Infrastructure procurement: delivering long-term value

March 2008

HM TREASURY

HM TREASURY

Infrastructure procurement: delivering long-term value

March 2008

HM Treasury contacts

This document can be found in full on our website at:

hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861
E-mail: public.enquiries@hm-treasury.gov.uk

Printed on at least 75% recycled paper.
When you have finished with it please recycle it again.

ISBN 978-1-84532- 426-1

PU486

Contents

THE INFRASTRUCTURE CHALLENGE

The next steps to secure long-term value for money

The 2007 Comprehensive Spending Review set out how the Government is progressing its ambition to create world-class public services that can respond to people's rising aspirations while equipping the UK for global change. It set out a new strategy for transforming public services over the decade ahead based on driving forward the next stage of reform and increasing investment while embedding value for money across government. Budget 2008 updates the analysis of the strategic challenges facing the economy, highlighting the importance of infrastructure in delivering not only public services that meet people's needs and expectations, but also economic prosperity and growth.

To build on this strategy, this document sets out the next steps the Government is taking to secure value for money in its procurement of significant assets, infrastructure and long-term service provision. In doing so, it recognises the continually evolving needs of the public sector, and also the changing approaches to complex procurement that have been developed over the past 15 years, and that will continue to develop, in many cases building on experience of the Private Finance Initiative (PFI). It outlines a framework for infrastructure procurement that is designed to drive value for money across the full range of procurement approaches and ensure the effective scrutiny of key projects, while continuing to improve public sector procurement and commercial skills. Through this, the Government intends to build on the techniques and processes learnt in PFI and apply them across a wider procurement spectrum.

The document:

- analyses in broad terms the changing investment needs and challenges for the Government;
- sets out a range of approaches that have developed to address complex procurement issues;
- outlines the role of private finance and the important contribution it can make;
- illustrates the key principles and drivers of value for money that public sector procurers need to use to evaluate a broad range of procurement approaches; and
- sets out how the Government is developing a more risk-based, systematic approach to the scrutiny of major projects, while providing support to them and further enhancing the skills of the public sector.

This document outlines the Government's approach both in order to assist public sector procurers and to act as a basis for further dialogue between the public and private sector on how the Government can best meet its investment needs and help drive value for money solutions in complex procurement. The policy proposals have direct effect only in England, as policy is devolved in Scotland, Wales and Northern Ireland.

1.1 The Government has an objective to deliver world-class public services. To achieve this, sustained increases in investment and new approaches are needed to meet the new challenges facing Britain. Strong and dependable public services also lay the foundations for a flexible and productive economy. This chapter sets out the progress made on the Government's investment plans to deliver public services, the scale of the Government's investment plans for the future and how the Government intends to reform its framework for the most complex procurement projects to harness the full range of procurement approaches and drive value for money.

The investment challenge

1.2 The UK's public services have historically suffered from a sustained legacy of under-investment. The UK experienced a steady decline in public investment as a proportion of Gross Domestic Product (GDP) between the 1970s and 1990s with consistently lower levels than in other G7 economies. Public Sector Net Investment (PSNI) fell by an average of more than 15 per cent each year between 1991-92 and 1996-97, and represented only 0.6 per cent of GDP in 1997.

1.3 Under-investment in new assets necessary for the effective delivery of public services was accompanied by a damaging backlog of repairs and maintenance and hampered the ability of public servants to deliver high-quality services:

- in 1997 the backlog of repairs in schools was estimated at around £7 billion;
- the backlog of maintenance in NHS buildings in 1997 was over £3 billion; and
- the public transport sector had suffered from decades of under-investment.

1.4 In response, the Government has, since 1997, significantly increased levels of public investment, consistent with meeting its fiscal rules and maintaining macroeconomic stability. In cash terms this has seen public sector net investment (PSNI) rise from £5.4 billion in 1996-97 to £25.8 billion in 2006-07. The 2007 Comprehensive Spending Review (2007 CSR) announced that PSNI will rise to 2¼ per cent of GDP compared with 0.6 per cent of GDP in 1997-98, locking in the step change in investment over the past decade. Over the three years of the 2007 CSR (2008-09 to 2010-11) PSNI is projected to grow at a real rate of 4 per cent per year.

TRANSFORMING PUBLIC SERVICES – MEETING NEW CHALLENGES

1.5 The environment in which public services operate has been transformed by far-reaching social, economic and technological developments over the past decade. Changing demographics and patterns of work and life, the impact of globalisation, new technologies such as the internet and other developments, including in relation to the environment, are creating new and rising demands on public services and substantial changes in public attitudes and expectations. Budget 2008 sets out the strategic challenges facing the economy and confirms the importance of infrastructure investment in driving economic prosperity and growth. The Government also needs to meet new environmental and security challenges. This requires further progress and investment in associated assets and supporting infrastructure. Government action to meet these challenges include:

- Education – total schools capital investment has risen from less than £700 million in 1996-97 to £5.9 billion in 2007-08 and is projected to rise to £8.2 billion in 2010. The long-term Building Schools for the Future and the new

Primary Capital Programme will be investing over £11.2 billion over the 2007 CSR period to transform the school estate in England: rebuilding or refurbishing around 315 secondary schools and 675 primary schools. Over the next 15 years, these programmes will rebuild or refurbish all secondary schools in England and at least half of all primary schools.

- Health – over the past 11 years the Government has undertaken the biggest hospital building programme in the history of the NHS. 93 hospital schemes (70 PFI and 23 public capital) worth £5.3 billion are already open and another 34 schemes (27 PFI and seven public capital) worth £6.3 billion are under construction. This investment is helping to deliver a modernised NHS estate; in 1997, 50 per cent of the NHS estate dated from before 1948 – today that figure is down to 20 per cent. The challenge now is to address investment in community-based health care. Progress is well underway in this area with the NHS Local Improvement Finance Trust (LIFT) programme already having invested over £1.5 billion.

- Transport – the 2007 CSR also extends the Long Term Funding Guideline to 2018-19, meaning that over the 20 years from 1997 UK spending on transport will have more than doubled in real terms. The Government will use this to take forward Crossrail and address the investment priorities highlighted by the Eddington Study[1].

- Housing – since 1997, £20 billion has been invested in improving the standard of social homes for tenants. As a result the number of households living in non-decent social homes has fallen by more than a million, and over a million children have been lifted out of poor housing. Over the next three years the Decent Homes investment programme will reduce the number of non-decent social rented homes by a further 500,000. In addition the Government will continue its long-term commitment to increase the availability of social housing by investing over £6.5 billion to deliver 45,000 new units of social housing a year by 2010-11.

- Defence – the 2007 CSR increased planned spending on defence by an average of 1.5 per cent a year in real terms over the next three years up to a total budget of £36.9 billion by 2010-11. This commitment provides for capital investment in the armed forces of £24.9 billion over the three years. This investment will help to ensure that our armed forces have the right balance of capabilities, both equipment and infrastructure, to be ready to meet a range of challenges. This will include building two new aircraft carriers for the Royal Navy, new protected vehicles for the Army, additional air transport capability and new investment in armed forces accommodation.

- Waste Management – the Government is increasing investment in more sustainable waste management options. The 2007 CSR announced £2 billion of PFI Credit funding for local authority waste investment. This is in addition to, and roughly matches, investment by local authorities themselves. This will allow the UK to continue to reduce the amount of waste sent to landfill, and will contribute to the UK's effort to meet its targets under the EU landfill directive.

[1] *The Eddington Transport Study*, HM Treasury and Department for Transport, 2006

- Climate Change – over the next two decades, the UK will need substantial investment in new electricity generation capacity to replace a number of closing coal, oil and nuclear power stations and to meet expected increases in electricity demand. The Government wants to ensure that the UK has an investment framework which encourages the private sector to bring forward investment at the right time. This includes low carbon forms of generation and other investment promoting sustainability. All procurement and investment programmes should consider sustainability and contribute to the Government's aim of moving to a low-carbon economy.

Better asset management

1.6 Good procurement is central to the start of the asset life cycle and it is crucial that procuring authorities use a whole-life costing approach rather than the cheapest or easiest option. Major infrastructure projects require detailed and careful planning and it is important that a robust, value for money assessment is made when choosing the procurement option.

1.7 In order to take advantage of the unprecedented increase in public sector investment over the last decade, 2007 CSR also adopted a more strategic approach to asset management, driving better value for money and encouraging efficient management of the government's existing asset base. This includes:

- with the agreement of the Treasury, departments being able to reinvest proceeds from the sale of surplus fixed assets in capital investment in addition to their existing capital budget;
- departments producing asset management strategies to set out their plans for actively managing their existing assets and to provide the strategic context for future investments;
- retention by departments of proceeds from more efficient use of assets arising from engagement in the Wider Markets Initiative;
- the Office of Government Commerce's (OGC) High Performing Property initiative to deliver increased efficiencies in the management of the government's property assets; and
- the National Asset Register to help ensure that government retains only those assets required for public service delivery.

1.8 Alongside continued assessments of the ownership and management of the government's corporate and financial assets, these initiatives have also ensured good progress against the asset disposals target.

DELIVERING PUBLIC SERVICES USING PFI

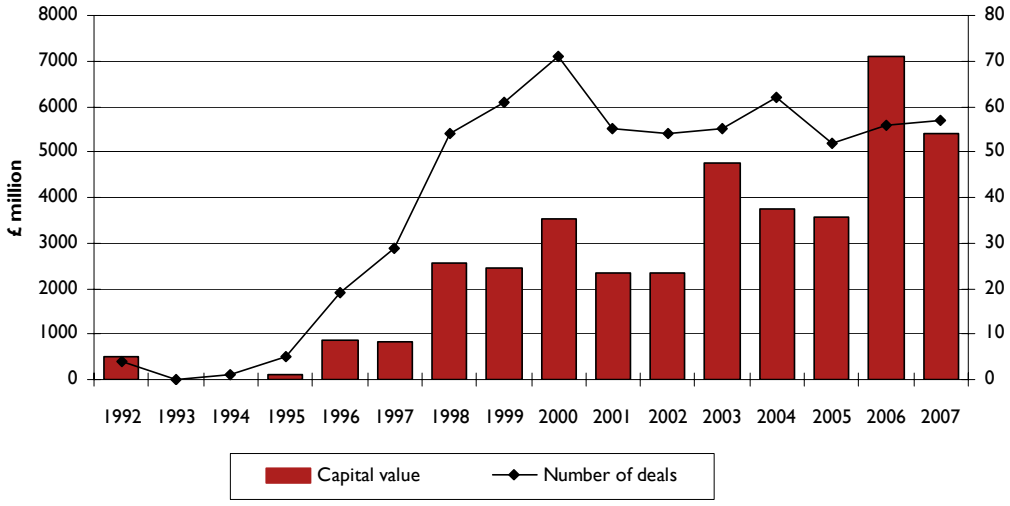
PFI and its place in public expenditure

1.9 The vast majority of investment in the UK's public services has been, and will continue to be, procured through conventional means. However, other innovative procurement approaches, and PFI in particular, have been used to deliver some of the government's most complex and significant public sector infrastructure projects and programmes.

1.10 Although PFI was introduced in 1992, there has been a significant increase in its use in delivering public infrastructure and services since 1997. Chart 1.1 sets out this historical trend. Over 625 PFI projects have now been signed with a total capital value of £58.7 billion. PFI has brought significant benefits to the public and Box 1.1 shows how

PFI has demonstrated good value for money and high levels of user satisfaction. The Government remains strongly supportive of the benefits PFI can bring to the public sector.

Chart 1.1: Development of PFI over time



Source: HM Treasury

PFI pipeline

1.11 The PFI programme continues to play a small but important part in the Government's investment plans with £5.3 billion of capital investment taking place in 2007 through PFI projects. The pipeline of future PFI deals is strong: £23.3 billion worth of projects are due to be signed over the next five years.

1.12 The 2007 CSR allocated a further £10.9 billion in PFI Credits for local authority PFI projects. The Government remains committed to the levels of PFI investment allocated at the 2007 CSR and previous spending reviews. There is now an aggregate pipeline of £20.1 billion of local authority projects of which £7.9 billion is not yet scheduled for signature within the next five years and so is not included in the £23.3 billion pipeline figure set out in the previous paragraph.

1.13 As set out in Chapter 5, the Projects Review Group, chaired by the Treasury, will continue to scrutinise local authority PFI projects and SoPC4[2] will continue as the standard form of contract. The Treasury will also work with departments that sponsor projects through PFI Credits to consider whether and what reforms should be made to the PFI Credit system.

1.14 Budget 2008 sets out that the Government intends to move to using International Financial Reporting Standards (IFRS), adapted as necessary to the public sector, from 2009-10. The Government has no preference between conventional procurement, PFI or any of the other procurement approaches outlined in this document. Its policy remains that PFI should be used for value for money reasons, regardless of accounting treatment, but not at the expense of staff terms and conditions. The Government also remains committed to a strategy which safeguards

[2] *Standardisation of PFI contracts version 4*, HM Treasury, 2007

UK jobs, as permitted within EU rules, ensuring that British industry can compete fairly with the rest of Europe.

Box 1.1: Key achievements of PFI

Over 510 PFI projects have now completed construction and are in operation. These projects have delivered new, modern facilities including:

- 70 hospital schemes now open, with a further 27 schemes under construction;
- 94 education projects covering over 800 schools;
- 43 new transport projects; and
- over 300 other operational projects in sectors such as defence, leisure, culture, housing and waste.

PFI has consistently demonstrated good value for money:

- a 2001 report found 81 per cent of public sector managers reported at least satisfactory value for money with 52 per cent reporting excellent or good value;
- it delivers projects on time and on budget more effectively than conventional procurement. In 2003 a National Audit Office (NAO) study, *PFI: Construction Performance*, found that in only 8 per cent of major PFI investment projects was the delay more than two months and in every case the public sector paid what it expected to pay. By contrast, in traditional procurement, 70 per cent of projects were late and 73 per cent were over budget; and
- the 30 most recent hospital projects to sign PFI contracts showed average savings of £29 million against their public sector comparators.

PFI has delivered good service results:

- a 2006 report showed that 96 per cent of public sector managers surveyed believed that operational performance was satisfactory or better, with 66 per cent believing it good or very good; and
- a 2008 report by KPMG indicated a statistically significant correlation between PFI school projects and improved educational outcomes.

The UK developed PFI model is used as a reference around the world:

- the UK has led the world in the development of PFI contracts. The UK model and guidance is widely drawn on around the world; and
- throughout the EU governments are setting up private finance units, based on the UK model, to take forward PPP projects.

Sources: Managing the relationship to secure a successful partner in PFI projects, NAO, 2001; PFI: Construction Performance, NAO, 2003; Department of Health; Report on Operational PFI Projects, Partnerships UK, 2006; and Investment in school facilities and PFI - do they play a role in educational outcomes? KPMG, 2008.

1.15 Since 1997 the Government has established clear criteria for where PFI is likely to provide better value for money than other forms of procurement and made a number of policy reforms to ensure that PFI continues to deliver value for money[3]. As a result the Government's PFI programme is supported by a considerable body of specific guidance, such as standard contracts and value for money guidance, that has become a core template in how to procure a PFI scheme successfully. The Government will continue to support PFI operational projects, those in construction or procurement and future projects, through the on-going development of guidance and policy as lessons are learned from experience. As part of this process the Government, working together with key shareholders, will continue to monitor the impact on staff.

1.16 The OGC has also produced additional supporting guidance on procurement, as set out in Box 1.2. In considering alternative and innovative approaches to the challenges of infrastructure procurement, the Government will expect procuring authorities and private sector market participants to consider the lessons from PFI and will seek to embed its benefits within other approaches.

Box 1.2: OGC's *An Introduction to Public Procurement*

This guidance is a high-level document that sets out the key concepts and principles of good procurement. It explains the strategic context of procurement, sets out procurement processes and activities and touches on the importance of capabilities in public procurement. *An Introduction to Public Procurement* is intended for senior officials with limited experience of public procurement. Although it focuses primarily on activities in central departments and closely associated bodies, it is also relevant where central government provides commercial governance, advice or support to the wider network, such as devolved public sector bodies.

An Introduction to Public Procurement is a major component of OGC's Policy and Standards Framework which covers all the key procurement policies to which contracting authorities are expected to adhere. For more information, see www.ogc.gov.uk

RESPONDING TO NEW INVESTMENT DEMANDS

Alternative procurement approaches

1.17 The Government recognises that a number of alternative public private partnership (PPP) approaches have been developed in the market, often building on the experiences of PFI, and that in some circumstances such alternative delivery models may be more appropriate and therefore better value for money than either PFI or conventional procurement. Where such alternative approaches potentially offer the best procurement solution, the Government encourages procuring authorities to explore using them with value for money being the test to determine the route chosen. Chapter 2 sets out an overview of alternative PPP approaches currently in the market and considers situations for which they may be appropriate.

1.18 Much of the focus in Chapters 2 and 3 is on PPP approaches. Many of the Government's largest infrastructure procurements, such as the 2012 Olympics and Crossrail, are however largely being funded by the public sector. Nonetheless, the solutions adopted to the complex procurement issues presented by these major projects also benefit from the experience and know-how developed on the back of PFI, which underlines the need for the single framework of evaluation and application of the

[3] See for example *PFI: Meeting the investment challenge*, HM Treasury, 2003 and *PFI: Strengthening long-term partnerships*, HM Treasury, 2006

alternative procurement approaches as described by this document. Accordingly, much of the content of this document is applicable to all infrastructure projects regardless of how they are financially structured.

Private finance

1.19 As PFI has become better understood and the market has developed, more companies are taking part in the PFI market in some form and it has become an attractive investment for private sector equity and debt. Over the past few years there has also been significant growth in the number of global infrastructure funds as infrastructure has become an asset class in its own right. Global infrastructure funds, which scarcely existed when PFI was launched, are introducing new possibilities for the ownership and management of infrastructure and in a number of countries are bringing a new range of opportunities for private sector involvement in public service delivery. Chapter 3 outlines the role private finance can play in public infrastructure investment and some of the issues the Government is taking forward.

Supporting value for money analysis

1.20 Chapter 4 describes the key principles and drivers of value for money that need to be taken into account in evaluating a range of possible solutions to complex procurement issues. It builds on the value for money guidance that has been developed for PFI and sets out parameters to ensure that complex projects proceed in a way that represents the best possible value for money in public service delivery.

Support, scrutiny and skills

1.21 PFI has also developed a relatively high level of scrutiny and central support, both at departmental level and from the Treasury. For example, local authority procured PFI projects are subject to review by the Project Review Group and more complex central projects by the Major Projects Review Group; both chaired by the Treasury. Chapter 5 sets out the current scrutiny arrangements for major procurements, including PFI projects, and the support available for projects in operation. It sets out how the Government will improve its ability to scrutinise projects, particularly at an early stage, and how this is intended to evolve into a more systematic, value-added, risk-based approach to the scrutiny of major public investment projects. It also provides an update on the progress the Government is making in enhancing public sector procurement skills.

1.22 Box 1.3 sets out the key measures of *Infrastructure procurement: delivering long-term value*.

Box 1.3: Key measures

Infrastructure procurement: delivering long-term value sets a direction of travel. While the Government will continue to use conventional procurement and PFI techniques where they represent value for money, this document seeks to stimulate innovative procurement approaches that may in some circumstances provide better value for money for the public sector in addressing the complex infrastructure investment challenges ahead. It does, however, also announce a number of specific measures.

To improve the procurement process, applicable to any delivery model, for large, complex infrastructure projects and programmes, the Treasury will:

- issue guidance on conducting tenders for complex projects under Competitive Dialogue procedures;
- issue guidance on project maturity – the state of development infrastructure investment plans should have before the public sector formally engages with potential private sector contractors;
- move to a risk-based approach to scrutiny, with scrutiny taking place earlier in the procurement cycle and with increasing focus on the delivery model and the procurement process; and
- continue to support a wide-ranging programme aimed at enhancing public sector procurement and intelligent client skills.

To support the consideration of a broader range of potential delivery models, this document provides high level value for money assessment principles. The Treasury will also:

- expand *Value for Money Assessment Guidance* for PFI to cover a broader range of approaches to complex procurement; and
- update and re-issue guidance on joint ventures.

To enhance the efficiency of PFI projects, both existing and future, the Treasury will:

- commission a survey of operational PFI projects and the current issues they face;
- work with departments to consider whether and what reforms to the PFI Credit system might be made; and
- issue guidance on specific PFI financing issues (related to refinancing, primary equity returns, underpinned debt and public sector capital contributions).

2 The broadening range of procurement approaches

Chapter 1 set out how the infrastructure challenge faced by the Government has evolved since 1997. Over the same period, the range of procurement tools and approaches available has also evolved, giving both the public and private sectors the ability to leverage the knowledge and experience accumulated through the Private Finance Initiative (PFI) and elsewhere. In some cases, these emerging alternatives to both conventional procurement and PFI may offer more effective and efficient means to build the next generation of infrastructure and provide improved levels of public service delivery.

This chapter:

- identifies what characteristics can make procurement complex and so potentially suitable for the greater range of approaches;
- explains the role of risk allocation and management in infrastructure contracts; and
- outlines examples of public private partnership (PPP) approaches.

The purpose is to assist procuring authorities and to encourage dialogue around these alternative approaches in order to apportion risk effectively between the public and private sectors. The Government does not intrinsically favour any one approach to contracting and risk sharing over any other. Its central objective is to secure value for money for the taxpayer.

Complex procurement

2.1 Government buys a wide range of goods and services, from routine, low value commodity items to highly complex assets and services. Procurement processes, techniques and issues differ greatly across this spectrum. At its simplest, the buyer knows precisely what it wants to buy and can clearly specify the required asset or service. Furthermore, there is a competitive market that can readily meet the requirement. At the other extreme, buying an asset such as an aircraft carrier can be considerably more complex and requires appropriate skills and expertise, suitable governance structures and advanced procurement tools and processes.

2.2 Sources of complexity in procurement include the following:

- project scale – for example several linked procurements being required to complete a larger project or a project with multiple parties involved;
- project duration – a long-term arrangement with a supplier or suppliers, as opposed to single, short-term delivery;
- internal interfaces – for example integration elements with existing business requirements or business process change;
- external interfaces – project exposure to market or demand risk, inter-connection with existing assets, or other externalities such as timing and conditions of planning consent;
- solution and scope – where it is not possible fully to define the technical solution up front;

- technology – the use of unproven technology or proven technology in novel circumstances, including the development of bespoke solutions;
- financial structure – where it is difficult or undesirable to settle the financial structure of the project up front;
- market – where there is inadequate existing market capacity to meet the need and a competitive supply market needs to be developed; and
- delivery risks – where there are high risks in managing the solution within fixed budget and timescales.

2.3 This document deals chiefly with the complex end of the procurement spectrum, though many of the principles set out could apply equally well to more straightforward procurements. The next section explains the allocation of project risk and management, which underpin the different procurement approaches.

APPORTIONING AND MANAGING PROJECT RISK

2.4 Almost all investments government makes involve the private sector in some way. Where government is procuring infrastructure at the complex end of the spectrum, the private sector may be involved simply as a supplier of goods to an input-specified project managed by the public sector. The private sector may, in other cases, be involved in designing the project to respond to the public sector's output specification, raising finance for the project, building it and managing the provision of the resulting service either to the authorities or to the consumer.

2.5 All infrastructure projects are subject to risk. There are, for example, risks that the project will cost more to build than anticipated and there are risks associated with its operation and maintenance, as well as with the possibility that it may attract fewer users than planned.

2.6 Project risks should be borne by those best able to manage them and to shoulder them. There are fundamentally only three classes of party to whom the risks can be allocated: consumers, investors (usually through private sector companies) and taxpayers (through the authorities). Risk does not disappear through contractual structuring, it is simply allocated differently.[1]

2.7 Appropriate risk allocation and associated contractual incentives are essential for cost-effective and efficient project delivery for the public sector. This was illustrated by a National Audit Office (NAO) study[2] which found that in only 8 per cent of major PFI investment projects was the delay more than two months and in every case the public sector paid what it expected to pay. By contrast, in traditional procurement, 70 per cent of projects were late and 73 per cent were over budget.

[1] *Ownership, Utility Regulation and Financial Structures: An Emerging Model*, Dieter Helm, 2006

[2] *PFI: Construction Performance,* NAO, 2003

2.8 Management of risk is important in the process of reducing the likelihood of projects underperforming. Many of the changes over the past 15 years in procurement, such as an integrated project process and partnering the supply chain, discussed in the Egan Report[3], involve the reduction of risk, and hence cost, by changing the relationship between the parties involved in the project. Indeed, some new approaches to delivering complex projects, such as alliancing, are largely conventional procurement combined with an intensive approach to identifying and managing risk through all tiers of the supply chain.

2.9 Delivery models are distinguished by how they apportion and manage risk. If construction costs on a public sector infrastructure project overrun under a cost-plus arrangement, the additional cost to complete the project is usually borne by the authorities. Under a PFI arrangement, the additional cost is borne by the private sector contractor and shared with its subcontractors in accordance with the subcontracting arrangements. Ultimately, losses arising from the additional cost are borne by the investors in the contracting and subcontracting entities (and in more extreme cases by those who have provided debt finance to the project concerned). They bear risk up to their capacity or their limit of liability. Beyond that point, residual risk in an infrastructure project is generally borne by the authorities to the extent they regard the service derived from the infrastructure as essential.

2.10 Procurement approaches and contracting structures other than PFI can also be used to shift the risk of construction cost and time overruns to the private sector contractor, for example through a fixed-price, date-certain turnkey contract. From the 1990s, a number of contractual structures were developed involving the private sector in project delivery and risk sharing beyond the construction phase. These structures were known by various acronyms, such as BOO (Build Own Operate), BOOT (Build Own Operate Transfer), DBMO (Design Build Maintain Operate), DBFM (Design Build Finance Maintain) and DBFO (Design Build Finance Operate). In the UK, these types of delivery models, usually involving a performance-related payment which begins after construction and only once the project has demonstrated that it is fit for purpose and has entered service, coalesced into PFI. Under PFI, the private sector is involved not only in operating and maintaining the asset and providing the service, but it is also amortising its cost of constructing the assets over their life, which may be 25 years or more. This requires the private sector contractor to raise long-term finance at risk. Chapter 3 considers the role private finance can play in public infrastructure provision.

2.11 In return for bearing and managing the risks inherent in a project, private sector investors expect a return. The more risky the project or the portfolio of projects in a programme the higher the required return. If the public sector is, through the chosen contract structure, bearing some or all of the project risks, it too should, notionally at least, take account of the higher required rate of return implied. Access to cheap funding is in itself not a good reason for an entity to assume more risks. Indeed, cheap funding can encourage ill-judged and ill-managed risk taking.

[3] *Rethinking Construction: the report of the Construction Task Force*, Department for Trade and Industry, 1998

DELIVERY MODELS

2.12 The past ten years have seen major changes in the public sector's procurement of assets and services. PFI has been at the heart of this. PFI has applied a range of construction, financing and service provision contracting techniques first developed in the utility, energy and natural resources industries. These techniques include fixed-price contracts, performance-related payments, long-term solutions and capital deployed at risk in service delivery. PFI adapted these to the public sector environment.

2.13 Over this period the private sector's appetite for increasing partnership with the public sector has grown markedly, as has its capacity and capability to deliver in the public sector context. Infrastructure has emerged as an attractive asset class and with that there has been a significant growth in the number and types of private sector participant interested in the public service delivery market. Increasingly, innovative solutions are being developed to address complex investment requirements in ways which potentially deliver enhanced value for money for the public sector.

2.14 The need to extend the choice in infrastructure procurement beyond the binary PFI – conventional decision is well recognised and has been picked up in a number of ways, for example:

- *PFI: strengthening long-term partnerships*[4] discussed alternative procurement vehicles including the NHS Local Improvement Finance Trusts (LIFT) and Building Schools for the Future (BSF), and also highlighted new approaches such as strategic partnerships and the integrator approach;
- departments have already begun to explore alternative approaches, for example as set out in the Ministry of Defence's *Defence Industrial Strategy*[5];
- *The Eddington Transport Study* recognised the merit in the public sector securing efficiency gains through private sector engagement in the provision of transport projects and noted that the challenge is to consider what new possibilities for partnership working are afforded by the maturing of the infrastructure market;
- *Building Flexibility: new delivery models for public infrastructure projects*[6] by Deloitte set out a range of models and suggested a decision tree based on the level of certainty the public sector has about its requirements as the key determinant in choosing among the models; and
- the Confederation of British Industry (CBI) published a report in 2007[7] reflecting on the success of PFI and considering how, as society changes, PFI might evolve and new models of partnership develop.

[4] *PFI: strengthening long-term partnerships*, HM Treasury, 2006

[5] *Defence Industrial Strategy*, Ministry of Defence, 2005

[6] *Building flexibility: new delivery models for public infrastructure projects*, Deloitte, 2006

[7] *Building on success: the way forward for PFI*, CBI, 2007

2.15 The Government will continue to use what are generally known as traditional or conventional delivery models in infrastructure (see Box 2.1) but it will seek to use them, as appropriate, in increasingly innovative ways as its procurement skills continue to develop (see Chapter 5). It will also continue to use PFI, a delivery model that is now well understood and has a proven track record in delivering value for money across a diverse range of sectors. But, as foreshadowed in the 2007 Pre-Budget Report, the Treasury is continuing and developing its dialogue with both the public and private sector around alternative value for money ways of delivering world-class public services and the next generation of Britain's infrastructure.

Box 2.1: Conventional procurement

Public sector conventional procurement has generally been characterised by input-based specifications, public sector funding and short-term contracts. Approaches include:

- a public sector managed build in which the public sector first procures the design of the building or asset. It then separately procures the contractor to build the asset. The contracting authority is likely to seek a fixed price for the work. Ultimately some cost and time overrun risks may rest with the public sector through, for example, change orders. There is generally limited contractual integration with maintenance and operational phases after the asset has been duly delivered; and
- a design and build (DB) contract in which an integrated project team is responsible for both the design and construction of the asset. Risks are typically shared between the public and private sectors through appropriate contract terms; for example, the risk of late delivery might be transferred to the private sector.

Conventional procurement can be priced in a number of different ways, such as cost-plus, fixed price, target-cost price and guaranteed maximum price. In practice, conventional contract structures can be nuanced to fit specific circumstances and large, complex infrastructure projects can combine different elements and approaches.

Standard contract documentation has evolved over time. Two suites of contracts, providing for different pricing options and now commonly used in conventional procurement, are the Joint Contracts Tribunal (JCT) 2005 suite and the New Engineering Contract (NEC3) family of contracts. Both suites consist of standard main contract documentation, sub-contracts and guidance on the usage of these documents. More information can be found at www.neccontract.co.uk and www.jctltd.co.uk

2.16 The remainder of this chapter sets out examples of infrastructure delivery modes that involve partnership between the public and private sectors. Box 2.2 provides an overview of the key features of PPPs. Some, but not all, of these approaches involve private finance, which is considered more fully in Chapter 3. The descriptions are not intended to be definitive and there are similarities and overlaps between the approaches. The Government does not favour any one model above others, and is not endorsing the specific application of any approach by including it here. Its overriding objective is to secure value for money.

2.17 It should also be noted that this discussion excludes:

- infrastructure constructed, owned and managed by regulated utilities; and
- the provision, whether by the public or the private sector, of soft services which involve only limited investment in fixed assets.

Box 2.2 What is a public private partnership?

PPPs are arrangements typified by joint working between the public and private sectors. In their broadest sense they can cover all types of collaboration across the private-public sector interface involving collaborative working together and risk sharing to deliver policies, services and infrastructure.

In the context of this document, the term PPP means project and programme-based PPPs involving the provision of assets. Such a PPP exhibits the following key features:

- a joint working arrangement between the public and private sector, which may be by contract or through a joint venture company, to deliver infrastructure assets and usually, but not always, the ongoing maintenance and operation of the infrastructure assets and the delivery of associated services;
- risks are allocated between the parties on the basis of which party is best placed to manage and bear the risk. Typically design, construction and operational risks are expected to be borne by the private sector; other risks which are shared are allocated in the way that best incentivises both parties to manage the risks;
- generally a PPP is a long term (25-30 years) arrangement between the parties but can be shorter term, for example where ongoing maintenance of the infrastructure assets and associated services are excluded;
- where ongoing operation and maintenance of the infrastructure assets and delivery of associated services are included, the public sector may pay the private sector for all or part of the use of the infrastructure over the life of the arrangement;
- payment to the private sector is structured in such a way as to ensure the private sector is incentivised to deliver the required services or obligations under the arrangement;
- payments are usually made by the authority but can be made by the end user, for example for the use of a toll road;
- the public sector is seeking to access private sector management and expertise to drive value for money; and
- the project is often financed either in part or in whole through private finance.

Private Finance Initiative

2.18 PFI is an arrangement whereby the public sector contracts to purchase services, usually derived from an investment in assets, from the private sector on a long-term basis, often between 15 to 30 years. An example of a PFI project is St James' University Hospital (see Example 2.1). Typically:

- the private sector will construct and maintain infrastructure in order to deliver the services required. The project thus entails a construction phase followed by an operational phase;
- the private sector party contracting with the public sector is usually a special purpose vehicle (SPV): a company with the specific goal of delivering the project, and can have one or more shareholders;
- much of the risk assumed by the SPV is passed to other entities (which sometimes are also shareholders in the SPV) through sub-contracts;

- the SPV uses private finance, usually a mix of equity and debt, to fund the up-front construction works;
- the SPV is paid a fee for the service it provides to the public sector. The fee is often referred to as a unitary payment and includes principal and interest payments on the debt and a return to the SPV's shareholders, as well as an amount based on the expected operating cost of providing the services delivered and maintaining the assets. The unitary payment normally commences after completion of construction once services start being delivered and continues over the rest of the contract life. The unitary payment is at risk to the SPV's performance during the life of the contract, such that payment is reduced if performance falls below the required standard; and
- the SPV manages and delivers the required services to specified standards, while sustaining the quality of underlying assets.

PFI has evolved since its introduction and the standardisation of PFI contracts (SoPC4) now sets out the standard approach to risk allocation between the public and private sectors and includes mandatory principles and drafting for certain key contractual clauses.

2.19 A PFI contract may be suitable where:

- there is a major capital investment need, requiring effective management of risks associated with construction and delivery;
- the nature of the service allows the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective and accountable delivery of public services over the long term, and where risk allocation between the public and private sectors can be clearly made and enforced;
- the nature of the assets and services identified as part of the scheme, as well as the associated risks, are capable of being costed on a whole-of-life, long-term basis;
- the capital value of the project is above £20 million to ensure that procurement costs are not disproportionate;
- the technology and other aspects of the sector are stable, and not susceptible to fast-paced change; and
- planning horizons are long-term, with confidence that the assets and services provided are intended to be used for a long period into the future.

Example 2.1: St James' University Hospital

The PFI scheme at St James' University Hospital in Leeds (the largest teaching hospital in Europe) has a capital value of £265 million. The PFI contract is for 30 years. The project reached financial close in October 2004 and the hospital opened in December 2007. Besides providing a new wing and refurbishing and adapting other parts of the existing hospital, the private sector partner also provides a wide range of other services, including specialist surgical services, clinical and non-clinical support services and is responsible for the provision and maintenance of medical equipment.

Concession

2.20 When government grants a concession, it grants a private entity exclusive rights to build, operate and maintain a ring-fenced asset over a long period of time. The M6 Toll Road (see Example 2.2) is an example of a concession. Typically:

- concession projects can be financially free-standing (though a public sector subsidy may sometimes be involved), with the private sector undertaking the project on the basis that costs will be recovered through charges for services to the end user;
- public sector involvement is generally limited to enabling the project to go ahead, for example, by undertaking some of the initial planning, defining the terms and awarding the concession, regulating charges, providing ancillary works, or assisting with statutory procedures;
- the private entity has to operate to certain performance requirements set by the Government; and
- demand risk is fully or partly transferred to the private sector.

2.21 A concession may be suitable for projects:

- with a clearly defined scope and relative certainty over the requirements during the lifecycle of the project;
- that can be structured to be economically independent while interfacing simply and efficiently with the surrounding infrastructure;
- where there is a market for the service, for which consumers are willing to pay;
- where the private sector concessionaire is able to some degree to influence demand; and
- usage of the asset is measurable in a straightforward manner.

Example 2.2: M6 Toll Road

The M6 Toll Road is a freestanding concession with no ongoing government financial involvement. The concessionaire generates investment and return from direct user charges. Government has transferred risks, such as planning, design, construction and revenue risk, to the concessionaire. The contract is for 53 years and at expiry the asset will revert to the public sector at no cost.

Strategic infra-structure partnership

2.22 A strategic infrastructure partnership (SIP) is an arrangement between a procuring authority and a private sector partner intended to address a series of infrastructure-related issues or projects over a set period of time. The SIP may take the form of a joint venture (see Box 2.3 later in the chapter) or it may be established by contract. Generally, and in contrast to the integrator approach described below, the private sector partner itself provides a significant amount of the works and services required by the contracting authority. Examples of investment programmes being undertaken through SIP structures are the LIFT programme (see Example 2.3) and the Local Education Partnerships (LEPs) in the BSF programme (see Example 2.4).

2.23 A SIP is often an exclusive arrangement. In return for exclusivity the private sector partner commits to a programme of continuous improvement through successive stages of work which is facilitated by the accumulating experience of working together. Stages subsequent to the initially priced portion of the programme are tested for value for money through means such as benchmarking and market testing, and the approach may involve open book accounting. Individual projects falling under a SIP arrangement can adopt a variety of delivery models, as appropriate to specific circumstances.

Example 2.3: Local Improvement Finance Trusts

NHS LIFT is a vehicle for improving and developing primary and community care facilities. NHS LIFT, as a national policy, is delivered by Community Health Partnerships, an independent company, wholly owned by the Department of Health, which in turn has established joint ventures between itself, the local NHS and the private sector partner. These limited companies, the LIFTCos, enter into 20 agreements to build, own, maintain and operate primary care buildings, which they lease to Primary Care Trusts, GPs, dentists, other local NHS providers or social care staff. LIFTCos organise their supply chains in a variety of ways to deliver value for money. Several operate as project delivery organisations, tendering key packages of work to a pool of suppliers. Others operate more fixed supply chains, with value for money assessed through benchmarking and market testing.

The LIFT programme has established 45 LIFTCos with three more to come, and has delivered 162 new primary and social care facilities in 48 geographical areas in England, covering more than half of Primary Care Trusts. A further 48 facilities are under construction and more are planned.

2.24 A SIP can operate either using a fixed supply chain or a competitive one. The contracting authority would expect to understand the details of the supply chain arrangements, and any impact on pricing and risk transfer arising during the competitive process, before selection of the private sector partner.

Example 2.4: Building Schools for the Future (BSF)

BSF is a 15-wave investment programme with over £9 billion allocated over the Comprehensive Spending Review period 2008-11. BSF's goal is to support the Government's educational reform agenda, by providing 21st century learning facilities aimed at improved educational outcomes. It is planned that nearly every secondary school in England will be rebuilt or renewed over the programme.

Partnerships for Schools (PfS) is a joint venture between the Department for Children, Schools and Families (DCSF) and Partnerships UK (PUK) that has been set up to manage the delivery of the overall BSF programme. PfS supports local projects and ensures that investment in secondary schools is based on robust educational strategies. PfS works with local stakeholders to ensure that BSF schools and academies are well designed, are built on time at a reasonable cost to the taxpayer and that arrangements are put in place so that they are properly maintained over their lifetime.

At a local level, Local Education Partnerships (LEPs) are usually set up, consisting of a private sector partner, the local authority and Building Schools for the Future Investments (BSFI), a joint venture investment vehicle between DCSF and PUK. The LEP then procures the delivery of approved projects, Approximately 50 per cent being PFI and 50 per cent design and build (DB), with DB generally being used for refurbishment and PFI for new-build schools.

2.25 Alternatively, SIPs can be established on a competitive basis, where several strategic infrastructure partners are selected to deliver the needs of a large-scale programme. After a certain period of time, the public sector evaluates the performance of each partner against the performance of their competitors. Based on this evaluation, it can then reallocate projects between the partners, increasing the work allocated to the strong performers. This model has also been called a competitive partnership.

2.26 A SIP may be suitable where there:

- are successive phases of similar types of work;
- are multiple local procurers for similar types of project;
- is certainty over the kind of infrastructure, but uncertainty about the timing or exact phases of work;
- may be advantages from private sector commercial input in the planning phases;
- is scope over the life of the contract for the partner to increase efficiency through continuous improvement and innovation; and
- are procurement times and costs that would be excessive if each element of the programme were separately tendered.

Integrator

2.27 Under the integrator approach, the public sector authority procures a project delivery organisation (the integrator) to manage the delivery of a project through pre-procurement preparation, procurement, construction and into operation. The contracting authority defines the overall policy and procurement objectives in the usual way, and then works with the partner to refine requirements and agree the optimum phasing and procurement strategy. The partner manages the procurement of the underlying assets and services and then integrates them to provide an overall service to the authority. The underlying packages can include both PFI and non-PFI elements.

The integrator takes on the role of delivery partner and manages delivery of the supply chain. A key difference between an integrator arrangement and a SIP is that the integrator takes a less direct role in delivering works and services itself. This increases overall competitive pressure on the supply chain, aligns the objectives of the authority and the integrator and tends to avoid conflicts of interest. Despite the close alignment of interests between the contracting authority and the integrator, this approach does involve:

- clear allocation of risks and responsibilities between the private sector and the contracting authority;
- performance, availability and price risk being transferred in whole or in part to the integrator;
- the integrator being incentivised through a payment mechanism to ensure timely delivery, achievement of target costs and performance of the service to the required standards; and
- transparency through open book accounting.

An example of a project being undertaken using an integrator is MoD's United Kingdom Military Flying Training System (see Example 2.5).

2.28 An integrator approach may be suitable in situations where there is:

- some uncertainty over the long-term requirement, with a resulting desire for flexibility and incremental acquisition, for example where new technology risk is present, end-user demands are subject to change, or policy changes are likely to affect how, where and what services are to be delivered in the future;
- uncertainty about the timing or exact phases of works;
- a long construction phase and where efficiencies could be derived from dividing the project into distinct phases or parcels;
- limited supply-side competition to provide the entire project as one, but where the project can be sensibly divided into separate packages and competition introduced in the supply chain in a transparent manner; and
- scope over the life of the contract to increase efficiency through continuous improvement and innovation.

Example 2.5: United Kingdom Military Flying Training System

The United Kingdom Military Flying Training System is a major change programme within the overarching Defence Change Programme portfolio and is an example of the use of an integrator model. The programme's aim is to provide a tri-service training capability to deliver the required numbers and quality of aircrew over a 25-year period and replace the existing flight-training systems for all aircrew disciplines throughout the armed forces. A training system partner will be appointed to work with the Ministry of Defence (MoD) under a contractual partnering approach to deliver a series of capabilities incrementally over a five- to seven-year period, using a mix of PFI and smart conventional acquisition.

As a result of the incremental approach to capability delivery, it did not make commercial sense to seek a fixed price at the outset. The intention is that the requirement for future capabilities will be refined and the delivery solutions developed jointly between the MoD, the three services and industry as the programme progresses. This involves new ways of working and developing incentives and payment mechanisms which are intended to align the objectives of the private sector closely with those of the MoD.

Alliancing

2.29 An alliancing approach involves two or more parties who share risks and rewards to enable the successful delivery of joint objectives. The incentives are closely aligned to ensure that common objectives are achieved. Alliancing relies very heavily on strong procurement and commercial skills and detailed day-to-day management involvement by a proactive authority willing to invest in its own capacity and capability to be effective. Key features of alliancing include:

- a strong focus on specifying outputs rather than inputs and processes;
- confidence and trust between public and private parties, with a focus on partnership and alignment of interests, and generally an integrated project team drawing on expertise from the authority and relevant contractors;
- strict risk management procedures on an integrated project basis;
- a sharing among all parties (including the contracting authority) of the costs and benefits of overruns and underruns; and
- open book accounting.

2.30 Alliancing may be appropriate where there is a high level of uncertainty about the nature of the infrastructure needed to meet the policy objectives, where there is significant technological risk, where there is a lack of a competitive supplier market, or where the project is large and not readily divisible into discrete parts that could be separately contracted. In contrast to many PPP models, key project risks under an alliancing structure are generally retained by the contracting authority. As such in alliancing:

- the contracting authority needs particularly strong contracting skills; and
- the value of private finance is limited.

Hybrid approaches

2.31 As noted previously, there are no firm boundaries between different delivery models. Many major projects, such as those that have been scrutinised by the Major Projects Review Group (see Chapter 5) have adopted specific approaches to unique procurement challenges. Many publicly funded projects draw on the developments in PPPs and vice versa. Examples of hybrid approaches that are being adopted to address specific requirements are Project MoDEL (see Example 2.6), and ProCure21 (see Example 2.7).

Example 2.6: Project MoDEL

Project MoDEL aims to consolidate MoD facilities in London onto a modern core site at RAF Northolt. The MoD has contracted an industry partner to deliver an integrated programme, including the disposal of surplus sites and the delivery of a construction programme. The proceeds of the land sales will be used to deliver the programme. The MoD has obtained a firm price for the first tranche of work. For delivering subsequent tranches the industry partner manages a competitive process. The industry partner is barred from delivering subsequent tranches itself in order to reduce potential conflicts of interest.

The industry partner is taking risks in relation to the pricing and quality of the works at RAF Northolt, the levels of receipt that can be achieved on sales of land in the future and its ability to manage the programme so as to minimise the finance costs associated with negative cash flow. It is remunerated primarily through the disposal receipts and is therefore incentivised to control costs and maximise receipts. The MoD shares in the benefits of the industry partner's efficiency.

Example 2.7: ProCure21

ProCure21 is the Department of Health's procurement method to improve the delivery of capital projects using public funding in the NHS. ProCure21 allows NHS Trusts to use a framework of construction companies, called principal supply chain partners, to deliver their capital schemes using common principles, practices and tools. This approach offers price certainty by using a guaranteed maximum price and any overspend is borne by the principal supply chain partner; whereas the benefits of any underspend are shared equally. ProCure21 requires the client and supply chain to work together in a transparent and cooperative relationship, by using open book accounting and early warning notices, which form part of a pro-active risk management framework.

The programme has over 360 schemes registered with a value of over £2.5 billion. To date, 200 schemes have been completed with a value over £1 billion. So far the ProCure21 approach has delivered positive results: 94 per cent of schemes in 2006 came within budget and 89 per cent of schemes were on time.

JOINT VENTURES

2.32 A number of arrangements between the public and private sector involve, or potentially involve, joint ventures. In a joint venture, two or more parties make a contribution to a commercial venture, share aspects of control and aim to share risks and return on an agreed basis. Where the public sector is party to a joint venture, there is often a public interest purpose behind the joint venture and without the authority's involvement the venture would not proceed. Box 2.3 sets out different legal forms a joint venture may take.

Box 2.3: Joint ventures

A joint venture can take a number of different legal forms, including:

- a company limited by shares – with joint venture parties as shareholders;
- an unincorporated partnership – which is an association between two or more entities. It is established by a legal agreement and liability is unlimited;
- a Limited Liability Partnership – similar to the unincorporated partnership but where the entity is registered and the liability of the partners is limited;
- a Limited Partnership – where a subset of the partners has limited liability; or
- a Community Interest Company – where the various parties invest in a limited company which is registered to ensure that any profits are reused for the stated community purpose.

2.33 A joint venture may exist for a specific project or for a longer duration. Joint ventures involving the public sector have been used in a number of ways and can be a feature of other forms of PPP. Examples include:

- LIFTs (see Example 2.3);
- LEPs (see Example 2.4);
- partnerships between British Waterways and developers to regenerate canal-side property (see Example 2.8);
- public private ventures to invest in low carbon technologies; and
- joint ventures for the design, development and through-life support of defence equipment.

2.34 In a joint venture, the authority selects one or more joint venture partners with whom it must agree terms. In the case of a joint venture established to invest in infrastructure, the joint venture itself then procures the project. The authority as a result can find itself one step removed from the project procurement process but will nonetheless require significant procurement skills to ensure its interests are protected. The public sector will also need the commercial skills required to negotiate the setting up of the joint venture and manage its long-term interest in the venture. This may involve acting as directors of a company.

Example 2.8: ISIS Waterside Regeneration

ISIS is a waterside property development joint venture, set up in July 2002. It is jointly owned by British Waterways, a public corporation caring for a 2,000-mile network of canals and rivers, in partnership with a private sector developer and a regeneration fund. The partnership was set up to provide value through development of waterside land and to earn income to reinvest in the waterways. ISIS focuses on major waterside developments across the UK with the ambition of delivering sustainable regeneration and housing along with environmental and social benefits for local communities and visitors to the waterways.

2.35 Guidance on forming joint ventures is provided by *A guidance note for public sector bodies forming joint venture companies with the private sector*[8]. This guidance concentrates on issues arising under the Wider Markets Initiative. The Treasury intends to update this guidance, setting it in the broader context of the framework outlined in this document.

SECTOR SPECIFIC COMPLEXITY

2.36 The issues of risk management and value for money described in this document apply to all forms of procurement. However, within certain sectors of procurement, specific or combinations of issues can arise which are beyond the scope of this document. An important example of this is procurement of Information and Communication Technology (ICT) and the implementation of business change enabled by ICT. Procurements in this area often have some strong characteristics of complexity, in particular:

- numerous internal and critical external project interfaces;
- situations in which it is not possible for the procuring authority to define fully the required technical solution up-front; and
- the use of bespoke technical solutions, notably customised software.

It is the extent, combination and often significant nature of these characteristics in ICT procurements which require a sector-specific response to risk management and specialised model contract terms as published by the Office of Government Commerce (OGC). More information on ICT procurement can be found on the OGC's website[9].

[8] *A guidance note for public sector bodies forming joint venture companies with the private sector*, HM Treasury, 2001

[9] www.ogc.gov.uk

3 PRIVATE FINANCE

Chapter 2 set out a range of possible delivery models for investments in public infrastructure. This chapter analyses the role of private finance in this context. The most common form of Public Private Partnership (PPP) finance is the structure employed in Private Finance Initiative (PFI) transactions, where the capital and other initial costs are funded through the use of private finance, in the form of private sector equity and debt, and a performance related service charge is paid by the public sector over the project life. Private finance is however also used in a range of other approaches and the sources of this finance are evolving. This chapter:

- outlines the benefits private finance can bring in helping to incentivise effective risk transfer and manage performance;
- describes the challenge of harnessing emerging sources of finance, particularly global infrastructure funds;
- shows how the lessons learned in PFI can be applied to other forms of PPP; and
- provides an update on a number of key issues in private finance.

3.1 All public projects, irrespective of delivery model, need to obtain finance from somewhere, whether from government or the private sector. The contractual structure not only determines risk sharing but also the timing and conditions of payments made by the public sector to the private sector contractor. Risk allocation and payment are closely linked. Depending on the contractual payment mechanism, requirements for private sector funding can be either very limited and short term, or extensive and long term. For example, under some forms of construction contracts the public sector makes milestone payments and the contractor has, as a result, limited need to support the works with its own funding. Under a concession or PFI arrangement, the concessionaire or contractor only receives compensation for its initial capital outlays over the life of the concession or PFI contract, and as such must raise finance to cover a prolonged period.

THE ROLE AND VALUE OF PRIVATE FINANCE

3.2 In developing PFI the Government recognised that, in order to bring the experience and capability of the private sector fully to bear and deliver the required outcomes, the private sector contractor needs to be tasked with managing those risks that it is best placed to manage and given the right incentives to do so. Box 3.1 summarises some of the benefits of having funds at risk in enhancing these incentives.

Box 3.1: The benefits of private finance

In a PPP structure the private sector bears the risks allocated to it under a contract with the public sector. Payments it receives are dependent on the management of those risks and therefore its performance under that contract. The inclusion of private finance in PPP delivery structures has brought key benefits to the public sector. These include:

- **Improved whole-of-life risk allocation and management** – the public sector has benefited directly from lenders and equity providers' detailed analysis, allocation and management of project risks on a whole-of-life basis. With payments linked to performance over the project life, the private sector must consider costs over the life of the asset, or at least the contract length, rather than just during the design and construction phase. Investment returns are dependent on the private sector's ability to control and manage risk effectively throughout the contract period.
- **Greater focus on due diligence** – the inclusion of debt funding has significantly enhanced the review of delivery solutions and contract structures. As debt is exposed to potential loss from default on delivery by the contractor, but has its return effectively capped at the repayment of principal and interest charges, it is incentivised to ensure disciplined risk allocation. Debt providers are therefore likely to take a firm view in dealing with problems revealed by due diligence reports.
- **Better integration of design, construction and operational skills** – with public sector payment for the service linked to performance, and the private sector being responsible for the costs of delivery, the return on private sector equity investment in a project is dependent on its ability to manage the interface between the different components of the solution and control costs over the long term. This has resulted in better long-term integration of service components, while maintaining desired outputs specified at the outset.

Source: The value of PFI: Hanging in the balance (sheet)?, PricewaterhouseCoopers LLP, 2008

Private finance risk premium

3.3 In order to obtain the benefits of private finance there is an associated risk premium payable compared with government gilts. This risk premium represents the cost of the private sector taking on and managing certain risks within a project that would otherwise be managed by the public sector and borne by taxpayers were the project wholly financed by public funds.

3.4 The Government's standard contractual terms for PFI projects (SoPC4) contain risk-sharing mechanisms and contract provisions that are designed to allow contracting with a project-financed Special Purpose Vehicle (SPV). While SoPC4 is only mandatory for PFI contracts, many of the contractual provisions and commercial positions set out within it are equally applicable to other forms of PPP. Procuring authorities are strongly urged to consider SoPC4 when negotiating contracts for alternative PPP solutions, particularly where private finance is used to fund all or an element of the capital requirement for the project. The Government will keep under review the need to adapt and extend guidance currently specific to PFI to other PPP models.

THE ELEMENTS OF PRIVATE FINANCE

3.5 Private sector finance is divided into two broad categories: equity and debt. This is true for private sector companies operating in the market economy generally as well as for the more specialised SPVs involved in infrastructure finance.

Equity

3.6 Equity is the primary bearer of risk. It is the first form of finance to be affected by the under-performance of a company, whether a general corporate entity or an SPV. The returns to equity investors vary with the fortunes of the entity in which they have invested. If a corporate entity performs poorly in the market, by failing to sell its output at an acceptable price or by having a higher cost structure than its competitors, the value of equity can be reduced or eliminated. In a PPP, where project risks are contracted to the private sector SPV, the same can happen; for example when costs are higher than those allowed for in the unitary charge paid by the procuring authority or when service provision does not meet contracted standards and the authority applies deductions in accordance with the terms of the payment mechanism. The transfer of risk is real: there has been a number of PFI projects where the private sector has absorbed cost overruns and so suffered reduced returns on their investments at the SPV level or, more particularly, at the subcontractor level. Conversely, where equity manages delivery standards and controls costs in an efficient manner, it can expect increased returns.

Debt

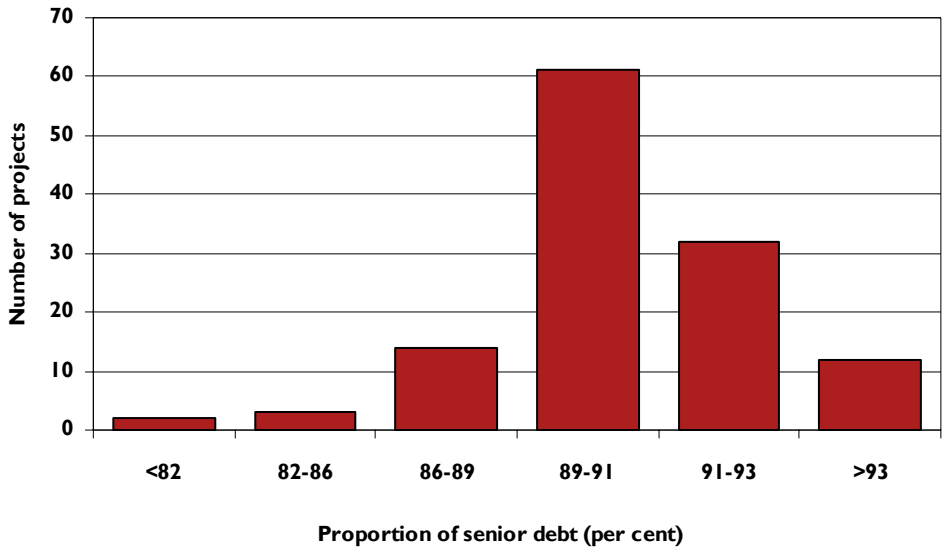
3.7 Debt is the second bearer of risk since it receives interest and repayments of capital ahead of equity. In the case of insolvency, debt holders have recourse to the company assets ahead of equity holders. Debt, in contrast to equity, receives a return in the form of interest which, except in circumstances of distress, does not rise or fall with the fortunes of the borrower. The focus of debt providers is therefore on ensuring that their interest is paid and their capital returned, as opposed to enhancing profit. In a PPP project, debt providers therefore have a strong interest in ensuring that the risks allocated to the SPV, through the contract between the authority and the SPV, are passed on to subcontractors who are able to manage them and are financially strong enough to bear them. Debt providers have a long-term interest in the project as their loan is repaid over time, often close to the full length of the project. They therefore also provide a benefit to the authorities through ongoing review and monitoring of the operations of contractors.

3.8 The dividing line between equity and debt is not clear cut and just because a financial instrument is called equity or debt does not mean it will necessarily have all the characteristics outlined above, or function as such. Various financial instruments exist that combine features of debt and equity in their design.

Debt-equity ratios

3.9 Generally, companies facing higher sets of risk require a greater percentage of equity in their capitalisation. In PFI arrangements, the ratio of debt to equity in the SPV's capital structure has tended to be approximately 90 per cent to 10 per cent (see Chart 3.1); these high debt-equity ratios have largely been driven by competitive pressures. Since debt is generally cheaper than equity, highly geared SPV capital structures tend to allow bidders to offer lower unitary charges to the public sector authorities, with risk mitigated primarily through the subcontracting arrangements.

Chart 3.1: Gearing ratios in signed PFI projects



Source: PFI: The state of the market, Partnerships UK, 2007

3.10 In some of the emerging PPP contracting structures, as set out in Chapter 2, where, unlike a typical PFI project, risk cannot be fully apportioned through the subcontracting structure at the outset, lenders may need to find alternative means of assuring themselves that their loans can be serviced. In such instances they may seek comfort through a lower debt-equity ratio or they may seek, in negotiating the contract, to pass some of their perceived risk back to the public sector. Procuring authorities need to be alert, when negotiating contracts which are different to SoPC4, to attempts to push risk back to the public sector in the more fluid situations that emerging PPP models may present.

The link between equity returns and cover ratios

3.11 As noted previously, project finance lenders focus on downside risks rather than the upside possibilities available to equity, and in PPP projects seek to protect their loan by minimising risks through the contracting and subcontracting arrangements. Lenders further seek to reduce the risks debt faces by requiring that the cash flow projections for the project show more cash available for debt service than is strictly necessary to pay interest and make repayments. This results in a requirement for minimum levels of cash to be available to equity in each period after debt service (cover ratio) and the establishment of undistributed cash reserves.

3.12 Some equity investors have commented that lenders' cover ratio requirements, together with high debt to equity ratios, restrict their ability to offer lower levels of equity returns and hence to make more competitive bids for PFI projects. The Treasury intends to issue guidance addressing this issue.

EMERGING SOURCES OF PPP FINANCE

3.13 When PFI was introduced there was no industry in the UK focused on long-term ownership of public sector assets, other than those companies running privatised utilities (where risk is allocated primarily through the regulatory regime rather than through a contractual structure). Construction companies had a natural interest in PFI because of their role in building the underlying asset, but were accustomed to being paid for an asset as it was built and did not then generally have balance sheets capable of supporting significant long-term investments in PFI infrastructure assets. In spite of this they were important providers of equity in early PFI transactions. Many of these companies have since developed investment arms that specialise in managing investments in PFI contracts.

3.14 The Government's PFI programme has stimulated the growth of entities whose business is the ownership and management of PFI infrastructure assets and the provision of the services derived from them. Construction companies still invest in PFI projects, but they now have the ability to sell their investments and use the proceeds to invest in further infrastructure assets. The secondary market in PFI assets provides liquidity, greater market capacity and better pricing.

The development of infrastructure funds

3.15 More recently, a substantial worldwide pool of capital has become available for investment in infrastructure through specialist managed infrastructure funds. It is estimated that, globally, dedicated infrastructure funds have some $130 billion under management and that some 77 per cent of this was raised in 2006 and 2007[1].

3.16 Infrastructure funds typically seek investments that offer a running financial return (or yield), rather than necessarily the prospect of capital growth, reflecting their relationship with pension and other long-term investment portfolios. As such they tend to favour investing in the operational phase of projects, rather than at the outset of their construction. They also tend to seek concession-type arrangements and regulated infrastructure assets. Because of the volume of funds available for investment in infrastructure assets, competition has pushed up asset values and led to infrastructure funds extending the boundaries of the infrastructure asset class. The Government welcomes engagement with infrastructure funds and other financial investors as it considers the full range of delivery models that might meet its objectives for the next generation of infrastructure investment.

Ownership of PPP companies

3.17 A key Government concern in the ownership of PFI or PPP companies is with the management behaviour brought about by that ownership. It is interested in fostering a partnership ethos that underpins good value for money and high-quality service provision over the long-term. The value of a partnership ethos was demonstrated in the 2008 NAO report *Making Changes in Operational PFI Projects*[2]. The Government looks for stability in management, good corporate governance, sustained quality of service provision and competition in the market to drive value for money.

[1] *How investors can get more out of infrastructure*, Robert N. Palter, Jay Walder and Stian Westlake, The McKinsey Quarterly, February 2008

[2] *Making Changes in Operational PFI projects*, NAO, 2008

PUBLIC SECTOR FUNDING IN PPP PROJECTS

3.18 In *PFI: meeting the investment challenge*, the Government set out its willingness to look at proposals that reduce the costs associated with private finance, but which do not compromise the disciplines of value for money and risk transfer brought by private finance to the procurement process. Contracting authorities should consider alternative funding methods only where this does not impact on risk transfer to the private sector or otherwise undermine the benefits that private sector debt finance at risk brings to projects.

Underpinned debt

3.19 Financial structures, variously known as "underpinned debt" and "de-risked PFI", have been discussed and used in the market. These structures are based on the concept that risk is greatest during the construction period and that, during the operational phase, the authority could benefit from lower risk premia on the debt if it were to guarantee a portion of the debt or underpin a certain level of compensation to lenders on termination for contractor default. The Treasury intends to issue guidance on this type of financing structure.

Authority capital contributions

3.20 The provision of public sector capital to a project has an effect similar to the underpinning of debt. The Treasury intends to address this matter in tandem with the guidance dealing with underpinned debt.

Joint ventures

3.21 As noted in Chapter 2, PPPs are sometimes formed through SPVs structured as joint ventures. In a typical joint venture, the public sector authority may participate in the funding through contributing assets such as land. The expectation is that cash funding for the joint venture's activities would normally come from the private sector, both through equity contributions and raising debt. In forming and participating in a joint venture and in setting up the financing arrangements, the public sector authority needs to take into account the principles for the allocation of risks and rewards set out in this document. It also needs to have at its disposal appropriate commercial and financial skills, taking into account that it may be both co-owner or equity participant in the SPV as well as customer for the services provided, and may need to manage both of these distinct interests.

4 Delivering value for money

The Government's aims to meet its infrastructure and public service needs in the most effective and efficient way possible. The value for money appraisal process is therefore key to decision making. Once an investment decision is taken, procuring authorities must assess what is the most appropriate delivery model and how the procurement process can best be designed and managed. This chapter:

- provides a framework that builds on the progress made in assessing value for money in Private Finance Initiative (PFI) projects;
- identifies the core value for money drivers and key principles that apply to the management of complex procurement; and
- establishes parameters to assist public sector project sponsors in determining the most appropriate procurement approach.

Departments should follow these principles when choosing appropriate delivery models and preparing business cases.

Procurement guidance and Accounting Officers

4.1 Accounting Officers are responsible for ensuring that value for money is achieved in all procurements. The National Audit Office (NAO) has defined procurement as being: "the whole-life process of the acquisition of goods, services and works from third parties, beginning when a potential requirement is identified and ending with the conclusion of a service contract or ultimate disposal of an asset[1]". The Treasury document *Managing Public Money*[2] sets out the principles which apply to the public sector's acquisition of goods and services and the responsibility of Accounting Officers to ensure that value for money is achieved in all procurements. It defines value for money as, "securing the best mix of quality and effectiveness for the least outlay over the period of use of the goods or services bought. It is not about minimising upfront prices. Whether in conventional procurement, market testing, private finance or some other form of public private partnership, value for money will involve an appropriate allocation of risk".

4.2 This chapter distinguishes between:

- the investment decision, whether or not to proceed with a particular programme or project, based on *Green Book*[3] analysis;
- the delivery model, regarding the appropriate procurement approach or model, including where appropriate those set out in Chapter 2; and
- the procurement process, and whether to compete the contract using the Open, Restricted or Competitive Dialogue approach.

[1] *Improving procurement: progress by the Office of Government Commerce in improving departments capability to procure cost-effectively,* NAO, 2004

[2] *Managing Public Money,* HM Treasury, 2007

[3] *The Green Book: Appraisal and Evaluation in Central Government,* HM Treasury

Box 4.1: Drivers of value for money in procurement

The drivers of value for money set out below and their importance to a particular procurement, or programme of procurements, will depend on the particular nature and circumstances of the procurement being considered. Procuring authorities need to:

- **be clear in their objectives** and assess these throughout the procurement process so that changing circumstances do not disproportionately affect desired outputs;
- **focus on whole life costs** rather than just the upfront costs involved, and ensure that externalities, including sustainability issues, are properly taken into account;
- **use an outputs specification approach** to drive the project description and procurement which, among other things, allows potential bidders to develop innovative approaches to satisfying the service needs of the procuring authorities;
- **optimise the allocation of risks between the various parties,** so that risks are allocated to the party, or parties, which are best placed to manage, minimise and bear these risks over the relevant period;
- **rigorously identify, transfer and manage risks** throughout the project lifetime so that the relevant costs and probabilities of occurrence can be controlled and minimised;
- **ensure there is a competitive market** which has or can develop the ability to meet the public sector's requirements effectively and efficiently;
- **ensure there are sufficient skills and expertise** in both the public and private sectors, and that these are deployed effectively in planning the project during the procurement process and subsequent delivery;
- **structure the procurement process appropriately** to enable any additional benefits to be realised, such as the release of any hidden asset values, or ensure that the overall costs are ameliorated through the use of any developed assets by third parties;
- **leave sufficient flexibility** to ensure that any changes to the original specification or requirements of the procuring authority can be accommodated during the delivery life of the project at reasonable cost. They also need to ensure that any effects of changing technology or delivery methods can be accommodated or, alternatively, building in break points to allow for separate procurements at each stage in an overall programme;
- **ensure there are sufficient incentives within the procurement structure** and the project contracts to ensure that assets and services are developed and delivered in a timely, efficient and effective manner, including both rewards and penalties as may be appropriate;
- **allow for sufficient and robust competition** to drive effective value for money and ensure that the scale and complexity of the procurement are appropriate to obtain a sufficient response from bidders to enable a competitive procurement process; and
- **set an appropriate term for the contract** to the scale of the project and the relevant lives of the underlying assets. As well as being important in terms of value for money this also has implications for affordability.

4.3 The focus of this chapter is on how to drive value for money using generic value for money drivers set out in Box 4.1. Procuring authorities should adhere to these when evaluating and selecting the appropriate delivery model or approach. Where procuring authorities do not have relevant internal experience of alternative procurement routes, or limited capability in this often complex area, then they should discuss these issues with their departmental private finance unit in the first instance or the relevant Treasury spending team.

THE STRATEGIC INVESTMENT DECISION

4.4 When considering the initial decision to approve an investment project, the senior responsible officer (SRO) should undertake a full value for money appraisal using the *Green Book* methodology. The investment decision should be the first step taken in assessing value for money. It should not be confused with decisions on the delivery model or the procurement process. In 2006[4], the NAO set out a list of key points to be considered in making an investment decision for a PFI project, summarised in Box 4.2. While the NAO report specifically addressed PFI, the points are applicable to complex procurement more generally.

Box 4.2: NAO key questions in considering the investment decision

In 2006 the NAO published a report setting out the issues that need to be considered in evaluating PFI projects. The points set out below are also applicable to major complex projects procured through other delivery models.

- Have clear objectives for the project been set?
- Does the project meet policy imperatives?
- Was the project assessed as being a priority?
- Has a preliminary evaluation of the benefits sought been made?
- Has long-term commitment to the project been demonstrated?
- Are the project outcomes clear?
- Have the project's wider socio-economic benefits been quantified?
- Does the proposed solution clearly meet business requirements?

Source: A framework for evaluating the implementation of Private Finance Initiative projects, NAO, 2006

The Green Book

4.5 The *Green Book* is intended to provide a comprehensive overview of the assessment process, from the justification for government action through to the development and implementation of lead options. Its aim is to provide non-specialists and senior managers with sufficient information to be comfortable with the structure of a typical appraisal. It should enable them to ask the correct questions, take informed decisions, and become supportive critics of the detailed analysis.

4.6 When assessing value for money it is important that the procuring authority fully considers the possible impacts that its procurement, and any specific impacts under a particular delivery route, may have in the context of wider public sector value

[4] *A framework for evaluating the implementation of Private Finance Initiative projects,* NAO, 2006

for money. Similarly to the treatment of externalities in the assessment of projects under the *Green Book*, it is important to consider the impacts of undertaking a procurement on other areas of the public sector and the wider economy as a whole. Such procurement-related externalities can be positive or negative. For example, undertaking a procurement may have an impact on the supply side capacity of a particular part of the private sector.

VALUE FOR MONEY IN THE DELIVERY MODEL DECISION

4.7 As noted above, value for money can be defined as the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user's requirement, and does not always mean choosing the lowest cost bid. While there is general agreement and reference to this high-level definition within the public sector and value for money is a concept often deployed across government, there is little actual detailed guidance on what value for money is and how it should be achieved, beyond the *Value for Money Assessment Guidance*[5] for PFI. While value for money is often a function of the delivery model and the contractual structure used, the procurement process itself, and the way in which it is managed and undertaken, can also have a major impact on delivering value for money.

Value for money as a relative concept

4.8 Value for money is a relative concept. It is measured in terms of a comparison with other potential or actual outcomes. To assess value for money therefore requires an ability to define, estimate or identify both a proposed approach and its related outcome and compare this to at least one alternative approach and its related outcome. The value for money drivers in Box 4.1 will assist procuring authorities in making this evaluation.

4.9 Value for money is assessed at various stages throughout the life of a project. In the early stages of a value for money assessment, both at the strategic investment decision stage and at the delivery model decision stage, in most cases there will be a high degree of estimation as to the likely outturn of both the preferred and possible alternative procurement routes. Even at the later stages of an actual procurement, unless two identical projects have been procured under alternative delivery models, which is highly unlikely in practice, a procuring authority will not be able to measure definitively the relative value for money of alternative procurement routes. However, procuring authorities should note that in assessing value for money they should not depart from the generally accepted definitions.

4.10 Information gathered from previous similar procurements, in the same or different sectors, can provide objective evidence of likely outcomes at least to the extent that similar outcomes would be expected. However, it is important for procuring authorities to acknowledge from the start that assessing the relative value for money of alternative procurement routes requires a considerable degree of judgement to be used, in conjunction with consultation and advice from other experienced parties.

4.11 In addition to value for money being relative between different projects and procurement routes at a given time, value for money can also be relative over time. As markets change and mature, what was once considered to be the most appropriate way to procure a project, or the terms which can be achieved, may itself change. Therefore care must be taken when comparing and benchmarking current situations to historical information and data. For example, the decline in risk premia on debt financing for PFI

[5] *Value for Money Assessment Guidance*, HM Treasury, 2006

projects as the market has become established illustrates how changing market conditions need to be taken into account.

Quantitative assessment of value for money

4.12 *Value for Money Guidance* for PFI requires the procuring authority to undertake a quantitative assessment of value for money for a PFI scheme as part of the stage 2 project appraisal. The quantitative analysis is a useful tool to help support the qualitative judgement of the most appropriate procurement route. The procuring authority should show that every effort has been made to quantify all relevant costs and benefits.

4.13 In exceptional cases there may be clear but unquantifiable costs or benefits which are deemed sufficient to override a quantitative value for money result. Where this is the case there must be a clear statement of these decisive factors, why they are considered sufficient to influence the decision, and why they cannot be quantified in the analysis. It is important however that such analysis is transparent and that it is not structured in such a way as to produce a biased or predetermined result. It is also important that procuring authorities consult with other authorities which may be affected by their procurement contracting decisions, the Treasury and, where appropriate, the Office of Government Commerce (OGC).

4.14 Departments have the responsibility for designing and implementing value for money delivery models and procurement processes. The Treasury expects departments to have or develop effective tools for assisting procurement teams and for appropriate scrutiny. In order to support departments and as experience with a range of models grows, the Treasury intends to revise its *Value for Money Assessment Guidance* to take account of the broader range of delivery options set out in this document.

COMPETITION AND THE PROCUREMENT PROCESS

4.15 Whichever delivery model is adopted it is important, in order for the value for money drivers to be effective, and for overall value for money to be achieved, that the procurement process is well planned, managed and executed. Successfully undertaking the procurement of major projects is a complex and substantial activity and resources with the relevant capacity (in terms of quantity of resources) and capability (in terms of the qualities and skills of the resources) need to be deployed.

4.16 Competition (and, indeed, contestability[6]) is a fundamental driver of value for money and productivity performance. Vigorous competition strengthens incentives to innovate and ensures that resources are allocated efficiently. By encouraging the private sector to innovate, reduce prices and improve the quality and choice of goods and services, it is also the most effective way of ensuring that the taxpayer receives a fair deal.

4.17 Competition should also be a key driver in delivering value for money through procurement, and as such any movement in procurement strategy or delivery model away from a competitive route, such as alliancing or exclusive partnering, should only be agreed following a thorough analysis of the benefits afforded and when they can be clearly demonstrated.

4.18 The European Public Procurement Directives provide for value for money to be obtained through competition. A report[7] commissioned by the European Commission

[6] *Competitive Edge: Does Contestability Work?*, The Serco Institute, 2007

[7] *Evaluation of Public Procurement Directives*, Europe Economics, 2006

estimates that the directives led to an overall price benefit of between 2.5 and 10 per cent in 2002.

Competitive Dialogue

4.19 The Competitive Dialogue procurement procedure, described in Box 4.3, was introduced into the UK in January 2006. There is now a presumption that the majority of major projects, including those delivered through PFIs and other Public Private Partnerships, will be procured under this procedure. Based on the experience of using Competitive Dialogue in a variety of circumstances over the past two years, the Treasury and the OGC will be publishing new guidance on the Competitive Dialogue procedure in spring 2008.

Box 4.3: Competitive Dialogue

The Competitive Dialogue procedure allows contracting authorities to undertake a pre-qualification process and then to invite short-listed candidates to participate in a dialogue process during which any aspects of the project may be discussed and solutions developed. The contracting authority can continue the dialogue until it identifies one or more solutions that are capable of satisfying its requirements. It then closes the dialogue and invites final tenders. Only limited discussion and clarification, which does not amount to "negotiation", is permitted once the dialogue stage has closed.

The new Competitive Dialogue procedure can only be used in the case of "particularly complex contracts". A public contract (under Regulation 18(1) of the Public Contracts Resolutions 2006) is considered to be "particularly complex" where at the outset the contracting authorities:

- are not objectively able to define the technical means capable of satisfying their needs or objectives; and/or
- are not objectively able to specify the legal and/or financial make-up of the project.

In addition, in order to use the Competitive Dialogue procedure the contracting authority must "consider that the use of the Open or Restricted procedure will not allow the award of the contract".

The process up to the point at which short-listed candidates are invited to participate in dialogue is broadly similar to the processes undertaken in the Restricted and Negotiated procedures. However, the requirement formally to start and end the dialogue stage is a significant variation from the Negotiated procedure, as is the limited room for manoeuvre which is available to both the contracting authority and bidders once dialogue has been closed.

4.20 The Competitive Dialogue procedure reinforces good procurement practice including, among other things, requirements as to the maturity of a project before it goes to market. As noted in Chapter 5, the early experience of the Major Projects Review Group has underlined the value of appropriate intervention at early stages of the project. As experience develops across a broader range of major procurements, the Treasury intends to issue guidance on project maturity in due course.

4.21 Undertaking a procurement process in an efficient, transparent and well-executed manner helps to reduce transaction costs, increases potential and actual bidder involvement and ensures a more competitive procurement, whatever procurement route or delivery model is used.

5 Strengthening scrutiny, support and skills

This chapter sets out the current scrutiny arrangements for major procurement projects and measures the Government is taking to provide a more systematic, value-added, risk based approach. In addition, it sets out the guidance and support available and the skills and experience that will be required to deliver complex procurements. This chapter explains that:

- departments will retain responsibility and accountability for scrutiny and value for money of their projects;
- the Major Projects Review Group will continue to provide independent, expert oversight of the largest and most complex government projects from an early stage;

and also outlines:

- how the capacity for independent central scrutiny will be further enhanced;
- how the Government will develop guidance and support for procurement and operational issues; and
- the steps the Government is taking to enhance the skills of public sector procurers.

Current scrutiny arrangements

5.1 By convention all government spending needs the approval of the Treasury. In practice the Treasury gives departments the freedom to spend their budgets according to their own priorities, subject to their internal approval processes, except for the very largest procurements, by setting financial limits for each department: the delegated authorities. Departments have full responsibility for expenditure below the limits, while above the limits they need the explicit approval of the Treasury.

5.2 Even in the latter case, however, it should be stressed that the departmental Accounting Officer, usually the Permanent Secretary or departmental head, has the final sign off and is ultimately accountable to Parliament for the decision to commit public money to a project. Treasury approval is a necessary, but not a sufficient, condition for a project to proceed. This is an important principle because it means that accountability for ensuring value for money rests with the department with the budgetary and policy responsibility.

5.3 While most spending authority within departments is likely to be cascaded down to more junior levels, Accounting Officers will normally personally approve the largest and most important items of spending. It is normal practice in departments for some form of investment board, or the main departmental board itself, to scrutinise the largest projects, to assist the Accounting Officer in making the value for money judgement. For Public Private Partnership (PPP) projects, departmental private finance units provide additional support.

5.4 Departmental delegated authorities reflect the different nature and complexity of the projects the particular department tends to undertake, their track record on delivering them and on financial management more generally. While scrutiny arrangements need to reflect differences in departmental capability, and the nature of their projects, the Government is taking a more systematic, risk-based approach.

5.5 Departments provide returns on the projects that are over their delegated authorities, including standard basic information on projected costs and where they are in the procurement process. This enables the Treasury and departments to plan how and when scrutiny will take place.

5.6 Departments that can demonstrate a good track record on delivering projects to time and budget should expect this to be reflected in their delegated authorities. Reviewers are also likely to factor in departmental capability when carrying out their project scrutiny.

5.7 When scrutinising a project the Treasury's focus is largely on policy questions around value for money and affordability. This will include whether the project is aligned with departmental objectives, whether the department has considered sufficiently alternative means of delivering the policy objectives that might be more cost effective and whether the department has the resources available within its budget to fund the project.

5.8 The Treasury challenges departments on these important issues before they commit substantial resources to these projects. The Treasury intends to focus more in future on scrutinising specific aspects of a project, such as the delivery model and the procurement process and their likely impact on the timely delivery of objectives. It will use, and be expecting departments to use, the principles outlined in Box 4.1.

Local authority scrutiny

5.9 Local authorities are responsible for scrutiny of their own projects. However, with some exceptions, there has been little or no central scrutiny of local authority procurement beyond the initial funding approval. An exception to this is the Private Finance Initiative (PFI) where local authority projects have been subject to a rigorous approvals process by the Project Review Group (PRG) which was established in 1997 following the first Bates Review[1]. Box 5.1 sets out further details on the work of the PRG.

Box 5.1: Project Review Group

PRG is the final confirmation step in the award of long-term funding support, known as PFI Credits, to local authority PFI projects. The PRG both oversees and is part of an overall scrutiny and approvals process in awarding such funding.

The PRG consists of a two-stage process, and is itself part of a more extensive process of assessment by the authorities themselves and sponsoring departments. This programme of scrutiny provides comfort to the private sector about the quality and maturity of projects being brought to the market, reassures local authorities that there is a fair and equal treatment across sectors and confirms that the project will attract funding from central government before a commitment is made to the major expenses involved in a Private Finance Initiative (PFI) procurement by both public and private sector parties.

The PRG is chaired by the Treasury and contains permanent representatives from Communities and Local Government (CLG) and the Public Private Partnerships Programme (4ps). Appointments are made to the panel for a period of 12 months and individuals are selected on the basis of their knowledge and experience of PFI rather than specific departmental representation.

[1] *Review of the Private Finance Initiative*, HM Treasury, 1997

A SYSTEMATIC RISK-BASED APPROACH TO SCRUTINY

5.10 No matter how good departments' governance arrangements are, there is a strong case for external scrutiny from the centre for the largest and most complex projects because:

- the centre of government can generally draw on people with a wider range of experience and expertise than an individual department;
- in a world where departments may be adopting the more novel commercial approaches to procurement including, but not restricted, to those set out in Chapter 2, early exposure to them will help the centre to keep pace with market developments. This will enable lessons from these projects to be disseminated to a wider audience where appropriate;
- external scrutiny can be more objective about a project's prospects, and be less constrained about making appropriate criticisms; and
- there is a greater risk that a department might not be able to absorb significant cost overruns on its largest projects within its own budget, so a proportion of this risk might fall on the Exchequer with, ultimately, implications for the resources of other departments.

Establishment of MPRG

5.11 Learning from, and building on, the example of the PRG's scrutiny of local authority PFI projects described above, the Treasury has established the Major Projects Review Group (MPRG), announced in *Transforming government procurement*[2]. Chaired by the Treasury, the MPRG is a panel of commercial experts from across government, set up to give Treasury ministers independent advice on the deliverability, value for money and affordability of the largest and most complex procurement projects at an early stage, before going to market, and again before the end of the competitive procurement process.

5.12 Projects are selected for review by MPRG on the basis of their whole life cost, complexity, and replicability. With respect to replicability, an individual project may not in itself be that expensive, but if it is a model that is to be repeated many times over in a programme of investment it becomes much more important to get it right. A further important factor is whether the procurement approach is in some way novel. All of the projects MPRG reviews are non-standard, and any large procurement project is likely to contain at least some elements that are bespoke to it. This makes it all the more important that there is effective scrutiny, to help mitigate risks for the projects themselves, but also to capture for wider benefit interesting innovations in the market.

5.13 The scrutiny points align closely with the Office of Government Commerce's (OGC) Gateway Review stages 1, 2 and 3 which guide the progress of public sector procurements. As an example, the Department for Transport's internal scrutiny arrangements follow this model closely, with the main board acting as the approval body. The Ministry of Defence (MoD) follows this model increasingly closely and, as set out in Box 5.2, has established a new scrutiny function within its commercial directorate to feed advice into its Investment Appraisal Board. The Treasury and departments are learning from each other in the development and importance they attach to central project scrutiny, with common approaches increasingly emerging from practical experience.

[2] *Transforming Government Procurement,* HM Treasury, 2007

Box 5.2 MoD's internal scrutiny process

The MoD's internal scrutiny process is separate from its acquisition function. This provides an independent, non-advocate, expert and critical analysis of an investment proposal to determine whether the evidence presented supports the recommendation made to the approving authority over other options.

This scrutiny tests the strength of a proposal by considering whether:

- it is coherent, justified and affordable within the context of the wider defence programme and planning assumptions;
- it will deliver the requirement and provide value for money;
- risks have been clearly identified and appropriate arrangements to manage them put in place; and
- the balance of risks and benefits has been addressed.

The MoD also seeks to ensure that the negotiated contract terms achieve the desired outcome. This includes an assessment of the risks, governance and technical feasibility of a project, which advises the approving authority whether the requirement will be deliverable under the proposed commercial terms, and if there is an appropriate balance of incentives and protections to ensure the MoD receives an appropriate level of service from the contractor during the life of the proposed contract.

5.14 The MPRG's working methods are still evolving. For example in some cases MPRG assessments are carried out together with, rather than in addition to, the relevant OGC Gateway Reviews where they are due to happen at around the same time; to reduce the burden on the project team the pipeline of future projects is settled earlier, so projects have more advance notice; and MPRG's areas of interest are decided and conveyed to the project in good time. Even during this early developmental stage, departments that have been through the process have welcomed the additional challenge and support it has provided.

5.15 Because of the expertise and experience of its members, MPRG can add value to projects, by challenging them and pointing out how they might mitigate key risks. Looking at these projects at an early stage and before they go to market, MPRG can help to ensure that concerns are addressed before full engagement with, and therefore significant bid costs are incurred by, potential suppliers.

5.16 The MPRG has advised on procurements relating to: the enabling retirement savings programme; Crossrail; the Nuclear Decommissioning Authority's competition for Sellafield; carbon capture and storage; the Defence Training Rationalisation Programme; and Pandemic Influenza Preparedness Programme. The Treasury's departmental report will provide further details of the MPRG's work to date.

5.17 Having established a working model that departments welcome and are increasingly familiar with, the Government is keen to extend those benefits to other projects for which additional scrutiny will be valuable. In particular, the scrutiny will seek to establish that in determining the delivery model, departments have rigorously applied the value for money principles set out in Chapter 4.

Approvals process for other major projects

5.18 There will continue to be projects that come to the Treasury for approval that may not warrant an MPRG review. In these cases the Treasury will continue its traditional policy scrutiny role, but with an increasing emphasis on early involvement before they go to market. A key object of early Treasury scrutiny is to shorten timescales and make the overall procurement process more efficient.

SUPPORT AND GUIDANCE

5.19 Since PFI became widely used in public sector procurement, an extensive body of guidance and other support has been developed, building on the lessons learned from over 625 PFI projects. This body of guidance is available from the Treasury website and is also supported by material published by departmental private finance units, the OGC and local government's procurement specialists, the 4ps.

Value for money assessment

5.20 *Value for Money Assessment Guidance* sets out a mandatory process and methodology to be used in considering whether value for money will be realised through a PFI procurement route. This is a thorough and highly developed procedure involving the application of both qualitative and quantitative tests. This assessment drives a procuring authority's decision to use PFI or not. As described in Chapter 4, the Treasury intends to build on this value for money guidance to make it applicable where a range of delivery models may be under consideration, rather than the binary decision between PFI and conventional procurement that is currently commonly applied.

Standardised contracts

5.21 The Treasury has also developed the Standardisation of PFI Contracts (SoPC), which sets out a standard approach to the risk allocation between the public and private sectors and includes principles and drafting for the key contractual clauses. The latest version, SoPC4, was released in March 2007 and is mandatory for all PFI contracts. In addition, each of the key sectors has in place a fully developed SoPC - compliant standard form contract. Any derogations from SoPC or the relevant standard form contract must be cleared by the Treasury.

Financial issues

5.22 A body of finance guidance issued by the Treasury covers issues such as strategies for managing inflation risk and technical aspects, for example the compensation payable to bond holders on early termination (application of the "modified Spens formula"). The guidance also sets out the voluntary code[3] for the sharing of gains between the public and private sectors under any refinancing of early PFI projects.

Operations

5.23 Three Operational Taskforce notes set out procedures for managing the transition to the operational phase, how to get the best value out of benchmarking and market testing exercises, and standardised drafting of a protocol for dealing with changes during the life of a project.

Moving forwards

5.24 Reflecting the Government's commitment to using PFI where it represents value for money, this body of guidance will continue to represent best practice for PFI projects and it will continue to be updated as appropriate. At the same time, the lessons learned from the public sector's experience of PFI will be applied to other procurements, including the approach to assessing value for money set out in Chapter 4 and the value of private finance in PPP projects, discussed in Chapter 3.

[3] *Refinancing of early PFI transactions - Code of Conduct*, 2002, HM Treasury

5.25 Guidance for PFI was developed in tandem with early PFI projects, starting with a principles approach and finally reaching the standardised terms and conditions codified in SoPC4. The Treasury will consider what additional guidance should be made available to support other emerging procurement routes and delivery models. For example, as set out in Chapter 2, the Treasury will revise the guidance for Joint Ventures.

OPERATIONAL PROJECTS

5.26 Over 510 PFI projects with an aggregate capital value of £45.1 billion are now operational. A major survey of operational PFI projects was carried out in 2005-6 by Partnerships UK[4] and published in *PFI: strengthening long-term partnerships*. This survey showed a high level of satisfaction among public sector managers with PFI projects. Also, a National Audit Office (NAO) report in 2008, *Making changes in operational PFI projects*, found that PFI contracts offered sufficient flexibility to manage the changing demands of public sector authorities. Box 5.3 summarises some of the key findings of this research.

Box 5.3: Performance of operational PFI projects

- **PFI is meeting the expectations of users.** Public sector contract managers report that 96 per cent of projects are performing at least satisfactorily, with 66 per cent of projects performing to a good or very good standard. Users believe that service standards were met always or almost always in 79 per cent of projects.
- **Payment and performance mechanisms are effective**. Payment deductions have been relatively low as contractors are generally meeting the required service levels under the contract for most projects and have generally been effective in stimulating performance where they have been levied.
- **Public/private sector relations are working well**. 97 per cent of public sector contract managers rated the relationship with their private sector counterpart as satisfactory or better, with 72 per cent rating it as good or very good.
- **PFI deals are offering sufficient flexibility to the public sector.** Contractors handle urgent requests in a timely manner and 90 per cent of contract managers are satisfied or very satisfied with the quality of work done to implement changes.

Sources: Report on Operational PFI Projects, Partnerships UK, 2006 and Making Changes in Operational PFI Projects, NAO, 2008

5.27 PFI projects in operation are supported by the Treasury's Operational Taskforce (OTF) based at Partnerships UK. The OTF helpdesk provides support to public sector managers seeking advice from its team of experienced practitioners across a wide range of issues. The Taskforce has also organised training and events for public sector contract management staff. Additionally, the OTF has carried out assignments to support individual projects. This work has included small variations, mergers of major departments, re-competition strategy, termination options, benchmarking of soft services, assistance with the development of change protocols and a number of pilot Operational Reviews.

[4] *Report on Operational Projects,* Partnerships UK, 2006

5.28 For local government PFI projects additional support is provided by the 4ps (Public Private Partnership Programme, an organisation sponsored by the Local Government Association) through a programme of training, sector-specific reviews and the creation of networking groups to share best practice. Departmental private finance units (PFUs) also provide support to operational projects.

5.29 The Government remains committed to supporting, and driving value for money in, operational PFI projects. The Treasury intends, during 2008, to commission a survey of the current position of operational PFI projects and the issues they face. It will use the results of that survey to inform its consideration of how support to operational projects might be strengthened. The OTF will also support the Treasury's moves to manage the PFI supplier market more proactively through a structured programme of engagement and dialogue. In due course the OTF will broaden its remit to provide support to the full range of PPP projects as they become operational.

Refinancing

5.30 The Treasury's Refinancing Taskforce, part of the OTF, provides support to operational PFI project refinancings. Refinancing is a specific, and often highly technical, issue faced by some PFI projects. *PFI: Strengthening long-term partnerships* noted that a small but significant number of PFI projects had amended their financial arrangements with debt providers and that all PFI projects were now subject to a gain sharing arrangement between the PFI contractor and the procuring authority. Refinancing has continued at a modest pace, with the Government receiving over £150 million from these arrangements in total.

5.31 The Government continues to support value for money refinancing and is currently reviewing, based on comments received from the market and procuring authorities, *Application note – value for money in refinancing*[5]. If it is determined that any aspects require clarification, an addendum to the Application Note will be issued. Where, under alternative delivery models, there may be a prospect of refinancing gains at a future date, the Treasury will expect gainshare mechanisms, based on principles similar to those set out in SoPC4, to be included in the contract.

5.32 Changes to the terms of debt financing generally result in a reduced ongoing cost of the initial debt over the remaining life of the project. The benefit of this change can accrue over time, or at the time of the refinancing where the structure of the debt is consequently altered and the total borrowing level increased. The provisions of the voluntary code and SoPC4 deal with the complexity that can be involved in determining the value of such changes.

5.33 In some cases, however, a contractor is able to negotiate a change in debt funding terms, in recognition of changes in the project's risk position or in the debt market generally. Where such a change is straightforward and does not involve a restructuring of the loans, the cost of full compliance with the provisions of the voluntary code or contract provisions may outweigh the benefit from the change. Treasury intends to issue guidance to enable simple refinancings, where there is no change to public sector liabilities in the event of termination, to proceed in circumstances where no refinancings would otherwise take place.

Portfolio debt refinancing

5.34 While the refinancing of debt can bring benefits for both the public and private sector, the costs involved in putting in place the changes necessary to realise these benefits can also be significant, one reason that there has been less refinancing activity in smaller PFI projects. The development of portfolios of PFI projects, where the Special

[5] *Application note – value for money in refinancing*, HM Treasury, 2005

Purpose Vehicle (SPV) equity for a number of projects is held by the same private sector entities, presents an opportunity for shareholders to look at debt arrangements for projects in combination. In some cases it is possible for new financing at a level above the projects (a corporate or "portfolio" level transaction) to replace the initial debt at project level.

5.35 The Government considers that PFI portfolio refinancings are governed by the gainsharing arrangements that have been put in place, either under the voluntary code or contractual arrangements. During 2007, the Treasury reached agreement with a private sector sponsor on sharing gains arising under a portfolio refinancing. The public sector's share of the gain created at the portfolio level has been shared among the relevant authorities for the underlying projects.

BUILDING CAPABILITY AND CAPACITY

5.36 As set out in Chapter 4, one of the key value for money drivers and hence a critical requirement for effective procurement is the ability of the authority to act as an intelligent client. Performance in the successful delivery of outcomes is strongly dependent on the skills of the client, not simply on the contract structure.

5.37 The skills required include those which are needed to create an effective engagement with the market, to structure the right deal and an underpinning contract to support and to drive continuous value from that arrangement throughout its life. Further value can be achieved by taking a whole-of-government view of key suppliers and driving performance improvement through strategic engagement, based on objectively measured performance. The Government is committed to building procurement capacity and capability, in the broadest sense, of the public sector to ensure it is able to deliver government's most complex projects.

5.38 Transforming government procurement sets out the following objectives in relation to procurement skills:

- Ensuring the right skills are available at all levels within government, with a career and pay structure that reinforces the recruitment and retention of high calibre professionals.
- Matching skills to projects, ensuring that the most complex and important procurements have the best staff assigned to them.
- Effective management of contracts in operation, where the right objectives, incentives, people and support need to be in place for contract managers to deliver public services outcomes.

To achieve these objectives the Government is committed to raising the level of procurement skills, and raising procurement capacity within departments and capability within contracting authorities more generally.

Government Procurement Service

5.39 To address this the Office of Government Commerce (OGC) reformed the Government Procurement Service (GPS), alongside the existing Professional Skills for Government programme. The vision for the reformed GPS is to create a sustainable balance of appropriately skilled and suitably managed procurement professionals, to match the growing scale and complexity of the Government's delivery agenda.

The role of the GPS is to provide:

- professional leadership and standards for government procurement professionals;
- a central framework of professional competencies; learning and development opportunities;
- career development support and advice; and
- to streamline and formalise entry routes to the profession across government that are supported by tailored learning and development portfolios.

Box 5.4 describes the progress made by the GPS.

Box 5.4 The Government Procurement Service

- The new Chief Executive of the OGC was appointed as head of the GPS to raise its status in line with the approach taken by other professional bodies within the civil service.
- The GPS Council has been established, comprising, the head of the GPS and the departmental heads of profession, to provide leadership to the procurement profession across central government.
- A skills strategy has been developed to provide a framework to identify gaps and create learning and development interventions to meet capability requirements.
- A competency framework for procurement practitioners and leaders has been set out.
- The GPS now provides professional career development support, and advice and details of learning and development opportunities across government.
- The GPS has launched three new routes into the procurement profession:
  - the Government Procurement Graduate Scheme, which takes trainees through a two-year accelerated learning and development programme, the second intake for this scheme is currently being recruited;
  - the Fast Stream Procurement Placement Option, which offers a number of places in commercial roles, with the aim of equipping future senior civil servants with a sound understanding of the significance and complexity of procurement activities; and
  - GPS Switch Track (mid-career entry), a pilot scheme to help departments meet their need for more professionally qualified procurement managers, allowing civil servants to switch career into the GPS and obtain professional accreditation.

5.40 During 2008 the OGC will continue to work closely with the departmental heads of profession to raise the profile of procurement as a profession within government and to increase the membership of the GPS. It will further develop its learning and development programme to ensure appropriate opportunities are in place to meet the needs of departments and the wider public sector.

Specialist training

5.41 The 4ps and Partnerships UK provide further specialist training in relation to PPPs. The 4ps has a skills development programme to build capacity in local authorities at strategic, project, specialist and operational levels to improve the delivery of projects and enable better procurement across local government. 4ps is developing a project directors' development programme, which will lead to a diploma qualification aimed at advancing the leadership skills and technical expertise of project directors within local government.

5.42 The OTF also provides support to project teams managing operational projects and has organised a number of training events for public sector contract management staff. More recently it has developed a programme of contract management training in conjunction with a private sector partner.

Procurement Capability Reviews

5.43 Procurement Capability Reviews (PCRs) were piloted in early 2007 and rolled out across government during the year. The purpose of these reviews is to assess how far procurement meets the demanding standards required to deliver value for money. PCRs provide an independent, strategic view of the overall procurement capability of a department and its wider network of agencies, identifying exemplars as well as areas for improvement. The reviews perform a challenge function at a strategic and structural level, covering the widest definition of procurement from commodities through to complex projects, including the whole life cycle, from policy and strategy to delivery and disposal.

5.44 The reviews involve small teams of high calibre commercial, procurement and programme and project management experts, drawn from the public and private sectors, engaging with departments over a relatively short but intensive period of three to four weeks. The OGC has committed to delivering 18 reviews by December 2008. The first three reviews, covering the former Department for Education and Skills, the Department for Communities and Local Government, and the Department for Work and Pensions, have been completed and the findings published. Each department has an individual action plan and follow up review to ensure that recommendations are acted upon. The next tranche of reviews will be published in early summer 2008.

5.45 Initial findings from the first three reviews have concluded that in order to meet the challenges of the different environments within which they operate the departments have each applied different approaches. The variable range of capability across the three departments is due to a number of factors and there is no single, simple solution to the issues they face. As the PCR programme grows, OGC will be drawing together the key themes and developing strategies to address the most pressing issues on a cross-government basis.

5.46 Procurement activity necessarily varies across departments, but all departments are assessed against a central common set of criteria based on three major capability areas – leadership, skills development and deployment, and systems and processes – with nine key indicators:

- visibility and impact of leadership;
- vision, aspirations, business and policy alignment;
- stakeholder and supply base confidence levels;
- effective resourcing of procurement activity;
- intelligent client capability;

- governance and organisation;
- strategic and collaborative approach to market engagement and sourcing;
- effective use of procurement and project and programme management tools and techniques; and
- knowledge and performance management.

5.47 The PCR programme is central to the Government's aim to ensure that procurement drives public service improvement. Actions based on recommendations from PCRs are expected to result in improvements to leadership, systems and skills, and ultimately to greater value from procurement.

Departmental private finance units

5.48 Departmental PFUs provide central support within departments to PFI procurement teams, both prior to and following contract signature. This focus has been a significant factor in successful PFI programmes. In some departments, PFUs have already extended their remit beyond PFI, applying the skills and experience accumulated to alternative delivery models as they have developed. The Government encourages the extension of the PFU's role into a broader commercial sphere as part of the enhancement of department's commercial skills more generally.

Commercial directors

5.49 A number of departments have already appointed commercial directors with responsibility for procurement and broader commercial activities. As part of the PCR programme, OGC will be identifying those departments that have not yet but should appoint procurement or commercial directors, due to the nature and scale of their commercial procurement activity.

ISBN 978-1-84532-426-1