Value for Money Assessment Guidance

November 2006

HM TREASURY

HM TREASURY

Value for Money Assessment Guidance

November 2006

© Crown copyright 2006

Published with the permission of HM Treasury on behalf of the Controller of Her Majesty's Stationery Office.

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Any enquiries relating to the copyright in this document should be sent to:

HMSO
Licensing Division
St Clements House
2-16 Colegate
Norwich
NR3 1BQ

Fax: 01603 723000

E-mail: hmsolicensing@cabinet-office.x.gsi.gov.uk

HM Treasury contacts

This document can be found on the Treasury website at:

hm-treasury.gov.uk

For general enquiries about HM Treasury and its work, contact:

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

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

ISBN-10: 1-84532-1-206-1
ISBN-13: 978-1-84532-1-206-9

© Crown copyright 2006.
This was printed on at least 75% recycled paper.
When you have finished with it please recycle it.

CONTENTS

		Page
Executive Summary		3
Chapter 1	Introduction	5
Chapter 2	Outline of Value for Money Assessment Process	15
Chapter 3	Stage 1 - Programme Level Assessment	19
Chapter 4	Stage 2 - Project Level Assessment	27
Chapter 5	Stage 3 - Procurement Level Assessment	41

Executive Summary

The Value for Money (VfM) Assessment Guidance August 2004 introduced a 3-stage assessment process and replaced Treasury Taskforce 'Technical Note 5'. This updated version of the Value for Money Assessment Guidance retains the 3-stage process and the application of both a qualitative and a quantitative test (for which there is separate user guidance) during stages 1 and 2. It also incorporates additional information which reflects some of the policy developments in PFI since 2004. This guidance supersedes the previous VfM guidance and should be used by procuring authorities, both at department and Local Authority level, who are considering the use of PFI for procurement.

The VfM assessment guidance highlights different issues that procuring authorities should consider in establishing what the driving factors for VfM will be in their particular projects. It sets out the process and methodology to be used in considering whether the factors driving VfM will be realised through the use of PFI procurement.

At stage 1 the procuring authority, typically the sponsoring department's central PFI team, should undertake the qualitative and quantitative analysis for programmes considered likely to be suitable for procurement through PFI. At stage 2 the project team should conduct more detailed analysis on the individual projects making up the programme. This must be completed as part of the Outline Business Case. Where these assessments conclude that PFI will deliver VfM, the stage 3 assessment is then a continuous appraisal following OJEU up until financial close. This stage is to ensure that the conclusions from the previous stages continue to hold given the latest information including the prevalent market conditions.

At all stages, the emphasis in the guidance is on:

Evidence: making a robust assessment based as far as possible on detailed evidence and previous experience. Data should be collected on all projects and used to aid future assessments.

Early assessment: it is important that appraisals are started early, and are undertaken prior to engagement with the market. Late changes to a project once procurement has commenced are likely to erode VfM.

Sufficient resourcing and planning: In order for the VfM drivers to be effective and for overall VfM to be achieved, the procurement needs to be well planned, managed, executed and transparent, whichever procurement route is chosen. The guidance emphasises that procuring authorities must ensure they have sufficient capable resources to apply to the procurement itself.

Taking account of more recent policy developments in PFI, the VfM assessment guidance now also includes a strengthened test for assessing VfM from soft services in PFI and further details on the factors to take account of in considering sufficient operational and financial flexibility; the process for single bidder procurements; and consideration of contract duration caps. Further guidance will follow on some of the areas mentioned.

1 INTRODUCTION

Background

1.1 In August 2004, the Treasury released its Value for Money Assessment Guidance replacing Treasury Taskforce 'Technical Note 5' for Private Finance Initiative (PFI) procurements. This introduced a new three stage process to assess the Value for Money (VfM) of PFI schemes, summarised below:

- **Stage 1 – Programme[1] Level Assessment** to ensure that PFI is only considered for use in those programmes where it is appropriate and is likely to represent good VfM;
- **Stage 2 – Project Level[1] Assessment** requiring an upfront procurement appraisal at Outline Business Case (OBC). This replaced the previous Public Sector Comparator (PSC) and identifies the aspects that are key to VfM; and
- **Stage 3 – Procurement Level Assessment** which is an ongoing assessment during the procurement phase of a project to ensure that the desired project can be delivered in view of, for example, the competitive interest and market capacity.

Objectives

1.2 This guidance outlines a process which starts by looking for evidence that PFI is likely to be a suitable procurement route that represents good VfM (see box 1.1). From this starting point, the guidance outlines key issues that procuring authorities need to consider in testing the suitability and VfM of PFI. The guidance ensures that all projects being considered for PFI across Government are assessed against the same criteria.

1.3 Procuring authorities should begin detailed assessments of the VfM of PFI projects at the earliest stage possible. While the appraisal of procurement options at the programme and project stage will inevitably involve some uncertainty, this guidance aims to provide procuring authorities with a rational and robust framework to consider whether PFI procurement will deliver VfM and how best to achieve it. Working through the assessment should provide a clear strategic direction, while allowing sufficient flexibility to take account of changes for individual projects.

Scope of guidance

1.4 Although there is an obligation to ensure that VfM is achieved for all forms of procurement, the scope of this guidance focuses specifically on procurement through PFI. However, some of the core principles relating to achieving VfM in PFI projects (as set out in Box 1.2) are also applicable to other forms of public sector procurement, in particular those projects that involve substantial capital expenditure.

Private Finance Initiative

1.5 PFI is an arrangement whereby the public sector contracts to purchase services from the private sector on a long-term basis, often between 15 to 30 years. Typically:

- under the contract the private sector will need to construct and maintain infrastructure in order to deliver the services required, hence there will be a development or construction phase followed by an operational phase;
- the private sector party contracting with the public sector will usually be a special purpose company;
- the special purpose company will use private finance, usually a mix of equity and limited recourse debt, to fund the up-front construction works;

---

[1] Please see Box 2.2 for further explanation of these terms

- the special purpose company will be paid a fee – often referred to as the unitary payment – that will include principal and interest payments on the debt and a return to the private sector shareholders (which together largely repay the up-front borrowings used to fund the initial construction work) plus an amount for the services delivered. The unitary payment normally commences post-completion of the construction work once services start being delivered and continues over the rest of the contract life;
- the unitary payment will be at risk to the contractor's performance during the life of the contract so that payment will be reduced if performance falls below the required standard, thus harnessing private sector management skills and incentivising the private sector to deliver services on time, on budget and to the required standard; and
- the risk allocation between the public and private sector is well understood and involves the private sector bearing cost overrun, delay and service standard risks. Government has developed Standardisation of PFI Contracts (SOPC) which sets out a standard approach to the risk allocation between the public and private sectors and includes mandatory principles and drafting for certain key contractual clauses.

Box 1.1: Factors which should form part of the evidence base for considering PFI could be successful and VfM

- a major capital investment programme, requiring effective management of risks associated with construction and delivery;
- the structure of the service is appropriate, allowing the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective, equitable, and accountable delivery of public services into the long-term, and where risk allocation between public and private sectors can be clearly made and enforced;
- the nature of the assets and services identified as part of the PFI scheme, as well as the associated risks, are capable of being costed on a whole-of-life, long-term basis;
- the value of the project is sufficiently large to ensure that procurement costs are not disproportionate;
- the technology and other aspects of the sector are stable, and not susceptible to fast-paced change;
- planning horizons are long-term with confidence that the assets and services provided are intended to be used over long periods into the future; and
- the private sector has the expertise to deliver, there is good reason to think it will offer VfM and robust performance incentives can be put in place;

1.6 PFI is only one type of Public Private Partnership (PPP). There are many other types of PPP arrangement, typified by some form of joint working between the public and private sectors. While this guidance is intended only for the purpose of assessing VfM for PFI projects, authorities undertaking other forms of PPP which involve contracting for services on a long-term basis and the construction of assets and infrastructure funded by private finance may also choose to apply this guidance.

1.7 Because PFI is characterised by a long-term commitment by the private sector to deliver and maintain new public infrastructure and services, and given the complexity generally associated with PFI procurements, PFI will normally only be relevant for certain types of investment, therefore naturally limiting its use.

Small Projects and IT/ICT procurements

1.8 Experience has shown that PFI is not appropriate for individually procured low capital value projects because of the relatively high level of procurement costs. Equally, PFI is not suitable for those projects where there is rapid technological or other change which makes it difficult for both procuring authorities and bidders to predict with reasonable certainty the service delivery requirements and to include sufficient contractual flexibility at a reasonable price. For these reasons, as outlined in the 2003 HM Treasury document "PFI: Meeting the investment challenge" (MTIC)[2], the PFI procurement route is not considered to be appropriate for individually procured projects with capital expenditure under £20 million or for IT/ICT procurements.

Procurement guidance and accounting officers

1.9 It is a primary responsibility of accounting officers to ensure that VfM is achieved in all procurements[3]. Chapter 22 of Government Accounting sets out the general principles which apply to the public sector's acquisition of goods and services, including works, and states that the Government's policy on procurement is to achieve VfM, having regard to propriety and regularity. Departments are responsible for achieving VfM, normally through competition, and ensuring that they comply with appropriate obligations under European and other international agreements. Departments are also responsible for ensuring that the Government's procurement policy guidelines[4] and the guidance on procurement which is issued by the Office of Government Commerce (OGC) are brought to the attention of other public bodies for which they are responsible, including Local Authorities where these are the procuring body.

Value for Money

1.10 PFI should only be pursued where it represents VfM in procurement. VfM is defined as the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the good or service to meet the user's requirement[5]. VfM is not the choice of goods and services based on the lowest cost bid. To undertake a well-managed procurement, it is necessary to consider upfront, and at the earliest stage of procurement, what the key drivers of VfM in the procurement process will be.

VfM - a relative concept

1.11 In assessing and delivering VfM it is also important to note that VfM is a relative concept which requires comparison of the potential or actual outcomes of alternative procurement options. This is reflected in the guidance with both Stage 1 and 2 assessments being based on a relative comparison between PFI and conventional procurement. This requires a high degree of estimation, especially where experience and/or data on similar projects procured under different procurement routes is limited. However, as markets change and mature, what may have been considered the most appropriate way to procure a project, or the best terms which could be achieved, may change. Therefore, care must be taken when comparing and benchmarking current situations to historical information and data.

---

[2] http://www.hm-treasury.gov.uk/documents/enterprise_and_productivity/PFI.cfm

[3] Procurement is variously defined, NAO defines procurement as being: "the whole-life process of the acquisition of goods, services and works from third parties, beginning when a potential requirement is identified and ending with the conclusion of a service contract or ultimate disposal of an asset".

[4] Annex 22.2 to Government Accounting

[5] http://www.government-accounting.gov.uk/current/frames.htm

VfM Driving Factors **1.12** Some of the key drivers of VfM are listed in Box 1.2 below.

Box 1. 2 Generic Factors driving Value for Money

- **The optimum allocation of risks between the various parties** –requires that risks are allocated to the party, or parties, which are best placed to manage and minimise these risks over the relevant period;
- **Focusing on the whole life costs** of the asset rather than only the upfront costs involved;
- **Integrated planning and design of the facilities-related services** through an early assessment of whether the possible integration of asset and non-asset services (e.g. soft services) should deliver VfM benefits;
- **The use of an outputs specification approach** to describe the Authority's requirements which, amongst other things, allows potential bidders to develop innovative approaches to satisfying the service needs of the procuring authorities;
- **A rigorously executed transfer of risks** to the parties which are responsible for them, ensuring that the allocation of risks can be enforced and that the costs associated with these risk are actually borne by the parties in the manner originally allocated and agreed;
- **Sufficient flexibility** to ensure that any changes to the original specification or requirements of the procuring authority and the effects of changing technology or delivery methods, can be accommodated during the life of the project at reasonable cost to ensure overall VfM;
- **Ensuring sufficient incentives within the procurement** structure and the project contracts to ensure that assets and services are developed and delivered in a timely, efficient and effective manner, including both rewards and deductions as may be appropriate;
- **The term of the contract** should be determined with reference to the period over which the procuring authority can reasonably predict the requirement of the services being procured. This will require careful considerations of factors including: potential changes in end-use requirements; policy changes; design life of the asset; the number of major asset upgrades or refurbishments during the period of the contract; potential changes in the way services could be delivered (e.g. technical advancements); and the arrangements for the asset at expiry of the contract;
- **There are sufficient skills and expertise** in both the public and private sectors, and these are utilised effectively during the procurement process and subsequent delivery of the project; and
- **Managing the scale and complexity** of the procurement to ensure that procurement costs are not disproportionate to the underlying project(s).

1.13 In order for the VfM drivers to be effective and for overall VfM to be achieved, the procurement process needs to be well planned, managed, executed and transparent, whichever procurement route is taken. This will reduce transaction costs, increase bidder involvement and ensure a more competitive procurement. To do this procuring authorities need to ensure, from the very earliest stages, that they have, and are able to apply, sufficient and capable resources to the procurement process itself. If they are unable to do so then it is unlikely that they will be able to realise VfM.

Protection for Staff

1.14 Procuring authorities should ensure that VfM is not achieved at the expense of employee terms and conditions and all existing guidance relating to the treatment of staff terms and conditions is fully taken into account. This includes the Cabinet Office Statement of Practice issued in 2001, HM Treasury guidance relating to bulk transfer agreements, the Best Value Code of Practice (including the extension of the Best Value code as set out in the 2004 Warwick Agreement), and NHS Retention of Employment guidance (for the NHS only). Procuring authorities should also note the policy advice on workforce issues as set out in "PFI: strengthening long-term partnerships" (SLTP)[6], published by HM Treasury in March 2006.

Other factors

1.15 Other factors that may have an important impact on the VfM of a particular procurement route include:

- **Externalities:** As set out in the Green Book[7], the assessment of externalities - negative or positive - is necessary in making an investment decision. For example, the undertaking of a procurement may have an impact on the supply side capacity of a particular part of the private sector. While this should be undertaken as part of the Green Book investment assessment, should different externalities exist for different procurement routes then these also must be taken into account in making the VfM assessment.

- **Long-term certainty:** Most PFI projects are procured under long-term contracts. The process of procuring long-term infrastructure and services funded by private finance can often provide greater certainty of the whole-of-life costs and standard of service compared to conventional procurement. This certainty may reduce absolute flexibility, but provided the procuring authority carefully considers the scale and scope of the service needed over a long-term and structures the contract for a commensurate term, may still generate a better VfM outcome. Upfront departmental consideration of the long-term policy strategy therefore should also feed into the VfM assessment.

- **Well developed projects are required before release to market:** It is important that procuring authorities allocate sufficient resource to adequately prepare and develop the project before formal engagement with the market. Excessive bid costs and delays in the procurement process resulting from poorly developed projects often erodes the VfM in procurement. This is prevented through strong project management and setting realistic timetables to ensure that projects are well developed before release to market.

---

[6] http://www.hm-treasury.gov.uk/budget/budget_06/other_documents/bud_bud06_odpfi.cfm

[7] http://www.hm-treasury.gov.uk./media/785/27/Green_Book_03.pdf

Affordability and accounting treatment

1.16 Fundamental to any procurement decision will be a realistic affordability calculation, which refers to what is affordable within the department/procuring authority's spending allocation or expected future settlements. The affordability calculations, which are estimated separately to the VfM quantitative assessment, should also be included as part of the OBC. Projects estimated unaffordable should not be pursued and must not be brought to market. It is vital that in drawing up specifications procuring authorities are mindful of their affordability envelope, and the future resource implications for a project. Procuring authorities need to prudently assess their ability to meet the payment commitments arising under their PFI contract to ensure upfront that their project is affordable. If a Spending Review settlement has just been finalised, procuring authorities should confirm that the project envelope remains affordable.

1.17 Procuring authorities and departments should note that the accounting treatment of a PFI project does not form part of the VfM assessment. The decision to undertake PFI investment, once affordability has been confirmed, is taken on VfM grounds alone. Whether the investment is on or off-balance sheet is a decision taken by independent auditors and is not relevant to the VfM of the procurement route. To ensure integrated and informed decisions on PFI are made as part of the capital spending allocation, departments should consider the consequences of the PFI being treated as a capital asset for accounting purposes. The assumption should be that projects will be on-balance sheet, unless there is significant historical record to suggest otherwise.

1.18 The manageability of the budgetary impact of accounting should be assessed early on as departments should not cancel a procurement judged to be VfM simply due to a change, later in procurement, of the accounting treatment. It is important that procuring authorities do not compromise VfM by transferring risks unnecessarily in order to get particular balance sheet outcome: risks should be held by those parties best able to manage them. This should reinforce the emphasis on taking account of both near and longer-term capital and resource commitments made as part of any investment decision.

Use of Competitive Dialogue

1.19 Competitive Dialogue is a procurement procedure introduced through the EU Public Sector Procurement Directive[8] and incorporated into English law by the Public Contracts Regulations 2006, which came into force on 31 January 2006[9]. It is considered that the Competitive Dialogue Procedure will be the relevant procurement procedure for the majority of PFI procurement.

1.20 Under the Competitive Dialogue procedure, procuring authorities must consider issues surrounding the procurement at an early stage. The notice to be placed in the Official Journal of the European Union (OJEU Notice) should set out the award criteria to be applied, and specify the process that the procuring authority intends to follow in the procurement (including for example whether a debt funding competition is expected to be held). There can be no changes to the basic features of tenders once submitted, with only limited clarifications, specifications, fine-tuning and additional information requests being permitted. The Competitive Dialogue procedure requires that there are no amendments made to the successful bid following selection of the preferred bidder which have the effect of modifying substantial aspects of the bid or

[8] Directive 2004/18/EC

[9] Further Information on the use of Competitive dialogue is available from the OGC website http://www.ogc.gov.uk/documents/competitive_dialogue.pdf

which risk distorting competition or causing discrimination. This requirement in particular places a significant limit on the amount of negotiation and amendments that can occur post selection of preferred bidder, and thus it is vital that all important issues are considered and settled at an earlier stage of the procurement. Thus while this guidance is applicable whatever procurement procedure the project follows, the use of the Competitive Dialogue procedure is particularly complementary to the approach of early consideration of issues which is encouraged in this guidance.

Use of a quantitative VfM assessment

1.21 For Stages 1 and 2 the VfM assessment comprises both a qualitative and a quantitative appraisal[10]. Long-term forecasting requires assumptions to be made about the future. This applies equally to conventional or PFI procurement. However, these uncertainties should not be used as a reason to not prepare quantitative VfM assessments, and it is a requirement to prepare a quantitative VfM analysis, while recognising its inherent limitations. It should also be noted that where during Stage 3 there is a significant increase in costs of the PFI option, over and above the original forecast costs, procuring authorities will be required to revisit the Stage 2 assessment. Box 1.3 provides further details on the quantitative assessment.

[10] Separate Guidance available on the application and use of the Quantitative VfM Model: http://www.hm-treasury.gov.uk/documents/public_private_partnerships/key_documents/ppp_keydocs_vfm.cfm

Box 1.3: Quantitative Assessment- Aims, Objectives, Inputs and Output

The use of the spreadsheet developed by HM Treasury for the quantitative VfM assessment is a requirement for the Stage 1 assessment and for the vast majority of Stage 2 assessments. Stage 2 requirements are further discussed in 1.25.

Aim: The analysis is intended to contribute to an assessment of whether the PFI option presents VfM compared to a conventionally procured project.

Objectives: The quantitative assessment aims to:

- Inform the qualitative judgement of officials involved in allocating capital between programmes, and of procuring authorities at project level in determining VfM;
- Enable projects to make appropriate use of private capital, to justify explicit additional costs against the benefits achieved as a result of transferring risk to the private sector; and
- Increase the evidence available to departments to support future procurements, and to be able to defend decisions taken in the context of government policy.

Input: The quantitative assessment considers how the quantifiable costs of using PFI as the procurement route are likely to compare with those of conventional procurement. For the PFI option, it calculates the cost of the project if it were to be funded through private finance. For the conventional comparator it assumes the capital expenditure is funded by public sector capital.

Departments and project teams will therefore need to secure as much evidence as is practicable and reasonable when substantiating their quantitative analysis. Procuring Authorities should note that:

- The evidence base will need to be continually refreshed by the incorporation of new information from projects at all stages of procurement and operation. The procuring authority should avoid relying on over-elaborate estimates and should conduct sensitivity analyses;
- If the current evidence base is inadequate, then other information should be sought to justify the inputs into the model and steps taken to remedy this gap for future procurement (the Quantitative User Model Guidance addresses ways this can be achieved); and
- While at the programme level the assessment will inevitably be conducted using high-level estimates, the assessment will develop as more detailed information is known about the programme and individual projects up to the completion of the Stage 2 assessment at the OBC.

Output: The results of the quantitative assessment at both Stages (1 & 2) should be presented, along with the qualitative assessment, as part of the business case for projects. The interpretation of the quantitative result is discussed in the VfM Quantitative Assessment User Guide and below.

Balance between quantitative and qualitative tests

1.22 This guidance provides a series of qualitative considerations that should frame the approach to the quantitative VfM assessment, with the intention being that the quantitative assessment is used as a support tool for making an overall assessment. It is important that the outputs from the quantitative or qualitative assessment should not be considered in isolation as a standalone case for, or against, PFI.

1.23 The following should be noted:

- **Marginal Results:** Where the difference in the results for the conventional option and PFI option are marginal (small positive for or against PFI) the figures should not be interpreted as sufficient evidence for or against use of PFI as a procurement route. In such cases more weight should be given to the qualitative than the quantitative assessment.

- **Uncertainty and level of sensitivity of results:** Where there is a high level of uncertainty around inputs, or outputs are highly sensitive to the input variables, it is appropriate to accord greater weight to the qualitative assessment or to invest more time and money in establishing higher confidence in the most critical assumptions. Procuring authorities should in any event undertake appropriate sensitivity analysis.

1.24 In all cases, the overall assessment must note an appropriate and thorough explanation of the leading factors in both the quantitative and qualitative analyses in coming to a decision, especially where the two assessments do not appear supportive of one another.

Stage 2 quantitative approach

1.25 The Treasury VfM spreadsheet was developed to provide a simple tool to enable procuring authorities to assess VfM and its use has been mandatory for all projects for both Stage 1 and Stage 2 assessments. Individual departments have however, in some cases, continued to use more complex models as part of the Stage 2 assessment to provide for their own needs, while also using the Treasury VfM spreadsheet. The Treasury consider the VfM spreadsheet is suitable for the vast majority of projects for the Stage 2 assessment but also recognise that a limited number of complex projects may require a more sophisticated quantitative assessment. As such departments may choose not to use the Treasury VfM spreadsheet for projects which it considers to be particularly complex and where the spreadsheet provides insufficient functionality for the particular circumstances of the project. This decision is for the sponsoring department rather than the procuring authority which should seek to discuss any change in approach with its department at the earliest opportunity. The Treasury expect departments to agree to a bespoke approach only exceptionally.

1.26 Use of the VfM spreadsheet will continue to be mandatory for all Stage 1 programme assessments and for those projects being considered by the Project Review Group (PRG) unless otherwise agreed by the PRG secretariat.

Update to the Guidance

1.27 Since the Value for Money Assessment Guidance 2004 was issued, the Treasury has issued further reforms to the PFI process as set out in SLTP. This update of the VfM Assessment Guidance incorporates some of the new guidance set out in SLTP and strengthens the VfM test for PFI (See Box 1.4 below).

Box 1.4: Additions to Value for Money Assessment Guidance

Further detail is included in this update on the following areas:

Sector Specific Contract lengths – highlights the need for sector specific caps on the length of PFI contracts, ensuring they reflect the optimal period over which the procuring authority wishes its services to be provided without unduly restricting long-term flexibility (para 3.8)

Single Bidder Projects - clarification of circumstances where single bidder PFI projects may be allowed to proceed (para 4.9)

Inclusion of Soft Service - strengthened test for rigorously assessing the VfM benefits of including soft services in PFI projects (para 4.25)

Service changes - consideration of the balance between affordability and contractual flexibility in terms of increased costs for large and small changes in service (para 4.32)

Flexibility - ways of considering the degree of flexibility in various financial structures proposed by bidders (para 5.22)

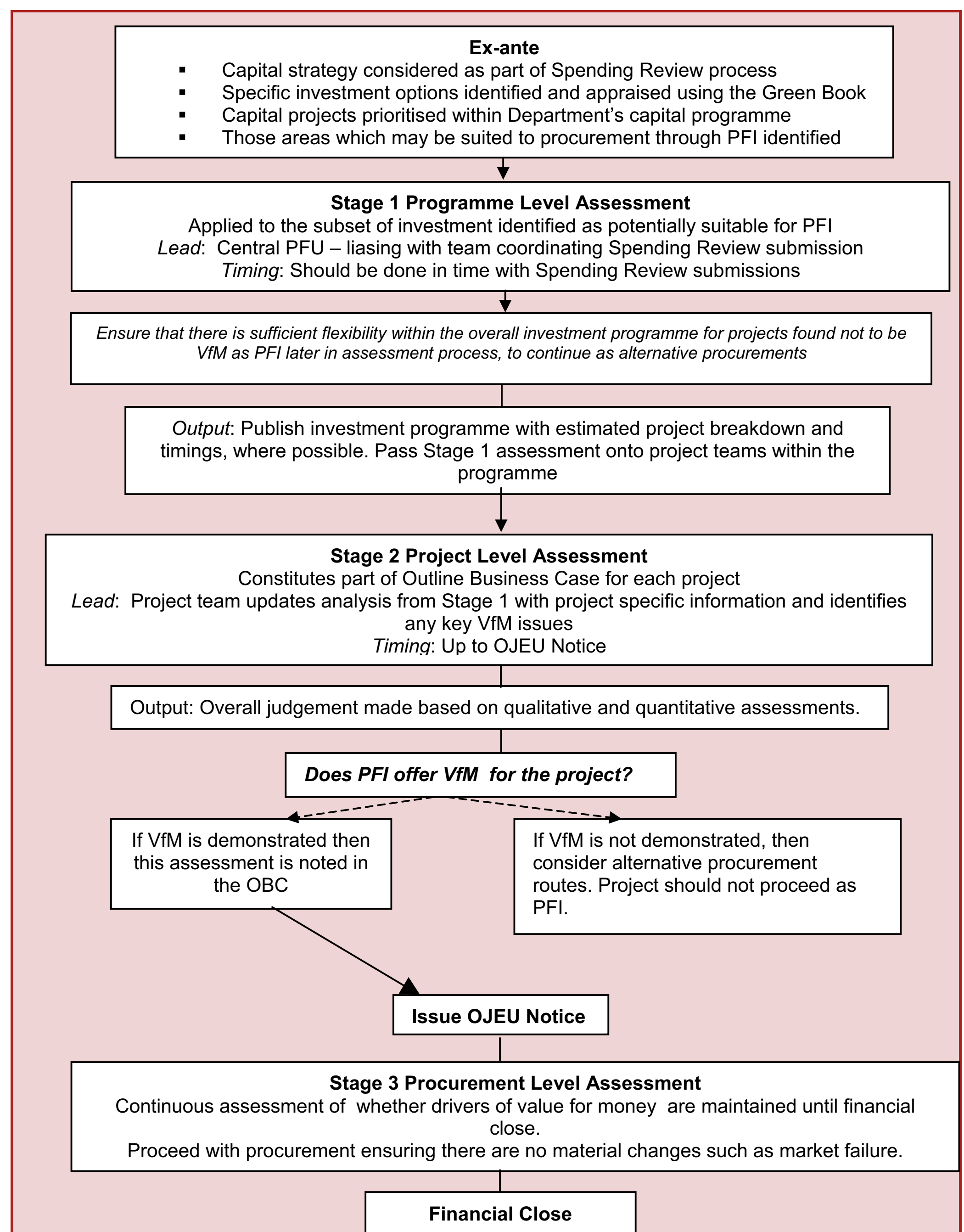
2 OUTLINE OF VALUE FOR MONEY ASSESSMENT PROCESS

Timing and scope

2.1 This chapter provides an overview of the VfM assessment process for PFI. Once departments consider that PFI may be a suitable procurement route based on prima facie evidence (see box 1.1), they should begin their VfM assessment.

2.2 The programme level assessment (Stage 1) should be applied during the annual budgeting round when any programme of investment is being considered. The project level assessment (Stage 2) should be undertaken at OBC before the OJEU Notice is issued. Finally, the procurement level assessment (Stage 3) should begin immediately post OBC and should continue through to financial close.

2.3 This process is summarised in Box 2.1 below:



Assessment responsibility

2.4 The accounting officer is responsible for ensuring that all programmes are assessed in accordance with this guidance and that the chosen procurement route represents good VfM. The accounting officer will need to delegate responsibility for the detailed work accordingly. For Stage 1 this will typically be undertaken by the central PFU in conjunction with the team coordinating the Spending Review submission during the run up to a Spending Review settlement. At Stage 2 the procuring team responsible for the project should update and refresh the analysis undertaken at Stage 1, with support from the central PFU. During stage 3 the procuring authority should make sure that there are no material developments that change the conclusions from the value for money assessment at stage 2.

The process for Local authority programmes

2.5 Where Local Authorities are in receipt of central funding, they will be required to adhere to this guidance. Stage 1 will be completed by sponsoring departments as part of their request for PFI credits which usually takes place as part of the Spending Review process. The finalised programme level analysis should then be passed on to the relevant project teams within Local Authorities once an individual project has received an indication that it may draw up an OBC to take to the PRG from the sponsoring department. The Local Authority project team, in conjunction with the sponsoring department, will then become responsible for completing stages 2 and 3 on that individual project. The quantitative VfM assessment does not form the basis for calculating affordability or for the allocation of PFI credits, which must be estimated separately.

Focus of assessment at stages 1&2

2.6 While the level of detail covered by stages 1 and 2 will differ, the same framework is applicable in both stages. Assessing factors affecting the viability, desirability, and achievability of VfM in PFI underpins the assessment methodology. In some instances (e.g. where projects are standardised) the programme level assessment will appear to be more important for departments whereas in other cases (e.g. highly tailored projects) Stage 2 will appear to have greater importance. However, in both cases it is necessary to undertake both Stage 1 and 2 assessments in order to ensure that all the key issues are considered as early and as robustly as possible.

2.7 Stages 1 and 2 will cover factors capturing the following:

- **Viability**: this involves assessing whether there are any efficiency, accountability or equity issues which demand that services are provided by Government directly rather than through PFI. It also considers the extent to which the service requirements can be adequately captured in a contract-based approach, with a clear specification in output terms for PFI to transfer risk effectively to appropriate parties.

- **Desirability**: involves assessing the relative benefits provided through different procurement routes, such as incentives and risk transfer in PFI versus the Government's lower cost of borrowing in conventional procurement. Requires upfront consideration of the relative advantages and disadvantages associated with a long-term contractual relationship between the public and private sector, and the strength of the mechanisms that could be used to ensure that different benefits are realised.

- **Achievability**: involves gauging the level of likely market interest, the skills and capacity of the private sector, their appetite for risk, any lender constraints and whether the procuring authority has sufficient capability to manage the complex processes involved.

Stage 3

2.8 In Stage 3 the emphasis is on identifying market problems as early as possible. This stage will apply throughout the procurement period, from the issue of the OJEU Notice through to financial close of the scheme. Procuring authorities will need to consider and agree key project milestones in line with this approach and any specific sectoral guidance available.

Information sharing

2.9 The conclusions of the VfM assessment, the evidence to justify the conclusions and the proposed project framework for the spending period should be summarised in existing, publicly available documents – typically Departmental Investment Strategies. However, where there are genuine issues of either commercial confidentiality or of prejudicing the public sector's negotiating position, departments may decide that the availability of such evidence needs to be circumscribed.

2.10 Box 2.2 below sets out commonly used terms throughout this Guidance.

Box 2.2 Common terms used throughout the Guidance

Programme: a portfolio of projects that have certain common characteristics and which are selected or commissioned, planned and managed in a co-ordinated way and which together achieve a set of defined business objectives. Departmental investment programmes vary significantly. For some, a single accommodation project might constitute the major part of its investment programme. Others may have many complex capital programmes and sub-programmes. Departments will therefore need to consider and determine what, for them, constitutes a coherent 'investment programme'.

Project: is one of the singular schemes which have been grouped together in the programme. As noted in the guidance (see para 1.8), individually procured projects under £20m are unsuitable for PFI.

Unique projects and Pathfinders: projects in new sectors or those being implemented as pilots are considered as pathfinder projects. In such instances, or where the project is considered novel or unique, the Procuring Authority should engage the HM Treasury spending team and PFI team as early as possible to establish how the VfM assessment should be taken forward. The general process is expected to be as noted in para 3.5 for these projects.

3 Stage 1 - Programme Level Assessment

Overview

3.1 The aim of Stage 1 is to provide a clear strategic direction, whilst indicating where there may be a need, later in the process, for flexibility in the chosen procurement route for some projects. Programmes must take account of the fact that a percentage of projects are likely to switch procurement routes at Stage 2, and a very small minority of projects at Stage 3 where there is, for example, market failure. The department must ensure that as far as possible switching away from PFI is a real option where their priorities are such that they need to continue with the project.

Objectives

3.2 Whilst the appraisal of procurement options at Stage 1 (Programme level) will inevitably involve some uncertainty, it does provide procuring authorities with a rational framework to consider whether PFI is likely to deliver VfM. The objectives of the Stage 1 programme level assessment are summarised in Box 3.1 below.

Box 3.1: Objectives of Stage 1

- provide an early assessment of whether PFI is likely to provide VfM for a programme of investment in public services, and an indication of the suitability for individual projects within the programme;
- increase transparency and improve deal flow;
- assist departments as a whole, during the spending review process, in deciding:
  - allocations between capital and revenue budgets;
  - the volume and scale of work programmes to be supported, given the amount of capital and revenue funding available; and
  - the affordability of investments i.e. estimating the cost envelope for programmes; and
- ensure departments and procuring authorities have in place the necessary framework (both in terms of structure, skills, and capacity) to implement a PFI programme in a manner which ensures optimal VfM and minimises transaction costs for both the public and private sectors.

Output and outcomes of the assessment

3.3 The outcome of the appraisal should be to have a more robust understanding of the suitability of PFI for a specific programme, and also to ensure a closer match between the requirements of each programme and the capability and capacity of procuring authorities to complete each programme. Once the Stage 1 qualitative and quantitative assessments have been completed, an overall assessment should be made. This should provide a detailed justification for the conclusion and should recognise the limitations in any of the component parts of the assessment, both for the preferred procurement route for the programme, and for its constituent projects.

3.4 The completed programme level assessment should be made available to procuring authorities and project teams charged with delivering the projects that fall within each programme. Such project teams may be based within the department or fall within an agency or Local Authority.

Unique projects and process

3.5 It is expected that, as a minimum, all departmental PFI projects will have been assessed at programme level prior to the procuring authority embarking on the completion of an OBC. The exception to this is for unique/pathfinder projects which do not easily fit into a programme level assessment. For these projects it is still necessary to undertake a VfM assessment, although it would be appropriate in such cases to begin with a Stage 2 assessment both at its inception at the spending review, and then again before the OBC is finalised.

Overall Approach

Stage 1 Qualitative Assessment

3.6 PFI schemes generally commit the procuring authority to a particular provider, and a long-term resource commitment. The success of these projects does not depend on cost alone. There are a range of qualitative factors that need to be considered, alongside the quantitative model, in making a decision on whether PFI is the most appropriate procurement route. As summarised in Chapter 2, these factors will cover the viability, achievability and desirability of PFI use as a procurement route.

Risk allocation

3.7 The rigorous identification and management of risks throughout a project- whether procured conventionally or through PFI- is one of the key factors driving VfM. Some of the risks which need to be considered in assessing the merits of different procurement routes are covered in Box 3.2 below and are referenced later in the detailed methodology (Tables 3.1 & 4.1).

Box 3.2 Risk Allocation

1. **Design**: can the service provider be made responsible for ensuring the design is fit for purpose and for all resources required for design and development activity?
2. **Financing**: can the service provider be made responsible for establishing and maintaining the funding for service provision throughout the contract life?
3. **Implementation**: can the service provider be made responsible for all aspects of implementation, transition and certification?
4. **Operation**: can the service provider be made responsible for delivery of a high quality service at required levels of availability and continuity?
5. **Usage**: can the service provider be made responsible for costs associated with variations in demand?
6. **Regulatory change**: can the service provider be made responsible for the consequences of changes in non-discriminatory legislation, such as national minimum wage?
7. **Obsolescence**: can the service provider be made responsible for ensuring that the technology underpinning service delivery - and the service delivery mechanism itself - remains consistent with contemporary market standards?
8. **Service provider lock-in**: can the service provider be made responsible for ensuring that the service is provided in such a way as not to constrain the Authority's ability to continue to meet its requirements cost-effectively in due course via an alternative supplier/solution?
9. **Residual value/disposal:** can the service provider be made responsible for the residual value of the assets at the conclusion of the service contract?

Maximum contract lengths

3.8 The Government is committed to ensuring that contract lengths are not driven by affordability requirements but by overall VfM. The length of the contract should reflect a variety of factors that need to be considered when selecting an optimum period over which a procuring authority wishes its services to be provided, ensuring an appropriate balance between affordability and VfM service delivery.

3.9 Following initial consultation in Summer 2006, the Treasury will enter further detailed consultation with departments and public sector bodies to establish appropriate sector specific contract lengths based on VfM. Caps will only be applied to new PFI projects that begin procurement after CSR 2007. Currently it is envisaged that the overall cap on contract lengths will be set at a maximum of 30 years with shorter contract lengths in some sectors reflecting the different service requirements in each sector – departments will need to demonstrate that projects in excess of 30 years can offer VfM. Consultation is likely to be finalised by early 2007 at which time specific guidance will be issued. While there is a process for further consultation to finalise sector specific contract lengths, procuring authorities should as part of their Stage 1 assessments now also include analysis on the choice of contract length.

Factors to consider for contract lengths

3.10 Preparatory work undertaken by the public sector should identify contract lengths before going to market. The length of loan periods available in the debt capital markets must not be a material factor in dictating the contract length. Factors that may influence the duration of the contractual relationship between the contractor and the procuring authority may, amongst others, include:

- **Duration of the requirement**, particularly the ability to forecast quality and quantity outputs in the longer term;
- **Life of the assets underpinning the service**, including the timing of major maintenance and renewals. For instance, a second major refurbishment cycle within the contract will involve a tradeoff between certainty of service provision and a pricing risk premium to account for costs 20-30 years in the future being highly unpredictable;
- **Importance of continuity in the delivery of the service** including the degree of transition difficulties and inefficiencies that might be caused by changing contractors and the extent to which the incentives on the incumbent in run up to change of contractor will be weakened and can be mitigated;
- **Ability and importance of maintaining performance incentives over time-** for example what would the consequences be of the contractor performing at a level just above default for poor performance over a long period of time;
- **Viability of re-competing the contract regularly** including consideration of private sector capacity, bidders likely willingness to bid against the incumbent, and the bid and process costs involved;
- **Ability of the contractor to accurately forecast its cost base**, including the link between indexation mechanisms, market-testing and demonstrating VfM for long term fixed priced contracts;

3.11 Some of the issues raised by these factors are best resolved by forming a long-term relationship, while others through re-competing the contract at more regular intervals. The balance between these positions will also be affected by the nature of the asset being considered for instance, differentiating between the asset and associated services provided. When a long-term contract is chosen there will be a need to include

specific mechanisms in the contract to address the downside of a long-term relationship, obvious examples in the case of soft services are the use of benchmarking and market testing and a robust mechanism for change.

3.12 In setting the contract length it is important to do so with reference to the period over which the need for the services can reasonably be predicted. For example, it would be poor value to enter into a long term contract for defined services if it is likely that the need for such services and how they are provided may change significantly due to demographic changes or changes in technology. It is poor value to rely on variation mechanisms under long-term contracts as an alternative to setting appropriately shorter contract terms initially.

Stage 1 Quantitative Assessment

3.13 The quantitative assessment at the investment programme stage will inevitably be conducted using only high-level estimates supported by evidence taken from past procurements, since all input assumptions should be predicated as far as possible upon evidence from past experience and projections. This approach has been adopted in part to discourage overly complex modelling and promote simplicity, as well as to reflect the inherent uncertainties at this point in the process. However, the quantitative assessment will develop further as more detailed information feeds back from previous programmes and constituent projects.

3.14 In completing their programme-based assessments, departments should have regard to the level of homogeneity of those projects that are likely to fall within each programme. Where the variety of projects within an investment programme is substantial, departments will need to ensure that the specific characteristics of each project are tested robustly at Stage 2. Given the uncertainty that a high level of variety in projects in a programme at Stage 1 creates, it is also important to make sure this is reflected in the stage 1 quantitative assessment. The programme assessment should consider scenarios beyond just the "typical" project, and look at the potential volatility of the programme.

3.15 For certain projects it may be particularly hard to gather relevant data inputs. In this case other information should be sought to justify the inputs into the model and steps taken to remedy this gap for future procurements (the Quantitative User Guide addresses possible ways this can be achieved).

Timing

3.16 Stage 1 should be undertaken following the initial investment appraisal analysis for a new programme, usually as part of the spending review process.

Limitations

3.17 Sponsoring departments and procuring authorities should note that whilst the quantitative and qualitative assessments provide a framework for assessing VfM, there are specific limitations that need to be recognised, in particular:

- Innovation is difficult to model at the investment programme stage – until the market has proposed innovative solutions, their costs and benefits are unknown. However, this is not designed to prevent departments from procuring large and/or unique projects. The ideal at stage 1 is to uncover the scope and potential value of innovation.

Where the evidence base is currently limited, or the quality is poor, it becomes even more important that departments ensure that they conduct and disseminate both post-programme and post-project evaluations.

Detailed Methodology – Stage 1

3.18 The following table sets out the methodology for implementing the stage 1 process and key principles highlighted in the Guidance. Departments will need to secure as much evidence as is practicable when determining the procurement route, to substantiate both the qualitative and quantitative analyses. Answers to the questions below are expected to provide fully detailed justification. Where departments are aware of any specific issues pertinent to the VfM of a programme but which do not currently fall under any of the table headings set out below, these should also be detailed in their assessment.

Table 3.1 Stage 1 Qualitative Assessment

VIABILITY For PFI to be viable the investment objectives and desired outcomes need to be translated into outputs that can form the basis of a contract and a sound payment mechanism; for example, the quality and quantity of the outputs need to be ones that can be clearly defined and measured. Many service areas can be described in contractual terms, but some areas will be inherently 'non-contractible as outputs.	
Issue	Question
Programme level objectives and outputs	Is the department satisfied that long-term contracts could be constructed for projects falling in this area? Can the contractual outputs be framed so that they can be objectively measured? Is the requirement deliverable as a service and as a long-term contractual arrangement? Could the contracts describe service requirements in clear, objective, output-based terms? Can the quality of the service be objectively and independently assessed? Is there a good fit between needs and contractible outcomes? Can the contracts be drafted to avoid perverse incentives and deliver quality services? Will there be significant levels of investment in new capital assets? Are there fundamental issues relating to staff transfer or other workforce issues? If there are interfaces with other projects, are they clear and manageable?
Soft services	Are there good strategic reasons to retain soft service provision in-house e.g. longer-term implications of skill transfer? What are the relative advantages and disadvantages? Is optimal risk allocation achieved by transfer or not? Is there a commitment that the assumed benefits can be delivered without eroding the overall terms and conditions for staff?
Operational flexibility	Is there a practical balance between the degree of operational flexibility that is desired and long term contracting based on up-front capital investment? What is the likelihood of large contract variations being necessary during the life of the contract? Can the service be implemented without constraining unacceptably the flexibility of the department to deliver future operational objectives?

Equity, efficiency and accountability	Are there public equity, efficiency or accountability reasons for providing the service directly, rather than through a PFI contract? Does the scope of the service lend itself to providing the contractor with "end-to-end" control of the relevant functional processes? Does the service have clear boundaries? Are there regulatory or legal restrictions that require services to be provided directly?
OVERALL VIABILITY	Overall, in considering PFI, is the department satisfied that suitable long term contracts with sufficient flexibility can be constructed, and that strategic and regulatory issues are appropriate for departments to proceed with PFI?
DESIRABILITY PFI can provide better risk management and produce incentives to develop innovative approaches to output delivery. Consistent high quality services can be incentivised through performance and payment mechanisms. However, risk transfer is priced into the contract. The purpose of these questions is to consider whether the benefits of PFI are likely to outweigh any additional costs and disbenefits.	
Issue	Question
Risk management	Is the private sector likely to be able to manage the generic risks associated with the programme more effectively than the procuring authority? Bearing in mind the relevant risks that need to be managed for the programme (see Box 3.2), what is the ability of the private sector to price and manage these risks? Can the payment mechanism and contract terms incentivise good risk management?
Innovation	Is there scope for innovation in either the design of the solution or in the provision of the services? Does some degree of flexibility remain in the nature of the technical solution/service and/or the scope of the projects? Is the solution adequately free from the constraints of imposed by the procuring authority, legal requirements and/or technical standards? Does a preliminary assessment indicate that there is likely to be scope for innovation in the programme?
Contract Duration & residual value	How far into the future can service demand be reasonably predicted? What is the expected life of the assets? What are the disadvantages of a long contract length? Are there constraints on the status of the assets after the contracts end?
Incentives and monitoring	Can the outcomes or outputs of the investment programme be described in contractual terms, which would be objective, specific and measurable? Can the service be assessed independently against an agreed standard? Would incentives for delivery of service levels be enhanced through a PFI payment mechanism?
Lifecycle costs	Is it possible to integrate the design, build and operation of the projects in the programme? Are there significant ongoing operating costs and maintenance requirement? Are these likely to be sensitive to the type of construction?

OVERALL DESIRABILITY	Overall, is the accounting officer satisfied that PFI would bring sufficient benefits that would outweigh the expected higher cost of capital and any other disadvantages?
ACHIEVABILITY While PFI may allow a more efficient and effective combination of public and private sector skills, determining the rules that will govern the relationship between the two sectors does involve significant transaction costs. In particular, the procurement process can be complex and significant resources, including senior management time, may be required for project development and the ongoing monitoring of service delivery. Authority capacity and capability, together with private sector side aspects will have direct consequences for procurement times and the level and quality of market interest. PFI needs a robust competitive process to fully deliver its benefits and so the choice of procurement route should be informed by an assessment of the likely market appetite.	
Issue	Question
Market Interest	Is there evidence that the private sector is capable of delivering the required outcome? Does a significant market with sufficient capacity for these services exist in the private sector? Is there likely to be sufficient market appetite for the projects in the programme? Has this been tested robustly? Is there any evidence of market failure for similar projects? Have any similar programmes been tendered to market? Has the procuring authority's commitment to a PFI solution for projects of the type covered in this programme been demonstrated?
Other Issues	Is the procurement feasible within the required timescale? Is there sufficient time for resolution of key procuring authority issues? Is the overall value of the contract significant (sufficient for the public and private sector to justify their transaction costs?) Does the nature of the deal and/or the strategic importance of the work and/or the prospect for further business suggest that it will be seen by the market as a potentially profitable venture? Does the procuring authority have the skills and resources to define, deliver and support the service throughout the procurement and the subsequent delivery period?
OVERALL ACHIEVABILITY	Overall, is the accounting officer satisfied that a PFI procurement programme is achievable, given an assessment of the market, procuring authority resources and the attractiveness of the proposal to the market?

4 Stage 2 - Project Level Assessment

Overview

4.1 This stage is designed for project teams to test that the indicative VfM conclusion from Stage 1 is relevant in light of the specific characteristics of individual projects. Using both the qualitative and quantitative approach, Stage 2 should identify those projects for which, contrary to the conclusions reached at programme level, PFI is not likely to be a VfM procurement route. Stage 2 should also identify issues within projects that need further work in order to ensure that the original conclusions reached for the programme can be confidently translated at the project level. The assessment seeks to verify that the assumptions upon which the decision was taken to proceed with a PFI procurement route remain supportable in the light of prevailing market conditions in the lead up to issuing the OJEU Notice.

Objectives

4.2 The Stage 2 assessment assumes that a conclusion has already been reached that, using the best available evidence at programme level, PFI is the most appropriate procurement route and represents VfM. The objectives of the Stage 2 project level assessment are summarised in Box 4.1 below.

Box 4.1: Objectives of Stage 2

- demonstrate that the initial decision to use PFI, based on an investment programme assessment, is valid for particular project;
- verify whether appropriate risk transfer arrangements are achievable;
- where project specific issues emerge so that PFI is no longer likely to offer VfM, direct the procuring authority early on towards the possibility of using other procurement routes including switching to conventional procurement;
- feed information back to the programme level to improve the evidence base and potential for market management;
- provide improved cost estimates so that, as part of the OBC, procuring authorities can be confident that the project is affordable;
- test whether the PFI solution has sufficient market interest;
- help ensure an efficient bid process is planned within a realistic timeframe; and
- provide the procuring team with a framework within which they can take decisions if the assessment should suggest that the market conditions are unfavourable.

Output and outcomes

4.3 The outcome of the appraisal should be a clearer understanding of the suitability of the PFI procurement route for a specific project. It will also provide the procuring authority with a better understanding of the capacity needed, against that available, to take the project forward.

Overall Approach

4.4 At Stage 2 the project team has the opportunity to verify that the programme level assumptions continue to apply to the project, and if not to review and modify the assumptions; this includes both the qualitative and quantitative assumptions, relating to the viability, desirability and achievability criteria.

Qualitative Assessment

4.5 Project teams should consult the departmental Stage 1 assessments and consider whether these assumptions hold in their particular projects. All assumption changes made at this stage should be fully explained and documented by the project leads. Where a PFI project does not look like it will deliver VfM the reasons should be considered carefully as part of the OBC. If it would be possible to achieve these benefits by delaying the timing of the project, for example if several similar projects have recently gone to the market, then the team should consider delaying.

4.6 If the cause is more fundamental, the first step for the team should be to examine the project to determine whether there are changes that can be made that will still deliver the business requirement and which represent good VfM. Assessors should consider the following:

- first identify why and whether the issue is specific to a PFI procurement route or to procurement of the project in general;
- consider the case for a delay to the start of the procurement, if this can address the concern;
- reconsider the criteria to be set out in the OJEU Notice and determine whether there is another way to deliver the business requirement; and
- reconsider the PFI route and the possibility of switching to other forms of procurement.

4.7 If the specific characteristics of a project suggest a different procurement route to PFI as identified at the programme level, then this deviation should be fully explained and documented. Market soundings undertaken throughout the procurement should be based on a well-researched, well-constructed project once outcomes and objectives have been clarified. It should, however, be noted that problems can arise if the procuring authority use market soundings to shape its objectives.

4.8 Procuring authorities must consider the results of the quantitative assessment in the context of the wider qualitative conclusions. Procuring authorities at this stage should also consider the appropriate criteria for Stage 3 and satisfy themselves that these are likely to be achievable as part of their qualitative assessment. Evidence of this should be included in the OBC.

Quality of Competition

4.9 A competitive procurement is one of the ways in which the public sector aims to achieve VfM in its procurement activities. An authority planning a procurement or an approach to the market should, as far as possible, assure itself in the early stages of planning that a competitive market exists, or will exist, to meet the proposed requirement. The procuring authority and the sponsoring department should be confident that any advertised procurement will receive an adequate competitive response and that competition can be maintained throughout any resulting procurement process. These activities should take place as early as possible in the business case planning process.

Market Soundings

4.10 Some form of market sounding is generally good practice. A market soundings exercise involves determining the potential level of market interest and the current and future capacity by talking directly to potential players, perhaps through issuance of a Prior Information Notice (PIN). Procuring authorities should however take care not to use the market to establish their requirements or to place an undue cost burden on the market at this stage.

4.11 Where projects are not of a standard nature, the procuring authority will be required by their departmental PFU to enter into market soundings. Procuring authorities should discuss these requirements with their departmental PFU at an early stage.

4.12 Procuring authorities need to consider the characteristics of either the supplier market and their own project which may affect market appetite, e.g. shortage of construction capacity due to other projects. If any doubts exist, procuring authorities should consider the case for more systematic market-soundings.

4.13 The Office of Government Commerce has guidance on 'Market Creation for the Public Sector' contained within the 'OGC Successful Delivery Toolkit'.

Role of sponsoring departments in the market

4.14 In relation to the supply side of the market, sponsoring departments should maintain regular dialogue with key PFI players in their sector and put in place mechanisms by which procuring authorities can be kept informed of the latest market developments. This should cover:

- being aware of the range and number of projects vying for market interest;
- being aware of any actual or emerging market capacity constraints within their sector or related sectors through dialogue with other departments where necessary11;
- assessing formally the level of market interest in particular projects in the context of both particular project circumstances and competing demand from other projects likely to approach the market at around the same time;
- considering the case for managing the release of projects to the market, thereby creating a transparent pipeline of projects and avoiding clusters of projects reaching market at the same time; and
- seeking to actively promote a dynamic market by, for example, ensuring that barriers to entry remain low.

Single Supplier

4.15 Where the required service and/or asset is of a particularly specialist nature there may only be one supplier in the market who is able to fulfil a procuring authority's requirements. These circumstances are likely to arise only rarely. Where this is the case and the authority is able to demonstrate this to the satisfaction of its own accounting officer and the relevant departmental PFU, the authority may wish to pursue a single source procurement.

4.16 If there is only one supplier this does not automatically mean that PFI is not an appropriate procurement route as the absence of competition may apply equally whatever the procurement route. As such the procuring authority should apply this Guidance in the usual way to ascertain if PFI is likely to be VfM.

4.17 If the assessment suggests that PFI is VfM then the procuring authority should consider what other protections can be put in place to ensure VfM is achieved in a single bidder environment. These might include:

- Requiring the bidder to undertake transparent market testing of those parts of the supply chain where competition can be generated;

[11] The central PFU may act as a co-ordinating entity for such information flows within a department.

- Where market-testing is not possible, gathering data on comparable procurements so the prices, terms and conditions can be compared and benchmarked. Understanding the extent of the adherence to SoPC terms;
- Ensuring that specialist technical advice relevant to the particular service is available either in-house or through appointing external advisors; and
- Examining the case for increasing flexibility in the contract term by limiting the initial term of the contract and/or incorporating break points in the contract such that the procuring authority can retender the contract should new suppliers enter the market.

4.18 Although the decision as to whether to proceed or not rests with the Departmental Accounting Officer, there is a requirement to inform HM Treasury where a project is proceeding as a single source PFI procurement. The procuring authority should also refer to guidance published by OGC on dealing with single supplier procurements.[12]

Quantitative Assessment

4.19 Procuring authorities should at this stage revisit the quantitative assumptions made at the programme level. At Stage 2 the project team will be expected to update the spreadsheet in respect of the project's specific characteristics and on the basis of past experience. (See also para 1.25).

4.20 The level of accuracy of the quantitative assessment should be borne in mind in undertaking the assessment. Where the outcome is particularly sensitive to subjective inputs this should be highlighted. In order to support this process, it is vital that information is gleaned at all stages of the procurement process and information from post-implementation evaluation exercises be fed back to programmes and projects beginning their life cycle.

Project Affordability

4.21 There should be a high degree of confidence that the PFI project is affordable, both before going out to market and during the procurement itself. It is crucial that cost assessments submitted at OBC are realistic. Any problem with affordability that arises late in the procurement process will increase transaction costs and undermine private sector confidence in the procurer and prejudice the procurer's ability to achieve VfM. Therefore, it is vital that in designing specifications that procuring authorities are mindful of their affordability envelope.

Timing

4.22 The Stage 2 assessment should be completed as part of the project OBC prior to issuing the OJEU Notice.

Limitations

4.23 There are limitations in the qualitative and quantitative approach that need to be recognised. For example, at such an early stage, only limited account can be taken of innovation. It will also be difficult to assess novel or contentious areas where, by definition, there may be little or no substantive evidence available upon which to base decisions. Analysis should take account of this and any mitigation measures that have been taken to address this.

Updated assessment

4.24 As outlined in Chapter 1, SLTP announced a series of new policy measures that will supersede the previous VfM guidance. While the qualitative methodology followed for Stage 2 is, as before, centred on analysis issues concerning viability, desirability and achievability of PFI as the procurement route, it is necessary to also consider new additions to this guidance. The following paragraphs consider some of these areas.

[12] OGC http://www.ogc.gov.uk/introduction_to_procurement_market_creation.asp

Strengthened Soft Services/ 'Facilities Management' (FM) Test

4.25 Soft facilities management (FM) (also referred to as 'soft services') generally relates to the day-to-day supporting services required in the operation of an asset. For example; catering, cleaning, security, and portering at a facility such as a hospital, school or office. While there is no single definition of soft FM, these services tend not to be capital intensive or to materially affect the underlying asset. However, the wide range of PFI projects and soft FM services available means that there is also room for variation in the importance and impact of soft FM for different assets, for example, depending on the sector and the particular soft service being considered.

4.26 As the most visible aspect of a project post-construction, soft services will have a significant impact on a user's perception of the project when in operation. In some projects the need for interim services will require that soft service provision commence prior to completion of asset construction. This means regardless of the procurement route chosen, the consideration of how soft services will be provided should begin at the earliest stages of project design.

Inclusion of Soft Services

4.27 It is crucial that the assessment of the VfM for including soft services in PFI should begin at the earliest stage of project planning. As before, the Government's policy is that departments have the option of not transferring soft services staff in a PFI project, where they believe their transfer is not required for achieving the overall benefits of improved standards of service delivery specified by the procurer. There is no a priori reason why a PFI scheme should or should not include soft services. In making their VfM assessment of the inclusion of soft FM in PFI, procuring authorities should be looking to answer on the basis of evidence available, how effectively the benefits of including soft FM in the PFI structure could be replicated if soft FM were provided outside of the PFI.

4.28 Taking account of the changes in soft service provision which have already taken place in the public sector in the recent past, it is also important for procuring authorities to be clear about what the relevant comparator for their programmes and projects may be. As many sectors now have outsourced soft services, the relevant comparator for the inclusion of soft FM in the PFI structure may not necessarily be in-house provision. Likewise, procuring authorities should not assume that PFI inclusion is simply a way of bundling previously outsourced services.

4.29 The emphasis for procuring authorities is to provide evidence in support of all elements of the VfM assessment. Different projects will involve a different range of soft FM. Within the range of soft FM in scope, some may be more significant to risk transfer and VfM than others. Procuring authorities need to assess which services will work best together in a PFI project. As procuring authorities decide which particular soft services are most important for different projects, so should there be strong evidence provided as to how the benefits associated with the chosen procurement route for each will actually be realised. This upfront consideration of contract, institutional and other arrangements in actual implementation is necessary to ensure that those benefits are then realised in practice.

4.30 Box 4.2 outlines the factors that authorities should take into account in making their VfM assessments, and provides some examples of mechanisms used in PFI projects, as well as alternatives. The detailed methodology for the soft services test is set out in Table 4.2.

Box 4.2: Soft FM- factors for consideration

Whole life costs: The long-term structure of PFI contracts requires upfront estimation of whole of life costs. Long-term contracts incentivise public authorities to think more strategically about the services required, whilst there is the incentive for private sector service providers to consider whole life costs. Because of the risk transfer inherent in PFI, the contractor is incentivised to find the best balance between upfront investment costs and ongoing operation and maintenance costs and hence deliver VfM. An example is where the initial investment in better materials, such as consistent use of the same cleaning materials or better flooring initially though costly, reduces the maintenance and life-cycle costs to the extent that a lower unitary charge can be bid.

Lower interface issues & single point of contact: With the use of one contract for services in PFI rather than several separately let services, interface issues become the responsibility of the contractor. Additionally, if the use of a single point of contact for a range services is considered important to the delivery of VfM then this can be mandated in the PFI procurement. This will be the case if the management of resources in this way reduces transaction costs and the authority's administrative burden, and provides additional flexibility in responding to issues. However, how this could be implemented optimally may differ depending on the size and coverage of the project. For example, for smaller and more localised service provision such as in a school it may be felt that there is greater benefit from a single general manager for the project, rather than a general helpdesk which may be more relevant to larger accommodation style projects.

While the PFI route may allow for a range of services to be included in one contractual agreement, over-reliance on the contract or lack of coverage in the contract may negate the potential interface benefits.

Design Integration: Innovation and integrated input from different parties into the design of an asset can improve its operational activity. It is therefore crucial to consider how soft (and hard) FM will be provided by service specialists. The inclusion of soft services in PFI could provide such specialist input. However it is important to remember that much of the benefit of design integration relies on early discussions of the issues. Thus the Stage 2 assessment should consider what actions should be taken to ensure this (e.g. clear questions asked in tender documentation to demonstrate that the bidders have done this, linked to bid evaluation/ assessment criteria; establish a formally meeting multi-disciplinary design team requiring representation across the board (service providers, constructors etc) within the contract).

Effective management of resources: Another VfM driver may be the exploitation of any efficiency available from economies of scale/scope, and expertise available in the private sector. PFI may import effective solutions to the management of subcontractors and resources where such an activity is its core business. While any improvement in management of resources should not be achieved at the expense of workers' terms and conditions, analysis of how more effective management of resources could be realised should be included in the Stage 2 assessment.

Flexibility: The requirement for some soft services may be uncertain or prone to greater change over the life of service provision than other soft services. If service needs are likely to change significantly, regularly or frequently then if they are included within PFI contracts they may not offer the best value for money. Assessment of the needs should also consider how the asset use may change over time.

Interim Services: In some sectors or projects, there will not be a discrete distinction between the build and operation phases e.g. some projects include extensions to existing assets/refurbishment. In such cases the use of interim services may be required. Interim services are those provided soon after financial close up until the asset is fully operational. The level at which they need to be provided will be different to that provided when at steady state (i.e. when the asset is fully operational).

Interim services in PFI involve the early transfer of service provision to soft FM providers as part of the SPV or those subcontracted to it. This can provide several benefits including better transition to the fully operational stage, and reinforcement of design and whole of life cost integration as service providers are involved from the outset and can provide feedback through experience of operation in the interim phase. A gradual increase in service provision during this phase can help ensure that services are provided at the right level (e.g. teething problems are worked out earlier and less time is needed to embed service provision changes) when the asset is fully operational. However the benefits from the use of interim services rely on an early assessment of their use and correct budget establishment (comparing like-for-like).

Financial Incentivisation: The use of the unitary payment system in PFI could provide better financial incentives than separately let services as the performance regime is directly linked to payment, with an integrated approach to different elements of the service provision. However the payment system will only work as an effective incentivisation tool where performance thresholds have been correctly calibrated. Confidence in the suitability of the performance regime could be established through mechanisms such as the use of a post-verification phase six to twelve months into the contract for instance. This will provide opportunity to re-assess performance standards and thresholds. Furthermore, given the generally longer duration of PFI contracts, the use of benchmarking or market testing adds value by providing an opportunity to test that services are fairly priced in the light of prevalent market conditions[13].

Operational and Financial Flexibility Issues

4.31 In assessing the VfM of undertaking a PFI contract it is vital that the procuring authority carefully considers the trade off between affordability constraints and the need for contractual flexibility over the life of a long-term contract. The lowest cost solution will often not be the one that gives the best VfM.

4.32 Though PFI contracts should only be entered into where the public sector's requirements are reasonably stable and can be predicted over the long term, given the duration of PFI contracts (often upto 25-30 years), it is inevitable that the public sector's requirements for services will change to some degree over that time. These changes may occur because of improvements in technology, changing demographics and/or changes in regulations or laws governing certain sectors. Changes may be predictable but some are likely to be unknown at the time of contract signature. In addition some changes may be driven by the public sector and others by the private sector. Some changes may occur because of events outside of the control of either party. Contractual mechanisms for proposing and evaluating changes must be comprehensive and take into consideration that the longer the contract, the greater the likelihood of change.

4.33 Procuring authorities should also specifically bear in mind that during procurement affordability constraints can lead to a reduction in contractual flexibility in service delivery. The desire to remove cost can affect flexibility in several ways including:

[13] Please see Operational Taskforce Note 1: Benchmarking and Martket-testing Guidance for further information http://www.hm-treasury.gov.uk/media/807/53/operational_taskforce_note_1.pdf

- the setting of a long contract life can make the unitary payment lower as the debt held by the special purpose vehicle (SPV) contractor would be repaid over a longer period, but may tie the procuring authority to service delivery for a sub-optimal period of time (see section on contract lengths, para 3.8);
- keeping only a small reserve in the contractor's budget as a contingency to pay for contractual changes may help affordability but may restrict the ability to implement necessary changes. However, holding too large a reserve may be expensive and unnecessary if service requirements are stable; and
- the public sector may find it useful, in order to increase flexibility in processing change requests, for the contract to include pre-pricing of scope variations or unit costs for undertaking works. However, such arrangements have a cost premium attached to them to reflect the unpredictability of factors such as construction and materials inflation. Not incorporating such features might aid affordability but decrease flexibility.

Project Maturity

4.34 It is important that procuring authorities allocate sufficient resource to adequately prepare and develop their project(s) and ensure that a robust appraisal is undertaken before formal engagement with the market. Making late changes to a project once the procurement has commenced is inefficient, adds additional costs for both the public and private sectors and delays the delivery of important public services.

4.35 Procuring authorities should ensure that their requirements have been fully developed and tested at an early stage so that all project stakeholders have a firm indication of the expected cost of the project. This will also establish the procuring authority's estimated affordability envelope for the project so that it and its key stakeholders can be confident that the scope and requirements of the project is proportionate to the expected cost. The Treasury will be issuing detailed guidance on project maturity and the project approval process in early 2007.

Detailed Methodology – Stage 2

4.36 This section sets out the methodology for implementing the process and key principles set out earlier in this guidance. The Stage 2 is undertaken by the project delivery team and looks at a project level at the key VfM drivers associated with PFI. The aim is to provide assurance to procuring authorities that PFI is able to deliver VfM in the context of the particular project. The assurance is evidence based, and looks in greater depth at both the qualitative and quantitative analyses.

4.37 The Stage 2 qualitative element of the appraisal examines a series of questions which address in turn the viability, desirability and achievability of the specific project in question, as set out below in Table 4.1. The assessment should be repeated separately for each individual project or procurement that is planned within the overall programme of investment considered at Stage 1.

4.38 The presumption is that a project being assessed at Stage 2 is part of a programme that has already been assessed at Stage 1 as being capable of delivering VfM if procured as a PFI. Therefore many of the high level strategic issues, considered for example under viability, will already have been assessed. If a project has not followed this route then the Stage 1 assessment should be undertaken in conjunction with Stage 2 at a project level.

4.39 Although many of the questions are similar to the stage 1 assessment a greater level of analysis is appropriate at this stage; for example, in examining the interest of private sector contractors then the assessment will need to undertake a specific market sounding bearing in mind the particular scope, boundaries and constraints of the project, rather than a more general analysis of the market conducted at Stage 1. Where departments are aware of any specific relevant issues that are pertinent to the VfM of a project but which do not currently fall under any of the table headings set out below, these should also be detailed in their assessment. The purpose at Stage 2 is to identify issues that may mean that the programme level judgement reached at Stage 1 needs to be altered.

Table 4.1 Stage 2 Qualitative Assessment

VIABILITY For PFI to be viable the investment objectives and desired outcomes need to be translatable into outputs that can form the basis of a contract and a sound payment mechanism; for example the quality and quantity of the outputs need to be ones that can be measured. Many service areas can be described in contractual terms, but some areas will be inherently 'non-contractible' as outputs.	
Issue	Question
Project level outputs	Is the project delivery team satisfied that a long term contract can be constructed for this project? Can the contractual outputs be framed so that they can be objectively measured? Is the requirement deliverable as a service and as a long term arrangement? Can the contract describe the requirements in clear, objective, output-based terms? Can the quality of the service be objectively and independently assessed? Is there a good fit between needs and contractible outcomes? Can the contract be drafted to avoid perverse incentives and to deliver quality services?

	Does the project require significant levels of investment in new capital assets? Are there fundamental issues relating to staff transfer? Would any transfer be free from causing any loss of core skills that have strategic and/or long term importance to the procuring authority? Is service certification likely to be straightforward in terms of agreeing measurable criteria and satisfying the interests of stakeholders? Does the project have clear boundaries (especially with respect to areas of procuring authority control)? If there are interfaces with other projects are they clear and manageable? Can the service be provided without the essential involvement of Authority personnel? To what extent does any involvement negate the risk transfer that is needed for VfM? Is the contractor able or likely to have control/ownership of the intellectual property rights associated with the performance/design/development of the assets for the new service? Will existing or planned elements within the scope of the project - or interfacing vitally with it - be complete before the start of the new service?
Operational flexibility	Is there a practical balance between the degree of operational flexibility that is desired and long term contracting based on up-front capital investment? What is the likelihood of large contract variations being necessary during the life of the contract? Can the service be implemented without constraining the delivery of future operational objectives? Is there confidence that operational flexibility is likely to be maintained over the lifetime of the contract, at an acceptable cost? (See also para. 4.33)
Equity, efficiency and accountability	Are there public equity, efficiency or accountability reasons for providing the service directly, rather than through a PFI contract? Does the scope of the service lend itself to providing the contractor with "end-to-end" control of the relevant functional processes? Does the service have clear boundaries? Are there regulatory or legal restrictions that require services to be provided directly? Is the private sector able to exploit economies of scale through the provision, operation or maintenance of other similar services to other customers (not necessarily utilising the same assets)? Does the private sector have greater experience/expertise than the procuring authority in the delivery of this service? Are the services non-core to the procuring authority? Is a PFI procurement for this project likely to deliver improved value for money to the department as a whole, considering its impact on other projects?
OVERALL VIABILITY	Overall, in considering PFI, is the department satisfied that suitable long term contracts can be constructed, and that strategic and regulatory issues can be overcome?
DESIRABILITY PFI can provide better risk management and produce incentives to develop innovative approaches to output delivery. Consistent high quality services can be incentivised through performance and payment mechanisms. However, risk transfer is priced into the contract. The purpose of these questions is to consider whether the benefits of PFI are likely to outweigh any additional costs and disadvantages.	

Issue	Question
Risk management	Bearing in mind the relevant risks that need to be managed for the programme (See Box 3.2) what is the ability of the private sector to price and manage these risks? Can the payment mechanism and contract terms incentivise good risk management?
Innovation	Is there scope for innovation in either the design of the solution or in the provision of the services? Does some degree of flexibility remain in the nature of the technical solution/service and/or the scope of the project? Is the solution sufficiently free from the constraints imposed by the Authority, legal requirements and/or technical standards? Does a preliminary assessment indicate that there is likely to be scope for innovation in the programme? Could the private sector improve the level of utilisation of the assets underpinning the project (e.g. through selling, licensing, commercially developing for third party usage etc)?
Contract Duration and residual value	How far into the future can service demand be reasonably predicted? What is the expected life of the assets? What are the disadvantages of a long contract length? Are there constraints on the status of the assets after the contracts end? Given the possibility of changes to the requirement, the assets and the operating environment, is it possible to sustain value for money over the life of the contract utilising as appropriate, mechanisms such as benchmarking and technology re-fresh? (See also para. 3.10)
Incentives and monitoring	Can the outcomes or outputs of the investment programme be described in contractual terms, which would be objective and measurable? Can the service be assessed independently against an agreed standard? Would incentives for service delivery be enhanced through a PFI payment mechanism?
Lifecycle costs	Is it possible to integrate the design, build and operation elements of the project? Are there significant ongoing operating costs and maintenance requirement? Are these likely to be sensitive to the type of construction?
OVERALL DESIRABILITY	Overall, is the accounting officer satisfied that PFI would bring sufficient benefits that would outweigh the expected higher cost of capital and any other disadvantages?

ACHIEVABILITY

While PFI may allow a more efficient and effective combination of public and private sector skills, determining the rules that will govern the relationship between the two sectors does involve significant transaction costs. In particular, the procurement process can be complex and involve significant resources, including senior management time which may be required for project development and the ongoing monitoring of service delivery. Authority capacity and capability, together with private sector deliverability will have direct consequences for procurement times and the level and quality of market interest. PFI needs a robust competitive process to deliver fully its benefits and so the choice of procurement route should be informed by an assessment of the likely market appetite.

Issue	Question
Market Interest	Is there evidence that the private sector is capable of delivering the required outcome? Does a significant market with sufficient capacity for these services exist in the private sector? Is there likely to be sufficient market appetite for the projects in the programme? Has this been tested robustly? Is there any evidence of market failure for similar projects? Have any similar projects been tendered to market? Has the procuring authority's commitment to a PFI solution for this type of project been demonstrated? Does the nature of the project suggest that it will be seen by the market as a profitable venture? Are the risks associated with design, development and implementation manageable bearing in mind the likely solutions to the project?
Other Issues	Is the procurement feasible within the required timescale? Is there sufficient time for: resolution of key Authority issues; production/approval of procurement documentation; staged down-selection and evaluation of bidders, negotiation, approvals and due diligence? Is the overall value of the project significant and proportionate to justify the transaction costs? Does the nature of the deal and/or the strategic importance of the work and/or the prospect for further business suggest that it will be seen by the market as a potentially profitable venture? Does the Authority have the skills and resources to define, deliver and support the service throughout the procurement and the subsequent delivery period?
OVERALL ACHIEVABILITY	Overall, is the accounting officer satisfied that a PFI procurement programme is achievable, given an assessment of the market, Authority resources and the attractiveness of the proposal to the market?

Soft services assessment for stage 2

4.40 An important element in some PFI projects is the inclusion or otherwise of soft services. Based on the thinking at programme level (Stage 1 assessment), project delivery teams should consider carefully the merits of transferring soft services to the contractor as part of the project assessment at Stage 2. If at the programme level the assessment concluded that soft services, perhaps for strategic or control reasons, should not be included then the question here is one of confirming that excluding these services has no fundamental impact on the delivery of VfM under a PFI project. If Stage 1 has indicated that the programme should have soft services included then the task for project teams is to assess whether the inclusion of soft services within a PFI project is VfM by creating overall benefits outweighing any additional costs, and how these benefits would be delivered.

Table 4.2 Detailed methodology for soft services assessment Stage 2

Issue	Question
Design Integration	How will the soft FM providers be bought into the design process? How early will this happen? What mechanisms can be used to ensure this? Will different PFI structures affect the incentives for the inclusion of important providers in the design stage in different ways?

	To what extent does design integration impact on VfM? If considerable, then is it possible to ensure that correct incentives are included in the project? (e.g. if this is fundamental to delivering VfM then can it be included in the tender assessment criteria?).
Whole of life costs	What and where is the scope for whole life savings? How material are the maintenance costs? Do these have any environmental/other externalities (e.g. more energy efficient buildings)? Do the proposed risk transfers incentivise the correct behaviour by the bidders?
Lower interface issues & a single point of contact	Which mechanisms will be used to ensure that the benefits will be delivered? Are they achievable and measurable (e.g. interface key performance indicators (KPIs))? What is the consequence if this does not happen? Would a single point of contact provide VfM? What form would be most appropriate for the project (e.g. general manager or helpdesk)? Is this feasible? Is there sufficient contract management expertise on both sides?
Effective management of resources	Will inclusion under PFI allow providers opportunity to exploit bargaining power in the supply chain? Will the soft service provider be able to cost inputs more cheaply due to bulk buying to cover all other projects they are working on, and how much is this saving valued at? Is there potential for shared overhead costs, provision of spares where combined holding is reduced and distribution costs shared, or bulk buying savings? How big is the potential? Is it possible to incentivise desired behaviour in PFI context e.g. can management KPIs be used? Are differences in training incentives likely and how will affect workforce incentives (e.g. private sector likely to offer accredited training scheme)?
Interim Services	What are the benefits of including interim services? When will interim services be considered? Will they be part of the bid criteria? Are there any issues which make providing interim services harder within the PFI contract (e.g. will the authority be able to account for transitional costs which are not covered in existing service budget such as one-off costs necessary to implement interim services)? Has proper account been taken of differences in quality/quantity provision for cost comparisons? Which services are most important to the operation of the asset? What are the risks to the delivery of soft FM in the steady state stage if interim services are not provided? • Procuring authorities must weigh the balance of additional costs against benefits provided and not use interim services provision as a way to manage short-term affordability issues. Rather than assuming that the existing service budget is sufficient for interim services, an assessment is needed of the difference in service standards and quality covered by existing and interim soft FM. • Interim services will add value where they have been specified early and budgeted for correctly. Analysis of the benefits and risks must be made in the context of a budget which accurately reflects the difference between existing services and interim service provision.

Flexibility requirements	Do the cost estimations take account of flexibility issues which may arise for particular services in the future, and what level of contingencies will be included for these? Is it possible to include specified re-assessment or break periods in the contract to take account of changes in service needs?
Financial Incentivisation	Will it be possible to test the suitability of the performance regime (e.g. re-checking minimum thresholds after a certain period, and/or the suitability of the monitoring system)? Is there experience with similar live projects to compare that performance mechanisms are properly calibrated and that monitoring (e.g. self-monitoring versus user feedback) drives the right incentives? Does benchmarking and market testing provide a sound way of managing the risks associated with pricing and ensuring continuing quality of soft services?
Overall do the benefits of including soft services in PFI outweigh any additional costs and constraints from inclusion?	

5 STAGE 3 - PROCUREMENT LEVEL ASSESSMENT

5.1 The aim of the Stage 3 assessment, which runs as a continuous assessment from the issue of the OJEU Notice to contract award, is to ensure that both procuring authorities and sponsoring departments are fully appraised of market conditions and can identify any market problems early on in the procurement process, in order to effectively evaluate whether there is any erosion of VfM.

5.2 The Stage 3 assessment is more iterative in nature and applies throughout the procurement process from the issuance of the OJEU Notice through to Financial Close of the project. Stage 3 involves a series of ongoing 'checks' to ensure VfM. The objectives of Stage 3 are outlined below in Box 5.1:

Box 5.1: Objectives of Stage 3

- Ensure that a robust competitive procurement process takes place and there is a healthly level of competition
- The financial viability and capability of bidders are sufficient to achieve VfM
- Feed back market intelligence to projects in earlier stages of planning and procurement
- Confirm that the proposed risk sharing is appropriate and deliverable
- Ensure that the Procurement process is efficient and equitable so that the costs emerging from competition and reasonable and stable
- Determine if there is market abuse or failure
- Determine the appropriate project structure and level of financial flexibility

Quality of Competition

5.3 A competitive procurement is one of the ways in which the public sector aims to achieve VfM in its procurement activities. The procuring authority and the sponsoring department should be confident that the procurement will receive an adequate competitive response and that competition can be maintained throughout the resulting procurement process.

5.4 Once the procurement has commenced the procuring authority and the sponsoring department should continue to assess the quality of competition at each stage of the procurement. If market interest drops below a competitive level, procuring authorities may need to reconsider their approach. In such cases, the qualitative assumptions made against the viability, desirability and achievability criteria should be reassessed at each stage.

5.5 The procuring authority should regularly review the quality and extent of competition throughout the procurement phase until the selection of Preferred Bidder. A robust competition requires a number of well-qualified bidders who have expressed strong interests in bidding for the project. If at any stage of the procurement process there are indications that this is not the case then *prima facie*, optimal competitive conditions may be absent. In such circumstances procuring authorities need to assess

the issues that may be restricting the competitive process before determining the actions that can be taken.

5.6 Some of the issues that the procuring authorities need to consider when assessing the procurement are highlighted below in Box 5.2:

Box 5.2: Key issues to be considered in assessing competition

- the approach and structure of the procurement
- specific sector related issues
- broader market issues and wider issues related to the timing of the procurement

Market Failure

5.7 If at any stage the procurement team identifies market failure (e.g. absence of competition), they should consider the implications for the project. Market failure or lack of competition occurs where there is only a single bidder for a project or perhaps where there are two or more bidders but only one is considered to be credible. The concern is that in the absence of competitive tension the bidder may not be appropriately incentivised to offer its best price, terms and conditions to the public sector. In this case market abuse might arise. Market abuse can be defined as a situation where the bid offered is out of the market, that is to say above the market price for similar projects, or where the risk profile has been substantially eroded relative to other similar recent PFI projects at this price.

5.8 In view of this it is unlikely that the project will deliver VfM unless other steps can be taken to secure VfM. However, a procurement should not automatically be stopped as a result of market failure. The department and the procuring authority should undertake a thorough review of the circumstances of the particular project in reaching their view on the way forward. If it is not possible to take appropriate additional action that satisfy the accounting officer then the procurement should be halted.

5.9 In considering whether the procurement should continue, the reason for the market failure should be examined closely. The team should establish whether the failure of competition is due to systemic problems in the market, in which case the failure should equally affect an alternative procurement route. In this case the procuring authority would probably wish to look at what additional protections might be put in place whilst allowing the current procurement to continue. Alternatively, the failure of the competition could be due to:

- concerns in the bidding community about the procuring authority's commitment to the project, or the skills or experience of their procuring team, in which case the procuring authority and department would need to consider as a matter of priority how to address these concerns; or
- sponsors who have overextended and found themselves shortlisted for too many projects have decided to withdraw from one or more projects.

In any event it is imperative to thoroughly explore the reasons for the market failure.

5.10 It would be difficult, and inappropriate, to provide a set of definitive rules to follow in the event of market failure. It is inevitable, and appropriate, that each case should be considered on its merits. It is however possible to identify some general principles that should be adopted:

- if the market failure occurs early on in the procurement process (i.e. before bids have been received), the procurement should be halted unless there are systemic market failures which would equally affect any alternative procurement route;
- where failure occurs after bids have been received, the procuring authority will wish to consider the strength and quality of the remaining or only credible bid, and will need to consider the extent to which the competition has been able to drive out and demonstrate VfM; and
- in any circumstance where a procuring authority considers it is appropriate to continue with a single bidder it should ensure there is transparent competition in the bidder's supply chain. Benchmarking is not an adequate alternative to market testing. If the bidder will not agree to market testing of its subcontracts, the procurement is unlikely to deliver VfM and should be halted.

5.11 There are many reasons why only a small number of bidders might express interest in particular projects. There is no substitute for procuring authorities and sponsoring departments jointly examining the circumstances surrounding a particular project and determining the characteristics that will demonstrate that a strong competition is taking place.

5.12 Departments must discuss all potential single bidder situations with HM Treasury as early as possible in the procurement process.

Risk Sharing

5.13 Appropriate sharing of risks is key to ensuring that the VfM benefits in PFI projects are realised. These benefits flow from ensuring that the many different types of risks inherent in a major investment programme, for example construction risk or the risk associated with the design of the building and its appropriateness for providing the required service, are borne by the party who is best placed to manage them. The Government's approach to risk in PFI projects does not seek to transfer risks to the private sector as an end in itself. Where risks are transferred, it is to create the correct disciplines and incentives on the private sector to achieve the best VfM outcome.

SoPC **5.14** All PFI procurements should follow the approach set out in SoPC3[14] and the relevant implementation letters issued by HM Treasury on Standardisation of Contracts. The overall aim of this approach is to establish the use of SoPC3 and sector specific contracts in order to frame a risk profile for the PFI procurement which provides proper incentives for the private sector to perform efficiently. VfM judgements should be made on the basis that the risk allocation is given in this context.

5.15 It is government policy to use SoPC3 and the risk profile that is sets out in all circumstances and procuring authorities should avoid alterations as this is likely to impact transaction costs. Procuring authorities should also note the Dear Accounting Officer letter on tax planning and tax avoidance[15].

[14] HMT http://www.hm-treasury.gov.uk/media/2CF/CA/PPP_SoPC_implementation_ver3_apr04.pdf

[15] HMT http://www.hm-treasury.gov.uk/media/1EF/41/dao0803.pdf

Stability of Costs

Contract Price

5.16 If cost estimates at OBC differ significantly from the price at Full Business Case (FBC) or financial close, questions should be asked as to whether there are legitimate external reasons which could not be foreseen and, if not, why this escalation was not captured by the Optimism Bias estimates. This analysis should then be incorporated into the Optimism Bias estimates for forthcoming projects. This is not however a reason at this stage to halt or revisit the procurement decision. This information should be used to inform future procurements.

5.17 Under the Competitive Dialogue procedure, once a preferred bidder has been selected there should be no further amendments having the effect of modifying substantial aspects of the bid or which risk distorting competition or causing discrimination. Subject to any cost movements associated with a funding competition (see below), costs should therefore be fixed following preferred bidder selection.

Funding competitions

5.18 The procuring authority should consider whether it would be appropriate to hold a funding competition for selection of the debt provider following appointment of the preferred bidder. Draft guidance outlining best practise in holding funding competitions (including the circumstances in which they should be held) has been issued (subject to feedback), with further detailed guidance to follow. The guidance "Preferred Bidder Debt Funding Competitions" dated 1 August 2006 can be found on the HM Treasury public website[16]. If the procuring authority determines that a funding competition should be held, this should be stated in the OJEU Notice.

Transaction Costs

5.19 A PFI transaction is one of the most complex commercial and financial arrangements that a procuring authority is likely to face. It involves negotiations with a range of commercial practitioners and financial institutions, all of whom are likely to have their own legal and financial advisers. Consequently, procurement timetables and transaction costs can be significantly in excess of those normally incurred with other procurement options.

5.20 These factors will also have an effect on the private sector's ability to compete for PFI transactions. Private sector sponsors of such projects will incur significant bid costs, both internal and external. The extent of these will affect their ability to bid for other PFI projects. Higher than expected bid costs can also lead to an increase in costs in the PFI project and in the longer term can limit competition for projects and/or increase the equity return sought for investment in such projects.

5.21 It is key, therefore, in achieving VfM for a PFI transaction that a realistic competition is maintained, but this is only likely to be the case if the public sector keeps tight control of these transaction costs and completes a realistic assessment of what will be necessary to ensure a competitive market for their project that minimises these costs for both public and private sector.

Financial Flexibility

Determining VfM and valuing financial flexibility

5.22 An important part of the assessment at this point is the impact that the use of different financial structures have on the flexibility of the project to accommodate changes to the project requirements. In pursuit of least-cost contracts and certainty of affordability (i.e. unitary payments that are fixed except for the impact of inflation), procuring authorities have previously often used evaluation criteria which favour the

[16] HMT http://www.hm-treasury.gov.uk/media/F87/47/preferredbidderdebtfundingletter_100806.pdf

maximum use of debt finance (the cheaper and relatively inflexible form of finance) and almost exclusively fixed interest rate debt, that further limits the flexibility to accommodate changes.

Effect of long-term fixed rate debt

5.23 There is a direct interaction between the type of senior debt finance and contract flexibility. This relates to the use of long-term fixed rate debt and the type of debt raised (bank debt or bond finance, fixed rate or index-linked). Whilst fixing an interest rate on a loan, or a bond, may appear costless to a procuring authority in cash terms at the time it enters the contract, there may be high exit costs incurred if it ever becomes necessary for the procuring authority to break the contract through Authority Voluntary Termination.

5.24 Bank finance is typically more flexible in accommodating changes than bond finance but inevitably this greater flexibility comes at a price and bond finance is often cheaper than bank debt. However, the cost of prepaying a bond will typically be greater than prepaying an equivalent bank loan, including the breakage cost of any interest rate hedging. There are very limited instances of procuring authorities encouraging bidders to use more expensive but more flexible finance over cheaper but less flexible finance. Procuring authorities and their advisers should compare and price financial flexibility as between funding solutions when determining the most appropriate financial structure for a PFI project.

5.25 Separate more detailed guidance will be issued to assist procuring authorities in considering the effect of various financial structures on flexibility.

Fixed rate or index-linked debt?

5.26 Guidance has been issued on interest rate and inflation risks in PFI projects. The purpose of the guidance is to help procuring authorities and their advisors develop, evaluate and implement cost-effective strategies for managing interest rates and inflation. The guidance "Application Note – Interest Rate & Inflation Risks in PFI Contracts"[17] can be found on the HM Treasury website. In determining the value of financial flexibility, procuring authorities need to take proper account of:

- The need for flexibility in determining the procurement strategy;
- The cost of any flexibility within the VfM evaluation framework used by procuring authorities; and
- Whether loss of flexibility due to affordability constraints can adversely impact overall VfM.

Financial Structures

5.27 There are three specific circumstances where the financial structures of the project could have an impact on flexibility:

- Contract variations;
- Refinancing; and
- Authority Voluntary Termination.

Contract Variations

5.28 The approach of SOPC3 is not to require contractors to maintain finance facilities in excess of what is expected to be required to finance known capital works, on the grounds that it is poor VfM to pay (through the unitary payment) fees to financiers

[17] http://www.hm-treasury.gov.uk/media/295/98/pfi_hedging120506.pdf

for commitments which are unforeseen or cannot be costed at the outset. In consequence, the contractor's obligation to procure future finance is limited to a "best efforts" basis and if finance is not procured, the procuring authority may need to consider paying directly for capital works.

5.29 It may be possible to build in some more flexibility in a debt structure to accommodate the contractor raising additional funds to cover the cost of procuring authority changes, but it is important that this issue is addressed when the original finance is put in place. If this is not done the original lenders' security rights may prevent new debt being added without their consent, and hence the original lenders will have a monopoly supplier position.

5.30 SoPC recognises that over time changes to the service specifications may be required to cater for changes in procuring authority requirements, and incorporates Authority Change Mechanisms to meet these requirements. Where procuring authorities judge that additional flexibility would deliver better VfM they should incorporate measures within the contract so as to:

- Include pre-priced options for changes in scope of services;
- Have pre-priced call off rates for small changes;
- Maintain reserve contingencies; and
- Require the contractor to maintain suitable back-up facilities (such as contingent equity).

Refinancing

5.31 The scope for procuring authority gains can be affected by the financial structure. Some financial structures may provide the lowest initial whole life cost but do so at the expense of future refinancing gains that would otherwise have been shared with the procuring authority. A bond may be cheaper than bank debt but is likely to be more expensive to prepay as part of a refinancing when the project is operating successfully.

5.32 Refinancing gains are not certain and hence procuring authorities should be cautious when giving a value to a refinancing gain in any comparative evaluation between financial structures.

Authority Voluntary Termination

5.33 The ultimate test of financial flexibility is the ability of a procuring authority to terminate a contract where the PFI service provision no longer meets the procuring authorities public service needs, for example following a material policy change. Under SOPC3, the costs of terminating a contract by AVT can be significant, particularly in respect of compensation for equity, breakage costs on interest rate hedges or prepayment penalties on bonds (the Spens clause).

5.34 Procuring authorities should consider the effects of the financial structure that is put in place at the time of contract signature when valuing their AVT option. Additional guidance will be issued in due course to help value this option when evaluating the benefits of the funding structures available to a project in procurement.

Contractor Distress

Contractor Distress Situations

5.35 There has been recent experience of the impact of contractor difficulties on PFI projects. Unlike traditional procurement, the public sector has considerable additional safeguards in PFI to ensure that assets and services continue to be delivered without the public sector incurring additional costs. However, procuring authorities should be

cognisant of the effect that the financial structure may have on contractor distress. The financial structure may also affect the ability of the contractor to continue to deliver following a sub-contractor distress event. Not least, a very highly geared SPV company will have less risk capital with which to affect a resolution to adverse conditions or unforeseen costs, and thus will need to structure its contractual arrangements so as to pass the vast majority of its construction and operating risks down to its principal construction contractor and operating sub-contractors.

5.36 Procuring authorities may take some comfort from the due diligence which senior lenders (if involved/ PQQ) will conduct, but should conduct their own evaluation of the robustness of the project vehicle. Sub-contractors should be assessed for their financial standing (credit ratings and parent company guarantees may be relevant), against a backdrop of their criticality to the project and ease of replacement. This should be evaluated in the context of the ability of the Contractor to deal with a default by a sub-contractor. If the contractor has a good financial status, including access to increased funding and reserves, or has the benefit of performance bonds or letters of credit in the event of a sub-contractor default, this will assist the contractor in ensuring delivery despite a sub-contractor default. If the contractor is an SPV, the procuring authority should consider the management expertise available to the SPV and the extent of any residual risks held at the SPV level.

5.37 Once a view is formed on the robustness of each bid, this should be evaluated in the wider context of bid quality and price. It is possible for one bid to be cheaper in terms of the Unitary Charge but also more prone to failure and consequentially worse VfM. A high level of risk of failure of an SPV is unacceptable in any project.

Efficient Timetables

5.38 A realistic timetable for the procurement should be set out in the OBC, and procuring authorities should monitor progress against key milestone dates. Significant slippage in the procurement timetable might indicate potential problems in achieving VfM. In particular, procuring authorities should monitor the time taken between the selection of preferred bidder and Financial Close. If this period has gone beyond the planned period then the impact on VfM must be explicitly considered, as should the drivers behind this slippage. Consideration of possible appropriate steps that might be taken to assure VfM under these circumstances should be made, these may include running a funding competition, market testing sub-contracts or consideration as to whether the PFI procurement route is suitable.

Documentation

5.39 Procuring authorities should periodically, post construction, undertake operational evaluations to ensure the project is performing and to populate the evidence base for future procurements.

Detailed Methodology – Stage 3

5.40 Table 5.1 provides a list of issues to consider as part of the continuous assessment in Stage 3

Table 5.1 Stage 3 Qualitative Assessment

MARKET FAILURE PFI needs a robust competitive process to deliver fully its benefits. Delivering the long term outcomes at a good price relies on competitive tension during the procurement phase.	
Issue	Question
Market abuse or failure	Is there any evidence from similar projects (in scope or location) to suggest that there will be a shortage of good quality financially robust bidders? Is there any evidence of market abuse?
Procurement issues	Was there a good response to the PIN/OJEU notice? How many potential bidders passed the PQQ criteria? Are the financial robustness and capacity of the bidders sufficient? Is there evidence of good competitive tension in pricing of risks etc?
OVERALL	Overall, in considering this procurement, is the project team satisfied that there is a sound competition?
EFFICIENT PROCUREMENT PROCESS A good procurement is important to sustain market interest.	
Issue	Question
Efficient Procurement	Is there a realistic project plan, and has this been adhered to without undue delays? Are bid costs likely to be proportionate to the contract value? Will any aspect of the procurement impact adversely on market interest? (e.g. restrictions imposed by Competitive Dialogue procedure) Are there any problems emerging with the way the procurement is structured?
Authority Resources	Does the procuring authority have the necessary resources to conduct a good procurement? Are sound project governance arrangements in place?
OVERALL	Overall, is the way that the procurement process is proceeding likely to have an adverse impact on the delivery of VfM?
RISK TRANSFER The decision to proceed with PFI is dependant on the market appetite for the project	

Issue	Question
Wider issues	Is the competition delivering the proposed risk transfer being? Does the Authority confirm that the nature of the deal and/or the strategic importance of the work still make it suitable for delivery through PFI? Is there still confidence that all the key VfM drivers will be preserved.
OVERALL	Overall, is the risk transfer achievable, given an assessment of the competition, and the procuring authority's constraints?

ISBN 1-84532-206-1