National Audit Office

Improving the PFI tendering process

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 149 Session 2006-2007 | 8 March 2007

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1 March 2007

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SUMMARY

1 Before new PFI assets are constructed and services delivered, there is a process by which procuring authorities invite tenders and select a winning bidder for the contract **(Figure 1)**. In order for value for money to be achieved in PFI deals, all stages of the deal have to be managed effectively, including this tendering stage.

2 This study has arisen out of concerns expressed by the Committee of Public Accounts in 2003 that the tendering of PFI projects did not follow good practice and was not handled with sufficient skill on the part of the public sector, incurring high costs and risking value for money. New European Union procurement rules reinforce the need for best practice in the future.

3 We examined the tendering process for all central Government Department PFI projects in England that closed between April 2004 and June 2006, including PFI schools and hospital projects.[1] The effectiveness of this process impacts directly on the value for money of PFI deals, though it is outside the scope of this report to provide an evaluation of the value for money of each single deal that closed over the period.[2]

1 We surveyed 49 projects with a combined capital value of just under £8 billion. We excluded a small number of local authority projects (combined capital value of £750 million) and projects with individual capital values of under £20 million that would now not be considered for PFI under Treasury guidelines.

2 See Appendices 1 and 2 for details of the methodology and projects covered in this study.

4 We found that key elements of the tendering process had not improved and in some respects had worsened:

a There are signs that the private sector is becoming more selective in developing detailed bids[3] for PFI projects, in part due to the cumulative impact of lengthy tendering periods and high bid costs. One in three projects that closed between 2004 and 2006 had two detailed bids competing for the business, compared with one in six authorities prior to 2004.

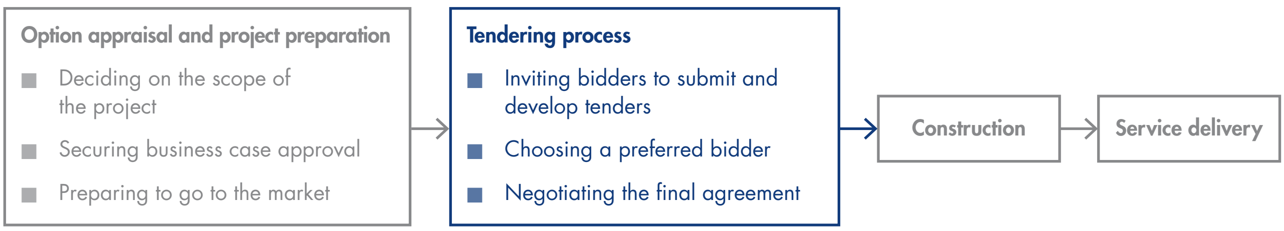
b Though with differences between sectors, tendering periods overall lasted an average of 34 months (25 months average for PFI schools, 38 months for PFI hospitals and 47 months for other PFI projects) - no better than the average for projects that closed between 2000 and 2003.[4] Shorter tendering periods are not desirable if they are achieved at the expense of the overall value for money of the projects. However, we found that many of the reasons for long tendering periods (some of which may relate equally to conventionally procured projects) could have been avoided or mitigated by the public sector, without risking overall value for money. Within the overall tendering period, negotiations to finalise deals with a single preferred bidder have increased, lasting on average over a year and in some cases as long as five years.

c Material changes (both upwards and downwards) were frequently made by public sector project teams and contractors to the prices of deals during preferred bidder negotiations, when the discipline of competitive tension had been removed. In one-third of projects we examined, there were major scope and specification changes (both upwards and downwards) during the preferred bidder period worth just over 17 per cent of the projects' present values or an average of £4 million a year for each project.

d Project teams have continued to plan less well than they should for the amount of professional advice needed for a PFI deal. Where budgets were set, spending was on average 75 per cent more than anticipated, or £0.9 million extra per project. The average cost of external advice for all projects was just over £3 million per project or approximately 2.6 per cent of the capital value of the projects. In the health sector, for which data are available over time, the amounts spent on advisers as a proportion of the value of deals has gone down marginally since 1997-2000.

e Although many project teams told us that they passed on lessons learned to others, systematic ways to ensure that useful lessons are shared were not always exploited. Some issues common to PFI deals were resolved by project teams acting in isolation. However, the issuance of guidance on standard PFI contract terms was one way in which lessons were captured and the Treasury believes that the further development and application of standard terms will yield further benefits in relation to both contractual terms and improved procurement times.

1 The position of the tendering process within a PFI project



Source: National Audit Office

3 Detailed bids for this purpose are defined as bids submitted at the Invitation to Negotiate Stage.
4 The overall average for deals that closed 2000-03 was 33 months. In no sector was there significant improvement compared with the period 2000 to 2003. Our figures for tendering times differ slightly from the figures quoted in *Strengthening Long-Term Partnerships* (HM Treasury, 2006). This is due to a different project selection: further details can be found in Appendix 1.

5 Public authorities are now expected to use a new procurement procedure known as Competitive Dialogue.[5] Under this procedure, more of a PFI deal has to be agreed with all bidders before a preferred bidder is selected than has been the case in the past, so maintaining competitive tension for longer and reducing the scope to make significant changes to the deal once the competition has been closed, as happened in the past. Some sector-specific guidance has now been issued to procuring authorities, however, the practical effects of Competitive Dialogue are uncertain at this early stage. The enhanced competitive element within the new procedure will in principle bring benefits, but any risk of increased tendering costs for the private sector will need to be managed so that bidder interest does not weaken.

Recommendations

6 In its March 2006 publication, *Strengthening Long-Term Partnerships*, the Treasury put forward several proposals to improve public sector skills and procurement support and to reduce procurement timescales and costs for both the public and private sectors. These included a greater emphasis on preparation of projects before they go to the market, increased monitoring and scrutiny of projects, including a new stage of scrutiny before selection of preferred bidder, and measures to address shortages of skills in the public sector. Other measures which had already been taken to address issues of lesson learning, co-ordination and skill shortages included the creation of sector-specific programmes such as Building Schools for the Future. This programme brings together all future PFI school projects with the aim of introducing centralised programme management. Our recommendations are intended to supplement and to complement these proposals and measures, and will remain relevant in the light of the Competitive Dialogue process.

Addressing the risk of PFI deals not receiving enough developed bids for a viable competition

a The level of public sector experience is a factor that can influence bidders' interest in projects. Authorities should always ensure that they can draw on staff with experience of complex capital procurement and Departments, including where relevant their Private Finance Units (PFUs), should also have sufficient specialist knowledge on which to draw. As part of the reform of the Government Procurement Service[6], the Office of Government Commerce (OGC) is considering how to facilitate the effective recycling of existing skills in complex procurement across the public sector and to promote an attractive career path in complex procurement, such as PFI, backed by a structured training and development programme.

b Public sector procurement teams have in the past aimed to receive detailed bids from at least three bidders. Under Competitive Dialogue, there may be circumstances in which, after eliminating weaker bidders, it makes sense to undertake the later stages of the dialogue with the two strongest bidders. However, where only two viable bids for a project are received early on, or if bidders pull out of the competition, leaving the procuring authority with only two bids to choose from[7], there should be a review by the relevant sponsor Department. The review should consider whether:

- there are any defects in the scoping or management of the project that may explain the low level of market interest and could be remedied in time for a re-run of the competition; and whether
- the bids on the table offer a good competition and are likely to lead to a value for money solution.

c The OGC should ensure that there are consistent principles and comprehensive guidance for practitioners across the public sector in applying the Competitive Dialogue procedure to PFI procurement. The OGC should also carry out a review after the first 18 months of the operation of Competitive Dialogue to identify any lessons, in particular to ensure that private sector bidder interest is maintained.

d For the first time there is now a database maintained by the OGC containing information about planned construction projects across the public sector. Departments should use this database to assess the impact of their planned projects on the market. In addition, the OGC should use the database to provide the market with information on when projects are expected to proceed to tendering and to monitor whether projected demand from the public sector is likely to exceed market capacity. Departments and, where relevant, the Treasury should also continue to assess whether project teams have tested likely market interest as part of the Outline Business Case approvals process.

5 This stemmed from an EU Directive, implemented into UK law from January 2006, which added the option of Competitive Dialogue to the existing range of public procurement procedures.
6 *Transforming government procurement* (HM Treasury, January 2007).
7 In cases where only one bid has been received, the Treasury has published specific value for money guidance.

Reducing the length and cost of tendering

e We have found examples of well managed and properly resourced projects that have taken 18 months to tender, including preferred bidder negotiations lasting less than six months. This suggests that a target of between 18 to 24 months would not be unreasonable for many projects, although it may be unrealistic for particularly complex, one-off PFI deals. Departments should agree with the Treasury what would constitute an appropriate target time for their sector, and individual procurement teams should be bound to this unless they can satisfy the Department that the target would be unrealistic in their case, even with more up-front preparation.

f To achieve much tighter timescales while maintaining good value for money, Authorities should:

- obtain commitment to the project from all key stakeholders at an early stage;
- develop better output specifications, including greater dialogue with potential bidders about the design of assets, before approaching the market;
- establish the affordability of the project before it is brought to the market and again before a preferred bidder is selected. In establishing affordability, authorities should calculate available resources against a range of scenarios; and
- agree the commercial basis of a deal as well as key aspects of the detailed design prior to selecting a preferred bidder – now a requirement under the Competitive Dialogue procedure.

g As part of good project and programme management using appropriate methodologies, the monitoring of projects as they progress through procurement should be ongoing and highlight where target times are likely to be missed. In these cases, the likelihood of missing the target time should serve as an alarm signal and trigger an action plan from the procuring authority.

h Partnerships UK maintains a database of information on PFI projects, parts of which are available on its website. The Treasury should consider whether information on the length of time taken to procure individual deals should be published, possibly in the form of an annual league table, to help motivate project teams to achieve shorter tendering times.

i The same issues arise repeatedly across projects, lengthening procurement periods and increasing costs unnecessarily. Departments should identify lessons from recently closed PFI projects of relevance to subsequent projects, revising sector-specific guidance and standard specifications where new issues recur across projects in a particular sector. Where appropriate, a programme approach to PFI projects such as that under Building Schools for the Future can facilitate the transfer of experience from earlier to later deals.

j There should also be a more structured process of learning and sharing lessons across sectors and public authorities, which includes:

- Departments ensuring that post-project evaluations are completed as a matter of course and any lessons shared with other public sector procurement teams;
- a more co-ordinated and targeted approach to sharing good practice by central advisory bodies such as the OGC, PUK, 4ps and the Project Review Group within the Treasury; and
- a forum through which procuring Authorities can share their experiences and raise queries, to complement the existing PUK helpline.

PART ONE

Introduction

This part of the report sets out the reasons for carrying out this study on PFI tendering, and provides the context of new procurement rules that came into force in January 2006.

1.1 The Private Finance Initiative (PFI) was launched in 1992. Since then successive governments have continued to negotiate projects that draw on private sector expertise, including the raising of finance, to provide services which had been provided directly by the public sector. In total, over 750 PFI deals have now been signed with a combined capital value of £55 billion.

The Public Accounts Committee has expressed concerns about the tendering of PFI deals

1.2 In 2003 the Public Accounts Committee published a report[8] that highlighted common problems in obtaining value for money from the PFI and expressed concerns that:

- Procuring authorities did not have staff with the right skills critical to good project management. There was a need for authorities to give much greater emphasis to developing such skills and to adopt best practice more widely.
- The cost of employing advisers was very high and in many cases exceeded budgets by a substantial margin. Procuring authorities needed to drive down advisers' costs and ensure that sensible budgets were adhered to. They also needed to be mindful of costs to bidders. Imposing excessive costs on bidders was likely to result in higher charges in the long run and risked deterring firms from bidding.
- Many procuring authorities had appointed a preferred bidder even though important issues remained unresolved. Negotiations with preferred bidders needed to be kept to a short and tight timetable.

The Committee concluded that the taxpayer was not always getting the best deal from PFI contracts because good procurement practice was not being followed.

Guidance for Departments to help resolve these concerns has been issued

1.3 **Figure 2** shows the principal measures taken by the Government since 1997 to improve PFI procurement. Some of the more important measures include: the development of sector-specific standard forms, introduced to improve the quality and consistency of PFI contracts and to reduce negotiation times; the introduction of new sector-specific delivery models such as the Building Schools for the Future programme; and the introduction of a lower limit of £20 million (capital value) below which tendering costs were considered to be disproportionately high. However, the Government has recently recognised that challenges remain, accepting that procurement timeframes are still unnecessarily long.[9] It has committed to a series of further measures designed to strengthen frontline procurement skills, to increase central scrutiny of projects and to ensure that projects are better prepared before they are brought to the market.

1.4 To test whether the issues highlighted by the Public Accounts Committee in 2003 are being addressed, we collected information on the tendering process for projects which closed between 2004 and 2006 and with a combined capital value of £7.78 billion.[10] Details of our methodology are set out in Appendix 1.

8 28th report from the Committee of Public Accounts, *Delivering better value for money from the Private Finance Initiative* (HC 764, Session 2002-2003).
9 HM Treasury (2006), *Strengthening Long Term Partnerships*.
10 The work covered all projects procured either directly by central Government or as part of major and well-defined central Government programmes covering PFI hospitals and schools. It excluded local government projects such as waste, social housing and street lighting. See Appendix 1 for more details.

2 Measures taken by the Government to improve PFI procurement

Date	Government Measures	Description
Since 1997	Development of Private Finance Units (PFUs)	Dedicated units providing advice and co-ordinating the use of PFI within Departments.
Since 1999	Introduction of standard PFI guidance and associated sector-specific contracts	Introduced to promote a common understanding of the main risks which are encountered in a standard PFI project, to reduce the period and costs of negotiation and to encourage a consistent approach between projects. Compliance with Standardisation of PFI Contracts (SOPC) was made mandatory from May 2004.
2000	Establishment of the Office of Government Commerce (OGC)	Works with Government Departments to improve value for money in commercial activities.
2000	Establishment of Partnerships UK	A Public Private Partnership with a public duty to improve the delivery of partnerships between the public and private sectors.
2001	Introduction of the Gateway process	A confidential assessment managed by the OGC of the deliverability of projects, including PFI projects.
2003	Meeting the Investment Challenge	A policy document which explained the Government's approach to PFI, set new limits on its appropriate use, and proposed improvements both to the process of assessing value for money and to the systems for delivering projects.
2004	Value for Money Assessment Guidance	The Treasury published guidance on assessing value for money in PFI transactions in August 2004. This guidance was updated in October 2006.
2004	Establishment of the Building Schools for the Future (BSF) programme	This is intended to improve the delivery model for PFI and non-PFI schools and is being run by a newly-created dedicated body, Partnerships for Schools.
2005	Reform of the Project Review Group (PRG)	Introduced in 1998 to act as an approval mechanism for local government projects, the PRG was reformed in 2005 to include the introduction of a second stage review prior to the appointment of a preferred bidder.
2006	Strengthening Long Term Partnerships	A document which identified a number of issues in the procuring of PFI projects and which proposed measures to address them, including a re-affirmation that projects needed to be properly developed before going to the market, the strengthening of Departmental PFUs, greater scrutiny of projects before preferred bidder selection and improving procurement skills through better training.

Source: National Audit Office

New public procurement regulations require a radical change in the way PFI deals are tendered

1.5 The procurement of goods and services by public authorities in the UK is governed by European Union Directives, designed to promote and encourage transparent and fair competition between contractors in EU member states. Changes to these Directives have been implemented in UK law from 31 January 2006. Prominent among the changes is the new procurement procedure of Competitive Dialogue for complex projects, such as PFI deals **(Figure 3)**.

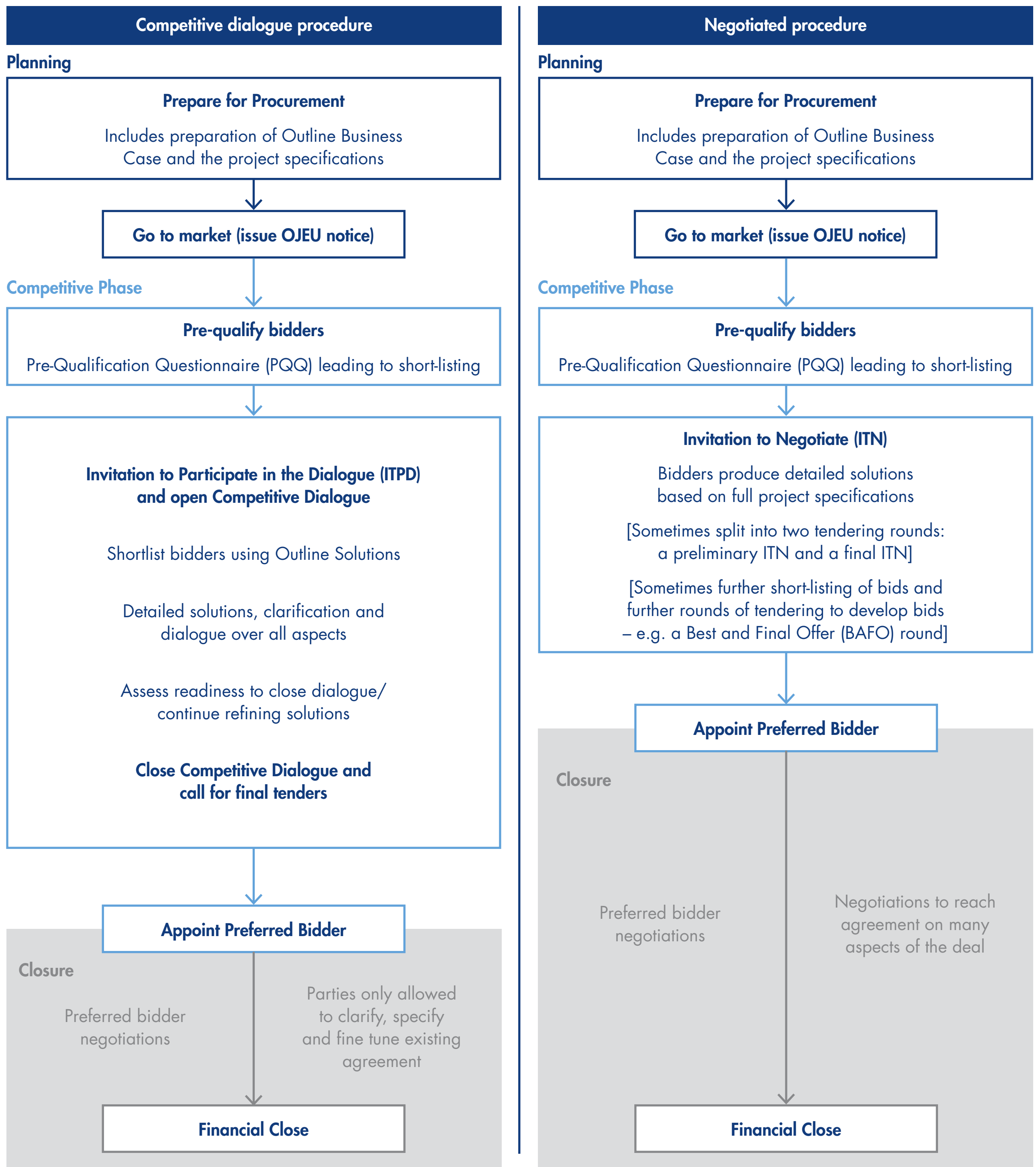
1.6 One of the main features of the new procedure is that there is less scope to make changes to a project after a preferred bidder has been selected. Although there is flexibility within Competitive Dialogue for bidders and the authority to discuss how the output specification will be met, once the competitive phase has closed, bidders can only be requested to "fine tune, specify and clarify their bids". Any change to the preferred bid must not substantially modify what had been agreed and must not distort the outcome of the competition, though the definitions of the scope or other changes that will be allowed during the preferred bidder period have yet to be tested in practice.

1.7 From 31 January 2006, the Competitive Dialogue process codifies in law what should have been good practice under the previous procurement procedure, for example:

- up-front planning with a clearly defined scope and a well-developed draft output specification before going to the market;
- not choosing a preferred bidder until all bidders' offers have been fully probed under competitive conditions.

1.8 The introduction of Competitive Dialogue should have benefits in terms of encouraging better procurement practice and strengthening the competitive element of the PFI procurement process, reducing the scope to make significant changes to the deal once the competition has closed. This should reduce time taken and costs in the preferred bidder stage, but there are risks as well. In particular, there is a risk that the need to negotiate more of the deal with a greater number of bidders prior to preferred bidder selection will increase overall tendering costs for both the public and private sectors, and that this, in turn, will weaken bidder interest.

3 The new and old procurement processes (illustrative)



Source: National Audit Office

PART TWO

PFI projects are attracting fewer bidders who are prepared to submit detailed bids

This part of the report examines the strength of the market for PFI projects as it affects tendering and considers the potential impact of new EU public procurement regulations.

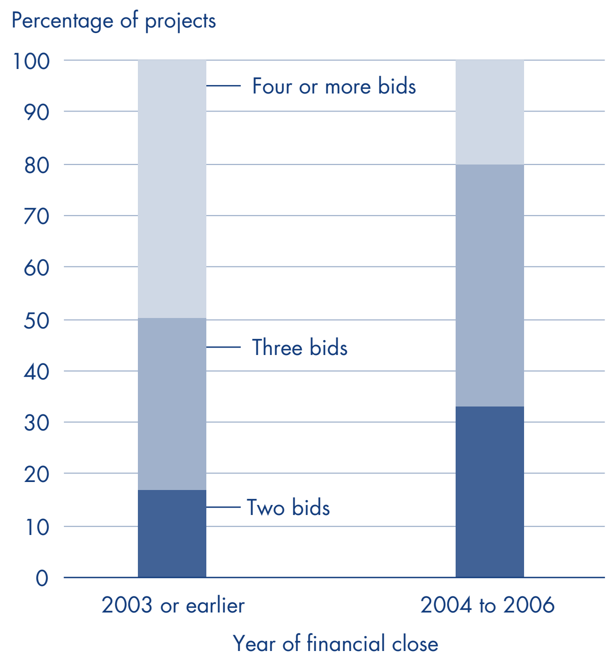
There is evidence that PFI projects are receiving fewer developed bids than previously

2.1 Strong competition is essential if PFI deals are to achieve the optimal mix of price, quality and risk transfer. We therefore looked at how effective the bidding process during tendering has been in generating and maintaining competitive tension, focusing especially on the point in the process where bidders are invited to substantially develop their bids (the "invitation to negotiate" or ITN stage). It is important that the public sector has strong competing bids to consider at this point.

2.2 We compared projects that closed at different points in time to explore trends in the number of developed bids submitted. **Figure 4** shows that 85 per cent of PFI projects included in our sample that closed prior to 2004 attracted three or more developed bids. However, the figure for a comparable number of more recently tendered projects has reduced to 67 per cent. One third of the projects included in our census, closing between April 2004 and May 2006 (with no differences between sectors), attracted only two bidders at the point they were requested to submit detailed bids.[11]

2.3 In the schools sector, there is a new delivery programme known as "Building Schools for the Future". Early indications from Partnerships for Schools, the dedicated body set up to oversee the programme, suggest that competition has been relatively strong so far. Fifteen out of the 17 schemes that have reached ITN (or its equivalent under the Competitive Dialogue rules) attracted three or more developed bids at that stage.

4 The proportion of projects attracting only two viable bids has increased in recent years



Source: National Audit Office surveys 2006

11 i.e. at the Invitation to Negotiate (ITN) stage.

2.4 In the majority of the projects receiving two developed bids that closed between April 2004 and May 2006, this was because of insufficient bidder interest in the project. Either there were only two bidders from much earlier in the tendering process, or existing bidders withdrew from the competition. It was comparatively rare for these procuring authorities to choose to eliminate weaker bids: the choice was effectively out of their hands **(Figure 5)**. Procuring authorities which received only two viable bids at ITN argued that the impact on value for money was limited. They considered that the two bids left on the table were of high quality, and that two bids still allowed for competitive tension (in contrast with single-bidder situations).

2.5 It may become more common under competitive dialogue for procuring authorities to choose to go down to two bidders at an earlier stage in the process than has been usual up to now because of the need to reach a greater level of agreement prior to the selection of the preferred bidder. Nevertheless, the absence of a third bid removes the possibility of having a 'second opinion' benchmark on value for money. It also leaves the procuring authority vulnerable if one bidder subsequently pulls out.

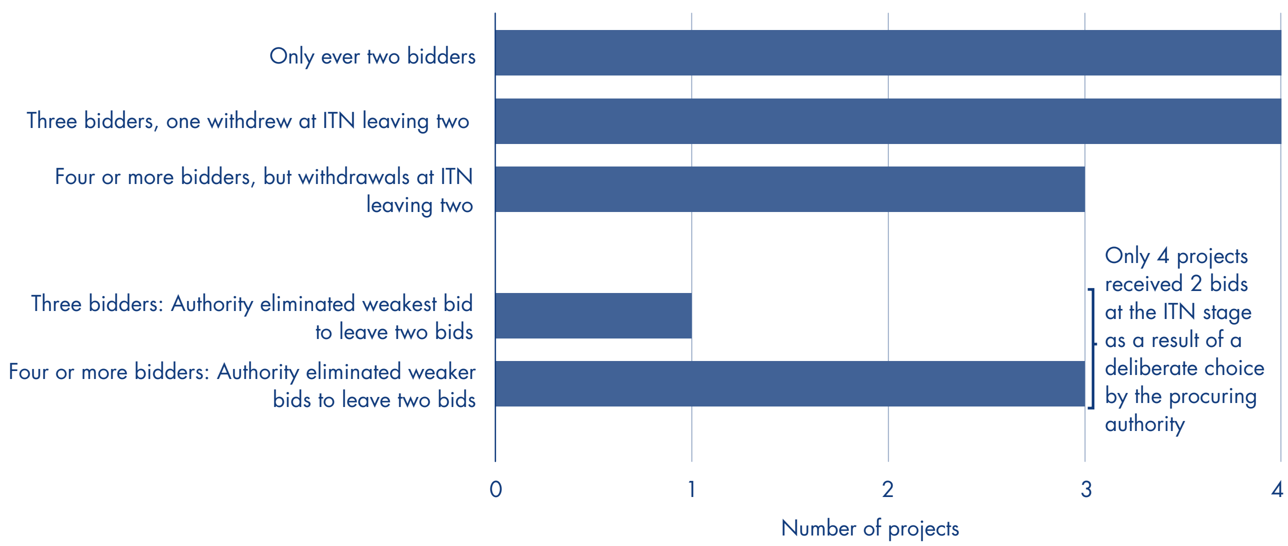
Lengthy tendering periods and inadequate preparation of projects have put off some bidders

2.6 As **Figure 6 overleaf** indicates, the number of developed bids received by procuring authorities has been unrelated to the size of the projects being procured. Larger deals have been as likely to receive relatively few developed bids as smaller deals.[12]

2.7 Instead, our discussions with private sector contractors, advisers and others indicated that there were two principal reasons why bidders may have been more selective in developing detailed bids for PFI projects:

- High bid costs and lengthy tendering periods, which reduced the number of projects for which contractors were prepared to bid in any particular year **(Box A overleaf)**. It was common for contractors to set an annual budget for how much they were prepared to spend on bidding for PFI and they would not exceed this.
- Greater international opportunities, which led to some companies reducing their exposure to the UK market.

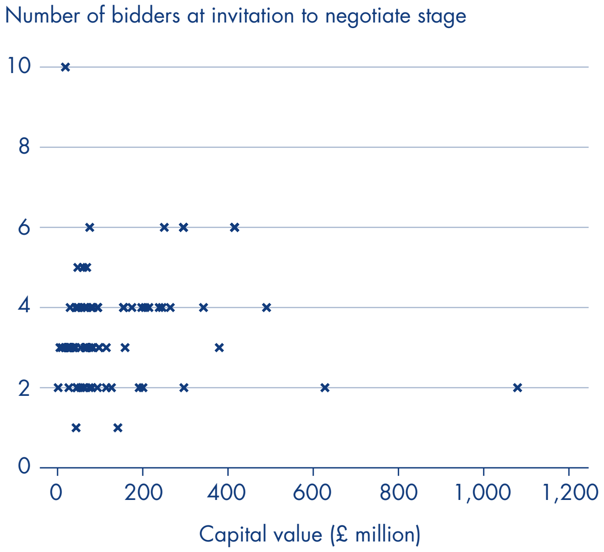
5 Most projects received two bids at ITN because of insufficient bidder interest (projects closing April 2004-May 2006)



Source: National Audit Office census 2006

12 See Appendix 4 for the statistical basis of this statement.

6 For projects closing between 1995 and 2006 there has been no relationship between the size of a project and the number of viable bids received



Source: National Audit Office surveys 2006

BOX A

The views of the Business Services Association, a representative body of PFI contractors

"In some ways capacity is limited because bidding companies now work to the assumption that procurement periods will typically be longer than planned for by Authorities… Delays are limiting the desire of companies to bid."[13]

2.8 In addition, there were four main reasons which contractors reported that led them to withdraw from competitions or to avoid particular projects altogether:

i) Perceptions of the level of skills and experience contained within public sector procurement teams

2.9 Contractors regularly assessed the level of skills and experience within public sector procurement teams to help reach a view on the viability of a project and the likelihood of delays. Just under one-third of procuring authorities reported that they had had insufficient resources or in-house expertise for part or all of the tendering process. This will have had an adverse impact on the competence of the public sector team as seen by potential bidders.

ii) Perceptions of the quality of preparation for particular projects

2.10 In the view of contractors, the adequacy of project preparation was very important in determining whether to bid, as evidenced by the quality of the project specifications and the overall tender documentation. Contractors thought there was scope to improve project preparation and also stressed to us the need for certainty about the affordability of projects.

iii) Inadequate planning of deal flow

2.11 In some cases, projects attracted fewer bids because of inadequate pre-OJEU up-front warning about the timing of projects being brought to the market or because of inadequate co-ordination of deal flow **(Box B)**. In either case, the result was that contractors were not in a position to respond when deals came to the market. Some contractors also commented that even where the deal-flow was well-managed within sectors, there was little co-ordination between sectors.

BOX B

Kirklees City Council – the importance of managing deal flow

Kirklees City Council first brought its special schools PFI project to the market in March 2002, just before the end of that financial year. However, many other projects went to the market at the same time, and the Council only received two bids.

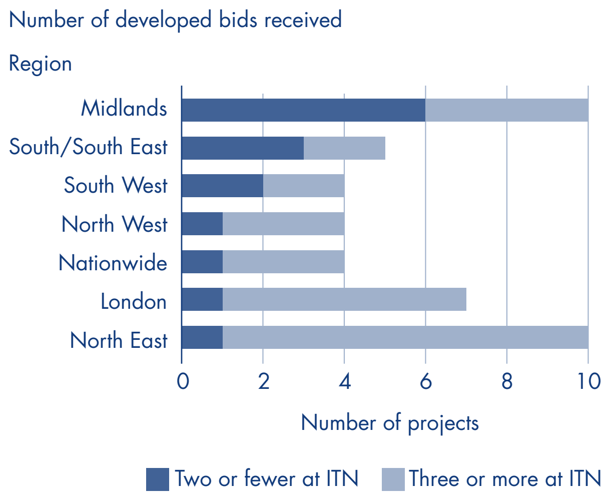
Following consultation with the Department for Education and Skills, the Council decided to re-submit the project to the market in May 2002. This time it received seven bids, of which six were viable bids.

13 Interview with Business Services Association, 28 February 2006.

iv) Geographical location

2.12 Figure 7 indicates that, with very few exceptions, projects that reached financial close in the two years up to May 2006 and which were tendered in London, the North West and North East had three or more bidders at the invitation to negotiate (ITN) stage. More than half the projects tendered elsewhere in England during that period were down to two bidders at ITN.[14]

7 The number of developed bids received for projects which closed between April 2004 and May 2006 has been partly influenced by geographical location



Source: National Audit Office census 2006

2.13 Some PFI advisers and contractor consortia pointed to impracticalities in bidding in certain parts of the country, due to the small number of regionally based sub-contractors who were acceptable to bidders and capable of taking on the work. In addition, some contractors felt that they would be at a competitive disadvantage in a region in which they had no existing links with sub-contractors.

The application of new public procurement regulations may make bidders more selective

2.14 As Part 1 of this report sets out, the procurement of PFI projects is now subject to a new procurement procedure known as Competitive Dialogue. This procedure requires that a greater part of the deal is agreed during the competitive phase of tendering with all bidders, before a winning bid is selected. There are potential benefits from maintaining competitive tension for longer. However, there is also an increased risk that the private sector will become more selective in the face of potentially higher bid costs and longer periods without certainty of winning the competition. This makes it particularly important that bidders' concerns are met by procurement teams: ensuring that projects are properly prepared before they are brought to the market, that teams are suitably resourced and that there is access to existing experience of complex procurement, so as to bring down tendering times and costs.

14 However statistical analysis has not confirmed a correlation between geographical location and the number of developed bids received, possibly because of the small number of cases involved. See Appendix 4 for further details.

PART THREE

Tendering for PFI deals can be improved

This part of the report shows that tendering for PFI deals takes longer and costs more than expected. Many of the delays and excessive costs would be avoided by a more professional, coordinated approach to public sector tendering.

It takes on average just under three years to tender and close a PFI deal

3.1 Tendering periods for all the PFI deals with a capital value of over £20 million that closed between 2004 and 2006 lasted an average of 34 months.[15] Between 2000 and 2003, the comparable figure was 33 months. There were variations between sectors, with the average times for schools, hospitals and other deals being 25, 38 and 47 months respectively. The shortest overall tendering period was 16 months and the longest 73 months **(Figure 8)**.

3.2 It is important for the ultimate success of a PFI deal that sufficient time is taken to ensure that tendering is done well, but despite Treasury and Departmental measures to improve and make the PFI procurement process more efficient, the average length of time taken to tender the projects which closed between 2004 and 2006 was no shorter than that for earlier projects, closing between 2000 and 2003. The lack of any official benchmark for tendering times means there is no guidance on this issue, and comparisons with conventionally procured projects are misleading. PFI deals require agreement not just on the construction of buildings or other assets but also on the services to be provided throughout a 25 to 30 year contract, and are thus inherently more complex to procure.[16]

3.3 In 2004, the Department for Education and Skills set up a joint venture with PUK, called Partnerships for Schools, to run the tendering of schools projects (including PFI projects) and to address some of the issues highlighted in this report. The joint venture has developed new procurement documentation, provided a central source of procurement expertise and consulted extensively with the market. It is too early, however, to determine its impact on programme delivery as most projects tendered under the programme have yet to reach financial close.

Almost half of the time taken to tender a PFI deal is taken up by negotiations with a single preferred bidder

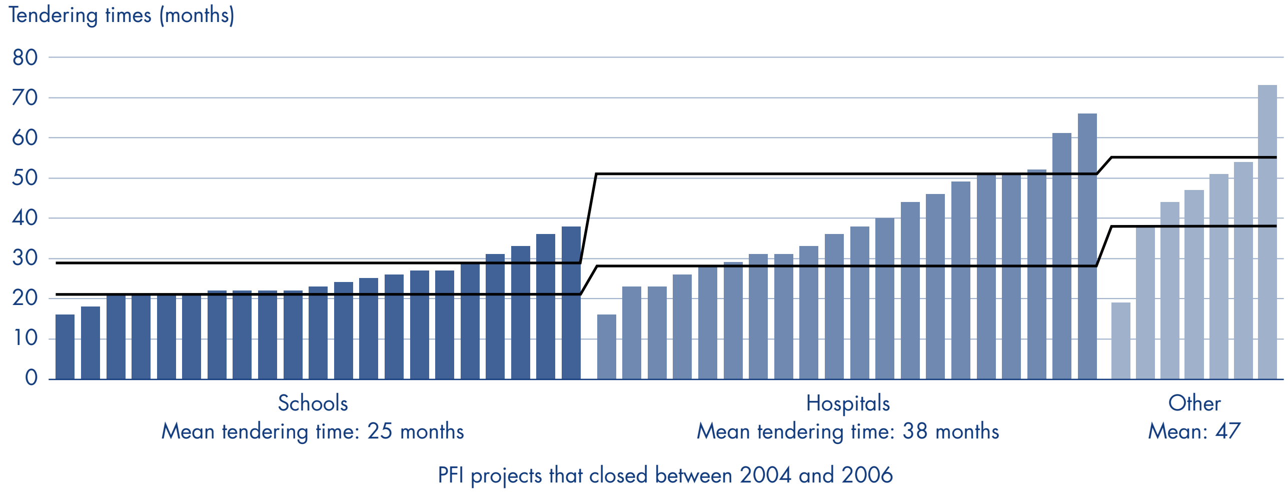
3.4 Because of the complexity of PFI deals, and because the backing of lenders has to be fully secured, bidders are usually unable to make final bids which are unconditional. As a result, it has been common practice for there to be a period of exclusive negotiations following selection of a single, preferred bidder before the deal is signed. Unless the procuring authority can keep careful control of this part of the process there is a high risk that the terms of the deal will become less favourable.

3.5 Prior to 2004, around half of PFI projects involved preferred bidder negotiations of a year or more. Between 2004 and 2006, two-thirds of PFI projects had preferred bidder negotiations lasting a year or more, and the average length of preferred bidder negotiations for all projects that closed during that period was 15 months **(see Figure 9)**. This is twice as long as Authorities expected when they selected a preferred bidder. On average, negotiations with a preferred bidder took almost as long as the competitive phase that preceded it.

15 This is based on our census data. The 11 local authority projects closing between April 2004 and May 2006 that we did not survey had a very similar average tendering time of 35 months.

16 OGC data for conventionally procured projects with a capital value of £20 million or greater indicated that average tendering times were approximately half those of PFI projects.

8 The length of tendering varied widely between projects and between sectors

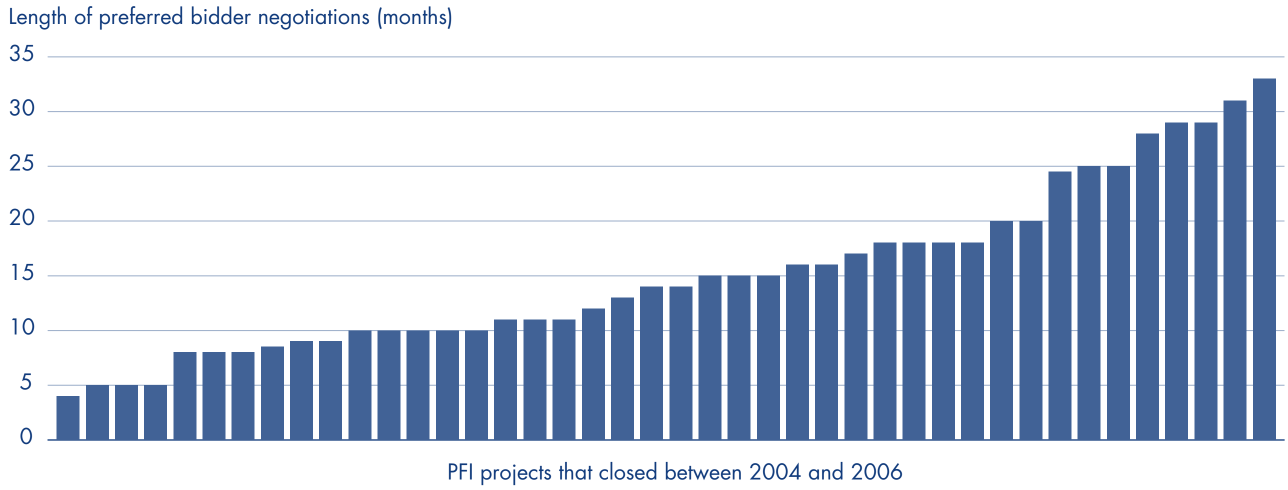


Source: National Audit Office census 2006

NOTE

The black lines represent the upper and lower quartiles.

9 Preferred bidder negotiations for projects were lengthy, lasting an average of 15 months



Source: National Audit Office census 2006

It is hard to find systematic explanations for variations in the lengths of tendering periods, although there are differences between sectors

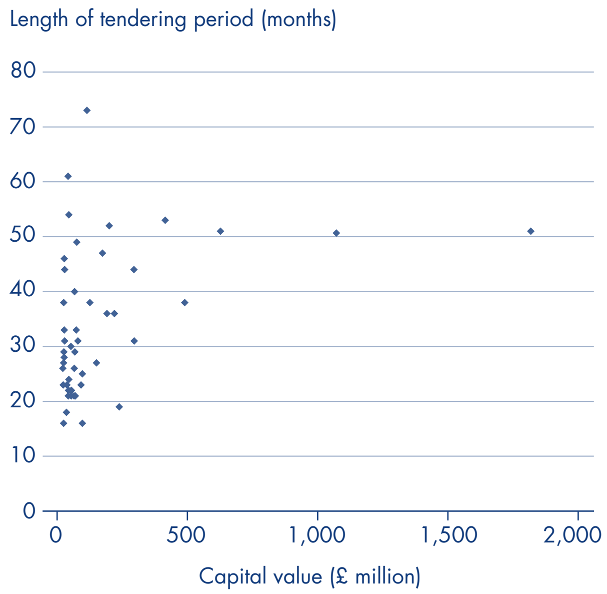
3.6 As illustrated by **Figure 10**, there was no direct correlation between the time it takes to tender a deal and the capital value of a deal. The type of deal, for example whether a deal is for a school, hospital or other serviced buildings did have a significant influence on time taken to tender. Overall, however, only about a third of the variation in tendering times was explained by factors such as deal size, type of deal and the experience of procurement teams in managing PFI projects.[17]

Tendering and negotiation periods could often have been reduced

3.7 We asked procuring authorities, Departmental Private Finance Units, advisers and contractors what issues they thought had been important in lengthening tendering times. **Figure 11** summarises these explanations, dividing them into causes of delays that were unavoidable, causes that were capable of being mitigated (whether by the procuring authorities or by the public sector more widely) and causes that were avoidable. Although this report focuses on PFI tendering, some of the causes of delay (such as policy changes and unforeseeable events) would also have caused delays in projects procured conventionally in the same period.

3.8 Factors cited as important included unforeseeable events which were entirely out of the control of public sector procurement teams. For instance, the events of 11 September 2001 had wide ramifications for the insurance market. Equally, some projects were affected by the financial collapse of Jarvis plc, a major contractor for PFI schools in particular **(see Case Example 1)**.

10 The length of tendering for PFI projects was unrelated to the size of those projects



Source: National Audit Office census 2006

11 Commonly cited causes of long tendering periods

Out of the control of the public sector

Unforeseeable events (such as the impact of the events of 11 September 2001 on the insurance markets and the financial collapse of Jarvis plc)

Private sector administrative and approval processes

Could be partly mitigated by the public sector

Negotiations surrounding changes to the bid proposed by the preferred bidder

Delays caused by public sector administrative and approval processes

Delays caused by planning procedures

Delays caused by having to adapt to policy changes (such as Agenda for Change in the health sector)

Reiterations of design, where these are caused by a poor response from bidders

Lack of expertise, experience or resources within the public sector procurement teams

Could be avoided by the public sector

Changes made by the public sector procurement team to the scope or specifications of the project

Reiterations of design where these are necessary because of authority-led scope and specification changes or affordability issues

Insufficient development of specifications prior to the project going to the market

Poor process management

Revisiting of affordability issues

Source: Views expressed by project managers of public sector teams, Departmental Private Finance Units, advisers and contractors

17 See Appendix 4 for the statistics to support this paragraph.

CASE EXAMPLE 1

Kirklees City Council – the impact of Jarvis' financial difficulties on the PFI tendering process

Kirklees Metropolitan Council selected Jarvis plc to be the preferred bidder for its special schools project in November 2003, following a competitive process. It reached commercial close in March 2004, and was ready to sign the contract in July 2004. However, Jarvis' financial difficulties were made public a few days before financial close was due and its funders pulled out of the deal. Throughout the summer, the Council worked with all interested parties to develop a way forward. As Jarvis was not able to provide the Council with the necessary reassurances about its financial viability, the Council de-selected Jarvis as its preferred bidder towards the end of September 2004.

The bidder which had come second in the competition agreed to take Jarvis' place, using some sub-contractors which had been part of the Jarvis consortium. However, the Council had to accept the addition of construction inflation to the cost of the project and some re-pricing of risk. This led to affordability issues and, as there was no further money available and a judgement was made that there should be no further compromises on design quality following lessons from a previous PFI project, a decision was taken to remove one school from the project to restore affordability.

3.9 Other factors might have been only partially within the control of public sector procurement teams, or outside of the direct control of procurement teams but within the control of the public sector as a whole. In particular, policy changes can affect PFI projects quite significantly, in terms of both cost and time, by requiring alterations to the services required, which will extend tendering periods if they occur during procurement. One third of NHS Trusts which closed PFI projects in the past two years considered that policy initiatives, such as Agenda for Change and the introduction of the Retention of Employment model, had prolonged their procurement timetables. Many of the remaining causes of long tendering and negotiation times, however, fell more directly under the control of public sector procurement teams and could possibly have been avoided by the public sector with better planning, management and exploitation of existing experience.

Projects are not always prepared sufficiently for the tendering stage

3.10 The Treasury has commented in its most recent assessment of PFI that procuring authorities are not allocating sufficient time and resources to adequately prepare and develop their projects before formal engagement with the market.[18] Many professional advisers we spoke to believed that more preparation would help to prevent large-scale changes to projects or unplanned extra rounds of tendering, both of which were seen as major reasons for tendering delays. Two-thirds of procuring authorities that closed projects between April 2004 and May 2006 made scope or specification changes to their projects after going to the market.

3.11 The amount of pre-tendering preparation by authorities varied between around five months and nearly five years.[19] There was no correlation between preparation time and size of deal; nor was there a significant correlation between preparation time and the subsequent length of the tendering process. In the latter case, this may partly reflect the fact that lengthy preparation periods were not always focused or backed with sufficient resources and levels of experience.

Experience was not shared as widely as would be useful

3.12 Many Authorities anticipated issues in advance of preferred bidder negotiations, but often found that they proved more difficult to resolve than expected. These issues include matters such as finalising the detailed design, obtaining planning approvals, land and property issues (such as covenants and deeds), employment, pensions and energy issues. Although these issues were common to many PFI deals, they tended to be resolved by individual Authorities acting in isolation. There may have been scope for improving the tendering process through further development of standard specifications and guidance frameworks. For instance, some NHS Trusts told us that negotiation times would have been reduced had there been a standard market approach across schemes where retained estate is included, a standard definition of latent defects and a common approach towards clearing backlog maintenance.

3.13 Many Authorities reported that they passed on any lessons learnt following the completion of their PFI tendering process to Departmental Private Finance Units (PFU), and sometimes to other Authorities. Such intelligence can be extremely effective, as the example in **Box C overleaf** suggests, but there was no systematic way of ensuring that useful lessons were shared within or across sectors. Although many Departments require projects to complete self-evaluation templates known as post-project evaluations, these were often not completed and were not pursued by Departments.

18 *Strengthening long-term partnerships*, p103.

19 We calculated this from the date of project initiation, defined as the point at which the decision was taken to begin the substantive work towards Outline Business Case.

BOX C

The benefits of sharing lessons between projects

Once they had closed their deals in 2004, both St George's Hospital Morpeth and Addenbrooke's Elective Care, Diabetics and Genetics Centre shared some lessons they had learned with two Trusts which were in the process of tendering for PFI hospitals. Both the Trusts which had received this advice had tendering periods significantly shorter than average, and both succeeded in keeping tendering costs to budget.

3.14 The Treasury's contract standardisation guidance and additional sector-specific guidance and standard contracts are a mechanism through which lessons have been learnt and passed on to future projects. An example of this is the new insurance provisions which have resolved difficulties experienced by a number of projects following the events of 11 September. Although there are clear benefits from the introduction of a standard contract, including greater consistency, we did not find that it led to an improvement in overall tendering times for the projects we examined. One reason for this was that some of these projects were delayed by the transition between versions two and three of the standard contract during 2004.

Delays are inevitable if an authority decides that it cannot afford the deal on offer

3.15 Authorities have to make an assessment of the likely cost of a project and confirm that it is affordable before taking the project to the market. This is a requirement for the approval of Outline Business Cases by all Departments. However, affordability issues often subsequently arise during the procurement, either as a result of changes in an Authority's requirements or because the bids received are more expensive than the authority expected. We found that, even at the point of preferred bidder selection, affordability had often not been completely resolved. Any changes made to the project or changes to the financial situation of Authorities necessitated a reconsideration of affordability, resulting in delays to the finalisation of a deal and sometimes requiring further changes to the project. A number of advisers put this point to us, including an adviser with extensive experience of procuring deals **(see Box D)**. In addition, affordability problems often arose as a result of a longer than anticipated procurement process. A major example was the St Bartholomew's and London Hospitals re-development PFI scheme, where delay and substantial public and private sector costs were incurred while decisions were made **(Case Example 2)**.

BOX D

The difficulty of confirming the affordability of a project when the tendering period has been lengthy

"Affordability curves can be very dynamic. This can lead to a vicious circle developing: the longer the procurement period, the more likely that the affordability equation will change, forcing scope changes and further procurement delays". (NAO interview with a PFI adviser)

CASE EXAMPLE 2

Barts and the London NHS Trust – affordability and planning concerns led to delays during the preferred bidder negotiations

At a capital value of £1,072 million, this 42 year project is the largest PFI hospital deal to have been signed in the UK. It will provide a new teaching hospital and a new cancer centre of excellence through the substantial redevelopment of the Royal Hospital of St Bartholomew and the Royal London Hospital. Financial close was reached in April 2006, following a tendering process that took just over 4 years, including a 28 month preferred bidder period.

The preferred bidder period was expected to last just over a year. It took twice as long for two main reasons:

- The redevelopment involved listed buildings in a conservation area and required approval from a number of bodies, all of whom individually needed to provide statutory consents. The preferred bidder's design was accepted without major changes at St Bartholomew's but the design of the Royal London Hospital required modification. Subsequent negotiations with planning authorities over changes to the project design caused a delay of ten months.
- Although the Trust considered it had reached an affordable position both prior to and after preferred bidder selection, the size of the scheme meant that the deal was subject to review by the Department of Health and the Treasury. The full business case was submitted to the Department and the Treasury in November 2005. This coincided with a review of NHS finances that included all prospective PFI schemes. As a result of this review, which involved a delay of three months, the scope of the deal was scaled back.

In total, the costs of the delays during the preferred bidder period added around £5 million to the annual unitary charge. However, this was offset by adjustments to the scope of the deal which resulted in a net reduction to the annual unitary charge of around 12 per cent (equivalent to £9 million a year).

Delays were caused in part by the lack of detailed design development prior to preferred bidder selection

3.16 During competitive bidding, many Authorities requested designs to a certain level of detail (e.g. drawings at a scale of 1:200) and then later requested a detailed design (1:50) after selecting a preferred bidder. Authorities had to consider the interests of internal and external stakeholders as detailed designs were being developed by the preferred bidder. This took time and sometimes revealed issues leading to changes that were not apparent at the less detailed level, when bidders were in competition with one another. There could be benefits to procuring authorities of requesting selected 1:50 information prior to the preferred bidder decision, thus highlighting at an earlier stage any issues that might be raised by stakeholders, although these would have to be balanced against the cost to bidders. It may be that this will have to happen in any case under the new Competitive Dialogue rules. Separately, the Treasury and the Department of Health are currently exploring the possibility of a greater amount of design work being completed earlier, perhaps by authorities, before projects go to the market.

The bidder and its funders may raise issues late in negotiations, causing delays, but experienced authorities can mitigate this

3.17 Authorities believe that some delays could be traced partly to the private sector and this was confirmed by PFI advisers to whom we spoke. Two issues create avoidable delay, risking higher costs and poorer value for money:

a) Attitude of the preferred bidder to negotiations

3.18 While it should be as much in the interests of the preferred bidder as the Authority for financial close to be reached quickly so minimising as far as possible the costs of putting a PFI deal in place, this is not always true in practice. Once chosen as a preferred bidder, contractors have the security of knowing that they are virtually guaranteed the contract. Authorities saw this as a primary cause of delays post-preferred bidder selection, citing examples such as contractors ignoring the contents of preferred bidder letters to which they had signed up, failing to produce timely information and regularly missing agreed milestones.

3.19 These risks underline the importance of public sector Authorities having access to and using strong commercial and negotiating expertise. As the example in **Box E** indicates, the conduct of private sector contractors can be influenced strongly by the presence of commercial experience within the public sector procurement team, as well as by sufficient prior development of the project specifications.

BOX E

The importance of actions by public sector procurement teams to prepare for preferred bidder negotiations

A PFI hospital project team had a very conscious strategy of making sure that it had gone into enough detail in its specification and in its evaluation clarification questions to make sure that negotiations, other than outright back tracking by the preferred bidder, were minimised. This worked and bidders remarked upon it.

b) The position of funders in PFI deals can be uncertain and may introduce delay

3.20 In bidding for a PFI deal, bidders have to demonstrate that they will be able to fund the construction of an asset before they are selected as the preferred bidder. As most bidders will usually seek to borrow the money required, they need to satisfy potential lenders that the deal represents a sound investment. Many funders are not, however, prepared to commit significant resources to examining a deal in detail until a preferred bidder has been chosen. In one project, terms were agreed with bidders but then rejected by the funders and the commercial basis of the deal had to be re-opened, which led to delays in reaching final agreement. **Box F**. For the future, the introduction of funding competitions for larger deals should help to prevent this problem.

BOX F

The position of a preferred bidder's funders was uncertain and caused delays

"Negotiations [to close the deal] would have been smoother if the preferred bidder had involved its funders at an earlier stage. It became obvious that the bidder started to talk to the funders in detail only after it had negotiated the contract with us. We were then left to re-negotiate points that the bidder couldn't agree with the funders, leading to a delay of three months."

(National Roads Telecommunications Services project)

The direct cost of tendering delays was at least £67 million

3.21 **Figure 12** shows the direct cost of tendering delays to the public sector, based on figures provided to us by public sector procurement teams that closed PFI projects between April 2004 and May 2006. Delays in completing negotiations will delay the benefits and any expected savings for public services envisaged in a PFI deal. There were other costs as well, including the additional cost of advisers and the need sometimes to add the cost of construction inflation to the original price of the bid due to the expiry of a previously agreed bid validity period. **Case Example 3** illustrates how these costs impacted on a large hospital deal.

3.22 It should be noted that the figures in Figure 12 are probably an under-estimate of the true cost to the public sector, although they are still small relative to the total value of the deals we examined (£7.75 billion). The majority of public sector procurement teams which stated that costs had occurred as a result of lengthy negotiations were unable to quantify them. The figures in the table are thus the total of those provided. The table does not include costs such as internal staffing costs and opportunity cost. On the other hand, the figure for overspends on adviser budgets may not be wholly attributable to delays in tendering, also reflecting in part unrealistic budgeting.

Professional advice usually cost more than planned and greater public sector experience would have led to savings

3.23 The cost of professional advice on PFI projects that closed between April 2004 and May 2006 was on average 75 per cent higher than budgeted for by the Authority at the outset of the project. Many Authorities considered that their original estimates of adviser costs had been unrealistic and our discussions with advisers confirmed this. Reasons given by Authorities and advisers for cost under-estimates included:

- optimistic assumptions about the project timetable;
- inadequate analysis of what advice will be needed when; and
- lack of forethought about the division of responsibility between the Authority's procurement team and professional advisers.

3.24 A significant cause of higher than expected advisory costs for Authorities was the length of time it takes to close a deal after selecting a preferred bidder, with most Authorities identifying this as the point at which costs begin to escalate. This situation was exacerbated by the difficulties of agreeing fixed or capped fee arrangements with advisers because of the uncertainties surrounding this period. The average cost of advisers for a PFI project which closed between April 2004 and May 2006 was £3 million, or approximately 2.6 per cent of the projects' capital value, though this proportion varied by sector, **Figure 13**. The percentages shown exclude any costs borne centrally, for example, in producing standardised building designs.

12 The cost of tendering delays: figures provided by Authorities for PFI deals in our sample which closed between 2004 and 2006

Type of cost	Percentage of projects affected (%)	Cost to the public sector (£ million)
Overspends on adviser budgets	59	23
Expiry of the bid validity period led to a re-costing of the project by the preferred bidder	50	20
Expected benefits from the PFI project delayed or not realised	36	7
Expected savings not achieved	15	6
Contracts for existing services extended until PFI deal becomes operational	33	1
Unquantified costs: e.g. internal fatigue of the project team, impact on current service provision, opportunity cost and the unavailability of internal staff for other work	15	–
Other unspecified impacts	2	10
Overall total	**–**	**67**

Source: National Audit Office census 2006

CASE EXAMPLE 3

University Hospital Birmingham – the complexities of a large hospital deal and the impact of delays to preferred bidder negotiations

University Hospital Birmingham was the second largest PFI hospital deal to have reached financial close, with a capital value of over £550 million. The scheme incorporated a new 1200 bed hospital, a new Royal Centre for defence medicine, a new Clinical Sciences Centre, a new mental healthcare facility, improved car parking and cycle routes, better bus and rail access and an improved road layout. Financial close was reached in June 2006 following a tendering period of just over four years.

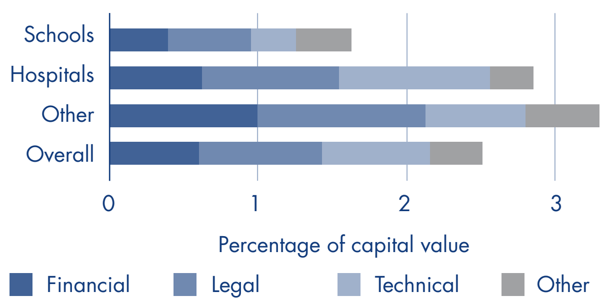
The main delays in the tendering process came during preferred bidder negotiations which took 29 months – well over half the total tendering period. The delays, in part, reflected the complexities of a deal of this size. For instance:

- The deal involved two separate NHS Trusts as well as the University of Birmingham and the MoD.
- Birmingham was the first Foundation Trust to agree a PFI deal. One of the parties raised issues about whether the relevant legislation allowed Foundation Trusts to do the deal, and this legal point took five months to resolve.
- A site that had been earmarked for a mental health facility fell through due to issues of ownership. An alternative site had to be found with new designs.
- The Advanced Works Agreement took from February to October 2005 to complete, which delayed commencement of work on the main Project Agreement.
- In addition to normal approvals procedures, a Treasury review examined the affordability of the scheme (as represented by the percentage of unitary payment to the Trusts' turnover) two and a half months before financial close.
- To achieve an affordable scheme considerable changes were made, leaving many issues to be resolved during the preferred bidder period. These included planning issues, affordability, design, the allocation of different types of contamination risk, energy and legal points such as covenants and clarifying all aspects of the agreement.

Some of these issues led to changes being made to the project specifications during preferred bidder negotiations. In total, these changes (whether additions or reductions to the original specifications) were worth the equivalent of just under £5 million per year for the lifetime of the contract, or eight per cent of the annual unitary charge as it stood at the point of selection of preferred bidder.

Costs of delay included additional spending of £6.54 million (one per cent of the deal's capital value) on advisers which was nearly double what was originally anticipated. In the outcome these costs were offset by favourable interest rate movements over the period and a decision to extend the length of the contract, which helped to ensure that the deal remained affordable to the Trusts concerned.

13 Average costs of advisers as a percentage of the capital value of a deal



Source: National Audit Office census, 2006

3.25 In the health sector, the only sector for which data are available over time, we found that the costs of advisers as a percentage of capital value had gone down slightly when compared with a sample of hospitals projects that closed between 1997 and 2000[20]. It is likely that the introduction of the standard form contract was partly responsible for this.

3.26 Our statistical analysis, Appendix 4, shows that variations in the cost of advisers across projects were determined mainly by the size of the project and to some extent by the sector allowing for size. The tendency was for adviser costs for schools projects to be lower per pound of capital cost than for PFI hospitals and both sector adviser costs were lower than for "other" PFI projects. This tendency is likely to be related to the intrinsic complexity of the type of PFI project services. Overall, some three quarters of adviser costs were accounted for by capital cost variation and sectoral differences. In addition, several advisers we spoke to told us that Authorities with experience of tendering PFI deals were using them far more cost effectively than those without experience. In practice, this meant going to advisers with a better idea of what they wanted **(Box G overleaf)**. The case of Leeds City Council illustrates the importance of experience in affecting tendering times and budgets **(Case Example 4 overleaf)**.

20 Hospital projects that closed between 2004 and 2006 spent three per cent of capital value on advisers. The comparable figure for hospital projects that closed between 1997 and 2000 was 3.3 per cent.

CASE EXAMPLE 4

Leeds City Council – the advantages of internal expertise and experience

Leeds City Council established a dedicated PPP unit in 1999, responsible for taking forward all of its infrastructure projects. Many of these have been privately financed, including schools, social housing, leisure and street lighting projects, with waste and highway maintenance projects currently being considered. In total, the Council's PPP Unit has managed the tendering of deals worth £800 million and projected to rise to £1 billion within the next two years.

The PPP Unit has worked closely with client departments within the Council in order to take forward this investment programme. For each project, sector-specific expertise has been provided by an appointed project director, responsible for defining the scope of the project and liaising with stakeholders. The role of the Unit has then been to supply the necessary procurement and commercial expertise to take the project forward, as well as to provide an internal challenge function.

The first deal signed by Leeds City Council ran into a number of problems during the procurement, reflected in a 15 month preferred bidder period and overspends on advisers. However, the Council's PPP Unit learnt from that experience. The last four deals signed, which included two relatively complex multi-site schools projects, were all tendered inside 18 months, with preferred bidder negotiations taking 4–5 months and advisers' costs coming within budgets. According to the Director of the Unit, the build-up of experience has been fundamental to this success, enabling:

- a better understanding of when and how to use external advisers;
- a better understanding of how to define the project specifications, with far less need for change later on in the tendering process;
- greater commercial awareness and more focused negotiations with the private sector.

BOX G

A leading legal adviser on PFI projects

"Some Authorities dump everything on the external lawyers where in-house lawyers would be better and cheaper. Others only use external lawyers when they absolutely have to and this is not always best either: documentation comes too late and has to be re-drafted and changed. The big Authorities, on their 3rd/4th/5th projects are noticeably different: they understand the process and when to involve advisers, and this undoubtedly leads to better vfm. There needs to be more support for authorities lacking that experience."

Significant changes were made to one-third of projects at the preferred bidder stage

3.27 The unitary charge is the annual sum paid, for the lifetime of the contract to the PFI contractor once the service becomes operational. Changes to the unitary charge figure were made in just under 60 per cent of projects between selection of preferred bidder and financial close[21], and the size of the overall change was usually within 10 per cent of the initial figure (in both directions).

3.28 Although these changes to the unitary charge were usually relatively small, they masked what was often a great deal of movement during preferred bidder periods, a phase when competitive tension is absent and changes should be minimal. For instance:

- 30 per cent of procuring authorities responded to renewed pressures that their project was unaffordable, in many cases because of increases to the scope or specifications of the project, by increasing the length of the contract. This masked the effect of any changes by reducing the level of the annual payment. However, in doing so, the total cost of the project over the lifetime of the longer contract was increased. Although maintaining affordability for these authorities, such changes contradict value for money guidance recently issued by the Treasury which emphasises the importance of setting the length of a contract to match the optimal period over which services need to be provided.
- Many procuring authorities benefited from favourable movements in interest rates or other financial terms. This benefit often offset the cost of delays or of project changes and therefore limited the impact on the unitary charge. Such benefits were fortuitous and the limited impact on the unitary charge was not a reflection of better value for money.
- It was common for procuring authorities to make both additions and reductions to the project scope during preferred bidder negotiations. The value of these changes, on average, was just over £4 million per project per year – the equivalent of 17 per cent of the value of each project as it was at preferred bidder selection. The more changes there are the more likely it is that value for money was at risk during the preferred bidder stage, even if the changes cancelled each other out to some extent in terms of their impact on the unitary charge.

21 This excludes projects which made changes to the unitary charge purely on the basis of inflation or changes in interest rates.

3.29 One-third of projects overall made changes during the preferred bidder period that, in our judgement, could be considered major changes. Such changes could be described as major changes, not just on the basis of their value, but because basic elements of the scheme were being altered. They included changes to the balance of new buildings and refurbishments, the addition or removal of major equipment components, changes to the agreed services to be provided, significant changes to the design solution and major changes made to the agreed risk allocation during this period. **Case example 5** provides an example of a project where the change – and resulting impact on unitary charge – was particularly large.

CASE EXAMPLE 5

Queen Mary's Hospital, Roehampton – a major variation was made to the deal during the preferred bidder period

The Queen Mary's Hospital site in Roehampton accommodates a range of services provided by three South West London NHS Trusts. An Outline Business Case for a new community hospital on the Queen Mary's site was approved in April 2000 and, following a competition, a preferred bidder was selected in April 2002. The Project was signed in May 2004 and new integrated community hospital facilities became operational in February 2006.

During the course of tendering and negotiating the project, two changes were made: one delaying completion by ten months, the other increasing the present value of the deal from around £350 million to £650 million.

PFI policy change: transfers of staff

At the start of the project it was assumed that facilities management services staff would be transferred to the successful bidder. Just before a preferred bidder was to be selected in June 2001, the Department of Health selected the project as a pilot for a new approach to soft facilities management services provision (the Retention of Employment Model – RoE). This approach meant that existing soft facilities management services staff would retain their NHS employment terms and conditions, but be managed by the private sector service provider. The development of the model, testing and subsequently resolving a number of significant issues, delayed the PFI procurement by ten months.

Scope change: addition of mental health facilities

At around the same time, local health authorities undertook a consultation on the provision of mental health services for adults and older people living in parts of South West London. Following the consultation and a subsequent evaluation of options, they concluded that the mental health facilities currently provided on the Queen Mary's site should be re-provided on the same site in a new facility, adjacent to the proposed community hospital. This was found to be unaffordable as a project in its own right. However, because of delays to the community hospital resulting from the introduction of RoE, it was considered possible to merge the two separate projects, retaining overall affordability without further delaying the Community Hospital project.

There were significant legal and financial risks

Extending the scope of the PFI project to incorporate mental health services provision without running a separate competition posed a significant legal risk, as advice had suggested that this might breach EU regulations. To mitigate this risk, the remaining bidders were consulted and indicated they would not contest any decision to proceed with an integrated Community Hospital. In the event of a challenge by any of the previously de-selected bidders, the Trusts felt that the original grounds for their de-selection would have continued to hold. The legal and value for money risks of proceeding without a competition had to be balanced against:

- another round of tendering at an estimated cost of £160,000; and
- a delay of seven to nine months caused by re-tendering.

It was felt that any further delay would impact adversely on the Community Hospital, putting back the intended improvements to patient services and attracting unsympathetic local and media attention for what was seen as a high-profile PFI scheme, delayed already by the RoE negotiations.

It was therefore decided to test the viability of developing an integrated scheme under the extant PFI procurement exercise. The Trusts issued a revised output specification to the preferred bidder. The preferred bidder and the Trusts then undertook separate evaluations to establish the most appropriate way of incorporating the integrated facilities into a single Community Hospital within the constraints of the Queen Mary's site, and both concluded that the majority of the mental health facilities should be accommodated on an additional floor, above the community hospital accommodation. The decision to include mental health facilities in the scheme was agreed in principle by all the key stakeholders including the Strategic Health Authority and Private Finance Unit of the Department of Health.

The addition of integrated mental health facilities to the project increased the whole-life cost of the project by some £300 million. To test the price offered by the preferred bidder, the Trusts obtained independent advice on what the additional facilities should cost. The Trusts worked up a Conventionally Funded Option (CFO) on the basis of the PFI design and the Trusts' architects prepared a 1:200 design solution. This was achieved using the footprint of the original PFI scheme design, which was further developed by the Trusts and their advisers as a CFO to provide a basis for evaluating development of the PFI design. The additional work to be undertaken was costed on an open-book basis, with margins no greater than the reference bid agreed at selection of preferred bidder. The independent cost estimate and the price offered by the preferred bidder were within 10 per cent of each other and further negotiations resulted in a five to six per cent reduction in the preferred bidder's price.

A variety of methods were used by Authorities to check the cost of changes but they could not be wholly satisfactory

3.30 Authorities often went to substantial lengths to verify the cost basis of changes wherever possible. Where substantive changes were made to the deal during preferred bidder negotiations, Authorities used a variety of methods to try to check the costs involved:

- strong reliance on advisers, both to conduct financial assessments or benchmarking exercises and to ensure that the preferred bidder is not asking for something that will prejudice the Authority;
- the agreement of the second placed bidder to act as a "reserve bidder", ready to step in if there are difficulties with the preferred bidder negotiations **(Box H)**. However, this strategy tends to lose credibility after a few months as a reserve bidder is unlikely simply to accept the result of all the negotiations between the Authority and the preferred bidder; and
- the use of "should-cost" models, the Public Sector Comparator or internal benchmarks to assess any changes proposed by the preferred bidder.

BOX H

Maintaining competitive tension during preferred bidder negotiations: the case of Docklands Light Railway, extension to Woolwich

"The preferred bidder decision to financial close took 5 months. This was achievable partly because of clarity over what was wanted and partly because of a determination to stick to timetable. The preferred bidder appointment was dependent on the bidder adhering to a clearly defined set of conditions, including a requirement to keep to timetable. If the preferred bidder failed to meet these conditions, TfL retained the effective right to reverse the appointment."

3.31 Despite the variety of methods used to check the basis of costs, there was near universal agreement amongst Departments and advisers alike, as well as from several public sector procurement teams, that such methods could not guarantee value for money. The fact that advisers made this point was particularly significant, given the reliance placed on them by procuring authorities. In the absence of competitive tension, the only way for Authorities to maintain value for money is to avoid changes to begin with.

APPENDIX ONE

Scope and methodology of the National Audit Office's examination

Study scope

1 In 2003, the PAC produced a report drawing together cross cutting PFI issues, *Delivering better value for money from the Private Finance Initiative*, (28th Report, Session 2002-2003), and in particular drew attention to reduced value for money because good procurement practice was not always being followed.

2 The objective of this study was to examine whether Authorities had addressed the main issues raised by the PAC report and to see whether procurement practice followed good practice in the following respects:

a Ensuring market interest in the PFI tendering phase, as a necessary condition of getting a good deal;

b Tackling the problem that PFI procurement costs were often higher or much higher than expected;

c Avoiding lengthy preferred bidder negotiations with one selected bidder, which risk a reduction in value for money through lack of competitive tension;

d Limiting "deal creep" during preferred bidder negotiations, where the unitary charge (the annual payment made to the private sector over the life of the deal) increased or services provided were reduced.

3 This study covers PFI projects procured in England either directly by central Government or as part of major central Government programmes covering PFI hospitals and schools. Projects with a capital value of under £20 million were not included as these would now be ineligible for a PFI approach under recent Treasury guidance. The very large public private partnerships for the London Underground, now categorised by the Treasury as PFI deals, were also excluded as they were not comparable with the majority of recent PFI deals and have been the subject of previous reports by the National Audit Office.[22] Schools procured under the Building Schools for the Future programme were not included as the programme was introduced too recently for an assessment to be made.

4 The effectiveness of the tendering process impacts directly on the value for money of PFI deals, but it was outside the scope of this report to provide an evaluation of the value for money of each single deal that closed over the period examined. This would have been impossible within the resources available. The assessment of value for money of an individual PFI deal normally comprises a National Audit Office examination and report in its own right, using various detailed methodologies.[23]

Study methodology

Background scoping work

5 In November to February 2006, we carried out some background scoping work to identify issues in the PFI tendering process through a web based sample survey of 86 central government PFI projects (including PFI schools) that had closed between 1995 and 2004. The sample was based on selecting up to 10 of the largest PFI projects across each of 15 Departments – though in most cases Departments had not carried out this many PFI projects. We received responses from 74 projects out of 86, covering £9.9 billion capital value or over 70 per cent of the total of £14 billion capital value of all central government and schools PFI deals in England closing up to 2004.

22 National Audit Office (2000), *The Financial Analysis for the London Underground Public Private Partnerships*, HC 54, Session 2000-2001; National Audit Office (2004), *London Underground PPP – Were they good deals?*, HC 645, Session 2003-2004; National Audit Office (2004), *London Underground: Are the Public Private Partnerships likely to work successfully?*, HC 644, Session 2003-2004.

23 For the methodology, see: *A Framework for evaluating the implementation of Private Finance Initiative projects* at www.nao.org.uk/publications/other_publications.htm. For a full list of National Audit Reports which examine single deals in a number of different sectors, see www.nao.org.uk/guidance/pfi_ppp_reports_by_sector.htm.

6 As well as general information, the survey responses also provided some useful and representative historical data that have been used in the report, particularly on trends in market interest. Non-responses were even across sectors, tending to be more common for older projects. Topics covered in the web based sample survey were:

- Fit with business requirements.
- Project management.
- Balance of affordability, quality and finance structure.
- Risk allocation and management.

Main survey work

7 Our main survey work for the study, in addition to the background data collection described above, was carried out in June 2006. We carried out a census of all 49 PFI projects within the study scope which reached financial close between April 2004 and May 2006, with a combined capital value of £7.88 billion.[24] Most of these projects were, in practice, schools and hospitals, although there were also several defence and transport projects and one courts deal (see Appendix 2 for project details). The questionnaire was returned by 46 projects representing a 94 per cent response rate, with capital value of £7.75 billion. Of the three non-responses, two were schools projects and one was a hospital project. The reasons given for failing to respond included key personnel moving on and the pressures of current work commitments.

8 The questionnaire asked for detailed financial and other objective evidence and for information on issues that are inevitably more subjective, such as the authority's reasons for actions they had or had not taken. The main topic headings were:

- Key financial information such as capital value, net present value at preferred bidder and at financial close, annual unitary charge figures at preferred bidder and at financial close and the value of any changes made to the project during preferred bidder negotiations;
- Market interest in bidding, number of bidders;
- Tendering times and costs, including the amount spent on advisers;
- Reasons for any delays or overspends; and
- Examples of perceived good practice adopted.

Survey analysis

9 Survey analysis was carried out using Excel and SPSS, excluding projects that had not provided data for a particular element of the analysis. In general, procuring authorities provided full responses. However, missing answers tended to be more common for questions that asked for quantification, such as the costs of tendering delays and the breakdown of costs of changes made to the project during the preferred bidder negotiations.

10 Some of the figures produced in this report, especially on tendering times, differ slightly from those contained in the 2006 Treasury publication, Strengthening Long-Term Partnerships. The average tendering time quoted by the Treasury is 27 months, compared to the 33 months quoted in this report. This is because the Treasury took a sample of projects based on the year in which they went to the market rather than, as for this study, the year in which they reached financial close. Whilst the Treasury approach had the advantage of enabling a clearer link to be made between policy initiatives and their effects on projects in procurement, it did mean that those projects with the longest procurement periods which had not yet reached financial close were not included.

11 We also carried out regression analysis to explore associations between key variables and the length and time of tendering, see Appendix 4.

Other fieldwork

12 The survey work was supported by further fieldwork, including:

- A programme of 30 interviews with private sector contractors, financial and legal advisers, officials in Departmental Private Finance Units and staff of other relevant public and private sector bodies, as in Appendix 3. Interviews were used both to 'triangulate' the issues arising out of the survey work and to explore them in further detail. They were chosen to ensure that we heard from a good range of parties with different perspectives and interests in PFI.
- Case examples of four PFI projects chosen to illustrate a) best practice in procuring PFI projects, b) the impact of Jarvis plc becoming insolvent, c) the management of lengthy preferred bidder negotiations and d) large-scale change during preferred bidder negotiations.

24 11 local government projects which were not part of major central government programmes, such as social housing and street lighting, were excluded with a total capital value of just under £750 million.

- An advisory Expert Panel, consisting of 12 PFI experts with a variety of backgrounds from within the public and private sector. The members of the panel were:

Name	Organisation	Position
Jo Fox	HM Treasury	Senior PFI Commercial Adviser
Andy Carty	Partnerships UK	Chief Operating Officer
Graham Beazley-Long	PPP Forum	Director (previously Director of Global Debt at Dresdner)
Sally Collier	OGC	Director of Procurement Policy
Mark Tribe, John Reed	4ps	Project Directors
Bruno Bodin	Business Services Association, Ecovert	Chairman of PFI Group (previously, Managing Director of Ecovert FM)
Andy Friend	Laing	Director (previously CEO), although left September 2006 to act as a commercial adviser to the Department for Transport
Charles Abel Smith	Arup	Head of PPP Advisory
Paul Grout	Bristol University	Professor of Political Economy
Paul Aitchison	Department of Health	Consultant
John Marchbank	Ministry of Defence	Deputy Director of PFU

APPENDIX TWO

Projects included in the survey work

Project title	OJEU date [project brought to the market]	Financial close date	Capital value (£m)	Contract length (years)
Schools				
Oldham Secondary Schools PFI	May 2004	May 2006	97	25
Birmingham 2 – Twelve Schools	Jul 2003	Mar 2006	74	30
Norwich Area Schools PFI	Jun 2004	Mar 2006	43	26.33
Gateshead – Group of Schools	Apr 2004	Feb 2006	55	26.4
Rochdale – Aiming High	May 2004	Feb 2006	45	25
Northamptonshire 2 – Northampton Review	Jan 2003	Dec 2005	191	32
Worcestershire – Bromsgrove Schools	Dec 2003	Dec 2005	65	30
Kent – Six schools (including Hugh Christie Technology College)	Nov 2003	Oct 2005	92	28
Manchester 2 – Wright Robinson Sports College	Dec 2002	Jul 2005	29	25
Nottinghamshire 2 – Bassetlaw Phases 1 & 2	May 2003	Jul 2005	151	25
Ealing 2 – Three schools	Nov 2003	Jul 2005	54	25
Barnsley – Thirteen schools[1]	May 2003	May 2005	45	26
Kirklees 2 – Special Schools Reorganisation	Apr 2002	May 2005	25	27
Sheffield Schools Phase 3[1]	Oct 2002	Apr 2005	53	25
Redcar & Cleveland – Grouped schools	Jul 2003	Apr 2005	54	28.75
Leeds 3 & 4 – Secondary & Post 16 PFI Project	Dec 2003	Apr 2005	97	28.33
North Swindon Schools PFI	Nov 2002	Apr 2005	68	25
Hadley Learning Centre and Jigsaw Project PFI	Jun 2003	Mar 2005	70	28
Derby – Grouped Schools	Mar 2003	Dec 2004	44	25
Coventry – Caludon Castle School	Oct 2002	Dec 2004	22	30
London Borough of Croydon – Ashburton School	Feb 2002	May 2004	25	30
Leeds 2 – Ten Primary Schools	Nov 2002	Apr 2004	36	26.33
Hospitals				
University Hospital Birmingham NHS Foundation Trust – Birmingham New Hospitals Project	Apr 2002	Jun 2006	559	35
Barts and the London NHS Trust – Redevelopment of the Royal Hospital of St Bartholomew and the Royal London Hospital	Feb 2002	Apr 2006	1,072	42

Project title	OJEU date [project brought to the market]	Financial close date	Capital value (£m)	Contract length (years)
Hospitals *continued*				
Ipswich Hospital NHS Trust – Garrett Anderson Treatment and Critical Care Centre	Nov 2003	Mar 2006	26	30
Hull and East Yorkshire Hospitals NHS Trust – Oncology and Haematology Development at Castle Hill Hospital	Nov 2002	Feb 2006	67	30
Portsmouth Hospitals NHS Trust – Queen Alexandra Hospital Redevelopment	Aug 2001	Dec 2005	236	35
Oxford Radcliffe Hospitals NHS Trust – Churchill Hospital PFI Project	Oct 2002	Dec 2005	126	33
Sherwood Forest Hospitals NHS Trust – Modernisation of Acute Services in Central Nottinghamshire	May 2003	Nov 2005	296	32
Northgate and Prudhoe NHS Trust – Walkergate Park for Neurorehabilitation and Neuropsychiatry	Sep 2003	Jul 2005	24	32
Newcastle NHS Trust – Transforming the Newcastle Hospitals	Aug 2001	Apr 2005	295	38
Daventry and South Northants Primary Care Trust Community Hospital[1]	Nov 2002	Mar 2005	27	30
Central Manchester & Manchester Children's Hospital PFI	Jul 2000	Dec 2004	415	38
Kingston Hospital NHS Trust – Redevelopment of Kingston Hospital	Feb 2001	Nov 2004	28	30
Addenbrooke's Elective Care, Diabetics and Genetics Centre	Apr 2002	Oct 2004	80	30
St James University Hospital, Leeds – New Oncology Wing	Oct 2001	Oct 2004	265	30
University Hospital Lewisham – Redevelopment	Jun 2002	Jul 2004	51	30
Royal Alexandra Hospital for Sick Children	Jul 2002	Jun 2004	36	30
Stoke Mandeville Hospital – Redevelopment Project	Apr 1999	May 2004	42	32
St George's Hospital, Morpeth – Reprovision of Mental Health Services	Aug 2001	May 2004	31	30
Queen Mary's Hospital Roehampton – Redevelopment Project	May 2000	May 2004	75	30
North Kirklees Primary Care Centres	Jan 2003	Apr 2004	25	30
Transport				
National Roads Telecommunications Services	Aug 2002	Sept 2005	237	10.5
Docklands Light Railway – extension to Woolwich	Nov 2003	May 2005	238	30
Defence and other				
Allenby-Connaught	Feb 2002	Apr 2006	1,257	35
Portsmouth Housing 2	Mar 2002	Oct 2005	27	25
C Vehicles	Jul 1999	Jun 2005	114	15
Aquatrine Package C	Mar 2001	Oct 2004	174	25
Avon & Somerset Magistrates' Courts	Feb 2000	Aug 2004	59	27

NOTE

1 Did not respond to our survey.

APPENDIX THREE

List of bodies interviewed for the study

Description	Organisation
Central Government: Departmental Private Finance Units	National Offender Management Service HM Revenue and Customs Highways Agency HM Courts Department for Transport Ministry of Defence Transport for London Department of Health Department for Education and Skills HM Treasury
Other central Government institutions	4ps OGC Partnerships for Schools Partnerships UK
Public sector procurement teams	Leeds City Council Kirklees City Council University of Birmingham NHS Trust Queen Mary's Hospital, Roehampton
Private sector representative bodies/ trade associations	Major Contractors Group Royal Institute of British Architects PPP Forum (representatives from eight companies including construction companies, banks and financial advisers) PPP Forum (single representative of the body as a whole) Business Services Association
Advisers to public sector procurement teams	PricewaterhouseCoopers Ernst & Young Grant Thornton KPMG Nabarro Nathanson Deloitte & Touche
Construction companies	Balfour Beatty Carillion
Other	Audit Commission CABE

APPENDIX FOUR

Statistical methodology

1 We carried out ordinary least squares multiple regression analysis to explore variations in tendering times and costs across the 46 PFI projects that responded to our survey.

Data

2 **Figure 14** sets out the variables used in the regressions, their definition and the likely impact the factor was expected to have on either or both tendering times and cost of tendering, as based on our discussions with experts in the PFI public and private sectors.

14 Data used in regressions and possible influences

Variable	Definition	Expected influence on tendering time and costs
Tendering time	Months from advertisement of project in the Official Journal of the EU to financial close	
Tendering costs	Total cost (£ million) of tendering to the procuring authority (consisting largely of adviser fees)	
Project size	£ million capital value	Possible increase in tendering time and cost with higher project size, which may be a measure of complexity as well as scale
Net Present Value	£ million discounted at 3.5 per cent to date of financial close	Possible increase in tendering times and cost with higher net present value
Sector	1/0 dummy variables covering 19 'Hospital' PFI projects and seven 'other' projects. All results presented are relative to schools (20 projects). See Appendix 2 for further details of projects.	Time expected to increase with the complexity and heterogeneity of sector though no a priori ranking
Authority experience	The number of previous PFI deals done by the Authority, with three 1/0 dummy variables: one to two deals with the Senior Responsible Officer (SRO) not having done any previous PFI deals, one to two deals with the SRO having done at least one previous PFI deal, three or more deals. All results presented are relative to Authorities with no experience of PFI deals.	Times and costs likely to reduce with public sector experience
Project preparation time	Number of months taken from the decision to begin the substantive work towards Outline Business Case and the date of OJEU notice	Times and costs likely to reduce with greater preparation time
Number of bidders	The number of bidders at invitation to tender (ITN) stage, when authorities ask for the development of viable bids	Might increase tendering time and cost as number of bidders increases. Or small number of bids may reflect difficulties with the project that would lead to increased tendering times and costs

Source: National Audit Office

Results for tendering times

3 **Figure 15** sets out the results showing all variables of interest. This model explained 38 per cent of the variation in the length of the tendering period (adjusted R2). The table indicates that the only factor that was statistically significant (at the five per cent level) was project sector. Health PFI deals took longer all else equal than PFI schools, and the 'other' PFI deals took longer still. Project preparation time was not significantly associated with reduced tendering time, though the variable had a negative coefficient. The Prior Experience variables were similarly not significant at the five per cent level, but are suggestive of a tendency for greater experience to be associated with shorter tendering times. The size variables were not significant, (net present value providing a better fit than capital value). This may be consistent with the greater use of resources on larger PFI deals.

Results for tendering costs

4 **Figure 16** gives the results of a stepwise regression analysis for tendering costs. This model explained 75 per cent of the variations in tendering costs (adjusted R2) and in view of the extent of variance accounted for, statistically insignificant variables are not shown from the regression which entered all variables. The results show that PFI sector was associated with higher tendering costs, with tendering for PFI hospitals and 'other' projects costing more than PFI schools. There was a strong link with the capital value of the projects even allowing for PFI sector, reflecting factors such as the scale of preparation of output specification which increased with capital value.

15 Multiple regression coefficients and significance values to explain PFI tendering lengths

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	108.718	38.458		2.827	0.014
	Other sector	25.861	8.944	0.771	2.891	0.013
	Hospital	16.848	6.128	0.720	2.749	0.017
	Net present value	2.98E–009	0.000	0.455	1.972	0.070
	One or two prior deals, but no SRO experience	– 7.781	7.534	– 0.194	–1.033	0.321
	One or two prior deals and SRO experience	– 6.160	5.343	– 0.294	–1.153	0.270
	Three or more prior deals	– 25.402	14.661	– 0.460	–1.733	0.107
	Project preparation time (months)	– 0.356	0.258	– 0.385	–1.380	0.191
	Strength of competition (number of bidders at ITN)	– 2.510	4.599	– 0.109	– 0.546	0.594

Source: National Audit Office

16 Multiple regression coefficients and significance values to explain the cost of PFI projects

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	391,384.810	623,253.731		0.628	0.535
Hospital	726,643.044	858,562.944	0.085	0.846	0.405
Capital value	0.009	0.001	0.671	6.823	0.000
Other sector	3,928,306.291	1,107,705.456	0.386	3.546	0.001

Source: National Audit Office

Results for developed bids received

5 We explored two possible causes of variations in the number of developed bids received by procuring authorities. First, we looked at whether the capital value of a deal was relevant, using an analysis of variance (ANOVA) test. **Figure 17** shows that deals with different numbers of bidders did not vary significantly in capital value. Second, we tested for a relationship between geographical location and the number of developed bids received using a chi-squared test, following indications in interviews that this could be important. However, the test failed to confirm a statistically significant relationship **(Figure 18)**.

17 An ANOVA test of the relationship between capital value and the number of developed bids received

Anova

	Sum of Squares	df	Mean Square	F	Sig.
Between groups	20,921,043,489,022,000	1	20,921,043,489,022,450	0.193	0.662
Within groups	4,325,472,172,028,323,000	40	108,136,804,300,708,100		
Total	4,346,393,215,517,345,000	41			

Source: National Audit Office

18 A chi-squared test of the relationship between geographical location and number of developed bids received by procuring authorities

		Strength of competition (number of bidders at ITN)		Total
		Two or fewer at ITN	Three or more at ITN	
Region	London	1	6	7
	North West	1	3	4
	North East	1	9	10
	Midlands	6	4	10
	South West	2	2	4
	South/South East	3	2	5
	National	1	3	4
Total		15	29	44

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	9.031[1]	6	0.172
Likelihood Ratio	9.488	6	0.148
Linear-by-Linear Association	2.665	1	0.103
N of Valid Cases	44		

Source: National Audit Office

NOTE

1 Twelve cells (85.7 per cent) have expected count less than five. The minimum expected count is 1.36.

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