them before using external advisors.

2 For the potential benefits of market testing to be realised there needs to be strong competition. Project teams and their respective departments have a role to play in keeping the market active and competitive, for example by keeping suppliers informed of future bidding opportunities.

3 The Treasury should continue to liaise with departments to draw up a central database of benchmarking and market testing information. The Treasury and departments should then consider whether further data is needed and how such data can best be obtained.

4 The price changes arising from value testing are part of the overall cost of procuring facilities services to the standards required under a PFI contract over an extended period. Departments should ensure that project teams follow Treasury guidance to assess the value for money case for including or excluding facilities services before letting a PFI contract and, to inform this process, should take steps to compare the cost and quality experience to date of procuring facilities services under the PFI with conventional outsourcing.

5 Project teams need to consider, in identifying affordability limits for PFI projects, that the contract price may increase after contract letting for factors which include service and price changes arising from value testing the ongoing service provision.

6 Where service amendments need to be made in conjunction with benchmarking or market testing exercises the amendments need to take into account the needs of users, opportunities for innovation and the ongoing demonstration of value for money and affordability.

7 In benchmarking the costs of PFI services for their particular projects authorities should be aware that if the project's investors are managing a number of similar projects or, if the facilities services providers are working on similar projects, the costs of the services being provided should reflect economies of scale which would not be available to other private sector parties without such a volume base.

8 Departments should bear in mind that the lessons in this PFI report, and the related Treasury guidance, relating to benchmarking and the recompetition of services through market testing may have relevance to testing the value of services in other long-term service delivery arrangements. These include conventional outsourcing, partnering and joint ventures, both during the life of these arrangements and on any subsequent recompetition of the service requirement.

PART ONE

Some early contracts had limited contract clauses and guidance but this is being addressed

This part of the report considers the expected effectiveness of the contractual clauses relating to benchmarking and market testing and the extent to which guidance has assisted project teams undertaking the process.

The first projects to value test services had limited guidance or help, but this has recently been addressed

1.1 Benchmarking and market testing (**Figure 4**) are the methods used in PFI contracts to value test the cost and quality of certain services being provided by PFI contractors in order to ensure that the authority is getting value for money (**Figure 5 overleaf**). Value testing normally first occurs between five and seven years into operation and gives both the public and private sectors the opportunity to renegotiate the prices of the services tested in line with market rates. It provides an opportunity for the public sector to benefit if costs are falling. Conversely, if costs are rising, it allows the private sector to limit its exposure to cost increases above the rate of general inflation for which the private sector normally receives an annual price increase under the terms of a PFI contract. When value testing takes place this is also an opportunity for the public sector to renegotiate the specification of the contract.

1.2 Benchmarking and market testing are primarily aimed at facilities management services such as catering and cleaning (**Figure 6 on page 11**) where there is no significant capital outlay in their performance. These services are often referred to as soft FM services (**Figure 7 on page 12**) and they constitute an important component of the whole life costs of the PFI project (Figure 1, page 5).

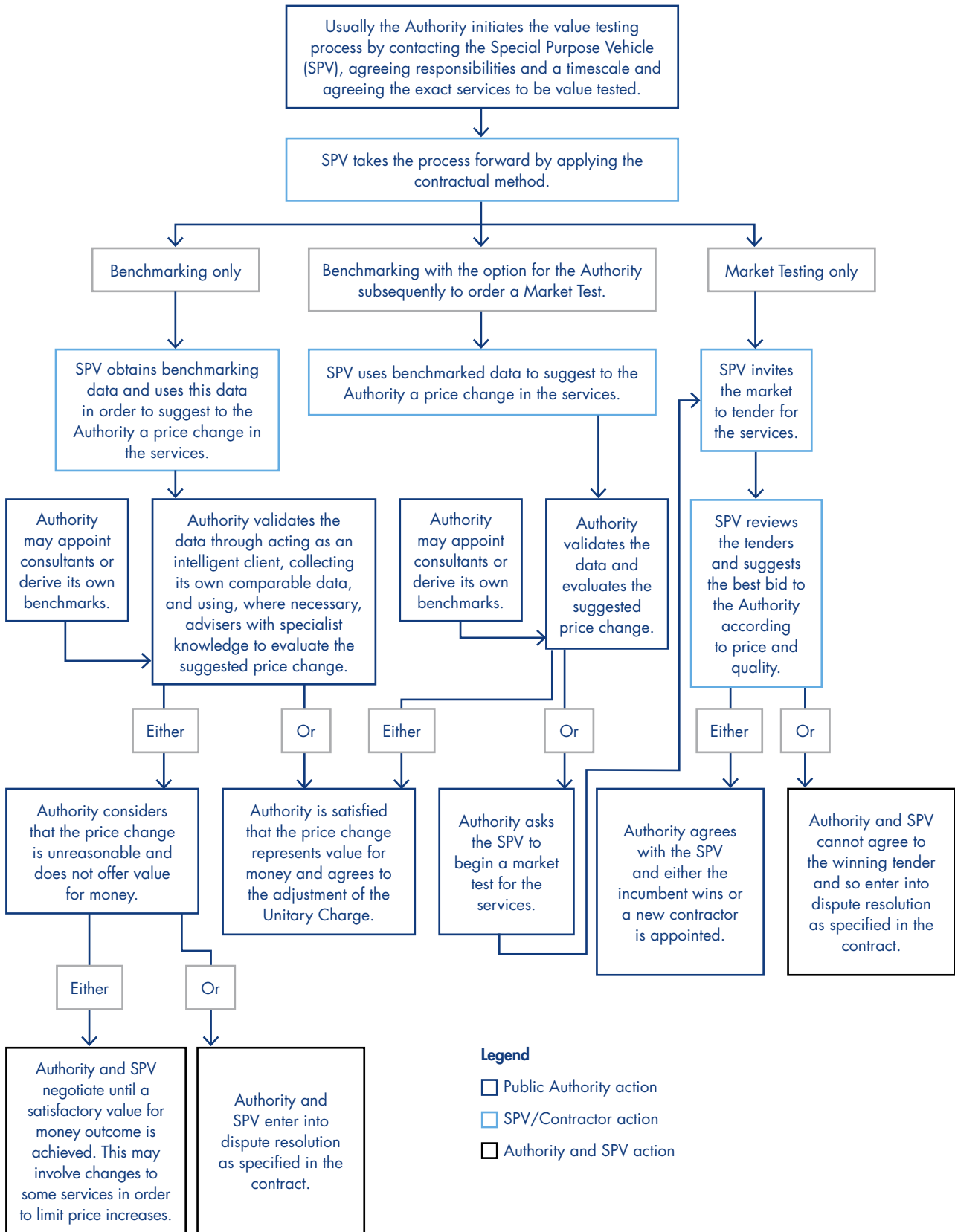
4 Treasury Definitions of Benchmarking and Market Testing

Benchmarking is the process by which the project company contractor compares either its own costs or the costs of its subcontractors against the market price of equivalent services. If the costs are higher than market prices, a reduction in the price charged to the public sector should be made on an agreed cost-sharing basis to reflect the differential. If costs are lower than market prices, the project company must justify any price increase.

Market Testing means the re-tendering by the project company of the relevant soft service so that the authority can test the value for money of that service in the market. Any increase or decrease in the cost of such a service following market testing should be reflected by an adjustment in the price charged to the authority.

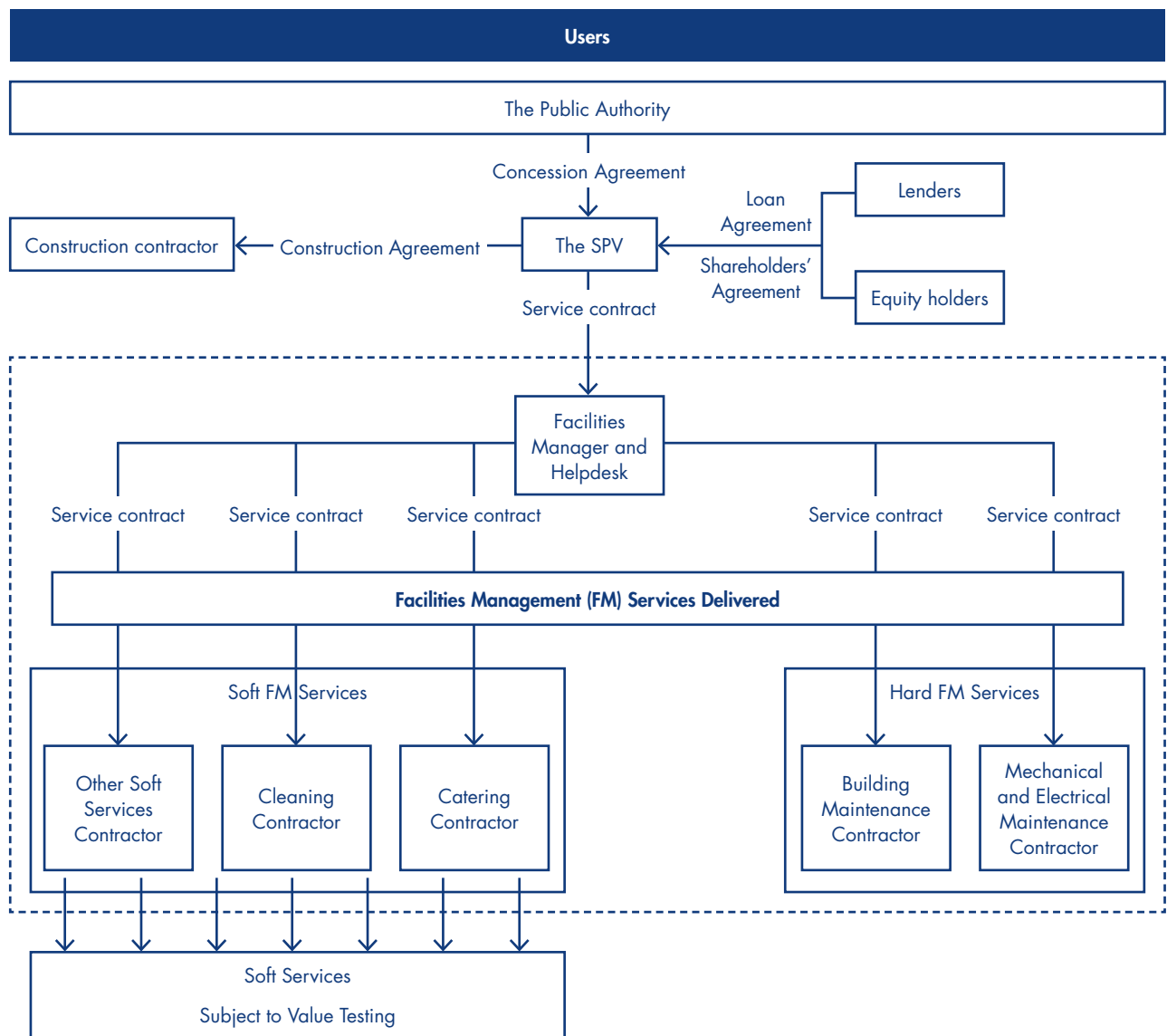
Source: Treasury

5 The Alternative Methods of the Value Testing Process



Source: National Audit Office

6 Typical organisational structure of a PFI project highlighting the soft FM component



Source: National Audit Office

1.3 Treasury guidance on benchmarking/market testing in PFI contracts first appeared in July 1999 in the Standardisation of PFI Contracts (SoPC) and has been revised and updated in subsequent versions of SoPC. These documents provide a commentary on the issues to be considered when drafting a PFI contract but they do not include required clauses so as not to be too prescriptive. This means that, especially in the early PFI deals let before 1999, contracts varied in the terms, if any, which they contained on how to proceed with a benchmarking or market test.

1.4 Recently the Treasury has published more authoritative guidance. It tasked PUK with researching the experiences of those early projects which had completed the process and it also took account of the initial findings of this NAO study. As a result, the Treasury introduced new guidance in October 2006, which supports project teams by providing more detail on the best process to be

adopted during a benchmarking/market test, reflecting many of the issues we deal with in this report. In addition, in July 2006, the Department of Health published a Code of Best Practice for benchmarking and market testing in conjunction with the private sector representative body, the PPP Forum.

To date there have been various types of contract clauses but in a sample we examined, they were often vague in what was required

1.5 We commissioned Nabarro as our legal consultants to examine the expected effectiveness of the benchmarking/market testing contract clauses for a sample of 34 PFI contracts, across departments, 13 of which were signed before the standardisation of contracts was introduced, and 21 of which were signed subsequently. The following analysis is based on a limited sample of PFI contracts and does not necessarily indicate what the outcome will be of using these terms. In the sample examined, Nabarro concluded that most of the benchmarking clauses and half of the market testing clauses were expected to have limited effectiveness (**Figure 8**). In these cases, where Nabarro's review of the contract clauses suggested that they were to have limited effectiveness, it may nevertheless be possible for the parties to carry out effective value testing if they develop suitable processes which may not have been set out in the contract.

7 Soft and Hard FM definitions

Soft facilities management (Soft FM) services are those services which are required for the operation of the building or facility. They include services such as cleaning, catering, porters, linen and laundry, security and reception.

Hard facilities management (Hard FM) services are those services responsible for the maintenance of the building or facility.

Source: National Audit Office

8 An assessment of the expected effectiveness of the benchmarking and market testing clauses in 34 PFI contracts both before and after Treasury introduced the Standardisation of PFI contracts in July 1999 (SoPC)¹

Type	Benchmarking Clauses			Total	Market Testing Clauses			Total
	Effective	Expected qualified effectiveness ²	Expected to be not effective		Effective	Expected qualified effectiveness ²	Expected to be not effective	
Before the 1999 first standardisation of contracts	1	6	6	13	5	2	6	13
After the 1999 first standardisation of contracts ³	4	5	12	21	12	7	2	21
Total	5	11	18	34	17	9	8	34

Source: Nabarro

NOTES

- Further information on the methodology for this analysis is set out in Appendix 2 including the rationale behind the selection of the 34 contracts.
- A clause was given 'qualified' status when it contained elements that could limit its effectiveness.
- There have been three further iterations of contract standardisation which have occurred since 1999 – SoPC 2, 3 and 4.

1.6 Figure 8 shows that in our sample, market testing provisions are generally expected to be more effective than benchmarking provisions and have improved since contract standardisation was introduced. The legal opinion by Narbarro indicates that benchmarking provisions show less improvement since standardisation and at least half of the contracts were judged to have ineffective benchmarking provisions which, unless addressed by project teams, will have a detrimental effect on the value testing process. Effectiveness of the clauses was limited in factors such as:

- no evidence of clear steps being given as to how to proceed with benchmarking;
- no clear identification of comparator groups for the benchmarking; and
- the public sector not having the right to audit the benchmarking data.

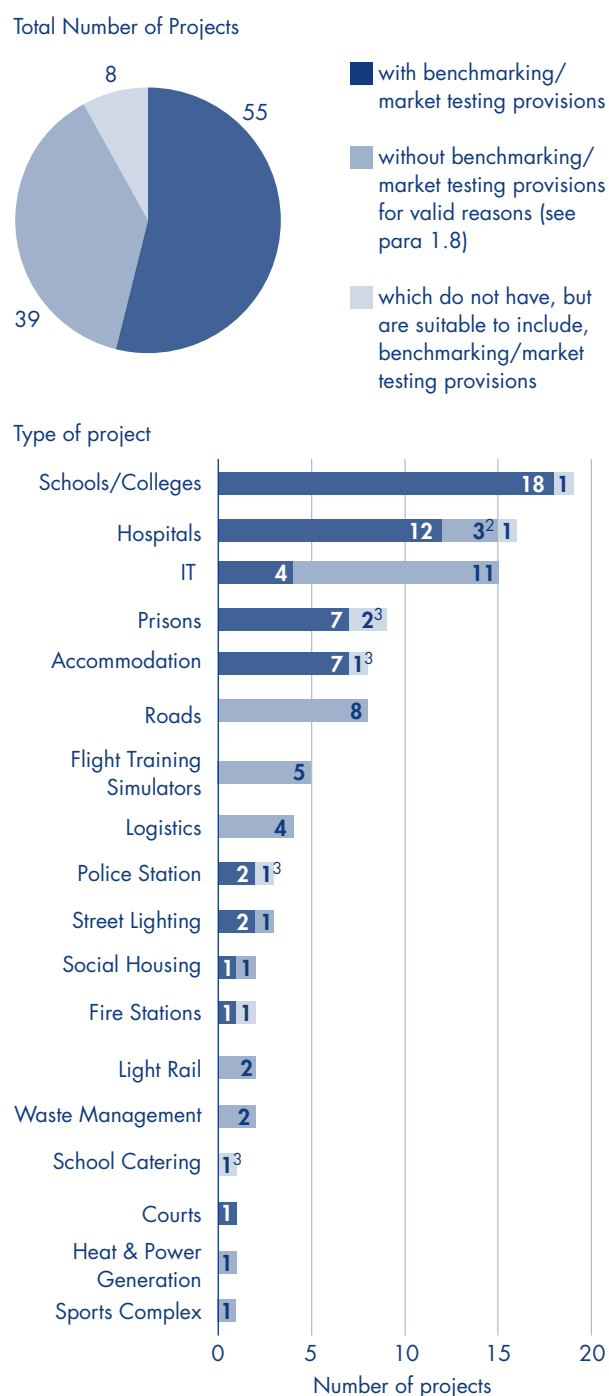
The Treasury has provided guidance on these issues in its 2006 document *Operational Taskforce Note 1: Benchmarking and Market Testing Guidance*. Our findings have highlighted, as recognised in the Treasury guidance, that authority teams on early PFI projects may need to engage early with the SPV in order to assess whether there are any weaknesses in the value testing clauses within their contract and to agree how best to make these clauses workable.

1.7 Projects we visited supported these findings by saying, for example, that although the contracts identified when the value testing was due to be completed, they were unclear on the process to achieve that outcome. We have shared our findings on individual contracts with the relevant authorities in order to help them deal with any weaknesses in their benchmarking provisions. The Treasury's new guidance will also help the authorities.

Some contracts do not have benchmarking/market testing arrangements, mainly for valid reasons, but we found examples where contracts would have been suitable for these arrangements

1.8 In addition to our review of the effectiveness of legal clauses for benchmarking and market testing, Partnerships UK (PUK) carried out separate research on PFI projects' value testing arrangements. In a sample of 102 PFI contracts now in operation, many of which were let before the standardisation of PFI contract terms were introduced, PUK found that in 47 cases (46 per cent of the sample) the contracts did not have benchmarking or market testing provisions but in 39 of these contracts there were valid reasons (**Figure 9**). For example:

9 A sample of 102 PFI projects carried out by Partnerships UK to assess those with and without Benchmarking/Market Testing provisions



Source: Partnerships UK

NOTES

1 The sample was drawn from operational PFI projects. Just over three-quarters of responses relate to projects that became operational between 1997 and 2000.

2 These three hospital projects reported that the contracts did not include soft FM.

3 These contracts were signed prior to the Treasury's introduction of standard contract terms in 1999.

- some PFI projects do not have a soft FM service component (e.g. waste and IT projects) so the need to value test such services does not arise;
- some PFI projects may have chosen to specifically exclude soft FM from the scope of the contract – as indeed was the case for three out of the four hospital deals identified in Figure 9. In such cases, the alternatives are either an in-house option or to let separate short term contracts for the soft FM services.

1.9 The remaining eight contracts were the type of project where benchmarking and market testing would have been appropriate. It was not part of the PUK research, or this examination, however, to consider other aspects of the projects' contractual arrangements and it is possible that these contracts included other arrangements to seek to maintain value for money from the service provision, for example through price caps or profit sharing. In addition, projects might agree separate non-contractual arrangements with contractors. For example, one of the eight PFI projects without benchmarking/market testing clauses where the projects appeared suitable for the Authority to value test the soft FM provision, Victoria Dock Primary School, had an alternative arrangement for the Authority to benefit from reductions in the costs of its service providers. The Head Teacher together with the contractor (Atkins) had agreed to an informal, non-contractual profit sharing scheme. Money saved by the contractor by, for example, having lower than expected maintenance costs, was shared with the school through the provision of additional services, such as new playground areas. While proper contractual arrangements are preferable, this example demonstrates that good partnering arrangements can improve the outcome for authorities where contracts do not include mechanisms for sharing in cost savings.

1.10 Five of the contracts, which were the type of project where benchmarking and market testing clauses would have been appropriate, were signed before the Treasury's 2006 guidance had been issued. The Treasury notes that, if there is agreement between both parties, its 2006 guidance could be followed to allow value testing by these projects which did not include value testing arrangements in the contracts.

PART TWO

The initial experiences of applying the processes have been mixed

This part of the report examines the first 11 PFI projects in England that have been through a benchmarking/market test. It shows that experiences have been mixed but in general, authorities and their private sector partners have worked together to overcome contractual weaknesses. Whilst price decreases have been secured in telecommunications projects, in the early PFI building projects, the resulting outcomes of the value test has initially mainly suggested the need for price increases. However, after negotiation, generally there has not been a great degree of price variation, although there have been some service changes to limit the price movement. Value for money has been achieved in some cases but was uncertain in others.

Because of contract vagueness in early deals, parties have had to develop new processes

2.1 We visited all 11 of the PFI projects that had undertaken a benchmarking/market test at the time of our study in summer 2006 (**Figure 10 overleaf**). During those visits we interviewed a total of 63 people (Appendix 1).

2.2 In general, authorities had engaged with their private sector partners to overcome the problems of ineffectual contract clauses and the then lack of guidance, to develop a plan to manage the process. For example:

- At Darent Valley Hospital both the contractor and the Authority commented on the vagueness or sparseness of the benchmarking clauses. As a result, they worked together to generate a process from first principles.
- At Norfolk and Norwich University Hospital, the Trust used the opportunity to work with the project company, Octagon, to develop those clauses in the contract which required clarification.

In Appendix 3 we show the practical application of the value testing process and the PFI structure for two projects: the Sussex Partnership NHS Trust and the Defence Fixed Telecommunications Service.

So far, experience is mixed

In the first examples of value testing the NAO assessed value for money as being achieved in five cases; in six cases value for money was uncertain

2.3 We reviewed the experience of the first eleven projects that had value tested. A summary of the key features of the results of our examination of these value tests is presented in **Figure 11 on page 18**.

Further information on factors which contributed to the NAO assessments of the extent to which value for money had been achieved in these early benchmarkings and market testings is set out in **Figure 16 on pages 28 to 31**.

The outcome of the initial benchmarkings varied with difficulties in finding comparable data

2.4 In the first eight early examples of benchmarking, two projects (the MOD's Defence Fixed Telecommunications Service and the Foreign and Commonwealth Office's Telecommunications Network) had achieved clear benefits by using benchmarking to secure price reductions in competitive markets where communications prices were falling. This was assisted by a good working relationship between the Authority and the private sector and input from specialist advisors.

10 Information on the projects we visited during our fieldwork in Summer 2006

Project name	Department	Project	Date of Financial Close	Capital Value £ million
Sussex Partnership NHS Trust	Health	Mental health facilities	24 June 1999	22
Darent Valley Hospital	Health	First major hospital contract to be let under PFI	30 July 1997	94
Norfolk and Norwich University Hospital	Health	Main site of the Norfolk & Norwich University Hospital NHS Trust	9 January 1998	229
Queen Elizabeth Hospital, Greenwich	Health	The redevelopment of a former Military hospital	8 July 1998	113
University Hospital of North Durham	Health	New district hospital for North Durham	31 March 1998	96
Debden Park High School	Education	A new secondary school in Loughton	28 March 2000	15
Defence Fixed Telecommunications Service (DFTS)	MOD	Telecoms service	1 July 1997	70
Foreign and Commonwealth Office Telecommunications Network (FTN)	Foreign & Commonwealth Office (FCO)	Provides voice data and messaging links for the Foreign Office worldwide	10 May 2000	74
National Savings and Investments	National Savings	Provision of services for the administration of retail financial savings and investment products (including Premium Bonds) to NS&I customers.	circa April 1999	N/A
Hereford and Worcester Magistrates' Court	Courts	New courthouses in Kidderminster, Hereford and Worcester. Refurbished courthouse in Redditch	29 March 2000	25
St John's House, Bootle	HMRC	Office accommodation	1 February 1997	12

Source: National Audit Office and Partnerships UK database

NOTES

- 1 This is a proxy figure from the annual cost of the contract multiplied by the years of the contract. This method of calculating the cost of the services for the whole contract life was agreed with the projects when they were unable to identify a figure from the financial model.
- 2 This sum is taken from the financial model as at December 2005 and shows the projected market tested service values as at December 2005. (These values do not include contract variations which have to be adjusted). The projected total is derived from the addition of the service fee costs across the requested period – August 2001 to August 2036 – to achieve a comparison for a typical 35 year contract.
- 3 The figure of £1.87 million is just for the soft services the hard services were due the following year.

Estimated lifetime value of services subject to value testing (cash prices in 2006 prices unless otherwise stated) £ million	Annual cost of services at time of benchmarking/market testing (2005-06) £ million	Operational length of the contract	Services benchmarked/market tested
27.8 ¹	0.9	30 years	Cleaning and catering
153.0 ¹	5.1	30 years	Catering, switchboard, laundry & linen, waste management, portering, portering other (transport/post), domestic, pest control, accommodation (e.g. homes for nurses, doctors)
428.0 ²	9.8	35 years (for soft FM services, 60 years for hard FM services with break options at 35, 40 & 50 years)	Domestic, catering, portering, laundry & linen, security, car parking, waste and grounds maintenance.
170.0 ¹	5.7	30 years (extendable to 45 years or 60 years)	Portering, catering, domestic window cleaning, pest control, security, car park, residential accommodation, help desk, switchboard
50.5 ¹	1.9 ³	27 years	Portering/courier service, catering service, domestic service, security/car parking, linen service, helpdesk service, telecom service, estates services
5.1 ¹	0.2	25 years	Cleaning, catering, ict support, caretaking and groundskeeping
1,505.0 ⁴	40.2 ⁵	15 years ⁶	Telecommunications
180.0	32.0	10 years	All services subject to benchmarking and market testing

The agreement with Siemens is a Public Private Partnership (PPP) currently in the 7th year of its 15 year term and NS&I estimate that savings to be realised by the agreement against the Public Sector Comparator amount to some £540 million. To acquire a true understanding of the cost savings arising from the agreement, a comparison would need to be undertaken between the actual investment Siemens has made to the business of providing the NS&I services, with the investment that NS&I would have had to provide in-house in order to deliver the same services, as well as quantify the risk and chances of success had the whole operation been undertaken in-house. Given the changes that have arisen since the start of the agreement, this comparison would be difficult to quantify.

20.0	0.8	25 years	Security, cleaning, portering, helpdesk, vending and catering telephone/switchboard and waste
20.0	0.8	25 years	Cleaning, waste management, grounds maintenance, vending etc

4 The total cost of the services over the life of the contract is £1,505 million. About 80% of the services are reviewed quarterly and if a service is judged not to be value for money then it can be subjected to the formal contractual benchmarking process. So far, one service has been contractually benchmarked: Restricted Local Area Network Interconnect (RLI).

5 The annual cost of the RLI service before benchmarking.

6 The original length of the contract was 10 years (1997-2007) but has been extended via a renegotiation from April 2005 to July 2012.

11 Key Features of the PFI projects that have value tested their services

Project Name	Type of services value tested	Value Testing Method	Supplier (after the market testing)	Annual Cost of Services (2005-06)	Final Agreed Price Change (excluding enhancements)	NAO assessment of whether vfm was likely to have been achieved through the value testing process (see Figure 16)
Sussex Partnership NHS Trust	Soft	Market Testing	In-house	£0.9m	+ 5.7%	Uncertain
Norfolk and Norwich University Hospital	Soft	Market Testing	Incumbent	£9.8m	- 2.2%	Yes
Queen Elizabeth Hospital, Greenwich	Soft	Market Testing	Incumbent	£5.7m	+ 6%	Uncertain
Darent Valley Hospital	Soft	Benchmarking	Not applicable ¹	£5.1m	- 2.4%	Yes
Debden Park High School	Soft	Benchmarking	Not applicable ¹	£0.2m	+ 14%	Uncertain
Hereford and Worcester Magistrates' Court	Soft	Benchmarking	Not applicable ¹	£0.8m	Not completed	Uncertain
St John's House, Bootle	Soft	Benchmarking	Not applicable ¹	£0.8m	0% (no change)	Yes
University Hospital of North Durham	Soft and Hard	Benchmarking	Not applicable ¹	£3.5m	+ 1.2%	Uncertain
Defence Fixed Telecommunications Service	Tele-communications	Benchmarking	Not applicable ¹	£40.2m	- 37.3%	Yes
Foreign and Commonwealth Office Telecommunications Network	Tele-communications	Benchmarking	Not applicable ¹	£32.0m	- 19%	Yes
National Savings and Investments	Financial	Benchmarking	Not applicable ¹	Difficult to quantify	Not yet quantified (Figure 15)	Uncertain

From the above 11 projects:

Service provider following market tests

Number of projects won by the incumbent	Number of projects won by in-house supplier	Number of projects won by new external suppliers	Total
2	1	Nil	3

Price changes for those projects that have market tested or benchmarked

Projects	Number of projects which had a price increase	Number of projects which had a price decrease	Number of projects where the price stayed the same	Unresolved	Not yet quantified	Total
Buildings	4	2	1	1	0	8
Financial/Communications	0	2	0	0	1	3
Total	4	4	1	1	1	11

Source: National Audit Office

NOTE

¹ There is no change of supplier in a benchmarking exercise.

2.5 In the other six projects, the effectiveness of the benchmarking was more varied. A key factor was that a number of project teams told us that comparable data for benchmarking soft FM services was sometimes difficult to find, and in some cases, data collected was of limited use. For example, the nature of the services provided will vary from project to project – cleaning will, for example, vary depending on the configuration of a hospital and the type of clinical services. There may also be regional variations in costs. For benchmarking to be successful therefore, comparable market data often needs to be adjusted to take account of the characteristics of the particular project. The Treasury, in liaison with departments, has started collecting information so that there will be a central source of data which can be used by projects.

2.6 A variety of information databases exist which contain benchmark costs although these will often include non-PFI data which is not directly comparable with PFI projects³. The Department of Health (DoH) is advanced compared with other sectors in providing a costs database, ERIC (Estates Returns Information Collection). However users of ERIC told us there are weaknesses within ERIC which can undermine the value of the data (**Figure 12**).

2.7 Based on our visits to the eight projects that had used benchmarking, although the projects had experienced these practical difficulties in applying benchmarking, the following factors in certain projects had contributed positively to the benchmarking process:

- A well structured PFI contract providing an effective means of price adjustment.
- The use of external FM consultants to collate appropriate data.
- The authority having a strong negotiating position enhanced by the option to instigate a market test if agreement cannot be reached.

The first market tests were competitive producing identified benefits

2.8 We also visited the three projects that had undertaken a market test: Norfolk and Norwich University Hospital, Sussex Partnership NHS Trust and Queen Elizabeth Hospital, Greenwich. All three projects had run competitive market tests from which they had identified benefits. It is not possible to draw wide ranging conclusions from just three market tests but these initial experiences provide early support to the Government's position that market testing offers the opportunity for increased competition and value

for money for the taxpayer. There were, however, certain issues which could affect the value for money of these three initial market tests:

- Sussex Partnership NHS Trust had decided to bring the soft FM services in-house at a cost of £981,000, saving £156,000 over the incumbent's tender, and £61,000 over the cheapest alternative. However the risks associated with taking the service in-house, such as, wage rate risk, redundancy cost and staff retention issues, had not been fully evaluated by the Authority and therefore it is difficult to make an overall assessment of the outcome in terms of value for money.
- Norfolk and Norwich University Hospital was in a position to limit the amount of the supplier's rising costs that could be passed on to the Trust following

12 Case Study: Department of Health ERIC (Estates Returns Information Collection)

Background

- The Department of Health (DoH) ERIC system is available only to public sector bodies e.g. NHS Trusts.
- ERIC is the most visible and potentially voluminous data source currently available to public sector departments.
- All NHS Trusts are required to submit ERIC returns.

Issues in using ERIC

- The DoH PFU observed that local 'benchmarking clubs'¹ would be a preferable way for the public sector to obtain comparable information. However, 'benchmarking club' information is currently not generally available for the collating and sharing of data.
- ERIC data often cannot be taken at face value and has to be readjusted to take into account variations such as regional price differences and service specifications.
- PFI projects are only a small proportion of the ERIC data set.
- DoH have no current plans to adapt the data collection process in order to provide more useful information for future PFI project benchmarking exercises. This would not be cost effective given the significant resources needed compared with the number of times PFI hospitals would need to access the database for benchmarking data.

Source: ARUP interview with DoH

NOTE

¹ Benchmarking clubs act as forums where members can share information and develop good practice. They may also carry out their own benchmarking of their members to obtain data to populate databases for their members to use.

³ Databases include the British Institute of Facilities Management, the International Property Database and Trade Organisations such as the British Institute of Cleaning Science. However, PFI projects have different contractual arrangements and standards to non-PFI projects. For example, service specifications may be set higher and payment risk regimes will reflect the fact that a service provider may face penalty deductions if the service does not meet the minimum standard.

a market testing because of a contract clause which caps any price increase. As a result the Trust achieved a one per cent reduction in the contract price after the market testing exercise. Whilst the price cap was useful to the Trust achieving a positive value for money outcome from their market test process and will limit the cost inflation risk arising from future market tests, it is difficult to judge the overall value for money of this arrangement as it is not known what, if any, additional price the Trust paid in the original PFI deal for the price cap.

- The outcome of the market test at the Queen Elizabeth Hospital, Greenwich, resulted in the incumbent winning based on a better quality bid that was marginally cheaper than the next best alternative. In this deal the incumbent had a 'right to match' clause whereby it was given the opportunity to match the best market test bid. The benefit of this type of arrangement is that authorities can secure the best price offered by bidders whilst retaining their existing supplier with whom they have established a relationship; but there are risks in that alternative contractors may lack an incentive to bid if their price can be matched. In this case however, three alternative suppliers had bid despite the contractual clause.

Of the three market tests, two were won by the incumbent and one taken in-house

2.9 In the three market tests to date, one resulted in the provision of service being taken back in-house (Sussex Partnership NHS Trust) and two have been won by the incumbent supplier (Norfolk and Norwich University Hospital, and Queen Elizabeth Hospital, Greenwich). New external suppliers bid but were not successful in these three initial market tests. In both cases where the incumbent won, the process was competitive with alternative suppliers putting in bids. For example, in the case of Norfolk and Norwich University Hospital, there were initially 16 expressions of interest by suppliers; after checks, this was reduced to six, and then to three for the final stages of the market test. Similarly, in the case of Queen Elizabeth Hospital, Greenwich, there were three alternative suppliers in the final stages of the market test. In both cases the alternative suppliers, having submitted bids, were unsuccessful in winning the competitions.

2.10 In any recompetition of a service contract the incumbent is often in a strong position to win, even if its tender is not the most competitively priced, for several reasons:

- The incumbent may have better knowledge and access to data to help with its bid.

- If the incumbent is also providing services relating to the infrastructure of the building (hard FM services) then its management costs are spread across a broad range of services, hence its bid price can be lower, and also its lines of communication with the authority are more straightforward.
- Assuming that the incumbent has built up good relationships with the authority, the authority may place high importance on those relationships and there is a perceived risk that a different contractor may not perform according to their tendered bid. As a result the authority may factor these risks into their assessment.

2.11 There is a possible risk to the competitiveness of future PFI market tests if, for any reason, bidders lose interest in competing. Some suppliers may conclude that there is little chance of any gain in competing against the incumbent if incumbents continue to win a very high proportion of these competitions and so may decide to save the time and cost of putting together a bid. However, in other outsourcing markets, where the costs of bidding are relatively low, companies may still be willing to bid, even where they perceive a low probability of beating an incumbent, in order to put competitive pressure on the incumbent to remove the opportunity for it to make excessive profit. In our view, for market testing to work most effectively there needs to be demonstrable examples of new suppliers winning these competitions in order to maximise the likelihood of strong competitions in future. To facilitate competition, the market test must be seen to be rigorous and equitable, with a transparent assessment procedure and detailed feedback to unsuccessful bidders. The Treasury is seeking to facilitate a market in benchmarking and market testing through publishing details of ongoing services that will be put out to competition. The Treasury intends to make this available on PUK's website.

Benchmarking/market tests surveyed have mainly taken about the same amount of time as recompeting conventional outsourcing contracts

2.12 Projects varied in their response as to how long the process had taken them. This was because in a number of projects there were various issues associated with the value testing process on which parties had a difference of opinion, but these were resolved through negotiation. These were related to, for example, the validity of the benchmarking information, the criteria used for assessing market bids from alternative suppliers and the apportionment of management overhead costs.

2.13 Based on the seven projects that had completed the value testing process for soft service provision, the benchmarked projects had taken between nine and 25 months and the market tested projects between 12 and 16 months. In the case of St John's House, Bootle, the benchmarking took 25 months as the public sector rejected the proposed 16 per cent increase in the price of services as this would have exceeded the cap on the services element portion of the quarterly Unitary Service Charge. One project, Hereford and Worcester Magistrates' Court, has yet to complete the benchmarking process it began in February 2004 because of difficulties in finding comparable data (Figure 13). However, there is little incentive for the private sector to push on with the process since the contract only allowed for a service price decrease at the time of the first benchmarking exercise.

2.14 Some of the projects examined told us, that in planning to carry out the value test, informal meetings between the authority and project company may take place at any time up to two years before the process was due to be completed. Projects commented that they had underestimated the amount of time that was needed to agree to benchmarked data, or to undertake a market test. This emphasises the need for all parties involved in the process to agree to a realistic project plan with clear timescales and responsibilities. These matters are now reflected in the Treasury's 2006 guidance.

2.15 Figure 14 compares the public sector experience of value testing the soft services within PFI contracts to that of the renewal of non PFI contracts. It shows that the PFI and non-PFI sectors are very similar in terms of the timing and duration of the process although one of the initial PFI benchmarkings is taking considerably longer to complete.

13 Time taken to complete the benchmarking or market testing process¹

Projects which have completed the benchmarking process	Time taken
University Hospital North Durham	9 months
Darent Valley Hospital	12 months
Debden Park High School	10 months
St John's House, Bootle	25 months
Projects yet to complete the benchmarking process	Time elapsed to end 2006-07 (March 2007)
Hereford and Worcester Magistrates' Court	37 months so far since Feb 2004
Projects which have completed the market testing process	Time taken
Norfolk and Norwich University Hospital ²	14 months
Queen Elizabeth Hospital, Greenwich ²	16 months
Sussex Partnership NHS Trust	12 months

Source: National Audit Office interviews with project teams

NOTES

1 The table sets out the building projects examined by the NAO and excludes the two communication projects (DFTS and FCO) and the financial services project (NS&I) whose timescales are not comparable.

2 Norfolk and Norwich University Hospital went straight to a market test whereas at Queen Elizabeth Hospital, Greenwich the decision to market test was taken four months after the value testing process had begun.

14 A comparison of the PFI and Non-PFI approach towards soft service contract renewal

	PFI	Non-PFI public sector
When does a change in soft FM supplier or price normally take place?	5–7 years	3–5 years
How long does it take to make the change?	Actual experience from nine months to over three years (Figure 13). Treasury guidance: from nine months up to two years.	6–24 months
What is the outcome of the process?	A benchmarked price through negotiation or a current competitive price and the possibility of a new supplier through a market test.	Competitive procurement or in some cases existing suppliers reappointed without a competition.

Source: National Audit Office and Business Services Association

Despite rising private sector costs there has not been a great degree of price variation, but this has required some changes to the service

2.16 Most PFI contracts allow an annual increase to the contract price to keep pace with retail inflation. Recently however, wage costs have risen above retail inflation due to, for example, increases in the national minimum wage. The average earnings index⁴ rose by 4.0 per cent during 2000-2005 compared with 2.5 per cent for the RPI.⁵ The introduction of minimum pay rates under the Department of Health's Agenda for Change, applicable from September 2005, will further affect wage costs in NHS service contracts. As shown in Figure 11, prices following value testing had increased in four of the seven building projects that had completed the process, with two other projects securing small price decreases. Although benchmarking and market testing had allowed the parties to determine a current market price for the services, this had usually been followed by a negotiation phase during which the public sector had, in some cases, reduced the scope of the services being provided to limit the scale of any price increase.

2.17 Based on information supplied to KPMG by the private sector⁶, most of the respondents reported that they were making profits on their services, 17 per cent were not and 38 per cent were not performing to operator expectations of profitability. This could suggest that some initial contracts for these services may have been priced too competitively at below normal market rates so that when costs increased, the contracts became unprofitable. In these circumstances it is still feasible that investors in the project (the SPV – Figure 6), can make positive returns on their investment if they have transferred the risk of rising costs to their subcontractors providing facilities services. If the contractor is also an investor, any losses as a contractor may be offset by their returns as an investor in the SPV.

2.18 The final price increases from these outcomes were mostly in the range -2 per cent to +6 per cent, although in the Debden Park School project there was a final price increase of 14 per cent. The final price increases were agreed following negotiations, initiated by the authorities, in response to higher price changes which were initially requested by the private sector.

2.19 The recent experience of rising facilities management costs above the annual increase in contract price for general inflation has brought increased pressure to bear on the private sector to, either make economies in the provision of these services, or to seek redress through price increases following benchmarking or market testing. The initial results of the seven value testing exercises of the soft FM projects we examined showed that, based on existing service levels and before taking account of Agenda for Change in the NHS, the private sector proposed price changes of between -1 per cent and +26 per cent with most seeking changes in the range -1 to +19 per cent (**Figure 15 on pages 24 to 27**). These proposed price changes were additional to the annual price changes for general inflation allowed by the PFI contracts.

2.20 This upward pressure on prices has influenced the authorities' approach to dealing with the results of the value testing process. In all the cases we examined, the public sector instigated some form of negotiation about the initial price change proposed, as is likely to be needed as part of the benchmarking or market testing process, which led to a reduction in the price increase that had been proposed. As part of these negotiations public sector teams saw benchmarking/market testing as an opportunity for the authority to consider what services were now required and at what level of specification. As a contract progresses, demand for services evolve, sometimes as a result of government policy (such as the initiative for cleaner hospitals) and sometimes in recognition that some services can be operated in a more efficient way. The authorities we examined considered these specification issues together with their wish to keep the contract price affordable following the value testing.

2.21 Figure 15 on pages 24 to 27 shows how the final price changed following these negotiations and how much the change was accountable for by changes in specification. This shows that, for the soft FM projects examined, the final price changes were lower than the private sector had initially proposed but there had been service specification changes to accommodate this. For the soft FM projects examined:

Final price changes ¹ were:	-2% to +14%	Mostly -2% to +6%
After negotiations from the initial price changes proposed:	-1% to +26%	Mostly -1% to +19%

Note 1: excluding service enhancements requested at the time of the value testing and the effect of Agenda for Change in the NHS.

⁴ Office of National Statistics: Average Earnings Index (seasonally adjusted).

⁵ Office of National Statistics: Retail Prices Index (all items).

⁶ KPMG review of PFI projects 'Effectiveness of operational contracts in PFI 2007'. Standard & Poor's PFI report 2006 also referred to losses being incurred on some PFI facility management contracts.

These projects were the first PFI building projects to use value testing processes and the price changes reflect cost changes in the market for facilities management services up to 2006. The resulting price changes are not, therefore, indicative of the price changes that may arise in future uses of value testing in PFI building projects.

2.22 In the final price changes, only Debden Park High School, at 14 per cent, fell outside the range -2 per cent to +6 per cent. In the case of Debden Park High School, the like-for-like price increase was primarily due to:

- an uplift to the catering price which was previously being run at a loss by the contractor; and
- a large increase in the price for grounds maintenance (which was assessed by the Local Authority against similar schools).

However, two service enhancements brought the final agreed price rise to 25 per cent:

- a need for catering to reach higher standards due to government initiatives regarding healthy eating; and
- the appointment of a new caretaker (as a result of a decision to improve the service performance).

2.23 The price changes set out above exclude the effect on the cost of services supplied to hospitals of the Agenda for Change⁷, which was still being discussed by the NHS Trusts we visited and their contractors at the time of our fieldwork and would have happened regardless of the value testing process. Subsequent to this, one NHS Trust, Queen Elizabeth Hospital, Greenwich, has adjusted its PFI contract price for the effect of Agenda for Change salary increases. The result has been to increase the price adjustment following its market test from +6 per cent to +37 per cent (attributable to £1.2 million for the Agenda for Change effects), although further price adjustments increased the final adjusted price change to 40 per cent. Other price changes in the health projects excluded the impact of further salary increases arising from the Agenda for Change, which has applied to the private sector since October 2005 but the handling of which was still being discussed by authorities at the time of our study.

2.24 Where authorities had reduced their service specification so that the contract remained affordable following the benchmarking or market testing, they considered that this had been effected by identifying efficiencies, which would not affect the service to the user of the facilities. The changes reflected aspects of the specification which they considered to be over specified or which could be delivered more efficiently. For example, following its benchmarking exercise, Darent Valley Hospital identified that office cleaning standards could be

achieved satisfactorily with a reduced cleaning regime and that it was not necessary to have two dedicated porters for operating theatres. Queen Elizabeth Hospital, Greenwich, informed us that some enhancements to the service which were being considered at the time of the market testing were not taken up in order to keep the cost affordable. Figure 15 overleaf provides some initial information on service performance following the value testing exercises but it is too early to judge with certainty whether the authorities' expectation, that service specification changes following benchmarking or market testing would not affect service delivery to the public, will be realised.

2.25 The prices that authorities pay for facilities services following benchmarking or market testing may also be different from those that had applied at contract letting due to changes in operational requirements since the contract was let. For example, at Darent Valley Hospital, reductions in FM service costs arose because the Trust had taken a separate decision, as part of its clinical strategy, to close a number of beds. This variation in service requirements occurred at the time of the benchmarking, but the Trust had been planning the change previously in conjunction with the local Primary Care Trusts in order to improve the efficiency and effectiveness within the hospital as part of a NHS-wide policy to increase efficiency. The Trust does not expect the bed reductions to affect patient care negatively as this will be balanced by improving day case rates and reducing the length of patient stay in line with current NHS practice.

2.26 The price changes that have arisen from these value testing exercises should not be viewed in isolation but are part of the overall cost of procuring facilities services to the standards specified in the PFI contracts over an extended period. The Treasury requires project teams to make a value for money decision on whether to include or exclude these services from the contract before embarking on a PFI procurement. We are not, however, aware of any systematic overall comparison to date between the cost and quality experiences of facilities services procured under the PFI with conventional outsourcing. There are difficulties in making these comparisons as the conventional examples may not be comparable to the PFI deals in terms of the required services or standard of performance. There is also limited experience to date of the price changes arising from using the value testing arrangements in PFI contracts. We consulted with our consultants Arup, the Institute of Facilities Management, the Business Services Association, the Office for National Statistics (ONS) and the Treasury and found that there is limited public data available on non-PFI procurement costs of these services. ONS has produced experimental data on the cost of catering and cleaning starting from 2000 but this data is not official ONS data due to its experimental classification.

7 Agenda for Change, see footnote 2, page 6.

15 Changes in prices following benchmarking/market testing (BM/MT)

Soft FM projects only		Change in price initially proposed to the Authority following BM/MT					Final negotiated change	
Project Name	Cost of soft FM services before the BM/MT (p.a.) £000s	For existing soft FM services £000s (A)	% change for existing soft FM services	Cost adjustment for +/(-) in services £000s (B)	Total Change £000s (A + B)	% change in soft FM price after incorporating service changes	For existing soft FM services £000s (C)	% change on existing services
Darent Valley Hospital ¹	5,106	219	4.3	0	219	4.3	219	4.3
Sussex Partnership NHS Trust	928	114	12.3	0	114	12.3	53	5.7
Norfolk and Norwich University Hospital	9,782	-129	-1.32	0	-129	-1.32	-212	-2.2
Queen Elizabeth Hospital, Greenwich	5,661	1,057	19	203	1,260	22	371	6 ³
	<i>5,661 (this line also incorporates Agenda for Change effects)</i>	3,146	56	203	3,349	59	2,086	37
Debden Park High School ⁴	166	43	26	21	64	38.5	24	14
Hereford & Worcester Magistrates' Court	818	27	3.3	0	27	3.3	←	
St. John's House, Bootle	783	126	16.1	0	126	16.1	0	0

in the soft FM price following BM/MT

Cost adjustment for increase/ (decrease) in services £000s (D)	Total Change £000s (C + D)	% change in soft FM price after incorporating service changes		Cost of soft FM services after the BM/MT £000s	Comment accounting for changes to the price proposed	Service Performance since the BM/MT
		(including enhancements)	(excluding enhancements) Figure 11			
-340	-121	-2.4	-2.4	4,985	Reductions in FM service costs arose because the Trust had taken a separate decision, as part of its clinical strategy, to close a number of beds ² , combined with a reduction in cleaning to non-patient areas and income negotiated from staff dining rooms.	Service performance post benchmarking maintained at the levels before benchmarking.
0	53	5.7	5.7	981	The increase in costs above the costs before benchmarking and market testing reflects external factors such as changes to minimum wage legislation. The reduction from the initial proposal reflects economies of scale from managing the service in-house.	Service performance is as planned.
0	-212	-2.2	-2.2	9,570	The laundry service moved to a new system where the Trust was charged for what items they used. Price reductions were based on usage volumes at the time of pricing and the PASA national framework contract for provision of laundry services.	Good - service development has been timely and mobilisation has been well managed and communicated. The process has demonstrated extensive liaison and consultation with the Trust by the service provider.
203	574	9.3 ³	6 ³	6,235	This is the change resulting from market testing the soft FM services at an operational level with additional services.	Improved monitoring scores from 80% to 86% Patient Environment Action Team (PEAT), which assesses the patient environment such as cleanliness and hospital food, also improved its assessment from "Acceptable" to "Good".
203	2,289	40	N/A	7,950	<i>This includes Agenda for Change and other adjustments including the removal of an initial SPV subsidy.</i>	
17	41	25	14	207	During the validation process of the benchmarking data, the Authority requested that the Contractor re-examine its use of comparators. This led to a reduction in the proposed price.	
Not completed →						
0	0	0	0	783		

15 Changes in prices following benchmarking/market testing *continued*

Soft and Hard FM, Telecommunications and Financial Projects	Change in price initially proposed to the Authority following BM/MT						Final negotiated change		
	Project Name	Cost of services before the BM/MT (p.a.) £000s	For existing services increase/ (decrease) £000s (A)	% change for existing services	Cost adjustment for +/- in services £000s (B)	Total Change £000s (A+ B)	% change in price after incorporating service changes	Increase/ (decrease) for existing services £000s (C)	% change on existing services
Defence Fixed Telecommunications Service	40,189	Once a service is judged not to be value for money, the Authority challenges the cost and suggests a new price following a review of comparator prices. BT have to respond, but are under no obligation to automatically change their prices. However, in the case where the value for money challenge was invoked, BT responded with a mutually agreed price adjustment.						-15,013	-37.3 ⁵
Foreign & Commonwealth Office Telecommunications Network (FTN)	32,000	-6,000	-19	0	-6,000	-19	-6,000	-19	
National Savings and Investments	Process benchmarking studies have been undertaken jointly with Siemens to deliver cost effective service improvements to NS&I's stakeholders and customers through the identification and implementation of best practice processes, rather than concentrating solely on a reduction in costs. Where operational efficiencies have been identified, these are considered for the benefit of both organisations. To date, the cost benefits from the findings of the benchmarking studies undertaken during 2005-06 on "Death Claims Process" and "Customer E-mail Correspondence Handling" have not been quantified as the benchmark studies are still in progress and are not expected to be finalised until the end of this year. Following the implementation of any recommendations arising from the benchmark studies, a further review would need to be undertaken at a later date to determine the operational, or other cost savings, resulting from these recommendations.								
University Hospital of North Durham	3,457	51	1.5	0	51	1.5	51	1.5	

Source: National Audit Office interviews of Project Teams

NOTES

- 1 Agenda for Change had not been incorporated into these figures for Darent Valley Hospital since the Authority was unsure at the time as to the exact impact.
- 2 This variation in service requirements occurred at the time of the benchmarking, but the Trust had been planning the change previously in conjunction with the local Primary Care Trusts in order to improve the efficiency and effectiveness within the hospital as part of a NHS-wide policy to increase efficiency. The Trust does not expect the bed reductions to affect patient care negatively as this will be balanced by improving day case rates and reducing the length of patient stay in line with current NHS practice.

in the soft FM price following BM/MT

Cost adjustment for increase/ (decrease) in services £000s (D)	Total increase/ (decrease) £000s (C + D)	% change in price after incorporating service changes		Cost of services after the BM/MT £000s	Comment, accounting for changes to the price proposed	Service performance since the BM/MT
		(including enhancements)	(excluding enhancements) Figure 11			
0	-15,013	-37.3	-37.3	25,176	The MoD also increased the minimum volume threshold in exchange for the cost reduction.	The Restricted Local Area Network Interconnect (RLI) service has been enhanced since the BM review.
0	-6,000	-19	-19	26,000	See note 6	Unchanged
-8	43	1.2	1.2	3,500	The service reduction of £8,000 was as a result of bringing part of the IT service in-house. Of the £51,000 overall price increase, hard FM decreased by 18% and soft FM services increased by 21%.	Good

3 These per cent figures were calculated on an adjusted base cost of £5,661,000 plus two adjustments including the removal of an initial SPV subsidy.

4 The cost adjustments for service enhancements were estimated from information provided by the department.

5 This figure includes 12 per cent additional benefit as a save to spend measure.

6 Additional non-cashable benefits of £6m to be delivered in the form of additional services to be supplied.

16 Issues affecting whether projects were likely to achieve value for money from the value testing process

Benchmarking	Darent Valley Hospital	University Hospital of North Durham	Defence Fixed Telecommunications Service	Debden Park High School
Did the PFI project have a comprehensive collection of data?	Yes Public sector adviser collected an extensive range of comparative data.	Uncertain The contractor provided anonymised data and the comparator data was based on a limited number of NHS Trusts.	Yes Comprehensive market data is collected on a three monthly rolling basis, but adjustments are needed to compare MOD data to non-military communications systems given the MOD's additional security requirements.	Uncertain There were some concerns expressed by the Authority that the contractor had not always used appropriate comparators. However, there was reluctance on the part of other authorities to provide benchmarking data since they saw this as confidential information.
Did the benchmarking process offer an effective means of price adjustment?	Yes The data collected was effectively analysed and used in negotiations with the private sector.	Uncertain There were data issues regarding regional variations and outliers which meant that the benchmarking process may not have been effective as possible.	Uncertain The benchmarking process was undertaken under a previous contractual arrangement, which although allowing annual price adjustments, was limited to two challenges a year on the seven service groups. This restriction has been removed in the renegotiated contract.	Yes An outcome was agreed and there was full visibility and dialogue between the parties.
Outcomes				
1. Price increase, decrease or stayed the same	1. There was a 2.4% reduction in the unitary charge for soft FM services.	1. A soft FM price increase was offset by a hard FM decrease to give a small net increase in price (1.48%).	1. There was a 37% decrease in the price of the benchmarked service.	1. There was a 14% price increase in the services. The price increase was largely accountable by an uplift to a service which was being run at a loss and an increase in grounds maintenance which was assessed by the Authority against similar schools.
2. Service performance since the value testing	2. According to the Authority there have been no adverse impact on patient services although some reduction in the service specification has occurred in areas which the Trust considered over specified or which could be delivered more efficiently.	2. Service performance has been good. A small service saving was made by bringing part of the IT service in-house.	2. The service has been improved since the benchmarking.	2. The School has expressed some concerns regarding cleaning standards. Service enhancements were also negotiated at the time of the benchmarking.

National Audit Office Value for Money assessment – see pages 30-31

St John's House, Bootle	Sussex Partnership NHS Trust	Foreign and Commonwealth Office Telecommunications Network	National Savings and Investments	Hereford and Worcester Magistrates' Courts
Uncertain	Uncertain	Uncertain	Yes	Uncertain
It was difficult to get agreed comparative data.	It was difficult to find other Mental Health PFI units as a comparator.	There was limited data available to act as a comparator due to the specialism of the services and the required flexibility demanded by the Foreign and Commonwealth Office (FCO).	However the speciality of the services involved makes it difficult to compare. In addition, benchmarking is on efficiencies rather than pure cost data.	The scale and scope of the data collected is not clear.
Yes	No	Uncertain	Yes	Uncertain
Although the benchmarking exercise took 25 months to resolve, the price increases suggested by the contractor were not accepted.	The parties had to resort to market testing.	FCO considered market testing at one point but they believed the contractor remained the best value credible supplier. However they consider that there are now a number of credible potential suppliers.	The internal benchmark studies undertaken jointly between NS&I and its partner, Siemens, are effective as they are part of an annual planning cycle that targets those areas to be benchmarked with emphasis on the delivery of benefits for both parties in terms of improved efficiencies and better services to customers.	There is only a downward price adjustment allowed on the first benchmarking which may have had a detrimental effect on the benchmarking process since the incumbent is not incentivised to engage fully with the process.
1. There was no change in the price of the services.	See market testing overleaf.	1. The Unitary Charge has consistently gone down in line with market trends.	The benchmarking process is still in progress (Figure 10 and 15).	The benchmarking process is still in progress (Paragraph 2.13).
2. There were no changes to the services.	See market testing overleaf.	2. Service performance has been unchanged.		

16 Issues affecting whether projects were likely to achieve value for money from the value testing process *continued*

Benchmarking	Darent Valley Hospital	University Hospital of North Durham	Defence Fixed Telecommunications Service	Debden Park High School
<p>National Audit Office Value for Money assessment</p> <p>Is it likely that value for money had been achieved through the benchmarking?</p>	<p>Yes</p> <p>There was a reduction in the unitary charge for soft FM services but according to the Authority no adverse impact on patient services.</p>	<p>Uncertain</p> <p>Lessons learnt from this first process have been incorporated into the second process which has commenced. This is designed to ensure better value for money in the outcome.</p>	<p>Yes</p> <p>The result was a price reduction with an enhanced service.</p> <p>The use of advisers who review service prices on a quarterly basis has given MOD added assurance that services are being scrutinised rigorously.</p>	<p>Uncertain</p> <p>The value test resulted in a 25% price increase. The school has expressed some concerns regarding cleaning standards.</p> <p>There was a significant price increase and a possible reduction in service standards</p>
<p>Market Testing</p> <p>Did the project attract sufficient market interest?</p> <p>Did the market testing process offer an effective means of price adjustment?</p> <p>Outcomes</p> <p>1. Price increase, decrease or stayed the same</p> <p>2. Service performance since the value testing</p> <p>National Audit Office Value for Money assessment</p> <p>Was value for money likely to have been achieved through the market testing?</p>	<p>Norfolk and Norwich University Hospital</p> <p>Yes</p> <p>There were 16 expressions of interest which reduced to six with a final reduction to three in the process.</p> <p>Yes</p> <p>An outcome was achieved.</p> <p>1. There was a 2.17% reduction in the unitary charge for soft FM services.</p> <p>2. Service performance has been good.</p> <p>Yes</p> <p>The result was a price reduction with no detrimental change in the level of service performance.</p>			

Source: Project reviews conducted by the National Audit Office and ARUP

NOTE

We considered the value for money of the completed value tests by reference to the resulting changes to the price and service specification, and the effectiveness of the value testing. Uncertainty was due to various factors including whether the best price had been secured where there had been price increases, weaknesses in the comparator data and authorities identifying that they would make changes to their value testing processes in future to achieve better outcomes.

St John's House, Bootle	Sussex Partnership NHS Trust	Foreign and Commonwealth Office Telecommunications Network	National Savings and Investments	Hereford and Worcester Magistrates' Courts
Yes The Authority successfully opposed a 16% price increase.	See market testing.	Yes The result was a price reduction with no change in service performance.	Uncertain	Uncertain

Queen Elizabeth Hospital, Greenwich**Yes**

Three alternative suppliers bid.

Yes

An outcome was achieved.

1. There was a price increase of 6%, the highest of the hospital projects examined. The Authority believes that this may have been greater under a benchmarking process.

2. Service performance has improved.

Service enhancements were also negotiated at the time of the benchmarking.

Uncertain

There was a price increase higher than the other hospitals examined.

Sussex Partnership NHS Trust**Yes**

Although initially two bidders withdrew from the process two new suppliers bid in the final stage of the process.

Uncertain

The Authority decided to bring the services in-house.

1. There was a price increase of 5.7%

2. Service performance is as planned.

Uncertain

The Authority decided to bring the services in-house as the revised cost of the services was lower than that obtained through benchmarking. However, this meant that the Authority would hold the risk associated with the delivery of the service. This risk was not formally calculated since the Authority considered that the difference in the risk was at worst neutral and at best in the Trust's favour. The Authority also considered that the risk of completing the market testing process was that the Trust could then be committed to an unacceptable price increase.

Advisors have been useful, and to date, their fees have been modest

2.27 Several projects had made use of advisers to assist them with the benchmarking/market testing. Most had been appointed for a modest fee (ranging from a total of £7,000 to £30,000), and had secured between them the following benefits:

- Commercial expertise.
- Legal expertise.
- Access to better quality data.
- A reduction in time required for data collection and analysis.
- A facilitator of the process.

For example, at Darent Valley Hospital, the advisers acted as a spokesperson for the Trust and had access to data sources which played an important part in the benchmarking. However, it is important that authorities should develop their role as an intelligent customer in this process (para 3.1), and before appointing advisers, evaluate the skills needed and whether these are available in-house.

It is unclear what effect benchmarking/market testing arrangements have had on the pricing of the original deals

2.28 The inclusion of value testing provisions in contracts should make the initial contract price lower since the private sector is less exposed to the risk of bearing cost increases

in the operational phase of the contract. However, we do not know what effect including benchmarking and market testing has had on the pricing of the original deals. There is no available data on how the contracts would have been priced without such arrangements although the expectation is that the contract prices would have increased as the private sector would have been exposed to not being able to recover from the public sector cost increases above the rate of general inflation. In addition, we noted in **Figure 17**, some early PFI deals where it was not clear whether some individual contract terms had affected the pricing of the deals.

Certain PFI investors and contractors have the ability to generate cost reductions through economies of scale

2.29 If the investors in the project are managing a number of projects, the investors may be able to reduce their projects' costs through economies of scale in their management of the service delivery across all their projects. Similarly, certain facilities management contractors provide similar services to a number of PFI projects and should be able to generate economies of scale. For the public sector to share in the benefits of these economies of scale there needs to be strong competition both in the letting of PFI contracts and in subsequent market testings of ongoing services. It remains to be seen what effect, if any, the growth in investors and contractors building up portfolios of interests in PFI projects has on these competitions and the resulting value for money of the service provision.

17 Contractual clauses which favour an authority or contractor in a benchmark/market test

Project	Contract Issue	What this meant in practice	Cost of including this clause in the contract
Norfolk and Norwich University Hospital	Service caps that limit the price rise for each service (para 2.8).	The caps limited the financial risk to the Authority and put the emphasis of the market test on a comparison of quality between the suppliers.	Unknown – the issue of service caps was never identified as a separate cost by the bidders.
Queen Elizabeth Hospital, Greenwich	'Right to Match' whereby the incumbent has the right to match the preferred supplier of the market test (para 2.8).	The incumbent won the market test, but there was concern expressed by the Trust that this clause could have a negative effect on competition in the future. At least one potential supplier decided not to enter into the market test because of the 'right to match' clause.	Unknown.
Hereford and Worcester Magistrates' Court	Only a downward price adjustment is allowed on the first benchmarking (para 2.13).	The benchmarking has over-run as the 'downwards only' clause may have been a disincentive to the contractor to complete the process.	Unknown.

Source: National Audit Office interviews of Project Teams

PART THREE

Authorities have identified lessons to improve the process and there is new Treasury guidance

This part of the report examines the lessons identified to date by the authorities who have undertaken a benchmarking/market test. It also considers how good practice has been incorporated into the recent Treasury guidance (October 2006).

Projects which have undertaken benchmarking/market testing have learned lessons for the future

3.1 We asked the 11 projects which have been through a value testing process to identify the lessons they had learned (Figure 18). The two most consistently mentioned lessons learnt by the projects were:

- identifying early on in the process whether good comparable benchmarking information exists, which can assist the authority in making an early decision on whether to benchmark (if there is good information) or to move quickly to a market test (assuming the option is given in the contract); and
- the need for authorities to realistically resource the value testing process both in terms of staff and staff hours.

It was also important that they act in the capacity of an intelligent client, that is, knowledgeable on the process being undertaken and with the negotiation skills to seek a value for money outcome, while being able to challenge their private sector partners where necessary. Furthermore, some projects promoted the appropriate use of external resources in the form of advisers in order to help the authority to better manage the process.

3.2 Projects considered it beneficial to agree to the scope and terms of reference of the benchmarking early on in the process. The Authority at the University Hospital of North Durham suggested having a benchmarking service statement, agreed to by all parties, which detailed the services currently being delivered and those which were to be included in the benchmarking process. Other projects had a similar service statement but also included a list of extra services that were costed separately and could be included in the final contract if the Authority considered them affordable.

18 The most frequently occurring responses when projects were asked to identify the lessons they had learnt that would enable them to improve the value testing process in the future

Lesson learnt	Number of projects
Availability of good comparable benchmarking information	7
A need for the Authority to realistically resource the value testing process	7
Early agreement of the scope and terms of reference of the process	6
Authority to act as an intelligent client	6
Agreement by all parties to a realistic timeframe	5
Appropriate use of external resources such as advisers	4

Source: National Audit Office interviews of Project Teams

3.3 Projects said that it was important to agree a realistic timeframe for the process. For example, Norfolk and Norwich University Hospital told us that the contract suggested the process begin no later than six months before the planned completion date. However, the Trust and project company agreed that this was unrealistic and so both parties agreed to allow 14 months for the process. Treasury guidance (October 2006) suggests a framework of 12 to 24 months⁸, but there may be the potential to reduce this by projects adopting a disciplined project management approach to value testing, with all parties adhering to their agreed responsibilities.

3.4 There was a genuine attempt by projects to learn from their experiences and to plan changes in the way they would undertake future benchmarking/market tests. For example, the University Hospital of North Durham has already begun its second value testing exercise and has incorporated lessons learnt into the new process, such as: having a larger Trust team committed to the process, agreeing a benchmarking service statement, and, extending to two months the time they have to consider their response to the benchmark report provided by the project company.

The Treasury has developed new guidance which takes account of the early experiences of using benchmarking and market testing

3.5 The Treasury issued new guidance in October 2006. This takes into account research which it commissioned from PUK during the spring/summer 2006 into the early experiences of projects that had benchmarked or market tested. We have also shared our findings from this study with the Treasury and were consulted by the Treasury as it developed its guidance. The Treasury also took account of work by the Department of Health who, in conjunction with the PPP Forum, produced a code of practice entitled 'benchmarking and market testing in NHS PFI projects' in June 2006.

3.6 Although the detailed Treasury guidance was not available to the 11 PFI projects we examined, it offers advice on the issues we uncovered in our study and will provide support to the increasing number of PFI projects about to undertake the value testing process. The value of services which will be subject to value testing is expected to grow significantly in the next few years. The annual value of the services tested in the building projects examined by the NAO which had value tested by 2006 was £27 million.⁹ The value of services being value tested will grow substantially over the next five years. Of the 500 PFI projects in the operational phase at least half have value testing provisions in their contracts.

The Treasury considers that there are advantages from market testing but benchmarking may be appropriate in certain cases

3.7 The ability of market testing to deliver its potential benefits depends on effective competition between alternative suppliers. Research by Arup has identified that there is a sufficient population of providers to form a competitive market for soft FM services and that despite consolidation, there are at least 20 substantial FM contractors. In addition, there are also sufficient small to medium sized enterprises offering a breadth of services at the local level. As set out in para 2.11, the success of market testing depends on there continuing to be strong competition when this process is used.

3.8 Based on our review of projects which have undertaken benchmarking or market testing, the arguments for and against each approach are presented in **Figure 19**.

⁸ The National Audit Office data in Figure 13 showed timescales for completed projects ranged from nine to 25 months, although this excluded one project that had not completed the process. As noted in paragraph 2.14 some projects hold informal meetings up to two years before the completion of benchmarking/market testing.

⁹ Derived from individual project data in Figure 15, page 24.

3.9 Up until 2006, the Treasury had favoured benchmarking as the preferred price review mechanism because of the potential disruptions and practical difficulties which market testing may cause. The Treasury's new guidance considers that market testing is likely to yield better value for money than benchmarking based on a view that market testing offers a more flexible approach to the provision of services, emphasises the importance of transparency and competition, and can now benefit from the maturity of the soft services market.

3.10 There are advantages to an authority in having both a benchmarking and market test option in the contract since it can then choose the best process for their particular circumstances. Benchmarking is an alternative to market testing if there is not the prospect of strong competition between suppliers. It can also be completed to a quicker timescale (Figure 13) and be cheaper than a market test (Figure 19). In those situations where an authority chooses, on expected value for money grounds, to start with a benchmarking exercise the incumbent supplier may be more likely to engage positively where there is the fallback of being asked to compete in a market test.

19 The advantages and disadvantages of benchmarking compared with market testing

	Benchmarking	Market Testing
Advantages	<p>Cheaper and quicker to implement.</p> <p>Maintains the spirit of partnering through negotiation with the incumbent.</p> <p>Stability in provider is a catalyst for process improvement.</p> <p>Avoids potential problems with the handover to a new service provider.</p> <p>Avoids further TUPE transfers.</p>	<p>Competitive process.</p> <p>More transparent process.</p> <p>Flexibility for reassessing the service provision and also performance measurement system since they can be drawn up anew without recourse to variation discussions.</p> <p>Can mean the start of new relationships and new ideas if someone other than the incumbent wins.</p> <p>May reduce the cost if a new service provider has a cost effective innovation to offer.</p>
Disadvantages	<p>Comparable data may not be available or be expensive to access.</p> <p>Expectations gap between the authority and the private sector over the cost of services may make agreement on the outcome difficult to achieve.</p> <p>Difficulties in finding suitable benchmarking data make it less credible as a transparent and accountable process and therefore harder to justify the value for money outcome.</p> <p>Audit trail not always clear. Private sector may limit benchmarking information due to commercial confidentiality.</p> <p>Potential for disagreement/dispute to drag on.</p> <p>Can strain current relationships.</p> <p>No opportunity to replace an unsatisfactory incumbent.</p>	<p>Lengthy preparatory time and usually a more costly process.</p> <p>The incumbent may be in a powerful position to win the market test and so the process may not be as competitive as initially thought.</p> <p>Lines of communication can become complicated when the replaced incumbent had provided both hard and soft FM.</p> <p>Requires a sufficient number of alternative suppliers to make it a competitive market.</p> <p>Tendered price may be non-negotiable.</p> <p>Process improvement opportunities can be lost.</p> <p>There is uncertainty for the incumbent's staff and possibly TUPE issues.</p>

Source: National Audit Office, ARUP and Norfolk and Norwich University Hospital

3.11 There is an option as part of a market test to consider taking the soft FM service in-house, which means removing it from the PFI contract and having implications for the risks being borne by the authority. Sussex Partnership NHS Trust decided on this option having been through a market test in which four competitive tenders were received – the incumbent’s being the highest priced (**Figure 20**). The Authority at Queen Elizabeth Hospital, Greenwich found that the Special Purpose Vehicle (SPV) was less keen to consider an in-house bid. The SPV perceived added risks such as the liability of the Trust to any damage that may arise to the building from authority staff such as cleaners and catering staff, and doubts regarding how the performance measurement system would work to incentivise an in-house supplier of services.

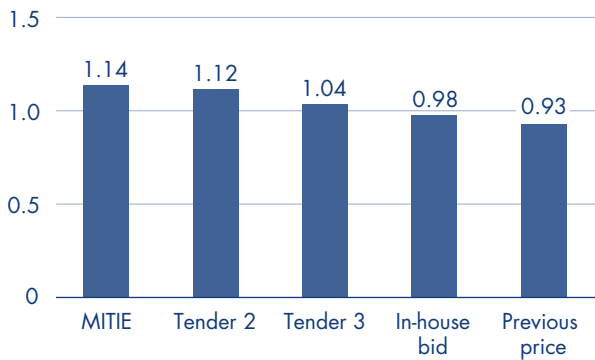
3.12 In our discussions with the Sussex Partnership NHS Trust, they were strongly of the opinion that taking the services in-house was the best alternative given affordability issues. The main contractor, Dalkia, was looking to increase the price since it was paying more to the subcontractor (MITIE) than they were receiving for the services through the PFI contract price. There had also been some service performance issues at the hospital sites. The in-house option offered the lowest price (Figure 20) which was only a slight increase over the existing price. However, the Authority had undertaken little analysis on the impact of transferring risk back in-house such as redundancy liabilities, staff retention, training issues and future wage inflation. In our opinion it was uncertain whether the chosen option provided the best value for money outcome.

20 Sussex Partnership NHS Trust Market Testing Results

Six FM Contractors including the incumbent (Tender 1: MITIE) were approached to tender for the Sussex Partnership NHS Trust. Two tenders subsequently withdrew.

The in-house bid was £156,000 less than the MITIE bid and £61,000 less than the cheapest alternative (Tender 3).

Submission Value (£m p.a.)



Source: Sussex Partnership NHS Trust

APPENDIX ONE

Study scope and methodology

Study scope

The objective of the study was to consider whether, based on early experiences, benchmarking/market testing is likely to contribute to the value for money of PFI projects. At the time of our fieldwork, only 11 PFI projects had undertaken the value testing process. Therefore, although we were able to comment on the value for money outcome in each case, and highlight lessons drawn from these first practical experiences, we did not have enough evidence to make a confident prediction of how the arrangements will work in the future. During our study, the Treasury released new guidance which we have referred to throughout the report. This new guidance will affect how value testing is used in the future.

An issue analysis approach was adopted to define the scope of the study. Initial background research was undertaken and meetings held with public sector stakeholders such as the Treasury (which has responsibility for PFI policy), Partnerships UK (PUK) and the Department of Health. From this it became clear that since standardisation was introduced in 1999, those PFI contracts written prior to standardisation were likely to have bespoke value testing clauses. We therefore decided that part of this study would investigate the

quality of the contractual provisions for value testing within PFI contracts both before and after standardisation. To facilitate this, we employed legal consultants as they had the necessary skills to assess contract clauses (see overleaf). We visited all 11 PFI projects that had undertaken a value testing process, undertaking interviews and file reviews in order to consider whether the projects had achieved value for money from the process. To complement this work we employed management consultants (see overleaf) in order to access their knowledge and expertise in the soft service market. Finally we decided it would be of value to get the perspective of the projects with regards to what they had learnt from the process. As a result, a series of high-level audit questions were set:

- Are the mechanics for effective benchmarking and market testing in place?
- Has the benchmarking/market testing process been successfully applied?
- Have lessons been learnt so far to improve the benchmarking/market testing process?

A study methodology was then designed to answer these questions.

Study methodology

Project interviews and visits

We identified 11 projects that had completed the benchmarking/market testing process from a range of sources: market knowledge from the Treasury and PUK (taking account of PUK's project database and their 2006 survey which incorporated some questions on value testing), market knowledge from the private sector and knowledge from within the National Audit Office arising from surveys recently undertaken by NAO PFI studies. We visited each of the 11 projects and in conjunction with a contact at each project, we set out to arrange an interview with:

- an operations/facilities manager who represented the public sector on the day to day management of the services that were value tested;
- a finance manager who reviewed the costs and prices that the private contractor generated as a result of the value testing exercise;
- a facilities executive who had an oversight role in relation to the value testing;
- a locally based manager working for the SPV, ideally with involvement in the value testing exercise;
- someone with user experience of the services provided both before and after the value testing; and,
- a brief courtesy meeting with the public sector Chief Executive.

It was not always possible to arrange for all of these interviews given staff availability but by the end of our fieldwork visits we had interviewed 63 people in total: Authority (39) (including chief executives, finance officers, contract managers and users), project company/contractor (19) and advisers (5). The interviews were semi-structured, using a standard template that was adapted to suit the interviewee and project context. We complemented these 63 fieldwork interviews with further interviews conducted with key private sector stakeholders: several contractors and project companies, the Business Services Association

(representing the interests of major companies providing outsourced services) and the PPP Forum (a private sector industry body representing PFI funders and contractors). We also discussed key developments in guidance and policy regarding benchmarking/market testing with Department Private Finance Units, the Treasury and its PFI Operational Taskforce at PUK.

Consultancy work

We used external consultants for two strands of work as part of the study. Our evaluation used in selecting the external consultants included full consideration of potential conflicts of interest.

Examination of contract clauses, carried out by Nabarro

We appointed, following a competition, Nabarro as legal consultants to use their PFI experience to review a sample of PFI contracts with provisions for benchmarking/market testing. They were asked to examine whether the provisions contain clauses which could be expected to test value for money. Nabarro's public sector team advises over 200 public sector clients and 100 local authorities. Appendix 2 has further information about their examination.

Consideration of the wider issues associated with benchmarking and market testing, carried out by Arup

We appointed Arup to carry out a programme of work which had been advertised to the eight professional firms which have been appointed as strategic partners to the National Audit Office. Their brief was to consider a series of issues we raised such as, whether sufficient comparable cost data is available to make benchmarking an effective means of value testing and whether markets exist for soft services to enable market testing to be an effective means of value testing. As well as expertise in property Arup has a wide range of experience relating to benchmarking/market testing working with Sony, the TUC and Toyota as well as experience with PFI soft services working as the banks' technical adviser for a number of PFI Hospitals and schools.

APPENDIX TWO

Contract clause analysis

We identified a number of criteria to test the expected effectiveness of the benchmarking and market testing provisions within PFI contracts:

- whether the contract clearly and unequivocally sets out the responsibilities of the public and private sector in relation to the operation of the benchmarking and market testing provisions;
- whether the services that are subject to benchmarking and market testing are clearly defined;
- whether the contract clearly provides guidance on how the process of benchmarking and market testing should be followed;
- whether the contract contains appropriate timescales for the processes of benchmarking and market testing to be started and completed;
- whether the contract clearly sets out the rights of the public sector to audit the data provided by the private sector to substantiate any benchmarking and market testing;
- whether the contract has a clearly defined dispute resolution process should the parties not agree the outcome of the benchmarking and market testing exercises; and,
- if there was the opportunity in the contract to bring services back in-house, whether the process of including an in-house bid in the market test was clearly defined.

This piece of work examined a separate sample of 34 PFI contracts. This sample was then subdivided into 13 projects that had benchmarking/market testing provisions in their contracts before the introduction in 1999 of The Treasury's Standardisation of PFI Contract Terms (SoPC) and 21 thereafter. These projects were selected mainly

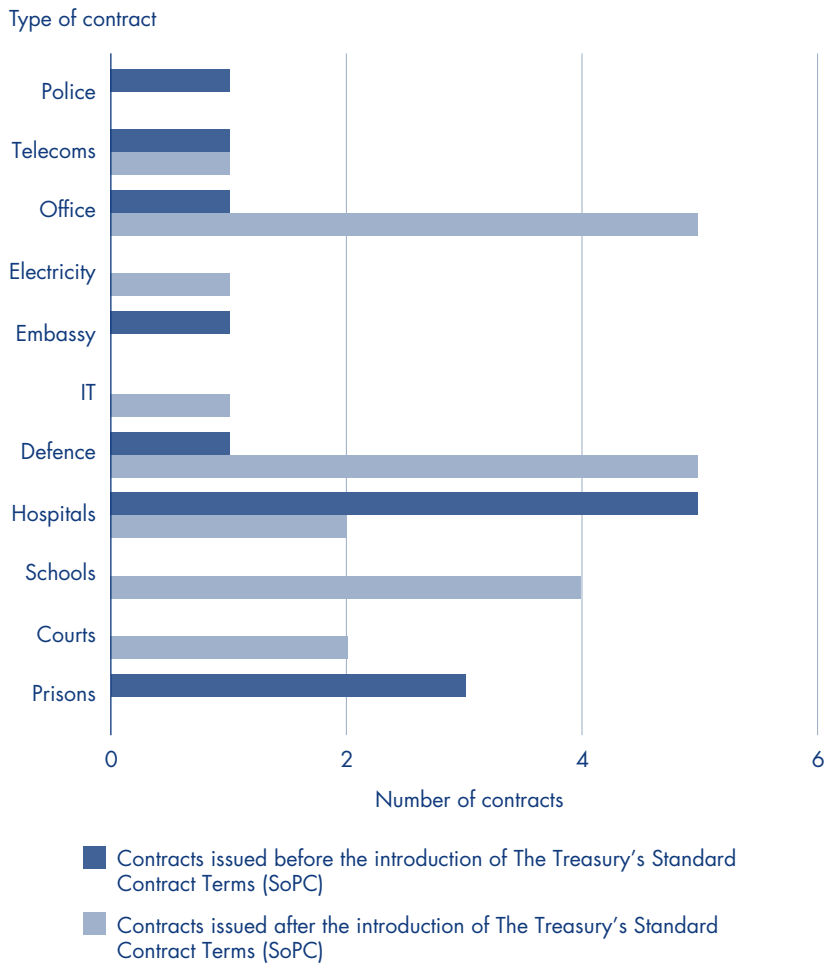
from the major users of PFI: Health, MOD, Transport and Education, although some were chosen from other government departments (see Figure 21 overleaf). The objective of this sampling was to illustrate whether there were any noticeable differences between the quality of the contract clauses in those projects for benchmarking and market testing signed before and after the introduction of standardisation. Information to assist in the selection of the contracts had been gathered from PUK, department Private Finance Units and previous work of the NAO. In addition a contract was examined containing the most recent Treasury standard contract terms (SoPC3) on benchmarking and market testing.

Nabarro assessed each PFI contract against these criteria. A clause was acknowledged as effective when it met the criteria clearly and unequivocally. Where a clause met the criteria but contained elements that could limit its effectiveness, then the clause was given 'qualified' status. Where a clause failed because it did not contain provisions relating to the criteria or the provisions did not meet the criteria, clearly and unequivocally, the clause was judged to be not effective.

The analysis represents Nabarro's legal opinion regarding the effectiveness of the benchmarking/market testing clauses and is based on a limited sample of PFI contracts. It does not necessarily indicate what the outcome will be using these terms since where Nabarro's review of the contract clauses suggested that they were to have limited effectiveness, it may nevertheless be possible for the parties to carry out effective value testing if they develop suitable processes which may not have been set out in the contract.

While the results in Figure 8 could be set out according to departmental groupings, the sample size is too small to make robust conclusions regarding the effectiveness of contract clauses by department.

21 An analysis of the 34 contracts



Source: National Audit Office

APPENDIX THREE

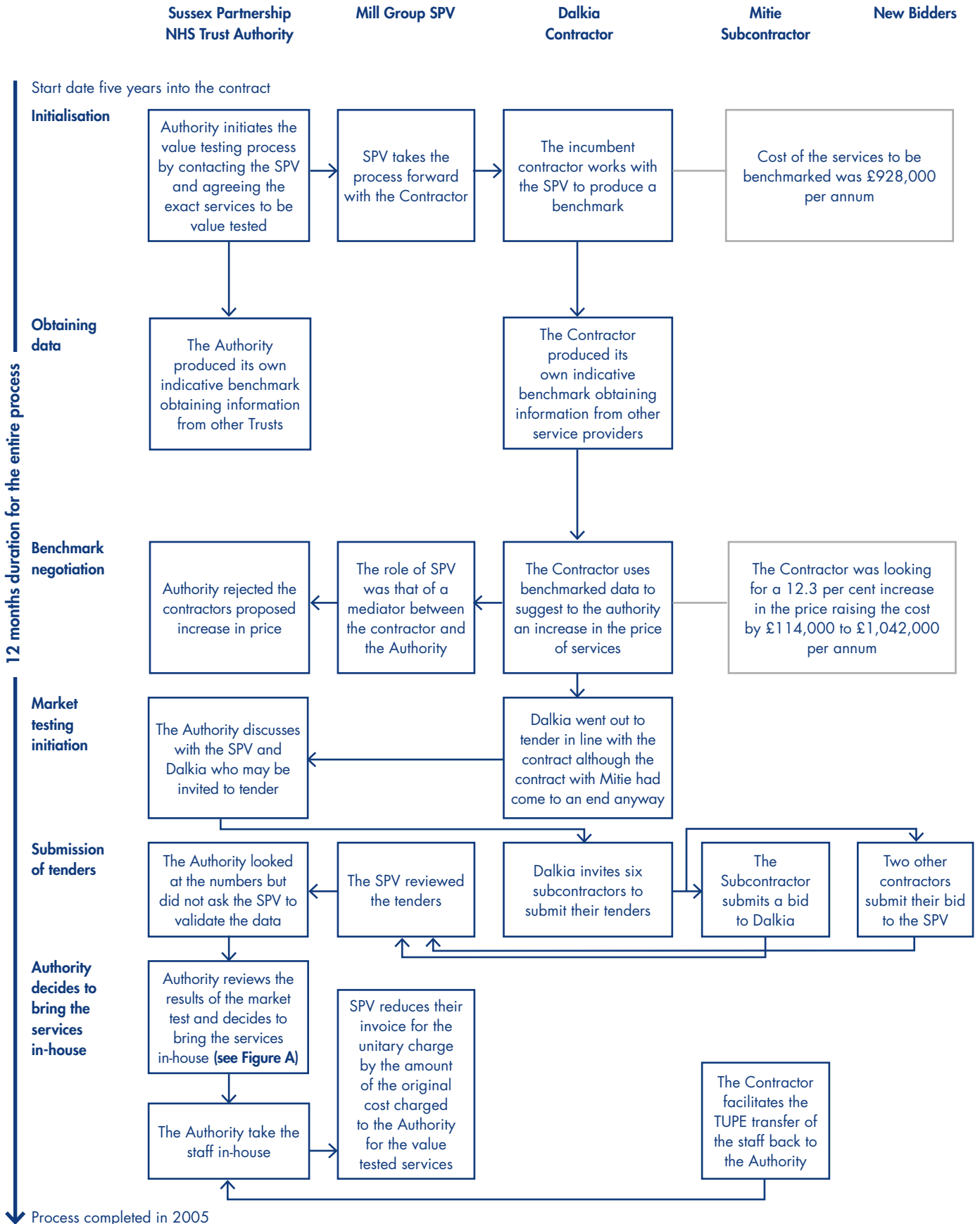
Case study examples – the Sussex Partnership NHS Trust and the Defence Fixed Telecommunications Service

Figure 6 in the report shows a typical organisational structure of a PFI project and Figure 5 in the report demonstrates the alternative contractual options of the value testing process. In practice there will be variances from these two standards. The structures of a PFI deal will vary depending on the funding of the SPV, the method of delivery and the type of services being delivered. The method of value testing will also vary as it will be dependent on the terms in the contract and how the parties decide to progress the process, this will include the responsibilities of each of the parties.

Variances from these standards were evidenced during the course of our fieldwork from our discussions with the project teams. Two particular examples show how the process can vary from the standard and also highlight the complexity of value testing. The first case study is the Sussex Partnership NHS Trust where services were benchmarked, market tested and finally brought in-house by the Trust. The second example is the Defence Fixed Telecommunications Service contract. This case study example involves the benchmarking of non-traditional soft FM services in the form of telecommunications services. In the case of the Defence Fixed Telecommunications Service the contract mechanism uses a 'Business and Economic Review' as the method for the Authority to challenge the prices of its contractor. This challenge was based on the evidence of a benchmarking report carried out by external advisers.

Both of the case studies are explored in more detail in **Figures 22 and 23 on pages 42 to 45.**

22 Sussex Partnership NHS Trust Value Testing Process



Source: National Audit Office

Issues arising/comments

Comparison to other experiences of Market Testing and Benchmarking

The contract was unclear as to how the benchmark should be carried out.

Other projects reviewed as part of the study had similar experiences with regard to the clarity of contract clauses.

In other instances the SPV rather than the contractor managed the benchmarking process.

There were difficulties in obtaining comparable data.

Other projects had similar difficulties of finding appropriate benchmarking data. In many instances use was made of external advisers to assist the public sector in determining appropriate comparators.

The contractors were looking for an increase in the price since they were paying more to the subcontractor than they were receiving through the unitary charge.

Dalkia went out to tender (the contract provided that if there was a dispute in the benchmarking procedure market testing was to be used).

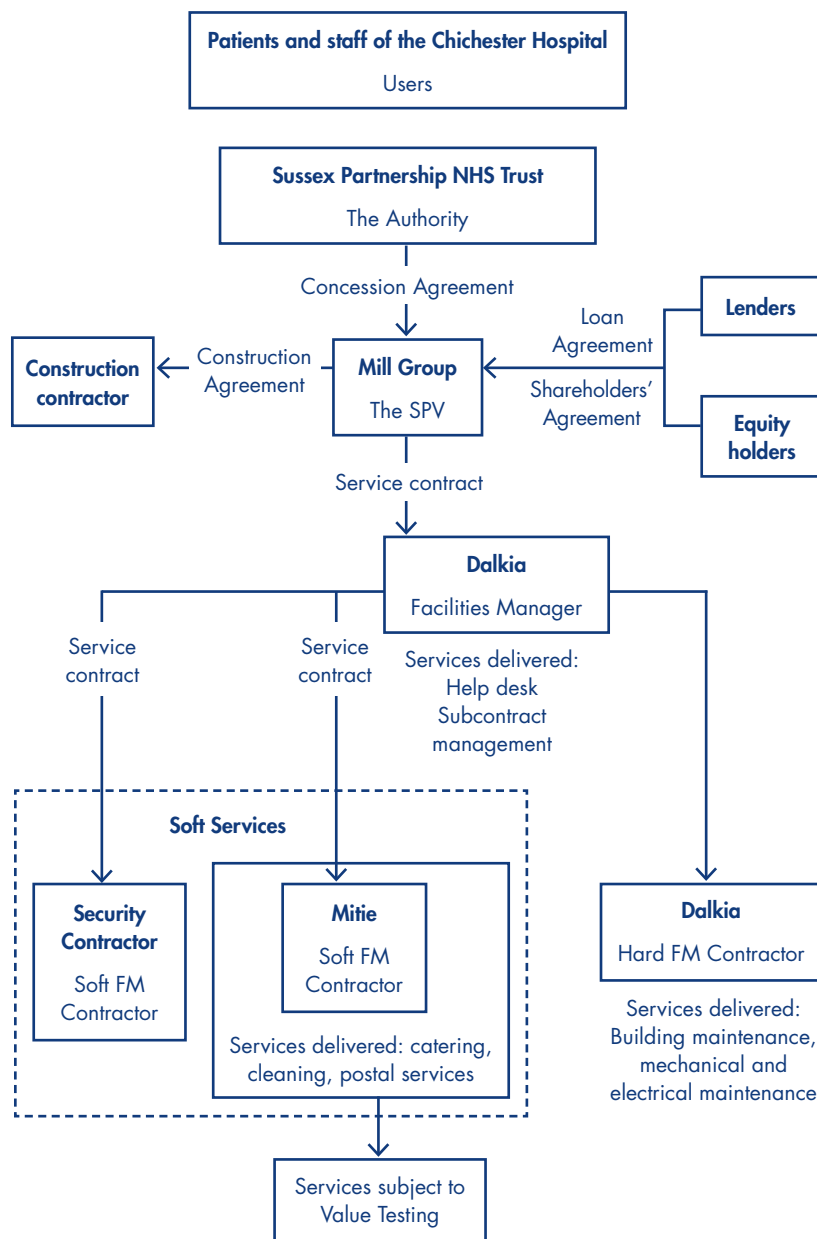
The tenders received were unaffordable, but the tender data was not validated or challenged.

The decision is based on the Authority's own calculation of the costs of delivering the service as they believe they can provide the service cheaper using less labour hours.

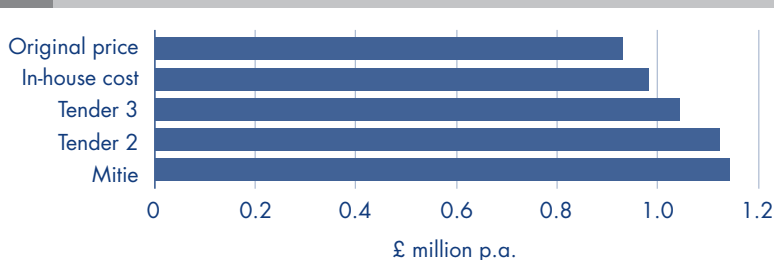
In some cases the in-house team put in a formal tender as part of the market testing process; in other cases the SPV would not allow an in-house bid to be considered.

The Authority bear the risks and responsibilities of the employees brought back in-house; these include issues such as wage rate risk, staff training, potential redundancy cost and staff retention issues.

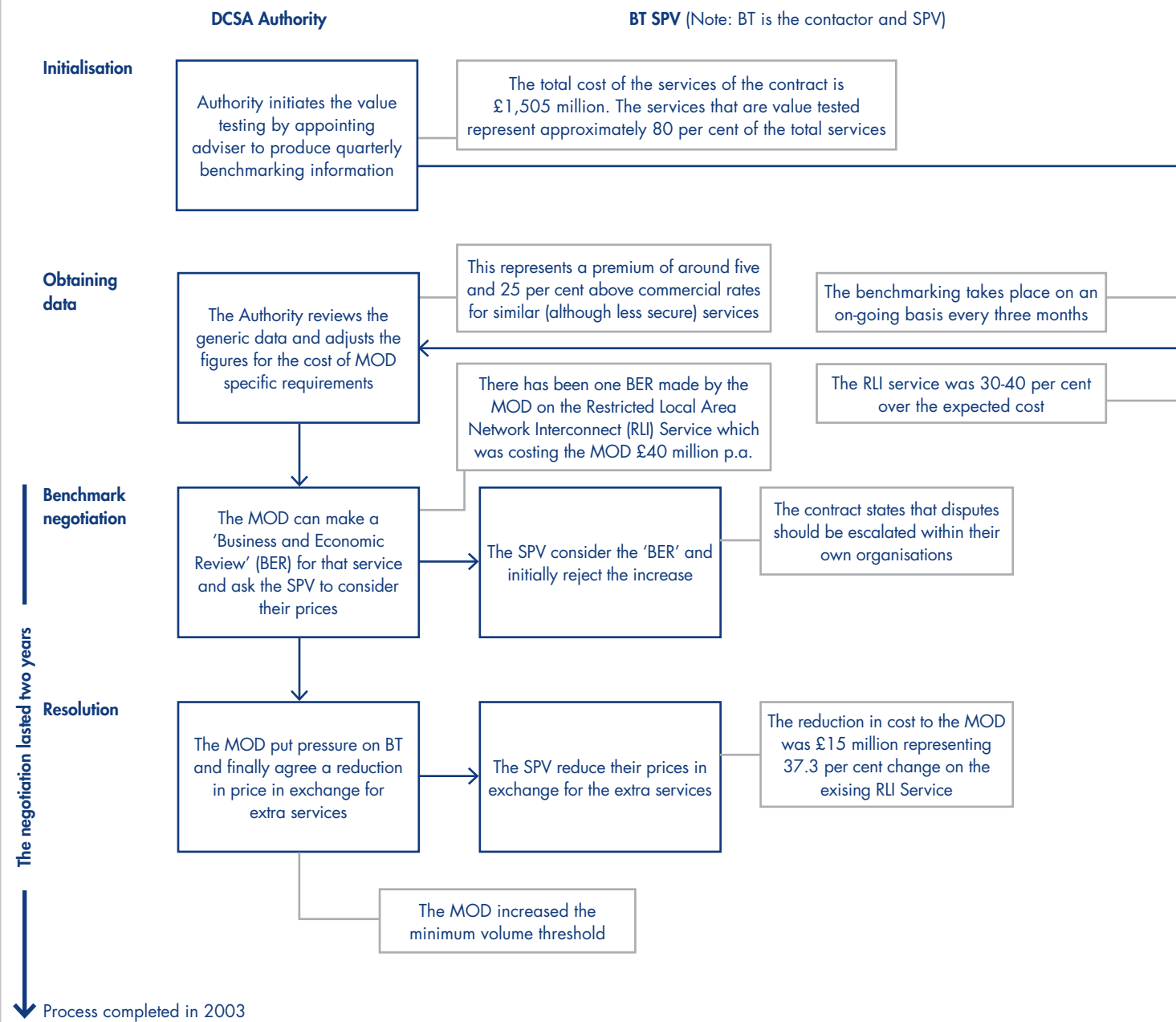
Sussex Partnership NHS Trust PFI structure



A Comparison of the cost of bringing the service in-house and the tenders received



23 Defence Fixed Telecommunications Service Value Testing Process



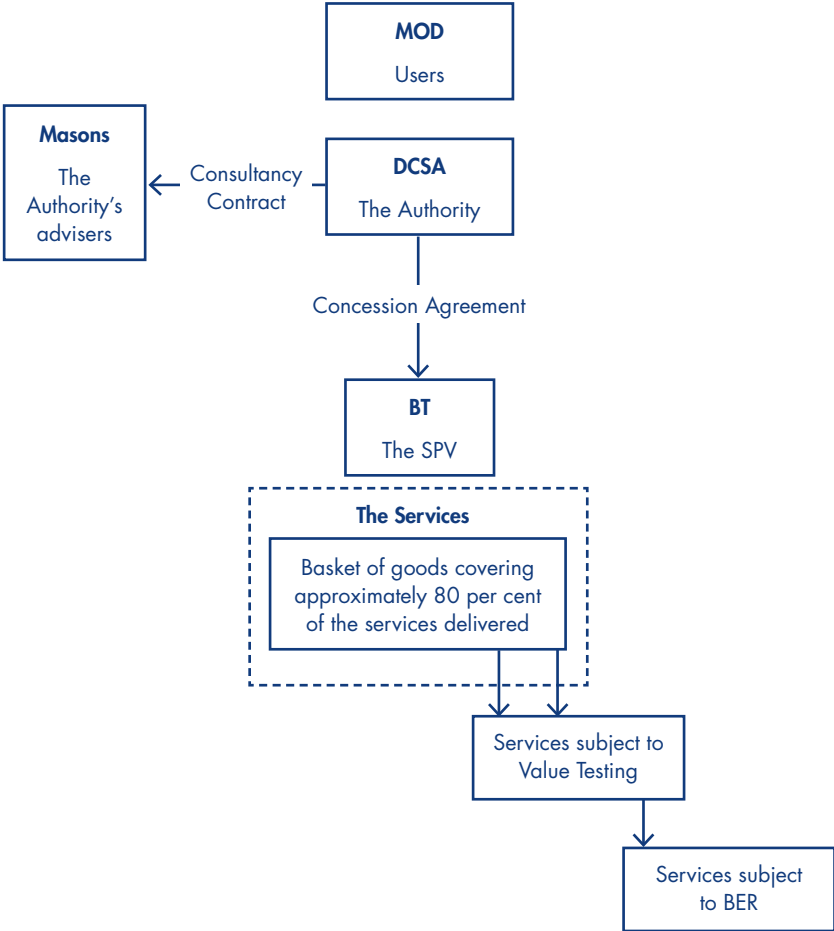
Source: National Audit Office

Advisers

Advisers identify appropriate commercial organisations to benchmark MOD services against

Advisers obtain generic benchmarking data and prepare their report identifying key variances to MOD cost

Defence Fixed Telecommunications Service PFI Structure



GLOSSARY

Agenda for Change	The new NHS grading and pay system for all NHS staff (with the exception of doctors, dentists and some managers). It harmonises staff pay scales and career progression arrangements across traditionally separate pay groups by evaluating their jobs against national job profiles. This also impacts on outsourced staff.
Authority	A public sector body which lets a PFI contract. This may be a government department or an agency of a department.
Benchmarking	The process by which the PFI contractor compares either its own costs or the costs of its subcontractors providing services against the market cost of such services.
BCIS	Building Cost Information Service.
DCSA	Defence Communication Services Agency (DCSA) is responsible for the delivery of Information and Communication Services across the Ministry of Defence.
Dispute Resolution Process	A process described in the contract through which disputes can be referred to a third party or some other form of tribunal ultimately leading to a resolution.
DFTS	Defence Fixed Telecommunications Service.
DoH	Department of Health.
ERIC	Estates Returns Information Collection – the DoH database of cost data.
FCO	Foreign and Commonwealth Office.
FTN	Foreign and Commonwealth Office Telecommunications Network.
Hard FM	Facilities management services such as building refits or life-cycle maintenance.
HMRC	Her Majesty's Revenue & Customs.
Market Testing	The retendering by the PFI contractor of the relevant soft service to test the value for money of that service in the market.
NS&I	National Savings and Investments.
ONS	Office for National Statistics.
PCT	Primary Care Trust.

Private Finance Initiative (PFI)	A policy introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services, while reducing the impact of public borrowing.
Private Finance Unit (PFU)	Each major department has a unit set aside to provide advice and assistance to PFI project teams, to act as a central PFI project information resource, and develop departmental PFI policy and guidance.
PUK	Partnerships UK. A joint venture between the public and private sectors working solely for the public sector to promote high quality public services and the efficient use of public assets.
RPI	Retail Prices Index.
Special Purpose Vehicle (SPV)	The project company who is party to the contract with the Authority and who normally is responsible for managing the benchmarking and market testing process.
SoPC	Standardisation of PFI Contracts. Introduced by the Treasury in 1999 (since updated) to allow for a consistent approach to be taken across departments entering into a PFI contract.
Soft FM	Facilities management services with a high labour content delivered to building occupants e.g. cleaning, catering, portering and security.
TUPE	Staff who transfer between different employers (such as to winning contractors of a market test) have certain rights safeguarded according to The Transfer of Undertakings (Protection of Employment) Regulations 1981.
UHND	University Hospital of North Durham.
Unitary Charge (UC)	The payment from the Authority to the consortium in respect of the provision and operation of the asset. This includes the provision of soft services and hence the Unitary Charge may well change following the benchmarking or market testing of the services.
Value for Money (VFM)	The achievement of the optimum combination of whole life cost and quality to meet the user's requirements.
Value Testing	This is the process used to test the cost and quality of services being provided in a PFI contract. The means by which this process can be achieved includes benchmarking and market testing.